GHEORGHE SANDU

THE ROLE OF CONTRACTS IN THE FINANCING DECISION OF THE ENTREPRISE

1. The alternative market-organisation with an example of our country

The reorganisation of the economic agents represents, along with the privatisation, the main objective of the reform in the Romanian economy. The reorganisation of the firms in general hints at the integration or the separation process of the different activities within the firms by the externalisation or the internalisation of some activities, and it also hints at reconsidering the activities within the firms with the purpose of rising their economic performances.

In the reorganisation process in our country there is the general tendency of dismembering the larger firms in financial difficulty. We do not argue with the idea that building up profit centres is an absolutely necessary activity. But it should happen in the context of the objective requests of the real market and not within an atomised market, imagined as perfect and based on an economical theory that has no connection with the economic realities.

The standard economy is an exchange economy expressing itself in terms of the stocks (initial endowments) and whose reference is the balance, and the prices have the role of market regulation.

We can distinguish two alternative forms of resources' allocation:

– Through the market mechanism, where the resources' allocation is made through prices (interest, the profitability rate) if the regulation is made by the price, the market is a sufficient mean of factors co-ordination;
– Through the internal mechanism of the firm, where the resources' allocation is made through orders and hierarchic rules.

The interest in considering the specific of the organisation (as related to the market) is, in particular, that it allows us to adopt the financing forms of the alternative enterprises for the market financing.

An. Inst. cerc. ec. „G. Zane", t. 10–11, Iaşi, 2001–2002, p. 21–29

2. The organisational dimensions of the enterprise

From the point of view of the transaction costs theory, the enterprise is a hierarchic and structured organisation. A firm requires essentially the existence of a number of contracts, which can be of two types:

The first type of contract insures the role of the production factors (labour force, natural factors, and capital) in its activity:

– employees commitment contracts;
– contracts for the rental or purchasing of buildings, equipment and cars;
– contracts for materials endowment;
– insurance contracts (policies).

The goods and the debts thus accomplished, through this type of contract, will appear in the enterprise capital balance. That is why we call an "investment decision" the selection of the capital elements necessary to the productive activity.

Choosing the real goods which will form the patrimony of a new enterprise or the goods used to modernise the patrimony of the functioning ones, as well as the way of disposing of these goods (by rental or buying), represents the first category of decisions which can define the financial policy of the firm. The criteria to be followed by these decisions are rentability and liquidity of the enterprise capital.

The second type of contracts are being closed with a natural or a legal person who rents the capital funds necessary for building the enterprise capital elements. The size of these sources will be recorded in the liabilities of the firm balance.

These contracts are called "securities" and can be classified in two categories:

– fixed income securities (short medium or long term liabilities), with relatively constant interest: bonds, discounts, etc.;
– variable income securities (or shares).

The capital funds suppliers can choose between these groups of securities, varying with the size of the expected gains and the risk to be covered, those with an established constant income at the time of the emission having a lower risk, and those with a variable income (the dividend, established proportionally to the rentability of the firm), having several risks (of closing the activity with low rentabilities or with losses, bankruptcy, etc.). Buying shares engages the disposable capital for an undetermined period of time, while financial liabilities and banking liabilities are being reimbursed in a given period of time.

On these criteria is based a second category of financial decisions regarding the relation of sold and issued securities in order to gain the necessary capital, reflected in the financial structure of the liabilities if the firm balance. A realist policy for selecting the sources for capital is conditioned by the deregulation of the financial market and the credit market. The criterion followed in the financial structure of the balance liabilities is for now and for the future, the achievement of the lowest cost of gathering capital, given the circumstances of a reasonable and controllable degree of firm liability.

In a theoretic trend initialised and developed by Knoght, Coase or Williamson, the enterprise (the organisation) is presented as means of alternative co-ordination to the market, a fact which is better observed if the market uncertainty is radical.

Generally, the markets' incapacity can be related to:

– a most inappropriate allocation of resources (inseparability);
– non-operativeness, that means that transactions cannot be made even if they are quite advantageous for both parts. This is due to the fact that certain agents can be insufficiently informed;
– situations can occur, when the market structure offers power to certain agents, especially in a monopoly or monopsony situation.

Several theoretic trends have been developed in order to clarify the organisational dimensions of the enterprise and, in a more general way, to define a clear concept, opposed to the market one, the "organisation" concept. Among these theoretical trends, the most important is the "transaction costs theory", introduced by Coase [1], and brilliantly developed by O. Williamson [2]. Organisations can be reduced to homogenous economical units, exchanging goods and services between them on the market.

The good functioning of the enterprise is dominated by risk. Building up an enterprise means accepting the engagement in a large investment, hoping for larger gains as compared to the initial investment. But, the future is always uncertain. The activity of the enterprise starts with an adventure, a bet, where the stakes are the initial investment.

The risk factors are not only related to uncertainty, but also to how well is the technology handled, to the quality of the organising and the accountancy, to the attitude of the environment and to the competition. Avoiding the risks is one of the aspects of the economic action and, with this quality, handling the risks is part of handling the enterprise. The enterprise always enhances a risky activity.

To probable risk is opposed uncertainty, which, alone, will demand the organisational dimension of the enterprise. Therefore, the existence of the market imperfections allows the introduction of the notion of uncertainty. Thus, the introduction of uncertainty may appear from the hypothesis of incomplete markets, the existence of the transaction costs and the imperfection of the information, which leads to opportunist behaviour, thus making the calculus of probability useless.

The models of Grossman and Stiglitz (1976; 1980) show that informed agents cannot deliver all the information to uninformed agents in capital markets. Knight [3] introduces the notion of uncertainty; how does it differ from risk, since it regards the circumstances which cannot be reduced to objective probabilities and therefore cannot be included in the calculus of probability.

The economical and financial theories have generally deformed this notion of uncertainty, replacing it with the notion of choice for an uncertain future.

Two types of uncertainty can therefore be distinguished: exogenous uncertainty - which determines the risk for endogenous variables (especially within pure and perfect competition) and endogenous uncertainty which is connected to the time elapsed between the investment decision and the moment where the investment is turned into a manufacturing capacity.

As observed before, if the market system is incomplete, agents must anticipate future prices, and their anticipations can be convergent or not, perfect or not. There is also an uncertainty, which relates to the mechanism of allocation of resources. Therefore, the investor cannot know precisely the distribution of probabilities over the events, or cannot know how to define it, or such a definition may be impossible.

These two types of uncertainty are not incompatible; on the contrary, in a stock exchange market, the uncertainty on future prices (or efficiency) of assets and the one regarding the intervention of investors on the market, are connected. Within a context of radical uncertainty there is a hierarchy in choosing the financing means (for example the credit market - the liability - can be preferred to the emission of new shares). Uncertainty may also be the outcome of the impossibility of agents to evaluate their assets or from the inconsistency of information regarding the nature of the goods exchanged.

But, the inconsistency of information is not only an economical problem, but resides in the moment of emission of limited information. Costs tend to rise, as the multilateral exchange multiplies. These costs may be high enough to justify the internalisation of decisions and of the choice, by the manner in which agents would rather relate to organising than to the market.

3. The theory of O. Williamson. The role of contracts

O. Williamson thinks in a manner very similar to that of R.H. Coase. In his theory, he departs from the transaction costs for the model of pure or perfect competition. The purpose is of knowing why certain rules of the game are imposed, why there is no pure or perfect competition and why are hierarchies developed. He assimilates the transaction costs to the flaws resulting from frictions in a mechanical or physical system: "the economical counterpart of the friction is the transaction cost" [4].

Thus the co-ordination of the economic agents can be alternatively effected through the market or the management, by the fact that:

- The markets and the enterprises are substitutable for making an assembly of transactions;
- The execution of a group of transactions on the market or within an enterprise depends on the relative effectiveness of each management model;
- The costs of writing and execution of complex contracts on the market depend on the one side of the features of the deciders involved in the transaction and on the other side of the objective properties of the market. Therefore, the causes of the transaction costs could be technological or induced by the agents' behaviour (taking into account the information necessary for the completion of an exchange).

These costs make the agents interiorise the exchanges within the organization [4] or close private contracts (Jensen and Meckling) [5].

Thus, for Williamson [2] the forms of the management and their diversity depend on the transaction costs, since they are the result of the management flaws of perfect markets. The organisations are "responses" to the transaction problems. The important difference between the organisation and the enterprise is that the latter is a hierarchic organisation, by the fact that certain messages are orders, that is messages which do not leave you with a choice, but the alternative of quitting the organisation.

The introduction of uncertainty reduces the possibility of making the calculus and probabilities of the economic agents. In this situation the contract is a weapon against uncertainty following three mechanisms revealed by E. Brousseau [6]: "First of all it allows for the stabilisation of the economic agent, thus reducing uncertainty. Second of all the associations between two or more agents are means of reducing the consequences of uncertainty. Third of all, the contract could lead to a collective treatment of the information".

At the same time, Williamson says that resorting to quotable contracts may be too expensive - more because of their elaboration than by their accomplishment. If the theory of contracts has always dealt with complete contracts, in economical reality, contracts are rarely complete, especially financial contracts. Incomplete contracts are the ones, which do not mention the decision of the parties in certain circumstances but give authority of taking decisions to one of the parties involved in it.

Not all the circumstances could be mentioned, for this action would ask for very high transaction costs, too high to allow the closing of complete contracts:

– it would be impossible to foresee all the circumstances which could affect the post-contract result;
– the circumstances cannot be known completely, since they are too many to be specified in the contract;
– certain actions or non-actions of the parties involved might not be checked after closing the deal, thus making the arbitration of a third party impossible.

In order to solve the problem of incomplete contracts it might be necessary the introduction of an institutional hierarchic structure for post-contract monitoring and adjustment. In this situation, the installation of routine would not allow the stabilisation of the environment of economic agents, from the point of view of creating interactions for the development of a common language. In this case, economic science allows for an established contract right, called "authority".

Finally, in order to prevent opportunism, agents organise surveillance and conflict reglementation systems. The quality of the surveillance depends on the major of the one who does it. The specialised surveyor thus appears more effective than in the justice system, the intervention of the latter assuming that the proof of any contract deviation would be not only observable but also checkable, that is having an objective form.

Williams is also the one who states that the choice of a most propitious financing structure is based on an arbitration between the uncertainty degree of this structure and - more or less - the reversibility degree of decisions taken within this structure. He distinguishes three structures: the markets, the intermediaries and the internal financing. Each of these forms is adapted to a type of transaction, varying with the features of the information for which the structure is most propitious. The markets are more appropriate when the information is well structured or defined in terms of risk; thus, complete contracts could be closed. On the contrary, intermediaries have an advantage for the following evaluation and adjustment, which requires the surveillance and the check resulting from uncertainty.

The dynamics of information brings important boundaries for the possibilities of closing complete contracts.

Speaking of contracts – which are not necessarily complete from the point of view of limited rationality – Simon (1951) proves that, from a certain kind of uncertainty, the organisational contract is most propitious when "the authority" (the management) is more flexible. For example, the employment contract could be incomplete because it is not defined in extension but only by the understanding of regulations of the working right. In this case, the employee might formulate certain contract clauses which appear varying with the circumstances and which were not mentioned in extension. The remuneration will therefore depend on the value of the employee's option, but at the disposal of the employer.

If rationality is limited, it is also procedural. Organisations exist not only for the extension of the rationality field, but also for their capacity of facing the unstable environment and to destabilise it. Uncertainty, asymmetry of information, this specifics of incomplete contracts and the possibility of opportunist treatment – as main determinants for the transaction cost – they all justify, from the economical point of view, the emergence and the persistence of organisations, nevertheless separating themselves from the market as forms of organising the trades.

The organisations are revealed as repeated allocations of resources based on a communication system. The adjustable behaviour is essential for the existence of the organisation's structure. The enterprise can be regarded as an emergence inside a group of individuals, representing an assembly of learning models and mutual comparable rules, representing at the same time models of response to the different attractions of the economic environment they are acting in. Straining to get information, to exploit them in order to get a specific balance, economic agents turn the information into organisation.

If the uncertainty becomes radical (improbable), the rationality is limited and the notion of organisation gets a whole new dimension, flexibility distances from the capacity of adjustment of the price variable, in order to approach that capacity of collective adjustment.

As O. Favereau [7] writes, "in a context of uncertainty and limited rationality, the management allows for an adjustment program, by the acquisition and the transfer of data through information".

A. Smith revealed in 1776 that the management allows the individuals to take interest in the advantages of productivity given by the work division. The existence of pre-established operational charts tends to reduce the costs associated to current decisions and allows for the correct affection of the most rare resources. In a more general sense, the organisation limits the problems of communication between the parties and it also raises the productiveness and efficiency of the informational system. The organisation reduces uncertainty, by its capacity of dealing with adjustable behaviours and allows for the "translation" of information into a common language that could communicate it faster and at a lower price. Thus, the greater the uncertainty, the greater the advantage of the organisation.

To conclude, the organisation is not part of the market but an alternative to it. Thus, as O. Favereau writes (1989): "the rational activity of individuals is extended over the choice of means of interaction: organisation or market". For example, if there are two ways of allocation of resources – the market and the organisation – flexibility would be a component of the organisation rather than the market. In the case of certain uncertainties, the market becomes more efficient than the organisation. Over this level, rationality becomes procedural and the most efficient way of allocation of resources would be the organisation. Thus the organisation- market-organisation cycles could be explained, as the evolution of the western financial system proves it to us.

Therefore organisations are not an accident, nor are they a subsidiary form dominated by the market, but they are a major structural part of the economic systems, meaning a market economy in its purest expression. The organisation does not appear only as a landing for the market insufficiencies; but it is a mean of practising control over the markets. Just as according to the standard theory, the organisation serves the market, according to the transaction costs theory, the organisation can go against the market. C. Menard (1989) sees that: "...the organisation is efficient as long as it establishes the rules of the game and is rewarded in an uncertain manner. Decisions rarely occur".

In closing this chapter, we consider that when the market is preferred, the reconstruction of the firm's activities requires first of all a separation which, in its turn, has two stages:

– the separation of the firm patrimony which will be rebuilt or extinguished;
– the building of two or more profitable enterprises which will become distinct economic and juridical entities and can cooperate in different forms, including by associations in groups without fusion.

When the alternative firm (organisation) is preferred, they usually resort to the internalisation of certain fusion activities, absorption, buying control packages from other companies, building some groups of firms. Usually, within created groups, the relationships between partners are regulated by closed contracts, which, as we have seen, are more or less complete. We consider that, in our country, the integration of some firms in the form of holding could lead to the sensible reduction of transaction costs.

Also, we could show that holding-type companies are mainly characterised, financially, through a series of specific elements:

- the holding has the chance of gaining capital at a lower price than other types of companies, because of its financial capacity and the high value of the holding (group) as an organisation with a legal body;
- the financial risk of the group is lower because of the diversity of activities within its components (subsidiaries), as well as their territorial disposal;
- a centralised accountancy of the financial resources allows for the lowering of financial expenses, because of the group co-ordination;
- the centralisation of financial information allows for the best decisions to be taken regarding investments, for a better co-ordination of the financial projection activity, as well as for a better accountancy of the group Treasury activity.

We consider that the integration of some firms or some activities should take into account, apart from the advantages of lowering the transaction costs, a series of restrictions imposed by the anti-monopoly policies and the increasing dynamism and openness of the world economy.

References

1. Coase, R.H., *The nature of the Firm*, Economica N.S., 1937.
2. Williamson, S., *Markets and hierarchies analysis and antitrust implications*, The Free Press, London, 1975.
3. Knight, F.H., *Risk, uncertainty and profits*, University of Chicago press, 1971, I ed. 1921.
4. Williamson, O., Winter, S.G., *Natura firmei*, translation into Romanian, Ed. Sedona, Timisoara, 1997, pg. 3 and the following.
5. Jensen, M.C., Meckling W.H., *Theory of the firm: Managerial behaviour, agency costs and ownership structure*, Journal of Financial Economics, vol. 3, 1976.
6. Brousseau, É., *Les théories des contrats*, Revue d'economie politique, nr. 103, 1993.
7. Favereau, O., *Les figures de l'irréversibilité en économie*, ed. Economica, Paris, 1991, p. 14.