

**THE POLITICAL ECONOMY OF CORRUPTION**

by

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Corruption, according to Rose-Ackerman (1996, p. 365), “occurs when officials use their positions of public trust for private gain.” It is “an extralegal institution used by individuals or groups to gain influence over the bureaucracy” (Leff, 1964, p. 8). That is, corruption involves transactions, typically between private parties and public officials, designed to manipulate the machinery of government. It may be of the permission-seeking type (quotas, licenses, permits, passports, and visas), the enforcement avoiding type (tax evasion, illegal pollution) or the competition-harassing type.

Corruption is closely associated with bribery which has been recognized since the 15 century B.C. as “a gift that perverts judgment” (Noonan, 1984, p. 12). Most of the literature on corruption and bribery is implicitly applied to lower level public officers. Kleptocracy and high level manipulation of policies and projects (“grand-corruption,” Rose-Ackerman, 1996), however, may be usefully regarded as part of the same “third-best” theory of government.

The purpose of the present paper is to provide a stylized history of corruption in the Philippines during the last three administrations and an explanatory framework that extends the theory of corruption and imbeds it in the more general political economy of public policy.

### Lessons from the Philippines

Corruption in the Philippines may be used to clarify and extend Schleifer and Vishny’s [1993] theory of corruption. In the Marcos regime, corruption was highly centralized. Imported goods, for example, were routinely seized and bribes paid to expedite their timely release and facilitate lower duties. Such operations had the tacit approval of higher authorities who were repaid with both bribe shares and political support.

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Not only did the centralization of corruption permit both higher bribe collection and lower excess burden (Schleifer and Vishny), it permitted greater grand corruption as well. According to some estimates, the Marcoses and their cronies were able to accumulate \$10-20 billions in assets from various operations.

But the styles of grand corruption were quite different even within the Marcos regime. Imelda Marcos allegedly extorted 30% of government contracts under her authority as Governor of Metro Manila and Minister of Human Settlements. President Marcos, in contrast, devised numerous schemes to extract wealth under the guise of legitimacy.

### 2.1 Legitimate Corruption

One of the most ingenious of such schemes involved the Philippine coconut industry. First a media campaign was launched to convince farmers and consumers of coconut products that they were being exploited by unscrupulous middlemen. Next an 18% tax was imposed on the gross (!) sales of coconuts and copra. Farmers were told that this tax was in exchange for shares in the newly formed United Coconut Planters Bank, headed by Marcos' best crony UCPB, however, had the status of a quasi-public corporation whose collections and disbursements were not fully revealed. UCPB then acquired UNICOM, a holding company for coconut oil processing plants, which quickly monopolized the industry thru bureaucratic harassment of the competition. UNICOM's monopoly position was further enhanced by banning exports of copra, thus leaving sale of whole coconuts to the very small domestic market as the only alternative outlet to the oil industry. These policies allowed UCPB/UNICOM to substantially increase the wedge between prices paid to farmers and charged to consumers (Clarete and Roumasset).

Schleifer and Vishny characterize the Philippines under Marcos as effectively a monarchy. While the Republic of the Philippines nominally retained its democratic institutions under Marcos, the legislature, judiciary, as well as provincial and local government offices were effectively centralized under the presidency. Nonetheless, Marcos' power was also contingent on his ability

to maintain the appearance of legitimacy. Once the government was no longer viewed as legitimate, due to the assassination of Benigno Aquino and other developments, so too was popular support, and the “People’s Revolution” to overthrow the regime.

Thus, unlike a kleptocracy modeled along the lines of Brennan and Buchanan’s [1980] Leviathan, Marcos was not free to directly pocket the proceeds from the 18% tax and other elements of the “wedge.” Further entrepreneurship was needed to develop schemes that transferred wealth of the quasi-public entity into private hands. One clever scheme involved using UCPB funds to purchase and plant an African hybrid variety on a plantation given to the head of UNICOM as “compensation” for a relatively small amount of land that he lost under the country’s land reform program. Moreover coconut farmers were mandated to replant their coconut farms to these same hybrids on the grounds that their higher yields would improve both farmers yields and the national economy.

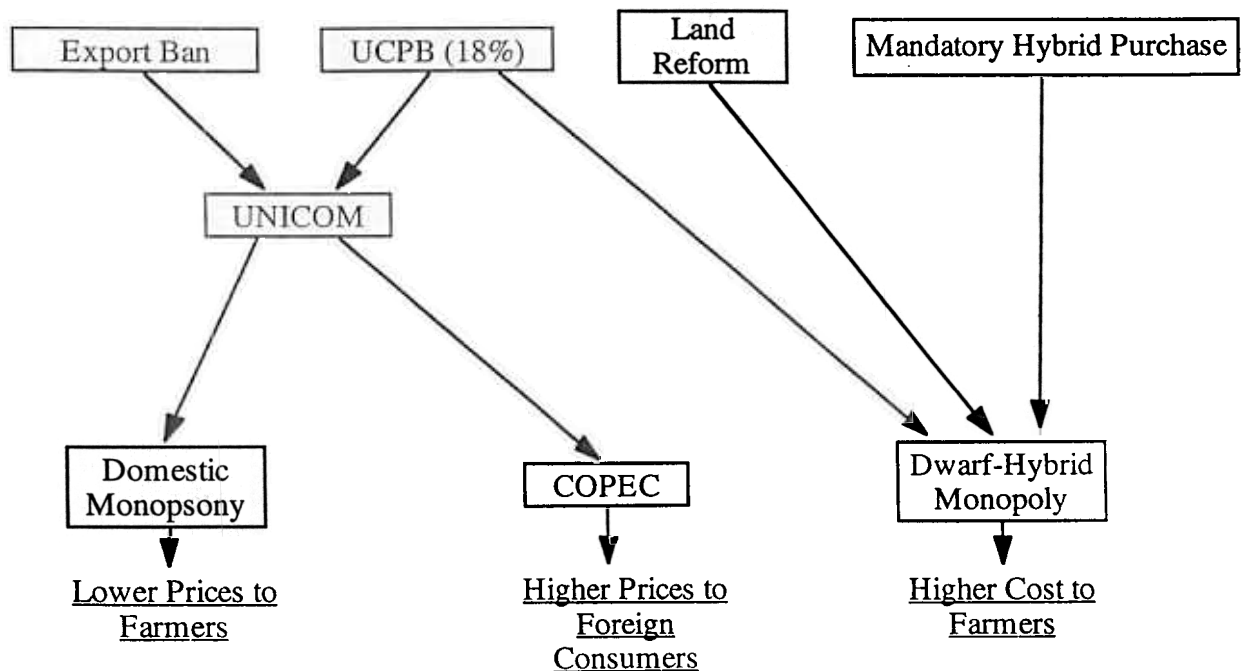
In summary, under the guise of what appeared to be legitimate public programs, a single private individual was given a monopsony on coconuts, a monopoly on coconut oil, and a monopoly on the one variety of coconut trees that farmers were required to buy. Moreover the effective owner of these industries was not required to buy them with private funds but was effectively granted them thru the allocation of public funds

## 2.2 Secrecy and Stupidity

Lucrative as it was, however, the scheme was “too clever by half.” The coconut oil monopoly, popularly known as COPEC, stockpiled oil in order to raise the world price. The plot backfired when the oil went rancid and, when it was eventually sold, spoiled the reputation of Philippine oil. As the result of this 18% tax and the nuisance value of the replanting requirement, the Philippines irrevocably lost its position as the world’s leading exporter of coconut oil. Moreover, the government was not in a position to exploit its oil monopoly on the domestic market. Cooking oil, like rice and gasoline is regarded as a basic commodity among urban consumers and the political repercussions of a rise in price can be severe. Finally, the African

dwarf hybrid program was a bust. Farmers were unwilling to replant, even under the threat of law and a highly subsidized price, and the program became unenforceable.

These errors suggest a corollary to the proposition that bribery is more distortionary than taxation, because the necessity of secrecy leads government officials to discourage more transparent activities in order to stimulate the more “briable” sectors (Scheifer and Vishny), to say nothing of differences in revenue disposition. While coconut scheme described above was not entirely secret, neither was it the product of thorough public debate, which likely would have partially overcome the failure to foresee adverse consequences. That is, secrecy not only begets inefficiency in intersectoral resource allocation, it begets collective stupidity.



**Figure 1: “Legitimate” Corruption of Philippine Coconut Policies**

### 2.3 Post-Marcos Evolution of Corruption

After the legitimacy of the Marcos administration had waned and the government of self-proclaimed “housewife” and widow of Benigno Aquino came into power, corruption returned to the decentralized, Spanish-mestizo-dominated form that had prevailed before Marcos’

second term.<sup>1</sup>

The loss of central control of corruption has two deleterious effects. First the degree of “theft” from the highest level of government increases. This in turn feeds the further spread of corruption thru a kind of Gresham’s Law (corrupt officials outcompete honest officials for jobs and bribe-giving producers drive out their competitors: “observance of law does not survive in a competitive market” (Schleifer and Vishny, p. 604). Second, and relatedly, the loss of central authority allows independent entrepreneurs to create or simply add more roadblocks to business ventures, in the limit driving “the cumulative bribe burden on private agents to infinity” (Schleifer and Vishny, p. 615) and bribe revenue to zero. As a consequence, the Philippine economy stagnated during the Aquino regime, even recording negative growth in some years.

A common element in both the Marcos and Aquino administrations was the tolerance for corruption by relatives. Mrs. Marcos’ blatant extortion was tolerated in part because she was the President’s wife and in part because of her own political following (the analogies with Mrs. Suharto of Indonesia and Evita Peron speak for themselves). Mrs. Aquino’s brother allegedly directed government spending to projects to which he then sold access. The striking part of these episodes was that he did so without the benefit of an official position.

Because of the excesses of the Marcos administration in its later years and the decline in central authority during the Aquino regime, the Philippines missed out on the 1980’s Asian growth “miracle.” It was not until the mid-90’s under President Ramos that the Philippines grew out of its “stray cat” status [Vos and Yap, 1996; Roumasset, 1997]. Ramos combined legitimacy -- as a General in the Philippine Army under Marcos, he opposed the use of force to suppress the People’s Revolution -- and both the reputation and ability to restore some amount of central authority. The nature of corruption, accordingly, became less burdensome. In addition, Ramos benefitted from the increased demand for foreign investment, especially in real estate that was the inevitable consequence of low wages and land values and high literacy/human capital relative to other Asian NTE’s. This permits higher bribe revenues at lower per unit bribe “prices.”

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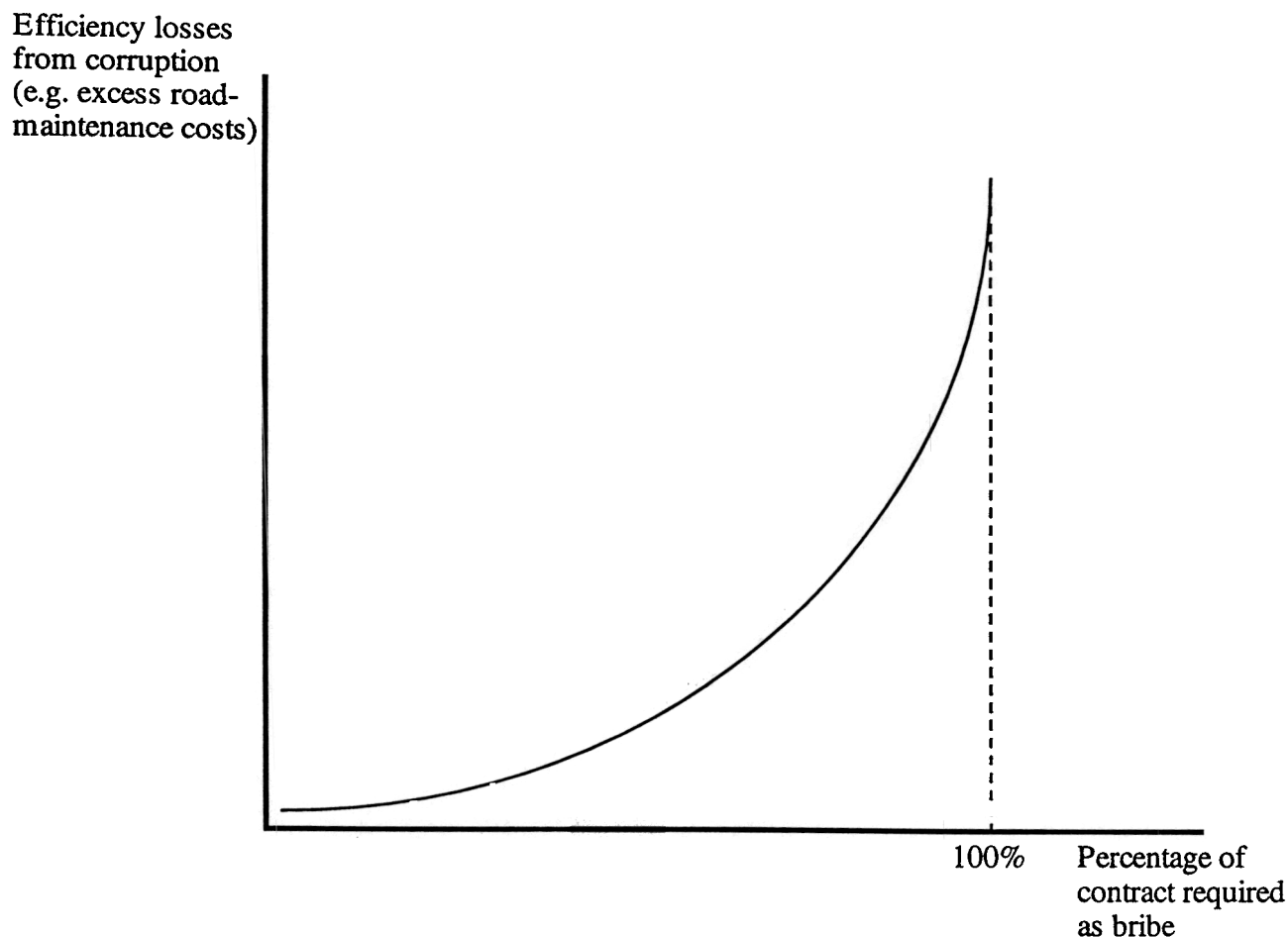
<sup>1</sup> Marcos did not become “Marcos” until he declared martial law in 1972, fully 7 years into his presidency.

If the Philippines is to sustain its current high rate of economic growth, it needs to keep corruption not only centralized but “growth-compatible.” The coconut scam described above was an effective pilfering mechanism in the short-run, but in the long-run it destroyed the incentive to invest in coconut farming and downstream industries.

Road construction provides a similar example. Suppose public officials wish to collude with construction contractors to pilfer 50% of a road contract. Building the highway half as long as prescribed is not an option -- it is too transparent. Instead, suppose that they collude to make the highway somewhat less than half as deep (making allowance for costs of design, clearing, asphaltting, etc.). The cost of keeping this operation “secret” is that the road will depreciate more than twice as fast as in the design, albeit road washouts and other types of deterioration can be conveniently blamed on acts of nature or road misuse. Clearly the inefficiency of corruption, measured as waste per peso of revenue, increases with the bribe percentage (see figure 2). For growth to be sustained, the percentages extracted need to be kept at manageable levels as exemplified by, say, Korea and the U.S.<sup>2</sup>

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<sup>2</sup> The tolerable percentage may also depend on the nature of the contract. The highest percentage take that I have heard of, for example, was 88% for curtains in selected government offices in Metro Manila.



**Figure 2: The Excess Burden of Corruption**

### 3. Generalizations

In most of the corruption literature, the nature of central government is taken as given. Either authority is centralized in an honest “principal” government that designs incentive compatible mechanisms to motivate corruptible bureaucrat-agents (Rose-Ackerman, 1978), authority is centralized in a kleptocratic (Rose-Ackerman, 1996), Leviathan (Brennan and Buchanan), monarchy (S-V), or authority is not centralized (and corruption is “S-V inefficient”). As Schleifer and Vishny themselves confess, this approach does not illuminate “the far deeper question” (S-V, p. 608) concerning the ability of high government officials to centralize corruption.

The case of the Philippines suggests that legitimacy is an important determinant of central



authority. Power does not, as Chairman Mao suggested, emanate entirely “from the barrel of a gun,” though legitimacy and the ability to monopolize violence are clearly joint inputs in the production of central authority. To the extent that such authority is “gun-produced,” leaving it as exogenous in economic models is understandable. But to the opposite extent, high-level and low-level corruption are co-evolutionary.

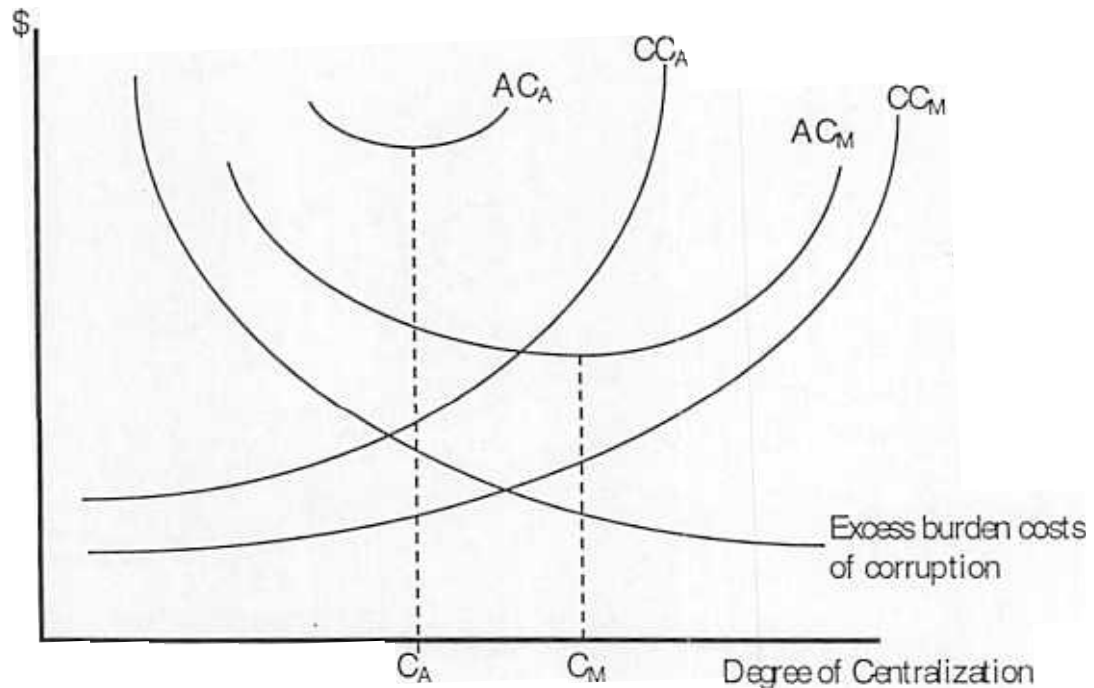
High-level or “grand” corruption may be distinguished from rent-seeking in shaping public policies on the basis of whether it is inside or outside of the law. Thus Imelda Marcos’ extortion may be said to be corruption and the coconut scam said to be mere rent-seeking. This distinction may turn out to be superficial and elusive in practice, however. What surreptitious threats were used, for example, to deter opposition to new laws governing coconut policy? It may be recalled, for example, that Senator Palaez was shot for revealing consequences of these policies for coconut farmers. More close to home, consider the case of policies that may have been influenced by illegal campaign contributions.

In any case, the economic causes of both phenomena are very much the same, and while there is no economic theory of grand corruption to speak of, there is a very distinct neoclassical theory of political economy that can be applied to grand corruption as well. Indeed, it has been suggested above that Imelda’s larceny was very much dependent on President Marcos’ ability to maintain popular support and the appearance of legitimacy about his government.<sup>3</sup> Since petty corruption and grand corruption are also usefully seen as part of the same theory, this suggests a unified theory of rent-seeking which encompasses corruption as well. Figure 3 illustrates the application of neoclassical political economy (also known as the “economics of the third-best”; see e.g. Roumasset, 1989, 1997) to “the deeper problem” of how cooperation becomes more or less centralized. The downward sloping excess burden costs represent the S-V theory discussed above. The upward sloping curve,  $CC_M$  and  $CC_A$  represent the costs of centralization under Marcos and Aquino respectively. Marcos’ entrepreneurial skill and credible commitment punishing

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<sup>3</sup> Peter Kann, now chairman of the Wall Street Journal, once referred to Marcos’ martial law government as “smiling martial law.” Marcos himself was extremely persuasive in arguing that martial law was itself consistent with the emergency power granted to the President under the Philippine constitution.

corruption-seeking independents is represented as a lower cost of organizing a sustainable central system of corruption. The corresponding equilibrium of centralization are given by  $C_A$  and  $C_M$ , the points of minimum agency cost (sum of excess burden and centralization cost) to the Aquino and Marcos administrations respectively.



**Figure 3: Equilibrium Centralization of Corruption**

Figure 4, illustrates the plausible consequences of centralization and corruption opportunities for the three regimes discussed above. The marginal costs of corruption,  $MC_A$  and  $MC_M$ , reflect the greater excess burden per unit of corruption under the more decentralized Aquino administration relative to that of Marcos. The marginal cost of corruption under Ramos is shown as even lower than that of Marcos due to the opportunities to take a smaller share from the greatly expanded private foreign investment. In addition, the marginal benefits are drawn to reflect the possibility that the Marcos' and their cronies were the most avaricious in their quest for corruption revenues. The figures are consistent with the propositions that the costs of corruption under the

Aquino government were greater than those under Marcos, even if the revenues gained from corruption were smaller and less under the Ramos administration even if revenues were larger.

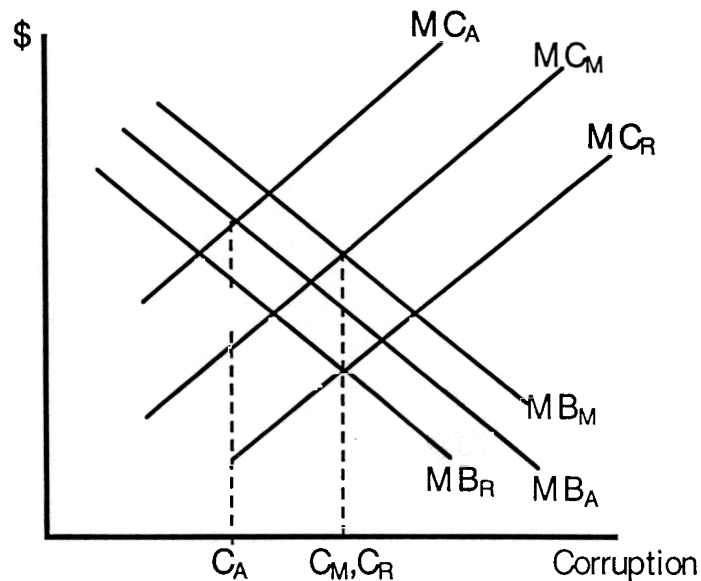


Figure 4: Comparative Corruption

### 3.1 “Good corruption”

Corruption can be welfare enhancing when it prevents “bad” laws from being enforced. Laws that prevent voluntary exchanges that have no third party effects, for example, are welfare reducing. To the extent that black markets reverse the effects of such laws and to the extent that corruption “greases the wheels” of those markets, corruption can be “good.”

A more direct example concerns bribes paid to officials responsible for allocating water in a irrigation systems (Wade, 1985; more generally, see Leff, 1964). If the highest willingness-to-pay users are the ones that end up “buying” water from the officials, the bribe is in effect a water price and a transfer payment.

### 3.2 “Bad” Policies and an Impossibility Theorem

Good corruption results from bad policies (so may bad corruption, e.g. if water rents are “dissipated” in the process of influencing officials). In the water case, for example, the government could have charged for irrigation water in the first place or provided transferable entitlements. Indeed, Japan is said to be pursuing deregulation as a device to reduce opportunities for corruption (Schesinger, 1997).

Prohibition of alcohol in the 1920's-U.S. and of mind-altering drugs today is suggestive of a kind of prohibition “impossibility theorem.” In the alcohol case, prohibition initially reduced consumption by one-third and dramatically increased the wedge between production costs and sales price. This made it increasingly attractive for suppliers to find innovative ways to provide their product at acceptable risks to themselves and their customers. One such method was the corruption of law enforcement. As a result, alcohol consumption approached pre-prohibition levels even as enforcement efforts tripled (Roumasset and Thaw, 1994).

In general, characteristics of some products and the enforcement technology of their prohibition may be such that increased enforcement expenditures drive the wedge between production costs and sales price high enough to motivate enough additional corruption that effective enforcement actually declines and consumption of the product increases. That is, a higher monetary product price is consistent with higher sales when the expected punishment is sufficiently reduced.

The prohibition-impossibility theorem dramatizes the irrationality of evaluating policy proposals without evaluating their consequences for corruption and effective enforcement. Yet that is exactly what economists and policy-makers alike normally do.

### 3.3 Incentive compatible audits

It remains to connect the S-V theory of corruption and the more traditional principal-agency theory (Rose-Ackerman, 1978, McLaren). To some extent these are two sides of the same coin

since P/A theory is germane to the question of how to keep lower-level officials from operating on their own.

The P/A mechanisms discussed in the literature usually presume an honest center and potentially corruptible lower official. Tax evasion by bribing tax official is prototypical McLaren paints unnecessarily bleak picture of this problem. He explains that Myrdal's suggestion of raising bureaucrats' salaries is likely to be either insufficient to deter collusion high enough to promote effort shirking. Moreover, paying tax officials on commission basis may promote corruption market where in taxpayers self-select into those willing and unwilling to pay bribes, thereby violating both efficiency and equity conditions of desirable taxation.

The problem that remains to be solved is under what conditions privatizing tax collection can be effective. What is needed to prevent this from merely degenerating into the above result concerning bonuses commissions is the possibility of developing guidelines for the tax collector's auditing procedure and the possibility of auditing the auditor. This of course presumes that some part of the central government is incorruptible, but it would still represent an advance over existing literature.

A related and also unsolved problem concerns how kleptocratic center enforces centralization. Anecdotal accounts suggest that simple pyramid sharing-schemes are commonplace, with lower officials receiving higher percentage shares but higher officials receiving larger bribe revenues due to the nature of the pyramid.

#### 4. Policy Implications and Concluding Remarks

Most of the corruption literature presumes social engineering perspective. From this vantage point, one can recommend the following sequencing of reforms analogous to or "sequencing of liberalization" literature. First, corruption should be centralized under the highest level of government. This will dramatically lower the costs of corruption and set the stage for the second step. Next, the per unit price of corruption should be reduced. This will promote mechanisms of corruption that are more conducive to growth without even necessarily reducing the

“take” of high officials. A third step involves liberalizing those policies whose enforcement increases corruption. The fourth step involves auditing systems that render government enforcement incentive compatible.

Since there is no such thing as a social engineer, however, one may ask about more pragmatic approaches. It is widely recognized that a free press and a demand for investigative journalism is one of the most effective weapons against bribery and rent-seeking generally. The government can be more proactive by improving auditing and reporting requirements so as to render the nature and consequences of government programs, policies, and projects more transparent to the public. Mandating benefit-cost analysis and reports such as environmental impact statements can similarly increase transparency. Indeed the Australian government at one time actually created a Transparency Agency to monitor government programs and to document who gained and lost from programs and how much. And Transparency International, based in Berlin, ranks countries according to corruption as perceived by private companies (The Economist, Aug. 2, 1997).

Education offers another way out of the stagnating sort of corruption. The more people understand that win-lose strategies tend to generate lose-lose results in situations where agents repeatedly encounter one another, they will be more inclined to employ win-win strategies. Economics and economists have an important role in this and the previously described types of transparency

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