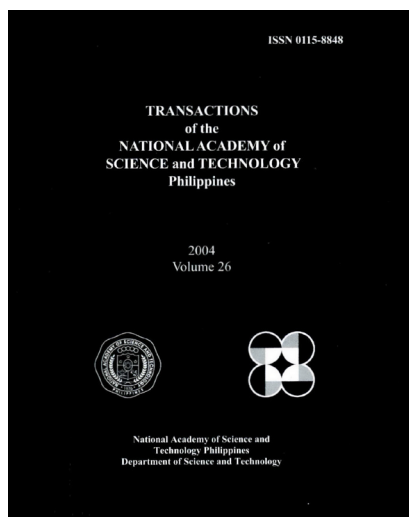


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Exchange-Relations, Economic History, and Philippine Institutions

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EXCHANGE-RELATIONS, ECONOMIC HISTORY AND PHILIPPINE INSTITUTIONS

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Abstract

Institutions have come to be recognised among the “deep determinants” of economic development. Institutions are defined [7] as “social factors – rules, beliefs, norms, and organizations – that guide, enable, and constrain the actions of individuals, thereby generating regularities of behavior.” Institutions surrounding and affecting exchange are particularly important in economic development in light of the principle that in giving rise to specialisation, exchange promotes productivity growth. Both in history and in principle, an expanding scope of exchange creates a demand for impersonal rules that go beyond immediate personal relationships to include more comprehensive common responsibility systems, and on to third-party enforcement mechanisms including the state.

This paper contributes to the hypothesis that a good deal of past Philippine under-development was due to the restriction of trade, and, more importantly, that such a restriction bore consequences for the subsequent development of Philippine institutions. The Spanish conquest suppressed the pre-existing free trade that existed between native communities and China and the South, replacing this instead by the mercantilist institutions, notably the galleon trade. For a great part of the Spanish occupation, domestic trade itself was also discouraged through arbitrary impositions, confiscation of goods by the colonial authorities, as well as the mis-guided formal restriction of credit transactions. The effect was not merely to severely limit wealth-generation among the native population of the time, but more importantly to prevent the emergence of institutions that would facilitate impersonal exchange separated in time and covering long distances. In particular, an experience of effective and impartial law failed to develop. What law there was, as embodied, e.g., in royal ordinances, failed

to correspond with facts on the ground and was violated arbitrarily by colonial officials and agencies.

It is then suggested that from this pattern may have originated some of the problems that plague even current Philippine institutions, including the continuing reliance on exceptions-based personal relationships rather than on impersonal rules, the weak definition of property rights and enforcement of contracts, and the lack of restraints on the actions of the powerful actors and hence their inability to make credible commitments.

Keywords: institutions, trade restrictions, development, exchange-relations

Whenever commerce is introduced into any country, probity and punctuality
always accompany it.

— Adam Smith

[Lectures on justice, police, revenue and arms Part II, par. 17]

The most commercial and most industrious countries have been the freest
countries.

— José Rizal

“The indolence of the Filipino”

Contemporary political events have thrown the quality of Philippine institutions into sharp relief. Over the last four years and in very short order, the mettle of the nation’s institutions has repeatedly been tested by such events as the impeachment and unseating of a president, an aborted impeachment of country’s chief justice, and a national election unprecedented in the rancour of its conduct and subsequent canvass.

In each of these instances, the adequacy and seriousness of the country’s most basic rules as contained in its basic laws and procedures have been tested to the limit, often dangerously. The question has thus been asked whether a genuine social consensus indeed underlies the formal rules that purport to govern public behaviour. Writers such as Hutchcroft and Rocamora [1] would refer to a “democratic deficit” in the Philippines – by which they mean a gap that exists between formal institutions and the perceived needs of people. Deep questioning regarding the nature and quality of Philippine institutions is not new, of course. A good deal of writing in political science and political economy deal with the notion that the credibility and adherence to institutions is weakened by the fact that the political system is unresponsive to the majority, and that much of this has to do with inequity in the distribution of income, wealth, and education. Without denying the importance and possible interdependence

of these factors, however, there should be room for a finer distinction between social equity on the one hand and the rule of law on the other. There are societies where the rule of law may prevail, even wealth may be unequally distributed (e.g., the United States), while those also exist where rough equality prevails but the rule of law may be weak (e.g., Zimbabwe).

In this country, what is apparent is a weak constituency for and acceptance of rules. Rules even before they have had the chance to ossify, are the subject of challenge through acute innovation, whether the rules have to do with an impeachment, a canvass, or contracts to build an airport, reclaim lands, buy vote-counting machines, and so on.

This paper's general hypothesis is that an important part of the institutional problem in the Philippines is the disconnect between formal institutions and informal ones, using the distinction made originally by North [2]. Formal institutions are constraints on behaviour that embodied in constitutions, laws, statutes, and written contracts and are in principle enforceable by the state. On the other hand, informal rules and constraints consist of unwritten norms of behaviour that people observe for their own convenience and benefit, however these may be defined. What is important is that these in principle require no intervention on the part of the state to make them effective; indeed they may at times involve behaviour that is technically illegal. But their existence and enforcement rely on no more than the beliefs of the actors, or on the real or imagined retaliation or consequences following upon their non-observance.

For the Philippines, an important first clue to using history to trace the disjunction between formal and informal institutions dates back at least to O.D. Corpuz's, who in his valuable but now little-noticed book of 1965 [3] (subsequently reiterated in Corpuz [4]), noted how, in order to escape the harshness of the colonial order, many subjected Filipinos developed the habit of dissimulation, i.e., of complying outwardly with formal rules while continuing to adhere to informal but often more compelling norms that pre-existed the occupation:

The potentially violent competition between Christian dogma and folk belief was resolved through the process of selective acceptance and mutual accommodation... The political and economic demands of the colonial regime upon the masses of the Filipinos through partial compliance and occasional evasion ...

.....

When their behaviour would be visibly contrary to the colonial requirements, the complied in order to avoid punishment. But they took advantage of every occasion to live under the morality of pre-Hispanic society [3]

.....

Thus the Filipinos shaped and created, in myriad ways, an independent life of their own, misunderstood by the Spaniards because they did not share that life; the Filipinos retreated to this life to escape the severities of the colonial order [3].

In these passages, Corpuz [3] presents a valuable insight into why the institutions of colonial government failed to take root and attain credibility in the Philippines. Essentially, he implicitly points to a competition between formal institutions and pre-existing informal ones. In this competition, however, it was the formal one that lost out. Drawing this strand through to the 20th century, Corpuz noted how the default institution of the family (or the clan) thus became juxtaposed to state institutions and how their competing value systems often clashed. This he uses as a partial explanation of the phenomenon of corruption that runs like a thread through all epochs of Philippine history.

What follows seeks to pursue the line of reasoning O.D. Corpuz has begun. We seek both to generalise as well as specify the argument, however. We generalise it by recasting a good deal of historical writing into the language of the new-institutional economics. By this means we hope to gain a better insight into those peculiar factors that prevented formal institutions in the Philippines from developing and gaining credibility and acceptance. At the same time, given the vastness of this topic, we have chosen to focus only the institutional aspects of commerce. This article hypothesises that historically the underdevelopment of Philippine economic institutions is at least partly traceable to the country's long history of suppressed trade. To lay down this hypothesis, however, we first discuss the inherent institutional problems posed by exchange in general.

Institutions and the problem of exchange

Beyond instantaneous or spot-transactions (*kaliwaan*), the basic problem of exchange has to do with the absence of guarantees of compliance. This is especially true of complex exchange [2], that which is separated in space or time, or, as Greif [5] [1997] puts it, where the “the *quid* is separated from the *quo*”. Credit is a canonical example: it involves the transfer of physical possession over some asset, whether a concrete good or money, to some other person, in exchange for a promise to replace this in the future with a larger value. What Greif [6] has called the “one-sided prisoner's dilemma” with respect to such exchange has to do with the real possibility that the debtor will choose to abscond with the asset and fail to keep his promise to repay with interest. Indeed, cooperation, as North [2] puts it, presents a theoretical problem.

Suppose the potential gains from trade are $p > 0$, and that if exchange is consummated, the gains are split between two Persons A and B, with each obtaining $p - c > 0$ and $c > 0$, respectively. Should no exchange take place, each gets 0. On the other hand, if Person A initiates exchange and B accepts but later reneges on the promise, the former obtains $v < 0$, while the latter obtains $r > c$. These results are summarised in Tables 1 and 2 below, which is an alternative representation of Greif [7].

Table 1.1 Person B's choices if A initiates exchange

A initiates exchange; B refuses	A initiates B accepts and complies	A initiates; B accepts and reneges
0	$p - c$	$v < 0$
	0	c
		$r > c$

Since $r > c > 0$, B's dominant strategy is to renege on the agreement if A initiates exchange, which under full information can be regarded as a certainty by A. Using backward induction, therefore, A's decision whether or not to initiate exchange takes the following form:

Table 1.2 Person A's choices

	Do not initiate exchange	Initiate exchange
0	0	$v < 0$
		r

In such a situation, the dominant strategy for A is clearly not to initiate exchange at all (since $v < 0$). Hence, the only sub game-perfect equilibrium is for exchange not to occur. Thus game theory suggests there is no persuasive solution to any one-period Prisoner's Dilemma as it is presented above

The path towards a solution takes essentially two forms. The first relies on the notion of repeated games, which essentially takes us away from the one-period dilemma. If instead of a one-period transaction, Person B can look forward to many repeated transactions indefinitely in the future, then the gain from renegeing in a particular game in any single period may be outweighed by the loss of future repeated transactions. To picture this most directly, suppose that the value of future transactions for B at any one period is C rather than c , with $C > r > c$. Then it becomes evident that the dominant strategy for B would be to comply with the terms of the contract (Table 2.1). Correspondingly, the table of A's payoffs is also revised to reflect the certainty of compliance, and therefore the dominance of the initiation of exchange (Table 2.2).

Table 2.1 Repeated exchange: Person B's choices if A initiates exchange

A initiates exchange; B refuses	A initiates B accepts and complies	A initiates; B accepts and reneges
0	$P - C$	$v < 0$
	0	$C > 0$
		$r < C$

Table 2.2 Repeated exchange: Person A's choices

	Do not initiate exchange	Initiate exchange
0	0	$P - C$
		$C > 0$

It is not noted frequently enough that Adam Smith [8] long ago saw the importance of repeated transactions (though not in the *Wealth of nations*), when he observed the changes in culture introduced by a society's opening up to regular commerce.

Whenever commerce is introduced into any country, probity and punctuality always accompany it. ... A dealer is afraid of losing his character, and is scrupulous in observing every engagement. When a person makes perhaps 20 contracts in a day, he cannot gain so much by endeavouring to impose on his neighbours, as the very appearance of a cheat would make him lose. Where people seldom deal with one another, we find that they are somewhat disposed to cheat, because they can gain more by a smart trick than they can lose by the injury which it does their character.

..... Wherever dealings are frequent, a man does not expect to gain so much by any one contract as by probity and punctuality in the whole, and a prudent dealer, who is sensible of his real interest, would rather chuse to lose what he has a right to than give any ground for suspicion. Every thing of this kind is (as) odious as it is rare.

The second possible solution to the one-sided prisoner's dilemma is the emergence of *third-party* enforcement, that is, an entity other than either contracting party is called upon to exact a penalty for any non-compliance. Historically this has usually taken the form a legal system enforced by the state. In terms of the pay-off matrices in the two-stage game, this may be depicted as a penalty on B in the case of failure to fulfil his end of the bargain. The penalty k should reduce the gains to reneging sufficiently so that they are less than the gains to complying, i.e., it should be set so that $r - k < c$, or such that $k > r - c$ (Table 3.1). To the extent this suffices to make compliance the dominant strategy for B, the payoff matrix for A's first move is revised accordingly as well (Table 3.2).

The difference between this and the previous case, of course, is that third-party enforcement does not rely on repeated transactions. While repeated transactions require frequent contact and the acquisition of information between the exchange-parties, third-party enforcement in principle applies even to exchange between anonymous parties and should operate even if exchange does not proceed beyond a single transaction.

Table 3.1 Third-party enforcement: Person B's choices if A initiate changes

A initiates exchange; B refuses	A initiates B accepts and complies	A initiates; B accepts and reneges
0	$p - c$	$v < 0$
0		c
		$r - k < c$

Table 3.2 Third-party enforcement: Person A's choices

Do not initiate exchange	Initiate exchange
0	$p - c$
0	$c > 0$

The difference between this and the previous case, of course, is that third-party enforcement does not rely on repeated transactions. While repeated transactions require frequent contact and the acquisition of information between the exchange-parties, third-party enforcement in principle applies even to exchange between anonymous parties and operates even if exchange does not proceed beyond a single transaction.

Trade and institutions in other contexts: Maghribis versus Genoese

Beyond the conceptual literature, the nexus between exchange and the emergence of institutions has also been the subject of historical investigation by a growing number of authors (e.g., North and Greif) who find that the two types of solution to the exchange problem adverted to in the previous section, i.e., mutually enforcing agreements (or second-party enforcement) and state enforcement, are to be observed in history.

The similarities and differences between these two modes is provided by Greif [5, 7], who studied the differences in trading practices between two medieaval trading communities. The Maghribis of the 11th century, Jewish merchants who lived as a minority under military Muslim rulers (specifically Berbers in Egypt and Turks in Turkey) relied primarily on reputation-based mechanisms that consisted of self-enforcing informal agreements among themselves. Copious information-sharing and horizontal relationships among themselves helped the Maghribis solve the inherent risks posed by the handling of a merchant's goods in long-distance trade. Maghribi merchants in different ports and countries would act as agents, receiving and selling goods for their compatriots who would otherwise be far-removed physically from the transactions that occurred. These merchant-agents in turn expected their colleagues in other cities to perform similar in their behalf in their turn. The threat of embezzlement by people acting in one's behalf was obvious. But ultimately, credible enforcement, in the form of a system of a system of cross-defaults and boycotts of agents who had been *Transactions Natl. Acad. Sci. & Tech. Philippines* 26 (2004)

dishonest, was used successfully to enforce “probity.” It is significant that in the process the Maghribis relied not on legal documents but only on the value of long-standing relationships of trust and honesty.

Greif contrasts the Maghribis’ trading practices with those of contemporary Genoese merchants. From the beginning the Genoese had tended towards a more individualistic ethos – in contrast to the Maghribis’ collectivist cultural beliefs. Unlike the Maghribis, who were a minority under foreign military rulers, the Genoese had themselves established an effective government that was under the merchants’ control.¹ Genoese merchants did not share information with each other, did not rely on collective punishment, and also did not restrict their dealings to fellow-Genoese. Instead, there was a clear delineation of functions and obligations as between merchant, agent, and ship-owner, a delineation that was reaffirmed by the Genoese invention of trade documents such as the bill of lading and the bill of advice [5]. In such an individualist society,

[a]n agent who embezzled goods would not be recruited by the cheated merchant again, but could become a merchant himself, able to utilize agents under the same conditions as the merchant he had cheated. Hence, only if agents’ wages are so high that anyone prefers being an agent rather than a merchant can agency relations be established. In other words, for agents to be employed, the merchants have to pay them all the profit and a part of the capital. Clearly there cannot be an equilibrium with such a wage. Hence, for agency relations to be established, there is a need for an external mechanism – such as a legal system backed by the state – that restricts agents’ ability to embezzle merchants’ capital [5].

Ultimately the Genoese legal system developed to register and enforce contracts, developing permanent courts to decide cases, and using the state to enforce penalties among both Genoese and foreigners alike, so that “the city of Genoa functioned as a formal enforcement organization to make the threat of collective retaliation credible” [5]. Among others, this included the threat of confiscating the wealth of the Genoese offender’s family or their imprisonment, as well as the retaliation by the government against compatriots of offending foreign traders.

Between these two, there are gradations, of course. An interesting halfway house between state-enforced rules and mutually but informally agreed conventions was the emergence of the mediaeval “law-merchant” (*lex mercatoria*). Merchants of differing nationalities who became involved in disputes during fairs (e.g., the famous fairs at

¹ Among other things, the Genoese republic entitled all adult males to vote, and in 1194 the system entailed hiring a non-Genoese for a limited period to be responsible for protecting property rights and operating the legal system. This level of accountability was not unique. The control by merchant classes over governments was apparently also true in many Italian cities during the period [5].

² The *piepoudre* (or piepowder) courts in England were the lowest form of court using the common law and adjudicated disputes during fairs. The term itself originated from the French *pied-poudré*, or powdered feet, because these were often held outdoors on the spot, with the litigants often coming in dusty shoes.

Champagne) would resort not to the local law but to a common body of custom adopted and accepted by merchants of differing nationalities and adjudicated by peers without recourse to existing state authorities. While the form by which such a body of law was implemented resembled third-party enforcement, e.g., ultimately involving specialised courts and judges², and while it facilitated impersonal exchange [2] the ultimate basis of such practices in mutual agreement and self-enforcement and its nature as voluntary arbitration was evident. A native merchant from country A could certainly have asked the local ruler to intercede (fairly or unfairly) in his behalf versus a colleague from country B, inevitably gaining the upper hand in the process. While the immediate benefit to such an action was evident, however, there would clearly be a long-run loss in the form of ruining one's reputation and hence prospects for doing further business. This underscores the truth in A. Smith's earlier-cited assessment that a merchant "sensible of his real interest, would rather chuse to lose what he has a right to than give any ground for suspicion". The law-merchant was notable, first, in that it asserted equality before the law, making it "a path-breaking deviation from the feudal class law" [9]. Second, of course, the law merchant notably came to be adopted by governments as forming part of their formal laws, with the state's enforcement mechanisms bolstering what were previously commonly agreed rules.

We are thus able to state the hypotheses flowing from a consideration of exchange and institutions in principle and in other historical contexts:

First, for exchange to proceed beyond spot-transactions, the bad-Nash equilibrium of exchange needs to be solved either by self-enforcing agreements that presuppose repeated transactions, or by third-party enforcement that will typically take the form of legal sanctions by a state.

Second, the gains from exchange themselves constitute a powerful incentive to establish such institutions; as a corollary, the absence of such sizeable gains from regular exchange will effectively diminish the demands for institutions of either type. If the prospective gains from trade are small, neither the costs of information-gathering and -sharing required for a network of relations to implement self-enforcing agreements, nor the resources needed to establish the mechanisms of impersonal government will be justified.

A *third* hypothesis concerns the factors that determine whether societies and groups tend towards formal and legal state-enforcement or informal mutual guarantees based on reputational mechanisms. While answers are far from complete in this regard, Greif [5] suggests that the outcome may depend on: (a) the cultural starting point, whether the group in question cultivates collectivist or individual traditions, and (b) whether the community occupies a dominant or minority position in the existing political system. The Maghribis were nurtured in a collectivist tradition and therefore already possessed the kind of "social capital" that – spread out over this small group

² Understanding social capital as a species of "fixed cost," it becomes plausible that costs first decline before they rise as the size of the group increases.

–permitted low costs of gathering and sharing detailed information about each other³, as well as of sanctioning its erring members through informal means. Not so the Genoese, whose individualistic traditions made such information-gathering costly and whose weaker social bonds also made it difficult to elicit cooperation with informal sanctions such as communal boycotts and shunning which require consensus. Under these circumstances, enforcement by a state may prove more expeditious.

Collectivist and individualist societies have distinct “demands” for a state. In particular, an individualist society, but not a collective society requires a government with the coercive power and administrative structure required to be able to confiscate individuals’ wealth and imprison them in case of need. Yet the ability for this demand to be fulfilled without undermining the economic growth by its own existence depends on the process through which the government is “supplied”. When a strong government exists, to advance economic exchange and performance, effectively it should be able to commit to the security of private property rights. In the absence of such commitment, individuals would refrain from using the legal system to support exchange, fearing predation [5].

As for the second point, namely the group’s position in the political system, the Maghribis were a minority, Jews in predominantly Muslim societies, while the Genoese claimed full birthright in their cities and were therefore in a better position to exact guarantees and check possible abuses from their government. For this reason, communities like the former, more so than the latter, will have found it more hazardous to seek to apply existing legal state-enforced mechanisms. One may hypothesise, then, that collectivist groups who are in minority or subordinate positions (indeed their subordinate social status may feed back and encourage their refuge in mutual protection) are more likely to subsist in informal, mostly reputation-based, arrangements. On the other hand, a resort to legal and state-enforced remedies may be more likely as a more individualistic ethos spreads, and to the extent socially dominant groups are involved.

Suppressed trade and the weak demand for impersonal institutions

It now remains to inquire whether and to what extent this framework applies to Philippine history and institutions. A hypothesis of this paper is that a principal reason that the demand for more impersonal institutions in the Philippines failed to develop was the suppression of trade under the long period of the Spanish conquest.

There is tantalising albeit fragmentary evidence of incipient complex exchange taking place in the Philippines in pre-Hispanic times. To demonstrate his point that his

³ Rizal [10] apparently used the earlier translation of the 13th century manuscript made by Friedrich Hirth, “Zur Geshichte des Orienthandels im Mittelalter.” *Globus* 56 (15) September 1839:238.

countrymen were involved in an “active trade not only among themselves but with all the neighbouring countries” before the Western contact, José Rizal [10]⁴ cited Chau Ju-Kua’s in “Records of various barbarian nationdxx” (*Chu-fan-chih*, dated 1225 AD). A later translation of the same document by Wu Ching-hong [11] is paraphrased by O.D. Corpuz [4] to describe the trading relationships between Chinese merchants and early inhabitants of a place called Ma-yi, which several historians take to refer to Mindoro or Luzon.

Chinese traders sail to Ma-yi and cast anchor before a designated trading place on shore. Ma-yi’s more than 1 000 families have their houses on banks of the river. The traders give umbrellas as gifts to the native chief. The native traders go on board and carry off the Chinese wares. There is apparently no tally of who of the natives carry off which goods; but the Chinese learn to identify the men, and so nothing is lost.⁵ (Filipinos prefer an older translation, which says that nothing is lost because the natives are honest.) The natives take the goods for barter in other barangays; they return months later and settle accounts by exchanging native products for the Chinese goods. The local products in the trade were “yellow wax, cotton, pearls, tortoise-shell, medicinal betel nuts, and *uta* cloth”. The Chinese barter goods were “porcelain ware, trade metals, iron tripod vessels, black lead, variegated glass beads, iron needles, etc.”

It is not sufficiently appreciated that this fragment actually depicts complex trade, involving what Greif has called a trade that literally involves the “separation of the *quid* from the *quo*,” a case of exchange separated in time. The original document speaks of a period of months⁶ before the natives returned with the proceeds of barter in the hinterlands. This example involves what in modern terms would be equivalent to supplier’s credit, a primitive form, but credit nonetheless. It is plausible to expect that the basis for the success of these arrangements was the expectation of repeat-business, and the operation of reputation mechanisms. The presence of repeat business is evident in the fact that “the Chinese learn to identify the men.” As previously seen,

⁴ Wu’s literal translation of the text reads: “The custom of the trade is that the barbarian traders come in crowds, and carry away goods with them into bamboo baskets. It looks as unable (sic) to understand them at the first sight, when slowly distinguish (sic) the men who remove the goods and nothing will be lost [11].”

⁶ Possibly relying on the German translation, Rizal interprets the account as saying that the natives took the Chinese goods away for distribution and did not return until nine months later (“travelling nine months and returning afterwards”). Wong’s [12] version, on the other hand, states that “they (the native traders) did not return until the 7th or 8th month of the year (viz., August or September)”, which by itself prevents any conclusion regarding the length of time they were away. Kolb[13], on the other hand, places Chinese traders as typically arriving in March of each year and leaving in May, which may explain Chao’s observation that merchants to the south seas were frequently the latest to return.

repeated games are one solution of the one-sided prisoner's dilemma problem, which is certainly what the Chinese would have faced.

This fragment is notable evidence of the fairly complex institutions that may arise in response to trading opportunities, even in the context of barter. Not less than the Maghribis, the thirteenth-century inhabitants of the Philippines and their Chinese partners had evolved an institutional solution to the agency problem in trade that was based on the desire to maintain mutually beneficial repeated transactions. Other passages in the manuscript also suggest that exchange with foreigners was also characterised by a kind of community responsibility system typical of societies built on communitarian principles. This is suggested by the role of the chief in implicitly guaranteeing the transactions.

At the very least, this fragment suggests that the potential existed for developing informal, reputation-based, self-enforcing agreements among some ancient communities in the Philippines. Whether and in what form this would have developed further, and whether some of these could have subsequently – as the Genoese did – branched off towards more a greater reliance on state enforcement is not clear.

Mercantilism

What is undeniable, on the other hand, is that the Spanish conquest precluded any further opportunities for an expansion of such self-organised trading institutions. Guided by a mercantilist policy and partly out of fear of invasion by neighbouring countries, Spain effectively closed off the Philippines to foreign trade except through Manila, and then only to Chinese traders. The fairly open trading regime that had existed hitherto between foreigners and various native communities prior to the occupation was replaced by the centralised and hopelessly limited galleon trade between China and New Spain, through Manila, which was carried on until 1813.

Rizal also condemned the mercantilist policy of suppressing exchange between the Philippines and other countries because it constituted a huge discouragement to effort and hence formed part of the explanation of the Filipinos' alleged "indolence":

Fearing to have the Filipinos deal frequently with other individuals of their own race, who were free and independent, as the Borneans, the Siamese, the Cambodians, and the Japanese, people who in their customs and feeling's differ greatly from the Chinese, the Government acted toward these others with great mistrust and great severity, as Morga testifies in the last pages of his work, until they finally ceased to come to the country. In fact, it seems that once an uprising' planned by the Borneans was suspected: we say suspected, for there was not even an attempt, although there were many executions. And, as these nations were the very ones that consumed Philippine products, when all communication with them had been cut off, consumption of these products also ceased. The only two countries with which the Philippines continued to have relations were China and Mexico, or New Spain, and from this trade only China and a few private

individuals in Manila got any benefit. In fact, the Celestial Empire sent her junks laden with merchandise, that merchandise which shut down the factories of Seville and ruined the Spanish industry, and returned laden in exchange with the silver that was every year sent from Mexico. Nothing from the Philippines at that time went to China, not even gold, for in those years the Chinese traders would accept no payment but silver coin. To Mexico went little more: some cloth and dry goods which the encomenderos took by force or bought from the natives at a paltry price, wax, amber, gold, civet, etc. but nothing more, and not even in great quantity... [10].

From the beginning the purposes of the galleon trade were extremely circumscribed. It was meant to provide a livelihood that would sustain the Manila traders, no more, no less. It was a concession within the more general mercantilist policy of preserving both the colonial and home markets for Spanish goods ("the factories of Seville"). Castillo [14] summarises the views of the significant Spanish mercantilist Uztárriz, who favoured limiting the galleon trade between the Philippines and Mexico "because the Chinese infidels and the Mohammedans were reaping the greater benefit of the traffic; draining America of the gold and silver which by right should go to Spain". The mercantilist policy deliberately limited the amount of both Chinese and colonial goods that arrived in the Americas and in Spain in order to preserve the market for Spanish goods. Laws that were implemented strictly beginning in 1593 limited the amount of merchandise carried on the galleons to Mexico, all as part of a policy limiting trade between the colonies:

All Chinese goods imported into Mexico had to be consumed there and shipment of Chinese cloth to Peru was absolutely prohibited, and in 1636 all traffic between New Spain and Peru was interdicted. The object of all these laws is very obvious; they were intended to reserve the American market for Spanish silk [14]

Similarly, Corpuz [4] notes that the underdevelopment of the economy's real sector was actually part of a mercantilist policy:

There was no legal system or official policy to promote either corporate or plantation agriculture because this would entail export of colonial produce, which would violate the narrow perspectives of the galleon trade, which was maintained to support the Spanish shippers of Manila and enrich the merchants of Cadiz and Acapulco – but in the end funnelled the larger part of the profits into the hands of the south China traders [4].

The restriction of trade and the designation of Manila as the only international trading port was logical if the point was to monopolise the market for Chinese goods (effectively lowering their price to the shippers) as well as to restrict the channels for selling these to New Spain (raising their price to the buyers there). The policy amounted to what in modern terms would be called a "voluntary export restraint" which aimed to

meet the twin goals of guaranteeing a degree of profits just enough to sustain the Manila colony while protecting the interests of the home industries.

From the viewpoint of nascent communities in the Philippines, however, the significant impact of these policies was effectively to restrict their links to cross-cultural trade. If anything, it even reinforced a reversion to local autarky and a discouragement of specialisation as the exactions of the colonial authorities placed a strain on food production. In addition, inter-provincial trade and labour movements were severely restricted. The impact of foreign trade on domestic specialisation, notably in agriculture, would not be felt until the reform-schemes of Basco in the late 1700s imposed the cultivation of certain cash crops, notably tobacco, in selected regions of the country.

Recall that the some early Philippine communities had at most reached the point of establishing reputation-based enforcement mechanisms that sustained the long-term informal and personal relationships that supported cross-cultural trade. It would be purely speculative to ask what would have induced further development along the lines of legal, state-enforced rules. Clearly, however, the decline of external trade itself removed any further prospects of advance. For it is typically the need to deal intensively with strangers possessing differing customs and requirements that necessitates the delineation of impartial rules (such as the law merchant) that do not simply favour the native if repeated transactions are to be supported. Where any kind of political authority exists, it must at least commit to being non-arbitrary and nonpredatory, particularly with respect to foreign interests with which it hopes to maintain future dealings. At a maximum, social investment is required to maintain courts, police, and other standing organisations to enforce contracts impartially. The incentive to invest in this type of social overhead would obviously diminish if the extent of trade with foreigners was small to begin with.

Aside from the decline in commerce itself, a second distinct reason that Filipinos native would not have demanded impersonal institutions was their inferior position in colonial society. Above we already cited Greif's conjecture that minorities and subordinate groups – even if they had been engaged in trade like the Maghribis – would have a greater likelihood of relying on informal and personal networks as means of enforcement, rather than on legal rules enforced by the state, in relation to which they were outsiders.

Indeed the indirect evidence that bolsters this conjecture is the Chinese community during the Spanish conquest. The position of the *sangleys* in Philippine colonial society most resembled that of the Jewish Maghribis in Muslim societies. The *sangleys* were engaged continuously in commerce and managed to attain a degree of prosperity, but as a subordinate class, they were always treated poorly by the Spanish regime, with persecution at times taking the extreme form of expulsions and massacres. For apparent reasons, therefore, the legal system of the Spanish regime would not have served them either to enforce contracts among themselves or to register mutual liabilities with either Filipinos or Spaniards. As a result, like the Maghribis, the Chinese

in the Philippines and elsewhere in Southeast Asia sustained their overseas and domestic trading activities by using informal networks based on kinship and geographical origin (hence the almost homogeneous Fujianese origins of Chinese in the Philippines).⁷

It should follow that given their dependence on the Chinese for supplies of traded goods and as a pool of craftsmen, the Spaniards should in principle have had an incentive to smooth out relations with the *sangleys* and have this expressed in their formal legal system. This indeed was the case: Corpuz [4] points out how an entire chapter in the *Recopilacion* (Libro VI, Titulo 18) was devoted to the Chinese and how such laws “attracted and protected them and regulated their numbers, terms of residence, occupations, as well as relationships with the Spaniards and Filipinos”. The problem, of course, was whether such laws amounted to and were regarded as binding obligations. The absolutist nature of the Spanish regime (both at home and in the colonies) made it difficult to make binding commitments – an issue to be discussed further below – and relations with the Chinese were time and again characterised by a high degree of arbitrariness, vacillating between a loosening of the quotas on immigration and settlement on the one hand, and pogroms and expulsions, on the other.

The *a-fortiori* argument to be made is as follows: if the *sangleys* themselves, who were continuously and intensively engaged in trade, had little incentive to make use of the superimposed Spanish legal system, preferring instead to resort to second-party enforcement, then the *indios* who were cut off from trade had even less reason to do so.

Domestic trade

Domestic trade at first glance might have seemed promising, since the Spanish regime did not in principle prevent natives from engaging in it; indeed they even appeared to reserve this sector for them (shades of retail-trade nationalisation) by prohibiting domestic trading by the Spaniards [4]. The *Recopilación de las leyes* explicitly forbade Spanish officials from engaging in domestic trade.

It was to be expected, however, that such a law would be ineffective, and that instead the real property rights would go to those with the most to gain by it [16]. There was a disjunction between the written law and facts on the ground, a case of what North and Thomas [17] called a lack of correspondence between the property rights and the proper incentives. It was, after all, the *alcaldes* who had both the capital and perhaps the entrepreneurial ability to engage in internal trade. The privileged social and political status of the *alcaldes* thus did not match their deprivation of rights in the law, which assigned this to the natives. Corpuz [4] notes how it became common practice for *alcaldes* to engage in trade, since after all:

⁷ The role of social networks among overseas Chinese in sustaining trade even in more recent times is mentioned in Rauch and Trindade [15].

Nobody could compete with the merchant-alcaldes and governors in their provinces. They were de facto entrepreneurs in local trade, whether overland or the coasting trade, with the friar-traders in the secondary role. This was the reason why the formula of the *indulto para comerciar* had been devised for them in 1751 [4]

Despite its paternalistic intentions, the regime in the end simply had to come to terms with the fact of the violation and allowed the *alcaldes* to trade for a fee, the well-known *indulto de comercio* or *indulto para comerciar*⁸ [4]. The basic problem, of course, was that overweening political power allowed petty tyrants merely to manipulate flows of domestic trade that admittedly became increasingly profitable as specialisation increased and population grew.

Taking Barzel's point, however, it should cause no surprise that the rights ultimately went de facto to the *alcaldes* and were tolerated, if not recognised. What is remarkable is that the natives, who possessed this right in principle, derived so little benefit from the fact. Theories of contract, à la the Coase theorem, would predict that the interest of the rights-holder should have at least been bought out by those who could derive a greater benefit from its use. The fact that this did not happen must be traced to the overweening power of the state and the lack of restraints on the actions of the elite. The need for contract and compensation is suspended when seizure and predation serve just as well (a point we shall return to below). Indeed, the *alcaldes'* participation in trade often took the form of forcible and arbitrary confiscations, bolstered by the existence of numerous restrictions on the movements of goods and persons.

Again, from the viewpoint of supporting domestic trade, this was obviously an unsatisfactory approach, and economic theory would predict – as indeed happened – that this would lead to is a contraction of commerce. Rizal [10] summed it up by noting how “the coastwise trade, so flourishing formerly, disappeared on account of the piracy of the Malaysians of the south, and trade in the interior of the Islands almost disappeared completely owing to the restrictions, passports, and other administrative requirements”.

Having considered the conditions of both foreign and domestic commerce, we contend, therefore, that no effective “demand” for impersonal rules invoking third-party enforcement could have emanated from the Filipinos (or the Chinese) early under the Spanish conquest. First the expanded trade across cultures and nations that would have made such impersonal rules necessary did not exist – indeed was suppressed –

⁸ This “remarkable” innovation was in fact a typical response of the mercantile system, which would have been anxious to earn revenues that were more easily collected from the *alcaldes* than from dispersed peasants. North and Thomas [17] note how “the beneficiaries of a monopoly were easily identified, the private benefits measured, and the tax readily negotiated. Enforcement of the monopoly by the state was not difficult, since the monopolist could inform the authorities of violations and the collection of the tax was easy.”

and second, the subordinate position of the population would have made an appeal for state enforcement futile.

The other possibility, of course, was for a demand for impersonal institutions to have arisen from and among the Spanish colonists themselves, since they were after all the de facto possessors of rights. Why this did not occur to any significant degree may be attributed to the low colonial settler-density in the archipelago, a fact that has also been adverted to by writers such as Acemoglu et al. [18] in explaining differential development between colonies. Pursuing a similar argument for the Philippines, Cruz [19] finds that Spaniards barely reached one percent of the population of Filipinas. The great distance and hazards of travel from the Peninsula and Spain's absorption with its wealthier American possessions played a role not only in limiting the number of colonists but also in selecting them adversely for quality, causing a high rate of turnover, and fostering a get-rich-and-get-out-quick mentality. Together with the overall mercantilist policy that was hostile to trade to begin with, no clamour for impersonal institutions was likely to arise even from that quarter.

The "supply" of legal enforcement

The converse of the Filipinos' lack of an exchange-motive for demanding impersonal, state-enforced rules is the government's inability to commit to such rules. Greif [7] notes that:

[e]stablishing an exchange based on the law amounts to providing a public good, implying that this will happen only if the society can overcome the associated collective action problem. Furthermore, establishing an effective legal system requires institutions that will enable a state to *commit to not abusing property rights* [7]. (Emphasis supplied.)

In short, the frequent resort to legal enforcement systems in exchange is likely to arise only if the state can restrain its actions and effectively commit to protect property rights in an impartial manner. It is well known, however, that the Spanish regime from the beginning failed to protect the rights and entitlements of the natives even from depredations of its own officials. The absolute power of the government during the Spanish period made it an unreliable enforcer of impartial rules, with only weak, if any, controls on the actions of the elite. The checks and balances that the king of Spain hoped to institute in the government of the colonies failed miserably, owing in no small part to the distance from the mother country, the adverse selection among the settlers in Filipinas, and the relative insignificance of the country. Hence the natives' complaint recorded by Bowring (cited in Corpuz [3]): "The governor-general is in Manila (far away); the king is in Spain (father still); and God is in heaven (farthest of all)."

Examples abound from the early years of the conquest of the Spanish regime's reliance on exactions rather than contract. The *tribute* was a compulsory head-tax *Transactions Natl. Acad. Sci. & Tech. Philippines* 26 (2004)

imposed on all natives (initially either cash or kind, but later explicitly in cash). The *compra* on the other hand was an exaction in the guise of a sale, in which *encomenderos* stipulated quotas for produce to be bought at a price they themselves specified [4]. Commodities were accumulated for the purpose of supporting expeditions and provisioning galleon crews. The former practice essentially removed the certainty of ownership over output. The forced labour imposed in the *polos y servicios* (for clearing forests, constructing galleons, erecting churches, and rendering personal services to the frailocracy, etc.) made the supply of own-labour unpredictable.

In *La indolencia*, Rizal recounts the earlier period of the conquest and cites the number of disincentives to work and trade:

Is it strange then that the inhabitants of the Philippines should be dispirited when in the face of so many calamities they could not tell if they would ever see sprout the seed they have planted, if their farms would be their graves, or if their crop would feed their executioner? What is strange when we see the pious but impotent friars of that time advise their poor parishioners, in order to free them from the tyranny of the encomenderos, to stop work in the mines, to abandon their industries, to destroy their looms, pointing to them heaven as their sole hope, preparing them for death as their only consolation? [10].

In another article entitled “Filipino farmers” [*Los agricultores filipinos*] for *La Solidaridad*, Rizal points to the primary disincentives to production on the part of Filipino capitalist-farmers (to which his own family belonged), which consisted of both natural causes of uncertainty and the uncertainty in property rights caused by the lack of peace and order, the rule of law, and arbitrary exactions by the elite:

The Filipino farmer has to struggle not only with plagues and public calamities, but also with petty tyrants and robbers. Against the first, defence indeed is permitted; against the latter, not always [10].

Sometimes, fortunately rare [sic] a *compañía volante* sweeps the province. Woe to those who have enemies! It is enough to be in the list of suspects for the head of the squad to pick him up and take him to another place without trial or filing of a complaint. Goodbye farm and goodbye everything! See if after this he will be encouraged to plant in other islands [10].

A further barrier to the emergence of exchange institutions was the insecurity of property in the land. To begin with, in the early *encomienda* economy, there was no landownership in principle, all lands belonging to the king’s estate. Natives were simply assigned lots of equal size to cultivate, with usufruct rights. Again Corpuz [4]:

The families were *landholders*, not owners of the lands they worked. The lands could not be pledged as collateral for loans or mortgaged or sold to enable the families to engage in alternative occupations. Property rights in the *pueblo* lands remained in the king, so

that they were untaxed. For this reason the lands were untitled to the assignees. The lack of a titling requirement effectively erased the need for a land survey and cadastral system. The pueblo lands remained untitled and unsurveyed during the whole of the Spanish era.

The lack of property rights to their fields and the loss of much of the output from cultivation through various obligations dulled or extinguished incentives on the part of the tillers for greater efforts and improvements in pueblo agriculture. The mass of pueblo families had no overt savings, or stocks of produce for trading.

In short, even as suppressed exchange and the subordinate position of the *indios* weakened the exchange-motive for the demand for law and state enforcement, the supply of governance itself during the greater part of the Spanish occupation was not of the sort that would have encouraged it. In such circumstances it was to be expected that Filipinos would not generally gain confidence that formal institutions and legal enforcement mechanisms could serve as effective and unbiased means to resolve disputes and enforce contracts.

Conclusion

It is important to note how the suppression of trade with the rest of the world removed an important external factor for the Spanish regime to improve its legal system. As a result, the economy largely developed without too great a resort to the law as a support to exchange – indeed the law would more frequently prove a hindrance, either because its contents did not match the facts on the ground (e.g., prohibitions on trading, on land sales, and on lending and borrowing) or because they provided the pretext for often abusive and arbitrary behaviour on the part of officials, who did not have to contract for what they could simply exact.

Competing against the legal system, on the other hand, were the older and more tractable second-party enforcement mechanisms for exchange, based on repeated transactions, reputation, and frequently kinship, such as those the Chinese and the mestizos had long been accustomed to. With the scope of trade limited, these informal reputation mechanisms were beyond the pale of the law but accessible and suited the purpose for a level of exchange that was mostly local in scale and limited in scope to begin with.

Indeed, it is indicative that even by the time the country was opened up to world trade and British and American firms had become active, there had been no great change in the manner in which these merchants operated: they largely internalised or mimicked the pre-existing informal channels of buying goods, particularly in agriculture, relying on Chinese merchants who had their own informal buying networks, or employing their own provincial agents who acted largely in the same way.

By examining aspects of the formation of institutions affecting exchange, it has been our hope to contribute to that larger effort of understanding the evolution of the

more general attitudes of Filipinos with respect to state institutions in general. At least from this vantage, we find that during the Spanish period – which represents a large slice of history –neither the demand nor the supply could be found for the establishment of large-scale impersonal institutions that would facilitate commerce and the enforcement of contracts. The three crucial and interrelated variables in this institutional failure have been the degree of openness to trade, particularly to foreign trade; the degree of subordination of ordinary Filipinos in the colonial political system; and the lack of guarantees within the system against the untrammelled actions of the elite. The first two reduced the demand for such institutions; the last acted on the supply of credible commitment.

As a result, the majority of the people then came to regard government largely as an abstraction, if not an actual burden, vacillating between extravagant expectations of the idyll of the law writ on paper, on the one hand, and the reality of its fecklessness and exactions on the other.

At its best, government came to mean for the Filipino an institution that was burdensome; at its worst, it was predatory. At the same time, that it was incapable of promoting his welfare, it deprived him of his liberty, and was an ever-present threat to his security. To the Filipino, government became an institution to be avoided, for its interests were contradictory to his. People and government were estranged from each other, and the bonds of community were dissolved [3].

Corpuz's words, it is well to remind ourselves, pertain to a historical past, although it may just as well have been taken from yesterday's papers.

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