

Fabella, Raul V.

**Working Paper**

## Conglopolistic competition in small emerging economies: When large and diversified is beautiful

UPSE Discussion Paper, No. 2016-05

**Provided in Cooperation with:**

University of the Philippines School of Economics (UPSE)

*Suggested Citation:* Fabella, Raul V. (2016) : Conglopolistic competition in small emerging economies: When large and diversified is beautiful, UPSE Discussion Paper, No. 2016-05, University of the Philippines, School of Economics (UPSE), Quezon City

This Version is available at:

<https://hdl.handle.net/10419/162631>

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## **UP School of Economics** **Discussion Papers**

Discussion Paper No. 2016-05

June 2016

### **Conglopolistic Competition in Small Emerging Economies: When Large and Diversified is Beautiful**

by

Raul V. Fabella

University of the Philippines School of Economics  
and  
National Academy of Science and Technology

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# ***Conglopolistic Competition in Small Emerging Economies: When Large and Diversified is Beautiful***

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Raul V. Fabella  
School of Economics  
University of the Philippines  
and NAST

(Work in Progress: Do not Quote)

## **Abstract**

The economic catch-up of the East Asian miracle economies went hand-in-hand with the emergence and even dominance of large private or quasi-state business groups such as the Zaibatsus in the pre-WWII and the Keiretsus of the post-WWII Japan, the Chaebols of South Korea and the Taipan-led business empires of South and South East Asia. The dominance of the so-called *Robber Barons* in the Gilded Age of the USA catch-up era (1870-1900) was of the same genre. The natural *vent for size* among firms, following the Williamson *make or buy* logic, manifests itself as vertical integration in large economies; in small economies, it manifests itself as horizontal integration or conglomeracy. The motivations are underdeveloped factor mainly capital and insurance markets. Weak public ordering also motivates size as firms to vertically integrate into private ordering to resist official and unofficial predation. Conglopolistic competition, the competition among conglomerates in many markets, is largely in the non-traded goods sectors where foreign competition is not felt and market saturation is quickly attained. We give show how conglopolistic competition is welfare-improving and give examples of how it boosts the collective action capacity of the weak Philippine state. The dynamism of the Philippine Service sector is due to lively conglopolistic competition which in turn comes from relatively free entry (apart from large capital cost) in these sectors. It is imperative to attract conglopolistic competition in the traded goods sector especially in industrial agriculture. We identify fragmentation of farm land and the 5-hectare ownership ceiling as the one barrier preventing the entry of conglopolistic competition in agriculture.

JEL Classification: L22, L25

Keywords: Conglomerates, horizontal integration, small emerging markets, conglopolism, non-traded goods sector.

## I. Introduction

### A. The Vent for Size

Coase's (1937) seminal observation—that market transactions are not without cost and the higher the cost of market transactions the larger the firms—started 'the boundary of the firm' problem. But the idea went into eclipse for 30 years before Oliver Williamson (1975), the 2009 Nobel Memorial Prize winner for seminal studies in the boundary of the firm, resurrected the idea in the 1970's and put 'transactions cost economics' and firm-market boundary back on the disciplinary agenda. The crucial decision problem for the firm in this arena is whether to 'make or buy' a service or an input, an issue alien to the black box of the Arrow-Debreu firm. In underdeveloped economies, market transactions and exchange costs tend to be prohibitive; the pioneering entrepreneur having no one to buy from or organized entities to sell to faces the entire attendant forward and backward linkage risks. The main reason is the underdevelopment of the factor markets (Khanna and Palepu, 1999). The *primus inter pares* among these factor markets is the capital market. Firms need capital to grow their businesses, but in LDCs the financial markets may not be able to meet their capital requirements at reasonable rates. The capital market failure is usually the motivation for state financial intervention in favor of certain companies and partly underlies the emergence of state-sponsored conglomerates. Firms outside the orbit of the state largesse need to raise capital internally (Williamson, 1975; Stein, 1997; Klein, 2001). Economic size is the private sector's way to remedy the capital market failure through internal capital generation. Large companies also tend to be sought after and favored with lower interest rate by the banking sector which, following the Stiglitz-Weiss logic, use size as a proxy for reputation and quality. They are also sought as partners by foreign investors and serve as conduits of foreign capital by direct borrowing.

The 'make' decisions taking the form of vertical integration to reduce those risks lead to the emergence of large vertically-integrated firms. The 'vent for size' going through vertical integration comes in this case from profit seeking through efficient provision and control of the value chain.

### B. Predation, Uncertainty and the Large Imperative

The vent for size is also more urgent in weak governance environments. Less developed economies are backward for many reasons but the most encompassing reason is weak governance due to weak institutions (Shirley, 2005). Weak governance starts with a hobbled state whose many organs of rule-making and enforcement intended in theory to advance the common weal are either too feeble or susceptible to capture and used as instruments of predation. This is analogous to the famous risk associated with the emergence of the state itself: it can be an instrument of protection or an instrument of expropriation (Acemoglu, 2002; North, 2005). Unfortunately, the political economy of weak governance in LDCs not only does not guarantee state benevolence but may indeed invite predatory behavior. Where weak public ordering is an integral part of the politico-economic landscape, the private firm must also vertically integrate into defensive private ordering in order to survive.

A weak governance environment begets the proverbial predation table where rents are divvied up. It is popularly observed that having a seat in the predation table means you do not end up in the menu. The seats in the table are, however, allocated according to political power. Economic size, in so far as it gets translated into political power, can procure for its holder a seat in that table. While size is a magnet for predators, it is also a rampart against predation. Small firms are vulnerable to predation because the cost of protection can be prohibitive and not affordable. Large firms in weak public ordering environments are those that have managed to survive the predatory jungle by acquiring defensive ramparts. Having a hand in the election of the president of the republic means having a say at who becomes the minister of finance or the commissioner of the tax bureau. Being able to afford the highest-paid, judiciary-savvy and high-profile lawyers gives the firm an edge in dealing with predatory tax collectors and regulators. This foray into the political economy arena is, in the O. Williamson's (1985) sense, a 'make' decision in order to render property rights and contract uncertainty manageable where the wielding of state power is unpredictable. In the Philippines, the most convincing reminder of weak public ordering is the ubiquitous "blue guards" providing which has become a big industry.

Thus, where governance is weak, firm size—in the language of evolutionary biology—is a trait selected for survival. They are like the bright colors announcing the toxicity of highly poisonous salamanders. Predators learn quickly to avoid a tussle with such firms and turn their attention to more vulnerable smaller ones. Once a self-protection capability is acquired, the marginal cost of its further use is negligible. Like a sunk capital, it is attended with economies of scale. It motivates size. An associated danger should not, however, be underestimated.

### **C. Too Big to Behave**

The danger of size in weak public ordering environment goes beyond the too-big-to-fail; it includes the too-big-to-behave. Having acquired a political or armed power to repel predators, the temptation is strong to use the same capacity to, in turn, prey on weaker rivals. Large conglomerates may succumb not only to the temptation of abuse of market power but to the employment of acquired political leverage for rent-seeking which prompts many to dogmatize Schumacher's 'small is beautiful'. Many large business groups may develop and maintain clandestine and privately mutually beneficial relations with political actors. This murky matrix of relationships and connected dealings became the favorite whipping boy of sanctimonious Western observers in the wake of the Asian Financial Crisis of 1998 which, for many, signaled the end of the proverbial East Asian Model ("In Praise of Rules" *The Economist*, 7 April 2001). As the Financial Crisis of 2008 revealed, however, the West is not immune from such financial self-dealing-based sinkholes despite its vaunted regulatory ramparts.

We do not underestimate this risk. Our view is: rather than condemn size at the outset because of the risk, we consider size as a necessary investment in efficiency. In the language more familiar to the legal profession, market or economic dominance is not a crime *per se*; its abuse is but that has to be clearly demonstrated according to the standards of the law and preferably the *rule of reason*.

## **II. Vent for Size in Small Economies**

## **A. Conglomeracy**

The spread of large business groups across many disparate unrelated markets through horizontal integration is also motivated in the literature by underdevelopment in the capital and insurance markets. The need to raise capital internally may also be addressed by size through diversification. But the pronounced motive for conglomeracy is the mitigation of risk and returns volatility. With developed capital markets, investors can reduce volatility by owning diversified equity holdings. Where the capital and insurance markets are underdeveloped, implicit portfolio diversification can be achieved by owning shares of a diversified conglomerate. Diversified holdings by firms can reduce returns volatility, lower bankruptcy risk and earn better credit rating. This should make conglomerate shares enjoy a premium in such markets. Other reasons for the premium have been proposed: lower interest borrowing, lower tax burden due to intra-firm transactions and leveraging of managerial resources.

Because markets are small and/or fragmented in small emerging economies, the vent for size among firms manifests itself as conglomeracy: playing in many markets at once. Note however that conglomeracy is quintessentially a Non-traded goods sector phenomenon. The vent for size in small economies need not manifest itself as conglomeracy among firms in the Tradable goods sector which sells to the vast global market and can grow large untroubled by quick market saturation. They can thus become big while staying within their core market and associated vertical integrates. The best example is *Foxconn* of Taiwan which grew very large as an original equipment manufacturer (OEM) for global digital equipment brands and has stayed as such even as it moved much of its operations to PRC. Yet another is *Convergys* of India which has stayed with business process outsourcing (BPO), which is a tradable service. Furthermore, institutional and market distortions which abound in emerging markets tend to weigh down the traded goods sector more than the non-traded goods sector and biases investment decisions away from traded goods (Rodrik, 2008).

## **B. The Philippines: A Case in Point**

In emerging markets, casual empiricism suggests that the dominance of conglomeracy in the Non-Traded Goods Sector is not abating. Contemporary Philippines, where most newsworthy economic projects involving large capital outlays are linked to one or more of the very visible conglomerates, seems emblematic of this trend.

In the Philippines, the following non-traded goods sectors host the following players: Banking (Ayala Group, Aboitiz Group, SM Prime Group, Lucio Tan Group, Gokongwei Group); Property Development (Ayala Group, SM Prime Group, Lucio Tan Group, Gokongwei Group, DMCI Group, Megaworld, Phinma); Retail Merchandizing (Ayala Group, SM Prime, Gokongwei Group) ; Telecoms (Metro-Pacific group, Ayala Group, San Miguel group) ; Power generation and distribution (Ayala Group, Aboitiz Group, San Miguel Group, DMCI, Benpres Group) ; Infrastructure construction and operation (Ayala Group, Metro-Pacific group, DMCI group, San Miguel group, Megaworld group) ; Tertiary Education (SM Prime group, Yuchengco group, Phinma group, Lucio Tan group), to name a few.

Contrast this to the large players in the vast US market that stayed largely within their original core markets including their vertical integrates, e.g., Walmart in Merchandizing, Bank of America, Citigroup and JP Morgan in Banking, Trump in Property Development, GE in Machinery and GM and Ford in Vehicle Manufacturing and Assembly, Apple in Digital Devices, Google in Search Devices and Facebook in Social Media.

Large diversified firms are beneficial in many ways. In the next section we explore the role of conglopolistic competition in boosting the collective action capacity of the nation.

### III. Conglomeracy and Collective Action

Weak public ordering in LDCs manifests itself principally in weak capacity for collective action. This is very important because the most important task of every state is the provision of public goods which, in essence, is a collective action problem. The provision of arterial public infrastructure requires sizeable resources which must first be collected in sufficient volume, and second allocated to large arterial infrastructure which in turn require coordination amidst myriads of demands for it use. States afflicted by weak public ordering find it difficult to do either or both of these adequately, thus, bad infrastructure and bad economic outcomes. Even when resources are raised, state implementation of large projects frequently end up mired in corruption and waste. Large conglomerates with their command of sizeable financial resources, considerable reputational capital and, more importantly, efficient and motivated management resources can be harnessed to boost the collective action capacity of the state. The now prominent Public-Private Partnership (PPP) follows this idea. The very successful privatization of water service in Metro-Manila for example could not have come about without these large conglomerates and conglopolistic competition (Fabella, 2011). We first view how conglopolistic competition improves welfare from a purely competition angle.

#### A. Welfare Dividend of Conglopolistic Competition

That more firms competing in the market (in this case more conglomerates) enhances consumer welfare is standard result in the Theory of Industrial Organization under symmetric Cournot Competition.

We consider a market with inverse demand function  $P = a - bX$ ,  $a, b > 0$ , where the number of firms is  $n \geq 0$  and  $X = \sum x_i$  is the sum of the outputs of  $n$  individual firms. In the following we will consider the inverse demand intercept ' $a$ ' as a proxy for market size (also called vertical growth by Hegji, 2001; Neumann et al., 2001). Each firm faces a fixed capital investment of  $K \geq 0$  to be amortized at fixed rate  $r \geq 0$ . The size of  $K$  has scale economic implication. We thus assume the total cost function facing firm  $i$  as

$$C_i = c_i x_i + rK, \quad c_i > 0. \quad (1)$$

The variable cost of firm  $i$  is  $[c_i x_i]$  and fixed cost is  $rK$ . The average cost  $(C_i/x_i) = [c_i + (rk/x_i)]$ , is decreasing at a deceasing rate as is customary with scale economies. The firms play a Cournot market game. We assume that  $(a - c_i) > 0$  for all  $i$ . This characterization of the oligopoly market with fixed  $K$  is

common (Dasgupta and Stiglitz, 1980; Neumann et al., 2001; see Hegji, 2001 for a case with endogenous  $K$ ). The symmetric Cournot market equilibrium production is

$$x^{\circ} = (a - c)/[b(n + 1)],$$

and the total production is

$$nx^{\circ} = \{n(a - c)/[b(n + 1)]\},$$

while the Cournot equilibrium price is

$$p^{\circ} = [a(1 - h) + nc]/[(n + 1)].$$

Using  $x^{\circ}$ ,  $nx^{\circ}$  and  $p^{\circ}$ , we find the welfare level using the consumer's surplus at Cournot competitive equilibrium with  $n$  firms,  $CS(n)$ , to be:

$$CS(n) = (n/(n + 1))^2(a - c)^2/2b. \quad (2)$$

The corresponding consumer's surplus at Cournot competitive equilibrium with  $(n + 1)$  firms and under the same  $K$  is:

$$CS(n + 1) = ((n + 1)/(n + 2))^2(a - c)^2/2b. \quad (3)$$

Now it is clear that  $CS(n) < CS(n + 1)$ . Thus, more firms competing in the market deliver a higher consumer welfare. The welfare dividend of greater competition is

$$[CS(n + 1) - CS(n)] > 0. \quad (4)$$

This is true for example if initial market has  $n = 1$  (a monopoly) and the subsequent market has  $n = 2$  (a duopoly). The implicit assumption here is that the market is large enough to accommodate the additional firm with the same fixed cost  $K$ . The fact alone that conglomerates compete in the same market improves welfare. No matter that their entry into these markets is profit-motivated. (4) is the harvest of Adam Smith's "Invisible Hand." The government's only role is to allow, even encourage, free entry and prevent collusion. The familiar exception to this is when the market is a *natural monopoly* as in power transmission.

## B. Conglopolistic Competition in Infrastructure Projects

We now switch to arenas where collective action challenges are present (also called public goods failure). Free entry alone will not suffice. Government's role is effective coordination. Public-Private Partnership for large infrastructure projects is possible only if there are large financially well-endowed players willing to undertake the associated risks to act as counterparty to the government. Moreover, where auction is the preferred market testing modality, there should be enough of them to constitute a successful bid. **Box 1** details a successful collective action initiative which became a reality only because there were large conglomerates which had the financial heft and the reputational capital to attract foreign partners with the specific expertise on water service delivery as minority partners (see, e.g., Fabella, 2011). This last is important especially because none of the domestic players had



previous experience and expertise in water service provision and there is a perception that minority owners are treated badly in LDCs.

### **B.1 Water Services Privatization**

#### **Box 1**

##### **Water Services Privatization: Firm Size As Catalytic**

Water services procurement in Metro Manila was privatized in 1997 and is now globally considered very highly as a public-private partnership success. Pre-privatization, water and sewerage service in Metro-Manila, Philippines was provided by a state-owned and -operated state agency, the Manila Water and Sewerage System. Water service quality was very poor (up to eight hours water interruptions) though water tariff was very low since upward water tariff adjustment was considered politically anathema. It thus had to be subsidized by the state and was a fiscal drain. Privatization would transfer the burden of financing capital requirement of water infrastructure spending to the winning bidders and ultimately to the water buyers. But the size of the project was immense and only very deep pockets would qualify. The reimbursement modality of the contract meant that only very large players can qualify. Likewise, the constitutional requirement of control by Filipinos of public utilities meant that foreign capital with water service expertise can be attracted to become minority partners only if the domestic partners could be found with reputation for upright dealings and with some financial heft. The players that responded were all huge conglomerates: Metro Pacific Corporation; Ayala Corporation; Benpres Holdings Corporation; and Aboitiz Holdings Corp. The intense competition among these conglomerates allowed a hefty discount to be passed on to the consumers of water. The aggressive behavior of the winner of the East wing, Ayala Corporation was interpreted as due partly to the conglomerate nature of the bidder (being primarily in property development. The quality of water service has approached global standards since privatization. Without these large domestic players, this momentous privatization would not have happened.

### **B.2 Conglomeratic Competition in Infrastructure: CALAX**

Yet another important PPP contract was signed in 2015. The Cavite Laguna Expressway (CALAX) is a 47-km eight-lane interchange tollway project to link the South Luzon Expressway and the Cavite Expressway. CALAX is to be procured under the Philippine government's Public Private Partnership Program. The auction parameter was the amount of money the bidders are willing to pay (premium) the government for the right to construct and operate the project on a user fee basis. The first CALAX auction in June 2014—won by the Team Orion with a bid of ₱11.66-billion in premium payment—was scrapped by the government when a technicality-disqualified contender, San Miguel Corporation-affiliated Optimal Infrastructure, opened its bid document to the public, revealing a ₱20.1-billion bid.

President Aquino—responding to the revelation—ordered a rebid with bid floor being ₱20.1-billion. This act by the government produced a spirited howl because the government seemed to have reneged on an implicit promise to honor an above-board auction. The government’s response was that the disqualification was too harsh for too flimsy an infraction over the bid security and it cannot, in conscience, leave ₱8-billion on the table. In the rebid held in May 26, 2015, Metro Pacific Investments Corporation won with a bid of ₱27.3-billion. Whichever side the rule-of-law falls on this controversy, the fact is, intense competition among conglomerates meant that the government realized an additional ₱27.3-billion for infrastructure projects in other jurisdictions. Yet again, showing that collective action capacity so lacking in most LDC governments can be boosted by proper channeling of large conglomerates. Other large infrastructure projects have already been completed (e.g., TPLEX: Tarlac-Pangasinan-La Union Expressway to San Miguel) or have been awarded and construction started (e.g., the ongoing Connector Road Projects one branch to San Miguel and the other to Metro-Pacific) after intense competition between conglomerates.

The main message here is simple: when the state has a weak capacity for collective action, the presence of large conglomerates can boost the state’s and the nation’s capacity to solve collective action problems of which the most important is in the provision of arterial public infrastructure. What is required is a credible regulatory environment and the nurture of healthy competition.

## **V. Liberalization and Entry**

The main feature is that where it is brisk, conglopolistic competition allows customers a choice which is invariably beneficial. And this is made possible by a policy regime of free entry (the absence of non-economic barriers to entry). The alternative is that there is only one large monopolist in each sector which would arise if the entry is deterred by some state-sponsored barriers for non-economic reasons such as ethnic preference. For example, the “Retail Trade Act of 1954” (RA 1180) which limited entry to direct selling to consumers only to 100%-Filipino-owned (translated non-ethnic Chinese) businesses was an ethnic preference policy. This restriction has abated over the years as ethnic Chinese residents became Filipino citizens (see e.g., Palanca, 2015, for a lively account of the rise of Chinese business). The “Retail Trade Liberalization Act of 2000 (RA 8762) allowed other nationalities to enter. Since 2008, even foreign investors with paid-up capital of \$2.5m are allowed to enter retail trade. This liberalization of entry into the non-traded goods sectors through the lifting of non-economic barriers contrasts with the non-liberalization on some traded goods sector.

Sometimes the entry barriers are indirect but just as deterring. Take agriculture for example. Though large conglomerates have exhibited a predilection for the non-traded goods sectors, some large conglomerates have expressed interest in entering, for example, food production and industrial farming. But farm land fragmentation and limitation on ownership of land to 5 hectares courtesy of the Comprehensive Agrarian Reform Program (CARP) means there are no readily available tracts of land sizeable enough to profitably accommodate large capital infusion. Consolidation is in theory possible but in practice is fraught with endless legal minefields and regulatory risks. The political circus that followed San Miguel Foods Incorporated’s hog farm project covering 140 hectares in Sumilao, Bukidnon, and which ran into the CARP property rights morass, is a cautionary tale on private capital

venturing into agri-industry. The message is “Investor, beware!” Small wonder then that the conglomerate, San Miguel Corporation, with roots in food and beverage manufacturing and has therein maintained a dominant presence, has since found greater comfort in the non-traded goods sector such as power generation and infrastructure.

This is just one example of institutional distortions that, according to Rodrik (2008), penalize the tradable goods sector vis-à-vis the non-traded goods sector, say retail trade and banking. The result is the flight of private capital from the agricultural sector and the dominance thereof of small uneconomic farms that spell low productivity and poverty.

#### IV. Summary

We contend in this paper first that there is a natural vent for size among firms in the competitive arena. Size, *ceteris paribus*, is a trait selected for survival in the competitive jungle. In large economies and markets, this vent for size comes via vertical integration into cognate activities in the same industry. In small economies and markets, this vent for size finds expression in conglomeration or the simultaneous presence in many disparate markets. Apart from the underdeveloped capital and insurance markets, size also serves as a bulwark against state and non-state predation in weak governance environments. Firms to survive also horizontally integrate into what O. Williamson calls the private ordering to compensate for weak public ordering. This may take the form of capture of state rule-making, enforcement and regulatory organs. This capture, though perhaps properly motivated at the start to facilitate exchange and welfare may, once acquired, can be used for predatory purposes such as blocking reform legislations. We note that in the Philippines, many large conglomerates compete at once in many important non-traded goods markets. We show that this actually enhances welfare in these markets. Finally, we argue that in states characterized by weak capacity for collective action and severe fiscal budget constraint, conglomeration serves to improve the collective action of the nation. Finally, we discuss salient examples of collective action successes, namely, the privatization of water services in Metro-Manila, the awarding of the CALAX project and the ongoing Connector Road Projects.

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