This is an opportunity that is very, very important to me. As some of you know, yesterday was Thanksgiving in the United States which is a significant family holiday in that country. I was here instead of being there, and even though I missed my family, I am very pleased to be here. On the other hand, today is what we in the U.S. call Black Friday, which is more a consumer madness, so I’m actually very glad to be here today rather than in the United States! I would like to thank the Chinese Development Forum and also thank Dr. Wu and his colleagues at Nanyang Technological University for inviting me to speak and for
putting on this forum. I think it’s worth giving a round of applause to Dr. Wu and his colleagues for their tremendous job.

I’m going to speak today about corruption, social inefficiency and economic development in China and in the United States. I would like to begin with a quotation from President Hu Jintao speaking at the opening session of the 18th Communist Party of China Congress:

“The reform of the political structure is an important part of China’s overall reform. We must continue to make both active and prudent efforts to carry on the reform of the political structure, and make people’s democracy more extensive, fuller in scope and sounder in practice.” He then adds something very important and that is, “if we fail to handle this issue [corruption] well, it could prove fatal to the party, and even cause the collapse of the party and the fall of the state.”

That’s a very strong statement that bears further consideration.

Let us start by looking at the control of corruption in selected countries measured in 2009 (see Figure 1). By this measure, China is somewhere between Argentina and Indonesia, whereas Singapore is way up just below New Zealand and above Sweden. Do you see the United States in
there? We are not doing quite as well and I'll talk about that in a moment. Being a professor, I'm trying to think what I would consider these ratings in terms of a grade point average, so the U.S. is around a B rather an A, if that gives you an idea.

Also comparing the corruption index with the U.N.’s Human Development Index (a measure combining health, wealth and education) demonstrates an interesting connection between corruption and human development (see Figure 2). You can see again that China is about a third of the way up the curve. Given the level of human development and the level of corruption, there appears to be a close connection. The United States is about two-thirds to three-quarters of the way up the curve, with Singapore again way at the top. This is an important
measure as it shows where China, especially, needs to go over the next period of time. Now, I do not pretend to be an expert on Chinese politics or administration or Singaporean politics or administration; rather, I’m an expert on United States political reform and administration, so I’m going to be talking about it from that perspective, based on a book that I published called *Reforming Bureaucracy*, which is actually translated into Chinese.

Figure 2:

I want to start out with the three basic conditions for private market economic development. First is the system of laws, regulations and enforcement that provides a credible commitment by the government to
support private investment return on the property and contract enforcement for economic exchanges. That credible commitment allows private investors to make an investment that, without it, they would not otherwise make. Even today, when investors face uncertainty like we had with the financial crisis, investors hold back. Second is the large capital investment for economic infrastructure. This is very important for the private market to get started because it faces the collective action problem of building roads, ports, and the basic utilities structure which are necessary for the market to function. Government needs to take the lead in providing this infrastructure, even when it partners with the private sector. Then, third, the economy requires national defense and public safety to be successful.

As you will see in a moment, most countries in history have not actually succeeded at meeting these basic requirements for developing an efficient private market. A key reason these are not achieved is due to what I call “political moral hazard.” There’s a great temptation for the government to use the surpluses generated by any private interaction for its own benefit and that is true over much of human history. This issue is stated succinctly by Douglass North, the famous economic historian, who said, “Any government that is powerful enough to guarantee property rights and economic exchange is also powerful enough to take
these rights away to enrich itself or for other purposes” (Douglass North, Study of 17th Century England).

There are several current and historical examples where these conditions have not been met. For instance, in the divine right of kings, monarchs expropriated much of what private exchange produced in the form of buildings, palaces, and wars. Similarly, this occurs in dictatorships like we see in Libya or in Iraq. We also find excessive permits in business clauses in many developing countries, in Peru for example, where it takes almost two years to get a business permit to start a one-person business. Sometimes political party ideology and religious movements hinder private market exchanges, such as we see in Fascism in Italy, Iran under Islamist mullahs, the Soviet Union, and China under Mao Tse-tung. Some of these instances are religious, some are right wing or left wing political ideologies, but in any case, they are not focused on private market development.

In my view, what has occurred in most of the countries that have succeeded in creating a private market is that there has initially been at least a state capitalism. This state capitalism creates a mutual interest between private capitalism and government officials to make the type of investments and create the kind of legal structure that I mentioned earlier. They use public decision processes to support private capital
investment in infrastructure and basic industries. Public officials in this process often use political support to expand their personal wealth and income, but in the process, they also build government wealth and capacity. An example is the Bridge Crown corporations in Germany and France which started out this way. During the 19th and 20th centuries in the United States, state capitalism was used to give the economy an early industrialized phase. Korea, Singapore, Thailand and Canada are newer examples, and now China, in a dramatic way, has used state capitalism to build industry. But it’s that mutual benefit – special benefits to those industries and special benefits to the politicians – that overcome collective action which prevents the government investing in home-based industrialization and basic infrastructure.

Let us turn to the United States for a moment and consider the political party machines in America in the late 19th and 20th centuries that invested heavily in franchises and rights of way in order to build basic infrastructure, utilities and transportation. This action made a lot of politicians very wealthy and produced huge tax revenues for the government, and it made these corporations very well off. It also formed partnerships with banks and politicians, who often sat on the corporate boards of banks, and they created local monopolies that benefited both the politicians and banks themselves. Railroads are a notable example in the United States where the government granted land (very cheap land)
for corporate railroads and developers to become extremely wealthy. Big cartel industries like this suppressed competition and made it hard for others to break in. These cartels were allowed to form and keep smaller industries out in order to build capital and higher production in the steel industry, for example. Public works obtained very lucrative contracts with private firms.

The problem with this over time is the diversion of a portion of the economic surplus from economic growth to politicians and monopolists. Such diversion, or what we normally refer to as corruption, was widespread during this period. There were kickbacks to officials for permits, land deals and speculation by politicians who knew where railroads, new streets, and sewers were going, so they were able to invest in that land in advance. When the sewers were built, the land went up in price and those politician investors became wealthy. Moreover, franchises were often required to pay fees to politicians, so there was a diversion of wealth that went to officials in an illegal way.

Secondly, there was a lot of rent seeking through special arrangements between officials and private firms. This is not necessarily illegal because politicians are just giving benefits to specific firms through subsidies, favorable regulations, or government supported cartels. However, those industries that get these benefits are not always the most efficient or
most productive, which slows economic development over time. In return, the officials get political support and opportunities for lucrative jobs when they leave the government.

So if we look at the history of the United States at least, state capitalism, and the kind of corruption that came with it, led to major issues that needed to be resolved by the time the country entered the early to mid 20th century. State capitalism with corruption produces an underinvestment over time in the general public interest.

For example, there was no protection for minorities, and rural areas were being exploited. This led to a strong populist movement, which was anti-government, anti-big banking, and anti-big industry. This populism spread in these geographic areas through people like William Jennings Bryan and led to the Progressive Movement. There was also no health care or social services for children and the needy because they did not produce that mutual exchange benefit for the industry or for the government officials. As public goods, health care and other social services were under-funded during that period.

Finally, there was severe environmental degradation. All the way into the 1950’s and 1960’s in Los Angeles, for example, citizens could hardly breathe the air or see the sun due to excessive air pollution. Again,
environmental safety is a public good that is not captured by this state capitalism/public-private partnership in which both sides are benefitting. A clean environment is a generalized benefit to society.

Huge inequalities of wealth were also created during this period of economic development in the 19\textsuperscript{th} and 20\textsuperscript{th} centuries. Furthermore, there was a stifling of innovation and entrepreneurship because this system prevented the entry of new small firms. In fact, it created vested, powerful interests who resisted change and innovation, creating large private interests that colluded with the government to maintain the cartel structure. Eventually corrupt government and monopoly industry reduced the legitimacy of the government itself, especially for the growing middle class. Citizens with higher education, small businesses, and moral and religious groups became less and less supportive of the government over time.

This led to the Progressive Movement in the U.S. from about 1880 to about 1930, which had two components: the administrative reform component, but interestingly, and very importantly, it also had a political component. The administrative reform introduced transparency and accountability in government, so that accounts were published and to which the news media had access. It created a professional civil service with ethics and norms for the profession as well as scientific
management. Public administration schools were established, including our own school of public administration in the 1920s at USC. Semi-independent commissions were created in addition to regulatory agencies that had some independence from the political process (I'll come back to that in a little bit). These developments also occurred at the local level. City managers and local commissions gained some independence from the political parties that operated the political machines.

And that’s why political reform needed to be a critical component of overall reform. The political machines still basically controlled administration and economic development during this whole period of time, but there were also very important changes that occurred. First, there were key leaders in the party itself, such as Teddy Roosevelt from New York or Robert La Follett from Wisconsin, who led reform from within the political parties. They were part of the political machine, they supported the machine, but they were leaders who made change from within the party. The reform movement led to the creation of the civil service and to improved democratic processes, including the secret ballot, at-large electoral districts to counter the dominance of political ward bosses, and the formation of a broad-based societal and political coalition to advocate for change. That coalition included small businesses, a growing and educated middle class, the professional and
scientific management movement, moral and religious groups, and small town populists.

There was one other phase of reform that I’m going to mention briefly. The extensive deregulation of industry and privatization of government services from the 1970s to 2000s led to innovations in several economic areas, including telecommunications, where we saw the development of the Internet, laptops, smart phones, and other mobile communications devices. Deregulation fostered an entrepreneurial drive throughout the United States during that period of time. There were also significant innovations in banking and finance. On the public side, the new public management led to the privatization of government services and greater competition in the delivery of services.

What were the outcomes of these reforms? They did significantly reduce government corruption and private cartels leading to further advances in economic growth, innovation and entrepreneurship. However, these reforms did not succeed in fully eliminating corruption and arguably have led to private sector excesses in some areas. We still have pockets of corruption around the country in such places as Chicago, Illinois; some cities in California; and in New Orleans, Louisiana, following the corrupt government response to Hurricane Katrina. We continue to have political backing for rent seeking, where the federal government
and the states provide targeted financial and regulatory support for agriculture (e.g., milk, sugar, tobacco) and the defense industries, sustaining ongoing inefficiencies. In addition, deregulation and privatization can lead to system risks, such as we saw during the financial crisis in 2008-09.

I see two implications for China. One is that the next phase of development will require political reform. While secure control of government is paramount to the Communist Party, institutional competition is important, both intra-party and across parties, in order to expand political participation and to build a broader coalition of interests. Administrative reform is also critical, especially in terms of creating a prominent role for professional norms, ethics, public management, transparency, and accountability. In the United States, these reforms succeeded through a broad coalition that consisted of political party leaders but also social movements and private organizations in civil society. These reforms produced further economic growth and entrepreneurship but also support for environmental sustainability, health and social services, cultural arts development, and development of the non-government, nonprofit sector. Over time, economic innovation and entrepreneurship, combined with meeting social and environmental needs, will contribute to political legitimacy.
There are other reform options. I just described reform alternatives in the United States, but these may not be the right approach for China, and may even be the wrong strategy for China. Other reform alternatives can be found in Korea, Japan, or Scandinavia where they have followed somewhat different patterns. Singapore, in fact, was quite a corrupt country until about 1960 when the People’s Action Party came into power and enacted comprehensive corruption laws. They had strong centralized political leadership as well as comprehensive anti-corruption laws that addressed various aspects of corruption. They also created a professional and semi-independent corruption agency to oversee reform and began to pay civil servants much higher salaries.

To conclude, I would like to suggest that there may be, and probably will be, a unique Chinese solution. I just summarized for you the United States’ path to reform. Other paths are relevant, and it is likely that China will find its own path. We can see this perspective in Hu Jintao’s words at the Party Congress:

“Political reforms are necessary but China will not imitate western political systems. We should unwaveringly consolidate and develop the public sector of the economy, allow public ownership to take diverse forms, deepen the form of state-owned enterprises…and invest more state capital in major industries in key fields that
comprise the lifeline of the economy and are vital to national security.”

This may mean a state-driven reform more like what we see in Singapore or Korea, or maybe it represents a unique Chinese approach. China has had remarkable economic development at amazing speed, and it is now time for China to achieve the next stage of advancing social and economic development. I look forward to learning about the exciting new things you will do. Thank you very much.