CAPITALISM AND INCLUSION UNDER WEAK INSTITUTIONS

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To Teena and Vigile

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INTRODUCTION

The Crisis of Inclusion in Capitalism

CAPITALISM is under siege. It is embroiled in the crisis of inclusion (Rodrik, 2017; Smith, 2017). Capitalism is an ugly duckling difficult to be enamored with except if you're fitted with Ayn Rand (1964) lenses. A regime that thrives on 'creative destruction' and whose popular image is linked with Gordon Gecko's "Greed is good" is likely to be more hated than loved. Since 1848, when Marx and Engels issued the *Communist Manifesto*, the end of Capitalism has been periodically announced, especially in the aftermath of economic crises. But news of Capitalism's demise has invariably proven premature. Capitalism has a resilience that provokes curiosity. It continues to evolve new varieties which survive and thrive after every crisis, while its detractors and loud pretenders have eaten its dust. The overlaying phenotypes change, but the underlying genome remains.

The very first sentence in the great Joseph Schumpeter's (1976) *Capitalism, Socialism and Democracy* written in the wake of the Great Depression was: "Can Capitalism survive?" The very next sentence was his answer—an emphatic "No." Was he dead wrong as history seems to suggest? No. Rather he was both right and wrong. Right because the Capitalism of his day (*Laissez-faire* Capitalism or the *Robber Baron* Capitalism) no longer exists today in the West; wrong because although sporting differentiated traits, the offspring of Capitalism abound today: the social market economy (Germany), the welfare state Capitalism (Sweden and Denmark), Chinese characteristic Capitalism (PRC), the Wall-Street-driven Capitalism (USA). Wrong as well because both the Entrepreneurial Capitalism with which he was enamored and its nemesis, Bureaucratic Capitalism, which he disdained, are still with us today. Mega corporations, such as Walmart, coexist with—and are under threat from—start-ups that are spawned in carports and emerge as Amazons.

Be that as it may, the twentieth century cannot be completely understood if divorced from the protracted struggle between the *Wealth of Nations*-inspired *efficiency first* ethic and *Das Kapital*-inspired *equity first* ethic. This, as everyone now knows, culminated in the collapse of the flag carrier and armada of the latter in 1989. Capitalism's triumph over the Socialist challenge points to one very important feature of the Capitalist genome: it allows experimentation with Darwinian selection among the different phenotypes. These phenotypes survive side by side because economic, socio-cultural and physical environments abound and economic efficiency cannot be divorced from—and must adapt to—these environments. For example, the oil crisis in the 1970s raised the competitiveness of the energy-scarce Japanese economy and its energy-economizing small car industry.

In contrast, Socialism—as we saw it practiced over the twentieth century—was always overshadowed by the imperative of ideological purity; it always trembled at the prospect of economic innovation undermining the Socialist order. This should not have been a surprise as the logical corollary of the Marxist doctrine of Economics as foundational to society. True, there were experiments with varieties of Socialism, but these were quickly suppressed by tanks and bullets; the Prague Spring was crushed by Soviet tanks; the innovating Deng Xiaoping in China in the 1960s was labeled a 'capitalist roader' and silenced. This fear of variety was crucial to the collapse in 1989 of the Socialist challenge; it became the great burden that finally broke, as it were, the camel's back. Why this same fate failed to befall the People's Republic of China (PRC), long in the phalanx of the Socialist challenge to Capitalism, is a compelling story which will concern us in chapter 2.

Although the events of 1989 in the minds of many put finis to Socialism as praxis, the inclusion imperative did not fold its tent and slink away. Capitalism was never allowed to forget its soft underbelly.

Varieties of Inclusion: Poverty Incidence vs. Income Inequality

That income inequality came—and remains— to be the dominant arena of the failure of inclusion in the high-income and developed West is logical; abject poverty in the West even in the 1970s has largely been routed. But abject poverty is the face of the failure of inclusion in low-income countries. This acute disparity in abject poverty incidence between the high-income

West and low-income countries finds expression in the immigration crisis now plaguing Europe and the USA and rending its political fabric.

That the face of inclusion failure in low-income countries is abject poverty is the judgment as well of the United Nation's MDGs from 1990 to 2015 and its successor SDGs to end in 2030. The MDGs managed to attain its target of halving global poverty incidence (at $1.25 cutoff) by 2015. But three-fourths (3/4) of this gain was made in the People's Republic of China (PRC), which achieved a poverty incidence reduction of from 64% in 1990 down to 4% in 2015. Roughly 600 million Chinese have crossed the poverty threshold since the 1980s. The Philippines is one of the few that failed to hit the target of 17% or half the poverty incidence of 34% in 1990, attaining instead only 26% in 2015. The SDGs now target zero poverty incidence by 2030.

The UN MDGs and SDGs have set no target for income inequality, which reflects the fact that the relationship between income inequality and other MDGs is unclear at best. Although admittedly flirting with the extreme and employed here only for rhetorical effect, the Tagalog term that may apply to the role of income inequality in low-income countries seems to be *saling-pusa*[1]. The Kuznets *Inverted U Hypothesis*, or what's left of it, says that income inequality should first rise with higher per capita income, reach a peak and then start to fall in later stages as per capita advances further (tracing as it were a curve that looks like an inverted U) and thus need not worry us; higher income inequality is a by-product of income growth. Berg and Ostry (2011) gave evidence to the effect that longer duration economic growth tends to associate with jurisdictions exhibiting more equitable income distribution. It is not clear from Berg and Ostry whether longer-duration growth spells bring about better income equality, or the other way around. Berg and Ostry lean towards the latter view when they argue that higher income inequality may trigger social unrest and/or bar the poor from human capital accumulation, either of which can shorten the growth spells. I tend to believe that there is a feedback loop at work, and that sustained growth leading to less income inequality is the more compelling. It is generally given that the relation between income inequality and economic growth is poorly understood. But deliberate redistribution (redistribution by *fiat*) is another matter again. Forbes (2000) and Banerjee and Duflo (2003) interpret their evidence as showing that redistribution hurts income growth. It is best to adopt policies that both reduce

[1] The *saling-pusa* flits around like everyone else in the game, but the score is unaffected.

poverty incidence and reduce income inequality. But many policies, especially redistribution by *fiat*, may actually hamper economic growth and poverty reduction. In this volume, we will zero in on a policy regime that serves both poverty reduction and better income distribution.

In the case of PRC in the era when poverty incidence tumbled by leaps and bounds, income inequality (measured by the Gini ratio) rose from 31% to 42%. This same era saw Chinese dollar billionaires (the 'Jack Ma phenomenon') emerge and hit the world stage. Could this phenomenon render the China miracle fragile? We don't know, but neither is anyone wagering good money on that possible vulnerability. So far, it has proven robust. The tempest will come howling as it always does in Capitalist economies, but by that time, PRC shall have attained a level that allows it to ride the storm. Instead, the 'Jack Ma phenomenon' may be argued to have helped rather than impede poverty reduction in China. If so, I call it a fair exchange! Not only that, it echoes as well the idea that some social distinctions possibly advance 'common utility' found in the US Constitution (1779):

> Social distinctions can be based only on common utility.
>
> - Declaration of Human Rights and the Citizen, 1779

This is not an endorsement of De Mandeville's *The Fable of the Bees* where inequality always manages to be inclusive while equality equates with social misery. That not all social distinctions advance the common utility is implied by the statement. As in China (PRC), the *Robber Barons* emerged during the Gilded Age of the USA when it caught up and even overtook Old Europe; the robber barons and their fabulous wealth may be argued to be in the service of common utility opening up opportunities for struggling immigrants like Andrew Carnegie. If fabulous wealth were a sin in each of these cases, it would be, in the book of St. Thomas of Aquinas, a sin whose complete suppression prevents a lot of good! ("*...multae utilitates impedirentur si omnia peccata districte prohiberentur*": also quoted in Hayek, 1988). If you had doubts about Aquinas being a genius, this line should put that uncertainty to rest.

There is of course a genre of inclusion that is interesting as a warning for policymakers, that is, *inclusive poverty*. This seems to have been the outcome of many a socialist regime, including that of Mao Zedong's China. Deng Xiaoping is said to have quipped referring to Mao's China with his usual playful venom, "I do not want to redistribute poverty." But the allure

of romantic Socialism did not expire in the momentous year of 1989 when the Berlin Wall crumbled. It persists today under various guises, say, in the so-called Bolivarian Revolution of Hugo Chavez and now of Nicolas Maduro in Venezuela. In a smaller way, the Comprehensive Agrarian Reform Program (CARP) in the Philippines since 1988 which created a new class of rural people, the 'landed poor' (Fabella, 2017a) echoes this romantic Socialism. If there is a thread common to all these, it is the belief that forcing wealth and income equalization will lead to poverty reduction. False, and tragically so. Inclusive poverty is the unerring progeny of such programs. Different approaches to wealth and income equalization had very different effects on the welfare of poor households, as shown by India (Besley and Burgess, 2000; Fabella, 2017a). The best result came from legally changing the sharing rules on distribution of the land's product in favor of the tenant but keeping share tenancy system itself, and the worst result came from the redistribution of land to the tenants precisely as in CARP.

The takeaway here is that for low-income countries, poverty reduction should be the obsession of policymakers. And revisiting the natural experiment that was Deng's China is the first step. As observed, the greatest gain in poverty reduction in the MDG era occurred in the PRC. This deserves ruminating over even if only to whet one's curiosity. What PRC has to teach us regarding the tradeoff between income inequality and poverty reduction is valuable. That is what we tackle in chapter 2.

A Bird's Eye View for the Time-Challenged

Time is a precious commodity and some of us do not have the luxury of leisurely perusal. This section of the Introduction is designed for time-challenged readers.

This enquiry proposes to tackle an ambitious project without being lengthy: to imagine Capitalism in third world countries (market economy) that is at once efficient and inclusive. Along the way, the central problem of weak institutions has to be faced squarely. In Part I, we start with contemporary Capitalism facing an inclusion crisis in the affluent first world; the whys and wherefores being hot issues. Piketty (2013) fired the most significant recent shots at contemporary western Capitalism as a natural ally of exclusion and a rampantly growing one at that. Piketty's broadside is about inclusion as growing income inequality especially in mature high-income

economies of Europe and the USA. Marx and Engels's condemnation against Capitalism (they called it *bourgeois* economy), by contrast, is about progressive impoverishment of the masses or abject or *absolute poverty*. The former does necessarily imply the latter. Marx and Engels saw no hope except in the complete rejection of Capitalism and its replacement with Communism following the revolt of the masses. Piketty sees hope in state intervention in the form of more aggressive wealth and income taxation.

Chapter 1 touches on Neo-Classical Economics, the workhorse of textbook economics, which has long struggled with the problem of reconciling efficiency and equity. Socialists have accused the Economics orthodoxy and rightly so of celebrating economic efficiency to the neglect of equity; they proposed the state ownership of the means of production and central planning as the friendlier route to equity. How? The debate raged with the Lange-Lerner theory proposed by Oskar Lange in 1936 and elaborated by Abba Lerner and others which states that if the state controlled capital allocation, then central planning can replicate all that an efficient market can deliver but without growing inequity, since all profits are socialized. Orthodox Economics countered with the Second Fundamental Theorem of Welfare (SFTW). SFTW states that a proper reallocation of initial assets (preferably with lump sum taxes that it assumed did not alter preferences), then any feasible Pareto efficient allocation can be reached by the market exchange including those that satisfy the social norms of equity. This mathematically beautiful result stood on a very strong set of—and empirically implausible—assumptions that include *homo economicus* and no market failures. Nonetheless, orthodox economics had succeeded with the SFTW in creating a firewall to the satisfaction of acolytes between equity and efficiency. Equity was the concern of Politics and Philosophy; efficiency was the interest of Economics.

This divide is exemplified by the political philosopher John Rawls's (1971) attempt to ground equity on the democratic voting under the *veil of ignorance*. With the SFTW, orthodox academic economists can now indulge their fancy at erecting the formal economic edifice unfettered by the awkwardness of possible unfairness that is rooted in the politics of power and influence. When the Visible Hand had to be resorted to, as was evidently required in the public goods market failure, the state acting as P. Samuelson's 'benevolent central planner' ("benevolent, omniscient, omnipotent," as A. Dixit characterized it) was the only politics allowed. It was of course delusional. The emerging Neo-Classical edifice became the Economics of what reality should be, not the

Economics of the reality as it is. The Public Choice revolution starting in 1960 with R. Coase's (1960) *The Problem of Social Cost* was an attempt to break out of this mental straitjacket, but it took another fifty years to really make its mark. Finally, with North, Williamson, Acemoglu and Robinson leading the charge, came the reluctant recognition that 'institutions matter' by mainstream economics and practitioners in multi-lateral institutions.

We discuss here the reliance of orthodox economics on strong institutions to clinch its central tenets, such as the fundamental theorems of welfare and how it implicitly banished the idea of the state from the market. With any incompleteness of markets, however, the state automatically enters as part of the efficiency equation. The Greenwald-Stiglitz theorem demonstrates that whenever there is any incompleteness or any missing market, the state can use taxes to improve social welfare. And incompleteness, especially information-based incompleteness, is ubiquitous. Stiglitz even views it as the norm. With the persistent empirical broadsides and powerful imaging tools from Cognitive Science and from Evolutionary Biology, Economics can no longer ignore the reality that economic agents are possessed of many behavioral types rather than just one (*homo economicus*) and the optimizing axiom extends to the choice of types by agents to deploy for different socio-economic environments.

While chapter 2 is all about the China (PRC) poverty reduction miracle and the role of Deng Xiaoping, it is China in broad strokes; not a detailed exegesis of the China Miracle. China (PRC) is especially interesting because it went through, as it were, a natural experiment in transitioning from the Mao Zedong era (1949–1976) to the Deng Xiaoping era (1976–1989). The same people, the same underlying politics, but a markedly different set of economic policies in that transition produced a massively different outcome in terms of inclusion! Deng Xiaoping moved China from the stranglehold of Mao's Socialism to the embrace of structures we only recognize as genomic Capitalism: free enterprise, profit-seeking, market determination of many prices, foreign investment and, finally in 2004, private property. Deng recognized that the state was doing too many things that other spheres of provision, e.g., the market, could do better and he gave those spheres space. To do these, Deng force-marched the Chinese state into a strategic retreat from domains that other spheres could do better.

True, China still held on to many state corporations such as in banking, railroads, steel, oil, etc., echoing, if not modeled after, the 'commanding heights'

Capitalism of the post-World War II Western Europe. Its catch-up strategy to complement greater space for the market was an infrastructure build-up not before seen in history, through a meteorically high and sustained investment rate and a mercantilist posture in its currency. This was meant to attract foreign investment and to sidestep the initially demand-challenged domestic market. This does not mean that Mao did nothing; but the reforms of Mao (such as strong usufruct right for farmers and township decentralization) failed to deliver people out of poverty. What may have mattered most as precursor to the subsequent Dengist revolution is Mao's delivery of what we call a 'restricted preference' polity in PRC: the scarcification in the Chinese populace of preferences that are likely to oppose the authority of the Communist party. This made decision making easier for the central authority. This may have seeded a coherent polity which made the state strong.

We follow up further on the lesson from Deng Xiaoping—recognizing spheres of provision other than the state and operating within one's domain of competence. The domain of competence of a sphere is that subset of activities or services that the sphere can provide at less cost than other spheres. We state the Efficient Assignment Rule thus: an activity or service x is efficiently assigned when it is supplied or delivered by a sphere of provision to whose domain of competence includes x. If the market can provide the good or service at the lowest cost for the same quality, the market must provide it. It does not mean the state quits the market altogether; it should provide regulation and/or competition enhancement where there is danger of abuse of market power. Weak states tend to overreach—to operate beyond its domain of competence. We discuss as one factor for overreach Hayek's 'fatal conceit'—the idea that state actors are unable to recognize the limits of their powers and feel especially compelled to intervene in organizations that evolved and emerged over time via the interaction of people (such being 'language' and 'the market') and were not explicitly engineered by man. Hayek characterized this tendency as 'fatal' because the outcome can be deadly if slow burning.

In chapter 3 we ask whether Deng's China is a template for low-income countries aspiring to hop on to the rapid growth investment-led trajectory traversed by the Asian economic miracles. Here we need to stop and pause. That China (PRC) is a hard act to follow is an understatement. The reason is that Deng's China had a strong state, strong institutions and a coherent polity.

Few LDC states are possessed of such vast room to maneuver. The Long March and the triumph of the revolution in 1949 gave the communist state and party enormous political capital. Furthermore, Mao had effectively ideologically cleansed China either by death in the millions as in the Great Leap Forward (the Tiananmen Square Massacre in 1988 was a reminder of that strategy), or by exile of actual and potential dissidents. The result was a Chinese Han polity with a 'restricted preference domain' (as opposed to Arrow's 'universal preference domain'). But political capital, however large at the start, rapidly erodes unless continuously justified by tangible improvements in the welfare of the polity. This was the lesson the now discredited Zimbabwean revolutionary leader Robert Mugabe never learned. This was what the pragmatic Deng sorely feared for China and the communist party. His moves were calculated to avert this grim Robert Mugabe outcome. Deng's was an instance of power deployed for the common good if for reasons of self-preservation.

Most third world countries do not have the luxury of a strong state at the helm nor have they the history that conduces towards a shared identity and vision. The 'imagined community' remains a constructible ideal. In the parlance of political science, they are still in the various stages of 'nation-building'—of forging a shared identity and a shared vision for the diverse groups constituting its polity. At its center is a tenuous political settlement emanative of unstable rules, unstable enforcement, the truck-and-barter of these rules and operational overreach (operating in domains that other spheres can do better). Note that we identify strong states with the quality of rules and enforcement rather than with a capacity to sow fear. Trust in the central authority among weak state polities is a very scarce resource and for good reason.

Buried under these drawbacks or perhaps foremost among them, weak states exhibit a particular defect—feeble capacity for collective action. Since public goods are quintessentially collective action problems, the common feature among these states is poverty of public goods. Public goods are of two kinds: soft infrastructure in the form of 'rules of the game' and hard infrastructure such as the Three Gorges Dam and low power cost. Hard infrastructure alone without the proper rules of the game will fall short. If provided adequately together, they will lower the cost of doing business and spur investment. If not, economic stagnation and abject poverty lurk nearby. A closely related salient feature of weak states is its inability to reject the importunings for special privileges and transfers by vested and tribal interests. Thus, most weak states indulge in an orgiastic overreach—doing far too many

things outside of its core competence with tragic consequences for fiscal integrity and sustainability.

In chapter 4 we double down on the problem of collective action, as well as why and how institutions matter. The role of weak institutions, many times glossed over, is made explicit when connected to the pursuit of solutions to collective action problems. A collective action problem is explicitly modeled as a social dilemma game, the Fishing Game, where the pursuit of individual advantage by the players results in inferior social outcomes. There are two social environments of interest: a coherent society and an incoherent society. In a coherent society, members are each driven to put the collective interest ahead of the personal interests. In this society, the dilemma in the Fishing Game does not arise. Extreme examples of this are the social insects, where coherence is enforced by pheromones working on extremely restricted preference. Ants and bees are genetically wired to align behavior with the collective interest. Coherent societies always attain the first-best outcomes in collective action problems.

Where agents have a choice between personal and collective interest, alignment with the collective interest must be induced. Inducement is effected via 'institutions'—firstly, by an internally evolved system of governance as in the Ostrom communities (relatively small communities that manage to avoid the *tragedy of the commons* through rules enforced by the stakeholders themselves and what D. North calls *second party enforcement*) can engender and sustain this coherence through 'norms'; alternatively, the collective can enlist a third party, an outside factor, that issues 'statutes' that enforce alignment with the collective interest. The famous Japanese movie *The Seven Samurai* comes to mind. An isolated community—defenseless and victimized by brigands—raises funds and enlists a group of *samurai* to rid it of the scourge. The norm or statute consists of rules, associated penalties, quality of enforcement on the part of governance authority, and the resource contribution of stakeholders. Both norm and statute attempt to align behavior towards the common good, and if successful, solve the collective action problem. But the norm or statute may be misguided or weak, that is, either it redirects behavior to wrong ends or does not change member behavior at all. The relation between institutions and the performance of collectives and societies is thus rendered explicit and formal.

In chapter 5, we relate the weak state's capacity for collective action with its incapacity to give credible commitments. The difficulty for the weak state

is that public goods are collective action problems whose address requires a contract involving investment by stakeholders today in exchange for future returns; and stakeholders may want their pie today, not in uncertain tomorrow (see, e.g., Fabella, 2013). If the state is to coordinate this contract of forgone present consumption for expanded future consumption, the state must be able to make credible commitments about its own behavior. In the phraseology made salient by Acemoglu and Robinson (2012), it must assure stakeholders that it can 'enforce contracts' and 'protect the property rights'. Governments buffeted by demands from constituencies may find it difficult to abide by the contracts it has entered into. Poverty of public goods is rooted in the incapacity of the state to make commitments credible enough for its publics.

Not everything is lost. Fortuitous alignment of events sometimes brings to power some well-meaning leadership. The chance configuration usually brings with it a conferment of considerable political capital. The sitting executive will be hamstrung at the outset by a poor reputation not of its own making. It is not enough that it be honest. It must begin to change the facts on the ground that will undermine the entrenched nexus of alliances that tie its hands. If so, what are its options? The new dispensation so hampered may overcome by offering credible commitment devices still within its power to dispense as the chief executive. We saw this when water service was privatized under President Fidel V. Ramos. His presidency, empowered by his conquest of the crippling 'power crisis', sent credible signals of departure from 'business as usual', such as de-hiring state water agency employees and raising the tariff. Furthermore, through the implicit concession in the contract that disputes will be subject to international oversight, it was able to attract private business to come to the party.

Weak institutions and the poverty of public goods exact long-term toll on the economy. In chapter 6, we focus on a long-term economic malady called Development Progeria—a phenomenon in low-income countries where the share of the Non-traded goods sector (Services) in GDP surges forward at the expense of share of the Traded goods sector (e.g., Manufacturing). This share dynamics is normal for high-income mature economies but is an anomaly for low-income countries. Development progeriacs exhibit slow growth, low investment rate and slow poverty reduction. The cross-country evidence is that poverty incidence associates significantly and positively with higher share of Services, but negatively and significantly with higher share of the Manufacturing sector. While the cross-country evidence offered here does not

necessarily mean the relationship holds for the Philippines, the suggestion is strong that it does. We illustrate this with the comparative trajectories of Manufacturing growth and poverty reduction in China (PRC), Vietnam and the Philippines. We argue that development progeria becomes engendered by market and institutional imperfections (the Rodrik Hypothesis) and by the unwarranted strength of the domestic currency.

In chapter 7, we explore the correlates of investment in an effort to decompress investment in low-income economies. We show evidence that the investment rate in low-income countries co-varies positively and significantly with the share in GDP of Manufacturing, but negatively and significantly with the share of Services in GDP. Good governance and an outward-biased exchange rate in combination with strong governance correlate positively and significantly with the investment rate.

Part II begins with chapter 8 where we turn our attention to the phenomenon of conglomerates and the positive role that they can play in low-income countries with weak capacity for collective action. We first note that there is a natural vent for size in Capitalist economies which is fostered by competition and Darwinian selection. Size in many markets is, as in the animal kingdom, a trait that is selected for survival. In Biology, this vent for size goes by the name Cope's rule: the tendency among vertebrates to acquire size over time. Large business groups stand a better chance of weathering volatility and changing fortunes; they have the financial wherewithal to internally bankroll new projects rather than rely on imperfect capital markets; they can afford the adoption of emerging technologies or engender new ones. The survival value of size is even more pronounced in low-income countries where institutions are weak and legal and/or extra-legal predation may be endemic.

In weak institutions environments, business groups are forced to vertically integrate into what O. Williamson calls *private ordering* to deter state and non-state predation and secure property rights. While simple vertical integration into the upstream activities was the original target for Williamson's private ordering, it can easily be extended to the imperative for security that is severely underprovided. In the Philippines, the 'blue guard' industry developed because people and businesses feel they need protection in addition to that provided by the state. And for good reason: the Philippine National Police (PNP) sometimes spawns criminal syndicates (the so-called *bantay-salakay*). Large businesses can acquire self-protection either by proprietary enforcement muscle or by co-opting public enforcement to protect their assets; this can come by

capturing *or influencing* centers of political or statal decision making. While the popular perception of private ordering is derogatory—usually associated with 'private armies' used to terrorize innocent people and 'rent seeking'—in certain underdeveloped jurisdictions, it may be the only way to get market exchange started and sustained. There is no question that private ordering capacity, once acquired, can itself be deployed for predation on others in society; such risk must be weighed against no-exchange at all. Thus, weak institutions reinforce the already considerable efficiency-rooted vent for size.

In the Philippines, business size expresses itself as horizontal conglomeracy—large business groups being present in many markets at once. This is because markets in the Philippines are small and, in order to grow, businesses must enter those not traditionally associated with them; in turn, they must suffer their own original niche to be invaded by others. This inter-conglomerate competition is what we call 'conglopolistic competition'. Conglopolistic competition reduces market power of incumbents and raise consumer welfare in those markets. Horizontal conglomerates in the Philippines are mostly in Non-traded goods sector, a legacy of the same historical factors that drove development progeria, which is how these two phenomena are related. Note, however, that while these conglomerates are large relative to the domestic rivals, they are mostly small when compared to global counterparts.

In a weak state, the capacity for collective action is diffused among many sub-national entities. It is not concentrated in the political center as in a strong state. Sub-national entities may have effective capacity for enforcement and rule-making in their limited jurisdictions. The Ampatuan clan was one such in Maguindanao politics; so is the Iglesia ni Kristo in the domain of religion. Conglomerates are such sub-national entities in the business and economic sphere. Conglomerates are repositories of substantial financial, organizational and human capital resources and have command over considerable capacity for collective action in the pursuit of profit and market share. If properly enlisted and rechanneled, they could boost the weak state's capacity for collective action, especially in public goods provision. We illustrate this by examples such as the privatization of water distribution services in Metro Manila, TPLEX, NAIAX and the soon-to-be completed Connector Road projects and the Clark International Air Terminal.

The privatization of the operation and management of water services in Metro Manila in 1997, the signal achievement of the Ramos administration, could not have come about without the enlistment and participation of

domestic conglomerates (see chapter 9). We are seeing this unfold in TPLEX and NAIAX, both delivered under Public-Private Partnership (PPP) by San Miguel Corporation. The Connector Road Projects also under PPP will soon greatly ease traffic in Metro Manila and, together with CALAX, will reduce logistics cost in Luzon. The case of CALAX shows how the public may gain from conglopolistic competition in infrastructure development. These landmark achievements re-channeled conglomerate capacity towards solving collective action problems. Nobody claims that PPP can solve every public works failure. The Philippines is on the right track with its deployment.

In chapter 10 we ask how we can overcome the relative stagnation of the past forty years. Most low-income countries are mired in 'overreach'—doing so much more than their competence warrants; concealing failed programs under even more ambitious programs. Learning from Deng Xiaoping, they should embrace 'strategic retreat': this means moving from ownership and operation to regulation and safeguard of market completion. Strategic retreat does not mean complete non-presence by the state. Note that the Philippines has already successfully navigated this route partway: in water distribution, petroleum products and power. Stepping back from ownership and operation towards regulation and safeguard of competition was not easy and took political courage. More can be done. Government can, for example, deregulate property rights in land in Philippine agriculture by lifting the land ownership limit. The privatization of the endless government headache, the Metro Rail Transit or MRT, should be prioritized.

To break out of development progeria, we should embrace, rather than fear, a weaker peso. We should encourage local firms and conglomerates to enter the slipstream of large global players in the Traded goods sectors, a tack which we call 'slipstream industrialization'. Together with that is the lifting of constitutional limits on foreign ownership. The presumption that stewardship of national patrimony by locals is superior to its stewardship by foreigners is grossly overrated. The upgrade of our public goods by BUILDx3 and so the proper and responsible use of TRAIN revenues is encouraged. Foreign borrowing is never a sustainable strategy for an investment-led growth of decadal durations.

Now for the warp and weft of the sweeping tapestry.

PART I
Capitalism and Inclusion

1

Inclusion and the Role of the State in Orthodox Economics and Beyond

Piketty and the Role of the State

THOMAS PIKETTY'S celebrated *Capital in the 21st Century* (2013) demonstrated with as much panache as is possible in the social sciences that income inequality in mature Capitalist economies grows without limit in normal times as income rises. The share in income and wealth of the top 1% of the population grows indefinitely. This flies in the face of the canonical wisdom we owe to Simon Kuznets (1955), the Inverted U Hypothesis, which was no doubt one of the major anchors of the award of the Nobel Memorial Prize on his person. The Inverted U Hypothesis says that income inequality—couched in the terms of the Gini ratio—first rises, reaches a peak, and then starts to decline as per capita income rises (Figures 1.1a and 1.1b).

That Piketty dares to call this Kuznetsian canon a 'fairy tale' tells one that something monumental is in store. Such *chutzpah* is bound to attract intense curiosity and even more intense scrutiny. It is not a step taken for the uncertain. The interrogation has been withering. But thus far, the empirical evidence has stood the test of time. Piketty's own growth theoretic explanation of the phenomenon cryptically succinctly expressed as $r > g$ (r being the interest rate that capital commands, while g is the growth rate of the economy) is, however, still and will continue to be hotly disputed. Whatever the explanation or explanations, Piketty foresees a grim future for Capitalism and democracy if such a state of affairs is left unchecked.

There are, though, some very salient differences between Piketty and Marx and Engels. Piketty's grim forecast was based on ever increasing income inequality; Marx and Engels dwelt on absolute and abject poverty. The bridge between abject poverty and revolution requires little elaboration. Peasant revolts in the past followed episodes of extreme deprivation. Piketty is not clear on how increasing inequality by itself will bring about the collapse of Capitalism and democracy. Increasing inequality is ethically distasteful, but all boats large and small can conceivably rise even with an unequally rising tide. He leaves it to our imagination.

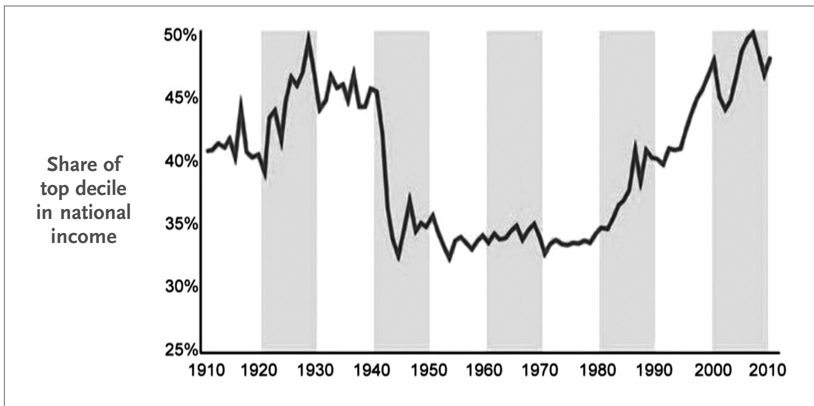

Figure 1.1a
Income Inequality in the United States, 1910-2010.

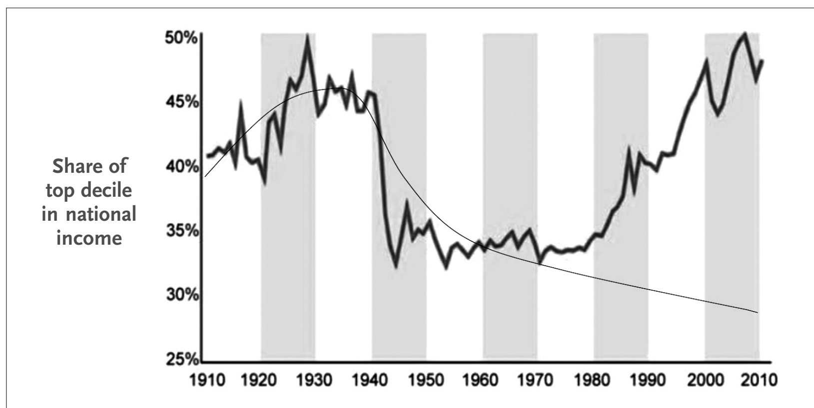

Figure 1.1b
Income Inequality in the United States, 1910-2010,
with notional Kuznets *Inverted U Hypothesis* (gray line).

There is another massive implication. Piketty was adamant in his claim that this is not due to some garden variety market failure. This was happening in well-behaved mature market economies which latecomers in the development game consider aspirational models. Rather it suggests that at the heart of mature well-behaved market economies exists another failure, a *meta-market failure*, which emerges when the Pareto efficient distribution of goods and services delivered by the well-behaved market departs from the distribution favored by the norms of society. Piketty has revived an old and venerable conundrum at the heart of Neo-Classical Economics—it is possible that Pareto efficiency attained by voluntary contracting locates at junctures that violate extant social norms of fairness and equity. One thus needs to actively square market efficiency with equity. Benign neglect will not do.

A. Smith, it appears, never imagined that the Invisible Hand would create a problem that would require a Visible Hand to cure—meta-market failure in the form of a crisis of inclusion. Piketty's suggested rampart against Armageddon, additional wealth and income taxation, was a battleground in the 1970s between the Neo-conservatives inspired by R. Nozick (1973) who viewed income and wealth taxes as theft and a violation of sacrosanct individual rights, and the utilitarian liberals inspired by, among others, J. Rawls, who demonstrated the idea that behind the 'veil of ignorance', risk-averse citizens would voluntarily enshrine equitable distribution as an ethical imperative. With the Thatcher and Reagan Revolutions in the 1980s leaning explicitly towards the Nozickian worldview of freeing 'the animal spirits' of Capitalism, income inequality started to rise. The timing of the post-1970 income inequality trajectory estimated by Piketty seems to suggest as much.

The Marxist Critique and the Lange-Lerner Paradigm

The Piketty conundrum was already posed by Marxists against the emerging orthodox economics in the 1930s and into the 1950s. Even if a Pareto efficient allocation will be attained by the hardly convincing assumption of no-market failure (as, for example, in the First Fundamental Theorem of Welfare), it may still violate the norm of equity. They argued that free enterprise is condemned to wallow in the meta-market failure trap and the only way around it is Socialism, that is, central planning and the

state ownership of all forces of production; in other words, the rejection of the free enterprise system. The state, granting gratuitously that it is benign and always pursues the common good, will ensure, guided by a central plan, that the distribution of goods and services will be efficient while at once in accord with the norms of fairness and justice. The most titillating rendition of that fairness and justice was Marxist and Communist: "From each according to his capacity, to each according to his need."

The role of the state in inclusion brings us back to *The Communist Manifesto* of Karl Marx and Friedrich Engels (1848) and *Das Kapital* of Karl Marx (1867). Marx and Engels also predicted the eventual and inevitable collapse of Capitalism. Internal contradictions leading to progressive impoverishment of the masses and falling wages allow no other conclusion. But the extant state being itself a tool of capitalist exploitation cannot be part of the solution. The answer was instead a class war where the masses—who have nothing to lose but their chains—seize state power and impose the 'dictatorship of the proletariat'. The new dispensation will then enforce equity and heretofore ride the attained technological efficiency to worker's Nirvana. This beguiling logic was bought by many peoples and movements. That it did not happen quite the way they saw it is now a fact. Nonetheless, the history of the twentieth century cannot be adequately told without reference to these two thinkers and these two works. Piketty, by contrast, recommends explicit state intervention—such as more aggressive income and wealth taxation—to push back on inequality Armageddon. Unlike Marx's, Piketty's view of the state is Lockean—the state is a commonwealth constituted by a social contract among free individuals to pursue the common good that individually cannot be attained. While wisdom is not always the state's virtue, the state can be a force for the good.

Some economists in the 1930s and 1940s, Oskar Lange (1936) and Abba Lerner (1944) and collaborators, argued compellingly that central planning with state ownership of capital using mathematical programming (really a trial-and-error process along the lines of Vilfredo Pareto and Leon Walras) can replicate everything that a decentralized market economy can generate, particularly Pareto efficient outcomes, and then some—it can avoid the meta-market failure dreaded by the socialists (Hodgson, 1998; Bator, 1958).

The Lange-Lerner theory was parlayed to respond to Friedrich Hayek's and Friedrich Von Mises's withering criticisms during the Socialist

Calculation Debate of central planning as infeasible on the grounds that the central authority will never have the access to the information decentrally dispersed among economic agents to make the requisite calculation for efficiency given by the condition: *Price = Marginal Cost*. Economic agents will not reveal their true preference unless there are incentives to do so. Such a problem spawned the modern discipline called Mechanism Design with a view towards incentivizing truthful revelation of preferences. (The latter earned Leonid Hurwicz, Eric Maskin and Roger Myerson the 2007 Nobel Memorial Prize in Economics Science.) Though rooted in the socialist calculation debate, Mechanism Design has transcended its origins. Meanwhile, the Lange-Lerner vs. Hayek-Von Mises controversy was never quite resolved. Neither was the Lange-Lerner model ever implemented in any real economy. The Lange-Lerner model—or 'market socialism' as it was then also called—never passed muster among praxis socialists who thought that market socialism, which was free enterprise minus only the capital market, was playing footsie with Capitalism. Ranged against ideological purists, it never had a chance at application. Strangely, when an affine and more market-friendly system was finally adopted in China (PRC), it became a world-beater.

The Neo-Classical Empire Strikes Back

In the 1950s, Neo-Classical economics found a comfortable sanctuary from the persistent efficiency vs. equity question in what came to be known as the Second Fundamental Theorem of Welfare (SFTW) in the general equilibrium framework of Arrow-Debreu. It states that every feasible Pareto efficient allocation can be reached as a market allocation following a proper redistribution of initial assets. Provided that the very strong assumptions among which were *homo economicus* and no-market failure assumption held. Provided, further, that the redistribution using preferably lump-sum taxes leaves preferences intact. Though the invariance of preferences under redistribution condition will hardly ever be realized in reality and many objections to the effect surfaced, the elegant mathematics sold the result to and ensured its acceptance among the realism-agnostic and formalism-drunk economic crowd. This became a virtual rule in the discipline: elegant mathematics always trumped empirical regularity. What it provided was a

firewall, however artificial, between efficiency and equity theoretically (Blaug, 2007). Equity was the realm of Political Science and Philosophy; efficiency was the realm of Economics.

The liberal tradition that made equitable income distribution as a social desideratum and which should get the state behind it, got a boost in the 1971 with John Rawls's *A Theory of Justice* that became US graduate school required reading in subsequent decades. Rawls argued that if we let our better and risk-averse selves speak, we would vote for a more equitable distribution of income. Our better self is one stripped of our current interests, capacities, social standing and genetic inheritance; one, in other words, deciding behind the 'veil of ignorance'. This veil of ignorance process puts the norm of equity on a more beguiling conceptual footing. Rawls approved of government policies such as incomes policy to alleviate poverty and inequality. Although we do not know how it impacted Rawls, it is interesting that the contest between the efficiency-leaning Capitalist market economies and the equity-leaning Socialist bloc was at the same decade at its most virulent with the sides threatening Mutually Assured Destruction (MAD) on the other. Robert Nozick, one of the gurus of radical Libertarianism, published his magnum opus *Anarchy, State and Utopia* in 1973 as a response to J. Rawls. Nozick and followers opposed the expanded role of government, especially its tendency to extract resources through taxation from private individuals. This was also the time when the Kuznets's Inverted U hypothesis was still considered canonical and thus economic growth would, without direct state intervention, solve the income inequality problem. This was, however, a largely high-income country issue.

Another of the crucial assumptions in SFTW that exorcised the state from the pursuit of efficiency is that of 'complete markets'. Every good or service, extant or imagined, must have a market which determines price through supply and demand. For example, to each contingent good, different for every state of the world, corresponds a properly functioning market. Stripped of this improbable condition, the state re-emerges as a compelling player for efficiency as demonstrated by the Greenwald-Stiglitz Theorem (1986): the state can improve welfare by proper taxation. The nature of the state has to be addressed because 'missing markets' are everywhere.

As engaging as the inclusion debate in the affluent First World prompted by the Piketty's *magnum opus* is, it may distract us from the more basic

inclusion problem in third world economies. This involves poverty incidence and, thus, poverty reduction. While there are circumstances or policy thrusts where poverty reduction and more equitable income distribution are served at the same time, there may be many others where serving one may hamper the other. This conflict may be especially true of redistribution by *fiat*. Forbes (2000) and Banerjee and Duflo (2003) give evidence that shows that redistribution hurts income growth. And by so doing hurt poverty reduction. One where they were both served by the same set of policy thrusts was the export-oriented (thus tradable goods) labor-intensive industrialization policies of the Asian economic miracles in their catch-up periods in the second half of the twentieth century. But many times, emphasizing equitable income distribution may hamper poverty reduction.

In the next chapter, we leave behind the realm of theory to explore the ambit of reality in the form of the People's Republic of China where, as we observed, the greatest poverty reduction gain in history happened.

2

Deng Xiaoping vs. Mao Zedong: PRC as Natural Experiment

HOW POVERTY REDUCTION of a scale unparalleled in history was attained in PRC deserves much dwelling upon. Mao Zedong enshrined Socialism in PRC in 1949 after routing and driving into exile General Chiang Kai Shek and the Kuomintang. Mao's Socialism was genomic: central planning, state ownership of all forces of production, no free enterprise, no private property, and no profit seeking. It brooked no revision. One of its first economic programs in the 1950s was 'The Great Leap Forward' intended to propel PRC to first world status under the Socialist banner. Ideological purity encompasses both instruments and outcomes as encapsulated by the Mao saying, *"It doesn't matter that the train is late as long as it is socialist."*

Thus, for example, the Lysenko system of farm cultivation was imposed because it came from the Soviet Union rather than being science-based. The Soviet *kolkhoz (collective* farming) system was also aped. Sharing of the collective's output was egalitarian. It proved to be a great debacle: upwards of 30 million Chinese died in the process. Deng Xiaoping, sent by Mao to limit the damage of The Great Leap Forward, had an epiphany—the realization that the state was doing too many things that other spheres could do better. In particular, the state should not tell farmers what to plant, when to plant, when to harvest, who to sell to, and at what price!

Letting the farmers play the market was Deng's recommendation. And the farmers obliged, partly dissociating from the collective farms and trying their hand at business and risk-taking. With one drawback: business sense

and risk-taking were not for everyone; playing the market meant some farmers became huge gainers and enriched themselves, while others failed and grew poor. This was too anti-egalitarian for the keepers of the faith in Beijing and the Politburo. As a result, despite the tangible prosperity among the farmers, Deng was hounded as a 'capitalist roader', stripped of power and banished into exile. Had he not been a prominent cadre of the venerated Long March, his life would surely have been snuffed, as was the life of dissident Leon Trotsky. This was how orthodox Socialism dealt with dissent, experimentation and innovation. Fortunately for PRC and the world, Deng survived and took the helm after Mao's death in 1976. The Deng Xiaoping revolution had begun.

First, he launched the program called the 'Household Responsibility System' which followed through what he started in the wake of 'The Great Leap Forward'. Chinese farmers were once more allowed to play the market and again they obliged with alacrity and farmer incomes grew impressively. This highly successful farm program was then leveraged to extend the market to nonfarm sectors.

Dengist China turned its back on Maoist Socialism after a monumental struggle with followers of the Gang of Four; as part of his 'Socialism with Chinese Characteristics', it embraced free enterprise, foreign investment, profit-seeking, an export platform status and, in 2004, it reinstituted private property, scrapping the Marxist dogma that 'property is theft'. Lost to nobody was that these embraces were precisely the genome of Capitalism that Marx and Engels despised. PRC still owns a good deal of state corporations and state financial institutions and, thus, capital allocation is directly or indirectly controlled. Deng's Socialism with Chinese Characteristics thus seems affine to the 'market socialism' of the earlier Lange-Lerner theory; it echoes as well the 'Commanding Heights Economy' which characterized the British post-World War II economy (Yergin and Stanislaw, 1998).

Deng's departures really sprang from two major heresies: one, that Socialism is about outcomes and not about instruments encapsulated in the most famous of Dengist sayings: *"It doesn't matter what color the cat as long as it catches the mouse"*; and two, that there exist spheres of provision besides the state which can outdo the state in efficiency in certain domains. One such sphere is the market where individual industry and risk-taking are rewarded. Was Deng thinking of poverty reduction as an end in itself? Was

it compassion? Most likely, no. More likely he was thinking 'survival' as did Machiavelli in *The Prince*:

> A ruler must also show that he admires achievement in others, giving work to men of ability and rewarding people who excel in this or that craft. What's more, he should reassure his subjects that they can go calmly about their business as merchants or farmers, or whatever other trade they practice, without worrying that if they increase their wealth they'll be in danger of having it taken away from them, or that if they start up a business they'll be punitively taxed. On the contrary, a ruler should offer incentives to people who want to do this kind of thing and to whoever plans to bring prosperity to his city or state.
>
> - Niccolo Machiavelli in *The Prince*, Chapter 21

This is the often overlooked message of *The Prince.* A state wallowing in poverty, as was Mao's China, has no wherewithal with which to defend its sovereignty. And the survival of the state was the overarching good for which "the end justifies the means." This early, Machiavelli recognized that good governance, credible rules, and letting citizens be their best are the roots of survival and prosperity. Deng was not outdone in wisdom.

The other chapters of the Deng program are well known and consistent. To nudge the market and investors to even greater heights, public infrastructure must be upgraded to equal—or exceed—world standards; and to do that meant an investment rate that saw no parallel in history—45% to 50% of GDP for decades. Evidence of this infrastructure building frenzy in the Deng era are the numerous breathtaking infrastructure wonders of the world—the Three Gorges Dam, the Lhasa-Beijing Railroad, the Hongkong-Zhuhai-Macao bridge, the longest high speed train system in the world, the 10,000 kilometers of railroad each year—and the list goes on. The Three Gorges Dam, with its 400-mile long reservoir, was, in particular, described by the dam construction's photographic chronicler, Clark Everett in 2007 as "…to Western eyes, is almost inconceivable change." 'Western eyes' spectacled by affluence and the diversity of visions and values that it affords, cannot conceive of how one nation can, in peacetime,

mobilize to tackle such massive collective challenge. The Three Gorges Dam promise became fully functional reality in July 2012. Yet another reason why future projects of PRC will have the support of its people.

Figure 2.1 shows the comparative investment rates of Asian countries from 2010 to 2015. Note that as late as the last five years, the investment rate (GDCF/GDP) of China (PRC) was as high as 45%. The investment rates among Asian countries were between 25–35% of GDP. The Philippines was a clear cellar dweller at around 20% of GDP. This is what we call *investment compression*. It was only since 2014 that the investment rate in the Philippines started to inch upwards to 24%. The economic cluster of the Duterte administration has rightly decided to raise government capital outlay to 8% by 2022 which would boost the investment rate to 25–28% of GDP.

Source: Fabella (2017b)[2]

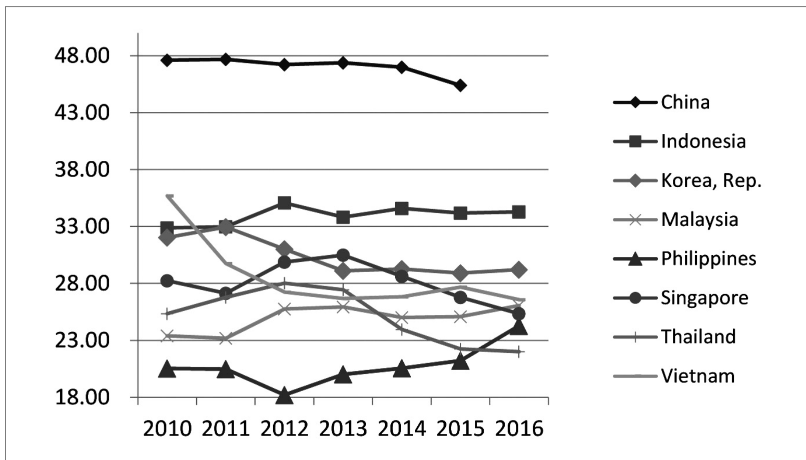

FIGURE 2.1
Comparative investment rates of Asian countries from 2010 to 2015

PRC's investment rate was not only meteorically high, it was also sustained. The latter is even more compelling than the former. How did it manage to be investment-led for 30 straight years? To sustain such high-octane investment-led growth, an economy must turn to the world for

[2] "Who's afraid of a weak peso?" *BusinessWorld*, 25 September 2017. http://bworldonline.com/whos-afraid-weak-peso/

markets. If it produces only for the domestic market, it quickly runs into production gluts—what the classical thinkers (Heckscher, 1935; see also chapter 21 of J.M. Keynes's (1936) *General Theory of Employment, Interest and Money*) already knew well as 'under-consumption theory'. The resulting economic busts quickly put finis to high investment rates. This was clear even in the post-Civil War high growth era of the United States called the Gilded Age (1870–1900). Rapid growth led first by railroads and then steel and oil was punctuated by depressions—first in the Panic of 1873, the Panic of 1883, and the Panic of 1893—which caused much dislocations and forced a pause in the economic activity. The USA then was largely inward-looking. The boom-bust cycle very prominent in inward-looking economies was thus avoided by PRC, as well indeed by the Asian economic miracles. In other words, Deng's PRC became export-oriented by the internal economic logic of an investment-led trajectory. His fascination with the East Asian Miracle economies (Singapore was a favorite) taught him some object lessons.

Two other policy innovations rounded up and ensured the sustainability of this program: the export processing zones to host export platform foreign investment and an aggressively weak *yuan* starting in 1994. The latter was vigorously opposed by developed trade partners, but which PRC repeatedly rebuffed showing an uncommon mettle. These policies made PRC 'the workshop to the world'. And the rest is history.

Lessons from Deng Xiaoping: Taming Overreach

The genius and heresy of Deng Xiaoping was in recognizing that there are spheres of provision other than the state and that these can do better than the state in many domains; that the state, however strong, may be *overreaching*, that is, operating beyond its domain of competence. His statesmanship consisted in forcing the state to a strategic retreat from those domains that other spheres can do better. In many low-income countries, the status quo is state overreach many times massive—the state unable to refuse the demand of vested interests for sources of rent does too many things and badly. China's overreach under Mao, however, was not due to the same incapacity of the weak center, but due to the Socialist dogma of state ownership of forces of production.

Consider the economy as an exhaustive collection of activities each producing a good or service. Each activity is assigned to one of three spheres of provision: the State, the Market, and Hybrid (PPP). Each sphere has a respective domain of competence: the subset of goods and services that it can produce at less cost than all other spheres for the same quality. We define the *Efficient Assignment Rule* (EAR) as the situation where every sphere provides goods or services included in its domain of competence.

Thus, a good or service is efficiently assigned if it is in the domain of competence of the sphere providing it. Efficient assignment means zero opportunity cost, at least in the dimension of provision. Overreach means that a sphere provides goods or services that other spheres could provide at a lower cost for the same quality.

Staying within one's domain of competence is not easy. Retreating back to proper confines once exceeded is even harder. Nobel Memorial Prize winner Friedrich Hayek (1988) called the inability of state actors to recognize their own limits to improve on markets a 'fatal conceit'. With political victory comes a sense of invulnerability. Reinforcing this is the political asymmetry in the pressure to act—the pressure on politicians to act or to appear to act is overwhelming; when the programs and projects fail, the sponsoring politician can always find some *force majeure*, such as the weather or dolts in the implementation bureaucracy, to blame. The most common fallback excuse is 'lack of funds' and the insider-favored remedy is 'higher budget allocation'. Or wherever there is term limit, the problem anyway is passed on as burden to the incoming administration. Inaction, on the other hand, spells political death.

Governments, however well-meaning, many times embrace even sensible ideas only to despoil them with over-ambition. Government honchos, following logics other than that of economic efficiency, tend to go for too big a bite. Massive social asphyxia follows mindless overreach. Surely, most markets are imperfect but perfecting them calls most times for 'nudges', not for lobotomy. Nudges may come in the form of regulations and the safeguard of competition.

The domain of competence of a sphere is not fixed; it can change with technological advances, with education, and even with better motivation due to better pay. Power companies used to be state-owned and integrated, but the improved capacity of the state to regulate monopolies and enforce long-

term contracts allowed the power sector to be unbundled and power to be efficiently provided by private firms. This is not to say that unbundled power sector is always better. But under weak institutions where government corporations are used as gravy trains, it may indeed prove a productive shift to a nudge regime.

The domain of competence of the state can shrink when the state loses competence, as when the state adds more and more activities to its already overfull agenda, thus resulting in inadequate budgets, low paid manpower, and a drop in the focus of decision makers. The weaker the state the smaller is its domain of competence, as observed above. The fact that government-owned railway companies are efficiently run in Berlin does not mean that railway companies should be state-owned in Djibouti or Manila. As we will see in chapter 6 below, the lack of competence of the state makes for failed interventions or state failures. The marked superiority in the service of privately run LRT over that of the state-owned MRT in Metro Manila serves as evidence that the Philippine state's domain of competence does not at the moment include train service provision.

Though Deng's China had lessons to teach, other countries may fail to learn. There may be hurdles to that learning or, armed with the learning, they may fail to follow through. What is the most significant obstacle to following in China's footsteps? We deal with this in the next chapter.

3

Low-Income Countries and Collective Action

DOES Deng's PRC provide the template for other low-income countries to follow? There are valuable lessons to learn, notably, (1) the recognition by Deng that there are other spheres of provision aside from the state, namely, the market, that can do better in some activities, and (2) the retreat of the state to core competence that Deng engineered. The emphasis on public infrastructure and outward orientation to sustain the investment-led growth, at least during the take-off stage of development, are valuable lessons.

But one must remember that Deng's PRC was *a strong state* with strong institutions and a coherent polity. Its overreach was ideological rather than political. Whether one likes it or not, Mao's legacy to Deng was a coherent polity bound together by a strong sense of identity and mission. The Chinese state was strongly supported by a fairly coherent polity enabled by a process which may be called preference restriction—where actual and potential opponents of the regime subscribing to alternative worldviews were exiled either to foreign shores or to the afterlife. China went through the era of ideological cleansing. The Arrow Impossibility Theorem, which we owe to Kenneth Arrow, states that satisfying a group of seemingly innocuous liberal axioms, first among them being *universal domain*, rendered rational social decision making impossible. Universal domain in turn meant that members of the polity are allowed to choose any and every well-behaved preference ordering. In short, the Arrow Impossibility Theorem states what is quite obvious: social decision making is harder the more varied the preferences that have to be given voice to. For example, the USA cannot seem to upgrade

its aging infrastructure because advocates of spending for an infrastructure upgrade cannot strike a deal with supporters of smaller government and deficits. The restriction of preference thus makes it so much easier to formulate rules and implement policies. The construction of the massive Three Gorges Dam entailed relocating 13 cities, 140 towns and 1.3 million people to complete, yet went smoothly and on time. "Incomprehensible" to Western eyes. With a capacity of 22.5 gigawatts of power, it can supply the whole power needs of the Philippines twice over. Many Westerners wondered why there was not more social unrest and rancor among those negatively impacted. They interpret widespread assent with the project as elicited by fear. "This could never have happened in the West," was the shared conclusion by Western observers. One possibility that Westerners can never come to terms with is that the Chinese polity may have had more trust and identity with the leadership in Beijing than is conceivable in the West. Beijing had delivered on promises in the past and that is sufficient to elicit assent. And from all indications, the leadership in the case of The Three Gorges Dam has once more fulfilled its part in the *quid pro quo*. This is quite a contrast with governance in many low-income countries where a simple bridge construction takes eons to plan and construct, if at all, and often what is finally delivered is only half a bridge.

State Capacity and Market Failures

Straying from its domain of competence is many times rooted in familiar triggers for intervention by the state, viz., *market failures*. We subscribe to the belief that this frequently adduced reason for state intervention should be redefined to account for the capacity of the state for crafting and implementing the intervention. Better it is to re-label the technical market failure as *proto-failure.* A proto-failure, like the orthodox market failure concept, is an engineering concept that is invariant to changes in time and space (see, Fabella and Fabella, 2016). A proto-failure is a failure whether one is in Berlin or in Djibouti.

The label *market failure* should refer to those proto-failures that the extant state can actually improve upon. Thus a market failure depending as it does on state capacity can vary across time and place. A market failure in Berlin may not be a market failure in Djibouti if Berlin has the capacity

to improve on the market failure while Djibouti has not. Proto-failures that the extant state *cannot* improve upon should be called the Williamson proto-failures (O. Williamson, 2010). Society is better off if forbearance with the Williamson proto-failures becomes the state's attitude. A Williamson proto-failure in Djibouti today may become a market failure a decade hence when technology has improved the capacity of the Djibouti government. Clearly, the lack of clarity between these two failures reinforces the already marked penchant for intervention among government bureaucrats. The question that should continually be asked of overzealous politicians and bureaucrats is, "Will your proposed intervention really improve on the status quo given the weak capacity of institutions?"

Most low-income countries are presided over by a *weak state*. The features of weak states are well known: unstable and inconsistent rules and enforcement, the truck-and-barter of rules by unscrupulous bureaucrats, the capture of state junctures of decision by private interests for private gain, and extension of the state to domains and activities where it has no comparative advantage. Most pronounced among the weak state's frailties is the inability to forge a coherent polity poised to solve collective action problems. The latter is very salient because adequate public goods require coherence among the polity to act as one. Since the provision of public goods requires a modicum of social coherence, the poverty of public goods is the usual flip side of social incoherence.

The poverty of public goods is the first spectacle greeting every visitor and *balikbayan* to the Philippines transiting in Singapore or Hong Kong and deplaning in NAIA Metro Manila. NAIA Terminal 1 is a relic from the dark ages and belongs in a museum. Until very recently, its toilets and transport amenities with its masses of hangers-on were, to put it mildly, a nightmare to navigate. NAIA Terminal 3 is better appointed, but for more than a decade after its turnover in 2002, it was idly gathering dust and decaying, its use blocked by a legal Gordian knot which the Philippine state was unable to undo. Congestion and poor air control equipment meant a 30-minute to one-hour delay for incoming or outgoing planes, hiking up fuel prices which air travelers ultimately defray, and courting air disaster over Metro Manila. And you can feel the cost of doing business in the country rising.

When you had finally cleared the Customs maze to leave the NAIA premises you faced a creaky, grid-prone road system that could take many

hours of your life to negotiate and shatter your equanimity. The new NAIAX eases this somewhat, but the nightmare is postponed only a few minutes. The legal gridlock that stood in the way of NAIA Terminal 3's early use is repeated in every sphere of public goods provision. Truly, when viewed from its public goods endowment, the Philippines is *prima facie* evidence of the ravages of weak collective action capacity. The relation of weak capacity for collective action and the poverty of public goods is our next concern.

Dampeners of Internal Conflict

In the past, political jurisdictions that had weak institutions were simply swallowed up by jurisdictions with stronger institutions. There was always an *imminent threat* of invasion from the outside when a state looked weak. This imminent threat galvanized internal coherence. That was the landscape when Niccolo Machiavelli wrote *The Prince*, where the strong monarch was equated with a strong state. But as we observed above, Machiavelli also instinctively knew that a strong state has to be well-endowed, one that has the wherewithal to resist encroachments by hostile neighbors. To survive, the aspiring state, the entity still having to establish its credentials as it were among the league of states, must grow up quickly; it should attain social coherence by suppressing internal conflicts and manage the rest through economic prosperity so that it can present a more formidable rampart against invaders. This is how the various peoples of Europe solidified into separate nation-states. Each gave neighbors the impression that the cost of territorial encroachment to intruders would be very high due to either or both internal coherence and the nascent state's alliances with other states. It is as if it is proclaiming to the rest: "Mess with me and it will cost you." The plot echoes the storyline from evolutionary biology, specifically *multi-level selection* of Wilson and Sober (1994)—inter-group competition leads to norms and laws that dampen intra-group competition, thus, engendering greater fitness at the group level; this, in turn, redounds to added fitness for members of the group.

Imminent threat is no doubt part of the story of South Korea, Taiwan and Singapore, the triad of East Asian success stories. South Korea experienced the Korean War and, with only a 'truce' between the warring parties more than half a century after, remains virtually at war with its neighbor

North Korea. We hope for better times in the post-2018 Winter Olympics era and the subsequent cordial and historic Moon-Kim meeting in the DMZ. But the virtual state of war over half a century left no room for errors for South Korea. It was shape up or ship out. Taiwan had only the Taiwan Strait separating it from the hostile giant, the PRC, and the occasional cannonade between the armies in the 1950s and 1960s would cause blood pressure to fluctuate. Singapore has preached to its populace that its size will always pose a temptation for neighbors to encroach. No doubt, imminent threat has played a part in dampening non-conformist beliefs and tendencies. The resulting coherence has underpinned phenomenal economic success.

In the age of the post-World War II United Nations, occasional territorial grab—though decidedly rarer—still rears its head. A case in point seems to be strong China's (PRC) encroachment into the Scarborough Shoal and other maritime territories also claimed by weaker neighbors. Russia's grab of Crimea from Ukraine is another. The same logic motivates North Korea to fanatically—and to the exclusion of other social goals—acquire a nuclear arsenal: again, "Mess with me and I will bloody your nose." That North Korea also brutally suppresses internal dissent is inevitable. But unless genocide, the use of chemical weapons or ethnic cleansing is being perpetrated, the threat of armed intervention by the global community seems to have waned. Zimbabwe under Mugabe was heavily mismanaged to the immense suffering of Zimbabweans without the world and its neighbors raising a threatening finger.

Engendering social coherence can be effected through the restriction of preference among the populace. This is done either via ideological cleansing (and its more familiar and abhorred relative 'ethnic cleansing'), by 'fission' or by the Gulag strategy.

Both modern China and Vietnam had episodes of ideological cleansing in their histories, driving into exile those who would or could foment ideological discord. Cuba is another country that has this feature, having driven all actual or potential dissenters to Florida, USA. The remaining populace is more likely to be contented and would readily agree with the ruling ideology and party, making decision-making less contentious. Cuba is interesting in that if the current post-Fidel Castro leadership discovers and embraces Dengism, Cuba's future may, like Vietnam's, prove miraculous. The Rohingya Crisis in Myanmar is an attempt by the Myanmar Buddhist

majority to eliminate real or imagined internal conflicts coming from the Muslim minority. Ethnic cleansing in the wake of the collapse of Josef Broz Tito's Yugoslavia is of the genre. Though in our colonial past, episodes of ethnic cleansing were perpetrated especially against the Chinese (*sangleys* as they were derogatorily referred to), such cleansing seems remote and thankfully so in the Philippines of the twenty-first century.

Fission is another way towards a restricted preference outcome. The Union of Soviet Socialist Republics (USSR) splintered into many states now each marching to a different tune. The centrifugal tendency among these disparate tribes of the USSR was formerly suppressed by the deafening anthem of world and Soviet Socialism. The erstwhile 'Yugoslavia' fissured in a bloody fashion into the constituent tribes that were previously forced to coalesce under the iron-fisted Josef Broz Tito. Homogeneous if smaller populations result from such fission—Serbia is Orthodox Christian, Croatia is Catholic, Herzegovina is Islamic. 'Czechoslovakia' fissured into the Czech Republic and the Slovak Republic peacefully by mutual consent. Both experiments seem to have left separate polities now pursuing separate futures; Yugoslavia's offshoots were by contrast somewhat traumatized by the unleashed and hitherto latent inter-tribal barbarism. Belgium, Spain and Great Britain are in danger of following suit. Brexit or the exit of Great Britain from the European Union has been electorally decided and its form is being negotiated. This is partly because the real or imagined external threats to common survival that in the past pushed internal tribal differences below the surface have slowly folded their tents. Instead of the famous United States slogan, *E pluribus unum*, the direction in our time seems to be *Ex uno, plures (*Many from one).

The fission viewpoint argues that the Filipino race may be better served by making three or four states out of the one Philippine state (say, Luzon, Visayas, Christian Mindanao and Bangsamoro Republic) with three or four votes in the UN. Each can then pursue a different course of economic and political management and who knows may do better in time. Singapore separated from the Malaysia Federation and both did very well indeed. This is not to be scoffed at in the Philippines simply because the tendency is emotionally deep-rooted. The Muslim restiveness in Mindanao, let's face it, is aimed ultimately at independence, not coexistence. The Visayan-speaking Filipinos have long chafed under the yoke of Imperialist Manila and the

Tagalogs in the same way that the Catalans of Spain resent the hegemony of Madrid and the Castilians. The vote for Duterte by the largely Visayan-speaking South was partly to spite the largely Tagalog-dominated North. Duterte's continued popularity rides on this undercurrent of resentment.

Most familiar, the most often resorted to dampener of internal conflicts, is autocratic rule. Its fellow traveler is the police *state*. This strategy sends behavioral tendencies and beliefs that contest the primacy of the dominant ideology or threaten the integrity of the social fabric into exile. Those who cannot or refuse to keep alternative worldviews buried and out of sight are sent to reform and/or work camps known as gulags. Deng Xiaoping himself was forced into internal exile. North Korea's gulag prison camps, the most well-known modern example, follow the Stalinist model made famous by A. Solzhenitsyn's *The Gulag Archipelago*. At the extreme the exile of misfits is to the afterlife which has materialized as *extra-judicial killings (EJK)* in the Philippines. The temptation to capacitate the state through autocratic rule is the easiest to sell to the public and no doubt will continue to enjoy widespread vocal advocates.

In the absence of terror, violence, and imminent threats, finding dampeners of internal conflict, as it were organically, is a huge challenge. Competition in the twenty-first century has become less expressed in armed conflict and tends to be benignly waged in various social and economic world league tables. Even so, those without appreciable levels of social coherence will persist at the basement of these league tables.

Coherence is attained with the alignment of behavior of members. We deal with how alignment of behavior is attained in the next chapter.

4

Social Incoherence and the Poverty of Public Goods

THIS CHAPTER is intended primarily for students of formal social sciences, but curious bystanders are more than welcome to pick up a few ideas. To bring the relation between social coherence and public goods provision into sharper relief, we detour into the world of small number dilemma games which I seriously believe should become major equipment in every social scientist's toolkit. We aim to bring the discourse to a level that transcends simple storytelling and anecdotes. This methodological *tour de force* is useful for establishing the formal relationship between economic success (or failure) and quality of 'institutions' made explicit through norms and statutes. In this chapter, the reader will not be spared the rod, as it were. We start by studying a collective action problem called The Fishing Game.

The Fishing Game as Collective Action Problem

We present the Fishing game as an iconic collective action problem. Its payoff table is given in Table 4.1 below.

Table 4.1. The Fishing Game and Tragedy of the Commons: Cases

- Two fisher folk, Ambo (*A*) and Berto (*B*) fish in the same lake.
- Their strategies consist of either: Fish with Net (*N*) or Fish with Dynamite (*D*)
- *Case 1: A* and *B* are total strangers: cannot cooperate/ coordinate their actions
- *Case 2: A* and *B* are brothers in trustful terms

The payoff matrix of the Fishing game is in Table 4.2:

TABLE 4.2. Payoff Matrix of the Fishing Game: Invisible Hand

		Berto	
		N	*D*
Ambo	*N*	10, 10	2, 15
	D	15, 2	3, 3

Note 1: Those with some exposure to elementary Game Theory will recognize that the Fishing Game is of the Prisoner's Dilemma Game genre and may omit the immediately following discussion. It is also called a collective action problem or a social dilemma game because the pursuit of selfish interest by players leads to a bad outcome for the society.

The payoff pair (x, y) says that Ambo gets x (the left number) while Berto gets y (the right number). For example, the payoff pair (2, 15) means that Ambo gets 2 and Berto gets 15. The payoff pair (10, 10) results when Ambo plays strategy *N* and Berto plays strategy *N*—both fishermen behave (do the right thing); the payoff pair (2, 15) results when Ambo plays *N* (behaves) and Berto plays *D* (misbehaves). When both fishermen play *D* (misbehave), (3, 3) results and each gets 3.

CASE 1: Ambo and Berto are total strangers (*homo economicus* in textbook Economics)

Each will only look after his payoff regardless of the payoff for the whole group. Suppose that both fishermen play *D* (misbehave), that is, the action pair is (*D*, *D*), the payoff pair is (3, 3) and each gets 3. If both behave, the action pair is (*N*, *N*) and the payoff pair is (10, 10), each getting 10. Now getting 10 is much better than getting 3. But The Fishing Game will tend towards (*D*, *D*) giving (3, 3) as payoff. Why? (*N*, *N*) gives (10, 10) but Berto will realize 15 if he switches to *D*; so will Ambo, since at *N* he does not care what Berto gets. So both will switch and they end up at (*D*, *D*) giving each (3, 3). We say that (*N*, *N*) is not stable and won't last. (*N*, *N*) is vulnerable to betrayal when both look only after his own payoff. Now they are at (*D*, *D*). Will (*D*, *D*) last? Suppose Berto switches to *N* (behaves) from *D*, Berto gets 2 which is less than 3 if he stays at *D*. So Berto will not switch; similarly Ambo. There is no incentive to switch, so (*D*, *D*) is stable. No other action pair has this property of stability. The stable feature of action pair (*D*, *D*) has a name in Game Theory; it is called the Nash equilibrium of the game. But (*D*, *D*) gives Ambo and Berto 3 each while (*N*, *N*) would have given each 10. The Nash equilibrium of this game is a *bad* outcome because there is a payoff pair (10, 10) which gives each higher! But because each looks only after his own selfish benefit (payoff), the Fishing Game ends up badly. In Economics, the Fishing Game exemplifies the popular label *market failure*. With many (more than two) fisherfolk, this result is called familiarly 'The Tragedy of the Commons' after Hardin (1968)—where the fish stock of the lake is degraded or destroyed and everyone is left in misery. 'The Tragedy of the Commons' is a *collective action failure* often associated with overexploitation and depletion of a common resource. A common resource is an asset owned by the collective and accessible for use to all members. It may be a body of water that sustains fishing, a forest that provides timber and game or the atmosphere that soaks up carbon emission.

CASE 2: Ambo and Berto are part of a coherent group whose members care for and look after each other (*homo reciprocus* or *socialis* in Behavioral Economics).

Now each will prioritize what is good for the community, in this case consisting of Ambo and Berto and their families. Since (*N*, *N*) gives each 10 and 20 together and no other action combination gives higher [say (*N*, *D*) gives (2, 15), which together gives 17 < 20], both will choose *N* and (*N*, *N*) is the solution of the Fishing Game for members playing this game. Choosing *N* is still vulnerable to betrayal but the players are reasonably confident that the other player will not exploit his vulnerability. In other words, there are considerations beyond the immediate payoffs that the players are paying attention to. Ambo and Berto in *Case 2* have avoided the 'Tragedy of the Commons'—the fish stock in the lake remains high to sustain a bright future.

We have the following definition: A *coherent group* is one whose members always choose the strategy that maximizes group welfare when playing a social dilemma game with other members of the same group.

Ambo and Berto in *Case 2* belong to a *coherent group*. By contrast, Ambo and Berto in *Case 1* belong to an incoherent group. The coherent group realizes the opportunity (the best outcome for the group) locked up in every collective action problem, while an incoherent group will fail. Groups that are coherent will thus tend to be more successful (in this case, harvesting greater returns from the common resource) than groups that are incoherent. Over time the difference in the success of both groups will be considerable. It will rival the remarkable difference in the success of the East Asian Miracle economies and the other less developed economies.

The provision of public goods is an iconic collective action problem. A public good, like a decent bridge across a river, makes life easier for everyone living in the vicinity—everyone can use it for free. But to construct a bridge requires financing which the potential beneficiaries must raise—those who will benefit must contribute to bring it about.

Suppose citizens are acting like Ambo and Berto of *Case 1*: looking out only for immediate personal interest and contribution is

voluntary. Potential beneficiaries will either refuse to contribute or will contribute much less than required for a decent bridge and its ample social benefit—that is, they will reason that they can anyway use the bridge once completed from the contributions of others. In other words, they will 'free ride' on other people's contribution. Since others similarly motivated will reason the same way, either no bridge is built [the Mancur Olson (1965) 'zero contribution hypothesis'], or only half a bridge is built. P. Samuelson's (1954, 1955) 'under-provision theorem' says that when members of a polity contribute voluntarily towards the building of a bridge, the contribution will fall short of the ideal—the size and quality of the bridge that maximizes the collective's welfare.

Suppose the citizens constitute a coherent group whose members look after and care for each other. Then their behavior will be governed by norms of cooperation that consider 'free riding' a grave social transgression; they will each contribute enough or more than enough resources so an ideal bridge is completed. And the community is all the better for it. How much easier it is for community welfare to be advanced in societies where coherence has been pre-established.

The takeaway from this section is that every collective action challenge contains a social opportunity. Coherent communities realize this opportunity; incoherent communities squander this opportunity. Over time, the performance of these communities will diverge in a big way.

Ferromagnets

Coherence, when attained, is very productive in nature. Consider an iron bar. An iron bar consists of trillions of electrons. Now each electron has a magnetic moment called the electron spin. The electrons of a regular iron bar have electron spins pointing randomly in all directions. The magnetic moments cancel. Now put the iron bar in the field of a strong magnet and the spins start to align. When all the electron spins are pointed in only one direction you get an emergent phenomenon called *ferromagnetism*. Its electrons are said to be in a coherent state (Figure 4.1).

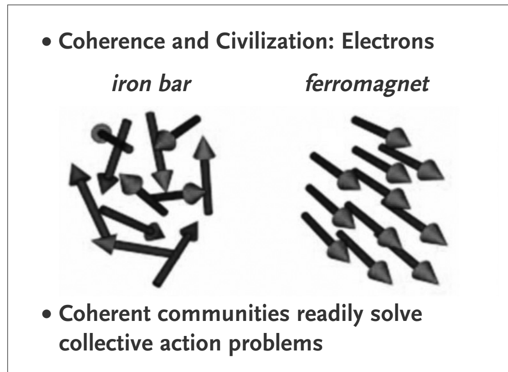

FIGURE 4.1
Social coherence and public goods

The humble iron bar has become a *ferromagnet*—now has a magnetic field and starts to act on other metals coming within its field. It now acquires the capacity for work. As children, we excitedly caused iron filings to dance on the surface of a sheet of paper with a magnet. Rotate a coil of copper wire around a ferromagnet and, lo, electricity begins to flow. Magnetism is the very touchstone of modern civilization. You get the Three Gorges Dam and the wonders of electric power like the Beijing-Lhasa Railway Line of PRC!

Similarly, communities characterized by social coherence are able to provide massive public goods. By contrast, incoherent polities are characterized by a 'poverty of public goods', low incomes, and low station in the world league tables.

Social Coherence

Social coherence is the capacity of the community to act as one to advance collective welfare. Faced with a collective action challenge, they will attain the first best outcome. Social coherence is either autonomic or induced. Autonomic coherence comes from forms of affinities: family, clan, religion, or shared life experience like victories in war. In this case, the imperative to act for the group comes from the inside of—and hardwired in—the cerebral cortex of members. The action potential towards cooperation is triggered in the limbic system of the brain and requires no deliberation. One does it like one seeks food when hungry.

The radius of members to which this autonomic impulse holds sway we call *the radius of coherence*. This is a circle of members with whom cooperation (behaving properly) is autonomic rather than deliberate. This radius differs for different groups. The radius for a particular group can fall by repeated betrayals or free rides by other members. In particular, this centripetal force degrades as the group becomes large, *ceteris paribus*, slowly in some groups and precipitously in others. The Japanese society is perhaps one example where the radius of coherence extends to the whole *nihon-jin* nation and degradation is slow. The smaller and largely homogeneous polities known as Scandinavian countries are also noted for being coherent. Rules such as traffic red lights are respected even at three o'clock in the morning because they are viewed as embodiments of the social family. They are as much "mine" as of the community. Since incidentally they also mostly lead the World Happiness Index, one is led to wonder whether there is a connection.

Some states, by contrast, consist of subgroups or tribes the radii of coherence of which do not extend beyond their immediate families or clans; these are known as 'tribal societies'. In this case, the state presides over a polity that is a nation *de jure* but not one *de facto*. A *de facto* nation is what political scientists call 'an imagined community', one whose members owe an autonomic allegiance to the whole. National Artist F. Sionil Jose's (1999) observation regarding the Philippines is suggestive: "We became a state before we became a nation." In other words, F. Sionil Jose posed the question: Is the Filipino polity today a nation *de jure* only or is it also *de facto*?

There is no presumption that social coherence will always be employed for the good. In the case of Japan, it was deployed to whip up frenzy for and wage World War II to disastrous effect. It was deployed by Adolf Hitler to embark on a war of expansion and self-destruction. But if it happens to be deployed for the good, such as the construction of public infrastructure, it can produce miracles. China under Deng comes to mind.

Induced Social Coherence

Social coherence, like everything else in the universe, is, however attained, subject to the *Second Law of Thermodynamics*—disorder always grows globally. Social coherence always degrades in time unless continuously

replenished. When un-replenished, as was the case of the fourth-century Roman Empire wracked by frequent bloody internecine rivalries, the fall is just a matter of time. As in nature, disorder can be kept at bay by capturing and transforming natural energy flow to push back the growth of local entropy. When coherence is being renewed or grown, we say that it is induced. We assume here that the players are not themselves disposed to cohere from the start.

There are two paths to induction: first is by internally evolved governance within and by the community itself and based on norms and associated penalties; second is by governance based on laws enacted and enforced by a party outside the immediate community which we call the state or government. We next detail the way this works to induce coherence in the game theoretic framework applied to a fishing community.

Statutes, Penalties and Coherence

Let S be a statute consisting of (i) a rule: dynamite fishing is a punishable transgression; (ii) a penalty: its users, if apprehended with probability f, $0 \leq f \leq 1$, will be punished to the tune of $p > 0$; and (iii) a head tax: that fisherfolk will each be charged $c > 0$ to help defray the expense of the system. Thus, we write the statute $S = (c, p, f)$). Let us see how this changes the Fishing Game. The payoff function of the new game with statute S is in Table 4.3.

TABLE 4.3. The S-Modified Fishing Game

		B	
		N	*D*
A	*N*	$10 - c$, $10 - c$	$2 - c$, $15 - c - pf$
	D	$15 - c - pf$, $2 - c$	$3 - c - pf$, $3 - c - pf$

Note that the head tax is paid, anyway, however the game ends. If Ambo plays N and Berto plays D, Ambo gets $(2 - c)$ while Berto gets $(15 - c - pf)$, where pf is the expected penalty for using dynamite. Let us first suppose that the *governance is strong*, that is, $f = 1$ or every transgression, if caught, is

meted a punishment p. So the payoff of Berto using dynamite is $(15 - c - p)$. The game changes, depending upon S. Let us consider a specific $(p, c) = (6, 2)$, as in Table 4.4 below.

TABLE 4.4. The S= (7, 2, 1)-modified Fishing Game

		B	
		N	*D*
A	*N*	10 – 2, 10 – 2 = (8, 8)	2 – 2, 15 – 2 – 7 = (0, 6)
	D	15 – 2 – 7, 2 – 2 = (6, 0)	3 – 2 – 7, 3 – 2 – 7 = (-6, -6)

The payoff matrix of the $S = (2, 7, 1)$-modified game has (8, 8) for playing (*N*, *N*), it is (0, 6) for action pair (*N*, *D*) (*D*, *D*), the previous Nash equilibrium which delivered payoff (3, 3) ceases to be so and (-6, -6) for action pair (*D*, *D*). Now the unique Nash equilibrium of the game is (*N*, *N*) giving payoff (8, 8). (*D*, *D*), the previous Nash equilibrium which delivered payoff (3, 3) ceases to be.

The statute S has changed the behavior of Ambo and Berto; more important, it has successfully aligned behavior towards the collective optimum (*N*, *N*). It has netted the community an aggregate payoff of 10 [(8 + 8) – (3 + 3)]. The group (Ambo and Berto) has achieved coherence, if an induced one. The energy that was employed to induce social coherence was the tax c (rechanneled from consumption to an investment in governance). This contribution is easily afforded in the first best outcome because the individual income from the first best outcome (8) was more than sufficient to cover the individual cost (3). The intervention in the form of statute S has created value for the community—it is a government success. The occasion for government success is a market failure. No amount of government intervention will create value for the community if there is no market failure. Thus we say: The first question of any proposed government intervention is, "What is the market failure?"

Whence is the Statute *S*?

(i) The statute *S* may emanate from evolved local governance worked out and enforced by the stakeholders—the fisherfolk themselves. The statute in this case is called a *norm*, the penalty *p* is informal, such as pariahdom (transgressors do not get invited to parties, expected mutual help may be denied, etc.). This was the pathway taken by the fisherfolk of the famous APO Island marine protected area (MPA) and the Sumilon Island MPA which captured world attention due to the heroic effort of the Silliman University team under the leadership of Professor Angel Alcala (2017). (Professor Alcala is also a National Scientist and a Magsaysay Award winner.) The virtue of governance by local stakeholders is that its transactions cost is low and it is more likely to be sustainable. In the typology attributed to Douglass North, governance by local stakeholders is second-party enforcement.

(ii) The statute *S* may emanate from outside the immediate group, say, the state or government which enacts rules that bind this and other groups. This is a third-party enforcement in North's typology.

Howsoever *S* is emanated, it is productive of social benefit only if there is a failure in the first place. That is why economists worthy of the name always ask of every proposed government intervention: What is the market failure? And if so, can the intervention improve on the status quo?

Government Failures

Third-party intervention does not always succeed. There are several drawbacks associated with this type of imported governance. One is simply that the statute crafted away from the venue may not be suitable for the local condition. It could backfire in many locales. The level of enforcement by paid outsiders may be lukewarm or indifferent, outsiders being themselves exempt from the cost of failure.

Suppose S =(c, p, f) = (4, 7, 4/7). That is, the system is more costly (4 > 2) and the enforcement is lukewarm; that is, probability of punishment for transgression is f = (4/7), meaning, that enforcement is weak as only 4 of 7 transgressions are punished. Thus effective average penalty is only 4 instead of 7. The modified payoff matrix of S = (4, 7, 4/7) is now:

TABLE 4.5. The S = (4, 7, 4/7)-modified payoff matrix

		B	
		N	*D*
A	*N*	10 – 4, 10 – 4 = (6, 6)	2 – 4, 15 – 4 – 4 = (-2,7)
	D	15 – 4 – 4, 2 – 4 = (6, -2)	3 – 4 – 4, 3 – 4 – 4 = (-5,-5)

Pay attention only to the number pairs in parenthesis. Note that (*N*, *N*) giving (6, 6) is no longer a Nash equilibrium because either player can do better if he switches to *D* to realize 7 > 6. Once at (*N*, *D*) or (*D*, *N*), there is no incentive for players to switch because that would mean getting (-5) instead of (-2). Thus both (*N*, *D*) and (*D*, *N*) are Nash equilibrium. The game has been transformed into an anti-coordination game with two Nash equilibria (D, N) and (N, D). It is also more familiarly known as a Game of Chicken. But note that either of these equilibria is inferior welfare-wise for the group—they each give an aggregate of 5 (7 – 2) but the original game gave an aggregate of 6 (3 + 3) > 5. Additionally, either equilibrium delivers a boon for one (7) and a disaster for the other (-2). It is, in other words, non-inclusive. Society is not only poorer; it is also nasty.

Society is clearly better off without the intervention S = (4, 7, 4/7). The intervention S fails because, first, it is more costly (4 > 2) and, second, its enforcement f is weak ((4/7) < 1). Governance imported from the outside which is (a) weak and costly, and (b) does not fit local conditions can make things worse! Note that there may be fishing jurisdictions in which S = (4, 7, 4/7) succeeds in aligning behavior for the best. But not here. This is the bane of third party enforcement—statutes may be a mismatch with local conditions and/or too costly to implement. Weak institutions do this.

The outcome with $S = (4, 7, 4/7)$ is what is known as a *government* or *state failure* (also a *Visible Hand failure*)! State failures make things worse than the *laissez-faire status quo*, the state of affairs prior to intervention. If $S = (4, 7, 4/7)$ is as much as it can offer, it is better that the state refrain from intervening at all. When the status quo is a government failure, it is a valid reason for further government action. For example, a subsequent statute $S = (7, 2, 1)$ to replace $S = (4, 7, 4/7)$ will produce the government success in Table 4.4 above. Thus, the more complete query for a government intervention is: What is the market failure or the government failure that it addresses? And how sure is it that the intervention will produce the identified benefit for society given the weak capacity of the state?

A government failure actually happened when the government took over the governance of the above-cited APO Island and Sumilon Island marine protected area from local stakeholders! Things quickly became dire and the harvest of fish dwindled. The situation improved only with the return of governance to local fisherfolk.

We saw above how influential a high expected penalty (pf) is in the attainment of the best outcome. So why not just raise the expected penalty pf or the statutory penalty p? It is not so simple since to raise pf you will have to finance it, and that entails a rise in the budget for enforcement and a rise in tax contribution c. This rise in c could make the final outcome undesirable ($10 - c < 3$). Furthermore, a rise in the statutory penalty p may reduce f as more enforcers succumb to higher bribe offers from apprehended violators. Mere increase in statutory penalty will not guarantee high pf jurisdictions of weak institutions. This is the bane of weak institutions.

Refraining from intervention or disengaging from failed programs by themselves require much wisdom and political courage, virtues which are in short supply in governments of low-income countries. F. Hayek in *The Fatal Conceit* (1988) claimed that government actors are possessed of the belief that they can always improve on the *status quo*, usually an autonomously evolved system of provisioning such as the market. There is, as it were, a hardwired pathology to intervene regardless of evidence. The result is not always pretty and may be very costly if not fatal.

By contrast, the superior capacity of the state made manifest by statute $S = (2, 7, 1)$ can induce social coherence which, in turn, engenders decent

public goods. $S = (4, 7, 3/4)$, on the other hand, fails to engender social coherence and consequently fails to unlock the opportunities hidden in the collective action problems. The poverty of public goods is the tangible expression of societal incoherence or the failure of its institutions to induce social coherence.

When $S = (4, 7, 3/4)$ is endemic in state interventions, state failures become the expectation of even well-meaning interventions. The state develops a reputation as the wellspring of failed programs. This reputation, having been acquired, is very difficult to shake off. Even when the top positions of government suddenly fall on the laps of a well-meaning benevolent leadership (which sometimes happens), it is still unclear that he/she would be able to make a difference. He/she would be holding *de jure* but perhaps not *de facto* power.

One makes a distinction here between the state of the institutions and the intent of the occupants of *de jure* positions of authority. This comes from the distinction between *de jure* and *de facto* power. From time to time, as if by Poisson process, the position of authority may fall on the shoulders of a well-meaning leader, one for whom the welfare of the whole polity is top priority. This leader we call 'benevolent'. Benevolence in this case may not be matched by *de facto* power to whip inherited weak institutions into shape. The new occupant will exercise *de jure* power only and will be hampered by the dismal reputation not of its own making. It will be like a careful and prudent driver at the steering wheel of, as it were, a 'moving casket' of a vehicle. The conventional wisdom is that the upright leader will be boxed into utter futility. With weak institutions as backdrop how can a well-meaning authority in weak institutions environment effect change? The answer is through 'credible commitments' which we will tackle next.

5

Credible Commitment Devices and Public Goods in Weak States

THE STATE'S CAPACITY to provide public goods relates very closely to how much confidence its commitments elicit from its public. This is the dimension of 'credible commitments'. A public good, say a bridge, is essentially foregone present gratification for larger future consumption. The state must convince the polity that ample future gains are forthcoming from the bridge to be financed through their taxes. A public good is always an implicit contract between the state and the polity. If the political center is viewed by its publics as unable to credibly commit to its part of the contract, that is, to safeguard and properly use the resources collected as taxes, the polity may opt to withhold the required tax contribution from the state either latently or patently and instead use it for private consumption. No bridge! From casual evidence, especially evident in the construction of The Three Gorges Dam, it appears that its public believes that the current leadership in China (PRC) delivers its part of the social contract. The Chinese leadership paid for that confidence with deliveries on past promises.

In The Fishing Game, the capacity to credibly commit emerges as a very high probability ($f = 1$) of punishment for malfeasance (dynamite fishing) as well as the low transactions cost of implementation. A miserably low probability ($f = 4/7$) of punishment for misbehavior and/or a very high cost of implementation reverses the prospect for positive social dividend. Stakeholders may vote (if that is granted them as a prerogative) in the first instance against the enactment *S* (also sometimes manifested as tax revolt). That prerogative is seldom

accorded. Again, either no bridge or half a bridge is delivered. The result is a government failure.

How does a government with a reputation for non-delivery and wastage improve its prospects as a partner in development moving forward? One way to do that is to offer a commitment device that makes it very painful to renege or to give a credible signal that business-as-usual is past history. The first is frequently resorted to: bank tellers are obliged to submit a 'bond' which is forfeited if the teller absconds with the money in her trust. This is modeled as 'hostage' by O. Williamson (1983). Japanese *daimyo* of old were obliged to leave behind their families in the capital Edo when they visited their far-off fiefdoms as insurance against subversive or anti-*shogun* activity.

The state struggling under a tarnished reputation can signal its departure from business-as-usual by doing something which, because of its actual or potential political cost to the state actors, could not be done under business-as-usual.

One way is to tether the state's commitments to international treaties which will make such obligations costly to renege on. Many of these treaties are entered into by states to make their respective jurisdictions friendlier to foreign investment. The global community has standards of behavior that infuse harmony and fruition to common endeavors. The local community despite its own contrary tendencies tries to appear to subscribe to these standards in return for foreign investment flows. The enactment of a competition law is viewed as such a commitment device which subsequently raises foreign investment inflow into the country (Clarke, 2011). This is also what happened in the run-up to the privatization of water distribution and sewerage services in Metro Manila.

Signaling a New Regime: The MWSS Privatization

Water distribution and sewerage in Metro Manila prior to 1997 was provided by the government entity, Manila Water and Sewerage System (MWSS). In view of the many problems of service interruption, water quality and fiscal drain, then President Fidel V. Ramos decided to privatize the system. The first hurdle to the MWSS privatization was getting enough private players to participate to avert an auction failure. The second was to get them to bid

aggressively enough to generate consumer surplus for the hitherto skeptical public. This was to happen with the backdrop being a state with a very bad record in its dealings with the private sector. For example, the Philippine Supreme Court among others decided in the 1990 "Garcia versus DTI" case that a projected petro-chemical plant could not be located in the investor's preferred site in the province of Batangas, thus, effectively wresting from private investors the prerogative of siting their plant. The foreign investor promptly packed its bags. To improve the outlook for MWSS privatization, the roll-out of credible signals and commitment devices on the part of the government was required.

Credible Commitment Devices

The state under then President Fidel V. Ramos implemented a number of drastic changes in the run-up to privatization:

(i) It engineered the passage of the National Water Crisis Act which gave the President targeted and time-bound emergency powers to negotiate and close contracts in the address of the water crisis and privatize MWSS; this reduced the likelihood of obstruction by other branches of government.

(ii) It raised water tariff substantially from Php5 per cubic meter to Php8.70; since inability to adjust the tariff was one cause of the MWSS burden, the move signaled the grim determination of the Ramos dispensation.

(iii) It reduced the state water system workforce by 30% (about 4,000 employees) by offering a generous retirement package for state employees. This was viewed as highly improbable in the old regime. There was a new political reality.

(iv) The involvement of the International Finance Corporation (IFC) as advisor in the drawing up of the contract (concession agreement, CA) was a signal that the parameters of the game will comply with best practices in the world where concession templates have proven successful. The CA was crafted jointly by the possible bidders and the state to ensure transparency and understanding of the provisions.

(v) The creation of an international Appeals Panel which required as chairperson an international dispute resolution practitioner guaranteed that global standards in dispute resolution will apply. Thus, disputes will be adjudicated at first instance not by local courts, which are viewed as weak. But when a local court does intervene, its judgment can be challenged in an international court outside the country.

The first three signaled a resolute benevolent leadership willing to take difficult steps for the common good. The next two instanced a case of tethering to global standards and effectively pole vaulting the weakness of local institutions. These were not easy steps and required a fortuitous alignment of events: a determined and open-to-experiment leadership of President Fidel Ramos who was previously empowered as the conqueror of the power crisis; the obvious failure of the state as water distribution services provider; and the ferment in the private global capital movement revived by the 1989 collapse of the Socialist challenge. The latter was frozen in the debt crisis decade of the 1980s. The role of Lady Luck cannot be denied, but one has to be ready to cash in when she smiles.

The Result

These devices suggested a radical change in the government as counter party in water procurement contracting. The success of the assurance exercise was made manifest by the number of parties that expressed interest, of which four were pre-qualified: Ayala Corporation with United Utilities, Metro Pacific Corporation with Anglian Water, Benpres Holdings Corporation with Lyonnaise de Eux, and Aboitiz Holdings with Campagnie Generale de Eux. The local sponsors were all conglomerates engaged in many other activities except water services which hitherto were largely a state preserve. The international partners were all global players in water and sanitation services and thus had the requisite expertise. These were either French or British. Each bidder submitted a tariff bid (i.e., per cubic meter of water). Whoever submits the lowest tariff (or the highest discount) wins. The aggressiveness of the bids surprised even the architects.

The bid results were as follows:

TABLE 5.1. Bids Tendered by Participating Consortia by Service Area

East	Percent Discount	Peso Bids
Ayala-United	73.61	Php 2.31
Aboitiz-CGE	37.12	Php 5.20
Metro Pacific-Anglian	35.49	Php 5.66
Benpres-Lyonnaise	30.21	Php 6.12
West	Percent Discount	Peso Bids
Ayala-United	71.36	Php 2.51
Benpres-Lyonnaise	43.41	Php 4.96
Aboitiz-CGE	43.12	Php 4.99
Metro Pacific-Anglian	33.10	Php 5.87
Tariff Prior to Bid	100.00	Php 8.78

Adapted from Dumol, 2000

The Ayala-United consortium won both the East and the West Zones at Php2.32 per cubic meter of water and Php2.51 per cubic meter, respectively. Ayala-United was awarded the East Zone, by virtue of a predetermined lower average formula. Thus, Benpres-Lyonnaise, with the second highest bid of Php4.96 per cubic meter for the West Zone, got the West Zone. Ayala-United's bid for the East was only 26.38% of current water tariff of Php8.70 per cubic meter. That of Benpres-Lyonnaise was only 56.57% of existing tariff. The feeling of total vindication by advocates was well placed and euphoria seemed in order. One broadsheet columnist summarized the reaction of the day as the "sweetness of privatization." Such an outcome would not have come about if the players did not get sufficient reassurance that the state would honor its part of the CA.

Two decades after, the privatization of MWSS remains a signal achievement of the Ramos administration. It represented a retreat by the state from a domain that the market can do better. It has been used as a template for reform in water by other countries in the world. Effectively, the

state retreated from state ownership to regulation of Metro Manila water service provision. What this shows is that poor reputation of the state can be overcome by offering credible commitment devices of future good behavior. Since these devices have to be by themselves costly to be credible, the reforming authority must itself be possessed of tremendous resolve. This is courage deployed for the common good; courage wedded to common sense! That itself is very rare. But, if and when such an authority emerges, a bad past need not completely condemn the future.

Such instances of success are encouraging and point the way for the future although by themselves they may be too few and far between to propel the escape from the tyranny of backward infrastructure. Left to fester, the poverty of public goods both soft and hard will take its toll on long-run economic performance. This is the issue we tackle in the next chapter.

6

Economic Stagnation, Development Progeria and Inclusion

WHAT IS development progeria? Development progeria is a phenomenon where, over the long term, the growth of Manufacturing lags behind that of Services in a 'low-income economy'. Manufacturing here proxies for the 'traded goods sector' and Services proxies for the 'non-traded goods sector'. This trajectory of the industrial shares is normal for mature high-income economies, but problematic for low-income countries. It is analogous to the medical condition called progeria, a genetic malfunction where a child of six years has the physical features and the life prospects of a 60-year-old.

We will show how problematic development progeria is for the low-income countries with special emphasis on inclusion defined as poverty incidence. First of all, in a fast-growing low-income economy on the convergence trajectory (meaning on the path to closing the gap between itself and the high-income OECD countries), Manufacturing (the traded goods sector) grows faster than Services (non-traded goods sector) and as a result Manufacturing share in GDP gains while the Services share loses.

As shown in Figure 6.1, the Services sector has been gaining industrial shares over the last 30 years while those of Manufacturing and Industry shares have trended downwards. Services sector now contributes about 58% of Philippine GDP.

Data Source: World Bank Development Indicators

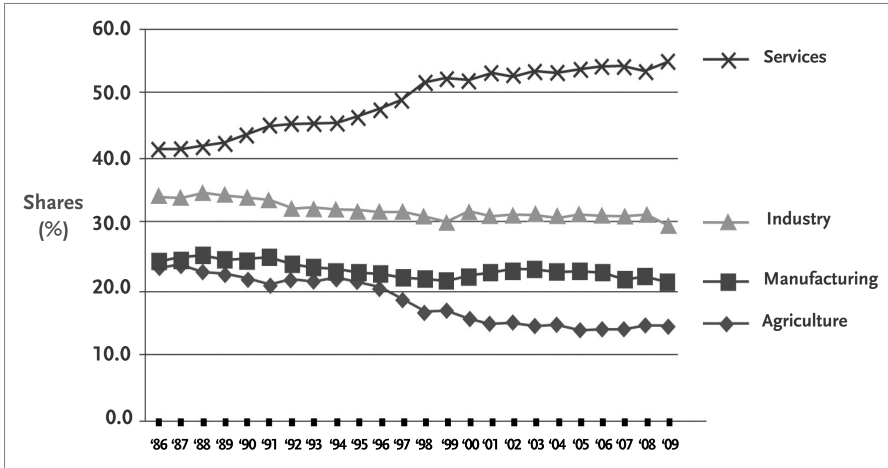

FIGURE 6.1
Trajectory of Philippine Value-Added by Industry as % Shares of GDP, 1986-2009

The contrast with countries on the convergent path is interesting and we think dramatic. The following shows the trajectories of industrial shares of select countries in the decade 1986–1996.

Data Source: World Bank Development Indicators

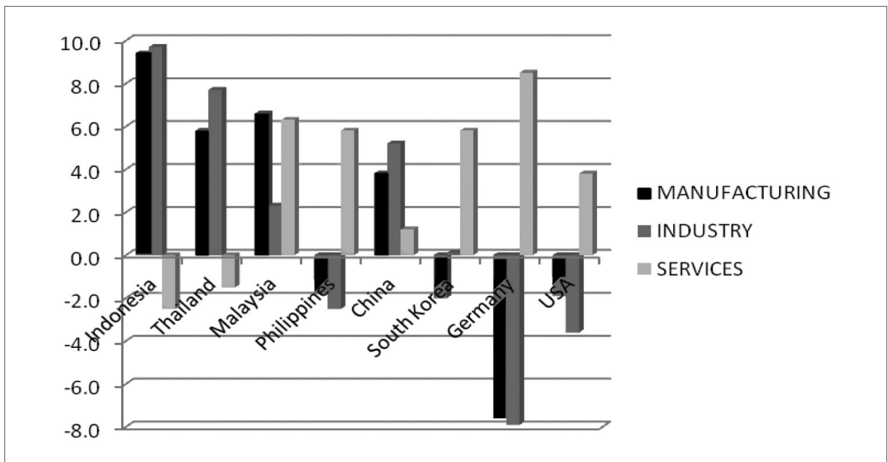

FIGURE 6.2
Change in % Industry Shares, 1986-1996

Columns above the '0.0' line means that the sector has gained shares in GDP in the decade 1986–1996; columns below the '0.0' line means that the sector has lost shares in GDP in the same decade. Focus on the Philippines for the moment. The Service sector gained during the decade while Industry and Manufacturing lost shares. Then consider the last two countries, Germany and USA, both representing the high-income mature economies. For these two countries, the Service sector gained shares in the decade while Industry and Manufacturing lost shares. The trajectory of industrial shares in the Philippines mimicked the trajectories of high-income mature economies, even though per capita income of the Philippines was very low. Now turn to the industrial shares trajectories for fast-growing but low per capita-income economies, Thailand and Indonesia. Through the decade 1986–1996, the Service sector lost shares while the shares of the Industry and Manufacturing gained shares. So their industrial shares trajectory is very different from that of the Philippines, Germany and USA. South Korea's trajectory reflects an economy in transition—the Services sector gained while Manufacturing barely earned even as Industry lost. China's trajectory shows gains for the three sectors led by a long shot by Industry and Manufacturing. Malaysia's trajectory also shows an economy in the middle income category where all sectors gained at the expense of Agriculture (not shown).

Figure 6.3 below shows the comparative per capita incomes of the select countries for two periods 1991 and 2002.

Data Source: World Bank Development Indicators

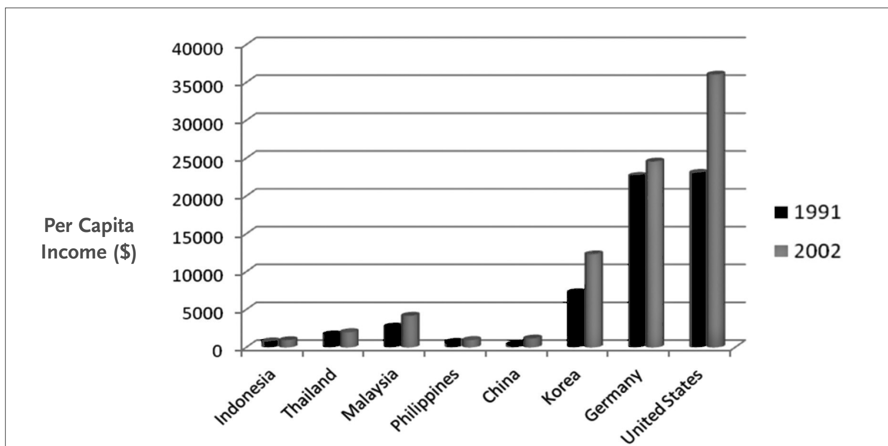

FIGURE 6.3
Per capita income (US$), 1991 and 2002

We see that USA and Germany are clearly mature economies with per capita incomes in excess of US$10 thousand throughout the periods. South Korea crossed the threshold in the second half of the period; the rest of the countries had a ways to go, although Malaysia is quickly closing the gap. We repeated the industrial share exercise for the period 1996–2009. The result is given below (Figure 6.4).

Data Source: World Bank Development Indicators

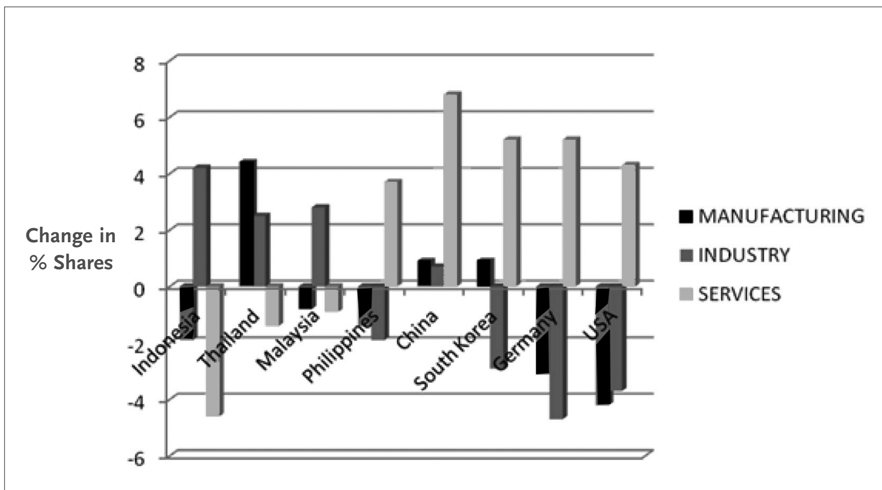

FIGURE 6.4
Change in % Industry Shares 1996-2009

A similar pattern emerges for the period 1996–2009. The Philippines' trajectory still mimics that of Germany and the USA. Thailand still presents a stark contrast to this pattern while Indonesia's Service sector still lost shares as did Manufacturing, while the Industry sector gained. We submit that this is partly why Thailand and Indonesia have left the Philippines behind in per capita income. But more important, how does it affect inclusion?

Development Progeria and the Strong Peso

Two factors, notably, weak institutions leading to poverty of public goods and the Philippines' pursuit of a strong peso, were mainly contributive to

the long-term retreat in the Philippines of Tradables, in general, and Manufacturing, in particular.

Rodrik (2008) broke new ground by giving evidence that market and institutional distortions tend to 'tax' tradables more than non-tradables. This deserves elaboration and reiteration. Tradables tend to be more complex and roundabout, need the cooperation of many agents, and thus more contract-intensive. Tradables move across borders and are subject to physical hijack and predation in weak states. Tradables also produce more positive externalities, technological spillovers and learning-by-doing (Korinek and Serven, 2010) than non-tradables and may exhibit more scale economies due to the Baumol Effect (barber shops will never exhibit economies of scale). What this means is that the poverty of soft and hard public goods tends to favor the non-traded goods sector (Services) which does not have to compete with foreign counterparts. Rodrik (2008) claimed that currency undervaluation levels the playing field for the traded goods sector and makes for a better long-term growth prospect. We will revisit this in the next chapter.

In the Philippines our policy response was the exact opposite. We maintained an enduring romance with the strong peso with roots in our colonial past. The Philippines' relatively high standard of living was confirmed by hordes of immigrants from neighboring countries wanting entry in the early post-war period; the peso-dollar exchange rate was then two pesos per US dollar (Php2/1US$). This was codified in our consciousness as defining the good life—enjoying access to imported US products. The ideal to be pursued became associated with a strong peso. That the Php2/1US$ was economically wrong was brought home by the BOP Crisis of 1949. But the authorities decided to defy economic logic and maintain the overvalued peso at Php2/1US$, exactly the opposite of exchange rate decisions in Taiwan and Japan in the immediate post-war era. In Japan, the exchange rate chosen was Y360/US$ in 1949 from Y3/US$ in the pre-WW II era; in the Philippines, it was Php2/US$ in the 1930s and exactly the same in early 1950s. No wonder that the Philippines became the favorite export destination of Japanese products. The subsequent Import Substitution regime was thought up to support the level of the peso by administratively—through tariffs and quotas—reducing the demand for imports. It only sowed the seeds of the boom-bust economy.

Two policy episodes in our history, one in the second half of the 1980s and another in the mid-1990s, illustrate this. In the wake of the BOP crisis—occasioned by heavy foreign borrowing plus wanton wastage and corruption under President Marcos—banker Jose 'Jobo' Fernandez was appointed Central Bank governor. The peso was rapidly depreciating and forex was fast flowing out of the country. The central bank under Governor Fernandez resolved to snatch the sacred peso from the jaws of devaluation in mid-1980s through the 'interest rate cure': it deployed the infamous "Jobo bills" with prohibitively high interest rate. This shrank the real economy to fit the massively misaligned Philippine peso. Banks snatched the Jobo bills realizing indecent returns even as the Philippine economy collapsed. The interest rate cure and the strong peso effectively aborted the prospect for a tradables-driven recovery under President Corazon Aquino. In this environment, given other entrenched institutional drawbacks, there was no room for new investments in Tradables and Manufacturing. While it is true that the political instability and coup attempts caused the Philippines to miss the Japanese foreign investment *tsunami*, the heightened overvaluation of the peso, thanks to the interest rate cure, left foreign and domestic investors without a prospect in the foreign markets and killed off any hope for an export- and Manufacturing-driven recovery. The twin curse of the Jobo bills and the coup plotters bent the arc of Philippine history towards a Service sector-led economy.

The second episode also involved the central bank, now rechristened the Bangko Sentral ng Pilipinas (BSP). In about the mid-1990s, in the waning days of the power crisis, strong portfolio investment flows attracted by still high interest rates put pressure on the peso to appreciate. When local business complained about the high cost of money, the central bank—instead of easing up on the high interest rate—encouraged them to borrow in dollars abroad. The BSP feared that a benign monetary policy would deprive the artificially strong peso of the support of a high interest rate. This surge in private foreign borrowing resulted in heavy dollar exposures of banks and private corporations. The heavy commitments of these dollar borrowings in the Service sectors, notably real estate, resulted in currency mismatches. It created stock market and real estate bubbles which made for an artificial and shaky prosperity. It failed to create a capacity to service the debt which would have materialized had the borrowings been invested in tradable goods and Manufacturing, had there been a more favorable exchange rate. The Asian

financial crisis starting in 1998 exposed the unsustainable and dangerous nature of the strong peso-high interest rate strategy which, in turn, effectively aborted the highly promising—if still domestic-oriented—Ramos recovery.

In early 1994, a group of us (Emmanuel de Dios, Benjamin Diokno, Cayetano Paderanga, Calixto Chikiamko and myself) together with PHILEXPORT called for the deliberate weakening of the peso. China had just devalued the *yuan* heavily and it (China) was threatening to 'eat our lunch'. This was a cause endorsed in a speech by then Senate President Edgardo Angara at the first plenary session of the 1994 National Economic Summit. Instead, we were treated worse than lepers. One mouthpiece of the then central bank governor labelled us the 'jukebox economists'—singing any tune the moneybags call. The implied moneybags, IMF and the World Bank, did not even know they were calling our tune; they were, in fact, calling the CB's tune. These moneybags had a catatonic fixation for floating the exchange rate which, at that point of considerable dollar inflow, pointed to appreciation. But even labor unions whose jobs we were trying to save called for our heads. One did not need rocket science to see that PRC's move would devastate Philippine manufacturing and employment. But our plea for economic survival fell on deaf ears. When the summit resolutions were read at the end of the day, there was not a pip on the exchange rate. Chikiamco's lament was classic: "We lost our balls!" This time it was Jobo bills in another guise that forced the appreciation. They were called the Special Deposit Account (SDAs) offering very high rates to the wealthy who had the cash to spare. This BSP instrument became the pet peeve of Foundation for Economic Freedom (FEF) stalwart Ernest Leung. He considered it a way to indecently transfer resources from the poor to the rich, since it would incur losses for the BSP which the taxpayers will then have to make good.

Inclusion and Development Progeria: The Average Tendency for Low-Income Economies

Our interest in this short volume is inclusion, defined as poverty reduction. Daway-Ducanes, Ducanes and Fabella (2017) (see also Fabella, 2017b) hypothesized that low-income countries showing symptoms of development progeria would also exhibit higher incidence of poverty; that is, the higher the share of the Service sector, the higher poverty incidence

is; contrariwise, the higher the share of the Manufacturing sector, the lower poverty incidence is. The authors tested this by running cross-country correlation regressions of these variables against measures of poverty for low-income countries (<$10,000 per capita). Their results are as follows (Table 6.1):

TABLE 6.1. Correlates of Poverty Gap and Poverty Head Count Ratio: The Role of Manufacturing

	System-GMM			
	Poverty gap		**Poverty headcount ratio**	
	$1.9/day	**$3.1/day**	**$1.9/day**	**$3.1/day**
	1	2	3	4
Poverty measure (-1)	0.528	0.685	0.724	0.872
	[0.010]***	[0.011]***	[0.012]***	[0.010]***
Manufacturing size	-0.063	-0.077	-0.155	-0.059
	[0.022]***	[0.029]**	[0.036]***	[0.035]*
Services size	0.106	0.145	0.192	0.262
	[0.009]***	[0.013]***	[0.033]***	[0.025]***
ICRG	-0.042	-0.096	-0.106	-0.258
	[0.008]***	[0.006]***	[0.012]***	[0.013]***
Real GNI per capita	-0.001	-0.001	-0.001	-0.001
	[0.000]***	[0.000]***	[0.000]***	[0.000]***
Number of observations	195	195	195	195
Number of countries	65	65	65	65
AR(2) Arellano-Bond test	0.753	0.715	0.419	0.423
Hansen p-test	0.477	0.54	0.54	0.582
Number of instruments	64	64	64	64

Robust standard errors in brackets
* significant at 10%; ** significant at 5%; *** significant at 1%

Note: The set of regressors included Period 2 to Period 6 (dummies) which are not shown.

Note that higher Manufacturing share in GDP on average associates significantly with lower poverty gap and lower poverty headcount. By contrast, higher Services sector share in GDP associates significantly with higher poverty gap and higher poverty headcount. Governance quality (ICRG) and per capita income serve as controls. It seems clear that, on average, development progeria associates with higher poverty incidence for these types of countries. These regressions do not establish that development progeria causes poverty incidence to rise; we only have a strong suggestion that on average across low-income countries, high Services share in GDP (development progeria) and higher poverty seem to strongly co-vary. When you see one you are likely see the other. In contrast, when you see high Manufacturing sector share, you are likely to see low poverty incidence. They are, as it were, good buddies. Applying results from a cross-country (ensemble) analysis to individual countries, however, runs into the problem of non-ergodicity—that is, the ensemble (cross country) average may not equal the time average for that particular country. There is no claim here that this central tendency applies to a particular country like the Philippines or China (PRC). So we need to look at individual country experiences.

China, Vietnam and the Philippines: Manufacturing and Poverty Reduction

To bring the above results in sharp relief, we present a visual comparison of three low-income countries, namely, China, Vietnam, and the Philippines (less than US$10,000 per capita) on the issue of Manufacturing share and poverty reduction in the first 20 years of the MDG (1990–2010). Figure 6.5 gives the poverty reduction experience of the three countries for the 1990–2010 period.

As observed above, the Philippines was one of the countries that failed to meet the MDG target of cutting by half poverty incidence (MDG1) between 1990 and 2015. By contrast, China (PRC) and Vietnam were two star performers of the MDG program as shown above. China went from 64% down to 10% while Vietnam went from 50% down to about 5% in 2010. In Figure 6.6 below, we juxtapose the average growth of Manufacturing and the average growth of Services between 1990 and 2010.

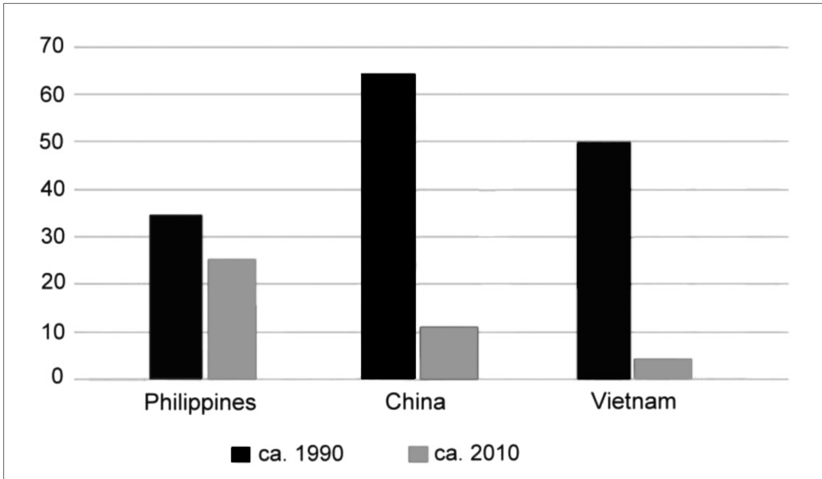

FIGURE 6.5
Poverty reduction (%): Philippines, PRC, Vietnam, 1990 and 2010

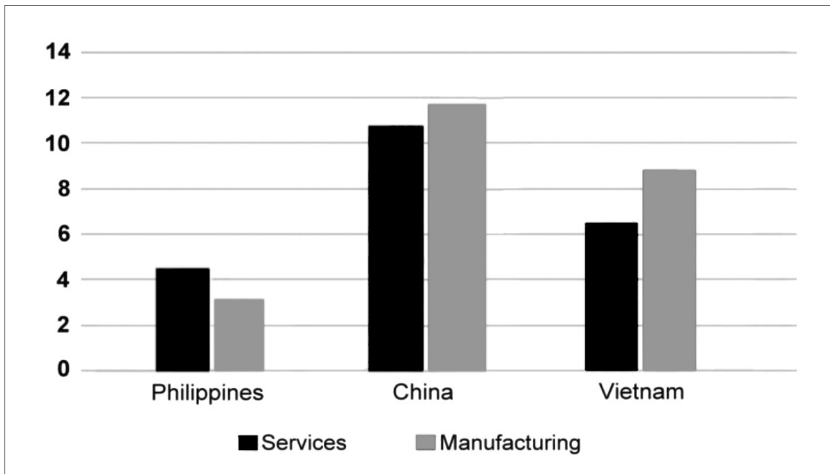

FIGURE 6.6
Manufacturing vs. Services average growth (%), 1990-2010

Note that for China and Vietnam, Manufacturing average growth outstripped that of the Service sector. By contrast, in the Philippines, the average growth of Manufacturing fell well below that of the Service sector. The contrast with poverty reduction is marked, suggesting a positive correlation between development progeria and poverty incidence.

No account of mediocre economic performance can be complete without a detour to the investment experience of these countries in the last two decades. The issues we elucidated on above (exchange rate bias against tradables, development progeria, weak institutions and infrastructural deficits) had to have impacted investment in these countries. We will turn to this in the next chapter.

7

Decompressing Investment in the Philippines

THAT CAPITALISM in the country has thus far failed to be inclusive deserves serious scrutiny. It is not the failure of Capitalism as genome, but of a phenome of Capitalism, a particular manifestation of the genome in a particular policy and governance setting. In the last chapter we identified a particular phenome called development progeria which appears to particularly like the company of poverty. Bad environments will produce backward Capitalist phenotype. But it is not Capitalism's fault; rather, the environment's. Under the right ecology, as was shown above, Capitalism has done wonders for inclusion, say, in China and Vietnam. There are enumerable interesting sound bites advanced to take the measure of non-inclusion in the Philippines. Some of these are 'bad elites', 'elite capture', 'crony capitalism', 'political instability', and 'rent-seeking', etc. This inquiry tries to provide the economic pathway which serves as reduced form of these sound bites to social outcomes. The economic pathway to economic outcomes, whether growth or inclusion, seems to us to traverse the quantity and the quality of investment. As far as I know only Dr. Emmanuel de Dios (2011) has investigated the econometric association between investment and an important sound bite, political instability, in the Philippines. His evidence points to the fact that political instability depresses investment. Political instability is clearly an institutional deficit.

Why have China and Vietnam forged an inclusive Capitalism? The secret ingredient seems to be that they have avoided contracting development progeria. How have they managed to do that?

As we observed, the investment rate (quantity of investment) of China has been meteoric at around the 45% level, while that of Vietnam has hovered in the 30% range for the longest time. At the paltry rate of 20% of GDP, the case of the Philippines may be called 'investment compression'. But even more important than the quantity of investment is the quality of investment as reflected by its allocation between the Tradable goods and Non-tradable goods sectors.

Market and Institutional Imperfections

As already alluded to above, Dani Rodrik (2008) has demonstrated that markets, as well as institutional imperfections, tend to herd investment away from the Traded goods sector towards the Non-traded goods sector. These imperfections add significantly to the transaction cost of Tradables which they cannot pass on to consumers in the competitive global economy. Non-tradables, in contrast, compete largely among themselves in the local economy, face the same market and institutional imperfections, and thus are not competitively disadvantaged. There is then coming from these failures a natural bias against the Tradable sector. Left to itself, investment will find comfort in the Non-traded goods sector and away from the Traded goods sector. The story Rodrik wanted to tell was that an economy can partly offset this local bias against the Tradable sector by maintaining a weak currency, a strategy he calls 'levelling the playing field'. He then showed that, indeed, those economies that had the courage to level the playing field by maintaining a weak (i.e., undervalued) currency have done better in terms of economic growth. China, of course, beckons as the modern exemplar; Japan and Taiwan led the way in the post-World War II era. The prospect of the Tradable goods sector worsens when the domestic currency is instead deliberately kept strong (i.e., overvalued) for other goals such as to fight domestic inflation and/or keep domestic food prices low by importation. The overall bias against Tradables is thus 'doubly skewed', resulting in a stampede out of Tradables.

The market and institutional deficits in Rodrik (2008) correspond to and manifest themselves as the poverty of public goods in this present work. Poverty of public goods translates into higher logistics cost which disadvantages the Traded goods sector against foreign rivals. As an instance, the president of IBM Philippines once made a visit to the UP School of

Economics. He was brought in by two vehicles—one of which ferried four bodyguards. This was at the height of kidnapping-for-ransom and, as president of IBM, he was 'kidnap quality'. That extra cost would not have been incurred by his competitors in Shenzen or Singapore. It was a real cost in the Philippines. The lack of social coherence, itself an institutional weakness, underpins the failure of the polity to adequately address these imperfections.

When investment flocks to the Non-traded goods sector, the problem of sustainability rears its head. The attempt to steeply ramp up investment by, say, cheaper credit, quickly creates 'price bubbles' in the Non-traded goods sector. These are invariably followed by 'price busts' which empties the gas tank of investment. Likewise, the ramping up of investment in an inward-looking economy runs up into what classical economists call the 'under-consumption crisis' as domestic market demand falls short of rampaging supply. When this happens, investment loses steam.

The investment-driven economies of East Asia and now China needed outward orientation to sustain the investment drive over long periods. South Korea sustained an 8% GDP growth for two and a half decades running from 1960 to 1984. This would not have been possible had S. Korea been selling only in the domestic market. An inward-looking economy cannot sustain such protracted high-speed growth. Overheating follows quickly in an inward-looking economy. Even the USA during the Gilded Age (1870–1900), a vast inward-looking economy, suffered such overheating and investment collapse, as happened in 1883 and 1893.

A weak currency helps not only outward orientation, but also the sustainability of such high levels of investment. But to work its magic, peso weakening must be sustained. It cannot be only episodal. We have had peso weakenings in the past that were promptly reversed (the exchange rate was once at Php50/$ and readily brought back to Php40/$). Those do not work at all. Unless the long-entrenched import bias in the currency is finally exorcized with incontrovertible signals, investors assume reversion to the status quo and act accordingly. They may even lobby for that reversion. The reason is hysteresis, a physical phenomenon familiar to engineers and exact scientists. Hysteresis in this case means that when an import bias (alias overvaluation of the currency) of *x* percent has built up an import orientation in the economy, it takes more than *x* percent depreciation (alias

undervaluation) of the currency and one sustained for a long period to reverse the orientation. Nonlinearity is of the essence; nonlinearity is at the heart of hysteresis; history matters.

Movements of the exchange rate, even within a band, always display short-run volatility. Investors expect the movements to be mean-revert and thus do not change investment plans. When an import bias is embedded for a long time in the currency, it shapes the investment trajectory of the economy. Short-run movements of the exchange rate have little or no effect on this trajectory. They have to be convinced that there is a *regime change* that looks and feels permanent before they would budge. Because their investment commitments are tied to the old regime, they may even be staunch advocates of the old regime. Such are most moguls of the Service industry. The signals of a regime change are the size of the change and its staying power, but preferably both. A change in the exchange rate in a weak governance environment will be interpreted as reflecting the weakness of the economy (as, say, reflecting macroeconomic instability) and thus as unwanted volatility; as such, it will only reduce the investment rate. But the exact same change in the exchange rate in a strong governance environment (and more likely also a strong economy which is not forced to devalue) will be seen as strategic and thus interpreted as sustainable. This will raise the investment rate.

If the Philippines is to shift to an investment-led growth, as seems to be the Duterte government rhetoric, insights into the behavior of the investment rate (*GDCF/GDP*) in low-income developing countries is of utmost importance. Daway-Ducanes, Ducanes and Fabella (2017) ran regressions of the correlates of the Investment Rate for low-income countries (<$10,000 per capita income), the same data set as above regressions on poverty incidence. The explanatory variables of interest are: the industry share of Manufacturing (*manu-gdp*) and the industry share of Services (*serv-gdp*), the proxy for governance and (soft and hard) infrastructure quality (*ICRG*), (*log rer*) which reflect movements in the exchange rate, interaction between exchange rate movement and the quality of governance (*lrer-ICRG*), and the inflow of foreign investment (*fdi-inflow*). For controls they have as starting point per capita income (*lgnicapita-cons*), the real interest rate (*real-interest*), lagged investment rates (*1-fixed k*, *12-fixed k*) period dummies, and dummy for tropical location (*Tropicar*). The dynamic panel data estimates are given in Table 7.1:

Dynamic panel-data estimation, two-step system GMM

Group variable: countryid		Number of obs =	365
Time variable : periodid		Number of groups =	102
Number of instruments = 88		Obs per group: min =	1
F(16, 102) = 207735.62		avg =	3.58
Prob > F = 0.000		max =	5

fixedk	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
l_fixedk	.6069841	.0097029	62.56	0.000	.5877384	.6262298
l2_fixedk	-.1486858	.0127669	-11.65	0.000	-.1740089	-.1233628
lrer	-2.442404	.2426952	-10.06	0.000	-2.923789	-1.961019
lrer_icrg	.0375798	.0037033	10.15	0.000	.0302344	.0449253
icrg	.0712697	.026818	2.66	0.009	.0180763	.1244632
fdi_inflow	.1540616	.0189124	8.15	0.000	.1165489	.1915744
tropicar	-.4429408	.2583699	-1.71	0.089	-.9554164	.0695348
manuf_gdp	.1035651	.0137019	7.56	0.000	.0763874	.1307428
serv_gdp	-.0527951	.0177249	-2.98	0.004	-.0879523	-.0176378
lgnicapita_cons	-.4941392	.2165501	-2.28	0.025	-.9236652	-.0646131
real_interest	.0264208	.0026133	10.11	0.000	.0212374	.0316042
period3	12.12158	1.757852	6.90	0.000	8.634893	15.60827
period4	11.15781	1.838909	6.07	0.000	7.510342	14.80528
period5	11.49781	1.798024	6.39	0.000	7.931436	15.06418
period6	13.30241	1.776806	7.49	0.000	9.778119	16.82669
period7	12.69041	1.776799	7.14	0.000	9.166134	16.21468

TABLE 7.1. Investment rate for low-income countries (<$10,000 per capita income)

The share of Manufacturing in GDP associates positively and significantly with the investment rate, while that of the Service sector associates negatively and significantly—again the footprint of development progeria in this sample of low-income countries. Good infrastructure proxied by *ICRG* and inflow of foreign direct investment also associate significantly and positively with the investment rate. The direction and significance of these relations are as we expect them.

The role of the exchange rate is interesting: movements in the exchange rate (*lrer*) by itself alone associates negatively and significantly with the investment rate consistent with the interpretation that such movements reflect macroeconomic instability and interpreted as unwanted volatility. But the interaction between the real exchange rate and quality of governance

(*lrer_ICRG*) associates positively and significantly with the investment rate. When movements of the exchange rate interact with strong governance, it is interpreted as invested with aforethought and resolve rather than as a result of weakness and, because sustainable, raises the investment rate.

The lesson is that investment compression associates strongly and negatively with development progeria, with good soft and hard infrastructure, and with a sustained and pro-export posture in the exchange rate. Furthermore, a healthy foreign investment inflow correlates with high investment.

The economic cluster of the Duterte administration in the Philippines is committed to a much higher investment rate and a more rapid job creation. It also wants to bring Manufacturing to the regions. All correct directions. An investment rate raised to between 25–35% of GDP is only part of the story; for an investment-led growth, the high investment rate must become sustainable over decades. This can be attained by becoming even more outward-oriented so as to escape the limited confines of the domestic economy. Thus, the contribution of Manufacturing to GDP must rise; the contribution of Manufacturing to regional GDP must rise. To attract more—and especially the right—foreign investment, it does not harm to signal outward orientation by a willingness (at least rhetorically, if not factually) to maintain a weaker peso. Weakening of the peso that only tracks global weakening against the dollar is of little help. We need to end our romance with the strong peso in order to attain a sustained rapid growth that will finally break the back of poverty in the Philippines (see Fabella, 2017c).

This march to an investment-led growth and rapid job creation can, however, be slowed down or even aborted by inconsistent policy steps. One such step is acronymed 'endo', short for 'end of contractualization'. Contractualization has been demonized as a strategy of business in the Philippines to exploit surplus labor by employing labor on contractual basis to avoid the substantial additional cost associated with permanent hires. But contractualization can also be viewed as 'labor sharing': scarce employment slots are being shared by more workers; permanent workers are paid less than they could be without contractual labor; contractual labor have some income, sporadic maybe but some, instead of none at all. The decay rate of work attitude and work aptitude is so much more rapid among the long-term unemployed than among those with only sporadic spells of

unemployment. If contractualization is ended and all employment mandated by law to be permanent, this will precipitate a substantial rise in labor cost and a substantial reduction in hired labor. Fewer workers will be employed and many workers now currently listed as underemployed will join the ranks of the openly unemployed. Job creation will also slow down as investors, foreign and domestic, think twice about locating in the Philippines. Businesses that are trapped and cannot relocate will invest more in machines that displace labor. More smart machines will prematurely replace workers. New organizations will be invented to eliminate jobs. The impact on the industrial structure will be considerable. The long-term unintended consequence on labor welfare may be the opposite of the intended.

In this volume, we argue for a determined pushback on development progeria by reducing the bias against the Tradable goods sector and Manufacturing. Endo will worsen that bias. Already, the cost of power has increased due to the lifting by TRAIN 1 of the VAT exemption on power transmission, a development that further raises the bias against Manufacturing. The Services sector will just pass on the added cost of labor due to Endo and added cost of power to domestic consumers; Manufacturing cannot do the same so Manufacturing is bound to lose out further. Thus, Endo is inconsistent with the Duterte administration's resolve to raise the investment rate, increase the contribution of Manufacturing, and speed up the rate of job creation.

In Part II of this volume, we will dwell on another phenomenon related to weak institutions, inward orientation and small markets. This is the phenomenon of vertical conglomerates and the game they play called conglopolistic competition in the non-traded goods space. Since conglomerates are ubiquitous in the Philippines, how should we view them? Should they be feared and pushed back or should they be rechanneled and enlisted towards greater welfare contribution?

PART II

Conglomeracy and Inclusion

8

Conglomerates and Conglopolistic Competition

ONE VERY salient feature of current Philippine economy is the unmistakable presence of conglomerates competing in many markets. Philippine conglomerates are horizontally integrated large corporations. Though originally emanating from different core businesses, their footprints in many disparate markets are very large.

The Vent for Size[3]

Coase's (1937) seminal observation—that market transactions are not without cost and the higher the cost of market transactions the larger the firms—started 'the boundary of the firm' sub-discipline in Economics. But the idea went into eclipse for 30 years before Oliver Williamson (1975), the 2009 Nobel Memorial Prize winner, resurrected the idea in the 1970s and put 'transactions cost economics' and firm-market boundary back on the disciplinal agenda. The crucial decision problem for the firm in this arena is whether to 'make or buy' a service or an input, an issue alien to the black box of the Arrow-Debreu firm. In underdeveloped economies, market transactions and exchange costs tend to be prohibitive; the pioneering

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[3] This section owes a great deal to Fabella (2016), "Conglopolistic Competition in Small Emerging Economies: When Large and Diversified is Beautiful." http://www.econ.upd.edu.ph/dp/index.php/dp/article/view/1492/975. Accessed November 2017. See also Fabella (2015), "N-Poly Viability and Conglopolistic Competition of Emerging Markets."

entrepreneur—having no one to buy from or organized entities to sell to—faces the entire attendant forward and backward linkage risks. The main reason is the underdevelopment of the factor markets (Khanna and Palepu, 1999). The *primus inter pares* among these factor markets is the capital market. Firms need capital to grow their businesses, but in LDCs the financial markets may not be able to meet their capital requirements at reasonable rates. The capital market failure is usually the motivation for state financial intervention in favor of certain companies and partly underlies the emergence of state-sponsored conglomerates. Where the financial market is weak, firms outside the orbit of the state largesse need to raise capital internally (Williamson, 1975; Stein, 1997; Klein, 2002). Economic size is the private sector's way of compensating for the capital market deficit through internal capital generation. Large companies also tend to be sought after and favored with lower interest rate by the banking sector which, following the Stiglitz-Weiss logic (that banks require warranties, collateral or reputational, to lend under asymmetric information) use size as a proxy for capacity to pay and for quality. They are also sought after as partners by foreign investors and serve as conduits of foreign capital by direct borrowing. In Biology, there is even a rule for analogous reason governing the tendency towards large size among vertebrates called the Cope's rule (McMahon and Bonner, 1983).

The 'make' decisions taking the form of vertical integration to reduce those risks lead to the emergence of large vertically integrated firms in large markets. The 'vent for size' going through vertical integration comes in this case from profit-seeking through efficient provision and control of the value chain.

Predation, Uncertainty and the Impulse for Size

The vent for size is also more urgent in weak governance environments. Less developed economies are backward for many reasons, but the most encompassing reason is weak governance due to weak institutions (Shirley, 2005). Weak governance starts with a hobbled state whose many organs of rule-making and enforcement intended in theory to advance the common weal are either too feeble to resist or too susceptible to capture and used as instruments of predation on weaker players. This is analogous to the famous risk associated with the emergence of the state itself: it can be an instrument of protection or an instrument of expropriation (Acemoglu, 2002; North,

2005). Unfortunately, the political economy of governance in LDCs not only does not guarantee state benevolence, but may indeed invite predatory behavior. Where 'weak public ordering', the term favored by O. Williamson, is an integral part of the politico-economic landscape, the private firm must also vertically integrate into defensive private ordering in order to survive.

A weak governance environment begets the proverbial predation table where rents are divvied up. It is popularly observed that having a seat in the predation table means you do not end up on the menu. The seats at the table are, however, allocated according to political power. Economic size, insofar as it gets translated into political power, can procure for its holder a seat at that table. While size is a magnet for predators, it is also a rampart against predation. Small firms are vulnerable to predation because the cost of protection can be prohibitive and not affordable. Large firms in weak public ordering environments are those that have managed to survive the predatory jungle by acquiring defensive ramparts or that have used the predatory landscape to their advantage. Having a hand in the election of the president of the republic means having a say at who becomes the minister of finance or the commissioner of the tax bureau. Being able to afford the highest-paid, judiciary-savvy and high-profile lawyers gives the firm an edge in dealing with predatory tax collectors and regulators. Such are out of reach for small- and medium-scale enterprises. Their only survival strategy is to pay off the corrupt tax man.

This foray into the political economy arena is, in the O. Williamson's (1985) sense, a 'make' decision in order to render property rights and contract uncertainty manageable where the wielding of state power is unpredictable and sometimes predatory. In the Philippines, the most convincing reminder of weak public ordering is the ubiquitous 'blue guards', now a big industry. As in Biology, large size allows cell complexity and diversity which makes for flexibility (McMahon and Bonner, 1983). The human brain's enormous capacity derives both from its size relative to human body mass and from the complexity of its neuronal connections. Not without reason did Adam Smith (1776) hail division of labor as the lodestone for progress.

Thus, where governance is weak, firm size—in the language of evolutionary biology—plays the role of a trait selected for survival. They are like the bright colors announcing the lethal toxicity of highly poisonous salamanders or of coral snakes. Predators learn quickly to avoid a frontal

tussle with such firms and turn their attention to more vulnerable smaller ones. The grapevine story has it that when Robina Gokongwei, scion to conglomerate magnate John Gokongwei, was kidnapped by a crime syndicate, John Gokongwei bankrolled another syndicate to hunt down and eliminate every member of the kidnap syndicate. Once a self-protection capability is acquired, the marginal cost of its further use is negligible. Like sunk capital, it is attended with economies of scale. Further acquisition of size lowers its average cost. It is no different from a political machinery: once set up, electing yet another member of the political clan costs very little. Concentration or political dynasty seems dictated by the dynamics of the political market. It thus serves as an entry barrier to the political market.

Too Big to Behave

The danger of size in weak public ordering environment goes beyond just the usual too-big-to-fail; it includes too-big-to-behave. Having acquired a political or physical firepower to repel predators, the temptation to use the same capacity to, in turn, prey on weaker rivals is strong. Large conglomerates may succumb not only to the temptation of abuse of market power, but to the employment of acquired political leverage for rent-seeking. This prompted many observers to mystify Schumacher's (1973) 'small is beautiful' view. Not representative but suggestive nonetheless of romanticism was the Schumacher statement: "Man is small, and, therefore, small is beautiful." Reminds one of the role of powerlessness in the attainment of efficiency in the First Fundamental Theorem of Welfare. Man is small relative to the cosmos, yes, but since he is also enormous relative to the amoebas, may we say that "enormous is beautiful"? And with more reason: our humanity, our capacity to reflect, depends upon the neuronal complexity and specialization of the human brain which are supported by our brain size. Schumacher had a dim view of Capitalism, but had high hopes for socialists who he thought should use nationalized industries "not simply to out-capitalize the capitalists… but to evolve a more democratic and dignified system of industrial administration…" Large, it appeared, can evolve if socialist, but not if Capitalist, into the "more humane". While there are areas where Schumacher's romantic view applies, we have exaggerated the utility of that view.

True, many large business groups may develop and maintain clandestine and privately mutually beneficial relations with political actors. This murky matrix of relationships and connected dealings became the favorite whipping boy of sanctimonious Western observers in the wake of the Asian financial crisis of 1998 which, for many, signaled the end of the proverbial East Asian Model.[4] As the financial crisis of 2008 revealed, however, the West is not immune from such financial self-dealing-based sinkholes despite its vaunted regulatory ramparts. The announcement of the death of the East Asian model proved grossly premature. PRC is its flag bearer in the twenty-first century.

We do not underestimate this risk. Our view is: rather than condemn size at the outset because of the risk, we consider size as a necessary investment in efficiency and sustainability. In the language more familiar to modern competition policy, market or economic dominance is not a crime per se; its abuse is. But abuse has to be clearly demonstrated according to the standards of the law and preferably the rule of reason. We recognize this danger, but neither should it blind us to the reality that in the world of market survival and competition, small is synonymous with fragile.

Horizontal Conglomeracy

The spread of large business groups across many disparate unrelated markets through horizontal integration is also motivated in the literature by underdevelopment in the capital and insurance markets. The need to raise capital internally may also be addressed by size through diversification. But the pronounced motive for conglomeracy is the mitigation of risk and returns volatility. With developed capital markets, investors can reduce volatility by owning diversified equity holdings. Where the capital and insurance markets are underdeveloped, implicit portfolio diversification can be achieved by owning shares of a diversified conglomerate. Diversified holdings by firms can reduce returns volatility, lower bankruptcy risk and earn better credit rating. This should make conglomerate shares enjoy a premium in such markets. Other reasons for the premium have been proposed: lower interest borrowing, lower tax burden due to intra-firm transactions, and leveraging

[4] "In Praise of Rules," *The Economist*, 2001.http://www.economist.com/node/559389.

of managerial resources. I recall talking to a taipan who revealed a desire to enter markets that are less susceptible to the vagaries of macroeconomic instability. He has since added to his considerable holdings hospital and infrastructure assets in keeping with this resolve.

Because markets are small and/or fragmented in small emerging economies, the vent for size among firms manifests itself as horizontal conglomeracy—playing and competing in many markets at once. Note, however, that horizontal conglomeracy is quintessentially a Non-traded goods sector phenomenon in the Philippines. The vent for size in small economies need not manifest itself as horizontal conglomeracy among firms in the Tradable goods sector which sells to the vast global market; these thus grow largely untroubled by quick market saturation. They can acquire heft while staying within their core market and associated vertical integrates. The best example is Foxconn in the People's Republic of China, a Taiwanese foreign investment which grew to enormous size as an original equipment manufacturer (OEM) for global digital equipment brands and has stayed as such even as it moved much of its operations globally. Yet another is Convergys of India which has stayed with business process outsourcing (BPO), which is a Tradable service. Furthermore, as observed in chapter 7, institutional and market distortions which abound in low-income economies tend to weigh down the Traded goods sector more than the Non-traded goods sector and draws investment decisions away from Traded goods (Rodrik, 2008).

The Philippines: A Case in Point

In emerging markets, casual empiricism suggests that the dominance of conglomeracy in the Non-Traded goods sector is not abating. Contemporary Philippines, where most newsworthy economic projects involving large capital outlays are linked to one or more of the very visible conglomerates, seems emblematic of this trend.

In the Philippines, the following Non-traded goods sectors host the following players: banking—Ayala group, Aboitiz group, SM Prime group, Lucio Tan group, Gokongwei group; property development—Ayala group, SM Prime group, Lucio Tan group, Gokongwei group, DMCI group, Megaworld, Phinma; retail merchandising—Ayala group, SM Prime,

Gokongwei group, Rustan's; telecoms—Metro-Pacific group, Ayala group, San Miguel group; power generation and distribution—Ayala group, Aboitiz group, San Miguel group, DMCI, Benpres group, Metro-Pacific group; infrastructure construction and operation—Ayala group, Metro Pacific group, DMCI group, San Miguel group, Megaworld group; and tertiary education—SM Prime group, Yuchengco group, PHINMA group, Lucio Tan group, and Ayala group, to name a few.

Contrast this to the large players in the vast US market that have stayed largely within their original core markets including their vertical integrates, e.g., Walmart in merchandising; Bank of America, Citigroup and JP Morgan in banking; Trump in property development; Intel in microchips; GE in industrial machinery; GM and Ford in vehicle manufacturing and assembly; Apple in Digital Devices; Google in search devices; and Facebook in social media.

Large horizontally diversified firms abound because their kind is selected for survival in uncertain environments. They may indeed be the most efficient path to progress for small emerging economies. In relatively more volatile environments, their depth and breadth allow them to survive the vagaries of politics and nature where small undiversified companies will fail. Their size enables them to afford new technologies mostly piggybacked on new fixed capital equipment. For example, a super critical steam generator could produce more electricity per unit of input than a subcritical steam generator because of the new technologies embodied in it that allow it to operate at super critical levels. But this also comes with a high initial price tag.

The points made here are not new, but are reiterated to counter a perceived bias against large firms and conglomerates in many LDCs. Many an economist, brandishing a PhD from the West, steeped in the grand tradition of the Arrow-Debreu world where powerlessness is the principal anchor of market efficiency, and exposed to industrial organization and competition studies in jurisdictions with strong public ordering, will rattle off Herfindahl and other indices showing concentration. Without proper grounding in the vicissitudes of business in small markets and in jurisdictions with weak public ordering, facile pronouncements about possible abuse of market power frequently don't make any sense. They often put the carabao before the cart.

9

Conglomerates, Consumer Welfare and Collective Action

WHILE THERE are many interesting issues associated with Conglopolistic Competition, there are two issues of immediate concern, viz., how they serve consumer welfare and how they boost the state's capacity for collective action.

Consumer Welfare and Conglopolistic Competition

That the more firms competing in the market (in this case more conglomerates) the larger is the consumer surplus, is a standard result in the Theory of Industrial Organization. This is shown formally in the Appendix for the interested reader.

The fact alone that conglomerates compete in the same market improves welfare, no matter that their entry into these markets is profit-motivated. The welfare gain is the harvest of Adam Smith's 'Invisible Hand'. The government's only role is to safeguard free entry and prevent collusion. In the Philippines, the enabling law for this is already enshrined (The Philippine Competition Act). The generally accepted exception to this is when the market is a natural monopoly, that is, when the fixed capital requirement is large and two or more firms producing for the same market will end up losing money due to economies of scale, and being unsustainable, will in time consolidate into one firm. The power transmission franchise granted the National Grid Corporation of the Philippines (NGCP) reflects the natural monopoly feature of power transmission. So do all the franchises to distribution utilities. The franchises granted to the two water service

concessionaires, Manila Water Company Inc. and Maynilad Water Services Inc. in Metro Manila reflect the natural monopoly in water distribution. By contrast, power generation (in the Philippines) has been declared by EPIRA as competitive, meaning that power generation not being invested with scale economies is a free entry sector.

Conglopolistic competition is especially pro-consumer welfare in jurisdictions where institutions are unable or unwilling to monitor and punish abuse of market power. SM North used to be the only source of 'malling service' in the West Triangle area until the Trinoma Complex was built by the Ayala group. Now, mallers have options; they can just cross the footbridge linking both malls. Likewise, the power of mall owners over retail locators is reduced since the locators could now play one mall against the other.

There is logic to why, in small emerging markets, these large firms will begin to invade each other's markets in the pursuit of overall size. In other words, one can show that mutual invasion of each other's market is a sub-game perfect equilibrium solution to the entry game when there are no barriers to entry (see Fabella, 2016). They tend to outgrow their original market niche and would seek to build size by mutual invasion. Thus, there is a natural tendency for conglopolistic competition to reduce market power and its abuse.

What is the role of competition policy in such environments? It is important that the competition watchdog ensures that these conglomerates stay at each other's throats and not collude in the Non-traded goods sector. The conglomerate ownership profile in the Philippines has an interesting ethnic feature—some are owned or controlled by Filipinos of Spanish descent, others are by ethnic Filipinos and still others, the majority, are by Filipinos of Chinese extraction. There is a healthy mutual suspicion among these ethnic groups which is a bar against collusive behavior. Of course they will not hesitate and should not be deterred from occasionally working together to raise the financing and share the risk in certain large projects. Although there is an established belief that competition and profit-seeking will eventually blur these ethnic lines, ethnic identity can still exert strong pressure to compete rather than collude. For one, ethnic identity makes it more unlikely for their offspring to inter-marry—an informal pathway often taken by consolidation.

It is different in the Traded goods sector where forbearance by the competition watchdog for collusion and consolidation by local conglomerates is in order as long as the economy is fairly open in those sectors. As banking becomes increasingly cross-border and banking services become increasingly cross-border-competitive, it may be wise for local banks to merge and for the banking regulator, BSP, to encourage it as indeed it now does.

Boosting the Nation's Collective Action Capacity

Weak public ordering in LDCs as we discussed earlier manifests itself principally in weak capacity for collective action. This is crucial because the most important task of every state is the provision of public goods which, first and foremost, is a collective action problem. The provision of arterial public infrastructure requires sizeable resources which must first be collected in sufficient volume and, second, allocated to large arterial infrastructure amidst myriads of competing claims for its use and which, in turn, require careful implementation. States afflicted by weak public ordering find it difficult to negotiate all or some of these steps adequately; thus, bad infrastructure and bad economic outcomes. Even when resources are raised, state implementation of large projects frequently end up mired in corruption and waste.

Large conglomerates—with their command of sizeable financial resources, considerable reputational capital and, more important, efficient and motivated management resources—can be harnessed to boost the collective action capacity of the state. They, of course, look for adequate bottom line before committing. The now prominent Public-Private Partnership (PPP) follows this idea. The very successful privatization of water service in Metro Manila, for example, could not have come about without these large conglomerates and conglopolistic competition (Fabella, 2011).

While social incoherence stands in the way of adequate public goods provision, sometimes the state can boost its collective action capacity by enlisting economic entities that possess and/or have demonstrated strong collective action capacity in their own endeavors. The conglomerates existing in its jurisdiction are candidates. Conglomerates possess the resources, the strong organization, and skilled, well-paid and highly motivated manpower to undertake large projects. As observed earlier, weak public ordering prompts

private entities to acquire private ordering capacity. Thus, weak public institutions are compatible with and even prompts the growth of capacitated private sub-national institutions. At this stage in its history, the Philippines already has a clutch of such conglomerates which, with proper incentives, can be launched towards large undertakings of greater public interest. Because of the anti-Manufacturing bias of our incentives structure, most of these conglomerates, in the interest of their bottomline, have stayed clear of Manufacturing. They are mostly rooted and compete in banking, power, retail trade and real estate development.

Rather than fear these conglomerates and impede their progress, the Philippine state will do well to embrace and redirect these conglomerates towards the provision of public goods and towards partnering with global players in the Manufacturing sector. The government's role requires itself to become a reliable counterparty in large projects, that is, to credibly commit to long-term and market-driven contracts and enforce them religiously. Weak states are especially vulnerable to clamors for short-term relief at the expense of long-term viability and prosperity.

Public-Private Partnership (PPP), perhaps the most popular method of enlistment for large infrastructure projects, is possible only if there are large financially well-endowed players willing to undertake the risks associated with being counterparty to the government. They must have the wherewithal to fight protracted legal battles when the sitting government reneges on contracts. The cost of litigating their claims against the government as in the case, say, of the income tax holiday written in the concession contract of water service concessionaires in Metro Manila, but contested and denied by the water regulator, is prohibitive for smaller firms. Moreover, where auction is the preferred market testing modality, there should be enough financially capacitated bidders to constitute a successful bid. Box 9.1 below details a successful collective action initiative which became a reality only because there were large conglomerates which had the financial heft and the reputational capital to attract foreign partners with the specific expertise on water service delivery to allow them to play the role of minority partners (see, e.g., Fabella, 2011). The latter is important especially because none of the domestic players had previous experience and expertise in water service provision and there is a perception that minority owners are treated badly in LDCs.

Box 9.1

Water Services Privatization: Firm Size as Catalytic

Water services procurement in Metro Manila was privatized in 1997 and is now globally regarded very highly as a PPP success. Pre-privatization, water and sewerage service in Metro Manila was provided by a state-owned and -operated agency, the Manila Water and Sewerage System (MWSS). Water service quality was very poor (up to eight-hour water interruptions) though water tariff was very low since upward water tariff adjustment was considered anathema politically. It thus had to be subsidized by the state and was a fiscal drain. Privatization would transfer the burden of financing capital requirement of water infrastructure spending to the winning bidders and ultimately to the water buyers. But the size of the project was immense and only very deep pockets would qualify. The reimbursement modality of the contract meant that only very large players can qualify. Likewise, the constitutional requirement of control by Filipinos of public utilities meant that foreign capital with water service expertise can be attracted to become minority partners only if the domestic partners could be found with reputation for upright dealings and with some financial heft. The players that responded were all huge conglomerates: Metro Pacific Corporation; Ayala Corporation; Benpres Holdings Corporation; and Aboitiz Holdings Corp. The intense competition among these conglomerates allowed a hefty discount to be passed on to the consumers of water. The aggressive behavior of the winner of the East wing, Ayala Corporation, was interpreted as due partly to the conglomerate nature of the bidder (being primarily in property development). The quality of water service has approached global standards since privatization. Without these large domestic players, this momentous privatization would not have happened.

Conglopolistic Competition in Infrastructure: CALAX

Yet another important PPP contract was signed in 2015. The Cavite Laguna Expressway (CALAX) is a 47-km eight-lane interchange tollway project to link the South Luzon Expressway and the Cavite Expressway. CALAX was to be procured under the Philippine government's PPP Program. The auction parameter was the amount of money the bidders were willing to pay (premium) the government for the right to construct and operate the project on a user fee basis. The first CALAX auction in June 2014—won by the Team Orion with a bid of Php11.66 billion in premium payment—was scrapped by the government when a technicality-disqualified contender, San Miguel Corporation-affiliated Optimal Infrastructure, opened its bid document to the public, revealing a Php20.1billion bid. Then President Aquino—responding to the revelation—ordered a rebid with bid floor being Php20.1billion. This act by the government produced a spirited howl because the government seemed to have reneged on an implicit promise to honor an above board auction. The government's response was that the disqualification was too harsh for too flimsy an infraction over bid security and it cannot, in conscience, leave Php8 billion on the table. In the rebid held on May 26, 2015, Metro Pacific Investments Corporation won with a bid of Php 27.3 billion. The project is now being implemented. Whichever side the rule of law falls on this controversy, the fact is, intense competition among conglomerates meant that the government realized an additional Php27.3 billion for infrastructure projects in other jurisdictions. Yet again showing that collective action capacity so lacking in most LDC governments can be boosted by proper channeling of large conglomerates. Other large infrastructure projects have already been completed (e.g., the Tarlac-Pangasinan-La Union Expressway/(TPLEX and the Ninoy Aquino International Airport Expressway/NAIAX by San Miguel Corporation) or have been awarded and construction started (e.g., the ongoing Connector Road Projects, one branch to San Miguel and the other to Metro Pacific) after intense competition between conglomerates.

Conglomerates and Inclusion

Do conglomerates contribute in a positive way to inclusion in its normal profit-motivated way? The answer is "Yes". One way is through empowerment. One ubiquitous example is the *tingi-tingi* and 'unli' prepaid SMS contracts which empower the lowest income classes. *Kasambahay* (househelp) now can follow the progress of their children's education in the provinces and can combat homesickness with frequent voice calls. Conglomerates can and do turn pursuit of the bottomline into empowerment of the poor.

FIGURE 9.1
Big business meets *sari-sari* store.

In pursuit of lower non-revenue water which represents lost revenue to the firm, the water concessionaires in Metro Manila started programs to connect informal settlers by working out an arrangement with the local barangay councils, which then becomes the legal counterparty in the ensuing contracts. Piped water gives the informal settlers at least two benefits: substantial monetary savings, since water-carrier provided water is very costly; and health benefits from higher quality piped water. It also improves the bottomline of the concessionaires. Manila Water's *Tubig para sa Barangay* has improved the lives of 1.8 million informal settlers.

Ariel G. Manuel

FIGURE 9.2
Tubig para sa Barangay: Manila Water provided piped water connection to 1.8 million informal settlers, reduced its NRW and boosted its bottom line. Ditto Maynilad.

Conglopolistic competition is alive as well in non-elite tertiary education where they have upgraded facilities and faculties. Mapua Institute of Technology (MIT) has now become Mapua University after it was acquired by the Yuchengco group. The University of the East now is under the Lucio Tan group; and National University is owned by SM Investments Corporation. Ayala Corp. has acquired the University of Nueva Caceres and the National Teachers College. All it took was for government to deregulate the tuition fees in tertiary education and conglomerate resources began to flow in.

Conglomerate CSRs (Corporate Social Responsibility) are also making headway in education, making available scholarships to thousands of indigent students (e.g., PLDT Gabay Guro Foundation) and in the upgrade of teaching and pedagogy in the country (Metrobank Foundation's Outstanding Teachers and Filipinos Awards). The SM group also gifted the University of the Philippines with the UP-BGC building and facility for UP graduate studies in the BGC, Taguig. Smart-PLDT Foundation's sponsorship and advocacy of the revolutionary Dynamic Learning Program (DLP) pioneered by Drs. Christopher Bernido and Maria Victoria Carpio-Bernido at the Central Visayas Institute Foundation (CVIF) in Jagna, Bohol, has touched the lives

and improved the learning opportunities of thousands of high school students in more than 200 secondary schools nationwide. Other examples exist and inspire.

There is, of course, the contentious issue that firms do CSR to reduce their tax obligation and thus as it were steal from public coffers and subtract from public weal. In strong institution jurisdictions where tax revenue does truly bankroll public infrastructure, this concern seems a given. That resources concentrated in the hands of the state get better social returns than when the same resources are left in private hands and privately deployed is on firmer ground under strong institutions. It may be less compelling in jurisdictions where ghostly public goods are rampant and state resources leak into innumerable private black holes. Nonetheless, it is always prudent to watch out for and minimize such eventualities.

The main message here is simple: when the state has a weak capacity for collective action, the presence of large conglomerates can boost the state's—and the nation's—capacity to solve collective action problems, of which the most important is in the provision of arterial public infrastructure. What is required is a credible and enabling regulatory environment and the nurture of healthy competition among private players. The Philippine Competition Commission is there for that. Rather than frustrate conglomerates for fear of size and abuse of dominance, we should re-channel them into competing among themselves in socially productive endeavors and competing against their counterparts in the world.

In the next chapter, we tackle the question of where we go from here, and how we may engender a greater coherence as a nation in order to tackle the poverty of public goods and the shortfall in inclusion.

10

Where Do We Go From Here and How?

THE INVESTMENT rate in the Philippines has been dismally low at around 20% over the last quarter century, a situation we described as investment compression. We need to raise the investment rate to between 25–35% of GDP where it stands among our neighbors. Internal consumption-led growth will not do; that is too prone to bubbles and busts. But it is normal for a polity that distrusts its leadership to prefer to consume in the present rather than seed the soil for a better future that may not be forthcoming. Nor do spasmodic spikes in the investment rate make for an investment-led growth. Rather than episodes of high investment rate we should aim for a high investment rate sustained for at least two decades running.

We do this by first raising our government capital outlay to 8% of GDP which will, in turn, crowd in private investment. This will support the present government's BUILDx3 program and ease up the severe poverty of public goods that is plain to see. The BUILDx3 program has to be financed, preferably internally, which is the goal of the enacted TRAIN 1. The Department of Finance version of TRAIN was at once future-enabling in its revenue target, compassionate in handling the impact on the very poorest, and courageous in its bid to plug revenue leakages. TRAIN 1 ran the gauntlet of, at least in this case, a backward-looking political process that endangered its integrity. Fortunately, despite the negative add-ons, such as the coal tax and the lifting of exemption of transmission VAT, the enacted TRAIN has sufficiently positive features to be contributive to rebuilding. The danger is that given the false generosity that holds both the legislative and indeed

the executive branches in thrall, after funding of freebies and entitlements, there may not be enough left for BUILDx3. To repeat, the enacted TRAIN 1 is positive despite the frailties tacked on for political expediency. The inflation uptick post-TRAIN 1 has become in early 2018 a *cause celebre* by the press even though TRAIN's actual contribution to the price uptick is minute. As with true reforms, the contribution from TRAIN to the inflation is immediate while the harvest is still to materialize. In truth, this inflationary uptick is a small price to pay for the contemplated economic transformation and future resiliency.

We say 'preferably internally' financed infrastructure build-up because external financing—either by foreign borrowing or aid—is never sustainable and the intended investment-led growth soon founders. We can run into a payments deficit as we were wont to do in the past. While it is better that the investment-led growth be anchored on internally mobilized resources, its flipside is the need to pair the investment-led growth with greater external market orientation. If we rely only on the domestic market to prop the supply side build-up, we soon run into the problem of under-consumption. A sustained investment-led growth is almost by necessity forced to hop on the global market for sustained demand. Thus, the Philippines must, for durable growth, shift its center of gravity much more towards the tradable goods (Manufacturing and Agriculture). What this entails is not only a quantitative, but also a qualitative change in our investment profile—not just higher investment rate, but also an investment that tilts towards tradables and Manufacturing.

We have shown how Manufacturing seems so much more in tune with poverty reduction in low-income countries. With so much market and institutional deficits in the Philippines which, on balance, favors investment in Non-traded goods (Services), it would help to have a pro-Tradable goods sector slant in the monetary and exchange rate policy—a slant towards weaker peso, rhetorically if not yet factually, to level the playing field as Rodrik would have it. This has at least three benefits: it will serve to attract domestic investment into the Tradable goods sector; it will attract export-platform foreign investment; and it will reduce profits from and incentives to smuggling. Export platform foreign investment was what started China (PRC) and the East Asian Miracles on the trail of global market success. By contrast, the tack taken by the Department of Industry seems backward; to revive the

ghost of import substitution manufacturing in, say, the car industry, via selective direct or indirect incentive, is futile and will end up the same way as the Import Substitution fiasco in the 1950s.

For the public to allow so much resources to be transferred from their pockets to the pocket of—and be deployed by—the government, the public must be reasonably assured that the waste and venality in the past government spending shall not have a reprise over the new resources. The government has to show itself capable of employing tax resources in socially productive endeavors and not frittering it away in palliatives and populist entitlements. In other words, *government has to earn public trust*. At the moment the signs do not inspire confidence; entitlement creation has so far trumped productive deployment, e.g., free tuition in state universities and colleges; increase in salaries of public servants without *mechanisms for* corresponding increase in efficiency. As regards the free tuition fee policy, it is deplorable that the very effective Socialized Tuition Fee Program (STFP) of the University of the Philippines became a victim and was phased out, very likely never to be revived. This program evolved over many years as a bargained settlement among stakeholders and made a distinction between rich and poor students, the former paying higher tuition fees to help subsidize the latter. In at least this case, generosity to the rich is the unintended consequence of generosity to the poor. It may not be unique.

This is where 'strategic retreat' by government is called for. The dismal record of government, that is, at making a 'muck' of most everything it touches, such as the daily breakdowns of state-run MRT and the still to be used imported rail cars, inspires only skepticism. The Philippine government must cede activities and services to spheres that can provide them better so more resources can be deployed for activities where it has comparative competence such as regulation, enforcing contracts and protecting private property. Moving away from owning and operating businesses towards regulation and the safeguard of competition is the preferred pathway in weak institutions environment.

The decision of the NEDA Board in January 2018 to privatize Clark International Airport (CIA) operations is eminently correct. In December 2017, the state authorities decided to make CIA in Pampanga as the second major gateway. Spot on! It would greatly declog both NAIA and Metro Manila especially EDSA by serving Central and Northern Luzon and not to say North

Metro Manila passengers. It now takes only between 1.30 to 2 hours by P2P bus from Trinoma in Quezon City to CIA. NAIA will now better serve South Manila, Calabarzon and the Bicol region passengers. NAIA 1, 3 and 4 should be next in the privatization pipeline.

The shift from ownership and operation to greater arm's-length regulation is not easy. It requires both wisdom and courage. But it is a direction that the Philippines has already traversed with some success. It no longer is hypothetical for the country. We do not have to re-invent the wheel here. It has worked to our benefit in the past (MWSS privatization, OPSF jettisoning, the EPIRA). As with all true reforms, teething pains cannot be avoided. Indeed, those teething pains signify that the reform is meaningful. Meaningless reforms are painless and non-contentious. We need to continue, not slacken, the pace of the state-ceding activities to other spheres of provision. Thus, for example, MRT should be privatized soonest (Santiago, 2017). Property rights and ownership in the agricultural sector should be unshackled by embracing tradable property rights and leaving the market to determine farm cultivation sizes. The five-hectare ownership limit in CARP (and CARPER) hamstrings farm modernization and productivity.

Rather than threaten to shackle the conglomerates in our midst, we should re-channel them to the Tradable goods sector, such as food production or towards that segment of the Non-traded goods that is ancillary to the Traded goods sector—power generation. We have already managed through PPP to re-channel them towards infrastructure development, a non-tradable service that is ancillary to traded goods sector. With trimmed down state agenda, the remaining programs will have more adequate budgets, manned by people who are more motivated because they are better paid and show overall better performance. Better performance of government programs will re-motivate trust in government. With increased trust and stronger fiscal position, the government can now entertain more ambitious programs. The polity can be induced to relent from its 'eat, drink and be merry for tomorrow we die' outlook because the government can be trusted to transform today's foregone consumption into tomorrow's bumper harvest. That is the real secret behind the Three Gorges Dam achievement. EPIRA is an instance where the plugging of fiscal drain from the state's ownership and operation of power supply and delivery allowed the government the wherewithal to bankroll and scale-up a CCT (also 4Ps) program.

Whatever resources it realizes from TRAIN 1 must be used to bankroll truly socially productive public goods. In other words, the visibility and tangibility of TRAIN 1-enabled infrastructure must be ensured. One of these must connect Mindanao to the Luzon-Visayas power grid by a submarine cable to finally create a One-Philippine Power Grid. In line with this is the upgrade of the still limited Luzon-Visayas and inter-Visayas power highways. The Mindanao-Visayas segment, once completed, can be turned over to NGCP for operation and management. Integration of power markets always leads to lower-priced and more stable power.

In regard to the greater outward-looking stance for sustainability, the lifting of the constitutional limits on foreign ownership, the easing of administrative hurdles to actual investment—whether local or foreign—and the maintenance of an export-friendly peso will help create a cascade of favorable news required to push the Philippines higher in the radar screen of investors. An export-friendly peso will attract the right foreign investment into the Tradable goods sector.

The role of foreign investment cannot be overemphasized. The history of the East Asian Miracles including now China (PRC) shows the pivotal roles of direct foreign investment. Foreign investment represents 'smart capital'—that which has the global network, the supply chain, the market savvy, and the track record to navigate the global traded goods market. Needless to add we have to be much more assiduous in our efforts to attract them. A new/old industrialization path with a twist can be considered.

Slipstream industrialization is a way for our conglomerates, now still mostly rooted in the Non-traded goods sector, to enter rapidly into the Traded goods space. *Slipstream* is that space directly behind a fast moving leader where air resistance is much reduced for a follower—it takes less effort for the follower to move forward. Much of development in the past has taken this route—less developed economies getting on the slipstream of mature economies via labor-intensive manufactures. In the modern era, it is now third world firms with designs on Manufacturing that should endeavor to enter the slipstream of global firms. As observed, Foxconn (Hon Hai) became a global giant as an OEM manufacturer in PRC in the slipstream of Apple, Samsung, Sony, etc. You don't see a Foxconn cellphone, but almost every upscale smartphone has an invisible Foxconn footprint. Foxconn is a Taiwan-

owned foreign investment company in PRC and now elsewhere in East Asia. The Philippines needs to facilitate the slipstream partnerships for our conglomerates.

In the next and last chapter, we recapitulate the lessons we learned to craft an overall vision that parts ways with the trajectory of wasted opportunities and blaze a path toward a new and more inclusive future.

11

Recapitulation

CAPITALISM faces an inclusion crisis the world over. This is true in the affluent OECD countries where the inclusion crisis is about income inequality. Income inequality in high-income mature economies has been shown to exacerbate with per capita income by Thomas Piketty's 2014 masterpiece. Inclusion in low-income countries with weak institutions is, however, more about the reduction of abject poverty than about income inequality. While there are policy regimes that promote both poverty reduction and more equitable income distribution, our position is that, when there is a conflict between these two facets of inclusion, abject poverty reduction should take priority. PRC reduced its poverty incidence massively while allowing income Gini to rise. It is arguable that the rise in income Gini in China actually helped along rather than impeded its poverty reduction. The 'Jack Ma phenomenon' is one of the unmistakable promontories of present-day China. As we observed earlier about the US Constitution, the 'Jack Ma phenomenon' may have been a case of 'social distinction' advancing the 'common utility' or collective welfare in modern parlance. The UN MDG and the subsequent UN SDG has targets for poverty incidence, but not for income inequality.

Piketty argued that Capitalism can no longer depend on the Kuznets Inverted U hypothesis to automatically push back income inequality. Instead, Capitalism should and could be made more inclusive by a more determined regime of progressive income and wealth taxation. We argue that Capitalism or its alter ego, the market economy, can be a vehicle for inclusion in low-income countries especially in the sense of poverty reduction. This can be pursued by raising government capital outlay to say 6–8% with which to scale up infrastructure spending, which will in turn draw in local and foreign

investment towards an investment rate of 25–35%. But the government must collect taxes with which to bankroll the increase in capital outlay. That is the reason behind the recently enacted TRAIN 1. TRAIN 1 is a good forward-looking program for job creation and poverty reduction despite the immediate cost in inflation.

As observed, the People's Republic of China (PRC) is the real superstar not just in economic growth, but more so in poverty reduction—three-fourths of all poverty reduction gains in the world during the MDG era (1990–2015) happened in China where 600 million people graduated out of poverty. In this, Deng Xiaoping was the real hero. Under Deng, PRC effectively adopted the genome we associate with Capitalism—free enterprise, profit seeking, foreign investment and world trade, and finally, private property in 2004—effectively scorning the Socialism of Marx and Engels and Mao Zedong, but repudiating as well the politics of the West. Along the way, Deng's PRC allowed the market to provide goods and services, previously the sole prerogative of the state. It went into overdrive in the upgrade of its infrastructure, built economic zones which welcomed the hitherto disdained foreign investment, allowed farmers to determine their own fates and, lately, allowed tradable usufruct rights on land (the Liuzhuan System; see, e.g., Fabella, 2014).

While we know more or less what Deng's China did, Deng's China remains a hard act to follow. The reason is plain enough: Deng inherited from Mao Zedong a China that was strong with a coherent polity and hard institutions. Those who opposed or were naturally disposed to oppose the political authority were rendered scarce by a process we call ideological cleansing. This strategy is hardly open to many low-income countries. That the Chinese polity and the central authority are in broad agreement is evidenced by the largely trouble-free construction of the Three Gorges Dam, a massive project that many Western observers opined could not be done in the West. The People's Republic of China has, as it were, attained the fullness of an 'imagined community'. Most low-income country governments, by contrast, are fragile political settlements that exhibit weak institutions and characterized by unstable rules, unstable enforcement, the truck-and-barter of rules and the capture of state organs by private interest for private gains. In other words, these polities are still in the process of what political scientists call 'state building'. Distrust of the central authority is the norm. Gridlock is endemic. In the Philippines, the San Roque Dam's capacity to irrigate 70,000 hectares of rice land was continuously

sidelined by conflicting claims that the Philippine state could not or would not resolve. The NAIA Terminal 3 was unused and decaying for a decade after its delivery in 2002 because it was bogged down by festering legal dispute that, in China, would have been ironed out with dispatch. Weak states and institutions manifest themselves as weak capacity for collective action; weak collective action capacity results in the poverty of public goods. The poverty of public goods, stunted economic growth and high poverty incidence are fellow travelers in the development highway.

Mounting game-changing projects run into intractable headwinds when public trust is low and the polity is fragmented. The state is often mired in the quagmire of 'overreach'—that is, it spreads itself too thin in too many puny projects and programs that reflect the fragility of its underlying settlement. Distrust is the currency of the land in many third world countries and with good reason. Most of its programs result in a harvest of waste and venality which becomes the signature of the state among its own polity. When a competition law was contemplated for the Philippines in the first decade of the twenty-first century under a compromised chief executive, the most powerful opposing argument was: "It will be another livelihood project for government bureaucrats!" A more crass, perhaps, but no less valid version of the biblical adage: "The spirit is willing, but the flesh is weak"! The oppositors won that fight. The Philippine Competition Act (RA 10667) finally became law in 2015 under President Benigno Aquino III.

Citizens, keenly cognizant of the very weak capacity of institutions in the Philippines, must constantly press upon advocates of the government intervention the question: What is the market or government failure that the state intervention or program addresses? Has the government the capacity to see through the intervention to the benefit of society? Unless adequate answers are supplied by advocates who should bear the burden of proof, opposition must be imperative.

We have seen how important trust is for institutions and how costly is the lack of trust. How do we restore trust in our institutions? The first step to restoration of trust is a strategic pause to new state programs only distantly related if not completely alien to its core competence and a strategic retreat from many extant but failed programs of the state. That is not easy. If Deng Xiaoping found it hard going outflanking the old guards and old ideas, ideas which the present-day National Democratic Front (NDF) still

champions, it is several orders of magnitude harder for many low-income countries. As this clearly goes against the grain of political wisdom in these countries, it takes a rare alignment of circumstances to pull off. Even with the most favorable of conditions, one can only hope for a slow evolutionary process of healing rather than radical Dengist turnaround.

Such alignments, if extremely rare, do occur. It starts with the fortuitous accession of a new well-meaning leadership. Deng Xiaoping is an example. He was a forlorn discredited outsider who had a heretical vision. As luck would have it he managed to wrest power after Mao's death in 1976. He exploited the emerging global forces outside PRC to outflank the opposition. In Deng's case, the cross-border movement of private capital and the Chinese diaspora served as lynchpin. The new economic zones established under Deng quickly became magnets for global export platform DFIs. Foxconn (Hon Hai), then a fledgling Taiwanese OEM company and three decades later the second largest private employer in the world after retailer Walmart in the USA, located in PRC in 1988. It was one of those facts on the ground and their harvest that could no longer be gainsaid. And the Deng Xiaoping era got its lasting lease on life.

The Philippines has, despite its weak institutions and poor reputation in contract compliance, has mounted a few successful strategic retreats by the state: the abandoning the OPSF and the privatization of downstream oil industry in 1998 and the privatization of water and sewerage services in Metro Manila in 1997 and the privatization of the electricity industry via the 2001 EPIRA. The first two occurred under President Fidel Ramos who, like Deng Xiaoping, enlisted a convergence of factors, namely, the presence of a crisis and global capital movement to support his reforms. President Ramos created a splash as the conqueror of the crippling 'power crisis' of the early 1990s. This he accomplished by drawing in independent power producers with a generous market risk-free 'take or pay' contract; this guaranteed independent power producers a high rate of return regardless of market conditions. Capital responded with 22 IPP contracts signed between 1991 and 1993 for 2.6 gigawatts (Abrenica, 2004). The power crisis was conquered (although at a high price, it turned out, when the domestic market collapsed in the wake of the Asian financial crisis). This conquest, nonetheless, gave President Ramos the political wherewithal to launch and see through other reforms. The privatization of water and sewerage service in Metro

Manila could not have proceeded without the well-publicized water crisis showing the failure of government provision of water distribution and the partnership between foreign capital and local conglomerates. Being acutely sensitive to, and seizing opportunities that emerge in the global economy, provided anchors for tilting the domestic balance of power towards game-changing reforms.

These precious few episodes of strategic retreat experienced growing pains at the start, but in time proved themselves beneficial. The considerable difficulty is the flipside of meaningful reforms. When painless, the reform will likely be meaningless. Which is why TRAIN 1 has a shot at meaningfulness.

Had our public infrastructure been adequate and our monetary and exchange rate policy more traded goods-friendly, the Philippine investment rate would have been higher while tilted more towards the Traded goods sector and Manufacturing; the economy would not have become mired in the malady of development progeria—when a low-income economy has the industry share dynamics of a rich mature economy—that is, its Service sector grows faster than its Manufacturing. Development progeria in low-income economies associates with economic stagnation, low investment and high poverty incidence. The roots of development progeria are market and institutional failures, such as poverty of public goods, compounded by a penchant—in low-income economies—to maintain an overvalued currency to cheapen imports and/or fight inflation. Together they hamstring Manufacturing in favor of Services. In the Philippines, it was literally a romance with the strong peso partly helped along by Dutch disease pressure from OFW remittance that cleared the way for a flourishing development progeria. These features are not genetic; they can be reversed.

The Philippines at this stage in its history has in its midst a number of large private conglomerates which are repositories of considerable financial, organizational and human capital resources. Because of the entrenched bias that drove investment away from the Traded goods sector (say, Manufacturing), these conglomerates are mostly in the Non-traded goods sector. These conglomerates tend to be horizontal (not in the sense of geographic but in the sense of activities) because markets in the Philippines tend to be small. To acquire size, which we observed is a trait selected for survival in environments characterized by weak institutions and predation,

these conglomerates grow horizontally. By doing so they invade each other's markets and enhance consumer sovereignty in these markets. This phenomenon we call 'conglopolistic competition'. Conglopolisitc competition tends to empower and benefit the consumers. This is true, for example, in banking which the retail trade giant, Shoe Mart Corp. (SM) entered after acquiring Banco de Oro and now gives the traditional banking community a run for its money. In turn, the Ayala group deeply entrenched in banking and property development has invaded the retail and malling services space long the preserve of SM.

Even more interesting, these conglomerates compete in the infrastructure development space as private partners in PPP projects of the government. We have seen the flowers of this competition. Metro Manila water distribution privatization could not have happened without these large conglomerates. Conglomerate competition figured in the Ninoy Aquino International Airport Expressway (NAIAX), the Tarlac-Pangasinan-La Union Expressway (TPLEX), the soon-to-be Cavite-Laguna Expressway (CALAX) and the sorely needed Connector Road projects. We saw how the government of President Benigno Aquino III realized Php28-billion in givebacks for the right to build and operate (the CALAX). This giveback can now be used to bankroll infrastructure projects in less viable regions. Thus the government's weak capacity for public goods provision has been increasingly boosted by the enlistment of these conglomerates via the PPP modality. The game changer here was the abandonment in the early 1990s of the deeply rooted view that transport and other infrastructure was the sole preserve of state provision. It would be foolhardy to abandon PPP now. It would be foolhardy for any government with designs on a bright future to keep breaking contracts its predecessor has signed on to, such as the income tax holiday in the water concession contracts, and thus show itself as an unreliable contract counterparty. It is a simple rule of law imperative that when a government sets aside a contract or a contract provision, it must adequately compensate the aggrieved private counterparty to the contract. And adequate compensation must be negotiated and cannot be arbitrarily imposed.

Development progeria—unlike its medical counterpart—is only phenotypic. As phenotypic, it is curable. Change the operating environment and the phenotype will adapt. The bottom line is that we can break out of development progeria by upgrading our infrastructure by leaps and bounds.

Raising the government capital outlay to 8% of GDP will go a long way towards decompressing investment, that is, raising the investment rate to 25–35% of GDP. Better infrastructure lowers the cost of doing business—for example, lower power cost always reduces the bias against the Tradable sector (Manufacturing and Agriculture) since these have to compete in the domestic and global market with Tradables from foreign jurisdictions with better public goods endowment and lower power cost. Rodrik (2008) has shown that the bias against the Traded goods sector can be reduced (the playing field can be leveled) by maintaining a weaker peso. Rodrik and others have demonstrated that higher economic growth and undervalued currencies are strong correlates in the development landscape.

Since at this stage in our history, we already have a clutch of conglopolistic competitors, our strategy should be to enlist and re-channel them towards boosting the state's weak capacity for collective action, that is, towards more public goods activities such as infrastructure development. The Duterte administration armed with considerable mandate (30% plurality is high in the Philippines) has a rare opportunity to swing the arc of history in favor of a more respectable future.

But vigilance against incoherence in policy and vision cannot be overemphasized. Adequate infrastructure through "BUILDx3" is designed to make us an attractive investment destination. But then we also impose higher power cost and we effectively mandate higher labor cost through 'endo'. The massive Hanjin shipbuilding investment in 2010 that would have employed 4,000 workers both directly and indirectly, in Northern Mindanao was aborted by local government interference which the central government could not or would not resolve (Sicat, 2015). This and like instances send very bad signals to foreign investors. Now we are embarking on giving more powers to local and regional governments through the federalism project. Investors especially in the Tradable goods sectors such as Manufacturing and Agriculture are very averse to incalculable risks emanating from the political projects. We may be calling a party from which investors shy away.

Fully aware that 'wasted opportunities' may well have been the middle name of the Philippines in the last forty years, we cannot stay on the shores of *business as usual*. Would that the future not be another showcase of squandered opportunities. The annals of failed development are painted on the canvas of squandered opportunities, *not* on the canvas of scarce resources!

APPENDIX

Welfare Gains from Conglopolistic Competition

WE CONSIDER a market with inverse demand function $P = a - bX$, $a, b > 0$, where the number of firms $n \geq 0$ and $X = \Sigma x_i$ is the sum of the outputs of n individual firms. In the following we will consider the inverse demand intercept 'a' as a proxy for market size (also called vertical growth by Hegji, 2001; Neumann et al., 2001). Each firm faces a fixed capital investment of $K \geq 0$ to be amortized at fixed rate $r \geq 0$. The size of K has scale economic implication. We thus assume the total cost function facing firm i as

$$C_i = c_i x_i + rK, \quad c_i > 0.$$

The variable cost of firm i is $[c_i x_i]$ and fixed cost is rK. The average cost $(C_i/x_i) = [c_i + (rk/x_i)]$ is decreasing at a decreasing rate as is customary with scale economies. The firms play a Cournot market game. We assume that $(a - c_i) > 0$ for all i. This characterization of the oligopoly market with fixed K is common (Dasgupta and Stiglitz, 1980; Neumann et al., 2001; see Hegji, 2001 for a case with endogenous K). The symmetric Cournot market equilibrium production is

$$x^o = (a - c)/[b(n + 1)],$$

and the total production is

$$nx^o = \{n(a - c)/[b(n + 1)]\},$$

while the Cournot equilibrium price is

$$p^{o} = [a + nc]/[(n + 1)].$$

Using x^{o}, nx^{o} and p^{o}, we find the welfare level using the consumer's surplus at Cournot competitive equilibrium with n firms, $CS(n)$, to be:

$$CS(n) = (n/(n + 1)^2(a - c)^2/2b.$$

Note that $CS(\infty)$ is maximum for any n = 1, 2,..., ∞. This is the *Nirvana* of competition viewpoint although it really has little practical value. The corresponding consumer's surplus at Cournot competitive equilibrium with $(n + 1)$ firms and under the same K is:

$$CS(n + 1) = ((n + 1)/(n + 2))^2(a - c)^2/2b.$$

Now it is clear that $CS(n) < CS(n + 1)$. Thus, more firms competing in the market will deliver higher consumer welfare. The welfare dividend of greater competition is

$$[CS(n + 1) - CS(n)] > 0.$$

This is obvious, for example, if the initial market has $n = 1$ (a monopoly) and the subsequent market has $n = 2$ (a duopoly). Note that the consumer surplus is monotonic increasing with respect to the number of firms. This is independent of the fixed cost or the size of K. The size of K, however, limits the number of firms that can make money in the x market. If the number of firms is such that all of them are losing money, then a consolidation will follow that whittles down the number of firms. As the number drops due to consolidation, consumer's surplus falls. Thus, the monotonicity relation holds whatever the size of K.

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CAPITALISM AND INCLUSION UNDER WEAK INSTITUTIONS

For several decades Professor Raul Fabella has set the benchmark for academic writing on economics and political economy on and in the Philippines. The hallmarks of his works are academic rigor, clarity of exposition, logical reasoning, and topicality, underpinned by a sense of urgency about pressing development challenges that his country faces. His beautifully crafted writings are always a pleasure to read, and this monograph on **Capitalism and Inclusion under Weak Institutions** *is no exception. Drawing on an eclectic group of authors, including Schumpeter, Piketty, Marx and many others, the 11 chapters range far and wide, from macroeconomics and international economic policy to institutional change and social policy. Taken together, they persuasively set out an agenda for a fairer and more prosperous Philippines. Professor Fabella's book is a must-read for anybody interested not only in the Philippines, but also the developing world in general.*

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