

THE SOFT STATE, THE MARKET AND GOVERNANCE

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1. Introduction

The Philippines, by many accounts, remains a “soft state.” This was the favorite talking point of former National Security Adviser Gen. Jose Almonte, whose crusade against “unearned income” and spineless soft state governance found its happy expression in aggressive deregulation by the Ramos Administration in the '90s. Was the action plan consistent with the philosophy? Let me first resort to G. Myrdal (1970) for some graphic description:

“The term soft state is understood to comprise all the various types of social undiscipline which manifest themselves by: deficiencies in legislation and in particular law observance and enforcement, a widespread disobedience by public officials on various levels to rules and directives handed down to them, and often their collusion with powerful persons and groups of persons whose conduct they regulate.”

If we pick either Singapore or South Korea as exemplars of the “hard state” in East Asia, the Philippines necessarily falls in the opposite category. A few examples would bring home the point: the way traffic, zoning and sanitary rules are openly transgressed; the sorry state of the Philippines’ international gateway, NAIA; the endless denunciation of the hoodlums in robes and the market for TROs and other juridical outcomes; the inability to prosecute the rape of property rights whether perpetrated by Marcos, his cronies or by professional quatters.

It is a casual but seldom challenged observation that governance matters for economic performance. Even the bastion of “getting prices right,” viz., the World Bank, was forced in its celebrated 1993 volume *The East Asian Miracle* to doff its hat, if reluctantly, to good governance. Why so?

At the heart of long-term economic performance is the allocation of resources and investment. In soft states, the quality of investment quickly erodes as investors get smart and begin to wager resources in the enormously profitable and *loaded gamble for rule changes* (see e.g. Fabella, 1996, 1994). As an example, the person who won a Marcos Presidential Decree for exclusive imports of cigarette filters became enormously rich. The rates of return of value-adding investments pale in comparison to those of gravy train-snatching investments wherever legal grounds are constantly shifting and the rules of the game are up for sale. Soft states and good economic performance do not rub shoulders.

How does a soft state come about? How does a soft state recapture hardness? Myrdal’s graphic description gives no clues. We suggest a framework.

2. The Genesis of the Soft State

There are stories and stories about how states descend into impotence. Allow me to suggest the following: (a) The state is a bundle of rules and the capacity to enforce those rules. (b) There are “democratically beneficial rules:” rules that break prisoner’s dilemma problems (coordination problems such as traffic jams); rules that enforce property rights; those that preserve basic human rights. These rules are, in the net, welfare-improving in a democratic sense. Their benefits are widely diffused. Social instinct, if not cold calculus, tells us they are necessary for civilized society. (c) The enforcement of rules is, in the last analysis, incumbent on the public as a whole (Cooter, 1997). To the eternal dilemma: “Quis custodes custodiet?” the only sensible response is, “Custodes custodiet populus.” (The public monitors the guardians of the law.) For as long as a rule is democratically welfare-improving, the public is an ally of enforcement and enforcement is usually well-served. (d) But the state, either due to knavery, capture, hubris, or to well-intentioned ignorance, can overextend itself

into “narrowly beneficial rules.” The benefits of these rules accrue to narrow vested interest groups in society. Such were the very high tariffs or quotas in the import substitution era. These were highly financially rewarding to certain interests but the high prices of commodities for the general public made the welfare outcome very dubious. The public had no stake in enforcing such rules and, indeed, benefited from subverting them. That was how smuggling became part of the social fabric. Rule transgression is *both socially and privately beneficial* in this case. (e) Once the public realized benefit from subverting such rules, their attitude towards rules in general erodes. This is the contagion effect that afflicts both law enforcement and law abidance (see Fabella, February 1999). Regulators make money by subverting “bad rules” since the probability of detection and punishment is low, with the public either looking away or in cahoots. (f) Eventually, both realize that they can make money subverting even “good rules,” helped along by an increasingly cynical public. (g) Finally, as the proportion of the public that gets touched by privately beneficial transgressions rises, a low level, self-enforcing, and stable equilibrium of undiscipline takes over. Society itself becomes the constituency of low grade disorder. The forces for higher order are marginalized and neutralized.

3. Marketization and Philippine Soft State

The story of Philippine governance in the post-war period can be viewed in this way. The pre-war period is generally looked back to with a sense of loss; as a period of civility and *delicadeza*. While World War II shattered many of the previously-held social verities, it was *import controls* and subsequent policies to supplant imports which captured the imagination of the business elite. Here was a new avenue to wealth. The regime relied on the monopoly and rationing of foreign exchange on the basis of a commodity classification of imports. This was a tremendous source of economic power and, what’s more, perfectly legitimate. Those who got easy access to the precious dollars got very rich very quickly. Such, it is told, was how an ambitious young congressman from the North got started on the road to wealth and power.

Those who did not have this access can still become rich through smuggling made profitable by exorbitant domestic prices. Suddenly, every town had its resident smuggler whose *kumpares* and *kumares* encompassed the local officialdom. The era left a linguistic heritage. Rubber slippers are known in the Western Visayas as *smagol*. These came tariff-free from Borneo and Singapore via Jolo, Sulu. *Blue seal* was the name for favored cigarette. These came by fast boat from the South. Very few escaped the allure of cheap smuggled imports. It was a highly popular movement to subvert import substitution and redistribute its gravy. True, the *Hukbalahap* insurgency captured the headlines. But it was economic insurgency in the form of smuggling that was permanently changing the social landscape. Soon, mayors and governors were in on the action, followed by local and then national legislators. Import substitution's costliest legacy was not a bevy of inefficient industries; it was the erosion of governance coming in the heels of the collapse of respect for the law. But it was *martial law* that finished the demolition job.

It was partly in the patent erosion of governance and the hanker to restore society to its previous proper moorings that Marcos found an excuse to impose martial law. But Marcos' own background, the crucial role played by unearned rents in his own becoming, made him a natural ally, not an enemy, of rents. Rents in the hands of his political enemies made for poor economic performance, not rents themselves. Rents in the hands of political allies and cronies will change all that. Thus, the politico-economic thrust of the martial law years was, first, the wresting of rent privileges from political enemies and, eventually, the widening of rent extraction net. It became in time an elaborate rent-extraction machinery sold to the public as a development strategy.

People responded rationally. The imperatives of the rent state created a *market for rules*. Indeed, it made this market the most watched and played. For the right consideration, one can have a special rent rule (e.g., the Presidential Decree granting a monopoly to import Australian beef). Those at the receiving end of these rules struggled to subvert them. Laws further lost their dwindling moral high ground and, thus, their moral imperative. First the tariff code, then the tax code, even the lowly traffic code, and finally, in its most threatening form,

the Temporary Restraining Orders (TROs) and juridical outcomes were put on the auction bloc. It was marketization gone berserk. Adam Smith standing on his head.

How ironic that while at the heart of the Philippine "soft state" is a market: a market for rules, its redemption may also be another market, the Smithian market.

4. Re-Engineering the State

The current orthodoxy favors a "strong state with limited agenda" (Streeten, 1994). Although a *limited agenda* does not, ipso facto, lead to a strong state, it is very unlikely that a state that overreaches (extends its span of control to rules that are beyond "*democratically beneficial*") will remain strong. Soft states are normally characterized by *control overreach* largely in an attempt to widen the rent extraction net, hiding behind the veil of nationalistic or ideological slogans. This leads to sparse enforcement and even open violations and corruption.

There is a good amount of debate on the limits of "limited agenda." A good many thinkers have settled on a few consensus items:

- (i) *The Smithian Agenda*, of which there are three types: (1) defending the people from "violence and invasion of other independent states;" (2) protection of members of society from "injustice or aggression by every other member;" and (3) "certain public works and certain public institutions, which it can never be for the interest of any individual or a small number of individuals to erect and maintain" (A. Smith, *The Wealth of Nations.*);
- (ii) The provision of sound macroeconomic fundamentals; and
- (iii) The management of externalities, i.e., the inhibition of negative ones, the promotion of positive ones and the breaking of coordination logjams.

Stiglitz (1996) lists under *broad infrastructure* of the Smithian Agenda [(i)-(iii)] a support for the following: (a) education (positive externality); (b) technology promotion (positive externality); (c) regulation of the financial sector as the area where coordination failure most likely happens; (d)

physical infrastructure; (e) environmental protection (mediating the claims of present vs. future generation); (f) creating and maintaining safety nets. Streeten (1994), on the other hand includes apart from (i)-(iii) above; (g) aggressive market and competition promotion, especially where this has been historically stifled; and (h) the reduction of income inequality. Under Smithian Agenda [(i)-(iii)], Streeten and others include the provision of legal framework, the enforcement of contracts, and the definition and enforcement of property rights.

The World Bank has itself promoted “getting prices right” as a veiled but convenient summary of the Smithian Agenda. “Prices are right” when the state stays where it has Smithian comparative advantage and leaves the rest to private agents. Advocates of the “Minimalist State” (Chicago School and J. Buchanan, 1986) would consider only the (1) and (2) of the Smithian Agenda. Deepak Lal (1985) interprets aggressive market-making as “... requiring a courageous, ruthless and perhaps undemocratic government to ride roughshod over those newly created special interest groups.” The authoritarian regime in East Asia found comfort in his views.

We have just given a flavor of the lively controversy surrounding the definition of “limited agenda.” What is not in question, in principle, are the following: (a) The state should stay clear of areas where markets can function properly. (b) The state should, at best, regulate in areas where market failures are endemic (as with prudential rules for banks where moral hazard is eminent) rather than acquire ownership. (c) The state should improve its performance in the Smithian Agenda.

This article of faith is summed up by the 1662 Book of Common Prayer: “We have left undone those things which we ought to have done; and we have done those things which we ought not to have done. And there is no health in us.”

Re-engineering the soft state in our times is really reverting to the Smithian Agenda — more or less interpreted. In this way, the state can be whipped to improved performance in its natural niche. But walking away from past involvements is easier said than done.

5. Disengagement from the Market

Type of disengagement

Granting the “principle of limited agenda for improved governance,” how does the state disengage from past involvements? This is a difficult question and has, in the Philippines, taken the following concrete forms:

- a) Trade Liberalization — the lifting of barriers such as tariffs or quotas to international commerce. Meaningful trade liberalization has been pursued since 1986 in the Philippines. Non-tariff barriers and tariffs have been progressively reduced by the past two administrations with some conviction and uniform tariff in 2003 is envisioned.
- b) Deregulation — (i) the lifting of entry barriers to competitors where the market was monopolized (usually with the aid of an enabling law); this has occurred in transport (air and sea), banking, telecommunications, etc; (ii) the lifting of legally imposed barriers to exchange and price caps such as those under rent control, the anti-usury law, and oil.
- c) Privatization — the transfer of ownership and control of state enterprises from public to private hands. We saw this in PNB, PNOC, and MWSS, among the more visible examples.

All these are concrete avenues of assault on the rent extraction net.

Efficiency goals

The avenues for market disengagement are usually sold to the public in the name of market efficiency. Market discipline, the looming possibility of bankruptcy, and out-of-pocket losses prod market players to innovation, lower costs, and prudent investments. But the greater long-term payoff is not market efficiency but the *redemption of the state*. Whereas the marketization of laws was the undoing of the hard state, the marketization of state overreach, in its many forms, will loosen, if only slowly, the pylons of the soft state.

State disengagement from the market means, first and foremost, the shedding off of rules that beget rents. The less the possibilities of rent-propelled wealth, the more resources

will be trained towards value-adding activities (see, e.g., Fabella, 1996) and the less the state will be hounded by endless hordes of rent-seekers.

As the set of rules retreats to the more basic Smithian core, its moral standing rises and its enforcement soars.

Many people have proposed innumerable approaches to improved governance. The most common is *moral regeneration*: people somehow switching off to Mammon and switching on to righteousness. Although people do get the government they deserve, there is more wish here than reality. The more law-and-order-inclined may cast their lot with another *strong man*. If he is benevolent, he will cleanse the Augean stables; if he is malevolent, well, the soft state is a small price to pay. Market advocates in the late 20th century, by contrast, whether consciously or not, double as advocates for better governance with a concrete program. Their program of preference is marketization. In this case, the market advocates may have it spot on. Gen. Jose Almonte was not an idle dreamer.

The way ahead

While the Philippines has embarked on the fateful journey towards the market with some tangible results, the way forward becomes progressively harder. The second-generation reforms are harder to pursue and are beset by thorny problems of implementation. In telecommunications, for example, the ubiquity of cell phones represents an early triumph. But the problem of *interconnection*, which determines whether the incumbent squeezes out new entrants by limiting access to backbone facilities, is harder to crack. The awarding of many franchise service areas without prior interconnection provision will delay the full harvest of deregulation.

The privatization of Metropolitan Waterworks and Sewerage System (MWSS) is being closely watched. How the issue of plungers and early renegotiation is resolved will affect the future of privatization as a whole. The privatization of National Power Corporation and the program to restructure the power sector is beset by hefty problems. What to do with *stranded assets* — costly and many times failed sunk costs such as the Bataan nuclear plant? Can we really do with costly (to industry) *cross subsidies*?

Then we face the problem of creeping re-nationalization

The call to put GSIS and Miyasawa funds behind the embattled Philippine Airlines is a case in point. Would the economy, in fact, be better served by an *open sky* policy?

Ahead of us are some obvious deregulation targets if only we can muster the political will. Sugar trade suffocates under the heavy hand of the Sugar Regulatory Agency (SRA). SRA regulates sugar trade to enrich sugar planters and millers at the expense of local sugar consumers and exporters. A jurassic agency like SRA has no place in the Philippines of the 21st century. Its abolition and that of concomitant sugar classification is in clear public interest. The opening up of *arrastré services*, which has choked local and foreign trade and limited the harvest from shipping deregulation, must be faced up to. The battle for improved governance has just begun.

5. Summary

The Philippine state has embarked on a long journey (since 1986) of disengagement from the market. This has taken two principal avenues, namely, the privatization of state enterprises and the deregulation of more and more markets. The public face of state disengagement is economic efficiency. And the early harvests are tangible in shipping and telecommunications. But the more important, if slow in coming, result of the retreat of the state from the market is the redemption of governance.

The Philippines remains a soft state as evidenced by the toothless enforcement of laws and the frequently denounced market for juridical outcomes. Weak governance will continue to hamstring economic and social progress. The Philippine soft state is the offspring of a confluence of historical forces. One such important historical force was the import substitution regime.

Import substitution was pursued with rules that were of dubious social benefits; rules that made a favored few very rich at the expense of the buying public. The latter discovered quickly that subverting the rules by patronizing smuggling was not only privately but also even socially beneficial. Once the public and the law enforcers tasted blood, the distinction between *privately beneficial transgressions* and *privately and socially beneficial transgressions* fades. As enforcement

begins to carry a pricetag, the transgression of *good rules* is not far behind.

It was martial law that entrenched the primacy of the *market for rules*. For the right consideration, a made-to-measure law can be secured. These were called Presidential Decrees under Marcos. Many of the vast wealth still being parlayed for political favors and economic advantage in the closing years of the '90s originated from Presidential Decrees. Now, the market for rules has, it is told, spread menacingly into TROs and other juridical outcomes. Governance lies moribund in the soft state.

The dismantling of the soft state begins with the dismantling of the multitude of rules of dubious social value. This is tantamount to limiting the reach of the state to the Smithian agenda. It is in the Smithian core where the public becomes an ally in the enforcement of rules. The retreat to the Smithian core via marketization likewise radically reduces the rent extraction machinery. Thus, the disengagement from the market will gradually loosen and uproot the pylons of the soft state. Governance will recover as the soft state fades.

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