

# Incentives and Corruption in Chinese Economic Reform<sup>\*</sup>

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This paper argues that, given the legacy of Chinese communism and its political structure, corruption, together with the threat of punishment for corruption and the selective enforcement of this threat, serves as a method of compensation that both satisfies the political objectives of the Communist Party and provides an effective inducement to local officials to promote economic reform.

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Many observers have suggested that a large part of the success of the Chinese economic reform is attributable to the transformation of the typical local government official from being an unproductive political entrepreneur prior to reform to being a productive economic entrepreneur after reform. As Weiying Zhang and Gang Yi (1996) point out,

Many reform programs have been initiated by locals and even by the grass-roots, and then recognized and adopted as national policies by the central government. Much of the planning system was dismantled by locals. Many locals have been far ahead of their national leaders in reforming the economy.

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Emphasizing the initiatives of local officials, Kang Chen, G. Jefferson, and I. Singh (1992) characterize economic reform in China as being both a top-to-bottom and a bottom-to-top process.

At the same time, and apparently paradoxically, both Chinese and foreign observers report that economic reform in China has been associated with an epidemic of corruption among local government officials. Melanie Manion (1997, page 34) observes that "of the 54 countries ranked by the Berlin-based public interest organization, Transparency International, according to the prevalence of corruption in 1996, China ranked 50th: corruption was judged more pervasive only in Bangladesh, Kenya, Pakistan, and Nigeria."

Taken together these observations are puzzling. How can pervasively corrupt local officials be the key to the success of economic reform? Furthermore, why do the Chinese authorities tolerate widespread corruption among those agents whose performance is essential to economic reform?

This paper attempts to answer these questions. We first elaborate on why the actions of local officials have been critical in China's economic transition. Then we explore how local officials have been motivated to promote economic reform and why the Chinese authorities are willing to live with this way of motivating local officials. Our analysis will develop the following hypothesis: *Because of the legacy of Chinese communism and its political structure, corruption, together with the threat of punishment for corruption and the selective enforcement of this threat, serves as a method of compensation that both satisfies the political objectives of the Communist Party and provides an effective inducement to local officials to promote economic reform.*

In arguing that selective toleration of corruption "works", we are not claiming either that all of the widespread corruption that we observe in China is instrumental or that corruption is not to some extent incidental, in the sense of being a concomitant of economic reform that is beyond the power of the authorities to prevent without incurring large costs. We also are not claiming that selective toleration of corruption is an optimal method of compensation, either from the perspective of the Chinese authorities or from the perspective of the average Chinese person. But, we are claiming that, whether the adoption of the policy of selective toleration of corruption was active or passive, there are good reasons for the Chinese authorities to live with this policy.<sup>1</sup>

The idea that corruption can facilitate economic development is not new.<sup>2</sup> But, although the literature discusses various positive effects of tolerating corruption, it does not address the question of why the authorities live with a policy of selectively tolerating corruption, when feasible alternatives presumably exist. Writing about contemporary China, Howard Davies (1995, page 165) points out that

“opportunities for corruption arise to a very great extent because of the administrative controls which still remain in the Chinese economy and because the government of the PRC has not yet established mechanisms for preventing the abuse of these controls”. Still, the question remains of why the Chinese authorities have not eliminated the conditions that breed corruption among local officials.

### **The Dual-Track Economy and the Role of Local Officials**

Although recognition of the efficiency of a market economy relative to central planning was an important motivation for the initiation of economic reform in China, the Chinese have not as yet completely eliminated central planning as a coordination mechanism for production and exchange. Instead, China has adopted a dual-track economy (*Shuang Gui Zhi*), which involves the coexistence of central planning with a market mechanism for the allocation of resources. Olivier Blanchard and Michael Kremer (1997) argue convincingly that the dual-track economy, preserving elements of central planning, has helped China to maintain economic growth during the transition to a market economy. Blanchard and Kremer sharply contrast China's smooth transition to the “disorganization” and associated collapse of production during the transition to a market economy in the states of the former Soviet Union. Lawrence Lau, Yingyi Qian, and Gérard Roland (2000) argue further that the dual-track economy has provided a way to compensate potential losers from economic reform in China.

A critical legacy of central planning in China, which remains important in the dual-track economy, is *Guanxi* arrangements, whereby “personal connections” among government officials and firm managers control the allocation of resources. Under *Guanxi* firm managers have to maintain good relations with relevant government officials and managers of other firms to ensure the provision of supporting resources (e.g. electricity, water, etc.) and the timely delivery of necessary raw materials and intermediate goods. Davies (1995) describes how *Guanxi* has evolved in China as a response, rooted in Chinese culture, to an underdeveloped system of property rights and contract law.

In this environment the transformation of local officials from unproductive political entrepreneurs to productive economic entrepreneurs has been critical to the success of Chinese economic reform for two apparent reasons: First, because government officials had the highest social and economic status prior to reform, they are likely to include some of the most talented people in China. Second, in the

dual-track economy, especially with the continued importance of *Guanxi*, local officials continue to play an critical role in coordinating production and exchange.

In post-reform China local officials are often *de facto* managers. For example, Jean Oi (1995, 1998) thinks the role of local officials in the economy is so important that she terms China's current political-economic system "local state corporatism". As Oi observes (1995, page 1132),

The state responsible for much of this growth is *local* governments that treat enterprises within their administrative purview as one component of a large corporate whole. Local officials act as the equivalent of a board of directors and sometimes more directly as the chief executive officers.

In another provocative study entitled "Local Governments as Industrial Firms," Andrew Walder (1995) argues that local officials in China's dual-track economy and corporate hierarchies in a market economy play similar roles in coordinating production and exchange.

Oi claims further that, in response to the new incentives associated with Chinese economic reform, local officials not only improved their efficiency in coordinating production and exchange, but they also began actively to play some new roles.<sup>3</sup> According to Oi (1995, pages 1139–1140),

Within a local corporatist context local officials turn the administrative bureaucracy – of which they are part – into a free channel for information and resources to facilitate market production... Using information and contacts that they develop beyond the locality through their routine conduct of administrative work, local officials can provide an array of essential services to their local enterprises. This might include raw materials, but increasingly, it has become important for information about new products, technology and markets for finished goods... Local cadres use their expansive connections and bureaucratic position to secure information that will serve local economic growth...

## **What is Corruption?**

It is important to be clear about how we are defining corruption. On our definition corruption is, in the words of Melanie Manion (1997), "the use of public office to pursue private gain in ways that violate laws and other formal rules."

We use this legalistic definition for three reasons: First, this definition accords with everyday language. Second, this definition is used in the compilation of data and is implicit in quantitative observations about the amount of corruption. Third, and most importantly, this definition does not prejudge the economic consequences of corruption.

Instead of our legalistic definition many authors implicitly adopt an economic definition that equates corruption with purely unproductive rent-seeking activity.<sup>4</sup> By abstracting from the positive incentive effects that we emphasize, these authors presuppose that corruption has only a negative effect on economic performance. In contrast, without denying that some of the corruption that we observe in China involves unproductive rent seeking, we want to allow for the possibility that corruption also includes practices that enhance productivity. Our legalistic definition of corruption, which accords with everyday speech and with measures of corruption, does not preclude the conclusion that tolerance of corruption can promote economic reform and improved economic performance.

Manion (1997) associates corruption in China with two general practices: One practice involves local officials who exploit their positions to extract bribes or to arrange nepotistic favors. This practice is often referred to as *tanwu shouhui* in Chinese. The other practice involves local officials who misappropriate public property or public funds for personal benefit. Examples include the use of public property or public funds to obtain lavish housing and fancy cars or to travel abroad. This practice is often referred to as *nuoyong gongkuan* in Chinese.

### Corruption as a Method of Compensation

What has motivated local officials to become efficient economic entrepreneurs? More completely, what have been the incentives for local officials to promote economic reform, and what has been the system of rewards and punishments through which these incentives have been implemented?

Some recent literature argues out that a positive relation between the economic performance of a region and local tax revenue provides local Chinese officials with incentives to promote economic reform and growth. For example, Susan Shirk (1993) claims that "fiscal decentralization is the 'cornerstone' of China's economic reform." In an interesting comparative study, Roger Gordon and David Li (1997) claim that local officials have much more strongly supported new non-state firms in China than in Russia, because local governments can obtain revenue from taxes on new entrants in China, but not in Russia.

The existing literature, however, does not adequately address the critical question of how local officials themselves benefit from the increased revenue in their administrative region. Although Oi, Walder, and other observers emphasize the role of local officials in coordinating production and exchange and in providing information about new products, technology, and markets, their writings do not explain how the Chinese local officials are compensated for these essential services.

As Jane Duckett (1996) stresses, Chinese local officials are not allowed to moonlight as formal employees of firms. Then how do the firms compensate these officials? Two practices suggest themselves: the extraction of bribes or nepotistic favors (*tanwu shouhui*) and the appropriation of public property or public funds for personal benefit (*nuoyong gongkuan*). Both of these practices are forms of corruption. In fact, fiscal decentralization facilitates both of these forms of corruption, and the Chinese authorities have vigorously promoted fiscal decentralization. Both of these observations are consistent with our view that much of the corruption that we observe in China is instrumental.

## **The Economic Function of Corruption**

Does selective toleration of corruption provide an effective inducement to local officials to promote economic reform? To motivate local officials, who are its agents, the Chinese central government, as principal, would like to reward behavior that contributes to good economic results and to punish behavior that contributes to bad economic results. But, the central government cannot perfectly monitor the efforts of local officials. Given their better access to information, local officials often are able to conceal from the central government that a good outcome resulted from good luck rather than from extra effort or that a bad outcome resulted from poor effort rather than from bad luck. Local officials naturally will exaggerate both the importance of their efforts in producing a good outcome and the importance of bad luck in producing a bad outcome.

As Daron Acemoglu and Fabrizio Zilibotti (1996, 1999) argue, the problems of incomplete information and asymmetric information between principal and agent, which complicate many principal-agent relations, are probably even more severe in poor and developing economies like China than in Western economies. The extensive literature on the principal-agent problem generally concludes that, although incomplete and asymmetric information complicates the design of incentive schemes, Western economies have invented and implemented methods of compensation that work reasonably well to motivate agents. As this literature

explains, incomplete and asymmetric information lead the principal both to decentralize the determination of compensation and to share the profits and losses of the enterprise with the agent.<sup>5</sup>

The important observation is that in China the use of corruption as a method of compensation embodies a decentralized compensation scheme and a sharing of profits and losses in much the same way as methods of compensation implemented in Western economies. Corruption, whether in the form of *tanwu shouhui* or *nuoyong gongkuan*, mitigates the problem of measuring and monitoring economic performance because those local officials who make the largest economic contribution are likely to be able to extract the largest bribes or nepotistic favors or to have the most valuable public property to appropriate. Also, the compensation that local officials obtain through corruption, particularly in the form of bribery, is paid directly by local firms, which have the best information on the performance of local officials.

Importantly, the Chinese authorities have eschewed the explicit implementation of methods of compensation commonly used in Western economies to solve the problems of incomplete and asymmetric information. Nominally the incomes of local officials are fixed and unrelated to their performance. The fact that the Chinese authorities have not instituted any alternative mechanism for providing appropriate incentives to local officials is consistent with our view that much of the corruption that we observe in China is instrumental.

### **Political Advantages of Corruption as a Method of Compensation**

That selective toleration of corruption is a workable solution to the problems of incomplete and asymmetric information by itself does not explain why the Chinese authorities are willing to live with this policy. It is also important that political considerations mitigate against the implementation in China of incentive schemes and associated methods of compensation used in Western economies.<sup>6</sup> These political considerations are both a legacy of the strategies adopted by the Chinese Communist Party in establishing its rule and a product of the Party's goal of maintaining its cohesiveness and absolute political power, which continue to yield large benefits to Party members.

Most importantly, using selective toleration of corruption as a method of compensation creates a situation in which the Party hierarchy always "has something" on most Party members and local officials. As Susan Shirk observes (1993, page 144),

Because an individual knows that higher-ups could charge him with corruption at any time, lack of exposure is in effect special treatment for which the official gratefully exchanges his political support.

Using selective toleration of corruption as a method of compensation enhances the control of the Party hierarchy over Party members and local officials and helps the Party hierarchy to maintain its political power while it is decentralizing economic decision making.

Other political considerations also may be relevant. For example, Party propaganda has always claimed that every member of the Chinese Communist Party is a selfless “public servant of the people”. Even today the Party’s General Secretary, Jiang Zemin, admonishes his compatriots “to learn from the selfless example of Lei Feng”. An explicit system of material incentives and rewards for local officials, most of whom are Party members, would be inconsistent with this propaganda and with the myth of the benevolent nature of the Party.

In addition, although many government officials and Party members play important economic roles in China’s dual-track economy, many others, including many of those connected with the army, are responsible only for political, military, and other non-economic activities. An explicit system of material incentives and rewards for economic performance would undermine the political and social standing of those government officials and Party members who are not involved in economic activities. The Communist Party, like any political organization, is a potentially fragile coalition, and jealousy and discontent, especially in the army, would threaten its cohesiveness. The use of selective toleration of corruption as a method of compensation, by avoiding explicit compensation of local officials for good economic performance, helps to preserve the political and social standing of those government officials and Party members who are not contributing directly to the success of economic reform.

## **Punishment of Corruption**

Manion (1997) provides a detailed description of the apparent efforts of the Chinese central government to control corruption. Although Manion confirms reports of severe punishment, and even execution, of corrupt officials, she also confirms the observation that enforcement of anticorruption measures has been highly selective. As Shirk points out (1993, pages 143–144), “Despite all the talk about corruption, Party and government leaders have punished few corrupt officials.”



The threat of punishment for corruption together with the selective enforcement of this threat apparently serves two purposes. First, with fiscal decentralization and with corruption as a method of compensation local officials proximately determine their own compensation. To make this system work effectively the Party authorities must deter local officials from being excessively corrupt – that is, from appropriating for themselves more than the amount to which they are entitled. Second, in order for the use of corruption as a method of compensation to enhance the Party's hierarchical control structure, the Party authorities must show that they are willing to punish any corrupt official whose political allegiance has become suspect.

If selective toleration of corruption is to provide appropriate incentives, then it must be the case that the more effort that a local official makes to promote good economic results the less likely he is to be punished for corruption. There are reasons to expect the administration of punishment for corruption to work in this way. Most importantly, the more income that an efficient but corrupt local official generates for his region, the more valuable he is to the citizens of his region and to the central government, both of whom share in this prosperity, and the greater is the chance that any potential replacement for this corrupt local official will not perform as well. Thus, even if a local official's corrupt behavior is revealed, the better is the economic performance of his region, the more likely that the central government will abstain from punishing him, beyond perhaps a slap on the hand. In contrast, corrupt local officials who seem easily replaceable, or, more generally, whose corrupt behavior is out of proportion to their perceived value, are likely to be the hapless victims of crackdowns on corruption.

In addition, the more income that an efficient but corrupt local official generates for his region, the more he can appropriate for himself while still leaving enough fruits of progress for ordinary people to assuage their natural jealousy of his privileged position. Accordingly, the better the economic performance of his region, the less likely are ordinary people to squeal on a corrupt local official or to complain about him. In contrast, a corrupt local official whose region's economic performance is poor is likely to encounter popular pressure to punish him. In sum, although, as Shirk notes (1993, page 144), "Laxity toward official corruption can be viewed as a side payment to officials to give them a personal stake in reform", selective punishment of corruption is essential to both the credibility and efficiency of the use of corruption as a method of compensation.

## **Future Prospects**

Our analysis of selective toleration of corruption as a method of compensation in China has focused on the strategic interactions between Party authorities, acting through the central government, and the local officials who, given the legacy of Chinese central planning, are effectively responsible for promoting economic reform. We have viewed the central government as the principal who determines the compensation scheme for local officials. The main implication of our analysis has been that corruption, together with the threat of punishment for corruption and the selective enforcement of this threat, serves as a method of compensation that both satisfies the political objectives of the Communist Party and provides an effective inducement to local officials to promote economic reform.

As evidence for our claim that much of the corruption that we observe in China is instrumental rather than incidental, we have pointed to three other aspects of Chinese economic policy that complement and support the use of corruption as a method of compensation. First, the Chinese authorities have actively promoted the fiscal decentralization that creates the opportunity for corruption by local officials. Second, the Chinese authorities have not instituted any alternative mechanism for providing incentives to local officials. Third, the enforcement of anticorruption measures, including punishments for corruption, has been highly selective.

What does our analysis imply for the future course of China's economic reform? The credibility and effectiveness of a compensation scheme that involves the threat of punishment for corruption and the selective enforcement of this threat depend critically on both the central government's reputation for reliability and its survival probability. If the survival prospects of the current central government were to become uncertain, and if local officials were to anticipate that regardless of their economic performance they have a substantial probability of being replaced as a result of political changes, then the threat of punishment would be unlikely to deter them from engaging in excessive corruption. This observation suggests that the success of the Chinese model of economic reform, a model that is itself a product of the Communist Party's goal of maintaining its cohesiveness and absolute political power, has depended on the Party's ability to achieve this goal. If the future brings threats either to the stability of the Party's hierarchy or to its monopoly of political power, then China will have to find another way to support economic incentives and to maintain economic growth during the transition to a market economy.

In any event, there is widespread agreement that China's current dual-track economy is a transitional state that will evolve in the future into a predominantly market economy. But, as we have observed, selective toleration of corruption as a method of compensation is associated with the critical role played by local officials in the dual-track economy. Presumably, the evolution towards a market economy will imply a decrease in the importance of *Guanxi*, an associated decrease in the economic importance of local officials, and a transition to methods of compensation similar to those implemented in Western economies. China's prospective entry into the World Trade Organization is likely to accelerate these tendencies. How economically and politically disruptive these changes will be remains to be seen.

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### *Endnotes*

1. In contrast to some literature - see, for example, Abhijit Banerjee (1997) - our analysis does not assume that the authorities have limited ability to punish corruption. We rationalize tolerance of corruption without assuming that the authorities, by imposing sufficiently severe penalties on enough corrupt local officials, could not eliminate all or most corruption.
2. Samuel Huntingdon (1968) is a classic reference. Francis Lui (1985) provides an example of a formal model of the benefits from corruption.
3. For other relevant studies of enterprise management in China, see Andrew Walder (1998), Jane Duckett (1996), and David Li (1996).
4. See, for example, Dan Usher (1992), Andrei Shleifer and Robert Vishny (1993), and Isaac Ehrlich and Francis Lui (1999).
5. Edward Lazear (1995) provides a comprehensive survey of this literature.
6. In contrast Daron Acemoglu and Thierry Verdier (1998) suggest a purely economic rationale for the existence of corruption in the presence of asymmetric information. In their model corruption is incidental, in the sense of being too costly for the authorities to prevent, rather than instrumental.