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Asia's Underachiever: Deep Constraints in Philippine Economic Growth

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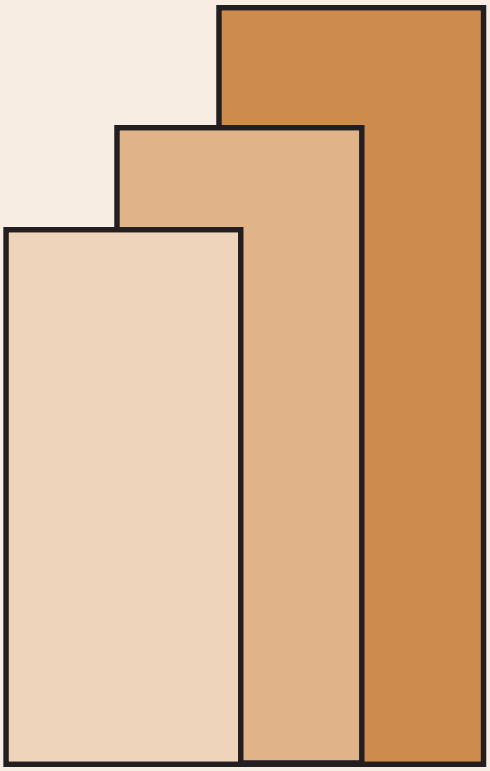

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ASIA'S UNDERACHIEVER: DEEP CONSTRAINTS IN PHILIPPINE ECONOMIC GROWTH

by

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Abstract

Numerous studies have tried to explain the poor growth performance of the Philippines. This paper critically reviews related literature on constraints to *long-run* growth, as it applies to the Philippines. We evaluate several factors, namely: culture; corruption; and institutions. The last offers the most convincing explanation for mediocre growth. Hence, to raise the country's growth trajectory, I recommend: sustained policy reform; less hand-wringing over Filipino culture and corruption; and above all, focused and sustained development of functional capitalistic institutions.

Keywords: development, growth constraints, Philippines, institutions

Asia's Underachiever: Deep Constraints in Philippine Economic Growth

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1. The Philippine economy: a surface view

In 2007, annual GDP growth of the Philippines reached 7.4%. What makes this spurt remarkable is the country's long history of tepid growth. Against this backdrop, sustainability of this growth is dubious, and even objections related to statistical validity (e.g. Medalla, 2007) now seem credible. Disappointment over the country's growth performance is based on two sets of comparisons. First is geographic, relative to over-achieving neighbors (Japan, Korea, Taiwan, Hong Kong, and Singapore, followed by Indonesia, China, Malaysia, Thailand, Viet Nam, and now India). Second is historical, relative to its favorable initial conditions in the 1950s, such as high levels of human capital and per capita output, political stability under a democratic government, and an initial phase of rapid growth that decade.

One hypothesis for the growth malaise in the ensuing decades is *bad policy*, in particular the pursuit of import substitution industrialization at the expense of a agriculture-led, outward-looking strategy. Policies went from bad to worst under the shift to authoritarian rule. Restoration of democracy in the mid-1980s brought with it a set of market-oriented reforms. However, economists have noted an apparently small "reform dividend" (Balisacan and Hill, 2003).

To explain this small dividend, one may draw from an emerging policy tool called *growth diagnostics* [REFS]. This exercise requires the isolation of factors that serve as binding constraints to growth, through the problem tree method (a common management tool). A recent study by the Asian Development Bank (ADB, 2008) identifies the following critical constraints to growth:

- Tight fiscal conditions;
- Inadequate infrastructure, particularly for transport and electricity distribution;
- Weak investor confidence, owing to political instability

- Market failures that restrict the size of the manufacturing base.

Growth diagnostics is pragmatically oriented towards pinpointing the policy priorities for immediate action. Implicitly its time horizon is short to medium term; understandably, the decision-maker prefers rapid feedback on the success or failure of the policy response. There is however value in considering a longer time span (say, decadal), to focus on the fundamental determinants of the fiscal conditions, infrastructure investments, investor confidence, and the persistence of market failure in broad-based industrialization – that is, the *deep constraints*.

This essay deals with these deep constraints. I make no claim to originality, as I aim primarily at a critical synthesis. The rest of this paper is organized as follows: I first review the fundamentals determinants of growth in the empirical literature (Section 2). This is followed by a discussion of the more popular versions of these deep constraints, namely culture and corruption (Section 3). I then discuss constraints related to institutions, particularly those underlying the operation of the capitalist system in the country (Section 4). I conclude by drawing implications for long term reform (Section 5).

2. Lurking in the the depths: environment, culture, and institutions

The literature on long run economic growth identifies three sets of fundamental determinants: physical environment, culture, and institutions. *Culture* is defined as socially-formed beliefs, attitudes, and values, held by individuals or groups; *institutions* meanwhile denote social arrangements and conventions that structure interaction between individuals and groups.

Regarding the physical environment, perhaps the best case for the importance of environmental factors is developed by Diamond (1997), at least for very long run and large scale differences in economic achievement. Eurasia developed technologically sophisticated civilizations because of its huge contiguous area with a similar climate, relative to Sub-Saharan Africa and the Americas. Such an area is favorable for settlement agriculture, formation of population centers, technological progress, and resilience to disease.

In the economic growth literature, cross-country evidence suggests that geography is indeed a fundamental determinant. Sachs (2005) underscores the role

of transport costs in land-locked or mountainous regions; agro-climatic conditions (i.e. arid environments) that could limit farm productivity; and disease prevalence in the tropical zone. Sub-Saharan Africa for example carries an added ecological burden given the extent of malaria-prone areas, and its endemicity of deadly viruses such as HIV. He notes nevertheless that, while geography increases the likelihood of poverty traps, such traps are not inevitable as humans can modify their environment as to overcome these limitations (i.e. building roads, imposing public health measures, conserving water and topsoils, etc.) In some cases though economies facing similar geographic conditions differ dramatically in economic achievement; moreover countries without geographic advantages may excel economically, while others with geographic windfalls (such as mineral resources) may persist in abject poverty.

As a growth determinant, a popular alternative to geography is culture. For example, a famous culture-based explanation is the "Protestant ethic" introduced by Weber. While Protestantism, in common with Catholicism, denied spiritual merit in wealth and its accumulation, it did regard material prosperity, industry, and frugality, as signs or manifestations of divine approval. In contemporary economic history, a proponent of culture as a determinant of growth is Landes (1998). While technological progress is a proximate factor in a country's economic success, ultimately it is the society's cultural flexibility, openness to change, and work ethic that allows it to accelerate the rate of technical change. In a similar vein a volume of papers has recently come out arguing that "culture matters" (Harrison and Huntington, 2001).

The third determinant, institutions, is highlighted by the *new institutional economics* (NIE). Key considerations in NIE are transaction costs, risk, imperfect contract enforcement, and asymmetric information. NIE distinguishes between first-order, second-order, and third-order economizing (Williamson, 2001). First – order economizing covers the institutional environment that determines the "rules of the game", in the areas of property rights, polity, judiciary, and bureaucracy. Second – order economizing involves governance structures and contract design. The first two types of optimization fall under NIE. Meanwhile, third – order economizing is straightforward resource allocation subject to marginalist efficiency conditions, the subject matter of neoclassical economics.

Our concern here would of course be first-order econoimizing; North (1993) points out that NIE relaxes the neoclasical assumption of "instrumental rationality", which treats the individual's perception of the environment, and the environment itself, as equivalent. If however individuals are boundedly rational – they have limited information and limited ability to process that information – then institutions evolve among individuals, to impose limits on human interaction and structure exchange. Hence, the competitive model with zero transaction cost is a highly exceptional case. The institutions that do emerge carry no presumption of efficiency. Nor is economic policy limited to simplistic prescriptions about "getting prices right", as such policies only work when a regime of property rights and enforcement is already in place to replicate competitive conditions. This does not imply that NIE favors jetisonning the market economy. On the contrary, it tends to elevate the standard neoclassical arguments favoring markets. It moves beyond static efficiency and equilibrium, and highlights the the institutional flexibility and dynamic adaptability of markets.

3. Monsters in the closet

Discussions in the popular media about Filipino under-achievement branch out to either an orgy of culture-bashing or diatribes against corruption. The two are related; indeed a phrase gaining vogue is "culture of corruption". The most provocative essay on the subject of culture (and corruption) is surely Fallows (1987) on the "damaged culture". The list of damning traits are quite familiar:

- myopic child-bearing – family size is unplanned, and additional children are not cared for properly, even as the majority faith of Roman Catholicism opposes birth control;
- a deep sense of national shame rather than pride, undermining social cohesiveness;
- loyalty to narrow social groups based on kinship or ethnicity;
- weak individual and social restraints on behavior that imposes negative externalities.

A more recent rant is that of the blogger writing under the pseudonym benign0, in his book, *Get Real Philippines.* The litany proceeds as follows:

- Inability to follow through a task to completion or perfection (*puede na*)
- Disregard for the consequences of one's actions (*bahala na*)
- prioritization of consumption over savings or investment (which one may refer to as *fiesta* mentality)

All these exercises in masochism share a common method: catalog a list of cultural failings, conjecture a link to underdevelopment, and persuade by tirade. Fortunately the epistemic limits of this method are patent. First, it is difficult to distinguish the inventory of traits from mere cultural stereotyping. The exceptions are sufficiently numerous to overthrow the rule; indeed there are contrary traits, such as *pakikisama* (over the supposed propensity for factionalism).In short there is no rigorously constructed measure or index of this or that supposedly anti-growth cultural trait. Second, even if the traits identified are real, a mere juxtaposition with the state of underdevelopment may well mistake correlation with causation. However inimical these traits are to economic progress, perhaps these are too small to matter – minor irritants, rather than deep causes. McCloskey (1998) raises these objections in her review of Landes epic on *The Wealth and Poverty of Nations*:

> It's the historian's vice: What happened happened, so it must have been. His main intellectual tool is hindsight. He claims, for example, that "one could have foreseen the postwar economic success of Japan and Germany by taking account of culture. The same with South Korea vs. Turkey, Indonesia vs. Nigeria." I don't think so. If things that always eventually happen (from hindsight) are foreseeable and therefore useful for policy or journalism or politics, why wasn't Germany's success foreseen? Most economists and historians in 1945 thought Germany would take 50 years to recover. It took 15. The reason Germany's recovery after the war was called a "miracle" is because people very willing to take culture as "predictive" made wrong predictions. The error is well known in social psychology: the tendency to attribute to character what is in fact a result of conditions.

Still, it is possible that cultural factors are elements of a deep explanation of economic growth. Barro and MacCleary (2003) revisit the Weberian theme and find that religious affiliation is an important determinant of growth. Other cultural traits

and behaviors are amenable to measurement and can be linked empirically to economic growth. Zak and Knack (2001) link *trust* to economic growth; subsequent work (Beugelsdijk et al, 2004) has confirmed the robustness of this link. In these studies, trust is obtained from the World Values Survey (WVS; see www.worldvaluessurvey.org).

On the other hand, Pryor (2005) clusters together the variables related to market success as measured by the WVS (e.g. hard work, economic aspiration, creativity and innovation, etc); he finds that such values are only weakly related to the overall level of economic development. Contrary to common belief, knowledge of such values (at least as elicited in such surveys) are not helpful in understanding economic growth or differences in level of economic development across countries.

The next bogeyman is corruption. Corruption involves at three types of behavior: a) *misappropriation* of public funds or property for private gain; b) *bribery* in exchange for favorable decisions in the public sphere; and c) outright *extortion*. Based on this definition, corruption is merely a transfer, and (contrary to popular belief) should have no direct effect on output. Its impact must therefore be felt indirectly, e.g. high-return projects are foregone due to misappropriation of funds, wrong projects get approved to facilitate overpricing, bad regulatory decisions are made as a result of gifts. Note however that are ways in which corruption may even have a positive effect on output, particularly when some policy distortion is waived in view of a bribe. For example, smuggling may be seen as underground trade liberalization; grease money may facilitate business registration, licensing, or certification. Hence the effect of corruption on growth cannot be established *a priori*, but only empirically.

Fortunately, unlike for cultural traits, quantitative measures are more readily available for empirical work. Svensson (2005) reviews the evidence linking growth to some corruption indicators, such as those produced by private risk assessment firms, e.g. the International Country Risk Guide, or subjective ratings, e.g. the International Corruption Perception Index (ICP) of Transparency International. He finds the evidence is inconclusive, which is somewhat surprising given that corruption does have negative economic consequences at the microlevel. The explanation may be

(taking cue from the equivocal theory) that corruption takes many forms, and not all types of corruption are equally harmful to growth.

Moreover the possibility of measurement error is high, leading to some discrepancies across multiple measures. The country's latest ICP index is 2.5, placing it at 131st in perceived corruption out of 179 countries (the top is Denmark, with an ICP of 2.5). However, the World Bank's "Doing Business" survey reports the following (Table 1): relative to the all countries, the country is seriously worse off only with respect to informal payments. Even for this problem, still much better off than its neighboring countries. Given these issues, it may well be that the evil trinity of corruption (misappropriation, bribery, extortion) may at best be a partial explanation for the growth malaise.

To conclude: the monsters of popular imagination – backward culture and rampant corruption – are found to be slippery villains in the story of economic growth. Measurement difficulties constrain rigorous empirical work; where data is available (typically in cross-country studies), surprisingly the links have been found to be weak and ambiguous at best. We therefore turn to the last set of constraints, that of institutions.

Table 1: Percentage of firms reporting corruption problems, Philippines

Corruption	Philippines	Region	All countries
Expected to Pay Informal Payment (to Get Things Done)	44.74	57.04	36.23
Expected to Give Gifts to Get an Operating License	15.02	14.1	16.69
Expected to Give Gifts In Meetings With Tax Inspectors	27.55	38.81	26.66
Expected to Give Gifts to Secure a Government Contract	17.54	25.02	26.9
Identifying Corruption as a Major Constraint	35.17	32.12	32.92

Source: World Bank, www.doingbusiness.org, accessed 20 March 2008.

4. The nature of the beast

Forms of capitalism

During the Cold War, one could distinguish two important forms of economic organization: the planned economy under communist or socialist regimes, and the market economy or capitalism for the rest. Poor performance and political instability in the former led to abandonment of cental planning in all but a couple of enclaves. However the now-regnant *capitalism* also appears to be failing to deliver on the promise of rapid economic growth to the remaining billions of the world's poor. One explanation is that capitalism is not homogeneous, but comes in different forms; these institutional differences may ultimately account for the differences in performance.

Montes (1988) and others draw a distinction between *rent-seeking* and *profit-seeking* behavior, based on Buchanan (1980); he views capitalism in the Philippines as characterized primarily by the former. Note that rent-seeking is related to corruption, but is not identical to it. Former President Estrada is wont to claim innocence of misappropriation, and therefore of corruption. But rent-seeking can be perfectly legal and yet inimical to growth. Lobbying Congress to pass stringent franchise requirements for entering an industry is legal, and may even be justified as protecting society from sub-standard products. However it has the unfortunate effect of shielding incumbents from competition.

The connection between rent-seeking, and growth was further elaborated in Murphy, Schliefer, and Vishny (1993). They point out a sort of convexity affecting the allocation of resources to rent-seeking; at least initially, the shift from productive to rent-seeking activity may cause returns to the former to decline relative to the latter at the margin. This raises the possibility of multiple equilibrium, with the low-level equilibrium characterized by high amounts of rent-seeking and low output. It is possible or even likely that the Philippines is stuck in one such poverty trap.

Hutchcroft (1998) develops a richer typology based on two dimensions: the degree of "patrimonialism" or patronage relations, in contrast to more objective, rational-legal relations; and the strength of the state apparatus relative to business interests. A simplified schema is shown in Table 2. Capitalism in the Philippines is

classified under the Booty type. By introducing state power, Hutchcroft provides a more coherent explanation for the predominance and persistence of rent-seeking behavior. His subsequent analysis focuses on the banking sector as a chief instrument for plundering the public coffer, primarily through the extension of fraudulent or "behest" loans, repayment of which was ultimately absorbed by the public sector.

Table 2: Typology of capitalism

	Strong state	Weak state
Rational-legal	Statist capitalism (development state)	Laissez-faire (regulatory state)
Patrimonial	Bureaucratic capitalism (patrimonial administrative state)	**Booty capitalism** (patrimonial oligarchic state)

Source: Hutchcroft (1998).

This underlies the "strong-state/weak state" typology popular among Ramos-era reformers such as Jose Almonte. Fabella (2000) traces the genesis of the soft state to the import substitution era; on the one hand, the business elite cornered the rationing of cheap foreign exchange; on the other, local traders cornered the rents from smuggling, "marketizing" local and national governance accordingly. The market for rules was expanded dramatically under Martial Law, under which the authoritatarian governnment transferred rent priveleges from political enemies to allies, while creating new ones. It became "an elaborate rent extraction machinery sold to the public as a development strategy (p.4)".

This machinery survives up to now, despite differences in identity of some key players. In capital-intensive sectors, corporate congolmerates are able to limit competition and monopolize cheap credit through policy influence and ownership of the major banks. Big chunks of the nontradable sector are dominated by oligopolies, often perpetuated by regulations – these include maritime transport, ports, air travel, electricity, and cement. Despite these structural constraints, the economy is able to grow because of the non-capital-intensive, competitive sectors, namely: consumer

electronics, telecommunications, the financial sector, private services such as voice-based BPO, and tourism (Bocchi, 2008).

Capitalism and innovation

At the heart of capitalism is the profit motive, i.e. the realization of surplus from combining factors of production and exchanging the products in a market. One source of such surplus is *innovation*, that is, introduction of new products, systems, and business processes that allow the capitalist to realize more revenues at the same cost, or lower costs at the same revenues, or both. Capitalism creates incentives to innovate via appropriation of the residual over the initial technology investment. Standard growth theory since Solow (1957) has established the centrality of innovation or technological change in determining the level of long run growth. Since Romer (1986), innovation has been endogenized in growth theory, with new techniques being developed to address the accompanying issues of nonconvexity and external economies of scale.

The institutional underpinnings of innovation are closely related to scale or firm size, as discussed in Baumol et al (2007). They distinguish between two types of innovation: radical or breakthrough innovation, and incremental innovation. The latter is typically necessary to the commercialization of a new product or process; however the new product or process itself origiantes from radical innovation. The seedbed of radical innovation is entrepeneurship, which is closely associated with small and medium size enterprises. Meanwhile big firms would tend to specialize in more incremental adjustments of a new product towards mass production and distribution.

Again the problem arises when big firms co-opt governance. The result is *oligarchic capitalism* (similar in spirit to booty capitalism), characteristic of many developing economies. Under oligarchic capitalism, the dominant elite find it necessary to restrict competition, not just through regulatory capture – though this is a large part of it – but through the rules of formal recognition by the governance institutions. As a result, entrepreneurship languishes in informality, with its parochial set of rules and property rights.

As de Soto (2000) sees it, the mysterious power of capitalist transformation is conditioned on rendering capital into a social abstraction, within a framework of formal rules and property rights. Formal property fixes the economic value of assets, makes it fungible, integrates dispersed information into a single represenational system, creates units of accountability (i.e. identities fixed in location and time), and protects commitments and contracts. Where formal systems fail, the informal sector arises in the vaccum, creating a dual economy. De Soto and his associates have thoroughly documented the vast economic potential in the informal sector, beginning from de Soto (1989). However this potential is not realized owing to the fractured state of the economy. The solution lies in integrating the formal and informal sectors within a single coherent system.

This policy recommendation is often reduced even by experts to a simple titling program. Given the failure of many titling programs, the property rights approach to asset reform is often ignored. However careful reading of de Soto shows that actually anticipates these failures, as long as titling programs impose formal rights in a top-down manner. A property system can only be established with the general consent of its participants. Expansion of formal property systems in the successful capitalist economies of the West was a complex complex historical process characterized by trial-and-error, conflict, and eventually, resolution.

Institutions as an empirical explanation

The viability of institutions as a deep explanation for economic growth is ultimately an empirical question. Fortunately, unlike the case of culture and corruption, the literature is beginning to build solid confirmation of the role of institutions. Acemoglou, Johnson, and Robinson (2006) highlight in particular the protection of property rights, which structure incentives to appropriate the residual from investment and innovation. They deal with a problem common to cross-country regressions of this type, which is simultaneity bias, as institutions themselves change as the economy develops. This is addressed using instrumental variable estimation, which show more conclusively that security of property rights explains much of the variation of per capita incomes across countries, while culture and geography variables do not.

Glaeser et al (2004) point to another problem, that of identification, which arises when institutional change is highly correlated with other features of economic development, such as human capital formation. More recent work by Bhattacharya (2006) demonstrate that enriching the representation of institutions (e.g. different indices for different aspects of institutions) reduces the multicollinearity and still shows the determinative role of institutions for growth. These indices correspond to: security of property rights, market regulation, market stabilization, and market legitimation (i.e. democracy). Furthermore regulation has a U-shaped effect, i.e. too much or too little regulation is bad for growth.

Another strand of this literature explores sub-national comparisons. Naritomi et al (2007) find evidence relating governance and access to justice to levels of development across Brazilian municipalities. Balisacan and Fuwa (2004) explain economic growth across provinces in the Philippines, and find that the presence of political dynasties in provincial politics has a negative effect on growth.

Approaching the problem from another direction is to relate the coverage of formal property rights and activities over the whole economy, to the performance or growth of that economy. Much of the studies in this area have focused on first measuring the size of the informal economy. For the Philippines, an estimate of the size of informal sector assets back in 1998 arrived at a figure of 132.9 billion dollars, four times bigger than the market value of the domestic companies listed in the stock exchange, and seven times bigger than all the savings and time deposits in commercial banks. Further research in should be able to confirm whether or not the accessibility of formal sector institutions is favorable to long term growth.

5. Becoming a Tiger

Supposing that institutions provide a definite explanation for the long run growth malaise of the Philippine economy – and I have every reason to suspect that they do – what are the implications for action and advocacy?

The first implication is to avoid passive counsels of despair, which so frequently conclude the standard harangues regarding culture and corruption. When economic growth is seen to hinge on widescale adoption of certain sets of individual values and behaviors, the descent into handwringing is inevitable. Working for virtue

is excellent – perhaps there is nothing better - but positing "moral revolution" as a precondition for economic take-off is a certain formula for frustration.

The second is to hold steady or *stay the course* in the reform agenda. The institutionalist perspective, far from raising further doubts about markets, actually create powerful arguments in favor of markets based on a deeper and more dynamic framework of social change. Arrayed against market reform is a strange and tacit alliance between big business and the populist movement. Both share a fear of free competition, especially with respect to the global economy, and point to the apparent failures of the reform agenda as a justification of their stance. This fear should be challenged by powerful counter-arguments, to show that many of the past reforms have had impressive results (the telecommunications story comes to mind), and that numerous putatitive reforms were thwarted in implementation, leaving the basic structure of oligopolistic capitalism intact.

The third is to move beyond the more simplistic versions of the market agenda towards a more general approach based on the parallel development of institutions. The institutionalist perspective shows that competition, negligible transaction costs, rule of law, symmetric information, enforceable property rights, and standards of fairness and equity, should not simply be assumed, but elevated as elements of the reform agenda itself. This would vastly complicate the design and conduct of reform. No longer would the creation of a market economy be treated as the monopoly of well-educated technocrats. Rather, it is should be seen as the grand project of multiple disciplines and constituencies united by the vision of national achievement and widespread prosperity.

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