

# The Institutional Economics of legal institutions, Guanxi, and Corruption in the PR China

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## **1. Introductory Remarks:**

### **China, Corruption and Economic Theory**

The phenomenon of corruption in the Peoples Republic of China has recently gained more attention in the public discussion, as the media have reported more intensively on cases of exposed corruption, associated arrests, court sentences and even executions.<sup>1</sup> Many have the impression that the extent of corruption in China has increased dramatically, but this conclusion is not warranted. The phenomenon has existed for some time (Kwong, 1997) but has been increasingly brought into the open, not least because the ruling elite have realised that rampant corruption seriously jeopardises the successful continuation of the economic transformation process and will also endanger their own claim to power in the medium term.<sup>2</sup>

This study examines the phenomenon of corruption in China using the instrument of the new institutional economics. The goal is not to illuminate the relationship between the parties involved in corruption using a principal-agent analysis. Instead, the analysis focuses on the institutional framework for corrupt transactions in China whose goal is to prevent opportunistic behaviour of one of the involved parties. In this respect, especially the relationship between corruption and the guanxi networks will be examined, and, in addition, how they are affected by the (non-) existence of a functioning legal system.

The study first provides a working definition of the corruption phenomenon and a description of the methodological approach (Section 1). Then, the order-creating function of the Chinese

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<sup>1</sup> See, for example, Agence France Press (2000a) 'China Sentences Top Lawmaker to Death for Graft', in <http://insidechina.com/news.php3?id=184562>, downloaded on 02.08.2000; *ibid.* (2000b) 'Chinese Official Sentenced to Death for Corruption', in: <http://insidechina.com/news.php3?id=182982>, downloaded on 02.08.2000; *ibid.* (2000c), 'Scores of Chinese Officials Punished for Three Gorges Corruption', in <http://insidechina.com/news.php3?id=221933>, downloaded on 21.11.2000. In the Corruption Perception Index published annually by Transparency International, China was ranked at 3.5 for 2001 (on a scale of 0.0 'very corrupt' to 10.0 'corruption free') and shared 57<sup>th</sup> place with Argentina, directly behind Turkey and Ghana. Russia was ranked at 2.3 in 79<sup>th</sup> place. The index comprised 91 countries in 2001. <http://www.transparency.org/documents/cpi/2001/cpi2001.html>, downloaded on 10.07.2001. In the preceding years China was ranked at 3.1 in 63<sup>rd</sup> place in 2000; 3.4 and 58<sup>th</sup> place in 1999; 3.5 and 52<sup>nd</sup> place in 1998.

<sup>2</sup> The President of State and General Secretary of the Communist Party of China, Jiang Zemin is quoted as saying that the struggle against corruption in the party and government is 'a matter of life and death of the party'. See Agence France Press (2000:c) 'Communist Party Orders Corruption Cases to Be Used as Ideological Fodder', in: <http://insidechina.com/news.php3?id=184548>, download on 02.08.2000.

guanxi networks is presented (Section 2), followed by an analysis of the particular importance of the guanxi networks for the coordination of corrupt transactions (Section 3). The complementary and substitutive relationship between the two order systems of the guanxi network and the legal system and the ensuing implications for the corruption phenomenon in China are examined in Section 4. A summary of results concludes the study.

## **2. The Corruption Phenomenon**

Corruption probably dates back to the very first instances of organised human life (Klitgaard, 1988, 77ff). In China, the penal code of the Qin Dynasty (221-207 BC) already includes the phenomenon of corruption and places heavy penalties on it.<sup>3</sup> The problem of corruption seems to be closely linked to the institutional conditions of humans living together. Once the constitution of institutions permits the escape from the Hobbesian jungle, this step also establishes and codifies the power of Leviathan and enables its (parasitical, self-seeking) exploitation in societal interaction (Hobbes, 1651). Institutional power over transactions – also of an economic nature – seems to inevitably lead to corrupt and corrupting behaviour, or, in the words of Lord Acton, ‘power tends to corrupt and absolute power corrupts absolutely’.<sup>4</sup>

**Definitional Considerations.** Corruption is closely linked with the norms and formal and informal rules of a specific society (Goudie/Stasavage, 1998), and cannot be viewed in isolation of its societal context. This means that a definition must necessarily be presented in a generalised form.<sup>5</sup> Accordingly, and especially with regard to the Asian and specifically the Chinese cultural context, it would be appropriate to follow the argumentation of Max Weber and to place the definition at the end of an epistemological process instead of at the beginning (Weber, 1904/05). Nevertheless, we will attempt a definitional framework into which the further steps of the investigation will be inserted and which will also expand the framework.

One of the most general definitions is offered by Bardhan for whom corruption is ultimately ‘the use of public office for private gain’ (Bardhan, 1997). A wide-spread definition in the literature based on Klitgaard sums up corruption as (Klitgaard, 1988):

behavior which deviates from the formal duties of a public role because of private-regarding (personal, close family, private clique) pecuniary or status-gains; or violates rules against the exercise of certain types of private regarding behavior.(Ney, 1967)

<sup>3</sup> It was an ‘Pflichtverletzung im Amt’ (infringement of duties in office) to accept gifts, to grant personal advantages, to bribe and to embezzle. The penalties ranged from reprimands to arrest, banishment and corporal punishment (Heberer, 2001). One of the oldest Indian sources on corruption dates back more than 2300 years (Klitgaard, 1988)

<sup>4</sup> Comment of Lord Acton (1834-1902) in a letter to Bishop Mandell Creighton (quoted after Bardhan, 1997)

<sup>5</sup> This is particularly the case for judgements regarding the moral and to a certain extent the legal dimensions of an action that is considered corrupt.

These very broad definitions form the basis for the following considerations, which will further specify the definition. Accordingly, the characteristics of corruption or corrupt behaviour are:

1. System-specific or system-immanent, de facto personally related power exploited for personal gain. This includes monetary and non-monetary rewards that transcend the income for work performed and that can be driven by both egotistic and also altruistic motives.
2. An immanent contract concluded via a specific transaction, i.e. the transference of property rights, which because of its illegality is not subject to any officially legitimised institutional executive or sanctioning instance.
3. At least two economic subjects always interact in the above transference of property rights. This explicitly excludes the theft or embezzlement of state property as well as influencing the political process to preserve power.

In addition to these characteristics of corrupt relationships, we also need to categorise the various identified types of corruption that are essential for an analysis of the phenomenon. A distinction can be made between spot-market corruption and relational corruption. Spot-market corruption includes all transactions that are carried out to avoid an isolated and immediate punishment or for gaining an isolated and immediate privilege. The transaction relationship ends with the exchange of the particular property rights and has no importance for the participating economic subjects either before or after the transaction. An example is giving a policeman money to avoid getting a ticket for a traffic violation. Although the existence and frequency of such transactions certainly allow for conclusions to be drawn with regard to the underlying institutional framework, i.e. its sanction possibilities and the credibility of sanction threats, this aspect of corruption is not the object of further analysis in this study. Instead, focus will be placed on the phenomenon of relational corruption, which also in Asia accounts for the major share of corrupt activities. This is understood as long-term (multi-periodical) transactional relationships which are formed on the basis of an implicit contract and which ensure the attainment of a system-immanent advantage (at least for one of the contracting partners) by influencing the political decision-making process on various levels; without the transaction this advantage would only be attainable – if at all – by using additional resources. Examples are the obtaining of licenses, access to public contracts, or the avoidance of safety or environmental-protection requirements.

**Theoretical Considerations.** Even though the theoretical discussion has not achieved definitional clarity or a widely accepted categorisation, the occupation with the corruption phenomenon has been a component in the economic research programme for some time. The main studies include those of Becker (Becker, 1968), Krueger (Krueger, 1974), Rose-Ackerman (Rose-Ackerman, 1978), Klitgaard (Klitgaard, 1988) and Tanzi (Tanzi, 1995). The

economic analysis has been increasingly concentrating on the application of the instruments provided by the new institutional economics.<sup>6</sup> Recourse is taken primarily to the principal/agent theory, which is used in a variety of forms. The common element in these models is the examination of the relationship between the superordinate institutions (principal) and the acting officials (agents). The corrupting individual is included in this relational network as a third element, which takes place, as by Klitgaard, via the incorporation of a client (Klitgaard, 1988). Mostly, however, the newly created transactional relationship is constructed as a principal/agent model with the special case of the existence of two principals who pursue and implement various goals and an agent who is obligated to both of the principals (Rose-Ackermann, 1978; Groenendijk, 1997). In addition, game-theory models are also finding increasing use for portraying within such models the sanction and incentive mechanisms as well as the economic dependencies in a corrupt transaction (Dabla-Norris, 2000).

Further model approaches make use of the theory of rent seeking. The argumentation is that corruption payments can be demanded on the basis of monopoly power created by institutional particularities. This approach examines scenarios in which resources for establishing or preserving particular institutional arrangements are used in order to siphon off monopoly rents vis-à-vis third parties, for example, in the form of corruption payments (Rose-Ackermann, 1978). In this theoretical framework we must include the analyses that examine the origin of corruption in the context of economic transformation processes and their institutional particularities. Points to examine here are, firstly, the discretionary scope for decision-making, which is created in the wake of such comprehensive processes of change and, secondly, other types of system arbitrage that result from the parallel existence of market-economy system elements and atavisms of the former command-economy system (e.g. consciously constructed dual price systems or poor institutional fits between sub-sectors that arose during the process of change) (Abed/Davoodi, 2000).

In all of these explanatory approaches, the general tendency of observing social and institution conditions only on the margins is a problem.<sup>7</sup> In many cases, then, arguments as to what is perceived as a corrupt or criminal transaction are hardly possible. Especially theoretical explanations using rent-seeking or principal-agent models are often implicitly based on normative assumptions as to what transactions in a society are already regarded as corrupt or still as normal political processes, such as lobbying activity. However, 'reciprocity is in any society a rule of life, and in some societies at least it is *the* rule of life' (Noonan, 1984; Posner, 1980). In China, owing among other things to the weakness of formal institutional arrangements, a system of transactions tied to persons as well as implicit and

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<sup>6</sup> Interest is focused here on studies that deal explicitly with the institutions that the corruption is based on (or with institutional deficits) and incentive structures. The literature that deals with the effects of corruption on economic growth is not considered here. For the latter, see in particular P. Mauro, 1995.

<sup>7</sup> An exception here is at best the examinations of corruption based on a transformation-induced system arbitrage.

relational contracts has been established, and this system is in need of closer examination. Thus, in the following, this system of the so-called guanxi networks will be analysed, and in the light of these results a new assessment and explanation of corruption in China will be given.

### **3. The Institution of the Guanxi Networks**

The Chinese guanxi networks can be understood as institutions that arose centuries ago to secure trade relations in an environment that was only insufficiently covered by the formal legal system (Carr/Landa, 1983; Posner, 1980). In numerous areas they are still an ordering factor in Chinese society, and virtually every Chinese person is connected to at least one guanxi network. These guanxi networks are based on personal relations marked by certain common elements such as coming from the same village or region, serving in the same military unit, belonging to the same party unit, schools, associations, etc. However, membership in a guanxi network is not limited to such common experience but can also be arranged by a person in a position of trust whose reputation is the guarantee of the proper behaviour of the person introduced. In this way individual people are able to expand their radius of economic relations, backed up by guanxi networks, to include various networks each with different resources (Krug/Polos, 2000).<sup>8</sup> A targeted expansion of one's network to people who are regarded as useful for the pursuit of common interests can also be achieved by the giving of gifts. By accepting the gift or service, the involved person obligates himself to perform an undefined reciprocal service at an unspecified time in the future. Thus, by accepting the gift or service, an implicit contract is concluded the fulfilment of which is linked to the particular network (Hsing, 1998).

The mutual exchange of services and the acceptance of abstract debt obligations is the main integrating force within a guanxi network. It can be understood as a mutual investment in social capital (Dasgupta/Serageldin, 1999), which is the framework of a system of order that co-ordinates the interaction between the network members. The resources used for this purpose are by no means insignificant. In a village investigated by Yan in the province of Heilongjiang, a household spends between 10% and 20% of its disposable income for the nurturing of its guanxi networks (Yan, 1996). The Hong Kong Independent Commission Against Corruption (ICAC) determined in 1993 that Hong Kong businessmen spent 3% to 5% of their investment in mainland China on gifts and maintenance of guanxi networks (Ming Pao, 21.08.1993, as quoted in Chan, 1999).

Guanxi networks can be seen as clubs that guarantee their members the enforceability of available property rights in an institutionally disorderly environment, thus lowering transaction costs (in the form of contact and especially control costs). The club assures that

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<sup>8</sup> 'Resources' refer to the information, goods and services accessible to the affiliated club members.

members have the certainty of disposal over their rights. The expenses necessary for club membership can be seen as an investment in social capital which upon joining have the characteristic of sunk costs. The stock of social capital created in a guanxi network are fixed costs for the members (Ben-Porath, 1980), which however enable the variable costs of contacts, negotiations and implementation of transactions between club members to be reduced to a minimum. Since the fixed costs are higher than the variable costs, the incentive for a high intensity of interaction is an integral part of the guanxi system. Contract fulfilment is assured in that information regarding the honouring or breaching of contracts spreads rapidly among the club members. Co-operative, contract-honouring behaviours thus also become the dominant strategy in one-period games (unique transactions between club members) since these unique games are bound up in an iterative system of multiple games (transactions) with other club members.<sup>9</sup> Honouring contracts and co-operative behaviour is positively sanctioned by the possibility of engaging in further, low-cost transactions with club members. In contrast, the response to opportunistic behaviour is a withdrawal of goodwill or even exclusion from the club,<sup>10</sup> which, for the club member affected not only means the loss of investment but also a massive cost increase for future transactions. These costs could be so high that withdrawal from the field of activity is necessary with possibly existence-threatening implications (Carr/Landa, 1983; Goudie/Stasavage, 1998).<sup>11</sup> The increase in utility that can be gained by maintaining long-term business relations thus clearly exceeds the short-term gains from an opportunistic breach of contract.

On the basis of this co-ordinating mechanism which clearly reduces the transaction costs of economic exchanges, the Chinese guanxi networks have advanced the development of the division of labour in the economic process (and also economic development) in Chinese society over the centuries, and they continue to exist as complementary and parallel mechanisms for ordering economic interaction. Especially in the reform period since 1979, the organisation of economic activities by the guanxi networks has regained importance. The Chinese reform model of gradual transition which is advancing the restructuring of institutional conditions in the form of a hardly foreseeable trial-and-error procedure rather than a system of economic policy that creates planning confidence (Rawski, 1999) is a cause of great institutional uncertainty in economic interaction (Wank, 1999). The reform period is characterised by the dissolution of established, central-administrative ordering mechanisms and a not always simultaneous creation of new, more strongly market-oriented elements.<sup>12</sup>

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<sup>9</sup> Axelrod shows that co-operative behaviour only becomes the dominant strategy in repeated games and is able to overcome the prisoners' dilemma (Axelrod, 1983).

<sup>10</sup> For a documentation of sanctions of varying degrees practised in China, see Wank, 1999.

<sup>11</sup> For a concrete example of how the mechanism is used in a Chinese community, see Krug/Polos, 2000.

<sup>12</sup> The first formal contract legislation, which did not take effect until 1 July 1982, four years after the reform process had begun, was still strongly bound to the old central administrative system and quickly came into contradiction to subsequent laws and decrees. Nevertheless, the law was not revised until 1993 and it was not until October 1999 that a comprehensive, uniform contract law went into effect. Even more problematic than this delayed reform legislation is the poor enforcement of existing law, which is the result of administrative interventions and an often insufficient training of the personnel that enforces the law (Tao/Zhu, 2001; Wank, 1999).

This leads to vacuums in the system of order which are filled by reverting to traditional, institutional arrangements and behaviour patterns and thus to a new heyday of personally oriented, relational assurance of transactions in guanxi networks (Root, 1996).<sup>13</sup>

#### **4. Corruption in the Context of Guanxi Networks**

In a society permeated by such guanxi networks, an analysis of the behaviour of isolated individuals can never be absolute but must be subject to an evaluation that is relative and suited to the situation. The definition of morally correct behaviour is not identical for all interaction partners but is based on the identity of the counterpart. Members of the core groups, i.e. a guanxi network, experience, in general, a different behaviour than individuals on the outside.<sup>14</sup> This is particularly important for the further analysis since the provision of certain goods or the implementation of transactions, which from the perspective of a guanxi relationship appear as normal and even necessary transactions within the club, from the perspective of a legal system that is independent of personal relationship would certainly fall within the sphere of corruption (Goudie/Stasavage, 1998). Insofar as guanxi networks and legal systems co-exist, there is a blurring of the limits between regular economic transactions and corruption.<sup>15</sup> For the individual economic actor this means that as long as no clear hierarchy exists between these two systems, and as long as guanxi transactions are assigned a clearly delineated functional zone within the legal system, conflicts of interest will always arise between maintaining club discipline, on the one hand, and following legal statutes, on the other.<sup>16</sup> Accordingly, a not insignificant portion of behavioural patterns that are classified

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<sup>13</sup> It would be wrong, however, to attribute the recent gain in importance of the guanxi networks solely to the planning uncertainty that has arisen in the wake of the Chinese transformation process. Already in the previous century, the Maoist policy of strengthening the allocative decision-making power of the state coupled with the expansion of the discretionary power of local cadres assisted the formation of personalised relational networks: guanxi networks. The guanxi networks that developed in this period were profitably used and expanded in the era of economic restructuring under Deng Xiaoping (Nee, 2000; Chan, 1999; Yan, 1996).

<sup>14</sup> The difference that emerges here is that between *zijiren* (in-group members), to which also all members of the guanxi network belong, and the *wairen* (out-group members). The latter are generally classified as *sheng* (raw) and thus have lower importance in all social interactions; they are confronted with an entirely different array of norms and rules. The situation-adequate relativizing of Chinese transaction relationships is also to be understood in this sense. These relationships are seen to be oriented around the collective in general (e.g. the guanxi network), but in particular social contexts they take on individualistic-discriminatory features (Gabrenya/Hwang, 1996).

<sup>15</sup> This effect is further exacerbated by the reformulation of value concepts and behaviour codes raised in the transformation process. Slogans such as 'let some first become rich' or Deng Xiaoping's famous saying, 'regardless of whether the cat is black or white the main thing is whether it catches mice' were by no means politically acceptable between the second half of the 1960s and the end of the 1970s. Determining the boundary between barely legal and already illegal behaviour has become much more difficult for the individual citizen to determine (Heberer, 2001).

<sup>16</sup> Moreover, in the context of the Chinese transformation process, which is only roughly controlled by the central state and otherwise based on the trial-and-error principle, the interpretation of specific behaviours as correct or incorrect is by no means always consistent. Instead, observations have shown that particular measures that were tolerated or even promoted at one point in time because they were considered useful for the economic development of a region or an industry, at a later point of time were then classified as illegal and were prosecuted. The concepts 'legal' and 'corrupt' are thus subject to a relativity that is determined by the changeable progress in the transformation process (Ding, 2000).

as corrupt by external institutions such as the World Bank or the OECD are important aspects of the social fabric (White, 1996). What is more, the network-preserving transactions, which appear illegal from the viewpoint of a supra-individual, codified legal system, are precisely that which establish institutions that create legal certainty in a relational, person-oriented environment. A moral and ethical evaluation of (economic) transactions, which are nothing more than social relationships, that is divorced from the social context (a not insignificant part of which was constructed by these very trade relation), is thus not justified. Examining the case numbers of corruption in China under this point of view, it is necessary to relativize the accusation of corruption in many areas.

It would be wrong, however, to dismiss the entire phenomenon of Chinese corruption as a problem of classification, caused by the parallel existence of two systems of order with differing functional principles and values. In Chinese society – independent of and beyond the grey zone that results from the parallel existence of personally bound and personally independent ordering mechanisms – there is also a clear, normative differentiation of morally unimpeachable behaviour and corruption or illegal granting of advantage, etc. That is to say, corrupt behaviour aimed at achieving private advantage can very well be identified in China, and there is a considerable amount of it. A particular characteristic here is that a considerable portion of these corrupt transactions take advantage of the existence of guanxi networks (Lee, 1991). It must be noted, however, that such transactions in interplay solely with the environment outside of the given guanxi networks can be classified as completely ‘corrupt’. Within the network itself they serve the formation of social capital and the maintenance of relationships just as any other ‘regular’ transactions and are indistinguishable from them.

It is a fundamental insight that corrupt transactions, just like all other economically based interactions, are grounded on the exchange of specific bundles of property rights and like these must deal with the cost problems of transaction initiation (search and information costs), of contract completion (negotiating and decision costs) and safeguards against opportunistic behaviour of the transactions partners (monitoring and implementation costs).<sup>17</sup> Corrupt transactions, however, are particularly endangered by ex post opportunism. Since corruption payments are a form of investment, which have no value outside the transaction, the payer places himself in a potential hold up of the receiver who can demand additional payment or who may not – or not sufficiently – perform the agreed service, without needing to fear counter measures from the payer.

In light of the illegal character of corrupt transactions, the established, formal institutions of the national market and legal systems cannot be laid claim to (Goudie/Stasavage, 1998), so that other ordering mechanisms must be utilised (Rose-Ackermann, 1999). The ideal solution of such a problem from the perspective of new institutional economics is the ‘vertical

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<sup>17</sup> On the costs of market utilisation, see Richter, 1990. For the specific risks and uncertainty factors of corrupt transactions, see Goudie/Stasavage, 1998.



integration' of all transaction partners under the roof of a governance structure that encompasses the entire transaction: an enterprise (Williamson, 1985). This solution, however, is not available for corrupt transactions because of their illegal character and the fact that one party is usually part of the public administration and not internalisable.

In contrast, the Chinese guanxi networks seem to offer a practicable, and under the given conditions, a transaction-cost-minimising (best practice) solution for the problem of corrupt transactions. The suitability of guanxi networks for the solution of the problem of corrupt transactions is seen in the ability of this institution to transform high-risk exchanges into self-implementing contracts. At the same time, they are an approximation of an ideal solution in terms of institutional economics: with their significant investments in building the network, all participating parties document a credible commitment; they expend resources which can only lead to a pay-off if future transactions are carried out in the interests of all contracting parties. The above argumentation shows that these contractual relations are 'stable' since all participating parties must have an interest in long-term transaction relationships. Because of their high portion of such investment costs, guanxi networks create governance structures that force contract-honouring behaviour of the transaction partners, analogous to vertical integration solutions (Reja/Tavities, 2000). Guanxi networks thus manage to provide an infrastructure in which the transaction partners can safeguard themselves from the ex post opportunism of one side.

The use of guanxi networks for co-ordinating corrupt transactions not only makes sense in functional terms; it is also optimal with regard to transaction-cost theory. As described above, transactions co-ordinated in guanxi networks have high fixed costs but low variable costs. For the individual this means that with a high volume of transactions the average cost of individual transactions can be lowered. There is thus an incentive to use a guanxi network for as many transactions as possible. The individual can thus use the same ordering mechanism that forms the basis for his 'regular' transactions also for transactions carried out with the clear intention of manipulating for personal advantage the political decision-making process – transactions that must accordingly be classified as 'corrupt'. In this way he cannot only save the costs of setting up a special system for co-ordinating corrupt transactions but can additionally also lower the average costs of *all* transactions co-ordinated via this guanxi network.<sup>18</sup>

Chinese guanxi networks are thus both efficient and transaction-cost-lowering co-ordination mechanisms for initiating, conducting and controlling transactions in an environment characterised by high institutional uncertainty. The question that must be examined is the

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<sup>18</sup> An example for the simultaneous use of guanxi networks for co-ordination of legal and illegal transactions is the phenomenon of smuggling in southern China. Most of these smuggling transactions are co-ordinated by the same guanxi networks that also serve the arrangement of legal relationships (foreign trade, direct investment) between parties, mostly in southern China, Hong Kong and Taiwan (Heilmann/Gras/Kupfer, 2000).

extent to which an intensified establishment of an institutionalised and codified legal system will lead to a displacement of the guanxi networks that permeate Chinese society, or whether the co-existence of two systems that offer legal security is possible in an economy in the long term. The following analysis of the complementary or substitutive position of guanxi networks in a legal system will therefore also try to clarify the questions of the medium-term continuation of the institutional underpinnings of a significant portion of what can be classified as corruption in China.

## **5. Guanxi Networks and Codified Law as Competing Systems of Order**

The increasing opening of the Chinese economy in the wake of the transformation process requires to an increasing extent an institutional framework that supports market transactions to ensure the availability of enforceable property rights. With this and also the impending membership in the WTO in mind, the Chinese leadership is endeavouring – and also obligated – to develop and introduce a legal system that codifies the security of property laws at a supra-personal level. Such a legal system will stand as a direct competitor to the established guanxi networks, which have been the main guarantor of property rights. Guanxi networks and a legal system thus characterise two independent systems of order which are initially not mutually exclusive. Although their coexistence seems quite possible within certain limits,<sup>19</sup> the questions remains as to whether this coexistence is desirable and can be permanent from overall economic and individual perspectives. The establishment of an institutional framework that offers legal security at a supra-individual level beyond social relationships seems at first glance to offer significant advantages especially with regard to transaction frequency, the free choice of transaction partners, and especially transaction costs.<sup>20</sup> This should lead individuals to no longer rely on the system of guanxi networks to secure their transactions since there is now no uncertainty regarding the enforcement of contractual rights. From this standpoint, guanxi networks should gradually lose importance and ultimately disappear once a functioning legal system gradually becomes established. For the phenomenon of corruption, this would mean that an important ordering mechanism would disappear, the transaction costs for corrupt transactions would increase, and, ceteris paribus, the incidence of corruption must decline.

The superiority of a supra-individual legal system postulated here vis-à-vis the personalised guanxi networks is, at closer examination, doubtful and certainly not supportable as a

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<sup>19</sup> On the basis of their surveys, Krug/Polos reach the conclusion that ‘trust and contracting are not seen as substitutes, let alone mutually exclusive. Instead they reinforce each other: Without trust no contract, and without ambiguity-reducing contract no trust’ (Krug/Polos, 2000).

<sup>20</sup> As a result of his cliometric studies, North asserts: ‘The move, lengthy and uneven, from unwritten traditions and customs to written laws has been unidirectional as we have moved from less to more complex societies and is clearly related to increasing specialization and division of labor associated with more complex societies.’ (North, 1990).

categorical formulation. Supra-individual legal systems appear superior in terms of their ability to provide good legal security, but this unambiguous assertion is no longer possible with respect to the transaction costs that are linked to the provision of good legal security. Especially the utility and cost-based rationale for shifting transactions once co-ordinated by guanxi networks to the ordering mechanism of a legal system appear doubtful in terms of the concepts of path dependency and embeddedness.<sup>21</sup>

**Transaction Security as a Public or Club Good.** In terms of the establishment of institutional order, legal security can be regarded as a public good. In contrast, legal security provided by guanxi networks, as discussed above, could be labelled a club good. Seen in these terms, a number of characteristics emerge that must be considered in the analysis. The central feature here is the optimal club size. With an increasing number of club members, an effective sanctioning of infringements is no longer assured. Once the optimal size of a club has been exceeded, the costs informing club members of individual infringements increase (Carr/Landa, 1983). Sanctioning misbehaviour, which depends on the complete information of all club members regarding the trustworthiness of all others, can no longer be guaranteed under all circumstances. This could make opportunistic behaviour appear worthwhile for some individuals (Buchanan, 1965), and the function of the club as a guarantor of legal security for its members is thus challenged.<sup>22</sup> With a public good, provided by a codified and institutionalised legal system, this problem does not arise (Buchanan, 1965). On the contrary, even an expansion of the number of ‘consumers’ of this good will not, by definition, allow any rivalry in consumption to arise. Additional users lower the per-capita payments without giving rise to crowding effects (Sandler/Tschirhart, 1997). Especially in rapidly growing economies such as China, the increase in transaction partners and the advancing division of labour via specialisation is a motor for this growth (North, 1984). With an increasing division of labour, Guanxi networks have definite limitations because of their club character, since the optimal club size is reached much before the optimal permeation of a division of labour (and accordingly the optimal number of transactions and transaction partners) has been reached.

**Fixed and Variable Costs of Transaction Assurance.** As shown above, guanxi networks can limit the variable costs of a transaction to a minimum. After a comparatively high initial investment in social capital for membership in the club, only marginal transaction costs (mostly limited to search costs) accrue for all further transactions. Since, however, the investments are in the form of sunk costs, these are no longer significant in an individual’s utility maximisation calculations. Guanxi networks thus contain an immanent incentive for maximising possible transactions, since each additional transaction must only be assessed in

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<sup>21</sup> For the future viability of guanxi networks, see also Wang, 2000.

<sup>22</sup> This can be seen in terms of the prisoners’ dilemma model in which defecting is the dominant strategy – as long as there are not an endless number of games. Once there is a significant likelihood that opportunistic behaviour will not be recognised and sanctioned because of information deficits, there is an incentive for opportunistic behaviour in dependency on the degree of sanctions – an incentive to prefer defecting over co-operating.

terms of its variable costs. In contrast, there are opportunity costs for club membership that arise because transactions with outsiders are not possible. These costs are hence a function of the club size, and decrease as the club size increases.<sup>23</sup>

In an institutional legal system there are no fixed costs for the individual. Legal security exists for every transaction and protects every transaction. In such a system, however, there is a fundamental difference between the existence of rights and their enforcement. The legal security granted by such a system is thus closely bound to the credibility and impartial application of sanctions. If one of the supports is weakened, however, be it that the judiciary is not sufficiently independent or the executive is not able to enforce the imposed sanctions, the system loses its functionality in many areas.<sup>24</sup> It must be clearly understood that the judiciary must not only be free of preferences in a personal regard but must also give out clear signals of its credibility. A codified legal system does not establish the public good of contractual and legal security simply as a matter of course. Rather, it is the task of particularly specialised individuals to manifest this in everyday social dealings. It is not clear, however, whether precisely these specialists, who because of their institutional position have (spatially limited) monopoly power, can be exonerated of opportunistic behaviour (Elster, 1989).

If, in addition, an economic community is highly opportunistic, i.e. contractual infringements are relatively frequent, the cost of pursuing claims that the individual must bear are very high. In the case of a contractual infringement, the individual thus incurs extensive transaction costs, which can be characterised as legal implementation costs. Accordingly, an individual who engages in a transaction has a high ex ante uncertainty over the actual variable costs of the transaction, which are a function of the likelihood of a contract infringement by the transaction partner as well as the institutional law enforcement. This uncertainty becomes part of the individual's maximisation calculation and tends to reduce the number of transactions carried out.<sup>25</sup>

**Path Dependency in the Use of Systems of Order.** A reduction of the importance of guanxi networks for the co-ordination of economic transactions and a strengthening or sole use of the legal system is prevented to a great extent by the phenomenon of path dependency (David, 1985). In the final analysis, path dependency points to competition failure in the area of institution selection owing to the lack of possibilities for setting up several parallel institutions

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<sup>23</sup> See here also the discussion of optimal club size and the control costs dependent on this in Sandler/Tschirhart, 1997 and Carr/Landa, 1983.

<sup>24</sup> Despite decades of intensive efforts in establishing a codified legal system with independent courts, great uncertainty still remains in China concerning the true independent status of the court system and thus the role of the courts as a legal arbiter (Wank, 1999).

<sup>25</sup> It should be pointed out that there is no agreement as to whether informal institutions should be introduced in any form as restrictions in an individual's utility calculations. It is often pointed out that informal institutions are obeyed not because of external sanctioning mechanisms but because the utility they give the individual, since complying with them is part of the individual's direct preferences – as a result of socialisation and internalisation (Mummert, 1995).

and making a direct comparison of performance.<sup>26</sup> Instead, decisions are made under conditions of great uncertainty for the establishment of a specific institution for which investments are made which, in the form of sunk costs, create incentives for the retention of the institutional solution that has been chosen even if, at a later point in time, another institution may be considered a better option. A change in systems of order among the competing systems is thus not made solely on the basis of weighing up the accruing costs per transaction. An economic actor with a short-term orientation will persist in using a once-established system of order until the opportunity costs of maintaining the existing system surpass the costs of constructing a new system within the calculation period that is relevant for this economic subject.

As shown above, guanxi networks display a great amount of sunk costs, which account for the great inertia of this ordering mechanism. The low variable costs of using this mechanism and the high fixed costs make it extremely resistant to changing to a competing mechanism once the initial investment has been made in the social capital it is based on. This means that the performance of the Chinese legal system must be regarded as considerably superior to the guanxi networks for the individual economic actor to view as rational the use of the legal system instead of the guanxi networks to safeguard transactions. Alternatively, massive pressure by political decision-makers must be exerted for legal systems to displace the guanxi networks.<sup>27</sup> It is also an open question whether these decision-makers are themselves truly interested in the establishment of an independent, unbiased legal system.

**Embeddedness of Order Mechanisms.** An additional argument for the continuation of guanxi networks stems from their embeddedness (Granovetter, 1985) in Chinese society as a whole. Within the overall system, the choice and arrangement of institutions does not follow economic efficiency criteria alone but is also influenced by cultural and social factors (DiMaggio, 1994). On the basis of their development within China over the centuries and millennia, the guanxi networks are strongly anchored in Chinese society and have an important function not only on the economic level but also dominate interaction on a political and social level. For Hamilton, guanxi networks are the primary cultural feature of China and stand, moreover, in an antagonistic relationship to the Western system based on legal rights.

In the West, Christianity combined with preexisting institutions to produce clear jurisdictional lines of top-down personalized authority. In the economic sphere, this led to legal definitions of property and ownership. But Chinese institutions rest on relationships and not jurisdictions, on obedience to one's own roles and not on bureaucratic command structures. [...] [B]oth jurisdictional principles and the autonomous individual are historically absent in the Chinese worldview, and thus were not incorporated

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<sup>26</sup> In the course of the Chinese transformation process, precisely this has occurred in a number of cases. By selecting regions whose differing institutional arrangements were tested within the context of pilot projects, it was possible to test the performance and suitability of competing institutions (World Bank, 1992).

<sup>27</sup> Such a politically induced replacement process can be associated with massive compensation payments to the 'losers' of structural change, depending on the political constellation.

in Chinese institutions. Instead, Chinese society consists of networks of people whose actions are oriented by normative social relationships. (Hamilton, 1994)

In this light, it seems doubtful that a rapid replacement of guanxi networks – motivated by economic efficiency considerations alone – by a comprehensive legal system is likely.<sup>28</sup>

## **6. Conclusions**

This article has attempted to illuminate the institutional foundations of corruption in China. To do this it was first necessary to contrast the traditional understanding of corruption from the perspective of a personally unbound legal system with an analysis of a system where socio-economic interaction takes place within personally bound systems of order: the guanxi networks. The results show that there are many areas where legal and moral assessments are not possible without taking into consideration the underlying social system. Whereas certain transactions are considered corrupt from the standpoint of a personally bound legal system, the same transaction from the perspective of guanxi relationships appears to be normal and even a necessary measure for maintaining a personally bound system of order. The definition of corruption cannot be made universally but must be undertaken on the basis of the system of order that a society is based on. In light of the parallel existence of both a personally independent legal system and numerous personally bound guanxi networks, the classification of individual behaviours in China as ‘corrupt’ must, in most cases, remain relative.

Apart from this relative concept of corruption that derives from the parallel existence of two systems of order, another form of corruption was also identified. This is not an endogenous part of the functional mechanism of guanxi networks but instead takes advantage of the co-ordinating mechanisms of existing guanxi structures. In actual fact, guanxi networks offer a transaction cost minimising solution (best practice) for the problem of order that corrupt transactions are confronted with. Guanxi networks, by binding investments in social capital, are able to transform very risky trade relationships into contracts that are self-implementing. Insofar as transaction activity within guanxi networks have high fixed costs and low variable costs, it is obvious that already existing guanxi networks transcend their normal use and are also used to co-ordinate illegal, corrupt transactions. In this way, not only the average costs of all transactions carried out can be lowered, but it is also possible to economise on the expenses for creating a special security mechanism for the share of corrupt transactions.

The intensified efforts to establish a legal system in China raise the question of whether this will displace the guanxi networks and ultimately also weaken the phenomenon of corruption.

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<sup>28</sup> DiMaggio, however, sees a counter trend on the global level, ‘If anything, relational contracting seems to be on the rise, as more firms develop “network” alternatives to conventional markets and hierarchies’ (DiMaggio, 1994).

An analysis of the factors that determine such processes of institutional change – institutional performance, cost structures, path dependency and embeddedness – shows, however, that a substantial displacement of the guanxi networks, even with a further strengthening of the Chinese legal system, is not to be expected. Thus, from this side, no stimulus for reducing the phenomenon of corruption in China can be anticipated.

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