

## Justice and the cost of doing business in the Philippines\*

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The performance of the judicial system has been thrown into the limelight as business surveys point to its performance as one of the main obstacles and disincentives to doing business in the Philippines. The channels through which judicial decisions may affect business behavior are straightforward: increased uncertainty and high costs. To quantify the perceived effects, a survey of 320 of the top 7000 corporations in the Philippines was conducted in 2001. Our findings show that governance problems are at least as important as economic or financial problems in doing business. Of more direct relevance to the judiciary, difficulties in settling legal conflicts were among the most frequently cited factor affecting business. Further, the current level of functioning of the legal system has an economic impact equivalent to foregoing at least 6-11 percent of total investment in the economy and foregoing at least one-fourth to one-half of a percentage point (0.25-0.46) of GDP growth annually, or an annual loss amounting to between Php7 billion and Php13 billion in 1999 alone. These are significant and recurring economic losses attributable to the nature and functioning of institutions and form a strong case for judicial reform.

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## 1. Introduction

The effect of the performance of the judicial system has been thrown into the limelight as the business sector has in various surveys pointed to its performance as being one of the main obstacles and disincentives to doing business in the Philippines. This sense is strengthened by the dissatisfaction with the performance of the judiciary documented in previous surveys, although it must be noted that lawyers and judges themselves are aware of the problem [Mangahas et al. 1996].

The channels through which judicial decisions may affect business behavior are fairly straightforward and may be reduced to two: increased uncertainty and high costs. One fundamental source of uncertainty lies in concerns over the credibility and validity of contracts and awards and their possible delay or reversal through the judicial process. Another may be found in frequent shifts in ground rules of business resulting from policy or legal disputes among branches or agencies of government, many of which end up in the courts. Still another area pertains to the security of property or personal security of business people put under threat by crime.

Costs, on the other hand, refer to both the monetary and nonmonetary opportunities that business people forego as a result of making use of the judicial system itself. Direct costs refer not only to the fees paid the courts but also to out-of-pocket costs arising from litigation itself (e.g., lawyers' fees and documentation). Indirect costs also inevitably arise, of which the most important are those incurred from delays in the resolution of cases, and the failure to come up with timely decisions. It should be noted that the source of high costs may vary. As an example, one might locate possible causes of delay in: (a) simple resource constraints that tax the judiciary's capacity to dispose of the case backlog; (b) lack of sufficient expertise or competence on the part of judges or lawyers to process cases in timely fashion; (c) judicial corruption; (d) political pressure, which complicates the resolution of cases; and (e) poor design of the law, which also renders cases complex.

In relation to uncertainty, there are again two issues, namely, predictability and fairness. Outcomes are said to be predictable when the results do not vary by a wide degree. For example, similar cases ought to be decided similarly and yield the same outcomes. Unpredictability may be due to the ill-defined or poorly written laws, or because of incompetence or lack of knowledge on the part of judges, or the possibility of corruption. Another aspect affecting uncertainty is fairness, or the absence of bias. This refers to the frequency with which the right side wins and the wrong side loses. Closer reflection will reveal that the same factors that were cited to account for high costs may also play a role in

determining the degree of uncertainty of judicial outcomes. Uncertainty and high costs act as powerful disincentives to investment. At the level of individual investors, uncertainty reduces the perceived benefits from any project and may as well increase costs.

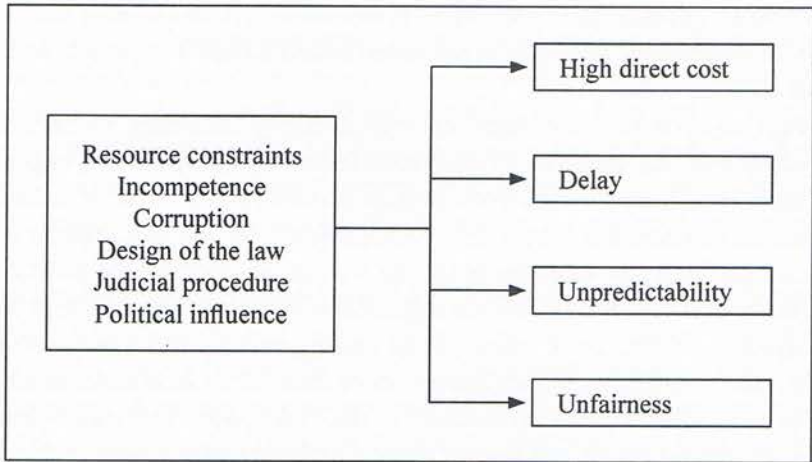
High costs, on the other hand, eat directly into profitability. The net result is a lessening of attractiveness of individual investment projects. It is important to note, however, that these effects pertain not only to the level of individual investment projects but may affect even projects that do not directly come into contact with the operations of the judicial system, to the extent that uncertainty and avoidable costs are regarded as systemic. This can lead to the downgrading of the credit rating of the entire country, which may reflect in higher risk premiums or higher interest rates charged by international lenders to all borrowers seeking to do business in the Philippines. This raises the cost of doing business for all, not just for those who have had occasion to deal with the justice system directly.

In addition, however, outlays are required in order to avoid potential problems of dealing with the judicial system. In the extreme, business deals between parties may be concluded under the jurisdiction of foreign countries rather than the Philippines (the resort to Hong Kong is a common example). The bother and expense of having to do this must be counted as part of the costs imposed by the present judicial system.

## **2. The problem locus**

Locating the possible reasons for unpredictability and high costs of resorting to the judicial system is a more complex affair than a summary assessment that these problems do exist, which appears to be the tenor of the first-generation debate. These assessments, however, have less value for an internal reform agenda, which the Supreme Court itself has resolutely and creditably pursued (see, e.g., Supreme Court [2000]). The next advance in a more positive agenda would seek to identify (a) the relative importance of various sources of dissatisfaction with judicial performance, (b) the possible reasons for these, (c) the sectors of the judiciary in which these are likely to occur, and (d) the perceived magnitude of the effect of these problems on the cost of doing business.

In general, high direct costs, delay, unpredictability, and unfairness may be traceable to several factors, including (a) pressure on resources, (b) incompetence or arbitrariness of judges, (c) corruption, (d) political pressure, (e) the design of the law itself, or (f) the design of judicial procedure (Figure 1).

**Figure 1. Factors affecting the cost of doing business**

As a specific example, the Supreme Court's role in several prominent business deals—such as the Bataan petrochemical case, the Manila Hotel case, and the oil deregulation law—has been frequently cited as compelling examples of undue interference by the courts in economic outcomes, a case of “unpredictability”. Yet this assessment is by no means clear-cut. An alternative view would locate the problem with the Constitution itself, which gives the Supreme Court the right to review cases where there may have been “grave abuse of discretion”; from this viewpoint, the Court itself may be considered as being no more than a prisoner of the circumstances, rather than the source of the problem. A proper understanding of the mandate of the Constitution, as designed, would seek a solution in a plea to reform the Constitution, which is an altogether different matter from pointing accusing fingers at “hoodlums in robes”, or thinking that judges were incompetent. As another example, the assessment of the significance of the delay in the disposition of cases will differ depending on whether it is thought to be due to the dilatory tactics of lawyers or prosecutors, or to the sheer backlog of cases that courts must dispose of owing to the inadequacy of resources.

It is also important to note that the judicial system is much larger than popular opinion makes it out to be. The judicial system consists not only of the regular courts but also of the special courts (e.g., tax court of appeals) and quasi-courts or administrative agencies, such as the National Labor Relations Commission. The inclusion of the latter is obviously warranted to the extent that their decisions are subject to review by the courts. The personnel who affect the performance of the judiciary narrowly construed involve not merely justices and judges but also fiscals and prosecutors, clerks of court and sheriffs, all of whom are officers of the court.

A fine line also exists between the judicial and the legal systems, which may be less obvious to public and business opinion. For instance, as already mentioned, unpredictability may result just as much from corruption as from insufficient knowledge, or the poor design of laws. In the latter case, the "problem" lies less with the judiciary rather than with the legal system itself.

Finally, to get an idea of the overall importance of the problem, there is a need to quantify the perceived effect of the workings of the judiciary on the various economic decisions and on investment in general.

While approaches to the study of the connections between economics and the law are varied (see, e.g., Mercurio and Medema [1997] for a survey), the framework used here owes much to the "new institutional economics" approach, deriving from the work of Coase [1937, 1960], Williamson [1985], and North [1990]. It was Coase who first pointed out how specific institutions may arise to mediate transactions among private agents, and how agents may choose among different institutions depending on the costs and benefits associated with using them. The existence of the firm [Coase 1937] as a set of implicit contracts (especially characterized by the employment relationship) arises owing to the costs of using the markets and straight contracting in situations where demand and technology are uncertain or subject to change. Similarly, the provisions of the law and the intervention of the courts would matter little to social outcomes if only private agreements could be written and enforced at no cost. (In particular, Coase [1960] illustrates the irrelevance to efficiency of the assignment of property rights in the case of torts where transaction costs are zero, in what has become commonly known as the "Coase theorem"). Firms, therefore, would not exist if only arm's-length market transactions were costless. The law and judicial intervention would be unnecessary and property rights assignment irrelevant if the costs of reaching and enforcing private agreements and private dispute settlement were zero.

Williamson [1985] elaborated this approach by pointing out how the choice of contracting arrangements can depend on a host of factors including

transaction costs, risk, the wider legal and political environment, custom, and the technical characteristics of the asset involved. Williamson is particularly associated with showing the conditions under which contracts are rendered vulnerable to opportunism or "holdup" by others, for which reason devices such as collateral or entering into joint ventures are resorted to.

At a much more aggregative level, Douglass North [1990] ventures the hypothesis that the great puzzle of development has always been how to secure cooperation and expand mutually beneficial exchanges, and that much of the development of what are now the industrialized countries had to do with the nature of the institutions that facilitated such cooperation and minimize disputes. Drawing from his work in economic history, North points, for example, to the definition of property relations, the devolution of power from absolutist regimes, and the rise of the rule of law as important elements in economic development.

The obvious implication that flows from this body of work on wide differing levels of analysis (whether dealing with the macro "institutional environment" or the micro "institutional arrangements" [Mercurio and Meder 1997:131]) is that the number of mutually beneficial or efficiency-enhancing transactions that can be accomplished will depend on the alternative institutional arrangements available and the costs associated with each. The judicial system is, of course, one of the principal means by which agreements between contracting parties are interpreted and enforced.

By enforcing promises optimally, the courts create incentives to efficient cooperation. Cooperation is efficient when the promisor invests in performing at the efficient level and the promisee relies at the efficient level. By interpreting promises, the court can reduce the transaction costs of cooperating. Specifically, the courts reduce the costs of negotiating contracts by supplying efficient default terms [Cooter and Ulen 1997:202].

High transaction costs in accessing the courts can thus have the effect of discouraging mutually beneficial exchanges and, in this way, affect aggregate economic performance. To be sure, it is obvious from the framework that the failure of one type of arrangement (including judicial recourse) will lead to the search for others, and one is far from saying that all disputes and uncertainties ought to be resolved through the action of the courts. Certainly, for example, even if the collection of outstanding debts through the courts is costly, there are probably other ways to cope with the problem, including requiring collateral lending only to prime clients, etc. These devices, however, also entail their own costs to the firms themselves and, moreover, to society at large, in terms of unrealized mutually beneficial bargains, say, in the form of foregone investment opportunities.

A basic premise of this study is that if these alternative arrangements were optimal and represented the first-choice among firms, then one should not observe firms reporting foregone opportunities as a result of the existing contractual arrangements they have entered into. If, on the contrary, firms report foregoing beneficial transactions that would otherwise have pushed through under a more efficient judicial system, then such opportunities represent a measure of the cost of judicial dysfunction, relative to which other institutional arrangements may have been unduly expanded.

### **3. Survey description**

To achieve the research aims, an empirical analysis was attempted based on a survey conducted among business people, who were asked several questions about how they assessed the efficiency of the judiciary and the likely impacts on output, investment, and employment of improving this efficiency. The spirit of this survey follows similar business surveys such as those carried out in Brazil [Castelar Pinheiro 1998], Spain, and Argentina. The survey's questionnaire<sup>1</sup> was designed to probe the following:

- (1) How business people rank problems with the judiciary in relation to other problems they face
- (2) Whether they felt that this inefficiency compromised the performance of the economy as a whole and of their firms in particular
- (3) How important they thought it was to rely on alternative mechanisms to solve disputes and/or to screen suppliers and clients to avoid having to resort to court
- (4) Whether in their sectors of activity they thought that the inefficiency of the judiciary led to palpable economic effects, such as high spreads on interest rates, curtailed investment, etc.
- (5) Whether the lack of trust in the good performance of the judiciary was ever the main reason for their firms not pursuing a line of action that would have been appropriate otherwise, such as not investing or substituting equipment for labor
- (6) Whether the firm would change its business practices if the judicial system improved its efficiency, such as relying more on outsourcing or investing more in other regions of the country

The framework itself suggests that the approach to measurement cannot be aggregative in nature, since the nature of the firm itself has some influence

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<sup>1</sup>Available from the authors upon request.

on the incidence of transactions costs and, therefore, on the magnitude of the benefits that it may enjoy from a functioning (or costs it may incur from an inefficient) judicial system. Size is represented here as revenue or level of employment. The effects of size, however, are not altogether unambiguous a priori. On the one hand, size may capture the intensity of contracting in which a firm is engaged. On the other hand, it is also possible that a large firm is better able to internalize and adjust to the intricacies of legal contracting. For example, it may be better able to afford either a legal department or to retain influential or well-connected law firms to represent its interest, which is particularly important given the political aspects of many judicial decisions.

The survey sought to cover some 300 respondents from among the top 7,000 corporations of the country as listed in the publication *Top 7000 Corporations in the Philippines 2000*, which also includes financial data such as gross and net income, net worth, leverage, among others, as well as the number of employees and other variables. In choosing this procedure, the researchers were conscious of exploiting the possibility of relating the responses to the survey questions to published information.

The top 7,000 corporations were then ranked into the top, middle, and bottom thirds (terciles) in terms of gross revenue, and called “large”, “medium”, and “smaller”.<sup>2</sup> A random sample of 100 firms from each category was drawn to arrive at a total sample size of 300 to whom the survey was administered by the Asian Institute for Journalism and Communication (AIJC). After replacements were made due to lack of response, in the end a total of 320 firms were surveyed with the distribution given in Table 1. In the end, the sample included 41 percent, 31 percent, and 28 percent in the top, middle, and bottom terciles, respectively. The majority of firms surveyed were found in services (52 percent) and industry (46 percent).

The respondents of the study consist of 320 firms from the top 7,000 corporations of the Philippines for 1999-2000. This is broken down as follows: a random sample of 220 respondents and a purposive set of 100 respondents; a detailed description of the sample size is shown in Table 1.

A listing of the companies interviewed is appended in Annex A. The study made use of the top 7,000 corporations (1999) as the sampling frame to draw a stratified random sample, with the population divided into terciles. A purposive sample was also used in the study, however, since a 300 random sample could not be obtained during the allotted data collection period. A total of 100 firms from business groups, associations, and others comprise the purposive sample: Philippine Chamber of Commerce and Industry (PCCI) = 36; Philippine Economic Zone Authority (PEZA) = 44; Other associations = 20.

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<sup>2</sup>The terminology and definition are adopted only for this study and do not correspond to the official definition of such firms in Philippine statistics.



The data collection instrument was a structured questionnaire that was pretested on a small sample of ten. Data collection took the form of face-to-face interviews and self-administered questionnaires accomplished over the period 2 April to 8 June 2001. The surveys took place around the Metro Manila area and the adjoining provinces of Cavite, Laguna, and Bataan, where industrialization has been rapid in the last decade.

**Table 1. Profile of respondents (percent)**

<i>Base respondents</i>	<i>Total</i>	<i>Random</i>	<i>Purposive</i>
	320	220	100
<b>RESPONDENTS' DESIGNATION</b>			
Manager / Director general	25	25	26
Top management	24	20	33
Department head	19	24	9
VP / Exec. VP / AVP	14	12	2
Supervisor	12	15	5
Legal staff	4	5	3
Not reported	2	-	4
<b>INDUSTRY OF FIRM</b>			
Manufacturing	68	19	49
Wholesale and retail, repair of motor vehicles, and personal and household goods	13	15	8
Financial intermediation	11	9	16
Transport, storage, and communication	8	10	4
Real estate and renting	8	10	5
Importer/exporter/retailer	7	8	6
Other community, social, and personal services	4	5	2
Construction	4	5	1
Electricity, gas, and water supply	3	4	2
Agriculture, hunting, and forestry	3	2	4
Others	9	8	3

*Revenue, income, and employment.* In Tables 2-4 we provide some financial and other statistics that further characterize the sampled firms in terms of size. An obvious gap exists between the largest and middle firms, with the former having 29 times the 1999 revenue of the latter and 86 times the after-tax income (Table 3). The difference in 1999 revenue between middle and bottom tercile firms is also marked, with revenues of the former being about twice that of the latter. Finally, the stark difference in income is obvious, with the smaller firms registering after-tax losses in both years, while the largest and middle firms continued to show profits. Nonetheless, there is a decline in both revenues and income for all, most likely reflecting the worsening economic climate in 1999 as the effects of the Asian financial crisis wore on. In terms of the number of employees, large firms had an average of 827, while middle and smaller firms had 307 and 264 (Table 5). The sampling included medium firms that were established somewhat more recently than the smaller firms. Broken up by sector, it turns out that the sampled service firms have the largest employment, followed by industry and agriculture. The industrial firms, on the other hand, are somewhat younger than either those in agriculture and services.

**Table 2. Firms sampled by size and sector**

<i>Size</i>	<i>Agriculture</i>	<i>Industry</i>	<i>Service</i>	<i>Total</i>
Large	0	63	68	131
Medium	2	55	43	100
Smaller	2	31	56	89
Total	4	149	167	320

**Table 3. Average gross revenues and net income (after tax) by size: 1998 and 1999 (in thousand pesos)**

<i>Size</i>	<i>Average gross revenues</i>		<i>Net income (after taxes)</i>	
	1998	1999	1998	1999
Large	3,008,444.0	2,746,686.0	232,885.8	123,949.2
Medium	101,874.7	93,872.5	4,422.0	1,436.0
Smaller	45,400.9	42,272.2	-570.3	-707.8

**Table 4. Average value of total assets, liabilities, and equity by size: 1998 and 1999 (in million pesos)**

Size	Assets		Liabilities		Equity	
	1998	1999	1998	1999	1998	1999
Large	13,400.0	16,400.0	11,700.0	13,000.0	4,293.0	3,141.2
Medium	322.0	353.8	190.1	199.4	132.9	150.1
Smaller	100.1	108.8	51.7	61.0	48.6	44.3

**Table 5. Average number of employees and years in existence by size**

	No. of employees	No. of years in existence
<b>BY SIZE</b>		
Large	827.4	27.9
Medium	306.9	16.1
Smaller	264.2	20.2
<b>BY SECTOR</b>		
Agriculture	167.5	25.5
Industry	407.0	18.2
Services	598.9	25.4

*Experience with the judiciary.* In terms of actual experience with the judiciary, somewhat less than half (45 percent) of the respondents indicated that they had been plaintiffs in court cases. The incidence of plaintiffs was higher among large firms (52 percent) compared to smaller (42 percent) and medium-sized firms (38 percent) (Table 6). Another "experience" variable was a self-rating question as to whether the respondents felt themselves to have been negatively affected by a particular decision of the judiciary. Only a minority (27 percent) declared themselves to have been so affected, with the incidence declining with size (Table 7).

**Table 6. Incidence of firms who have been plaintiffs in court cases (percent of respondent)**

	Total (320)	Large (131)	Medium (100)	Small (89)
Yes	45	52	38	42
No	55	48	62	58

**Table 7. Whether or not firms were negatively affected by a decision of the judiciary (percent of respondents)**

	<i>Total</i> (320)	<i>Large</i> (131)	<i>Medium</i> (100)	<i>Small</i> (89)
Negatively affected	27	39	23	18
Not negatively affected	63	51	68	70
Don't know	10	10	9	12

#### 4. Perceptions of business conditions

On the whole, the firms surveyed rated business conditions they faced as being somewhat better than "satisfactory" (Table 8), giving an average response of 3.3 on a 5-point scale, where 1 is "very poor", 3 is "satisfactory", and 5 "very good". This is consistent with external data for 2001, the year the survey was taken, which showed that the economy continued to recover (albeit not yet fully) from the previous years' slowdown. Firms in services and in agriculture gave a slightly higher rating, which again is consistent with manufacturing being the sector hardest hit by the economic crisis. Breaking the responses down by size of firms (Table 9) gives no additional insight, with responses being fairly uniform across size categories. It is noteworthy that the assessments of business conditions reveal no obvious biases related to either sector or size.

**Table 8. Rating of current business conditions (respondents by sector)**

	1 <i>Very poor</i>	2 <i>Poor</i>	3 <i>Satisfactory</i>	4 <i>Good</i>	5 <i>Very good</i>	<i>No response</i>	<i>Average score</i>
Agriculture	0	1	1	1	1	0	3.5
Industry	4	26	61	48	8	2	3.2
Services	3	20	73	54	16	1	3.4
Total (320)	7	47	135	103	25	3	3.3

**Table 9. Rating of current business conditions (percent of respondents, by firm size)**

	1 <i>Very poor</i>	2 <i>Poor</i>	3 <i>Satisfactory</i>	4 <i>Good</i>	5 <i>Very good</i>	<i>No response</i>	<i>Average score</i>
Large (131)	2	14	42	34	8	2	3.3
Medium (100)	0	16	42	35	7	0	3.3
Small (89)	5	15	44	27	9	1	3.2
Total (320)	2	15	43	32	8	3	3.3

The factors most frequently cited as having “important” to “very important” effects on the business are shown in Table 10. The significant purely economic factors that firms said affected their own businesses were, first, weak market demand, which was perceived by almost three-fourths (74 percent) of respondents as an “important” or indeed a “very important” factor. What is interesting, however, is that the next three most frequently mentioned factors pertained to governance issues: corruption in government was cited by 66 percent of the respondents as being important/very important. This was followed by the high crime rate (57 percent) and the low level of trust in government laws and policies (56 percent). These three governance factors were cited more frequently than the economic problem of high power costs. These responses appear to reflect the continuing concern of businesses regarding government credibility, especially in the period after the EDSA 2 phenomenon (the surveys were undertaken in May 2001), which was characterized by a fall in business confidence.

**Table 10. Perceived importance of some factors that may affect own business (percent of 320 respondents)**

	<i>Important</i>	<i>Very important</i>
Weak market demand	20	54
Corruption in government	27	39
High crime rate/peace and order	28	29
Low level of trust in laws and policies	32	24
High power costs	27	29
Difficulties in settling legal conflicts	25	23
Poor physical infrastructure	25	19
Lack of access to reasonable credit	20	21

More pertinent to the judicial organization itself, difficulties in settling legal conflicts was the sixth most frequently mentioned factor affecting business and the fourth most important factor in governance. It is noteworthy that legal difficulties were a factor more frequently mentioned than poor physical infrastructure and access to credit as being likely to affect business.

In sum, the responses suggest that governance problems are at least as important as economic or financial problems in doing business. While it is not the most important governance problem (corruption and peace and order are), the operation of the judiciary is certainly one of the main factors affecting the overall atmosphere for doing business.

## 5. Effects of an ineffective judiciary

When asked how the functioning of the judiciary would affect their own company, respondents generally said there would be some effect, although this could not be termed major (a score of 2.31 on a scale of 1-4), with the smaller firms according the matter the least importance (Table 11). In general the decline in the importance accorded to judicial functioning as the size of firm falls is in line with a hypothesis that the need for adjudication likely increases with transactions. The average figure, however, conceals variations since roughly 39 percent, 43 percent, and 29 percent of large, medium, and smaller firms, respectively, said an inefficiently functioning judiciary would affect their companies "much" or "very much", suggesting that a significant number consider the functioning of the judiciary important for doing business. A breakdown by sector (Table 12), on the other hand, suggests that only firms in industry and services are more likely than those in agriculture to be affected if the judiciary is dysfunctional.

**Table 11. Effects of the functioning of the judiciary on the company (percent of respondents by firm size)**

Size	4 <i>Very much</i>	3 <i>Much</i>	2 <i>A little</i>	1 <i>No effect</i>	Average score	Count of no opinion	Count of no response
Large (131)	18	32	57	20	2.38	4	0
Medium (100)	11	28	35	17	2.36	9	0
Small (89)	7	17	39	19	2.15	6	1
Total (320)	36	77	131	56	2.31	19	1

**Table 12. Effects of the functioning of the judiciary on the company (percent of respondents by sector)**

Size	4 <i>Very much</i>	3 <i>Much</i>	2 <i>A little</i>	1 <i>No effect</i>	Average score	Count of no opinion/ response
Agriculture (4)	0	25	50	0	2.00	0
Industry (139)	10	30	40	20	2.30	10
Services (157)	14	22	47	17	2.32	10
Total (300)	12	26	44	19	2.31	20

Almost all parts of the judicial system were regarded as having a potential positive effect on both the economy and the respondents' own firms (Table 13). Interpreted carefully, this is an indication of the respondents' degree of belief (tempered by their own experience) in the capacity of those structures for beneficial contributions to the economy or their individual organizations. The highest positive rating is given to the Supreme Court, followed by provisions of laws. Somewhat lower in the respondents' estimate are the constitution and the court of appeals. Clearly, the respondents recognize the wider ramifications on the economy of framework-setting institutions whose scope of influence is much broader.

Rankings differ somewhat when the issue is potential impact on one's own firm. The greatest importance is given to lawyers, then provisions of laws, and only then the Supreme Court. This result is intuitive and clearly reflects the more direct impact on firm's more limited interests in the services of lawyers and the provisions of specific laws.

**Table 13. Aspect of the judicial system which has the largest potential impact on the economy and on own firm**

	<i>On economy</i>	<i>On own firm</i>
Supreme Court	+52	+32
Provisions of laws	+45	+34
1987 Constitution	+37	+32
Court of Appeals	+37	+25
Legal procedures	+31	+25
Lawyers	+30	+44
NLRC	+23	+22
RTC Judges	+20	+16
Fiscal/public prosecutors	+11	+10
Sheriffs	+3	+4
Clerks of Courts	-3	-1

On the question of which aspect of business an efficiently functioning judiciary is likely to have the most impact on (Table 14), a potentially large impact was cited for breaches of contract (cited by 56 percent), labor disputes (50 percent), and the settlement of tax liabilities (53 percent). Smaller judicial impact is foreseen for other issues as trademark piracy, product liability, debt collection, among others. The weight of these responses may be taken as the degree of business expectations regarding areas of judicial performance and

serves as a priority list if the judiciary wishes to begin reforms in issues that matter most to businesses.

The reference to breach of contract as the primary area affected by judicial functioning suggests that other businesses are more likely to be the second parties in the cases foreseen, which is consistent with responses to other questions (see also the discussion of Table 15 below). The response also substantiates business expectations about the law and the judiciary as enforcing, interpreting, and regulating promises made by private parties. Obviously labor relations are regarded as another problem area where the judiciary has a prominent role (through the NLRC), this time likely involving workers' organizations. Finally, the government is the second party in the area of tax liabilities.

**Table 14. Influence of efficiently functioning judiciary/judicial system on some business transactions (percent of 320 respondents)**

	<i>Large impact</i>	<i>Small impact</i>	<i>No impact</i>
Breach of contract	56	31	13
Labor disputes	56	28	15
Settlement of tax liabilities	53	29	18
Trademark piracy	38	32	30
Product liability	37	38	24
Collection of debts	34	34	31
Results of auctions and bids	34	34	31
Government contracts	33	38	28
Technology purchases	33	38	28

The potential effects of an inefficient judiciary, as the respondents perceived them, are shown in Table 15. The most frequently cited effect is an increase in the spread of banks (81 percent), the decision not to implement investment projects (84 percent), and the acceptance of bad agreements. At bottom, these factors point to the effects of a generally low level of business trust that respondents feel will result from the absence of a rules-based system if the judiciary should fail in its task. The feared rise in bank spreads would result, for example, if the risks of contract breach and debt defaults were pervasive. Uncertainty and lack of trust are also the basis of a failure to invest and greater reticence to engage in subcontracting activities. In all this, the courts play a role in facilitating cooperation.



**Table 15. How an inefficient judiciary would affect conditions for business (percent of respondents citing)**

	<i>Will definitely affect</i>	<i>Will probably affect</i>	<i>Will not affect</i>	<i>No opinion</i>
Banks will increase their spreads	43	38	10	9
Firms will decide not to implement investment projects	43	41	10	5
Bad agreements will be accepted	36	37	12	13
The use of contractual labor for labor-intensive activities will increase	35	41	12	12
Firms will take special care in choosing business partners	45	36	9	9
Firms will subcontract less production activities	17	51	13	19
Firms will avoid business in regions where the judicial system seems unreliable	45	33	8	14

A related but distinct set of issues pertains to labor relations. The respondents consider that the failings of the judiciary may possibly be reflected in greater labor "casualization", a move to avoid the complications and potentially costly legal struggles arising from formal employment relations. Again, this response echoes the previous concern that labor disputes are a problem area for businesses where the judicial system is expected to play a major role. Finally, a geographical or regional impact may be present as firms avoid areas where the justice system is unreliable.

Further information was obtained when the smaller subgroup of firms that had been negatively affected by court decisions was asked about the consequences for their businesses (Table 16). The bulk of the responses (41 percent of the total) referred to losses of opportunities for investment opportunities or tempo, suggesting that the bulk of the cases pertained to prospective projects. Losses in earning opportunities in the form of tied-up provisions or deposits was another major category (reported by 28 percent of subgroup), while 18 percent reported that the adverse consequence took the particularly acute form of interfering with current operations in the form of either a reduction of work, a cessation of factory operations, or that of office activities.

**Table 16. How firms were negatively affected by the judiciary's decisions (percent of those answering "yes")**

	Total (90)	Large (51)	Medium (23)	Small (16)
Investment projects harmed/delayed/suspended	41	43	43	38
Office activities stopped	4	4	9	-
Factory operations stopped	1	4	-	-
Number of work hours reduced	13	8	17	13
Provisions/deposits made	28	20	22	44

## 6. Coping mechanisms

The companies surveyed appear to have already taken some kind of precaution against breach of contracts other than go to court. Precautions cited (Table 17) as being "important" or "very important" were as follows: examining the reputation of the partner before a business deal (92 percent), favoring well-known clients or suppliers (84 percent), consulting a list of poor debtors (79 percent), requiring initial deposits (69 percent), and demanding third-party guarantees (65 percent). The prevalence of these practices may be taken as indirectly supporting the hypothesis that transactions and information costs are incurred by a majority of the private sector to avoid what are presumably higher costs associated with a weakly functioning judiciary.

**Table 17. Assessment of the importance of some precautions taken by firms against breach of contracts, unreliable suppliers and debtors (percent of respondents)**

	Very important	Important	Not important	No opinion
Examine the reputation of the other party before entering a business deal	63	29	4	3
Favor well-known clients or suppliers	37	47	12	5
Consult list of poor debtors	48	31	14	7
Require initial deposit	28	41	23	8
Ask for a third party to guarantee payment in case of default by the other party	24	41	25	10
Avoid doing business with the government	12	25	28	35

## 7. Assessment of the judiciary

Respondents were asked to assess the overall performance of the judiciary over a range. Most answers (46 percent) clustered around ratings of “poor” to “very poor”, with the average response falling short of “satisfactory”, i.e., 2.6 on a scale of 1-5 (Table 18). On the other hand, 43 percent said judicial performance was satisfactory, while about 10 percent considered it at least good (only one respondent said it was “very good”). There is little difference in rating by size of firm, however, with the smaller firms giving slightly more favorable assessments.

By sector (Table 19), firms in agriculture (of which there were only four) gave the highest rating (3 or “satisfactory”), followed by those in services and industry, which gave more or less the same rating (2.6 and 2.56, respectively). Again, this differentiation may reflect the more intensive nature of transactions in the two sectors, as well as the smaller size of the surveyed firms in agriculture.

**Table 18. Overall assessment of the judiciary  
(respondents by firm size)**

	1 <i>Very poor</i>	2 <i>Poor</i>	3 <i>Satis- factory</i>	4 <i>Good</i>	5 <i>Very good</i>	<i>Average score</i>	<i>No response</i>
Large	5	62	46	17	1	2.60	0
Medium	5	41	46	8	0	2.57	0
Small	5	31	45	7	0	2.61	1
Total (319)	15	134	137	32	1	2.58	1

**Table 19. Overall assessment of the judiciary  
(respondents by sector)**

	1 <i>Very poor</i>	2 <i>Poor</i>	3 <i>Satis- factory</i>	4 <i>Good</i>	5 <i>Very good</i>	<i>Average score</i>	<i>No response</i>
Agriculture	0	1	2	1	0	3.00	0
Industry	7	63	64	14	0	2.56	1
Services	8	70	71	17	1	2.60	0
Total (319)	15	134	137	32	1	2.59	1

Respondents were also asked about particular aspects of judicial functioning, namely, transparency, predictability, cost, speed, and impartiality. The responses by sector are summarized in Table 20, while details are given in Tables 21-23. The mean ratings for all aspects fall between "poor" and "satisfactory", a result that is independent of but consistent with the summary assessment in the previous section. The less-than-satisfactory ratings on all aspects of performance indicate a significant dissatisfaction with the effectiveness with which the judiciary has functioned.

**Table 20. Assessments of particular aspects of judicial performance: all sectors (mean ratings on a 1-5 scale)**

	<i>Transparency</i>	<i>Predictability</i>	<i>Cost</i>	<i>Speed</i>	<i>Impartiality</i>
Agriculture	3.00	3.25	2.00	2.00	2.75
Industry	2.73	2.78	2.54	1.89	2.51
Services	2.86	2.74	2.60	1.84	2.57
Total	2.80	2.77	2.57	1.86	2.55

It is nonetheless evident that the functional aspect with which most firms are dissatisfied was speed (rating: 1.86). This was also the aspect that was consistently ranked lowest across all sectors, merely reiterating the commonplace business complaint about the protracted process before judicial outcomes can be obtained. The system fared somewhat better on transparency (rating: 2.80) and predictability (2.77), although it is probably more accurate to state that these were aspects with which the respondents were least dissatisfied.

**Table 21. Assessments of particular aspects of judicial performance: agriculture firms (respondents by aspect; N = 4)**

	1 <i>Very poor</i>	2 <i>Poor</i>	3 <i>Satisfactory</i>	4 <i>Good</i>	5 <i>Very good</i>	<i>Average score</i>	<i>No response</i>
Transparency	0	1	2	1	0	3.00	0
Predictability	0	0	3	1	0	3.25	0
Costs	1	1	1	0	0	2.00	1
Speed	3	0	1	0	0	2.00	0
Impartiality	0	2	1	1	0	2.75	0
Overall	0	1	2	1	0	3.00	0

**Table 22. Assessments of particular aspects of judicial performance: industrial firms (respondents by aspect; N = 149)**

	1 <i>Very poor</i>	2 <i>Poor</i>	3 <i>Satisfactory</i>	4 <i>Good</i>	5 <i>Very good</i>	<i>Average score</i>	<i>No response</i>
Transparency	11	39	80	17	2	2.73	0
Predictability	5	44	76	22	0	2.78	2
Costs	11	51	79	4	1	2.54	3
Speed	57	59	27	5	1	1.89	0
Impartiality	14	53	72	9	0	2.51	1
Overall	7	63	64	14	0	2.57	1

**Table 23. Assessments of particular aspects of judicial performance: service firms (respondents by aspect; N = 167)**

	1 <i>Very poor</i>	2 <i>Poor</i>	3 <i>Satisfactory</i>	4 <i>Good</i>	5 <i>Very good</i>	<i>Average score</i>	<i>No response</i>
Transparency	9	40	85	30	2	2.86	1
Predictability	8	53	82	22	2	2.74	0
Costs	11	60	81	10	3	2.60	2
Speed	74	55	29	8	1	1.84	0
Impartiality	15	60	75	11	4	2.57	2
Overall	8	70	71	17	1	2.60	0

The mediocre-to-poor assessment of the judiciary appears to be uniform and pervasive across all firms. One may still ask, however, whether it is systematically related to any specific characteristics of the respondent-firms. To test this, an analysis of the firms' overall assessment of the judiciary is made by regressing the fact that a firm has rated judicial performance as "poor" or "very poor" against its characteristics, including two more control variables: (a) whether the respondent has ever appeared as a plaintiff in the last five years, and (b) whether it has ever been negatively affected by a court ruling over the past ten years. These variables can be taken as "experience" factors. If a particular firm's assessment is simply based on "common knowledge", then experience may either confirm or invalidate it. Hence, if the common knowledge or scuttlebutt says judicial performance is poor when in fact it is superior, then one would expect the experience variables to have the opposite sign. For this purpose a probit regression model is estimated where the value

of 1 is assigned if the firm has a "poor" or "very poor" overall assessment of the judiciary, and 0 otherwise. A significantly positive (respectively, negative) estimated coefficient means that the variable in question is a factor in increasing (respectively, reducing) the probability of a poor assessment of the judiciary.

The results of various specifications are shown in Table 24. Revenue size, sector, employment, and income clearly do not figure in the explanation of the firms' overall assessment of the judiciary. What seems to matter at all is whether the firm had ever received an adverse decision or been a plaintiff in a court case in the last five years. These factors increase the probability of a poor or very poor assessment by 0.18 and 0.22, respectively. One may be allowed the conclusion, therefore, that the perception of mediocre judicial performance is pervasive, and actual experience with the system, if anything, tends to reinforce rather than to contradict it.

## 8. Perceived reasons for judicial inefficiency

Even as firms may be aware of the effects of an inefficient judiciary for their own businesses, the actual reasons for the judiciary's shortcomings may or may not be known by the companies themselves. Nevertheless, it is important to probe into the reasons that businesses perceive are responsible for a less than effective judicial system.

The judiciary's shortcomings are attributed to the following (Table 25), in order of importance: political influence and pressure on the courts (79 percent), followed by corruption among judges and other court officers (75 percent). The two most important reasons given, therefore, have to do with problems of governance within the judiciary.

It is also notable, however, that the inadequacy of resources devoted to the courts is given as a major reason for the judiciary's failure to live up to expectations. This is the third reason for judicial dysfunction on which most (57 percent) of the respondents agree, followed by questions regarding the competence of judges and rigid judicial procedures. Only a minority (39 percent) see problems with the design of laws and the constitution. At the very least, this indicates variations in perceptions among business people and internal assessments of the judiciary (e.g., Sereno [1999]) that would assign at least an equal weight to factors such as rigid procedures and laws, including the constitution as being partly responsible for judicial dysfunction.

**Table 24. Factors affecting the probability that a firm will assess the judiciary's performance as poor**  
(Dependent variable: Assessment; Probit estimates)

Explanatory variables	Model 1		Model 2		Model 3	
	Coefficients	dF/dx	Coefficients	dF/dx	Coefficients	dF/dx
Constant	-1.28 (-1.743)*		-1.211 (-1.616)**		-1.329 (-1.717)**	
Income99	-2.15e-07 (-1.289)	-8.57e-08 (-1.29)				
Income99 <sup>2</sup>	-3.88e-15 (-0.121)	-1.55e-15 (-0.12)				
Employee			-0.0003 (-1.563)	-0.0001 (-1.56)	-0.0002 (-1.270)	-0.0001 (-1.27)
Employee <sup>2</sup>			2.78e-08 (1.523)	1.11e-08 (1.52)	2.18e-08 (1.096)	8.66e-09 (1.1)
Large	0.33 (1.453)	0.131 (1.45)	0.281 (1.215)	0.112 (1.22)	0.296 (1.227)	0.117 (1.23)
Medium	0.323 (1.392)	0.128 (1.39)	0.252 (1.068)	0.1 (1.07)	0.362 (1.489)	0.143 (1.49)
Industry	0.596 (0.809)	0.234 (0.81)	0.635 (0.845)	0.248 (0.84)	0.691 (0.913)	0.269 (0.91)
Service	0.689 (0.939)	0.269 (0.94)	0.683 (0.913)	0.266 (0.91)	0.673 (0.898)	0.263 (0.90)

**Table 24. Factors affecting the probability that a firm will assess the judiciary's performance as poor (continued)**  
(Dependent variable: Assessment; Probit estimates)

Explanatory variables	Model 1		Model 2		Model 3	
	Coefficients	dF/dx	Coefficients	dF/dx	Coefficients	dF/dx
Adverse	0.352 (1.625)**	0.14 (1.63)**	0.458 (2.038)*	0.181 (2.04)*	0.463 (2.002)*	0.183 (2.00)*
Plaintiff	0.584 (3.077)*	0.23 (3.08)*	0.531 (2.755)*	0.209 (2.75)*	0.56 (2.810)*	0.22 (2.81)*
Year					-0.0002 (-0.018)	-0.0001 (-0.02)
Year <sup>2</sup>					0.00005 (0.47)	0.00002 (0.47)
No. of observations	241	241	230	230	221	221
LR $\chi^2$	27.05	27.05	23.97	23.97	26.11	26.11
Prob> $\chi^2$	0.0007	0.0007	0.0023	0.0023	0.0036	0.0036
Pseudo R <sup>2</sup>	0.0511	0.0811	0.0755	0.0755	0.0855	0.0855

Notes: Figures in parentheses are z-statistics. dF/dx is the change in the probability for a unit increase in the explanatory variable.  
\* Significant at the 5 percent level; \*\* significant at the 10 percent level.



**Table 25. Perceived reasons for judicial dysfunction (% of respondents)**

<i>Base:</i> <i>All respondents (320)</i>	<i>Strongly</i> <i>agree</i>	<i>Agree</i>	<i>Uncertain</i>	<i>Disagree</i>	<i>Strongly</i> <i>disagree</i>
1. Political influence/ pressure	39	40	15	4	1
2. Corruption among judges and other officers of the court	37	38	19	4	2
3. Inadequate public resources given to the courts, including judges' salaries	29	28	30	10	3
4. Incompetence of judges	15	34	34	15	2
5. Rigid judicial procedures	13	34	30	19	3
6. Poorly designed laws	9	30	32	23	5

## 9. Cost of access to the judicial system

With minor variations, respondents tended to assess the costs of access to the judiciary as “high, without being prohibitive” (average rating of 2.13 on a scale of 1-5). As many as 72 percent of those who responded rated the cost of accessing the judiciary as either “high” or “very high”, with 16 percent saying it was even “very high to the point of being prohibitive” (Table 26). The proportion of respondents who think the costs are prohibitive appears to increase as the size of the firm falls, indicating what is intuitive, namely, that smaller firms will tend to have less access. On the other hand, more small firms also considered the cost of access “reasonable”.

Another way of measuring the perceived cost of accessing the judiciary is to ask how large unpaid debts must be before a company considers a resort to litigation. This may serve as a measure of the “reservation price” of firms. A larger stated proportion implies that the cost of using the judiciary is perceived as being higher. Respondents were therefore asked how big a debt uncollected for 180 days must be (as a proportion of revenue) before they would consider litigation. A relatively large number of firms failed to respond, but of those that did (Table 27), 71 percent gave answers that clustered around 1-5 percent. Ten percent said the debt would need to be more than 10 percent of their revenues. These answers appear consistent with the assessments given in the previous question, in which the firms surveyed said access to the judiciary was “high but not to the point of being prohibitive”.

**Table 26. Perceived cost of access to the judiciary (Q8)  
(percent of respondents)**

<i>Size</i>	1	2	3	4	5	<i>Average score</i>	<i>Don't know/ No response</i>
Large (125)	14.4	59.2	25.6	0.8	0.0	2.13	6
Medium (94)	16.0	58.5	22.3	2.1	1.1	2.14	6
Small (87)	19.5	48.3	31.0	1.1	0.0	2.14	2
Total (306)	16.3	55.9	26.1	1.3	0.3	2.13	14

1 = very high, to the point of hindering access; 2 = high, but not to the point of preventing access; 3 = reasonable; 4 = low; 5: very low, to the point of encouraging excessive access

**Table 27. Required size of debt unpaid for at least 180 days before resorting to litigation (percent of respondents)**

<i>Size</i>	<i>Percent of revenues</i>			
	< 1.0 %	1.0 - 5.0 %	5.1-10.0 %	> 10.0 %
Large (82)	11	76	7	6
Medium (60)	12	67	10	12
Small (65)	14	68	6	12
Total (207)	12	71	8	10

Notes: Figures in parentheses are number of respondents.

113 firms gave no response or said the question was inapplicable.

Regressions were run to determine whether this measure of "reservation price" (the magnitude of debt unpaid for at least 180 days required to induce litigation) was systematically related to any of the firms' characteristics. The results are shown in Table 28. Two variables appear statistically significant based on the t-statistics.

First, the experience of having been a plaintiff increases the reservation price of litigation, thus capturing a "once bitten, twice shy" effect. That is to say, having gone through the experience so discourages one that a higher amount would be needed before venturing into it.

Second, the "large" size of the firm, as measured by its belonging to the top-revenue tercile, reduces the reservation price. Relative to those who belong to the bottom tercile, this means large firms are more ready (in terms of a lower reservation price) than either smaller or medium firms to engage in litigation to collect debts.

The fact that the coefficient for medium firms is insignificant is itself interesting. This says that larger firms are more willing than either smaller or medium firms to litigate. This suggests that increases in size do not matter below a certain threshold. Exactly why this threshold exists cannot be determined; possible factors are the high fixed costs involved in engaging in litigation, such as maintaining legal retainers, which only larger firms can afford, or access to public opinion and political networks when important corporations become involved. The phenomenon is suggestive enough to merit a closer study. There are sufficient grounds, however, for saying that significant cost barriers exist especially for smaller firms in gaining access to the judiciary.

It will be recalled that 45 percent of the total sample (or 144 firms) had been plaintiffs in court cases. When asked whether the benefits of going to court exceeded the costs, these firms answered in the manner shown in Table 29. A plurality (37 percent) of this group of respondents said that the benefits exceeded the costs. A little more than one-third (34 percent) said that the costs of going to court exceeded the benefits, while 29 percent said the benefits were worth about the same as the trouble.

Notably, the incidence of those reporting greater benefits seems inversely related to firm size, with a markedly lower incidence among the largest firms (an incidence of 28 percent, versus a total-sample average of 37 percent). Larger firms have a greater tendency to assess their court experience more negatively than smaller firms. This, however, does not necessarily contradict the hypothesis that large firms face lower barriers and have a greater readiness to litigate than smaller firms. Larger firms could, after all, have a wider scope of remedies *ex ante* than simply going to court, and hence, they could have higher expectations of benefits from the litigation process than smaller firms do. This is still perfectly compatible with large firms having a lower perception of the absolute level of costs and a lower reservation price.

On one issue, debt collection, the responses in Table 27 may be processed further to obtain a measure of the private cost to firms of judicial inefficiency. Applying the in-sample revenue thresholds to the respective terciles allows one to obtain the total revenue that is willingly foregone before litigation is resorted to. The total figure obtained (bottom right corner of Table 30) is about Php 8 billion annually. Assuming a 10 percent interest rate, this represents an opportunity cost of Php 800 million annually (equal to 12 percent of the judiciary's budget in 1999), which is a lower limit to the cost of accessing the judiciary for debt collection. Put differently, the "transaction cost" of resorting to the judiciary for debt collection is at least Php 800 million annually, since firms would willingly forego (or, what is effectively the same thing, pay) that amount in order to avoid resorting to the judiciary.

**Table 28. Factors that determine the threshold percentage share of unpaid debts in gross revenues before the firm starts to sue its client (Dependent variable: Percent; OLS estimates)**

<i>Explanatory variables</i>	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>
Constant	-4.088 (-0.458)	-4.363 (-0.484)	-2.662 (-0.280)
Income99	2.93e-07 -0.241		
Income99 <sup>2</sup>	-3.40e-14 (-0.250)		
Employee		-0.001 (-0.295)	-0.001 (-0.380)
Employee <sup>2</sup>		5.61e-08 -0.19	8.32e-08 -0.269
Large	-5.238 (-1.955)**	-5.019 (-1.855)**	-4.988 (-1.737)**
Medium	-1.19 (-0.442)	-1.284 (-0.471)	-1.543 (-0.536)
Industry	7.084 (0.927)	7.333 (0.95)	7.411 (0.938)
Service	6.616 (0.874)	6.804 (0.891)	7.432 (0.951)
Adverse	2.481 (0.879)	2.815 (0.978)	3.107 (1.03)
Plaintiff	4.347 (1.827)**	4.427 (1.835)**	4.936 (1.946)**
Year			-0.084 (-0.781)
Year <sup>2</sup>			0.0002 (0.228)
Poor_assess	3.08 (0.586)	3.419 (0.64)	2.84 (0.514)
Satis_assess	0.883 (0.275)	0.711 (0.217)	0.821 (0.242)

**Table 28. Factors that determine the threshold percentage share of unpaid debts in gross revenues before the firm starts to sue its client (continued)**  
(Dependent variable: Percent; OLS estimates)

<i>Explanatory variables</i>	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>
Good_assess	3.27 (0.679)	3.507 (0.721)	3.235 (0.646)
No. of observations	159	156	149
F-stat	1.05	1.05	1.06
Prob>F-stat	0.4087	0.408	0.3978
R <sup>2</sup>	0.0726	0.0741	0.0927
Adjusted R <sup>2</sup>	0.0032	0.0034	0.0054

Notes: Figures in parentheses are t-statistics.

\* Significant at the 5 percent level;

\*\* Significant at the 10 percent level.

**Table 29. Assessment of the costs and benefits of going to court (percent of respondents)**

	<i>Total</i> (144)	<i>Large</i> (68)	<i>Medium</i> (38)	<i>Small</i> (38)
Benefits exceeded costs	37	28	39	42
Cost exceeded benefits	34	38	37	26
Benefits about the same as cost	29	34	24	29

Base: Respondents answering "yes" to question whether they had ever been plaintiffs in the last ten years.

**Table 30. Projected foregone revenues of firms who do not collect unpaid debts from clients (in thousand pesos)**

<i>Size</i>	<i>No.</i>	<i>Sample foregone revenues*</i> (1)	<i>Sample total revenues in 1999</i> (2)	<i>Ratio</i> (3) = (1)/(2)	<i>Total tercile revenue</i>	<i>Sample foregone revenue</i>
Large	60	2,992,475	95,845,980	0.031	232,954,504	7,273,238
Medium	43	287,410	3,971,545	0.072	7,388,150	534,660
Small	38	138,468	1,529,764	0.091	2,320,592	210,051
Total	141				242,663,246	8,017,948

\*Percent threshold multiplied by firm's gross revenues in 1999.

## 10. Effects of judicial dysfunction

Respondents were asked whether certain aspects of judicial dysfunction had ever caused them to take some specific actions. As distinguished from previous questions inquiring into what firms conceptually regarded as likely or probable effects of judicial dysfunction, the question inquires into decisions they have actually made.

Notably, about half of the respondents (Table 31) reported a resulting avoidance of the public sector—in terms of doing either little (30 percent) or no business with it (20 percent)—as one of the frequent consequences of judicial dysfunction. Apprehensions about three factors of judicial dysfunction (i.e., cost, delays, and possible bias) have apparently caused businesses to avoid public-sector deals. Although this issue could not be probed further, it is easy to enumerate possible reasons that would raise perceived transactions cost when dealing with the public sector, including the greater number of regulations involved, leading to a greater scope for suits from third parties; and possible bias and pressure brought to bear on the courts where the complaint is against government. The frequency of this effect may be contrasted with the relatively low rank given in Table 17 to “avoiding doing business with the government” as one of the conceptually important effects of an inefficient judiciary. This apparent discrepancy is explained partly by the fact that the results in Table 31 are a measure of frequency of occurrence in the sample, rather than an assessment of degree of importance.

Twenty-eight percent of the respondents said that the quality of judicial decisions had dissuaded them from carrying out investment projects; 40 percent said they had decided not to employ more workers; and more than a fifth said they avoided outsourcing as a result. An impact on firms’ location decisions is also present, with 30-40 percent saying they did little or no business in a particular region owing to the unevenness in the quality of judicial decision making.

## 11. Mediation and arbitration

About one-fifth (21 percent) of respondents have included a specific clause foreseeing dispute resolution through mediation and/or arbitration in most of their contracts. Close to a third (32 percent) have rarely included such a clause in their contracts, while over one-third have never included such clause. As may be seen from Table 32, a greater proportion of large firms include such clauses in their contracts compared to the medium and small firms.

**Table 31. Whether certain judicial components have ever caused the firm to ... (percent of responses)**

	<i>Cost of court cases</i>	<i>Lack of trust in speed of judiciary</i>	<i>Lack of trust in fairness of judiciary</i>
Do little business with the public sector	34	30	29
Not carry out an investment project that would otherwise have been undertaken	28	27	28
Not do business with a person or company	26	23	24
Not rely on outsourcing	25	23	23
Not employ workers	23	18	20
Not do business with the public sector	20	22	19
Do less business in a particular region	21	18	19
Do no business in a particular region	18	16	16
Not invest in another region due to lack of trust in the local judiciary	18	17	16

**Table 32. Whether or not a specific clause foreseeing dispute resolution through mediation has been included in contracts entered by firms (percent of respondents)**

	<i>Total (320)</i>	<i>Large (131)</i>	<i>Medium (100)</i>	<i>Small (89)</i>
Yes, in most contracts	21	27	19	17
In some contracts/rarely	32	31	33	30
No/never occurred	37	32	35	45
Don't know	10	10	13	8

In terms of actual experience with arbitration and mediation (Table 33), approximately a third (32 percent) of respondents have frequently and always resorted to mediation and arbitration before resorting to the judiciary. On the other hand, more than one-third (37 percent) have rarely solved conflicts through mediation/arbitration, and 28 percent have never tried these means of dispute resolution. More large firms have tried solving conflicts through mediation/arbitration, compared to the medium and small firms.

**Table 33. Frequency of trying to solve conflicts through mediation/arbitration before resorting to the judiciary (percent of respondents)**

	<i>Total</i>	<i>Large</i>	<i>Medium</i>	<i>Smaller</i>
Always (5 in 5 cases)	16	20	13	15
Frequently (3 to 4 in 5 cases)	17	21	16	13
Rarely (1 in 5 cases)	37	31	36	43
Never (0 in 5 cases)	28	25	32	26
Not reported	3	2	3	3

**Table 34. Frequency of resorting to mediation in wage negotiations for labor-related cases before the dispute goes to DOLE**

	<i>Total</i> (320)	<i>Large</i> (131)	<i>Medium</i> (100)	<i>Small</i> (89)
Always (5 in 5 cases)	17	23	17	11
Frequently (3 to 4 in 5 cases)	13	15	10	13
Rarely (1 in 5 cases)	32	27	32	37
Never (0 in 5 cases)	33	28	37	35
Not reported	5	7	4	3

Responses are almost evenly split (Table 34) on the frequency of resorting to mediation in wage negotiations for labor-related cases before the dispute goes to the Department of Labor and Employment (DOLE). Almost a third (32 percent) rarely and another one-third (33 percent) never resorted to mediation in wage negotiations for labor-related cases before the dispute goes to DOLE. More large firms have resorted to mediation in wage negotiations for labor-related cases before the dispute goes to DOLE, as compared with medium and small firms.

Considering previous assessments regarding the high cost of access to the judiciary, it would be valid to ask why more of the respondents have not resorted to nonjudicial mechanisms such as arbitration and mediation. Without an explicit comparison of the relative costs of alternative mechanisms, however, a definite answer to the question is not possible. One cannot presume, after all, that a high cost of access to the judiciary always implies that nonlitigious measures will always be preferred, since costs will be incurred in the latter as well. It may well be that information and the social infrastructure for arbitration and mediation are not fully developed or functioning either.



## 12. Contracting using laws of foreign jurisdiction

Possibly one of the most vivid and decisive ways to avoid the costs of the Philippine judicial system is not to use it altogether and resort instead to writing contracts using laws of foreign jurisdiction. A significant number of firms in the sample (14 percent) reported that they had in fact entered into contracts using foreign laws, while 31 percent were at least aware of other firms entering into such contracts. By size of firm, it is seen that larger firms are more likely to be acquainted with the possibility (37 percent, Table 36) and to have actually entered into contracts using foreign laws (18 percent, Table 35), compared to medium and smaller firms. This result is intuitive since no less than local laws and legal systems and the use of foreign laws also entail fixed costs, and larger firms are better able to hurdle these barriers than small firms since these costs can be spread out over a greater number of transactions. By industry, on the other hand, it is the service-sector firms that by far (61 percent) have greater information about the use of contracts governed by laws of foreign jurisdiction.

A significant inverse relationship also appears to exist between the fact that a firm has entered into contracts using laws of a foreign jurisdiction and those who were negatively affected by judicial decisions in the last ten years. This is borne out at one level by simply looking at Table 38, where those not negatively affected have a much lower incidence of entering into contracts involving foreign laws. More rigorously, a probit regression analysis was made of the factors affecting the probability that a firm has in fact entered into a contract using laws of a foreign jurisdiction. The results are shown in Table 39.

The variable that signals whether firms have been affected by adverse decisions is significant and positive in all regressions, suggesting that such firms would have a strong incentive to enter into contracts governed by foreign laws. (Simply being a plaintiff, on the other hand, is insignificant.) In the same vein, other things being equal, firms with a better assessment of the judiciary are less likely to have participated in such contracts. The "default" dummy variable is a rating of "very poor". As might be expected, improvements over this assessment dissuade a firm from "voting with its feet" and entering into contracts using laws of foreign jurisdiction.

**Table 35. Incidence of firms entering into contracts using laws of foreign jurisdiction (e.g. Singapore, Hongkong) (percent, by size)**

	<i>Total</i> (320)	<i>Large</i> (131)	<i>Medium</i> (100)	<i>Small</i> (89)
Have entered	14	18	13	11
Never entered	85	82	84	88
Not reporting	1	--	3	1

**Table 36. Number of firms who have heard of other firms entering contracts using foreign laws (percent, by size)**

<i>Size</i>	<i>Yes (heard)</i>	<i>No (not heard)</i>
Large (131)	37	63
Medium (100)	27	73
Small (89)	26	74
Total (320)	31	69

**Table 37. Number of firms who have heard of other firms entering contracts using foreign laws (percent, by sector)**

<i>Sector</i>	<i>Yes (heard)</i>	<i>No (not heard)</i>
Agriculture (4)	0	100
Industry (149)	25	74
Service (167)	36	63
Total (320)	31	69

**Table 38. Number of firms who entered into a contract using foreign laws and whether they are negatively affected by judicial decisions during the past ten years (percent, by response)**

	<i>Enter into contract using foreign laws</i>	<i>Did not ever enter into contract using foreign laws</i>	<i>Don't know/no response</i>
Negatively affected (99)	27	71	2
Not negatively affected (197)	11	88	1
Don't know/no response (33)	0	100	
Total (320)	14	84	1

**Table 39. Factors affecting the probability that a firm has entered into a contract using laws of foreign jurisdiction  
(Dependent variable: Foreign; Probit estimates)**

Explanatory variables	Model 1		Model 2		Model 3	
	Coefficients	dF/dx	Coefficients	dF/dx	Coefficients	dF/dx
Constant	-5.91 (-12.506)*		-5.809 (-11.584)*		-5.417 (.)	
Income99	1.30e-06 (1.629)**	1.52e-07 (1.63)**			1.65e-06 (1.687)**	2.62e-07 (1.69)**
Income992	-3.70e-13 (-1.487)	-4.32e-14 (-1.49)			-4.78e-13 (-1.510)	-7.56e-14 (-1.51)
Employee			0.0002 (1.129)	0.00004 (1.13)		
Employee2			-1.64e-08 (-0.830)	-2.62e-09 (-0.83)		
Large	0.139 (0.435)	0.016 (0.43)	0.153 (0.485)	0.025 (0.49)	0.148 (0.447)	0.024 (0.45)
Medium	0.211 (0.644)	0.026 (0.64)	0.098 (0.285)	0.016 (0.29)	0.13 (0.381)	0.021 (0.38)
Industry	5.329 (23.457)*	0.875 (23.46)*	5.352 (.)	0.907 (.)	5.095 (9.554)*	0.891 (9.55)*
Service	5.5454 (.)	0.892 (.)	5.447 (23.256)*	0.928 (23.26)*	5.303 (9.975)*	0.91 (9.98)*

**Table 39. Factors affecting the probability that a firm has entered into a contract using laws of foreign jurisdiction (continued) (Dependent variable: Foreign; Probit estimates)**

Explanatory variables	Model 1		Model 2		Model 3	
	Coefficients	dF/dx	Coefficients	dF/dx	Coefficients	dF/dx
Adverse	0.573 (2.068)*	0.083 (2.07)*	0.615 (2.124)*	0.12 (2.12)*	0.626 (2.167)*	0.121 (2.17)*
Plaintiff	-0.047 (-0.175)	-0.006 (-0.18)	-0.094 (-0.335)	-0.015 (-0.33)	-0.099 (-0.345)	-0.016 (-0.34)
Year					-0.005 (-0.408)	-0.001 (-0.41)
Year <sup>2</sup>					5.56e-06 (0.059)	8.97e-07 (0.06)
Poor_assess	-0.726 (-1.771)**	-0.081 (-1.77)**	-0.837 (-1.917)**	-0.124 (-1.92)**	-0.869 (-1.995)*	-0.13 (-1.99)*
Satis_assess	0.115 (0.215)	0.014 (0.21)	0.163 (0.311)	0.026 (0.31)	0.125 (0.223)	0.02 (0.23)
Good_assess	-1.497 (-2.440)*	-0.205 (-2.44)*	-1.631 (-2.614)*	-0.3 (-2.61)*	-1.6 (-2.584)*	-0.285 (-2.58)*
No. of observations	241	241	230	230	226	226
LR $\chi^2$	32.38	32.38	29.42	29.42	33.35	33.35
Prob> $\chi^2$	0.0007	0.0007	0.002	0.002	0.0015	0.0015
Pseudo R <sup>2</sup>	0.1651	0.1651	0.1618	0.1618	0.1775	0.1775

Notes: Figures in parentheses are z-statistics. dF/dx is the change in the probability for a unit increase in the explanatory variable.  
\* Significant at the 5 percent level; \*\* Significant at the 10 percent level.

### 13. Economic impact

A final exercise permitted by the survey results is an attempt to quantify the economic effect of judicial dysfunction. A fundamental hypothesis on which this paper is based is that a more efficiently functioning judiciary, in its role as enforcer and interpreter of claims, would facilitate greater cooperation and levels of trust among firms and lead to more mutually beneficial exchanges among them.

Firms were therefore asked whether they thought there would in principle be economic advantages from using laws and a judicial system that approximated the type that prevailed in either Singapore or Hong Kong. Somewhat less than a third of respondents perceived the following advantages of entering into contracts using Hong Kong or Singapore laws: increased sales volume, 32 percent; increased annual investment, 31 percent; increased volume of sales in other parts of the country, 31 percent; and increased outsourcing, 31 percent (Table 40).

**Table 40. Perceived advantages of entering into contracts using laws equivalent to those of Singapore or Hong Kong**

<i>Increases in:</i>	<i>Total (320)</i>	<i>Large (131)</i>	<i>Medium (100)</i>	<i>Small (89)</i>
annual investment (over previous year)	31	29	36	27
volume of sales	32	31	35	31
number of employees	29	26	33	28
investment in other parts of the country	29	25	30	31
volume of business in other parts of the country	31	27	36	29
activities carried out through outsourcing	31	32	35	27
volume of business with the public sector	28	28	31	25

More important, the respondents were asked whether and by how much they themselves might change their economic decisions or behavior (e.g., in terms of an increase in annual investment, increase in employment, or higher sales, among others) if their contracts were covered by laws equivalent to those of Singapore or Hong Kong.

Between 28 percent and 32 percent of the respondents (91 to 103 firms of 320) stated they would themselves change their decisions, or experience change in their economic situation (Table 41) as a result of a change in the legal system. Seventy-seven firms or 24 percent responded that they would increase their investments by a positive amount if the legal system were like Singapore's

or Hong Kong's. This figure is consistent with virtually the same number who answered on a previous question that the quality of decision making had dissuaded them from making investments. Of those who responded positively, almost one-fourth (24 percent) stated they would increase their investments by amounts equal to 10-19 percent of their revenue, and an equal number said they would raise investment by 20-39 percent.

Majority believe that an increase in sales would result, with most of these (31 percent of respondents) reporting a likely increase of 10-19 percent. On the other hand, anticipated increases in employment are bimodally distributed, with a significant number (24 percent) stating they would increase employment by less than 5 percent or current levels and 23 percent stating employment could increase by 10-19 percent. A possible increase in the proportion of outsourced activities is also frequently cited (32 percent).

These results may be further described through the estimation of a probit model where the probability that a firm would respond positively to the question of whether it would increase investments under a different legal system is regressed against (a) firm characteristics such as size and sector, (b) experience with the judiciary, and (c) subjective assessments of the judiciary. The results are shown in Table 42.

In different specifications, the experience-variable of having been a plaintiff is the most statistically robust factor, making it 16 percent more likely that a firm would increase its investment if the legal system were improved. The explanation is straightforward: those who have had direct experience of the legal system are better able to appreciate its shortcomings and how a superior system would help improve the conditions for doing business. The other experience-variable, the fact that a firm has been adversely affected by a court decision, bears an unexpected negative sign. It is somewhat less robust, however, and is significant in only one of three specifications.

Compared to those rating the judiciary as "very poor" (the omitted category), firms that rate the judiciary as "poor" are more likely to increase their investments when the legal system improves markedly. But those that give the judiciary a "satisfactory" or "good" rating are not more likely to invest than those who rate it "very poor". This is a nonlinearity, since one typically expects the positive response be inversely related to a good assessment of the judiciary. A threshold appears to exist, however. On the one hand, what this result captures may be the relative hopefulness of firms that rate the judiciary "poor" relative to those who rate it "very poor". On the other hand, firms that rate the judiciary as already being "satisfactory" and "good" obviously see less benefits from further improvements, which will make it less likely for them to increase investments, even if the legal system were to improve.

**Table 41. Estimated increase for each perceived advantage of entering into contracts using laws equivalent to those of Singapore or Hong Kong (percent of respondents stating percent increases)**

	Number						
	< 5	5-9	10-19	20-39	40-59	60+	N.R.
Increased annual investment (percent of revenue)	98	6	17	24	24	2	4
Increased volume of sales	103	8	14	31	19	7	2
Increased number of employees	92	24	16	23	10	3	3
Increased investment in other parts of the country	91	15	23	20	12	4	5
Increased volume of businesses in other parts of the country	98	17	16	28	15	3	3
Increased proportion of activities carried out through outsourcing	101	10	14	33	16	2	5
Increased volume of businesses with the public sector	89	15	19	21	16	7	1

Table 42. Factors affecting the probability that a firm will increase its annual investments if it were possible to use laws equivalent to those of Singapore or Hong Kong (Dependent variable: Investments; Probit estimates)

Explanatory variables	Model 1		Model 2		Model 3	
	Coefficients	dF/dx	Coefficients	dF/dx	Coefficients	DF/dx
Constant	-1.646 (-1.883)**		-1.722 (-1.943)**		-1.347 (-1.460)	
Income99	-3.46e-08 (-0.199)	-1.01e-08 (-0.20)			-3.03e-07 (-0.426)	-8.98e-08 (-0.43)
Income992	-2.19e-14 (-0.687)	-6.39e-15 (-0.69)			-1.36e-14 (-0.064)	-4.05e-15 (-0.06)
Employee			-0.0004 (-1.705)**	-0.0001 (-1.70)**		
Employee2			3.56e-08 (1.640)**	1.05e-08 (1.64)**		
Large	0.131 (0.504)	0.038 (0.5)	0.269 (1.003)	0.081 -1	0.164 (0.596)	0.049 (0.6)
Medium	0.4 (1.556)	0.122 (1.56)	0.461 (0.080)**	0.144 (1.75)**	0.389 (1.46)	0.121 (1.46)
Industry	-0.313 (-0.448)	-0.091 (-0.45)	-0.298 (-0.426)	-0.088 (-0.43)	-0.38 (-0.524)	-0.112 (-0.52)
Service	0.103 (0.148)	0.03 (0.15)	0.157 (0.226)	0.047 (0.23)	0.123 (0.172)	0.037 (0.17)



Table 42. Factors affecting the probability that a firm will increase its annual investments if it were possible to use laws equivalent to those of Singapore or Hong Kong (continued) (Dependent variable: Investments; Probit estimates)

Explanatory variables	Model 1		Model 2		Model 3	
	Coefficients	dF/dx	Coefficients	dF/dx	Coefficients	DF/dx
Adverse	-0.435 (-1.766)**	-0.116 (-1.77)**	-0.375 (-1.463)	-0.103 (-1.46)	-0.395 (-1.522)	-0.108 (-1.52)
Plaintiff	0.541 (2.505)*	0.159 (2.50)*	0.594 (2.698)*	0.179 (2.70)*	0.572 (2.507)*	0.172 (2.51)*
Year					-0.021 (-1.756)**	-0.006 (-1.76)**
Year <sup>2</sup>					0.0002 (1.738)**	0.0001 (1.74)**
Poor_assess	0.817 (1.563)	0.246 (1.56)	0.924 (1.705)**	0.284 (1.70)**	0.779 (1.455)	0.239 (1.45)
Satis_assess	0.156 (0.464)	0.046 (0.46)	0.187 (0.55)	0.056 (0.55)	0.173 (0.51)	0.052 (0.51)
Good_assess	0.456 (0.772)	0.131 (0.77)	0.495 (0.811)	0.144 (0.81)	0.402 (0.668)	0.118 (0.67)
No. of observations	241	241	230	230	226	226
LR $\chi^2$	19.74	19.74	24.97	24.97	25.46	25.46
Prob> $\chi^2$	0.049	0.049	0.0092	0.0092	0.0201	0.02
Pseudo R <sup>2</sup>	0.0756	0.0756	0.0978	0.0978	0.1015	0.1015

Notes: Figures in parentheses are z-statistics. dF/dx is the change in the probability for a unit increase in the explanatory variable.  
\* Significant at the 5 percent level; \*\* Significant at the 10 percent level.

Another nonlinearity occurs in size variables. In one specification, the coefficient for medium-revenue firms is positive, indicating that firms with larger revenues (relative to the smaller firms, which is the omitted variable) are more likely to respond to a substantial uplift in the legal system. Interestingly, however, the coefficient for large firms is not significant in any of the regressions, suggesting that the large firms per se are not more likely to respond than the smallest firms. These results taken together imply a nonlinearity, where the medium firms, rather than either the largest or the smaller, are most likely to respond positively to legal improvements.

As seen in the coefficient for age of firms, older firms are less likely to respond to improvements in the system of law, suggesting a possible "jadedness", where such firms have adjusted to or accommodated the current state of the current legal system. Employment enters with a negative sign: firms with larger employment seem less likely to increase investment.

#### **14. Quantifying economic impact**

As a final exercise, it is possible to give a rough order of magnitude of the impact of judicial dysfunction on aggregate output and incomes, using a simple growth model of the Harrod-Domar type. The model used to derive these estimates is explained in an Appendix. Essentially, however, since long-run growth in output depends on the rate of accumulation, it becomes a straightforward matter under certain assumptions to apply the increases in investment in the sample to obtain a resultant change in growth.

Tables 43-44 show the implied magnitudes of lost investment opportunities based on the survey questionnaire for the high and low ends of the ranges indicated by respondents for each tercile.

The results are summarized in Table 45. The survey responses suggest that real investment could increase between 6 and 11 percent annually, which would raise the investment rate (the ratio of investment to gross domestic product [GDP]) from the level of 22 percent in 1999 to about 23 or 24 percent. In turn this would raise predicted GDP growth permanently from a quarter to almost half a percentage point, i.e., between 0.24 and 0.46. Hence, for example, GDP growth in 1999 could have been 4.51 or 4.29 percent rather than 4.05 percent. This would have been equivalent to an extra annual flow of between Php 7.03 billion and Php 13.26 billion in prices of 1999. These figures are somewhat smaller than results obtained for Brazil by Castelar Pinheiro [1998], who estimated that judicial reforms would raise GDP growth in that country by a fourth.

**Table 43. Projected change in investment (Low end)**

	<i>Large (top tercile)</i>	<i>Medium (middle tercile)</i>	<i>Small (bottom tercile)</i>
Average percentage change in investment $\Sigma h_i^k R_i^k / \Sigma R_i^k$	0.089	0.150	0.154
Total revenues (in bn pesos) $R_i$	359.81	9.39	3.76
Change in investment (in bn current pesos)	32.02	1.41	0.58
Total change in investment (bn current pesos)	34.01		
Total change in investment (in 1985 bn pesos)	12.02		

**Table 44. Projected change in investment (High end)**

Sample: 320	<i>Large (top tercile)</i>	<i>Medium (middle tercile)</i>	<i>Small (bottom tercile)</i>
Average percentage change in investment $\Sigma h_i^k R_i^k / \Sigma R_i^k$	0.169	0.233	0.282
Total revenues (in bn pesos) $R_i$	359.81	9.39	3.76
Change in investment (in bn current pesos)	60.89	2.19	1.060
Total change in investment (bn current pesos)	64.14		
Total change in investment (in 1985 bn pesos)	22.64		

**Table 45. Simulated change in 1999 GDP growth**

	<i>High end</i>	<i>Low end</i>
Total change in investment (in 1985 bn pesos)	22.64	12.02
As percent of actual investment (base: P200.7 bn)	11.3	6.0
New investment rate (base: 0.2188)	0.2319	0.2435
Change in predicted real GDP growth (percent)	0.4575	0.2426
Level-change (in 1985 bn pesos)	4.06	2.15
Level-change (in 1999 bn pesos)	13.26	7.03

\*Change in predicted GDP growth = change in investment x ICOR investment capital output ratio (ICOR) = 5.4

In appreciating these magnitudes, it should be remembered that they refer only to the top 7,000 corporations of the country and therefore represent an underestimation, if anything. Nonetheless, given the highly skewed size-structure of Philippine industries in favor of large firms, on the one hand, and the more limited exposure of smaller firms to legal contracting, on the other, the order of magnitude should be indicative.

## 15. A summary of findings

The principal results of the foregoing analysis may be summarized as follows:

1. Governance problems are as important as economic or financial problems in doing business. Only weak market demand was cited as being more important than corruption, high crime levels, and lack of trust in government laws and policies as important obstacles to doing business. Of more direct relevance to the judiciary, difficulties in settling legal conflicts were the sixth most frequently cited factor affecting business, after high power costs but even more important than poor physical infrastructure and access to credit. While not the most important governance problem (corruption and peace and order are), the operation of the judiciary is certainly one of the main factors affecting the overall atmosphere for doing business.
2. All parts of the judicial system, if properly functioning, are deemed to have potentially positive effects on both the economy and the respondents' own firms. The highest positive rating is given to the Supreme Court, followed by provisions of laws. Somewhat lower in the respondents' estimate are the constitution and the court of appeals. Respondents appear to recognize the wider ramifications on the economy of framework-setting institutions,

but the work of lawyers is deemed to have the most important impact on the more limited interests of individual firms.

3. The importance accorded to judicial functioning falls with the size of the firm, in line with the hypothesis that the need for adjudication likely increases with the number of transactions.
4. An efficiently functioning judiciary is likely to have the most impact on business issues involving breaches of contract, labor disputes, and the settlement of tax liabilities. Such responses may be taken as the degree of business expectations regarding areas of judicial performance and serves as a priority list if the judiciary wishes to begin reforms in issues that matter most to businesses.
5. An inefficient functioning of the judiciary is most frequently thought to be reflected on the increase in the spread of banks, decisions not to invest, and the acceptance of bad agreements, pointing to the effects of a generally low level of business trust in the absence of a rules-based system. Labor relations and employment are also likely affected by way of a greater resort to casual labor in the effort to avoid labor disputes.
6. In a smaller subgroup of firms that had been negatively affected by court decisions, the consequences took the form of losses of investment opportunities or tempo, and losses in earning opportunities in the form of tied-up provisions or deposits. A much smaller number reported that particularly acute consequences in the form of a reduction of work, a cessation of factory operations, or that of office activities.
7. Companies take precautions against breach of contracts other than going to court. Frequently cited forms include examining the reputation of the partner before a business deal; favoring well-known clients or suppliers; consulting a list of poor debtors; requiring initial deposits; and demanding third-party guarantees. The prevalence of these practices support the hypothesis that significant transactions and information costs are incurred by a majority in the private sector to avoid higher costs associated with a weakly functioning judiciary.
8. Firms rated the judiciary's functioning overall as unsatisfactory, with most answers clustering around ratings of "poor" to "very poor". In addition, the fact that a firm had received an adverse decision or been a plaintiff in a court case in the last five years increase the probability of a poor or very poor assessment. Hence the perception of mediocre judicial performance is pervasive, and actual experience with the system, if anything, tends to reinforce rather than contradict it.

9. On each of five aspects of judicial functioning—namely, transparency, predictability, cost, speed, and impartiality—the overall assessment was still less than satisfactory. The judiciary's ratings were close to "satisfactory" on the aspects of transparency and predictability, but were worse than "poor" on the aspect of speed.
10. Respondents attribute the judiciary's shortcomings primarily to problems of governance within it, namely, political influence and pressure on the courts, and corruption among judges and other court officers.
11. The inadequacy of resources devoted to the courts is given as a third reason for the judiciary's failure to live up to expectations. This is followed by questions regarding the competence of judges and of rigid judicial procedures. Only a minority perceives problems with the design of laws and the constitution.
12. Respondents on average assessed the costs of accessing the judiciary as being "high, without being prohibitive". A larger proportion of small firms think costs are prohibitive.
13. The amount involved (as a proportion of revenue) before firms are induced to litigate increases with the experience of having been a plaintiff or adversely affected by court decisions in the past. That is, everything else being equal, firms with court experience are "once bitten, twice shy". Significant cost barriers also exist to gaining access to the judiciary, with the largest firms facing lower entry barriers and having a lower reservation price (hence a greater readiness) to litigate than small or medium firms.
14. A plurality of respondents (37 percent) with court experience said the benefits exceeded the costs, but only a little less (34 percent) said that the costs exceeded the benefits, with the rest saying the benefits cost about the same as the trouble.
15. On the single issue alone of debt collection, firms seem willingly to forego at least Php 800 million annually in the form of opportunity costs to avoid resorting to the judiciary.
16. Among the frequently cited consequences of judicial dysfunction were reduced dealings with the government, cancellation of investment projects, refraining from contracting with other private parties, reducing outsourcing, and reducing employment, among others.
17. Only a minority of the respondents frequently resorted to mediation and arbitration, with more large firms resorting to this method than medium and small firms.

18. Only a minority of firms actually entered contracts under laws of foreign jurisdictions, with large firms being more likely to be acquainted with the possibility and to have actually entered into such contracts, bolstering the hypothesis that larger firms are also better able to hurdle these transaction costs than smaller firms. Firms that have been negatively affected by court decisions are more likely to enter contracts under foreign laws.
19. Access to a legal system equivalent to that of Hong Kong or Singapore would, according to respondents, cause them to increase investments, experience increase in sales, expand employment, and outsourcing.
20. Firms that have experienced being plaintiffs are more likely to declare they would increase investments if the legal system were improved, possibly because they are better able to appreciate the current system's shortcomings and how much of an improvement a superior system would represent. Respondents who rate the judiciary's performance "poor" but not "very poor" are also more likely to respond to improvements in the legal system, as are medium firms, rather than the largest or the smallest. Older firms tend to be "jaded" and respond less to improvements in the system of law.
21. The current level of functioning of the legal system has an economic impact equivalent to foregoing at least 6-11 percent of total investment in the economy and foregoing at least one-fourth to one-half of a percentage point (0.25-0.46) of GDP growth annually, or an annual loss amounting to between Php 7 billion and Php 13 billion in 1999 alone. These results statistically cover only the responses of the largest 7,000 corporations, hence in principle it represents an underestimation. Nonetheless, these are significant and recurring economic losses attributable to the nature and functioning of institutions and make a strong case for judicial reform.

## **16. Implications**

The study has identified significant issues that surfaced from the findings.

### *16.1. Issues for the Supreme Court*

- How important is contributing to economic development in its scale of priorities?
- To what extent will it coordinate its reform programs with the overall macroeconomic development program?

- To what extent is it ready to prioritize certain areas of reform?
- To what extent is it ready to measure performance of the judiciary's components?

#### *16.2. Issues for planners of development and of development aid*

- What kind and amount of resources must be channeled to the judiciary for maximum impact? What is the priority and schedule for the channeling of these resources?
- How could all nationally funded/supported reform measures be coordinated for efficiency?
- How should the priority in all important public sector reform areas be determined?

#### *16.3. Issues for the legislature*

- How should a resource allocation system be designed to maximize the impact that judicial improvement can have on the economy while making it the account for measurable and specific performance targets, yet respecting judicial independence?
- How much to allocate to judiciary and how soon?

#### *16.4. Issues for the business community*

- To what extent is it willing to reallocate its private subsidy budgets to support the judiciary's reform agenda while always respecting judicial independence?
- To what extent will it abandon rent-seeking to live within the strictures of a rules-based legal and judicial system?

#### *16.5. Issues for civil society*

- To what extent will its different sectors recognize areas of reform that must be prioritized to maximize economic impact?
- To what extent will they abide by the reality that they will not be first-level beneficiaries of these reforms?
- To what extent will they internalize that improvement in business conditions that benefit all, including their particular sectors?



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**Appendix A**  
**Definitions of regression variables**

<i>Variable name</i>	<i>Definition</i>
Large	1 if the firm belongs to the top tercile, 0 otherwise
Medium	1 if the firm belongs to the middle tercile, 0 otherwise
Small	1 if the firm belongs to the bottom tercile, 0 otherwise
Agriculture	1 if the firm belongs in the agriculture sector, 0 otherwise
Industry	1 if the firm belongs in the industry sector, 0 otherwise
Service	1 if the firm belongs in the service sector, 0 otherwise
Income99	Net income in 1999 (in thousand pesos)
Income99 <sup>2</sup>	Square of net income in 1999 (in thousand pesos)
Employee	Total number of employees
Employee <sup>2</sup>	Square of the total number of employees
Year	Number of years in existence
Year <sup>2</sup>	Square of the number of years in existence
Adverse	1 if the firm was ever negatively affected by a judicial decision in the last ten years, 0 otherwise
Plaintiff	1 if the firm has been a plaintiff in a court case, 0 otherwise
Assessment	1 if the firm's overall assessment of the judiciary's performance is poor or very poor, 0 otherwise
Good_assess	1 if the firm's overall assessment of the judiciary's performance is good, 0 otherwise
Satis_assess	1 if the firm's overall assessment of the judiciary's performance is satisfactory, 0 otherwise
Poor_assess	1 if the firm's overall assessment of the judiciary's performance is poor, 0 otherwise
Very poor_assess	1 if the firm's overall assessment of the judiciary's performance is very poor, 0 otherwise
Investments	1 if the firm will increase its annual investments if it was possible to write business contracts using laws equivalent to those of Singapore or Hong Kong, 0 otherwise
Foreign	1 if the firm ever entered into contracts using laws of foreign jurisdiction, 0 otherwise
Percent	Percent share of unpaid debts to annual gross revenue (that makes it worthwhile for the firm to sue its client)

**Appendix B**  
**Descriptive statistics**

<i>Variable</i>	<i>Obs.</i>	<i>Mean</i>	<i>Std. Dev.</i>	<i>Min.</i>	<i>Max</i>
Large	241	0.4398	0.4974	0	1
Medium	241	0.3278	0.4704	0	1
Industry	241	0.4896	0.5009	0	1
Service	241	0.4938	0.501	0	1
Income99	241	81205.7	934240.5	-1.02e+07	6762990
Income99 <sup>2</sup>	241	8.76e+11	7.47e+12	900	1.04e+14
Employee	230	561.2	1454.999	3	12000
Employee <sup>2</sup>	230	2422769	1.52e+07	9	1.44e+08
Year	226	20.8	22.27	1	167
Year <sup>2</sup>	226	925	2673.1	1	27889
Adverse	241	0.2614	0.4403	0	1
Plaintiff	241	0.4606	0.4995	0	1
Assessment	241	0.4772	0.7491	0	1
Good_assess	241	0.5228	0.5005	0	1
Satis_assess	241	0.4149	0.4937	0	1
Poor_assess	241	0.4274	0.4957	0	1
Very poor_assess	241	0.0498	0.218	0	1
Investments	241	0.2324	0.4232	0	1
Foreign	241	0.1411	0.3488	0	1
Percent	164	8.7378	20.06	0	100

### Appendix C

#### Estimating the growth impact

Let  $h_i^k$  denote the stated proportion of their revenue  $R_i^k$  that respondents in tercile  $k$  ( $=1,2,3$ ) would invest, where  $0 < h_i^k < 1$ . The mean proportion for the tercile may then be estimated as  $h^k = (\sum h_i^k R_i^k) / (\sum R_i^k)$ , where the sum is taken over the sample-respondents for the  $k^{\text{th}}$  tercile. This proportion  $h^k$  may then be applied to the entire revenue of the tercile  $R^k$ , to obtain  $\Delta I^k = h^k R^k$ , the estimate of the increase in investment for the tercile  $k$ . The estimate of the change in investment over the entire population of firms is then  $\Delta I = \Delta I^1 + \Delta I^2 + \Delta I^3$ .

This potential increase in investment is mapped onto GDP growth through a simple model of the Harrod-Domar type, which affects the growth rate  $g = \Delta Y/Y = I/Y$ . If investment increases by  $\Delta I$ , then the new growth rate is given by  $g' = (I + \Delta I)/Y$ . The results of this computation are shown in Table 45.