

# State Policy and *Guanxi* Network Adaptation in China: Local Bureaucratic Rent-Seeking\*

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*Recently, guanxi, or personal networks, has emerged as a significant factor in explaining business success in Chinese societies. This paper examines the celebrated "instrumental thesis of guanxi" by challenging the term's culturalist fallacy. The argument is that the structure of rent-seeking behavior is what has generated and reinforced the economic instrumentality of personal networks. Therefore, structural and institutional factors such as state policy and China's place in the world economy should be duly emphasized. Guanxi works as a convenient tool for investors to work out a cooperation protocol (or conspiracy pact) with local officials. However, when relevant state policies are altered and the space for renting-seeking is trenched, the incentives for actors will change in response, thereby affecting existing guanxi webs and making them unproductive or even deleterious for investors. The study is based on field work conducted in China, Hong Kong, and Taiwan during 1994-96.*

**KEYWORDS:** *guanxi* network; renting-seeking; state; local government; China

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In early 1994, this author attended a banquet in Taipei. During the private gathering, gossip held that a Taiwanese business club in Xizhu City gave a Mercedes-Benz to a Chinese Communist Party (CCP) secretary named Zhou.<sup>1</sup> Zhou accepted the gift. Later in the year, the author visited a Taiwanese company in Xizhu. At a dinner that followed a round of interviews, the Taiwanese managers discussed recent central policy changes regarding foreign exchange and land development. These changes had affected the relations these businessmen had with the central government and local officials. The company representatives also mentioned troubles Mr. Zhou had been having in the party. He had been held for "internal investigation" for several months and would probably be dismissed from his post soon. The businessmen seemed concerned with the secretary's bad fortune during this time of policy change and were also worried about their personal ties to him. After guessing at possible successors, someone proposed that they should begin to establish ties to the most promising candidate. Two years later, in early 1996, a Guangdong newspaper announced that the former party secretary had been sentenced to ten years' imprisonment for "taking bribes and misconduct in illicit land development."

The story highlights important characteristics of government-business connections within China: many local Chinese officials are ready to deliver policy goods to "friends" who know how to express "appropriate gratitude" in return. Conceiving such a relationship to be crucial to the success of business in an uncertain policy environment, businesspeople invest a great deal of time and energy in establishing ties to such officials. Sensitive to policy and personnel changes, they act swiftly and skillfully to secure whatever goods they need from officials.

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<sup>1</sup>Xizhu, a code name for a prosperous city in the Pearl River delta, hosts thousands of factories that are supported by foreign capital, mostly from Hong Kong and Taiwan. Most industries in Xizhu are labor-intensive and export-oriented. Xizhu is a typical region in Southeast China that has utilized foreign capital for rapid rural industrialization. Townships and villages have thrived and have also urbanized in a somewhat crude way thanks to these processing and assembly-type investments. The author conducted interviews in Taiwan, Hong Kong, the Pearl River delta, and other regions of China in the period 1994-96. Most of the names, institutes, and locales are coded in order to protect informants in the field.

## Argument of the Paper

In recent academic work, *guanxi* (關係), or personal networks, has emerged as a significant factor in explaining business success in Chinese societies.<sup>2</sup> This article continues such research by exploring how *guanxi* networks are organized within a particular policy environment and how they adapt to policy change. The focus is on government-business relations between Taiwanese enterprises and Chinese local officials via the illustration of the patterns of economic interaction across political borders.<sup>3</sup> The main argument is that the structure of *rent-seeking* behavior is what has generated and reinforced the economic instrumentality of personal networks. The expectation is that when policies are altered and the space for rent-seeking is trenched, the incentives of actors will change in response, thereby affecting existing *guanxi* webs and changing the patterns of networking. Methodologically speaking, the behavior known as *guanxi* is construed as an intervening factor between socioeconomic structure and business networks.

The article is organized in the following order. The first section examines the cultural explanation of economic behavior and clarifies the concept of *guanxi*. The second section explains *how* rent-seeking in

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<sup>2</sup>See, for example: Gary Hamilton and Kao Cheng Shu, "The Institutional Foundations of Chinese Business: The Family Firm in Taiwan," *Comparative Social Research* 12 (1990): 95-112; Alan Smart, "Gifts, Bribes, and *Guanxi*: A Reconsideration of Bourdieu's Social Capital," *Cultural Anthropology* 8, no. 3 (1993): 388-408; David L. Wank, "The Institutional Process of Market Clientelism: *Guanxi* and Private Business in a South China City," *The China Quarterly*, no. 147 (September 1996): 820-38; and Macro Orru, Nicole Woolsey Biggart, and Gary Hamilton, eds., *The Economic Organization of East Asian Capitalism* (London: Sage, 1997).

<sup>3</sup>The allusive and vague notion of "being a Chinese" has been a focus of academic debate. It is further complicated by the recent popular use of "Greater China." For the problem of "Chineseness," see Wang Gungwu, *The Chineseness of China: Selected Essays* (Hong Kong: Oxford University Press, 1991); Wang Gungwu, "Greater China and the Chinese Overseas," *The China Quarterly*, no. 136 (December 1993): 926-48; and Tu Wei-ming, ed., *The Living Tree: The Meaning of Being Chinese Today* (Stanford, Calif.: Stanford University Press, 1994). For a discussion of Greater China, see Harry Harding, "The Concept of 'Greater China': Themes, Variations, and Reservations," *The China Quarterly*, no. 136 (December 1993): 660-86. Aware of the debate, I technically treat Taiwan in this research as a Chinese society (*huaren shehui*) for its linguistic and cultural similarity with mainland China. We can thereby make cross-societal comparison among the Chinese societies such as colonial Hong Kong, sovereign Singapore state, and overseas Chinese communities around the world.

reform-era China has paved the way for business networking. The article concludes with a case study of Taiwanese businessmen cultivating *guanxi* with local officials and responding to central policy change. Field work and in-depth interviews were conducted in Guangdong, Shanghai, Hong Kong, and Taiwan during 1994-96.

### **Guanxi: Culture, Behavior, and Structure**

The remarkable economic performance of the East Asian countries in the postwar era has inspired contending explanations of the "economic miracle." A major debate has occurred over whether the *market* or the *state* has played the leading role in this rapid growth.<sup>4</sup> More recently, in the midst of the economic growth inspired by China's opening-up policy, scholars of Chinese society and culture have joined the debate. These newcomers provide cultural-institutional explanations either by positing a functional equivalent of the Weberian capitalist spirit<sup>5</sup> or by emphasizing

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<sup>4</sup>Alice H. Amsden, "Taiwan's Economic History: A Case of Etatism and a Challenge to Dependency Theory," in *Toward a Political Economy of Development*, ed. Robert Bates (Berkeley: University of California Press, 1988), 142-75; Stephan Haggard, *Pathways from the Periphery: The Politics of Growth in the Newly Industrializing Countries* (Ithaca, N.Y.: Cornell University Press, 1990); Frederic C. Deyo, ed., *The Political Economy of the New Asian Industrialism* (Ithaca, N.Y.: Cornell University Press, 1987); Chalmers Johnson, "Political Institutions and Economic Performance: The Government-Business Relationship in Japan, South Korea, and Taiwan," *ibid.*, 136-64; Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton, N.J.: Princeton University Press, 1990); Gary Gereffi and Donald L. Wyman, eds., *Manufacturing Miracles: Paths of Industrialization in Latin America and East Asia* (Princeton, N.J.: Princeton University Press, 1990); Richard Whitley, *Business Systems in East Asia: Firms, Markets, and Society* (London: Sage, 1992); and Richard Whitley, "Dominant Forms of Economic Organization in Market Economies," *Organization Studies* 15, no. 2 (1994): 153-82.

<sup>5</sup>For Max Weber's classical arguments for the cultural origins of capitalism and a lack of such cultural and institutional characteristics in China, see Max Weber, *The Religion of China* (New York: Free Press, 1951) and *The Protestant Ethic and the Capitalist Spirit* (London: Allen and Unwin, 1930). For the efforts in establishing sociocultural models of East Asian development, see Peter Berger, *The Capitalist Revolution: Fifty Propositions about Prosperity, Equity and Liberty* (London: Wildwood, 1987); Peter Berger and Hsin-huang Hsiao, eds., *The Search of an East Asian Development Model* (New Brunswick, N.J.: Transaction Books, 1988); Nicole Woolsey Biggart, "Explaining Asian Economic Organization: Towards a Weberian Institutional Perspective," in Orru, Biggart, and Hamilton, *The Economic Organization of East Asian Capitalism*, 3-32; Gary Hamilton and Kao Cheng Shu, "Max Weber and the Analysis of the East Asian Industrialization," *International Sociology* 2,

the organizational characteristics of the Chinese *family*.<sup>6</sup> Such studies have interpreted the postwar experience in a way that Chinese culture is both complementary to the market economy and in accordance with the "developmental state" explanations.

### "Rediscovery of Guanxi"

A research agenda that has emerged from a synthesis of the prior works is the celebrated "rediscovery of *guanxi*."<sup>7</sup> One may say that recent studies are constructing an *instrumentalist thesis of guanxi*. Such research has found that personal connections occupy a central position in Chinese daily life; that the density of personal networks appears to be extraordinarily high compared to other societies;<sup>8</sup> that *guanxi* networking is regarded as socially productive; and that *guanxi* deeply influences the market and business organizational behavior.

However, the renewed interest in *guanxi* culture has not proceeded

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no. 3 (1987): 289-300; S. Gordon Redding, *The Spirit of Chinese Capitalism* (Berlin: de Gruyter, 1990); and Tu Wei-ming, ed., *The Confucian Dimensions of Industrial East Asia* (Cambridge, Mass.: Harvard University Press, 1995).

<sup>6</sup>Susan Greenhalgh, "Families and Networks in Taiwan's Economic Development," in *Contending Approaches to the Political Economy of Taiwan*, ed. Edward Winckler and Susan Greenhalgh (Armonk, N.Y.: M.E. Sharpe, 1988), 224-45; Hamilton and Kao, "The Institutional Foundations of Chinese Business"; and Orru, Biggart, and Hamilton, *The Economic Organization of East Asian Capitalism*.

<sup>7</sup>See, for example: Lucian W. Pye, *The Mandarin and the Cadre: China's Political Cultures* (Ann Arbor: Center for Chinese Studies, University of Michigan, 1988); Lucian W. Pye, *The Spirit of Chinese Politics* (Cambridge, Mass.: Harvard University Press, 1992); Ambrose King, "Kuan-hsi and Network Building: A Sociological Interpretation," *Daedalus* 120, no. 2 (1991): 63-84; Smart, "Gifts, Bribes, and Guanxi"; Mayfair Yang, "The Gift Economy and State Power in China," *Comparative Studies in Society and History* 31 (1989): 25-54; Mayfair Yang, *Gifts, Favors, and Banquets: The Art of Social Relationships in China* (Ithaca, N.Y.: Cornell University Press, 1994); Wank, "The Institutional Process of Market Clientelism"; and Yunxiang Yan, "The Culture of Guanxi in a North China Village," *The China Journal*, no. 35 (January 1996): 1-25. Whyte has examined the changing views on the Chinese family in regard to economic development. See Martin King Whyte, "The Social Roots of China's Economic Development," *The China Quarterly*, no. 144 (December 1995): 999-1019 and "The Chinese Family and Economic Development: Obstacle or Engine?" *Economic Development and Cultural Change* 44, no. 1 (October 1996): 1-30. Note that it is beyond the author's ability to cite the enormous literature on Chinese culture and history. It suffices to say that the instrumental perspective of *guanxi* represents an intellectual reaction to the treatment of Chinese culture and Confucian tradition as "shackles" of modernization, an approach adopted by many of the prior generations of Chinese scholars and writers.

<sup>8</sup>Peter M. Blau, Danching Ruan, and Monica Ardelit, "Interpersonal Choice and Networks in China," *Social Forces* 69 (1991): 1037-62.

without difficulties. First of all, enthusiastic treatment of the East Asian "business culture" variable is often seen as being insensitive to the effects of power and interest in the social structure, and is further criticized as legitimizing the "pre-modern belief system."<sup>9</sup> This critique is compelling when one acknowledges the fact that labor costs in the East Asian newly industrialized countries (NICs) had been held low by the authoritarian rulers in these societies where loyalty, discipline, and submission were socialized in the patriarchal family and school system.<sup>10</sup> As yet, this attack is not intractable. Possible is that an authoritarian regime may try to use "feudal values" to indoctrinate its subjects for political stability and labor discipline. However, when we take a closer look at the authoritarian regimes in the region, sheer political oppression and social control have been more common than cultural indoctrination. The latter may be merely a by-product of political control. In order to test such statements, we can design comparative research for pairs of Chinese societies with the same cultural heritage but with different levels of both authoritarian control and economic development. Then we can determine to what extent economic performance can be attributed to a "pre-modern belief system" and state policy or other factors, respectively.

Important is to note here that the alleged problem of insensitivity has originated in an unrealistic assumption implicit in many cultural explanations, that is, a traditional culture tends to evolve in a determinate manner, independent of time-space and institutional context. In order to avoid this pitfall, we need to contextualize beliefs and behavior in the social and economic structure. This leads to the debate over the explanatory power of structure and culture.<sup>11</sup>

In the eyes of structural theorists, the "culturalists" treat Chinese culture as a *static* and *constant* factor, an embedded character of ethnic Chi-

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<sup>9</sup>Barry Wilkinson, "Culture, Institutions, and Business in East Asia," *Organization Studies* 17, no. 3 (1996): 421-47.

<sup>10</sup>Frederic C. Deyo, *Beneath the Miracle: Labor Subordination in the New Asian Industrialism* (Berkeley: University of California Press, 1991).

<sup>11</sup>See Bruce J. Dickson, "What Explains Chinese Political Behavior? The Debate over Structure and Culture," *Comparative Politics* 25, no. 1 (October 1992): 103-18, for a review of the debate over culture and structure in the explanation of Chinese behavior.

nese. For these scholars, the art of *guanxi*, or the social networks based on primary relations, is taken for granted, rather than outcomes of social interaction. To illustrate, an eminent British researcher explained the emerging economic integration among Chinese societies as follows: "The complex nexus of relations on which the economic ties of Greater China are based may be said to be those of family, or the long-standing social links between overseas Chinese and their ancestral villages and, more broadly, the networks of relationships (*guanxi*) that transcend bureaucratic barriers."<sup>12</sup>

Bureaucratism is indeed a historical problem impeding commerce, and informal social networks may be useful in overcoming the problem. In the above quotation, however, *guanxi* networks are assumed to be a constant element in Chinese societies. This line of logic does not actually explain either the impetus of industrialism in Taiwan, Hong Kong, Singapore, and China, or the upsurge in economic integration among these regions. This argument does not explicate why the positive effect of Chinese family ties has not consistently functioned in pre-modern China or, more recently, in Mao's China, given the assumption that such ties are inherently instrumental for "transcending bureaucratic barriers." The reality may be, on the contrary, that patriarchal officialdom in imperial China had suppressed the positive side of the Chinese family in the economic sphere. China's changing place in the world economy is then one factor that has offered the Chinese family networks an opportunity to directly stimulate economic development.

The flaw of this culturalist argument is evident: How can a repressed element of culture in *time A* gain an upper hand over its repressor in *time B*, unless there have been some fundamental changes in the exogenous conditions? Therefore, Martin Whyte observed:

In all four Chinese regimes under consideration, including the PRC since the onset of reforms in 1978, a more supportive role by the state and more secure legal and other institutions created an environment in which family-based entrepreneurial activities can flourish as they could not in China during the century prior to 1950.<sup>13</sup>

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<sup>12</sup>Michael Yahuda, "The Foreign Relations of Greater China," *The China Quarterly*, no. 136 (December 1993): 688.

<sup>13</sup>Whyte, "The Chinese Family and Economic Development," 17-18.



Since changes in exogenous conditions are driving forces of the positive elements of Chinese family, we find that the culturalist fallacy is rooted in its static treatment of culture. Such a treatment explains little about changes in individual behavior and economic performance over time, for how can a constant factor explain a changing pattern of behavior? Moreover, the significance of *guanxi* has far gone beyond the primary relationships of family and kinship. Such relations have become a pervasive phenomenon in the Chinese socioeconomic life as exogenous conditions changed over time. Therefore, attention should be directed toward the origins of *guanxi's* transformation. To sum up, the static cultural approach is thus rejected by the structural theorists as "holism" or "cultural determinism."<sup>14</sup>

Notwithstanding the above methodological criticism, difficult is to deny the significance of the cultural factor in economic activities, for human relations are not molded by structural forces alone. References to belief systems and human agency are always needed to fully explain a choice over diverse courses of action where such a choice set really exists. A certain degree of human agency, or a "thin rational choice" at least, is warranted if one does not want to fall into an opposite fallacy, "structural determinism."<sup>15</sup> The structural critique is valid insofar as it exposes the failure of the cultural explanation by specifying structural forces that transform particular social behavior. The challenge is to ferret out what structural conditions have what degree of affinity with particular cultural ele-

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<sup>14</sup>For general statements of structural explanation, see Brian Barry, *Sociologists, Economists, and Democracy* (London: Collier-Macmillan, 1970); Barrington Moore, Jr., *Social Origins of Dictatorship and Democracy: Lord and Peasant in the Making of the Modern World* (Boston: Beacon Press, 1966); and Theda Skocpol, *States and Social Revolutions: A Comparative Analysis of France, Russia, and China* (Cambridge, U.K.: Cambridge University Press, 1979).

<sup>15</sup>For a definition of thin rational choice theory, see Michael Taylor, "Rationality and Revolutionary Collective Action," in *Rationality and Revolution*, ed. Michael Taylor (Cambridge, U.K.: Cambridge University Press, 1988), 63-97. For a broader debate of cultural versus structural/institutional perspective, see Thomas A. Koelble, "The New Institutionalism in Political Science and Sociology," *Comparative Politics* 27, no. 2 (January 1995): 231-44; William H. Sewell, Jr., "Theory of Structure: Duality, Agency, and Transformation," *American Journal of Sociology* 98, no. 1 (July 1992): 1-29; Michael Taylor, "Structure, Culture, and Action in the Explanation of Social Change," *Politics and Society* 17, no. 2 (1989): 115-62; and Richard Whittington, "Putting Giddens into Action: Social Systems and Managerial Agency," *Journal of Management Studies* 29, no. 6 (1992): 693-712.



ments. In short, cultural and structural perspectives can be complementary for a comprehensive explanation of economic behavior.

A related issue is the notion of "uniqueness" in cultural comparison. For some scholars, Chinese culture is so distinctive as to shun meaningful comparative studies.<sup>16</sup> For instance, Lucian Pye argued, "cultural factors dominate public life in China more than in just about any other country."<sup>17</sup> This statement suggests that the Chinese people are the most culturally-laden in the world. However, how can we employ this uniqueness of Chinese national character as a causal explanation? This line of cultural argument easily slips into a "hermeneutic circle." A possible way out of the predicament, suggested by Andrew Nathan, is to "use hermeneutic methods to achieve findings about *difference* rather than uniqueness."<sup>18</sup> The emphasis on personal connections is far from uncommon across societies. As Andrew Walder has argued, the notion of *guanxi* is "by no means culturally unique: the term *blat* in Russian, and *pratik* in Haiti refer to the same type of instrumental-personal tie."<sup>19</sup> Walder described *guanxi* in a socialist state in a climate of economic scarcity: "Networks of instrumental-personal ties thrive in the modern communist enterprise because of the social and economic resources they control, the scarcity that characterizes the consumer economy, and the wide discretion that officials have in interpreting the rules and distributing resources."<sup>20</sup>

What is significant about *guanxi* is not its uniqueness. Instead, the focus should be placed on how this networking behavior interacts with particular structural conditions. In a Soviet-style economy, scarcity (or "shortage") and official discretion are two such conditions that shape the patterns of social interaction. To sum up, recent studies on the cultural determinants of Chinese economic behavior tend to overlook the causal

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<sup>16</sup>Andrew J. Nathan, "Is Chinese Culture Distinctive?—A Review Article," *Journal of Asian Studies* 52, no. 4 (1993): 923-36.

<sup>17</sup>Pye, *The Mandarin and the Cadre*, 30, quoted in Nathan, "Is Chinese Culture Distinctive?" 933.

<sup>18</sup>Nathan, "Is Chinese Culture Distinctive?" 928.

<sup>19</sup>Andrew G. Walder, *Communist Neo-Traditionalism: Work and Authority in Chinese Industry* (Berkeley: University of California Press, 1986), 179.

<sup>20</sup>*Ibid.*, 26-27.

effects of economic structure and state policy. They have also blurred the fine boundaries between the culture of *guanxi* and the behavioral expressions facilitated by *guanxi*. As a matter of fact, the behavior of *guanxi* carries different configuration of meanings and utilities in diverse social settings.<sup>21</sup>

### *Guanxi Culture in Action*

*Guanxi* network as a form of social exchange is similar to gift exchange from the perspective of anthropology. This type of social exchange is *informal* in nature and particularly *unstable* in a transitional economy like China. This paper defines the culture of *guanxi* as "a set of values and beliefs that emphasize instrumental personal ties in everyday life." Hence, *la guanxi* (拉關係 "pulling" connections, literally) is understood as a behavior of cultivating networks. People use such informal relationships to modify the formal rules in specific political and economic environs. This definition is a revision of Douglass North's neoinstitutional model of the interplay between formal and informal rules. North stated: "The formal rules will result in the creation of a variety of informal constraints that modify the formal rules and extend them to a variety of specific applications."<sup>22</sup> The present study assumes, however, that informal rules are not necessarily created by formal rules. Informal rules as spontaneous order in a society may have existed for a long period of time, but they can gain new implications and vitality under a new set of formal rules imposed by the state. This causes a process of *incarnation* and *reinvigoration* of informal rules. In other words, informal rules not only set the boundaries for an actor but also provide inspiration and resources for social actors as well.<sup>23</sup>

Because of the nature of informality, *guanxi* should not be seen as a

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<sup>21</sup>This has been argued in several empirical findings. See Yang, *Gifts, Favors, and Banquets*, for different meaning of *guanxi* in Mao's era and in Deng's reform; and Yan, "The Culture of *Guanxi* in a North China Village," proposed that *guanxi* in the countryside functions dissimilarly than in the urban areas.

<sup>22</sup>Douglass C. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge, U.K.: Cambridge University Press, 1990), 95.

<sup>23</sup>In this sense, culture functions like a "tool kit" for a social actor. See Anne Swidler, "Culture in Action: Symbols and Strategies," *American Sociological Review* 51 (1986): 273-86.

fixed or reified fabric,<sup>24</sup> but is instead situated in the dynamic process of social interaction. First of all, after taking root in social relationships, *guanxi* involves a ceaseless exchange process in which "all of the relational boundaries in one's *guanxi* network have to be defined and redefined repeatedly through active participation in social exchanges."<sup>25</sup> To use a rational choice analogy, there is ideally no "end-game" situation in *guanxi*.<sup>26</sup> That is, a player in the *guanxi* game is bound, to a varying degree, by an uncertain future. A rational actor will not choose defection (i.e., not fulfill his obligation) in an interwoven relationship, given that any defection will be observed and punished.<sup>27</sup> Connections have to be maintained (維持關係 *weichi guanxi*) in exchange for unknown needs in the future. There is inherently a dimension of *suspension* in *guanxi* networking. This holds true even for the most calculating actor.

This characteristic has important implications for calculation in personal connections. *Guanxi* exchange as a form of "gift economy" stands in sharp contrast to market exchange.<sup>28</sup> In a pure market situation, a transaction is completed when goods and payment are exchanged,<sup>29</sup> whereas in a gift interaction, exchange is not yet finished when the gift is offered and accepted. For instance, one may intentionally present a gift to commit a friend to repay favors in the future, but at the present moment, one would not know what one will require in return and when such a need may arise.<sup>30</sup> The *moratorium* makes the values of future goods unknown.<sup>31</sup> Extending

<sup>24</sup>Cf. Yang, *Gifts, Favors, and Banquets*.

<sup>25</sup>Yan, "The Culture of *Guanxi* in a North China Village," 4.

<sup>26</sup>An end-game situation, like in a one-shot game, tends to encourage noncooperation and defection because there will be no more expected interaction in the future. In contrast, repeated games tend to induce cooperation. See Robert Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984).

<sup>27</sup>Failure to fulfill an obligation usually signals a withdrawal from a social relationship.

<sup>28</sup>Cf. Marcel Mauss, *The Gift* (New York: Norton, 1967). Note that Mauss assumed a "misrecognition" of instrumental motivation involved in gift exchange. Smart has a parallel argument in Smart, "Gifts, Bribes, and *Guanxi*," 395-97.

<sup>29</sup>If the transaction is not made in cash, the seller of goods at least has to secure some kind of certificate or claim of the equivalent value in return.

<sup>30</sup>If one knows what specific good is desired in return for gift-giving, this form of exchange is bribery. Cf. Yang, "The Gift Economy and State Power in China."

<sup>31</sup>This is evident when compared with commodity exchange. A credit purchase involves a

Bourdieu's distinction between social capital and "objective" economic capital, the former, "designating such things as obligations and trust, is by its very nature vague and immeasurable. Obligation is always potential: once it has been used, it does not exist anymore; and until then, there is no certainty that the obligation or 'gift debt' will actually be reciprocated."<sup>32</sup> Thus, cultivation of *guanxi* is a very special kind of investment. One may say that a person saves a lot of "*guanxi* capital" through investment in multiple social networks, but the asset of *guanxi* is definitely unlike an inventory of capital stock, hoarded in banks or warehouses. In short, a social exchange relationship cannot be objectified.

A tricky feature of *guanxi* exchange emerges when perverse effects or unexpected outcomes are considered. *Guanxi* is often assumed as being positive and symmetric insofar as the occurrence of *negative ties* and *asymmetric relations* is not incorporated.<sup>33</sup> Yet, there is little theoretical ground in presupposing that a positive channel will persist within a network over time; the possibility of perverse outcomes always exists. This danger originates in the very nature of suspended reciprocity in social exchange. For an actor "waiting" for future returns, the "content" of a *guanxi* may alter altogether if the surrounding conditions change in the interim. As a result, the incentive structure of the actor changes together with his perception and calculation in regard to such a *guanxi* web. For example, in the following events, positive *assets* turn into negative *liabilities*:

1. One such case is when a prior mutually beneficial relationship goes sour. This often happens in a dyadic relationship. Two friends who have densely interacted may one day turn against each other due to a conflict of emotion, perception, or—most importantly—interest. This two-person situation can be extended to a multiple-person network. The utilities of

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clear and measurable debt to the merchant. In favor exchange, however, this is not the case. As Peter Blau argued: "Social exchange entails unspecified obligation. There is no contract, and there is no exact price." See Peter M. Blau, *Exchange and Power in Social Life* (New Brunswick, N.J.: Transaction Books, 1986 [1964]), 315.

<sup>32</sup>Smart, "Gifts, Bribes, and *Guanxi*," 393.

<sup>33</sup>This phenomenon was pointed out by Mark Granovetter: "Ties discussed in this paper are assumed to be positive and symmetric; a comprehensive theory might require discussion of negative and/or asymmetric ties." See Mark Granovetter, "The Strength of Weak Ties," *American Journal of Sociology* 78, no. 6 (1973): 1361 n. 2.

existing business ties can be easily impacted by a change in formal institutions, power positions, and relative prices. As a result, close partners may become strange bedfellows under a rapidly changing policy environment. An actor thus faces a dilemma in maintaining or ending a relationship: to continue fulfilling an obligation causes obvious loss in himself, but to break up a relationship may beget loss, distrust, and hate in his alienated partner—and may in the worst-case scenario even extend to retaliation. The relationship thus becomes cost-inefficient.<sup>34</sup> People normally do not expect that a friendship would break up when they initially engage other people. The case of unexpected deterioration of relationships is a perfect expression of the "asymmetry of reciprocity" inherent in social exchange. For those who are damaged by the relationship with others, the bottom line is not that they get no reward from the invested social network, but that they receive negative returns, counter to their original intention.

2. A second example is when people find themselves caught in a *hazardous* network. This is usually found in a patron-client relationship. A patron in a powerful position can distribute privileges to his followers. However, this is premised on the continuance or further promotion of his power. If one falls from the ladder of power, the hopes of his followers also sink. The relationship may turn dangerous. Such cases abound in the power struggle of Third World and communist regimes. When a patron faces political troubles, the fate of a whole faction is affected. Thus we observe that people haste to distance themselves from a prior close relationship (撇清關係 *pieqing guanxi*) when their friends endure hard times. The story of secretary Zhou, told at the beginning of the paper, clearly indicates this aspect of the political danger of personal ties. His arrest coincided with a change in state policy. Taiwanese managers were worried about his arrest and eager to seek a new patron. Zhou's dismissal would have affected his followers in the party and would also have dismayed those entrepreneurs closely linked with him if the government had decided

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<sup>34</sup>For a case study in kin employment in relation to unexpected problems in such network employment, see Josephine Smart and Alan Smart, "Obligation and Control: Employment of Kin in Capitalist Labour Management in China," *Critique of Anthropology* 13, no. 1 (1993): 7-31.

to expand the scope of persecution. In that case, the social web spun around the official would thus become a disaster for the business community.

The above analysis urges us to look at the Janus-face of *guanxi* networking, which, fueled by institutional uncertainty, installs an intrinsic volatility in itself. Breakup of a *guanxi* network means an end-game situation (however unforeseen) and creates dynamics for a new round of busy social dealings, demonstrating how unstable a social network can be in a transitional political economy. In fact, negative effects of networks occasionally loom high, but are ignored or played down by the instrumentalist perspective of *guanxi*. The conventional wisdom that "the denser the network of connection, the more benefits accrue to the *guanxi* cultivator" is no longer warranted. On the contrary, a strategy of "weak ties" may yield better outcomes in constantly changing political settings. In summary, expected returns to social investment are not solely determined by the quantity of personal ties but instead adjust in response to other relevant structural conditions. The configuration of interests and mutual relationships in a social network is sensitive to policy change. This is the main theme that will be illustrated in the next sections.

### Rent-Seeking and *Guanxi* Networking in China

Following the above clarification, we can now take structural variables into account. Individuals act in a matrix of structural conditions which in turn shape their incentives and constrain their choice sets. The following will demonstrate that the *rent-generating structure* in China is what makes informal personal webs flourish. Hence bureaucratic patronage and political favoritism thrive.

Interpersonal connections have an "elective affinity" with rent-seeking activities in a "shortage economy."<sup>35</sup> Many have argued that the Soviet style of centrally planned economy is actually a type of rent-distribution

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<sup>35</sup>See Janos Kornai, *Economics of Shortage* (Amsterdam: North-Holland, 1980), for the concept of shortage economy.

and rent-seeking system.<sup>36</sup> Rent-seeking can also be construed as a competition for exclusive property rights through government regulation. Features of a rent-seeking society—such as a wide range of regulations and monopolies, rampant special privileges, heavy investment in lobbying activities, loss of national welfare, and inequality and social waste—are well detected in the Soviet-style economies, as in all nonsocialist countries to a varying extent.<sup>37</sup>

The Chinese economy in the Mao era had already exhibited rent-seeking characteristics. The economic reforms since 1978 enlarged the scope and changed the nature of rent-seeking activities in the transitional economy. A gambit of Deng's reform was "playing to the provinces."<sup>38</sup> By way of decentralization (instead of full-blown liberalization), the reforms motivated local officials to engage in economic activities. This reform strategy launched a restructuring of rent distribution alongside the CCP's *nomenklatura* system. Local governments and officials were accorded more power to decide investment projects and loans, offer tax breaks, and deliver personal favors. This inflation of local power was coupled with a

<sup>36</sup>Gary M. Anderson and Peter J. Boettke, "Perestroika and Public Choice: The Economies of Autocratic Succession in Rent-Seeking Society," *Public Choice* 75, no. 1 (1993): 101-18; Andras Nagy, "Institutions and the Transition to a Market Economy," in *The Emergence of Market Economies in Eastern Europe*, ed. Christopher Clague and Gordon C. Rausser (Cambridge, Mass.: Basil Blackwell, 1992), 301-7.

<sup>37</sup>For the case of the Soviet Union, see Helene C. D'Encausse, *Confiscated Power: How Soviet Russia Really Works* (New York: Harper & Row, 1980) and M. Voslensky, *Nomenklatura* (New York: Doubleday, 1984). For the general problems of rent-seeking, see Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64, no. 3 (June 1974): 399-458; Richard Posner, "The Social Costs of Monopoly and Regulation," *Journal of Political Economy* 83 (August 1975): 807-27; James M. Buchanan, Robert D. Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society* (College Station, Texas: Texas A&M University Press, 1980); Gordon Tullock, "Rent-Seeking as a Negative-Sum Game," *ibid.*, 16-37; Gordon Tullock, "The Costs of Special Privilege," in *Perspectives on Positive Political Economy*, ed. James E. Alt and Kenneth A. Shepsle (New York: Cambridge University Press, 1990), 195-211; and Robert D. Tollison, "Rent-Seeking: A Survey," *Kyklos* 35, no. 4 (1982): 575-602. Note that I adopt a broad definition of rent-seeking, including revenue-seeking activities through government regulation, tariffs, quota, and contracting. Cf. Dennis C. Mueller, *Public Choice II* (Cambridge, U.K.: Cambridge University Press, 1989), chap. 13. These activities are also named "directly unproductive profit-seeking activities (DUP)." See David C. Colander, ed., *Neoclassical Political Economy: The Analysis of Rent-Seeking and DUP Activities* (Cambridge, Mass.: Ballinger, 1984).

<sup>38</sup>Susan L. Shirk, "'Playing to the Provinces': Deng Xiaoping's Political Strategy of Economic Reform," *Studies in Comparative Communism* 23, no. 3/4 (1990): 227-58.



shift in official ideology. In Mao's time the state directed substantial resources toward economic equality and political struggle, whereas in the post-Mao reform era officials were told to focus on building a "socialist market economy." In addition, a lack of a comprehensive legal framework for private capital made local bureaucratic patronage an alternative to the vacuum of formal institutions. Local officials, with a political mandate for development and acting upon a mixed economy of plan and market, now possessed a great deal of power to create exclusive rights for local public revenues and personal welfare within their administrative jurisdictions.<sup>39</sup> The opportunities for rent-seeking have hence increased with the advance of decentralization and the opening-up policy.

However, opportunities do not automatically bring in new businesses. In order to take advantage of state policies, officials had a strong motivation to establish a local property rights regime in favor of local development.<sup>40</sup> These diverse local regimes across China provide officials as well as entrepreneurs with ample room for economic maneuver. What local

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<sup>39</sup>For the characteristics of Chinese economic reform, cf. Nicholas R. Lardy, *Foreign Trade and Economic Reform in China: 1978-1990* (Cambridge, U.K.: Cambridge University Press, 1992); Barry Naughton, *Growing Out of the Plan: China's Economic Reform, 1978-1993* (New York: Cambridge University Press, 1995); and Carl Riskin, "Neither Plan nor Market: Mao's Political Economy," in *New Perspectives on the Cultural Revolution*, ed. William A. Joseph, Christine P.W. Wong, and David Zweig (Cambridge, Mass.: Harvard University Press, 1991), 133-52. For political aspects of reform strategy, see Steven M. Goldstein, "China in Transition: The Political Foundations of Incremental Reform," *The China Quarterly*, no. 144 (December 1995): 1105-31; and Susan L. Shirk, *The Political Logic of Economic Reform in China* (Berkeley: University of California Press, 1993).

<sup>40</sup>By "local property rights regime," this author refers to a system of formal and informal rules within a local jurisdiction that regulates the general assignment of property rights, ownership, and fiscal relationships. This definition also implies that there is more than a unitary local regime in China. Instead, diverse local regimes exist in response to each region's factor endowment and previous institutional arrangements. For the concept of property rights, cf. Armen A. Alchian and Harold Demsetz, "The Property Right Paradigm," *Journal of Economic History* 33 (1973): 16-27; Harold Demsetz, "Toward a Theory of Property Rights," *American Economic Review* 57 (1967): 347-59; and Thrainn Eggertsson, *Economic Behavior and Institutions* (Cambridge, U.K.: Cambridge University Press, 1990). For the role of local government in promoting rural economic development, cf. Nan Lin, "Local Market Socialism: Local Corporatism in Action," *Theory and Society* 24 (1995): 301-54; Jean C. Oi, "Fiscal Reform and Economic Foundations of Local State Corporatism in China," *World Politics* 45, no. 1 (October 1992): 99-126; and Jean C. Oi, "The Role of the Local State in China's Transitional Economy," *The China Quarterly*, no. 144 (December 1995): 1132-49.

institutions have created for each locality, in terms of the assignment of property rights, is fundamentally a specific *rent-generating structure*. This structure delineates the boundaries in regard to who can compete for economic rents and who is eligible to receive benefits from government regulation. In this formulation, rent-seeking is seen as a conflict over the assignment and reassignment of property rights.<sup>41</sup>

Therefore, *guanxi* fits snugly into the rent-seeking environment in the embryonic market institutions. First, consider the "supply side." The economic power of local officials derives from both government regulation and intervention. This power is expressed on the one hand in *discretionary decisions* benefitting favored persons, and on the other in holding *information* about policy change and policy implementation. There thus exists a market for economic privileges. An official can sell the privileges and information in exchange for side payments. Unable to be transacted on "open markets," this kind of business must go through the back door. The official thus needs to find somebody to deal with that he can trust. Therefore, *personal trust*, embedded in *guanxi* networks, has become particularly useful for such exchanges.<sup>42</sup> *Guanxi* networks serve as an instrumental tool helping officials to sell privileges and realize revenues.<sup>43</sup>

In terms of the "demand side," the rampant rent-seeking in China incurs arbitrary implementation and thus high transaction costs, posing a nightmare for businessmen who have to ensure that a given policy or a promised benefit would not change within a certain period of time in order to make investment decisions. How can companies obtain such a "guarantee"? Under such unfavorable institutional constraints, businessmen will inevitably seek personal deals with powerful officials, a rational choice as

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<sup>41</sup>See Eggertsson, *Economic Behavior and Institutions*, 278. Also see Douglass C. North, "Three Approaches to the Study of Institutions," in Colander, *Neoclassical Political Economy*, 33-40, for an insightful synthesis of the two approaches of rent-seeking and property rights.

<sup>42</sup>Supposing that a special privilege has a price, a "shadow price" so to speak, reasonable is to assume that the returns the official receives from his buyer of privilege would be always lower than its "market value" if such a privilege market existed.

<sup>43</sup>Mayfair Yang, in *Gifts, Favors, and Banquets*, made a distinction between use-value and exchange-value of *guanxi*. She argued that exchange-value has prevailed over use-value in the reform era.

long as the side payments do not exceed expected returns from such deals. Similar to the officials themselves, companies need trustworthy middlemen to usher them through an official's back door through *guanxi* networks.

Let us turn to another form of mutual benefits that *guanxi* networks are supposed to yield. Widely known is that arbitrary infringement on private property such as "*san luan*" (三亂 illegal charge, exaction, and apportionment by local officials) has been a serious problem in China since reform. Yet, there is little knowledge about how enterprises actually tackle the problem. How do businessmen ward off predatory behavior? A popular strategy, ironically, is that enterprises pay a certain amount in extra fees to a bureaucratic patron in exchange for financial security.

Political dependence on the state has been a characteristic of the classical socialist enterprise. Ideally, every enterprise either belonged to a government unit or was affiliated with one in a hierarchical ownership relationship between government and business. Even under reform, most of the private enterprises have continued the practice, seeking an ostensible ownership affiliation with the government. The rationale to do so is in part due to political security for business property rights. Another motivation for enterprises to voluntarily associate with a particular public unit is for protection from rampant corruption and acquisition of cheaper production factors, as described above. Because there are usually many potential providers in the political market competing for buyers of their "bureaucratic service," enterprises have a limited range in the selection of patrons. Interestingly, business affiliation is not confined to domestic firms, but also usual for investors from Hong Kong and Taiwan in particular. The key for partner selection hinges on *guanxi* connections.

### **Networking between Taiwanese Businesses and Chinese Officials**

Two seemingly contradictory factors have penetrated the economic interaction between Taiwan and China: sociocultural affinity and political hostility. Cultural and linguistic affinity is often cited as a major factor attracting Taiwanese capital to China's market. Taiwanese, supposedly car-

rying a *Chineseness* in their ethnic origin and cultural practices, know how to mobilize *guanxi*. In terms of particularistic relationships, however, most Taiwanese carry few primary ties on which to build *guanxi* with the mainland Chinese because of a virtual social isolation for four decades across the Taiwan Strait.<sup>44</sup> As a result, we should not take this category of personal ties for granted. Instead, the feeling of strangeness and suspicion often prevails given the political hostility and social separation. Nevertheless, when Taiwanese began to rush into China in order to utilize cheap labor beginning in the mid-1980s, the Chinese quickly found "communicating" with these *tongbao* (同胞 compatriots) quite easy. Beyond cultural-linguistic familiarity, there was a less noticed affinity pulling the two together: institutional similarity in the realm of political economy.

### *Institutional Affinity between Chinese and Taiwanese*

Social actors have to decipher the environment when they enter unfamiliar institutional or physical settings.<sup>45</sup> Taiwanese who speak Mandarin can easily decode hidden or implicit norms and rules in the mainland. In this sense, Taiwanese (and most people from Hong Kong and Singapore as well) enjoy a competitive edge over non-Chinese. Yet, the critical thing is more than language. As a Taiwanese manager commented on the problem of corruption in the Pearl River delta area of Guangdong province:

We have to maintain good connections with the people in the tax bureau and customs. Low-level officials are especially troublemakers. As we understand it, there is a difference between breaking the rules and breaking the law. We are not perfect. They can always find fault with our business. They come to talk about a lot of irrelevant things. But the words imply more than evident at face value. They merely want to get surcharges and fines, or bribes. It is exactly the same thing in Taiwan's early development experiences. We have already been trained quite well in Taiwan. . . . From what I hear, Japanese businessmen are often frustrated here because they do not know how to deal with these officials.<sup>46</sup>

It is past experience in Taiwan that helps Taiwanese businessmen

<sup>44</sup>The primary ties here refer to those that originate in families, kinship, classmates, etc.

<sup>45</sup>For a discussion of behavioral assumptions of economic theory, see North, *Institutions, Institutional Change, and Economic Performance*, 20-26.

<sup>46</sup>Interview in Guangdong, summer 1995.

ferret out what the Chinese cadres really desire. Taiwanese experienced, during the period of rapid economic growth under authoritarian rule from the 1960s to the mid-1980s, much that is similar to what has been happening in reform-era China, including extensive regulations, rampant rent-seeking, and bribery and corruption. These experiences have remained fresh in their minds. Now Taiwanese businessmen can "transpose" the rules of the game to China.<sup>47</sup> In this way, the costs for Taiwanese businessmen to manipulate *guanxi* networks on the mainland are relatively low vis-à-vis other foreigners.<sup>48</sup> This deep structural affinity in development experience can better explain the characteristics of *guanxi* webs between the two societies.

### *Cooperation Protocol or Conspiracy Pact?*

Since "transpose" is different from "transplant," the Taiwanese had to adapt to and decode the environment in each new application of the rules of *guanxi* in China. These businessmen interacted with Chinese officials under changing structural conditions, which in turn affected the utility and dynamics of the social networks they built. Below is an illustration of a typical pattern of government-business relations in the Pearl River delta area of Guangdong province.<sup>49</sup>

The opening-up policy which heralded the start of economic reforms in the late 1970s favored export-led industries in the southeast coastal area. This policy design included the creation of several key institutions such as multiple foreign exchange rates, foreign exchange earning retention, tax concessions for foreign capital, special economic zones (SEZs), and open cities. The timing of China's opening-up policy was particularly right for

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<sup>47</sup>The term "transpose" is redefined from William Sewell's "transposability," which is in turn taken from Pierre Bourdieu's "transposable." See Pierre Bourdieu, *Outline of a Theory of Practice* (Cambridge, U.K.: Cambridge University Press, 1977). "The verb 'transpose' implies a concrete application of a rule to a new case, but in such a way that the rule will have subtle different forms in each of its applications." See Sewell, "Theory of Structure," 17.

<sup>48</sup>It is assumed that other overseas Chinese who come from a well-established liberal democracy would not be able to play the *guanxi* game as adroitly as the Taiwanese.

<sup>49</sup>Below I draw heavily on my prior case study: Wu Jieh-min, "Strange Bedfellows: Dynamics of Government-Business Relations between Chinese Local Authorities and Taiwanese Investors," *Journal of Contemporary China* 6, no. 15 (1997): 319-46.

Taiwan's industrial restructuring, given that the labor-intensive manufacturers were about to move off the island in search of cheaper labor and lower pollution costs against the backdrop of a steeply appreciating New Taiwan dollar. As a result, most Taiwanese investment in China through the early 1990s concentrated in the coastal provinces, notably Guangdong and Fujian.<sup>50</sup> The local governments in the region welcomed such investment with favorable prices in labor and land and other generous concessions. Since these businesses were mainly processing and export-type industries, their raw material sourcing, product marketing, and negotiation of letters of credit were all done offshore. Consequently, processing fees (工繳費 *gongjiao fei*) became the major source of income that Chinese earned from these plants. Before 1994 China implemented a policy of multiple foreign exchange rates and allowed local units to retain a portion of foreign exchange earnings. The policy was intended to stimulate the financial incentives of local officials and thus promote exports. As a part of the institutional arrangements, foreign investors were required to remit a certain amount of foreign currency every month to pay for processing fees. The fees were calculated roughly on the basis of the amount of labor utilized in each processing contract signed with local governments or foreign trade companies. The foreigners obtained the *renminbi* at the official rate while local governments retained portions of foreign exchange entitlements which could be sold at the foreign exchange swap centers at market price (the so-called "adjustment rate"). There was a substantial price difference between the official and market rates under the multiple exchange system. The earnings in effect constituted an important source of funding for local governments.<sup>51</sup> The price differentials in foreign exchange were

<sup>50</sup>During the period 1986-94, a total of twenty thousand companies with a capital of US\$20 billion had moved from Taiwan to China. For the trends of Taiwan's investment in China, see Tse-kang Leng, *The Taiwan-China Connection: Democracy and Development across the Taiwan Straits* (Boulder, Colo.: Westview, 1996); and Chen Xiangming, "Taiwan Investments in China and Southeast Asia: Go West, But Also Go South," *Asian Survey* 36, no. 5 (May 1996): 447-67.

<sup>51</sup>Take Xizhu, for example: the city realized US\$2.3 billion processing fees from 1979 to 1994. Precisely calculating the differences in exchange rates earned by local units over time is difficult due to the complicated foreign exchange retention formula at different stages for different units and the changing official prices of the *renminbi*. Instead, we can

nicknamed "*rentou shui*" (人頭稅 head taxes) by the Taiwanese because they were collected through counting the number of workers they employed.<sup>52</sup>

This financial arrangement deeply influenced the way in which the Taiwanese worked *guanxi* networks. Now relying heavily on the processing fees, the local units became a focal point for negotiations between the Chinese and foreign investors. Because there were many local units (various levels of governments, foreign trade companies, and township and village enterprises) available for cooperation, foreigners enjoyed a certain bargaining niche. Negotiable items included land prices, workshop rents, tax concessions, and processing fees. For instance, the monthly remittance for processing fees should be set at HK\$600 per worker in Baoan county and around HK\$700-800 in Shenzhen, the special economic zone, according to government regulations. In fact, foreign firms enjoyed an average 20 percent rebate on such fees.<sup>53</sup> Moreover, the number of workers was also a target for bargaining. The discount rate has usually depended on the relationship between the partners. A shoe company near Guangzhou hired thousands of workers but only paid the head tax for half of the workers, thanks to the enterprise's good relations with the township leadership that invited the investment. A plastic plant at Xizhu employed 1,700 workers but paid the head tax for only 700. The monthly remittance for processing fees, moreover, was only 400 *yuan* per worker, about 30 percent lower than the official price. The same discounting also occurs in dealings with other government units. For example, after bargaining with the labor and public security departments, the plant was able to officially claim a total of 1,100 workers, thereby avoiding paying taxes for 600 workers to both authorities.

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roughly estimate the figure for the city in 1992, two years before the end of the multiple rate. Xizhu received a total remittance of US\$390 million. The difference in the two rates was about 0.28 *yuan* per dollar. Then the local units should have gathered 109 million *yuan*. By comparison, the government budgetary revenues in the same year were 560 million *yuan*. This clearly shows the importance of processing fees for local financial income in the region.

<sup>52</sup>In some places, the term "head tax" also referred to the management fees charged by labor bureaus since the fees were also collected based on the number of workers.

<sup>53</sup>Shao Mingjun, *Zhongguo tequ shuiwu gailun* (An introduction to the taxation in special economic zones in China) (Beijing: Zhongguo jingji chubanshe, 1992), 550.



All the disguised numbers were achieved based on the good *guanxi* between the firm and local units. As a Taiwanese manager of the company said, "The number of 'heads' is bargainable, being different from unit to unit. They can cut the number as a favor if you cultivate a good relationship with them. Besides, once the number is settled with a bureau, it becomes fixed. So they do not really know or simply do not care whether we have hired more workers afterwards." Having good political relations with local politicians thus has enabled the company to offer inaccurate information to the government and cut fees and payments accordingly.

In addition to processing contracts, the Chinese local units have been eager to sign a variety of "joint venture" agreements with foreigners for several reasons.<sup>54</sup> First, local units were assigned responsibility for earning foreign currency and securing industrial output. The government also encouraged the localities to organize joint ventures with foreigners because these would bring in capital-intensive and high-tech investments whereas processing plants would only utilize cheap labor. Moreover, Chinese partners can share favorable tax treatment with foreign companies in the joint-venture relationship, including tax-free imports of production equipment and other durable consumer goods like luxury cars and air conditioners. Most importantly, the Chinese can file for export tax returns through their association with foreign companies. They can inflate the prices of imports and earn excess tax returns. PRC Vice-Premier Zhu Rongji in 1995 openly criticized Guangdong for tax evasion and submitting illegal tax returns, and blamed the State Administration of Taxation for implementing an erroneous rule of a flat 17 percent tax return rate.<sup>55</sup> In 1996, nine foreign trade companies in Guangdong were found guilty of "cheating the state in tax returns."<sup>56</sup>

The above cases seem to point to wide local collusion between the PRC units and foreign companies, especially those from Hong Kong and Taiwan. The above analysis has demonstrated that the real terms of a "joint

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<sup>54</sup>Many of the joint ventures were in fact "fictive joint ventures" as described above.

<sup>55</sup>*Zhongguo shibao* (China Times) (Taipei), July 25, 1995.

<sup>56</sup>*Shijie ribao* (World Journal), December 30, 1996.

venture" are usually not found in official documents. In fact, putting these terms into formal documents is impossible. The "cooperation protocol" simply covers the informal government-business *guanxi* networks based on mutual benefit and personal trust. In the eyes of the central government, this local behavior constitutes a sort of "conspiracy pact" running against the interest of the state. The issue of the legality of such cooperation is interpreted differently by the foreigners, however. Many foreigners insist that although they gain many tax privileges from the government, they actually pay a large amount of surcharges and fees to the local authorities, which are roughly equivalent to, if not more than, the potential taxes. A Hong Kong manager justified the situation in this way:

[The central-local tension is] their own problem. The central government makes unpredictable changes in policy. Whom can we trust? What we can count on is only our close connections to local cadres. These cadres can protect our interest. We are paying a lot for that service. We do not care at all who takes the money as long as our business can move on.<sup>57</sup>

For foreigners, the accusation of "cheating the state" was a problem of interest allocation between the Chinese central and local governments. Nevertheless, the central government has not interpreted such local behavior in the same way. As shown below, the local patterns of the *guanxi* game have been susceptible to changes in state policy; the center obviously desires to alter the behavioral pattern of its local agents given worries of a declining state fiscal capacity.<sup>58</sup>

### *The Threat of Changing State Policies*

The relative predictability of the cooperative relations between local units and foreigners has been based on a particular policy and corresponding institutional conditions. As argued above, the multiple price system greatly engendered the opportunities of rent-seeking inherent in the socialist system. Taiwanese and Hong Kong businessmen, with the help of local

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<sup>57</sup>Interview in Guangdong, winter 1994.

<sup>58</sup>For an influential but controversial argument regarding a declining Chinese central state and the need to reverse the trend, see Wang Shaoguang and Hu Angang, "Wang Shaoguang Proposal" (A Report on China's State Capacity), *Chinese Economic Studies* 28, nos. 3 and 4 (1996).

political entrepreneurs, worked out a subtle balance of interest within the *guanxi* networks. Deepening economic reforms have challenged the relative equilibrium of local government-business relations. Necessary then is to take a look at the scope of the policy change in recent years.

Several new policies were launched around 1994. First, the central government canceled the dual-track foreign exchange practice, devaluating the *renminbi* to approximate the actual market price in 1994; the foreign exchange swap centers were scheduled to be closed after a brief period. The regulations on foreign trade were also further liberalized. Meanwhile, the average tax return rate for exports was decreased three times in 1995-96 from 17 percent ultimately to only 8.27 percent; and the tax-free import of production equipment was annulled in 1996 with only a few exceptions. Second, a comprehensive tax-sharing reform package replaced the fiscal contract responsibility system in 1994. Third, more strict policy in land appropriation and labor protection was also introduced. Fourth, the "regional slant policy" was to some extent reversed. The interior provinces were granted favorable policies similar to those given to the coastal region a decade ago. This reform obviously was aimed at redressing the trend of interregional disparity in development and income level. Another concern was the reform of the financial and banking systems. The central government, under pressure from the World Bank and the International Monetary Fund, intended to replace the traditional measures of administrative control over inflation and excess investment with macroeconomic tools such as monetary and fiscal policy. Finally, many preemptive steps were taken in a bid for World Trade Organization (WTO) membership. For example, better protection of intellectual property rights was implemented under the pressure from the United States; the tariff level has been gradually reduced and the domestic markets were opened up in a few industries. In other words, the Chinese economy has been undergoing a fundamental readjustment in structure.

The reforms immediately stirred up trouble for local businesses. Guangdong was among the most severely affected, being particularly hurt by the new foreign exchange policy and tax reform. The retrenchment in export tax returns hurt many local foreign trade companies. The abolishment of the dual foreign exchange rate was hailed by foreign firms, but

hated by the local governments. Now that the dual-track rate has been abolished, foreign firms will no longer "lose" the differences between the official and market rates as under the old system. As observed above, however, having traditionally been heavily dependent on the earnings from processing fees, many local units find giving up these revenues in a short period to be difficult. The localities asked foreign firms to continue remitting the processing fees and insisted on taking a portion of money roughly equivalent to what was handed over in the era of the dual rate. In the eyes of foreigners, such behavior was now simply a form of corruption. The dispute soon caused tension between foreign investors and local governments. Some foreign businesses wanted to seize on the opportunity to get a better price for the head tax, some simply stopped remitting, still others changed partners, but many were simply left frustrated. The situation was very complicated because many cooperation projects could not be stopped in the interim. Above all, the mutually beneficial relations in the previous period carried over to restrain their current choices.

In terms of property rights, the new round of economic reforms changed the "relative prices" in the local social exchange market and hence impaired for a decade the preexisting equilibrium of local government-enterprise relations. The new policy in part enabled foreign investors to have increased legal protection from local surcharges. Socially, however, they were not able to claim the rights in a straightforward manner as the investors still relied on their local friends to deliver goods and services for them in the transitional period. As a manager explained: "We have built our factory here. We cannot move it, like one drives a car. We have also invested a lot of time and money on the social relationships. Although the policy has now changed, we still have to survive."<sup>59</sup> Although relations with old friends worsened, these foreign businesses had to maintain these ties, at least for a period of time. Thus, many foreign investors had to utilize their existing *guanxi* networks in order to resolve the conflict. As a result, many firms "recontracted" with their old partners, obtaining slightly better terms for a variety of local payments. Some even agreed to pay the

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<sup>59</sup>Interview in Guangdong, summer 1995.

head taxes under an adjusted name of "management fees" (管理費 *guanli fei*).

Here we have observed the dynamics and limits of state power over its local agents: a change of central policy indeed can alter the behavioral patterns at the local level, but not necessarily in a way intended by the policymaker. The social exchange networks that developed at the previous stage of economic reform intervened in the process of reform in the current stage and influenced the form of new pattern of social interaction. Deepening economic reforms effectively truncated the legitimate space for revenue-seeking. However, under the pressures of reduced local surcharges and heavier duty in collecting taxes, the local agents tried to draw compensations in their own way. Moreover, the reforms in part provide local officials with more regulatory power over foreign firms, including in the areas of sanitation, labor management, and land use. They may use the regulatory power for snatching more revenue. A Taiwanese manager described his experience with the new situation:

It is right that the dispute over the head tax is almost solved. But now local cadres become desperate for revenues. They invented more kinds of items by which to squeeze money from us. The other day, I just settled a package with the local tax bureau. They wanted me to accept a kind of tax responsibility. I promised to pay them 30 *yuan* a month for every worker to the bureau. Then I gave another 5 *yuan* per worker to the officials who are in charge of my case. What do you name this payment? Taxes, management fees, or *hongbao* (紅包 money gift)?<sup>60</sup>

At the micro level, the interaction between new state policy and prevailing government-business relationships in the Pearl River delta demonstrates an intriguing phenomenon of what we have called the paradox of *guanxi*. The continuing of a current relationship would obviously damage one's own interest, but the densely entangled "gift exchange" networks make escaping the social webs very difficult. Bounded rationality also forces the investors to adopt a cautious approach because cutting old ties could also be dangerous since they cannot accurately forecast any possible negative outcomes. For instance, a Taiwanese company wanted to termi-

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<sup>60</sup>Ibid.

nate a cooperation contract with a local unit and sign a new one with another unit. Being notified, the old partner threatened to reveal some under-the-table information regarding the company to the government. The Taiwanese had to somehow continue the relationship while seeking new ties under such pressure. For the firm, the previous *guanxi* asset turned into a *liability* in the ledger of political investment.

Facing the rapid policy change and a reshuffling of government-business ties, a few foreign businesses adopted a minimum strategy of *guanxi*:

I do not make connections with the Chinese officials without specific things to do. I do not make any purposeless contacts. Gossip spreads around the community very fast. If you talk about yourself too much without asking for assistance, you just let them understand what you are thinking and doing. If you have nothing to do with them, why should you try to make connections with them?<sup>61</sup>

For this person, *guanxi* was not a panacea. "Gossip" here refers to information. He did not want local authorities to learn too much about the operation of his factory. He avoided mobilizing the social networks within his controllable range even during hard times. He thought that the more officials know about his business, the more they will try to exact money from him. He was obviously practicing a "strategy of weak ties." This example reminds us once again of the volatile nature of personal networks in the government-business exchange and the fact that the efficacy of *guanxi* varies with the institutions and other structural conditions. Consequently, for these processing-type enterprises, the *guanxi* game has seemed to have reached some sort of limit under deepening economic reforms.

## Conclusion

The above analysis begins with a redefinition of the government-business networks at the intersection of behavioral motivation and structural conditions. This approach helps explain why *guanxi* networks appear indispensable for doing business in China and why the Taiwanese business-

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<sup>61</sup>Ibid.

men enjoy a cultural advantage vis-à-vis other foreigners in the mainland. Such an explanation also elucidates the dynamics of *guanxi* behavior in response to changing policy conditions.

Due to the nature of China's transitional economy, the *guanxi* networks between Taiwanese entrepreneurs and Chinese officials have been interwoven with the rent-seeking economic structure. This analysis has shown that as the rent-seeking space was narrowed, the existing government-enterprise networks were rendered less benign. Thus we come to a tentative conclusion: *guanxi* works as a convenient tool for investors to work out a *cooperation protocol* (or *conspiracy pact*, dependent on the case and interpretation) with local partners under specific policy conditions. This pattern of cooperation through informal connections produces a relatively predictable management environment and effective protection of property rights. Nevertheless, this type of *guanxi* becomes unproductive when a relevant state policy is enduring a radical or rapid change, which in turn causes political ripple effects such as "anti-corruption" campaigns. In this way, networking proves to be cost-inefficient or, even worse, trouble-making.

Therefore, the social practice of *guanxi* presents a dilemma. Players will inevitably wish to secure personal political access in a rent-seeking economic structure. However, China's state policies and local implementation are in fact far more unpredictable than those either in a market democracy or a pre-reform Soviet-style system. The policy uncertainty occasionally turns an apparently lucrative game of *guanxi* into an awkward and nasty play. In other words, the art of personal relationships in a transitional system is a double-edged sword, a highly risky maneuver.

Many recent studies have assumed a straightforward positive effect of *guanxi* in the explanation of Chinese business success and increasing economic ties across the Taiwan Strait. This research has, however, demonstrated that there is an intriguing interaction between culture, behavior, and structural forces. The meaning and utility of *guanxi* networks are not constant and static over time. The outcomes of *guanxi* networks are not solely determined by cultural affinity and individual calculation but are also contingent on economic institutions and state policies.