Deconstructing the Philippine Investment Puzzle: The Role of the State and Collective Action[1]

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Introduction

Our strategy in this paper is to put old wines in new wineskins. New combinations of ideas from economics, political science, and biology may shed new light on an old and inscrutable social reality. The reality in question is the Philippine disease and its flip side, the Philippine investment puzzle. The Philippine disease (PD) is the label we use for the long-term retreat of the Philippine economy from close to the top down to the bottom of the East Asian League table over the second half of the last century. It echoes the British disease, the retreat of the British economy from front runner in Europe to also-ran in the aftermath of the second world war. It has been attributed to the pervasive state control of the "commanding" heights of the economy and the progressive veto of economic policy by populist politics and the labor unions. Many explanations have been put forward to explain the PD. We think we can start to unpack the PD if we untangle a puzzle, the Philippine investment puzzle (PIP).

Standard explanations for the PD abound: chronic fiscal imbalance, the high cost of doing business, poor infrastructure, regulatory uncertainty, weak formal and informal institutions, corruption, political instability, damaged culture, rapacious elites, flawed democracy, high discount rate, etc. The explanations belong to either of four genres: resource deficit, policy deficit, institution deficit, and culture deficit. Some of these may be expressions of our genotype, which we can't hope to change within our short lifetime, such as culture deficit. The resource deficit explanation has been put to bed by the fact that in the last decade the Philippines has become a balance-of-payments surplus economy and a net lender to the world with the PD still persisting. The most tractable, and thus of interest, are phenotypic expressions ultimately rooted in how members of the Philippine collective make their choices (vote, allocate resources between present and future, pay taxes, etc.) and craft political settlements (EPIRA, CARP, NFA, PDAF) in pursuit of ends which are either aligned and reinforcing, or conflicting and mutually undermining within a given environment. Phenotypes are adaptations to the environment. Dr. Jose Rizal (1890), in *The Indolence of the Filipinos,* vehemently argued that indolence among Filipinos is strategic, thus phenotypic and reversible.[2] Filipinos are lazy because the social milieu penalizes hard work. We believe with Dr. Rizal that PD is environmental, not natural law. This is the view that we embrace in this inquiry. Our choice of vehicle towards understanding reflects this.

The Philippine Investment Puzzle

Why has the Philippine investment rate remained so low both absolutely and relative to its neighbors? Observers of the Philippine economy have asked the question. Both public investment and private investment are dismally low. The appalling state of public infrastructure in the Philippines compared to its East Asian neighbors is testimony to the former. Disembarking passengers at the Ninoy Aquino International Airport (NAIA) Terminal 1 over the last 20 years have been invariably appalled by the stark contrast between the state of the airport they just left and the terminal that greets them: a case of time travel into the dark ages, complete with periodic brownouts and toilets well past the age of retirement. This sinking feeling is reinforced as one drives away from the airport.

The decline of the economy's manufacturing sector, lately the subject of many conversations, is another element of the PIP. It is part of a larger phenomenon we call development progeria.[3] Development progeria (DP) is the phenomenon where a low-income economy exhibits the industry share dynamics of a mature, high-income economy. In a country afflicted by DP, the service sector becomes increasingly dominant while the industry and manufacturing sectors progressively retreat even as the per capita income remains low. The resulting growth rate is much slower than in income-comparable economies in a catch-up mode (catch-up mode means being on a growth path which promises eventual membership in the high-income club, the Organisation for Economic Co-operation and Development [OECD]).

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As a marker of failure, DP has also many fathers of which we will focus on two: perverse exchange rate policies and weak institutions, both of which hamstring the tradable goods sector, notably manufacturing and agriculture.[4]

Collective Action Failure

Is there a common thread running through many of these explanations? In pursuit of this thread, I propose to explore a deeper layer of the proverbial onion: collective action failure (CAF). If a unified social science is to happen, it will begin with the study of collective action, that is, how members of a collective work together to achieve ends that benefit all. Its language is game theory. We owe the collective action concept to political scientist M. Olson.[5] CAF is the result of the incapacity of a collective to solve collective action challenges. *The annals of underdevelopment are painted on the canvass of wasted collective action opportunities, not on the canvass of the scarcity of resources.* The usual disguise collective action failure takes in public discourse is the ubiquitous default explanation: lack of political will. We are not just offering a new name; collective action failure as a concept lends itself to formal analysis.

Contrast, for vividness, two outcomes: one, a resounding collective achievement, the Three Gorges Dam in the People's Republic of China (PRC); the other, a resounding CAF, the NAIA Terminal 3.

Collective action challenges are social situations in which the pursuit of immediate individual gains by members of the collective leads to social outcomes that are inferior for the collective as a whole. These have formal counterparts as social dilemma games. For example, all public goods (roads, bridges, airport terminals) are collective action challenges: resources have to be mobilized from members of the polity, and, with the tax revenues, public goods are procured through layers of principal-agent contracts. The project may fail because of failure in one or more layers. The Three Gorges Dam is the embodiment of actualized or seized opportunity and the superior development outcome. It is a huge project started in 1994 and completed in 2012, in the process displacing 1.3 million people. In terms of installed capacity it is the largest power station in the world (22,000 MW). Think of the relatively puny NAIA Terminal 3 project. Completed in 2002, it remains largely idle and decaying 10 years later. Only in 2014 are foreign carriers beginning to move in. The project was paralyzed by interminable lawsuits during and after construction. Think as well of the San Roque Multi-Purpose Dam. It was designed to generate electricity as well as irrigate 70,000 hectares of farmland. It is generating electricity, but is unable to irrigate the 70 thousand hectares of agricultural land for which it was also designed, again because of intractable conflicting claims that the state should have but could not iron out. Think of the LRT and MRT, still un-integrated and wasting immense network externalities. Wasted collective action opportunities all. Why collective action successes in China and not here?

The State

The state is the most important human artifact created to address collective action problems in large polities, a subject many authors have written about, among them, T. Hobbes, J. J. Rousseau, A. Smith, J. Locke, P. Samuelson, M. Olson, and R. Nozick.[6] Small polities, where interaction is face-to-face, repeated, and multidimensional, do evolve coherent trust groups that solve collective action challenges, such as the management of a common resource. The extensive research of E. Ostrom and her group,[7] as well as numerous laboratory experiments, bear this out. We are, however, concerned here with large polities. P. Samuelson (as well as M. Olson and, going all the way back, Adam Smith) showed that private voluntary contributions among self-centric individuals will fail to provide adequate public goods in large polities.[8] Olson goes further: unaided by outside intervention, no public goods will be engendered—thus the idea of the state. But not just any state can solve collective action problems. There are many types of states extant today.

The Perfect State

When the state is perfect, the public goods failure (or any market failure) is solved promptly. Samuelson showed that voluntary private provision leads to public goods under-provision,[9] and that a benevolent central planner is an antidote to public goods under-provision. Avinash Dixit described the perfect state as "omnipotent, omniscient and benevolent."[10] Such state exists only in the mind, not in reality. It is uncanny how many social propositions that make perfect sense under a perfect state turn silly under an imperfect one.

But unbelievable as it may seem, that is the underlying assumption in most economics textbooks. This immense disconnect with reality was the motivation for the public choice revolution in economics in the 1960s[11]: the state is imperfect and one must so anchor economic policy. It is run by heads of state and bureaucrats whose motivations may be other than benevolent. The alignment mechanisms are costly and may be unworkable. With imperfect states, government interventions, even well-meaning ones, can become government failures. They can become purveyors of waste and conduits of venality. How to transform Hobbes' *Leviathan* into Locke's *Commonwealth*, that is, putting effective power in the service of inclusiveness, is the biggest collective action challenge of all time. In the literature the challenge is also variously disguised as the "acquisition of good institutions"[12] or the move from "limited access order" to "open access order".[13]

An imperfect state is of two types: first, a weak state, one which does not have the autonomy to promulgate its rules and does not have the capacity to enforce the same; and two, an imperfect strong state, one which has the capacity to promulgate and enforce rules but is nonetheless afflicted by a deficit of benevolence or competence or information. Let us parse each of them.

Flawed Strong State

A strong state is autonomous in the promulgation of laws and can enforce them on the ground. Hobbes' Leviathan is the iconic strong state. It had power of life and property within its jurisdiction. But this power does not presume benevolence and competence. The iconic modern example of power without benevolence is North Korea under the Il Sungs where individuals are pawns of the state. When a strong state commits to the public good, it can do miracles of collective action. South Korea under Park Chung Hee and Mainland China under Deng Xiaoping are examples. The declaration of martial law by Ferdinand Marcos was an attempt to create a strong state and escape the democratic gridlock and paralysis of democracy. The first years of martial law produced unmistakable markers of a strong state.[14] Tax effort rose and public goods provision quickened. It was greeted then with praise by observers of the Philippines. But a strong state is not immune from a lack of benevolence, information, or competence. When non-benevolent, the strong state may embark on massive projects motivated by selfish interests and that result in massive waste and venality. It can backstop wrong projects with tremendous resources. The Eleven Major Industrial Projects crafted by Bobby Ongpin, blessed by the dictator Marcos, and financed largely by foreign borrowing greatly facilitated by then Prime Minister Cesar Virata's reputation among multilateral lenders of competence and incorruptibility, left a legacy of white elephants whose massive debt service served as Marcos' revenge on subsequent regimes. It is arguable that a weaker Philippine state in the 70s would not have climbed so fast and fallen so low in the 80s. For one, it could not have borrowed so much.

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Weak State

At the center of a weak state is a convenient but fragile political settlement struck between competing groups with different ideas of possible futures and their pursuits. The political center is considered a trophy for the current winner, who is expected to amass resources for future battles. To maintain the tenuous equilibrium, and because revenues are always short, organs of government and even regions of the national territory become allocated not on how well the public interest will be served but on strategic political considerations: which groups need to be rewarded or neutralized. Effort and resources are thus constantly being dissipated in contests for bargaining positions. At times the quantum of resources expended in the contest for a bigger share of the pie leaves little or nothing for pie-growing investment.[15] The natural corollary of this equilibrium tenuousness is rent-seeking—the regime where private ends become served ahead of public ones. Groups will trade resources and support in the contest for the control of the center.

A weak state's signature is policy gridlock. The promulgation of the rules of the game is a many-sided tug-of-war in which progress is imperceptible and allowed space only long after its usefulness. The state treasury is viewed by different groups as a common resource where the familiar outcome is a tragedy of the commons. Large arterial public goods are vetoed in favor of small but less economically impactful projects that are locally visible (in time for the next election). Since a weak center cannot make credible commitments, it cannot mediate with dispatch inter-temporal and inter-group conflicts of interest. All public, especially arterial, infrastructure—crossing as they do many political jurisdictions and delivering returns with long time lags—require such mediation. We call this the "Divide-by-N" regime in public projects.[16] No wonder our arterial public infrastructure system is so poor.

An iconic manifestation of a weak state relation is the award of virtual sovereignty over a region to a powerful clan or tribe. The most renowned case in the Philippines was the implicit grant of quasi-sovereign power over Maguindanao to the Ampatuan clan, ostensibly to help keep the area free of Muslim separatist challenges to Philippine sovereignty. Other examples of the weakness are no less telling. The national government is unable to overcome the local ordinance against open-pit mining issued by the provincial government, which derailed the US$6 billion Tampakan Gold and Copper Mining project in Surigao. The new 600 megawatt Redondo coal power plant has been idled by the Supreme Court despite the clear and present danger to the Philippine economy posed by a looming power crisis. Private investment cannot but be mired down by these scenarios.

In the case of public goods provision, the state has first to collect the tax, and then to procure the goods. The tax collection may fail because the enforcement is weak and attended with widespread venality. On the other hand, the state intervention may be *inefficient*: it either procures the good at enormous cost (the Diosdado Macapagal Avenue) or procures an inferior substitute (the helicopter scandal; Loboc half-a-bridge; ghost deliveries).

A Case of the Second Best

When massive procurement failures mar the state's visible hand, it may be better for society if the visible hand is bound by collection failure. That is, tax evasion may at times become for citizens not only ethically chic but also outrightly welfare improving! This is an instance of the *theory of the second best*. The result is the same: no public goods. But welfare may ironically be better served! Even when financing is no longer a constraint, a perfectly socially productive project may go begging for so long due to regulatory and legal hurdles. The SLEX-NLEX connector road project, a public-private project (PPP), thus fully funded, has been long delayed by legal hurdles associated first with the Philippine National Construction Corporation franchise claim and then with the government's trepidation over negotiated bids.

Calculability and the Weak State

For Max Weber, mature and dynamic capitalism is rooted on a *rational state* that renders the economic environment calculable. Investors take calculated risks but shy away when the risk is incalculable.[17] In particular, a rational state solves the Investor's Dilemma: investors will balk if the danger of ex-post opportunism or illegal expropriation, either by their partners or by the state, is considerable. A regulatory environment that protects property rights and enforces contracts raises calculability and hastens investment and growth.[18] The opposite of the rational state is precisely the weak state where rationality is ever trumped by political exigency, rendering calculability tenuous. The Comprehensive Agrarian Reform Program's

(CARP) un-settling of property rights in agriculture (recall Hacienda Luisita and the Sumilao-San Miguel Corp disputes) has chased private capital out of agriculture. When investors are not accorded adequate protection from expropriation, they will shy away.

Private Ordering

When the regulatory regime is weak, private ordering can sometimes substitute for public ordering.[19] Since arms-length contracting is hazardous under weak public ordering, private ordering in the form of vertical integration or controlling ownership can still salvage a value-adding opportunity. The downside is that in a weak state, private firms may seek comfort in regulatory and state capture in order to provide cover for investment. In weak governance environments, capture (even elite capture) acts as home-made insurance to crowd in investment. It is no mystery that at the start, East Asian governments actually nurtured large business conglomerates (*chaebols, zaibatsus, taipans*) with special dispensations to do the investing.

Full ownership by foreign firms is many times prohibited in the name of local stewardship of national patrimony. But where public ordering is weak, full ownership by a foreign investor can reduce the risk of misbehavior by local partners. Where full ownership is prohibited to favor local stewardship, foreign investors may be forced to find a dummy, which may also be illegal. Thus they descend into the twilight zone of unenforceable, because illegal, contracts. The NAIA Terminal 3 fiasco has roots in the foreign ownership limit enshrined in the Philippine Constitution. But more likely, with such red flags as the NAIA Terminal 3 and the Tampakan mining regulatory fiasco, foreign investors go elsewhere. Direct foreign investment is so very low as a result.

Instrument Space Compression

Because of their inability to punish perpetrators, weak states tend to take the easier way out through outlaw policy instruments: we outlawed integrated power companies (calling it unbundling) before the regulatory environment for arms-length contracting was secure; we outlawed take-or-pay due to the independent power producer (IPP) morass; we outlawed government provision of power generators through the Electric Power Industry Reform Act (EPIRA) except after a power emergency declaration by the president when it usually is too late; we outlawed negotiated contracting over projects; we outlawed larger than five-hectare land ownership and the market for land through CARP. The weak state indulges in the *compression of the policy instrument space*. In the process, it makes war on flexibility to respond to changing environments.

Mao Zedong, the Great Leader of the People's Republic of China, mutilated the policy space in the name of ideological purity as is shown in the slogan, "A socialist train that comes late is better than a capitalist one that comes on time." The so-called Lysenko method of agriculture was imposed because it was of socialist origin. This, among others, produced the disastrous Great Leap Forward. Deng Xiaoping, sent to limit the damage, instead mended the policy space ("It doesn't matter what color the cat as long as it catches the mice") and ultimately produced the miracle of China that we witness today! Still, Deng was lucky because he was riding an already strong state. In the Philippines the starting block is a weak state.

Regaining Trust

Fukuyama uses the label "low-trust society" for many less developed countries. I prefer the label "fragmented trust societies."[20] The fund of trust may be being conserved, but it is highly dispersed, having retreated to smaller and smaller trust groups which people rightly think can better nurture their aspirations. Small groups in fragmented trust societies can, within its boundaries, be very coherent. They are also mostly exclusivist–thus, the Ampatuan clan, the Iglesia ni Cristo, and the Greek-letter fraternities. The state, the embodiment of society at large, is distrusted. Competing groups want their share *now* because the state cannot guarantee a fair redistribution later.

Strategic Retreat

How do we start arresting the weak state? Weak states are, as a rule, overloaded with too many commitments (such as the National Food Authority [NFA], CARP, the Oil Price Stabilization Fund [OPSF], and the Twelve Major Industrial Projects under Marcos) far in excess of the number it has financial and expert resources to implement well. It thus becomes for its own people the purveyor of waste, white elephants, and venality. The first step towards a more effective state is a *strategic retreat* from the most egregious failures (say, NFA and CARP). The state retreat from water and sewerage service in Metro-Manila and the retreat from OPSF produced great benefits for society. The state must do fewer, more fundamental things better based on competitive advantage. It is not from Hayek or Nozick (state size ideology) that I vote for a more strategically limited state but from Deng Xiaoping (pragmatism). The size of the state must be efficient! And efficiency is a learned virtue.

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Simpler Modalities

The second step is adopting simpler modalities to pursue the same ends (low uniform personal and corporate income taxes to reduce discretion). State programs must respect the state's limited capacity for implementation. The Conditional Cash Transfer (CCT) program is a much simpler modality for safety net provision. A replacement for CARP to attract private capital to agriculture will do for farm productivity more than government can. The third step is enlisting the market to do things it can do better (PPP is correct but does not substitute for state public infrastructure spending and reviving the market for farmlands). With a pared down agenda, each commitment will be done better, what with larger budgets, higher salaries, and more focused attention.

A Deng Xiaoping-inspired Rule

Deng Xiaoping's career is a must read for economists and social scientists. He changed the face of China and the world. The policy rule I derive from his career is this: *Render unto the state everything that the state can do better by virtue of comparative competence; outsource everything else!* But doing these goes against the grain of all traditional politics. Deng almost lost his life promoting this rule.

Development Entrepreneurship

Isolated but sometimes substantial instances of reform can be engendered by determined agents called "development entrepreneurs."[21] The critical mass of changes will come about only when the state itself mutates towards greater inclusiveness. The biggest challenge for development entrepreneurship is the bringing about of such mutation. The privatization of water services in Metro Manila is one instance where development entrepreneurship within government (pursued by President Fidel Ramos and Angel Lazaro) used government powers to engender lasting meaningful change. We badly need a state capable of swimming against the tide. We need to recapture the commanding heights of politics for trust.

Trust will return to the political center when the state ceases to be seen as the wellspring of betrayal and becomes instead its punisher and nemesis.

We need to reconsolidate trust. Trust will return to the political center when the state ceases to be seen as the wellspring of betrayal and becomes instead its punisher and nemesis. We have already placed under house arrest the past president for plunder and have removed the chief justice for corruption. Jailing the perpetrators of the Priority Development Assistance Fund (PDAF) scam is the sine qua non next step of this arduous journey. This is why returning the judiciary to its original mandate of enforcing accountability is task one. Institutionalizing accountability and transparency is the close second. The removal of Renato Corona as Chief Justice was an immense conjuncture we have no right under heaven to waste. Events of the last two years (rising global credit and governance ratings, "the next big thing") suggest we are witnessing the birthing of a cascade of positive perceptions when the flapping of butterfly wings can become a gale. This has the making of a singular collective opportunity. We need to sow the wind some more (e.g., the Freedom of Information bill) in order to reap the positive whirlwind. Would that we all join in the flapping of the wings!

Summary

We set for ourselves the task of deconstructing the Philippine disease and its flipside, the Philippine investment puzzle (PIP). The PIP asks why the investment rate in the Philippine is so low, both absolutely and relative to its neighbors'. A related phenomenon is the secular decline of manufacturing in the Philippines, which we related to another phenomenon we call development progeria (DP), the progressive decline of manufacturing and industry share in total value-added and the rising share of the services sector in a low-income economy. Part of the explanation for DP is the persistent strong peso policy which puts a squeeze on all tradable sectors—manufacturing and agriculture—and reduces investments in these areas. Part of the reason for DP and PIP is also myriad institutional failures, such as the regulatory morass and the high cost of doing business, all related to the genre of activity called public goods provision. It is here where this paper focuses: why is public goods provision so poor?

Since all public good provision is a collective action challenge, and the state is the quintessential organ for public goods provision, the paper starts with a typology of states. There is the perfect state—omniscient, omnipotent, benevolent—and the imperfect states, of which there are two: strong states with autonomy to promulgate rules and enforce them but facing benevolence-, information-, and competence-deficits; and weak states which do not have the autonomy of rule formation and enforcement. In weak states, rules and their enforcement (rules of the game) are endogenous, that is, subject to political and other influences, such as rent-seeking. The political center is a tenuous compromise among powerful groups jealous of their share in the spoils, consisting of the state treasury and other privileges. The rules of the game determine how the spoils are divided, and so the groups battle over the rules. The weakness of the state is, in effect, a state of affairs favored by entrenched groups. The weak state is not about providing public goods for inclusive outcomes; it is about maintaining the tenuous political settlement by the sharing of the spoils. In consequence, public goods provision is not a priority, and revenue mobilization by the state is rebuffed by taxpayers—rightly so since revenue collection is wasted or stolen. The result is very low public investment rate.

Defective public goods, such as those in transport and in power generation, result in high costs in doing business. This leads to low private sector investment. Furthermore, the provision of soft public goods (peace and order, upright law courts, regulatory environment, enforcement of contracts, etc.) determines the calculability of the investment space. If the investment space is unpredictable, investment is ruled by the Investor's Dilemma: investors abandon unpredictable investment destinations. Again private investment suffers. The PIP is directly related to the nature of the weak state. The weak state cannot be the sponsor of inclusive development.

Healing the weak state starts with rebuilding trust in the political center. Getting a trustworthy and inclusion-oriented leadership is a matter of mutational luck because the ladder to the top position is closely guarded by the centurions of the entrenched rent-oriented system. Some very unlikely convergence of events (call it a "black swan") has to happen. When, however, the unlikely happens, how does the leadership proceed in entrenching trust? One is by strategic retreat from government failure to de-clog the state agenda; a smaller agenda means better focus, higher budget, and better per project results. Second is to simply say no to enumerable demands for state actions. Third is to recognize the limited informational and organizational capacity of the state to implement programs and to respect the superior capacity of other non-state actors, especially the market.

Notes

1 [I would like to thank the PEJA-UP Fellowship Program for this unique fellowship grant. This program is innovative and unprecedented in its support for an expanded thinkspace which academics value more than fat bankbooks. My mandate, as I understood, it is to think, as it were, outside the box, on an emerging or enduring issue confronting the nation. In this I have benefited immensely from listening to many of you in the audience. Errors are mine alone.]

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