Chapter 1
Introduction

A. Objectives

The Philippines' economic growth during the past five decades has not been impressive compared with that of many of its neighbors; in per capita terms, the growth was even less favorable. As a result, the pace of poverty reduction has been slow and income inequality remains high. In 2003, about one in four Philippine families and 30% of the population were deemed poor and, in 2006, the Gini coefficient of per capita income (a commonly used measure of income inequality) was slightly over 45%, among the highest in Southeast Asia.

The Philippine Government is committed to sustained growth, the rewards from which are within reach of every Filipino. The commitment is spelled out in the current Medium-Term Philippine Development Plan.

This report has two interrelated objectives. The first is to seek to identify some critical constraints to long-run economic growth and equitable development in the Philippines. The second is to spell out some policy adjustments that stand a good chance of overcoming the constraints identified to broad-based growth and to achieving the Government's development targets.

B. Methodology

The study uses a diagnostic approach, and broadly follows growth diagnostics developed by Hausmann, Rodrik, and Velasco (2005). The growth diagnostics approach provides a consistent framework for identifying the most critical or binding constraints to growth and for discerning the priorities and sequence of policies required to ignite and sustain growth. The growth diagnostics approach differs from the laundry list approach, as implied by the Washington consensus, and recognizes that the economic and political environment differs a great deal among developing countries; there is no "one-size-fits-all" solution to development problems and, therefore, the ordering of policy priorities contingent on country-specific circumstances is critically important. Further, countries at an early stage of development may not have adequate capacity to implement a wide array of policy reforms at the same time. With the diagnostic approach, reforms can start with easing a few critical areas that truly constrain growth. Therefore, the approach offers a practical tool for policy makers and development planners to use in formulating country-specific growth strategies. The application of growth diagnostics is one of the efforts in the search for new approaches to growth strategy after the Washington consensus was questioned in recent years.

The growth diagnostics approach starts with a set of proximate determinants of growth, investigates which of these pose the greatest impediments or are the most critical constraints to higher growth, and figures out specific distortions behind the impediments. The point of departure of the inquiry is a standard endogenous growth model in which growth depends on the social return to accumulation, private appropriability of this social return, and the cost of financing (Box 1). Each of these three broad determinants of growth is in turn a function of many other factors, which can be presented in a problem tree (Figure 1.1).

The problem tree provides a framework for diagnosing critical constraints to growth. The diagnosis starts by asking what keeps the level of private investment and entrepreneurship low. Is it low social return to investment, inadequate private appropriability of the social return, or high cost of financing? If it is low social return, is that due to insufficient levels of complementary factors of production—in particular, human capital, technical

Box 1
An Endogenous Growth Model

A standard endogenous growth model yields the result that, at the steady state, consumption and capital grow according to

$$\frac{\dot{c}_t}{c_t} = \frac{\dot{k}_t}{k_t} = \sigma\left[r(1-\tau)-\rho\right]$$

where a dot over a variable denotes the rate of change over time, and where other definitions are as follows:

c = per capita consumption,
k = per capita capital,
σ = elasticity of intertemporal substitution in consumption,
r = rate of (the expected) social return to investment,
1- τ = private appropriabilty of social return, and
ρ = cost of financing.

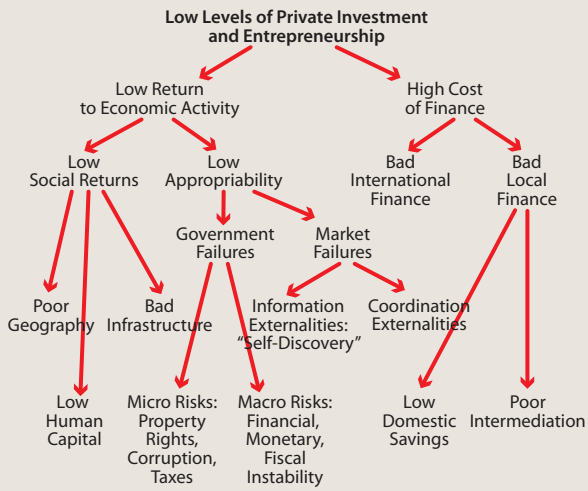
- The rate of (the expected) social return to investment (r) is a function of the availability of complementary factors of production such as infrastructure, technical know-how, and human capital. Lack of complementary factors reduces social return to investment and, with given private appropriability and cost of financing, leads to lower private return to investment and hence to lower private investment.

- The private appropriability of social return (1-τ) is a function of (i) micro risks such as high taxation, poor property rights and contract enforcement, and labor-capital conflicts; (ii) macro risks such as high inflation, currency crises, and financial meltdown; and (iii) market failures due to issues such as learning and information externalities, and coordination failures, with (i) and (ii) being interpreted as government failures. Higher micro and macro risks and larger market failures lower the private appropriability of social return and, with a given social return and cost of financing, lead to lower (expected) private return to investment and hence to lower private investment.

- The cost of financing (ρ) is a function of domestic savings rate, efficiency of domestic financial intermediation, extent of integration with external financial markets, and perceived country risks. Higher cost of financing, with given (expected) social return to investment and private appropriability, leads to lower private investment.

Source: Hausmann, Rodrik, and Velasco (2005).

Figure 1.1
Growth Diagnostics Framework



Source: Hausmann, Rodrik, and Velasco (2005).

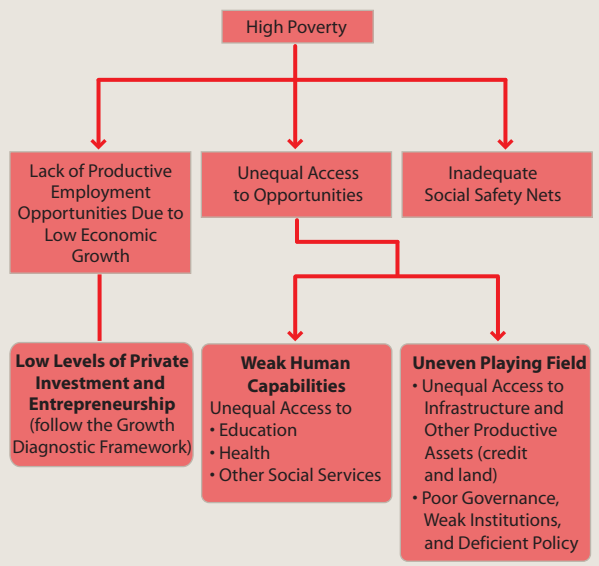
know-how, and/or infrastructure? If the impediment is poor private appropriability, is it due to macro vulnerability, high taxation, poor property rights and contract enforcement, labor-capital conflicts, information and learning externalities, and/or coordination failures? If high cost of finance is the problem, is it due to low domestic savings, poor intermediation in the domestic financial markets, or poor integration with external financial markets?

At each node of the problem tree, the diagnosis looks for signals that would help answer the question. The two types of diagnostic signals that one can look for are price signals and nonprice signals. Examples of price signals are returns to education, interest rates, and cost of transport. For instance, if education is undersupplied, returns to skills/education would be high and unemployment for skilled people would be low. If investment is constrained by savings, interest rates would be high and growth would respond to changes in available savings (for example, inflows of foreign resources). If poor transport link is a serious constraint, bottlenecks and high private costs of transport would occur.

The use of nonprice signals is based on the idea that when a constraint binds, it results in activities designed to get around it. For example, high taxation could lead to "high informality" (e.g., under-reporting of income, resulting in lower tax revenues); poor legal institutions could result in high demand for informal mechanisms of conflict resolution and contract enforcement; and poor financial intermediation could lead to internalization of finance through business groups. Cross-country and cross-period benchmarking and results of business surveys are useful means to gauge whether particular diagnostic evidence signals a binding constraint for the country concerned.

Although the growth diagnostics approach was developed to identify the binding constraints to growth and associated policy priorities, the approach can also be applied to other areas of policy analysis, such as identifying critical constraints to poverty reduction (Figure 1.2). Slow pace of poverty reduction can be caused by the lack of economic opportunities due to poor growth, weak human capacities that prevent individuals from participating in the growth process, absence of effective and adequate social safety nets, and/or inequitable access to opportunities due to poor governance and weak institutions. Each of these could be due to many other factors. The growth diagnostics approach focuses on identifying the root causes of poverty and critical constraints to poverty reduction.

Figure 1.2
Diagnostic Framework for Poverty



C. Organization of the Study

The rest of the report is organized as follows. Chapter 2 provides an overview of the Philippine development performance and evolution of development policies during the last several decades. It describes the episodes of growth, discusses key growth drivers, and examines progress in poverty reduction. Chapter 3 elaborates on growth diagnostics, focusing on the three broad determinants of growth that could act as constraints: social return to investment, private appropriability, and cost of finance. Chapter 4 looks at the links between growth and poverty and at critical constraints to broadening the inclusiveness of growth. Chapter 5 summarizes the findings and discusses policy implications.