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Rent-seeking and economic governance in the structural nexus of corruption in China

Tak-Wing Ngo

Abstract This article examines the sources of widespread rent-seeking practices and their relations to corruption in China. It argues that rent-creation and seeking are difficult to eliminate because they have become institutionalized as the constitutive parts of economic governance. Using case studies drawn from a number of industrial sectors, this study shows that the creation and allocation of economic rents has become a major policy instrument used by various levels of governments to manoeuvre industrial plans and development priorities. At the same time, the discretionary power exercised by state agents in implementing development priorities has created mounting opportunities for exchanging rents with bribes. The result is a structural nexus between economic governance, rent-seeking and corruption that defy administrative measures aiming at achieving a clean government in China.

Rent-seeking constitutes one of the most common sources of corruption in present-day China. Economic rents are generated when productions licenses are rationed, when prices are fixed, when trade quotas are imposed by the government, and so on. Typically, bribes are offered by businesses to government officials in exchange for the creation and allocation of rents. Ample opportunities of rent-seeking therefore bear directly on the prevalence of corruption in China.

Constraining the creation and the pursuit of economic rents thus constitutes one of the many steps towards controlling rampant corruption in China. This article argues, however, that rent-creation and seeking are difficult to eliminate because they have become institutionalized as the constitutive parts of economic governance. Rent has been used by the central government as a policy instrument in effecting industrial plans and development priorities. Local governments have relied on rent allocation to manoeuvre the development of local political economies. At the same time, many private businesses have become

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T.-W. Ngo (✉)
Sinological Institute, Leiden University, Postbox 9515, 2300 RA Leiden, The Netherlands
e-mail: t.w.ngo@let.leidenuniv.nl

dependent upon rents granted by local authorities to compete in a national market dominated by oligopolies. In other words, the creation, allocation, and pursuit of economic rent have been embedded in the regulatory framework governing industrial and economic developments at the national as well as the local level. Unless radical reforms are taken to change the existing framework of political and economic governance, rent-creation and seeking will continue to proliferate and fuel corruption in China.

The distinction between rent-seeking and corruption

Rent-seeking in China often arises from government–business collusion in accruing extra profits to enterprises. In the process bribes are often exchanged for particularistic advantages. In 2006, the central government and the Central Disciplinary Inspection Commission of the Chinese Communist Party made the combat against business bribery a main focus of anti-corruption campaigns. Corruption practices relating to rent-seeking in six areas have been singled out for special attention. These include government–business collusions in rent-seeking in construction works, land sales, property rights transfers, medical and drug supplies, government procurements, and the exploitation of natural resources [44]. The ostensible goal is to fight corruption simultaneously against its symptoms and root causes. However, as we will argue, rent-seeking and corruption are not just the symptoms of pathological organizations and practices. The root causes go much deeper. They are to a large extent fashioned by the policy and regulatory frameworks which govern industrial planning and set development priorities.

Part of the complication lies in the fact that although rent-seeking and corruption are intimately related, they are not the same thing. They are intimately intertwined because officials can utilize their power of rent-creation as a means of bribe-seeking. At the same time, economic actors frequently pay bribes to officials as a means of rent-seeking. Despite their close relation, rent-seeking and corruption belong to different realms of practices. It is such delicate distinctions which make it difficult to control rent-seeking during anti-corruption campaigns.

In this regard, a clarification of the conceptual distinction between rent-seeking and corruption is needed. Corruption is commonly understood as the use of public power for private gain. However, beyond this simple understanding a more precise defining of corruption is anything but straightforward. Generations of scholars have produced competing definitions of corruption, ranging from legalistic, normative, functional, to economistic understandings (see the debate about definitional problems in [15]). The problem is aggravated in the analysis of China, as Chinese law and official policy consider almost all forms of official malfeasance by state and Party cadres as corruption. These range from crimes with material returns such as embezzlement of public property, fraud, bribery, tax evasion, smuggling, profiteering, and rent-seeking; to power abuses such as negligence, collusion, sectionalism, and nepotism; to improper behaviour of officials such as womanizing, gambling, drinking, stock market speculation, extravagant living, and superstition. In response, some scholars have taken a broad definition of corruption (see for example [20, 23, 34]). Others prefer a narrower definition confining to the usurpation of public authority for private gains as corruption proper, while leaving aside non-material forms of official malfeasance such as power abuse and misconduct (for instance [39]).

Even among those who prefer the narrower definition, many regard rent-seeking as a form of corruption. This stands in contrast to the conventional understanding of rent-seeking which draws its meaning from public choice economics. Such understanding derives from the concept of rents put forward by Buchanan, Tullock, Tollison, and others. They focus on the extra return above the market clearing price. Rent is the payment made to an owner of resources over and above that which those resources could command in alternative uses [3]. In other words, rent is a return in excess of opportunity cost. In the ideal market system of textbook economics, all economic rents will be eroded or dissipated through time. This is because above-cost payments to any resource owner will attract other profit seekers to engage in identical pursuits. The entry of more and more profit seekers will thus drive the rent down. Eventually, rents will disappear altogether in the long run. Critical to this process is the freedom of entry. If the entry of other profit seekers is blocked, such as in a cartel, monopoly or government regulation, output price will not fall and hence no dissipation of rent can occur. Economists consider this kind of rents as “artificially” contrived. Such artificially contrived rents are subject to competition, or rent-seeking. Put differently, the creation of rents by state intervention and the allocation of rents to political supporters invite other social players to engage in rent-seeking.

In such conceptions of rents and rent-seeking, it is clear that the creation, allocation, and pursuit of economic rents are prone to corruption but they do not necessarily involve corruption in the form of usurpation of public authority for private gains. A good illustration is the price cartel formed by instant noodle manufacturers in China. The cartel was organized by the China arm of the International Ramen Manufacturers Association (IRMA). Members of IRMA China hold a 95% share of the instant noodle market in China. After several meetings, they reached an agreement to raise the price of instant noodles in June 2007, resulting in a nation-wide price hike. The jacked-up price thus offers extra profits to the cartel members in the form of rents. The price increase alarmed the China Consumers Association which filed a complaint to the National Development and Reform Commission. The Commission subsequently ruled that the price cartel contravened the Price Law [6]. In this case, the practice is illegal as it hinges upon a conspiracy to manipulate the market price which is punishable under Chinese law. However, no public authority was involved in the creation of rents by means of price cartel. It is a clear example of illegal rent-seeking without involving corruption.[1]

In the same vein, there is no shortage of corruption cases which involve government–business collusion for private gains but do not relate to rent-seeking. The Yuanhua scandal is one of the most widely reported cases in this regard. In the province of Xiamen, the Yuanhua Corporation set up a dozen companies and smuggled into China an estimated RMB 53 billion worth of goods during a four-year period from 1996 to 1999. The Corporation’s founder, Lai Changxing, established a web of personal networks with officials in foreign trade, public security, customs, military, and banks. Lai offered bribes in terms of cash, real estates, gifts, club membership, mistress, and so on, to government and Party officials to cover up and maintain his smuggling empire. When the case was eventually investigated by the central government, more than 200 officials were implicated. The Yuanhua case is regarded by observers as an indication of the rise of collective corruption in China.[2] It is a case involving government–business collusion in organized crime. The crime concerns illegal evasion of taxes in the form of smuggling, and corruption in the form of taking bribes to cover up the smuggling. It is not exactly rent-seeking since there is no transfer of economic rents above the market clearing price.

[1] IRMA China apparently was not officially registered. It was subsequently investigated by the Ministry of Civil Affairs.

[2] The case is widely studied. See, for example, [30].

The preceding examples demonstrate the difference between rent-seeking and corruption. Corruption is only one means of seeking rents. There are many other ways of rent-seeking such as lobbying and cartel formation. Conversely, whereas bribe is often offered in exchange for rents, bribes can also be used in exchange for votes, official positions, priority treatment, covering up illegal activities, and suchlike. Such kinds of bribery practices as exchanging spoils for the protection of smuggling are outside the realm of rent-seeking as they do not involve the pursuit of extra returns above the market price. Certain acts of usurpation of public power for private gains, such as appropriation of public property, the maintenance of extra-budgetary funds for private usage, local government exaction in the form of arbitrary charges, are also unrelated to rent-seeking.

In brief, rent-seeking should not be regarded as a form of corruption. It can better be understood as a source of corruption. The distinction is important because, as we will show in the subsequent discussions, it is the dissimilarity between rent-seeking and corruption as well as the inter-relatedness between the two practices that contribute to the impasse in controlling corruption arising from rent-seeking.

Rent-creation as legitimate intervention and as a source of corruption

There is a further clarification to be made about rent-creation. This concerns the dual facets of rent-creation as a legitimate government action and as a source of corruption. Specifically, since the creation of rent involves the manipulation of price and market entry, it can be a perfectly legitimate act of the government (even though many economists argue that it is an undesirable act). In fact, price control and market entry control have been prominent features of the Chinese economy during the market reform. As long as state agents do not profit privately, the rents created from price control can be legitimately allocated to specific groups in accordance with government policy. However, in exercising their discretionary power to ration rents, state agents are prone to bribery offers from economic actors who strive to capture the rents. In such circumstances, the creation and allocation of rents become a source of corruption.

We can take two examples to illustrate the dual facets. In the example of the auto industry, the State Council selected three enterprises (First Auto Works in Changcun, Second Auto Works in Shiyan, and Shanghai Automotive Industry Corporation in Shanghai) in 1987 as the key manufacturers of passenger cars. In the following year, another three (Beijing, Tianjin and Guangzhou) were selected as the auxiliary manufacturers. This became the so-called “Big Three and Small Three” strategy which still holds to date [9]. In an attempt to fence off “random competition”, the central government erected strict market entry controls. All manufacturers other than the six selected enterprises were excluded from car assembly by state licensing arrangements. At the same time, import restrictions were imposed to protect domestic production. The policy has created a highly protected market characterized by high price and high profit, thus accruing extra rents to the oligopolies. It is, however, a legitimate intervention by the government using rent-creation as a policy instrument.

The second example of highway monopoly offers a typical case of a combination of government exaction, rent-seeking, fraud, and corruption. Among the 100 highways of 16 provinces, 158 unauthorized toll booths have been set up. Until the end of 2005, the Department of Audit discovered RMB 14.9 billion of illicit toll collected from these highways. Another RMB 8.2 billion came from over-charging in seven provinces. Furthermore, 35 commercially operated highways in 12 provinces were given exceptionally long franchise, resulting in a profit return of up to 10 times of their endowed investment. Among the 106 franchised highways investigated by the Department of Audit in 10 provinces, 60% of the franchised projects were found to have been illegally approved by unauthorized local government agencies. Collusion between banks, local governments, and the bidders has been found. The value of many highways has been deliberately deflated by local governments. The bidding conditions for the franchise project were tailor-made to a specific bidder. The source of capital investment was also problematic. It was found that in 18 franchised projects, RMB 17 billion of the total RMB 24.3 billion capital (that is, 70% of the investment capital) came from bank loans using the franchised highway itself as the mortgage. An outstanding example is the Hefei-Chaohu-Wuhu Highway. The Anhui government franchised the highway to a private enterprise from Shanghai using invited tender in 2003, and then re-purchased it in 2005. Because the selling price was deflated in 2003 and marked up in 2005, the government lost RMB 1.24 billion to advantage of the colluder [21].

Very often, the division between rent-creation as a legitimate intervention and as a source of corruption is a thin one. It is such fuzzy boundaries that make it difficult to constrain rent-creation. Suffice it to say here that it is the second aspect of rent-creation and its resulting rent-seeking through corrupt means which attracts much scholarly and political attention in China. Wu Jinglian, an influential economist in China, is one of the earliest and most outspoken critics of the rent-seeking phenomenon in China. He argues that a vicious circle of corruption is fashioned by rent-creation and rent-seeking in China. Government officials and businesses which benefit from exchanging rents with bribes will try to maintain or expand the existing rent regime, hence leading to more corruption.[3] Wu's idea has been echoed by another influential scholar Hu Angang. In a series of seminars organized by the Central Disciplinary Inspection Commission, Hu ranked rent-seeking as the foremost source of corruption.[4]

The pursuit of rent, surplus, and subsidy

Before we proceed to analyze the structural causes of rent-seeking in China, it is worth noting that the pursuit of extra profit by the manipulation of price is not limited to rent-seeking. During the early reform period, China maintained a dual-track price system as a strategy of incremental reform. Under the system, two prices existed for the same commodity, of which the official prices were lower than the market price. Price control was applied to a wide range of commodities, including coal, pig iron, steel, aluminium, copper, wood, cement, crude oil, petrol, gasoline, natural gas, chemical fertilizer, pesticide, automobile, electricity, cotton yarn, paper, television, refrigerator, food, and many more. The cheaper priced commodities had to be rationed to privileged groups. Strictly speaking, this kind of privilege cannot be considered as rents according to our definition, since they do not predicate upon monopolistic price. They come about as the result of direct control over price. In this regard, the controlled supply of goods at fixed prices below market

[3] See Wu Jinglian's interview in [40], p. 13.

[4] According to Hu, the second source of corruption comes from the black market and underground economy. These include smuggling, unlicensed factories, drug trafficking, prostitution, gambling, and informal transactions such as usury. The third source of corruption derives from tax evasion, such as unfair tax relief or exemption of customs tax. The fourth relates to public expenditure. It includes corrupt practices in supplies procurement and illicit public investment. See [16], p. 39.

clearance creates a contrived surplus. In contrast to rent which is created by the price gap between the market clearing price and the higher monopolistic price, a surplus is created by the price gap between the market clearing price and the lowered price set by the government [18]. The privileged few who receive the rationed goods at a lowered price can cash the surplus by re-selling the goods to buyers in the black market who will be prepared to pay up to the market clearing price to get the goods in short supply.

In China, the extent of such surplus is staggering. One critic of the dual-track system gave an estimation of the amounts of surplus created in 1988. According to his estimation, surplus created by price control in some 30 commodities amounted to RMB 150 billion at that time. Surplus created by bank loans under subsidized interest rates amounted to RMB 113.88 billion. The difference in foreign exchange rates between official and black market rates added another RMB 93.04 billion. From this the critic concluded that the dual-track system alone contributed to a total surplus of RMB 356.9 billion, which amounted to 30% of the national income in 1988 [17].[5] The calculation was updated by another Chinese scholar in 1992 after the price reform [37]. He suggested that the amount of surplus arising from the dual-track system had vastly reduced, but still accounted for no less than RMB 76.66 billion in current price. Surplus created by differences in interest rates for bank loans amounted to at least RMB 64.85 billion. Difference in foreign exchange rates created another RMB 115.71 billion.

With such an extent of surplus-creation, surplus-seeking can be expected. Government officials who control the power of rationing low-interest loans, under-priced commodities, or foreign exchange can either cash the surplus themselves or award the surplus to cronies in exchange for parochial or personal returns. Subsequent reforms in the commodities market, capital market, and the foreign exchange market in the 1990s have gradually eliminated price differences and hence eroded much of the surplus. However, legacies of the dual-track price system still persist to the present day. Price control still applies to a number of commodities. These include tobacco, salt, chemical fertilizers, certain medical drugs, school textbooks, natural gas, water from cross-provincial reservoirs, electricity, transportation (railways, ports, airports, and air flights), postal services, telecommunication, and a number of professional services such as notary services and surveying.[6] In addition to these commodities, surpluses are still widely created and rationed in a number of crucial areas: when banks extend policy loans to specific industries or enterprises on favourable interest rates; and when local governments offer cheap land to attract investors. In a recent example of surplus-seeking, the Shanghai State Asset Co. Ltd obtained a loan of RMB 290 million from Zhaoshang Bank at an annual rate of 5.022%. It then re-lent the money to property developers at the rate of 8% [21].

Besides rent and surplus, another kind of extra economic advantage which is highly sought after by businesses is direct subsidy from the government. Direct subsidy includes tax break or tax reduction, grants, and import and export exemptions. Unlike rent and surplus, direct subsidy is not related to price. There is no obvious loss to consumers, but the costs incurred to national income and national resources are obvious. Similar to rent,

[5] Note that Hu considered these as “rents” rather than surpluses. He also included “rents” from smuggling, tax evasion by enterprises, unclear land rights, import and export licenses, difference in profit margins across industries, variations in fiscal retention across different provinces and cities, and the welfare privileges enjoyed by cadres. From these he calculated a rent sum of over RMB 400 billion, or 40% of the gross national income.

[6] The last update of the price control list was announced in 2001 which is still applicable to date. See [7].

surplus and subsidy are valuable and highly demanded economic goods. As such they are fiercely sought after. The pursuit of surplus and subsidy follow similar logic as rent-seeking. They are subjected to a similar pursuit through the mobilization of resources such as bribery, crony exchanges, and lobbying. In other words, the pursuit of surplus and direct subsidy is prone to corruption as much as rent-seeking is.

Because of that, we will include the pursuit of surplus and subsidy in our following discussions on rent-seeking. It is worth noting that not all scholars undertake a strict distinction between rent, surplus, and subsidy. Khan and Jomo, for example, define rents as generated through the creation, maintenance or transfer of rights ([19], p. 12). Rent-seeking for them is the activity which generates rents for particular individuals or groups. In such a conception, surplus and subsidy are merely different forms of rent involving transfer of rights to a privileged few. For our purpose, it is useful to keep the distinction since the policy outcomes implicated in the creation and allocation of these advantages are somewhat different.[7] For instance, rents created by the erection of local market entry barriers may violate central policy, but lawful subsidies offered by local governments to selected enterprises rarely contradict central directives. Subsidy has a direct bearing on local government budget, while rent and surplus do not affect government expenditure as such. In the case of surplus allocation, the purchaser benefits directly from the lowered price at the expense of the goods/service provider; this stands in contrast to rent-creation when a consumer has to pay a higher price to the seller of monopolistic products. All in all, it is the plurality of implications afforded by different combinations of rent-, surplus-, and subsidy-seeking that allow governments and enterprises to manoeuvre public policy benefits as well as private gains.

The creation and allocation of rents in industrial planning

The Chinese government has made active use of various combinations of rent-, surplus-, and subsidy-creation and allocation as policy instruments in undertaking industrial planning and assigning development priorities. In essence, the government creates rents by granting subsidies to targeted industries, extending preferential loans to individual businesses, or picking and protecting winners as monopolies. As a matter of fact, the Chinese state is not unique in utilizing rent-creation and allocation as an active policy instrument. The so-called developmental states in East Asia are characterized by their developmental capacity which allows them to distort market mechanisms, or “making the price wrong” as Wade puts it, for the sake of promoting industrial development [36]. These rents, according to the developmental state theory, are channelled into productive purposes rather than personal gains because of the presence of institutional safeguards such as state autonomy, technocratic insulation, social embeddedness, and collaborative government–business relations.[8]

[7] There is a further form of particularistic advantage, namely special favour and convenience offered by governments and officials to a few selected economic actors. It involves priority access to raw materials (such as electricity and water), permission to deviate from regulations, or simplification of bureaucratic procedures. Such kinds of advantages can exert direct bearing on business operations as they affect the level playing field in the Chinese market. They can also be exchanged through illicit practices (for example, bribery) as well as through legal and legitimate means. Since the extension of special favour and convenience often involves non-material benefits, we have excluded it here in order to simplify the discussion.

[8] For a critique of such stylized understanding of the East Asian states, see [2].

In China, such developmental imperative manifests itself during the market reform in the central planning over the development of strategic industries. The first comprehensive industrial development policy paper was published in 1989 by the State Council [10]. The paper singled out a number of industries as priority areas of development. Strict market entry was imposed. This was followed by the promulgation of another policy paper in 1994: *Guideline to National Industrial Policies in the 1990s* [11]. Several pillar industries have been identified, including machine tools, electronics, petrochemical, automobile, and construction. The goal is to raise technological capacity, promote large indigenous enterprises, and enhance international competitiveness. This shares the same rationale behind the policies taken by other East Asian states such as Japan and Korea: to eliminate excessive competition, to prevent duplication of production, and to achieve economies of scale. The goal is to foster a few national giants that are capable of competing in the world market, and to avoid industrial isomorphism that often results in excessive investments and random competition [25]. To realize such goals, a few enterprises are designated by the government as market winners. A series of regulations and preferential policy treatments are then created as the framework of economic governance in coordinating the development of that industrial sector. In doing so, rent-creation becomes embedded in the governance structure shaping sectoral developments.

Let us take a close look at the passenger car industry as one typical example. As we have noted earlier, the “Big Three and Small Three” strategy has been promulgated as the intended development target. Under the strategy, three sets of policy measures have been taken to achieve economic governance: market entry barriers, import restrictions, and preferential allocation of resources. In each of the category of policy measures, economic rents were created and allocated to the specific target groups. It is worth noting the extent of such rent-creation.

Entry barrier to sedan production was erected by using administrative directives. The central government demanded that all regions, departments, and enterprises must obtain clearance from the State Council before they could set up car production plants. All existing sedan projects which did not have the State Council’s permission had to be brought to an end. A catalogue system was implemented to maintain the entry barrier. A list of enterprises and vehicle models were registered in the catalogue. Only those enterprises appearing in the catalogue were allowed to engage in auto assembling. License plates would only be issued to vehicles that were included in the catalogue [27].

A second kind of measure was import restrictions. High tariffs were imposed on imported automobiles to protect domestic companies. In 1985, the tariff for automobiles was 120–150% and that for parts was 60%. In June 1985, 80% of adjustment tax was added to it. In 1986, the tariff for cars rose to 180–220% in order to restrict the import of sedans. Since 1992, however, the government began to lower the tariff. The average tariff was reduced from 71.5% in 1992 to 39.5% in 1997 ([42], p. 62). Besides high tariffs, regulations had been tightened to prevent loopholes from being used by local governments for parochial benefits. A series of related protective measures were implemented, including import quotas, foreign exchange control, control of foreign trade licenses, import permits, and control over import categories. Ports were banned from giving clearance to whole-vehicle imports, except for six authorized ports in Dalian, Tianjin, Shanghai, Huangpu, Manzhouli, and Huanggang. The annual quantity and types of auto imports had to be approved by the State Council. No vehicle was allowed to be imported as gifts or donations ([24], p. 93).

Finally, surplus- and subsidy-creation were used to assist the picked winners. These included tax reduction, low interest loans, priority for foreign investment, and speedy procedure for stock market listing. These measures were mostly outlined in the *Industrial*

Policy for the Auto Sector announced in 1994 by the State Planning Commission. To achieve this goal, existing enterprises were encouraged to expand their production capacity, sales volume, and R&D investment. Enterprises that had reached a specified production, sales and R&D target would receive government assistance to double their production capacity [8].

With strict entry barriers in place, the passenger car market was characterized by high price and high profit. To capture this high profit without delay, all the designated car assemblers chose to form joint ventures with foreign carmakers. Technological and management know-how from foreign carmakers was traded with market entry in the highly protected but growing domestic market, as well as the high profits and rents associated with it. The strategy of joint venture formation proved to be effective in capturing the sedan market within a short period of time. The overall result was the emergence of a few oligopolies with foreign participation. By 1997, the three major groups, the three auxiliary groups, and the official organization China National Automotive Industry Corporation together accounted for 64% of China's total vehicle production and 93% of its car production ([32], p. 661).

Rent-seeking as a structural feature in economic governance

The passenger car policy offers a remarkable example of enormous rents and surpluses created legitimately by the central government in the name of industrial policy and economic governance. Unsurprisingly, the existence of huge extra profits invited rent-seeking using both lawful as well as illicit means. In this regard, Tullock argues that one way to reduce rent-seeking is to introduce bias into the selection process. By picking only those players that possess certain traits, it discourages those that do not possess those traits to invest in rent-seeking because it does not pay ([35], p. 109). The Big Three and Small Three strategy apparently follows this principle since the bias is clear from the outset. However, it is no secret that during the reform period there are multiple possibilities of getting around state restrictions. It is these possibilities that invite rent-seeking in the auto industry.

From the outset, the enterprises being picked as market winners were not necessarily strategic players or outstanding performers. Very often the choices were political rather than economic. The criteria were often fuzzy and because of that much room existed for rent-seeking. In the passenger car industry cases, the Big Three were selected partly because of power contentions within bureaucratic politics. Intensive lobbying occurred behind the scene when the policy was made. While Second Auto Works succeeded in lobbying itself to be designated as one of the Big Three's, the enterprise had no prior experience and know-how of sedan production at all [4]. Later on, special permission was obtained by the China Ordnance Industry Corporation and the Guizhou Aviation Industry Corporation to set up new car factories. Both corporations were formerly engaged in the defence industry and had close relationships with top government leaders ([32], p. 662).

In the mean time, foreign carmakers such as Volkswagen, Peugeot, and Citroen sought rents by forming joint ventures with the designated car assemblers. Much lobbying has been undertaken by these carmakers to obtain state approval in many of the joint projects.[9] There is no way to tell whether these lobbying efforts involved illicit exchanges. However,

[9] A detailed account of the lobbying behind the Guangzhou Peugeot and the Beijing Jeep projects can be found in [12].

later development shows that many of the joint ventures were poorly conceived. For instance, Citroen joined hands with Dongfeng (renamed from Second Auto Works) in the Shenlong project. The project started in 1992 but did not begin actual operation until 1997. The daily production volume was only 30 cars and the factory was running only 4 days a week. Another foreign carmaker, Panda Motors, a US-based company with Korean financial background, succeeded in obtaining approval to set up a car assembly despite opposition from the powerful State Planning Commission and China National Automotive Industry Corporation. Yet the project was pulled off before actual production ([13], p. 160).

Some enterprises have exploited a loophole in the licensing system to overcome the entry barrier. State policy required a company and its car models to be listed in the catalogue of auto manufacturers and products before the company could produce for the market. However, it was not until 2004 that the regulations explicitly forbid the buying and selling of production licenses. This had been used by newcomers, especially private enterprises, to break through the protection wall. Some joined the industry by taking over existing state-owned enterprises which had been at the edge of bankruptcy. For instance, Geely took over a bankrupting state-own automobile factory in Sichuan in 1997; while BYD Auto established itself in 2003 by acquiring the majority shares of an auto factory in Xi'an. Others bought their license from incumbent producers. Chery Automobile is a case in point. The enterprise was a joint investment by enterprises in Anhui Province and Wuhu City. It offered 20% of its shares for free to Shanghai Automotive in exchange for its production catalogue. Some enterprises such as the Aux Group simply assembled cars under someone else's license. Aux used to be a well-known manufacturer of air conditioners. It formed a joint venture with Shenyang Shuangma Light Vehicle Manufacturing in 2003 to produce SUV models such as Yuandongli, Langjie and Ruitu. Instead of applying for inclusion in the production catalogue, Aux produced the cars under the licenses of Shenyang Fusang Panther, a company whose 49% shares were controlled by Aux's joint venture partner Shenyang Shuangma [1].[10]

All these cases show the wide range of rent-seeking activities arising in response to the central government's industrial policy. Here the central government itself is a major provider of rents and other particularistic advantages, which indirectly creates massive opportunity for corruption and illicit exchanges in the course of rent-seeking. But this is not yet the end of the story. An even more staggering feature associated with economic governance during the reform period is the role played by the creation and allocation of rent, surplus, and subsidy in local development.

Rent-creation and developmental discretion in local economies

Local authorities in present-day China control large amounts of resources which can be allocated as surpluses and direct subsidies. These authorities also command regulatory power that can be used to erect market entry barriers, sponsor price cartels, and create rents. More importantly, under the system of fiscal and economic decentralization, local governments have a strong incentive to utilize these resources not just for private gains but also for the good of local development (and often at the expense of other localities). This phenomenon, commonly referred to as local protectionism, derives from a framework of local economic governance under which local governments are required to balance their own budget, fulfil development targets, raise employment level, and achieve economic

[10] Aux announced in March 2005 its withdrawal from the automobile sector due to bad sales and financial problems.

growth. The performance of state and Party cadres is judged by the well being of the local economy under their jurisdiction [5]. In the words of one observer, local governments assume a double identity both as a state political agent and a local economic principal [33]. As state agents, local governments enjoy discretionary power to make and implement public policies. As economic principals, they are responsible for the management and development of their local economies. The problem in the exercise of such dual responsibilities is that one cannot easily distinguish policy discretions undertaken with genuinely developmental or entrepreneurial concerns from policy discretions taken with an agenda for private gains.

Let us illustrate the point with the auto industry. The industry has been designated by 24 provincial governments as a pillar industry. The industry offers high economic and tax returns, affords strong economic linkages to a wide range of local auxiliary sectors, and provides a lot of employment opportunities. It is thus no surprise that local governments pay special attention to its development in their own localities. Given their interests in maximizing economic benefits in their own locality vis-à-vis other regions and other levels of governments, local government agents do not assume a neutral, arbitrator's position. They collaborate with enterprises under their jurisdiction to seek rent from the highly protected auto market. At the same time, they create surpluses and subsidies through their control of opportunities and exemptions, and distribute the resources to a selected few with specific terms of exchange. They are thus rent-creators and seekers at the same time. The situation is self-enforcing: given the multi-layers of protection, rent-creation and distribution, enterprises can hardly compete in this kind of market without first seeking ad hoc favouritism from state agents.[11]

Many auto enterprises have been closely related to local governments in one way or another.[12] They have benefited from the support of local authorities, either in terms of preferential provision of resources, granting of regulatory convenience, or protection against non-local competitors. Even for enterprises that are genuinely private, the ability to manipulate official favouritism is a key factor in their survival.

The case of Geely is particularly interesting. Geely is the first private auto company in China based in Taizhou City of Zhejiang Province. One of the most important forms of assistance offered by the local government is the move to overcome entry barriers. To help Geely obtain its listing in the passenger cars catalogue, Taizhou government sent officials to Beijing to lobby for Geely. Taizhou government also invited research institutes and central government think tanks to visit Geely and asked these institutes to give positive recommendations to relevant central departments. After Geely succeeded in obtaining official license to assemble passenger cars in 2001, numerous direct subsidies and surpluses have been granted by local governments in the name of promoting new and high-tech industrial development.

The estimated value of these policy benefits is startling. In 2002, Luqiao district government offered Geely an industrial area of 3,000 *mu* for its passenger car production. The land was sold by special tender. The tender was tailor-made for Geely, so that no other

[11] Lin describes this as the logic of the political market. See [22].

[12] Except First Auto Works and Dongfeng which are directly under central government supervision and Chang'an, Hafei, and Changhe which are under the military system, most of the other automakers are within the jurisdiction of local governments. Major enterprises such as Shanghai Automotive, Tianjin Auto, and Guangzhou Auto are owned either by the provincial or prefecture city governments. There are also private enterprises which disguised themselves as collective enterprises under the consent of local governments, in a practice which often referred to as "wearing a red hat". Brilliance China Automotive during the directorship of Yang Rong is a case in point.

bidders could fulfil the specific requirements. The selling price was RMB 63,000 per *mu*. Within this total area, the government also allowed 500 *mu* to be used for "labour quarters" which in actual fact was used for commercial real estate development. At that time, the market price for industrial land was around RMB 130,000 per *mu*; while that for real estate was RMB 500,000 per *mu*. The economic surplus accrued to Geely in terms of this land sale amounted to RMB 386 million. This is only a conservative calculation. The property market rose sharply shortly after the sale. Before the labour quarter construction was completed, land price had surged to RMB 2 million per *mu*, adding an extra RMB 750 million to Geely's fixed asset [27].

Other forms of subsidies, administrative privileges and regulatory exemptions offered to Geely have been considerable. It is estimated that the tax relief offered by Tiazhou government was more than RMB 80 million per year. In 2005, Taizhou government decided to give Geely RMB 600,000 as a reward for its six new types of car. Zhejiang provincial government listed the 24 new proposed automobile and key parts projects of Geely as special projects eligible for priority treatment in terms of project and land approval. Special institutions have been established jointly by the Economic and Trade Committee of Zhejiang Province and municipal government of Taizhou to help Geely overcome any difficulties during its course of expansion.

The local government of Taizhou also helped create monopolistic rents for Geely. The government promised to promote the sale of 10,000 locally made vehicles by means of government purchase and related measures. This is undertaken in the name of supporting local industrial development. In essence it means creating local market protection by discriminating vehicles produced outside the region.

It should be noted that the rent, surplus, and subsidy created by officials in this case fall within the legitimate responsibility of the local government. They do not involve such illegal practices as the tucking away of off-budgetary revenues, embezzlement of public properties, or arbitrary levy of fees and fines. The last-mentioned practices are notoriously common among local governments that led one observer to label the system of local economic governance as "decentralized predation" [29].

Arguably, the particularistic benefits offered by local governments in Zhejiang to Geely constitute a kind of local developmental policy. Without these benefits it is doubtful whether Geely can compete in a national market dominated by a few oligopolies that have been enjoying central government protection. In this regard, local governments share the same interests as local enterprises because they need investments, tax revenues, job creation, and economic development in their own localities. They need to compete with other cities and regions with respect to their economic and social performance.[13] As a result, rent, surplus, and subsidy are allocated to selected enterprises with certain terms of exchange. In the case of Geely, Taizhou government has asked the company to pay extra taxes from time to time in order to fulfil set revenue targets. Besides, the government requires the company to maintain a production volume of at least 300,000 cars per year, and with an annual sales plan of RMB 18 billion. There is an implicit agreement that Geely will not relocate its headquarter elsewhere. Geely will not invest in other regions until its production capacity reaches one million cars per year (in 2006 the capacity was 400,000 cars). Furthermore, Geely has promised to sell two million cars in 2015, of which one million is to be produced in Taizhou [27].

The case of Geely is typical rather than unique. In Pingyang county of Zhejiang Province, the local government offered land at a favourable price to attract Inbev to invest

[13] Montinola, Qian and Weingast describe this as Chinese-style federalism. See [26].

in a beer plant. The auction price was expected to reach RMB 300,000 per *mu*. To suppress the price, Pingyang government earmarked the land for a beer plant. Inbev succeeded in bidding the land for half of the market price. In Wenzhou city, the government went so far as to set up road barriers to prevent Hangzhou Beer from reaching the city to compete with the local Yongjia Beer [41].

The problem is that while the power of discretion is by definition a prerequisite for the effectiveness of state-led development, many corruption activities also derive from the allocation of discretionary resources. For instance, the hidden profit accrued to Geely and Inbev during the land sale is an exemplar of grooming market winners through making the price wrong. But similar exercises elsewhere have been plagued with corruption. There is no shortage of high level corruption cases involving people as senior as the governor of Yunnan Province Li Jiating, the governor of Guizou Province Liu Fangren, and the Party secretary of Hebei Province Cheng Weigao. It is reported that from 1998 to 2003, a total of 710,000 cases concerning land deals were investigated for corruption ([33], p. 90).

In short, during the allocation of particularistic benefits, the distinction between ad hoc favouritism and developmental discretion is a blurred one. More significantly, the exercise of policy discretion, most notably in the form of rent- and surplus-creation and allocation, has become part and parcel of the regulatory framework constituting the governance mechanism for local development. It has at the same time fuelled outstanding economic growth as well as rampant corruption. Unless the whole framework of local economic governance is changed, it is not easy to call a halt to the exercise of such discretionary power without throwing the baby out with the bath water.

State intervention and the structural nexus of corruption

The prevalence of rent-seeking activities has been attributed by economists to the scope and range of government activities in the economy ([3], p. 9). In order to reduce rent-seeking and to curb opportunities for corruption, it has been argued, the reduction of state intervention in the market is a pre-requisite. In Wu Jinglian's words, there should be a two-prong attack. The first is constraining administrative interference in market exchange, because the use of political power in economic transaction is "the systemic basis of rent-seeking". The second is the strengthening of democratic supervision of executive authorities at every level.[14]

Logical as it seems to be, such an argument is ahistorical. It is as if state intervention can be removed in one stroke without affecting the existing politico-economic system. The intricate relationship between industrial planning, developmental discretion, and economic governance as discussed earlier is one that accounts for the resilience of state intervention and rent production in China. Yet there is a further historical/political dimension related to its recurrence. Waterbury reminds us that the key to a politically viable option in advancing economic reform is to avoid alienating too many groups at once that may shake the ruling coalition ([38], p. 39). In societies which experience rapid socioeconomic changes such as China, the ruling regime has to enlist shifting coalitional support from local leaders, the bureaucracy, rank and file, emerging entrepreneurs, and so on. However, the means available to an authoritarian regime to secure political support are rather limited. In this regard, rent, surplus, and subsidy come in as usable resources. While rents created by state intervention may be economically "unproductive" and prone to corruption, they do produce

[14] Wu Jinglian's interview in [43], pp 21–22.

"political goods" in the process of exchanging selective rewards for coalitional support [28].

During the transition, the central government has contracted out its authority to make policy as well as its power to intervene in the economy to various levels of bureaucratic agencies and local governments in order to create coalitional support. Those state agents who are entrusted with such contracted responsibilities become strong supporters of market reform because they now enjoy unprecedented discretionary power. They capitalize this power by creating profits and rents through extensive participation in market activities.

This has given rise to the phenomenon of state agents as rent seekers, or the "referee as player" problem [22]. At present, there exist a vast number of government departments and agencies with ambivalent jurisdictions and blurred public-private divide. In 2005, there were 5,074 subsidiaries directly under the control of the 31 central ministries. Among them, 2,212 were professional establishments while 2,862 were state-owned enterprises or stock holding companies. The total number of staff was 1.64 million and the total asset amounted to RMB 447.98 billion. Despite numerous efforts to reduce Party and state overhead and to rectify party-state functionaries, one-third of these units have been set up after 1998. These are numbers in the central ministries. It is merely the tip of the iceberg if local bureaucracies are taken into account.

These government agencies have involved directly and indirectly in the regulation and operation of economic activities. As a consequence, rent-creation by governmental establishments has been more than common. Many of these establishments have directly and indirectly taken up executive and regulatory functions, including powers of approval, management and supervision of social and economic activities. In return, they gain by levying administrative and service charges. Revenues derived from fees and charges amount to billions annually. At the same time, they set up economic entities as subsidiaries, which directly participate in various business activities. These subsidiaries act like crony enterprises and enjoy a wide range of privileges. They benefit from the protection of their affiliated governmental agencies and often monopolize respective market sectors.

At the same time, some regions, sectors, and specific enterprises have been given special privileges, policy exceptions, priorities, or extraordinary authority. The original idea is to try out new reform measures in controllable pilot areas. Other regions, sectors, enterprises, and so on are not allowed to do the same until the scheme proved to be successful. The special economic zones set up in Shenzhen, Zhuhai, Xiamen, and Shantou are early examples of such pilot schemes. This kind of dual-track policy creates enormous rents and surpluses in various forms. Enterprises within these zones enjoy a wide range of privileges including tax breaks, preferential loans, import and export exemptions, low-priced land, and management autonomy. They thus command huge market advantages over other enterprises outside the zones.

It should be noted that not only do businesses benefit from the dual-track policy, the governments of those local pilot areas also enjoy a stake in their higher economic growth, better employment condition, increased revenue, and greater local autonomy. They in turn enjoy a more competitive position vis-à-vis other localities. One observer calls this a strategy of "particularistic contracting" [31]. It rests upon the distribution of material benefits embodied in the differential and generous terms of contract in exchange for political support. Rent-creation and allocation in turn helps these local governments create grateful clients that consequently expand the ranks of the reform coalition.

Particularistic contracting has given rise to extensive rent-seeking and corruption. One of the earliest and most notorious case is the Hainan car scandal of 1984. In an attempt to spur development of the island, the central government exempted Hainan from import restrictions and tariffs. Taking advantage of the policy, Hainan officials imported tens of thousands of cars and vehicles and resold them to other provinces at three to five times of their purchasing prices. More than 89,000 cars and vehicles, mostly from Japan, were bought and sold in this manner, accruing huge sum of economic rents to the local government. One report suggests that the money spent on the Hainan car imports was more than that on the island's eight major projects.[15]

Over time, particularistic contracting has resulted in huge income inequality between regions. Bureaucratic participation in economic activities has created a lot of market irregularities, embezzlement of public properties, and abuses of environmental resources. These unintended consequences of the reform have prompted the government to further intervene in the economy to redistribute resources to the underprivileged in order to maintain political acquiescence. These interventions take the form of social projects. In fact, there are thousands of specific projects at all levels of administration. Many of these are related to programmes of poverty alleviation, environmental protection, health improvement, and human resources development. Examples include the reconstruction of unsafe school premises, protection of natural forest projects, the Three Gorges Dam project and its related migration project, good quality staple projects, animal disease prevention projects, village road construction projects, birth control projects, hygiene projects, rural medical care projects, fishery projects, coalmining safety projects, water transport projects, flood prevention projects, technical education projects, and so on. The implementation of these projects invites more rent-seeking. For example, in the Three Gorges Dam project, half of the construction projects have been contracted out to crony enterprises without following tender procedures. Many contractors illicitly subcontracted the project to other companies and benefited from charging "management fees". Half of the staff in monitoring units are not qualified as inspectors.[16]

In retrospect, reducing state intervention in such circumstances requires limiting the discretionary power of various levels of bureaucratic administrations, restricting the political autonomy of local authorities, and giving up efforts to improve the social condition of the losers of the reform. This would be too high a political risk to take from the point of view of regime maintenance even though the cost of extensive state intervention is widespread rent-seeking and corruption. It is for this reason that Pei describes the transition as being "trapped" [29]. Further reforms can at best be gradual and incremental. As one observer puts it succinctly, in order to minimize the cost of reform, the government needs to avoid impairing the interests of the status quo actors when putting forward new reform measures. In such a stone-groping approach, every reform measure is the result of compromise. Because of their lack of thoroughness, these reform measures soon become the stumbling blocks for further progress. In consequence, the results of earlier reforms quickly become the targets of the next reform ([14], p. 214).

Conclusion

From the above discussion we can conclude that the production of economic rent is structurally embedded in the existing politico-economic order in contemporary China. Rent-production (including the creation, allocation and pursuit of economic rent) is fixated

[15] Cited in Harwit [12], chapter 2, note 55.

[16] This is the estimate given by the Department of Audit from a sample investigated in 2006. The actual percentage will undoubtedly be much higher. See [21].

by historical contingencies associated with Deng Xiaoping's stone-groping approach to market reform. Its occurrence has entwined with coalitional politics, decentralization, and strategies of industrial and regional developments.

Contrary to what economists conceived of as social waste, economic rents can become valuable resources which state agents can create/manufacture by simply using administrative directives. Rent-creation and allocation can become a source of state capacity when being used as a policy instrument to guide national and local developments. At the same time, the capacity over rent-creation has generated strong incentives among state agents to support the market reform as well as to boost local economic development. Rent-production is thus a source of state capacity, political acquiescence, and developmental incentive. Yet it is also a source of dire social problems.

Rent-production under the prevailing framework of economic governance has provided a fertile ground for corruption. This is because policy discretions informing the allocation of rents are inevitably ad hoc and arbitrary. In a society characterized by informal relations of patronage, cronyism and nepotism, such official arbitrariness more than often ends up in corrupt exchanges. The combination of extensive state intervention, policy discretions, and profound clientelism thus produces a strong structural nexus between economic governance, rent-seeking, and corruption. In the absence of any basic changes in economic governance, such structural nexus will defy administrative measures aiming at achieving a clean government in China.

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