



The Mixed Forms –

**A Generalization and Comparative Case Study
on the ETRE Systems of China and the EU**

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ABSTRACT

There is a lack of applicable model for understanding stability affected by combination of incentive and direct control for an economic regulation within mixed-forms. The research on stability of an economic regulation has mostly been focused on incentive or direct control in a U-form or M-form dominated organization. Therefore, the purpose of this study has been to discover a universal model for explaining stability affected by combination theory, leading to high mixed-form organizations performance.

This dissertation illustrates the relative theories bound to the research topic and moves one step forward into hierarchies, the U-form dominated and M-form dominated mixed forms. And this dissertation puts forward a hypothesis on how to lead an economic regulation to more stable. The suggested theory was empirically tested in a case study and received strong support. The conclusion of the conducted research is that an economic regulation governed by an M-form dominated organization with stronger incentive and less direct control is more stable than a U-form dominated organization with weaker incentive and more direct control.

FORWARD

Kristianstad, May 2005

The dissertation can be one of the tests on what we have learned throughout the semester year. With the coming end of this dissertation, we are going to complete our unforgettable studies at Kristianstad University. During the whole research work, we have encountered a lot of difficulties and frustrations, which we have never expected to happen.

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Chapter 1

Introduction

The first chapter introduces the background of the dissertation. The research problems and the purpose are discussed. Further, the limitations, definitions and research questions are defined. Finally, the outline is presented.

1.1 Background

As international students with years of working experiences in the management area in particular, most of us have experiences of establishing or implementing an economic regulation in a specific organization. This made us realize how significant the stability is to a successful and efficient regulation. In the age of globalization, every sovereign state or supranational organization is involved in global competition and cooperation. The economic regulations in organizations may also become a source affecting economic competency. After graduation, we may have to face the problem of keeping and improving the stability of an economic regulation. Therefore, there is great necessity for more research in this area.

When we discuss the Export Tax Refund/Exemption (ETRE) system in China and that in the EU, we find that they are quite different from each other. The ETRE system is one of the big issues in recent China. Its instability has been criticized in the past decade. On the contrary, the EU has a harmonious ETRE system with a tariff free common market combined by a bundle of sovereign states. These two ETRE systems are economic regulations in different organizational forms. Usually, in the unitary centralized countries, like former Soviet Union, most economic regulations are very rigid and stable. On the contrary, in many loosely united countries, like many African states, their economic system and subsystems are very vulnerable and instable. And most theories suggest that a

centralized organization can facilitate the necessary coordination (Charles Hills, 2003). But why the Chinese ETRE system is so inharmonious? And why do not other loosely united international economic organizations, like OPEC and OECD, have stable and effective economic regulations, while they lack the methods of strong direct control on their members extremely?

Both of them are economic regulations—the ETRE systems, introduced by mixed-form organizations, U-form dominated or M-form dominated, under the circumstances of a single market and a large export economy. Why is one more stable than the other? Is it the conflicts of interest that make these differences? And what are the conflicts of interest incurred by? We find that they spring from the different strength of incentive and direct control in a mixed-form organization when it regulates an economic issue. Now what we want to understand is what kind of combination of incentive and direct control can lead to stability of an economic regulation in a specific mixed-form organization.

We hope to find an existing theory to explain the different results of the two systems. Unfortunately, we realized that there are relatively few studies about the relationships between the stability of a regulation and the combination of incentive and direct control in a mixed-form organization. However, there are many literatures providing guidance and advice on the subject, but they lack of academic reliability. Therefore, it becomes our main purpose to find the most applicable academic theory on the relationships between the stability of a regulation and the combination of incentive and direct control in a mixed-form organization.

1.2 Problem

The problem is that there is a lack of academically reliable research about the relationship between different combinations of incentive and direct control and stability of an economic regulation in a specific mixed-form organization. In modern economic reform area, an approach only by incentive or only by direct control is largely replaced by a

combination of incentive and direct control. There are a lot of mixed-form organizations in reality instead of extreme U-form or extreme M-form ones. The fact that many economic regulations in a mixed-form organization have stability problems indicates that there is a need for an applicable theory on the stability of an economic regulation.

1.3 Purpose

The purpose with our dissertation is to discover which kind of combination of incentive and direct control can lead an economic regulation in an M-form dominated organization to stability, and which kind of combination of incentive and direct control can lead an economic regulation in a U-form dominated organization to instability. The lack of academically reliable stability of an economic regulation research on mixed-form organizations encouraged us to investigate the subject and find a stability theory that would lead to high mixed-form organization performance. If we cannot find a universal stability theory that suits our purpose, the intention will be to create a theory that explains how the stability of an economic regulation can be affected by a combination of incentive and direct control.

1.4 Limitation

We have studied many researchers within the field of efficiency and stability of regulations in the economic area. However, the time constraint limited us to concentrate on the most known and supported theories. Concerning the empirical study, we decided to only study the ETRE system in China and the EU. We do not have enough resources or access to make a similar research in wider fields of economic regulations in more organizations and to find more combinations of incentive and direct control.

1.5 Research Question

The dissertation is based on the following Research Questions:

1. What differences and causes can be identified between the two ETRE systems of China and the EU?
2. How can the ETRE system in a loosely united organization become more stable than that in a unitary centralized organization?
3. What is the possible solution for improving the Chinese ETRE system in a practical way?
4. Are there existing theories that can explain how the paradoxical phenomena can happen in reality?
5. If not, is it possible to provide an analysis framework that can explain such phenomena theoretically?

1.6 Definitions

Here we give the definitions of the terms frequently used in the dissertation. Beside these, other definitions will be clarified in the text.

U-form dominated organization: within a mixed form, the U-form dominated organization refers to such an organization in which the internal regulations are dominated by U-form arrangements.

M-form dominated organization: within a mixed form, the M-form dominated organization refers to such an organization in which the internal regulations are dominated by M-form arrangements.

1.7 Outline

The dissertation has the following outline.

Chapter 2: The methodological strategy, research design and scientific approach are presented.

Chapter 3: The theoretical framework is presented. First, we analyzed Alternative Organizational Forms and Transaction Cost Approach. Second, we attempted to move One Step Forward into Hierarchies. Finally, we modified an existing theory based on the U-forms and M-forms.

Chapter 4: The empirical case study and conclusion are presented. We started by presenting the Concept of Export Tax Refund/Exemption and Comparability between the two ETRE systems. Then we described the ETRE system in China and in the EU respectively and indicated the observable interest conflicts. Further, we compared the differences and analyzed the causes of the two ETRE systems and gave a brief interpretation based on the hypotheses. Finally, a case study conclusion was presented.

Chapter 2

Method

The methodological strategy is presented. The research design is discussed in two parts: one is the Theoretical Framework, and another is the Empirical case study. The Research Approach is also described in this chapter.

2.1 Methodological Strategy

As described in the introduction, the goal of this dissertation is to find a theoretical explanation for the paradoxical phenomena presented in the comparative case study on the ETRE systems of China and the EU. Further, it is also designed to carry out a primary solution for improving the Chinese ETRE system in the future. Therefore, some existing theories on organizational forms are studied in the literature review, and different combinations of incentives and coordination are also classified in the mixed forms (Williamson 1975). A small modification is made on the Williamson's Mixed-form Theory based on U-form and M-form models (Chandler 1962, Williamson 1975). Two different categories of the mixed forms are the focus of the dissertation: U-form dominated organizations and M-form dominated ones. The hypotheses are based on the two different mixed forms and the different combination of incentive and direct control.

In the case study, the benchmarking of the two ETRE systems is interpreted by the modification of the Mixed-form Theory and the two hypotheses. The inductive approach is the main approach in the study. However, as we come to a brief discussion for a possible practical solution that may be able to improve the Chinese ETRE system, the deductive approach is applied to the analysis based on the different combination of incentive and direct control. In this way, it is a mix between inductive and deductive

research (Saunders et.al., 2003).

The comparative case study is the most appropriate research strategy empirically for the purpose of this dissertation, because it is aimed to a rich understanding of the context in the research and the systematic processes of the two cases (Morris & Wood, 1991). The benchmarking method is also adopted in order to enable the study to be done in a more analytical way, and in this way make the hidden conflicts of interest within the two comparative economic systems identified.

2.2 Research Design

2.2.1 Theoretical Framework

Most theories on organizational forms in the existing literatures focus on the general characteristics of an organization, but the mixed organization forms are not widely studied. Our literature review is based mainly on Williamson's work and other researches in the transaction cost field as well as relevant critics. We critically review the literatures before starting the writing process and choose only the theories closely related to interest conflict, organizational forms, transaction cost and hierarchies.

The literature review is started with the work of Mintzberg (1983), and the work of Miles and Snow (1986), Harrison (1994) are very helpful to explain the "dynamic network" and the relative diversity and flexibility of firms. However, as Van de Ven and Grazman (1999, P.18) have pointed out: "There is no one comprehensive theory of organizational change able to explain how and why organizations grow and develop as they do." Thus, the theories available are all situational dependent.

There are many organizational forms identified by different researchers, but among them the U-form and M-form are the most profound. After Chandler's (1962) contribution, Williamson (1975,1985) is a pioneer who classified the organizational forms systematically. In the latter discussion, Williamson (1975) also identifies other

organizational forms. The H-form is denoted to the holding company in which the internal control apparatus is undeveloped. The transitional multidivisional form and corrupted multidivisional form are also very shortly described. The X-form is denoted to the mixed form classification, but he doubts that the X-form is apt to be viable over the long run, although it is possible that within the different divisions the functional forms normally prevail (Chandler 1962, 1977, 1990, Williamson 1975, 1985). Pihl's (2003) work on the different coordination mechanisms is also very helpful to understand the change of organizational forms.

Mintzberg (1983) takes another approach classifying organizational forms. Each of the four organizational forms: machine bureaucracy, professional organization, entrepreneurial startup and adhocracy, in Mintzberg's scheme depend on different mechanisms for coordination. But different types of the elemental hierarchies within organizations are not clearly classified for comparative study.

All the arguments and critics take different perspectives, but the nature of hierarchies remains as a puzzle. To understand hierarchies better, it is necessary and possible to take one more step forward to classify the different forms of relationship existing inside hierarchies. Transactional relationship, semi-transactional relationship and non-transactional relationship are also classified in the dissertation. It is possible that there are other different types of relationship between two parties involved in an elemental hierarchy. That is to say that the dominant relationship can characterize the nature of an organization or a low level arrangement within the organization (See Chapter 3.3)

What is more, a mixed form combined with a U-form and a M-form can be widely observed in reality, and the mixed form phenomenon is also very shortly discussed by Williamson (1975, P.154).

The U-form and M-form model is originally presented for studying large business organizations, but it is also fit for analyzing large non-firm organizations. We give three main reasons for this argument in Chapter 3.4.2.

Furthermore, two different categories of mixed form can be further identified as a modification and development of the mixed form theory (Williamson 1975): (1) the U-form dominated organization, and (2) the M-form dominated organization. The two hypotheses presented in the dissertation are based on this classification.

We modify the mixed-form theory for understanding the comparative case study better. Such a modification is also necessary for the further study on the practical solution.

2.2.2 Comparative Case Study

In order to test our scientific hypothesis, we conducted an empirical case study. The hypothesis was that there is a relationship between stability of an economic regulation in a mixed-form organization, and the combination of incentive and direct control. Furthermore, one combination of incentive and direct control brings an economic regulation in an M-form dominated organization more stable, while another combination brings an economic regulation in a U-form dominated organization less stable. The case research strategy was chosen since it can be a very worthwhile way of exploring an existing theory. In addition, a simple, well-constructed case study can enable you to challenge an existing theory and also provide a source of new hypotheses (Saunders et.al., 2003).

We tested whether an economic regulation in an M-form dominated organization affected by one combination of incentive and direct control is more stable than that in a U-form dominated organization affected by another combination. What matters is not the label that is attached to a particular strategy, but whether it is appropriate for your particular research questions and objectives (Saunders et.al., 2003). Therefore, we adopted comparison and analysis in this case study because the approach of combining them is

very appropriate for our research.

The reasons why we chose the ETRE systems in China and the EU as our cases are as follows. First, it is most comprehensive and has abundant data, concerning stability of an economic regulation. Second, the data of the ETRE system in China can be compared with that of the EU. Third, the research can be more profound and comprehensive through comparison between the two samples. Fourth, since it is a particular real life phenomenon, the hypothesis of our research can give some suggestions on a certain ETRE system.

In the beginning of the case study, we introduced the background, including some necessary concepts and comparability of the two ETRE systems in China and the EU. The reasons for comparison were summarized as both of them are mixed-form organizations, single markets and large export economies. We thought that the Chinese ETRE system could be compared with that of the EU due to having these fundamental aspects in common.

Then, we described the two systems in detail. In this part, we introduced their historical backgrounds in order to help readers understand the entire context of them, including the evolution and stability. The current contents of the systems were also described very objectively and concretely. The observable conflicts of interest were conducted as the end of this part.

Further, we focused on the comparative analysis of the two systems. We compared the differences of the two systems focusing on the high likelihood of a regulation, responsible bodies of refund, rates of refund and time lag of refund. Through comparing the two systems, we disclosed the different degrees of the conflicts of interest involved.

Finally, a conclusion was given, which included two main points. One was the conclusion in theoretical perspective; the other was some suggestion about the future reform of the Chinese ETRE system.

2.3 Scientific Approach

The interpretivistic research philosophy is adopted in the dissertation. The researchers using this direction are less theoretical in the generalizations of the complex world (Saunders et.al., 2003). It is emphasized that the theory presented in the dissertation is only valid in a very limited area, and the complex issues of circumstances and organizations can influence the generalisability in some extreme situations as well as for non-economic tasks.

Generally, the stability in this research is analyzed in a qualitative way, although there are some detailed quantitative data to support the analysis. The data presented is not sufficient for determining the causality or fortifying the theory completely.

Finally, the case study can be a very useful way of exploring existing theories. Furthermore, a well-constructed case study can also help researchers to find a source of new hypotheses (Saunders et.al., 2003).

Chapter 3

Theoretical Framework

To find a clue for establishing a theoretical framework, we first research the literatures on the nature and diversity of organizational forms. Second, discuss the transaction cost approach to understand the institutions and hierarchies behind the forms. Finally, we improve a model for studying our empirical case based on the U-forms and M-forms.

For finding an appropriate theoretical framework to answer the questions presented in beginning of Chapter 1, we will start the literature review with some background theories about the organizational forms, because the paradoxical phenomena about the two ETRE systems studied mainly exists together with the different organizational forms and their normal economic behaviors.

3.1 What Are Organizational Forms

General speaking, organizational form is the overall characteristics of the structure of an organization (Mintzberg 1983). There are various types of organizational forms in reality, and the number of identified forms is always increasing. Different forms may influence the organizational performance dramatically.

3.1.1 The Nature of Organizational Forms

The organizational forms are very dynamic and situation dependent. They are always

evolving. Within a complicated organization, there may be a variety of forms related to different tasks at different time.

Some theorists emphasize the environment and contingency to understand organizational forms. A simple environment can be comprehended by a single individual, and so enables decision making to be controlled by that individual. A dynamic environment means organic structure: Because its future state cannot be predicted, the organization cannot effect coordination by standardization. (Mintzberg 1983, cited by Fred Beshears 2003) A progressive replacement of the bureaucratic system by the commitment system can be found in contingency theory that combines the environmental and organizational characteristics of firms (Burns and Stalker, 1966; Lawrence and Lorsh, 1967). This argument weights the accumulative effect of changing the organizational forms. It also implies that the replacement by a new organizational form need not always happen suddenly at a time.

Other researchers focus on the economic importance of internal and external networks of organizations. The various types of firms are linked together within a "dynamic network", that provides diversity and flexibility to deal with interest conflicts in the organization (Miles and Snow 1986, Harrison 1994). Harrison (1994) also analyses the disintegration of the large bureaucracy and the emergence of network forms of organization. Centralization or decentralization is just the different option for achieving the organizational objectives.

In studying the emergence of new organizational forms, some co-evolutionary theories incorporate both environmental selection processes and organization adaptation processes (Lewin and Volberda 1999), in which the question is raised as to whether the organizational form of the business organization of the future will be forced towards a universal model or will be fragmented due to national particularities (Bryn Jones 2000). As Van de Ven and Grazman (1999, P.18) have pointed out: "There is no one comprehensive theory of organizational change able to explain how and why organizations grow and develop as they do". This theoretical approach can explain some historical changes of organizational forms, but it needs a supportive explanation to show

how the organization adaption can be done internally.

To analyze the internal dynamics and conflicts, coordination within organizations is highlighted by various theories while the neo-classical economics emphasizes market coordination and neglects coordination by alternative institutions, and the understanding on other public organizations can be expanded as well (North 1984). Larsson (1990) summarizes that different contributions emphasize formal rather than informal coordination, pre-planned rather than on the spot coordination, top-down rather than self-coordination and material rather than abstract interdependencies. To analyze the development of organizational forms, Hakan Pihl (2000, 2002) presents a coordination compass with four mechanisms: authority, rules, price and ideology. These contributions confirm that coordination is a key to understand organizational forms, and there are a variety of coordination types.

Williamson (1975,1985) suggests studying the simple hierarchy and other organizational forms in a perspective of cost-and –benefit analysis, and he emphasizes the concept of “cost of processing information”. This approach opens a new window for understanding the nature of organizational forms in an economic way.

3.1.2 The Diversity of Organizational Forms

There are many types of organizational forms identified by different economic researchers. But among them, most studies suggest that the U-form and M-form are very profound economically, because they can clearly show the basic confrontation between direct control and indirect incentive in economic management.

After Chandler’s (1962) contribution, Williamson (1975,1985) is a pioneer to classify the organizational forms systematically. Based on Chandler’s work (1966), Williamson defines the term U-form formally referring to those organizations that are structured along the functional lines and can be called as unitary form (Williamson 1975 P.133). In the same work (P.136-138), the M-form is defined as multidivisional firms on the basis of

dividing up the task and assigning responsibility.

In the latter discussion, Williamson (1975) also identifies other organizational forms. H-form is denoted to the holding company in which the internal control apparatus is undeveloped. Transitional multidivisional form and corrupted multidivisional form are also very shortly described. X-form is denoted to the mixed form classification, but he doubts that X-form is apt to be viable over the long run, although it is possible that within the different divisions the functional forms normally prevail (Chandler 1962, 1977, 1990, Williamson 1975, 1985).

Different combination of direct control and indirect incentive can also be found in other organizational forms. In the past two decades, various examples of new organizational forms have been identified and described, such as the internal network form (Miles and Snow 1986), the spherical form (Miles and Snow 1994), the N-form (Hedlund 1994), the hypertext organization (Nonaka 1994, Nonaka and Takeuchi 1995), the platform organization (Ciborra 1996) and the flexible form with very little direct control (Volberda 1998). In analyzing the emergence of organizational forms, these contributions asked for theories addressing questions such as: How and why do new strategic forms of organizing emerge and evolve from ancestral forms? (Lewin and Volberda 1999).

Pihl (2002) suggests a new "W-form" for the new organizational form. The "W" visually illustrates the new organizational structure compared to the top-down-structure of the "M"-form. The new form has increased emphasis on decentralized front-line units and middle and top-levels are given more supportive roles. He also points out that when it comes to the more precise description of how co-ordination becomes more complex and flexible, different researchers give different answers.

Mintzberg (1983) takes another approach to classify organizational forms. Each of the four organizational forms: machine bureaucracy, professional organization, entrepreneurial startup and adhocracy, in Mintzberg's scheme depend on different

mechanisms for coordination fundamentally. But different types of interest conflicts within an organization are not further classified.

Through the literature review above, it becomes more and more concentrated on a consensus that coordination for conflicts is not only a clue for understanding the nature of different organizational forms, but also a widely suggested criterion for classifying those different organizational forms.

Although some theorists may still mix the discussion of “spontaneous coordination” in market with the discussion of visible hand coordination in organizations, here we strongly suggest that there is no “pure market”, because there are always some formal or informal regulations embedded in a market, for example, a certain form of property rights. If we take a state as a super-organization, then religion, culture or law is just the internal regulations of the super-organization. Or we must distinguish market from other coordinated hierarchies, when a sub-state organization is being discussed.

Is there any thoroughly discussed direct correlation between the organizational forms and the stability of an internal regulation?

Table 3.1 Mintzberg’s Situation-dependent Organizational Forms

	Simple	Complex
Stable	Machine Bureaucracy <i>Standardized Work Processes and Output</i>	Professional Organization <i>Standardized Skills And Norms</i>
Dynamic	Entrepreneurial Startup <i>Direct Supervision</i>	Adhocracy <i>Mutual Adjustment</i>

Source: Fred Beshears 2003,
http://ist-socrates.berkeley.edu/~fmb/articles/mintzberg_18-3-05

Mintzberg (1983) introduces four environmental dimensions together with his four organizational forms. It is also recognized as one of the classical classifications for situation dependent organizational forms (See *Table 3.1*). This classification shows the correlation between the stability of environment and the options of hierarchies. But it does not answer the relationship of the organizational forms and the stability of an internal regulation.

Other researchers suggest studying organizational forms by investigating the relationship between the organization and its funding agencies and other stakeholders. The demands, or perceived demands, of the funding agency legitimate the initial organizational movement away from fully participative structures. External communication requirements come to dominate internal preferences for collective forms of operation (Mantle 1985, cited by Margaret Grieco and Len Holmes 1990).

Competition is a very important environmental variable that can influence organizational forms dramatically. In contrast to early treatments of competition as an exogenous source of “environmental uncertainty” (e.g. Thompson, 1967), modern organization theories regard competition as generated by organizations, so that as organizations change so do their competitive effects.

Most organization theorists would agree that environmental forces shape the configuration of organizations, but it is also possible that organizational forms evolve to tap into particular resource opportunities (McKelvey & Aldrich 1983). By contrast, a new theoretical approach for explaining why organizations become so much alike leads into two competing explanations: competitive isomorphism (Hannan & Freeman 1977, 1989; Hawley 1950) and institutional isomorphism (DiMaggio & Powell 1983; Meyer & Rowan 1977).

Terry L, Amburgey, Dawn Kelly, William P, Baenett (1993) try to test two very interesting hypotheses: first, organizational change tends to increase the organizational failure rate, and it is independent of the effects of the changed organizational

characteristics; second, the disruptive effect of organizational change tends to increase with the age of the organization.

We suggest that Organizational instability cannot be simply equalized to failures. Sometimes, instability is just a necessary preparation for further reforms, if the conflicts do not destroy the basic framework of an organization before an effective reform is introduced.

3.2 The Transaction Cost Economics Approach

Some sociologists and political scientists may study organizations in a non-economic way, but such researches do not provide clearly cut costs-benefits analysis framework based on bounded rationality (Simon 1955). Nevertheless, the focus of this dissertation is to understand some economic regulations and their performances, so the economic approach is the natural and suitable way to fulfill such a task.

The transaction cost economics approach emphasizes economic factors for understanding why an organizational regulation emerges from voluntary market exchanges, and this approach can also provide a cost-benefit analysis for understanding the interest conflicts economically, because this approach is quite applicable to analyze the interest conflicts between buyers and sellers that triggers the transaction costs. For further study, the transaction cost approach is widely adopted as a good starting point for analyzing organizational forms. Furthermore, the transaction costs and other administrative costs within an organization can construct a bridge that transforms the interest conflicts to the organizational changes.

In this section, the main theories of transaction cost economics approach and their limitations will be discussed before we can come to a further classification of mixed forms.

3.2.1 Main Theories of This Approach

The starting point of the transaction cost approach is based on the distinction between market and firms. “The distinguishing mark of the firm is the suppression of the price mechanism.”(Coase 1937)

With the emphasis on the importance of contractual relationship in organizations, some theorists also point out that the economics of governance distinguishes three basic governance structures: classical markets (simple spot market exchange), hybrid (market with a long-term contract), and hierarchies (firms, bureaus). Their governance features – differential incentive intensity, administrative control, and contract law regime – are changing in internally consistent ways. (Williamson 1979,1985,1996)

North (1994 pp.4) argues, “The sources of change are the *opportunities* perceived by entrepreneurs. They stem from either external changes in the environment or the acquisition of learning and skills and their incorporation in the mental constructs of the actors.” It is an insight for understanding the origin of organizational forms, although this argument triggers more arguments about the “mental mode” and so on. “Social scientists have incorporated the costliness of information in their models but have not (for the most part) come to grips with the subjective mental constructs by which individuals process information and arrive at conclusions that shape their choices”(North 1990 P.21).

The focus of the neo-institutional economics is on the long-term institutional changes. Many other factors are also considered in their theoretical framework. “The economies of scope, complementarities, and network externalities of an institutional matrix make institutional change overwhelmingly incremental and path dependent.”(North 1994 P.22)

Stigler, George J., (1961) suggests that economic agents may search until the expected marginal gains from searching equal the marginal costs of continued searching (including opportunity cost of time). The search costs can be very high for certain some products, so organizations may arise and market innovations are necessary to minimize these costs.

Based on an incomplete contract model, Seabright (1996) argues that the accountability will decrease when the degree of centralization increases in an organization. Other theorists (e.g. Pennings 1974) suggest, for example, if many members face one task, it favors centralization. This approach takes task as a very vital factor for analyzing centralization and decentralization, although the concept of accountability is still somehow ambiguous and very difficult to measure.

Williamson (1979) concludes that markets efficiently organize non-specific transactions, while recurrent transaction-specific exchanges are more efficiently governed internally. Becker, Gary, and Kevin Murphy, (1992) especially emphasized that there are various costs of "coordinating" specialized workers who perform complementary tasks, and the amount of general knowledge available. Fumas, Vincente Salas, (1993) suggests that the introduction on incentives in a hierarchy which is performing imperfect supervision may not be sufficient to remove the limits to the firm's size which is attributed to this imperfection.

Spekle, R.F. (2003) seeks to integrate different factors influencing control within an organization into a single framework with a focus on the nature of the organization's activities, because the control problems are inherent in these different type of activities, and the unique problem solving potential of various archetypal control structures. It is an organization's activities oriented research direction, although it is not necessary to assume that all activities in organization are transactional.

3.2.2 The Limitations on This Approach

There are many arguments inside and outside the transaction cost economics approach. Such arguments are mainly related with the limitations of this approach, and such limitations are mainly caused by the negligence of other conflicts of interest besides transaction within an organization.

Some extreme theorists in the transaction cost economics are widely criticized. An extreme view based on the transaction cost approach might be that all organizations are really boxes of contracts (Handy, 1995). But this extreme approach has been criticized for over-emphasizing legal and contractual forms of corporate governance whilst largely ignoring the role of internal social relations, trust and culture (Grabher, 1993).

Coase normally takes a very prudent perspective and stands in the middle way. In his paper *The Problem of Social Cost*, Coase (1960 pp.9) writes:

The government is, in a sense, a super-firm (but of a very special kind) since it is able to influence the use of factors of production by administrative decision. But the ordinary firm is subject to checks in its operations because of the competition of other firms, which might administer the same activities at lower cost and also because there is always the alternative of market transactions as against organization within the firm if the administrative costs become too great.

Here Coase strongly suggests that a firm may always compare the administrative cost with the alternative of market transactions. But this point is not widely cited.

Some advocates of this approach also admit the weakness of the transaction cost economics without the consideration of other types of relationships. Williamson (1979, 1996 *The Mechanisms of Governance* pp.4) notices that:

As Against simple market exchange, governance is predominantly concerned with ongoing contractual relations for which continuity of the relationship is a source of value...but therein lays the rub: continuity can be put in jeopardy by defecting from the spirit of cooperation and reverting to the latter.

Clearly, such a “spirit of cooperation” needs a good explanation academically.

Avinash Dixit (*The Making of Economic Policy*, 1998 p. 35) says, "Transaction costs do not provide a single *analytical* framework but only a loose *conceptual* framework for organizing many different analytical models".

McManus, J.C., (1975) observes that organizations of any kind consist of behavior constraints, which serve to direct individual behavior towards the mutual interest of the relevant group. These constraints, prices or management directives, are costly to enforce. Enforcement costs are treated as equivalent to the costs of detecting changes in activities, such as the quality of goods and work effort. Because price constraints are costly to enforce and because different types of constraints will have differing costs of enforcement, the latter provide an economic basis for choice among different forms of organization.

Coase (1960 pp.8) also emphasizes:

It does not, of course, follow that the administrative costs of organizing a transaction through a firm are inevitably less than the costs of the market transactions which are superseded. ...This solution would be adopted whenever the administrative costs of the firm were less than the costs of the market transactions that it supersedes and the gains which would result from the rearrangement of activities greater than the firm's costs of organizing them.

It prudently implies that the rearrangement of organizational activities may have other benefits beside the reduction of administrative costs of organizing a transaction.

Alchian and Demsetz (1972) show how team production can result in organizations characterized as the "classical firm." The team production will arise a problem that the activities of workers cannot be perfectly separated; so it is not possible to pay for workers' jobs based on their marginal output.

Granovetter (1985), Fligstein (1985), Perrow (1981) carry out an argument in which the core is the concept of "embeddedness", used in the sense that "economic action takes place within the networks of social relations that make up the social structure, as a critique of transaction cost economics.

Interestingly, when most neo-institutional economists come to discuss governmental

activities, they are usually quite critical. Coase (1960 pp.9) comments:

It is clear that the government has powers which might enable it to get some things done at a lower cost than could a private organization (or at any rate one without special governmental powers). But the governmental administrative machine is not itself costless. It can, in fact, on occasion be extremely costly.

North (1994 pp.7) states, “Both external sources of change and unanticipated consequences of their policies may weaken the power of existing organizations, strengthen or give rise to organizations with different interests and change the path.”

In reality, there are a variety of reasons responsible for organization failures. Here is a statistic based on an investigation in some businesses of western society; and the result is interpreted as that the problems with *coordination, incentive and budgeting* are the main causes leading to failures (See *Table 3.2*). In other words, it implies that there may be more other factors besides the transaction costs that should be taken into consideration.

Table 3.2 Reasons for Decline

<i>Too much Debt</i>	<i>28%</i>
<i>Inadequate Leadership</i>	<i>17%</i>
<i>Poor Planning</i>	<i>14%</i>
<i>Failure to Change</i>	<i>11%</i>
<i>Inexperienced Management</i>	<i>9%</i>
<i>Not Enough Revenue</i>	<i>8%</i>

Source: Buccino and Associates: Seton Hall University Stiffman School of Business, as reported in August 25, 2003, Business Week, cited by Murray Johannsen 2002

What triggers these internal costs of an organization, however, remains unanswered clearly. It is necessary to take one step forward to understand the internal structure and interest conflicts in an organization.

3.3 One Step Forward into Hierarchies

In most theoretical papers, hierarchies, as an alternative to the flat structures, are normally discussed as a whole or described by the appearance. It is important to peer into the internal structure of a hierarchy and to identify the different relationships between the players involved in the hierarchy.

Some theorists are very aware of the conflicts of interest inside an organization, but they usually do not get them pointed out economically. Mintzberg (1983) states that the rules and regulations are embedded into machines, not workers. And machines never become alienated, no matter how demeaning their work. So out goes the need for direct supervision and technocratic standardization and with it the obsession with control.

Some arguments inside the transaction cost economics are also worthy to be mentioned. When asset specific is explained as a reason for vertical integration (Williamson 1975) in the transactional interpretation, Alchian and Demsetz (1972) insist that 'nonseparability' is the leading reason to explain the origin of firms. They contend that 'nonseparability' occasion the shift of economic activities from market oriented exchange to internal organization. It is not widely cited that Williamson (1975 pp.49) concedes "that this is sometimes the case, I submit that: (1) There are reasons other than nonseparabilities for internal organization to appear; (2) nonseparabilities are much less widespread than is commonly believed; and (3) though nonseparabilities constitute one of the reasons for primary workgroups to appear, the argument has little bearing on the joining of simple hierarchies to form complex hierarchies."

Some new arguments lead people to understand the hierarchic structures in depth. Pihl (2003) suggests that the evolution from the simple hierarchy level to the complex W-form level can be explained by identification of situational factors and by the use of different coordination mechanism. Spekle, R.F. (2003) seeks to integrate into a single framework with understanding in the nature of the organization's activities, and the control problems are inherent in these activities, and the unique problem solving potential of various

archetypal control structures.

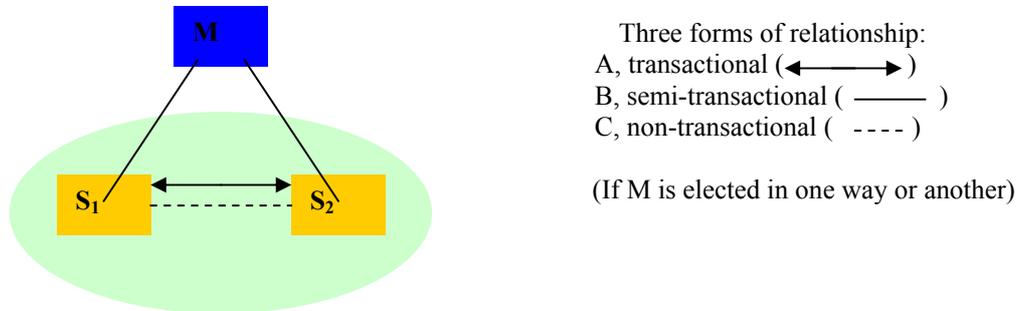
Some researchers connect hierarchies with inertia, although what is the inertia needs a good explanation as well. The structural inertia model (Hannan and Freeman (1984)), some recent models of organizational learning, and some economic theories of the firm all emphasize some internal factors: organizational routines and competencies (Nelson and Winter, 1982; Hannan and Freeman, 1984; Levitt and March, 1988). Routines refer to the repetitive patterns of activity by organizational members, both individuals and groups. Some define routines as what the organization knows, and writings in this area tend not to distinguish knowledge and action (Nelson and Winter, 1982; Levitt and March, 1988). To overcome the inertia, there will be some administrative costs triggered by the conflict of interests.

Opposite to the emphasis on organizational inertia, many influential theories assumes that organizations are malleable to a certain extent, able to adapt the changes of circumstance (e.g., Thompson, 1967). Hannan and Freeman's (1977, 1984) structural inertia theory contends this view, depicting a world of relatively inflexible organizations in which change is both difficult and hazardous. Theorists usually consider these views to be mutually exclusive alternatives (e.g., Scott, 1987). In this spirit, recent work has tried to define boundary conditions between the two views, distinguishing among changes as either adaptive or disruptive and distinguishing among conditions that facilitate or impede change (Hannan and Freeman, 1984; Singh, House, and Tucker, 1986; Kelly and Amburgey, 1991; Haveman, 1992).

All the arguments and critics take different perspectives, but the nature of hierarchies and the internal interest conflicts remain as a puzzle. To understand hierarchies better, it is necessary and possible to take one more step forward to classify the different forms of relationship existing inside hierarchies.(See *Figure 3.1*)

Transactional relationship: It is the most studied type of relationship academically. It can be roughly described as the following way: in a given social network (Burt 1992), if one party connect another with formal or informal transaction activity, then the two connected parties have a transactional relationship.

Figure 3.1 Three Forms of Relationship:



Note: Here M is referred to managers, whilst S_1 and S_2 are referred to subordinates.

Semi-transactional relationship: Here is a rough definition. Given an activity in a certain social network, if some parties involved interact in a transactional way, but there is one more interactions between the participators where some participators can take without giving or give without taking, and the other participators cannot rule them out the game under the regulation of the activity, then the whole relationship of all parties in the inseparable activity is called semi-transactional.

An election is typically semi-transactional. There are always some voters, who do not vote or do vote against the man that is finally elected, who can benefit from one policy or another issued by the elected. *Vise versa*. There are always some collective (public) goods (Mancur Olson 1965) in some social activities.

Non-transactional relationship: in a given social activity, if no two parties involved are playing the give-and-take transactional game, and no specific property rights or other legal rights of the parties are being exchanged between each other eventually, and every party is bounded in the multiparty activity under some certain regulations, then the relationship of all parties in the activity is called non-transactional.

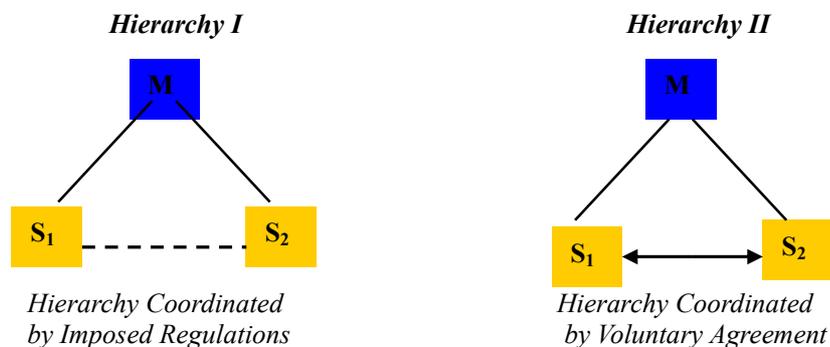
Competition or co-working under some regulations are two examples of the non-transactional relationship. A worker p may deliver a certain amount of products to a

worker q in the same firm, but the property rights of the products have not been changed at all, because they always belong to the owner of the business in that production process.

Based on the classification made above, two of many elemental hierarchies can be identified and they can join together to build some more complex hierarchies. (See *Figure 3.2*)

The diagram highlights the differences of coordination in an explicit way. The two different hierarchies can typically characterize the different nature of two ETRE systems in our comparative case study. The nature of the EU ETRE System is dominated by a voluntary agreement reached by member states. On the contrary, the nature of the Chinese ETRE System is dominated by an imposed regulation.

Figure 3.2 Two of the Elemental Hierarchies



It is possible that there are two more different types of relationship existing between two parties involved in an elemental hierarchy. For example, in the hierarchy I, the relationship between S_1 and S_2 is dominated by the imposed regulation, but it is also allowed to make some agreements between them if S_1 and S_2 do not violate the principles of that regulation. What the dominant relationship is can characterize nature of an organization or a low level arrangement within the organization.

Although such diagrams are just taken as a complementary explanation to the U-form dominated and the M-form dominated mixed forms in the dissertation, it is also possible to argue that a hierarchy should have at least one more non-transactional or semi-transactional relationship to distinguish itself from the market.

3.4 The U-form Dominated and M-form Dominated Mixed Forms

Through the whole literature review in this chapter, we have not found an existing theory that can perfectly explain the problem shown in our case study. But Chandler's (1962), and Williamson's (1975) U-form and M-form model is a good starting point for further analysis in our case study. A necessary explanation and a small modification of the mixed forms will be carried out in this section.

3.4.1 Characteristics of the U-form and M-form

There are very clear definitions of the U-form and M-form theoretically. The U-Form (or functional) Structures are usually established on the basis of their common expertise/experience or because they use the same resources or focus on the same activities. M-Form decentralizes the operating decision-making to the business unit/division level where all necessary competitive and operational decisions are made, while Strategic decision-making responsibility is retained at the headquarters level (Chandler 1962, Williamson 1975).

In Williamson's (1975) argument, the cost of processing information is explained as a reason for why the M-form is generally better than the U-form. But there is no good explanation for why a firm does not go directly to the better forms in reality? It is often time consuming and quite costly to make a switch from one form to another.

Knight (1992) suggests that such studies can be characterized according to two criteria: first, the institutional effects invoked to explain maintenance and stability; second, the

mechanism for institutional changes.

Other researchers (Manny Martinez, Yi-Hsuan Lee 2003) synthesize the advantages and disadvantages of the U-form and M-form according to the following table (See *Table 3.3*).

It is interesting to know the general features of the U-form and M-form. But As it is insistently emphasized in the literature review, all organizational forms and the hierarchic structures are very situational dependent. An abstract discussion on which form is better is not very appropriate.

What is more, the mixed forms combining a U-form and an M-form can be widely observed in reality, and they are also very shortly discussed by Williamson (1975, P.154). But there is no further classification for the mixed forms (they are denoted as X-forms by Williamson).

Table 3.3 The Characteristics of U-form and M-form

	U-form	M-form
Advantages	<ol style="list-style-type: none"> 1. Increased specialization 2. Economies of scale in monitoring 3. Critical decision-making centralized to one top person 	<ol style="list-style-type: none"> 1. Uses objective market/output performance measures 2. Bureaucratic controls with clan/cultural controls 3. Encourages the exploiting of economies of scope across divisions 4. Frees corporate to focus on strategic concerns 5. Facilitates diversification and growth
Disadvantages	<ol style="list-style-type: none"> 1. Cannot handle the complexity of multiple activities well 2. Sub-goal pursuit problems can become acute 3. Absence of objective measures of performance 4. Operational concerns can divert attention from strategic issues 	<ol style="list-style-type: none"> 1. Introduces additional levels of Hierarchy 2. Opportunism and information distortion problems 3. Myopic focus 4. Divisions may compete at the expense of cooperating 5. Transfer pricing battles

Source: Martinez and Lee

http://ai.eller.arizona.edu/hchen/class_presentation/mis580-discusant-1021-Manny-and-Tom.ppt, cited 20-3-05

3.4.2 A Small Modification on the U-M Mixed Forms

Why the U-form and the M-form model suitable for studying the governmental issues? The U-form and M-form model is originally presented for studying large business organizations, but we argue that it is also fit for analyzing large non-firm organizations:

First, the basic power distribution between a manager and the subordinates in firms and non-firm organizations is same. Consequently, the internal conflicts of interest are also posing a challenge to the non-firm organizations as well as to the firms. When governments or super-state organizations come to perform an economic task, they also pursue the maximized benefits as a large firm normally do. Furthermore, the two ETRE systems compared in the dissertation meet the definitions of a combination of U-form and M-form (mixed form) in a good way. Although the U-form and M-form originate from the studies on large firms (Chandler 1962, Williamson 1975), it is still a good approach for understanding other internal structures of organizations in an economic way.

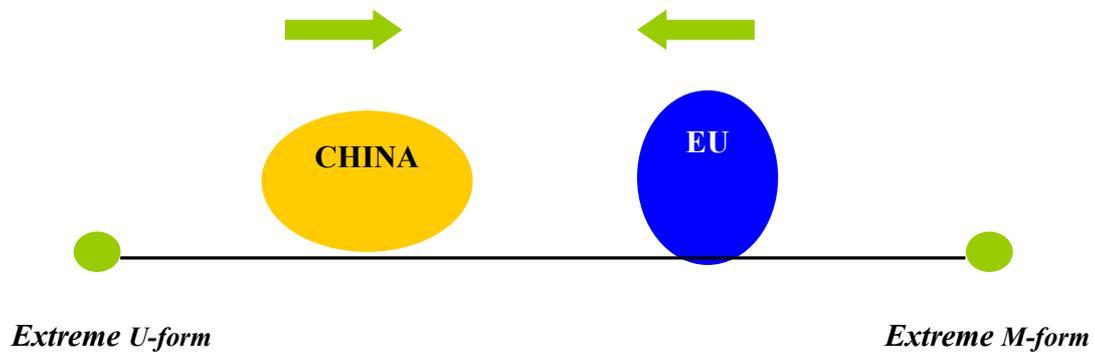
Second, both the U-form and M-form are widely studied. Many papers focus on testing them empirically. Some researchers study comparable macro-economies based on the U-form and M-form approach. For example, Gerard and Qian (2003), Qian and Xu (1993) analyze the economies of states in transition with a U-form and M-form model. It is argued that although there is not a coherent reform program in China, the multilevel M-form arrangements can explain the successful transition of the Chinese economy comparing with some East Europe nations in the past two decades. In our case study, it is planned to compare the ETRE systems of China and EU, which can be characterized by a combination of the U-form and M-form organizations. It is also observed that some top level U-form arrangements are sometimes necessary in a generally M-form organization, and such mixed forms can influence the way of the same task is being performed.

Finally, among all the organizational forms identified, the U-form and M-form are the most fundamental and identifiable. As elements of hierarchies, these two forms are also observable at different levels of many complex hierarchies. For example, the U-form

arrangement may prevail in the subunit of an M-form (Williamson 1975, P.138), and *Visa versa*. Sometimes, they appear in a combination. The transformation of organizational forms may become very complex in some cases, but a combination of the two foundational forms is still identifiable, if we focus on a particular activity or a specific regulation within the organization.

To illustrate the forms for analyzing the two ETRE systems, we can place the extreme U-form and extreme M-form at two ends of a scale, and then we have *Figure 3.3*.

Figure 3.3 A Scale of U-M Mixed Organizational Forms



Generally, both systems are not in extreme situation. They are mixed forms. China is a unitary centralized state with some decentralized arrangements in many economic areas, whereas EU is a loose states union with a few highly integrated economic arrangements. For example, the EU is generally an extreme M-form organization, but the European common agriculture policy and the ETRE system are typically centralized arrangements at the EU level, and the Euro currency policy is also mostly centralized. On the contrary, China adopts a lot of tax sharing arrangements today; even the Value-Added-Tax (VAT) is shared between the central and local government. Such decentralized arrangements can provide flexibility and opportunities for initiating some regional experiments in China.

So it is reasonable to suggest that the two ETRE systems are mixed form (Williamson 1975, P.154). Furthermore, two different categories of mixed form can be further identified as a modification and development of the mixed form theory (Williamson

1975):

(1) *U-form dominated organization*: within a mixed form, the U-form dominated organization is referred to such an organization in which the internal regulations are dominated by U-form arrangements.

(2) *M-form dominated organization*: within a mixed form, the M-form dominated organization is referred to such an organization in which the internal regulations are dominated by M-form arrangements.

In the further discussion of this dissertation, the term “U-form dominated organization” is used to describe the Chinese ETRE system, and “M-form dominated organization” to describe the EU ETRE system.

This difference is the basis for understanding the background of the case study in the following pages. For some complex organizations, the mixed form may be much more necessary and long-lived than some researchers once have suggested.

3.4.3 The Interpretation and Benchmarking Approach of This Dissertation

The objects we are going to compare in this dissertation are two particular taxes related systems, and the core of the Export-Tax-Refund/Exemption systems is the regulation and its enforcement. Organizational forms are characterized by the sum of its internal interest conflicts. So it is designed to understand the different performance of the two ETRE systems based on the organizational forms as well as their combination of incentive and direct control. That is the starting point of the interpretation.

It is necessary to review some literatures on conflicts of interest related with organizations. In many papers, researchers have studied conflicts of interest and how an organization will balance them, and both the internal and external conflict of interest have

been theoretically analyzed.

Papandreou (1952 P.183) suggests that an increase in some interest's rights may require "rebalancing" of all rights. A theory of conscious cooperation or "social contract" (i.e., of multi-party cooperative bargaining across multiple values) is required. Paine (1994 P.1) observes, "The toughest decisions are those involving conflicts among these groups. You have to decide what's fair in these circumstances and constantly work to fulfill and balance these commitments".

Boatright (1994) argues that the moral equality of stakeholders' claims is not guaranteed in reality. ALI (1994 P.65) carries out a principles that suggests costing of social impacts: "It is now widely accepted that the corporation should at least consider the social impact of its activities, so as to be aware of the social costs those activities entail. By implication, the corporation should be permitted to take such costs into account, within reason"). The term "reason" suggests balancing of some sort.

The internal interest conflicts, implicit or explicit, within a certain level hierarchy drive the administrative costs at that level: (1) the mutual communication between the subordinates and the managers must consume a certain amount of time, energy and other resource that can lead to an opportunity cost as well (Burt 1992 P.17-23); (2) even if the subordinates can understand the managers' commands very well, it does not mean that the subordinates will perform automatically as they are required, because the subordinates normally have their own optimal options at a price of the organizational tasks; (3) Sometimes regulation may become an obstacle. A regulation may be necessary for performing a certain function, but it may barrier another function in a different circumstance. Then the conflict will trigger a certain reform someday. Such conflicts can be widely observed in reality.

Coase (1960 P.9) insists to use a wordy term "administrative costs of organizing a transaction" rather than the term "transaction cost". They may appear as a high cost for incentives, or a high cost for direct coordination (Fumas, Vincente Salas, 1993). Administrative cost is an organizational measurement of the intensity of interest conflicts,

and it is the necessary intermedium to transfer a signal of interest conflicts to the relative managers.

In the transaction cost approach, the different combination of incentives and other direct coordination in organizations are often discussed. If there is no interest conflict at all, then it is not necessary to do coordinating or motivating, and the collection of the information about what other people are exactly doing is also meaningless.

Coase (1937) posits that the marginal costs of coordinating by fiat increases in the number of transactions. At some point, coordination via the price mechanism or within a different firm becomes less costly.

Following Coase's study, Alchian and Demsets (1972) develop their theory based on joint production and monitoring, the latter making it possible to assess each agent's contribution. They suggest the general rule that decision rights can be allocated to the individual with the strong incentives for value maximizing. They also argue that the ownership of firms can be effectively defined by a bundle of rights, in other words, the best way to provide the monitor with appropriate incentives.

Williamson (1975, 1985) expresses the idea that low incentives are good to accommodate ex post adaptations and writes that "low powered incentives have we known adaptability advantages. That, after all, is what commends cost plus contracting. But, such advantages are not had without cost — which explains why cost plus contracting is embraced reluctantly" (1985, P.140). He also argues that the M-form will replace the U-form in large-scale businesses (1975).

North (1994 P.3) writes, "The constraints imposed by the institutional framework (together with the other constraints) define the opportunity set and therefore the kind of organizations that will come into existence." He also states that institutions can even be described as an "incentive set".

Other researchers suggest that social capital (Burt 1992) like trust and reputation are an important part of administrative resource, and there is also a replacement cost when a certain social capital is damaged. Such social capital can be a source of interest conflicts too.

That is a rough literature review on conflicts of interests. Theoretically, our argument is also aiming to answer the paradoxical phenomena of the two ETRE systems mentioned above. We analyze the causes of such differences with the following interpretation:

Every organization contends with conflicts of interests between stakeholders. One important conflict is that between different levels in a hierarchy (the principal-agent problem). Hierarchical control in an organization can be exercised through either of two primary means: direct coordination or through the alignment of incentives. These two forms of control may exist to differing extents in the same organization. However, it is to be expected that one form or the other will be dominant. If both forms of control are weak this would lead to inefficiency. Combining strong forms of both means of control is to incur unnecessary costs.

Consequently, the different balancing mechanisms: a combination with strong incentive but little direct coordination, or a combination with weak incentive but much direct coordination, can lead to different results (e.g. stability) of performing a same task.

Generally, in an M-form dominated organization, if a task initiated with a strong incentive, the subordinates will have more autonomy to pursue the organizational objectives as well as their self-interests. So, the conflict of interests within an organization can be reduced, and the direct control will become less important, if the incentive does work in that organization. It is reasonable to suggest that such forms will be more stable while performing an economic task. On the contrary, in a U-form dominated organization, a relatively weaker incentive system and more top-down imposed regulations may increase the probability of conflicts of interest, and the manager is more likely to be involved in direct control, thus the opportunity cost and direct control cost are inevitably high.

Before a benchmarking in our case study, it is also necessary to clarify the definition of benchmarking the comparability of the two systems.

The definition of benchmarking is as follows: “Benchmarking is a continuous systematic process for evaluating the products, services and work processes of organizations that are recognized as representing best practices for the purpose of organizational improvement.” (Spendolini, J.M. 1992, P.2)

The comparability of the two ETRE systems is based on the following facts:

Both China and EU are single market; Both ETRE systems are mixed form; Both China and EU are large export economy; Both ETRE systems are performing the same task. And these points will be further discussed in the empirical case study.

Thus, the focus of the comparison and the benchmarking in the next chapter deals with the following three aspects:

- (1) The different nature of the two systems. The nature of the EU ETRE System is based on a voluntary agreement. On the contrary, the nature of Chinese ETRE System is based on an imposed regulation.
- (2) The different stability of the two systems. The Chinese ETRE System has been changed three times in the past ten years, whereas the EU ETRE System has been very stable during the past decade.
- (3) The different efficiency of the two systems. In the EU ETRE system, exporters can take back the refunds or enjoy exemption completely and efficiently. It is not the case in the Chinese ETRE system, however.

Then the possible improvement of the Chinese ETRE system will be focused on the necessary redesign of the Chinese tax collection and revenue sharing system practically.

3.4.4 A Summary and the Hypothesis

To improve the Chinese ETRE system, a practical solution leads to a possible redesign of the entire incentive system for tax collection and revenue sharing between the central and local government. Because most conflicts of interest in the ETRE system are rational, they are just a direct result of the current tax collection and revenue sharing system. To be a modern nation, it is necessary to have an effective and efficient tax collection system, and continuous reform should be done in this area. But the depth of such a discussion is quite limited in this dissertation because of the limitation of time and the data available about the entire taxation system.

The analysis framework presented above has an important theoretical clue leading to the hypothesis stated below.

If type A denotes the M-form dominated organization with strong incentives but less direct control, and type B denotes the U-form dominated organization with weak incentives but more direct control, then, theoretically, we present a hypothesis for further interpretation in the case study:

Hypothesis: An economic regulation in type A is more stable than in type B.

It must be pointed out here that the validity of the hypothesis is affected by the following limitations:

- (1) Theoretically, the time, energy and other administrative resources of a manager consumed are a measurement of the strength of direct control and alignment of incentives. But in reality, such administrative costs are not easy to measure, and their opportunity costs are more complex (Burt, 1997, North, 1994).
- (2) The hypothesis is valid only when an organization is performing some certain economic tasks like what is discussed in the dissertation. If it is expanded to explain other non-economic tasks, the hypotheses may not hold true. The reasons are that the goal of

non-economic task is usually more vague and immeasurable, and the arrangement of incentives and coordination may be completely different.

(3) The validity of the hypothesis is based on the two mixed forms, so the hypotheses may be completely invalid to explain the stability of organizations in extreme U-form or M-form. In some extreme situations, an extreme M-form organization for performing a given task may be very instable too. That can also help to answer some questions carried out at the very beginning of the Chapter Introduction.

Chapter 4

Empirical Case Study

The Empirical Case Study is presented. We will start by an introduction where the aim of the case study and entire process is explained. Further, the relative export tax refund (ETRE) systems in China and the EU including some concepts are described after their comparability is illustrated. Then, the causes of the stability of the two ETRE systems in the respective organizations are analyzed. Finally, the Conclusion of the Case Study is presented.

4.1 Introduction

In order to test our scientific hypothesis, we conducted an empirical case study. The hypothesis was that there is a relationship between the stability of an economic regulation in a mixed-form organization and the combination of incentive and direct control. Furthermore, that one combination of incentive and direct control brings an economic regulation in an M-form dominated organization more stable, while another combination brings an economic regulation in a U-form dominated organization less stable.

The reasons why we chose the case are as follows. First, it is quite comprehensive and has abundant data for our research, concerning stability of an economic regulation. Second, the data of the Chinese ETRE system can be compared with that of the EU's. Third, the research will be more profound and comprehensive through comparison between the two samples. Fourth, due to that it is a particular phenomenon in a real life, the research of our hypothesis will give some suggestions on a certain ETRE system.

In the beginning of the case study, we will introduce the background, including some

necessary concepts and the comparability of the two ETRE systems in China and the EU. They can be compared since both systems are mixed-form organization, and both China and the EU can be considered as single markets and large export economies.

Then, we will describe the two systems in detail. In this part, we introduce their historical backgrounds at first in order to help readers understand the entire context of them, including their evolution and stabilities. And the current contents of the two systems are described very objectively and concretely. The observable conflicts of interest are briefly presented at the end of this part.

Further, we focus on the comparative analysis of the two systems. In order to find the relationship between the stability of a system in a mixed-form organization and combination of incentive and direct control, we present a simplified model of the relationship and disclose the conflicts of interest existing in the two systems.

Finally, a conclusion is given, including two main points. One is in theoretical perspective; the other is the suggestion about the future reform of the Chinese ETRE system.

4.2 Comparability of the Two ETRE Systems

The ETRE System is a hot topic in China recently, and it is widely criticized for its instability and inefficiency in the past decade, especially after the latest reform in 2003. When we change our view to the EU, it is surprising that the EU has a harmonious ETRE system with a tariff-free common market combined of a bundle of sovereignty nations, in which different rates of value-added tax are being introduced. The strange phenomenon makes us attempt to find some explanations. There are many reasons to compare the ETRE systems in China and that in the EU; however, we just focus on some substantial similarities.

From a geographical perspective, the European continent is as same large as China if Russia is excluded. Clearly, the two systems are performing a same task in different organizations. However, the most substantial similarities of the two units lie in their background:

- Single Markets
- Large Export Economies
- Mixed-Form Organizations

Single Markets

Generally speaking, a single market calls for three basic requirements: (1) the elimination of internal trade barriers and the creation of a common external trade policy; (2) free movement of goods, labor, capital and service without any obstacle; and (3) adoption of a common currency. According to these requirements, China is undoubtedly a single market.

As to the EU, the single market started to form after the Single European Act was adopted by the member nations of the EC in 1987. The Single European Act required that all restrictions on foreign exchange transactions between member states should be removed by the end of 1992. According to the VAT Brochures published by the Swedish tax agency, the so-called export refers to sale of goods or services to a place outside the EC. This objective has been realized. Although many economists think it is very difficult to adopt a common currency, the Euro is used by 12 members up to now. And a common foreign trade policy is adopted. So the EU has formed a single market in a trade perspective.

Large Export Economies

It is an overt fact that each of them is a large export economy. In 2003, the EU accounted for 15.0 per cent of global merchandise exports (as compared to 10.7 per cent in the US), valued at US\$940 billion, not including intra-EU trade (*Export EU: A guide to the European Union for Australian Business, April 2, 2005*) While in the same year, China

constituted approximate 7 per cent of global merchandise exports, valued at US\$438 billion. (国家统计局: 我国高新技术产品出口呈现新特点. April 2, 2005) This shows that Exports plays a significant role in both economies.

Mixed-Form Organizations

As mentioned in the previous chapter, a mixed-form organization refers to a combination of both a unitary form and a multidivisional form. That is to say a mixed-form organization belongs to neither an extreme U-form nor an extreme M-form.

China is a sovereign nation, whereas the EU is an economic union so far, but both of them are a concrete organization in fulfilling a given task. Although there are a lot of differences between China and the EU, both of them are mixed-form organizations on a U-form and M-form organization theory basis, especially in the economic area.

China is a mixed-form organization instead of an extreme U-form one. Generally speaking, China is a unitary centralized state, but there are also some M-form arrangements in many Chinese economic areas. Some evidences have been mentioned in the end of the chapter 3 and are witnessed by the track of the Chinese ETRE system during the two decades.

China is a mixed-form organization or rather a U-form dominated one in economic field. The reasons why China in the ETRE system can be regarded as a U-form dominated organization are as follows. The top level determines all important policies about this special task. In this case, we can think that the top level is the Central Government, including its subordinates--Ministry of Finance and the State Administration of Taxation who are responsible for taxation and tax refund. This is a characteristic of a U-form organization. Instead of entrusting local tax offices with the task of collecting all taxes, the Central Government established its own revenue collection agency since an important tax reform in China in 1994. Now there are two parallel systems of tax administration: a national system to collect central taxes and a local system to collect local taxes. This is another characteristic of a U-form organization but has shown some autonomy of

subordinates. Another reasonable fact for some M-form arrangements is that some operational decisions can be made by local governments, especially from the introducing the tax assigned system, which means the Central government and local government are responsible for different portions of the tax refund respectively from 2004. In short, these reasons tell us China is a U-form dominated organization in the ETRE system.

The EU is a mixed-form organization instead of an extreme M-form organization. It is a loose union binding together 25 member states in May 2004, but there are also some U-form arrangements in many economic areas. Its business is carried out by five institutions. The decision-making institutions are the European Council, the Commission of the European Communities and the European Parliament. The European Court of Justice and the Court of Auditors are judicial bodies. The EU performs as a whole body to fulfil its economic tasks.

Both the history and the reality of the EU show that it is an M-form dominated organization from the aspect of its ETRE system. After the two world wars, many Europeans were aware of the potential economic benefits of closer economic integration of the countries. Although the present EU springs from forty years of negotiation and coordination, it remains a loose states union with a few highly integrated economic arrangements. Every member state in the EU has a full autonomy. The responsibilities for decision-making are decentralized to each sovereign country, while strategic decision-making responsibility remains at the EU level. Once the EU produces an agreement, every member should obey it automatically. Every member country is required to levy VAT in accordance with the new common VAT system, and the EU is doing its best to deal with economic issues in order to integrate European economy. Thus, from the issue of the ETRE system, the EU can be characterized as an M-form dominated organization.

In terms of the ETRE system, both China and the EU are a mixed-form organizations. In this part, we have given a picture about the dominance of the two mixed-form organizations in the economic area, especially in the ETRE system. After discussing the

organization of China and the EU, we suppose that China is an U-form dominated organization, while the EU is an M-form dominated one. Although the differences still exist between the two organizations, the fact that both of them are mixed-form organizations is obvious.

4.3 Two ETRE Systems in China and the EU

4.3.1 Concepts

Before starting the description of the two systems, we shall first make some key concepts clear so that we can go on to make a comparative case study and support our suggested theory step by step.

1. *Value Added Tax (VAT): VAT is*

- ✧ a general tax that applies, in principle, to all commercial activities involving the production and distribution of goods and the provision of services.
- ✧ a consumption tax because it is borne ultimately by the final consumer. It is not a charge on businesses.
- ✧ charged as a percentage of price, which means that the actual tax burden is visible at each stage in the production and distribution chain.
- ✧ collected fractionally, via a system of partial payments whereby taxable persons (i.e., VAT-registered businesses) deduct from the VAT they have collected the amount of tax they have paid to other taxable persons on purchases for their business activities. This mechanism ensures that the tax is neutral regardless of how many transactions are involved.
- ✧ paid to the revenue authorities by the seller of the goods, who is the "taxable person", but it is actually paid by the buyer to the seller as part of the price. It is thus an indirect tax.

(Europe<European Commission<Taxation and Customs Union<Taxation<VAT General Overview. March 28, 2005)

2. **Tax Refund:** Tax Refund refers to a tax repaid by the government to a taxpayer in settlement of over-payment of tax.

3. **Exemption:** Exemption here refers to release from liability for payment of taxes.

4. **Deduction:** Deduction here refers to a tax write-off: a reduction in the gross amount on which a tax is calculated;

5. **Export Tax Refund:** Export tax refund refers to the money the tax authority returns to exporting enterprises for the indirect tax they pay in the production and distribution process. It is commonly practiced in international trade.

To ensure fair competition, every country requires imported goods to be subject to the same tax rate as its domestically produced counterparts. Therefore, regardless of whether export goods have been taxed by the exporting country, the importing country will still tax them. Thus, the main purpose of the export tax refund policy is to avoid double taxation on export goods and to enhance a country's competitiveness in foreign markets. As far as the WTO is concerned, the practice is not illegal. In fact, under both the General Agreement on Tariffs and Trade and the WTO, the export tax refund is not considered a "subsidy" so long as the tax refund does not exceed the amount of tax paid to domestic tax authorities (Cui, 2003). The ETRE mentioned hereinafter refers to the export tax refund/exemption on VAT especially.

4.3.2 The ETRE System in China

4.3.2.1 Historical Background

Since the launch of the economic reforms in 1978, China's exports have been growing phenomenally. To encourage exports and increase the competitiveness of exporting

enterprises in the international market, the Chinese government formulated and implemented a series of policies of which the ETRE is one of the most important. At the same time, however, this system has exposed some signs of inefficiency and instability.

The evolution of China's ETRE policy can be divided into four stages. According to Dr. CUI Zhiyuan in the *China: An International Journal* in 2003 about China's ETRE Policy, *the first stage* is from 1985 to 1993. The government of China began to implement the ETRE policy in April 1985. In 1988, the "full refund" principle was established. By 1991, the export subsidy (above the amount of export refund) was abolished. *The second stage* is from 1994 to 1997. The VAT was zero for export goods. That is to say, export goods would get a 17 or 13 per cent VAT refund in accordance with the tax rate paid. *The third stage* is from 1998 to 2003. To counter the negative impact of the 1997 Asian financial crisis and promote exports, the Chinese government increased the ETRE rates for various products nine times from early 1998 to the end of 1999. In 2000 China's exports increasing by 27.8 per cent (Cui, 2003). *The fourth stage* is from 2004 to the present. With the rapid growth of China's exports, public finance of the Central Government cannot cover all funds needed for export refunds on a timely basis; there has been default in the payment of refunds since 2000. The delayed payment of tax refunds has made many export-oriented enterprises face the problem of insufficient working capital and affected their normal operation. From the four stages above, it's not difficult to find that China's ETRE policies are relatively changeable.

4.3.2.2 Content of the Current ETRE system in China

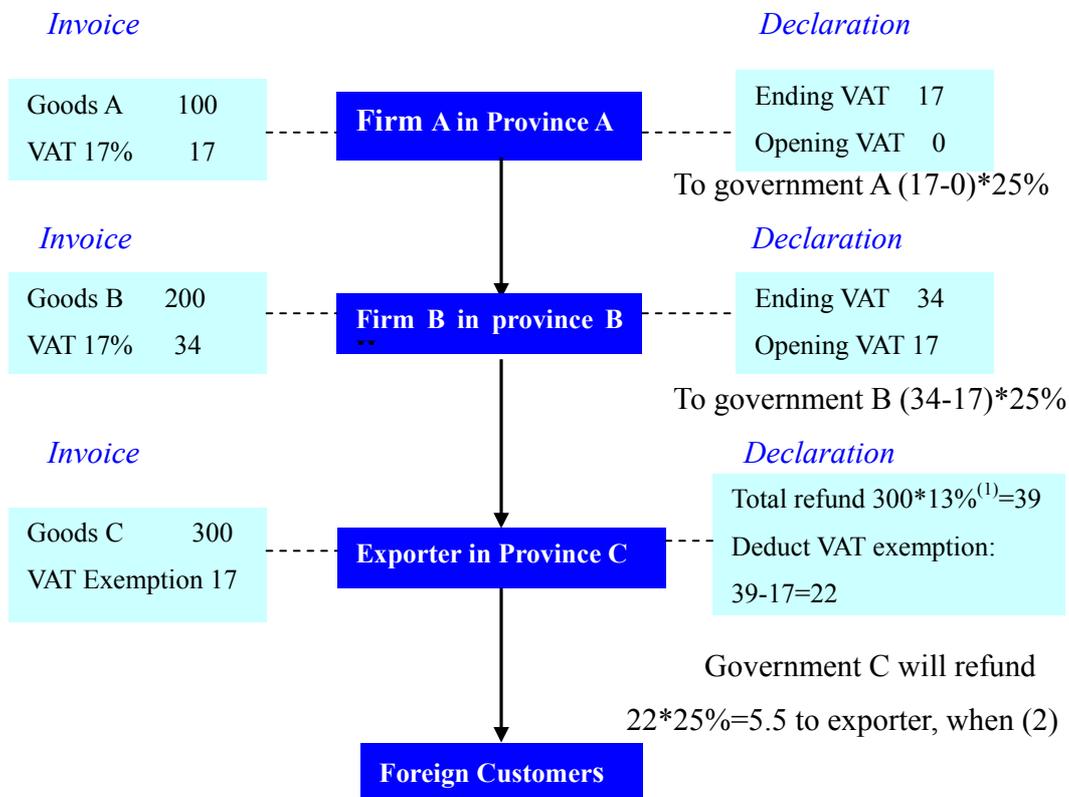
The ETRE system has been an issue in China for years. To alleviate long-outstanding export refund claims and reduce the heavy burden on State finance, the Ministry of Finance and State Administration of Taxation issued a document- *Notice on the Adjustment of Export Refund Rate* (Caishui [2003] No.222) on October 13, 2003 that represents a structural change to the Chinese ETRE system.

According to the new policy, the tax refund rates will be changed from four rates to five

rates, i.e., 17%, 15%, 13% and 5% to 17%, 13%, 11%, 8% and 5%, as shown in *Appendix 1 The new VAT refund rates by major exported goods categories*. The new rates are effective as of January 1, 2004. The overall average reduction in refund rates is 3 percent.

A timetable has not been set by which all old debts owed to exporters thus far will be settled. However, the government guarantees that increases in central import duties will first be used to pay tax refunds, and thus, no new debts are likely in the future. The central government also guarantees payments of old debts with interest. In this regard, local governments will share, on a 25 per cent: 75 per cent basis, the fiscal burdens with the Central Government. In other words, the Central government will provide a limited amount of funds to each province in advance for ETRE. However, when the amount of fund is not enough for the province, the local government will have to pay 25% of the remaining part, and the Central Government will still pay the remaining 75%. *Figure 4.1* shows a simplified model of the current ETRE system in China.

Figure 4.1 A Simplified Model of the Current ETRE System in China



Note:(1) assume refund rate of this kind of goods is 13%; (2) the refund provided by the Central Government is not enough; (3) the Central Government has received $34*75%=25.5$, will refund $22*75%=16.5$ to the trader.

Figure 4.1 above shows the operating procedure of the Current Chinese ETRE system in the following three steps. *Step I:* Firm A in Province A sells Goods A valued at \$100 to Firm B in Province B. Firm A has to pay \$17 for VAT, which is 17% of the value of Goods A. The government A will take 25% of the VAT \$17, and the Central Government will keep the remaining 75%.

Step II: Firm B makes Goods B with a value of \$200 by adding value \$100 to Goods A and sells it to an Exporter in Province C. Firm B has to pay VAT \$17, which is 17% of the added value of Goods B. The government B will get 25% of the VAT of \$17, and the Central Government will keep the remaining 75%.

Step III: The exporter in Province C makes Goods C with a value of \$300 by adding another \$100 value to Goods B and sells it to a Foreign Customer. The exporter shall have had to pay \$17 for VAT, which is 17% of the added value of Goods C, to the Central Government and local government, however, this VAT \$17 will be deducted from the ETRE provided by the government after Goods C is exported.

At the same time, according to the current ETRE policy, the government shall refund the VAT that has been charged during the whole production procedure of the goods and different categories of goods have different refund rate from 5% to 17%. Therefore, in this case, provided that the refund rate is the average rate 13%, the government shall refund the Exporter 13% of the total value of Goods C, which is \$39. As mentioned above, the VAT of \$17 of Goods C shall be deducted from \$39. So the exporter will get \$22 back after Goods C is exported.

If the ETRE in Province C have exceeded the amount of funds provided by the Central

Government, the local government of Province C will have to pay 25% of \$22 to the Exporter according to the current ETRE policy, though the Central Government will pay the rest. This causes the money loss of the local government. The larger the amount of export, the more the local government has to pay, if the amount of the payment has exceeded the provided amount of the funds from the Central Government.

4.3.3 The ETRE System in the EU

4.3.3.1 Historical Background

The EU is the product of two political factors: (1) the devastation on Western Europe in the two world wars and the desire for a lasting peace, and (2) the European nations' desire to hold their own political and economic position on the world's stage. In addition, many Europeans were aware of the potential economic benefits of closer economic integration of the countries.

Belgium, France, West Germany, Italy, Luxembourg, and the Netherlands formed the original forerunner of the EU, the European Coal and Steel Community, in 1951. Its objective was to remove barriers to intragroup shipments of coal, iron, steel, and scrap metal. With the signing of the Treaty of Rome in 1957, the European Community was established. The name changed again in 1994 when the European Community became the European Union following the ratification of the Maastricht Treaty.

The Single European Act formalized the use of majority voting rules on some issues. Most other issues, however, such as tax regulations, still require unanimity among council members if they are to become law (Hill, 2003). The European Commission is responsible for proposing EU legislation, implementing it, and monitoring compliance with EU laws by member states (Hill, 2003). The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and Economic and Social Committee, adopt provisions for the harmonization of legislation

concerning turnover taxes, exercise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and functioning of the internal market within the time-limit laid down in Article 14 (Wahl, 2003).

The History of VAT in the EU was started from April 11, 1967 when the first two VAT Directives were adopted. They replaced all other turnover taxes in the Member States with a general, multi-stage but non-cumulative turnover tax. However, a Common system of VAT (a uniform VAT coverage) was not formed until 17 May 1977, the time when the Sixth VAT Directive was adopted. It ensures that each Member State has a broadly identical "VAT base"-VAT levied on the same transactions.

The realization of the single market in 1993 resulted in the abolition of controls at fiscal frontiers. However, rates of VAT were too different in Member States and there was no adequate mechanism to redistribute VAT receipts to mirror actual consumption. Therefore, the Community adopted the Transitional VAT System which maintains different fiscal systems but without frontier controls. For transactions between taxable persons it is still a destination based VAT system. (Akesson, March 22, 2005)

4.3.3.2 The Content of the Current ETRE System in the EU

After the "Single Market" became a reality on January 1, 1993, trades between Member States were duty free. Goods exported to non-member countries are zero-rated and no VAT is charged.

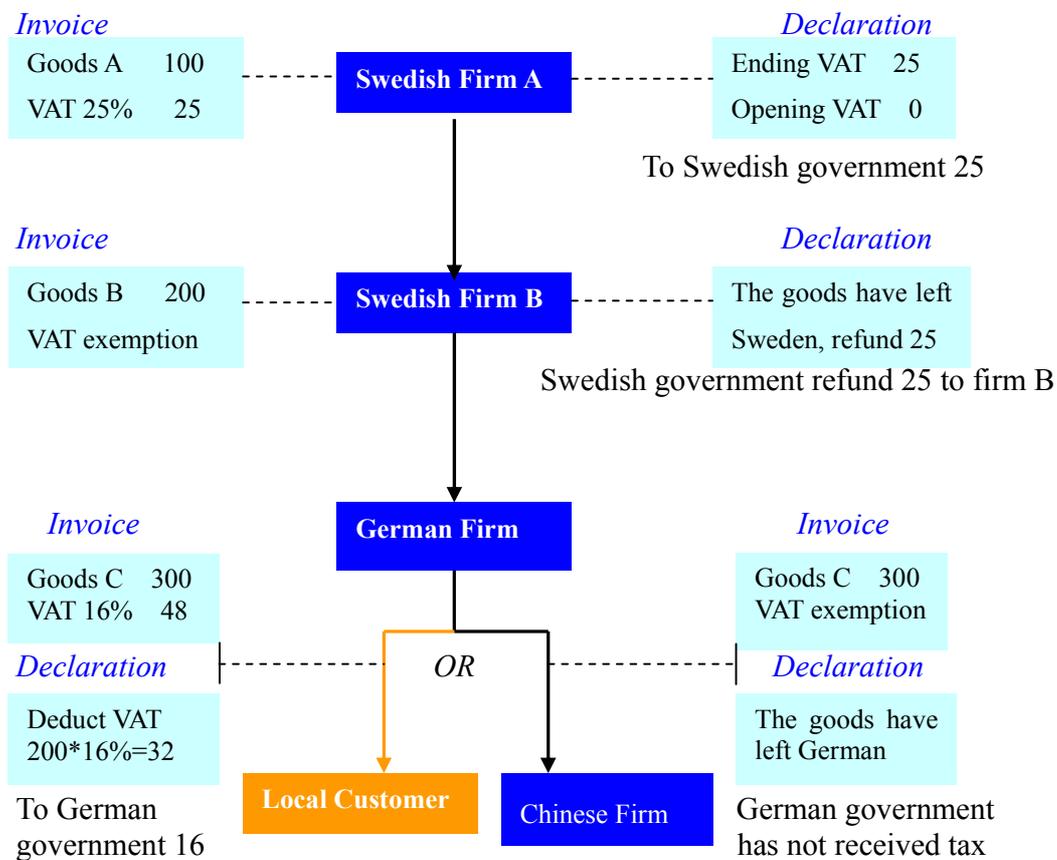
The VAT already paid on the inputs of the good for export is deducted. This is an exemption with the right to deduct the input VAT, sometimes called 'zero-rating'. Thus there is no residual VAT contained in the export price. Taxable people registered for VAT will be allowed to deduct this VAT in their next VAT return.

Under the new system, each trader applies VAT at the local rate without any other formality; each trader deducts the VAT paid anywhere in the European Union on his normal VAT declaration. A simplified model of the ETRE system in the EU is shown in

Figure 4.2. It consists of three steps.

Step I: Swedish Firm A sells Goods A with a value of \$100 to Swedish Firm B. Swedish Firm A charges VAT \$25 from Swedish Firm B, which is 25% of the value of Goods A, to Swedish Government.

Figure 4.2 A Simplified Model of the ETRE System in the EU



Step II: Swedish Firm B makes Goods B with a value of \$200 by adding value \$100 to Goods A and sells it to a German Firm. Swedish Firm B must check that the German Firm is liable for VAT in Germany. Swedish Firm B then sells to the German Firm free of VAT, and sends a declaration to the Swedish government. Swedish Firm B must prove that the goods B have actually left Sweden. Normally, Swedish Firm B will get a VAT

refund of \$25 from the Swedish Government in a stated cycle after his declaration. The stated cycle is normally a week.

Step III: The German Firm makes Goods C with a value of \$300 by adding a value of \$100 to Goods B and sells it to domestic customers or a Chinese Firm. When German Firm sells his Goods C to domestic customers, it declares VAT to Germany Government. Meanwhile, it deducts VAT at the rate 16%, the rate in Germany. When the German Firm sells his Goods C to a Chinese Firm, it will get a VAT exemption from the German Government. The German Firm must prove that Goods C have actually left Germany.

A visitor or traveler to the EU may apply to a Member State for a refund of VAT paid on goods that is supplied in the territory of the Community and will be taken out of the Community. VAT refund procedures should be inquired about at the time of purchase. Refund procedures differ in different Member States, but chances are that forms are filled out when the goods are bought.

Table 4.1 The VAT Rates in the EU Member States ⁽¹⁾

Member state	Rate	Member state	Rate
<i>Belgium</i>	21	<i>Luxembourg</i>	15
<i>Denmark</i>	25	<i>Netherlands</i>	17.5
<i>Germany</i>	16	<i>Austria</i>	20
<i>Greece</i>	18	<i>Portugal</i>	17
<i>Spain</i>	16	<i>Finland</i>	22
<i>France</i>	20.6	<i>Sweden</i>	25
<i>Ireland</i>	21	<i>United kingdom</i>	17.5
<i>Italy</i>	20		

(1) At 1 May 1999 (Taxation and Customs Union DG, March 20, 2005).

New strategies are being considered by the EU to simplify, modernize and standardize the

VAT system. Although the EU mandates certain guidelines to the VAT coverage and rates, it only requires that the standard minimum VAT must be 15% and standard VAT rates ranging from 15% to 25%. So each Member State has its own VAT law. Rates vary among Member States (as shown in *Table 4.1*) and among certain types of products. In addition, certain Member States have retained separate rules in specific areas. Therefore, the new strategies emphasize the uniform application of implementing rules in the Member States and closer administrative cooperation between them to combat fraud.

4.3.4 Observable Conflicts of Interest

Through the brief introduction to the two systems, it is clear that there are different observable conflicts of interest existing in the two systems.

In the Chinese System, a main conflict lies between the Central Government and local governments. The local governments should refund money that they have not collected from the exporters. As it is shown in *Figure 4.1*, the local government C has to refund US\$5.5 to the exporter that does not pay VAT at all in the case of export. This happens mainly to local governments concentrated in the coastal area of China, where most exporters are located. If the local businesses export more, then the local government will lose more. It is a dilemma for the local governments.

Another main conflict lies between government and exporter. We can find that the conflict comes from at least the following three aspects involved. The first are the rates of refund. Most of rates of refund stipulated are less than the corresponding VAT rates. The second is the time lag of refund. There is no refund deadline to the taxation authority in the Chinese ETRE system. The last but not least, the default of export tax refund also incurs a great deal of complaints from exporters.

Due to these conflicts above, the Chinese ETRE system has been changed dramatically during the two decades. And it is now still facing a new series of reforms.

In the EU system, the internal conflict is caused by the different VAT rates in the different member states. It can stimulate firms' opportunism to avoid high VAT through selling and purchasing in different member states at different prices. Although the EU has successfully coordinated VAT deduction and procedures among its members, it is very difficult to provide an appropriate way to uniform the VAT rates in a foreseeable future, because the VAT rate is very important for government revenue and unanimity is necessary for such coordination within the EU.

Furthermore, China does not have a tax refund system for the foreign tourists today, because the VAT collection and tax refund system is too costly to fulfill such a task.

The EU, however, has already established a very harmonious and efficient tax refund system for foreign tourist, in use since 1996, although it requires a transfer payment arrangement among the member states.

4.4 Analysis

4.4.1 Introduction

Based on the knowledge above, in this part, we will give an analysis of how, in a mixed-form organization, a combination of incentive and direct control influences the stability of an economic regulation,

We will firstly present *A Simplified Model of the Stability of the ETRE System* in a mixed-form organization. Then we will argue for the high likelihood of the two ETRE systems influenced by the different combination. Further, we will present the conflicts of interest incurred in the two ETRE systems, which can mirror the stability. Finally, we will draw our conclusions in the following two points: one is about the existing relationships between the stability of a regulation and the different combinations of incentive and direct control in different mixed-form organizations; the other is about the suggestions on

the future reform of the Chinese ETRE system.

4.4.2 A Simplified Model of the Stability of the ETRE System

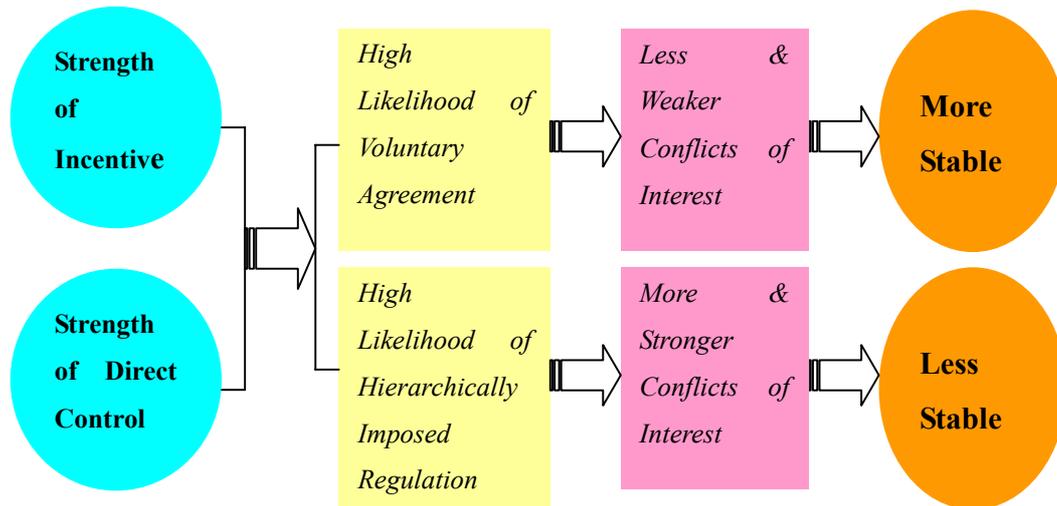
Our dissertation focuses on two kinds of mixed-form organizations, U-form dominant and M-form dominant organizations. There are various approaches in forming an economic regulation for an organization. It does not mean that the form of an organization will necessarily decide that it will adopt a specific approach in dealing with its economic issues. The U-form or M-form dominance of a mixed-form organization at most implies a tendency of its governing approach.

A combination of incentive and direct control is one kind of approach. According to the different strength of incentive and different strength of direct control, we can get four different kinds of combinations of them. However, our dissertation is just limited in the two of the four kinds of the combinations, strong incentive with less direct control and weak incentive with more direct control.

Figure 4.3 is a simplified model of the stability of the ETRE system. It illustrates the relationship between the combination and the stability of the ETRE system in a mixed-form organization. From the figure, we can find easily that the stronger incentive the combination has, the more stable a system will be. On the contrary, the more direct control the combination has, the less stable a system will be. In the meanwhile, the figure also tells us how a combination affects the stability of a system. Generally, when a mixed-form organization adopts the combination of stronger incentive and less direct control, the system is of high likelihood of voluntary agreement. Then, the system probably brings less and weaker conflicts of interest from different stakeholders involved. We think it is reasonable to take the degree of conflicts as a measurement to assess the stability of the system. Obviously, the system that has less and weaker conflicts will be more stable. On the contrary, the system lack of enough incentives instead of direct control will be less stable due to more and stronger conflicts incurred by this system

itself.

Figure 4.3 A Simplified Model of the Stability of the ETRE System



4.4.3 Analysis on High Likelihood of the Two ETRE Systems

In this section, we analyse high likelihood of a system through the dominance of a mixed-form organization combined with what approach adopted by this organization. We would like to exhibit the conclusion in advance. The ETRE system in the EU springing from stronger incentives but less direct control is of high likelihood of voluntary agreement. While the ETRE system in China bearing from weaker incentive but more direct control is of high likelihood of hierarchically imposed regulation.

The ETRE System in the EU is of high likelihood of voluntary agreement, which means that the ETRE System in the EU is mainly as a result of the negotiations and compromises between the associated member states on the basis of voluntary principle. According to relative rules of the EU, tax regulations require unanimity among council members if they are to become law instead of the use of majority voting rules on most

other issues. On the contrary, the ETRE System in China is of high likelihood of imposed regulation, which means that the ETRE System in China is mainly the result of the decisions from the Central government. Although the proposal has been argued by experts or supported by some factors from certain surveys, the Central government plays a key role in the establishment of the ETRE System without paying too much attention to the way of negotiations and compromises with local governments and exporters.

The reasons why the ETRE system made by the EU is a voluntary agreement are mainly contributed to its M-form dominated organization. To a great extent, the EU has many characteristics of an M-form organization. Each of the 25 member states has an extensive autonomy in deciding a regulation that will apply to the whole union. Moreover, in the regard of a country's economy and government revenue, tax rules are very important. Therefore, when a tax proposal is discussed, every member will pay full attention to its own benefit—incentives of a regulation without doubt. Any compromise is too difficult to be given by any member nation with ease. Just because of the above reasons, the treaty of the EU stipulates that every tax rule is not applied to the use of majority voting rules.

Though a voluntary agreement, it is difficult for us to imagine that it can be reached under the circumstance lack of incentive perceived by members involved. In the EU, an economic agreement is always obtained under strong incentives. Even through the origin of the EU, we can find it is the potential economic benefits that attract the European to build a union except for the two political reasons. Incentives in an agreement are shown not only by visible substances but also by invisible awareness. This case is forceful evidence. From population perspective, each member state is a small one compared with any large population country. The difficulties are obvious to develop the economy only relying on its domestic demand. A large free market is very attractive to every European country. Further, we can easily find that once a voluntary agreement is established, the so-called conflicts of interest will be probably avoided and direct control will hardly need during its following implementation. Normally, a voluntary agreement has a long working life and strong stability, which has been proved by the part of this case, the ETRE system in the EU.

As for the ETRE system in China, the U-form dominated organization makes it possible to enact imposed regulations in the system. The organizational form of China is fundamentally based on U-form. One of the most obvious characteristics of U-form based organization is the critical decision-making centralized to its top level, which is greatly conducive to the establishment and implementation of an imposed regulation. It cannot be denied that some objective factors influence the nature of an economic regulation in China. *Firstly*, China is a developing country, so the eagerness of China government to develop its export-oriented economies is much stronger, which allows shorter period in the establishment of the system. *Secondly*, Chinese government is lack of the related experience of the ETRE system because of its shorter history in the operation of the system. *Thirdly*, combined with the complicated situations of the ETRE system itself and the imbalance of economic development between east area and west area, unaffordable time and money would have had to be spent if the Central Government took a full agreement before a final decision. Under the fierce global competition, this centralized decision-making way can save long periods of time and save most of administrative cost caused by the long process to a final agreement as that in the EU. A voluntary agreement may lead China loss lots of God-given opportunities in economic development. Instead of a full agreement, more direct control is necessary within a birth of an imposed regulation and extends to its implementation period. In economic area, including the ETRE system, the Chinese Central Government is used to make imposed regulations directly instead of voting by majority or unanimity.

Usually, an imposed regulation needs lots of direct control not only in its building period but also in its implementing period. Instead of strong incentive, much direct control in the process of building and implementing an imposed regulation will make some disadvantages. And they can also lead to various kinds of interest conflicts, which have been proved by the history of China's ETRE system. When the VAT refund system was first introduced in 1985, its purpose was to increase the international competitiveness of Chinese products, boost export growth and increase employment in the country. It was seen as a means to attract more foreign trade and manufacturing industries. At that time

the refund rates were as high as the mark of 17 percent. The incentives offered by the ETRE policy have been a very influential instrument in encouraging exporting companies in China. However, when it comes to actually receiving the refund, many exporters have been left in the cold or waiting for many months (and some upwards of over a year) to receive their refund. With Chinese exports predicted to increase at an even faster rate over the coming years, the problem is only likely to get worse. These disadvantages are incurred by the nature of the Chinese ETRE system. Mainly depending on direct control, the imposed regulation is easy to bring interest conflicts. And the conflicts of interest need more direct control as well. Thus, to an imposed regulation, lack of stability is inevitable.

Table 4.2 Summary of Natures of the Two Systems

Organization	the ETRE System	Approach
<i>China(U-form dominated)</i>	<i>Imposed regulation</i>	<i>Weaker Incentive & More Direct Control</i>
<i>The EU(M-form dominated)</i>	<i>Voluntary agreement</i>	<i>Stronger Incentive & Less Direct Control</i>

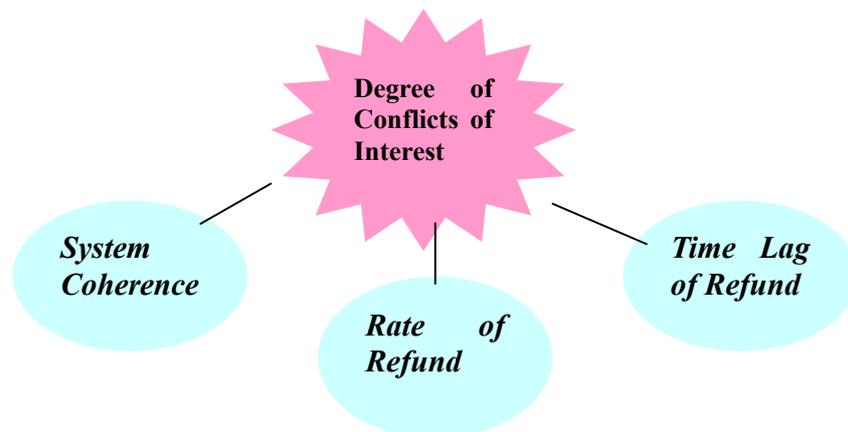
This section can be summarized as the *Table 4.2* above. The ETRE system in China is an imposed regulation. It is mainly due to the U-form dominated organization. A lot of direct control adopted during the whole building and implementing procedures of the ETRE system leads to the conflicts of interest within the Central Government, local governments and exporters. The consequence is the system lacks stability relatively. While the ETRE system in the EU is a voluntary agreement. The system is decided by the unanimity of all member states on a strong incentive basis. And the strong incentives are also brought by the ETRE system through its implementation, thus the conflicts of interest are hardly incurred. The system is stable comparatively.

4.4.4 Comparison of Conflicts of Interest from the Two Current ETRE Systems

The ETRE system, whether voluntary or imposed, is doomed to bring some conflicts of interest during its implementing procedure. If differences exist, the main difference is the degree of the conflicts. The reason for the conflicts is the implementation of an economic regulation always re-allocates or re-adjusts vested interests more or less. Likewise, the implementing ETRE system concerns the vested interests of stakeholders from different social levels. The relationship, between the ETRE system whether voluntary or imposed and conflicts in question, has been referred above. However, how to measure the conflicts are stronger and more or weaker and less is a little bit difficult. Below is a convinced qualitative analysis on the degree of conflicts through comparing three aspects.

To a great extent, whether the system is voluntary or imposed determines the contents of the associated ETRE system in different organizations. In the next, for the sake of disclosing the degree of conflicts, we will discuss the topic from three perspectives: the system coherence, the rates of refund and the time lag of refund (see *Figure 4.4*).

Figure 4.4 Three Main Aspects Reflecting the Conflicts of Interest in the ETRE System



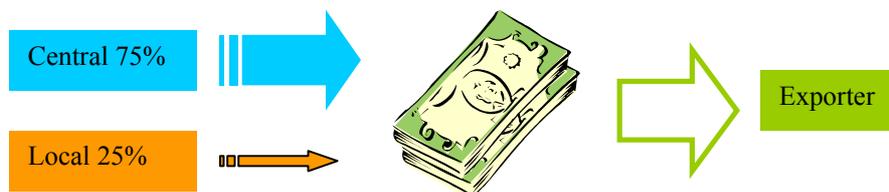
Conflicts of Interest from System Coherence

From the prior introduction of the two systems, we can find that the resource providers of

the tax refund are totally different. The provider in Chinese ETRE system is divided into two levels. One is the Central Government and another one is a certain local government. While, the providers of the ETRE system in the EU member states are in single level-the Central government.

In the ETRE system of the EU, the responsible body of fulfilling the task is fairly explicit; this is probably difficult to result in some conflicts between member states or different areas within a member state. It is each member state that has responsibility for its VAT levying, exemption and refund. Thanks to strong incentives during a procedure of gaining an agreement, almost all foreseeable interest conflicts can be smoothed over before the agreement being effective. Maybe, direct control is unnecessary within the organization in this circumstance.

Figure 4.5 Resource Providers in the Chinese ETRE System



While in the current Chinese ETRE system, refunds are shared by both the Central Government and local governments, although the central pays the major proportion, as shown in *Figure 4.5*. And which local government should take responsibility for a certain refund depends on the exporter where his firm registers. This stipulation supplied by the Central Government mainly took account of following explanations. The first is the financial ability of the Central Government. We have understood that the Central Government has owed exporters a large amount of refunds by the end of 2003. And the latest ETRE policy announces that this debt will be returned by the Central Government, simultaneously no new refund debt will be permitted. Because the central coffer cannot keep up with the growth of the ETRE like the past, the risk to it in the new process needs to be locked. The second is the tax-shared system in VAT. Since 1994, both the central

and local governments according to 75 percent to 25 percent share VAT in China. These two main reasons resulted in the stipulation.

The rule that both central government and local governments share refunds has incurred a series of interest conflicts. Which a certain local government should take responsibility for an associated refund just depends on the exporter where his firm registers regardless of industry chains. It is reasonless. Some export-oriented provinces will share a part of refunds that should be paid for by other provinces originally. Moreover, the change about responsible body for refunds before the reform and after the reform is dramatic. The old system has lasted over ten years. It may be more costly during the implementation of the policy; however, it is much more stable after implementation. Before the end of 2003, almost every local government did its best to encourage local enterprises to export due to the incentive—all refunds paid by the Central Government. At present, some export-oriented provinces are afraid of the rapid export growth of their local enterprises. Because the 25% of refund has become a heavy financial burden for local government, especially for those export-oriented ones where there are a great deal of exports. All of them have no help to develop economy.

In short, the refund-shared mechanism in China has incurred a series of conflicts of interest within the three parties: the Central Government, local governments and export enterprises. This is because of the lack of incentive from the Central Government to local governments in the payment of the refund. While in EU there are no such conflicts because of its single level of resource provider policy in the ETRE system created by strong incentives.

Conflicts of Interest from Rates of Refund

Depending on the discussion above, there is a balance between the taxation rate and the refund rate in the EU ETRE system. This means that the government refunds back the total amount of VAT that it taxed to exporters. While in China, the average refund rate of current policy is approximate 13% with the VAT rate 17% to all goods. It's not difficult to find that the taxation rate is 4% higher than the average refund rate, which means the

government gets a financial surplus in this point. This is quite different from the design of ETRE rates in the EU, where every member state gets zero VAT in this regard. This is a difference in nature of two rate designs.

The design of ETRE rates in the EU results in almost no conflict of interest between a government and associated enterprises in this regard. When an exporter sells goods to a member country or other non-member one, the VAT on these goods is exempted automatically. If some suppliers to this exporter declare that the materials for export have been levied VAT before, they will get refunds from their governments entirely. So enterprises in the EU hardly complain about their ETRE policies in this regard.

The current design of the refund rates in China is now making the Central Government facing more challenges.

First, because the growth in the tax refund volume is much faster than that of the National Finance Income and makes the government finance burden overloaded, the average refund rate is designed lower and lower than before and what's more, a lot of VAT levied in the production step before the export is not fully refunded though the VAT in the export step is deducted. Both of them cause the loss of profit to exporters and lessen the encouragement to exports. What makes the policy still possible to be implemented in China at present is the lower labor cost of China which may compensate some loss of profit for exporters and the centralized decision-making way in its ETRE system.

Second, the higher VAT rates and comparatively lower refund rates policy in China also weakens the competitiveness of export companies in the international market. Because the Chinese exports are not completely VAT free, while their EU rivals can always enjoy an export without any VAT.

Third, the current rates of refund cut in China creates extra VAT costs, which may have great unfavorable impact on the enterprises that have signed contracts with suppliers or

importers before the new policy. That is another cost for the instability of economic regulations.

Fourth, the calculation of the tax refund is very complicated and the ETRE system is changeable, which has incurred a good few complaints from relative enterprises, in particular potential investors.

Due to the four main problems in the design of the ETRE system in China, the rise of conflicts between governments and exporters becomes inevitable. Although the conflicts have not been strong enough to affect the China's export, the policy does create the weak incentive to exporters to some extent, which may finally affect the development of Chinese export-oriented economies. While in EU there are no such conflicts between the government and exporters because of its balance policy of the two rates in the ETRE system.

Conflicts of Interest from Time Lag of Refund

This part focuses on the discussion about the time lag of the two systems. A period in operating a concrete policy normally shows whether an organization is efficient or not. And it is very easy and direct to incur complaints about the ETRE system. In the EU ETRE system, the time lag of refund is very short after a refund declaration by an exporter if the export goods have been levied VAT. Comparing with that of the EU, the time lag of refund in China is unimaginably much longer, which can be lasted as long as more than one year or even far further.

The time lag of refund in the EU is very efficient. It can be proved by an example in Sweden. Normally, a Swedish exporter can get his tax refund no more than seven days after his declaration. An efficient ETRE system always benefits both exporters and taxation authorities. For the EU exporters, the direct exemption mechanism of VAT may not only contribute to the cash flows of export enterprises but also save them some operating costs. In the meanwhile, for the EU taxation authorities, it can save much direct control in organizing this policy. Therefore the period is favored by both relative agencies

and enterprises.

Compared with that in the EU, the period in China to cope with export refund is relatively inefficient. Although the Chinese Central Government has made a promise that the arrears will be return and the time lag of refund will be as efficient as possible, four factors existing keep the problem of refund inefficiency as the same as well. *Firstly*, for several coming years the Central Government will still have inadequate budgets to fill its ETRE hole, the payment periods of the 75% of refund from the Central Government will be still lasting long. *Secondly*, the local governments' inactiveness to the refund system is becoming stronger because the 25% of refund is also a burden especially for those in export-oriented economies. *Thirdly*, there is more than one government department involved in the ETRE operation. The Customs and local Administration of Taxation regulate foreign trade and export refund scheme. They often acquire a long declaring and verifying period of relative documents. *Fourthly*, the State Administration of taxation urged the tax authorities in charge of export refunds to expedite the process in the 2004 Export Refund Conference, but the condition of stipulating a special deadline only to exporters rather than to authorities involved has still not been changed.

The failure of timely settlement of tax refund and arrears influences firms' liquidity position and has impacted the normal production of export-oriented enterprises to a great degree. The inefficiency incurs another conflicts of interest between the government and exporters. On the contrary, in the EU, there are no such inefficiency and conflicts in its ETRE system.

After our discussing on the conflicts of interest above from the three main aspects, it is necessary to give a short summary about the degree of the conflicts. As to the ETRE system, system coherence, rate of refund and time lag of refund are its material components without doubt. Through the comparing them in the associated system, we have disclosed that the conflicts incurred in every aspect in the Chinese ETRE system is easier than that in the EU's. It is visible that the degree of the conflicts in China is more and stronger than that in the EU. And the history during the recent decades has witnessed

the stability of the two systems as well.

4.5 Case Study Conclusion

We have introduced and compared the Chinese ETRE system and the EU's ETRE system in detail, and have analyzed the causes result in the different stability of the two systems. After our comparing and analyzing about the two mixed-form organizations performing the same economic regulation—the ETRE system, we attempt to draw our conclusions. One is in theoretical perspective, while another is in practical.

A Short Interpretation Based on the Hypothesis

From the case, we have discussed the approaches adopted by the relative mixed-form organization within a whole process of an ETRE system, especially including building procedure and implementing procedure. The approaches were emphasized on incentive and direct control, especially on two combinations of incentive and direct control. The combination of strong incentives with less direct control can be found in the EU ETRE system, while the combination of weak incentive but much direct control can be found in the Chinese ETRE system.

The relationship between combination and stability of an economic regulation is obvious. The ETRE system in the EU is more stable than that in China. That is to say when a M-form dominated organization carries out an economic regulation conducting with combination of strong incentives and less direct control, the regulation will be more stable than that in a U-form dominated organization adopting the combination of weak incentive and much direct control. Theoretically, a manager must choose an appropriate combination of incentive and direct control to practice a regulation according to the characteristic of his organization.

If an organization gives weak incentive to an economic regulation, for example, in this

case, the Chinese Central Government asks the local government to share the responsibility of ETRE, and design relative low refund rates compared with the VAT rate, then it is predictable that the conflicts of interest will inevitably increase as an aftermath.

Obviously, the regulation that is decided mainly based on more direct control instead of incentives also needs more direct control to ensure its implementation, but these conflicts of interest cannot be smoothed by more direct control easily. A lot of imposed regulations are introduced by the Chinese Central Government, but complaints about the ETRE system exist as well.

On the contrary, if an organization adopts strong incentive instead of much direct control, like the EU, then conflict of interest will hardly arise, and the requirement of direct control will be less not only during its building procedure but also during its implementing procedure.

In order to make our conclusion more convinced, we can discuss another case very briefly--*agricultural reform in China and the former Soviet Union*. Agriculture reform in both countries was aimed at replacing collective farming by household farming. The success in China is due to its appropriately applying incentives and coordination. Thus, an economic regulation born by a U-form dominated organization is not doomed to be less stable. Another substantial factor is which kind of governing approach is adopted. The determinants of the stability of an economic regulation are not only organization form but also its governing approach.

All in all, the consequence is remarkable that the former, which is born by a M-form dominant organization on a strong incentive but less direct control basis, is more instable than the latter, which is born by a U-form dominant organization on a weak incentive but much direct control basis, even if continuously on such kind of basis during its implementing period.

A Possible Improvement for the Chinese ETRE System

Practically, both the two ETRE systems need to be further reformed, but the Chinese system may be more instable in the near future. There are more conflicts of interest in the Chinese ETRE system, and it will cause an increasing direct control from the Central government, if local governments cannot undertake the part of the responsibility any more. Below are some suggestions on the coming reform of the Chinese ETRE system.

The ETRE system is a task for different members, it is better to get it centralized as well as the VAT collection and sharing system. But the Central Government may have to redesign the entire taxation system simultaneously, because the incentive to the local government to develop manufacturing industry is very necessary.

The development of China is in a critical period of industrialization, and most infrastructures are still invested by the local government. Furthermore, most responsibilities for education and health care also go to the local governments, and it is hopeless to get the welfare system centralized, if the tremendous gap of development between the coastal area and the inland China cannot be narrowed in the years to come.

So there are two main challenges for further reform of taxation in China: 1) Because of the inefficiency of tax collection, the property tax in China has not been started to levy and the personal income tax are also difficult to collect. It makes the Chinese local governments difficult to find an alternative revenue source. 2) Because of the lack of central government revenue, the Chinese local governments have to keep arranging the differentiated local welfare systems independently. Considering the size of China, the Chinese local governments are certainly more sensitive to the demands of local people.

The two challenges are entangled all the way. Today is the age of globalization, and such challenges become more complicated for the ETRE issue in the international context.

Thus, China maybe needs a comprehensive taxation reform to deal with the dilemma of the ETRE system.

In the coming reform, it has to be taken account that strong incentive is more useful than much direct control. That means the incentives for the local governments should not be weakened during the industrialization. Of course, it should depend on the momentum of economic growth.

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Appendix

The new VAT refund rates by major exported goods categories

Exported goods	Before (1/12004)	After (1/12004)	Change
Agricultural products with a current VAT export refund rate of 5% (e.g., soybeans)	5%	5%	0%
Agricultural products with a current VAT export refund rate of 13% (e.g., cotton); industrial products processed with agricultural products as raw materials with VAT export refund rate of 13%; goods with an export refund rate of 13%	13%	13%	0%
Goods with the current refund rate of 17%	17%	17%	0%
Wheat and maize flour, meat and edible offal of ducks, rabbits and hares, etc.	5%	13%	+8%
Products derived from natural resources, coke and semi-coke of coal, light-burned and dead-burned (sintered) magnesite, feldspar, talc, steatite, etc.	13%,15%, 17%	5%	-8%~ -12%
Products derived from natural resources: unwrought aluminum, yellow phosphorus and other phosphorus, unwrought nickel, molybdenum ores and concentrates, etc.	13%,15%	8%	-5%~ -7%
Petroleum; unwrought zinc; coal and chemical fertilizers, etc.	13%,15%, 17%	11%	-2%~ -6%
Certain electronic machinery; clothes and textiles etc.; certain iron or steel articles, small hardware, organic or inorganic chemical materials, plastic-ware, toys, shoes, clocks and watches, ceramics and porcelain, fiber, rubber-ware, sports products, leather craft, travel utilities and luggage, etc.	15%,17%	13%	-2%~ -4%
Products derived from natural resources: crude oil, wood, paper pulp, goat wool, eel fry, ore of rare earth metals, phosphorus ores, natural graphite, etc.	5%,13% 15%,17%	0%	-5%~ -17%

Source: The Hong Kong Account, February 2004, pp62