Surplus Seeking and Rent Seeking Through Back-Door Deals in Mainland China

Price Control and Central Planning Fix Prices Below Market Clearance, Creating a Contrived Surplus

By K. K. Fung*

ABSTRACT. When the selling price is set below the market-clearing level through government *price control,* the price gap represents a *contrived surplus* transferred from the producer to the buyer. But, due to incomplete assignment of property rights to this contrived surplus and/or high enforcement costs, contrived surplus is often a non-exclusive income subject to competitive capture. *Exchange of favors* between buyers and sellers to gain preferential access to rationed goods has become a dominant method of *surplus seeking* (*cf. rent seeking*) in the People's Republic of China. But since only well-placed individuals in the distribution channels for such goods and officials who control access to positional goods have favors to exchange, these exchanges sabotage government efforts to achieve fairer access to scarce goods. And since favors involve illegally diverted *resources,* such *back-door deals* threaten the integrity of *government.* Furthermore, exchange of favors fosters particularistic values which hinder modern economic development.

I

Introduction

PEOPLE WHO HAVE VISITED mainland China have noticed that almost anything gets done faster or easier through personal connections. These ways of getting things done are commonly known as back-door deals because they are not officially approved.[1] If these people had read Vogel's (1965) paper on comradeship, they would have been very surprised to find this apparent absence of comradeship

* [K. K. Fung, Ph.D., is professor of economics, Memphis State University, Memphis, TN 38152.]
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as a universalistic ethic and the pervasive presence of a particularistic ethic in the form of personal connections. But to someone who is familiar with the general effects of price control, the emergence of back-door deals in China with its pervasive price control is all but inevitable. This predictability, however, does not overshadow the irony that the Chinese Communist government has inadvertently strengthened China's age-old practice of side payments in economic and social transactions which it intends to abolish. Nor does it mean that the general economic and social implications of price control have been thoroughly understood.

It is these economic and social implications that this paper will examine. Specifically, back-door deals are viewed as attempts to capture the non-exclusive contrived surplus generated by the gap between the market-clearing price and

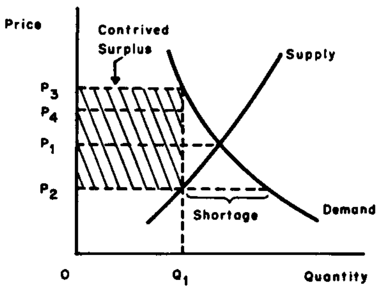

Figure 1

Contrived Surplus
(Without Price Discrimination)

P_1 = equilibrium price without price control

P_2 = controlled money price

P_3 = market-clearing price (or effective price)

$P_3 - P_2$ = average contrived surplus or additional cost needed to clear the market

the lower controlled price. It will be seen that any unequal exchanges, where the buyer cannot pay up to and the seller cannot charge what the price-controlled good is worth in money terms, must necessarily foster particularistic values. And that universalistic values are only possible under equal exchanges. In other words, "comradeship" is more compatible with the market economy than the centrally planned economy.

China is a particularly interesting case for the study of price control because of its strong ideological commitment to the planned economy and its long tradition of non-market-regulated social behavior. As such, it should provide a strong contrast to the regime of isolated price control in a predominantly market economy.

II

Surplus Seeking

WHEN THE SELLING PRICE of a good is artificially set below the market-clearing level through government price control, the price gap represents benefits which are transferred from the seller or the producer to the buyer. This gap represents a potential benefit which cannot be legitimately captured in the form of money received by the seller and a potential benefit which cannot be legitimately secured by the buyer through higher money payment. The difference between what a good is worth in the market and its lower controlled price is a *contrived surplus* somewhat analogous to the consumer surplus generated in competitive market exchanges (see Figure 1). It is a surplus because some (*i.e.*, inframarginal) buyers would be prepared to pay up to the market-clearing price to get the good in short supply. And it is contrived because it arises from an artificially lowered money price rather than from a uniform market-clearing price. But, due to incomplete assignment of property rights to this contrived surplus and/or high enforcement costs, contrived surplus under price control is often a nonexclusive income (Cheung, 1974) subject to competitive capture by the buyer and the seller.

In the absence of price control, any gap between the current price and a higher market-clearing price would be automatically eliminated by competitive bidding for the goods in short supply. Any incidental surplus between the current price and the higher market-clearing price is therefore temporary. With price control, the contrived surplus is permanent because the resulting shortage cannot be eliminated by inducing the producer to produce more.

Although price control can artificially lower the money price, it cannot lower the effective price as long as shortage exists. If money price is not allowed to allocate the price-controlled good, quantitative rationing must be used to reduce waiting time and to ensure fairer access to the price-controlled good. In principle, if the exact quantities supplied, their quality differences, the individual needs, and the purchasing power of the buyer are known, a price control and quantitative rationing scheme can be designed to closely approximate the price rationing arrangement in the market economy, but with fairer distributional effects (Nichols, Smolensky, and Tideman, 1971). In practice, the controlled prices and the quantitative rations are unlikely to be set correctly. Thus dissatisfaction can arise from:

a. Too many ration coupons;
b. Coupons not reflecting quality differences;
c. Controlled prices not reflecting quality differences;
d. Rations not reflecting needs;
e. Rations not reflecting purchasing power;
f. Shortages created by low controlled prices.

These dissatisfactions can be reduced if the dissatisfied consumer is allowed to offer higher money payments to meet their unsatisfied needs. But allowing higher money payments means the abandonment of price control. If money payment is not allowed, the dissatisfaction from price control and quantitative rationing can be circumvented in the following legitimate and semi-legitimate ways:

A. Extra waiting time to ensure first choice;
B. Limited barter of rationed goods;
C. Extra efforts to join groups which enjoy more favorable quantitative rations;
D. Extra efforts to make oneself likable to sales clerks.

Like higher money prices, these additional resources (in this case extra time and efforts) still determine who gets the rationed goods. But unlike higher money prices, these methods do not encourage production since any extra time and effort spent by the buyer cannot materially benefit the seller or the producer. They merely *offset* the contrived surplus for the buyer. When the contrived surplus is simply offset by additional resources without benefiting the seller or the producer, the contrived surplus can be said to be *dissipated.*

But if additional non-money resources are needed for the buyer to redeem his coupons, why should the buyer and the seller be content to let them be dissipated. There is thus an irresistable temptation for the buyer and the seller to reduce dissipation of the contrived surplus by other illegitimate means. Suppose the seller offers the buyer preferential access to a rationed good in exchange for preferential access to another rationed good controlled by the buyer, the buyer can shorten his waiting time and the seller can also enjoy better access to another short-supplied good which the buyer controls. Since this simple exchange of favors produces mutual private benefits at the expense of third parties, there is an irresistible tendency for it to be consummated in spite of its illegitimacy.

In China, this produces an attempt that involves the offer by the buyer and the exaction by the seller or the producer, of money and other illegitimate non-money side payments to secure price-controlled goods, particularly in excess of the assigned rations. These transactions are regarded by the Chinese authorities as *back-door deals.* Since the purpose of back-door deals is to reduce dissipation of the contrived surplus, we can more appropriately call these deals *surplus-seeking activities.* The focus of past analyses of surplus-seeking activities in the West has been on the black market where money is used as a side payment over and above the controlled money price. Our concern in this paper is primarily with surplus-seeking activities involving exchange of favors as side payments. Specifically, we are interested only in those favors that represent illegal diversion of resources from the rightful share of unwilling third parties.

Surplus seeking need not, of course, be confined to situations where the government restricts the freedom to set prices. Where a fully developed market for a good does not exist, or where custom forbids the price to be set at the market-clearing level, a surplus can exist without being contrived. Attempts to reduce surplus dissipation in these cases are also surplus-seeking activities. But these activities will not be covered in this paper. And they will be mentioned only to provide contrast to surplus-seeking activities under price control (see sections 6 and 7).

Surplus seeking should not be confused with rent seeking (see section 7) although the sizes of the contrived surplus and the contrived rent may be identical, given the same supply and demand conditions (see note 5). A contrived surplus results from restricting the freedom to set prices and is created to facilitate a more even allocation of goods in short supply. It is therefore illegal for the seller to capture the surplus by charging the market-clearing price. On the other hand, a contrived rent results from restricting the freedom to enter a market and is created to confer benefits on a selected few. It is perfectly legal for the seller to capture the rent by charging the market-clearing price.

III

Price Control in China

WITH THE EXCEPTION of some goods produced in small volume and large variety and some above-quota output of the rest, all agricultural and industrial producer and consumer goods in China are purchased and sold by the State and affiliated distribution sectors. Though prices of all these goods are set by the State, not all of the goods are rationed and some prices may be at or above the market-clearing level. But, on the whole, more prices are below the market-clearing level than above. That explains the genuine concern among Chinese economists that letting all prices float will result in substantial inflation of the general price level (Xue, 1982: pp. 72–75).

To allocate scarce goods without resorting to price rationing, price control and quantitative rationing are used. Producer goods are allocated by plan depending on State priorities. But because of over-commitment to investment, it is not uncommon that production units receive less than their assigned quota of producer goods. This practice is commonly characterized as the three 80% system. That is, 80% of needs are approved; 80% of approved needs are accepted when orders are placed; and 80% of the accepted orders are actually delivered (Xue, 1982: p. 27n). There is thus a constant scramble for more producer goods.

For example, steel was always in short supply before the recent de-emphasis on heavy industry. At present, chemical fertilizers and construction materials are very short.

Consumer goods in short supply are allocated by ration coupons. The three staples of food grain, cooking oil, and cotton cloth have been consistently rationed. A typical list of other rationed items for urban residents in the 1970s includes pork, fish, sugar, eggs, chicken, soybean curd, soap, coal, kindling, sewing machines, television sets, and wristwatches (Whyte and Parish, 1984: p. 87). The length of the list varies according to the overall supply-demand conditions. Even for unrationed items such as fruit and vegetables, their prices are tightly controlled. Whyte and Parish reported that it was possible that the number of coupons exceeded the amount of goods available. Chinn (1980) confirmed that, with the exception of grain coupons, most other rations were binding. While most food items and daily necessities are rationed on a per-capita or per-family basis in terms of needs, consumer durables such as bicycles, television sets, and wristwatches are rationed also in terms of other criteria as they are too few to be distributed on a per-family basis.

Rationed items may also be legally available at much higher prices without coupons from State-run shops. Those who receive remittances from overseas also have extra coupons to be redeemed in special shops.

In a competitive capitalist economy, price control discourages production owing to lower profitability. In a planned economy such as China; production decisions can be independent of pricing decisions. In other words, the planners may choose to increase production of the rationed items so that rationing becomes unnecessary. Three methods have been used singly or jointly to more or less achieve this goal. First, there is the price subsidy method. Producers can be paid close to market-clearing prices although the products are retailed to final users at controlled prices. Second, there is the input-availability method. Prices and availability of State-allocated producer goods can be adjusted to users' favor without raising the purchase prices of their products to the market-clearing level. Third, there is the output-selection method. The State can curtail the output of products that are not subject to quantitative rationing and impose strict sanctions against under-fulfillment of output quotas for the quantitatively rationed goods.

The output-selection method was most widely practised before 1979 in sectors outside heavy industry. In agriculture, the one-sided emphasis on food grain forced many areas whose comparative advantage lay in the production of non-food items to produce food crops and in food-producing areas to concentrate more on food grain. Private plots maintained by peasants in their spare time were always jealously controlled. And what little they did produce were often not allowed to be freely traded. In light industry, small rural and urban independent and collective producers were starved of raw materials or forcibly absorbed into the State sector. Service Industry was particularly hard hit. The number of retail and service establishments in China was said to have been reduced by some 80% between 1957 and 1979 with substantial decrease in employment amid an ever expanding population (Whyte and Parish, 1984: p. 98). Mobile service vendors such as peddlers, porters, and knife sharpeners have been all but driven out of existence (Xue, 1982: pp. 55–61). Apart from drastically reducing the variety of consumer goods and services, the output-selection method was not successful even in eliminating shortages in agricultural products (Xue, 1982: pp. 41–43 and p. 50). In 1979, it was reported that one fourth of the urban needs for food grain had to be imported. Even cotton, edible oil, and sugar had to be imported (Xue, 1982: p. 15).

While investment in agriculture, light industry, services, and housing were neglected, the resources obtained from agriculture through in-kind taxes, unified purchase, and quota purchase at below market-clearing prices were diverted to heavy industry. Here output was encouraged by the availability of input. This input-availability method was supported by the unified revenues and expenditures system. This is a system of financial management in which all profits and most depreciation charges of State enterprises are to be turned over to the State treasury. And almost all capital expenditures, including quota circulating capital, of State enterprises are to be financed interest free by the State treasury regardless of individual enterprise profitability. Under such a system, there were no incentives to reduce output because of low profitability. But because of overcommitment to capital construction and investment imbalance within the sector, shortages were also endemic (Xue, 1982: Ch. 2).

The system of unified revenues and expenditures was by no means confined to heavy industry but was applicable to all State enterprises. Although such a system would not reduce output because of low profitability, it did discourage output of goods with low constant prices and encourage output of goods with high constant prices. This was so because fulfillment of the gross output[2] quota which was based on constant prices was required to ensure access to circulating capital and bank credit (Fung, 1982: Ch. 2). Thus it is easier for an enterprise to fulfil its given gross output quota if a greater percentage of its output is devoted to products with higher constant prices. But since constant prices were changed rarely in order to facilitate material balancing, preference for products with higher constant prices often resulted in overproduction of goods that were no longer scarce and goods with a high material cost rather than technology content. Shortages were therefore endemic for goods with low constant prices and high technology content as scarce resources were diverted to produce oversupplied goods with high constant prices. This diversion was particularly serious within enterprises among goods with different constant prices.

Since 1979, to encourage the production of short-supplied goods, most of the producer and consumer goods previously purchased and sold only through the State and affiliated distribution sectors have been allowed to be sold in the free market by individuals and enterprises at higher but still controlled prices once their State output quotas are fulfilled. The State has also resorted more often to higher prices for above-quota purchases from producers. In agriculture, there is more freedom for production units to produce according to their comparative advantage. Handicraft light industry has gotten a new lease of life as raw materials can be purchased and products sold in the free market. Small-scale independent service industry is permitted to operate providing a substantial source of employment. Amid all these liberalizations, price control and quantitative rationing still continue for major producer and consumer goods. However, more consumer goods can be purchased from the State and affiliated distribution sectors at higher prices with less quantitative restrictions and the list of rationed farm products has shortened (Whyte and Parish, 1984: p. 105n).

To prevent the relaxation of price control from increasing the cost of living and threatening fair access to goods in short supply, the State has increasingly resorted to price support with price control. In food items, this was achieved by increasing the average purchase price at a much faster rate than the average retail price. And wages were adjusted upwards to more or less offset the moderate increase in retail prices. The difference between the higher purchase price and the lower retail price is made up in the form of subsidies from the State treasury. In the 1979–1983 period, the food price subsidy increased by 3.5 times, far outstripping the increase in food output (25%) and State revenues (8%) (Ji, 1984). There is no doubt that higher purchase prices for farm products do encourage higher output, especially in the absence of any increase in the agricultural tax. But the heavy reliance on price subsidy instead of an equivalent increase in wages to be spent on goods sold at market-clearing prices means that consumers do not have enough incentive to conserve quantitatively rationed goods, thus preventing the demand side of the supply-demand situation from playing a full role in relieving shortages. To fully convert the annual food price subsidy alone into wages, wages of staff and workers would have to be increased by one third (Dai, 1981). If all food and non-food price subsidies are so converted, wages would have to go up by two thirds (Zhu, 1985)[3].

There is widespread evidence that relaxation of price control has led to massive diversion of producer goods. The amount of diverted producer goods can be gauged by the following figures. Between 1965 and 1982, the percentage under unified State distribution for steel products declined from 95 to 53; the percentage for cement declined from 71 to 24; and the percentage for coal declined from 75 to 51 (*People's Daily*, July 21, 1983: p. 1). Because of the provision of self-marketing since 1979, it is not surprising to see some decline in the percentage of goods handled through the State distribution system. But these cited drastic declines were largely due to illegal diversions because the amount diverted greatly exceeded the self-marketing quota while quota delivery of contracted output to the State was under-fulfilled (*People's Daily*, September 9, 1983: p. 1). Illegal diversion of agricultural producer goods was also rampant as evidenced by a notice issued by the State Council in October, 1983 to control such diversion (*People's Daily*, October 15, 1983: p. 1).

What distinguishes price control in China from price control in non-planned economies is its unified purchase and guaranteed marketing system covering all major goods and services. Price control in China not only determines prices, but also the output level, the output mix, and output distribution. Indeed, price control is an integral part of the centrally planned economy. Price control makes it possible to divert resources from agriculture and light industry to heavy industry and from rural areas to urban areas. It also facilitates control of population migration from rural to urban areas and transfer of urban youths to rural areas. Equally important, it enforces price stability by fitting quantity demanded to quantity supplied. And stability of consumer prices makes low wages tolerable. Perhaps such a total control over prices and output distribution would not have been necessary even for a planned economy if the Chinese economy had not been so poor and overpopulated to start with.

IV

Sources of Contrived Surplus

THE SIZE OF CONTRIVED SURPLUS depends on the gap between the quantity supplied and the quantity demanded at the controlled money price. But this gap can be eliminated if the quantity supplied is price supported or if the quantity supplied is fixed at a level close to the total ration. For example, in the case of food grain, the policy of taking grain as the key link prior to 1979 essentially forced the quantity supplied to a level close to the total grain ration. Because of such output selection, there was very little contrived surplus in grain as a whole. Since 1979, supply has been ensured by paying producers higher prices in addition to output selection. Because the gap between the quantity supplied and the quantity demanded is reduced at the controlled money price through price support to the producer, the amount of contrived surplus is correspondingly reduced. Such shortage-reducing methods also apply to other farm products such as edible oil, cotton, and meat.

Where quantity supplied is not administratively fixed to equate with quantity rationed, or where enforcement is lax, the contrived surplus can be substantial when the controlled price is set too low compared to the market-clearing price. This was the case in lesser farm products that were subject to unified purchase. This was also true in manufactured goods such as sewing machines, cigarettes, alcoholic drinks, bicycles, and television sets. Contrived surplus can also be substantial when demand is artificially inflated. This was the case in steel, coal, electricity, transportation, and construction materials because of over-commitment to capital construction induced partly by the unified revenues and expenditures system.

And in general, because of absence of significant price differentials between high and low quality, there is more contrived surplus in high-quality goods.

V

Who Gets the Surplus?

IN AN ECONOMY where all major producer and consumer goods are allocated through the State and affiliated distribution sectors, the contrived surplus created by price control does not go to the producers at all. Instead, it goes in the first instance to those who control the distribution of these goods. Doctors, drivers, and sales clerks ("the three treasures") are the most talked about examples of people who have favors to offer and therefore are recipients of favors. Doctors can reduce one's waiting time in a visit to the clinic and provide medicine in short supply. Drivers with trucks can provide scarce short-distance transportation which is indispensable for exchange of favors involving bulky or large amounts of goods. Sales clerks can put aside goods of specified quality to be picked up at one's leisure or can inform one of the arrival of a new shipment of goods in short supply (Butterfield, 1982: p. 95).

In addition, contrived surplus goes to those people who controlled access to positional goods[4] which are limited in supply but cannot be auctioned off to the highest bidder because of considerations of merit. Illegitimate access to positional goods is always a problem in any economy and is properly treated under rent-seeking behavior (see section 7 below). But when preferential access to positional goods is offered to capture contrived surplus created by price control, it is also a surplus-seeking behavior.

For example, party secretaries at all levels have power to recommend candidates for party memberships. In China, party memberships are highly desirable positional goods that are pre-requisites to jobs that can dispense favors. By giving preferential access to people who have favors to offer, party secretaries can capture a lot of contrived surplus created by price control. Or the head of an urban enterprise can transfer children of party and government officials back to the cities from the rural areas by giving them preferential access to jobs in his enterprise. Because of tight population migration control from rural to urban areas, an urban job assignment is a very desirable positional good and can command a lot of contrived surplus.

Since favors offered must in the long run be equal to favors received, exchange of favors can bring net contrived surplus only when the favors exchanged represent resources that do not come from the recipients of contrived surplus. They must instead be resources diverted from the rightful shares of unwilling parties outside the back-door deals. These unwilling parties who are not in a position to divert still other parties' rightful shares of goods must now increase their expenditure of waiting time trying to compete for the remaining rationed goods or pay higher money prices in the higher-priced legal or black markets.

Thus those who have more favors to offer will capture more of the contrived surplus; those who have less favors to offer will capture less of the contrived surplus; and those who have no favors to offer will not get any contrived surplus. In other words, those who have more favors to offer can offer favors equal in value to the gap between the effective price (P_3) and the controlled price(P_2). When these favors are returned in equal value, the whole of the gap between the controlled price and the effective price ($P_3 - P_2$) is thus received as contrived surplus (see Figure 1).

As an example of the size of the exchange network for someone who had a lot of favors to dispense, we can cite the well-known case of Liu Boping, a deputy director of an office under the North China Petroleum Management Bureau. Evidence leading to his indictment shows that in a five year period, Liu offered favors to 110 officials at or above the office level. And the total number of people receiving favors from him in the same period totalled 261. Examples of favors offered included free supply of liquefied gas cooking equipment, below-cost supply of liquefied gas, preferential job assignments, and below-cost supply of color television sets and videocassette recorders imported with unauthorized foreign exchange (*People's Daily*, March 8, 1983: p. 2).

Those who have less favors to offer can only offer favors equal to part of the gap between the controlled price and the effective price, say $P_4 - P_2$. Even when these favors are returned in equal value, they must still cover the remaining, though smaller, gap between the effective price (P_3) and the controlled money price plus favors offered (P_4). The net surplus received ($P_4 - P_2$) is thus less than the whole of the contrived surplus.

Those who have no favors to offer must pay the controlled money price (P_2) and the difference between the effective price and the controlled money price (*i.e.*, $P_3 - P_2$) if they want to obtain any rationed goods. For them, the contrived surplus is completely offset by money and/or non-money payment. They are generally users at the bottom of the distribution chain who must resign themselves to receiving considerably less than their assigned quotas of price-controlled goods. For example, one typical agricultural production team (the basic unit of collective production) in Anhui province received only 19% of its first quarter plan allotment of chemical fertilizers while the cadres and masses of 5 agricultural brigades (one level higher than the team) in the same commune diverted 87% of the first quarter State allotment of fertilizers for private gain. As a result, the team was forced to pay much higher market prices for their fertilizer deficit (*People's Daily,* August 31, 1983: p. 8 and August 11, 1983: p. 2).

Not all exchanges of favors are voluntary, however. Quite often, exchange is conducted under threat. The telephone company may refuse to install telephones in new housing units until it gets its cut of the units (Butterfield, 1982: p. 112). Employees of the electric power company may threaten to cut off supply in peak hours to a store unless it gives them some short-supplied goods (*People's Daily,* July 18, 1981: p. 3).

Exchange of favors is of course only one form of surplus seeking. Those who have favors to offer are equally eager to convert the contrived surplus into money receipt whenever desirable and possible. When higher prices were offered for above-quota purchase by the State and limited self-marketing by producers were introduced in 1979, a multiple-tiered money price structure for purchase from producers was ushered in. This gave official and unofficial impetus to a multiple-tiered money price structure for sale to users. As a result, there is a built-in temptation to divert goods to the higher-priced market (*People's Daily,* July 7, 1983: p. 1). While this conversion of contrived surplus into money prices may reduce the amount of contrived surplus available for exchange of favors, it also provides a much needed safety valve for those who still prefer exchange of favors as a form of surplus seeking. Those who do not have favors to exchange can now openly bid for both diverted and legitimate above-quota goods in the higher-priced market if they cannot get their rations at the lower controlled price by waiting.

Surplus seeking through illegal diversion of resources may also be pursued at the organizational level. For example, resources controlled by an enterprise may be diverted to barter for other resources needed to fulfil its profit and output targets. Such exchange of favors at the organizational level has become more frequent since enterprises were allowed to retain part of their profit in the early 80s. And after the financial responsibility system was introduced in the early

80s to the distribution sector, stores have been quite ingenious in illegally diverting goods to the higher-priced market through bulk sale and quality substitution (*People's Daily,* August 31, 1983: p. 8; August 4, 1983: p. 2; and June 30, 1983: p. 1). They are now motivated to fulfil certain profit and sales targets in order to receive or increase retained profit for bonus wages and additional fringe benefits.

In addition, surplus seeking may be pursued at the regional level. For example, after fiscal management by administrative level and enterprise profit retention were introduced in the early 80s, producer goods have been diverted to local use to increase revenues of local governments and retained profit of local enterprises (Xue, 1982: pp. 132–133).

VI

Pure Exchange vs. Reciprocity

WHEN THE BUYER cannot pay up to and the seller cannot charge what the rationed goods are worth, an *unequal exchange* is present. If the buyer obtains the rationed goods without additional expenditure of waiting time, a favor must have been received. Before this indebtedness is discharged, the exchange remains unequal and incomplete. Oftentimes, the favor is granted voluntarily without any prior agreement as to the exact amount of indebtedness involved except some more or less conscious expectation that this favor will some day and somehow be returned. And if this favor is indeed returned more or less in value, a reciprocal relation is established (Gouldner, 1960). Even when a favor is returned, the exchange may still be incomplete because the uncertainty of whether the favors exchanged are equal in value remains. As long as the terms of exchange are not explicitly stated, any exchange involving favors is necessarily unequal and consequently incomplete. The remaining sense of indebtedness will energize further reciprocal transactions and create an intimate personal bond. Unequal exchanges are therefore generally conducted within close-knit groups. We can characterize these exchanges as *reciprocal exchanges,* or simply *reciprocity.*

On the other hand, when the terms of exchange are unambiguously stated in terms of a commonly accepted medium of exchange and when no side payments of any sort are involved, exchanges are equal and complete. Once a transaction is consummated, there is no longer any sense of indebtedness. Further exchanges are motivated by favorable terms of exchange and not by any lingering sense of gratitude. And since exchanges are conducted in a generally accepted medium, they need not be confined within a close-knit group. Equal exchanges are blind to strangers and can potentially be extended to a very large group. Equal exchanges can be called *pure exchanges* and are approximated by exchanges in a highly developed money economy with market-determined prices.

From the above discussion, it is clear that pure exchange encourages the development of universalistic values and reciprocity particularistic values. Particularistic values go well with local economic sufficiency, strong kinship bond, old-boy networks, and cliques. On the other hand, universalistic values are essential for economic specialization, inter-regional trade, resource mobility, and professionalism. Economic development thus involves the replacement of particularistic values by universalistic values. And since price control encourages particularistic values, developing countries can ill afford such a luxury. But paradoxically developing countries are highly addicted to price control.

There is nothing wrong with particularistic values per se. They may merely reflect preference for some element of personal discretion in business transactions. Indeed, Gouldner (1960) claimed that the reciprocal relationships that result might be instrumental in establishing new exchange relationships where none existed before. However, this is only true when favors exchanged represent private resources, not otherwise diverted from other unwilling parties' rightful shares. In the case of China, the particularistic relationships induced by surplus seeking involved favors from illegally diverted resources. Because of the illegality of the favors exchanged, the resulting particularistic relationships can never be converted into pure exchange. Instead, they must forever remain underground. Indeed, there is a tendency for the participants to build an ever tighter network of insiders for the sake of self protection. Thus political campaigns which were intended to eliminate unhealthy tendencies such as surplus seeking through exchange of favors served only to eliminate outsiders (Liu, 1979: p. 112). In this light, it is just as well that political campaigns have fallen into disuse since 1979.

In his highly suggestive 1965 paper, Vogel observed the decline of friendship and the ascendancy of comradeship as an ethic of interpersonal relationship in China. Comradeship was characterized as a universalistic morality which stressed friendliness and helpfulness regardless of personal preference, status, and degree of closeness. Vogel thought that comradeship was essential for people from diverse social backgrounds, geographical areas, and with different personal tastes to work together to modernize the Chinese society. And he correctly pointed out that the emergence of comradeship to replace friendship in China was based on forced betrayal of confidence among friends in periodic political campaigns.

But Vogel did not go into the stability of this new ethic. If comradeship can only be maintained through organized periodic betrayal of confidence and is not supported by the development of an unrestrained market economy, comradeship can never become a dominant universalistic ethic. The contrived surplus created by pervasive price control provides ample temptation to undermine comradeship. Retrogression towards "friendship" to exchange favors is all but inevitable especially when shortages induced by price control worsened during the Cultural Revolution (1966–1976) and political campaigns slackened off after 1979.

VII

Surplus Seeking vs. Rent Seeking

WHEN THE SELLING PRICE is artificially kept below the market-clearing level, a contrived surplus is created. Competition for this surplus is described here as surplus seeking. On the other hand, when output is kept below the competitive level, a contrived rent is created. Competition for this rent is elsewhere described as rent seeking. There is already a sizable literature on rent seeking (see Tollison, 1982) pioneered by Krueger (1974). And since contrived rent and contrived surplus are under some conditions but two sides of the same coin[5], is surplus seeking merely a mirror image of rent seeking? We believe it is not. Does the study of surplus seeking offer additional insight which literature on rent seeking has failed to uncover? We believe it does.

Because of the context in which the concept was first developed, rent seeking has been exclusively associated with government restriction on market entry. But there is no analytical reason why the concept of rent seeking should be so narrowly confined. In cases of natural monopoly and positional goods (see note 4), entry is necessarily limited even without government restriction. In other words, there can be rent seeking even without "contrived" rent as long as rent exists.

The narrow focus of rent seeking literature on contrived rent makes it natural to emphasize the undesirable effects of rent seeking. This bias is evident in the imprecise usage of the term "dissipation." In our discussion of surplus seeking, we found it important and useful to distinguish between *offsetting* the surplus and *dissipating* the surplus. When the surplus is offset, it means that additional resources over and above the controlled money price must be spent by the buyer to secure the price-controlled goods. If the amount of additional resources is equal to the contrived surplus, no net surplus is received by the buyer. But it does not necessarily imply that the expended resources will not be received by the seller or other parties. If they are received by the seller or other parties, the surplus is not dissipated to these parties. In fact, these parties end up receiving the surplus. The surplus is dissipated only when the additional resources expended by the buyer to secure the price-controlled goods are not available to anybody. This happens when the additional resources consist of waiting time, for example. The whole purpose of surplus seeking is to reduce such dissipation. In rent seeking literature, on the other hand, the two concepts of rent offsetting and rent dissipation are confused. This confusion serves to highlight the undesirable effects of rent seeking. When the contrived rent is offset by rent-seeking resources in the surplus-seeking sense, it is consistently described as being dissipated instead. But the context clearly shows that the rent-seeking resources are available to some parties, though perhaps not to the parties intended.

If offsetting resources are not dissipated in rent seeking, are they still far in excess of the contrived rent as is claimed in rent seeking literature? But this question obscures the role offsetting resources play in determining who the ultimate winners are in any competitive process. Even in rent competition under free entry, the amount of offsetting resources still exceeds the rent sought because not all entries are successful. There are, however, good reasons to believe that the more contrived the rent (or surplus) is, the more offsetting resources are needed to capture it because rent seeking (and surplus seeking) involves unequal exchanges. Only when entry rights can be openly auctioned off with money payments can these offsetting resources be minimized. But only entry rights that are to be distributed on the basis of cost efficiency can be so auctioned. If entry rights must be distributed on the basis of merit to ensure high-quality output, there is a severe limit on how much offsetting resources can be reduced.

Because surplus seeking is analyzed under price control in this paper, there is also a danger that the concept may be seen as exclusively identified with government restriction on pricing. As was pointed out earlier, non-exclusive surplus can exist whenever a fully developed market based on pure exchanges is absent. Therefore, surplus seeking need not be confined to "contrived" surplus.

If rent and surplus seeking exist even without contrived rent and surplus, what is wrong with rent and surplus seeking involving only contrived rent and surplus? In rent and surplus seeking not involving "contrived" rent and surplus, the ultimate recipients of the rent and surplus are not imposed from outside but are determined by the competitive process. The outcome of such processes may be efficiency-enhancing. For example, in the case of surplus seeking, exchange of favors with private resources can be instrumental in developing previously non-existent but much-needed markets. With "contrived" rent and surplus, the government imposes a solution from outside which is often contrary to what the competitive process would dictate. Rent and surplus seeking under these circumstances often benefit those who facilitate access to the "contrived" rent and surplus and who would not otherwise have any claim to the naturally arising rent and surplus. Such corruption must be explicitly be taken into account whenever contrived rent and surplus are contemplated. This means that the market should be left alone to carry out its business of resource allocation whenever possible. And if the market fails to achieve the desired objectives, the transfer of benefits among groups should be carried out with as little leakage to unintended recipients as possible.

VIII

Summary and Conclusion

WHEN THE SELLING PRICE of a good is artificially set below the market-clearing level through government price control, the price gap represents a contrived surplus transferred from the producer to the buyer. But, due to incomplete assignment of property rights to this contrived surplus and/or high enforcement costs, contrived surplus is often a non-exclusive income subject to competitive capture by the buyer and the seller. When the additional resources over and above the controlled money price expended by the buyer merely offset the contrived surplus without benefiting the seller or the producer, the contrived surplus is simply dissipated. Any attempt to reduce this dissipation is a surplus-seeking activity. Because surplus-seeking activities involve illegitimate side payments, they are regarded as back-door deals by the Chinese authorities.

Exchange of favors between buyers and sellers to gain preferential access to rationed goods has emerged as a dominant method to capture contrived surplus in China. Unlike the expenditure of waiting time where extra time spent by the buyer cannot materially benefit the seller or the producer, exchange of favors minimizes the "dissipation" of contrived surplus as favors offered can be received.

But since only well-placed individuals in the distribution channels of rationed goods and officials who control access to positional goods have favors to exchange, exchange of favors to gain preferential access to rationed goods defeats the purpose of price control, which is to ensure fairer access to scarce goods. And since favors exchanged represent resources illegally diverted from some unwilling parties, exchange of favors also threatens the integrity of government.

The special bond and the particularistic values created by exchange of favors within small close-knit groups are particularly unfavorable for the development of universalistic values which are necessary for the development of a modern money economy.

Back-door deals as a way of life in China can no longer be contained by periodic political campaigns as they have become too wide-spread and entrenched. Partial relaxation of price control only encourages the black market as an additional form of back-door deals. Nothing short of total decontrol of prices can eliminate back-door deals as it alone will eliminate contrived surplus.

The same objective of fair access to scarce goods can be achieved by converting the contrived surplus into a fixed lump-sum cash income transfer to be financed by taxes on producers while decontrolling all prices. But this is not likely to happen in China soon because past price control has induced too many unhealthy adaptations and vested interests.

Notes

1. China, of course, has a tradition of making or exchanging gifts in connection with business and social transactions. The deals we are concerned with here are different, comparable to what is known as "under the table" deals in the West—deals lacking general legal and social approval.

2. The gross output of a State enterprise is its output at constant prices gross of material costs.

3. Although shortages can be more efficiently handled by converting price subsidies into an equivalent wage increase, there are tricky problems to be overcome. First, a uniform across-the-board wage increase, though administratively simple, would not address the problem of varying family size among workers. Second, losses suffered by distribution units arising from selling below cost in connection with price subsidy are covered by receipt of revenues from the State treasury. Some of these losses may be due to poor management rather than the policy of price subsidy. If price subsidies are converted into wages, the State would have to tackle the knotty problem of management-induced losses in the distribution sectors (Dai, 1981).

4. Positional goods are those goods, services, work positions, and other social relationships that are either (1) scarce in some absolute or socially imposed sense or (2) subject to congestion or crowding through more extensive use (Hirsch, 1976: p. 27).

5. If the quantity supplied is fixed at the level as determined by an uncontrolled price which is equal to the controlled price (Q_1 and P_2 in Figure 1) and the producer is permitted to charge the market-clearing price, the gap between the market-clearing price and the uncontrolled price represents contrived rent. This rent is equal in value to the contrived surplus if the same uncontrolled price is now controlled and the producer is not permitted to charge the market-clearing price.

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What Really Causes Mass Unemployment

UNDER HARDING, Coolidge and Hoover, the United States sought to curb speculation and cool down the boom by protection for foreign trade and contracting the money supply. It didn't work. Under Roosevelt and his successors, the United States tried demand side policies of the disciples of Keynes. That didn't work. Under Nixon and his successors, supply side policies were emphasized. They didn't work. From the time of Harding to that of Reagan, mass unemployment persisted.

Why? No one knows the full explanation. But one reason is that ever since the time of Harding, the U.S. has had an economy dominated by monopolies, oligopolies, companies with market distorting power achieved by privilege and advantage. And so most prices were sticky when they weren't rigid, and the market failed to adjust as neoclassical theory assumed it should and would. This explanation, worked out by a number of economists including Paul Douglas, was championed in 1977 by Edmond Malinvaud, director general of the French National Institute of Statistics and Economic Studies, in *The Theory of Unemployment Reconsidered* (1977). Now he has made available a second edition which takes account of recent theoretical research (New York and Oxford: Basil Blackwell, 1985, $9.95 paper).

Professor Malinvaud analyzes the problem of persistent mass unemployment in terms of the modern theory of general equilibrium. He argues econometrically that "price rigidities are due to some fundamental features in the social organization, as well as to costs in information gathering, in contracting and in adjusting exchange relationships in a permanently moving environment" (p. viii). Unfortunately, although a decade has gone by, there is as yet little empirical validation.

In a book published in 1984, *Mass Unemployment* (Oxford, England and New York: Basil Blackwell, 116 pp., index, $19.95 cloth), Professor Malinvaud argued that mass unemployment can be seen as macroeconomic disequilibrium, which may be Keynesian (demand side), or classical (rising costs, decreasing profitability, insufficient capital formation) or a mixture of the two, producing ineffective adjustments in the capital and labor markets. As pointed out in a masterly foreword by John M. Letiche of the University of California, Berkeley, the book is especially valuable for its delineation of needed research.

W.L.

Bibliography on Affirmative Action

Kathryn Swanson has compiled an annotated bibliography. *Affirmative Action and Preferential Admissions in Higher Education* which summarizes more than 1,000 books, reports, articles and newspaper stories on the topic, published between 1970 and 1980. It is available for $17.50 from Scarecrow Press, P.O. Box 656, Metuchen, N.J. 08840.