

THE ECONOMICS OF CORRUPTION AND CRONYISM
— **AN INSTITUTIONAL APPROACH**
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ERIM REPORT SERIES <i>RESEARCH IN MANAGEMENT</i>	
ERIM Report Series reference number	ERS-2001-83-ORG
Publication	December 2001
Number of pages	27
Email address corresponding author	bkrug
Address	Erasmus Research Institute of Management (ERIM) Rotterdam School of Management / Faculteit Bedrijfskunde Erasmus Universiteit Rotterdam P.O.Box 1738 3000 DR Rotterdam, The Netherlands Phone: +31 10 408 1182 Fax: +31 10 408 9640 Email: info@erim.eur.nl Internet: www.erim.eur.nl

Bibliographic data and classifications of all the ERIM reports are also available on the ERIM website:
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REPORT SERIES RESEARCH IN MANAGEMENT

BIBLIOGRAPHIC DATA AND CLASSIFICATIONS		
Abstract	<p>Moral outrage was the response of the Chinese press, when Cheng Kejie, one of the country's highest officials, Vice-Chairman of the Standing Committee of the National People's Congress (NPC) and former Governor of the Guangxi Zhuang Autonomous Region, was arrested on grounds of corruption on 25 April 2000. Cheng's arrest came amidst a spate of serious corruption cases that reached into the top echelons of China's state leadership (China Aktuell 2000). His case attracted wide public attention in national and international Chinese media because of his high office, the number of officials implicated, and the involvement of his lover Li Ping (dubbed the 'Jiang Qing of Guangxi' by the Hong Kong and overseas Chinese press) (Ming Pao 2000), daughter-in-law of his predecessor in the position of Governor of Guangxi, and for years the most influential woman in Guangxi. This was not just a case of a local official embezzling public funds, but a story of love and greed of a popular political leader, who had achieved much for his province. This was also not the story of an anonymous mistress, but of an ambitious, intelligent and attractive woman using the position of first her father-in-law then her lover to systematically and on a long-term basis exploit the powers vested in the office of provincial governor. The accusation against them focused on three crimes: appropriation and sale of real estate development and construction rights, sale of publicly subsidized goods at market prices and promotion of trusted allies into official positions of power. While the personal details of his deeds and his final execution in September 2000 fascinated the Chinese and Hong Kong press, his case also demonstrates how corruption works in China today (Hendrischke 2001).</p>	
Library of Congress Classification (LCC)	5001-6182	Business
	5546-5548.6	Office Organization and Management
	5548.7-5548.85	Industrial Psychology
	HV 6295.CHINA	Offenses against the government
Journal of Economic Literature (JEL)	M	Business Administration and Business Economics
	M 10	Business Administration: general
	L 2	Firm Objectives, Organization and Behaviour
European Business Schools Library Group (EBSLG)	K 42	Illegal Behavior and the Enforcement of Law
	85 A	Business General
	100B	Organization Theory (general)
	240 B	Information Systems Management
Gemeenschappelijke Onderwerpsontsluiting (GOO)	2 B	Public administration
	Gemeenschappelijke Onderwerpsontsluiting (GOO)	
	Classification GOO	
Keywords GOO	85.00	Bedrijfskunde, Organisatiekunde: algemeen
	85.05	Management organisatie: algemeen
	85.08	Organisatiesociologie, organisatiepsychologie
	89.59	Politieke processen
Free keywords	Bedrijfskunde / Bedrijfseconomie	
	Organisatieleer, informatietechnologie, prestatiebeoordeling	
	Corruptie, China, Overheid	
Free keywords	Corruption, China, Governance	

THE ECONOMICS OF CORRUPTION AND CRONYISM - AN INSTITUTIONAL APPROACH

Barbara Krug and Hans Hendrischke

1. Introduction

Moral outrage was the response of the Chinese press, when Cheng Kejie, one of the country's highest officials, Vice-Chairman of the Standing Committee of the National People's Congress (NPC) and former Governor of the Guangxi Zhuang Autonomous Region, was arrested on grounds of corruption on 25 April 2000. Cheng's arrest came amidst a spate of serious corruption cases that reached into the top echelons of China's state leadership (China Aktuell 2000). His case attracted wide public attention in national and international Chinese media because of his high office, the number of officials implicated, and the involvement of his lover Li Ping (dubbed the 'Jiang Qing of Guangxi' by the Hong Kong and overseas Chinese press) (Ming Pao 2000), daughter-in-law of his predecessor in the position of Governor of Guangxi, and for years the most influential woman in Guangxi. This was not just a case of a local official embezzling public funds, but a story of love and greed of a popular political leader, who had achieved much for his province. This was also not the story of an anonymous mistress, but of an ambitious, intelligent and attractive woman using the position of first her father-in-law then her lover to systematically and on a long-term

basis exploit the powers vested in the office of provincial governor. The accusation against them focused on three crimes: appropriation and sale of real estate development and construction rights, sale of publicly subsidized goods at market prices and promotion of trusted allies into official positions of power. While the personal details of his deeds and his final execution in September 2000 fascinated the Chinese and Hong Kong press, his case also demonstrates how corruption works in China today (Hendrischke 2001).

Research on China's major corruption cases, such as the one involving Beijing mayor Chen Xitong and the still unsolved case in the city of Xiamen, has often linked them to power struggles and factional alliances within the top leadership (Wedeman, 1996). More general analysis points to the Leninist state-party system that is not bound by its own rules as the deeper cause of continuing corruption (Manion, 1997). Reasons for corruption are a particularly vexing issue in all societies, open to cultural, psychological and political analysis (Holmes, 1993, chap. 5) as well as anthropological (Rocca, 1992), or more focused economic explanation (Rose-Ackermann, 1999, chap. 3). Chinese researchers tend to emphasize the moral dimension (Yang Xiliang, 1997).

The following will present an economic analysis of corruption, with a particular focus on cronyism and nepotism as a network based form of corruption open to institutional analysis, as one group of actors positively discriminate "outsiders" and in favour of members of their own group.

2. **Talking about Cronyism**

Forms of corruption and cronyism have been observed in most societies; however, their importance differs between countries and periods. Some economies seem to be almost completely run by cronyism, like Marcos' Philippines, while in others, like Switzerland, cronyism seems to be unknown. The people most concerned about corruption and cronyism seem to be politicians and journalists. They treat them as either legal issues or as moral scandals. From the perspective of political science corruption and cronyism are considered to be institutional issues, mainly in transforming or weak political systems as they are often found in developing countries. Institutional analysis usually relates them to clientelism or patronage and focuses on the given dependency of those involved in, for example, clan systems. Consequently, corruption and cronyism in these institutional environments are not looked at in terms of voluntary exchange (Eisenstadt & Lemarchand, 1981).

Surprisingly, corruption and more specifically cronyism are rarely dealt with in economics (Boycko, Shleifer & Vishny, 1995). They occasionally appear in economic history concerned with changes in property rights or specific allocation systems that preceded the emergence of market economies (North, 1981). On the other hand, the literature on the shadow economy and related corrupt activities rather concentrates on the question why people find it profitable to leave the official sector, but stops short of investigating the individual calculus for engaging in corruption and cronyism (Cassel, 1986; Rose-Ackerman, 1978; Weck, Pommerehne, Frey, 1984; Haslinger 1986).

These explanations look at corruption and cronyism from a macro (-economic) point of view. Yet, since both arise from decision by individual actors, it might be useful to turn to the microeconomic perspective as first developed by Becker (Becker, 1971 and 1982; Shleifer & Vishny, 1993; Krug, 1988; Fan & Grossman 2001). We start by contesting that preference for relatives; people from the same origin or comrades are the only determinants for cronyism. Instead, by arguing that institutions matter, we can revisit questions such as, what are corruption and cronyism and what are their causes. Do different institutional settings constrain cronyism, either by reducing incentives or by exercising more efficient control? Can the prevalence of corruption and cronyism observed in a country such as China be linked to the co-existence of a socialist and a market sector? Can it be concluded from this analysis that cronyism is the result of a weak institutional context rather than the newly emerging market sector?

This paper is organised as follows: First, the question of honesty is addressed (Sec 3) in order to clarify the relation between corruption and cronyism. Next corruption and cronyism as a problem in the public sector labour market will be dealt with (Sec. 4) followed by an analysis of corruption and cronyism as an economic (rent seeking) problem (Sec. 5). The final section shows that the need to “network” turns corruption and cronyism into a problem that is shaped by the interdependency of the political market and the economic sector (Sec. 6).

3. **Corruption and cronyism as a problem of morality**

Usually corruption refers to the sale of state provided goods by a government official in return for private gains. An individual will engage in such a scheme if by doing so s/he can expect a higher income than by acknowledging procedural rules and working for promotion.

In moral terms, what makes a politician or bureaucrat honest is their resistance to the temptation of increased income by working in the “public interest” only. Yet, from an economic point of view, a bureaucrat does not need to be intrinsically honest; it would suffice to be indifferent to the distributional consequences of state-organised allocation of goods. For example, as long as s/he follows the usual bureaucratic practice of “first-come-first-serve”, her/his personal morality is not an issue. The problem starts the moment the bureaucrat “cares” who gets what. Cheng Kejie’s commitment to Li Ping was based on personal affection and infatuation with her refinement and cosmopolitan flair that transcended his provincial horizon. His hope was to eventually being able to marry her, to which she agreed, provided that they would together be able to earn enough money to lead an independent life. As part of their arrangement, Li Ping took care of their finances and transferred her illegal gains to Hong Kong under her name. In Cheng’s view this was meant to provide for their later life after his retirement. This commitment by Cheng Kejie makes the corruption case special, because money gained with his support flowed primarily to his lover, to some of his family members, but hardly to himself, who was still on a nominal monthly salary of 900 yuan.

Thus, love or caring is the defining element of cronyism and nepotism as a special form of corruption. For the purpose of the following analysis the two terms will be defined as follows: *Cronyism describes the willingness to break procedural rules and to forego revenues/ income appropriable in a system of corruptive practices in order to provide better income earning opportunities to people for whom one cares. If those cared for people belong to one family, then we talk about nepotism.*

This caring leading to positive discrimination can be based on emotions for certain people, can be subject to pressure of interest groups on whose support a bureaucrat's political or professional survival depends, or can be based on the expectation that the beneficiaries will "pay back" the favour in kind or money. In other words, cronyism and nepotism caused by affections is based on intrinsic motivation while the two latter cases point to extrinsic (monetary) incentives at the base of corrupt behaviour. Unfortunately, from an analytical point of view, both can also be mixture of all three elements as the following analysis and the story of Cheng shows.

One way to model cronyism is to conceive of it as a gift (literature in Neilson 1999; for China Yang 1994). If most members of society were honest, i.e. immune against the monetary incentives corrupt practices promise, cronyism and nepotism would be limited to *gifts* between relatives, friends, or, indeed, lovers. In the Cheng case, at least two groups of people who might fit this description can be singled out. First, his lover Li Ping and the Hong Kong business man Zhang Jinghai, who as her Hong Kong lover received large sums of money from her, which he converted into Hong Kong investment. Another, very broad group is the Zhuang population in Guangxi's border regions to Vietnam, a national minority population to which Cheng Kejie

belonged. By successfully lobbying the central leadership in Beijing, Cheng Kejie succeeded to get a six-lane motorway financed, which connects the minority counties, but could hardly be justified on technical or economic grounds. By supporting border trade as a provincial policy and turning a blind eye to large-scale smuggling along the Sino-Vietnamese border, he created major economic benefits for the minorities in these areas, which had been long neglected (Hendrischke 1997). From a personal, moral perspective one could argue that had Cheng been indifferent to Li Ping's charm and to the needs of the minorities, he probably would not have become engaged in corruption.

The problem with that kind of argument is that it is hard to judge from the outside what the real motives were that prompted Cheng's behaviour. One might be prepared to believe that he was "truly" in love with Li Ping and wanted to see her well off. His caring for the minorities is harder to judge: Turning a blind eye on smuggling could have been prompted by a wish to help the border minorities, by enforcing a development policy that made the development of the poorer regions at the border to Vietnam part of his programme (Hendrischke, 2000), or his ability to create a new revenue source from which he personally profited.

In any case, the comment in the Chinese Press, that he was somebody, who had "developed an ideological style of money worship, hedonism, and extreme individualism" (FBIS-CHI-2000-0420) is premature, to say the least. Moreover such moral judgement cannot explain how Cheng could go on with his acts of corruption for such a long time; neither can it explain how he became Vice-president of the NPC.

For this Institutional Economics suggests another way of modelling. Instead of concentrating on the motives of individual actors, i.e. why they embark on corruptive practices, such an analysis concentrates on the ability to do so, i.e. on the institutional setting that allows individuals to hand out gifts, or take bribes. The following two sections will therefore analyse the conditions that allow corruption and cronyism to emerge.

4. Cronyism as a labour market problem in the public sector

Not all employees working in the public sector can hand out state provided goods in return for bribes or change the allocation rules. The ability to do so requires the following powers:

The government official needs to hold *effective property rights*¹, in the sense that he can first exclude anybody from using (or transferring) the assets under his control. Second, he must be able to make the use of an asset dependent on his approval. Basically, s/he controls and allocates the right to use a resource. It is the trade in permits and approvals, which in most cases dominates corruption. As officially all goods provided by the public sector are in state ownership in China, effective property rights executed by officials indicate weak institutions. Consider the following example from the Cheng/Li file. A piece of land was originally assigned to the provincial-level Nationalities Affairs Commission for development. Cheng as the local Governor was able to reverse this allocation and to transfer the development rights for the site to his lover who sold them for a huge sum to an associate of the

Governor. This is one side of weak institutions; in a setting with strong legal institutions, the Commission could have filed a case against the Governor for interference into administrative procedures. Another side is that the beneficiary of the land deal can also not be sure if his payment for the development rights secures the necessary property rights, which will still rest with the bureaucracy. Contracts between the bribe-taker, i.e. the person in control of state provided goods, and bribe payer, the individual who complies with the payment, are unenforceable in any political system, resulting in a (high) risk premium. In our case, enforceability was secured through the promotion of personal allies of the Governor into bureaucratic position in charge of development approvals and allocation of goods.

He enjoys managerial *discretion*² which quantity (or quality) to sell to whom, or which permit/approval to give to whom. In the Cheng/Li case goods and permits were first offered to his lover as a middle person and to associates. In this case cronyism refers to weak government rather than weak institutions. It is a problem of *principal-agent relations* in which the principal, i.e. the central government, cannot monitor the provincial agents closely enough to enforce behaviour. The most striking feature of the Cheng/Li case is certainly that Cheng as the provincial Governor was entitled to monitor the behaviour of the provincial state administration, in other words he would have been entitled to monitor and punish himself, or to make sure that appropriate legislation would limit the managerial discretion of people like himself. It is this blurred distinction between the principal, i.e. legislation, and the executive side of government as the agent, which offers **beneficiary groups** the chance to embark on corruption. These groups then ensure through networks of cronyism that their

members occupy positions, which allow them to engage in corrupt practices at low costs.

As the revenue from corruption also depends on the *monopolistic position*, the ability to limit the number of competing suppliers of the same good is crucial (Olson, 1965, chap. 1-2). Otherwise s/he has to share the monopolistic rent, with the threat that competition will drive the bribe-price down. An easy way to do so is to control production of the good in question. As long as a few large state firms are the only suppliers of certain goods, control of these firms allows appropriation of the monopolistic rent. Another way is to design regulation for local jurisdiction, or control export/import licences. In all cases the strength of the monopoly depends not only **on** the ability to block “market entry” of other suppliers but also on the mobility of resources that are subject to regulation.

Cheng was able to exclude lower level bureaucrats from the process of issuing land development rights and from the distributive mechanism for centrally subsidised scarce good, such as edible oil and white sugar.

As will be shown presently, the effectivity of such a corruptive network will ultimately depend on a proper job placement policy. Personal sympathy might play a role as for example when Cheng made Li head of the Guangxi trade representation in Hong Kong. Another condition is that the person will collaborate with the corruption practices established so far. Otherwise the fine tuned system of bribes might collapse or at least become harder to enforce. It might be fatal to place a kinsman who is honest into a position where he is expected to collaborate.

This is basically the reason why it is so hard to judge from outside to which extent single acts of cronyism indicate “caring” or self-interest. Simple microeconomics can show how corruptive practices work.

5. Corruption and cronyism as a problem of (mis-) appropriating rents

In the Cheng case, the press added the costs of his behaviour in the following way.

Table 1

Years	Item	Foreign currency amounts	RMB Yuan
1994-1997	Real estate development	HK\$8,040,000	17,300,000 8,603,000
	Contract construction		2,200,000
1994-1998	Promotions of officials	US\$35,000 HK\$20,000	595,000 290,000 21,400
1992-1997	Quotas and allocations		9,030,000
Total		(US\$4,583,000)	38,040,200

These sums represent the costs from a legal point of view, namely the income earned by illegal behaviour. An economic analysis does not limit itself to the actual money transfers but includes the distributional effects as well as the indirect costs that accrue out of the misallocation of resources. In order to understand corruption in China it is essential to distinguish to “rights”, first the control right over the operational side of a business or bureaucratic procedures and the “property” right over net return or cash flow.

Take the following example from the Cheng/Li file, where corruption occurred in the distribution of sugar and oil. In general the following practices can be distinguished.

Graph 1

Assume that sugar is controlled by a state agency and distributed at a fixed price (p_1) so that x_1 consumers can be served (Graph 1). The light shaded area is the consumer rent that all buyers enjoy who would have been willing to pay a higher price. By asking for a bribe, which raises the total price for sugar to P_2 , the bribe taker can appropriate part of the consumer rent, in Graph 1 the dark shaded area. The higher total price works like a tax and will lead to a decline in total demand depending on price/income elasticities. Thus, if white sugar is regarded as essential for cooking then the drop in demand will be low. This explains why corruption concentrates on goods whose demand is relatively inelastic, such as energy, water, food, housing etc. In this case the bribe taker (Cheng) would have acknowledged the property right of the national **treasury** which would see the revenues generated by the sale of sugar at the state fixed price transferred. The loss of for the treasury would be the difference between the lower demand (x_2-x_1) times the state price. At a general level consumer would not be hurt as long as the number of people who had been willing to offer a higher price does exceed the number of consumers no longer able (or willing) to pay the higher price. The bribe taker gains form the appropriation of the consumer rent.

In the Cheng/Li case rent seeking involved the conversion of government allocations of subsidised goods and import quotas into options that could be sold on the market. Such allocations to the provincial government are routinely channelled from the

central State Planning Commission to the provincial Planning Commission, which is in charge of distributing them to local import/export firms, which in turn have to provide the goods to provincial users. This process normally takes place in March/April every year. Items for which such import quota are allocated are essential goods in short supply on the domestic market, such as fertiliser, edible oil, and indeed, refined sugar. Local sources state that Li Ping became involved in this type of business activity in 1993 by trading allocations of low-priced refined sugar when there was a shortage of sugar in the market leading to high market prices.

Another situation occurs when the state agency in control of the sales of sugar acts as a monopolist. Then we have a case of corruption plus embezzlement of funds. In this case the state agency would ask for a monopolistic price, appropriate the whole monopolistic rent. In other words, the bribe taker will not respect the property rights of the national treasury over the revenues generated by the sales of sugar. He will not transfer revenues from the sale of sugar at the state fixed price but instead keep everything himself. Subsequently, both consumers and the national treasury are hurt. The bribe taker needs to pay attention to two constraints. In order to keep his (local) monopoly he must be able to limit competition from other state agencies (or private firms) offering the same product or a close substitute. As his profit depends on (marginal) costs for the input, i.e. white sugar "bought" within the state controlled bureaucracy, he has to make sure to know people willing to sell him the sugar even if they know his business practices. One way to ensure a steady supply of low priced sugar is to agree to share the monopolistic rent with the supplier agency. Another way is to make sure that like-minded people are appointed to those agencies that allocate sugar within the bureaucratic system. The same means need to be employed for

keeping out competitors. Provincial legislation/regulation offer powerful tools to limit entry to local markets by means of taxation, regulation, or registration. Offers to share the monopolistic rent here, too, is an attractive means to “buy votes”, i.e. support, in the provincial, or county, administration. In the latter case the regulation can be advertised as a policy to protect local farmers, local (infant) industry, or certain groups such as minorities. As in all cases of protectionism the distributional effects are such that the producers benefit to the detriment of the consumers (plus the national treasury).

In both cases, corruption with or without embezzlement, the ability to appropriate part of the consumer or the monopolistic rent, depends on the ability to coerce others into collaboration or to “buy” their support. The minimum requirement is that the state controlled price agreed upon in the political arena is lower than the market price. Otherwise there would be no rent to appropriate (Cheung 1996). Coercion turns corruption into a political problem, buying support turns corruption into a problem of a malfunctioning bureaucracy, i.e. a principal agent relation problem in economic parlance. The analysis shows that corruption in order to survive needs to expand and include more and more people in positions that are able to limit free trade.

For this reason, in the long run the social costs of corruption and cronyism need to include the re-allocation of resources to those opportunities that offer high gains. Thus, for example, it can be expected that goods and regulation which private economic agents cannot avoid, i.e. low price and income elasticities, will be favoured. This might explain in the Cheng/Li case the sugar and oil-deals both ingredients in Chinese cooking for which substitutes are hard to find. Other examples are prestigious

large-scale infrastructural investment projects to which the national budget has itself committed to. The large sunk costs that would have to be accepted if the investment should fail allows participating (construction) firms to heavily overcharge the government as customer. Part of the gain from overcharging can be used for bribing those who decide which company will be involved. At the same time construction firms are also willing to offer bribes for getting contracts, knowing that they can retrieve these costs by overcharging the government as customer later. Knowing this, one no longer wonders how the six-lane motorway in the province fits into this picture.

Another example and the one that led to the demise of Cheng Kejie was Li Ping's involvement in the construction of the Nationalities Palace. This brought her into conflict with the provincial Party School. The Nationalities Palace was one of the government projects for the 50th anniversary of the People's Republic of China in 1999. It was built in the centre of Nanning on land that was partially owned by the Party School. Because it was a government project, the Party School could not raise any objections against losing its apartment buildings on the site. However, when it turned out that Li Ping, with the consent of Cheng Kejie, had become involved and had transferred the construction contract from the Nationalities Affairs Commission to her ally Zhou Kun, who in turn included members of Cheng's family in the project, the Party School started to pressure the Central Discipline Inspection Commission in Beijing to get involved in the case. Reportedly, this case was also initially referred back to Guangxi and suppressed by Cheng Kejie. The Party School finally approached the Head of the Central Party School **in Beijing** and required his personal intervention. As a result, in May 1999, one of the Deputy Secretaries of the

Commission was sent to Guangxi to personally head the investigation. After conclusion of her investigations, Cheng Kejie was put under a specific form of house arrest (*lianggui* or *shuanggui*), which restricted his movements and contacts.

Another long-term effect is that private investment will be crowded out by corruption. The difference between control rights over the operational side of a business and the property rights over net return or cash flow are crucial in this case, too (Shleifer and Vishny, 1993). Assume a company where the management has complete rights with respect to production, investment, price, and output. It has to pay taxes on profit, but is free to allocate net returns according to its own policy. For example using part of profits for paying dividends, part for re-investment, part for upgrading technology or research, and part for intra-firm consumption. In short, after tax, the company enjoys full property rights over its revenues. These property rights are respected by state agencies at all levels. Even if one state agency, say a city government, would ask for an additional tax or fee, companies could cope with this as long as the additional fee is low enough to allow the company to stay in business and as long as the fee can be anticipated and remains stable. Corruption again would take the form of a local tax, affecting total production costs which, depending on price and income elasticities, can be transferred to consumers and clients of the company. The negative effect would be shared between consumers and producers, the bribe takers could appropriate part of the producers' rent. Corruption becomes destructive when part of net profit is confiscated by local authorities asking for part of the cash once they become aware of the profit situation of the company. That can take the form of "voluntary contributions" to the building of local roads or a new football stadium, cash hand outs to state officials, or participation in intra-firm consumption budgets by obtaining

invitations to banquets, access to the firm's car park, free airplane tickets, or seeing relatives of officials employed by the firm. Empirical surveys have shown that the more corrupt a country, the lower the level of private investment.

Another form is regulation concerning the use of cash flow. When for example state agencies force companies to re-invest in infrastructure, such as housing, or research, the state agency might not directly profit (in monetary terms) from the regulations. Yet, the property rights of the company over net profit are **attenuated** nevertheless.

So far the analysis suggests, that with increasing liberalisation and deregulation, corruption would disappear. That is, indeed how many Western economists argue (Stigler, 1988, chap. 6-8). Yet, this kind of an analysis overlooks the interdependency between the economic sector and politics. It is within the political "market" that monopolies are created or broken up. As long as bureaucrats are not controlled by a government – the executive or parliament – or a strong constitution the principal-agent problem will not disappear. The effectiveness of corruption and cronyism under such a condition will then depend on running an effective network of co-ordinated price policy.

6. Cronyism as a network for discrimination

So far the analysis offered a static view of corruption and cronyism. In order to understand the dynamics of corruption, the supply side in the market of corruption needs to be analysed further. As was said before, to the extent that a bureaucrat cannot

control a monopoly over goods and/or over lucrative positions within the bureaucracy (is not an independent “price setter”), s/he needs to rely on collaborators. Thus, Li Ping entered this business by establishing a network of local officials who had the power over land allocations and building approvals. The core members of this network were arrested at the same time as Cheng Kejie. Their ranks were at provincial departmental level, corresponding to state-level ministers. As will be seen presently the kind of relationships between collaborators (or competitors) strongly influences the level and content of corruption.

It was argued before that contracts between bribe takers, i.e. bureaucrats in control over state provided goods and their customers are not legally binding or otherwise (socially) enforceable. The same is the case when two or more bribe takers at the supply side need to co-ordinate their action. In this case too all partners in the network of corruption cannot rely on binding contracts. This “institutional weakness” is an inherent feature of corruption and cronyism, which leaves the system of bribes and cronyism a fragile construction. In order to understand this, consider the following cases:

In order to avoid competition, (bribe) price setters must carve out local monopolies whose heads pledge to stay within the territory assigned to them at the beginning. Different cost structures or demand might then lead to different monopolistic prices. There is therefore an incentive to shirk the original agreement and move the “business” to the territory that offers the highest rent. As in all cartels, compliance with the original agreement is hard to enforce.

Officials are able to “create” complementary state provided input on whose use the total value of assets depends. One example would be the acquisition of land for the purpose of building a factory. The land remains “useless” if in order to do so permission needs to be “bought” from other state agencies. One state agency might ask for a bribe for the permission to build the factory, another for firm registration, a third for access to water and electric power, each of which knowing that without this permission the whole venture might collapse. The chain reaction that can be observed starts when the bribe revenues appropriated by one agency will attract the attention of another branch of the bureaucracy, which in turn will invent another monopoly in form of licences and permissions. This chain reaction finds its end only if the total sum of bribes to which the customers are (over-) charged will lead to a drop in total demand. Then, by ignoring cross-elasticity in demand, the result will be that all interdependent bribe takers are worse off. In order to avoid this, a strategy of joint profit maximisation is needed. Once more the problem of co-ordinating the action of different bribe takers shows up as the crucial one, if unilateral increases in bribes are to be avoided. It is worth emphasizing that the final breakthrough for an enquiry against Cheng and Li by the Central Discipline Inspection Commission did not come as the result of State and Party watchdog institutions pursuing their duties, but when economic interests of powerful institutions were negatively affected.

As Institutional Economics has shown, the co-ordination problem knows a monitoring and an enforcement aspect. The fact that corruption and cronyism are illegal makes secrecy an essential pre-condition for their functioning (Posner, 1980, 1-53). One effect is that not only law-enforcing agencies, but also all collaborating members face high costs for detecting a violation of rules. In the first case the violation of rules is

referring to the illegality of corruptive practices, in the latter the violation of rules refers to the original agreement between all partners in the network of bribes and cronyism. As such networks cannot rely on the “official” law enforcement agencies, they need to “police” themselves with the effect that the costs for running a system of corruption increase progressively over time and with increasing number of members at the supply side³. One way to keep the monitoring costs down is to employ only people on whose trustworthiness one can rely as a “police force”. These people might be relatives, members of the same ethnic groups, or those bound together by special pledge of allegiance. The mafia still serves as the proto-type of such an organization (Gambetta, 1993). In the case of Cheng it is known that he used the powers of his office to appoint a network of officials to those positions where their trustworthiness was crucial for his corrupt dealings. It is no wonder that the official report on corruption would later claim that “All major policy decisions, the appointment or dismissal of leading cadres (...) must be fully discussed by the collective, and no individual or small group is allowed to take arbitrary decisions” (FBIS-CHI-2000-0420).

Yet, even if the individual behaviour of network members can be effectively monitored at low costs, there is still the enforcement problem. Here again the Mafia-organisational structure and policy can serve as a model (Posner 1981, chap. 5 and 8). When no recourse to the law is possible, then three other institutional devices are available: first, revenge with or without violent means that works as a deterrent; second, hierarchy within the network of corruption and cronyism, to the effect that one person controls the network while other members comply to his/her commands; third, an alliance with politicians that allows to prosecute rule-violators with the help

of the official law enforcement agencies. Thus, Cheng during his time as provincial governor acted as a “Godfather” for the network of corruption and cronyism. In this case he did not need to seek an alliance with politicians since he himself held the top political position in the province. Therefore he could use or **threaten** to use official law enforcement agencies for controlling the network. In the Cheng/Li case, there were reportedly large numbers of letters of complaints to the Central Discipline Inspection Commission from county level officials concerning the sale of quota. While Cheng was Governor, these letters were sent back and suppressed at provincial level, where institutions could not act against the governor. Other examples of institutional complaints from the provincial level that were not followed through, are reports by the Head of the Guangxi Customs Office to his headquarters in Beijing on Li Ping being caught on many occasions taking cash and gold to Hong Kong. In such cases the Governor’s personal secretary had to interfere on her behalf to secure her release and prevent further prosecution.

It is noteworthy, that Cheng became vulnerable only when he left the province in order to become the Vice-chairman of the Standing Committee of the National People’s Congress in Beijing, a move for which he had to give up his position as provincial governor, and subsequently his godfather position. Hierarchy as a way to co-ordinate the network failed once he got promoted to **distant Beijing**, as did his ability to buy support for covering up schemes.

7. Conclusions

An economic analysis shows what the real life case so vividly illustrates: Institutions matter. Regardless what the motives: love, greed, passion or caring, corruption and cronyism depend on institutions that create **opportunities**. Ill-defined property rights are essential as are state regulated prices and state controlled “monopolies” over licences, permissions, and approvals. Consequently, market liberalisation via the introduction of private property rights and free prices plus deregulation would destroy the rents that can be appropriated by corruptive practices. The total profit from corruptive practices would decline, **as would the** number of people who might find it profitable to embark **on** such activities.

As the analysis further **shows**, however, two other institutions need to be taken into account for explaining corruption and cronyism. **The first is** the bureaucracy, more precisely, the principle-agent-relation problem that characterises bureaucratic discretion at all levels of state administration. **The second is** the political sector, which can be modelled as the political market where the supply of and demand for regulation, state monopolies, and national price policy is co-ordinated.

In a dynamic view, corruption creates a costly economic system. It drives resources to such investment opportunities, and into such **sectors**, which promise the highest net gain from corruptive practices, instead of directing the resources to their “best use” as allocative efficiency would expect. Second, networks for corruption are costly co-ordination device. In order to protect the networks’ rent-seeking powers, more and more people need to be taken in which in turn leads to actively searching for more and different opportunities. Moreover, the co-ordination of activities of individual network members also asks for an institutional solution. As Cheng was to learn, the

moment he lost his position as provincial governor of Guanxi, he became vulnerable. He **himself and most of his** former cronies came under investigation and were prosecuted.

An ultimate loss might **be seen in the forgone contributions that someone like Li Ping could have made** to the development of China's emerging private sector in terms of astuteness and innovativeness. She undoubtedly was an entrepreneurial talent who for ten-fifteen years superbly **understood how** to systematically exploit the institutional **opportunities, in this case the weaknesses**, of China's economic and political system.

¹ The following is based on the conceptual frame as developed first by Demsetz, 1987; Fama and Jensen, 1983; and the contributions in: Furubotn and Pejovich, 1974.

² The seminal papers are Arrow, 1984; Niskanen, 1974; Pratt and Zeckhauser, 1984.

³ It is worth mentioning that this mechanism can help to explain why economies relying on cronyism and/or nepotism, such as Indonesia or the Philippines can survive for some time, but at one point implode. The "implosion occurs when the costs for maintaining the corruption system exceeds the gains in the official sector. For other cases see Sanchez and Waters, 1974.

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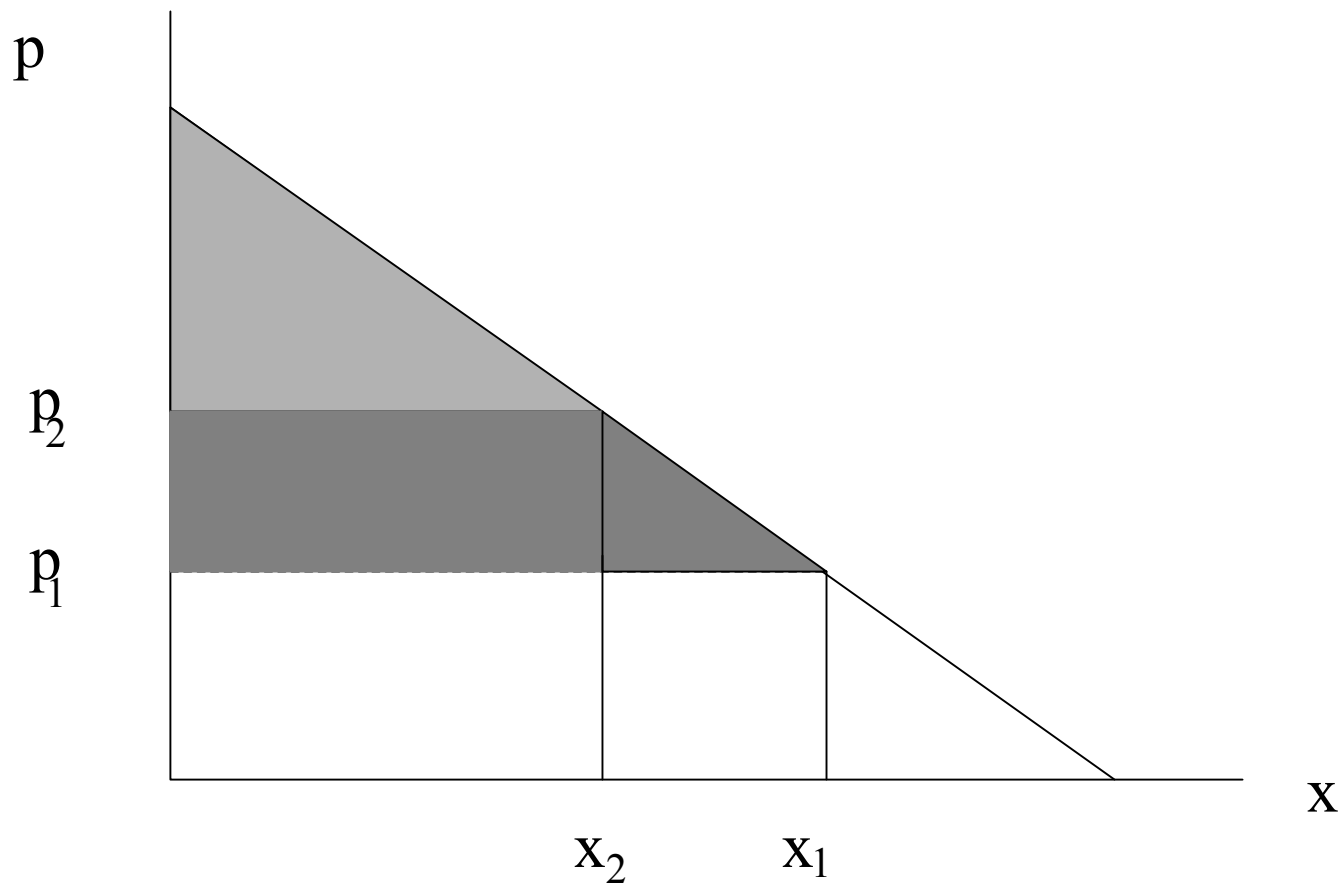
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