

# FINANCIAL CONTRACTING AND AUSTRIAN ECONOMICS: A PRAGMATIC ESSAY ON METHOD

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## 1 Introduction

The proponents of the “Austrian” school of economics have ever since the formative years more than a century ago written much on the methodology of economic science. Austrian economists have been preoccupied with issues of scientific method even to such an extent that to some observers Austrian economics seems to be merely endless methodological speculation rather than constructive analysis of real economic phenomena. Also this paper is about method. However, instead of prescribing how the others ought to do economics in order to make it better than what it is at the moment, I take in the following a look at how I have in fact done economics in the past and how the results of my work differ from those of other economists.

I have found highly useful to study both the phenomena of the political process that shapes the law of a society and the phenomena of the market process that proceeds under the law as *processes of contracting* among purposeful human beings. It is a common practice in economics to search for and make use of imaginary constructions, such as the model of perfect competition, in which there are no obstacles to trade and the cooperation between individuals produces as good results as it ever can. My choice is to examine how the obstacles to contracting, or *contracting costs*, are or could be in reality lowered. We start by going through in the next section a classification of contracting costs that a person, intent upon investing a given sum of money, typically encounters in the financial market. We examine then some Austrian reflections on financial contracting, and extend finally the analysis to social contracting.

## 2 A classification of contracting costs

Let us assume that there are 100 persons with extra cash of 10 000 mk each, all ignorant of the existence of each other, and a producer willing to borrow up to 1 000 000 mk to finance a modernization of her production plant. I examine in the following, in the order of typical appearance, the costs of contracting that the parties on the supply and demand sides of the financial market incur while trying to find each other, drawing up a loan contract, and making sure the terms of the contract are complied with. The classification of contracting costs, elaborated at greater length in an earlier paper (Vihanto 1992b), is based on the treatment of the obstacles to trade and the corresponding market-making activities by Mark Casson (1982). More extensive treatises on contracting costs include those by Oliver E. Williamson (1985) and Paul H. Rubin (1990).

The time and money a would-be investor expends while combing newspapers for advertisements and phoning at random local business firms (or sending them E-mails) are examples of *contact-making costs*. They tend to be high in particular for parties who enter infrequently, or even only once in their lifetime, into loan agreements and lack therefore a “touch” with the financial market. A stereotyped example of an uninformed borrower would be an artisan, about to start her own business after years in another’s employ, who knows all about her trade but feels completely lost in matters of finance and law. Contact-making costs, along with other contracting costs, explain why businesswomen of this sort may think it best to resort to methods of “financial bootstrapping”, such as selling their houses, scrounging from their relatives, and asking their friends to give a hand in fixing equipment bought second-hand from bankrupt’s sales (Winborg – Landström 2000).

Once one of the investors has found an interested producer, he can sell his information to the other investors and spare them the trouble of reading newspapers and making phone calls. The entry of a *broker* of this kind into the market does not remove contact-making costs in full because those willing to lend or borrow must find him first before being able to contract. The costs are supposedly much lower because the broker can stay in business even though his customers change as time goes on.

After an investor has found, in one way or another, a producer ready to borrow his savings, he begins next to inquire how sound is the purpose for which the producer plans to use his money and how creditworthy is she as a person. *Screening costs* result, for example, from analysing the firm’s financial statements of the past few years and checking for possible defaults with other creditors.

Again, once the investor has found out enough for a rational lending decision, he can make multiple use of his information by selling it to other

investors. The investor is acting then as a *rating agent* who contributes toward a more efficient use of capital in the economy by saving on screening costs. A further cost advantage of the rating agent is that he can utilize the general knowledge he piles up while screening one loan applicant to screening an infinite number of other applicants. At first sight it may seem that only the investors benefit from the scale economies, but in fact the benefits are shared with those producers to whom the investors now dare to lend at a lower interest.

A problem of the rating agent is that the other investors are easily able to free ride on his efforts to increase information. They can buy a rating second-hand at a discount or simply imitate the customers of the rating agent. A solution is that the rating agent borrows himself from the investors, takes the funds to his balance sheets, performs a size transformation, lends the total to the producer, and converts himself into a *banker*.

If the banker borrows at a fixed interest rate, he acts at the same time as an *insurer* against a default by the producer. In order to perform this function properly, the banker must buy a reinsurance from a central bank, assumed here to be privately owned, or, more aptly, lend to a large number and different kinds of producers. Each of the investors could in theory agree upon similar risk sharing separately with all the others, but contracting costs would then be prohibitively high, and some of the most risk avert investors might choose to never enter the financial market.

When the banker's business expands and he must of necessity take partners and hire employees, new contracting cost problems emerge that set finally an economic limit to the expansion. This is but one example of the numerous occasions where a means to lower contracting costs in one quarter heightens them somewhere else and makes contracting cost economizing essentially an act of comparing the pros and cons of alternative contractual arrangements.

We return now to the lone investor of my original example who after screening begins to discuss the terms of the loan contract with the producer he finds creditworthy. A means for the producer to avoid the *negotiating costs* involved in such discussions separately with each investor is to have the IOUs ready printed and sell them on a take-or-leave basis like sausage in a supermarket. A further advantage of such standardized financial instruments is that, due to easy screening, they are more liquid in the secondary market and sell at a lower interest than tailor-made loans.

Negotiating costs tend to be high when a contracting party expends resources specific to the contract. An example of such contract-specific capital is the knowledge that an investor obtains, perhaps with considerable time and effort, while acquainting himself with the business of the producer. Unless the

investor succeeds in protecting his investment through an appropriate contingency contract, the producer may take advantage of his nonsalvageable investment and bargain a reduction of interest when borrowing for a second time from him. Integration is a solution, but there are a host of countervailing reasons why investors are seldom prepared to acquire the possession of entire business enterprises.

After the terms of the loan contract have been conclusively negotiated, the contract will be typed, left to a lawyer for legal check, and finally signed by both parties. Later the debtor must take care that she remembers to pay the annuities in time, and also the creditor must keep a record of the payments. All this involves what might be called *executing costs* of the contract. By developing special expertise in processing loan documents and servicing loan contracts, a banker has a good chance to save also on these costs and to further reinforce his competitive edge in the financial market.

At the *ex post* stage of the contracting process, with the names put irrevocably on the paper, the main and often the only interest of the investor concerns the ability and willingness of the debtor to pay the principal and interest as specified in the contract. For the purpose of making sure that the debtor indeed complies with the terms of the contract, the investor monitors her and her business by, for example, paying occasional plant visits and keeping himself up to date in the central financial ratios. A means to reduce the *monitoring costs* is to use restrictive covenants that enjoin the producer to maintain adequate fire insurance, to inform of financial ratios moving above or below certain thresholds, or to do other things.

Monitoring as a function of loan contracting is to a large extent similar to screening, and both call for expertise of the same kind. We may therefore expect that a banker experienced in screening can make profitable use of his skills also in monitoring, and he has a comparative advantage both in screening and as a *delegated monitor*. Monitoring is a partial substitute for screening, and quite considerable effort may be put to it when screening is difficult such as in venture capital business.

If the producer defaults for some reason and fails to pay what was agreed, the investor must consider means to enforce the contract. The time and money expended to exercise moral suasion on the debtor or to take legal action against her are examples of *enforcing costs*. The fear of a ceasing relation to the creditor and, more generally, of lost trade in the future provides a powerful incentive for the producer to act as promised even without any threat of legal enforcement whatsoever. A banker is better able than an individual investor to create such a market sanction because of his capacity to make bigger loans. This gives a further contracting cost reason for the existence of financial

intermediaries. An individual investor can strive toward the same effect by lending short term and renewing on the condition of good performance.

The sanction mechanism of repetitive trade is more effective when the producer has a *well-known name*, registered and protected by the government, which makes it easy for the customers, employees and other trading partners to communicate their experiences of the trustworthiness of the firm. The government can assist the market in avoiding enforcement costs by protecting, besides proper nouns, professional titles such as “banker”, “rating agent” and “chiropractor” against use by people unqualified for the profession (Vihanto 1995b). Legislation of this kind does not probably entail excessive interference with the workings of the free market because even if no “mutual fund” were allowed by law to own more than 10 % of the stock of any single company, a firm with another name could well do whatever its owners conceive judicious. A good reputation, associated with a business name, is in banking more important than in most other industries, and it shows itself, for example, in the readiness of producers to disclose their valuable business secrets at the stages of screening and monitoring.

The market is vulnerable to the obstacles that contracting costs place in the way of efficient exchange, but it is also clever at discovering ever new ways to avoid contracting costs. The bank is an age-old innovation that, as we have seen in this section, helps the process of exchange in a number of ways. The banks of the free market can assume further functions or give up some of those examined above. For example, a bank can borrow by accepting deposits with immediate maturity, or it can leave the funding function altogether by confining itself to underwriting bonds issued by corporate enterprises. The particular arrangements that a bank finds the most expedient for its purposes depend on the prevailing circumstances and vary from one time and place to another. For example, when the legal protection of property and contract rights is weak, a bank may lend primarily to its depositors with the double object of organizing an interest group against a government itching to seize its reserves and of making a credible commitment not to defraud of the funds itself (Rajan 1998).

Contracting costs are not the only *raison d'être* for banks (Allen – Santomero 1998). For example, an individual investor may be able to purchase financial derivatives exactly at the same cost in the exchange as the banks, but he still chooses to charge his bank with the risk management of his assets if he knows nothing at all about American-style call options and the like. The investor is in this case like a patient who consults his chiropractor sooner than studies professional books in a medical library in order to find a cure for his back pain.

### 3 Austrian reflections on the contracting process

Most of the insights into financial contracting explicated above have probably been found out through *introspection*, and all of them can be understood introspectively, with only limited knowledge of the particulars of financial reality. I wonder with Donald N. McCloskey (1983) why economists could not frankly admit that introspection is of such central importance in their discipline and that they are able to develop economic theory simply by imagining themselves in the place of the human beings whose actions they are supposed to explain and predict (Vihanto 1999a). It is also difficult for me to see any reason of principle why economists could not take their inquiries into the human mind one step further and utilize the findings of psychology at least to a limited extent in economic explanation. For example, while explaining the lending behaviour of banks, I found it highly useful to know what the loan officers are in fact thinking to themselves and how they come to their decisions in reality (Vihanto 1998).

An Austrian economist F. A. Hayek puts forth in one of his major books a psychological theory according to which human beings act by *following rules* (Hayek 1952). For example, a loan officer, starting to negotiate on the terms of a loan contract with one of his clients, does not optimize, as most economists would like to make us believe, but he follows more or less crude modes of behaviour that have proved to work in the past. The officer classifies first the case at his hand by comparing it to previous cases with at least partly similar qualities, recalls then the results of acting in different ways in those classes of cases, and repeats finally the action that has produced the best result. The officer is not capable of directly choosing the best course of action because he cannot know the future and, even if his knowledge were somehow miraculously perfect, he could not handle all of it due to bounded rationality.

A practical implication of this for financial economics is that the decisions of a loan officer depend essentially upon what he has learnt so far in his life. For example, if an officer has never experienced the horrors of a bank failure, or it was so long ago that, in the terminology of the economics of psychology, the remembrances are not easily “available”, he may negligently overestimate in his mind the value of the collateral pledged by a borrower and expose the bank to an excessive credit risk. Human beings need not experience all events themselves in order to be able to allow for them in their own actions, but reading of adversities from books or learning of them from others in other ways may not, to use an expression coined by Israel M. Kirzner (1992), make one “alert” enough to the possibility of their coming one’s own way.

The structure of the mind of an individual is a complex product of lifelong learning, and it is never a perfect replica of that of any other individual. The knowledge of each one is *subjective* and lends itself not always to an easy access by others. For example, a loan officer and a loan applicant may assess very differently the prospects of a business plan in consequence of their differing dispositions to interpret the same perceptions and to make differing perceptions in the first place. Economists usually stress as the chief problem of screening the asymmetries in information which to them mean hidden information, almost as a general rule, by the borrower for opportunistic endeavours, and which lead to the notorious phenomenon of adverse selection. In reality, asymmetric information need not have anything to do with opportunism, and it does not necessarily refer to plain facts that any competent loan officer is able to interpret once the loan applicant decides to disclose them (Langlois – Foss 1999). A consequence of loan applicants failing to make their plans understood by outsiders is that they are forced to resort to internal financing or to give up their plans altogether.

As a result of their emphasis on incentives rather than knowledge, economists pay excessive attention to moral hazard, respectively, as the chief problem of monitoring. The same bias leads to an underestimation of the capability of lenders to discover new ways to reduce monitoring costs and to an exaggeration of the “failures” of the free loan market. In the Austrian view, contracting is an *open-ended process of discovery* in the course of which the parties innovate ever new ways to circumvent contracting costs and whose particular products are to them often unforeseeable or in the extreme total surprises (Vihanto 1995a). No one can know in advance, before the innovations have in fact been discovered, what in particular they will be and who will discover them. The most we can do is to strive for them indirectly by creating favourable conditions for the individuals apt for creative thinking, whoever they might be, to apply their talents and produce solutions that all will appreciate after the event.

In the market order, the rules of private property provide a good framework for mobilizing the creative potential, scattered in the minds of the market participants, by permitting everyone to make free use of his or her own possessions in order to experiment with novel ideas. In an organization, such as a big bank, means to induce variation of action are to hire employees with different backgrounds and to establish quasi-independent divisions. Even the government of a socialist commonwealth is able to provoke some novelty by, following the argument of an Austrian version of the Tiebout hypothesis (Vihanto 1992a), dividing its banking activities into local subunits.

Besides entirely new knowledge, the contracting process of the market may generate discoveries of facts which are already known but only by some

and which, once more widely utilized, enable a *coordination of the plans of the market participants*. For example, a bank may discover to its great surprise that a method of advertising, used for years by firms in other industries, makes many investors realize the breadth of its services and gives a strong push to its business.

All contracting costs tend to fall off under stable circumstances where the market participants have enough time to find out the best available courses of action. This tendency holds true in particular for contact-making costs that may disappear altogether in equilibrium. All opportunities for better contracts have then been fully exhausted, and action degenerates into routine repetition of decisions, seen to be optimal during the preceding process of equilibration. The attainment of full coordination, or general equilibrium, is conceivable in the imaginary conditions where the data external to the coordination process cease to change, the people learn to repeat the optimal courses of action and, in the telling terminology of Ludwig von Mises (1949), the economy becomes “evenly rotating”.

Most economists use equilibrium models while trying to understand the contracting process and, not unexpectedly, pay scanty attention to the devices of the market to dodge problems of contact making. Austrian economists emphasize in particular the role of *market prices* in making entrepreneurial market participants alert to unutilized opportunities for exchange. Money enables the buyers and sellers in the market to express their plans in terms of the same commodity, and differences in these expressions, price differentials, display in turn possible discrepancies between the plans (Vihanto 1989). Whereas for the equilibrium theorists prices perform their social function by providing incentives to act optimally, for Austrians they are of value especially by helping us discover the optimal actions in the first place.

#### 4 Social contract and government action

I have assumed so far, as Austrian economists often do, that there is a government that enforces the rules of the free market economy. This imaginary legal system might be defined as one where everything scarce is in the private possession of some individuals, and all have an unlimited freedom to use their property in whichever ways they desire, subject to the sole proviso that they do not violate the equal rights of any other individuals to use their property. For example, when an insider of a public company, such as a member of the board of directors, buys shares of the company at a price that the seller considers later too low, there is a tort only in so far as the act of the buyer somehow infringes upon the rights of the seller.

What troubled me for long in this definition of the market system was that in a large number of cases it does not yet alone help us determine in practice how to resolve conflicts in the use of private property. For example, in land use tough issues of incompatible exercise of private property rights frequently emerge and put the courts before awkward decisions. My answer to the dilemma is based on the finding, known from ancient times, that in a great majority of legal disputes a *prominent solution* exists that seems somehow obvious or natural to almost any reasonable human being and stands out among all the others as soon as someone discovers and carefully states it (Vihanto 1992c). Following this line of thought, we might define the market economy in a more accurate and, above all, operational way as a legal system that is based on prominent rules of private property.

The idea of prominence is useful in many other instances besides those in which the general rules of just conduct are laid down. For example, when the government of Finland sold in 1993 the bankrupt Savings Bank of Finland to the remaining four bank groups, it assigned the bank offices by giving in any particular case the first choice to the group with no activities in the locality (Ursin 1994).

Prominence is of decisive importance for the emergence of social order because it helps the members of society attain unanimity about the introduction of rules of law. According to a fundamental assumption of Austrian economics, the values of individuals are subjective, directly inaccessible to others, and the only truly reliable way to get to know about the values is to see them revealed in real action (Mises 1949). If we apply this view to laws, as I think we ought, we have grounds for considering a law “good” only to the extent that it is good in the opinion of those whom it affects, that is, all the members of society, and that all have given their express consent to enforcing it. The theory of *social contract* as, for example, James M. Buchanan (1959) puts it forth in his seminal paper seems to constitute the only conceivable foundation for a welfare economics in line with Austrian premises (Vihanto 1999b).

The obstacles to an efficient social contract, or a contract of any kind, can be analysed in terms of exactly the same classes of contracting costs we saw earlier to put friction on financial contracting. In consequence of prohibitive negotiating and other contracting costs, there has never been, and will probably never be, an actual situation of social contracting. This increases the responsibility of the economists by giving them the natural task of finding out what the participants in an imaginary social contract *would probably agree upon* if given an opportunity. Introspection is a vital method in the contractarian speculations, but the subjectivity of values limits its usefulness (Sen 1979).

If someone believes to have discovered an inefficiency in the financial market, offering an opportunity for a Pareto improvement, he can try to exploit it in principle either by suggesting new contracts to selected market participants under the existing law, or by persuading all the other society members to consent to a revision of the law. Individuals can usually be relied upon to find the most profitable modes of market contracting themselves, and economists need not bother to give advice on practical issues like that. In fact, if one none the less gives such a piece of financial advice, he is regarded with suspicion and urged to stake his own money on what appears so obvious an opportunity for getting rich. The case is different as far as social contracting is concerned because it is not a real phenomenon but exists solely as a thought experiment in the minds of the economists. On the contractarian view, the role of the political financial economist is to try to figure out which legal changes might get the unanimous approval of all and would in this way prove the attainability of a social improvement.

The participants in a social contract are free to make any decisions they desire just as the parties to financial contracts. Austrian economists want them to remember, however, that, also exactly as in financial contracting, they are involved in an open-ended process of discovery the particular results of which are largely unforeseeable (Vihanto 1993). The participants are well-advised to choose fairly general rules of law that give ample room for those living under the law to experiment with novel ideas. A means to make sure of favourable conditions for innovation in the sphere of law itself is to bestow extensive freedom on the courts to find solutions to disputes left them to a decision (Vihanto 1996). Legal evolution is a highly path-dependent process, and attempts to transfer its end products from one society to another are often doomed to failure. For example, financial legislation proved to be expedient in industrialized countries may be as such entirely unsuited for less developed countries with backward financial markets.

## 5 Conclusion

The way a person interprets an economic problem depends greatly upon his framework, or “lens”, through which he observes his environment. When a big bank turns down the application of a small starting business firm for a term loan, a layman, with all his prejudices against “big money”, may regard the conduct of the bank as a plain indication of arbitrary monopoly power. His solution is a revision of the rules of law that renders similar injustice impossible in the future. A contracting cost economist suspects first a screening problem that arises from the efforts of opportunistic loan applicants to mix with

others and the failure of a good risk applicant to make her promise to repay the loan credible. Finally, an Austrian economist tends to pay his main attention to knowledge problems that are a consequence of, say, the failure of a loan officer to comprehend the train of thought of the applicant or the specifics of the field of her business.

I have aimed in this paper, as in my other work, to understand the events of the market and the society generally by combining the three approaches into one coherent whole. Important in this enterprise is to analyse all social phenomena as results of the actions of human beings. The main method in such an analysis is introspection that can be complemented, as the need arises, by the findings of experimental psychology. The end product may not always correspond to anyone's conception of pure Austrian economics, but this is alone of little relevance in today's relentless competition between scientific research programmes.

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