

## Corruption Threatens China's Future

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With its economy soaring at around 10 percent a year for nearly three decades, China's ascendance seems unstoppable. High savings, integration into the global economy, and private entrepreneurship are expected to power Chinese economic growth for years to come. Behind China's dynamism, however, lurk many dangers that could derail the Middle Kingdom's reemergence as a great power: environmental degradation, population aging, rising inequality, a tattered social safety net, and, above all, endemic corruption.

Combating corruption is perhaps one of the toughest tasks ahead because it requires politically difficult reforms so far eschewed by Beijing for fear of undermining the supremacy of the ruling Chinese Communist Party (CCP). But without intensifying its fight against official corruption, the Chinese government runs many serious risks. The experiences of other developing countries show that runaway corruption undermines critical governing institutions, fuels public resentment, exacerbates socioeconomic inequality, creates massive economic distortions, and magnifies the risks of full-blown crises. The failure to contain official corruption will inevitably endanger China's economic development.

### Measuring Corruption in China

Measuring corruption is all but impossible in most countries because of the illicit nature of

corrupt activities. In the case of China, the general lack of transparency adds to the difficulty. Nevertheless, public perceptions, official audits, press reports, official anticorruption enforcement data, and estimates based on international norms indicate that corruption in China is both pervasive and costly.

Opinion surveys of government officials and ordinary citizens in recent years identify corruption as one of the top public concerns. Each year, researchers at the CCP's Central Party School, which trains senior and mid-level officials, survey between 100 and 120 officials enrolled at the school. From 1999 to 2004, these officials listed corruption as either the most serious or second most serious social problem. The State Council's Development Research Center asked 4,586 business executives (87 percent of them in nonstate firms) in late 2006 to rate their local officials in terms of integrity. Almost one-quarter (23 percent) of the respondents said that their local officials were "bad," and 12 percent said they were "very bad." According to the Corruption Perceptions Index compiled by Transparency International (TI), a Berlin-based nongovernmental organization, China ranks among the more corrupt nations in the world. From 2001 to 2006, China's "corruption perception score" averaged 3.4 on a 1–10 scale (the lower the score, the more corrupt a country is perceived to be by its public,

### SUMMARY

Corruption poses one of the most lethal threats to China's future economic development and political stability. Illicit activities such as bribery, kickbacks, theft, and misspending of public funds cost at least 3 percent of GDP. Corruption also undermines the legitimacy of the ruling Chinese Communist Party, fuels social unrest, contributes directly to the rise in socioeconomic inequality, and undermines China's environmental security. The prevalence of corruption in China is rooted in the country's partially reformed economy and absence of genuine political reform. Corruption in China has spillover effects beyond its borders. To protect its own interests and encourage China in its transition toward a more market-based economy and open society, the United States should rely on mutual legal cooperation to assist China in its struggle against corruption.



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domestic private entrepreneurs, and foreign investors). This consistently places China among the bottom one-third of the countries included in the TI index.

The results of annual audits performed by China's National Audit Agency (NAA) offer another measurement of corruption in China. The NAA's audits from 1996 to 2005 uncovered 1.29 trillion yuan (\$170 billion) in misappropriated and misspent public funds (illegal practices include overstating the number of staff, setting up slush funds, misappropriating special funds, and collecting illegal fees). By this measure, misused government funds represented about 8 percent of the on-budget spending for this period.

Frequent press reports of high-profile scandals paint a grim picture of corruption in China. The amount of money stolen by perpetrators, for example, has risen exponentially. In the 1980s, few corruption scandals involved more than 1 million yuan. Even after adjusting for inflation, the sums of money looted by government officials today are astonishing. Even a relatively low-level official can amass an illicit fortune in tens of millions of yuan. One CCP secretary in Jianwei county in Sichuan Province, for example, acquired a fortune of 34 million yuan. Another local CCP boss in a southern city was found to have stashed away 32 million yuan when he was arrested in 2006. His colleague, ironically the city's anti-corruption chief, collected bribes worth more than 30 million yuan.

The large number of government and CCP officials disciplined and punished for wrongdoing offers one more data point. Based on the statistics supplied by the CCP's antigraft agency, the Central Discipline and Inspection Commission (CDIC), the CCP has punished and disciplined an average of 130,000–190,000 party members each year for various types of misdeeds and crimes since the early 1980s. The CDIC's data for 2006 show that 32 percent of the CCP members disciplined and punished that year committed possible criminal offenses (such as obstructing and harming

the social order) and 16 percent engaged in economically corrupt activities. Thousands of local officials are disgraced by corruption scandals every year as well. From October 1997 to September 2002, 28,996 cadres at the *xian* (county) and *chu* (division) levels as well as 2,422 officials at the *tin* (department) and *ju* (bureau) levels were prosecuted for corruption. On average, 6,000 senior local officials were prosecuted for corruption every year during this period.

To estimate roughly the direct cost of corruption, we can suppose that 10 percent of government spending, contracts, and transactions is used as kickbacks and bribes or is simply stolen. The Chinese government's procurement budget in 2005 was 300 billion yuan. The so-called administrative spending in China's official budget, about 20 percent of the total spending (470 billion yuan in 2003), is another juicy target. If 10 percent of the procurement budget and administrative spending is stolen or misused, this would amount to 0.65 percent of gross domestic product. Sales of land user rights by the government generated 580 billion yuan in 2005. Bribes to local officials could easily amount to 10–20 percent of the revenues generated (58–116 billion yuan, or 0.5–1.0 percent of GDP). In 2003, the state-owned entities spent 2.1 trillion yuan (19 percent of the GDP) on fixed-asset investments. If 10 percent were stolen, it would cost nearly 2 percent of GDP. Based on the conservative assumption that 10 percent of the land lease revenues, fixed investments, and government spending is stolen or misused, the *direct* costs of corruption in 2003 could be 3 percent of GDP, roughly \$86 billion, an amount exceeding the government's entire spending on education in 2006.

### Characteristics of Corruption

Corruption in China is concentrated in the sectors with extensive state involvement: infrastructural projects, sale of land user rights, real estate, government procurement, financial services, and heavily regulated industries.

The absence of a competitive political process and a free press in China makes these high-risk sectors even more susceptible to fraud, theft, kickbacks, and bribery. A 2006 study of 3,067 corruption cases found that about half of the officials or individuals engaged in corruption related to infrastructural projects and land transactions.

The pervasiveness of such corruption can be seen in the downfall of many local officials in charge of transportation and urban planning. Half of provincial transportation chiefs in China have been sentenced to jail terms (some have even been executed) for corruption. Corruption is also widespread in the acquisition and transfer of land. Typically, local officials use illegal (and sometimes violent) means to acquire farmland at low prices and later sell the user rights of the land to developers in exchange for bribes. A survey of sixteen cities conducted by the Ministry of Land Resources in 2005 found that half of the land used for development was acquired illegally. According to the head of the Regulatory Enforcement Bureau at the Ministry of Land Resources, the government uncovered more than one million cases of illegal acquisition of land between 1999 and 2005.

China's financial sector is similarly beset by corruption. Kickbacks for loan approval, massive theft by insiders, misuse of funds, and large-scale fraud are routine in Chinese banks, brokerage houses, insurance companies, and rural credit cooperatives. In 2004, China's banking regulators uncovered 584 billion yuan in misused funds; in 2005, they found 767 billion yuan in misused funds. A large number of top executives in China's largest banks have been jailed for corruption. In a 2003 survey of 3,561 employees in banks, state-owned enterprises, private firms, brokerage houses, and rural households, 82 percent of respondents said that corruption was "pervasive or quite pervasive" in financial institutions. On average, borrowers paid bribes equal to 9 percent of the loan amount.

Corruption of local state institutions, primarily through the practice of *maiguan maiguan* (buying and selling appointments in the government), is another cause for concern. Unheard of in the 1980s, *maiguan maiguan* has become common, particularly in less-developed regions, since the mid-1990s. Although the Chinese government does not provide aggregate data, frequent press reports

**The direct costs of corruption in 2003 could be as much as \$86 billion—the indirect costs are incalculable.**

indicate that this practice has tainted many jurisdictions. In one extreme case, 265 senior local officials in Heilongjiang—they included a governor, five deputy governor-level officials, and the party bosses in half of the prefects in the province—were involved in selling and purchasing government appointments. The chief perpetrator in this scandal, a prefect party boss, netted 24 million yuan during 1997–2002.

Like *maiguan maiguan*, collusion among local ruling elites (corruption cases involving groups of officials who cooperate and protect each other) is another sign of political decay—and is also a post-1990 phenomenon. Sample surveys suggest that 20–65 percent of all corruption cases could be classified as collusive. In the worst instance, collusion has transformed entire jurisdictions into local mafia states. Fuyang, a city with a population of 9 million located in Anhui Province, has the dubious distinction of producing a succession of corrupt party chiefs and mayors; some of them have even been executed. Hundreds of local officials have been punished for corruption. Most of the chiefs of the city's main bureaucracies, including successive police chiefs, have been removed for corruption. Collusive corruption appears to be most common in the financial sector. One study found that about 60 percent of all financial corruption and crime cases involved multiple collusive perpetrators.

### Causes of Corruption

Endemic corruption in China originates in the country's partially reformed economy, lax enforcement efforts by the government, and the CCP's reluctance to adopt substantive political reforms.

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### PARTIALLY REFORMED ECONOMY

International experience shows that corruption is closely related to the state's involvement in the economy; countries where the state controls significant economic resources and intervenes extensively in the economy tend to have more corruption. In China, the state remains deeply and extensively entrenched in the economy despite three decades of economic reform. Today, the state sector accounts for more than 35 percent of GDP; controls the nation's largest corporations; monopolizes key industries such as banking, power generation, and natural resources; owns trillions of dollars in fixed assets; and makes hundreds of billions of dollars in new investments each year. In addition, the state also controls key prices (most importantly the interest rate and land prices) and tightly regulates certain economic activities (real estate development and infrastructure). Such a hybrid economy creates a fertile ground for corruption because officials wielding the power of approval can easily abuse it for illicit personal benefits.

### LAX ENFORCEMENT

Casual observers are often impressed by the apparently harsh penalties (lengthy jail terms and death sentences) imposed on corrupt officials in China. (The most recent example was the execution of China's chief drug regulator who took \$1 million in bribes for approving more than a thousand drugs, many of them of dubious effectiveness and six of them outright

fakes.) Yet appearances are deceiving. Despite severe punishment against officials in high-profile cases, official enforcement data indicate that Beijing punishes only a very small proportion of party members and government officials tainted by corruption. For example, nearly 80 percent of the 130,000–190,000 CCP members disciplined and punished by the CCP annually since 1982 got at most a warning. Only 20 percent were expelled from the party. Less than 6 percent were criminally prosecuted. In recent years, half of those convicted of corruption received suspended sentences and did not serve any jail time. Therefore, the odds of an average corrupt official going to jail are at most 3 out of 100, making corruption a high-return, low-risk activity.

### FAILURE TO ADOPT POLITICAL REFORM

In combating corruption, Beijing has favored a top-down approach. It has routinely issued tough-sounding directives and regulations designed to curb corruption at the local level. The government has more than 1,200 laws, rules, and directives against corruption on the books, but their implementation appears ineffective and spotty. In recent years, in response to growing public outrage, Beijing has introduced new top-down measures such as rotating provincial anticorruption chiefs, appointing central government officials to head provincial antigraft commissions, making anticorruption chiefs in ministries, agencies, and key state-owned enterprises report directly to the CDIC, and dispatching inspection teams to the provinces to check up on provincial party bosses. These centralizing initiatives, though welcome, have only limited effects. At the same time, out of fear that a more comprehensive approach would threaten the supremacy of the CCP, the Chinese government has consistently resisted steps to further reduce the role of the state in the economy, increase judicial independence, and mobilize the power of the media and civil society even though international experience shows that only such full-fledged efforts can root out systemic corruption.

## Why Corruption Matters

It is tempting to discount the deleterious effects of corruption on China. To many, China's high economic growth despite rampant corruption proves that corruption does not always limit economic growth. Others may point to the records of China's East Asian neighbors—South Korea, Japan, and Taiwan. They all experienced varying forms of crony capitalism during similar stages of rapid growth but apparently suffered no serious consequences. One may even argue that corruption in the Chinese context might be the proverbial grease for the bureaucratic wheels of an otherwise unmotivated state: productive economic transactions might not have occurred without it.

Unfortunately, such views do not correspond with either Chinese reality or historical fact. First, the total costs of corruption in China are huge. The direct economic loss owing to corruption represents a large transfer of wealth—at least 3 percent of GDP per year—to a tiny group of elites. This annual transfer, from the poorer to the richer, is fueling China's rapid increase in socioeconomic inequality and the public's perception of social injustice. Second, the indirect costs of corruption—efficiency losses; waste; and damage to the environment, public health, education, the credibility of key public institutions, and the morale of the civil service—are incalculable. The high price China is already paying is ample evidence that the toll of corruption is not theoretical. For example, the bill for bailing out China's state-owned banks, prime victims of corruption in the financial sector, is close to \$500 billion. Corruption at the local level sparks tens of thousands of riots and violent collective protests each year, undermining social stability and necessitating extra spending on internal security. Corruption has also contributed to China's massive environmental degradation, deterioration in social services, and the rising costs of housing, health care, and education.

So far, high savings, strong trade performance, and favorable demographics have en-

abled Beijing to offset the *direct* costs of corruption and maintain growth. But corruption has lowered the *quality* of China's economic growth because its economic expansion has been accompanied by assorted social ills, many of which will require heavy investment to correct. With a lower level of corruption, China would have achieved growth of a higher quality, with much less damage to the environment, economic efficiency, public health, and social stability. High-quality growth is more sustainable than low-quality growth.

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Finally, it is worth noting that China's neighbors, ranging from Japan to South Korea, Taiwan, Thailand, and Indonesia, have all paid a steep price for corrupt crony capitalism. South Korea, Thailand, and Indonesia experienced spectacular financial collapses during the Asian financial crisis a decade ago, in no small part because of the massive corruption in their financial and corporate sectors. Japan's economy stagnated for a decade, also because of systemic corruption in its corporate sector and political process. Taiwan's growth performance has lost its momentum in the past decade, and corruption scandals have caused financial strains in the banking sector and tainted almost the entire political establishment.

It is small comfort to argue that China is not as corrupt as Russia, Suharto's Indonesia, or Mobutu's Zaire and that it has prospered in spite of corruption. True, corruption has not yet derailed China's economic rise, sparked a social revolution, or deterred Western investors. But it would be foolish to conclude that the Chinese system has an infinite capacity to absorb the mounting costs of corruption. Economically, runaway corruption stifles commerce, investment, and innovation, as recent academic research has established. Eventually,

growth will falter. Politically, corrupt ruling elites pay dearly for their misrule at times of crisis. True, everyday corruption does not cause revolutions. But ruling elites perceived by the population as irredeemably rapacious and self-serving enjoy little popular legitimacy and would more likely get overthrown when a major crisis hits, as shown by the fall of Marcos in the Philippines in 1986 and the collapse of Suharto's dictatorship in Indonesia in 1998. The Chinese government itself is well aware of these political perils. In the Tiananmen crisis of 1989, public anger at official corruption was one of the factors that led millions of people throughout China to take to the streets in support of the prodemocracy student movement.

### **Corruption has spillover effects beyond its borders and the U.S. should assist China in its struggle against corruption.**

The most dangerous threat of corruption is actually invisible. Endemic corruption steadily increases a country's *systemic risks*. As a result, its financial system is fragile, its environment degraded and vulnerable, its law enforcement establishment tainted and ineffective, its infrastructure insecure, its public health system irresponsive, and its regulatory system creaky. The list goes on. Obviously, the accumulation of systemic risks caused by corruption only increases the likelihood of a major crisis.

#### **Policy Implications for the United States and Its Allies**

Corruption in China has spillover effects beyond its borders. A China governed by a corrupt ruling elite will not be a reliable strategic

partner or evolve into a liberal democracy. Globalization and China's growing economic presence throughout the world mean that corruption in China directly harms Western economic interests. Inside China, corruption endangers foreign direct investment because illicit behavior by local officials could expose Western firms to potentially vast environmental, human rights, and financial liabilities. Corruption creates serious obstacles for Western companies facing rivals who engage in illegal practices in order to win business in China. Corruption puts Western firms' intellectual property rights particularly at risk because unscrupulous local officials routinely protect Chinese counterfeiters in exchange for bribes.

The spillover effects of corruption from China are real and substantial. Environmental disasters—such as toxic spills into major river systems—that are caused by corruption could affect China's neighbors. Global public health and safety could also be endangered through China's internal corruption that facilitates the production and export of tainted foodstuffs and counterfeit drugs. Corruption at the local level has hampered the Chinese government from honoring the international agreements it has signed, and this has undermined global cooperation and increased tensions between China and the West. Corruption in China affects other countries through the spread of cross-border crimes such as drug trafficking, human smuggling, and money laundering.

It is in the interests of the United States and its Western allies to assist China in its struggle against corruption. Although the United States can exert little influence on how the Chinese government fights corruption at home, Washington has some leverage in motivating Beijing to adopt more institutional reforms because China increasingly wants to bring to justice

a large number of Chinese officials who have fled to the West with their ill-gotten wealth. Chinese law enforcement authorities claim that as of May 2006 more than 800 suspects have escaped abroad. The amount of money directly involved in their cases exceeded 70 billion yuan (\$9 billion).

Even though concerns with Beijing's human rights record and lack of judicial independence make it politically impossible for the United States to sign an extradition treaty with China (France is the only Western country with such an agreement with China), Washington should consider three modest initiatives to assist China:

**Share information.** The United States should increase the collection and sharing of information with its allies regarding corruption in China. As the Congressional-Executive Commission on China (CECC) has ably done in the area of human rights monitoring, the U.S. government needs to devote resources to the establishment of a database that tracks reported cases of major corruption that have resulted in serious financial losses; human rights violations; and damage to public health, the environment, and public safety. Such information will be highly valuable to Western firms in assessing business risks in China. For policy makers, this database will help evaluate China's economic and political prospects and provide early warnings of spillovers of corruption that threaten the welfare and public safety of Western societies.

**Increase legal cooperation.** On the basis of the existing mutual legal assistance treaty, Washington and China can expand their cooperative efforts in the area of illegal immigration (nearly all corrupt officials who have fled to the United States have resorted to shady immigration methods) and money laundering. China's recent admission into the

Financial Action Task Force on Money Laundering should facilitate U.S.-China cooperation in tracking and recovering assets stolen by corrupt Chinese officials. The successful joint operation carried out by the U.S. Federal Bureau of Investigation and the Chinese Ministry of Public Security in shutting down a major software piracy operation in China in July 2007 offers another model for future cooperation in combating cross-border criminal activities perpetrated by corrupt Chinese officials.

**Insist on reform of China's police and legal system.** Washington must insist on reforms in Chinese law enforcement practices and legal procedures as a condition of providing assistance to Beijing in tracking Chinese fugitives in the United States and recovering the assets they have looted. The United States may thus induce China to undertake key reforms and comply with international norms in its law enforcement practices. ■

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## RESOURCES

Visit [www.CarnegieEndowment.org/pubs](http://www.CarnegieEndowment.org/pubs) for these and other publications.

**The Dark Side of China's Rise**, Minxin Pei (*Foreign Policy*, March 2006)  
[www.carnegieendowment.org/publications/index.cfm?fa=view&cid=18110](http://www.carnegieendowment.org/publications/index.cfm?fa=view&cid=18110).

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**China's Governance Crisis**, Minxin Pei (*Foreign Affairs*, October 2002).

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