

Centre on Regulation and Competition

WORKING PAPER SERIES

Paper No. 104

**OF GUANXI AND TAIPANS:
MARKET POWER AND THE EAST
ASIAN MODEL
AS A COMPETITION POLICY
PACKAGE**

**Raul V. Fabella
School of Economics
University of the Philippines**

April 2005

ISBN: 978-1-905381-03-04

Further details: Centre Secretary
Published by: Centre on Regulation and Competition,
Institute for Development Policy and Management, University of Manchester,
Harold Hankins Building, Precinct Centre, Oxford Road, Manchester M13 9QH, UK
Tel: +44-161 275 2798 Fax: +44-161 275 0808
Email: crc@manchester.ac.uk Web: www.competition-regulation.org.uk

OF GUANXI AND TAIPANS: MARKET POWER AND THE EAST ASIAN MODEL AS A COMPETITION POLICY PACKAGE

Raul V. Fabella

I. INTRODUCTION

Solutions to idiosyncratic and non-standard obstacles to production and exchange are par for the course of a special set of players known as *entrepreneurs*. These hurdles may be technological, organizational, and financial or risk related. In frontier or under-developed areas, the common missing ingredient is the absence or the severe inadequacy of *formal* or *state-provided* contract enforcement and property rights protection (North, 1990; Barzel, 2002). Ex-post opportunism makes for prohibitive transactions cost that result in highly fragmented or even missing markets. Not only is the state remiss in contract enforcement, it may itself serve as a vehicle for expropriatory tendencies among the political elite. For an entrepreneur to thrive, it must solve these twin weak governance problems.

The *guanxi* system, also known as *relational contracting*, solves the contract enforcement and ex-post opportunism problem by limiting exchanges among players who are also members of a group or community that is subject to an existing, informal, but effective, system of sanctions. Guanxi-based contracts face lower opportunism risk and transactions cost than and, thus, can drive out, those contracts dependent only on absent or weak state-provided or *third party enforcement*. In North's (1990) phraseology, *guanxi* is a *second party enforcement mechanism* drawing its power from community sanction. Williamson (1983) called this genre of effort *private ordering* in the absence of adequate *public ordering*.

Because political power may be lodged outside this group or community, the *guanxi* entrepreneur, if successful, also faces considerable expropriation risk. The wielders of political power can either selectively enforce certain laws or pass new laws to effect partial or total expropriation. The entrepreneur solves this by coupling with or capturing the state's rule-making apparatus. Property rights protection is effectively internalized.

The entrepreneur that successfully deals with these twin problems of weak governance is a *taipan*. The very process of his emergence in the weak governance setting should explain the many stylized facts about taipans and their operations. We first pause to review some known facts about taipans in East Asia.

A. Modern Taipans

The economic landscape in most of East Asia is dominated by very large conglomerates headed by powerful tycoons or *taipans*, largely overseas Chinese (huaquio). Between 60-80% of market capitalization in Indonesia (60%), Thailand (80%), Malaysia (70%) and the Philippines (50-60%) are in their hands ("Asian Business Survey" ("ABS 2001" from here on), *The Economist*, 7 April 2001). The stylized facts about the taipans and their operations are the following (ABS 2001):

1. They operate largely on the basis of *Guanxi* – contracting on the basis of relations and connections rather than written rules, the *relational contracting* mode.
2. They preside over sprawling business empires without the blessing of clear synergistic logic (Robert Kuok of Malaysia is into food, manufactures, banking, property, media, etc.; Lucio Tan of the Philippines is into airlines, banking, tobacco, breweries, property. The Salim's are into retail trade, banking, property, etc.).
3. Each company in the empire is run by a family member and outside auditors and professional managers are a rarity;
4. The use of complex pyramids of share-and-cross holdings of companies anchors their legendary penchant for secrecy. Books of account, when available, are opaque and uninformative. (Lucio Tan of the Philippines (ABS, 2001) thrives on such pyramids).
5. The delegation of authority is meager and information is a closely guarded monopoly of the patriarch;
6. Wherever the taipan operates, he enjoys a monopoly or near-monopoly position;
7. The cultivation of political powers via rumored shady but mutually beneficial relations is par for the course (Harry Stonehill was run out of the Philippines in the 1960s to keep his *payola black book* from being opened and implicating many figures. Lucio Tan was a close associate of then President Joseph Estrada of the Philippines; Danding Co-Juangco of the

Philippines said to be a close Marcos crony and was also a favorite of Estrada; the Salims of Indonesia were linked to the President Suharto).

8. The taipans have a very pronounced ethnic minority (usually Chinese) flavor.

The feature that the paper focuses on is the need for and the acquisition by the entrepreneur of contract enforcement and property rights protection to support market exchange where the state is weak.

Observes *The Economist* (7 April 2001) on the clash of Asian business cultures: "Developed economies have rule-based governance systems that incur enormous fixed cost but negligible incremental costs...By contrast, the poor countries of Asia have not been able to afford the investment in high fixed costs of such a system, and have, therefore, settled for the large incremental costs of a *guanxi*-based system." The *guanxi* system, like the *Maghribi* system (Grief, 1993, 2001) and even the *merchant law* (Grief et. al, 1994) is a second party contract enforcement system developed in the absence of adequate third party enforcement (North, 1990; Barzel, 2002). But the *guanxi* system is only one side of the taipan coin. The other side is the acquisition of private property rights protection capability. While only a faint penumbra of their 19th century counterparts, the stylized facts about the current crop of taipans, nonetheless, echo most pronounced aspects of 19th century taipans – vertical integration into second party property rights enforcement in the absence of weak governance (see, e.g., Criswell, 1981). It is also evident, however, that as some East Asian countries progressed rapidly in the wake of opening up, the grip of *guanxi* and second party enforcement has slowly loosened in favor of more rules-based contracting (e.g., ABS, 2001, focuses on ACER and its chairman Stan Shih as exemplar).

B. Vertical Integration Into SPE

The motivation for vertical integration is myriad. Coase (1937), addressing the boundaries of the firm, proposed the umbrella concept of high *transactions cost* of arm's length market exchange. Subsequent proposals would elaborate on Coase. Williamson (1975), following Coase but with sharper lenses, threw in ex-post opportunism, lock-ins and asset specificity as the driving forces behind high transactions cost of market exchange. Klein et. al. (1979) added the threat of *quasi-rent appropriation* and its avoidance as a motivator. Barzel (1982) placed the difficulty of measurement and the disputes it triggers at the roots of integration. Grossman and

Hart (1986) identified *residual rights of control* as one motivator. Holmstrom and Roberts (1998) revisiting the boundary of the firm issue found that the universe of motives cannot all be accounted for by the transactions cost (Coase-Williamson) or the property rights (Grossman and Hart, 1986) paradigms.

The absence of an adequate supplier of a particular input or service essential for the production or distribution of a final product signals the high transactions cost of arms-length exchange and motivates vertical integration. This market for the input or service may be missing or the state tasked to provide it may be weak and unable to deliver. Third party enforcement (North, 1990) of property rights and the enforcement of contracts are some such all-important supposedly state-provided services. The boundary of the firm in the frontiers where public ordering is weak, thus, extends into the provision of Williamson's *private ordering* (1983).

In the Middle Ages, such TPE was inadequate in Europe and had to be supplemented by second party mechanisms, such as *Community Responsibility System* (Greif, 2001) and *Maghrabi trading* or merchant law based on network (Greif et. al., 1994). In the Wild West of America, the railroad tycoons maintained their own private enforcement force as well as financed: occasional posses and bounty hunters to deal with bandits and troublemakers. They also sometimes "privatized" public enforcement agencies to deal with unions. In the Far East through the Victorian period, the *taipans* of the Princely Hongs maintained virtual private armies and navies to protect their trade and mete occasional punishments on bandits and pirates (Criswell, 1981). Their influence on the foreign office meant access to the Royal Navy's capability to cow even sovereign states. Entrepreneurship in this environment required vertical integration into second party enforcement. Second party enforcement, however, conduces toward less competition even as it resolves the "missing market" problem.

This type of vertical integration is very special because enforcement becomes *private* and *excludable*. Other players cannot avail of it and, thus, cannot operate. These effectively form barriers to competition. Since enforcement has considerable scale economic potential, this has serious implication for the structure of the market.

In this paper, we propose a nexus-of-contract explanation for the emergence of a taipan, characterized loosely by the above. The background is a weak *third party enforcement*

environment where entrepreneurs to operate and survive must acquire enforcement capacity. The take-off model used here is in Fabella (2005), where contracts involve a cash advance in period one from a principal P to an agent A who delivers effort or repayment in period two. This is called cash-in-advance contracts.

The idea is that a taipan is a primarily market exchange-oriented entrepreneur who in a weak TPE environment is forced to vertically integrate into *second party enforcement (SPE)* to survive. While TPE is public, SPE is *private and excludable*. Thus, the taipan is, on the one hand, Schumpeterian in that he brings otherwise infeasible markets into existence through his command over an SPE, and on the other a potential predator that this command may be trained against potential competitors. In particular, pursuit of an SPE may lead to the capture of state decision-making apparatus, which may retard institutional change. The *robber barons* of the 19th century industrializing American comes to mind. Whether the taipan stays Schumpeterian (growth enhancing) or becomes a predator (growth-retarding) is an important question. The effect of openness on the evolution of taipans is discussed.

In Section II, we model the contract environment characterized by weak TPE and results in a “missing market”. The guanxi approach is then developed as a contract theoretic response. In III, we cover the birth of a taipan as entrepreneur who captures state enforcement and rule-making apparatus in order to internalize property rights protection.

II. THE CASH-IN-ADVANCE CONTRACT

A. Weak Third Party Enforcement

Consider a production contract where the principal P advances the agent A a portion $w_1 = bw$, $0 \leq b_1 \leq 1$ of the agreed-on fee w in period one, A supplies observable and contracted effort e in period 2 and, when the output X is observed in period 2, receives the rest of the fee, $(1-b)w = w_2$. We assume the division “ b ” to be fixed. We assume that spot contracts, i.e., $b = 1$, are not feasible. The perfect function is $pF(e) - w$, where the price p is parametric.

A, after receiving w_1 and enjoying $u(w_1)$ may, however, decide to renege, i.e., refuse to supply e and, instead, supply e to his next best alternative, which gives him his outsider reservation utility U^0 period 2. Let the probability of being punished be Q and the punished be $L > 0$. The expected second period utility with renegeing is $Q(u^0 - L) + (1-Q)U^0 = U^0 - QL$. If he reneges,

his total two-period utility is $U^0 + [u(w_1) - QL]$. The parenthesized expression is the incentive for ex-post opportunism. When $u(w_1) > QL$, we have in North's (2002) terminology, weak *third party enforcement (TPE)* and opportunism pays. When $u(w_1) < QL$, TPE is strong and opportunism does not pay. Q is the index of efficiency of state-supplied TPE. Thus, A abides by the contract only if

$$(i) \quad u(w_1) + u(w_2) - v(e) \geq U^0 + u(w_1) - QL = U^{00}. \quad (1)$$

This becomes under weak TPE and strong TPE, respectively,

$$(i) \quad u(w_2) - v(e) \geq U^0 - QL$$

$$(ii) \quad u(w_1) + u(w_2) - v(e) \geq U^0. \quad (2)$$

(2.i) is the *augmented participation constraint (APC)* for the model. If (2.i) is true, then the ordinary participation constraint (2.ii) is automatically satisfied. If (1) is satisfied, A will never renege despite weak TPE since it does not pay to forfeit the second period payment w_2 . An analogous condition has also been called the *enforcement proofness constraint* (see e.g., Laffont and Mortimart, 2002) in an adverse selection context. To highlight the governance problem, we let effort be observable and unique, i.e., $3 = e^0$.

The principal offers a contract $C(w, e)$ to A where (w, e) solves the following:

$$\max_w pF(e) - w \quad (3)$$

s.t. either (2.i) or (2.ii).

Let $C(w^*, e^0)$ be the weak TPE contract and $C(w^{**}, e^0)$ be the strong TPE contract. The following is obvious:

Lemma 1: (i) The optimal contract is costlier for P under weak than under strong TPE, i.e., $w^* > w^{**}$. (ii) As QL rises w^* falls towards w^{**} .

Proof: (i) Since $U^0 + (u(w_1) - QL) > U_0$ and the APL binds strictly under optimal contracts, $u(w_1^*) + u(w_2^*) - u(w_1^{**}) - u(w_2^{**}) > 0$. Thus $w^{**} < w^*$. (ii) As QL rises, $(u(w_1) - QL)$ falls and the relevant difference approaches zero.

Q.E.D.

As QL falls it is obvious that $(pF(e^0) - w^*)$ falls and the principal may decide to cease operation altogether. Governance failure can result in a missing market failure.

The difference $(w^* - w^{**}) > 0$ constitutes a "bribe" to keep the agent from exercising his option to renege. In an imperfect capital market, weak TPE can constitute an entry barrier.

III. THE GUANXI CONTRACT

Suppose a potential entrepreneur observes that a subset of the population of agents exists for whom "informal sanctions" against ex-post opportunism are binding. That is, for this subset of agents, contract violation entails an added personal or social penalty G unrelated to QL. G is a certainty. He can limit his choice of agent to this subset perhaps because he also belongs to this subset. The tradeoff is that the "technical aptitude" of the average agent in this subset is *inferior* to that of the average agent from the whole population and this impacts on the prospective revenue of the enterprise. Indeed, one can continue trading off "technical aptitude" for higher G by a progressive narrowing of the subset.

Let f , $0 \leq f \leq 1$, be the index of the restrictiveness of the set of agents from whose ranks A is drawn. If the set is the whole population, $f = 0$. Let $g(f)$ be the technical aptitude associated with f , and $g'(f) \geq 0$, $g(1) = \max g$, $g(0) = 0$. Thus, "technical aptitude" is at its highest when $f = 0$. For $f > 0$, the effective production technology becomes $F(e)(1 - g(f))$. But as the set of agents progressively shrinks (f rises) the personal cost G also rises, i.e., $G(f)$ and $G' > 0$, $G(0) = \max G$, i.e., the reneging likelihood also falls. Again let $e = e^0$.

The optimal guanxi contract $C(w^g, e^0)$ for this entrepreneur solves the following:

$$\begin{aligned} & \max_{w, e} \quad pF(e)(1 - g(f)) - w \\ \text{s.t.} \quad & u(w_2) - v(e) \geq U^0 - QL - G(f). \end{aligned} \tag{4}$$

Optimal w^g is solved from the APC:

$$u(w_2) - v(e^0) = U^0 - QL - G(f) = U^g < U^{00}. \quad (5)$$

w^* monotonically decreases as f (or QL) rises. The maximized profit written as a function of f alone is:

$$\Pi^*(f) = pF(e^0)(1 - g(f)) - w^*(f). \quad (6)$$

As f rises, the response of Π^* is ambiguous, since f is costly to the firm via $g(f)$. Note that for some high $f = f^0$, $u(w^1) - QL - Q(f^0) < 0$ and the APC becomes $u(w_2) - v(e) \geq U^0$, the familiar P.C.

The role of entrepreneurship here is to find the proper (g, G) profile that results in (6) being positive. The entrepreneur who does so is a *guanxi entrepreneur*.

Guanxi, thus, allows entrepreneurs who may otherwise stay out due to inadequate contract enforcement and ex-post opportunism to become viable. The *guanxi approach* consists of judicious limiting of the choice of agents to a subset of the population whose personal renegeing cost G is prohibitive enough and independent of the TPE penalty QL . The set may be limited to close blood relations, a cohesive religious minority or to the same close-knit ethnic group among whom "face" or other informal sanctions are important. But this approach is no free lunch as it trades off average technical aptitude for less opportunism.

Guanxi limits the number of players to those with access to f . It, thus, serves as entry barrier and may underpin market power.

The cost of guanxi becomes revealed, however, as the economy modernizes and QL rises. Clearly, where QL has become large enough to by itself deter renegeing, only "technical aptitude" will matter. When competing with products of other producers operating under adequate TPE, i.e., where QL is sufficiently high, the opportunity cost of guanxi becomes telling and burdensome. If he buys inputs only from his small guanxi circle while a competitor buys inputs from a larger circle that includes the guanxi circle, the competitor gets his inputs at, at

worst, no higher but presumably at lower (if the larger circle is the world, e.g., in an open economy) price.

Incidentally, this second party enforcement mechanism appears also to describe the Maghribi system in the Middle East participated largely by members of the ethnic Jewish minority. Having solved the contract enforcement problem and with market power becomes wealthy, he must then address another property rights protection problem. The taipan is one who goes beyond guanxi.

IV. TAIPAN: BEYOND GUANXI

A guanxi entrepreneur must also solve the risk of expropriation problem very eminent in weak governance milieu. This risk may originate from the holders of state powers themselves. Suppose he faces an expropriation tax t , legal or illegal, the level of which is a decreasing function of the intensity of pressure, r , applied in taipan T 's behalf by the Leviathan or political power authority K . That is $t = t(r)$, $t' < 0$ and $t(0)$ is large. That is, if $r = 0$, the taipan is not viable. To be viable, T must buy r from K . Let K 's utility function be $U_k = u_k(m) - v_k(r) \geq U_k^0$, where $u_k(m)$ is K 's utility defined over payoff $m > 0$ from T , $v_k(r)$ is the disutility to K of pressure r in favor of T and U_k^0 is K 's reservation utility. Thus, the full contract design problem facing T involves:

$$\begin{aligned} \max_{w, e, m, r} \quad & pF(e)(1 - g(f)) - w - t(r) - m \\ \text{s.t.} \quad & u(w) - v(e) \geq U^0 - QL - G(f) \\ & u_k(m) - v_k(r) \geq U_k^0. \end{aligned} \tag{8}$$

Again letting $e = e^0$ for simplicity, (8) generates two optimal contracts: $C(w^*, e^0)$ and $C(m^*, r^*)$. The first contract is opportunism-proof vis-à-vis the agent A and the second is expropriation-proof beyond $t(r^*)$ vis-à-vis the Leviathan K .

The taipan is the entrepreneur who finds the profile (g, G) and the contract $C(m^*, r^*)$ which makes the market exchange viable. The second contract in effect privatizes the public enforcement under K .

The taipan vertically integrates into property rights protection by either (a) privatizing the state rule-making and enforcement apparatus under K or by hiring private property rights enforcers.

This aspect the taipan shares with 19th century *robber barons* of America. Since the payoffs here are normally illegal, they should never appear in the books of accounts. Thus, the secrecy and double bookkeeping.

It is, however, possible for t to be simply a *legitimate tax*. K may be the *tax collection and/or judicial apparatus*, and m may be the payola to K . This is simple tax evasion. Indeed, for even higher r , $t(r) < 0$ which means that the taipan gets subsidized by favorable treatment.

It is possible for all to coexist at any given time. "Taipan" Lucio Tan is rumored to dine with Presidents, own or pick the BIR commissioner, buy key legislators to get favorable treatment for his beer and cigarettes. His predecessor in cigarettes, Harry Stonehill, being American in an increasingly anti-American environment of the 1960s, may have been just fending off predatory expropriation by putting key politicians in the payroll. He failed due partly to his flamboyance and the threat he posed to national security. Lucio Tan has so far succeeded.

IV. ANTI-COMPETITION OUTCOME

These defensive mechanisms, once established, can be turned into anti-competitive instruments. The capture of rule makers can result in laws favoring the taipan and legitimizing entry barriers. Their largely private character means that other players cannot avail of them and operate at a disadvantage. The structure of the Philippine specific tax on cigarettes, claimed to highly favor the products of Fortune Tobacco Corporation, is maintained by a phalanx of legislators beholden to owner-taipan Lucio Tan. This is clearly in accordance with Stigler's (1974) idea of state regulation. Currently there is a suit brought to the Supreme Court by Anglo-American, a smaller rival, claiming that the specific tax structure illegally favors Fortune Tobacco. New players are especially disadvantaged by the structure.

In a guanxi-dominated environment, contracts other than spot are effectively limited to a subset of the population where informal sanctions have a bite. The business profile tends to have an ethnic and/or religious hue. The SM Group owned by taipan Henry Sy which runs the largest chain of supermarkets in the Philippines is said to favor *Iglesia ni Kristo* sect members for whom unionism is a "sin". Labor unions complain loudly about this practice and business, in turn, accuse labor unions of pursuing extraneous agenda. Inter-marriages within the group only

strengthen the informal sanction mechanisms and reinforce guanxi. The tendency towards market power concentration and collusion is pronounced, especially when the two or three competitors are of the same ethnic and/or social group. Market power and wealth, in turn, become highly concentrated and attracts expropriatory overtures from political powers. These must then be softened or captured.

V. REGULATORY DILEMMA

The common approach, known as the “inhospitability” or “anti-trust” tradition, is to pass laws directly to counter the usual manifestations of collusion such as price manipulation. In strong governance environment, this can be effective. In a weak governance milieu, this law can itself lack teeth and become a yet another rent tollgate for political powers. Anti-trust laws designed to break up concentrations of market power may only attack the symptoms. They do not attack the source of the problem. The “inhospitability rule” may not, as Williamson (1983) observed, be welfare-improving. The Sherman Act of 1890 in the USA was observed more in breach than in compliance in its first two decades of existence. Affected firms find it cheaper to subvert public enforcement than comply. The result is regulatory capture rather than an even playing field.

The real entry barrier is the weak TPE of contracts and property rights. If QL is strengthened, then entrants from outside the taipan and guanxi circle can raise competition and reduce concentration. The courts of law could be upgraded to protect property. Thus, investing in the rule-of-law could be the best competition policy initiative. This is, of course, easier said than done. How did this happen in East Asia in the second half of the 20th century?

VI. MARKET ENHANCEMENT as COMPETITION POLICY

The East Asian model’s emphasis (see Fabella, 1999) on export and foreign investment promotion spearheaded by export processing zones (EPZs) in East Asia may have served the cause of competition and regulation policy reform very well as the unintended consequence.

- (a) Export promotion meant a shift in the incentives structure in favor of the export sector. Those who dare test the waters (mostly guanxi types in the beginning) find themselves

competing for export shares with rivals whose goods are, in contrast, not weighed down by guanxi-related costs. The guanxi circle is no longer a help in the distribution segment of these firms in the world market while they may carry guanxi-related costs at home. These players, in time, become effective advocates for stronger TPE. Other non-guanxi players may also find foreign export niches that were not open to them in guanxi-dominated local market. The local distribution and marketing segments are where export opportunism is rife. Export markets are relatively immune. In this way, export promotion may have given a political constituency to better rule-of-law in export-oriented East Asia.

- (b) The export promotion via foreign investment strategy took another very effective form – the export processing zones – which helped foreign and local non-guanxi players along. The EPZ was not only a set of export-friendly hard infrastructures. It was, even more, a commitment to better, faster and largely faceless procedures; a new set of rules and even a new set of enforcers with which foreign investors were familiar. This was a crucial part of the attraction of EPZs. Indeed, the *Subic Bay EPZ* (Philippines) sells itself to investors less as an infrastructure-enabled hub than as a new set of institutions that are familiar to foreign locators.

Thus the so-called East Asian Model was not only a trade posture; it was a competition and regulation policy posture brought about not by direct confrontation with the taipans but by market enabling policies. It created a strong rule-of-law enclaves where non-guanxi and non-taipan players do not have to deal with unfair advantages that taipans can steer their way. The EPZ culture, because it spawned winners such as the IT sector in Taiwan, gradually infected the whole polity.

- (c) The gradual import liberalization forced guanxi players to compete with foreign rivals unburdened by guanxi costs. This made the tradeable sector less congenial for guanxi-based business. Most retreated to the nontraded goods sector, viz., banking property and retail trade, where the external pressure was only tangentially felt.
- (d) The relaxation of entry of foreign investment in these service areas again forced the guanxi businessmen to further modernize, either by joint ventures or by Harvardizing

the next generation, as did Li Kashing of Hongkong. The rules of engagement in the service sectors had to be rewritten to entice foreign players. The case of the privatization of Manila Waterworks and Sewerage System (MWSS) is a pronounced case in point (see Fabella, 2005). The dispute resolution mechanism involved an Appeals Panel which is international in composition. This took local politics and judicial pliance out of the picture.

Thus, competition and regulation policy was eminently served by enabling the market through openness which was central in the East Asian model. The "inhospitality rule" could not have done better.

V. SUMMARY

In weak third party enforcement environments, entrepreneurs have to confront additional idiosyncratic hurdles of ex-post opportunism by business partners and the absence of adequate property rights protection from predatory political elites. *Guanxi* serves to address the first by shrinking the set of potential partners to those for whom nonformal sanctions and even second or first party enforcement bind. Thus, the business activity takes on an ethnic, religious or familial color, which is true of East Asia. To address predatory property expropriation, the entrepreneur enlists state officials and politicians in a web of payoffs and favors. Who succeeds in both, we characterize as the taipan. Bringing to vigorous life otherwise missing or highly fragmented markets is his Schumpeterian role.

We model the taipan as a nexus of contracts involving a vertical integration into second party enforcement and property rights protection. Many of the accepted stylized facts about East Asian taipans: tax pyramids, legendary secrecy, an aversion for outside auditing, monopoly or shared monopoly positions, business sprawl, shadowy cultivation of politicians and the capture of rule-making apparatus can all be traced to this two vertical integration into second party enforcement. The boundary of the firm is different in the periphery than in the center.

Since second party enforcement is *private and excludable*, it tends to foster market power and entry barriers. Second party capability is, thus, a second best substitute to good third party

enforcement: it can underpin the existence of markets but it can also truncate those markets once extant.

The usually prescribed regulatory remedies include confronting market power and cartels with new laws directly penalizing so-called unfair “restraint of trade” practices. This is the “inhospitability tradition” in regulation. Heavier taxes are also par for the course. In weak governance environments, this is either ineffective or counter-productive since enforcement is what is precisely lacking. They serve to deter only those without connections, thus, raising entry barriers and enrich the unscrupulous bureaucrats. Extant taipans respond by committing more resources to developing political leverage resulting in even more uncertain political economy. This explains the resistance from the business sector to a proposed anti-trust agency in the Philippines.

New laws surrounding contracts enforcement such as *bankruptcy laws* are helpful only insofar as the enforcement apparatus (sheriffs and judges) are rule-of-law-minded enough. If they are not, the cost of doing business rises with hardly an improvement in quality.

In East Asia, throughout the second half of the 20th century, competition and regulation policy appeared to have taken a backseat to the so-called imperatives of the *East Asian model*. This is true only insofar as the competition policy was understood in the inhospitability tradition which requires strong enforcement to be effective. But weak enforcement was still widespread in the early second half of the 20th century. The market-enabling features of the East Asian model, viz., export promotion, export processing zones, direct foreign investment liberalization and gradual import liberalization, served as the better regulation and competition policy package in weak governance environments. Where the model was a great success, these features did serve to weaken guanxi and transform taipanism into its more modern reincarnation. Market enabling policies and openness served to indirectly advance the first best policy – the provision of adequate third party enforcement. Direct confrontation would have been only harmful.

This could explain why *institutional quality* seemed to have played such a crucial role in the development of East Asia at the time when the *East Asian Model* held sway (see, e.g., Rodrik, 1996). This also suggests an institutional interpretation of the East Asian Model.

REFERENCES

- Barzel, Y., 1982, "Measurement Cost and the Organization of Markets," *Journal of Law and Economics* 25, 27-48.
- Barzel, Y., 2002, A Theory of the State: Economic Rights, Legal Rights and the Scope of the State (Cambridge: Cambridge University Press).
- Coase, R. H., 1937, "The Nature of the Firm," *Economica* 4, 386.
- Criswell, C., 1981, The Taipans: Hong Kong's Merchant Princes (Hong Kong: Oxford University Press).
- Dixit, A., 2003, "Lawlessness and Economics," unpublished manuscript, reported on by *IMF Survey* 32, May 19, 2003.
- Fabella, R., 1999, "The East Asian Model and the Currency Crisis: Credit Policy and Mundell-Fleming Flows," *The Manchester School* 5.67, 475-495.
- Fabella, R., 2004, "Optimal Cash-in-Advance Contracts Under Weak Third Party Enforcement," UP School of Economics, Unpublished Monograph.
- Fabella, R., 2005, "Shifting the Boundaries of the State: The Privatization and Regulation of the Metropolitan Waterworks and Sewerage System (MWSS)," a UPecon-CRC Regulation and Competition Policy Series.
- Greif, A., 1993, "Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders," *American Economic Review* 83, 525-48.
- Greif, A., 2001, "Institutions and Impersonal Exchange: From Communal to Individual Responsibility," Unpublished Monograph, Stanford University.
- Greif, A., P. Milgrom and B. Weingast, 1994, "Coordination, Commitment and Enforcement: The Case of the Merchant Guild," *Journal of Political Economy* 102, 745-76.
- Grossman and Hart, 1986, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration," *Journal of Political Economy* 94, 691-719.
- Holmstrom, B. and J. Roberts, 1998, "The Boundaries of the Firm Revisited," *Journal of Economic Perspectives* 12, pp. 73-94.

Klein, B., R. Crawford and A. Alchian, 1978, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," *Journal of Law and Economics* 21, 326.

Laffont, J.-T. and D. Martimort, 2002, The Theory of Incentives: The Principal-Agent Model (Princeton: Princeton University Press).

Laffont, J.-J. and M. Meleu, 2000, "Enforcement of Contracts with Adverse Selection in LDCs," Mimeo, IDEI, Toulouse.

North, D., 1981, Structure and Change in Economic History (New York: Norton Press).

North, D., 1990, Institutions, Institutional Change and Economic Performance (Cambridge: Cambridge University Press).

Nozick, R., 1974, Anarchy, State and Utopia (New York: Basic Books).

Rodrik, D., 1996, "Institutions and Economic Performance in East and Southeast Asia," Round Table Conference: The Institutional Foundation of Economic Development in East Asia, International Economic Association, Tokyo, 16-19 December 1996.

The Economist, 7 April 2001, "Asian Business Survey."

Williamson, O., 1971, "The Vertical Integration of Production: Market Failure Considerations," *American Economic Review* 62, 112-23.

Williamson, O., 1975, Markets and Hierarchies: Analysis and Anti-Trust Implications.

Williamson, O., 1983, "Credible Commitments: Using Hostages to Support Exchange," *American Economic Review* 74.4, 519-54.