# "ALTERNATIVE CONTRACTING FOR INFORMAL ECONOMY FINANCING "

# "ALTERNATIVE CONTRACTING FOR INFORMAL ECONOMY FINANCING"

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CONTENTS

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## INTRODUCTION

The informal economy in South Africa is a source of considerable debate. Academics and practitioners struggle to define, characterize, measure and place the informal economy in South Africa's macroeconomic picture. Despite the polemic, it is generally agreed that the informal economy is important. Every collection of ideas regarding the South African economy includes some thoughts on the informal economy. The compelling point is that these thoughts are generated in a wide variety of disciplines. The informal economy features in collections addressing economics, politics, history, urban planning and even literature.[1] Christian Rogerson and Eleanor Preston-Whyte's recent collection, "South Africa's Informal Economy", is testament to the broad application of the informal economy.

Beyond the debate of definitions and characteristics is the debate on how to assist the informal economy. Leiman suggests that one of the major constraints on the informal economy is "blocked access".[2] Blocked access refers to limited access to product and factor markets. In the case of the informal economy this reference means limited access to raw materials, skills and capital. In South Africa the limited resources directed to informal economy activity can be largely attributed to past government policies that were hostile to the informal economy's existence and development. As such, the role of informal economy development was left to non-governmental and welfare organizations.

One organization that is addressing access problems in the informal economy is the Triple Trust Organisation. The Triple Trust provides the informal economy entrepreneurs with skills and business training, access to credit, business consulting services and market access. However, the Triple Trust's credit scheme has faced some dire problems. The default rate hovers around 50% and debtor control is lacking. In order to redress these problems the Triple Trust reviewed the scheme's selection, control and contracting mechanisms. This paper reports the results of the review and subsequent adjustments.

The scheme was analyzed from its most basic components. The most basic economic block in the scheme is exchange. The Triple Trust exchanges credit with informal economy entrepreneurs, who promise a future stream of payments. The scheme was also analyzed as a selection mechanism. The Triple Trust must search for indicators that will announce credit worthiness. Finally, the scheme was analyzed as a contracting regime. The Triple Trust contracts with selected entrepreneurs. This procedure is particularly tricky in the informal economy. Portes suggests that the informal economy is an activity "outside of modern contractual relationships."[3] As such the contractual relationship between the Triple Trust and the entrepreneur required comprehensive analysis.

The tools of analysis are those prescribed by what Oliver Williamson calls *New Industrial Economics*. These conceptual devices view exchange from a perspective outside of traditional economic analysis. They address questions regarding the identity of contracting parties, the hazards involved in selection and the nature of a contract. Further, *New Industrial Economics* suggests specialized contracting frameworks for different transactions. The challenge is to apply these tools to an informal economy specific dilemma.

This opus is divided into four chapters. The first chapter introduces the informal economy with specific emphasis on the polemic of varying issues. It outlines the context within which the subsequent analysis takes place. The second chapter describes the function of the Triple Trust Organisation. The third chapter introduces *New Industrial Economics* and defines its conceptual tools. The fourth chapter uses these tools to analyze the Triple Trust's credit scheme and make recommendations for altering the scheme. In conclusion, this paper recommends a general framework for contracting between financial institutions and the informal economy.

ENDNOTES

1. See Deborah Hart in Rogerson and Preston-Whyte
2. Leiman "The Informal Sector", pg. 21
3. Portes in Rogerson and Preston-Whyte, pg. 2

# CHAPTER ONE : SOUTH AFRICA'S INFORMAL ECONOMY

## SOUTH AFRICA'S INFORMAL ECONOMY

In order to set the framework for the Triple Trust's operations, it is necessary to characterize the South African informal economy. The Triple Trust Organisation trains and services informal economy entrepreneurs, thus, the informal economy is the environment in which the Triple Trust operates. Any meaningful analysis of the Triple Trust must begin with a review of the informal economy.

The informal economy in South Africa exists. Beyond this statement there exists little agreement regarding any single issue credited to the informal economy. The lexicon for the informal economy is in constant flux. Academics, policy makers and practitioners cannot fully agree on what to call the phenomenon. Every dissertation, article and discussion regarding the informal economy begins with disclaimers, caveats and finally a definition of what will be discussed. Once defined, the informal economy must be measured. However, the same polemic exists over its size and contribution to the national economy. Current literature cites estimates between 3% and 41%.[1] The debate surrounding the informal economy's role in the national economy is equally polar, although along traditional lines. Marxist view the phenomenon as subordinate to the formal economy, neo-classicists see it as linking with the formal economy.

### Lexicon

The underground economy, the submerged[2] economy, the hidden economy, the shadow economy, the spaza economy, the informal sector, the unregulated sector or economy, the black economy and the informal economy have all been used across a variety of enterprises to describe the same economic phenomenon.

Abedian and Desmidt point out that all the terms carry some implicit value judgement. As such, they may describe different phenomena to different observers. However, they carry on to say that all of the terms elicit visions of some sort of "illegitimacy - illegality". The universal perception is that the businesses are illegal, because they are not registered. This perception opens up the category to a large number of diverse entrepreneurs and traders.

Rogerson labels the phenomenon a *process*.[3] The informal economy is a "process of income generating activities" the aggregate of which is "outside modern contractual relationships of production."[4] It is a process of production "unregulated by the institutions of society."[5] This process cuts across "the entire social structure". By recognizing the unifying mechanism as a process, Rogerson is saying that the informal economy consists of a variety of enterprises.

The Ladder Group, a South African association of organizations involved in developing the informal economy and small business, identified five levels of business that could be considered part of the informal economy. These levels are survivalist, larger survivalist, informal, larger informal and emerging.[6] These classifications include any legal status. They center on operation, location (home or other premises) and management structures. Again, the application to a diverse number of businesses is clear.

Until recently, the most widely used term for the informal economy has been the informal sector. Abedian and Desmidt suggest that the term "sector" is dubious. They define sector as "activities that have either a common nature, or are subject to the same dynamics."[7] In light of the above classifications and generalizations regarding the informal economy, the term "sector" is inappropriate. All of the authors suggest that the informal economy is diverse. The classifications offered cut across many potential industries. As such, relegating the industries to a single sector is inaccurate. Rogerson and Preston-Whyte sum it up by stating "any study of the "informal sector" must begin by barring the use of the term "informal sector."[8]

The bias for informal economy as a general term will pervade this piece. "Economy" implies a diverse arena of exchange, at both micro and macro levels. The term economy appreciates the complexities that will affect each business, as well as the entire grouping of businesses. In this way, "sector" is limiting. By selecting the term economy one recognizes that the phenomenon applies to a vast cross section of businesses, production techniques and services.

Defining the Informal Economy[9]

Defining the informal economy is slippery. The key to an appropriate definition is identifying pervadsive characteristics. However, the informal economy consists of a wide variety of businesses. As such, strict definitions will exclude businesses that rightly belong in the informal economy. Likewise, a broad definition relegates businesses to the informal economy inappropriately.

The first attempt defined the informal economy as all self employed people.[10] However, as Nattrass points out, this definition is rife with problems. She cites Davies as pointing out that this definition precludes employees of informal economy entrepreneurs, which is definitely problematic. Further, it incorrectly includes a large number of entrepreneurs in the formal economy.

Part of the problem defining the informal economy is that the definition is often used to somehow locate individuals rather than to describe an economic phenomenon. Nattrass points out that definitions of the informal economy are often used to categorize the urban poor.[11] She points out that this automatically assumes that all informal economy operators are poor. This assumption is simply untrue. Further, it is susceptible to including poor formal sector operators.

Leiman cites the International Labor Organization's definition of the informal economy. They define the informal economy as businesses characterized by: ease of entry, reliance on indigenous resources, family ownership of enterprise, small scale of operation, labor intensive technology, skill acquired outside of the formal schooling system and unregulated and competitive markets.[12] This definition is important because it pinpoints many of the micro and macro economic conditions that affect the informal economy.

Leiman continues by adding criteria for an "up to date" definition. He states that the following criteria are unambiguously characteristic of informal enterprises. They are unregistered under a companies act, serve a low income clientele, display a higher elasticity of substitution between labor and capital than in formal enterprises and perception of the owner.[13]

His final point merits expansion. He states that "if the owner of an enterprise perceives himself as part of the low income economy, as opposed to merely serving it, he is not only in, but likely to remain in, the informal (economy)."[14] The gist of this point is that an entrepreneur is in the informal economy if that entrepreneur thinks he or she is in the informal economy. He adds a corollary, a business is in the informal economy if the observer thinks it is in the informal economy. Simply put, "you know the informal economy when you see it."[15] Leiman admits that these criteria are difficult to identify, however, it is a useful in that it draws non - economic issues into the debate.[16]

Currently, the simplest and broadest definition of the informal economy is that it consists of all unregistered businesses.[17] Abedian and Desmidt point out that this definition may be problematic because it includes all illegal activities, such as prostitution and drug dealing.[18] They state that the inclusion of these activities distorts the size of the informal economy.

Rogerson and Preston - Whyte expand this definition to specify the type of illegality. They define the informal economy as all businesses that are "unregulated by the institutions of society, in a legal and social environment in which similar activities are regulated."[19] This definition limits the businesses illegality to being unregistered. This addresses Abedian and Desmidt's concern that a spaza shop in a white suburb would be considered a cafe. Businesses that require illegal activity as a necessary input, ie. drug dealing, would fall outside of this definition. These businesses are not regulated in other sectors, because they are illegal as well.

The polemic regarding the definition of the informal economy will continue, particularly as the informal economy is seen as a viable policy option for development. The challenge is to find a definition that walks the thin line between illegal and illegitimate, and also addresses the micro and macro economic variables characteristic to the system. Until such a time, Dewar and Watson sum up the debate by stating that "it is clear that an analytically verifiable definition of the informal sector still remains to be constructed."[20]

## Size of the informal economy

Attempts to measure the informal economy have produced more variation and polemic than any other informal economy issue. For policy makers and academics, knowing the magnitude of the informal economy is essential. One cannot know how to handle an issue without knowing its dimensions. However, measurements credit the informal economy as contributing from 3 to 40% of the South African GDP. Studies utilize a variety of methodologies and of course definitions, both of which provide a major bias to studies' results.

Phillipe Barthelemy provides a succinct outline of the most common informal economy measurement techniques. He identifies four basic methods: the monetary approach, the accounting approach, the labor market approach and the compound approach. Abedian and Desmidt and Hartzenberg and Leiman review Barthelemy's list of techniques.

The monetary approach measures the size of the informal economy by measuring changes in monetary aggregates over time. Unexpected changes are attributed to the informal economy. The accounting approach measures the size of the informal economy by calculating the difference between national expenditure and national income estimates.[21] The discrepancy is attributed to the informal economy by assuming that it accounts for any production over expenditure. The labor approach is a survey technique that estimates the number of individuals relying on the informal economy. The compound approach relies on a number of variables and assumptions to predict the size of the informal economy.

Both Abedian and Desmidt and Hartzenberg and Leiman[22] cite many pitfalls with these approaches. Abedian and Desmidt state that *ceteris paribus* - the common constraint when using the monetary approach - is not realistic. Hartzenberg and Leiman note that the accounting approach ignores a plethora of actual accounting practices that bias the measure. Both illuminate the fact that the labor approach relies on survey information, which inherently biases a measure. Finally, Hartzenberg and Leiman criticize the compound approach on grounds that it makes *apriori* assumptions regarding informal economy operations. Thus, it is open to systematic errors from the assumptions.

In a survey of South African estimates, Hartzenberg and Leiman cite a broad parameter of methodologies and results. The following table is taken from Hartzenberg and Leiman page 207.

| Author | Method | Contribution to GDP | Year |
|---|---|---|---|
| Abedian and Desmidt | induction | 12% max | 1989 |
| CSS | survey | 3% | 1988 |
| CSS | survey | 7.9% | 1989 |
| Kirsten | extrapolation | 6.5% | spread |
| Kantor | monetary | 41% max | 1988 |

* the CSS studies exclude white informal economy entrepreneurs

The polarity of these results indicates the potential biases inherent in the methodologies. Survey and monetary approaches have been addressed. As such, a short critique of Kirsten's and Abedian and Desmidt's models is warranted.

Hartzenberg and Leiman suggest the following limitations of the two models.[23] Both models rely to some extent on calculating the size of the available work force. As such, they must define those available for informal economy activity. In both cases, the estimates begin by defining the economically active population. The problem is those regarded as economically inactive in the formal economy may be fully active in the informal economy. Both studies exclude potential productivity by those not considered active in the formal economy. Further, they criticize Abedian and Desmidt by suggesting that their steady state equilibrium assumption is inappropriate. They suggest that, contrary to steady state equilibrium, workers do shift from formal to informal work (and vise versa) regularly.[24] Finally, they suggest that the studies are limited by the exclusion of all white informal sector entrepreneurs.

## Interaction with the Formal Economy

As with the other aspects of the informal economy, the role it plays in the national economy is hotly contested. The difference is that this debate's protagonists tend toward traditional economic poles. In this case, Marxist theorists suggest that the informal economy is a subordinated institution. Within the Neo - classical ranks debate rages regarding the informal economy's ability to link with the formal economy and expand to the benefit of both.

Marxists see the informal economy and the national economy interacting in two disparate ways. One, is described as "benign". The benign approach suggests that the informal economy has the capacity for growth regardless of its interaction with the formal economy.[25] Per the benign approach, the informal economy may interact with or be independent of the formal economy. Regardless of the relationship, the informal economy will accrue positive benefits to the participants. Critics of the benign approach claim that by interacting with the formal economy, informal entrepreneurs increase their rate of exploitation. They feel this is true because the informal entrepreneurs will be seconded by formal enterprise through subcontracting, thereby acting to lower production costs. Further, if an informal economy enterprise becomes profitable it will attract formal economy business. This process will serve to squeeze informal enterprises into low profit markets and the "poor market".[26]

These critiques form the bulk of the subordinate approach arguments, the second view held by Marxists. As suggested, the subordinate approach views the informal sector as an avenue for further worker exploitation by formal enterprises. Leiman quotes Lenin in defining the tenets of the subordination arguments.[27] Lenin states that small enterprise has three adverse results: benefits accrue to firms putting out (subcontracting) the work, it preserves conditions in the contractee's workplace which are worse than in the factory and retards the development of industry and capitalism. It is suggested that the formation of this subordinate class of entrepreneur is permanent, not transitory. Thus, by establishing small or informal enterprises to contract with larger ones, one is basically locking "petty capitalists" out of "capitalist production markets".[28] In Marxist terms, the informal economy creates a permanently subordinate class of producer.

Neo - classicists offer two disparate views of the informal - formal economy relationship. Some adopt the dualist argument. This argument suggests that the informal economy exists independently of the formal economy. The informal economy thrives, grows, produces and provides all necessary inputs independent of the formal economy. Leiman states that this position is particularly relevant in less developed economies.[29] However, he vehemently states that this situation is not indicative of the South African situation. In an more developed economy, such as South Africa's, considerable linkage is bound to exist between the informal and formal economies. Linkage refers to inputs and outputs that cross from formal to informal and vise versa.

There is considerable support for linkage theories. Rogerson forwards the idea of "flexible specialization".[30] Flexible specialization is a type of production that focuses on integrating informal economy businesses with collaborative production. The idea is that informal economy businesses would produce different inputs in a production process. Somewhere down the line, an informal economy business would assemble the final product. Rogerson states that this idea captures the "nexus of small enterprise clustering, co-operation and competition."[31] A similar idea is advocated by Theo Rudman. Rudman states that the future of the informal economy lies in centralized sub-contracting.[32] Centralized sub-contracting entails formal sector businesses "farming" out different production processes to informal economy businesses. He cites the benefits as greater agglomeration at the macro level and increased cost efficiency for the firm.

Why enter the informal economy?

If all the pitfalls suggested in the previous section exist, why do individuals join the informal economy? The Marxist interpretations paint a bleak picture for an entrepreneur entering the informal economy. Following their arguments, entrepreneurs will be subordinate, exploited workers without the protection unified bodies can offer. Under these conditions an individual would only enter the informal economy as a survival option. On the other hand, the neo - classicists arguing for expanding the informal economy, suggest that informal economy entrepreneurs stand to gain, in some cases more than in the formal economy.

The argument boils down to a question of desire: does an informal economy entrepreneur want to be in the informal economy? Leiman suggests that in many cases the answer to this question is yes. He cites surveys in which 74% of informal entrepreneurs would not leave the sector if offered a formal sector position.[33] He cites another study by Davies that suggests that, among unskilled workers, wages in the informal economy are equal to or greater than that in the formal economy.[34] This finding would support the idea that among some members of the population the informal economy may be a first choice for employment.

The other side of this argument is that people are forced to join the informal economy as a survival strategy. These individuals see no other option. They become entrepreneurs due to a lack of choices, rather than selecting entrepreneurship from a list of choices. Survivalist arguments are supported by informal economy economic phenomena such as involution.[35] Involution describes a static economy with low barriers to entry and consequentially an increasing number of traders sharing less and less profits. In this case, if an informal economy entrepreneur enters the industry, the whole industry loses profits and that entrepreneur can actually expect profits to continually decrease. Rogerson corroborates this argument by stating that in cases of low informal economy wages (which will ultimately be the effect of involution) only those on the line between survival and starvation will actually benefit.[36]

The Ladder Group reconciles these arguments to an extent. As with the other authors, they recognize the diversity of the informal economy. As previously stated, the Group classifies informal economy business into five different levels.[37] The first two levels are survivalists - these would be people setting up a small makeshift fruit and vegetable stand outside their door. They are labelled survivalists because they started businesses due to a lack of choices. They are characterized by not keeping records, no separation of home and business accounts and they would definitely accept formal economy employment. On the second tier are two levels of informal businesses - these individuals may have a larger, more successful spaza shop. They are characterized by moving their business out of the home - even if on the same premises. They keep rudimentary records and would accept only attractive formal economy employment. Finally, the Group defines an emerging business. This business is preparing to leave the informal economy. The business is considering registering, relocating to new premises and has more sophisticated internal controls. By using these definitions the Ladder Group suggests that both survivalists and entrepreneurs by choice exist in the informal economy.

## The Informal Economy's Access to Capital

Financing and access to capital has not escaped the controversy endemic to the informal economy debate. As previously stated, Leiman suggests that the informal economy may be characterized by "blocked access". Access to capital is a noted victim of this blockage. Nattrass notes the consequences by stating that a shortage of capital is a major obstacle to informal economy growth.[38] However, the desirability of financing the informal economy is not clear.

Leiman cites Marxist critiques that suggest informal economy financing subordinates the informal entrepreneur. Nattrass illuminates two cogent neo - classical critiques of informal economy financing.[39] Further, Leiman notes the high elasticity of substitution between capital and labor.[40] This fact means that for every unit of capital employed in the informal economy, more labor will be forgone than in the formal economy. The irony is that one of the merits of informal economy development is labor intensity. Nattrass suggests that informal economy businesses operate at a low rate of return and, as such, an additional burden can push marginal business into bankruptcy. Additionally, she indicates theoretical problems with credit. She states that the higher the interest rate institutions charge to compensate for informal economy risk may actually increase the level of default.[41] Practically, financial institutions highlight the risk of informal economy financing. In addition, they state that a small loan costs the same to administer as large loans, yet render less revenue.

Despite the problems with informal economy financing, many informal economy credit schemes exist. Internationally, the most heralded scheme is Bangladesh's Grameen Bank.[42] The Grameen Bank operates mainly in rural areas. It grants credit to groups of entrepreneurs. The groups are formed by individuals from varying industries, but who are from the same area. The idea is that all of the individuals in the group are responsible for loan repayment, if one person defaults the entire group must repay. Individuals are discouraged from default by "peer pressure". The real "collateral" is that individuals are from the same area, and likely to stay in the area. Individuals will be loathe to cross people they have known and are likely to deal with for their entire lives. By operating in a rural area the community tends to be static, there is not considerable migration. The Grameen Bank claims a 99% recovery rate.

One South African informal economy loan schemes operate on much the same basis. The Get Ahead Foundation, a Witwatersrand based informal economy development organization, provides financing to informal entrepreneurs through the "Stokvel Lending Programme".[43] The program mandates that individuals form groups. Get Ahead lends the groups money and the group is responsible for repaying the loan. As with the Grameen Bank, peer pressure is the incentive to make timeous payments. Additionally, as with the Grameen Bank, the individuals must come from the same area. The Get Ahead Foundation posts a 95.5% recovery rate.

One striking difference between the Get Ahead and the Grameen is that the Get Ahead operates in urban communities. This point is salient because one would expect urban communities to be in more flux than rural ones. As such, the use of peer pressure in rural areas would seem more efficacious.

ENDNOTES

1. The CSS, 1989 and Kantor respectively, See Hartzenberg and Leiman in Abedian and Standish, pg. 207

2. Shadow and submerged are from Abedian and Desmidt, pg. 405

3. Rogerson and Preston - Whyte "South Africa's Informal Economy: Past, Present and Future" in Rogerson and Preston - Whyte, pg. 2

4. Ibid

5. Ibid.

6. Minutes from the Ladder Group meeting at Guarantee Trust, Sandton City, South Africa, August 15 1990

7. Abedian and Desmidt, pg. 405

8. Rogerson and Preston-Whyte, "South Africa's Informal Economy: Past, Present and Future" pg. 2

9. For purposes of this paper a strict definition of the informal economy is not required. However, the systems introduced assume the informal economy is characterized by low barriers to entry, exists on a low capital labor ratio, utilizes basic technology per industry standards. Further, it may be

characterized by Rogerson and Preston - Whyte's definition.

10. Nattrass pg. 217

11. Nattrass, pg. 218

12. Leiman, pg. 1

13. Leiman, pg. 2

14. Ibid.

15. Leiman, Interview

16. Rogerson suggests that research in the informal economy requires imagination beyond economics.

17. Hartzenberg and Leiman use the definition "all economic activities pursued without the sanction of the authorities."

18. pg. 405

19. Rogerson and Preston - Whyte "South Africa's Informal Economy", pg. 2

20. Dewar and Watson in Rogerson and Preston - Whyte, pg. 182

21. Abedian and Desmidt, pg. 409

22. See Abedian and Desmidt, pg. 407 and Hartzenburg and Leiman, pg. 200

23. pg. 209 - 10

24. The Ladder Group fully supports this concept. They state that at the survivalist level, if an informal economy entrepreneur is offered a job, he or she will accept it and exit the informal economy.

25. Leiman "The Informal Sector", pg. 10

26. Nattrass, pg. 224

27. Leiman "The Informal Sector", pg. 13

28. See Nattrass's reference to Le Brun and Gerry, pg. 224

29. Leiman, Interview, March 23 1992

30. Rogerson "Policies for South Africa's Informal Economy" in Rogerson and Preston-Whyte, pg. 216

31. pg. 216

The type of "clustering" Rogerson refers to is already occurring at Small Business Development Corporation "hives"

32. Theo Rudman, informal economy presentation. The Mobil Centre, Cape Town, South Africa, March 23 1992

Mr Rudman is executive director of the Self Employment Institute, which trains informal economy entrepreneurs in business skills.

33. Leiman "The Informal Sector", pg. 5

Leiman goes on to qualify his findings by reiterating that these findings were among informal economy entrepreneurs, not among the population as a whole.

34. Ibid pg. 4

35. Hartzenberg and Leiman suggest involution is a characteristic of the informal economy, pg. 193

36. Rogerson and Preston-Whyte, "Informalization ..." in Rogerson and Preston-Whyte, pg. 225

37. Definitions are from the Minutes of the Ladder Group meeting in Sandton, South Africa, August 15 1992

38. Hart in Nattrass, pg. 221

39. pg. 223

40. Ibid pg. 1

41. This critique is the basis of Akerlof's "Lemon Principle" which is discussed in chapter 4.

42. All Grameen information is from Harper and Soon, *Small Enterprise in Developing Countries: Case Studies and Conclusions*

43. Get Ahead Foundation information is from the November 1989 Get Ahead Foundation Newsletter.

# CHAPTER TWO : THE TRIPLE TRUST ORGANISATION

THE TRIPLE TRUST ORGANISATION[1]

The Triple Trust Organisation (TTO) is a non - profit company that trains and services informal economy entrepreneurs. The TTO provides skills and business training, provides trainees with capital equipment, helps informal economy entrepreneurs operate their business and offers businesses market access. The goal of training is to help the unemployed poor earn a living through self employment. The TTO directs it's programs at "survivalist" and "informal" level businesses.[2] As such, all the programs described in this chapter are for those who are self employed due to a lack of choices and informal economy businesses that have enjoyed a modicum of success.

The TTO began in 1988. It was the vision of James Thomas, current managing director. Mr Thomas was a training manager for the clothing industry. When he was called up for military service camps, he filed for and received conscientious objector status. In lieu of military service, Mr Thomas was seconded to the Department of Manpower to assess and certify corporate training programs. In addition, he had to evaluate and audit grants given by the Department of Manpower for job creation. During this time, Mr Thomas noted that the training programs were too short, were prone to systematic failure and were not holistic, thereby ignoring necessary areas of training. In addition, he noted that labor demand was waning and that the training organizations were making no provision for self employment. Following his stint with the Department of Manpower, Mr Thomas started Trident Training to act as a consulting agency to retail companies with in - service training programs.

In 1988, Mr Thomas decided to expand Trident into the area of job creation. The greatest need for job creation was among the black[3] community. Mr Thomas founded the Triple Trust Organisation to address this need. In the early stages of the TTO Trident subsidized the TTO with the help of a government unemployment training subsidy. However, as the TTO's success grew, it became unnecessary and undesirable to be government supported. The subsidies were dropped and TTO and Trident became entirely separate enterprises.

The TTO was started with the philosophy that simple skills training was insufficient. In order to be an entrepreneur an individual had to have business skills and access to resources. The TTO was established to train individuals in low level production skills, business skills, give them access to credit and assist in marketing. After two years of operation the TTO added business assistance to the list of services.

Today, the TTO is a group of four Section 21 companies (non - profit).[4] The Neighbourhood Training Trust, the Self Help Financing Trust, the Triple Trust Community Enterprise Services and Africa Trading Co-Operative Trust. The Neighbourhood Training Trust trains unemployed individuals in labor intensive skills as well as basic business administration. The Self Help Financing Trust provides successful trainees with access to credit. The Triple Trust Community Enterprise Services assists informal economy entrepreneurs in operating their businesses by training business mentors and helping entrepreneurs complete business plans and loan applications. The Africa Trading Cooperative Trust assists by finding markets. This trust buys raw materials in bulk and passes on the savings to informal entrepreneurs. Further, Africa Trading Cooperative Trust purchases certain items made by trainees for resale.

The Triple Trust Company

The "Triple Trust" Section 21 company is a shell that holds the four other Section 21 companies in the TTO group. The purpose of the shell is to legally organize activities that affect the other entities. These activities are secretarial services, catering services, janitorial services and fundraising. Further, the "Triple Trust" shell serves to attenuate confusion regarding the company. It is easier to use one name that generally refers to the group, than to constantly refer to each company by name. This label greatly simplifies matters for funders wishing to donate to the project as a whole. Although, many funders prefer to donate to individual trusts, training centers or projects.

The Triple Trust and the other trusts are non - profit and are supported by contributions and donations. Approximately eighty five percent of the donations originate domestically. A vast majority of those are from corporate South Africa. The balance is from private citizens and foundations. Because the TTO has a close relationship with the community, the TTO does not accept funds directly from the government.[5] As previously suggested, this strategy is to prevent any contradiction, real or perceived, in services. The additional fifteen percent of funding comes from international institutions. These funds are primarily from foreign based development and welfare projects and foreign governments.

The Neighbourhood Training Trust Company

The NTT trains individuals in basic production skills and business skills. The company offers courses in sewing, knitting, flower arranging, leather works and butchery. Each course is augmented by business training. Business training introduces the trainees to basic concepts such as, working capital - and not consuming it on non - business expenses - costing, savings, planning and marketing. All the training courses are eight weeks, with the exception of butchery, which is six weeks.

The NTT operates fourteen courses at twelve centers throughout the Western Cape. The NTT currently operates seven sewing, two knitting, one butchery, one leather work and two flower arranging courses. It plans to add five sewing courses, two knitting courses, three leather work courses and one butchery course by mid year 1992. To date the NTT has trained slightly more than 3000 individuals. It plans to train 1400 in 1992. The NTT does not own any real estate. All training is done at pre - existing community centers at the invitation of the community and the centers involved. Further, all TTO trainers work in conjunction with community workers attachted to the center. The NTT provides a training service and all equipment necessary to train.

Legally, the NTT is a Section 21 company with Section 18a status. Section 18a status means that the NTT is a certified training organization. Financially, it means that all donations to the NTT are completely deductible from taxes paid, not taxable income.

The NTT structures all training courses in the competency based modular training (CBMT) framework. This training philosophy suggests that all production processes be reduced to their most essential basic tasks. For example, butchery requires cutting and sawing. During training, a trainee must attain 100% proficiency in each task and use that task to produce before progressing to the next task. A trainee can graduate once all tasks are mastered and implemented in production.

One of the problems the NTT identified with the course was that individuals were attending the course and never utilizing their skills. The NTT identified a number of contributing factors. Firstly, the NTT provided a travel allowance and lunch to all trainees. The NTT surmised that many trainees were attending the course simply to have lunch and earn the allowance. Considering the opportunity cost to an unemployed individual, this assumption is not unwarranted. Secondly, the NTT felt the individuals did not perceive any benefit since they did not pay anything to attend the course. Thirdly, business skills and training were not emphasized sufficiently.

To combat these problems the NTT removed the travel allowance and lunch incentive and instituted a forty Rand course registration.[6] Developmentally, the registration serves to attenuate trainee dependence on the TTO. In addition, the NTT reorganized the course to include more business activity. The course requires each trainee to sell what he\she produces. In the latter four weeks of the course (regardless of whether it is a 6 or 8 week course) the trainees must buy their own raw materials. They purchase these materials on a "temporary credit" scheme. Temporary credit is a scheme by which trainees are given credit for relevant raw materials. The trainees use the raw materials to make finished goods and sell those goods. The trainee must repay the temporary credit in order to get more raw materials. Trainees only get temporary credit during training.

Each trainee is also versed in basic business skills with the business game. The NTT has developed a business game (the Game), a role play, to train basic business skills. The NTT operates the business game for 2 hours biweekly for each training course. The Game is interactive and is facilitated by the trainer and a mentor trained in operating the game. Each trainee is given a "loan" to start a business. The trainee buys raw materials and produces. After production, they sell and can use the money as they please. The trainer suggests using some of the money to buy more raw materials, paying off the loan, saving some and of course allocating some to family expenses. As the course and the Game progresses the trainees are faced with more difficult choices. Trainees are faced with unforseen contingencies, choices of markets and must pay an increasing number of monthly bills. The Game is operated in a controlled environment, however, it is useful for disseminating basic business concepts.

The Self Help Financing Trust Company

The Self Help Financing Trust (SHFT) provides selected NTT training graduates with credit for capital equipment purchases. The scheme does not loan capital, only capital equipment relevant to training. Each training program has a different capital equipment package. All credit sales require a R 200 deposit and are subject to a ten month repayment period.

The SHFT scheme only provides capital equipment, not capital, because of the propensity for survivalist and informal[7] level businesses to consume working capital. Only providing capital equipment attenuates this temptation for entrepreneurs. Selected sewing graduates can purchase a sewing machine, knitting graduates a knitting machine, butchery graduates a butchery pack[8], leather worker graduates a leather pack[9].

The amount of credit allowed varies depending on the equipment purchased. The knitting machine costs more than the butchery pack, thus in actuality, the knitting trainee is receiving more credit. The SHFT purchases equipment, adds 32% to the costs, this covers the costs of administering the program, and requires ten fixed monthly payments. The actual interest rate under this scheme is 2.8% monthly, 33.6% per annum[10], if payments are made diligently. Clearly, the longer the repayment period the lower the interest rate at an increasing rate. Currently, the scheme has a total portfolio of R 258 000. Of that, R 154 000 is outstanding with R 76 000 in arrears. These numbers clearly indicate problems. The TTO is painfully aware of these problems and effected the changes that are addressed in Chapter Four.

The selection process for the scheme is simple. A NTT graduate applies (see application in this chapter's appendix) and submits a R 200 deposit. The NTT manager reviews the applicant's attendance and temporary credit record. A house visit is ordered by the NTT manager. This practice was not standardized and over the course of time *de facto* fell away. In addition, the applicant is required to have three friends sign surety. From these criteria the NTT manager decides to grant or deny credit. If credit is denied, the deposit is immediately returned. If selected, the graduate receives the equipment and must begin monthly payments.

Once selected the debtor can pay at any training center or at the TTO administrative offices located at the Waverley in Mowbray, Cape Town. If a debtor defaults a TTO agent will visit the debtor for collection. Continued default is handled in the same manner. The scheme's contract makes no provision for repossession. Thus, in the case of continued default the TTO agent must repeatedly visit the defaulter. Ostensibly, in the case of default the three signing surety are meant to repay for the defaulting trainee. However, common practice is to have another trainee sign surety, a trainee that most probably has a debt as well, and is unlikely to be able to repay two debts.

The scheme's information is kept on a data base at the Waverley. The data base is actually more of a hinderance than a help. It is inflexible and cumbersome. At any given time, it could take up to twenty four hours to unearth the particulars regarding a debtor. A lacuna of information regarding individual debtors and aggregates is a major problem for the scheme.

## The Triple Trust Community Enterprise Services Company

The Triple Trust Community Enterprise Services (TTCES) assists informal businesses in completing funding applications and business plans. In addition, the TTCES trains and places mentors that assist informal economy businesses in running more efficiently. These services are available to any informal economy business regardless of level.[11] It is the only TTO service that applies to businesses classified above survivalist and informal. TTCES is the youngest of TT's companies. It began December 1991, and causes Triple Trust's oxymoron.

The TTCES freely offers its services to any informal entrepreneur that solicits them. The TTCES staff helps entrepreneurs prepare business plans - mapping out the business' future - and helps them apply for loans. The major commercial credit avenue open to informal economy entrepreneurs is the Small Business Development Corporation (SBDC). The SBDC offers credit to qualifying informal economy businesses. The TTCES has in-depth knowledge of the SBDC's criteria. Thus, with TTCES guidance, an informal economy business can increase the chances of loan approval. To date TTCES has helped 45 entrepreneurs set up business plans and apply for loans.

The TTCES also operates the Community Business Consultants (CBC) program. The CBC program links trained mentors with informal economy businesses. The consultant linked with the business provides guidance in record keeping, cash and stock controls, marketing, costing and access to resources. Any informal economy business is eligible for the service at no cost.

The CBCs are trained by the TTCES staff at the offices in Mowbray. TTCES staff members introduce trainees to the informal economy, the nature of economics and business in the townships, cross cultural communication, basic business analysis and making business plans. After training the mentors are linked with informal economy businesses desiring the service.

To date 200 mentors have been trained. They have linked with 75 businesses. TTCES attributes the large discrepancy in these figures to the fact that the course is only 1 year old and that early participants were "gatekeepers". Early participants on the course came to assess the course for its merit, as well as, to set the groundwork for groups in the future. As of last August, the number of active CBCs per course has increased at an increasing rate.

## The Africa Trading Co-operative Trust Company

The Africa Trading Co-operative Trust (ATCT) buys raw materials in bulk and passes on the bulk savings to township producers. In addition, ATCT does market research for possible products and buys back and resells selected items produced by NTT trainees. ATCT also provides purchasing and warehousing for the other TTO companies.

ATCT was part of Mr Thomas' original vision. He saw that training individuals, but giving them no access to markets or materials, was tantamount to not training them at all. ATCT was developed to address the problem of access. For most township producers, the closest outlet for raw materials was in the Northern industriam or in Mitchell's Plain. Further, it is extremely difficult and costly for township producers to search for buyers outside the townships. ATCT is located in the Airport Industria. It is adjacent to Nyanga and easily accessible from other townships. ATCT is one of only two marketing operations directed at assisting informal economy entrepreneurs.[12]

ATCT buys fabrics, cotton, bobbins, other sewing paraphernalia, yarns, knitting accoutrements, raw leather, leather intermediate goods and leather paints. All of these goods are purchased in bulk, and the savings passed on. In addition, ATCT has set a network with local cut - make and trim operations for *lappies* - small off cuts. ATCT sells bags of *lappies* to township sewers. Thereby, providing an inexpensive, high rate of return source of raw materials. In fiscal year 1991, the ATCT purchases R 650 000 worth of raw materials.

ATCT also buys back certain goods produced by trainees. ATCT has an extensive market for leather goods, sewn toys and sheepskin slippers. Individuals can come to the ATCT warehouse in Airport Industria and sell ATCT finished goods that are up to standard. ATCT retails the goods for the producers. Currently, ATCT services 150 outlets country wide. Last year ATCT sold R 987 000 in total.[13]

ATCT provides essential services for other TTO companies. ATCT warehouses all of the raw materials necessary for training, save butchery and the capital equipment sold by the SHFT. In addition, ATCT is a purchasing agent for these two companies. ATCT purchases all of the training equipment for NTT and the capital equipment sold by the SHFT. ATCT is a necessary entity for temporary credit. In order to make temporary credit more "realistic", any trainee who makes a product marketed by the TTO during temporary credit may sell the product to the ATCT at the warehouse. The trainee is involved in a direct market exchange replete with quality standards and allocation choices - the trainee may immediately purchase more raw material from ATCT.

The TTO takes a holistic approach toward informal economy development. Every company is an essential cog in the TTO system. None-the-less, the remainder of the chapters focus on the SHFT and to some extent the NTT system as examples of contracting in the informal economy.

ENDNOTES

1. I owe many thanks to the management and staff of the Triple Trust Organisation for the information contained in this chapter. The information is from interviews with: James Thomas, Managing Director, Margaret Mallows, General Manager, Kirsten Kennedy, NTT manager, Don Shay, CBC manager, Vuyani Ncguka, Carol Bower, ATCT manager, Jill Ritchie, fundraising manager and Michelle Wrensch, financial assistant.

2. See The Ladder Group's classification's in Chapter 1.

Directing programs at the lower levels of informal economy businesses acts as an internal selection device, thereby restricting TTO's services to the target community.

The services provided by the TTCES are an exception that will be addressed in this chapter.

3. In the loaded political jargon of South Africa, black refers to all population groups except white.

4. Originally there were three, thus the Triple Trust.

5. The TTO received a Development Bank of Southern Africa (DBSA) loan to assist the SHFT and the ATCT. DBSA is a parastatal organization, thus the TTO indirectly received government money. However, the TTO practice is not to receive any direct government funding.

The TTO is changing its attitude towards government funding as the government changes its attitude towards democracy and development.

6. The average cost to TTO per trainee is R 1 200.

7. See Chapter 1 for the ladder group's classification of informal economy businesses.

8. A butchery pack consists of a knife, a saw, a cleaver, a tub, a hand mincer, a scraper, and a *steel*.

9. The contents of the leather pack are not finalized. However, it will contain leather work tools, moulds and brushes.

10. This high interest rate can be directly attributed to the size of the credit portfolio. All of the SHFT costs must be borne by a relatively few individuals. The TTO recognizes that this situation is undesirable. It would be much more desirable to have commercial institutions handle the credit. They could spread the costs and risks of informal economy credit across a vast portfolio, thereby lowering the costs. The TTO have continually lobbied commercial financial institutions to open their doors to informal economy entrepreneurs. To date, these institutions are beginning to stir. However, until they offer such a service it must be handled by interim institutions such as the TTO, which are forced to charge higher interest rates.

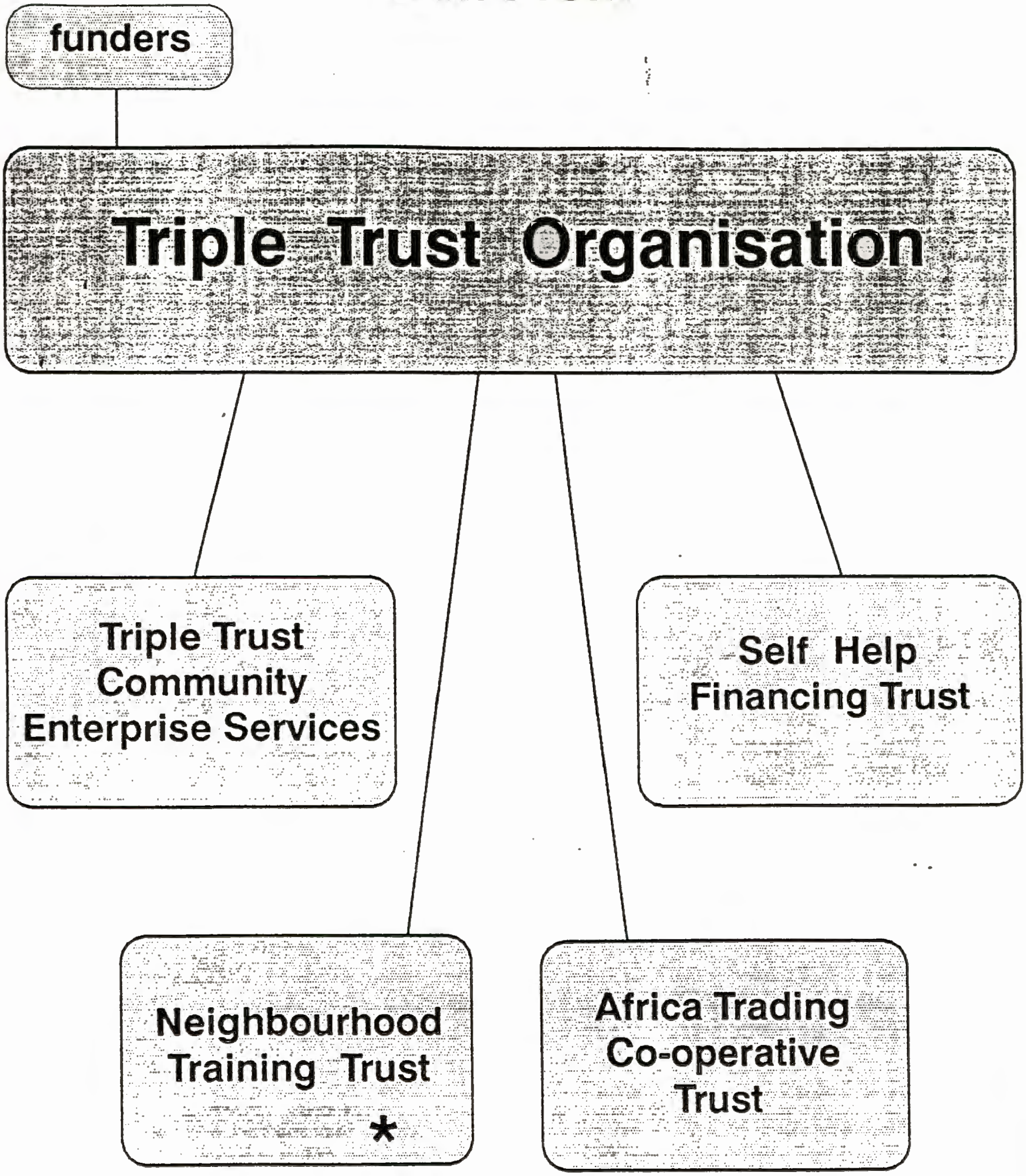
11. Level refers to the Ladder Group's classification system, See Chapter 1.

12. The Ladder Group

13. This figure includes raw materials sales, finished goods sales and equipment sales to township producers, outlets and other TTO companies.

# CHAPTER TWO APPENDIX

# Non-Profit


funders
Triple Trust Organisation
Triple Trust Community Enterprise Services
Self Help Financing Trust
Neighbourhood Training Trust *
Africa Trading Co-operative Trust

# CHAPTER THREE : INDUSTRIAL ORGANIZATION

# INDUSTRIAL ORGANIZATION

## BACKGROUND

Traditional microeconomic analysis asserts that individuals and firms decide how to allocate resources by comparing the marginal costs and marginal productivities of those resources. An individual or firm will continue to "purchase" a resource as long as the marginal productivity of that resource is greater than the marginal cost. Adherents of this approach have been appropriately labelled "marginalists"[1]. Marginalists treat individuals as "consumption functions" and firms as "production functions", what Oliver Williamson refers to as a *"black box"*[2].

Economists have challenged the view of the firm as a *black box*. Armen Alchian noted in "Uncertainty, Evolution and Economic Theory" that simple "profit maximization is not a guide to action"[3] because individual agents live in a world of uncertainty. In his 1966 Presidential Address to the American Economic Association Fritz Machlup pointed out the irony of economists who adhere to traditional "scientific methodology". He stated that "the received theory of the firm, by and large assumes that the firm does not exist."[4] Machlup suggests that the trouble with marginal analysis is that it does not realistically explain a firm's internal decision making. Therefore, he includes cogent arguments for a "behavioral theory of the firm"[5]. He suggests that a possible solution to the conflict is to merge behavioral analysis and marginal analysis into a theory of "maximizing behavior"[6] rather than simply maximizing profit. This would serve to accommodate the realism sought by behavioralist and the eloquence sought by marginalist.

The long standing *raison d'etre* of firms was challenged in 1937 by Ronald H. Coase[7]. Coase asked "why a firm emerges at all"[8]. Why is a firm necessary if the marginalists are correct and price movements regulate production ? As with Machlup, Coase questions marginalist analysis on the basis of realism.

Coase outlines a "manageable - realistic" dichotomy. Coase intimates that marginalist analysis was so prolific because it was manageable. He identifies the need for some other explanation of the firm because it is real. He states that

> "outside the firm, price movements direct production, which is co-ordinated through a series of exchange transactions on the market. Within the firm these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator."[9]

The importance of this statement is that it shows Coase recognized the need for a more sophisticated form of analysis. He explained the coordination of activities within the firm by other means than the price mechanism.

Coase replaced the price mechanism with the entrepreneur. He defined the entrepreneur as the "person or persons who, in a competitive system, take the place of the price mechanism in the direction of resources."[10] The entrepreneur would organize and coordinate a firm's activities. In *Control of Industry* D.H. Robertson likens the entrepreneur organised firm to "lumps of butter coagulating in a pail of buttermilk."[11] The compelling factor is that the firm is not organized by the price mechanism. There are other factors that bring the "lumps of butter" together.

Coase identifies factors that explain the firm "coagulating". The first deals with varying individual utility functions. He states that some individuals will simply desire to control and organize others. Others, in this case the entreprneur, will desire to bear the costs of discovering available labor supply and equilibrium price. This concept is tantamount to the entrepreneur paying a higher wage than the employee would capture on the open market. In reality the entreprneur pays the wage plus the search costs. Coase says the "cost of using the price mechanism"[12] is the main reason firms will arise. By taking on search costs - what will later be called transactions costs involved with offering a wage, entreprneurs contract employees to only perform a specific task. Thereby, employees are relieved of the need to "discover relevant prices." The result is that employees becomes specialist in the prescribed task.

Noting that the employee's task is contracted is seminal to Coase's argument. Since the task is contracted it gives the entrepreneur more flexibility to plan for the long term. Coase states, as Alchian does 35 years later, that because of uncertainty a firm will be organized by an entrepreneur rather than by the price mechanism. Uncertainty justifies long term planning, thus "a firm is likely to emerge in those cases where a very short term contract would be unsatisfactory."[13]

The concepts considered by Coase carried strong implications for the future of analyzing the firm. Coase's recognition of the importance of the contract between the entrepreneur and the employee are the roots of principal agent theory. By identifying contractual superiority over the price mechanism in long term planning Coase set the stage for Williamson's work in transactions costs and asset specificity. Coase's use of uncertainty as a tool of analysis formed the groundwork for concepts such as asymmetric information, opportunism, moral hazard and adverse selection. All of these concepts come from Coase's analysis that "a firm, therefore, consists of the system of relationships that comes into existence when the direction of resources is dependant on an entrepreneur"[14] and not simply the price mechanism.

## DEFINING THE NEW METHOD OF ANALYSIS

As indicated, the idea was widely accepted that marginalist microeconomic analysis was singularly inappropriate to explain the formation of the firm. As such, economists began to expand Coase's concepts into a coherent paradigm of the firm. Coase's recognition of the entrepreneur as an organizer of resources lead him to recognize the firm as a "nexus of contracts." A contract was the tool at the entrepreneur's disposal to ensure resources were organized as intended. The firm became the structure responsible for organizing those contracts.

In *The Economic Institutions of Capitalism*, Williamson lays out the role of the firm as an organizer of the "nexus of contracts." He identifies two distinct contractual necessities that precipitate the firm. These are incentive alignments and transactions cost.[15] As a group, he labels the these concepts as New Institutional Economics.[16]

Incentive alignments are contractual tools that encourage an individual to carry out a desired action. Incentive alignment literature focuses on two methods of encouragement. The first varies property rights assignments. "Property rights literature emphasizes that *ownership matters*."[17] Ownership entails the right to use, alter or accrue returns from an asset.[18] The importance of property rights for the firm was the suggestion that separation of ownership and control attenuates incentives. Thus, firms (entrepreneurs) must offer incentives to individuals in order to elicit desired action.

The need to elicit this action precipitates the second form of incentive alignment, agency theory. Agency theory deals with the type of incentive that must be folded into a contract in order to elicit desired behavior. Williamson notes two agency paradigms: positive theory of agency and principal agent theory. The positive theory of agency relies on market forces to mould the contract. Conditions in the labor market, capital market and information cost will shape the contract. Principal Agent theory relies on contractual mechanisms for eliciting desired responses. Principal agent theory suggests various contracting schemes for different individuals and informational situations.

Transactions cost economics addresses problems that arise after the contract has been agreed upon. It is the general problem of incomplete contracts. Transactions cost economics recognizes limited information and individual's propensity to maximize personal utility. Thus, transactions cost economics folds different arbitration structures into contracts in the case of dispute. The importance for the firm is that "bargaining is pervasive" through the life of a contract and transaction costs establishes a framework to address bargaining problems.

The different concerns addressed by these theories can be generalized by their temporal orientation. Incentive alignments address problems before the contract is executed. Transactions cost economics address problems during the execution stage of a contract. Williamson labels these stages of contract, *ex ante* and *ex post*. *Ex ante* encompasses pre-contract negotiations that establish incentives necessary to encourage expected completion of a contract. Ex Ante negotiations include the type of remuneration a worker might receive and assignment of property rights. All incentive alignments are *ex ante* concerns. *Ex Post* concerns deal with necessary contractual alignments to address conflict during the execution of a contract. *Ex Post* considerations include contractual safeguards against unforseen contingencies and "self serving activity". All transactions cost are *ex post concerns*.

## *EX ANTE* CONSIDERATIONS - PRINCIPAL AGENT THEORY

Agency theory addresses the problems involved with *ex ante* contracting. These problems include assignment of property rights and incentive contracting. In the entrepreneur lead firm the entrepreneur is assigned rights of ownership. Incentive contracting is necessary to address the problems arising from separation of ownership and control. Thus, incentive contracting is a necessary theoretical addendum to property rights assignments. As Williamson indicated, incentive contracting is addressed by principal agent theory.

Martin Ricketts states that "a principal agent relationship exists when one party agrees to act on behalf of another party."[19] Ricketts defines the agent as "a person who is employed to undertake some activity on behalf of someone else."[20] The principal is defined simply as the "someone else."[21] Steven Shavell expands the definition to include some sort of remuneration for both parties. This expansion is important because it explicitly states that the relationship is an exchange relationship. He states that the agent "receives some sort of fee from the principal" for agreeing to act on behalf of the principal."[22] Further, the principal is "the one who "enjoys" the outcome of the agent's action."[23] The breadth of these definitions makes all contracting situations subject to principal agent analysis.

Shavell's inclusion of remuneration does not explain the origin of the remuneration. Harris and Raviv extend the idea of remuneration by assuming remuneration to both parties is "determined by a function which may depend on any variable which is observable by both parties."[24] The importance of this statement is that remuneration is some "division of the (agent's) product"[25]. The fact that division must occur affects the nature of the contract, because different principals and agents have different utilities. Further, that the division is determined by an "observable variable" means different situations will warrant different forms of contracting.

Different principal and agent utilities refers to different attitudes toward risk. Attitudes towards risk have been classified by agency theorists as risk averse, risk neutral and risk preferring. Ricketts defines risk averse as an individual that "always rejects a "fair" bet."[26] By a "fair" bet he means one with an expected value equal to zero. In other words, on average the individual will not gain or lose from taking the bet. The risk averse individual will constantly abate utility by accepting more risk.

A risk neutral individual will "always accept the "fair" bet."[27] Over time an expected payoff of zero does not deter this individual. This individual is neutral as long as the average payoff, expected value, stays zero. The risk neutral individual's utility is not altered by accepting the "fair" bet. For heuristic argument Ricketts proposes the "risk preferring" individual. This individual prefers to accept the "fair" bet. A risk preference means that the individual's utility increases by accepting the "fair" bet.

The importance of these different individuals is that they will demand different types of risk allocation arrangements. Shavell and Ricketts indicate that risk averse agents will seek contracts with some sort of fixed payment guarantee. Likewise, a risk averse principal will want to receive some fixed "effort" guarantee from the agent. In both instances the principal does not want to accept any risk. A risk neutral agent or principal will accept the "fair" bet. Either will be willing to share risk with the other contracting parties, but only if the expected payoff is zero.

Ricketts explains these arrangements using the classic "sharecropping example".[28] In this example, the farmer is the principal and the sharecropper is the agent. A risk averse sharecropper would desire a lump sum payment, regardless of the amount of crop reaped. In this way the agent is protected from risk of bad weather, pestilence, etc. Equally, a risk averse farmer would demand the sharecropper to hand over a lump sum crop, regardless of the amount of crop reaped. Under this arrangement the farmer is protected from nature's risk. A risk neutral farmer or sharecropper would accept a situation whereby they received a given percentage of the crop. This situation distributes the risk of natural consequences to either one or both parties.

The contracting parties' attitudes toward risk are not the only determinants of the contract. Attitudes toward risk describe the contracting parties' preferred method of remuneration, but not the level of remuneration. Harris and Raviv stated that the division (remuneration) is determinant on some "variable which is observable". If this is the case, simply stating a risk preference does not guarantee that the contract will satisfy both parties. In order to remunerate or be remunerated in accordance with risk preferences there must be some reference to guide the level of remuneration.

In Ricketts' example, the risk averse farmer desires a guaranteed level of effort from the sharecropper. However, the farmer is unable to monitor effort with certainty. Ricketts, Rasmusen, Shavell and Harris and Raviv point out that monitoring effort is an exercise in uncertainty, because "monitoring is uncertain."[29] Rasmusen specifically labels monitoring as a "costly acquisition of information".[30] Monitoring is limited in usefulness. Thus, in Harris and Raviv's terminology effort is not an "observable variable", without informational difficulties. Since the farmer cannot base remuneration on monitored effort, the sharecropper's remuneration must be based on other factors that are observable.

The risk averse sharecropper and the farmer are seeking contracts to protect themselves against bad weather, pestilence, etc. They want protection from these circumstances because they affect output, and subsequently remuneration.[31] Agency theorists aptly call these conditions the "state of the world" (SOW). SOW are any "chance factors" that affect the agent's outcome.[32] In the case of the sharecropper, SOW is what Harris and Raviv label an "observable variable" that affects output. Since output is a direct function of SOW, remuneration can be based SOW. Harris and Raviv point out that under these circumstances contracting parties must simply agree, *ex ante, on the remuneration schedule* *for different SOW's.* Further, as long as SOW is observable risk neutral principals and agents may also contract to advantage.

The problem arises when SOW is not observable. The only observable variable is output. Under this condition remuneration must be a function of output. Holmstrom defines this situation as a "second best solution".[33] A "second best solution" is one where the principal can observe the payoff but not the agent's effort. Holmstrom calls this situation a "second best solution" because it "trades off some risk sharing benefits for provision of incentives."[34] The contract trades off risk for incentive, because a principal or an agent must be willing to accept output as the sole determinant of remuneration. For the agent this means unfavorable, albeit unobservable, SOW can negatively affect output and therefore remuneration, despite "effort". Equally, the principal cannot guarantee a level of effort from the agent. The agent could easily benefit from a favorable SOW or attribute low productivity to an unfavorable SOW.

Holmstrom labels this type of activity "moral hazard".[35] Moral hazard exists when "individuals engage in risk sharing activities and their private actions affect the probability distribution of the outcome."[36] In this case of the sharecropper, the agent or the principal can engage in activity that affects outcome. The risk of such activity must be borne by both contracting parties, even though, all the benefits accure to the one party.

Rasmusen uses a game theory approach to address the dilemma of moral hazard. He defines the principal as a "player who has a *coarser* information partition." The agent is the "player who has a *finer* information partition."[37] A *coarser* information partition simply means that the principal has less information about the agent than the agent. Likewise, the agent, with a *finer* information partition has more information about the agent than the principal. Rasmusen's rules of the game are that the principal hires the agent to a task.

Rasmusen explains two types of moral hazard. One is moral hazard with hidden action. This type of moral hazard means that the agent may partially dictate the outcome by choosing a given level of effort, with full knowledge of ability. The outcome is determined as a function of SOW and agent effort. However, since effort is unobservable the game is one of "hidden action". The second moral hazard conjectured by Rasmusen is hidden information. Moral hazard with hidden information means neither player knows the agent's ability at the outset. However, during the course of the game the agent discovers ability and uses it to partially dictate the outcome. Since the agent does not share the information with the principal it is a game of "hidden information".

Harris and Raviv offer some general contractual structures that integrate an individual's risk preference with asymmetric information.[38] They state that in general a risk neutral agent prefers any contract which depends only on output to a performance contingent contract. A risk neutral sharecropper would rather pay the farmer a lump sum of crop than have some set percentage of the crop. They also say a risk averse agent prefers to hedge risk by taking a performance contingent contract rather than one based only on output. The corollary would suggest that risk neutral principals will desire output contingent contracts and risk averse principals will demand performance contingent contracts.[39]

Holmstrom suggests one possible contractual tool to combat moral hazard. He suggests that a principal can use a "forcing contract". A "forcing contract" is a contract that "forces the agent to choose a particular level of effort by functionally attaching the level of effort to the outcome."[40] The crux of a forcing contract is that the agent "chooses" a level of effort that is congruous with a level of remuneration. An example of a forcing contract would be a principal who offers two different remuneration packages. One package offers a flat rate of remuneration, although SOW and effort are unobservable. This package is commensurate with a risk neutral principal. The second package offers an agent a nominal flat rate plus some sort of payment contingent on output. The idea is that at a given level of effort the second package is more remunerative. The principal knows that under such a scheme the agent will exert a level of effort sufficient to earn a greater remuneration than under the first package.[41]

The importance of principal agent theory to the firm is that all contracts in the "nexus" will in some way be subject to the preceding dynamics. All labor and capital employed, all purchases and sales must be considered within the framework of principal agent theory. All exchanges must contain some sort of incentive for the "agent to preform the specified task." Further, these incentives must be planned *ex ante*. In principal agent framework it is clear that information matters and that personal utilities will impact the firm beyond the consumer. All of the problems addressed are basically classified as informational. For the marginalists, it means that a combination of information and personal utility variations will drastically change the complexion of "the firm".

## CHOOSING AN AGENT - SELECTION, SIGNALLING AND SCREENING

The whole of principal agent theory relies on the type of agent with whom a principal contracts. Different agents will have varying capacities, propensities for moral hazard and attitudes toward risk (as previously stated). Spence stated that when "an employer hires an employee he is actually buying a lottery of potential outcomes."[42] The impact of the agent on the type of contract is a matter of record. The problems may be broadly defined as informational. In order to address these informational problems theorists have created an array of tools to aid principals in selecting agents.

Rasmusen defines four types of information: perfect, certain, complete and symmetric.[43] Each one of these also has a converse : imperfect, uncertain, asymmetric and incomplete. Information is perfect (imperfect) if a player is (not) in a single unambiguous position. Information is certain (uncertain) if chance does not move (moves) after any player. If information is certain all SOW are chosen before any player moves. Information is complete (incomplete) if an SOW is chosen first and is observed (unobserved) by all players. Information is symmetric (asymmetric) if any position where a player chooses an action or the final position contains the same (different) information to other players. The general case is that an agent has personal information that the principal does not. Thus, most selection tools are geared to attenuate the effects of asymmetric information.

To combat asymmetric information principals will ask agents to "signal" their type. In *Market Signalling* Spence[44] defines signalling as "adjustments an individual makes in order to alter an observable characteristic." Principals will require agents to signal, hoping to gain insight on the agent's attributes and attenuate asymmetric information. If the attribute is mutable it is a signal. Spence defines a signal as "a manipulatable observable attribute or activity that conveys information." The fact that a characteristic is mutable is vital. An agent can alter an attribute if the agent expects the principal to have an interest in that attribute. This attribute is defined by Spence as a potential signal. It is a signal which the agent thinks the principal will use. An actual signal is a signal that "actually influences the employer's (principal's) decision." Rasmusen adds an important factor to the dynamic of signalling. He states that a signal is not costless. Thus, agents must consider which signals they are willing to proffer. Further, the fact that a signal must be observable is obvious. An unobservable signal does little to attenuate information problems.

Immutable attributes are indices. Spence defines an index as an "observable unalterable characteristic." The importance of an index is that it is immutable. For a principal this means that an agent not embodying this characteristic will not be able to attain it. Indices are a more secure assessment of an agent. Agents will take note of potential indices, "any observable unalterable characteristic." Actual indices influence a principal's decision.

Jervis and Spence propose that the signal\index dichotomy may not be steadfast.[45] Jervis extends the definition of an index to include "involuntary" behavior. It is a useful and logical extension. Involuntary behavior is immutable and would serve as a useful indicator of an action. Spence lightens the definitional line slightly by saying that an alterable attribute, with an exceptionally high cost can serve as an index. Although the attribute is mutable, its high cost precludes much agent induced change. Spence suggests marital status and home ownership as mutable indices. Expanding the definition of an index is important because indices are stronger informational tools than signals due to their immutability. Thus, conceptually, Spence gives principals more reliable tools for assessing an agent.

Naturally, agents try to predict which signals principals are looking for and how they process the information. Thus, the necessity for defining actual and potential signals and indices arises. In *Market Signalling* Spence states that principals "attach certain probabilities to various possible outcomes."[46] Spence and Rasmusen[47] also suggest that a principal's belief as to which signals indicate which outcome is a function of past experience. In addition, the principal will attach a probability to the signal indicating a particular outcome. This belief is also a function of past experience.

Rasmusen carries the process a step further and suggests the use of Baye's Rule for updating beliefs.[48] Per Bayes Rule as more information becomes available individuals revise previously held beliefs. As time goes by individuals will observe signals and outcomes. They will constantly revise their previously held beliefs[49] by observing the probability of particular information foreboding an event. The importance here is that the actual value of a signal is constantly changing.

Principals use signals and indices as one method of deciding with whom to contract and how. Another device for selecting agents is screening. Joseph Stiglitz defines screening as "the identification of qualities that we know make a difference in commodities."[50] In order to screen one must have a screening device. Stiglitz defines screening devices as "devices that sort according to these qualities."[51] Signals are sought by principals and paid for by agents. Screens are set, maintained and paid for by principals. As signals are not costless for agents, screens are not costless for principals. However, the benefits will also accrue to principals.

Rasmusen delineates signalling and screening by defining screening as signalling after the contract is signed.[52] Principals screen by offering the agent some sort of package that is folded into the contract. Principals can screen by moulding a contract that will only be beneficial for agent types they prefer. Hallagan and Stiglitz call this type of contracting self selection. Hallagan uses an example similar to Holmstrom's "forcing contract". Hallagan offers two remuneration packages. In the first, remuneration is partly offered on a performance contingent basis. The other is simply a straight wage. Agents who are able to perform at a higher level will take the performance contingent contract, because it offers greater remuneration. In this way the principals screen for agents capable of better performance. The mechanism is the same as a "forcing contract". However, the ends are very different. A "forcing contract" is used to elicit a given level of effort. A self selection contract is used to screen for ability.

The importance of selection safeguards in a world dependant on contract yet subject to asymmetric information is obvious.

Without knowledge regarding the nature of an agent, the efficacy of *ex ante* contracting abates considerably. As will be illuminated in the next section, insipid *ex ante* contracting complicates the process during contract execution.

*EX POST* CONSIDERATIONS - TRANSACTION COSTS ECONOMICS

Agency theory deals with planning contractual incentives *ex ante*. Principal agent theory suggests general contracting formulae for encouraging agents to "preform specific tasks." However, agency theory does not address the contractual problems that arise during the execution stage. The "execution stage" is *ex post*. *Ex post* concerns are those that arise after the contract has been agreed upon. Transaction costs economics addresses *ex post* contracting concerns.

Kenneth Arrow defined transaction costs, the costs of executing a contract, as "the costs of running the economic system."[53] These are costs that are to be expected in the everyday functioning of an exchange economy. Williamson analogizes transaction costs to friction in the physical system.[54] Transaction costs direct the momentum of a contract and set parameters for a contract in cases of dispute. As such, transaction costs economics usurps the legal system as a means of contractual negotiation. Karl Llewellyn proposes that "institutions of private ordering are crucial to an understanding of contract."[55] By private ordering Llewellyn means the nature of the contract and the exchange it is meant to regulate. The firm will arbitrate the contract efficiently. He openly challenges the need for "court ordering". As previously ascribed to Williamson, one of the basic tenets of transaction costs economics is that the courts are not efficacious and that a strong justification for the existence of a firm is to negotiate *ex post* contractual disputes.[56]

In "What is Transaction costs Economics" Oliver Williamson notes five major characteristics of transaction costs.[57]

Transaction costs economics is "more microanalytic than other approaches." Meaning that it actually goes deeper than marginalist microeconomics, it delves into the economics of contract. Transaction costs economics is "more self conscious about its behavioral assumptions." As with agency theory transaction costs economics is very particular regarding individual behavior under varying conditions. Transaction costs economics "introduces and develops the economic importance of asset specificity." Asset specificity plays a major role in transaction costs economics and will be a major focus in this section. It "regards the firm as a governance structure rather than a production function." A canon of transaction costs economics is that the firm is established to negotiate *ex post* contractual concerns. Finally, "the firm places greater weight on the *ex post* institutions of contract, with special emphasis on private rather than public ordering." This point relates strongly to the previous one in that the firm is seen as a more efficacious means of addressing contractual dispute.

Transaction costs economics survives in the environment of contracts. In *Transaction Cost Economics* Williamson identifies the basic economic building blocks for contracts.[58] These basic units are bounded rationality, opportunism and asset specificity. Bounded rationality is "restricted cognitive competence", the inability to perceive all possible outcomes. It is the existence of bounded rationality that makes *ex post* concerns necessary. Opportunism is the "propensity to self interest seeking activity." The fact that agents will try to maximize individual utility. Finally, asset specificity is "trade that is supported by non trivial investments in transactions specific assets." Asset specificity basically means that a transaction is reliant upon an investment that may not be easily redeployed.

Asset specificity is a seminal concept to transaction costs literature. Williamson refers to asset specificity as the "fundamental transformation"[59] away from the marginalist approach of viewing the firm. Williamson delineates between different types of costs. He defines *highly specific* costs and *non specific costs*. A highly specific cost is expenditure on some good that is not easily redeployable. An example of a highly specific cost is the capital expenditure on a piece of equipment specifically designed for a business. In this case, that piece of equipment may not be easily resold, redeployed. The extent to which a cost is highly specific is that cost's "asset specificity".

The "fundamental transformation" is the fact that the buyer matters. Not just anyone will have the need for highly specific equipment. Thus, simple open market operations will not be sufficient. Williamson states that without asset specificity "spot contracting" is efficacious. A seller may go on to the market at any time and achieve a market efficient price. In this way there is no need to contract. The system works "under the iron discipline of competition."[60] However, increasing levels of asset specificity will attenuate competition's efficacy to achieve an efficient solution. In the open market, "large numbers bidding" can achieve an efficient solution. However, in a case of "bilateral" negotiation the same does not hold true. Thus, Williamson states that the "fundamental transformation" away from neo - classical economic forms of contracting and definitions of the firm "occurs in conjunction with contracts that are supported by transaction specific investments."[61]

The higher the level of asset specificity the greater will be the incentive to find efficacious resolution to contract disputes outside of the courts. Williamson refers to this idea as asset specificity encouraging *ex post* institutions of contract. *Ex post* institutions of contract are agreed upon methods that contracting parties use in case of execution stage dispute. Williamson calls *arbitration by ex post* institutions of contract "private ordering". The contracting parties are using internal methods ("private") of arbitration rather than the courts. The more asset specific a transaction the more likely "private ordering" will render an efficient solution. The idea being forwarded by Williamson is that in cases of asset specificity the firm, for economic reasons, will effectively assume the role of the courts.

From the basic building blocks of contract Williamson suggests four types of contracting processes.[62] These processes are constructed to address the problems that arise from bounded rationality, opportunism and asset specificity. The processes are planning, promise, competition and governance.[63] These processes are delineated by degree that they respond to the above mentioned problems. The following chart is taken from Transaction Cost Economics pg. 31.

Behavioral Assumptions

| Bounded Rationality | Opportunism | Asset Specificity | Implied Contract Process |
|---|---|---|---|
| 0 | + | + | Planning |
| + | 0 | + | Promise |
| + | + | 0 | Competition |
| + | + | + | Governance |

+ = behavior present to a significant degree
0 = behavior presumed absent

Types of Contracting Processes[64]

A "planning" process is effective if contracting parties have "unrestricted cognitive competence". Opportunism and asset specificity are present, however, since contracting parties can foresee all possible contingencies they may simply "plan" for those contingencies. The planning process is tantamount to perfect *ex ante* planning. The need for *ex post* arbitration is nil, because all contingencies have been foreseen and negotiated.

Under conditions where the contracting parties can be implicitly trusted (no opportunism) a "promise" is sufficient. Despite the existence of asset specificity and bounded rationality the "agent's word is as good as his bond". Thus, a promise suffices as a contracting process. This type of process will require an *ex post* institution, however, it will be self enforcing because it is simply a promise between contracting parties.

The "competition" process occurs in the absence of asset specificity. It is the mechanism of the open market. As indicated in Williamson's discussion of the "fundamental transformation", the absence of asset specificity makes open market operation efficient. Since assets are trivial it makes no difference who buys them. The competition process is simply an open market auction. As with a promise, the competition process needs only one type of *ex post* institution. In this case, the market will effectively arbitrate execution stage conflict, another buyer can easily be found.

Under conditions of bounded rationality, opportunism and asset specificity the governance contracting process will be the most efficient. In contrast to planning, the governance process must cope with bounded rationality and thus the inevitable failure of *ex ante* contractual negotiation. The governance process specifies various types of *ex post* institutions. Unlike a promise or competition contracting processes that need only one type of *ex post* contractual institution, governance contracts must provide various *ex post* contractual options. Further, these options are "private". Because of asset specificity, court ordering will not necessarily be efficacious. Clearly, governance processes are the most complex. However, they are also powerful, because they address all the problems endemic to exchange contracts.

These processes fit into three general contracting frameworks. The framework and the process will shape the type of contract.

Consequently, the framework and the process will also shape the type of *ex post* contractual institution.

Williamson labels the three general contracting frameworks classical, neo - classical and relational contracting.[65] Classical contracting is tantamount to "planning". It provides "comprehensive contracting whereby all relevant future contingencies ... are described and discounted with respect to both likelihood and futurity."[66] As a contractual framework, classical contracting does not acknowledge the presence of bounded rationality. Classical contracting disregards bounded rationality because it utilizes a "competitive *ex post* contractual institution", contingencies are left to the market for efficient contract resolution. The type of contract that would arise from classical contracting is a "contingent claims" contract.

Neo - classical contracting acknowledges the presence of bounded rationality. By acknowledging bounded rationality neo - classical contracting acknowledges the possibility of contractual dispute due to unforseen contingencies. As such, neo - classical contracting utilizes a more sophisticated *ex post* contractual institution in the case of dispute. Williamson offers three possible neo - classical responses to dispute caused by bounded rationality. One is to avoid all transactions that could hold unforseen contingencies. The restrictive nature of this option does not warrant comment. Secondly, one could avoid dispute by taking the transaction out of the market - i.e. vertically integrate. This option contains other economic trappings that restrict its applicability.[67] Finally, neo - classical contracting would suggest creating "a different contracting relation which preserves trading, but provides for additional governance structures."[68] This option fully adheres to the governance contractual process. However, it only utilizes a limited type of governance. It advocates establishing an external *ex post* contractual institution - i.e. providing for an external arbitrator in case of contractual dispute.

Relational contracting sets up contracts with the expressed purpose of building a relationship between the contracting parties. It places emphasis on the evolution of a relationship. As such, changes in contracting will begin with the relationship as a reference point. Relational contracting fully acknowledges bounded rationality, opportunism and asset specificity (this will be seen in the following paragraph). It also adheres to using the governance process for arbitrating contract disputes. However, since relational contracting establishes a relationship between contracting parties, disputes will not be arbitrated via an external party. *Ex post* contractual institutions will be incorporated into the relationship. The degree of incorporation will depend on the nature of the transactions that exist between the contracting parties. An example of a "less incorporated" relational contract is the contract that exists between a labour union and a factory. An example of a "more incorporated" relational contract is the contract between *kiretsu* companies in Japan.

Transactions that Affect *Ex Post* Contractual Institutions[69]

Williamson suggests using different contracts under different transaction conditions. He states that different transaction conditions will affect the complexity of the necessary contracts. Simple transactions will require simple contracts and complex transactions will require complex contracts. Classical contracting is considered the least sophisticated, because it relies solely on market structures as *ex post* contractual institutions. Neo - classical is more sophisticated in that it demands a specified arbitrator. Relational contracting is considered the most sophisticated, because it requires agreed upon internal arbitration that evolves over time.

Williamson identifies three parts of a transaction: uncertainty, frequency and asset specificity. Uncertainty is the lack of information in a transaction. Basically, all problems that exist in a transaction can be attributed to lack of information.

Frequency is the level of recurrence of the transaction. Asset specificity is the redeployable nature of the product in question. The nature of a transaction depends on the extent to which these characteristics exist in the transaction. Transaction complexity depends mostly on asset specificity. The more asset specific the more complex a transaction is likely to be. Asset specificity multiplies the complexity of frequent and uncertain transactions. However, an environment of low frequency or certainty abates the importance of asset specificity.

The nature of the transaction is important because as it dictates the type of contract it dictates the *ex post* contractual institution. The "simpler the contract the simpler the governance structure, the more complex the contract the more complex the governance structure."[70] The following chart demonstrates the connection between contract, *ex post* contractual institution and transaction type.

| | | Asset Specificity | | |
|---|---|---|---|---|
| | | Non Specific | Mixed | Idiosyncratic |
| Frequency | Occas | Purchasing Standard equipment<br><br>market *ex post* contractual institution (Classical Contracting) | Purchasing Customized Equipment<br><br>trilateral *ex post* contractual institution (Neoclassical Contracting) | Constructing a Plant<br><br>trilateral *ex post* contractual institution (Neoclassical Contracting) |
| | Recurr | Purchasing Standardized Equipment<br><br>market *ex post contractual institution (Classical Contracting)* | Purchasing Customized Equipment<br><br>bilateral *ex post* contractual institution (Relational Contracting) | Site Specific transfer of intermediate products across successive stages<br><br>unified *ex post* contractual institutions (Relational Contracting) |

From the table it is clear that occasional non specific purchases will require the least sophisticated *ex post* institutions. This type of purchase is tantamount to buying an off the shelf garment. The only necessary, and indeed available, arbitration are market *ex post* institutions. These arbitration methods are the domain of classical contracting. Further, recurring non specific purchases require only classical arbitration methods. Standard material can and will be sold on the open market, the identity of the purchaser does not matter. Non specific products require unsophisticated contracting.

Mixed asset specificity indicates that an alternative buyer will be costly to locate. As such the transaction will require more sophisticated arbitration techniques. In the case of occasional purchases of customized equipment Williamson suggests that *ex post* contractual alignments will be neo - classical. Williamson calls this a "trilateral" arrangement. One of the contractual options perceived by neo classicists is the provision of "additional governance structures." As such, neo classicists are prepared to introduce an outside arbitrator to the *ex post* institutional structure. The additional of another party to the table elicits the name "tri" - lateral. At the greatest level of asset specificity trilateral *ex post* contractual institutions suffice. This logic is consistent with reality. If one considers that relational contracting, the most sophisticated, is an evolutionary process, it does not make sense to establish such contractual institutions for an occasional purchase.

An environment with recurring purchases and a moderate level of asset specificity will demand a relational contract. Williamson's example is the recurring purchase of customized equipment. He suggests that the recurring nature of the transaction and the difficulty in locating an alterative buyer supports a "bilateral" *ex post* contractual institution. As the name would suggest bilateral indicates that some sort of long term arbitration structure will be set up between the contracting parties. Unlike, trilateral contracting, arbitration is only between the contracting parties. An example of bilateral structures would be negotiation channels between factory management and a representative union or the arbitration arrangements between two companies in a *kiretsu* arrangement.

A situation with recurring transactions that are highly asset specific would also merit relational contracting. However, Williamson suggests that the relationship be more sophisticated than bilateral contracting provides. Under bilateral contracting their is still an economic incentive to trade across the market interface. However, Williamson feels higher levels of specificity and occurrence attenuate "incentives for trading." Thus, he suggests developing "unified" *ex post* contractual institutions. As. the name indicates, unified contractual institutions suggest that the contract be brought under one roof. The parties are working so closely and repetitively that "a quantity of adjustments will be implemented at whatever frequency serves to maximize the joint gain to the transaction."[71] Williamson is saying that flexibility of contract warrants unifying the two parties. A clear example of a unified contractual institution is vertical integration.

Uncertainty and frequency play similar roles in determining *ex post* contractual institutions. In conjunction with non specific assets, uncertainty will play little role in determining contractual safeguards. The is because the buyer is "faceless, thus the asset is easily transferred to another buyer."[72] Therefore, with non specific assets classic contracting with market *ex post* institutions will suffice. As with increasing levels of frequency, greater asset specificity increases the hazards of uncertainty. The above chart will hold, *mutatis mutandis,* for high and low levels of uncertainty. One difference does occur in the case of little uncertainty and an idiosyncratic product. Unlike frequency, low uncertainty and idiosyncratic asset specificity will require relational contracting. In contrast to frequency, this transaction will benefit from evolution. Further, Williamson suggests that the effect of increasing uncertainty is that more sophisticated contractual machinery will be required.[73]

The importance of transaction costs economics is that it justifies the existence of the firm past *ex ante* contractual concerns. It extends the role of the firm to execution stage contractual concerns. Additionally, it demonstrates that as an organizational structure a firm can better control its contracting and therefore it transactions. All of these can be achieved by recognizing more sophisticated contracting methods than the market has to offer.

ENDNOTES

1. See Fritz Machlup "Theories of the Firm: Marginalist, Behavioral, Managerial"

2. Williamson, Oliver "The Economic Institutions of Capitalism" pg. 15.

3. Alchian, Armen "Uncertainty, Evolution and Economic Theory", pg. 111

4. Machlup, Fritz "Theories of the Firm: Marginalist, Behavioral, Managerial" pg. 10

5. Ibid. pg. 4

6. Ibid. pg. 6.

7. Coase, R.H., "The Nature of the Firm"

8. Ibid. pg. 335

9. Ibid. pg. 333

10. Ibid. pg. 333

11. D.H. Robertson from Coase, pg. 333

12. Ibid. pg. 336

13. Ibid. pg. 337

14. Ibid. pg. 339

15. See pp. 26 - 9

16. Ibid pg. 26

17. Ibid pg. 27

18. Ibid

19. Ricketts, Martin, "Transactions Costs" pg. 117

20. Ibid

21. Ibid

22. Shavell, Steven, "Risk Sharing and Incentives in the Principle Agent Relationship" pg. 56

23. Ibid

24. Harris, M. and Raviv, A, "Some Results on Incentive Contracts with Applications to Education, Employment, Health Insurance and Law Enforcement." pg. 21

25. Ibid

26. Ricketts pg. 123

27. Ibid pg. 124

28. See Ricketts pp. 117 - 21

29. See Ricketts pg. 120, Shavell pg. 59 and Harris and Raviv pg. 25. Rasmusen, E "Moral Hazard: Hidden Information" provides interesting incites on the monitoring problem from a game theory perspective, pg. 168.

30. Rasmusen, E "Moral Hazard: Hidden Information" pg. 168

31. See Ricketts pg. 117 equation 5.2

32. See Ricketts pg. 117 and Rasmusen, E "Moral Hazard and Hidden Actions" pg. 134

33. Holmstrom, B. "Moral Hazard and Observability" pg. 74

34. Ibid

35. The principle of a forcing contract to combat moral hazard is theoretically an *ex post* issue, because it falls under the rubric of transactions costs. However, Holmstrom and Rasmusen have creatively used them to address principle agent problems, which is clearly an *ex ante* concern.

36. Ibid

37. Rasmusen, E "Moral Hazard: Hidden Action" pg. 134

38. In "Dynamic Games with Asymmetric Information" Rasmusen defines asymmetric information as "a players information set at any node where he chooses an action or an end node that contains different to the information sets of different players." pg. 53. Simply put players make decisions with disparate information. Rasmusen describes the Principle Agent dilemma as a game of asymmetric information.

39. It is interesting to note that Harris and Raviv suggest the same general contracting forms for observable and unobservable SOWs. None the less, the importance of noting the observability of the SOW is that under unobservable SOW conditions the

individuals are making decisions based on their willingness to trade off risk and incentive.

40. Holmstrom pg. 74

41. A forcing contract could also be classified as a selection issue. A forcing contract relies upon the same mechanisms as self selection. Selection issues will be addressed in this chapter.

42. Spence, AM *Market Signalling* pg. 5

43. Rasmusen, E "Dynamic Games with Asymmetric Information" pp. 50 - 55

Rasmusen uses game theoretic framework, thus his definitions are in game theoretic terminology.

44. Spence, AM *Market Signalling* pp. 5 - 13

45. Jervis, R pp. 21 - 26 and Spence, AM "Loans and Household Credit"

46. Spence *Market Signalling* pg. 7

47. Rasmusen, E "Dynamic Games with Asymmetric Information" pg. 56

48. Ibid

49. Rasmusen calls the previously held belief a "posterior". I have retained using the longer term "previously held belief" to avoid confusion.

50. Stiglitz pg. 284

51. Ibid

52. Rasmusen, E "Moral Hazard: Hidden Actions" pg. 135

53. Arrow in Williamson, O "What is Transactions Costs Economics" pg. 176

54. Ibid

55. Llewellyn in Williams, O "What is Transactions Costs Economics" pg. 175

56. Oliver Williamson is the accepted guru of transactions costs economics. As such, this section will rely upon his writings exclusively. Any other academics mentioned are quotes from a Williamson piece.

57. pg. 174

58. pg. 30 - 31

59. The following definitions and ideas are taken from Williamson, O "What is Transactions Cost economics?" pp. 179 - 81

60. Williamson, O "What is Transactions Cost Economics?" pg. 180

61. Ibid

62. It must be stressed that these are contracting processes not contracts. The process will be integrated in to the general framework of a contract. Different contracting frameworks are discussed in this section.

63. Ibid pg. 177

64. The following definitions of contract have been synthesized from Williams, O *The Economic Institutions of Capitalism* pp. 177 - 78

65. The following definitions are taken from Williamson, O "Transactions Cost Economics: The Governance of Contractual Relations" pp. 103 - 5

66. Ibid pg. 103

67. None the less, the basic mechanism behind "internalizing" the transaction will be used more thoroughly in relational contracting.

68. Williamson, O "Transaction Cost Economics: The Governance" pg. 104

69. The following ideas and chart come from Williamson, O "Transactions Cost Economics: Governance" pp. 106 - 116

70. Ibid. pg. 105
Williamson uses the word governance structure. He defines governance structure as an *ex post* contractual institution. I have used the term *ex post* contractual institution throughout to avoid confusion with the "governance contractual process", which requires the use of *ex post* contractual institutions in cases of execution stage contract disputes.

71. Ibid pg. 116

72. Ibid pg. 117

73. Ibid

# CHAPTER FOUR : APPLICATIONS AND RECOMMENDATIONS TO THE TRIPLE TRUST CREDIT SCHEME

## APPLICATIONS AND RECOMMENDATIONS TO THE TRIPLE TRUST CREDIT SCHEME

The concepts proposed in the previous chapter are useful for analyzing exchange. They are designed for analyzing any complex contracting situation. New Institutional Economics literature focuses primarily on how exchange forms the firm. Exchange between principals and agents, between job applicants and between different firms affect firm and contract structures. Therefore, industrial organization is the leitmotif of a bulk of the literature. Much of Agency theory and Transactions Cost Economics directly addresses hierarchial firm structure. However, "organization" does not only refer to industrial structure.

Exchange encompasses all internal and external exchanges. Williamson's various *ex post* contractual institutions and transactions characteristics indicate when a transaction should be internalized. Principal Agent theory analyzes internal and external *ex ante* transactions to advantage. The classic sharecropping example is actually a market, rather than a firm, relationship. Selection literature has focused on market exchanges, including credit.[1] Further, as Williamson demonstrated, all exchanges are complex contracting situations.

The Triple Trust (TTO) credit scheme (the scheme), described in Chapter Two, is a complex contracting situation. It is a market exchange, with a clear principal and agent. It has a selection system for choosing agents. Thus, the system must address *ex ante* contractual problems. Since an exchange takes place, there are transaction characteristics and contractual structures to consider. Fundamentally, the system must cope with bounded rationality, opportunism and asset specificity problems. As with all exchange, the TTO credit scheme is an appropriate candidate for New Industrial Economics analysis.

In this section relevant system characteristics are identified and categorized. The most logical general categorization is *ex ante* and *ex post* contractual concerns. *Ex ante* can be further divided into principal agent concerns and selection issues. *Ex post* categories are contracting process, transaction characteristics and contract type. In the subsequent section a new system is suggested to address the problems and inconsistencies identified.

## EX ANTE CONCERNS

### Principal Agent

The TTO credit scheme contracts with informal economy entrepreneurs. The scheme sells the entrepreneurs capital equipment on credit, the entrepreneurs must repay the principal and interest in full. The scheme claims right to all residuals. The relationship in this exchange is clear. Per Ricketts' and Shavell's definitions[2], the TT is the principal in this contract. The scheme enters into a contract with an informal economy entrepreneur to purchase capital equipment on credit and make a future stream of payments to the scheme. Since the scheme realizes a gain, it "enjoys the outcome of the (entrepreneur's) action." The logical corollary is that the informal economy entrepreneur is the agent. The entrepreneur must "undertake some activity on behalf of (the scheme)" in order to repay the credit. Most importantly, the entrepreneur "receives some sort of fee", in this case capital equipment, for agreeing to make a future stream of payments.

The scheme requires that all debtors must make fixed monthly payments, without exception. This repayment situation reflects a risk averse attitude on the part of the scheme. The scheme is unwilling to consider natural vagaries and the entrepreneur must bear the full risk of the SOW. The ramification of this risk attitude is that, theoretically, it attenuates the number of potential agents. Ricketts uses an Edgeworth box to show risk averse agents and principals have only one possible contracting point.[3] Further, in "The Market for Lemons: Quality, Uncertainty and the Market", Akerlof suggests that the TTO scheme is inherently open to risk.

Akerlof hypothesizes that credit schemes in underdeveloped markets are subject to greater risks if operated by extracommunity firms due to the "lemon principle".[4] The "lemon principle" is an economic phenomenon that holds the quality of goods in a market declines quicker than the price. The crux of the mechanism is that at the margin agents will attempt to dispose of increasingly poorer goods. Akerlof uses the mechanism to describe credit schemes in developing countries. He shows that in developing countries a credit scheme operated by a community operation would stand less chance of default than an extracommunity organization. The reasoning is that a group operated by the community attaches an extra cost to default because of the consternation it causes in the community. In this way, a community credit scheme automatically raises debtor standards.

Selection Concerns

The TTO credit scheme only accepts individuals who have attended a Triple Trust training course. The purpose of this is to attenuate problems associated with asymmetric information. Capital equipment is sold on credit. The credit applicant must be able to operate the equipment properly to realize a return. Since the scheme only contracts with graduated TTO trainees, the applicant is known to have received training in operating the equipment.

Attending the course also serves as a signal for stability, credit history and some business knowledge. The scheme has access to the trainee's attendance during the course. It uses attendance as a signal for stability. During the course a trainee is obliged to take "temporary credit". The trainee's performance repaying temporary credit serves as a signal for a trainee's willingness to repay credit. Additionally, an applicant must have rudimentary business skills to realize a gain and be able to repay. All TTO training courses incorporate business training into the curriculum. Thus, having received training also signals that the applicant has some basic business knowledge. All of these are mutable, low cost and voluntary options for trainees. Further, TTO lets the trainees know that these are actual signals for credit selection.

The only index involved in the process is the "house visit". Part of the application process is that a TTO representative visits the home or place of business of the applicant. Purchasing or renting a venue is a mutable attribute. However, per Spence's definition, a mutable high cost attribute is actually an index. For the market considered, purchasing or renting a venue is a considerable cost, thus constitutes an index. As indicated in chapter two, the process has not been utilized. In addition, this process is problematic, because it is not standardized and holds many potential signals.[5]

The Neighborhood Training Trust (NTT) manager reviews and approves the applications. There is no set formula or scoring system in the selection process. The manager simply reviews the application and looks for the signals noted above. Over time, this situation is subject to Bayes Rule. The manager will constantly revise the probability of the signal's ability to indicate a particular outcome. In this case, the outcome is the applicant's probability of completing a future stream of payments.

The scheme requires that the applicant pay a R 200 deposit on all credit purchases. The intention was that the deposit act as a screen. Every applicant selected had to pay R 200, a quite hefty deposit, in order to demonstrate ability and willingness to cope with payments. However, the process subverted itself. The applicants actually paid R 200 with the application.[6] In this way, the R 200 acted as a signal rather than a screen.[7] The problem is that as a screen a hefty first payment shows a willingness to abide by the agreed upon contract, particularly in a governance environment. As a signal, R 200 is easily purchased and can be very misleading. Consequently, it can serve to corrupt more subtle, but substantial signals. Further, as Akerlof suggests, it may actually signal a poor credit risk.[8]

There is only one application that offers no choices.[9] The application has no self selection device. Both of these issues will be addressed in the following chapter.

## *EX POST* CONCERNS

### Contracting Process

The TTO credit scheme does not exist in a text book. The scheme moves in a real world environment rife with bounded rationality, opportunism and asset specificity. The two former concerns are clear. TTO employees cannot foresee all contingencies and informal economy entrepreneurs will attempt to maximize their own utility. The level of asset specificity is stickier. The identity of the agent matters - the agent must be an approved TTO training graduate. However, beyond that, equipment is not specialized. Although the equipment is standard, contractually the identity of the agent must be known. Thus, asset specificity is present to some degree, because the scheme will not sell to every individual demanding the product. Per Williamson's definition, the combination of these three factors suggests a governance contracting process. It is important to assert that the contractual <u>process</u> is being defined. The presence of asset specificity is necessary to define the process. The degree to which it exists will only feature in defining transaction characteristics.

In order for a governance process to exist the contract must specify *ex post* contractual institutions. The TTO credit scheme specifies no such institutions. Therefore, the current contract is a competition contract, relegates governance to the market. It assumes away asset specificity and makes no explicit provision for handling execution stage disputes. As indicated in chapter two, the only governance structure is one TTO representative charged with following up defaulters. This structure is not folded into the contract, it is not agreed upon by both contracting parties and, as indicated, it is not efficacious.

Transaction Characteristics and Contract Type

TTO training graduates make only one credit purchase of standard equipment. By Williamson's definition, this situation would indicate a non specific occasional transaction. However, the scheme may only contract with TTO training graduates, in this way the customer is actually customized. Thus, by definition the transaction type would be a mixed occasional transaction, an occasional transaction with a moderate level of asset specificity. Williamson maintains a mixed occasional transaction warrants neo-classical contracting with a trilateral *ex post* contractual institution. This contracting suggests that the TTO credit scheme should incorporate some sort of third party to arbitration, as opposed to utilizing simple market transactions.

As previously stated, the scheme uses competition contracting processes. This process is consistent with classical contracting and market *ex post* institutions. The scheme has no agreed upon governance, thus, uses market governance by default. By recognizing the customer as embodying a moderate level of asset specificity, classical contracting is appropriate. Williamson suggests classical contracting for non specific occasional transactions. Thus, the scheme is currently using inappropriate contracting for a mixed occasional transaction. This dilemma is investigated further in the following section.

The point of this section was to demonstrate the applicability of New Industrial Economics to the Triple Trust Credit Scheme. The scheme is an exchange. It is subject to *ex ante* and *ex post* contractual problems. The tools offered by New Industrial Economics not only apply to this situation, but actually pin point some potential problems with the scheme. The next section dedicates itself to addressing the theoretical problems and possible solutions illuminated by these concepts.

## ADDRESSING CONCERNS

The preceding paragraphs illuminate theoretical problems with the TTO credit scheme. The scheme has an inflexible attitude toward risk that poses underlying theoretic concerns. Selection mechanisms are misplaced and under utilized. Most striking, the contractual process and contracting method are inappropriate for the type of transaction. All of these concerns boil down to information problems. Due to poor information, the Triple Trust is unable to make efficient decisions regarding their role as principal, who to select as an agent and how to contract with them. The proof of the pudding and TTO's motivation to alter the system lies not in the theoretic concerns, but in the fact that 50% of the scheme's portfolio is outstanding. Of that, half is currently in arrears.

## THE NEW SCHEME

The new scheme[10] (from here "the scheme", "the former scheme" refers to the previous system) works within the same major framework as the former scheme. Only TTO training graduates are eligible for credit. All credit is given in the form of capital equipment relevant to a particular training course, no cash is loaned. The Neighborhood Training Trust manager will actually select who receives credit and the Self Help Financing Trust will manage the scheme. All credit is expected to be repaid within ten months at an annual interest rate of 33.6%. Beyond the basic framework, substantial philosophical and structural changes have been made to the system.

The scheme starts by placing more emphasis on trainee selection for training courses. Since TTO views all training applicants as potential debtors, information gathering begins immediately. When individuals apply for a training course they are interviewed by TTO mentors.[11] The mentors look for signals and indices indicating a sense of community[12], stability and need. TTO perceives that these criteria will signal a lower probability of debtor default.

A logical extension of recognizing training selection as the first step to credit selection is that more selection criteria are drawn from the training course. TTO has changed training systems to be more efficacious and to better contribute to the credit selection process. The new programs introduced by TTO have training merit as well as applications to the credit scheme. Only applications to the scheme are discussed here.

The "temporary credit" system used during training has been changed. Trainees receive a stream of temporary credit rather than a once off. This system gives TTO a better opportunity to assess trainee attitudes toward credit. In addition, it gives trainees more opportunities to signal their credit risk. Further, it is explicitly stated that failure to repay temporary credit will exclude the trainee from future TTO loan programs.

One of the major contributors to the default rate is the fact that many trainees do not use their skills to start a business. This factor may partly be attributed to inappropriate programs[13] and to poor selection. This issue will be addressed in depth. However, equally to blame is the fact that trainees did not receive adequate business training with skills training. TTO has incorporated a new "business game" into training. The "business game" is simply a role play in which trainees must allocate proceeds back into the business, into household expenses and savings. After training, a trainee's performance in the business game is used as an assessment of the trainee's potential as a businessperson. In addition, trainees are required to pay a registration fee during the first and second weeks of training.[14] This structure contributes to further weed out individuals not truly interested in learning a skill and opening a business.

The loan application process has changed substantially. Initially, each trainee receives formal information regarding the loan scheme[15]. The information spells out what a trainee receives; how much, when and where a trainee must pay; and how to apply. The new application proffers a self selection device. This device forces applicants to choose whether or not they desire a business mentor[16], and thus sends a signal regarding their commitment to operating a business.

The assessment process has been formalized. TTO has created an assessment package for the loan scheme. The package includes: a house visit, the applicant's temporary credit history, the applicant's application, a record of the applicant's attendance at courses and payment of registration fees, a business game assessment, a post training assessment submitted by the trainer and a consultation between the NTT manager and the trainer.

The house visit, which was under utilized and disjointed in the old scheme, has been formalized. A TTO agent[17] visits the applicants's house or place of business and looks for certain criteria thought to contribute positively to running a business. These criteria are security, facilities, business atmosphere and general impressions. The TTO agent submits a report included in the assessment package.

The need for the applicant's temporary credit history is clear. The applicant's performance with temporary credit will signal possible performance with extended credit. The applicant's application reviews the initial impressions regarding the applicant's stability, community and need. As indicated above, TTO considers these criteria vital to a good credit risk. The applicant's attendance and payment of registration are used as indicators of the applicant's resolve for improvement and willingness to start a business.

The post training assessment, business game assessment and trainer assessment are vital interactive criteria in the selection process. The post training assessment is an assessment submitted by the trainer after training. It addresses the trainee's sales, quality, organization and perceived business skills.[18] The business game assessment critiques the trainee's progress with business concepts introduced in the business game. The trainer's assessment is a one on one conversation between the trainer and the NTT manager. The conversation covers all trainee who have applied for credit from a particular trainer's training center. In this conversation the trainer may cover contingencies not provided for in the application process.

The scheme clearly delineates between the application and the contract. The new application is simply an application with all of the selection devices mentioned above. As previously indicated, the former scheme confused the two processes. Unlike the former program, the scheme requires a R 200 deposit after selection. This scheme does not subvert the use of the screen. The deposit must be paid on delivery of the capital equipment. Further, this contract clearly spells out TTO expectations. The contract clearly defines when, where and how the debtor is to pay. The first payment is always due the month subsequent to the first full month after the contract was signed. Most importantly, this contract establishes *ex post* contractual institutions.

A major change in the scheme is that trainers are responsible for collections. All payments are made at the training center. Each trainer has full information regarding who is to pay, how much they owe, their balance outstanding and the trainee's address. The trainers are required to monitor and report on the trainee's payment progress. Further, the trainer must know why a trainee is not making payments. In order to provide an incentive for carrying out their duty, the trainers are given a percentage of the payments made at the center.[19]

The scheme utilizes the trainer to a much greater extent than the former scheme. TTO places great importance on increased trainer involvement. The trainer obviously plays a substantial role in selection for training and actual training. In addition, the trainer is actively involved in business training, temporary credit, disseminating credit information, credit selection and collections. Increased trainer involvement and local payments are important because it locates the credit scheme in the community. Akerlof provides compelling theorectic support for locating a scheme in the community.[20] Additional theoretic support for a community located credit scheme are discussed later in this section.

In case of default the scheme provides two possible arbitration avenues. If a debtor defaults the trainer must complete a default report. In this report the trainer gives suspected reasons for the default. The SHFT manager reviews the report and deems the debtor a "problem defaulter" or "not a problem defaulter". The criteria that could indicate a "problem defaulter" are consecutive defaults, relocation, missing appointments with CBC's and those who aggressively refuse to repay. If the defaulter is deemed a "problem defaulter", a TTO agent will attempt collection. In such a case the agent receives the incentive payment. If the defaulter is not deemed a problem defaulter, the default is overlooked and payment is expected the following month.

All of the tools available to New Institutional Economics address informational problems. In addition to employing these tools, the TTO credit scheme has attempted to address informational problems by developing a new data base. The former scheme used an inflexible outdated data base. The system could only retrieve by one field and did not generate any reports. The new scheme makes information readily accessible. It generates reports regarding payment, default, outstanding balance, incentive payments and the final credit payment.

## Selection Concerns

The new Triple Trust credit scheme's first alteration is the way selection is approached. The former scheme isolated credit selection. Selection for credit did not begin until the applicant applied for credit. The revised scheme recognizes that selection for credit begins with selection for the training course. The attributes sought in trainees are stability, community and need.

Community and stability are important: stability, because a stable individual is less likely to default, due to relocation or personal crisis, community, because an individual who has been part of a community for quite sometime has more chance of operating a successful business. That individual will garner more community respect and support. The individual is less likely to move around, thus if default does occur the person may be easily located. Further, a stronger sense of community will contribute to an individual's respect for a community located credit scheme. Community and stability tests consist solely of indices.[21] Examples are how long a person has resided in a community, affiliation to a stokvel, church group, civic association and plans to relocate. These are indices because a substantial time or financial investment is necessary.

Need is relative. In the case of TTO, an index of need is whether or not a trainee will be the sole bread winner for a household. If not, relative need is not as great. This status is clearly an index. Encouraging another household bread winner to leave a job costs enough to be considered an index. Another index is the size of the family. An individual with a large family would be given preference over an individual with a small one.

One of the leading contributors to the default rate is the fact the trainees do not utilize the skills they have learned. A trainee will take credit and then not open shop. Training selection seeks to identify those desiring to start a business. The questions are simple, "Why do you want to do this course?" and "What do you expect from this course?". TTO can screen trainees who apply for credit by referring back to this question. The screen is whether or not an individual is still planning to carry out activities professed in training.

The preceding paragraphs have described how training course selection has affected the scheme. As such, the selection concepts introduced in the previous chapter are fully utilized in actually selecting individuals for the credit scheme. The house visit is clearly an index. Although, certain criterion are mutable, they would be inordinately costly to do so. For instance, getting electricity or burglar bars installed. The nature of the TTO credit scheme is to be accessible. Thus, few indices are incorporated. The easiest way to increase access is to use signals and make potential signals known. The trick of course is to set actual signals that, although mutable, will accurately indicate the nature of a debtor.

Many signals are incorporated into the selection process. Trainee performance during training, temporary credit, the business game and the criteria on the post trainer evaluation are all mutable. An individual chooses to attend the course and pay the registration fee. An individual chooses to repay or not repay temporary credit. TTO makes it very clear that all of these potential signals of credit performance are actual signals for credit selection.

TTO designed all its training courses to stress quality production and selling. As such, the trainees can signal favorable characteristics by choosing to produce quality goods and make an effort to sell. The quality of goods will be subject to individual variation, but, as indicated in chapter 2, the training process has a built - in guard against individual variations.[22] Sales has a built in market control as well. The trainer can easily see if a market does not exist for the goods. If all, or a substantial percentage of trainees are having difficulty selling, an adequate market does not exist for the goods. In both cases the trainees' post training evaluation will reflect their performance during the course and states of the world.

Performance on the business game can be considered a signal for business acumen. Performance in the business game is voluntary, one may choose to do poorly. However, in order to do well one must embody certain characteristics. As the game progresses a trainee may signal their business knowledge with their performance. As previously stated, business knowledge will weigh heavily in the applicant's assessment.

The scheme's application also includes a self selection device that will help assess the applicant's commitment to operating a successful business. The application clearly states, "If selected for credit I would like to have a business consultant help me run my business." The applicants are instructed by the trainees to write either yes or no. All trainees are introduced to the CBC program by their trainers. They are familiar with the services offered and particularly with the fact that the program is free of charge. If an applicant checks no, it is seen as that applicant not being serious about running a business. Naturally, the question is put to the trainer during the trainer consultation. The applicant could excel at business, perhaps the applicant previously ran a business. However, the fact that the answer is no would raise suspicion.

As previously mentioned, the deposit after selection acts as a screen. The fact that the former scheme placed it before actual selection subverted its usefulness as a screen. Further, by requiring the deposit before selection the former scheme actually put pressure on itself to select individuals it may not have, or at the very least select individuals quicker than usual. The deposit is not a strong screen. Two hundred rand is easy to obtain. However, the fact that the deposit is required on delivery means that the screen is implemented immediately. This situation is useful because it will allow governance structures to be employed while a TTO agent is available.

All of these selection issues are subject to Bayes Rule. The trainer, although from the community, will continue to update beliefs on who does and does not constitute a good credit risk. In addition, the trainers will update their perception of who has business acumen, sales potential and what constitutes "good quality". The NTT manager will constantly update beliefs regarding the make up of a good credit risk. Further, the NTT manager will alter the probabilities attached to the choices made by the trainers. Finally, the SHFT manager will constantly update who and under what conditions constitutes a "problem defaulter".

## Principal Agent

The scheme is still the principal and the debtor is still the agent. Further, the scheme still requires agents to make fixed monthly payments. In this way the attitude toward risk has not changed, it is still risk averse. However, a mechanism has been added that could change Triple Trust's risk attitude to risk neutral, meaning it will share the risk of SOW vagaries, in certain cases. If the defaulter is determined "not a problem defaulter" TTO will not expect payment or penalize late payment. TTO will share the risk in the case of natural disaster, a good CBC report - yet market vacillations - and a good trainer's report. In this way TTO actually changes its risk attitude to neutral. This mechanism is an *ex post* contractual mechanism, as such it will be expanded with *ex post* concerns. However, it is included here because it affects TTO's risk attitude.

The above description covers the TTO - trainee contract, however, the scheme is a multi-contractual agreement. TTO also contracts with the trainer. Under the TTO - trainer contract TTO is the principal and the trainer is the agent. TTO receives the payments from the debtors, via the trainers. The trainer agrees to diligently monitor the payment progress of the debtors. In return the trainer receives a portion of the payment. TTO's risk attitude under this contract is clearly risk averse. The trainer is on a strict performance contingent contract. There is no provision for varying SOWs. It must be noted that this risk attitude between TTO and the trainer only holds for the credit contract. Each trainer also receives a flat monthly wage for training, which indicates a risk neutral attitude by TTO.

*Ex Post* Concerns

Regarding transactions cost economics, the most important change to the scheme is making it multi-contractual. The contract between TTO and the trainee and TTO and the trainer is clear. TTO provides credit to the trainee in exchange for a future stream of payments. TTO offers the trainer a percentage of the payments in exchange for administering the loan at the local level, tracking debtors from a particular center and encouraging debtors to repay. A third, more subtle, contract also exists. The implied contract between the trainer and the debtor. This contract is an exchange based on community belonging and obligation.

Triple Trust - Trainee Contract

The TTO - trainee contract is the most standard contract. It is unchanged from the former scheme. TTO grants the trainee credit in exchange for a future stream of payments. As illuminated in the previous section, the exchange is rife with bounded rationality and opportunism. The trainee receives a piece of standard capital equipment on credit. However, the trainee, now a debtor, is specialized. The debtor's identity matters because the scheme will only contract with TTO training course graduates. Thus, asset specificity also exists. As with the former scheme, this scenario suggests a governance contracting process.

The transaction characteristics also echo the former scheme. TTO only contracts with each trainee once. In addition, the trainee's identity does matter, however, there are more trainees. Thus, the transaction is occasional with mixed asset specificity. These transaction characteristics are compatible with neo-classical contracting. Neo-classical contracting recommends trilateral governance. A governance structure that relies on a third party to arbitrate disputes.

The former scheme relied, inappropriately, on classical contracting. In accordance with neo-classical contracting, the new scheme establishes two trilateral governance institutions to address default. The first line of governance is the "default report". The trainer completes the default report and submits it to the SHFT manager. The manager will designate the defaulter a "problem" or "not a problem" on the strength of the report. In this contract, the trainer acts as a third party. The second and most stringent line of governance is repossession. If the item is not paid off in full, the contract states that the item will be repossessed. The parties agree that if the first line of governance fails, they will allow an agent of TTO to repossess the item on behalf of TTO.

TTO - Trainer contract

The TTO - trainer contract for the credit scheme must be seen in isolation from the pre-existing contract. The pre-existing contract dictates that trainers are paid a lump weekly sum to train trainees. The scheme's contract provides that trainers receive a percentage of the payments made by individuals they have trained. The exchange is subject to bounded rationality and opportunism. Neither TTO or the trainer can foresee all contingencies. Further, the trainer will optimize between effort and the amount earned to maximize personal utility. In this transaction, the trainer's identity matters. Thus, the transaction is also asset specific. The ramification is that TTO must use a governance contracting process.

The transaction is recurrent and, as stated above, asset specific. The recurrent nature of the contract is clear. Each debtor must make ten payments to the trainer. The more difficult question is the level of asset specificity. The trainers are skilled laborers. They know and train low level manufacturing. Williamson suggests that laborers at this level constitute a mixed level of asset specificity.[23] In addition, part of the trainer's duty is to build a relationship with the trainee. Over an eight week training course the trainer will guide, instruct, socialize and generally build a relationship with a trainee. In this way, the trainer is quite asset specific.

The relationship fostered between the trainer and the trainee constitutes a high level of asset specificity for the trainer. However, the trainer and the trainee develop this high level of asset specificity not the trainer and TTO. The importance of this relationship will be stressed in the following section. The transaction between TTO and the trainer is better characterized by a mixed level of asset specificity.

A high level of asset specificity and a recurring transaction suggest relational contracting with a unified governance structure. Williamson suggests that unified governance is warranted only in situations where the transaction is incorporated into the firm.[24] The transaction between TTO and the trainer is certainly incorporated into the firm. However, Williamson also suggests, that in arbitration "a quantity of adjustments will be implemented at whatever frequency serves to maximize the joint gain to the transaction."[25] This statement does not describe the situation between TTO and the trainers.

As previously stated, the trainers are subject to maximizing personal utility at the cost of TTO's. Relational contracting with bilateral governance better describes this situation. TTO and the trainer have a relationship characterized by a level of asset specificity that makes it worth maintaining. However, if arbitration is necessary finding solutions that are suitable to both parties can be difficult. Williamson attributes at least part of this difficulty to the fact that bilateral adjustments are "zero sum".[26] Both parties will attempt to maximize personal utility, if necessary at the cost of the other contracting party. Williamson suggests both of these characteristics are indicative of bilateral governance.[27]

These conditions characterize the relationship between TTO and the trainers. In arbitration, the NTT manager must meet with the trainers to hash out a solution. There is little threat of dissolving the contract, that would be too costly. However, in the framework of the credit contract, adjustments are seen as zero sum. Whatever the trainer gives up in incentive, TTO gains and visa versa. The negotiation reflects classic labor management arbitration, in which "adjusting the contract can be problematic."[28]

Trainer - Trainee Contract

The trainer and trainee have an implied contract. They do not officially exchange resources as they do with TTO. They have a contract that has developed over eight weeks of training if not longer. The trainer chose the trainee for the course, instructed the trainee, granted the trainee temporary credit, helped the trainee through the credit application process and stood up for the trainee to become a debtor. Some of the trainees know the trainers from months of waiting to attend the course.[29] Since the trainers are from the community, many of the trainees know the trainers as neighbors. They have a "communal contract". It is the same basic mechanism the Grameen Bank and the Get Ahead harness by using loan groups.

What I am referring to as a "communal contract" has old conceptual roots. The idea of a bond between friends and neighbors is not new. In African society the idea is often termed "ubuntu". Vilakazi defines "ubuntu" as humanism, a code of conduct that exists between human beings.[30] It is the force behind the Sotho saying "motho ke motho ka botho".[31] Lukhele suggests that it is this code of conduct that lays the foundations for such community based financial structures such as stokvels, burial societies, *gooi gooi's*, and savings clubs.[32] The "communal contract" is implied in belonging to a community. However, the strength of the contract is also a tangible concept that should be incorporated into transactions.[33]

As stated above and in the previous section, the contract exists because of the relationship between the trainer and the trainee. The relationship involves bounded rationality, opportunism and asset specificity. Bounded rationality is clear. Opportunism is a reality. The question surronding the communal contract is how opportunism is controlled and arbitrated. These support mechanisms will vary from community to community. Asset specificity is also clear. In the relationship the trading partners' identity matters. The existence of these three characteristics indicates that the communal contract process will require governance.

The relationship is recurring and idiosyncratic. As neighbors or colleagues the trainer and trainee will encounter one another time and time again. This point is vital to building a relationship. The training and contracting process goes to lengths to make the recurrence meaningful. The trainer must choose the trainee to attend the course, the trainer trains the trainee in a skill, the trainer helps the trainee to receive credit. All of these exchanges are recurring. In addition, the trainer and trainee have exchanges on the sidewalk, in the shops or at church. The relationship is clearly asset specific. Both parties' identity matters. The relationship may not be replaced, it is unique between the trainer and trainee. Under these conditions the relationship is idiosyncratic.

In Williamson's terminology, the relationship is subject to relational contracting and unified governance. The relational is obvious, it is a relationship. However, unified governance suggests that two are incorporated somehow, the social equivalent of "vertical integration". Unified governance suggests that arbitration serves to "maximize joint gain". In this situation, the fact that the trainer has acted to increase the trainee's gain is clear. The trainee received access to credit. Likewise, the trainee may increase the trainer's gain, by making repayments. The linchpin of the contract is that the relationship between the trainee and the trainer is equal to or greater than the trainees' future stream of payments. The trainee must value the relationship more than the payments.

The question for TTO is whether or not the relationship, either developed or pre-existing, is strong enough to be considered a relational contract with unified governance. Unified governance is more sophisticated and stronger than bilateral governance. The incentive to maintain the contract is much greater under unified governance structures. The parties are actually integrated. However, those structures must be warranted. Under ideal situations, the contract between the trainer and trainee would be relational with unified governance. However, the reality is that this contract will probably vary from trainee to trainee. Thereby, weakening the overall contracting mechanism.

ENDNOTES

1. See Akerlof, G "The Market for Lemons" and Spence, M "Loans and Household Credit" as examples.

2. See the previous chapter of this opus.

3. See Ricketts pg. 124

4. pg. 497

5. However, of all the potential signals on the house visit the TT representative has no indication of actual signals. This situation is problematic. Baye's Rules would suggest that the probability and the "event" (signal in Bayesian terms) would vary over time. In total it means that the assessment varies too much to be useful. Changes to the assessment are suggested in the following chapter.

6. See Chapter 5 Appendix

7. Per Rasmusen's definition a screen is set after the contract is signed, a signal is sent before the contract is signed.

8. See the concept of a "lemon" in Akerlof, particularly in reference to credit in developing countries. pg. 497

9. See Chapter 5 Appendix

10. See Chapter 4 appendix for "new scheme" documentation

11. Mentors are TTO employees from the community.

12. The use of "community" is pervasive in this section. In South Africa community has been a loaded term. For the purposes of this work, community refers to a neighborhood and more widely to a particular township. Community structures include church groups, stokvels, other savings clubs, civic associations, sports teams and local political organizations.

13. Previously, TT provided trainees with lunch and a travel allowance. The feeling is that these programs encouraged individuals with no interest in operating a business to attend the course.

14. The registration fee is only a means of discouraging those not interested in training. TT spends approximately R 1 200 per trainee, the registration fee is R 40 per trainee.

15. See Chapter 4 appendix

16. See Chapter 2 regarding Community Business Consultants and the Triple Trust Community Enterprise Services

17. TT requires that the agent be from the community. In this way TT attenuates external biases from the assessment.

18. See Chapter 4 appendix. Also, see Chapter 2 for a description of the NTT training process. Note: business skills are an implied part of the training.

19. The incentive schedule is as follows: 10% for monthly payments, 50% for the final payment. These percentages were derived by Southern Life actuaries. Providing such an incentive requires the credit scheme to reduce default to 18% in order to break even.

20. Akerlof, "The Market for Lemons", pg. 497

21. In the selection lexicon an index is an immutable characteristic. It does not refer to a vector of criteria that is statistically manipulated to render a ranking.

22. See Chapter 2, NTT uses competency based modular training only. This training philosophy dictates that no trainee may progress to subsequent training topics without achieving 100% proficiency on a current training topic.

23. Williamson, O "Transaction Cost Economics: Governance of Contractual Relations" pg. 119

24. Ibid pg. 116

25. Ibid.

26. Ibid.

27. Ibid. pg. 115

28. Ibid.

29. See Chapter 2, virtually all of the NTT courses have waiting lists.

30. Vilakazi pg. 7

31. seSotho: A person is a person because of other people.

32. This community code of conduct is a leitmotif in *Stokvels in South Africa e Stokini*.

33. Rigorous coverage of "ubuntu" is outside the scope of this opus. However, the concept is applied extensively to economic exchange. See Albert Koopman "Transcultural Communication", Anne Newman, Professor HW Vilakazi and Dr Oscar Dlhomo. All presented at the seminar on the "Incorporation of Ubuntu into a uniquely South African approach to management", October 30, 1991, Midrand, South Africa.

# CHAPTER FOUR APPENDIX

## APPLICATION FOR TRAINING
************************

SURNAME ............................................

FIRST NAMES ............................................

IDENTITY NUMBER ............................................

AGE ............................................

FIXED ADDRESS ............................................

............................................

A CONTACT TELEPHONE NUMBER ............................

EDUCATIONAL STANDARD ............................

COURSE ............................................

VENUE ............................................

SPONSORED BY ............................................

FOR OFFICE USE ONLY

---

APPLICATION APPROVED :

........... YES ............... NO

COMMENCEMENT DATE ............................

COMPLETION DATE ............................

---

# A G R E E M E N T
****************

I have received materials on CREDIT from AFRICA TRADING CO-OPERATIVE TRUST to the value of R ____________________

I agree to use these goods to make products for my profit under supervision of THE NEIGHBOURHOOD TRAINING TRUST.

I promise to pay for all these goods on or before ________

I also agree to pay R10-00 per week for administration costs and use of equipment.

NAME: ______________________________________________

ADDRESS: ______________________________________________

______________________________________________

______________________________________________

______________________________________________

SIGNATURE: ______________________________

FORMER SCHEME DOCUMENT

APPLICATION FOR LOAN
**********************

I apply to THE SELF-HELP FINANCING TRUST for a loan to start my own business.

I would like to buy on terms the following equipment:-

| | Loan Amount | Monthly Repayment |
|---|---|---|
| a SEWING MACHINE @ R560 | R740-00 | R54-00(for 10 months) |

Please find with this form the first amount of R200

I promise to repay this loan as agreed so that the money can be used again to help other people start in business also.

SURNAME: MR/MRS/MISS/MS.......................................

FIRST NAME: .......................................

DATE OF BIRTH: .......................................

IDENTITY NUMBER: .......................................

ADDRESS: .......................................

.......................................

.......................................

SIGNATURE: .......................DATE............

We, friends of the applicant, guarantee the repayment of this loan:

| NAME | ADDRESS | SIGNATURE |
|---|---|---|
| .................. | ...................... | ........... |
| .................. | ...................... | ........... |
| .................. | ...................... | ........... |
| .................. | ...................... | ........... |

# LOAN AND REPAYMENT AGREEMENT
******************************

For equipment supplied to me, I agree to pay THE SELF-HELP FINANCING TRUST R......... every month for ten months.

COST OF MACHINE R ......

The first payment will be made on .....................

I promise to pay every month on time, so that the money can be used again to help other people in business.

NAME: ......................................

IDENTITY NUMBER: ......................................

ADDRESS: : ......................................

......................................

......................................

SIGNATURE: ......................................

DATE: ......................................

TRIPLE TRUST
SIGNATURE: ......................................

# APPLICATION FOR TRAINING

SURNAME ..................................................

FIRST NAMES ..................................................

IDENTITY NUMBER ..................................................

AGE ..................................................

FIXED ADDRESS ..................................................

..................................................

NEXT OF KIN: NAME ..................................................

ADDRESS ..................................................

..................................................

CONTACT TELEPHONE NUMBER ..................................................

EDUCATIONAL STANDARD ..................................................

INTERVIEWED BY ..................................................

DATE ..................................................

SIGNATURE OF APPLICANT ..................................................

APPLICATION: ACCEPTED .............. REJECTED ..............

---

OFFICE USE

COURSE: SEWING / KNITTING / FLOWERS / LEATHER / BUTCHER

VENUE ..................................................

..................................................

START DATE ..................................................

END DATE ..................................................

SPONSOR ..................................................

# POST TRAINING ASSESSMENT

TRAINEE :

TRAINING CENTRE:

TRAINER :

COURSE :

DATE COMPLETED :

| | |
|---|---|
| Has trainee been selling products? to whom? | |
| Would you buy from the trainee? Why? | |
| How easily did the trainee learn? | |
| Do you think the trainee needs more training? | |
| How organised is the trainee? | |
| How did the trainee do in business training? | |
| How will the trainee do in business? | |

# TEMPORARY CREDIT AGREEMENT

I have received materials on CREDIT from THE TRIPLE TRUST amounting to:

| | Amount of Credit | Amount Paid |
|---|---|---|
| Week 1 | | |
| Week 2 | | |
| Week 3 | | |
| Week 4 | | |
| Week 5 | | |
| Week 6 | | |
| Week 7 | | |
| Week 8 | | |

I agree to use these materials to make products under the supervision of THE TRIPLE TRUST. I understand that I am entitled to all profits from these products.

I promise to repay the loan after I have sold my products or within a week.

I understand that failure to pay the money due or to make the weekly payments will automatically exclude me from other TRIPLE TRUST credit programmes.

NAME : ______________________________

ID NO. : ______________________________

ADDRESS : ______________________________

I promise that the above information is true.

______________________ SIGNATURE ______________ DATE

I promise the above named is a trainee in my course and I have provided materials to this person.

______________________ SIGNATURE OF TRAINER ______________ DATE

# TRIPLE TRUST LOAN INFORMATION

After your training course has been completed you will have the necessary skills to start your own business, *but will you have the money?*

The Triple Trust Organisation offers credit to individuals wishing to start their own business.

## WHO CAN QUALIFY

» Those who successfully complete a Triple Trust training course

» and receive a good evaluation from their trainer

## WHAT DO YOU GET

» Enough credit to buy a sewing or knitting machine

› *(depending on your training course)*

» A Triple Trust certificate of good credit for timely completion of credit payments.

» this can be used to secure future credit

## WHAT ARE YOUR RESPONSIBILITIES

» You must pay a deposit of R 200

» You must pay R 54 (sewing machines) or R 150 (knitting machines) on or before the tenth of each month

» The total loan amount is R 740 (sewing machine) or R 1700 (knitting machine)

» You must pay your trainer at the training center where you were trained

## HOW DO YOU APPLY

» You may get applications from your trainer

» Your trainer will supervise you through the application process

Should you have any questions regarding the Triple Trust loan scheme please consult your *trainer.*

# SEWING MACHINE PURCHASE APPLICATION

NAME: ______________________________

ID NO.: ______________________________

ADDRESS: ______________________________

TELEPHONE NO.: ______________________________

I apply to the SELF HELP FINANCING TRUST to purchase a SEWING MACHINE on credit. I want to purchase a machine so that I can start my own business.

I understand that if selected I must pay a deposit of **R 200** before I can receive my machine. I also understand that I must pay my trainer **R 54** on or before the tenth of each month at the center where I was trained until the machine is paid off.

I agree to let a SELF HELP FINANCING TRUST representative visit my place of business as part of the application evaluation.

I have read and understand the information sheet regarding credit from the SELF HELP FINANCING TRUST. Further, my trainer has explained the credit process to me.

If selected for credit I would like to have a business consultant help me run my business ☐

I promise that all of the information is true.

______________________ ______________

SIGNATURE DATE

I have explained the SELF HELP FINANCING TRUST credit procedure to the applicant. I have attached the applicants temporary credit application, repayment schedule and evaluation. I promise that I have trained the individual named above.

______________________ ______________ ______________

SIGNATURE OF TRAINER DATE CENTRE

# HOUSE VISIT CHECKLIST

This checklist is to be completed on all house visits. It is one of the criteria for evaluating a candidate for loans.

NAME : ______________________________

ADDRESS : ______________________________

TRAINING CENTRE : ______________________________

TRAINER : ______________________________

TYPE OF CREDIT : ______________________________

## QUESTIONS

1. Where do you plan to run your business from ? (if not from home you must visit that location)

2. Which facilities does your place of business have?

| | | |
|---|---|---|
| electricity: | yes____ | no____ |
| water : | yes____ | no____ |
| phone : | yes____ | no____ |
| lights : | yes____ | no____ |

3. How many people live in the dwelling?

4. Are they all from the same family?

5. Will any of them work for the business?

6. What type of security do you have?

| | | |
|---|---|---|
| locks on doors : | yes____ | no____ |
| burglar bars : | yes____ | no____ |
| dogs : | yes____ | no____ |
| other : | | |

## Subjective Analysis

1. Did the place of business have a good work atmosphere?

2. Was there adequate space for work?

3. Would you give them a loan?

I promise I have visited the above named.

______________________________

SHFT Representative

# SALE AGREEMENT

**NAME:** ________________________________

**I.D#:** ________________________________

**ADDRESS:** ________________________________

**TELEPHONE:** ________________________________

I have received from the **SELF HELP FINANCING TRUST** (SHFT), one Singer sewing machine, model________ serial number___________.

I understand that until I have paid the purchase price of **R 740** in full the sewing machine is *owned by SHFT.* If I fail to make any payment by the due date SHFT will be entitled to sue me for the full balance of the purchase price and repossess the sewing machine. If this happens SHFT will be entitled to keep all payments made on the sewing machine, including the deposit.

I promise to pay the purchase price in installments as follows:

Firstly, a **R 200 deposit** when the sewing machine is delivered to me.

Subsequently, **10 monthly installments of R 54** each or equal payment until the machine is paid for in full. I promise to pay these installments by the 10th day of each month at the training center where I was trained.

The first payment must be made by________________.

I understand the conditions of the contract and promise that all the information is true.

______________________________ ______________
Signature of Purchaser Date

I have explained the terms of the agreement in full to the purchaser.

______________________________ ______________
Signature of Deliverer Date

______________________________ ______________
Signature of Seller's Agent Date

## CONCLUSION

It is clear from *New Industrial Economics* theory that the TTO credit scheme required critical adjustment to its selection and monitoring mechanisms. Additionally, an analysis of the TTO credit scheme suggests that under the conditions prevalent in the informal economy a multi-contractual procedure for granting credit is advantageous. The contracts between TTO and the trainer and the trainee are standard. They exist under the basic conditions of a risk averse principal and utilize standard performance contingent incentives. However, the twist is that those contracts are supported by an implicit "communal contract" that exists between the trainer and the trainee. The pitfall for the Triple Trust is that an inherently strong contract between the trainer and trainee may not exist or ever develop.

As pointed out, whether or not the TTO's scheme can adequately secure credit is a direct function of the trainer. This point emphasises the importance of critical trainer selection. However, the value of the findings is that they are applicable beyond the TTO's credit scheme. The general contracting framework suggested for the TTO scheme is generally applicable to all credit contracts where a pre-existing relationship exists. However, the relationship must be strong and enduring. The crux of the contract is a relationship that can support a relational contract requiring unified governance mechanisms. Under these conditions, financial institutions looking for more secure loan or credit schemes for the informal economy can use the suggested credit scheme, although they may not have a community insider, as with the TTO.

The key for a financial institution is to link the credit to a community institution that maintains a relational contract with the entrepreneur. Examples of these institutions are *stokvels*, burial societies, civic associations, sports clubs, churches and professional associations. From a financial perspective membership is a form of collateral. The same basic contracting framework utilized by the TTO is applicable. The financial institution contracts with the "club" and the individual who is a member of the "club". The "club" and the individual have an implicit contract that supports the other contracts.

This system is quite different from the Grameen or Get Ahead schemes. Both of these schemes form groups and contract with those groups for the purpose of lending money. They assume a strong relationship exists. Under a TTO contracting regime an organization would only contract with pre-existing groups. One knows a relationship exists, and does not have to assume or create one. This type of relationship is much stronger. There will be less latitude for opportunism and the "communal contract" between the individuals is more likely to be truly unified. Under this contracting scheme the governance structures will engender less animosity than under the "peer pressure" scheme. This condition can be surmised because the pre-existing group is meant to survive beyond the life of the loan. In the Grameen and Get Ahead structure the group reverts to its former relationship.

As previously indicated, the Get Ahead scheme sets itself apart by using the "peer pressure" method in an urban area. It must be emphasised that the Get Ahead operates in the Witwatersrand's more established townships. The TTO scheme is geared for dealing with more mobile communities. In this way, it is exigent that there is a strong pre-existing relationship. In an ephemeral or inchoate community, building a group on an assumed relationship is not a strong contracting procedure.

The importance, size, structure and characteristics of the informal economy are debatable. However, the fact that it exists is immutable. Efforts to develop the informal economy cannot ignore that access to necessary inputs, particularly capital, is critical for informal economy growth.

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