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# Due Diligence: Chinese Corruption

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## Bahamas: The Right Choice...



Burke Files assesses the various levels of corruption in China and considers where this problem might lead in the future.

I worked in China a number of years ago and while it was corrupt then - it has, in my opinion, become markedly worse. I was asked: can one actually do business in China of any size and not run into trouble amidst all the anti - bribery and corruption laws? My answer was - no. Read on.

I think we can all agree that China is a corrupt nation - if you think otherwise - do not bother reading any further and see if Alice has any tea for you too?

### Heidenheimer's Framework of Corruption:

Let's begin with the accepted definition of corruption. Heidenheimer's framework includes three categories:

- Class A or 'black corruption': the corrupt practices in this category include bribery, fraud, embezzlement, extortion, smuggling, tax evasion etc.
- Class B or 'grey corruption': the key characteristics of this category are when leaders of public institutions use their power to increase the revenue of their institutions and improve the welfare of their staff illegally.
- Class C: or 'white corruption': constitutes a kind of 'common practice' of social life. They include nepotism and favouritism in personnel recruitment and promotion.

**Looking deeper into the problems relating to corruption:**

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### **The Bahamas: The Right Choice for Latin America**

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Under Mao there was no economy per se. Local officials lied about agriculture production to get recognition, they lied about output to get promotions and in the end the agriculture economy was destroyed by central planning that was fed incorrect information. When this happens, the scenario is always unreliable since the participants cannot get accurate information. What develops when there is no reliable economy and no reliable currency? The development of an *economy of favours*.

When the Khmer Rouge destroyed all currency and private property - the most extreme form of anti-capitalism ever seen - what popped up? The economy of favours. This economy of favours has existed since civilization and the birth of the homo-economist. An uncle does a favour for the mayor so the mayor gets his son to do a favour for the uncle's nephew so the nephew can get a job. This is how the Chinese had to live under communism as the economy of favours was the only one that worked. Having grown up under this system, the ruling members of the party unfortunately still work in the same way.

The perverse problem is that it has gone from small-scale transactions as part of daily life to every aspect of commercial, professional and local government functionary life.

### **Let's look more into why...**

The Chinese authorities, right or wrong, have considered all three of the above categories in their anti-corruption work. However, by so doing, the Chinese authorities have set a difficult goal for themselves since the general consensus on Class C (white corruption) is that white corruption is not only acceptable but necessary. The party line on white corruption has increased the difficulty of fighting the grey and black corruption. The labeling of some common practices as illegal and morally offensive has delegitimised the government's efforts and lost the support of the people.

### **Viewed in Closer detail, the 3 Classes are thus seen:**

Class A: corruption as a form of economic crimes has increased with the following manifestations. First, the number of large-scale corruption cases has increased profoundly. The so-called “large-scale cases” refers to the huge amounts of money obtained by corrupt officials through bribery, embezzlement, smuggling and other illegal activities. In the early 1980s, “large scale cases” referred to amounts over 10,000 yuan, but recently the standard has been raised to 100,000 Yuan. In especially big cases -involving amount over 1 million Yuan- illegal activities have also increased.

Class B: As Wei Jianxing, head of Central Commission for Discipline Inspection (CCDI) pointed out, the unchecked spread of corruption such as the use of public power for personal gain, the ever escalating extravagance, waste, and moral degeneration of party members have all been very difficult. For example, in the city of Xinmi (a city in Henan) the total “extra budgetary income” from imposing “fines” and “special fees” by government departments was greater than the city government’s total legitimate budgetary of 200 million yuan!

Class C: networks of personal ties with senior officials have become an important resource for accessing political power and gaining economic wealth. Consequently, ‘investing’ in the creation and maintenance of such networks is a common and rational practice for many people inside and outside of government.

### **Where will China’s corruption lead them in the future?**

**Corruption is leading to significant political instability, economic instability, and a pending crisis for the Chinese regime.** Chinese political legitimacy derives from public support, and public support is based on the government’s ability to provide public goods and improve its citizens’ lives. If the ability to provide for the citizen fails - so will the Chinese government. The authority and legitimacy of public officials depends on the use of their power for the public good. If officials use their power instead for personal gain as opposed to public interest, their authority will be lost. In China, rising corruption has led to significant public outrage, functioning as an important force in the student demonstrations in 1986 and in the better known demonstrations in 1989. If the Chinese government loses their moral authority and ability to provide for

the people, they will lose their legitimacy to govern. When China enters a period of recession while corrupt officials maintain a much higher (and more self-centered) life style, corruption will become an explosive issue that will threaten any remaining political stability.

Corruption is also blocking a peaceful transition toward democracy and a full market economy. Widespread corruption and inefficiency in public administration reinforce each other to the public's detriment. Those in power do not want to leave power or greatly alter the current system as it is making them a great deal of money. Logically, one can see the end game very clearly.

Widespread corruption formed a stratum with a vested interest in maintaining the current political system and status quo for profit. Such a stratum naturally resists any change which would threaten their power and thus their profit. Such an opposition could well block the possibility of a peaceful transition to democracy. In what we call dark humour, Chinese corruption is undermining the implementation of their centralised economic planning and developmental policies. Their very own corrupt practices are leading to their inability to run or even profit from their own planned economy.

Economic fragility is a consequence of corruption. Corruption removes informational feedback mechanisms from the market place from reaching the participants. This removal of information is both damaging in the short run and ultimately fatal, in all cases - no exceptions.

### **Tiaducheng, Zhejiang Province: a living example of China's current problem**

Local officials used their power to take land and sell it to developers. They also used their power to issue permits for developments such as the French themed development. Each successive planned development was greater and grander. They used their ability to create local government financing vehicles (off the record so to speak) to buy the land and construct the infrastructure. The demand for housing was so great that more and more rounds of land and building all occurred with borrowed funds. Also the more housing unit's built the more likely it was that the local officials would be promoted. Some of the funds were used for development and some were

used to keep future funds flowing from the SOE banks, but as demand slowed a problem occurred. All Ponzi schemes run out of money. The city had paid too much in bribes and took on projects without commitments for complete financing and the city defaulted on its obligations. The people working on the water supply, roads, and sewage all resigned from their jobs as they were not getting paid. This left a city of some 200,000 mostly without running water, a freeway that ends short of the town in a gravel strip and no sewage or garbage pickup. Not even the SOE banks will lend the city any more money.

The leaders of this enthusiastic little town have assembled a huge portfolio of land to collateralise the short-term loans from the SOE banks. All to ensure they met the projected demand and got their promotions. The leaders of the government did make money each time they amassed undeveloped land to be developed as they could not borrow against the developed value of the undeveloped land; a perverse incentive, to be sure. At the current rate of development the city has amassed a portfolio of land that will last 28 years.

Corruption and perverse economic incentives prevented the feedback mechanism from the market place - such as unsold units and no water etc. - to temper the city's leader's development efforts. The party functionaries suffered no damages as a result of their bad decisions - so they just kept going until - economically - it blew up.

This raises the question: how much have the local government financing vehicles raised in money? Officially, the local government financing vehicle debt is only 16.8 per cent of total national debt - but rumors have shown the real ratio is approaching 60 per cent. The cities owe the money to the SOE banks that are in turn financed by the central government. Here again there is no feedback mechanism from the market economy to the participants. There is no consequence to be felt as the banks continue to reschedule the loans. The local officials, the bankers etc... have no blame in the game if they get it wrong. This will all work - until there is an economic downturn - and that will always happen.

**China's debt: Focusing on statistics**

<u>Country</u> ( <a href="http://en.wikipedia.org/wiki/Cape_Verde">http://en.wikipedia.org/wiki/Cape_Verde</a> ).	Debt as a per cent of GDP
<u>United States</u> ( <a href="http://en.wikipedia.org/wiki/United_States">http://en.wikipedia.org/wiki/United_States</a> ).	90.72
<u>Singapore</u> ( <a href="http://en.wikipedia.org/wiki/Singapore">http://en.wikipedia.org/wiki/Singapore</a> ).	109.78
<u>Ireland</u> ( <a href="http://en.wikipedia.org/wiki/Republic_of_Ireland">http://en.wikipedia.org/wiki/Republic_of_Ireland</a> ).	110.16
<u>Grenada</u> ( <a href="http://en.wikipedia.org/wiki/Grenada">http://en.wikipedia.org/wiki/Grenada</a> ).	111.28
<u>Italy</u> ( <a href="http://en.wikipedia.org/wiki/Italy">http://en.wikipedia.org/wiki/Italy</a> ).	114.65
<u>Portugal</u> ( <a href="http://en.wikipedia.org/wiki/Portugal">http://en.wikipedia.org/wiki/Portugal</a> ).	115.62
<u>Greece</u> ( <a href="http://en.wikipedia.org/wiki/Greece">http://en.wikipedia.org/wiki/Greece</a> ).	158.33
China	180.00

Source average of IMF and World Bank

Currently - according to a recent series of articles in the *Financial Times* - including all of the local government financing vehicles China's debt is over 180 per cent of their GDP, worse than Ireland, Spain, Italy, Portugal and Greece. Who will bail China out?

## **What's the repercussion?**

Cracks in the false front are showing - over 11,000 demonstrations a day - yes, every day are held against government officials and their abuses. China is a large country and these demonstrations range from a few dozen people to a few thousand. Last year (2012), 15,000 Chinese government employees sought sanctuary in other countries for fear of retribution for their corrupt practices. Also the net out migration of Chinese millionaires is stunning. 350 millionaires leave China each day and never come back.

The process called the "tyranny of the status quo," is a tendency for situations to stay the same. The present rules over the past and the future. Once a government begins to do something - it becomes nearly impossible to get rid of it. It becomes the status quo. The tyranny of the status quo helps governments grow. Existing conditions do change, and they, for a government, usually change in one direction. Governments grow and gain power. This path continues until the governing system collapses through a revolution of some sort.

## **A Revolution: The Middle-Class**

This tyranny of the status quo works if the society is divided between the rich and the poor. The rich do not want to change a system that has made them rich. The poor do not want to change a system for the fact things may get very much worse for them during a revolution. The people that initiate revolution are not the rich or the poor - it is the middle class. China has a fast growing middle class that does not like the level of corruption. The very fact that they - the middle class - are taxed to support the corruption and that corruption is not seen as beneficial is irksome. The middle class have both the education and the knowledge of what is right and wrong. They are equally appalled at the excesses of the rich and the suffering of the poor. The government officials have set themselves up to be the rightful target of this increasing discontent.

## **A Heavy Consequence:**



In the end the government's legitimacy has been severely affected. One can see this by riots, open defiance of laws, and new laws being passed to ban public gatherings and the censoring of the internet and 12 things one should not discuss.

This is the end game. This is where an economically dominant minority passes new laws to impede any threats from the poorer majority that could challenge the status quo. This is the last step before revolution as seen in - South Africa and Zimbabwe (whites dominating blacks), Fiji - (Indians dominating natives), Northern Ireland (Protestants dominating Catholics), Indonesia (ethnic Chinese dominating Indonesians), Sri Lanka (Tamils dominating the Sinhalese).

The economic dominant minority in China are the Chinese government officials.

#### **On a personal level:**

To what extent has the state of affairs diminished? My client, the owner of a small company that sells air fresheners for cars - 100 million a year - was working with his Chinese supplier. The Chinese supplier kept asking if my client liked women or cash or watches. He was trying to bribe the sole owner of the company. 'Yes' - was his answer, 'but not now'. Four hours later he got back to his hotel room to find a lovely Cartier watch on his bed. He called me and asked what should he do? We talked for a bit - and he laughed and we had come up with a scheme. First he returned the watch and told the watch seller to credit the suppliers account. That took 90 minutes. He said that was the most fun of the trip shoving back a bribe watch and demanding the seller give proper credit to the supplier. After that he went and saw the supplier and demanded that the order price be discounted by the price of the watch as he was obviously paying too much if the supplier could buy him watches and offer women. The supplier yelled at my client - so he left. My client was right and found another supplier for 17 per cent less and on much better terms. As he said - I was right (never get tired of hearing that): - if bribery is part of the deal - you are paying too much.

Mind your business in China and with the Chinese Nationals... And ask them with currency export control - how did they get their money out of China?

## ABOUT THE AUTHOR



### **L. Burke Files DDP CACM, President, Financial Examinations & Evaluations, Inc**

Mr. Files is President of Financial Examinations & Evaluations, Inc. He is an international financial investigator and due diligence expert who has run cases in over 130 countries and has visited over 100 countries. Mr. Files has tackled investigations running from a few hundred thousands dollars to over 20 billion. Along the way he became familiar with the knowledge of what people need to do, for due diligence, preventing corruption, and to avoid helping criminals launder money. He brings this experience of hands on investigating and problem solving experience to his lectures on Due Diligence, AML, and Anti-Corruption. Prior to founding FE&E, Inc. he served as the Director of Corporate Finance for American National an investment bank focused on development stage venture capital. He was also employed by Oppenheimer/Rouse as a commodities specialist trading customer accounts in Agri-Business and 24-hour gold, silver, and foreign currency trading. Mr. Files has authored six books, and many white papers and articles. He has been quoted in major publications including The Guardian, The Financial Times, Forbes, US Newsweek and more. He is the author of the award winning book Due Diligence For The Financial Professional 2nd Edition. Mr. Files serves on the board of directors for several private companies, funds, and non-profits. Mr. Files is active in several civic organizations. In the past Mr. Files has served as a member of the Arizona Governor's Board on Solid Waste Management, as an advisor to the Governor's Board on Economic Planning and Development. Mr. Files has also received a Commission and a Medal of Merit from the President of the United States.

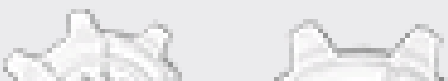


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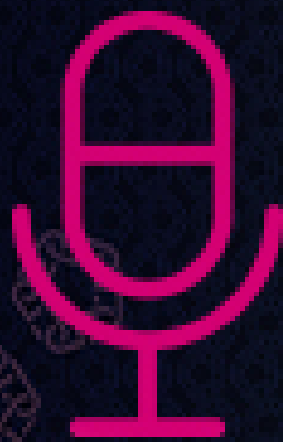
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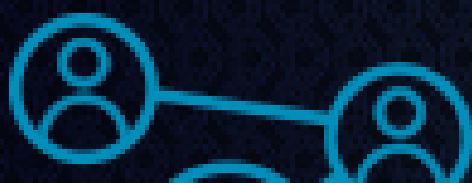




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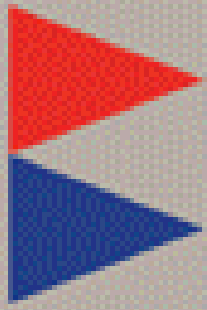
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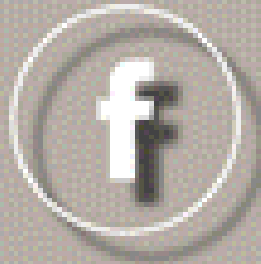
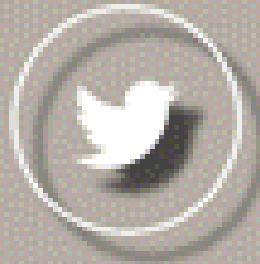
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