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China's Corruption Paradox

Research suggests graft helped spur China's growth. Are Xi's anticorruption efforts undermining it?



A Communist Party official standing trial for corruption in 2015 in Xianning, China. PHOTO: ZUMAPRESS.COM

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In the 90s and early 2000s, China was very corrupt but also fast-growing. These days, the country is less corrupt by most measures but also slower growing.

That may not be just a coincidence: A growing body of work hints that in the absence of deep institutional and financial-sector reforms, a certain degree of corruption might actually have been essential to China's growth model.

Forcing unruly local officials into line has been a hallmark of President Xi Jinping's administration, which began in 2012. A brutal, wide-ranging campaign targeting official corruption helped bolster his standing and consolidate his power. But cutting off alternative routes for dealing with the government may be most punishing to small, privately owned companies, which already have the cards stacked against them in China's bureaucratic system. Since these are the companies responsible for China's explosive growth over the past three decades, that is a big problem.

Corruption is notoriously hard to measure, but two widely cited metrics—Transparency International's Corruption Perceptions Index (CPI) and the World Bank's "control of

corruption” governance indicator—have both improved substantially since Mr. Xi’s anticorruption crackdown kicked off. China, which was in the 37th percentile on the World Bank’s measure in 2011, had by 2016 hit the 49th percentile—a dramatic improvement. The number of officials punished for discipline violations more than doubled between 2011 and 2015 to over 300,000.

Even before Mr. Xi’s rise, scholars were highlighting the curious relationship between graft and growth in China. The basic argument is that when public institutions like courts and markets are fair and well-functioning, corruption hurts growth. When they aren’t—and when officials have a direct stake in growth—moderate corruption can help local bureaucrats and companies circumvent ineffective institutions or nonsensical regulations.

A 2012 paper in the *China Economic Review* highlighted the way this works at the firm level. The authors, economists at China’s Renmin University, found indicators of probable corruption—in this case the number of days companies interacted with government departments—explain a significant proportion of sales growth, particularly for small and privately owned companies.

Most interestingly, the impact was magnified for companies struggling to secure financing—a common problem for private companies in China, whose state-owned banking system is heavily tilted toward state-owned firms. That suggests Beijing’s heavy-handed crackdown on shadow banking beginning in late 2016, in addition to the anticorruption campaign, compounded problems for the economy’s growth engines. In the past, private companies might have found ways to offset the funding squeeze. Now officials are terrified of stepping out of line.

More recent research has found similar relationships. “Chinese private firms succeed, in part, by obtaining a special deal from a local political leader, which enables them to either break the formal rules or obtain favorable access to resources,” wrote Chong-en Bai, Chang-Tai Hsieh and Zheng Song in a May 2019 National Bureau of Economic Research paper. They found that private firms with better political connections grow faster and have better access to bank loans.

The corruption crackdown may have undermined growth in more subtle ways too. Scholars have long highlighted how China’s bureaucratic model promotes competition—and experimentation—among different localities to boost public revenue and growth, directly impacting officials’ career prospects. Successful experiments like China’s special economic

zones can then be cited by different factions in Beijing to make the case for their policies and rolled out nationwide. Permitting a certain amount of graft and creativity in generating nontax revenue—through permit fees for construction, for example—gives local officials a direct stake in growth and erodes their resistance to reforms.



Zhang Huawei, a former high-ranking state official, standing trial for bribery in Beijing last year. PHOTO: XINHUA/ZUMA PRESS

Yuen Yuen Ang of the University of Michigan posits such a “franchising” model of Chinese bureaucracy in a 2017 article published in *Regulation and Governance*. She also notes that many local officials nabbed in the corruption dragnet were considered star performers before their downfall. In an October *Korea Times* editorial, Ms. Ang says her forthcoming study of municipal party secretaries’ careers shows that 40% of those felled by corruption charges had been promoted in the previous five years.

By so effectively destroying competing factions and realigning local officials’ incentives away from growth and entrepreneurship and toward strict compliance with Beijing, Xi’s administration may therefore have also inadvertently undermined one of the pre-Xi system’s great strengths: its creativity.

The free hand local officials once had created plenty of problems too, with overinvestment and lax environmental regulation among the most obvious. Mr. Xi’s administration has been effective at tackling these scourges. The cost has been great, though, particularly in the absence of well-functioning markets and fair courts to help the best companies get funding, challenge unfair regulations and fend off predatory state-owned competitors.

A squeaky clean Chinese bureaucracy may cause as many problems as it solves.

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