

# China Watch

A China Business Report prepared by David Mahon,  
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M I D - S U M M E R 2 0 1 3

*Your virtue is the foundation of your professional work;  
no house frame ever lasted without a solid foundation.  
Your mentality is the root of your prosperity;  
no branches and leaves ever flourished  
without a well-planted root.*

Huanchu Daoren, sixteenth century

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## Graft is a public-private partnership

**T**he sheer momentum and rate of China's GDP growth over the last three decades has developed the country and spread prosperity, but it has also disguised numerous economic flaws and social imbalances. The Chinese Government has argued that increasing income inequality, social injustice, environmental damage and even corruption was the unavoidable price of lifting the country out of poverty and sustaining a successful economic revolution, and that these problems would be addressed in time. History suggests that nearly all nations that have gone through economic and industrial revolutions tolerated elevated levels of corruption until enlightened leadership, responding to popular demand for change, created institutions to govern excessive graft. In the present accelerated situation, China does not have generations to stabilise, refine and govern its own system. It has less than ten years.

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Corruption is circumstantial; it is not cultural. Britain's industrial revolution would not have been possible without the enslavement of Africans abroad and the forced relocation of farmers and exploitation of children and adults at home. One of the pillars of British colonialism, the East India Company, paid fortunes to British government officials to avoid the restraint of its adventures in Southeast Asia, India and China, and to protect its monopolies back home. Bribery and corruption were also widespread in the nineteenth century during America's 'Gilded Age'. Robber barons bribed government officials for the rights to monopolise the oil industry and to build railway lines, and later controlled the prices of the goods that they delivered to the towns the lines spawned. The history of the rise of these empires is not simply one of exploitation and corruption; these were also ages of aspiration and social reform which

resulted in a more integrated world. Greater social awareness developed during these times, and the conventions of human rights and international law evolved. China's rise has emerged within these global norms and conventions, but the country has manifested many of the same failings and injustices of its modern historical predecessors.

Government corruption and commercial monopolies are endemic in China. Arguably China may differ from Britain and the United States in that it has not relied to the same extent on slavery and colonisation to become the second largest economy in the world. Some factory employees and ethnic minorities would take issue with this, but China has created unprecedented common wealth in a short period of time and – as poor as the rule of law and government transparency may still be – the improved individual rights and general living standards are in sharp contrast to those experienced by Chinese in the 1970s and 1980s.

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China is now largely industrialised and partly urbanised, and inextricably bound to the global economy. With key phases of its economic revolution completed, the Chinese Government is trying to consolidate its gains by slowing economic growth and correcting some of the imbalances that

it can afford, or has the power, to address. One example is the government's recent moves to crack down on graft and overly-high prices in the pharmaceutical industry. But for the Chinese Government to confront graft in the economy, it must first confront it in itself.

## Conflicted interests

**T**he Chinese people are cynical about their government, seeing it as complicit in the corruption that adds considerable cost to their daily lives and narrows their access to education, employment and healthcare. Corruption motivated by human greed allows the wealthy elite to indulge themselves at the cost of the general population. Chinese people are realistic and understand that corruption is also structural and often necessitated by China's many underdeveloped institutions – the healthcare system creates incentives which all but force doctors, patients, administrators and officials to engage in corrupt practices.

*We accept that a doctor who works 16 hours per day and makes RMB 3000 per month (the same as a taxi driver) deserves more. When my father was sick, I had to pay a few thousand renminbi to the doctor to ensure that he got decent care. I know how the system works, and I could afford the bribe. But this must change, as it is the government's responsibility to ensure that doctors are properly paid, not mine. If the system were better structured these bribes would be un-necessary.*

Beijing fund manager

*If I go to the doctor I am always encouraged to buy expensive medicines. On a visit for what is in fact a minor ailment, such as a cold, I may end up spending over one thousand renminbi on drugs I don't need. I am also concerned that this has led to my son being overexposed to antibiotics, and he is not yet six.*

Shanghai businesswoman

China's hospitals were effectively privatised in the mid-1990s. They previously offered rudimentary care, but access was inexpensive and open to most urban Chinese. Largely cut off from state funds, hospitals were forced to generate the bulk of their revenues from selling patients expensive prescription medicine and from deals with the suppliers of medical equipment and pharmaceuticals, either directly or through agents. The communist legacy of universally low wages for all state servants, regardless of level of responsibility and skill, remained in force (this also remains the case in education and the police department). The

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development of health insurance in China has exacerbated extortion by hospitals, as they milk the policies of those urban Chinese who can afford them. The untenable state of hospitals in China has been exposed by the ongoing GlaxoSmithKline controversy.

Several GlaxoSmithKline managers were recently charged with bribing doctors, administrators and government officials in the Chinese healthcare system. It is alleged that the company spent RMB 3 billion to ensure that its products were taken in preference to those of competitors. GlaxoSmithKline allegedly 'reimbursed' doctors for their attendance at conferences that never took place, and then arranged for travel agencies to provide invoices so it could hide the graft from the tax department and possibly its own senior management.

*Unrecorded cash transactions in China are common as they help companies avoid taxes. The government has encouraged this at a mundane level, as company taxes are far too high. I am aware of a company that was set up simply so it could get tax status and issue a lot of official receipts. Once the receipts were printed, the company closed. The receipts were then traded to companies which needed to be tax compliant but were buying goods and services from companies that were reluctant to issue receipts.*

Businessman from Shenyang

The GlaxoSmithKline case comes at a time when China's National Development and Reform Commission ('NDRC') is in the midst of a campaign to reduce profiteering, fraud and monopolies in a range of sectors, including infant formula and pharmaceuticals. In addition to its wider macroeconomic responsibilities, the NDRC's mandate is to monitor

and police prices in the economy; it is not an anticorruption agency. The NDRC may have preferred to continue its investigations into pharmaceutical companies more discreetly, but this was made impossible by a disgruntled former employee of GlaxoSmithKline, who presented authorities with evidence of the company's bribery and tax fraud. It appears that the employee had first expressed concerns to the company's senior management which, after investigation, concluded there was no issue. The company will now pay dearly for allowing this situation to develop. Under public scrutiny, the Chinese justice system is obliged to

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make an example of GlaxoSmithKline in an industry rife with corruption. Once a distribution chain has been corrupted in this way, all suppliers are under pressure to find ways to match the incentives offered by their competitors. Pharmaceutical companies face Faustian choices every day.

Beyond the petty bribes paid to poorly-compensated doctors, pharmaceutical firm lobbying of Chinese policymakers – including officials in the China Food and Drug Administration ('CFDA'), the Ministry of Health and the NDRC – represents a deeper form of graft. The Chinese healthcare industry is estimated to be worth USD 400 billion annually, and this is projected to more than double by 2020. In 2012, over USD 80 billion was spent on pharmaceuticals in the country. Imported drugs accounted for approximately USD 10 billion of the total, and Western firms have also gained a dominant position in locally-produced medicines through over 1,500 joint ventures. From 2010 to 2015, 35% of the world's top 20 pharmaceutical companies' drug patents will expire, costing them billions. In a market as important as China's, the major companies are doing all they can to influence Chinese policymakers to extend patent periods, maintain patent-expired drugs on 'reference lists' priced far higher than generic drugs, and even to reregister patent-expired drugs as new, more expensive products under different names. Some officials, such as the former director of the CFDA, Zheng Xiaoyu, have been caught facilitating the process. Zheng was executed in 2007 for taking bribes from pharmaceutical companies to approve unsafe drugs which led to patient deaths.

The NDRC's investigation has now spread to all pharmaceutical companies, both multinational and Chinese. Its campaign appears to be as much about lowering prices as it is about tackling corruption. Given how close the NDRC has historically been to the pharmaceutical industry, it remains to be seen whether the organisation can be transparent enough to investigate itself. It is likely that the NDRC will ensure that its own staff are largely protected during the investigation, and at the most, give up a few scapegoats. A former NDRC deputy director, Liu Tienan, is currently under investigation for corruption.

## A fine balance

**G**ood foreign and domestic Chinese companies can and do function in China without resorting to corrupt practices, but it requires vigilant managers with deep local knowledge, and oversight by engaged boards. Also, when dealing with cultures where gift-giving and exchanges of personal favours are customary, the international policies of both foreign companies and foreign governments regarding 'incentives' cannot be too draconian.

*If some of the greedier doctors and hospital administrators are arrested in this investigation, it will help reduce corruption. Having worked with foreign pharmaceutical companies, my impression is that they are not all corrupt and, like most multinationals, strive to be compliant in China. The Chinese authorities understand that foreign companies cannot prevent corruption in every aspect of their supply and distribution chains, and are tolerant towards those who do their best.*

Shanghai entrepreneur

*We have done well in China but could perhaps be growing at 30% more each year if we conducted business in the same way as our local competitors. We do not pay bribes and run a vigorous oversight programme.*

Manager of a foreign produce company

There will be allegations of protectionism and economic nationalism as the Chinese Government takes on major sectors of its economy. This attitude may exist to an extent, but it is only an aspect. Foreign companies are held to higher standards than Chinese companies, but in all the current drives to root out corruption, local companies are not being spared. Foreign companies that discover corruption in their business in China tend to focus primarily on limiting damage to their reputations and brands. While this is

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an understandable approach, foreign companies should also look to their headquarters and reassess the depth and objectivity of their own governance. Multinationals should not hope that flaws and unaddressed problems will go away.

*In order to avoid being caught up in corrupt practices, foreign companies need experienced managers. Employing senior people without China experience and Chinese language skills is asking for trouble.*

Shanghai entrepreneur

As corruption is exposed and the stories are carried in the increasingly independent Chinese media and discussed within China's fervent social networks, the Chinese Government has little choice but to act. Social media and the general interconnectedness of Chinese society provides a dynamic that has not existed in the history of the great social revolutions. Chinese people have the capacity to endure all manner of hardship and injustice, but they also have the capacity to stand up against oppression, naked greed and corruption. The question is whether this swelling public opinion will be enough to empower the government to act, not just against fraud in the economy, but in its own ranks and those of the Party.

*The Chinese economy is distorted by corruption, but it cannot be corrected in a short period of time. I accept that bribes are paid to get things done and that low-paid officials accept gifts and cash. Sometimes they are asked to facilitate transactions worth tens of millions when their own salaries are only a few thousand. But it is a matter of equilibrium. The extremes we are seeing in the infant formula industry anger me, as I am the father of a six-month old child. I have just had to pay a bribe to the local government to register my son here, as both my wife and I are not Beijing citizens. If the government can do something toward reducing the extremes, and make a more comprehensive job of rooting out people like Bo Xilai, I can be patient.*

Beijing businessman

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Historically, few political cultures have initiated difficult reforms in times of growth and prosperity; most required crises to force them to change. The Chinese Government can see that the seeds of future crises have already been sown, but it still has a chance to avert a period of widespread and corrosive instability. Only enlightened leadership

by a few within the Party can seize the opportunity being presented to it by the people's aspiration for change. Harnessing this groundswell of popular desire for greater fairness of opportunity, the leadership needs to empower independent agencies to fight graft in all areas of government, and to make the difficult changes needed to remove the structural incentives for corruption. A key question is one of pace. The government needs to balance these reforms (and the risks that they carry) along multiple sectors and agencies.

There is precedent for this endeavour. A common but spurious argument is that China has focused too much on economic reform over the last two decades, paying too little attention to political reform. In fact, China embarked on a path of both political and economic reform in 1978. Deng Xiaoping was as much an administrative and political reformer as he was an economic reformer. The ramifications of his reforms have been

evidenced by three smooth transitions of power within the Chinese Communist Party since his retirement. True economic reform has in fact been lacking, and the poor structure of the Chinese economy in part facilitates corruption and graft today.

## The hollow role model

**T**he West is at a moral disadvantage when judging and offering advice on how to deal with corruption in China. In many countries, the much vaunted Western democratic process is coerced by excessive corporate influence, which has resulted in loose antitrust constraints in industries such as finance, oil, mining and media. The Global Financial Crisis of 2008 was an act of corruption and complicity by financial institutions, rating agencies and regulators on an unprecedented scale. Just as the Chinese Government is concerned that an overly-aggressive and widespread campaign against corruption might have serious and adverse economic ramifications, the West has failed to regulate its banks for fear that doing so would stifle general economic recovery. Banks saved by public funds are now posting profits and paying huge management bonuses, while good, cash-starved, small- and medium-sized businesses stagger along the fringes of insolvency. Financial institutions that were considered too big to fail are now considered too crucial to capitalist economies to curtail.

Despite some recent losses, multinationals such as GlaxoSmithKline have made substantial returns from the Chinese market for decades. They have also been a party to the corruption that has cost the Chinese people dearly. Announcements that foreign companies are co-operating with authorities and claims such as infant formula companies have made, that prices will be lowered, are not enough to win the trust of consumers. Those shopping for infant formula this week have seen little change in prices, despite promises of reductions of up to 15%. Too many reform initiatives in China start with great fanfare and fade quickly, as complex issues arise to confront the government and divert the attention of the people.

The Chinese Government is able to maintain a growing economy and increase oversight and transparency. It has no choice – the social stability that it places above all else is at threat if it fails. Foreign companies can no longer turn a blind eye to corrupt practices, but must do all they can to distance themselves from those points in their distribution chains where corruption occurs. Profit margins may be slimmer, but their businesses will be less vulnerable. ☹