

China Thrives Despite Corruption

by Shaomin Li and Judy Jun Wu

It is commonly believed that corruption distorts the allocation of resources by diverting much-needed capital from economic development into corrupt officials' pockets. Thus high-level corruption in a country is considered detrimental to its economic growth. However, some countries such as China have achieved rapid economic growth in spite of rampant corruption.

Corruption allowed the late President Ferdinand Marcos of the Philippines and his pals to pocket between \$3 billion to \$6 billion.

Both public-opinion polls in China and surveys by international organizations confirm that the level of corruption in China is deeply rooted and widespread. However, in spite of this endemic corruption, the Chinese economy has been growing rapidly, with an average annual growth rate of approximately 10% over the last 20 years. China is not alone; there are other countries that show similar patterns, mostly in East Asia.

This poses a puzzle: Is corruption really detrimental to economic growth? More specifically, why does corruption seem to be more harmful to some countries and less harmful to others in terms of economic growth?

Some researchers have made the "efficiency enhancing" corruption argument. Under a political and economic environment where regulations are extremely rigid and antibusiness, bribery may serve as lubricant to circumvent stifling regulations and thus help economic performance. But the researchers have failed to further specify why some countries tend to enjoy this "efficiency enhancing" effect while others do not.

Our study sheds light on this issue. We argue that a major factor that may systematically distinguish countries with predominantly "efficiency-enhancing" corruption from countries with predominantly "predatory" corruption is the level of public trust in a society, namely, trust between strangers. In a society with a high level of public trust, corruption tends to be efficiency-enhancing, or less harmful to economic growth, whereas in a society that lacks public trust, corruption tends to be more predatory and more harmful to economic growth.

This seems to violate common sense, since trust is viewed as one aspect of moral behavior, while corruption is the antithesis of morality. So why would trust be important in corruption?

Trusting Souls

Corruption is illegal in all societies, at least on paper. Thus an important factor in taking bribes is the risk of being caught. Trust is important in bribery-corruption relationship because of the time lag and geographic separation between the bribe payment to the corrupt official and the delivery of the public good to the briber. This is especially true in large-scale corruption involving government contracts or market access worth hundreds of millions of dollars, as opposed to petty corruption that can be accomplished on the spot, such as paying a police officer to cancel a traffic ticket.

Should the briber pay first, or should the official deliver the goods first? If there exists a high level of trust between the briber and the official, timing is less of a concern. Otherwise, the deal cannot be done since there is very little legal protection for bribery-corruption relationships. Furthermore, without trust, there is a high risk that the briber may turn the official in or blackmail him.

Suppose there are two types of societies in terms of the level of public trust: Society A has a very high level of public trust, whereas society B has virtually no public trust. In society A, where strangers tend to trust each other, corrupt officials would feel comfortable taking bribes from almost anyone, because the likelihood of being turned in by the briber is very low. Furthermore, whether the briber pays first or the official delivers first is not a major issue, since they trust each other. Thus it can be logically argued that in society A, there is an extensive and efficient bribe-taking corruption market; corrupt officials sell the public goods—contracts, profitable information, or market access—to the highest bidder who has the most efficient business operation. Bribers pay and officials deliver, creating “efficiency-enhancing” corruption.

In society B, people are highly suspicious of each other, and therefore corrupt officials will only accept bribes from people they know well, such as their relatives and longtime friends. In these close relationships, the time lag between payment and delivery is not a big problem. But such transactions are limited to only a small number of people, meaning that the corruption is likely to distort the allocation of resources away from those people who could make the most efficient use of them.

Moreover, if corruption is rampant in society B, it implies that corrupt officials must extract bribes from strangers. But with strangers, the time lag and geographic separation (such as paying bribers in one city and delivering the goods in another city) becomes a difficult issue. Since there is little trust and thus no guarantee that the official will deliver, the potential bribers are not willing to pay up front.

Likewise, the official will not deliver without payment first. The likelihood of bribe-taking is further reduced because there is a risk of being turned in by the briber. If corruption is rampant in such a society, then it implies that officials control most resources and have absolute authority to extract payment from ordinary citizens and businesses. Such corruption is predatory, a pure extortion that does not deliver.

What countries tend to have higher levels of public trust? Research suggests that public trust is built during a long history of informal networks between people in social, economic, and political exchanges.

Based on the above analysis, in countries with a more expansive and thicker social network, as reflected in the higher level of public trust, bribery-corruption relations tend to be more extensive (more people participating) and efficient in the sense that the briber pays and the corrupt official delivers what the briber wants, facilitating business activities and thus economic growth.

In contrast, in countries with a weak social network, as evidenced by a low level of public trust, bribery-corruption relations tend to be limited to a small number of related people (family members or friends), who may not necessarily be the most efficient users of the public goods they receive as a result of their bribes. Under a low level of public trust, the bribe payment by strangers will degenerate into extortion, producing a net loss to the briber and no efficiency gain for the economy.

The case of China and the Philippines will illustrate our argument. As shown in the table nearby, both countries have similar scores in terms of the perception of corruption, but display wide differences in the level of public trust and economic growth rate. China had a much higher rate of GDP growth than the Philippines in the 1990s, and the Chinese public expresses a massively greater degree of trust than is found in the Philippines. What can explain this?

Unwritten Rules

China is best known for its culture and practice of *guanxi*. *Guanxi* refers to the informal social networks based on the private relationships among people. It functions as a relation-based governance system that provides a private means to facilitate and protect economic transactions.

Game theorists show that without initial trust, even repeated games may not work well since each party may be afraid that the other party may take advantage of his trust. In a relation-based society with a high-level of public trust, the likelihood of cooperation between strangers is high so that a potential briber and a prospective corrupt official can make a deal quite quickly.

The bribery-corruption relationship in China closely resembles such conditions of high public trust. In China, due to the monopoly of most economic resources by the government, corruption is rampant. The widely accepted view in China is that “power cannot be deposited in a bank, so you had better profit from it while you can.” Furthermore, the strong and thick social network allows the bribery-corruption relationship to extend beyond family and friends.

In China it is common that a businessman may need special help from a government department. He would likely go around asking all his friends if they might know someone

in that department. Very likely, one of the friends would say, “I don’t know anyone there directly, but my sister-in-law has a co-worker who knows someone who has a student who is the son of a senior official in that department.” In a society with low trust, such an indirect relationship would be deemed too risky to discuss bribes. But in China, many bribery-corruption relationships can be established in just this way, due to its strong guanxi culture.

This high trust can be seen even from the behavior of foreigners in China. Ethan Gutmann’s book *Losing the New China* quotes a multinational executive explaining how his firm would give a large “slush fund” to a consultant to pay bribes in China: “The terms of the deal was...a \$10 million discretionary fund. Hands off, no questions asked. Don’t ask [the consultant] where the money goes....We know exactly what he was up to, and exactly how successful he would be....”

According to *Takungpao*, a Chinese government newspaper, bribers and corrupt officials in China have taken the art of corruption to the next level. One of the new features can be called the “globalization” of bribery. Bribes are paid not in China, but outside of China, in the form of luxury homes, bank accounts, or gambling trips. Obviously these activities and assets are exchanged outside of China to reduce the risk of being caught. But the geographic and temporal separation of payment and delivery also means that there has to be a high level of trust between the briber and the official.

Perhaps the most innovative feature of corruption in China is that it has taken the form of futures options: The briber and the official often develop a mutual understanding that the incumbent official will help the briber now but will not be paid immediately. Years later, when the official is retired, the briber will pay him in some way. Obviously, this arrangement substantially reduces the risk of being caught. Again, without such a high level of trust, the corrupt official will not choose this option.

Corruption in the Philippines

The case of the Philippines is very different from that of China. A major type of corruption in the Philippines, at least historically, was that the state head would control entry into an industry or simply monopolize it, and impose a tax or surcharge on all the products of the industry or extract a fee for entering the industry. The state head would appoint one of his cronies to be in charge of the industry and steal all the collections from the state coffers. To the private sector payers, these taxes, surcharges or fees, are nothing more than robbery, a deadweight loss in the economic sense. The collecting officials simply impose the fees on the payers, without facilitating or helping any business activities. Furthermore, the victim of the corruption, the payers, would have no evidence with which to turn in the official collector, because the latter is simply carrying out a state order.

Several cases of major industries in the Philippines demonstrate such a corruption pattern. In the coconut sector during the 1970s (accounting for roughly 25% of Philippines’ export income), former President Ferdinand Marcos imposed a tax on all

sales of coconuts and copra. The agency in charge of collecting this tax was headed by his close friend Manuel Cojuangco. Mr. Cojuangco then used the extorted money to buy banks, which in turn funded his acquisition of many coconut-oil pressing mills. Then he put all the tax money into a fund and used the fund to subsidize the mills he and Marcos controlled.

There is a similar corruption pattern in the cigarette industry. In 1975, President Marcos imposed a 100% import duty on cigarette filters, but gave a special 90% import-duty reduction to the Philippine Tobacco Filters Corporation, a company owned by one of his close friends, Herminio Disini. Mr. Disini in turn supplied the filter at below-market prices to Fortune Tobacco, a major cigarette maker owned by another Marcos ally, Lucio Tan. Together they drove the competition out of market and monopolized the cigarette industry.

In the sugar industry in 1974, Marcos ordered that all sugar exports be monopolized by the Philippine Exchange Company, which was controlled by his college friend Robert Benidicto. With the blessing of Marcos and subsidies from state funds, Mr. Benidicto manipulated sugar prices for his own profits at the expense of Philippine sugar farmers and producers.

In all these corruption cases, there was little cooperation between the briber (the payer of the surcharges, entry fees, and other types of extortions) and the corrupt official. The briber was forced to pay, and the official did not enhance the efficiency of the briber's business. It is estimated that through these extortions, Marcos and his associates amassed assets valued at between \$3 billion to \$6 billion.

A statistical test using cross-sectional data from 42 countries supports our view: The negative effect of corruption on economic growth is mitigated by a higher level of public trust in a country. In general, a one percent increase in the trust level will decrease the negative effect of corruption by 0.23%.

What can the reader take away from this study? First, we are not saying that corruption is good. Corruption has a negative effect on economic growth in all countries. However, this negative effect may be reduced when corruption interacts with a higher level of social trust. Second, since the briber and the corrupt official both benefit, the briber has little incentive to turn in the corrupt official, making corruption difficult to detect.

In general, the high level of trust in societies with predominantly "efficiency enhancing" corruption implies that cleaning up corruption is very difficult. A strong and thick social network makes it very hard to encourage "whistle blowing." If this logical conjecture is true, then the prospects for eradicating corruption in highly relation-based countries like China are not good.

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