Taking Institutions Seriously: Rethinking the Political Economy of Development in the Philippines

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Despite the current fashion for issues such as institutional transparency or corruption, the modern policy development literature does too little to integrate the core ideas of modern political economy with standard economic theory. Little is done to distinguish the advice given to developing countries—especially on macroeconomic aggregates—from that given to richer nations with stronger institutional environments. The essay uses the Philippines as a case study to suggest what is wrong with leading prescriptions. It suggests a framework that starts from a basic analysis of sectoral distortions to identify the areas where ideal reforms are likely to have the most impact and then pairs such analysis with more institutionally consistent considerations to see which second best reforms are most likely to be implemented. The focus should be on incentive compatible, self-enforcing policy mechanisms which usually imply greater market access and decentralized competition.

JEL classification: O10, O43, O53

I. INTRODUCTION

The rise of the new institutional economics has done much to revitalize thinking on the role of governance, structure, and policy in promoting or hindering economic development. In particular the work of Nobel laureates Douglass North on historical institutions, Ronald Coase on transactions costs, and Elinor Ostrom on local institutional arrangements have often been cited as core ideas inspiring modern ideas about policy in major development agencies. Earlier work on interest groups and social policy deriving from the work of Mancur Olson also helped to reshape modern policy. Institutions are increasingly cited as crucial to growth in mainstream neoclassical studies of development, most notably in the work of Acemoglu, Johnson, and Robinson (2001), and Rodrik, Subramanian, and Trebbi (2004).

But what have we really learned about institutions, and how do we reconcile this with the core lessons of neoclassical theory that should still serve as...
starting points for any discussion of underperforming economies and the quest to encourage growth?

This paper reviews some of the most salient ideas of the new institutional economics and discusses how these ideas can be interacted with more standard neoclassical concepts to serve as a baseline for framing policy. It argues that sensitivity to institutional and political economy concerns does not invalidate the core ideas of neoclassical theory but should change the way we analyze our options. It will then use the problem of reform in the Philippines as an example to show how much basic economic analysis is either missing or neglected in current debates. It suggests where we might start to find what we still need to know to make useful and effective policy recommendations.

II. THE BASIC INSIGHTS OF THE NEW INSTITUTIONAL ECONOMICS FOR DEVELOPMENT

The core ideas of the new institutional economics are the modern day extension of a long-standing debate that goes back to Hobbes and Smith.

Adam Smith—the founder of modern economics—made voluntary exchange the centerpiece of all wealth-creating activity and extolled the importance of specialization and division of labor. This suggests that we benefit from trading with those with different preferences, skills, and endowments as elaborated by the economist David Ricardo. Indeed, one might say that the more different those we trade with, the greater the potential gains from trade.

But Smith’s arguments presuppose a world of voluntary exchange. Unfortunately, as Smith’s predecessor Thomas Hobbes argued, man in his natural state is prone to disagreement and conflict—often of the nastiest and most brutish sort. As a result, the maintenance of voluntary exchange and our ability to grow prosperous is heavily dependent on the ability to maintain peace and order. This order however, is easier to obtain in groups that are homogeneous and like-minded, and harder to maintain when groups are too heterogeneous in wants, temperament, or background. At the very least, even well-meaning groups find it expensive to cooperate where transactions costs are high. At worst, continual conflict leads to violent struggle that rules out steady economic growth. The necessity for order puts Hobbesian norms at odds with Smithian rules for wealth creation.

Thus the central paradox of political economy that has been at the core of the new institutional economics is the choice between leaders that promote production or predation. Unfortunately, any group (like the state) capable of enforcing rules of cooperation and contracting is also powerful enough to abuse those rules for its own benefit. This paper calls this problem the choice of “make
or take," by analogy to the “make or buy” decision in the Coasian theory of the firm.

This is the heart of the credible commitment problem pointedly highlighted by North and Weingast’s famous analysis of the benefits of the Glorious Revolution of 1688 for England (North and Weingast 1989). Even a sovereign who wishes to do good will be limited in his attempts to borrow or to engage in credible policy if his power is so unconstrained that citizens and investors can see that he can arbitrarily renege on agreements without consequence.

In an earlier work, Nye (1997) discussed how an expanded Coasian theory of the state underlies most of Douglass North’s ideas about political development. In a nutshell, the polities that are sustainable at any time are those where the balance of hierarchy, state control, technical production, and political competition are such that dominant groups have no incentive to switch to alternative systems. But this means that otherwise “unproductive” or “low growth” political economies are not only feasible but stable, where technological barriers limit the potential for further growth and the demands of the powerful cannot be bought off by the possibility of higher wealth in exchange for greater political competition. One way of viewing the rise of the modern, developed world is to see how growing prosperity has gone hand in hand with more checks and balances and a state that for all its problems and corruptions is still more beholden to the citizenry in the richest countries than in most of the world, and certainly more open to competition than rulers in earlier times. To some extent, in the wealthy part of the world, it is almost as if we “hire” the government we wish while seeking to confine them to managerial duties we design for them. But of course this does not mean that any state is immune to the push and pull of interest groups striving to skew the polity to favor them and their allies. Nor that the states can rise above the desires and irrationalities of their underlying populations.

But as North, Wallis, and Weingast (2009) have argued recently the typical natural state can be seen as a coalition of dominant elites who carve out a limited access order to limit violent conflict among each other, to protect themselves from the encroachment of the masses, and to provide a stable platform for promoting economic growth within the favored groups. In exchange for maintaining order for the country as a whole, progress for most is obtained by playing within the rules of a system that are skewed to a favored few. This is the default position of most countries in the world.

Development theory is at its weakest when it ignores the stability of preexisting social arrangements and treats growth as a mere technological game in which capital, labor, resources, and technology are to be rearranged so as to produce a well-planned growth machine. Naive versions of this view, excoriated by numerous observers and notably by prominent researchers with research
experience in the World Bank and other institutions (e.g., Easterly, Shirley) tended to dominate the thinking of development policy through at least the 1990s.

More recently, there has been a turn to focus on governance and institutions as the major development agencies have come to realize the futility of mere capital and technology transfers and as naïve views of planning whether in the East (former communist states) or in the West have faded.

But institutional issues are often discussed in a disjoint and ad hoc fashion as if institutional improvement were a matter of a legal instead of a technological fix. At its worst, this tends to a kind of technical legalism in which reform is all about bringing “best practice” administrative style or legal rules to developing nations. At its best, this sort of thinking is superficial though benign. At its worst, this sort of improvement through better administrative management treats the state as a well-meaning but misguided enterprise in which politicians really want high growth and development but are just stuck with an antiquated legal apparatus that only waits for modern upgrades from the richer nations.

Moreover, if there is no integration between institutional issues of governance with the standard problems of core distortions as highlighted by neoclassical theory, which then serve to explain the distribution of benefits that support the existing political economy, it is unlikely that (i) we will even identify the areas where reforms are the most severely needed and (ii) we will be able to structure reforms to make them feasible and more important sustainable in an incentive-compatible sense in the longer run.

Indeed, there can be a temptation to treat governance and state capacity independent of the distortions of what North, Wallis and Weingast call “The Natural State” of limited access and constrained elite control. But of course, it is the very distortions that serve to create the conditions for the existing stable order and so it is not easy to discuss reform without identifying the incentives for dysfunctional government or understanding why different groups might not support or willingly implement policies that promote greater political or economic access.

But what does this mean in practice? For reasons both of selfish rent-preservation motive and the difficulty of providing national public goods in an underdeveloped country, you see the economy functioning in different partitions, with sectors of the economy segregated or more readily accessible to the well-connected elite. Creating rules that hold equally and universally in practice, as well as in theory, are difficult not least because it is hard for national politics to rise over local patronage. And of course the stronger the degree of personalized patronage, the more difficult it is to expect well-ordered universal rule of law. Or perhaps it is the converse—the very difficulty of establishing enforceable, reasonably unbiased rules pushes groups to value patronage relationships even more.
More often than not, this sustainable political distortion—not mere infrastructure or poor geography—creates what we see as dual economies with a small productive zone and a large, mostly agricultural low-wage economy.

It is not uncommon for agriculture to be especially unprogressive and backward because important political factions benefit from this immobility. Yet there is no easy way to push the nation out of currently existing relations without upending the sources of stability and order. And it is not surprising that structural imbalances and massive sectoral distortions are the bases for successful private fortunes. Moreover, the thickets of legal rules that are complicated, hard to manage, and imperfectly enforced are especially good barriers to entry for those with the wealth, power, connections, and historical ties to authority. Attempting to simplify and clarify existing rules is in effect a diminution of the special privileges earned by those that have risen up in the current system.

Moreover, one should expect alliances between populists and elites, as well as by blocking groups like labor unions or certain types of activist organizations. Successful elite groups will have forged ties designed to withstand easy challenge in both democracies and autocracies. Often, in what the economist Bruce Yandle called a “baptists and bootleggers” phenomenon (after the successful confluence of support for Prohibition in America by the religious and the venal), the ideological predilections of one group will be selectively supported where it makes for easy profits by others. A more open, competitive system will be resisted as it will be both politically incorrect and as yet unsupported by new challengers that, almost by definition, have not been able to emerge yet.

III. WHERE SHOULD PHILIPPINE REFORMS BEGIN?:
THE LESSONS FROM ECONOMICS

Sometimes referred to as the “sick man of Asia”, the Philippine economy has been marked by steady but mediocre growth performance over the last few decades. Despite setbacks, growth has stayed in the range of 1–5 percent per year in terms of real gross domestic product (GDP) for the last 2 decades, which has been useful in mildly reducing absolute poverty in a nation of over 90 million people. Moreover, the Philippines has not suffered too obviously from the recent financial crisis. But this is more an indication of the weakness of the national economy than a result of especially good policy. The Philippines has been a laggard in Asian growth, whether in comparison to the People's Republic of China (PRC), the various East Asian tigers, or to its neighbors in South East Asia. And why should that be?

Consider what is thought to be the most pressing problem for long-term adjustment of the Philippine economy, the slow movement out of low paid rural agricultural jobs into mostly urban commercial and industrial jobs. This problem
was formally discussed at least as far back as the early 1990s when it was highlighted in a joint report on the Philippines by a team of four economists headed by Paul Krugman (Krugman et al. 1992). The report focused on the “extreme dualism of the Philippine economy. A tiny manufacturing sector, employing only 10 percent of the labor force—less than in 1970—produces roughly one quarter of GDP at domestic prices. Meanwhile, almost two thirds of the labor force is employed either in agriculture or in “other services” (primarily marginal urban jobs), generating only one-fifth as much output per worker (Krugman, et al. 1992, pp. 9–10).” The report then went on to decry this dualism and put part of the blame on the high tariffs and poor export orientation of the Philippine economy.

However, since then tariffs have come down substantially and there has been some improvement, but the dual nature of the Philippine economy has mostly stayed the same with only modest changes. To this day, roughly one quarter of the workforce is in industry or manufacturing and three quarters is in agriculture or forestry, or in services. While a few of the service jobs are in high-paying areas, for the most part services are still dominated by low productivity, often marginal jobs. What can possibly account for this stagnation in the movement of labor from the relatively unproductive part of the economy to the more productive and technologically more advanced sectors?

On this most observers have been relatively silent. There is some discussion of lack of competitiveness of Philippine industry and the tendency of Philippine manufacturing to fail to export, though there is no detailed discussion of first principles. The World Bank’s Philippines Discussion Note on Economic Growth (World Bank 2010) highlights the gap between industrial and agricultural productivity without explaining the source of this distortion. It is therefore surprising that when discussing possible reforms, emphasis is placed on fiscal improvements, infrastructure development, and improving governance. While there is reference to “barriers to factor mobility” (World Bank, 2010, 10) we are not told what these barriers consist of. Nor do we learn why the three areas promoted for growth would do much to overcome structural impediments, however well they may serve as practical suggestions for reform.

Yet some clues to the problems facing Philippine industry may be gleaned from work by Philippine labor specialists. For example, despite the higher productivity in the urban industrial sector and the need for highly skilled workers, the unemployment rate is higher for college-educated students than less educated workers. In 2008, the college-educated had a 10.6 percent unemployment rate compared to 8.6 percent for those with only high school degrees, 3.3 percent for those with elementary education, and 2.1 percent for those with no elementary schooling at all (see Table 1). This is so much the opposite of what is typical in the developed economies that it suggests the importance of high barriers to entry
in the formal job market that are not binding in the low-wage, heavily informal service and agricultural sectors that are more likely to employ the least educated.

### Table 1. Unemployment in the Philippines by Educational Attainment, 2008

<table>
<thead>
<tr>
<th>Educational Attainment</th>
<th>Labor force (thousands)</th>
<th>Unemployment Rate (percent)</th>
<th>Share (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>36,805</td>
<td>7.4</td>
<td>100</td>
</tr>
<tr>
<td>No grade</td>
<td>660</td>
<td>2.1</td>
<td>0.5</td>
</tr>
<tr>
<td>Elementary</td>
<td>11,425</td>
<td>3.3</td>
<td>14.0</td>
</tr>
<tr>
<td>High school</td>
<td>14,457</td>
<td>8.6</td>
<td>45.0</td>
</tr>
<tr>
<td>College+</td>
<td>10,263</td>
<td>10.6</td>
<td>39.9</td>
</tr>
</tbody>
</table>

Source: Esguerra (2010).

But what are these barriers?

Esguerra (2010) points to two features of Philippine industry that would dramatically inhibit job creation: (i) a high industrial minimum wage and (ii) strict employment protection. Note that these rules are only binding on the industry sector and not on either agriculture nor the bulk of the services sector. Moreover, it is likely that these rules would be more strictly enforced the more visible and formal the enterprise, which one would expect of the largest national and multinational enterprises.

Esguerra continues that out of 130 countries, the Philippines had the 28th highest minimum wage in the world in 2007 at purchasing power parity (PPP) rates, and the 8th highest minimum wage out of a group of about 30 developing and transition economies.

In addition, regularization rules force companies to convert employees into full-time workers and make it virtually impossible for firms to fire workers after regularization. The predictable effect is that firms have a large number of employees hired on a low-wage, short-term track, with most let go after only 3 or 4 months. A smaller group of high-productivity, higher-paid workers make up the permanent employment core.

These two features alone would be enough to explain a large gap between the labor markets of the industry and services sectors or the agriculture sector. Rural workers are not bound by these laws, and for the most part neither is the service sector. Moreover, it would be hard to monitor and enforce such rules even were they to be universally applied.

Hence, it is now easy to understand that high minimum wages and complicated and protective work rules serve as a tax on the most productive and progressive part of the Philippine economy, supporting the duality decried by experts for the last several decades. Unfortunately, many expert analyses have identified labor market rigidities as being critical to Philippine underdevelopment while misunderstanding how policies, like the urban minimum wage and other

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1These are only the most prominent ones. A more detailed study might reveal the multiple layers of constraints.
“high wage” policies, actually contribute to the problem of low wages in the overall economy and high unemployment.²

Indeed, the regulations on labor—especially on the most advanced, yet protected urban labor at the center of modern development—are a major component in explaining the slow movement into the urban commercial sector and the peculiar pattern of Philippine unemployment. As documented in Esguerra (2010), the unemployment rate is strangely skewed to the most highly skilled workers. This is completely at odds with the research in the most highly developed economies where the link between education and unemployment goes the other way. In general the best educated and most highly skilled workers are less likely to be unemployed in the United States (US) and Europe than those with little or no education. After all, education is optional and costly, especially postsecondary education. If education did not pay, it would make sense for most to simply forego college.

But of course this pattern is consistent with what we would expect from a highly segmented workforce produced by regulatory barriers. In effect, the mix of high minimum wages, combined with regularization rules and other policies designed to limit firing of workers in the formal sector, contributes to a formidable barrier to entry into the most highly paid jobs. Thus firms have the incentive to create two tiers of workers—the few who are relatively well paid and hard to fire, and the many who are low-paid, temporary workers to be released after a few months, so as not to run afoul of the law mandating regularization and guaranteed employment after 6 months. That means that you encourage queueing in the formal sector while labor is flexible but poorly compensated in the rural and informal service sectors. In effect, college workers are participating in a lottery in which it pays to be educated on average even if the likelihood that you will be fired is higher than if you possess only elementary education. This sort of queueing also resembles what one observes in rural areas where poor workers queue up for employment abroad, and it often pays for towns to have a few workers highly paid abroad with many more unemployed and waiting, than to have all workers more gainfully employed at home. Queueing in the Philippine formal economy and queueing for overseas positions share some of the same dysfunctions arising from an efficient and highly regulated labor market complemented by poor competition in sales, retail, production, and in the associated capital and land markets.

²For example, Balisacan (1994) correctly identified labor market rigidities as contributing to the dual nature of the Philippine economy. Yet he strangely decried the fact that minimum wage laws are not effectively enforced outside the unionized industrial sector. But that is a benefit of the system. Rather, the lax enforcement is good for encouraging overall growth but bad for the sector most tied to the regulation.
IV. PROBLEMS WITH URBANIZATION STUDIES AND LIMITS ON IDENTIFYING THE PROBLEM

One of the biggest issues with understanding the transformation of the Philippine economy is identifying the sources of distortion in limiting labor’s transition from low-productivity to high-productivity sectors. In the literature, this is usually treated as a subset of the problem of rural to urban migration. But there are both practical and conceptual problems with this.

As noted earlier, many of the most distortionary labor market regulations do not affect the gap between urban and rural markets per se so much as they affect the difference between the urbanized commercial and industrial sector and both rural agriculture and urban service industries. Thus, the wage and productivity gaps brought about and sustained by labor market regulations are often less clearly to be seen in the market for unskilled urban versus rural labor. Rather, the gaps are likely to be most severe when considering employment in the developed commercial/industrial sector versus both urban and rural sectors not covered by these regulations.

Furthermore, even the existing rural urban wage gaps that are still visible in the aggregate macroeconomic statistics are masked by the confusing definition of urban sectors used by the Philippine statistical authorities. As Jones noted in his survey of urbanization in Asia (2002) the Philippine definition of urban areas is so inclusive that even small villages with a mere 1,000 people are considered urban. Thus, comparative statistics on the Philippines and Thailand over the last few decades gives the counterintuitive impression that the Philippines is more urbanized and more rapidly urbanizing than Thailand despite the latter’s greater success in promoting growth and industrialization. But it turns out that this finding is almost surely an artifact of the Philippines’ broad definition of urban areas and Thailand’s more restrictive definition, labeling some areas of more than 20,000 people as being rural. Hence, no study yet exists that properly captures the scale of the urban migration problem in the Philippines in ways that match our basic intuitions and adequately correct for definitional problems.

Of course, there is a further problem that it many private firms knowingly skirt the existing rules and regulations and so labor market constraints may not be fully binding (cf. Squire and Suthiwart-Narueput 1997). Nonetheless, the inverted pattern of unemployment by education, the obvious forms of queuing in local industry for jobs, and the use of short-term industrial employment contracts to avoid the 6-month rule on regularization make clear that the existing regulations have real observable effects. What is not yet established is how broad the effects are and how important the deadweight losses from such distortions are relative to other distortions.

Moreover, these are not the only impediments to structural adjustments. Other rules and regulations interact with labor market constraints to maintain
segmented labor and capital markets and limit the efficient allocation of capital and labor while lessening investment prospects.

As is well known, competition and investment are hampered by constitutional rules that limit foreign participation in local business to minority status and that prohibit foreigners from owning property with a few limited exceptions such as inheritance. This severely restricts the entry of firms with the greatest knowhow and managerial experience that would benefit the Philippine economy.

It is not a surprise that skilled workers are among the Philippines’s largest exports. Overseas workers on a variety of temporary assignments cannot find employment in their home country because enterprises are heavily constrained in their ability to enter. It is simpler to hire Filipinos abroad than at home with predictable costs for growth and developmental progress.

Zoning of land adds a further dimension of immobility and inefficiency. Lands designated as agricultural cannot be exploited as commercial property, hindering expansion and once again limiting competition in the urban regions where productivity is highest.

Of course, this further contributes to the overcentralization of economic activity in the established regions. Both physical infrastructure and social networks will favor existing leaders. Lack of competition in land and labor markets, as well as transportation costs due to both infrastructure and regional protection, will also go against any market-correcting tendencies to shift resources and investment outside the National Capital Region (NCR). Indeed, the gap in GDP per capita between the NCR and the average of the three Visayan regions remained at roughly three to one between 1985 and 2000 with no signs of convergence (Capuno 2010).

Land reform, which had the ostensible goals of breaking up the largest estates and transferring ownership to poor farmers has had unintended consequences as detailed by Fabella (2009). Because land transfers do more than give land to farmers but actually restrict their ability to resell the lands while often constraining them to plots that are below the minimum size necessary for fully efficient farming in the marketplace, farmers do not benefit as much from the transfers as one would think. Moreover, the restrictions that were designed to limit large landholders’ ability to reconsolidate the lands after transfer do little to hinder the power of the largest estate holders while making the agricultural sector even more uncompetitive and immobile than it already is. In many cases, farmers informally resell the lands to the dominant landholders at below market prices. Only the largest and most politically connected families have the capacity to buy back the land and informally control their property rights without benefit of legal sanction. The net effect is the opposite of what was intended. Although inconvenienced, the large landholders reobtain these lands but now benefit from the limited competition in this land market. Why? Because smaller or less
powerful groups seeking to buy these lands would not be able to do so legally and do not have the social power to informally enforce de facto property rights (Fabella 2009).

Indeed, given the problems with both interregional competition and with sidelining low-productivity agricultural land and shifting it to commercial and industrial production, it is no surprise that researchers have found an increase in the divergence of land prices between and within the urban and provincial regions (Capuno 2010). At best the limited local price convergence on some limited dimensions coupled with minor geographic spillovers show how little progress the country has made in moving toward a single integrated Philippine domestic market.

All these rigidities—whether deliberately created by self-interested elites or whether they are holdovers from historical accidents—contribute to a nation of wasted opportunities and persistent rent seeking. It is precisely these sorts of distortions that are well exploited by the most well-trained, best connected, and most influential preferred groups that North, Wallis, and Weingast (2009) describe as typical of the limited access order.

V. WHAT ARE THE MOST COMMONLY RECOMMENDED REFORMS?

Despite the clear and glaring problems that these and other distortions represent, what are two of the most highly promoted reforms often suggested for the Philippines?

Tax collection (or fiscal reform) and infrastructure development.3

An unbiased observer would be hard pressed to see why these reforms flow naturally from the problems we have identified.

What’s wrong with these reforms? Although these suggestions have long and distinguished pedigrees, and if implemented often would improve the lot of most underdeveloped nations, at least from the standpoint of macro stability, it is never made clear by the various investigating agencies why these are the first reforms usually promoted for Philippines and many similar nations. Is it an implicit admission of impotence in the face of more serious structural distortions? Does it reflect a financial/fiscal bias on the part of organizations like the World Bank or IMF that focus over strenuously on the direct determinants of short term investment? Is there some dire fiscal crisis that is imminent? That there are no convincing answers to this suggest that the focus of analysis has been misplaced. There is never a clear link made between the more fundamental distortions in the

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3 Increasing tax revenues are the primary reforms discussed by the International Monetary Fund’s (IMF)Arora (2010) in discussing suggestions for promoting investment in the Philippines. They are also first on the list of growth-promoting reforms in IMF (2010). Yet neither proposal draws a tight link between the dysfunctions of the Philippine economy and tax collection.
Philippine economy and these proposals. Above all, there has never been a comprehensive effort to estimate quantitatively the areas where distortions are greatest and where reform is of greatest import nor to argue why these reforms are liable to make a large measurable difference should they be successfully implemented. Indeed, there have been few, if any, nations in history that were able to promote successful long-term development primarily by beginning with fiscal restructuring. At best, fiscal reform accompanied more fundamental changes that jumpstarted the economy.

Because the nature of Philippine distortions have not been well-studied, especially from a quantitative standpoint, it is not possible to say if the labor market constraints or those on agricultural lands, or on zoning, or on foreign ownership are the most important sources of uncompetitiveness and factor market inefficiency in the Philippines. But they are almost certainly more plausible candidates for lack of structural adjustments than the oft-cited problems of poor tax collection or poor infrastructure. Yes, low revenues harm the government’s ability to supply public goods, but it is unlikely that more revenue per se would do much to bridge the gap between industry and agriculture if it is simply not feasible to hire workers to the point were the wage gap between the two would simply disappear. Again, infrastructure can contribute to easing the lack of competition, but it is constrained by a world in which uncompetitiveness and monopoly are built into the laws and aided by poor institutions and corrupt politics.

Now if we turn to another common reform—the reduction of corruption and facilitating improved governance—things get interesting.

It is almost certainly the case that problems of governance and poor institutional arrangements account for many of the illnesses faced by developing nations. But often governance is discussed in purely technocratic fashion. But as researchers on corruption have noted, corruption is a multifaceted phenomenon, and attempting to simply reduce corruption without regard to its sources or varieties is often apt to make the overall problem worse.

Indeed, we need to be reminded that while systemic corruption is bad, individual acts of corruption often have utility in dysfunctional environments. “In short, if the prevailing system is bad, then corruption may be good” (Klitgaard 1988, 33). For example, systems with very defective regulations, such as high import tariffs or monopoly enhancing regulations, may destroy so much potential trade and investment that corruption is actually a sensible and relatively efficient mechanism for partially defeating the worst regulations. Unfortunately of course, corruption, even if individually efficient, contributes to the deligitimization of the entire legal and political system and in so doing, makes it hard for a state to reassert its authority in much needed areas, whether in law and order, or contract enforcement, or in social aid to alleviate poverty or promote public health.
It is interesting that one of Klitgaard’s case studies in his book *Controlling Corruption* (1988) focused on the work of Justice Plana in his attempts to rein in corruption in the Philippines’s own Bureau of Internal Revenue (BIR). In discussing the limits of anticorruption measures, Klitgaard acknowledged that Plana’s reforms seemed to work best for a limited period of time, and that backsliding was typical from the 1980s on. Nonetheless he praised Plana’s efforts and suggested a framework for reform centered on selecting appropriate agents, changing their reward structure, gathering better information, restructuring the agent–client relationship to minimize monopoly power, and changing attitudes about corruption. Of these measures, the first three seem closely tied to a technocratic solution within existing agencies while the latter two points seem well outside the bounds of any particular branch of the government. In that sense, the point about limiting monopoly power is not about the task of any specific agency but about changing the policy regulations themselves. If the government is asked to do too much, and if the tasks that the government effectively urges its servants to perform are focused on limiting access to business and blocking open commerce, it will inevitably lead to despair as huge incentives will build up to evading or ignoring the strictures. As for the culture of corruption, it is rather difficult to see how much of this is due to social or historical habits that are difficult to change, and how much is a result of failed enforcement leading to a sense that anticorruption is a short-run gain whose benefits are too small to be sustainable in the long run without changing the overall rules.

In that sense, it is hard to see how limiting corruption can be a general strategy. Rather, controlling corruption is like curing the common cold. There are a huge number of forms of corruption and reasons for its existence just as there are a multitude of cold-causing viruses. Thus controlling specific types of corruption entails a joint product of reforming a particular sector of the regulatory and fiscal structure simultaneously with a renewed effort to enforce selected laws and rules. Absent a sweeping change in what is being taxed, controlled, or collected, it is unlikely that a mere blanket endorsement of greater strictness toward bureaucrats will result in lasting victories.

Moreover, it should be clearer that quantitatively estimating which sectors would most benefit from improved enforcement and which sectors are likely to produce greater resistance for minimal gain is critical to any serious plan of action. As the Plana reforms centered on the BIR and on tax collection, why is the BIR the most important source of corruption and how much of its problems would be minimized if many taxes were to be removed or simplified? The quixotic desire for increased revenue without changing incentives for efficient production seems at best marginal, and at worst, not clearly supported by historical work on the rise of successful economies.
VI. UNDERSTANDING SUCCESSFUL REFORM

How should we analyze development proposals? Does identifying the major areas of distortion tell us where we should focus our reform proposals? This is where an awareness of institutional conditions and political interests tempers the crude lessons of a neoclassical analysis of economic distortions. Just because sector A or region X is the major source of poor performance does not imply that the preferred proposal is to simply remove said distortion. Even if a reform to the ideal first-best solution exists in theory, there are many political and institutional reasons why it is unlikely that many first-best reforms are either infeasible or unsustainable with current social and political arrangements.

Though developing and implementing actual reforms is not a one-off proposal, the following should guide us as constraints in our action:

First, development and external aid agencies are not only limited in their power and capacity to insist on reform, but even when they are empowered—perhaps through conditionality or through some fortuitous political circumstances—to promote particular changes, they are ill-suited to monitor such reforms in the long run. Indeed, the willingness to give aid on the part of individuals and of donor nations is not matched by an equivalent willingness to make sure that the aid is properly used and truly benefits the intended recipients. Thus, we should be skeptical of any proposals that would only work if an idealized external bureaucracy—itself beholden to political interests from donor countries—were to monitor and enforce reforms on a regular basis.

Second, because existing conditions, including the very distortions that serve as the biggest obstacles to a natural development path, are an equilibrium supported by coalitions of elites and important segments of the masses it is likely that any truly useful reform will only come about if a critical subset of those coalitions sees that the new reforms are in their best interests. This usually comes about if there are external shocks, such as a major technological change, some sort of political economic crisis, or a change in international conditions of trade, or perhaps even a shift in public opinion that allows for reforms that undermine the existing arrangements. But for these reforms to promote greater openness and development and not be merely superficial, the proposed reforms must be supported by a critical segment of the elites. They must see that they would gain more from supporting or at least passively acquiescing to the changes than resisting them. More importantly, the new economic regime should persist and develop by creating interest groups that benefit from progressive development and improved competition and that would fight to maintain and expand reforms.

As stressed in a previous section, limiting corruption without reforming a legal and regulatory system that encourages and supports a distorted economic system is both futile and is likely, even with partial success, to encourage longer-run dysfunctions by increasing the strain between what is demanded and what
opportunities are being bypassed. The larger the opportunity costs of market destroying rules and regulations, the greater must political patronage and rent-seeking be to tie the interests of the critical coalitions to existing arrangements. This is why sudden technical innovations or shifts in the nature of world business have often been the catalysts for sustained reform where well-meaning, long-run legal efforts have previously failed.

A good example can be seen in the world of telecommunications. All over the world the pattern for most of the 20th century was one of a highly centralized national monopoly on telephone service, typically with pricing arranged so that long distance calls subsidized local service. In most poor and even many developed nations, access to telephones was severely limited. Moreover, obtaining and paying for a phone line was marked by both long queues and often a need for side payments and/or political influence. Various programs of reform were frequently discussed from the 1960s through the early 1980s, but most countries did little to liberalize telecoms.

The Philippines was in especially bad shape with less than one fixed land line for every hundred people as late as 1990—a ratio that had changed very little since a decade or two earlier (Morales 2010). However a combination of government reforms aimed at liberalizing telecommunications combined with the arrival of mobile telephony in 1993 and after served to dramatically change the landscape of personal and business communications. Within 10 years, land line teledensity had increased to about 9 per 100 people. But more importantly, mobile telephony really served as the great equalizer, rapidly overtaking land lines in importance and use by 2000. Indeed, compared to its neighbors in ASEAN, the Philippines went from being substantially below average in telephone access to having greater than average coverage in 2000. Moreover, it was nearly alone in having about twice as many mobile subscribers as land lines. By 2009, there were roughly 70 million mobile phone subscriptions in the Philippines for a country of 92 million people, which meant being close to universal access even when taking into consideration the substantial numbers of people with multiple cell phones (Morales 2010).

Of course, this is not to say that telecommunications is either fully open or fully competitive in the Philippines. It is still a highly regulated and somewhat closed industry. But the usefulness of the example is to illustrate how a major technological innovation combined with even imperfect regulatory reforms can combine to dramatically increase access and competition in a way that is politically sustainable. Almost all countries that opened up to mobile telephony saw the monopoly rents from land lines erode. But in this case the opportunity cost was so huge that most states faced a stark choice, either lose the benefits of a fully controlled government monopoly on telecoms or lose out on the huge benefits of mobile telephony. Thus, even where the introduction of mobile telephony required concessions to powerful local interests that created new
monopoly rents, the generally greater competitiveness and huge consumer surplus to be derived from widespread phone access guaranteed that a second-best solution would inevitably lead to greater consumer welfare, and in the long run spill over to improved competition in businesses and industries—from computers, to marketing, to outsourced services that are dependent on improved phone infrastructure. More importantly, it aligns business and consumer interests with improved communications. This is an important lesson about encouraging second-best solutions that promote greater openness in the longer run even if they seem to be structurally flawed in the short run.

VII. FRAMING SOLUTIONS

Although we have relied heavily on the example of the Philippines in this essay, certain principles can be used to frame most problems of development policy.

First, make full use of standard economic theory to develop a rigorous, quantitative analysis of the major structural distortions of a given economy. For the most part, this is valuable for all nations at whatever stage of development. However, this will be especially useful for less developed economies. Why? Because absolute precision is less important than identifying the major imbalances in the economy and assigning rough estimates of their overall costs. Almost by definition, a very poor country is operating far away from the current technological production frontier. This requires that major obstacles must be in place that prevent capital and labor from being reallocated more productively. Indeed, as should be clear from the case of the PRC and many poor nations that have suddenly seen rapid economic growth, even partial reforms that simply allow a reallocation of labor to the more productive sectors, and a limited opening up of the economy to the world market can produce extraordinary improvements in a short time because the technology already exists to be copied or adopted in the right institutional context.

Absent such an analysis of economic distortions, which might require the support of a major national agency or of groups like ADB, the World Bank, or the IMF, most reform proposals on countries like the Philippines are flying blind. Since we do not know which distortions matter most, we will be hard pressed to understand which of our proposals are primarily about development or about humanitarian assistance, and which ones are likely to provide good “bang for the buck” (benefit–cost ratio) even relative to ideal conditions. But this is only the first step. Knowing what the major distortions are does NOT necessarily tell us where policy should be directed, especially in the absence of better political and institutional knowledge.
The second would be to identify where possible the broad groups that benefit and suffer the most from the existing distortions in the national economy. This analysis is critical to understanding why such a dysfunctional structure persists and perhaps even of understanding the positive political features of the current political economy. The compromises that make up the rules and regulations that de facto limit growth and investment will have grown up over time in a haphazard and rarely conscious fashion. Even the strongest elites that have and continue to benefit from the current system will not have foreseen all the consequences of the various rules and distortions. Moreover, even the most narrowly venal leaders will want to find ways to promote greater prosperity so long as it does not undermine their political and social position. Furthermore, a complex mix of social, cultural, and ideological considerations may also explain public support for particular policies or proposals that serve to tax the nation’s economic development. In some cases we may find that bad rules are often a substitute for poorly developed state capacity to enforce order or are a byproduct of political compromises worked out to ensure the peace. At the same time, policies that were mistakenly proposed to solve old problems but which only created new ones will have spawned maladaptive business and political arrangements as groups and individuals sought ways to profit while accommodating themselves to the new rules. This of course will create new rents and special interests that will work to preserve those inefficiencies that are now being exploited for individual benefit. Ideally, the identification of distortions in the first stage and of associated interest groups in the second will help match proposed reforms to areas where resistance is likely to be weaker or which can be more easily redirected along parallel lines.

Third and most difficult is to assess and propose policies that try to address the major distortions in ways that are both politically and institutionally feasible. This means being aware of the constraints on the part of the reform-promoting agency and of the government and private actors charged with enforcing the reforms and promoting their continued operation. The ideal reforms will not only lead to greater competition but will create local interests with a strong stake in seeing to it that the more positive aspects of the change are maintained and broadened whenever possible. Projects that create demonstration effects or that serve as incentives to other regions, agencies, or groups to perform better are especially desirable. Market-opening reforms are to be prized not out of some sense of idealistic adherence to liberal principles but out of an awareness that for a small country with weak institutions, nothing is more important than to limit the discretion of local political organizations with regard to matters pertaining to investment and the economy. With only limited control of the trade in a product or service, it becomes harder for corruption to flourish or for groups to be excluded. Moreover, open international competition makes the costs and benefits
of ineffective policy more transparent as the worst forms of interference lead to immediate and highly visible costs.

Ideally reforms are started where resistance is weakest and where changes become self-sustaining and hard to resist once under way.

The range of possible ideas that might be promoted should a more careful analysis of the Philippine economy be undertaken must be considered. Many of these have already been proposed by various aid agencies or are variants on existing ideas in the literature but they take on new meaning when seen in this framework.

One issue commonly promoted or discussed is encouraging federalism or decentralization. However it has to be borne in mind that it is rarely the case that these political decisions are undertaken de novo or independently of other policy changes. The important issue to focus on is the creation of more opportunities for political and social experimentation and to create more possibilities for greater access to political and economic competition. The lesson of the PRC’s coastal reforms should not be that the PRC chose the one true method of opening up a closed system, but that they made it possible to try out variations, and then committed to protecting the regions that successfully reformed by allowing them to keep opening up and retaining control of their newly created revenues. This is usually the problem with most experiments with so called free trade zones. In most cases there is very little actual autonomy granted, there is only minimal respite from existing regulations, and there is no credible commitment that longer-term investment, especially by foreigners, will be protected from opportunistic predation by the state. Often a lower tax rate and some mild regulatory exemptions are treated as sufficient to declare an area a “free trade zone.” Thus, an interesting possibility is to promote more genuinely open trading zones in countries like the Philippines, where rules about entry, investment, taxation, labor regulation, and ownership (even immigration) are heavily liberalized in exchange for longer term commitments and the provision of infrastructure and other investments on the part of foreign firms.

Even here we must be realistic. There is a reason why the major centers outside the capital are not viable alternatives for most investors. New ventures must be backed by sufficient political and social authority that credibility will be obvious to potential entrants. This often means allying with prominent families or factions in the country that might benefit differentially. The critical issue is that every concession granted should be structured in exchange for greater openness and enhanced trade in the future.

In some ways, the Charter Cities concept of Paul Romer (2011) is an extreme version of this idea. In effect the nation cedes administrative control of some area of the country and allows another nation (presumably one that is developed and has a reputation for good institutions) to administer the territory for a limited period of time free of interference from the home country. The goal
is to create mini versions of Hong Kong, China within existing national territories.

Allowing for a semiautonomous region within a given nation state that is still administered by the national government is an intermediate solution that does not seem to compromise local authority as much and may be easier to support politically. At the same time, the very fact that such regions would now be tied to the existing national government makes their promises of independence less credible. Thus, the Romer solution would seem to be best, but only if we ignore the high political hurdles to be overcome. Yet simply being able to approach this limiting case with weaker approximations should be an issue that more agencies should promote, not least because multiple experiments with semi-autonomy in countries with great growth potential would be an effective means of trying out new ideas and testing the limits of political tolerance to greater growth.

Consider a semiserious suggestion—expanding the range of shopping malls to entire towns or communities. If one looks around Asia, it is clear that the rise of the large mall is an exercise not only in fashionable retail but a means of creating public goods within a very delimited physical and contractual space. On the one hand, the large malls prevalent in countries like the Philippines would seem to belie the problems of insecure property rights and high constraints on efficient collective action typical of developing nations. But it is obvious that the successful large malls are those where their backers have already solved many of the basic problems of regulatory oversight and credible commitment to longer-term property rights. This does not imply either corruption or cronyism although it explains why tight political ties would be necessary or desirable. Only the strongest or most powerful patrons could provide the necessary backing to make the venture credible. Once in place however, it serves as an oasis of mostly smooth functioning formal law with network externalities, as well externalities of scale and scope in providing goods and services.

We should consider whether this is a viable model for encouraging regional development especially outside the already overcrowded capital city centers. To a large extent the goal would be to encourage ever larger regional centers with enough privatization to provide credible protection for both large and small investors in the area. Participation by local and foreign companies would be encouraged in exchange for coordinated provision or subsidization of necessary infrastructure. The goal of course is not just to spread urban development beyond the usual centers, but create enough alternatives to the existing cities so that even arrangements that may begin from a semimonopolistic basis might still promote greater economic and political competition.

Similarly there should be a means to encourage more agricultural investments that take into account the reality of necessary scale economies and the difficulty of expecting small holders to be genuinely competitive once all political obstacles are taken into consideration. Nonetheless, finding ways to
encourage larger investors for whom greater access is granted at the expense of increased competition from both local and international companies would be steps in the right direction.

Ultimately, the issue is not one of any given reform. The goal is not to prejudge the macroeconomic status of any particular adjustment. The idea is to realign incentives to permit greater entry, greater accountability, and a credible commitment to further openness and continued reform despite the near certainty that those in a position to benefit from current restrictions will want those restrictions to continue. We therefore have to ask how to show them that relaxing those constraints either buys them more or find ways to encourage competition that cannot be easily quashed. This is not a counsel of despair but a suggestion that a realistic integration of economic quantification and political analysis is a necessary precondition for a reliable assessment of growth promoting initiatives.

Thus, any reform evaluation should involve a proper accounting of the relative quantitative importance of different distortions, an ordering of feasible reforms that address the major distortions, and a consideration of which politically acceptable reforms are liable to lead to long term interests sustaining desired changes and encouraging further reform.

REFERENCES


