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Governance, Institutions and Political Economy: Abridged Version

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1. Introduction and definitions

It is difficult to argue how the role of institutions can be avoided in explaining constraints to growth. An *institution*, after all, is defined as “a system of rules, beliefs, norms, and organizations that together generate a regularity of (social) behaviour.” [Greif 2006:30].¹ Understood at this fundamental level, institutions are pervasive and affect *any behaviour* that manifests any semblance of regularity, including political behaviour among political leaders, bureaucrats, and the citizenry itself. In particular, to the extent that formal rules, informal norms, beliefs and convergent expectations, and organisations are implicated in the acquisition and exercise of political authority, then *governance* itself – understood as “the manner in which public officials and institutions acquire and exercise the authority to shape public policy and provide public goods and services” [World Bank [2007:i] – must be understood as the outcome of institutions. *Political economy*, on the other hand, is understood here to mean the analysis of the effects of political constraints on economic policies and economic outcomes². “Political constraints” is merely shorthand for conflicting or heterogeneous interests, since upon closer consideration, complete homogeneity of interests would imply an almost axiomatic absence of conflict. Viewed from this aspect, the content of policies themselves assumes second-order importance, since whether or not policies are taken and the degree to which they are implemented become matters that are endogenous to the prevailing institutions and political economy that prevail.

To sum up, therefore, governance deals with the mode of acquiring and exercising political authority in a society, and this is directly related to the systems of rules, beliefs, norms, and organizations that govern political behaviour. The strength and efficacy of such institutions, however, is conditioned by the nature and degree of divergence of interests in society. It is then an empirical matter to determine to what extent such considerations affect economic performance.

In the growth-diagnostics framework of Rodrik, Hausman, and Velasco [2006], institutions exert a direct influence on investment – and hence on growth – owing to “government failures” that raise the costs of private investors, notably through corruption. The importance of institutions can, of course, be expanded beyond these to span the other branches of the growth-diagnostic tree. (Infrastructure deficiency, for example, can be traced to a failure of efficiency or corruption in the public-spending programme, or to an inadequate tax effort – itself possibly due to ineptitude or corruption in revenue agencies). For present purposes,

¹ This differs slightly but significantly from the definition of institutions as “rules of the game” and organisations as “players in the game” originally provided by Douglass North [1990].

² This definition is adopted from Drazen [2000:7].

however, this paper puts aside these second-order effects and confines itself to the direct or first-order effects of governance issues on investment.

2. The case for governance as an issue

To determine whether governance-institutions are first-order causes hindering investment and economic growth in the Philippines, it is first necessary to see whether objective measures exist suggesting that the country suffers from such issues. For this purpose, we use the data on governance outcomes collected by Kaufmann, Kraay, and Mastruzzi (KKM) [2006], which amalgamates data from a wide array of sources and standardises scores to delineate five aspects of governance for various years (annually since 2002). For each governance-outcome indicator, we determine whether the Philippines scores significantly better or worse than other countries, controlling for per-capita income levels, for each year that KKM have provided data. The details can be seen in **Annex Tables 1 and 2** but are summarised in **Table 1**.

It will be apparent that for most of the years covered, including the most recent period, the Philippines scored respectably on the aspect of “voice and accountability”. This largely reflects the formal guarantees of civil liberties, a free media, democratic processes, and checks and balances prescribed in the country’s constitution and affirmed in public discourse. The Philippines also scores relatively well in terms of regulatory quality and about average in “government effectiveness”, though less unambiguously for the “rule of law”. It is in the two governance-outcomes of political stability and control of corruption, however, that the Philippines seems to fall consistently below the average.

Sharper focus can be gained by considering a smaller set of neighbouring countries as comparators. Using the same data from KKM, **Figures 1a and 1b** show the percentile ranking of the Philippines on individual governance aspects – control of corruption and political stability. The shifting pattern across countries becomes apparent particularly in the last few years. For corruption, Thailand has always remained several notches above the Philippines, but the loss of momentum for the Philippines is apparent, which has allowed Vietnam and fairly soon Indonesia to catch up with it in this governance aspect. In terms of stability, it is Vietnam that rates the highest, consistently doing better than the 50th percentile. Again, the Philippines’ loss of ground in this aspect is apparent, particularly relative to 1998. (Thailand, on the other hand, lost ground largely owing to the successful coup launched by its generals that deposed a civilian government.)

A longer historical perspective can be gained from a series available from the *International country risk guide* (gathered and maintained by the private risk-rating firm PRS Group), which is the same set used in the well-known work by Kiefer and Knack [1995]. The total political-risk score in this case is made up of twelve sub-indices, including³ political stability, corruption, internal conflict, external threat, law and order, and bureaucratic quality, the sum of which is constructed to range from 0 to 100. **Figure 2** plots this overall index for the years 1984-2006. The Philippines was in the “very high risk” category for the years 1984-1994; reaching the lowest point in 1991. Thenceforth, the index improved gradually – coinciding with the holding of successful elections in 1992 –reaching “moderate-risk” levels by 1997 and even

³ The rest of the twelve categories are: socio-economic conditions, investment profile, the military in politics, the role of religion in politics, ethnic tensions, and democratic accountability.

“low risk” for the three years 1998-2000. It is significant that this coincides with the holding of credible elections in 1998. There is a noticeable turn for the worse in 2001, however, following the EDSA 2 events that led to the removal of President Estrada. Despite a slight improvement, perceived political risks in the country deteriorated after 2004, notably another election year.

It will be noted, finally, that some of these issues, measured at the macro-level, are also palpable at the micro-level, though with slight variations in emphasis. To take an example, the survey of business conducted jointly by the Asian Development Bank [ADB 2006] polls Philippine firms regarding what they regard as major or very severe constraints to operations and compares their responses to those of firms elsewhere. The most frequent responses of Philippine firms (by percentage of respondents citing) were: macroeconomic instability (40.0); corruption* (34.4); electricity (33.3); tax rates* (32.1); regulatory policy uncertainty* (29.0); crime, theft, and disorder* (26.3); tax administration* (26.0); cost of financing (24.3); labour regulations* (24.1) and anticompetitive or informal practices* (24.1) [ADB 2006: 61, Appendix Table 4a]. Other issues are regarded as distinctly less significant, being cited by less than 20 percent of respondents. What is striking about this list, is that of nine items, seven (those marked by asterisks) manifestly pertain to issues of governance or institutional quality. More importantly, we can in fact demonstrate that at least part of the explanation for the most frequently chosen response – macroeconomic stability – is at least partly explicable by institutional factors as well.

To sum up, therefore, the Philippines’ place in international rankings, its performance through time, and direct surveys of firms operating in the country strongly suggest that past and current issues of governance have been significant constraints to investment and growth.

Both cross-section and longitudinal assessments point to three significant channels by which governance-outcomes can negatively affect investment and growth.

First, at the highest levels, political instability arising from questions of legitimacy and legal infirmity may place the entire formal institutional framework of government in question. Changes in political regime – the extreme being represented by social revolutions – could signal large-scale changes in property rights, causing the investment regime to become uncertain and affecting both current and potential investment. Particularly in economies with a significant openness in the capital account, such risks will be reflected in larger risk premiums on borrowing and ultimately higher interest rates domestically.

Second, the quality of public choices is bound to be affected by the nature of institutions, as well as by the heterogeneity of interests affecting governance. In particular, public-investment decisions can be distorted by narrow agendas, corruption, or bureaucratic ineptitude, resulting in choices that are sub-optimal, overpriced, or both. The resulting under-provision of public goods in turn results in less private investment for want of the complementary public infrastructure. The concern of private business over the cost and availability of power, for example, is traceable to a failure of governance in the energy sector from the end of the Marcos period.

Third, in terms of regulatory quality, a major impact of weak institutions is the intrusion of narrow interests into the design or implementation of rules and regulations which, in principle at least, ought to have been designed in consideration of overwhelming public interest. The phenomenon of cronyism during the Marcos period is an important and historically documented instance of this phenomenon. On a less grandiose scale, the continuing restriction of entry into selected sectors of the economy and the accommodation of special private interests in strategic economic sectors – notably ports, shipping, air transport, and others – are a hindrance to investment – directly in those sectors, and indirectly owing to the uncompetitive conditions they

create in other sectors requiring their services. Hence, for example, the toleration of monopoly power in the electric-power industry can cause high prices that cascade to all other industrial power-users.

In principle, the unsatisfactory quality of public decisions as well as of the quality of regulation may be the result either of bureaucratic ineptitude, corruption, or both. All this, of course, is a matter of degree. From the KKM data set, at least, it would not appear that the Philippines fares poorly in governance aspects related to bureaucratic capacity (e.g., government effectiveness and regulatory quality). Comparing the Philippines' score for regulatory quality to those of comparable countries in the region (China, Indonesia, Thailand, and Vietnam), it does not appear that the country rates as a substandard performer (**Figure 3**). Indeed regulatory quality in the Philippines rates better than that of China on average. On the other hand, it is also known that the country's corruption score has fallen in recent years relative to the mean of those of the same countries mentioned. This is essentially also confirmed in the ICRG data set. What this suggests, therefore, is that corruption and pressure from special interests rather than inherent bureaucratic incapacities may be the more important obstacles to sound policy-choice and implementation.

3. Evidence

Historically the most obvious and palpable manifestation of the effect of institutions and political economy on economic performance is the impact of political instability on growth, particularly working through investment. Episodes of overt political instability over the past fifty years have involved attempted or consummated changes in political regime through the declaration of martial law and emergency rule, civilian-military uprisings, coups d'état and cabinet crises (See Table 1). As argued in the preceding section, large-scale political-regime changes can unsettle distribution and property rights and in this manner affect investment. A major hypothesis, therefore, is that investment decisions should generally be sensitive to actual or threatened political regime-changes that have characterised recent Philippine history.

From an historical perspective, the precipitous decline in per-capita income in the 1980s must be regarded as the single most significant episode that caused the Philippines to fall behind its neighbours in economic performance. This becomes evident when one considers any comparative record of long-term growth, such as those provided by A. Maddison or Summers and Heston: the 1980s can justifiably be regarded as the "lost decade" for the Philippines, and it is no accident this same period was marked by episodes of political severe instability. The most notable and extended period of instability was associated with the events leading up to the popular uprising known as "the EDSA people power revolution" of 1986, which toppled the Marcos regime. The record makes evident that this led to the worst postwar decline in investment and growth in the Philippine economy.

Political instability

The installation of a new government led by President Corazón Aquino failed to produce immediate political stability owing to the fragile and tentative nature of the coalition that stood behind it. In particular, military elements that had broken with the Marcos regime and initiated the uprising sought to assert what they perceived as their prior claims over government and sought continually to swamp and ultimately depose the popular civilian politicians that were behind Mrs. Aquino. Such claims lay behind the attempted putsches that took place in August 1987 and December 1989.

The putsch attempts of 1987 and 1989 were particularly ill-timed, since they coincided with a period of huge increases in Japanese out-sourcing investments throughout the region that resulted from the yen appreciation following the Plaza Accord of 1985. Events in the Philippines effectively demonstrated, however, that the newly installed Aquino government was not yet fully in control. The impact of the 1989 coup attempt was particularly devastating since it occurred in the country's financial district⁴

Figure 4 shows the behaviour of the government-stability measure taken from the ICRG data set for comparable countries covering the years after the Plaza Accord until the eve of the Asian Financial Crisis. Clearly the country's perceived level of stability had already been badly affected by the political crisis in 1984 and was well below those perceived for others in the region. There was an incipient improvement until 1987 (Panel 1) but this was interrupted by a sharp decline after 1987 and 1989, lasting until 1991 (Panel 2), coinciding with the period of violent coup attempts against the Aquino government.

A hypothesis advanced here that the Philippines failed to benefit from an exogenous event, namely, substantial Japanese investment flows following upon the Plaza Accord that lifted other economies of the region, particularly Thailand, Malaysia, and Indonesia, and provided these countries with a valuable stimulus for growth during the period leading up to the Asian financial crisis. Over the period 1984-1997, foreign direct investments in Malaysia, Indonesia, and Thailand, respectively, averaged \$3.31 billion, \$1.86 billion, and \$1.6 billion annually, with an accelerating trend. By contrast, in the Philippines, the Philippines averaged only \$808 million dollars in annual foreign direct investment (**Figure 5**).

A straightforward test of this hypothesis is shown in **Table 2**, which relates relative FDI per capita flowing into comparable countries of the region (Indonesia, Malaysia, and Thailand), to the relative political stability of those countries. For the entire period, 1985-2006, the lagged index of relative political stability is positively and significantly related to the relative amounts of FDI per capita going into the country. The higher statistical significance of the coefficient of relative stability and the explanatory power (up to 50 percent) for a sample confined to 1985-1992 alone suggests the crucial nature of that period, owing to the one-time investment surge that occurred.

That the impact of political instability is not limited to direct foreign investment may also be seen in **Table 3**, which shows estimates of the effects of various sets of governance variables on lending interest rates, which of course affect investment. Signs on the coefficients of variables associated with governance outcomes are consistently negative, implying that better governance outcomes are associated *ceteris paribus* with declining lending rates. It also becomes evident that a combination of variables relating particularly to government stability, corruption, and internal conflict (Model 5) performs best in explaining the penalty to investment, as measured by changes in the lending rate. Indeed other aspects of governance-outcomes such as democratic accountability, bureaucratic efficiency, etc. do not seem to contribute strongly to the explanation, as seen from the fact that their inclusion actually *reduces* the explanatory power of governance indicators (Models 1-3). As already suggested in an earlier section, however, special attention must be paid to the government-stability variable (Model 4). By itself, this variable provides the bulk of the impact of governance indicators on the interest rate, and therefore investment and growth more generally.

⁴ Anecdotal accounts state that the putsch attempt caught a large delegation of prospective Japanese investors at the very Makati where the rebellious soldiers holed up.

While the problem of political stability subsided significantly in the period 1992-2000, which spanned the Ramos presidency and the aborted term of the aborted Estrada administration (Panel 3), it reappeared with the deposing of Estrada (Panel 4). It deteriorated further with the scandals hounding the Arroyo administration, particularly with respect to the legitimacy and honesty of the 2004 elections. This saw the breaking of a hitherto customary pattern, in which post-election periods were typically associated with enhanced stability.

Evidence on the impact of corruption on the investment rate

Examples of corruption and their impact on investment are numerous but difficult to systematise in any simple manner. Petty corruption, which is practised among the low- to middle-ranking bureaucracy, partakes of the nature of a regular activity implemented through implicit collusion among insiders of an agency who exercise discretion through the selective implementation of well-known rules. The better-understood examples of these are the revenue-collecting agencies (internal revenue and customs) and some large line-departments (e.g., education, public works, and defence) that routinely engage in large-scale purchasing, recruitment, or front-line dealings with the transacting public (see, e.g., the reportage by PCIJ's Chua [1999] on education; for a survey, see de Dios and Ferrer [2001].). It is largely possible to predict this phenomenon and comprehend it as a "going concern" the channels of which are well known but difficult to close, since they are integral to the regular functions of these agencies themselves. Left to their devices, however, it is unlikely that such activities would cause large shifts in investment behaviour that would change the trajectories of countries' growth. This is because the scope of the functions of low- to mid-level bureaucrats is well-defined and the detection of a repeated activity would be in principle be relatively straightforward. To ratchet these activities to substantially enlarge the take will therefore typically require the initiative and protection of highly placed "backers". Smuggling, for example, or even the protection racket for the small numbers game can assume an unusually large scale when customary operators obtain implicit the support from the highest places in the political establishment.

The conduits of *grand* corruption are almost invariably projects and deals, frequently of a one-off nature, that involve the disbursement of huge sums⁵ (typically billions of pesos). Again this can occur only through the witting or unwitting complicity of centrally placed politicians, most notably the chief executive. It is noteworthy, for example, that currently the only channels for big-ticket national infrastructure are (a) foreign assistance, or (b) some form of build-operate-transfer involving the private sector. The budgetary process in congress itself has degenerated into a mere ritual for legislators to lobby for their own local projects. Both foreign-funded projects or BOTs in the meantime are largely the prerogative of the executive branch and not subject to congressional scrutiny. The controversies over the the PEA-Amari deal under Ramos, the IMPSA power project under Ramos and Estrada, the NAIA Terminal 3 project spanning the Ramos, Estrada, and Arroyo administrations, and the NBN-ZTE broadband network and Northrail projects under Arroyo were all under the purview of executive discretion. The explicitly political (rather than routine-bureaucratic) nature of decisions taken at higher levels of government also mean that the bases for objective evaluation of such decisions become more amorphous for the public at large, and the distinction between well-meant executive discretion and corruption becomes blurred.

One effect of corruption on investment is, of course, that it (a) works like a tax or a transfer transferred from a productive project proponent to politicians or deal-makers, thus

⁵ Rose-Ackerman [1998] defines grand corruption as "a substantial expenditure of funds with a major impact on a government budget and growth prospects".

adding to cost and reducing the incentive to invest. But (b) it is worse than a tax to the extent that it is unpredictable in the magnitude of payoffs asked; and unreliable in the (illegal) delivery of the contract to the briber. There is cross-country evidence [Campos, Lien, and Pradhan 2001] to suggest that the “predictability” of corruption also matters. Periodic political competition in the Philippines, however, Beyond these, however, it may also (c) pre-empt competition and new investment, by awarding vital projects and economic sectors to interests with credentials and talents other than entrepreneurship and productivity, but rather, say, rent-seeking and political extortion; finally (d) corruption may introduce a bias in the choice of investments particularly public investments. Decisions are more likely to correspond to the priorities and conveniences of corruption insiders rather than those of the public at large: the overspecification in recent proposals for information technology for a government broadband and for “cyber-education” are the most recent glaring examples.

A worsening of corruption differs in its effect from deteriorating political stability in that the latter can develop quite rapidly and is therefore more prone to affect volatile price variables, such as interest rates and exchange rates, as well as *potential* new investment, particularly direct foreign investment. A rise in corruption, on the other hand, is likely to be more gradual and to be felt and recognised by investors who are *already* present in the domestic economy. It is therefore more likely to affect the overall investment or accumulation rate, e.g., investment as a proportion of GDP, rather than potential investment. (Separate tests – not reported here – show the corollary: that political instability variables are not a strong influence on the investment rate.)

Empirically, therefore we test whether measures of corruption contribute significantly to equations that seeking to explain the rate of accumulation. **Table 4** contains various specifications using either current or lagged measures of the corruption index, together with the typically

included variables such as real interest rates, lagged investment, or some measure of predicted or past levels of output. In the great majority of these specifications, what is notable is that the corruption index, whether current or lagged, emerges as an important explanatory variable to explain the investment rate, sometimes overshadowing more traditional explanatory variables such as real interest rates or predicted or lagged GDP. Perceived corruption ratings easily explain from a quarter to a half of the variation in the investment rate.

Regulatory capture

It is difficult to quantify the impact of regulatory capture on investment, since regulations typically affect specific sectors, and a proper specification would have to posit pre- and post- or counterfactual situations. The reasonable – close to or above the mean – values for regulatory quality and government effectiveness in the KKM data for the Philippines seem to suggest that little if any institutional problems here exist. One shortcoming of survey data, however, is that they are based on general assessments of a general situation, without allowing for a more nuanced appreciation of strategic or critical sectors. It is true, of course, that after the Marcos period, successive Philippine administrations (notably under Ramos) embarked on a spate of liberalisation and deregulation reforms in many sectors. Notable successes have been registered in telecommunications, for example, where the dismantling of a monopoly notwithstanding an imperfect reform, has resulted in increased investment and customer access. Llanto and Gonzales [2007] and Patalinghug and Llanto [2007] document, however, how this initial pace of reforms has been faltering shipping, power generation, and telecommunications have begun to falter with the respective regulatory agencies hesitating to take what are thought to be essential next steps to complete the reform process and create a

more competition in their respective industries. At least some part of this must be traced to the intrusion of political agenda in what ought to be independent regulatory agencies.

Llanto and Gonzales [2007:10] call regulatory agencies “a point of political access for purchasing major influence over government policy” on the part of affected firms or special interests, with entrée being provided by the fact that in almost all cases, such regulatory and quasi-judicial bodies are made up of presidential appointees with no fixed tenure. In the power industry, for example, new private investment has been held up owing to a badly designed law that allowed cross-ownership between distributors and generators. This has created uncertainty among potential investors who are at a disadvantage with respect to parties with secure contracts with their affiliate distributors. Similarly, telecommunications rules have allowed incumbent telcos to offer value-added services to their own subsidiaries on terms not made available to third parties. The popular suspicion cannot then be avoided that regulatory agencies tend to treat dominant firms in their industry depending on the political accommodation these have reached with the appointing powers. Ultimately, the question raised is to what extent an independent and professional bureaucracy continues to exist in the Philippines given the extraordinary power of the president and the nature of political institutions and transactions.

4. Analysis and recommendations

Elections and constitutional legitimacy

The roots of political instability are ultimately found in the problem of regime legitimacy. Legitimacy can be validated either *de jure* or *de facto*, or both, and Philippine political institutions have unfortunately failed on both counts. On the level of formal or *de jure* institutions, recent Philippine history has been riddled with political transitions that tested prevailing formal constitutional rules to the limit. As a result, the legitimacy of such changes has invariably been open to doubt and to credible challenges by at least some sections of the population, leading to instability. This legal adventurism began with the declaration of martial law by President Marcos in 1972 as a means of evading the term limits set down under the 1935 constitution. Marcos’s term was prolonged thereafter owing to the ruse of a “transition” government that was putatively allowed by the succeeding 1973 constitution. The travesty of two constitutions committed during the Marcos era ultimately provoked a backlash that was equally audacious, the people’s power revolution in 1986, which began as an exposed coup d’etat and ended as a popular urban uprising.

While the legitimacy of the Aquino government ostensibly derived from a victory in the snap elections – and there need be no doubt about Mrs. Aquino’s popularity – it was ultimately enforced in practice by a people’s uprising and the defection of a large section of the armed forces. The fact that Mrs. Aquino’s mandate could be thus disputed opened her to challenges from military forces that launched coups d’etat in 1987 and 1989, which – as discussed – wreaked havoc on stability and investment. Improvements in stability came only when Mrs. Aquino made a credible commitment to abide by a new constitution (1987) and credible local and national elections came to be held thereafter.

The country’s next experiment in extra-constitutionalism was the overthrow of President Estrada in 2000 through a second people’s uprising backed by a withdrawal of military support. The constitutionality of Mr. Estrada’s removal has always remained in doubt, since it failed to

fulfil the conditions as set forth in the existing constitution⁶. As a result, the supreme court itself needed to find a legal construction to legitimise Mrs. Arroyo's assumption of power. That the legal basis for Mrs. Arroyo's assumption of power was less than iron-clad in turn provided a plausible legitimacy to parties that wanted to weaken or topple the government. What finally determined the ensuing legitimacy crisis, however, was the disputed victory of Mrs. Arroyo in the 2004 elections. Ordinarily, the successful holding of elections under constitutional rules should enhance regime legitimacy. The emergence of the electoral scandal against Mrs. Arroyo, however, further diminished her claim to legitimacy. The questioned legitimacy of the Arroyo administration opened it to coup attempts (notably in 2003 and 2006) and led to pressure from various sectors for the president to resign or to be impeached. This tradition of breaking with or stretching the constitution to its limits has not been cut short, as witness the precarious calls by some middle-class leaders and members of the media for a simultaneous resignation of the country's top officials and the holding of a snap election.

Obviously a greater adherence to constitutional processes and limits is needed in order to break the downward spiral of legitimacy, where both administration and those who oppose it constantly threaten to infringe normal constitutional limits in order to gain power.

What renders this difficult, however, has been the formal political system's failure thus far to justify itself *de facto* to its principal bearers and supporters – the educated urban middle classes. Easterly et al. [2006] find that social cohesion – particularly as embodied by a broad middle class – is an important factor explaining the stability of formal governance, owing largely to the implicit consensus they maintain regarding the efficacy of impersonal institutions (a pattern true since the mediaeval period in Europe). The Philippines, however, has long suffered from a history of economic inequality, with a numerically small middle class that is often squeezed in an electoral democracy between the numerous poor for whom the prescriptive rules of a formal democracy are but an abstraction, and an elite which is not above distorting such rules to preserve economic and political privileges in intra-elite competition. Ironically, therefore, in the Philippines it has been the middle classes that has stood for adherence to constitutional rules, but also supplied the supportive audience for extraconstitutional attempts (coups d'état and popular uprisings alike) when these have felt the system not working according to their conceptions. Moving forward, both government and people need to make a common investment in the infrastructure of secular constitutional processes that are allowed to operate normally, no matter that the results do not immediately correspond to middle-class or even religious ideals. Undermining this trend in the meantime is the option of outmigration for increasing numbers of the middle classes. This further depletes their numbers, alienates them from the political system, and weakens the constituency for stable formal governance institutions.

Abating this process may require consideration of the following: (a) implementing long-delayed election modernisation; (b) instituting campaign reforms and election-finance reforms; and (c) publicly delegating the president's authority to appoint members of the electoral commission to an impartial body.

Limiting presidential power

An important inducement to political corruption and political instability comes from the centralisation of power in the presidency [de Dios and Esfahani 2001]. More powerful than the

⁶ Particularly the required formal resignation of Mr. Estrada to justify the succession of Mrs. Arroyo, then vice-president.

US president, the Philippine president exercises selective fiscal discretion and unprecedented powers of appointment, commanding both the armed forces and police. (The chair of the civil service commission estimates [David 2007] that presidential appointments may number as many as 10,000 from supreme court justices, to the commission on elections, to board-members in government corporations, regulatory agencies, down to minor officials in far flung municipalities and cities.) The powerful presidency is the central object of intra-elite contention, around which the political alliances of local elites is organised. A negative externality of intra-elite competition in this system is the observed distortion of public investment choices and regulatory capture.

Among the major challenges for the country in the coming decades is changing the balance of power in government, away from the executive and mainly towards congress and the local governments. The present administration in particular has illustrated and tested the limits of presidential powers (e.g., declaring a state of emergency; invoking executive privilege; concluding executive agreements without congressional approval; persistently reappointing persons passed over by the congress, and so on). Owing to congress' subordinate and financially supine position, however, it has failed to assert its prerogatives [de Dios 1999], with only the supreme court in recent times interposing objections to the further expansion of presidential powers. The result has been a growing culture of impunity within the executive branch, with the negative consequences already mentioned regarding opportunities for corruption and regulatory capture.

Key steps that may be considered to address this trend may include: (a) quantitatively reducing by law the president's powers of appointment, particularly enlarging the legislature's role in the selection of members of constitutional bodies, and ensuring the integrity and security of tenure of the career civil service; (b) appointing members of regulatory bodies to fixed terms (the monetary board being an exemplary success); (c) systematically involving congress in year-round review of national expenditures (i.e., beyond the budget period) and the reduction of lump-sum allocations over which the president has discretion; (c) instituting congressional oversight on prospective foreign borrowing; (d) removing presidential discretion to withhold the release of funds appropriated by congress; and (e) devolving more power to local governments and redesigning the formula for internal revenue allotments to local governments to at least partly reflect their own revenue efforts. Some of these may in the future be addressed through a constitutional amendment or perhaps the change-over from a presidential to a parliamentary system. In practical terms, however, smaller changes within the current constitutional ambit may be less destabilising than open-ended charter reforms that have historically been an opportunity for the realisation of ulterior motives.

Rebuilding civil society

Ultimately, it is the convergence of people's expectations regarding the rules that govern public life work – and the fact that these are normally serviceable – that yields political stability, stabilises investor expectations, and gives a fair chance for superior economic growth to occur. The historical heterogeneity of Philippine society, however, currently militates against this occurring: instead it causes a dangerous feedback from inequality to divergent beliefs, to political instability and corruption, to low growth and high poverty, and thence again to further differentiation. The gulf in political values becomes evident, for example, as between the middle classes and the *masa* in their differing appreciations of the judicial fate of former president Estrada, both before and after conviction – what is perceived by some as the operation of the rule of law is regarded by others as unusual punishment for a popular leader. The peril in the present situation lies in the growing despair and waning interest among many of the intellectuals and middle classes regarding further participation in the political system itself – i.e., the

decimation of civil society. This is particularly true for those with the option of “voting with one’s feet” to seek institutions more in accord with one’s beliefs.⁷ Left unchecked, such a trend would mean an even smaller and weaker constituency in support of formal political institutions that were accountable to the public interest, which would normally mean an invitation to greater impunity and intense rivalry among the political elite, hence a deeper legitimacy crisis.

But the present stability in economic circumstances situation (and caused partly by that very trend, i.e., the migration overseas with the resulting return-flow of remittances) may itself afford a small opening, to the extent that it affords upward social mobility and a higher education among a larger number in society. In a sense, therefore, even the middle-class diaspora may be helping to recreate the future middle classes. If the example of successful middle-class civic organisations (e.g., Gawad Kalinga) are any guide, then process of repoliticisation begins not from explicitly political organisations themselves but from common professional, civic, or local interests that build up a sufficient solidarity to hold political institutions to account. The question then becomes whether and how to speed up the re-engagement of such new emerging elements in the rebuilding of the country’s ravaged institutions.

⁷ In some public-opinion surveys, as many as a fourth of adults from the rich to upper-middle classes and from the educated express a preference for living and working abroad permanently.

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Table 1
Governance indicators for the Philippines
Cross section and for selected years

Governance indicator	1996	1998	2002	2003	2004	2005	2006
Voice and accountability		+	+	+	+	+	+
Political stability	-	-	-	-	-	-	-
Govt effectiveness	+					+	+
Regulatory quality	+	+	+	+		+	+
Rule of law	+	+	-	-	-	-	-
Control of corruption	-	-	-	-	-	-	-

Legend: (+), [resp. (-)], denotes a governance score for the Philippines that is significantly better [resp. worse] at the the 5-percent level or less, compared to countries with similar GDP per capita for the period

Source: Table A.1 and author's computations using data from Kaufmann, Kraay, and Mastruzzi [2006]

Table 2
Foreign direct investment and political stability (OLS regression; 1985-2006)

Dependent variable	Relative FDI per capita ¹	
	1985-1992	1985-2006
Constant	1.84103 (1.01)	4.07829*** (4.45)
Lagged relative political stability ²	1.59409** (2.50)	1.01625** (2.16)
Sigma	2.51775	2.40543
R ²	0.509704	0.1976747
Log-likelihood	- 17.5877	- 47.1784
F-test (d.f.)	6.237; (1,6)	5.447; (1,19)
D.W.	1.32	1.28
AR 1-1 test: F (d.f.)	0.010330; (1,5)	0.11841 (2,17)
ARCH 1-1 test:	0.49315; (1,4)	0.83755; (1,17)
Normality test : $\chi^2(2)$	2.0642	0.30705
Hetero test: F(d.f.)	n.a.	0.647660; (2,16)
Hetero-X test:: F(d.f.)	n.a.	0.64760; (2,16)
Reset test: F(d.f.)	3.6307; (1,5)	0.0017584; (1,18)

** significant at the 5-percent level; ***significant at the 1-percent level

¹Relative per-capita FDI: mean of annual per-capita of FDI into Malaysia, Indonesia, and Thailand as a proportion annual per-capita FDI of the Philippines

²Stability ratio: mean ICRG Government Stability scores of Malaysia, Indonesia, and Thailand as proportion of the ICRG Government Stability score of the Philippines

Table 3

Dependent variable: First-difference in lending interest rates (OLS estimation; annual data: 1986-2006)

	Model 1:	Model 2	Model 3	Model 4	Model 5
Constant	-0.412692 (-0.707)	-0.28575 (-0.512)	-0.273362 (-0.513)	-0.415578 (-0.776)	-0.231485 (-0.474)
Difference in inflation	0.417040*** (4.03)	0.409148*** (4.22)	0.371635*** (3.82)	0.402492*** (4.17)	0.344901*** (3.89)
Lagged difference in logs of Governance 1	-7.89052 (-1.15)				
Lagged difference in logs of Governance 2		-7.76819* (-1.88)			
Lagged difference in logs of Governance 3			-8.54232** (-2.28)		
Lagged difference in logs of Governance 4				-8.55233** (-2.00)	
Lagged difference in logs of Governance 5					-8.15274** (-3.05)
Sigma	2.57284	2.43709	2.34798	2.41008	2.16209
R ²	0.54002	0.587371	0.616992	0.596466	0.675237
Log-likelihood	-48.0244	-46.886	-46.1038	-46.652	-44.3717
F(2,18)	10.57	12.81	14.5	13.3	18.71
D.W.	1.89	1.89	2.0	1.95	2.04
AR 1-2 test:: F(2,16)	0.57281	0.13118	0.028501	0.027160	0.029781
ARCH 1-1 test: F(1,16)	1.7259	0.74194	1.2782	0.038058	0.27683
Normality test : $\chi^2(2)$	0.75732	0.17726	0.25946	0.13009	0.67898
Hetero test: F(4,13)	0.13223	0.11274	0.11970	0.091947	0.31736
Hetero-X test:: F(5,12)	0.10554	0.084617	0.098547	0.080944	0.24171
Reset test: F(1,17)	2.6225	2.1435	1.9030	1.5202	1.1075

*significant at the 10-percent level;

** significant at the 5-percent level

*** significant at the 1-percent level

Governance 1: Total score on 12 governance components (PRS)

Governance 2: Governance 1 less scores on socioeconomic conditions, external conflict, religion in politics, and democratic accountability (PRS)

Governance 3: Sum of scores on government stability, corruption, internal conflict, and investment profile (PRS)

Governance 4: Score on government stability

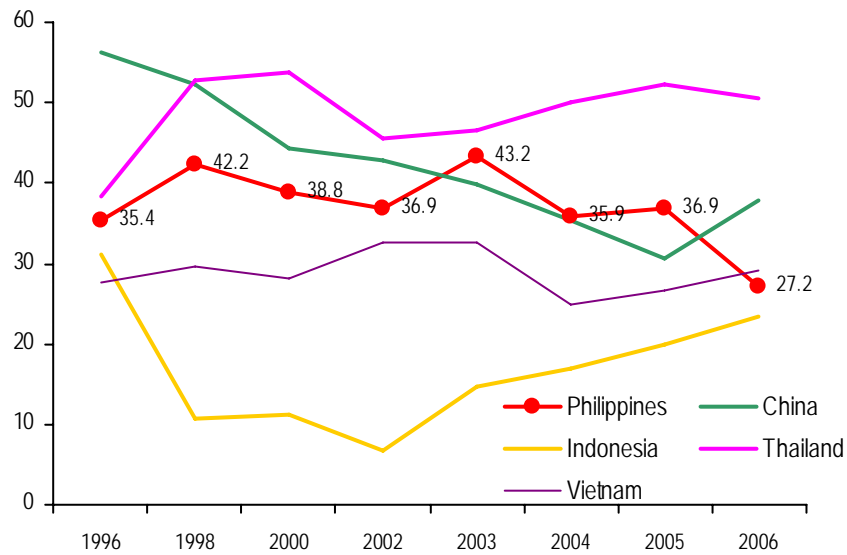
Governance 5: Score on government stability, corruption, and internal conflict (PRS)

Table 4

Dependent variable: Investment ratio (OLS Estimation: annual data)

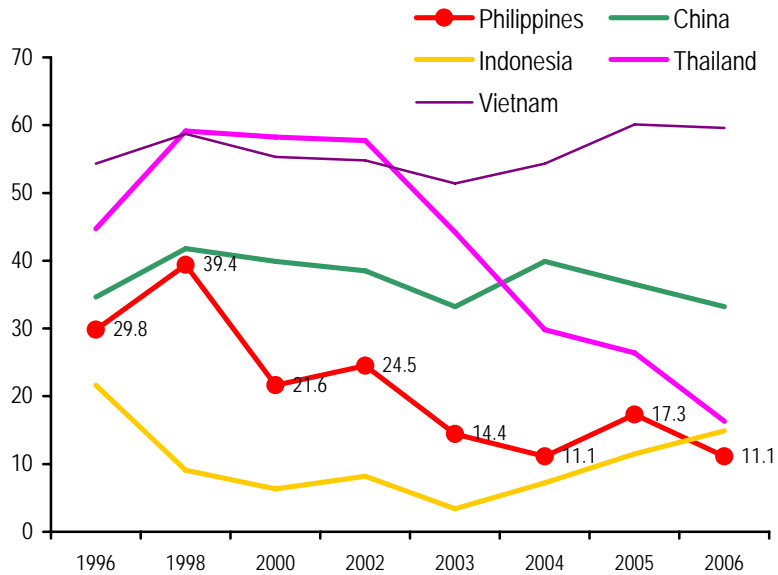
	Model 1 1984-2006	Model 2 1984-2006	Model 3 1985-2006	Model 4 1985-2006	Model 5 1985-2006
Constant	19.7433 (0.688)	18.24999 (0.647)	10.6855** (3.26)	8.90129** (2.74)	7.93916* (2.45)
Lagged investment ratio	0.438040** (2.90)	0.454500** (3.32)	0.276124 (1.60)	0.354844* (2.05)	0.355959** (2.22)
Lagged GDP	- 0.891797 (- 0.420)	- 0.814160 (- 0.387)			
Real interest rate	- 0.107748 (- 0.312)				0.326867 (1.17)
Lagged real interest rate		- 0.0560761 (- 0.181)	- 0.107073 (- 0.2678)		
Lagged nominal interest rate				0.0511975 (0.628)	
Inflation rate				-0.0852405 (-0.896)	
Corruption score	1.88295*** (3.88)	1.87210*** (3.86)			
Lagged corruption score			2.12317*** (4.05)	2.00497** (3.46)	2.17246*** (4.39)
Sigma	2.02621	2.02984	1.70948	1.7207	1.65483
R ²	0.629827	0.6285	0.734012	0.745481	0.750745
Log-likelihood	- 46.0585	- 46.0997	- 40.8054	- 40.3206	- 40.0907
F-test; (d.f)	7.656; (4, 18)	7.613; (4, 18)	16.56; (3, 18)	12.45; (4, 17)	18.07; (3, 18)
D.W.	1.94	1.91	1.61	1.52	1.52
AR 1-2 test: F(d.f.)	1.4294 (2, 16)	1.4280; (2, 16)	1.6663 (2, 16)	1.3081; (2, 15)	1.2204 (2, 16)
ARCH 1-1 test: F(d.f.)	6.6314; (1, 16)	6.5662; (1, 16)	0.3333 (1, 16)	0.7562 (1, 15)	1.0709 (1, 16)
Normality test : $\chi^2(2)$	0.35398	0.25006	0.16153	0.90195	0.61942
Hetero test: F(d.f.)	0.47680; (8, 9)	0.50364; (8, 9)	0.31008 (6, 11)	0.38193 (8, 8)	0.15077; (6, 11)
Reset test: F (d.f.)	11.656; (1, 17)	10.013; (1, 17)	0.12708 (1, 17)	1,4525 (1, 16)	2.2161 (1, 17)

Figure 1a
Percentile rankings of selected countries in the control of corruption



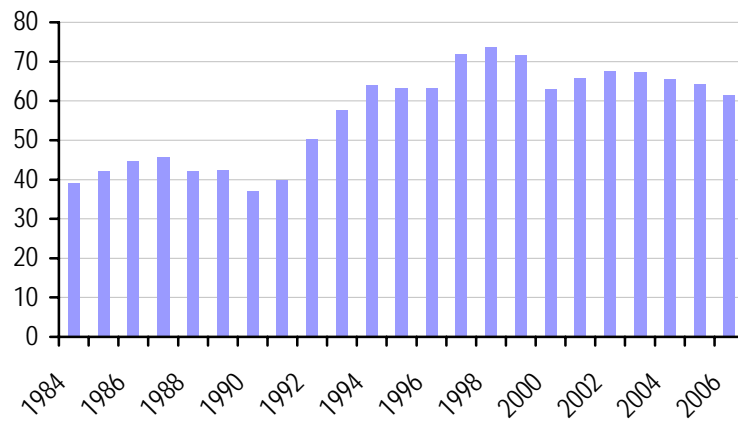
Source: Kaufmann, Kraay and Mastruzzi [2007]., as generated from <http://info.worldbank.org/governance/wgi2007>

Figure 1b
Percentile rankings of selected countries in political stability



Source: Kaufmann, Kraay and Mastruzzi [2007]., as generated from <http://info.worldbank.org/governance/wgi2007>

Figure 2
 Overall “political risk”: Philippines (1984-2006)



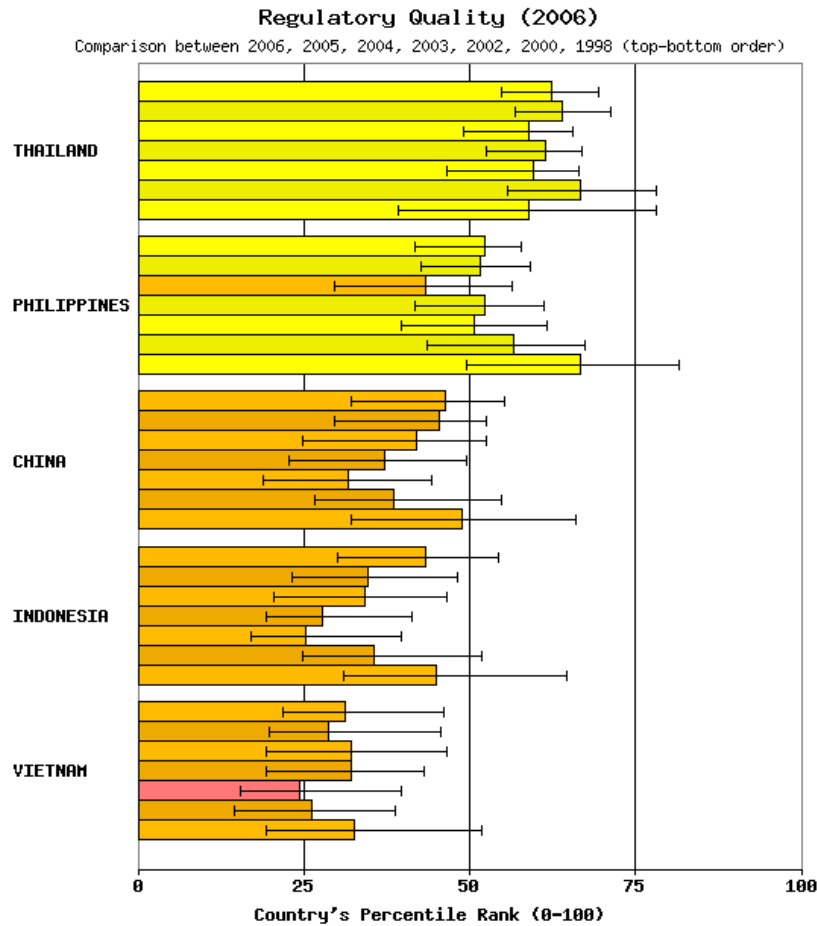
Source: Political Risk Services. *International country risk guide*

Legend:

[0, 50) = Very high risk
 [50-60) = High risk
 [60-70) = Moderate risk

[70-80) = Low risk;
 [80,100] = Very low risk

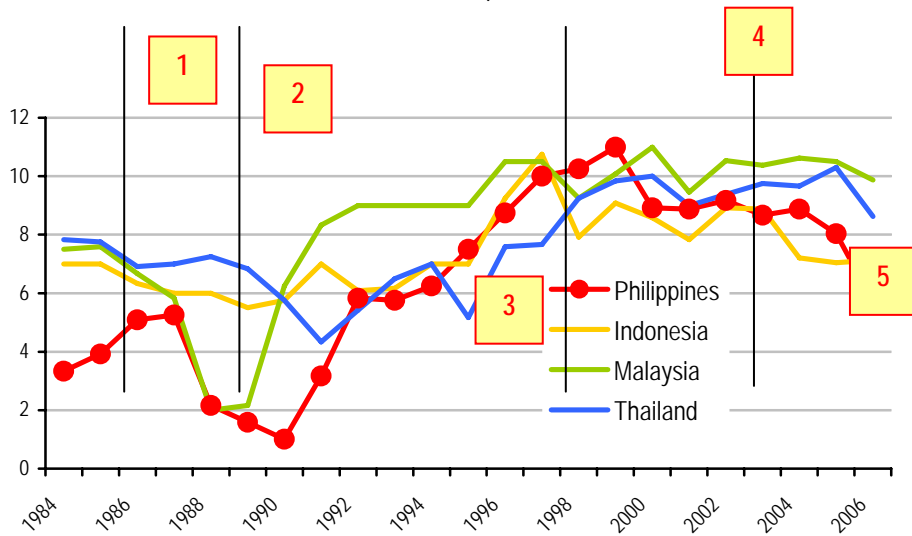
Figure 3



Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2007: Governance Matters VI: Governance Indicators for 1996-2006

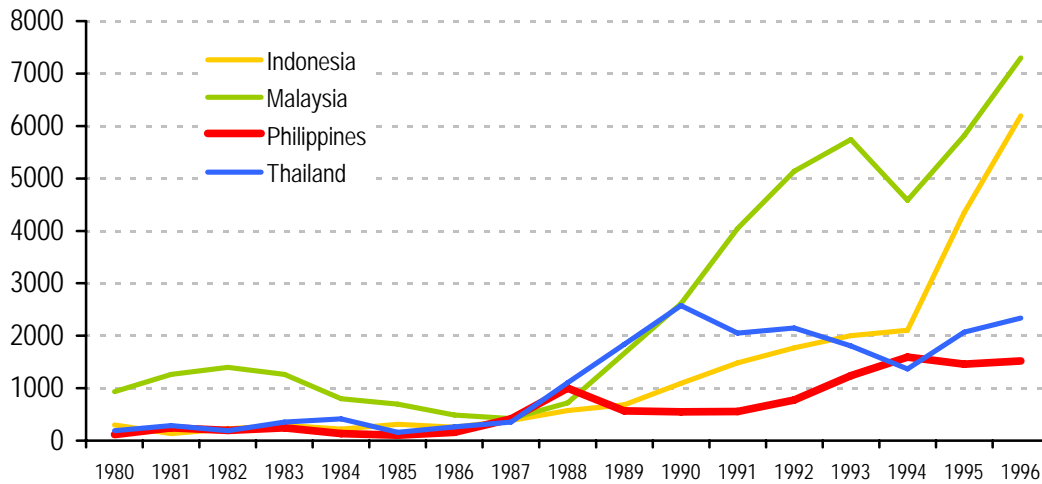
Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. Countries' relative positions on these indicators are subject to indicated margins of error that should be taken into consideration when making comparisons across countries and over time.

Figure 4
 Government stability index for selected countries
 (1 = least stable to 12 = most stable; 1984-2006)



Source: Political Risk Services, *International Country Risk Guide*

Figure 5.
 Foreign direct investment flows Philippines, Malaysia, Indonesia, Thailand
 (in millions of current dollars; 1980-1996)



Source: UNCTAD (www.unctad.org)

Annex Table 1

Definitions of six governance-dimensions used by KKM

1. *Voice and Accountability (VA)* – measuring the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.

2. *Political Stability and Absence of Violence (PV)* – measuring perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including domestic violence and terrorism

3. *Government Effectiveness (GE)* – measuring the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies

4. *Regulatory Quality (RQ)* – measuring the ability of the government to formulate and implement sound policies and regulations that permit and promote private-sector development

5. *Rule of Law (RL)* – measuring the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence

6. *Control of Corruption (CC)* – measuring the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests

Source: Kaufmann, Kraay, and Mastruzzi [2007]

Annex Table 2.
Deviation of Philippine governance scores from mean controlling for per capita GDP¹

Governance Indicator	N	Deviation ²	P-value ³	Significance ⁴
Voice and Accountability				
2006	180	0.04	0.50	
2005	180	0.26	0.00	***
2004	180	0.18	0.00	***
2003	183	0.27	0.00	***
2002	179	0.34	0.00	***
1998	179	0.62	0.00	***
1996	176	0.42	0.00	***
Political Stability				
2006	180	-1.03	0.00	***
2005	180	-0.83	0.00	***
2004	180	-1.01	0.00	***
2003	179	-1.00	0.00	***
2002	175	-0.45	0.00	***
1998	175	0.12	0.08	*
1996	171	-0.27	0.00	***
Govt Effectiveness				
2006	180	0.22	0.00	***
2005	180	0.16	0.00	***
2004	180	0.03	0.49	
2003	179	0.05	0.27	
2002	179	0.04	0.33	
1998	179	0.02	0.65	
1996	173	0.17	0.00	***
Regulatory Quality				
2006	180	0.16	0.00	***
2005	180	0.19	0.00	***
2004	180	-0.06	0.20	
2003	179	0.17	0.00	***
2002	179	0.16	0.00	***
1998	179	0.69	0.00	***
1996	174	0.80	0.00	***
Rule of Law				
2006	180	-0.22	0.00	***
2005	180	-0.17	0.00	***
2004	180	-0.39	0.00	***
2003	179	-0.35	0.00	***
2002	179	-0.32	0.00	***
1998	179	0.13	0.01	***
1996	162	0.23	0.00	***
Control of Corruption				
2006	180	-0.47	0.00	***
2005	180	-0.35	0.00	***
2004	180	-0.31	0.00	***
2003	179	-0.20	0.00	***
2002	179	-0.32	0.00	***
1998	179	-0.15	0.00	***
1996	146	-0.22	0.00	***

Source: Own computations based on Kaufmann, Kraay, and Mastruzzi