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About that bag on the hotel bill...

**By Ivan Png
For The Straits Times**

FOR A long time, one of my colleagues wondered why many luxury goods stores in China are located inside hotels. One day, while waiting to check out from a Chinese hotel, he overheard an exchange between a guest and a hotel employee.

Employee: 'Sir, how would you like to handle the bills for the handbags, shoes, ties, etc?'

Guest: 'Just include them in the room bill.'

Not surprisingly, entertainment and travel (E&T) expenditures are a standard category of expenses in Chinese accounts. More surprising is the magnitude of these expenditures. In a World Bank survey among 3,470 Chinese businesses, average E&T spending amounted to 20 per cent of total wages or 2.6 per cent of sales.

Entertainment and travel, however, can be legitimate business expenses. Big deals are struck over long lunches at fancy restaurants. Business executives travel to scout out new opportunities and meet potential clients and vendors.

But why do Chinese businesses spend so much on entertainment and travel? Business development in a fast-growing economy? Company officials giving themselves a tax-free fringe benefit?

Or could businesses be using E&T to bribe government officials? At one time, the Chinese government decreed that any meal provided to government officials could not exceed four dishes. The result? Record-breaking plate sizes.

Three economists - Hongbin Cai (UCLA), Hanming Fang (Yale University) and Lixin Colin Xu (the World Bank) - recently published an analysis of E&T spending among Chinese businesses in 18 cities across China, plus 15 cities in Liaoning province.

It is interesting to compare two of those cities. One is Shenzhen, the dynamic Special Economic Zone next to Hong Kong. The other is Guiyang, the capital of Guizhou province in the relatively backward south-west of China.

According to the World Bank survey, average entertainment and travel amounted to 1.2 per cent of sales for businesses located in Shenzhen, and 5 per cent of sales for those

located in Guiyang. The difference was 3.8 percentage points of sales. Guiyang businesses spent four times as much on E&T as Shenzhen businesses!

The challenge for economists Cai, Fang and Xu was how to distinguish between the various reasons for entertainment and travel spending. The World Bank survey asked businesses in each city to report the percentage of government officials they perceived to be helpful. This information was the basis for an index of official helpfulness.

The theory underlying the index is that in cities where government officials are inherently more helpful, there is less need to bribe them for protection or assistance. On the index of official helpfulness, Shenzhen was rated 36.7 per cent, while Guiyang was rated 22.6 per cent, which was more than a third lower.

The World Bank survey also reported taxes that businesses paid. Taxation in China is notoriously arbitrary. Even within a single city, the local government may impose different rates of taxes. Moreover, enforcement and collection efforts vary greatly across the country and even within cities.

As a percentage of sales, the average tax was lowest in Shenzhen at 3.8 per cent, and almost three times higher in Guiyang at 11.2 per cent. The higher the average tax, the greater is the incentive for businesses to bribe government officials for lower taxes.

How much of the difference in entertainment and travel spending between Shenzhen and Guiyang can be attributed to corruption? Using statistical analysis, economists Cai, Fang and Xu showed that in cities with higher tax rates, businesses spent relatively more on E&T. Further, in cities with poorer government service, businesses spent relatively more on E&T.

Based on the statistical analysis, slightly over half the difference in E&T spending between Shenzhen and Guiyang was due to poorer government service and higher tax rates in Guiyang. After making allowances for certain assumptions, the results imply that at least 38 per cent of entertainment and travel spending by Guiyang businesses went into paying off government officials!

No wonder sharks are becoming endangered and China's airlines are booming.

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