

# Corruption, Smuggling and Guanxi in Xiamen, China<sup>1</sup>

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## Introduction

Lai Changxing used to be one of Xiamen's success stories – a peasant-turned-entrepreneur, head of Xiamen Yuanhua Inc., a consortium of real estate and property development companies. Lai, a Fujian Province native who had returned to Xiamen from Hong Kong to set up his own company in 1994, quickly became the town's most prominent figure, the walls of his office plastered with pictures taken with party cadres, high-level provincial and state officials.

Lai was known as a successful businessman, building a 88-storey skyscraper and a 30-storey luxury hotel, and a philanthropist, who built a hospital, paid pensions to old folks in his hometown, bought an A-league soccer team for Xiamen and even build a copy of the Heavenly Gate (complete with portrait of Chairman Mao) in the town's outskirts. He led a lavish life, owning several villas and luxury apartments in Xiamen and Hong Kong, driving around the city in a fleet of luxury cars.

But his fortunes have changed. Currently, Mr. Lai is under house arrest in Barnaby, B.C., Canada, desperately fighting his extradition to China, where he faces charges of smuggling, tax evasion and bribery in what is allegedly the biggest case of smuggling and corruption<sup>2</sup> ever since the founding of the People's Republic of China (PRC) in 1949. He is slowly running out of money since Chinese investigators have found and frozen his accounts. The Canadian authorities seem eager to get rid of him; so far his appeals for refugee status have been turned down. And the Chinese authorities are eager to bring him back to trial. As

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<sup>1</sup> This case study is mainly based on Hai, Yun: 厦门元华大案 – 查缉赖昌星走私犯罪集团纪实 (Beijing 2001), Cernetig, Miro/ Mickleburgh, Rod: "Mr. Big's big day" (Globe and Mail, 23.06.2001) and Lawrence, Susan V. "A City Ruled by Crime" (Far Eastern Economic Review, November 2000). Throughout the text the Pinyin system of romanization is used for all Chinese names. Names are written according to Chinese tradition - family name first, given name second.

<sup>2</sup> Ever since Deng Xiaoping's Policy of Reform and Opening the number of smuggling cases is on the rise and a lot of big-scale cases involving high-level officials have been uncovered

part of this they are promising not to invoke capital punishment, thereby honouring Canada's restrictions in extradition policy.

But how did Lai Changxing, who, being one of eight children to a poor peasant, had received no more than 3 years of primary school education, manage to set up a smuggling operation that was protected by corrupt officials? How did he become so powerful that other smugglers wishing to operate through the port of Xiamen had to pay for his permission?

### **Setting up Yuanhua Inc.**

The port city of Xiamen (Fujian Province) is located in south-eastern China at the Formosa Strait, which separates Mainland China from Taiwan, just 500 km north of Hong Kong and about 800 km south of Shanghai.

When Lai Changxing decided to shift his business back to Mainland China in 1994 he chose to set up his company in Xiamen, maybe because of its strategic location, maybe because of its closeness to his ancestral home or maybe because of the good connections he had to Zhuang Rushun, at that time deputy head of Fujian Province Public Security Bureau (PSB – Chinese police, both uniformed and plainclothes) and Yang Qianxian, who had just been appointed head of Xiamen Customs) both of whom he had known since his times as a restaurant-owner and small-time smuggler in the mid-80s, when he had regularly treated the two to free dinners at his restaurant.

The company was set up with a registered capital of more than US\$ 1 million and registered as Xiamen Yuanhua Electric Ltd., two office buildings were rented and Lai announced he was going to build a factory producing high-quality consumer electronics. But first of all, he wanted to introduce himself to everyone holding some power in Xiamen and he certainly knew how to make an impression. To celebrate the formation of his company he invited more than 1000 guests - among them provincial and city leaders, high level customs, police and tax officials and the directors of the big state-owned banks in Xiamen – to a banquet at Xiamen's best hotel, treating them to the most expensive delicacies including shark-fin soup and imported whiskey and handing out gift-bags of expensive watches, perfumes and imported spirits.

According to investigations, Yuanhua Electric Ltd. never set up any production facilities or hired factory workers. Mr. Lai was busy setting up a completely different operation. He spent his time and money hosting banquets, giving gifts and so-called “hongbao”, establishing good connections with customs officials, members of the harbour patrol and commodities inspection office. “Hongbao” are red envelopes containing money and are traditionally given to friends and relatives on gift-giving occasions like spring-festival.

These “hongbao” are often used to disguise bribes. In return for some generous gifts, these officials overlooked the fact that Yuanhua Ltd. was lacking necessary permits to import goods. They helped Yuanhua to import dutiable goods free of duty. Tax officials provided fake VAT receipts, so the smuggled goods could be sold on the Chinese market.

In the beginning, Yuanhua smuggled only a few containers and profits were immediately reinvested in the expansion of Mr. Lai’s “guanxi”-network. The Chinese term “guanxi” literally means relationship. It is often used to refer to interpersonal connections, which are characterized through the exchange of gifts and favours.

Smuggling was a profitable business, import duties were high and so was the profit margin. There were rumours going round in Xiamen that Yuanhua was operating a smuggling ring. Lai always laughed this off by saying “Yuanhua doesn’t even have an import licence, how could we smuggle goods?” Despite his seeming nonchalance, Lai realized that he needed protection from above if he wanted to continue and expand his business.

### **Building a network of connections**

Smuggling is a complicated task. Various government agencies are involved in clearing goods before they can be sold on the domestic market. A company needs an import licence to buy goods from a foreign company. One of the state-owned banks is needed to provide a letter of credit. A state-regulated transport agency has to be hired to arrange shipment. Harbour authorities have to inspect the ships and keep logs of every single ship entering the harbour and its cargo. Inspection and clearance by customs official and receipts, that Value Added Tax has been paid, are needed to sell goods domestically. For some goods such as vegetable oil an additional inspection by the Commodities Inspection Office is needed to certify that the good is of the required quality and safe to be sold.

Smuggling is also a dangerous task, penalties range from several years of imprisonment (which in China often means being sent to labour camps in the rural areas and engaging in manual work on a daily basis) to death penalty in severe cases. The Chinese government is regularly embarking on new anti-smuggling campaigns, seeking to reduce the high incidence of smuggling.

But most of all, smuggling is highly profitable. Estimates from 1998 put the profit rate on smuggled cigarettes at above 200%, while the profit rate on smuggled sedans exceeded 150%.

With the proceeds of his smuggling operation Lai managed to cultivate a network of connections that was extending into the highest ranks of provincial and central government. Many figures in this network were not involved in any actual smuggling; instead they were

passing on information on new government policies and campaigns, shielding Lai from investigations or suppressing reports of his smuggling operation. The highest-ranking figure in Lai's network was Li Jizhou (at least he was the highest-ranking official convicted in the trials following the uncovering of Yuanhua's operations), former Vice-Minister of Public Security, responsible for the PRC's anti-smuggling operations. He was sentenced to death with a two year reprieve following a conviction of accepting bribes by Mr. Lai and others totalling US\$ 650.000. On at least one account he personally interfered on behalf of Mr. Lai and Yuanhua Inc. to stop investigations.

His connections granted Mr. Lai access to confidential information concerning anti-smuggling purges, provided him with opportunities to invest in legal ventures, helped him advance the promotion of customs officials, who were cooperating in his smuggling operation, to strategic positions. According to the estimates, Yuanhua Inc. used about 50 - 70% of its profits to establish and maintain its guanxi-network.

Bribes paid to state agents differed in size and form. Lower-ranking customs and tax officials often received regular "salaries" for their services, differing with the value of the service and the risk involved. In many cases payments were made to department heads, who then passed on part of the bribes to their subordinates. Higher-ranking officials received various kinds of gifts and non-regular payments. For example, Ye Lichen, director of the Xiamen branch of the Industrial and Commercial Bank of China (one of the four big state-owned banks), received RMB 6.000.000 (approx. € 600.000) for providing Yuanhua Inc. with letters of credit to buy the goods from foreign suppliers, abusing his position as the bank's director to circumvent government regulations.

But Yuanhua did not only use money to induce cooperation. Mr. Lai maintained good contacts to the secretaries of high-ranking members of the central and provincial government. He used these contacts to introduce himself and his friends to these officials. Whenever prominent government figures visited Xiamen, Mr. Lai made sure they were entertained at company expenses. Through these contacts he furthered the promotion of several loyal officials, including Yang Qianxian (Head of Xiamen Customs) by introducing them to the "right" persons and providing them with the "ammunition" necessary to make a favourable impression (notably smuggled cigarettes and spirits).<sup>3</sup>

One of Yuanhua Inc.'s office buildings was refurbished to provide facilities for entertaining guests. The building, which was also Yuanhua's headquarter featured luxury apartments, a banquet hall, a cinema, sauna and swimming pool, a massage parlour and

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<sup>3</sup> The term "ammunition" is used in Chinese for certain kinds of bribes. Shouliudan (hand grenade) is a brand name of Chinese liquor, jiguangqiang (machine gun) is a homonym to a pack of cigarettes.

several karaoke rooms. At the height of its operation Yuanhua employed more than 50 women to entertain its guests. Some government officials regularly dined at the so-called “Red Mansion”<sup>4</sup>, enjoying the girls’ “services” several times a week.

The company also maintained a fleet of luxury cars and let these cars to government officials free of charge. To disguise the bribes, the cars remained property of the company, which was also paying the insurance and taxes, while the officials could use the cars as they wished and exchange them for newer models at any time.

Another way of disguising bribes was giving money and gifts not to the officials themselves, but to their wives, children or mistresses. Yuanhua Inc. paid for the overseas education of some officials’ children. When the son of Vice-Mayor Lan wanted to study in Australia, Yuanhua purchased an apartment worth AUS\$ 300.000 in his name. The company also maintained several luxury apartments in Hong Kong and Xiamen, which were given to officials’ mistresses. When the relationship between Yang Qianxian (head of Xiamen Customs) and his mistress turned bad and was threatening his reputation and his position, Mr. Lai personally interfered on behalf of his ‘old friend’, providing the woman with a job in Yuanhua’s Hong Kong branch, a residence permit and a luxury apartment. He also bought a luxury apartment in Xiamen for Yang’s second mistress and transferred large sums to her Hong Kong account.

Through his contacts Mr. Lai also managed to obtain passports and Hong Kong residence permits for his partners. Protected by this network of connections Yuanhua was able to expand.

### **Smuggling on a big scale**

In 1996 Yuanhua Electric Ltd. was transformed into Yuanhua Inc., a consortium of several firms with one branch in Hong Kong. It was around this time that the company started smuggling on a big scale. During the first 2 years of operation Yuanhua had mainly smuggled computers and occasionally cigarettes, but now Mr. Lai was eyeing for more profitable business.

The posts on Yuanhua’s Board of Directors were held by Lai Changxing, his brothers, his wife and his brother-in-law, making sure that all vital positions were filled by loyal persons. He hired former customs official Hou Xiaohu to be his vice-manager. Mr. Hou had

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<sup>4</sup> The red exterior of the building prompted locals to call it “Hong Lou” (red house) in allusion to the title of the famous classic novel “Hong Lou Meng” (Dream of the Red Chamber) – a tale of the rise and fall of four aristocratic families during Qing dynasty, noted for its criticism of the periods decadence and widespread corruption.

good knowledge of the customs operations, he was able to forge customs documents and still had many friends within the customs office, which facilitated the bribing.

Mr. Lai also hired former members of the People's Liberation Army, some of them acting as bodyguards, others due to their contacts to Army enterprises. Forced to expand and convert its internal military economy into market-oriented civilian production in the 1980s, the People's Liberation Army had turned into one of the most important economic actors in China by 1998, operating a multi-billion dollar international business empire running everything from large farms, to world-class hotels and transnational corporations. Many army enterprises are operating in heavily state-regulated fields, often providing them with quasi-monopoly power, some of them holding import/export licences. In 1998 the Central Government announced plans to reduce the scope of army business interests following involvement of army enterprises in big corruptions scandals.

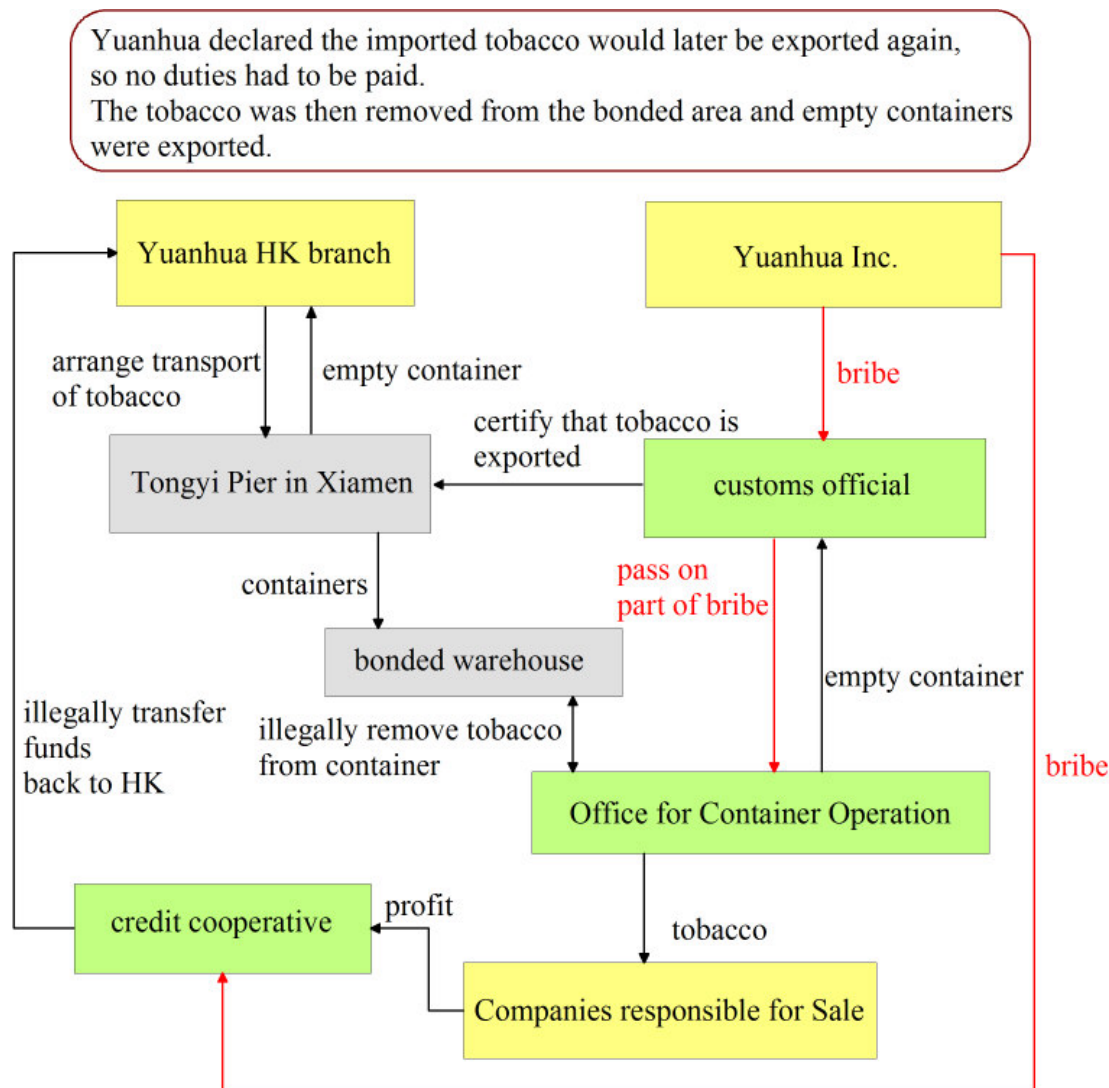
Around 1996, Mr. Lai started cooperating with Chen Guanghui, general manager of Kaiyuan Inc. a huge state-owned company with 16 Chinese and 2 foreign subsidiaries. Mr. Chen had first approached Mr. Lai when he failed to get customs clearance for some goods imported by his company, by that time word had spread in Xiamen that Mr. Lai knew how to get things done. For a share of the profits Yuanhua Inc. took care of the necessary paperwork, bribing officials to provide customs documents and VAT receipts, a service it would later provide to several would-be smugglers who were lacking the right connections, thus acting as an intermediary on their behalf.

Afterwards the two companies engaged in a profitable business relationship to smuggle soybean oil<sup>5</sup>. Kaiyuan Inc., which had the necessary contacts and import licences, would buy oil from a foreign supplier. Yuanhua Inc. would use its contacts at the state-owned banks to get the necessary letter of credit, and bribing officials to get customs clearance, VAT receipts and Commodities Inspection Certificate. The oil would then be sold through Kaiyuan Inc.'s distributions channels. The profits were shared on a 7:3 base, granting the bigger share to Yuanhua.

Yuanhua Inc. and its various subsidiaries also cooperated with other state-owned and army-owned enterprises, bribing their managers and key staff to gain access to import licences, distribution channels and storage facilities in the bonded area of Xiamen's harbour.

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<sup>5</sup>Soyoil - 1) is a "Tariff Rate Quota" (TRQ) commodity - for which quotas are difficult to obtain, and in aggregate, fall short of national demand, 2) is subject to a 13 percent tariff, 3) is subject to a 13 percent VAT and 4) is only importable by six authorized importing agents (figures from 1998)



**Figure 1: Cooperation with customs officials to smuggle tobacco**

The extent to which cooperation between state agencies and Yuanhua Inc. took place is vividly illustrated by figure 1, portraying the smuggling and alleged re-export of tobacco. Another example of cooperation is provided by the following incident:

In May 1996 a customs official filed a report with the Customs Inspections Office stating that he had discovered 4 containers with forged customs seals which contained 12 luxury cars. The department chief in turn reported to the director of Xiamen Customs, Mr. Yang, who decided to hand the matter over to a team of customs officials. All of these officials happened to be on Yuanhua's payroll. Mr. Lai approached the team asking them to misplace the file, which was impossible because too many people already had notice of the matter. They finally agreed on replacing the 12 cars worth several million RMB in the containers by old ones, so that Yuanhua Inc. would not incur big losses when the customs officials had to confiscate the containers. The plan was jointly executed by customs officials and employees of Yuanhua Inc.

## **The investigation**

Investigation into the Xiamen smuggling and corruption scandal began in spring 1999, when a 74-page tip-off letter containing details of the operation and evidence such as bills of sale was sent to the central government. Details and evidence were provided by a disgruntled ex-employee of Yuanhua Inc., who was seeking revenge. This ex-employee (a former deputy director) had a gambling problem and Yuanhua Inc. repeatedly settled his debts, until Mr. Lai decided that his employee's habit was becoming too costly for the company. The latter decided to leave the company, asking for a severance payment, a demand that was laughed off by Mr. Lai. The infuriated man then tried to set up his own smuggling operation in Xiamen, using his contacts at Xiamen Customs Bureau, an attempt that was effectively blocked by Mr. Lai. Seeking revenge, he decided to blow the whistle.

Reports on Yuanhua Inc.'s actions had been filed earlier, but Mr. Lai's network of contacts had always managed to suppress investigations. This time, however, their efforts were countered by a group of Xiamen enterprises. These faced shrinking profits as a result of Yuanhua Inc. flooding the market with cheap goods smuggled into the country. This group of enterprises mobilised their own connections to make sure investigation was carried out. Although Mr. Lai's contacts could do nothing to stop the investigation, they managed to warn him of the imminent investigation.

Mr. Lai and his accomplices quickly started to cover-up their activities, destroying evidence. The company's assets were liquidated and the money transferred to overseas accounts. When the central government dispatched several hundred investigators to Xiamen in June 1999 to collect evidence, Mr. Lai had already left for Hong Kong. He kept contact with Yang Qianxian (head of Xiamen Customs Bureau) and Zhuang Rushun (now vice-head of the provincial Public Security Bureau), who informed him on the proceedings of the case. Mr. Lai returned to Xiamen several times during the investigation, his arrest was prevented by whistle-blowers inside Xiamen's police. The investigators found the phones at their hotel tapped by local police with links to Vice-Mayor Lan.

The investigation was complicated by destroyed evidence, reluctant witnesses and the number of persons involved (600 people were suspected, about 300 have been put on trial.) Only when it became clear that the government would follow through the investigation, people started coming forward with evidence.

The manager of one of the import/export companies involved in smuggling oil provided the investigators with a whole bag of evidence. It turned out he had kept copies documenting the smuggling of oil and the involvement of Yuanhua Inc. Another employee of



one of the state-owned companies cooperating with Yuanhua Inc. in the smuggling of cigarettes turned over documents he had hidden at his home when the company's manager ordered them to be destroyed. While he didn't dare contradicting the manager, he also feared being held responsible if the records were destroyed.

The investigations revealed that between 1996 and 1999 Yuanhua Inc. smuggled through Xiamen port everything from crude oil to vegetable oil, natural rubber, cars, cigarettes and electrical appliances. Official Xinhua News Agency said investigators determined that from 1996 on, Lai and his accomplices handled some RMB 25.000.000.000 (€ 2.500.000.000) in smuggled goods, evading RMB 11.500.000.000 in taxes. Unofficial reports suggest that at one point, as much as one-sixth of the crude oil on the Chinese market was smuggled by Yuanhua through the port, distorting national oil prices. Another 30 companies in Xiamen were implicated, either cooperating with Yuanhua or smuggling and bribing officials on their own account. In the criminal proceedings following the investigation more than 300 persons were tried. Many of them were sentenced to several years of imprisonment, 14 death penalties were handed down for the most serious offenders. Mr. Lai fled to Canada, where he applied for refugee status.

### **Smuggling and Corruption in China**

Considering the evidence and the number of people involved it seems astonishing that an operation of this size managed to go undiscovered for more than 4 years. In fact, Lai Changxing's operation was what Chinese call a "publicly known secret". The evidence and reports, brought forward by citizens after the investigation started, revealed how many persons knew about the smuggling without actually being involved. Mr. Lai had managed a closely-knit network that efficiently suppressed investigations until his operation collided with the interests of other powerful enterprises.

However, the Yuanhua Case is far from being unique, not even in terms of scale. In 1998 investigations unveiled a smuggling operation in Zhanjiang (Guangdong Province), where smugglers had colluded with customs officials, the city's party secretary, deputy mayor, the director of the Customs, the head of the Border Security Bureau and many other key city government officials. The Zhanjiang "Office for Crackdown on Smuggling" was referred to as "smuggling office;" the customs office performed the function as the "vehicle for smuggling" and the city's party chief himself was called "umbrella for smugglers."

The case was deemed to be the largest case of smuggling and corruption since the founding of the PRC, a title soon claimed by the even larger Xiamen operation, which was discovered only a few months later. Investigations into both cases came in the wake of a national anti-

smuggling campaign called into existence in July 1998 by Premier Zhu Rongji to fight the rampant smuggling and corruption in customs authorities.

According to estimates the value of goods smuggled into the country amounted to 10% of the value of legally imported goods. The collection of import duties at times only reached about one fifth of the estimates based on import values. Only about half of this could be attributed to import tax rebates given to foreign investors in China's coastal regions, the rest resulted from collusion and corrupt transactions on local level.

Whole industries were threatened by smuggling activities. China's petrochemical industry incurred huge losses due to illegal imports from South Korea and Taiwan. Of the 10 million mobile phones sold in 1998 an estimated 50% were illegal imports.

Chinese foreign trade is characterized by protectionist measures (high tariffs, restriction of trading rights, allocation of licenses and quotas), non-standardized special provisions (for Special Economic Zones, Export Processing Zones and High-Tech Zones) creating a certain amount of administrative power and economic rent, so many enterprises sought to gain competitive advantage by establishing "special relations" to local authorities. Since evading custom duties only reduced the central government's revenues while not directly affecting local interests, local authorities made little effort to curb it. In many cases authorities were found to collude with smugglers. Corruption in China became what political scientist Gong called a "collective venture, where recent corruption cases show an alarming tendency for party and government officials to collude with each other, as well as with people outside the government, on a massively corrupt scale"<sup>6</sup>

Following the investigations into the Xiamen and the Zhanjiang case and in preparation of the WTO entry in 2001 the Chinese government started a reorganization and modernization of its customs offices and a reduction of trade barriers. In January 2000 the National Customs Administration announced a 81% rise in revenue compared to 1999.

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<sup>6</sup> **Gong, Ting (2002):** Dangerous Collusion: Corruption as a Collective Venture in Contemporary China in: Communist and Post-Communist Studies, Vol. 35

<b>Accepting bribes</b>	
amount of more than RMB 100,000	more than 10 years of fixed-term imprisonment or life imprisonment and confiscation of property in especially serious cases: death penalty and confiscation of property
amount of more than RMB 50,000 but less than RMB 100,000	more than 5 years of fixed-term imprisonment and confiscation of property
more than RMB 5,000 but less than RMB 50,000	more than one year but less than seven years of fixed-term imprisonment
less than RMB 5,000	less than two years of fixed-term imprisonment In lighter cases, they will be given administrative action
Punishment is increased when the official actively demanded the bribe	
<b>Offering bribes</b>	not more than five years of fixed-term imprisonment or to criminal detention;
Bribes offered to seek illegitimate gain Causing damage to state interest	not less than five years and not more than 10 years of fixed-term imprisonment, or to not less than 10 years of fixed-term imprisonment or life imprisonment when the circumstances are extremely serious
Whistle-blowers receive lighter punishment or exemption from punishment	

**Figure 2: Penalties for bribery under the provision of the Chinese Criminal Law<sup>7</sup>**

<sup>7</sup> wording of the Chinese Criminal Law can be found at: <http://www.qis.net/chinalaw/>