

# **Corruption and FDI in China: inseparable issues or distinct entities?**

by

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## **I. Introduction**

As we approach the end of the first decade of this new millennium, many scholars are asking the same questions: Will the U.S. remain as the sole dominant economic superpower of the 21<sup>st</sup> century? Will China surpass the U.S. as the new economic leader in the Asia-Pacific region and in perhaps even the world. I believe the validity of these questions are moot unless we consider the current state of the Chinese economy, the sustainability of her economic infrastructure and her potential for growth into the near future. One of the biggest contributors to China's economic growth is the amount of inward foreign direct investment (from hereon referred to as FDI) pouring into the country. One of the biggest impediments to her growth is the prevalence of corruption at all levels of government and within public & private sector industries. The purpose of this paper is to study the relationship between FDI and corruption in China. I will try to answer the following questions: What are the economic effects of corruption and how is that related to FDI going into China? Can we show a negative correlation between FDI and corruption in China through mathematical modeling? How can we quantify the presence of such an intangible variable as corruption? To encourage sustained FDI, is it necessary for us to combat corruption going into the future and if so, how?

Currently, China is still a developing economic power. According to World Bank's International Finance Corporation, an emerging market is any country with a per capita income of less than \$8956 in 1994. Other sources, such as the investment bank, Morgan Stanley defines an emerging economy as a country where growth and "a process of change" is occurring. No matter which definition one uses, China fits the mold of what a typical investor would view as an emerging market. Since 1978, China has

maintained an average output growth of around 10% annually. However, evidence shows that the country is very much dependent on foreign direct investment to provide the strong boost needed for its sustained rapid economic growth.

Since the beginning of China's transition from a planned economy to limited market capitalism in the 1980's, it has been beset by political and economic corruption. Under the leadership of Party Secretary Deng Xiaoping, whose motto is "to get rich is glorious", Chinese society has been transformed into a market-oriented semi-capitalistic economy in a span of only 20 plus years. One of the driving forces behind this transformation is the copious amount of foreign direct investment that began to pour into China since the late 1980's. This move toward capitalism also brought many social and economic problems to the forefront of Chinese public consciousness. Chief among them was the growing pervasiveness of corruption.

It is safe to say that corruption currently plays a major role within the Chinese economy. It is estimated that, from 1999-2001, corruption has resulted in average annual economic losses of 14.5 – 14.9 % of GDP<sup>i</sup>. These numbers are all the more shocking when we consider that the real GDP of China for 2001 was \$1.076 trillion.

The amount of FDI that China absorbed during this same period was \$47 billion<sup>ii</sup>. A key question that is certainly to be of interest to current Chinese leaders as well as "China scholars" is whether or not China has "lost" significant amounts of potential FDI from the international community due to the pervasiveness of economic corruption in the country. Common logic dictates that a foreign investor would be unwilling to invest in a country with a high level of corruption. There would be an increase in transaction costs, bureaucratic barriers (bribes), and the likelihood of possible embezzlement of the

invested funds. However, waves and waves of foreign investment continue to pour into the country annually despite the pervasive atmosphere of corruption that is widely acknowledged even by top government officials like Premier Zhu Rongji.

In the following sections, I shall give an account of the current corruption and inward FDI situation in China today. Then, I shall proceed to analyze the relationship between the two and attempt to quantify this relationship through statistical modeling. I will conclude by summing up the results of my study and propose ways in which the Chinese government can combat corruption in the future.

## **II. Corruption Situation**

Corruption looms as one of the biggest political and economic challenges China is facing in the 21<sup>st</sup>. century. In the context of our study, corruption is defined as *the misuse of public power for private benefits*, e.g. the bribing of public officials, taking kickbacks in public procurement or embezzling public funds. Most conservative estimates quantify corruption as consisting of 13-16% of China's GDP in the late 1990's<sup>i</sup>. This represents a huge economic loss and a "social pollution," contributing to problems such as environmental degradation, social and political instability, and the decreased credibility of government officials. According to a survey conducted by Prof. Hu Angang of Qinghua University, Chinese citizens viewed corruption as the number one factor contributing toward social instability<sup>iii</sup>. In 2000, fearful of the pains of economic reform and China's imminent entry into the WTO, Chinese people only named "unemployment and the fear of being laid off" ahead of corruption as the primary source of social instability.

The extent of corruption in China is such that in 1994, the government received more than 1.36 million complaints about corruption from citizenry and jailed over 20,000 individuals for corruption. In 2001, Chinese courts at all levels investigated over 36,000 corruption cases involving more than 4.1 billion Yuan. From 1994-2001, the number of people indicted under corruption charges grew by an average of 12.5% annually. In 2001 alone, those found guilty of corruption included five provincial/ministerial level public servants, 89 prefecture level officials, and 419 county-level officials<sup>iv</sup>. In all cases involving bribes and embezzlement, the suspects were members of state-owned enterprises.

There are several theories circulating within academic circles about the causes of corruption in the particular case of China. Almost all observers agree that the roots of this problem stem from the unique characteristics of China's socialist market economy. Academics that call themselves the "New Leftists" claim that corruption is caused by the capitalist market mechanism introduced through Deng's open-door policy to the West. They argue that China's rapid economic development in the past twenty years are actually the products of the solid economic foundation built during Mao Zedong's era. On the other hand, they point to capitalist reforms as the culprit for all the negatives aspects within China's economic development: inflation, unemployment, corruption and higher crime rates among the civil population. There is some truth to their argument that Chinese have gradually become greatly money-oriented due to the lack of a moral compass with the passing of communism (communism exists in name only currently). The solution they advocate is that China should restore Mao's socialist political and economic system to save itself from all kinds of social troubles and popular unrest.

However, the New Leftist theory on corruption has not been able to find many supporters among the general population with the exception of a small group of CCP officials who have lost their privileges during the reform. Most Chinese of Mao's generation, who have lived through the upheaval brought about by Mao's Great Leap Forward policy, the Cultural Revolution and the widespread famine of the 1960's realize that that bygone period is anything but a model of economic efficiency or social stability. In fact, many blame Mao for creating the very political system that grants and protects a privileged few from facing corruption charges.

Others, arguing from a sociological point of view, say that China's corruption problems stems from the basic characteristics of Chinese culture. They argue that Chinese as well as other Asians coming from Confucian cultural backgrounds have a long tradition of placing personal connections above the law. They believe that China's corruption problems can never be avoided no matter what political, economic, or social changes are brought about in the future. Many top political leaders and businessmen subscribe to this view and see corruption as simply another expense that must be factored into the costs of doing business in China. If we ignore the stereotypical implications of this argument for the moment, we can still refute this argument by examining past history. In the Western world, there are countless examples of societies where through the introduction of a new political and legal system, political and economic abuses by individuals was reduced to a minimum. Prior to the introduction of the Magna Carta and the common law system in England and even for some time afterwards, the nobility abused their privileges and drained the imperial coffers for self-enrichment. However, after a period of time when the new social norm gradually takes root, the political-legal

environment can change people's perceptions and behavior. There is nothing to suggest that there are characteristics within Chinese culture that encourages corruption as opposed to Western cultures. Furthermore, there is little evidence to show that change from a corruption-ridden society to one of law and order is not possible. In fact, one can draw parallels between the end of China's Nationalist regime in the late 1940's and the current situation. Immediately after the communists came to power, corruption under the prior Nationalist government was all but eliminated and the people were ecstatic about the change.

Most economists and scholars who study China believe that the true cause of China's recent corruption problems is due to the lack of separation between business and government, a weak judicial system and minimal economic transparency. These factors happen to coincide with the "opening up" of the Chinese economy and helps to magnify the extent of corruption. To understand the evolving growth of corruption, we must take a brief look at how the Chinese Communist Party handles the question of succession and as well as the management of political and economic affairs. Since the CCP came into power in 1949, the top party leaders and their subordinates have granted enormous privileges to their own children, relatives and friends in order to secure their hold on government. Thus, today, one can see that the overwhelming majority of leaders of the CCP Central committee, the military, the provincial governments and the state-owned enterprises are all successors of the elite and members of a privileged class. It is irrelevant whether or not these privileged elite have the intelligence or the capability to rule. Their familial ties ensure that they will retain an important position within the government bureaucracy upon the end of their formal education. To ordinary citizens,



their words are the law. To the top leaders in Beijing, the bureaucrats serve as reliable representatives of the state to the people.

Given this apparatus of choosing leaders of society, it is inevitable that abuses of power will result, which directly leads to two forms of corruption: implicit and explicit corruption. According to Prof. Shuntian Yao of Nanyang University in Singapore<sup>v</sup>, implicit corruption are the special privileges and benefits the state grants to these privileged individuals in exchange for their loyalty. For example, a state-factory owner would have cars, drivers, housekeepers, and guards that are all paid for by the government. However, the amount of actual work done by these individuals is miniscule due to the fact that most administrative duties are handled by their subordinates and assistants. Thus, the advantages these individuals exploit from society far outweigh their contributions to society. This is corruption in the sense that these privileges lead to economic inefficiency. Under a free market system, such an individual would never be able to receive so much profit without working for them. Under the Chinese communist system, he is “legally entitled” to these benefits because of his important role in political and economic decision-making.

Explicit corruption represents the expansion of these privileges through the illegal efforts of such individuals in their official capacity. Due to their control of state-owned resources, party officials can often extort bribes from those in need of their services. For example, a human resources director could expect “gifts” from a colleague in exchange for a decent government position for his son. With the evolution of the Chinese economy during the reform, the nature of corruption also changed. Privileged party members now know how to utilize their monopoly power in these semi-free markets. In terms of

foreign direct investment for example, foreign companies are expected to pay “off-book” commissions to certain bureaucrats if they wish to be awarded a government contract. These “commissions” are never recorded in any official accounts and can run as high as the extortionist wishes. Thus, the Chinese monopolist works for the state in name only, abuses the state-owned resources under his control and pays no taxes for his undocumented “commission” income. We can now see that no matter the form of corruption, the presence of the privileged class system is the root cause of China’s corruption problem under this theory.

In China, the best methods for detecting corruption are studying rent-seeking behavior as well as corrupt activities and data either stated or implied by the government. The main types of corruption in China are tax evasion; rent-seeking behavior; involvement in the underground economy, where the management of the goods is legal, but the income is illegal; involvement in the underground economy, where the management of the goods is illegal; and the abuse of public investment and expenditures. Corruption is particularly rampant in the railroads, aviation, telecommunications, and electricity production sectors of the economy.

First, economic loss from tax evasion is considered to be the largest type of corruption. In 2000, tax evasion accounted for losses of 7.6-9.1% of GDP. Next, illegal management of public investment monies and public expenditures has made these activities the second largest economic loss to corruption, accounting for 3.4-4.5% of GDP. Third, rents from monopolies are the third largest economic loss to corruption, accounting for 1.7-2.7% of GDP. Rent-seeking behavior leads to a loss in consumer surplus and in social welfare. The main sources of rent-seeking behavior are dual track

pricing, which is in decline; abuse of economic privilege and monopoly power; high import tariffs and quotas; and favorable government policies given to specific sectors or interest groups. Finally, income from the “black market” economy in illegal goods-smuggling and drug trafficking-is the fourth largest economic loss to corruption, accounting for 0.4-0.5% of GDP<sup>iii</sup>.

The history of anti-corruption enforcement is also not very encouraging. The probabilities of bureaucrats getting caught and punished are very small. At the ministry level, the chance of corrupt officials getting caught is about 1 in 10. The probability becomes 1 in 20 for county level officials, where 90% of corrupt activities take place. Of those that get caught, the number of officials that get sentenced by criminal courts is about 6.6%<sup>iii</sup>. The reason for this is that the penalty for corruption can be quite light as long as the culprit retain close connections with those in law enforcement and the judicial system. The risks of engaging in corrupt activities are also too low. The decentralization of government power in recent years has also contributed to a loss of control and judicial oversight. On the provincial and country level, officials, in cahoots with local thugs, police and judges, often feel that the central government won't be able to punish them because their reach is limited in scope.

The Chinese government has taken numerous measures to fight corruption. These measures include forbidding the government, police, and military to take part in business enterprises; implementing different accounting channels for revenues and for expenditures; and implementing a system of "accountant accreditation." Furthermore, corrupt officials who are caught are punished harshly, with sentences usually ranging from life imprisonment to execution depending upon the scope of the offense. The

results from these initiatives are a mixed bag. While corrupt activities often ground to a halt for the short-term (prompted by the fear of discovery and punishment), the long-term cancer of corruption remains. Year-over-year, as one can from exhibit 1, there is no visible reduction in corruption.

### **III. FDI Situation**

For us to do a comprehensive study on the relationship between inward FDI and corruption, we must examine how China interprets and quantifies FDI inflows.

The Chinese government defines FDI according to the International Monetary Fund's standards. According to the OECD, FDI *"reflects the objective of obtaining a lasting interest by a resident entity in one economy ('direct investor') in an entity resident in an economy other than that of the investor ('direct investment enterprise'). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise."* This definition includes 12 types of investments: equity capital, reinvested earnings of foreign companies, inter-company debt transactions, short-term and long-term loans, financial leasing, trade credits, grants, bonds, non-cash acquisition of equity, investment made by foreign venture capital investors, earnings data of indirectly-held FDI enterprises, control premium and non-competition fee. As we can see by exhibit 5, by the year 2000, equity joint ventures, representing 46% of cumulative FDI, was by far the most popular form of entry for foreign investment in China.

Inward FDI can be divided into two groupings: realized FDI and contractual (or pledged) FDI. When a foreign investor feels that a favorable set of political, economic

and social conditions exist in a particular region of the world, he would make a decision, sign a contract, and pledge his investment into that area. This would be considered contractual FDI. However, later on, the investor may decide that it is not a wise decision to invest in this area for any number of reasons. If he decides to renege on his contract, the FDI would be considered unrealized. If he goes ahead with his investment and FDI actually materializes, that would be considered realized FDI. Based on realized FDI figures, in 2001, China recorded FDI inflows of \$46.8 billion, making it the 6th largest FDI recipient in the world. Based on current calculations from the Development Research Center of China's State Council, China has already surpassed the U.S. as the largest FDI recipient in the world with roughly \$52.7 billion in FDI inflows for 2002<sup>vi</sup>.

The quality of foreign investment into China also seems to be improving. The number of newly approved Foreign-Invested Enterprises (FIEs) nationwide, the amount of contractual foreign investment and the amount of paid-in foreign investment all exhibits continuous growth trends. The sectoral focus of foreign investment continues to witness change, with a greater percentage of foreign investment flowing into high-tech industries. In 2000, a significant growth margin was witnessed in the number of newly established FIEs and committed foreign investment, with the biggest growth margin of foreign investment inflows to be found in the electronics and telecommunications equipment-manufacturing sector.

The year 2000 saw the approval of 12,196 newly-established foreign enterprises (wholly owned by foreign investors), with contracted and paid-in foreign investment reaching US\$34.309 billion and US\$19.264 billion respectively, a year-on-year increase of 45.70%, 62.45% and 22.47% and accounting for 54.58%, 55.00% and 47.31%

respectively in the nations foreign investment absorption aggregates<sup>vii</sup>. For the most part, FIEs that are currently in operation are showing above-average performance -- their growth margins in terms of such leading economic indicators as industrial value added, export value, tax payments, value of surplus of foreign exchange settled with and sold to banks all higher than the national mean.

In terms of cumulative foreign investment absorption aggregates (the number of newly-approved FIEs nationwide, the amount of contractual foreign investment and the amount of paid-in foreign investment, as is the case thereafter), Sino-foreign equity and contractual enterprises continued to be the main form of foreign investment absorption in China. By the end of the year 2000, China had cumulatively approved 256,354 Sino-foreign equity and contractual enterprises, with contractual and paid-in foreign investment standing at US\$ 439.094 and US\$ 231.417 billion, accounting for 70.45%, 64.95% and 66.43% respectively of the nations cumulative foreign investment absorption aggregates (cumulative number of FIEs, contractual foreign investment and paid-in foreign investment)<sup>vii</sup>.

According to exhibit 4, the U.S. is still the largest “foreign” investor in China both in dollar terms and in the number of target enterprises. In the year 2000, American invested enterprises in China numbered 2609, a year-on-year rise of 28.65%; contractual foreign investment was valued at US\$8.001 billion, a year-on-year jump of 32.99%; and paid-in foreign investment rose stood at US\$ 4.384 billion a year-on-year upward inch or 3.99%. The 10 Asian countries/territories surrounding China (Hong Kong, Macao, Taiwan Province, Japan, the Philippines, Thailand, Malaysia, Singapore, Indonesia and South Korea) established a total of 15,981 enterprises in China and put in \$30.454 billion

in committed foreign investment in 2000 – a rise of 30.17% and 25.55% respectively year on year. Actual investment from these nations was \$25.386 billion, down by 5.25% from the previous year<sup>vii</sup>. This downward sloping trend in investments seem to reflect the uneasiness these countries feel toward China as a dangerous economic competitor in the region and also as a diverter of FDI from Western industrialized nations.

By the end of 2000, the top 10 investors in China included not only large developing nations such as the U.S. and Japan but also Asian neighbors whose economies are intricately tied to those of China. The US had overtaken Japan to become the second biggest foreign investor in China. However, Hong Kong is surprisingly the biggest overall investor in China. In fact, many critics of China's FDI calculation methods point out the fact that regions like Hong Kong, Taiwan and Macao continues to remain on the top of the list of "foreign" investors in China when in actuality, these territories are all, for the most part, internationally recognized as being part of the country of China.

In the year 2000, China's eastern and western regions both experienced slow growth with regards to the number of newly established FIEs, the value of pledged FDI and the value of paid-in FDI while the central region saw a slight drop in connection with paid-in FDI. Of the nation's FDI aggregates, the eastern region won an even bigger share while the central and western regions both were faced with a declining share. Despite the Chinese Government's commitment to western development and offers of favorable measures to try to direct foreign investors to the region, the 12 provinces, autonomous regions and municipalities in the west make up only 5 per cent of China's total foreign investments in terms of accumulative amount<sup>vii</sup>.

By the end of 2000, the nation had cumulatively approved the establishment of 363,885 foreign-invested enterprises, among which approximately 160,000 enterprises had expired in their term of duration, been terminated or stopped operations. Foreign-invested enterprises have directly employed 21 million people, or approximately 10% of the urban work force in the country. For FIEs as a group, in terms of such leading economic indicators as industrial value added export volume and value of surplus of foreign exchange settled with and sold to banks, their growth rates were all higher than the national average, thus providing a boost to the sustained, rapid and healthy development of the Chinese economy. Foreign-related tax revenues mainly sourced from FIEs' tax payments (excluding tariff and land taxes) reached 221.7 billion Yuan, growing by 35.45% year-over-year and accounting for 17.50% of the nation's tax revenues<sup>vii</sup>.

In the year 2000, exports and imports of foreign-invested enterprises continued to expand at a high rate and comprised an even bigger proportion of the nation's total import and export volume from the previous year. For the year as a whole, FIEs reached an import and export value of \$236.714 billion, bulging by 35.64% as compared with the year 1999, and accounting for 49.91% of the nation's total value of imports and exports (\$474.308 billion)<sup>vii</sup>. Many major foreign investors, especially those from Asia, use China as a cheap labor source and export low-tech products to other regions around the world.

As we can see from the above numbers, FDI is now an integral contributor to the health of the Chinese economy. The government relies on FDI for taxes, technology/knowledge transfers, and economic development while the Chinese people rely on FDI for employment and an increase in living standards.



#### **IV. Empirical History**

If one looks at the range of works circulating in academia on the topic of corruption and its effect on foreign direct investment, we can see that very limited study has been done in this area. If one delves deeper and tries to find research on this topic in relation to the current economic situation in China, the amount of precedent material are even scarcer. What academic discussion exists focuses on finding evidence that corruption has a negative effect on economic activity and how best to quantify that effect. Papers such as Wei and Kaufman's "Does grease money speed up the wheels of commerce?"<sup>viii</sup> aimed to investigate whether or not corruption payments led to more efficient outcomes for firms that dealt with an inefficient government machinery. The results from these studies were rather conclusive: firms that pay more bribes are likely to face higher, rather than lower, costs of capital. This occurs because the "efficient corruption" argument fails to take into account the fact that government agents who profit from corruption are very likely the same ones who are making the rules, regulations and their interpretations in the first place. Thus, the only incentive that corrupt agents would have is to increase the opacity and cumbersomeness of laws so that they would have more opportunities to engage in extortionist activities of self-enrichment. The end result is that foreign investors will have to overcome a maze of financial hurdles and graft in order to successfully do business in corrupt countries.

Other empirical studies by scholars have clearly established the negative effects of corruption on economic performance, investment and growth. James Hines Jr.'s study on the relationship between U.S. direct investment in foreign countries and the level of

corruption within each country found a very small correlation between the two factors<sup>ix</sup>. However, American FDI in corrupt countries grew more slowly than in less-corrupt countries from 1977-82. Shang-Jin Wei, a Harvard-based academic who has devoted many of his writings on the relationship between corruption and FDI, has suggested that corruption may be a symptom of the malfunction of governments. Therefore, corruption would impose added costs to foreign investors when they deal with a government during their investment experience. Using data on a matrix of bilateral FDI from 14 source countries to 41 host countries, Wei estimated the magnitude of the negative effect of corruption on inward FDI relative to that of corporate income taxes on inward FDI<sup>x</sup>. The result seems to indicate that severe corruption within a country (or at least the perception of the severity of corruption---which is the only direct measure available for corruption) deters source countries from investing into the corrupt host country. Severe corruption has the same effect as raising the tax rate within the host country by an additional 40-50% points.

If we subscribe to the popular view that corruption does have a negative effect on inward FDI, we must examine some of the possible ways corruption may discourage foreign investment and how they can be best measured. First of all, corruption is a non-transparent activity that has very little enforcement mechanisms embedded within it. An investor who pays a bribe to a government official receives no guarantees whatsoever that the official will carry out his promise (be it processing licenses or supplying other services) due to the illegal nature of corruption. It will create an atmosphere of uncertainty and opacity for a foreign investor. We can think of corruption as a random variable cost, unlike taxes, that could be imposed on the investor at any given moment

during his dealings with the host country bureaucracy. Thus, there are two negative aspects to corruption in this case. It is a risk that cannot be hedged by the investor and it has a volatility level (amount of the bribe or payment) that may be difficult to judge. For an investor whose goal is to maximize their profits in the host country, the arbitrary nature of corruption would wreak havoc with the investor's estimate of return on his investment. Therefore, the investor must categorize corruption as a political risk and assign an appropriate risk premium to the discount rate that he normally uses for calculating his investment returns in a particular project or avoid investing in corrupt countries entirely. For example, Standard and Poor's, as well as most other political risk analysts tend to quantify corruption as one of the risk factors that ultimately contribute to their country credit rating decisions. AT Kearney, the global consulting firm, publishes an FDI confidence index, which measures the investment attractiveness of over 20 countries. Corruption is one of the major variables that determine investor confidence in these target nations.

A significant survey linking FDI and corruption was performed by John Bray of Control Risks Group (an organization that provides consulting services in the fields of corporate accountability and anti-corruption), which attempts to rank the effect of various risk factors on a company's investment decisions. The survey (Exhibit 8) was conducted by the Industrial Research Bureau on behalf of the consulting firm in September and October of 1999, focusing on the international business development directors of 50 American and 71 European firms. Respondents were asked whether they had held back from an otherwise attractive foreign investment on account of a country's reputation in corruption, human rights, labor abuse or the environmental preservation. Among

American companies, corruption was the overwhelmingly most important factor that directors based their investment decisions on. Among European firms, corruption was also indicated to be the most important issue but the margin of its magnitude relative to other negative factors is much less. We can see that foreign investors do consider corruption to be the most vital risk factor in shaping a country's investment appeal.

Secondly, corruption can simply act as an additional tax imposed on foreign investors. If that is the case, these "taxes" raise the break-even point for investment projects. It may create incentives for investors to move into the informal sector and not comply with government regulations. It may also lead to economic distortions if the fee varies with respect to the official involved and if not all businesses pay the same fee. The result is that overall economic activity is reduced. Shleifer and Vishny have provided a theory of the industrial organization of corruption in which they show that the level of corruption depends on the level of competition among government officials for gains from this illegal activity<sup>xi</sup>. In highly organized governments, the bribe income is shared among officials such that once the bribe is paid, the investor can be certain that he has full rights over the government good he bought and no further costs will be imposed upon him. However, in a highly decentralized government where officials are competing with one another for illegal revenue (bribes, fees, etc.), the costs of corruption will be driven up. Furthermore, one could extend the argument to include the fact that in regions where there is a high level of bureaucracy and where the government revenues are greatest, one would be more likely to encounter a high cost of corruption. The incentive for charging additional bribes and miscellaneous fees not found in the legal code will be very great in

a country where the overlapping tangle of bureaucracy and unclear power boundaries make law enforcement and corruption detection difficult.

Thirdly, corruption reduces a firm's competitive advantage vis-à-vis rivals in the form of less protection of intangible assets, and a lowering of the probability that disputes between foreign firms and local firms will be settled fairly in host country courts.

Studies by Wei and Smarzyska have raised the possibility that foreign firms have learned how to circumnavigate this negative effect from corruption<sup>xii</sup>. By forming joint ventures with local firms within the host country, a foreign investor may be able to reduce his transaction costs (i.e.: amount of bribery for local permits) and cut through government red tape. Given that corruption is so difficult to measure and yet obviously plays an important role in the investment decisions made by any rational foreign firm, perhaps an examination of a foreign investor's choice of entry mode may reveal how much corruption is present within China. It is important to take into account the fact that foreign investors with sophisticated technologies may be less inclined to invest through a joint-venture due to possible diffusion of their assets to a local firm.

While the above theories focus on the FDI-corruption dichotomy on the global scale, China's macroeconomic factors make it a unique specimen for the purposes of our study. We need to construct a new theoretical framework to understand how FDI and corruption interact in a country that practices capitalism with socialist characteristics. The first question we should ask is: What are the causes of corruption in China? The detailed economic factors that foster corruption and corrupt behavior in general are too numerous to be mentioned here but if we speak in generalities, corruption is caused by a

combination of a) government involvement in the marketplace, b) lack of market enforcement mechanisms, and c) an ineffective legal system.

The biggest positive contribution that the government makes to the marketplace in capitalist economies is in its protection of private property rights. However, in China, the authoritarian communist government involves itself in the affairs of private markets in a variety of negative ways. First of all, the Chinese government has created a labyrinthine tangle of laws and regulations pertaining to the conduct of business in the marketplace. These rules are often extremely unclear, open to interpretation, subject to constant change, and do not serve their original purpose of providing transparent guidelines for all the market players to follow. There is an even greater maze of government bureaucracies that supposedly oversees the proper administration of these regulations. In such a confusing environment, there is a great deal of cracks and loopholes that allow corrupt activities to escape unnoticed. For example, one of the main reasons there is such a lack of protection for intellectual property rights (IPR) lies in the confusing issue of jurisdictional oversight of IPR enforcement. Authority over IPR enforcement in China is spread across a plethora of government agencies: the Trademark Office under the State Administration for Industry and Commerce, the China Patent Office, the National Copyright Administration, and the Cultural Market Administration. Secondly, the government meddles in the market in the form of State-Owned Enterprises (SOE). Besides being inefficient and economically unsustainable entities, the administrators of many state-owned enterprises tend to abuse their power by implementing arbitrary charges on the populace (as mentioned above), engage in embezzlement and other opaque corrupt activities. The allure for engaging in such corrupt activities stems from

the fact that SOEs answer to no one but the government. There is no incentive for profit maximization or a need for building strong relationships customer relationships centered around the concept of trust.

Market enforcement mechanisms can be divided into regulatory and economic mechanisms. Examples of regulatory mechanisms include monetary penalties, product standards, official permits, compliance schedules, etc. They are rules created by the government with the intention of shaping interactions between players within the marketplace. These mechanisms certainly exist within China but they lack significance because of a lack of enforcement on the part of government officials. Decentralization and information asymmetry is one of the causes of this lack of enforcement. For example, a well-meaning official in the central government in Beijing may draft and pass a law that denies permits to all vendors that sell poor-quality foods (determined by inspection). A vendor that sells rotten food in a backwater province can circumvent that law by simply bribing the local policeman on the corner, assuming that the local bureaucracy even bothers to enforce this law in the first place. Economic, or market-based enforcement mechanisms rely on the players within the marketplace to regulate one another. The concept of reputation plays a large role here.

The legal system, for all intents and purposes, is nothing more than an instrument of the ruling government, used for preserving social order. Judicial decisions are often arbitrary and do not necessarily follow the sentencing guidelines set out in the Chinese constitution or the criminal and civil codes. There are no checks and balances within the Chinese government that would prevent the executive and legislative powers from interfering in judicial matters. When this is the case, the Chinese public, investors and

even government officials themselves develop a lack of trust in the fairness and supposed impartiality of the judicial system. This encourages all actors within a marketplace to think in terms of short-term gains, the consequences be damned, and not in terms of long-term benefits. Actors who engage in corruption can seek protection from the legal system by “greasing the right palms”.

How does the above discussion of corruption in China affect FDI? Without a well-developed and independent judiciary, an enforceable system of law and adjudication, effective institutional mechanisms that govern marketplace transactions and a strong buffer between private markets and the government, foreign investors are unable to invest with confidence in China due to the lack of investor protection. Every step of one’s investment is subjected to a great deal of uncertainty, hazards and risks such as: possible infringement on intellectual property (in the form of piracy or illegal technology transfers), biased decisions in a court of law, increased transaction costs (in the form of bribery, extra procedural “fees”), possibility of embezzlement and financial corruption on the part of local employees, and increased information costs (difficulty in identifying which regulations to follow). The evidence here seems to point to the fact that corruption does have a negative effect on the investment decisions of foreign investors.

However, one can also give the counter-argument that greater FDI leads to greater economic growth which would in turn lead to an improvement in market mechanisms in terms of legal enforcement—ultimately reducing corruption. This causality issue has still not been conclusively resolved in academic circles. In this study, on the basis of our above discussion on the causes and effects of corruption, we will assume that the former causal direction holds a greater sway in China than the latter causal direction.



Corruption is certainly not a problem that only relates to economic loss. It is also a socio-political contagion that does not create any new wealth but only transfers wealth from the general public (“laobaixing” in Chinese) to those who wield political and/or economic power in Chinese society. It is an abuse of public power that unfairly redistributes social goods and services through hidden illegal measures. Corruption leads to not only greater inequality in terms of a social “wealth gap” but also creates indirect problems such as greater disregard for private property rights, greater incentive to engage in trickery and deceit when conducting business within the marketplace, and greater reluctance to invest, due to the aforementioned effects, on the part of investors—both foreign and domestic.

One manifestation of corruption in China is the government’s monopoly on consumer markets. Similar to a free market monopoly, government administrated monopolies impede fair competition and destroy market balance. Unlike free market monopolies, which are governed by anti-trust laws, government monopolies are considered to be legal and use government power to control the distribution of goods and services. Thus, it is natural for government officials to extort bribes in exchange for services rendered to the public. Hu Angang, a well-known economist from Qinghua University, posits that government administrative monopoly causes economic losses of between 50-100 billion Yuan annually<sup>iii</sup>.

Administrative monopolies not only damage the interests of the public and of other industries and enterprises, but also damage the long-term interests of a country. First, administrative monopolies are usually in industries that are the source of fundamental materials for the public at large and for enterprises, such as power,

telecommunications, rail service, and water. If prices of these products are sky-high, this will inevitably force ordinary people to cut other expenses to pay for these products. This expense shift not only hinders the healthy development of other non-monopolistic industries, but also leads to unbalanced consumption patterns and market structures.

Second, administrative monopoly has greatly wasted and damaged effective social resources. For instance, administrative monopoly has led to corruption and low efficiency in China's postal administration, which always shifts its losses to consumers by raising the prices of its services. This shift has led to market decline and has created a gargantuan but bloated postal service network that utilizes only half of its capacity. Despite all this, public criticism has been muted due to fears that officials will punish any agitators by further raising the prices of goods/services for that individual.

Thirdly, administrative monopoly has actually shrunk the market for administrative monopolistic industries and creates significant barriers to entry for foreign competitors seeking to enter the market. In 2001, it is estimated that the state-controlled Chinese banking industry is overburdened with over \$7 trillion in loans to loss-generating state industries controlled by government officials. Without healthy competition however, state banks have no incentive to increase its efficiency, productivity and reduce corruption within its rank and file. State banks, as an administrative monopoly itself, continue to provide credit to its fellow administrative monopolies with the savings of the general populace instead of making profitable investments into growth markets. We can further postulate that FDI into such industries that are dominated by an administrative monopoly is retarded due to these conditions. The foreign investor would not wish to face government hassles and restrictions while the corrupt officials will do all they can to

protect their privileges and prevent pure competition from taking place in their spheres of power. Therefore, we can conclude that administrative monopoly has become one of the largest bottlenecks in China's national economic development.

To buttress our argument that administrative monopolies tends to hinder FDI, we need only refer to exhibit 9. From 1999-2000, the average FDI growth rate for one of the 52 sectors and industries in the Chinese economy is 154%. However, for each one of the industries that can be categorized as an administrative monopoly according to our previous definition, only far below average negative FDI growth was exhibited.

## **V. By the numbers**

Previous studies of economic corruption across the globe have presented strong evidence of a direct negative relationship between the amount of FDI a country receives and its perceived level of corruption by its own citizens and the international community. However, China has always been an outlier in these studies. Is China special somehow? Do foreign investors place greater importance on economic and environmental factors other than corruption in deciding whether or not to inject FDI into China, and how much FDI to allocate? In the following section, we will run a series of statistical regression tests to try and depict, with as much as accuracy as possible, the relationship between corruption and FDI. I will compare the results from these tests and try to interpret what their significance is for foreign investors, Chinese lawmakers and academics interested in this topic. Furthermore, we will examine what variables other than corruption a foreign investor may take into serious consideration when China is a focus of their investment decision.

Before we analyze the results of my testing, a brief explanation of the methodology I employed is necessary. The three basic questions that need answering in a simple regression analysis are: how much variation in the dependent variable do the independent variables explain? Are there any outliers that might distort the results of our test? What is the extent to which our results can be trusted? In order to answer these three questions and accurately interpret my regression analysis, I first proceed to look at the F statistic and the adjusted Coefficient of Determination (R-Square). The F-statistic tells me the statistical significance of the observed differences among the means of the samples. The greater the F-statistic, the less likely our null hypothesis is true (that our variables have no relationship to one another). The R-square tells us what percentage of the variation in the dependent variable is explained by the independent variable. We also check the p-value to see what our confidence interval is for a particular independent variable. The closer to 0 is our p-value, the more likely it is for us to reject the null hypothesis and consider the variable to be statistically significant. I set the significance level of the p-test to be 10% in order to make up for the margin of error that may result from the small sample size employed in most of the regressions. To find any outliers that may unduly influence our results, we must plot a graph of “residuals vs. fitted values” as well as a “fitted-line” graph. Any offending observations that are completely outside the normal pattern of distribution should be removed and the regression rerun for accuracy’s sake.

There are two types of FDI in China: contractual FDI and realized FDI. Contractual FDI is the amount that investors state they wish to invest at the instance when they are applying for government approval. The actual, or realized FDI invested

usually turns out to be very different and is for the most part, smaller than the pledged amount. In almost all regression analyses I conducted, I used the inward contractual FDI as my dependent variable as opposed to realized FDI on the assumption that investors have done background research on their target market and have fully weighted the risks (although corruption may be difficult to take into account during initial investment planning stages) and returns of their proposed venture.

Due to the fact that there are very little publicly available government documented or third-party data on the extent of corruption in China, I am forced to compromise on the quality of the corruption data. Corruption can be both measured directly and indirectly. The first test I decided to employ is a regression analysis with FDI as the dependent variable and third-party corruption data as the independent variable. This direct measure of corruption involves anywhere from 10-15 surveys of the private sector's perception of the extent of corruption among public officials within China. For my purposes, I decided to use Transparency International's Corruption Perception Index (CPI) from 1994-2001 as my primary measure of corruption. Transparency International ranks over 100 countries in the world on their degree of corruption as seen by businessmen, academics and risk analysts. A score ranging from 10 (highly clean) to 0 (highly corrupt) is given to each country and they are ranked accordingly. This index is updated annually and is the most respectable measure of corruption originating from a third party not-for-profit institution. As you can see from exhibit 10, China's score in terms of perceived corruption has steadily improved from the years 1995-1998 but has stagnated since then. After running a simple regression analysis between the CPI score and the amount of contractual FDI into China (in U.S. dollars), I analyzed the results as

shown in exhibit 11. According to the T-ratio and corruption coefficient, the relationship between corruption and contractual FDI is a negative one. This means that the higher the CPI score China receives, the lower its amount of inward FDI. The p-value is under 10% and is therefore significant. Our conclusion is that there seems to be an inverse correlation between the two factors that defies popular theory.

Another way to directly measure corruption is employing Chinese government data on the number of corruption cases investigated by the state over recent years. Even though one can reasonably conclude that the government's data may be faulty due to attempts to downplay the seriousness of the problem for the citizenry, the media and foreign investors, the data does have the benefit of being continuous in nature and being the only recorded data of "real" as opposed to "perceived" corruption over time. When we examine exhibits 12 and 13, we can see that the growth rate in the level of real corruption according to the number of corruption cases investigated, the number of county-level and above officials prosecuted for corruption, and the economic loss suffered by the state is similar to our CPI results. Both measures show a rampant corruption increase from the early to mid-90's. Both measures also seem to show that the Chinese government was able to bring the corruption situation under control by the late 90's and the start of 2000. Just like before, after running a series of simple regression analysis between FDI vs. the number of corruption cases investigated, FDI vs. corrupt officials prosecuted, and FDI vs. the estimated economic loss caused by corruption, I discovered a very surprising result. The regression results (Exhibits 14-16) based on the official government corruption data seem to indicate that there is little to no relationship between corruption and FDI whatsoever. In each test, the adjusted R-Square

result was 0 or near 0. Furthermore, the p-values indicate that the null hypothesis may very well be true. There are two conclusions one can draw from these test results: (1) that the government's reporting of the extent of corruption is deliberately misleading and inaccurate, or (2) there is indeed no relationship between FDI and the corruption level in China. It is difficult for me to believe, based on both past academic research and on pure logical grounds, that corruption has no effect whatsoever on the decisions foreign investors make with regards to China. Whether or not a deliberate attempt by the Chinese government to understate the extent of corruption within China has contributed to the skewed outcome of this test is debatable.

Given the fact that the government data on corruption has proven to be a poor determinant of FDI movements and that the CPI score is only an index of "perceived" corruption levels in China, we must seek further evidence that may bolster the popular assumption that corruption has a negative effect on FDI. China is one of the most FDI-dependent economies in the world. Hence, the absolute values of FDI do not necessarily tell us how important FDI is for China's economic development. In other words, we will not be able to correctly measure corruption's impact on the significance that FDI plays in the Chinese economy using only absolute FDI values. On the other hand, the amount of successful FDI transitions from contractual to realized investment is a better measure of corruption's influence on investor activity. We can presume that foreign investors may renege on or reduce the amount of their planned investments into China if they feel that, upon further research and through their experiences in dealing with government officials, corruption — a component of political risk, is too high. In addition, we need to take into account China's economic growth relative to the growth of FDI. If a negative

correlation exists between corruption and FDI, FDI relative to GDP would most likely decrease. The size of FDI inflows relative to the size of the host country's economy can be gauged through the use of FDI/GDP as our dependent variable.

I therefore ran two more simple regression tests with CPI as the independent variable and FDI/GDP alternating with the conversion ratio as my dependent variable. Sure enough, upon examining the regression results (exhibit 17 & 18), we find that the CPI Index and the conversion rate are positively correlated with one another. According to R-square, the CPI index can explain roughly 48% of the variation in conversion rates. The p-value is also significant. Our conclusion is that the less corrupt China happens to be at a particular point in time, the more likely that investors will inject FDI up to the original promised value. FDI/GDP exhibit an inverse relationship with corruption in our test and fails to support the popular theory.

To further our understanding of the relationship between corruption and FDI, I decided to run a regression analysis between the contractual value of joint ventures (a type of FDI) and the CPI corruption index from 1994-2001. According to past academic theory (see pg. 21 on Wei and Smarzynska), the number of joint ventures formed within a country may indirectly reflect the presence of corruption. Foreign investors may want to reduce their exposure to corruption by taking on a local partner while at the same time employ that local partner, who is supposed to have greater knowledge of the customs of graft and bribery, to deal with corrupt government officials on most business matters. The results were enlightening and radically different from our previous tests. The adjusted R-square of 88.3% tells us that the CPI index can explain the majority of the annual variation in joint venture value. The p-value shows the corruption variable to be



highly significant. Furthermore, the coefficient for corruption is negative and the large F-ratio helps to reject our null hypothesis. In other words, a testing of our limited observations have shown that the higher the CPI score for China (the lower the corruption) in a given year, the lower the value of the total number of joint-ventures formed. These results seem to introduce a new idea into our study: that increasing corruption levels in China doesn't so much reduce inward FDI as change the nature by which foreign investors utilize their capital. In other words, the more "clean" the investment environment, the less need for investors to use joint ventures as their primary FDI mode-of-entry.

Finally, to determine the amount of influence that other economic factors have on an investor's decision-making process in China, I decided to run a multiple linear regression analysis on FDI and some of the most common economic variables investors take into account during their investing process. The data would be sorted according to the 31 provinces, municipalities, and autonomous regions that together form Greater China. The 31 observations were further reduced to 24 observations, as certain data for certain regions were not publicly available. For example, Tibet, due to its politically sensitive nature for the Chinese government, is not open to foreign investment. I was also unable to take into account corruption in this analysis due to the fact that it is not quantified by province, directly or indirectly. The independent variables used in this regression were the annual enterprise income taxes generated, GDP growth, per capita monthly income of the average household (adjusted for inflation), the growth rate of value-added of industrials, and the export value of commodities. I ran three different sets

of tests using 3 measures for my FDI dependent variable: contractual FDI, FDI/GDP, and the conversion ratio.

As we can see from the results of these regression analyses, the export values and the per capita household income are the only predictor variables that are statistically significant under the different measures of FDI (exhibits 20, 21, 22). The conversion ratio is not statistically significant relative to any of the independent variables. The independent variables account for 83.2% of the variation in contractual FDI and the export values have a direct relationship with FDI values. This seems to support the prevailing academic views, which theorize that low cost labor and export potentials fuel the growth of FDI into China.

The independent variables account for 45% of the variation in the FDI/GDP ratio and the per capita variable has a direct relationship with FDI/GDP. The significance of per capita household income in our model seems to support the “ownership-location-internalization” theory of FDI. In other words, firms try to exploit ownership-specific advantages (such as market size, government policies, shipping costs) when deciding exactly where to invest. We can theorize from our model that foreign companies see China, first and foremost, as a potential consumer market “gold mine”. The amount of disposable incomes available in a particular region tends to drive, to a large degree, the amount of investment into that region. A quick glance at exhibit 23, showing the top 15 largest foreign investors in China within the last few years, supports our theory.

Motorola, Volkswagon, Nokia and Ericsson are just some examples of giant foreign corporations that specialize in affordable products for the middle class and are targeting a fast growing segment of the Chinese consumer market whether it's in mobile phones or

family sedans. We can therefore postulate that while variables such as low labor cost and high economic growth may have been the primary factors influencing an export-focused investment strategy into China during the 1980's (during the birth of economic reforms), and early 90's, corporations today are investing for Chinese domestic consumption and to court the "1 billion" potential Chinese consumers.

I think there are important caveats to consider before we reach a conclusion based on these regression results. Is there a linear relationship between taxation and FDI? Common sense would tell us that firms would avoid investing in regions of high taxation. On the other hand, in areas of high FDI activity, one is likely to see an increase in business revenues and therefore higher tax payments. Once again the causality issue comes into play. Further complicating matters, FIEs often receive favorable tax treatments, tax breaks and tax holidays from certain local governments that are seeking to attract FDI. How should we take these intangibles into account? Have we correctly quantified the complex role that taxation plays in the corruption-FDI relationship? The main source of tax revenue for the government comes from large capital-intensive firms and import tariffs. In addition, many local officials charge supplementary "under-the-table" fees that obviously go unreported in official statistics. The tax evasion rate is estimated to be quite high by many academics, and also contributes to many tax payments never showing up on reported government ledgers. Furthermore, tax competition between officials who engage in corruption and legitimate tax collectors can undermine the tax base. As a result, we can hypothesize that the higher the corruption activity in a particular region, the lower the recorded tax payments, and the lower the amount of FDI.

Is the government data on corruption prosecutions a good measure of the overall corruption situation? The answer is probably no as shown by my statistically insignificant results and the fact that the government tends to understate corruption in general. Those who are caught and prosecuted by the government may be an indirect reflection of the corruption situation in China but they are by no means an exact measure of the actual level of corruption activity that is taking place at a particular period in time. Three main features of corruption in China in recent years make it more difficult for their detection by the government. (1) Higher ranking officials are getting increasingly involved in corruption schemes, (2) Corruption cases that are investigated reveal signs of becoming more closely tied with organized crime elements, and (3) The amount of economic loss due to corruption (in terms of bribes, embezzled funds, etc.) on a case-by-case basis is becoming larger and larger. In addition, in some cases involving particularly high-ranking officials, it is not unusual to see the CCP committee of discipline inspection intervene and thus, such cases are kept off the record books of the judicial organ. We can conclude that the judicial offices may be somewhat effective in deterring and controlling corruption but it is by no means an effective detector or universal remedy for a corruption problem that stems from the unbridled political power of the CCP.

There are issues concerning FDI data reliability from official Chinese sources. One can argue that FDI from ethnically Chinese economies should not be classified as truly “foreign” investments. However, that argument can be rebutted by the fact that the IMF defines FDI as investment across two different economies, not necessarily two different countries. One can also argue that round-trip FDI (investment capital from Chinese firms that are first exported, then imported back into China) should not be

included in official statistics. However, even though researchers estimate this type of investment to be around 20-25% of total FDI inflows into China, it is very difficult to definitively calculate and single out such investments from total FDI. Ignoring the fact that such investments does not conform to popular definitions of FDI, we can still postulate that Chinese firms are less sensitive to corruption than their foreign peers. They will take advantage of the FDI loophole as a means of receiving favorable tax benefits and other advantages granted to FIEs. If this is the case, the results of our study must be reconsidered and a new experimental framework be built.

There are many independent variables affecting FDI other than corruption that we have not accounted for in our analysis. Information costs, infrastructure, agglomeration effects, and other investment incentives could all affect an investor's decision on if, when and where to invest in China. Several variables that are traditionally considered to play an important role in attracting FDI—a host country's education level and endowment of skilled labor are purposely ignored in this study. Past literature (Wei, 2000) have shown that these variables are simply not statistically significant for FDI regression analysis purposes. To conclude, the above are all theoretical issues that were not addressed in this study quantitatively but could potentially have an important influence on our results.

Through our regression analysis, we have seen that corruption plays a limited yet significant role in foreign investor behavior. Though there is no evidence of a direct negative correlation between corruption (whether “perceived” or “real”) and FDI, there is evidence that corruption shapes the foreign investment entry mode as well as the conversion ratio from contractual to realized FDI. Among the economic factors that should logically influence FDI decisions, we have found that FDI is most affected by the

household per capita income levels as well as the export capabilities of different regions in China. We can tentatively conclude that recent FDI provides limited statistical support to certain traditional FDI theories such as John Dunning's eclectic approach to FDI.

Again, it is important to emphasize that we not rush to judgment based solely on an analysis of these imperfect statistical experiments. Our study was limited by small sample sizes of observations, vital information not available in the public domain, and government data of questionable accuracy.

## **VI. How to combat corruption**

One of the most difficult challenges for implementing anti-corruption reforms in China will be gaining the aid and implicit approval of the Chinese Communist Party (CCP). Currently catering to special interests, the Chinese government must democratize its internal affairs. Collusion among CCP cadres, the judiciary, the police, and organized crime groups must end. There is precious little research on how this transition should occur and what its consequences will be. In fact, there is very little academic research (foreign and Chinese) on the root cause of Chinese political/economic corruption in general due to the embarrassingly sensitive nature of the topic for the ruling communist elite. Hopefully, this transition will be a peaceful one brought about by reform-minded CCP officials.

However, as government reform proceeds, there is a danger that power struggles among elites in the central government will sidetrack the goals of the reforms. To deal with the possible politics of fighting corruption, strong institutionalized rules of behavior must be set up for top politicians, which would render them rights equal to those given to

an ordinary citizen before the law. Having consistent rules will not only increase the transparency of the transition process, but it will also increase people's confidence in and the credibility of political leaders.

One of the most consistent arguments which Chinese government officials has presented in the past with the hopes of averting economic and political reform is that they must forgo rapid reform in order to maintain stability. The post-communist chaos in Russia is often cited as an example of the dangers of speedy political reform moving forward hand-in-hand with economic reform (“Shock Therapy Theory”). However, no one can dispute that corruption itself leads to social, economic, and political instability. If economic development continues without political reform, corruption will deepen and ultimately retard China's development.

This study wishes to put forward several anti-corruption policy recommendations: (a) increasing transparency of government affairs, (b) encouraging public participation in government affairs, (c) ensuring an independent judiciary, (d) holding major government officials responsible for mistakes made under their tenure, (e) broadening the freedoms of the media, and (f) improve public governance by reducing red-tape. In addition, governmental interference in the economy and the discretionary power of government officials should be reduced.

## **VII. Conclusion**

In recent years, while the absolute values of FDI into China looks very impressive on paper despite the presence of rampant corruption, the data can actually be quite misleading. Many observers are quick to dismiss corruption as a factor that has any

effect on FDI based on China's strong FDI history. However, when we consider the fact that most of China's inward foreign investments come from overseas Chinese in Hong Kong, Taiwan and Macao, we can see that China still has a long way to go before it truly fulfills its potential (given its size, economy, and resources) as an attractive target for investors on the world stage. These "overseas Chinese" investments represented a whopping 57.8% of total inward FDI in 2000. Another factor that should be a source of concern for Chinese government is the amount of FDI into Hong Kong. This former British colony seems to be drawing away potential investors as many source countries wish to avoid the corruption and labyrinthine bureaucracy on mainland China. Many foreign corporations also use the trading companies in Hong Kong as a stepping-stone for their eventual investment into China. According to a regression analysis done by Shang-Jin Wei, while the presence of Hong Kong partly helps to attract FDI to China, it does not compensate for the loss of potential FDI from corruption and other environmental factors which investors wish to avoid.

Though this study has been constrained by a significant lack of transparency in terms of corruption data, it was still able to uncover certain interesting patterns in FDI behavior. Foreign investors seem to be extremely adaptable to conditions in China. If they perceive rampant corruption in the ruling bureaucracy of a particular target region, they will either reduce their promised FDI upon the start of the actual investment project or choose a mode-of-entry that will best mitigate the costs of corruption.

The author will be the first to admit that the analysis made here are not without substantial flaws. The inherent difficulty in measuring the complex relationship between corruption and FDI lies in the lack-of-availability of vital data. A myriad of special



factors such as local investment incentives (e.g. tax breaks and tax holidays) and changing FDI laws and restrictions that one encounters in a special case like China make research on this topic even more challenging. This paper was written in the hopes of attracting the interest of future researchers who can explore this neglected yet enlightening topic further. Corruption ultimately threatens the stability and legitimacy of the ruling Chinese Communist Party. Sustained economic growth supported by a healthy dosage of FDI can only exist with the curbing of corruption. If corruption should render laws irrelevant and destroy the confidence of the people in the government, the enactment of another violent revolution in Chinese history is not out of the realm of possibility. In that not-too-distant future scenario, the availability of FDI will be the least of the government's worries.

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