Guanxi in Chinese Commerce: Informal Enforcement in Spanish Philippines

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How did Chinese merchants remedy opportunism in a prevailing scenario of weak state enforcement during the Spanish period in the Philippines? The paper attempts to analyze 19^{th} century historical accounts in elucidating how the utilization of *guanxi* sanctions provides useful insights in addressing the gap between state enforcement and property rights violation. These sanctions constitute informal enforcement among Chinese merchants based on personalistic ties. With credible enforcement, Chinese principals could manage networks that facilitated merchandize trade throughout the Philippines. By the 19^{th} century, Chinese networks consisting of Chinese merchants and agents became crucial in large scale wholesale and retail trade.

Keywords: Ethnically homogeneous middleman groups, Informal sanctions, Enforcement

JEL Classification: N85, D23, C61, L14, D86

I. Introduction

When Chinese migrants reached the Philippines, they discovered the vast commercial opportunities that came with the coming of the Spanish. Instead of transacting with individual pre-Spanish polities at port, access to commerce in the entire archipelago was now possible under a com-

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mon colonial policy. The challenge was, the exchange environment was marked by weak property rights enforcement and worse it was predatory against the Chinese — formally and informally. Institutional action against the Chinese included trade restrictions, banning of commerce, segregation, expulsions, massacres and various financial levies. With the onset of the colonial economy, the potential economic gains were high but so was the exchange risk.

Wickberg (1965, p. 68-9) analyzed 19^{th} century Chinese commerce in the islands and finds that it was contingent on a combination of characteristics associated with success (*e.g.* patience, pioneering spirit); the deft utilization of credit; and an effective economic organization. However, Wickberg gave more importance on the use of financing and 'patronage organization' as factors in Chinese success.[1] This paper focuses on the manner with which the Chinese organized themselves informally. In particular, we look at *guanxi*, a Chinese social construct based on personalistic ties, as a source of informal sanctions that stabilized contracts.

A. The context of guanxi as a social construct

Rooted in Confucian ethics (King 1991), *guanxi* is known in China as a 'way to get things done,' which refers to relational modes in dealing with people. The meaning of the word *guanxi* has many dimensions (Tsui, Farh, and Xin 2000). *Guanxi* denotes a state of connectedness among parties. In regard to relationships in particular, *guanxi* can refer to the quality of relations shared by parties. On the other hand, *guanxi* can also refer to the parties in the relationship such as the individual, the firm, connected parties and even a network (Chen and Chen 2004). The common factor in the various definitions is the reference to a type of interpersonal relationship that involves particularistic elements (King 1991). This paper refers to *guanxi* as a personalistic tie based on common experience or heritage such as kinship, dialect or geographical origin. Contracts based on these ties are defined as *guanxi* contracts while networks in which the enforcement of agreements operates are referred to as *guanxi* networks (Jacobs 1980; Tsui, Farh, and Xin 2000; Chen and Chen, 2004; Landa, 1998). Punishment or retribution based on *guanxi*

[1] Comprehensive quantification of Chinese success remains an empirical inquiry. Where Chinese mestizos (*i.e.* mixed race) are concerned, Comyn (1810, p. 39-40) acknowledges the accumulation of sums of money but the 'amount, distribution, or the secret places in which they are hoarded' are not possible to determine. The lack of documentation is worse for the non-mestizo Chinese.

shall be referred to as *guanxi* sanctions.

Guanxi becomes significant as we are concerned with how Chinese merchants in the Philippines used informal sanctions in protecting contracts from the propensity to violate agreements (*i.e.* the commitment problem). These sanctions are based on deliberate particularization of exchange relations within ties of kinship and ethnicity (Landa 1981, 1999).

B. Guanxi as Informal Enforcement

We consider *guanxi* sanctions as enforcement in the context of underdeveloped institutions in the exchange environment. The literature underscores that alternative enforcement mechanisms arise as substitutes for inadequate property rights protection utilized by economic players. Examples of enforcement alternatives abound, as seen in corporate governance networks to compensate for weak laws (Klapper and Love 2004; Berglof and Claessens 2004); inter-firm governance against opportunism (Aviram 2003); mafia networks (Anderson and Bandiera 2001; Hendley, Murrell, and Ryterman 2000); market broker systems (Gabre-Madhin 1999); community responsibility systems (Greif 1997); and merchant coalitions in twelfth to thirteenth century Europe (Milgrom, North, and Weingast 1990) and pre-modern Japan (Okazaki 2001). Landa's (1981; 1999) analysis on the Ethnically Homogeneous Chinese Middleman Group (EHMG), Grief's (1993) formal approach on the Maghribi traders' coalition and North's (1981) work on economic history provide the foundations of this article. This paper considers sanctions based on *guanxi* as constituting an informal enforcement mechanism, which remedies opportunism where state sanctions are weak. In this sense, the paper seeks to enrich the discourse beyond the traditional "firms-and-markets" paradigm (*e.g.* see Jwa 2002) and attempts to provide a perspective through which historical outcomes can be analyzed.

C. Outline of the Essay

The succeeding sections are outlined as follows. Section II briefly introduces the scenario of the state enforcement apparatus, which is found weak and worse, predatory against the Chinese. Section III delves into patterns of commercial relations among Chinese traders in 19th century trade. We explore the themes of ethnic particularization in the principal-agent context as well as merchant cooperation. These aspects provide major themes in understanding the use of *guanxi*. Section IV focuses on the features of *guanxi* sanctions, which are informal remedies to inadequate state enforcement. The main themes of the section are network restrictedness and the forms of punitive action when agreements are violated. Section V extends the analysis by exploring the intertwined fates of the expanding import-export trade, large-scale credit and Chinese commercial networks. As a point for further research, section V ends with how *guanxi* fits into this picture. Section VI provides the conclusion, which covers the perspective on *guanxi*'s place in Philippine economic history as well as implications of the historical study on the present context.

II. The Dilemma: Weak State Enforcement and Opportunism

The institutional context in Spanish Philippines is described by weak state enforcement throughout the colonial period. Comyn (1810) captures the conflict of interest among Spanish authorities in his account of magistrates advancing their own personal interests as they became 'the chief consumers, purchasers, and exporters of everything produced and manufactured within the districts under their command, thus converting their license to trade into a positive monopoly.' However, in regard to the Chinese, enforcement was not just weak but also predatory. Attempts to control Chinese influence took the form of commercial restrictions, financial impositions, segregation, expulsions and massacres ever since the earliest times of Chinese migration to colonial Philippines. Historical accounts of these are replete and well documented in the literature (Blair and Robinson 1903-1909; Liao 1964; Purcell 1965; Wickberg 1965; Felix 1966, 1969).

Documentary evidence states that the Spanish colonial government set up a *parian*—a locality outside Manila that segregated unassimilated Chinese or those not baptized into Catholicism from the rest of the population. The *parian* represented the measure of control imposed on the mobility of Chinese in the Philippines. However, the *parian* became self-supporting and thrived with commercial transactions (Guerrero 1966, p. 27).

From a legal standpoint, the intention of the segregation measure was benevolent. That is, it was in the context of protecting the Chinese from acts of abuse from the administration in particular and non-Chinese population in general.[2] In Morga's work of 1609, he explained that the

[2] Interestingly, while the official position was benevolent, there were other views

parian was headed by a Chinese governor who is appointed to address legal cases of civil and commercial nature among fellow Chinese. Also, appeals could be forwarded to the *parian*'s magistrate of trade, and can be further elevated to the *Audiencia de Manila* (Spanish high court in Manila), which functioned as a Supreme Court (Rizal 1962, p. 346). However, the actual condition in the *parian* reflected the overall weakness in legal enforcement in the Philippines, consistent with MacMicking's (1967) observation during the 19^{th} century of the 'dilatoriness of the law.'

Spain put in place a series of policies in the early 17^{th} century to institutionalize protection of the Chinese. The royal decree of April 15, 1603 appointed the Governor-General as protector of the Chinese. Philip II passed into law a modified version of this policy in June 12, 1614. The law gave the fiscal of the *Audiencia* the function of giving legal advice to the *parian's alcalde*. However, the office was saddled with compromises in terms of extortions and bribes. In the end, the fiscal had to be replaced (Guerrero 1966, pp. 30-1; Philip II, Philip III and Philip IV 1903-1909, p. 155). *Parian* governance, therefore, which was meant to provide a third party enforcement for the Chinese community, turned out to be ineffective and at times was used for expropriation. Beyond the *parian*, the institutional environment likewise, could not be depended on.

III. A Glimpse of Chinese Commercial Relations in Nineteenth Century Trade

This section investigates two factors in the use of *guanxi* sanctions in commerce: ethnic particularization and collusion. Historical accounts document the former in relation to the principal-agent context while the latter is documented as strategic behavior among merchants. As documentary evidence shows, these factors are most observable by outsiders in the arrangements they are associated with due to the issues that arise within those arrangements. In particular, the crowding out of non-Chinese competition through the *cabecilla's* network of agents was an oft-repeated issue. In the case of merchant collusion, it was uniform

on allowing Chinese self-governance. Tavora (1903-1909, pp. 251-2) derogatorily opined for instance that it would be best for the Chinese to govern themselves because only their laws can deal with their behavior. If Spaniards were to govern the Chinese, this would require conforming to their ways, which was considered untenable.

pricing and other forms of cooperation that got the attention of outsiders. While the violation of price-fixing agreements is not the type of opportunism that can be punished by the state, even if state enforcement were strong, we nevertheless explore it here to elucidate the workings of merchant cooperation and punitive implications of not keeping agreements.

A. Ethnic Particularization in a Principal-Agent Context

During the 19^{th} century, the position of Chinese traders evolved. Sir John Bowring (1963, p. 111) noted the domination of Chinese traders as they evolved from petty traders in the beginning of Spanish colonization, into wholesale merchants who engaged in large-scale export and import trade in the 19^{th} century. He observed that Chinese traders indeed utilized agents scattered over most of the Philippine islands. Indeed, in the 19^{th} century, the Chinese merchants established themselves as *cabecillas*. Following Wong (1999, p. 151), a *cabecilla* is the firm's principal, who is involved in the large-scale trade of import-export goods. The *cabecilla* engaged with Manila-based foreign mercantile houses. The *cabecilla's* retail stores were distributed all over the islands and were operated by his various agents. The agents were tasked to sell imported goods and gather crops for export through the trade houses. The *cabecilla* extended credit to the agents, supplied goods, and found buyers for the local produce they bought.

Robert MacMicking's (1967) recollections of his travels to Manila in the mid-19^{th} century astutely describe several significant points. The first important observation is on the domination of Chinese merchants over the provincial trade in manufactured goods. MacMicking noted the numerous Chinese shops operating across the islands. Second, Chinese shops that operated throughout the islands were run by Chinese agents employed by Chinese principals, establishing the ethnic particularization of the principal-agent contract. Third, the Chinese agent kept the Chinese principal informed of the needs of the store while the principal made wholesale purchases in Manila and sent these goods to the provincial shops. Elsewhere, MacMicking made specific note of the remuneration structure in the principal-agent contract between the Chinese business owner and Chinese employee. He noted that the effort level of Chinese agents is maximized when remuneration is a profit share rather than a fixed wage. This affirms that indeed, a principal-agent contract existed and there was ethnic particularization.

The principal-agent relationship between *cabecilla* and Chinese agent can further be characterized through the *sari-sari* store, a retail outlet that sold a variety of basic goods that are purchased in small quantities. The proliferation of sari-sari stores in the context of the *cabecilla's* operation may be traced to the second half of the 1800s. Grass root *sari-sari* storekeepers who functioned as agents of the *cabecilla* in a dual middleman role, were depended on for two roles. They did not only collect various commodities from producers. But they also engaged in the distribution of products on retail. Hence, *sari-sari* storekeepers combined retailing and the collecting of produce (Wong 1999). The Chinese replaced mestizos and Filipinos as retailers, repeating the pattern of crowding out non-Chinese competition. These stores dominated retail trade all over the country (Bowring 1963, p. 109).

Nicholas Loney, the British Vice-Consul for Iloilo province, wrote to W. Farren, the British Consul to the Philippines, on April 12, 1857. Loney reported the commercial traffic facilitated by Chinese agents in Iloilo. His report noted that of the thirty Chinese settled at the town of Molo, majority functioned as agents or partners of Manila Chinese. This corroborates MacMicking's earlier reports. Loney described Iloilo Chinese to be travelling between Manila and Iloilo in carrying out merchandize distribution and collection. Collections were in the form of goods or cash (Loney 1967, pp. 232-3).

In July 10, 1861, Loney related to Farren the situation in Iloilo wherein Chinese traders were supplanting mestizos in retail trade. Because competition with Chinese traders has made the retail trade unprofitable for non-Chinese competitors, mestizos who in Loney's observation became superfluous, were turning to agriculture. The incentive to engage in agriculture was further compounded by the fact that cultivation area and production had no institutional impediments for mestizos such as those that barred Chinese. The other interesting implication is, the criticism against the Chinese that they did not engage in agriculture, which was the basis of being permitted to penetrate the interior in the first place, was now less important. This is owing to the observation that Chinese commerce resulted in 'displacing native capital less beneficially employed and transferring it to other ... more productive channels' (Loney 1967, pp. 247-8).

It is worth noting that the *cabecilla*-agent relationship was close and usually kept outside public scrutiny. This was understandable given that when dire commercial straits arise, secrecy protects both parties from liability. The extent of liability will depend on independent credit arrangements availed by each party, which are in turn affected by the nature of the commercial relationship between *cabecilla* and agent and extent of operations each undertake. For instance, Chinese wholesalers could be import distributors and/or export produce collectors while Chinese retailers could be agent distributors of *cabecillas* and/or direct distributors of imports. Despite the secrecy recognized in the literature, the latter nevertheless observes strict adherence of agents to settle credit obtained from the *cabecilla*. This underscores the strength of implicit sanctions. That is, agents of Manila retail shops had to settle cash payments on a weekly basis such that prices on Sundays were observed to be reduced so that price-elastic demand would result in the desired volume of sales[3] (Wong 1999; Wickberg 1965).

Several points are underscored in this subsection. First is the existence of ethnic particularization of the principal-agent relationship between *cabecillas* and Chinese agents. The second is that inter-island trade was managed by the Chinese through a network of agents. Third, it was observed that Chinese traders supplanted non-Chinese competition. These three points are exemplified in an excerpt from the United States of America Philippine Commission (1900, pp. 441-2):

> We can now judge how it is that the Chinese were always successful in the commercial competition, which they raised in the Philippines. To put it in one word, they were successful because there exists among them a cooperative protection incapable of being destroyed either by law or by any measures, which may be taken to counteract it. In fact, they succeed everywhere in obtaining a monopoly of wholesale and retail trade, becoming by the unity of purpose which they possess the proprietors of mechanic arts and trades in the country. They lend each other cooperative aid and all work together for the same end, thus forming a vast commercial society with which it is impossible for other merchants who work separately to compete. Some foreign business houses established in Manila import dry goods from Europe and turn them over for prompt and certain sale to a small number of Chinese merchants, in whose power to collect the value of the merchandise they have confidence. These merchants divide the articles received among the shops of their countrymen and also send quantities of the goods to their principal agents in the provinces, who in turn distribute them among the different Chinese who have open shops in the towns and provincial capitals. They previously mark the prices on the articles and the shopkeepers are not allowed to reduce them under any pretext. Under this system the result is that although there may be many Chinese establishments in one town,

[3] Wickberg (1965, p. 72) cites Moya y Jimenez, Francisco de. "Las Islas Filipinas en 1882." *Revista de Espana*, 93 (1883): 189 and Blumentritt, Ferdinand. "Die Chinesen Manilas." *Globus*, 62 (1890): 100.

> the same article exists or may be secured in all of them, and the price is uniform in high and low alike and only follows a general rule, whether the article is plenty or scarce in the place.

B. Collusion among Chinese merchants

In the context of concerted action among *cabecillas*, we find that *guanxi* sanctions upheld collusion among merchants even after markets were Chinese-dominated. As early as August 4, 1628, Governor Tavora's letter to Philip IV acknowledged two significant things: (1) A network among Chinese traders through which collusion existed; (2) An enforcement mechanism existed within that network, which maintained collusion. Shirking among merchants led to *guanxi* punishment, which was identified in Tavora's account as destruction of reputation — a very valuable intangible resource. The close-knit nature of networks facilitated reputational effects and hence, destruction of reputation was a credible threat. In particular, Governor Tavora (1903-1909, p. 250) described merchant collusion as follows:

> As they have control of all the merchandise, trading, gains, and mechanical trades of the country, their extreme readiness to scatter bribes is remarkable. There is no Spaniard, secular or religious, who obtains his food, clothing, or shoes, except through them. Consequently, there is scarce a Sangley[4] who does not have his protector. Among themselves they have great system and energy in all those of one trade acting together in all matters that affect them. They guard one another against the Spaniard to such an extent that, if I wish to change my shoemaker, I will not be able to find among all those engaged in that occupation another who will sell me a shoe. If anyone would dare to do so, the others upon his return to China would bring suit before their mandarins, and thus they would destroy him and all his relatives.

In July 7, 1741, Justice Enriquez reported that Chinese merchants acted in unanimity in setting the same price for their merchandise so that a monopoly was observed and 'it was not because the natives were not useful but because the Chinese confederated among themselves so that they did not mind losing a thousand pesos to bankrupt a few men who tried to get into a new business' (Diaz-Trechuelo 1966, p. 196).[5]

[4] "Sangley" is a colloquial reference to a Chinese person.

[5] Diaz-Trechuelo (1966, p. 196) cites Manila, July 7, 1741, Archivo General De Indias 202.

This is indeed very significant documentary evidence because it explicitly described details of concerted action by merchants and the enforcement against deviance.

In the account of Manuel Bernaldez Pizarro (1903-1909, pp. 228-9) in April 26, 1827 on the needed reforms for the Philippines, the way the Chinese conducted business was also described. Below is Emma H. Blair's annotation on the account.

> Their method of doing business is explained-practically the same as is done in the United States at the present time; united capital and effort, division of the gains accordingly, quick sales and small profits, etc. They have obtained the exclusive retail trade in Manila, and a great part of the wholesale trade, 'and thereby have aroused the hostility of corporations and private persons, notwithstanding that they are a class of peaceable and industrious people in the country.'

Sowell's (1983, p. 46) contemporary work corroborates Blair's recognition of the parallel between Chinese organization in the Philippines and that of the United States. Sowell makes reference to the existence of an organized Chinese community in the United States akin, in turn, to what was in operation among overseas Chinese in Southeast Asia. Sowell describes that the community, which was known as the Six Companies or The Chinese Consolidated Benevolent Association, was networked all the way to China and it also had enforcement mechanisms that were apart from formal institutions in mainstream society. The Six Companies was an enclosed group that functioned as a bloc.[6] In the late 19^{th} century, Lala (1899, p. 106) observed that the Chinese in the Philippines indeed paid attention to protecting themselves through their own guilds, secret societies and courts. Incidentally, Blair noted this observation and referenced Lala in his annotation (Bernaldez Pizarro 1903-1909, p. 231).

Translating from Lannoy's 1849 work, Wickberg (1965, p. 74) cites another set of interesting specifics on how the Chinese merchant cooperation worked.

> There prevails a broad unity of purpose among the Chinese merchants, who act in concert so as not to compete with each other in the purchase of merchandise from Europe, which they divide among themselves, and give to those of them who, being less known, or having a more restricted scope of

[6] Sowell (1983) cites the work of Chen, Jack (1980) *The Chinese of America*. San Francisco: Harper & Row. See pp. 27-8.

business, do not enjoy the same trust in the foreign business houses.[7]

In one account, a group of Chinese textile merchants in the 1840s banded together to control prices and protect supply by standing as a bloc in bargaining with the European importers. The group operated until the middle of the 1880s (Wickberg 1965, p. 74).[8] In this case, while collusion was present, it was not permanent and did not operate in the context of a guild as it was formed and known by the 1880s. The following two accounts provide valuable information on cooperation through *cabecilla* organizations. In 1894-1895, the I Ho Chu Pu Shang Hui association was formed to mobilize a commercially debilitating boycott against a German merchant for his legal sanctions against a Chinese textile merchant for debts incurred. The association along with two other textile merchant groups — Fu Lien I Pu Shang Hui and Kuan Ti Yeh Hui — cooperated for a common emergency fund, while maintaining group autonomy. Further, *guanxi* was the factor that prevented Chinese merchants from attempting to monopolize supply or to engage in predatory price competition within the network. It also filled a pareto-improving role by ensuring that even merchants with limited scale of resources and business operations were able to benefit from network clout (Wickberg 1965, pp. 75-6).[9]

This pattern of in-group cooperation continued and was documented in the American period. For instance, in the 1920s, the grocery business of an American failed to sustain itself owing to the group advantage that the Chinese competitors used in demanding discounts from importers. The 5 to 15 percent discount the Chinese group was able to get from importers rendered the American's grocery business unviable (Harper's Magazine 1950).

[7] Wickberg (1965, p. 74) translates from Lannoy, J. (1849, p. 112) *Iles Philippines*, Bruxelles, Impr. de Delevigne et Callewaert.

[8] The specific reference in Wickberg (1965, p. 74) corrects the cited pages in Clemen118).

[9] We posit that persistence of collusion or in other words, the longevity of networks with enforcement mechanisms was not contingent on being formally organized. Collusion in the context of informal organizations was more prevalent in the exchange environment during most of the Spanish colonization period. However, in the late 19th century when Chinese traders had more space to engage and predation was alleviated to a certain extent, formal organization was possible, with its attendant advantages.

IV. The Remedy: *Guanxi* Sanctions

Even in the event that effort is observable, the agent's commitment remains an issue owing to weak enforcement muscle on the part of the state. Appendix A presents an example of a contract design between the principal and agent where contract violation is inadequately addressed by existing formal enforcement from the state. The illustration adopts Fabella's (2009) 'exogenous cash in advance contract' for the specification of the model. Appendix B introduces *guanxi* sanctions into the model and demonsrates theoretically how such sanctions remedy inadequate state enforcement.

The *cabecilla* will prefer to operate in a strong state enforcement context because contracts are cheaper. That is, it would take a higher wage inducement for the agent to abide by the contract as compared to the wage in a strong state enforcement context. In light of weak state sanctions, *guanxi* sanctions enter into commercial contracting to fill this enforcement void. Given the enforcement picture during Hispanic times, the Chinese compensated for weak and predatory enforcement by resorting to personalistic ties (*i.e. guanxi*) in contracting. These ties carried implicit sanctions on deviant behavior. This section looks at three major points. First is the requirement of restrictedness in the network of commercial partners (*i.e.* agents and merchants). Second is a consolidated discussion of enforcement based on *guanxi* ties. Third is a discussion on the human capital implication of network restrictedness on commercial outcomes.

A. Guanxi Increases with Homogeneity

Since *guanxi* refers to personalistic ties that are particular to Chinese, the existence of *guanxi* between *cabecilla* and agent is hinged on a restricted agent pool. *Guanxi* increases upon increased particularization of relationships, which is only possible when restriction is likewise increased. For instance, we can understand the intuition behind agent pool restriction through group homogeneity. The literature elucidates the different bases of *guanxi* such as kinship, hometown and place of work (Tsui and Farh 1997; Tsui, Farh, and Xin 2000; Jacobs 1980; Landa 1981). With respect to the Chinese in the Philippines during the Spanish period, they were strongly homogenous in terms of hometown origin. That is, most migrants originated from Fujian province in China or the associated speech group, which in common parlance is referred to as Fukienese or Hokkien. Outside the unit of family, identification with locality of origin or hometown figures strongest as the basis for *guanxi*. The more homogenous the group, the more particularized personal ties are and hence the stronger *guanxi* is and in turn, informal sanctions (Landa 1981). The less restricted the group, ties become less personal, which decreases the effectiveness of sanctions based on *guanxi*. Chinese in the Philippines, at the onset of the 19*th* century, were highly homogeneous. Migrants from Fujian province possibly made up the majority of the Chinese population in the Philippines. This is also consistent with the fact that the junks bound for the Philippines sailed from Quanzhou or Xiamen, both located in Fujian. The Cantonese, who became part of the Chinese community after 1800, did not substantially alter the Chinese ethnic composition. It is worthy of note that these Chinese who did not originate from Fujian or did not belong to the Hokkien-Chinese speech group, organized their own homogeneous communities (Wickberg 1965, p. 38; Chu 2012). Chinese immigrants maintained their local identities owing to entrepreneurial motivations (Wang 2003), affinity to their culture (Bernal 1966) and the desire to return to their homeland (Pomerantz and Topik 2005).

B. Guanxi Ties and Enforcement

In contextualizing the enforcement feature of *guanxi*, reciprocity is an important tenet, which refers to 'the give and take of objects, favours, obligations, debts, responsibilities and loyalties.' Expected actions are at times well specified but often they are implicit and 'felt' (Hodder 1996, p. 52). In the sense of Albert Hirschman's (1970) concept of 'exit' and 'voice,' sanctions can be in the form of disgrace and blacklisting, respectively (Wong 1999). These measures, while not sponsored by the formal state enforcement apparatus, constitute viable punishment or retribution that can even be graver than formal punitive action. Amyot (1973, p. 66) for instance aptly describes that 'a Chinese dares not betray this trust or else he would be cut-off from all business associations should word get around.' Amyot (1973, p. 119), further shares an interesting statement from a respondent in his research on familism among Manila Chinese. The respondent relates that his preference for working with his brothers is due to trust. He says that being swindled and getting away with it is not possible since his brothers are "tied" to him.

It is important to underscore that in context of reciprocity, sanctions simply exist as the other side of trust. When a commercial relationship is contingent on *guanxi* ties, the betrayal of trust is tantamount to a consequence. Weightman (1960) points out that a Chinese merchant with a good record would enjoy the ease of accessing loans from fellow Chinese but would suffer sanctions if he departs from uniform pricing and does not adhere to agreements.

Aside from informal sanctions such as disgraced reputation, which is facilitated through word of mouth throughout the network, it is worth noting that in the American period, while the possibility of litigation became a viable avenue for enforcement, it was seen as a last resort. The less restricted particularization of business partners even among Chinese makes it more difficult to employ informal means as sanctions against violation of agreements. In addition, the American period saw the increased use of promissory notes and guarantors (Wong 1999). A resolution in 1934 for instance, was circulated in Chinese business circles in the Philippines. It detailed the sanctions against Chinese merchants who were deemed to have purposely avoided the settlement of credit. Not only were names and photographs spread throughout business networks in the country, the individuals were also blacklisted (Wong 1999). Several points deserve attention. First, the nature of associations has evolved from how they were described in section III.B. There is more organization not just in terms of facilitating cooperative action but also carrying out sanctions on erring members. Second, betrayal from erring merchants in the network is not just felt by the aggrieved parties but also by others in the network. The non-aggrieved parties in the network derive disutility from knowing that they exerted cost in keeping agreements while others break them. In this light, carrying out sanctions now draws from a community motivation. Related to this, the detection of deliberately trying to escape obligations compounds the gravity of the sanctions owing to relational dimensions such as the absence of sensitivity and empathy. Third, litigation, although in consonance with state enforcement, is still done in consideration of the community's effort to resolve the concern.

C. Human Capital Implication of Network Restrictedness

As Haley, Haley and Tan (2009) posit, the Chinese face competitive disadvantages associated with a restricted pool. These include competency restricted to the home turf or the home market only; lack of checks and balances; proprietary capabilities, family limits and lack of professionalization. However, the interesting context of Chinese traders in the Philippines during the Spanish period shows the opposite. Given the particularities of the period, the Chinese derived the most advantage when the pool was absolutely restricted. As the agent pool becomes more restricted, human capital increases, which in turn results in a positive effect on revenue.

This essay recognizes an insight from Lim (1983), that ethnicity is irrelevant between the top and bottom levels of the economic structure. However, in the middle level of SMEs engaged in commercial and relatively simple industrial activities, ethnicity becomes important. The Chinese predicament during the 16^{th} to 19^{th} century period in the Philippines fits this context. In terms of the index of restrictiveness, we see that the *cabecilla* would have the most advantage in relying on agents who were all Chinese. In the middle level of economic activity, more resources are required. Economic agents in the bottom level without resource access or a conduit such as *guanxi*, which also facilitates access to capital, credit, technology, find it difficult to enter into the middle level. This difficulty was the experience of the indigenous population. The transition from the middle level to the higher level requires the help of foreign firms and/or the state. It is interesting to note that during the latter half of the 19^{th} century, among the Chinese, this transition is best investigated in the context of taipanism. Although this is beyond the scope of this study, documentary evidence show that major commercial relationships had to be built with non-Chinese. As we will demonstrate later in the *cabecilla's* optimization problem with the *guanxi* element, we differ from Lim (1983), which considers ethnicity as a means of economic access while it is not considered an independent variable in the trader's objective function.

It is interesting to see that during the twilight of Spanish rule, the status of the *cabecilla* began to change as the economy gradually opened up. In other words, as the *cabecilla* transitioned into the top level of economic activity as Lim (1983) describes, the importance of restricting the agent pool changes. More players were required. In particular, the *cabecillas* built commercial relationships with foreign houses that allowed trade on credit while they relied on the *cabecilla's* network of collection and distribution of goods. In this sense, the more restricted the agent pool becomes, aptitude deteriorates, negatively affecting the *cabecilla's* profit. A rise in network restrictedness ambiguously affects the profit of the *cabecilla* and it becomes a challenge for the *cabecilla* to use *guanxi* discriminately.

V. Large-Scale Trade and Chinese Commercial Networks

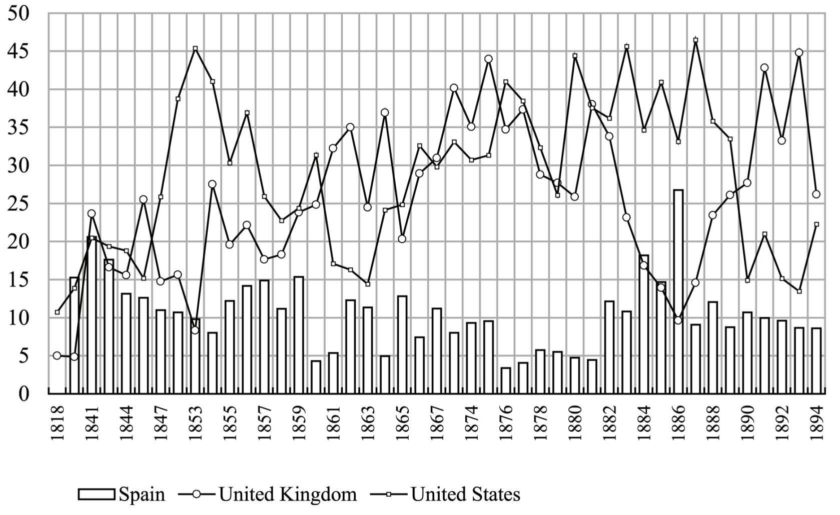
The second half of the 19th century brought a new landscape of export-import trade where wholesaling and retailing offered tremendous opportunities to traders. Foreign merchant houses entered the picture and needed a conduit to gather up export produce and distribute imports. The Chinese recognized this opportunity. Given the *cabecillas*' commercial network, moving goods was not new to them. But because the scale of operations is so much greater than before, large-scale credit was crucial. Even without collateral, *cabecillas* were given access to the import-export business in partnership with foreign merchant houses due to the widely recognized Chinese commercial networks. In other words, these trade networks tipped commercial advantage towards *cabecillas*. And it is in this particular sense that these networks were essentially perceived to constitute the major requirement[10] in the granting of large-scale credit.

The first subsection below establishes the increased commercial traffic as a motivation in the changing demands of business operations. The second subsection gives attention to the role of large-scale credit in the new commercial picture. The last subsection explores the significance of Chinese networks in the import-export trade.

A. Foreign Merchant Houses and the Commercial Traffic

To demonstrate commercial traffic through foreign merchant houses we use export data from Castro (1982). Figure 1 shows that in the beginning of the 1840s until the end of the 19th century, British and American houses cornered Philippine exports while the Spanish in the Philippines suffered a decreasing share in the export pie. The data confirm the observation of MacMicking (1967) in the second half of the nineteenth century that Spanish export commerce lagged behind that of foreign houses. To appreciate what specific commodities were most significant, Figure 2 presents export data on the top two export produce of the Philippines — abaca and sugar, which constituted the majority of the entire basket of exports. Data in Figure 3 show the share of England and the United States in raw abaca exports while Figure 4 shows the country shares in

[10] Widespread commercial networks became the major consideration for the granting of credit, which is analogous to collateral in a conventional context. In other words, Chinese networks were valued as 'currency' by foreign merchant houses and in this particular context are these networks referred to as 'collateral substitutes.'

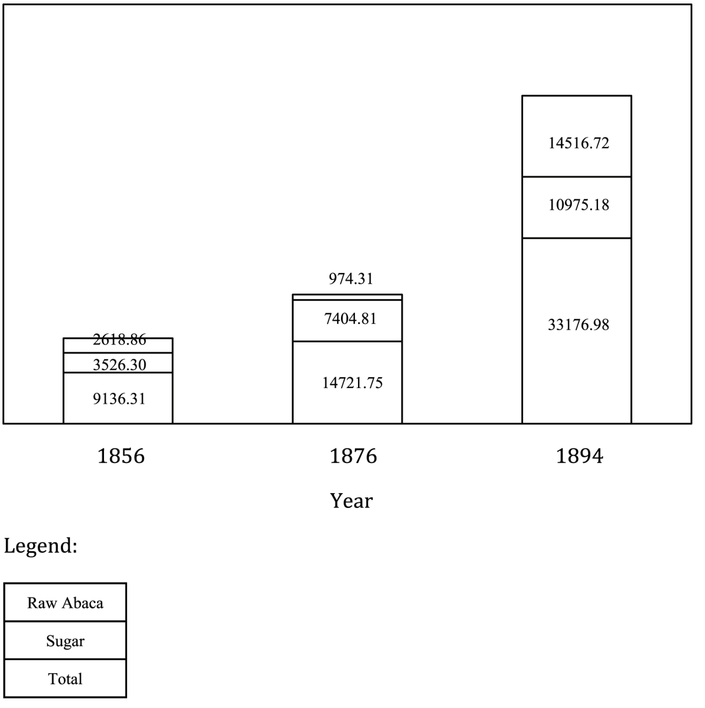


Source: Compiled from data in Legarda (1999).

FIGURE 1
GEOGRAPHIC DISTRIBUTION OF PHILIPPINE EXPORTS, 1818-1894
(% OF TOTAL EXPORTS)

sugar exports. Taking Figures 2-4 together, we find that where abaca and sugar were concerned, England and the United States dominated for many years. At least in raw abaca exports, the domination was until 1894 when the United States' share exceeded that of England. In regard to sugar exports, both countries were front runners until 1876. In 1894, while the U.S. was not listed for sugar exports in Castro's (1982) data set, the general pattern for 1894 remains. That is, non-Spanish houses and Western houses in particular, were the leaders in percentage shares in sugar exports.[11] Hence, on the part of the Chinese, the ability to secure deals with non-Spanish houses and strategically, with British and American merchant houses, for many years was advantageous in cornering a bulk of the wholesale and retail market.

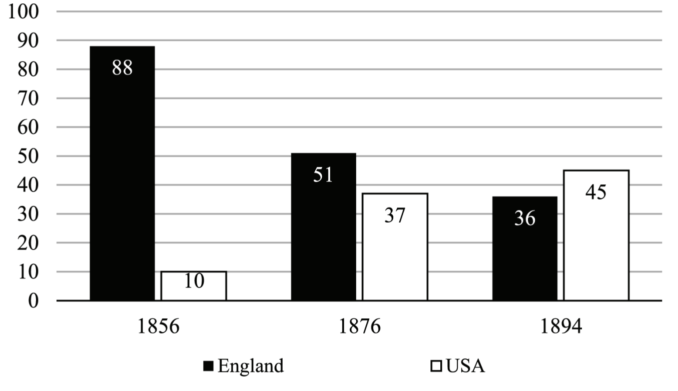
[11] Clemente (2010, p. 115) cited the substantial combined shares of England and the U.S. in sugar and raw abaca exports for the years 1856, 1876 and 1894. The combined shares are 56.9%, 67.4% and 48.46%, respectively. We correct the share attribution for 1894. That is, in Castro's (1982) data for 1894, the U.S. is listed as the top exporter in raw abaca *but is not listed for sugar exports*. Nevertheless, the material point remains that non-Spanish houses, in particular, Western countries, still cornered sugar exports in 1894.



Source: Castro (1982).

FIGURE 2

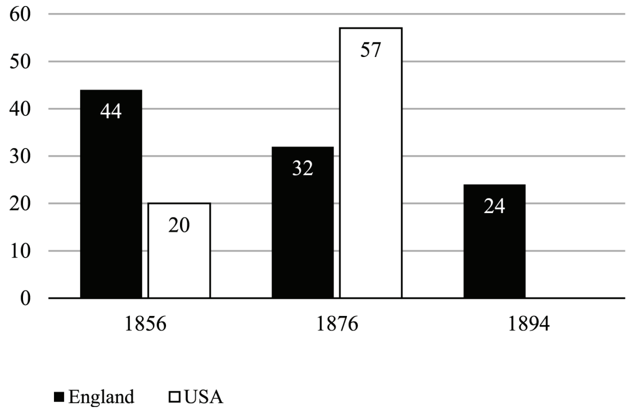
TOP TWO PHILIPPINE EXPORTS, 1856, 1876, 1894
(IN MILLIONS OF PESOS)



Source: Graph constructed from data in Castro (1982).

FIGURE 3

COUNTRY SHARE IN RAW ABACA EXPORTS, 1856, 1876, 1894 (%)



Source: Graph constructed from data in Castro (1982).

FIGURE 4

COUNTRY SHARE IN SUGAR EXPORTS, 1856, 1876, 1894 (%)

B. Role of Credit in Large-Scale Trade

A hallmark of the latter half of 19th century commerce was the necessity of substantial credit in facilitating the breadth of operations in large-scale wholesaling and retailing. In MacMicking's (1967, pp. 18-9) account below, the Chinese discovered the advantages of bulk-buying, which in turn was made possible by credit access.

> There is another advantage which the Chinese have found from the system they pursue—that large purchases of goods from the merchants who import them for sale are frequently able to buy them for less money than those smaller traders who are not in the habit of making purchases to the same amount from the importers—as the credit of a small dealer is not sufficiently good to induce a merchant to sell them more than he imagines he is likely to be paid for.

It was during this period that the Chinese trader transitioned into being large-scale wholesalers and retailers. As Bowring (1963, p. 111) aptly observed:

> Of late, however, many are merging into the rank of wholesale dealers and merchants exporting and importing large quantities of goods on their own account, and having their subordinate agents scattered over most of the islands.

When Europeans and Americans established mercantile houses in the Philippines, two major changes happened. First, the no-credit regime that the Chinese had to endure before 1850 became a thing of the past. Second, the foreign houses drew from their connections with international financial centers, thereby accessing a large amount of capital. In June 26, 1899, R.W. Brown, an agent of Chartered Bank of India, China and Australia, revealed that foreign banks eventually set up shop in the colony as they recognized the commercial potential in the archipelago. These banks provided financial intermediation services for the import-export trade. R.W. Brown reported that the 'two English banks, the Hong Kong bank and ourselves' have brought funds to the Philippines from credit abroad to finance the export trade (United States of America Philippine Commission 1900, p. 201).

The foreign mercantile houses were essentially financial conduits and this was how American and British houses established firm footing in Philippine commerce. In effect, these mercantile houses introduced large-scale financing access to merchants that was a crucial competitive edge that determined supply control (Legarda 1999, pp. 256, 280, 284).[12] Notably, the Chinese were able to take advantage of this financial development. Americans were known for crop advances while British merchants were noted for making credit and loans accessible to the Chinese (Wickberg 1965, p. 71; Legarda 1999, p. 283). Western business firms also became co-signees or guarantors but they also granted credit or cash to Chinese merchants without requiring collateral. Promissory notes were likewise not required at times (Wickberg 1965, pp. 69-71, 80). In this sense, the Chinese struck agreements on the basis of trust. Formal paper work was merely a supplementary measure and more of a reflection of procedures.[13]

With the need for external financing, the Chinese needed to develop relationships with strategic non-Chinese parties. Repeated transactions facilitated the building of trust capital. Since ties that are bound by

[12] See the entire discussion in Legarda (1999, pp. 255-89), which provides details on how foreign merchant houses operated.

[13] In Wong (1999, pp. 121-41) and Landa (1983, pp. 90-5), useful details on credit practices, for instance, within the Chinese community are respectively documented in early 20th century Philippines and late 20th century Kuala Lumpur and Singapore. It is of curious note that contemporary patterns of cooperation and informal sanctions are consistent with cooperative scenarios in Spanish colonial Philippines except for the availability of large-scale capital for the Chinese before the mid 19th century.

TABLE 1
LIST OF FOREIGN MERCANTILE HOUSES IN THE PHILIPPINES, 1850

British	American	German and Swiss	French
Butler, Sykes & Co.	Peele, Hubbell & Co.	Peter Jenny & Co.	Augusto, Van Polanen Petel & Co.
Holliday, Wise & Co.	Russell, Sturgis & Co.	Peters & Co.	J. A. Guichard & Sons
Ker & Co.		Eugster, Labhart & Co.	
W.R. Patterson & Co.			
Martin, Dyce & Co.			
Constable, Wood & Co.			
Philips, Moore & Co.			
B.A. Barreto & Co.			

Source: Diaz Arenas, Entrega 5 as cited by Netzorg in MacMicking (1967, p. 167).

kinship or ethnicity were absent, the following factors contributed to the contract enforcement. First is the value of 'face' among the Chinese. Based on his experience as Governor of Hong Kong, Bowring (1963, p. 112) astutely observed the Chinese in the Philippines and related that, 'the Chinese religiously respect their written, and generally their ceremonial, engagements — they lose face if these are dishonoured.' Second, the small community of foreign merchant houses increased the severity of losing face, which can result in being blacklisted. Table 1 gives the list of foreign business houses in Manila in 1850.

Given the traffic that was present in the commercial scene of the Philippines, evidentiary support from historical accounts shows that the Chinese accessed these trade opportunities by securing credit from foreign houses. The following account by MacMicking (1967, p. 19) shows that the foreign houses transacted heavily with the Chinese on credit.

> The amount of business done by some of these Chinamen with the principal importers of manufactured goods, who are the British merchants, is very considerable, some of them frequently making monthly purchases to the extent of fifteen thousand dollars from one person, nearly all of the goods being sold to them on credits of three, four, or six months after the date of

> purchase and delivery of the merchandise. Occasionally, however, some of them break down, and those importers who have been trusting them for large amounts, of course burn their fingers; Chinamen, as a general rule, being honest and trustworthy only so long as it appears to be their own interest to remain so.

C. From Guanxi Ties to Networks to Large-Scale Trade: Exploring Further Research

The previous subsection established that foreign merchant houses engaged Chinese merchants in large-scale import-export trade. Despite the risk of non-payment, Chinese traders were still engaged by foreign merchant houses, which in turn was made possible by large-scale credit (Legarda 1999; Wickberg 1965; MacMicking 1967; Loney 1967). This section explores the assessment of Western merchant houses towards Chinese commercial networks, which proved to be valuable in deciding to engage the Chinese in trade.

Edwin H. Warner, a merchant from Warner, Barnes and Co. testified before the United States Philippine Commission in April 12, 1899 and related that the Chinese merchant 'is a very good distributor of merchandise' and acknowledges that the entire import trade 'has all been in the hands of the Chinese' (United States of America Philippine Commission 1900-16, p. 17).

R.W. Brown, agent of Chartered Bank of India, China and Australia likewise testified before the commission in June 26, 1899. Brown corroborated Warner's statement regarding the role of the Chinese in import distribution and also noted Chinese ability in commerce, which he deemed superior to that of Filipinos (United States of America Philippine Commission 1900-16, p. 204). On June 27, 1899, H.D. Jones, in-charge of the Hong Kong and Shanghai Bank, stressed how the Chinese have become indispensable in the Philippines as the entire commercial system is hinged on Chinese peddlers. He claimed that the Chinese are not only noted for their entrepreneurial importance of opening up new areas for commerce, which no other group can do. This underscored the use of a network (United States of America Philippine Commission 1900-16, p. 216).

H. Ashton, partner of Wise & Co., on the other hand, articulated in June 28, 1899, that the Chinese was embedded in the commercial linkage between the European and American importers and the indigenous population. Chinese trade provided crucial intermediation services, without which the entire commercial operations would cease to work. Ashton assess, 'If you take away the Chinese wheel in the machinery the whole thing would stop' (United States of America Philippine Commission 1900-16, p. 341).

In reply to the question by the Commission if almost the entire retail business is under Chinese control, A. Kuensle, importer of Kuensle & Strife provided in July 3, 1899, gave an encompassing answer regarding Chinese commercial activity:

> Yes, sir; and also the wholesale trade for the provinces. The firms here, with very few exceptions, only sell in Manila and to the Chinese, who are the intermediaries for the provinces. They sell wholesale to the countrymen. ... For importers and exporters it would not have been possible to do any work at all; in fact, the trade of the islands, small as it is compared to what it might be, has depended entirely upon the Chinese, because on one side they sell to the men in the interior, and barter with the natives for produce in exchange for imports-they go into the interior; they have opened up communication; you will see the Chinese hawker everywhere; he will go into the last nook and corner, and he will offer his goods and sell them, because if the Filipino sees a thing he must have it. The Chinaman is the man to develop the business. A European can not work outside here for any length of time (United States of America Philippine Commission 1900-16, pp. 228-9).

Operational advantage from Chinese networks tipped investment in favor of *cabecillas* as the network assured an efficient distribution of imported goods and an efficient gathering of export produce. It also yielded savings for the foreign houses in terms of investing resources in their own networks, agents to be stationed in the various provinces, monitoring costs, retrieving provincial market information and a host of other activities involved in wholesaling and retailing operations in the import-export trade. What this section underscores is that the commercial reach of *cabecillas* throughout the archipelago, as recognized by foreign merchant houses, was contingent on the commercial relationship between *cabecillas* and agents as well as among *cabecillas*. In turn, the commercial relationships are characterized by *guanxi*, which has resulted not only in multi-faceted commercial cooperation but also in sanctions for breaking agreements.

VI. Concluding Remarks

Existing literature on the economic success of overseas Chinese in contemporary Southeast Asia cite the use of *guanxi* as a link to pooled resources, labor market advantages and market entry opportunities (Lim and Gosling 1983; Limlingan 1986). For instance, drawing from fieldwork on Hokkien-Chinese rubber traders in Singapore and Western Malaysia, Landa (1999) develops a theory of Chinese merchant success, arguing that Chinese middlemen remedied the lack of state provision of needed infrastructure. Critical infrastructure were contract enforcement; supply of credit and information; and reduction of risks of bankruptcy. In various case studies, Chinese middlemen provided such public goods for themselves.

Guanxi remains relevant in economies with underdeveloped institutions. Where institutions are well developed, *guanxi* remains relevant but with a non-enforcement role. This implies that the application of *guanxi* as a source of informal enforcement depends on the efficiency of formal enforcement and the improvement of formal institutions of contract law. For instance, if at present, *guanxi* sanctions still constitute a robust informal enforcement mechanism just as it was during the Hispanic period, it indicates little improvement in the formal contract-enforcement institutions of the Philippines. Since present conditions, while imperfect, have improved compared to what prevailed during the Hispanic regime, there is a need to qualify the use of *guanxi* sanctions in the contemporary context.

It is important to note that the human capital trade-off in utilizing *guanxi* enforcement during Spanish times was absent. *Guanxi* entered the *cabecilla's* optimization problem through a positive human capital effect and a positive enforcement effect. But in contemporary times, the use of *guanxi* sanctions results in a trade-off. In particular, as network restrictedness increases, the gains from *guanxi* enforcement are weighed against the deterioration of the pooled human capital of agents (Lim 1983; Fabella 2005; Haley, G., Haley, U., and Tan 2009). In other words, outside the extreme conditions of the predatory exchange environment in the Spanish era, the human capital effect of *guanxi* begins to be a concern. In addition, as contract law improves and the importance of non-Chinese capital cooperation rises, the restriction of the pool of agents may not be worthwhile any longer.

The historical study shows that amidst changing institutions that govern economic activities, the utilization of *guanxi* sanctions likewise alters. The study shows that *guanxi* enforcement was successful as an informal contract enforcement solution because the sanctions against uncooperative behaviour were effective. The secret of the effectiveness of these sanctions was the fact that Confucian ethics were embedded in these strong particularistic ties. Sanctions for deviant behavior, which included destruction of reputation, loss of trust and blacklisting, were credible threats (see also Landa 1981). Further study on the workings of *guanxi* in contemporary Chinese business groups can be explored.

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Appendix A: Inadequate state enforcement against opportunism

This section adopts the model of Fabella (2009) in presenting an example of the dilemma in the *cabecilla*-agent contract. The exposition seeks to demonstrate the scenario when state enforcement is inadequate to address agent opportunism. In this light, the model dispenses with moral hazard issues.

1. Contracting parties, payments and output

The principal is the Chinese principal whom we refer to as *cabecilla*, denoted by C. The latter hires an agent A and a relationship results, which is governed by the principal-agent contract. C and A agree upon a wage denoted by w, which is to be given to A in two periods. A receives an outlay denoted by bw in the first period where b, given that $0<b<1$, is fixed and denotes the contracted proportion of w to be given as cash in advance. The payment in the second period is denoted by $w_2 = (1-b)w$.

2. Enforcement problem vis-a-vis information problem

A encounters a commitment problem that is rooted in the non-coinciding of wage payment and supply of effort denoted by $e=1$. Since A already receives an initial payment without effort supply and the resulting output delivery being required at the same time to coincide with the initial payment, there exists an inducement for A to supply effort to the next best alternative. In the event that A carries this out, effort supply is zero, *i.e.* $e=0$ and A gets a payoff of U^0 which is defined as the outsider reservation utility. Hence unenforceability of contracts does not stem from unobservable effort which would have resulted in moral hazard problems, for which incentives would be remedial. Instead, unenforceability comes from a mismatched timing of wage payment and effort supply. The weak or absent third party enforcement allows tenable contract violations. The issue here is an enforcement problem and not an information problem.

3. The agent's decision to participate

What tips A's decision to agree to C's contract if the total utility that A derives from wage payments in both periods less any disutility from supplying the effort level that the contract requires, is higher or the same as the utility that A can get from the next best alternative. If A opts for the latter, which is an opportunity outside of C's contract offer, A receives U^0, which is previously defined as the outsider reservation utility. The participation constraint is specified as follows:

$$u(w_1)+u(w_2)-v(e)\geq U^0. \tag{1}$$

where we have the additional definitions:

$u(w_1)$ = first period
$u(w_2)$ = second period utility
$v(e)$ = disutility of effort

We assume that utility from wage payment is characterized by strict concavity and are twice differentiable.

4. State retribution for contract violation

With the assumption of an existing third party enforcement embodied by the state, we provision for state retribution against contract violation. A will not violate the contract if the contract $C(w, e)$ meets the following rule:

$$u(w_1)+u(w_2)-v(e)\geq U^0+u(w_1)-\varphi R \tag{2}$$

where the last term follows this definition:

φ = likelihood of receiving state retribution
R = retribution from the state against contract violation

Note that satisfying (2) also satisfies (1). It is necessary that (2) holds if state retribution is to be effective in deterring contract violation. In addition, the expression $[u(w_1) - \varphi R]$ will exceed zero when state retribution is weak while it will be less than zero if state retribution as represented by φR is strong. Since $u(w_1)$ cancels out from (2), we have the participation constraint rewritten as,

$$u(w_2) - v(e) \geq U^0 - \varphi R. \tag{3}$$

5. *The cabecilla makes a decision and arrives at an optimal contract*

Following Fabella (2009), we specify below the optimization problem that C attempts to solve by offering A the contract, $c(w, e)$:

$$\begin{aligned} &\operatorname*{Max}_{w,\ e}\ pF(e) - w \\ \text{s.t.}\quad & u(w_1) + u(w_2) - v(e) \geq U^0 \end{aligned} \tag{1}$$

or

$$u(w_2) - v(e) \geq U^0 - \varphi R. \tag{3}$$

We further denote (1) as the participation constraint in a strong state retribution context while (3) is the participation constraint that applies in the context of weak state retribution. The characteristics of the function, $F(e)$, are the same as that of the utility function with respect to differentiability and concavity.

To solve the optimization problem in the context of weak state retribution, following Fabella (2009), the Lagrangean is maximized with respect to w and e. The solution is the contract $c(w^*, e^*)$. Using the FOCs, we arrive at a positive result for the multiplier, which means that the participation constraint in a weak state retribution context strictly binds. That is, (3) holds as an equality. In the same vein of analysis, solutions pertaining to the FOCs and the multiplier under the strong state retribution context, yield the following results. The multiplier is strictly positive, *i.e.* $\lambda > 0$, and the PC strictly binds. Further, the optimal contract in the strong state retribution context is $c(w^{**}, e^{**})$.[1]

6. The optimal contract

Under weak third party enforcement, Fabella (2009) shows the following claims. First, 'for the same optimal effort level $e^{**}=e^{*}$, the wage rate $w^{*}>w^{**}$.' This shows that A is better compensated under weak governance: $U^{00}>U^{0}$, where U^{00} is the insider reservation utility. Second, 'a rise either in third party enforcement efficiency φ or a fall in R, lowers w^{*} and raises e^{*}.' This shows that the stronger third party enforcement is, the cheaper is the fixed cash-in-advance contract for C. Clearly, C would be better off with good governance. On the other hand, the weaker governance is, A is better off getting hired. Further, excessively weak third party enforcement can lead to C backing out and to the disappearance of such a contract altogether. C may need additional mechanisms to stay in business.

Appendix B: *Guanxi* sanctions as a remedy for weak state enforcement

1. Effectiveness of guanxi sanctions is contingent on a restricted agent pool

We introduce theoretically how *guanxi* sanctions augment inadequate state enforcement through the human capital and enforcement effects. The exposition begins with *guanxi* being contingent on agent pool restrictedness. In restricting the pool of agents, we adopt the framework of Fabella (2005) then we apply important modifications. Let g, given that $0\leq g\leq 1$, be the index of restrictiveness of the agent pool. When the agent pool is not restricted, $g=0$. This implies the inclusion of the entire population in the pool and in effect, *guanxi* does not exist. In this respect, incorporating *guanxi* sanctions modifies the model through an enforcement effect and an aptitude effect.

2. Guanxi is reflected in the model through the enforcement and aptitude effects

Enforcement effect

We first specify *guanxi* retribution as denoted by R^{G} as a second party enforcement remedy that the *cabecilla* uses to remedy enforcement inadequacy. *Guanxi* enables the *cabecilla* to attach implicit expectations on the agent's behavior. When the agent violates the contract by taking the initial wage payment while not supplying contracted effort, the informal second party sanction, R^G, is imposed as a punishment. R^G augments the ineffective formal legal structure in the *Parian* or in the larger Spanish rule apparatus. *Guanxi* retribution is a function of agent pool restrictiveness, which we denote as $R^G(g)$. *Guanxi* retribution increases as restriction increases, *i.e.* $R^{G\prime}>0$. *Guanxi* retribution reaches its maximum when the agent pool is absolutely restricted as expressed by $R^G(1)=\max R^G$.

Human capital effect

Following Fabella (2005), let $h(g)$ represent human capital that is a function of agent pool restrictiveness. Human capital deteriorates as g increases. The inverse relationship between human capital and agent pool restrictiveness is expressed as $h'(g)\leq 0$, where the following extremes are expressed as $h(1)=0$, $h(0)=\max h$. In other words, when the agent pool is absolutely restricted, human capital is zero. On the other hand, when there is no restriction, human capital is at its maximum. The more that the agent pool is restricted, human capital increases and hence, revenue increases. We therefore specify that $h'(g)\geq 0$, $h(1)=\max h$, $h(0)=0$.

3. *Cabecilla*'s *optimization problem with guanxi sanctions*

We modify *C*'s optimization problem to incorporate *guanxi* and specify the optimization problem, following Fabella (2005):

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

where (4) is the *guanxi* participation constraint (GPC) in the weak state retribution context.

Akin to the analysis in the previous section, we solve for the FOCs by maximising the Lagrangean,

$$L=pF(e)\ [1+h(g)]-w+\lambda[u(w_2)-v(e)-U^0+\varphi R-R^G(g)]. \tag{5}$$

$C(w^G,\ e^G)$ is the solution to the *guanxi* contract. State retribution remains weak while *guanxi* sanctions operate. The FOCs with respect to w^g, e^g are:

$$-1+\lambda[u'(w_2)(1-b)]=0 \tag{6}$$

$$pF'(e)\ [1+h(g)]-\lambda v'(e)=0 \tag{7}$$

Solving for the multiplier in (6), we find that it is strictly positive. That is,

$$\lambda=[u'(w_2)(1-b)]^{-1}>0. \tag{8}$$

This means that GPC binds strictly and holds as an equality. Akin to the analysis of the previous claims, we find that where the *guanxi* contract $C(w^G,\ e^G)$ is concerned, the agent receives his reservation utility,

$$U^0+u(w_1)-\varphi R-R^G(g)=U^G<U^{00} \tag{9}$$

where the incentive for opportunism, $u(w_1)-\varphi R-R^G(g)$, approaches zero despite weak state retribution *i.e.* low φR, and U^G approaches equality with U^0. Hence, *guanxi* has effectively taken the place of strong state retribution. To get $C(w^G,\ e^G)$, solving simultaneously for w^G and e^G from the GPC and FOCs yields $w^G=w^{**}<w^*$. Optimal effort level is $e^G=e^{**}=e^*$. As the index of restrictiveness of the *guanxi* agent pool, g, increases, R^G increases, causing w^G to fall and e^G to rise. We posit that a change in g has an unambiguous effect on the profit of the *cabecilla*. That is, a rise in g leads to a rise in R^G which in turn causes w^G to decrease, while a rise in g also leads to a rise in $h(g)$. Both result in higher profit for the *cabecilla*. This describes the historical accounts of Chinese traders during the Spanish colonial context.

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