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DEBT AND EQUITY CONTRACTS IN THE THEORY OF SOCIAL ECONOMY

Usamah A. Uthman

*Assistant Professor of Economics
Finance & Economics Department
King Fahd University of Petroleum and Minerals
Dhahran 31261, Saudi Arabia.*

Abstract

In an advanced economy, equity financing should be the rule and not the last resort. Profit-sharing provides more flexibility in meeting contingencies. It combines 'rules' and 'discretion'. Debt is restrictive, unforgiving; and hence less stable. There is a "fundamental paradox" in the "sale" of both information and money, precluding the image of a "normal" commodity. Debt provides a market mechanism that may invite opportunism in addition to the usual moral hazard problem. Equity has no such mechanism and hence there is less room for opportunism. The property-right approach shows an imbalance and asymmetry of rights between the contracting parties in a debt contract. In an interest-based contract, there is a demand for a peculiar type of insurance.

I. Introduction

Why have so many economists confused interest and profit? Why have they treated them as one and the same? Bohm-Bawerk (1884) gives us a clue to an answer. He writes:

People get interest not because they work for it, but because they are owners. Interest is not an income from labour, but an income from ownership. (Bohm-Bawerk, 1884, p. 304).

Bohm-Bawerk is correct, except for the fact that he uses the word interest to denote both contractual interest (on loans), and natural "interest" (or profits). It is correct that both interest and profit are incomes from ownership, not from labour; that both are surplus values, and that both are flow concepts. These may be the major causes for confusing the two concepts (interest and profit), at least at the economic-theoretical

level. Yet the hallmark difference between interest and profits is as Schumpeter explains, that *interest (payment) is a contractual, permanent flow that is derived (deducted) from ever-changing, transitory, residual profits* (Schumpeter, 1934, p. 176). *The interest rate is an explicitly negotiated price (of debt)*, a result of a non-step bargaining process between the capitalist rentier and the borrowing entrepreneur. The profit rate is not an explicitly negotiated rate nor is it a price. It is the result of a *two-tier* bargaining process wherein the entrepreneur has to negotiate the price of his inputs on the one side, and has to negotiate price of his output on the other. The entrepreneur's power to "negotiate" is conditioned by the degree of competition in both markets. This implies that unregulated profits can never be contractually guaranteed, because profits are the residual of two bargaining processes that take place in two different markets. Therefore, the entrepreneur is expected to be subject to more risk than is the capitalist lender. Things get further complicated if the firm has to negotiate for the financing of its investments. In equity financing the firm pays dividends (profit) if any. In a debt financing it must pay interest to its creditors regardless of profit.

The growth of debt finance in the seventies and eighties of this century has been alarming. Henry Kaufman (1986) explains seven underlying causes for the growth of debt in the United States (and probably in the world). These are: 1) the change of attitude towards debt, 2) financial deregulation, 3) financial innovation, 4) debt securitization, 5) internationalization of financial operations, 6) tax preferential treatment of interest payment over the payment of dividends and, 7) the impossibility of practicing financial prudence on the part of the major participants of the financial system.

The objective of this paper is not to discuss why would a firm go for one type of finance rather than the other. Instead, it tries to investigate the implications of debt and equity finance, with no further attempt to discuss other forms.

To do that, we analyze the subject from (a) the transaction cost-governance structure approach, and (b) the property rights approach. Both approaches show the efficiency implications of interest-based debts as opposed to those of profit sharing.

II. The Transaction Cost Economics Approach

This is a recent approach that is attracting increasing attention of economists who study the firm theory. Williamson (1985) explains transaction costs economics (TCE) as a branch of the new institutional economics that is closely related to the field of industrial organization. The approach is complementary rather than exclusive with respect to other approaches and Williamson argues that any issue that is either the result of, or which can be reformulated as, a contractual relation can be examined usefully as a transaction cost problem. The behavioural assumptions of the transaction costs economics approach are *bounded rationality and opportunism*. Bounded rationality is a semi-strong form of rationality in which economic agents are assumed

Usamah A. Uthman: Debt and Equity Contracts in the Theory of Social Economy

“intendedly rational but only *limitedly so*” (Simon, 1961, p. xxiv). According to Williamson, *opportunism* means self-interest with guile (in a greedy or predatory sense). The industrial organization problem that faces the contracting parties is to “devise contract and governance structures that have the purpose and effect of economizing on bounded rationality while simultaneously safeguarding transactions against hazards of opportunism” (Williamson, 1985, p. xiii). Bounded rationality leads to non-optimal decisions, while opportunism leads to predatory practices that threaten the stability of contracts.

Contrary to orthodox thinking, which normally treats the firm as an impersonal, entrepreneurless production function, transaction costs economics develops the idea that the firm (for many purposes at least) is more usefully treated as a governance structure, or a problem of contracting (Williamson, 1985, p. 20). In addition to the behavioural assumptions of bounded rationality and opportunism, the third important factor that influences the design of a contractual relationship is the degree of asset specificity (redeployability). The less redeployable the assets are to other uses, the more specific they become to the firm. The purpose of contracts, then, is to economize on bounded rationality while simultaneously safeguarding against the hazards of opportunism. This is a more complex view of what a firm is than the simple production function idea in conventional economics (Williamson, 1985).

When it comes to financing decisions, Williamson’s views are in sharp contrast with the Modigliani-Miller theorem on the irrelevance of the firm’s capital structure (1958). According to Williamson (1988), the degree of the firm’s assets specificity (redeployability) is the major determinant as to how an investment should be financed. Williamson argues that highly redeployable (less firm-specific) assets will be financed with debt while equity is favored as assets become highly nonredeployable. He contends that in contrast to equity finance, debt is a comparatively simple structure, a (more strictly) rule-governed relationship and thus has relatively low set-up costs. Williamson explains that debt financing usually imposes strict rules on the debtor, including (a) the payment of interest and principal instalments at regular intervals; (b) the satisfaction of some liquidity measures, and (c) the permitting of creditors to have priority access to the firm’s assets in the event of business failure and liquidation. Debt is unforgiving. Williamson comes up with a provocative conclusion, which is that “the TCE, approach postulates that debt is the natural financial instrument. Equity appears as the financial instrument of *last resort*” (Williamson, 1988). However, we may express some reservations about Williamson’s conclusion. The degree of asset specificity is not the only, and sometimes not the most important element with respect to financial decision making. Although highly important asset specificity is only one element in a spectrum which determines the degree of risk of an investment, the degree of asset specificity is related to the division and specialization of labour¹.

The more advanced an economy is, the more specialized is labour (and capital), and, hence, the more specific would become the firm’s assets. In an advanced economy, asset specificity is the rule and not the exception. In such an economy, and in

accordance with Williamson's rule (of using more equity the more specific the assets are), equity financing, contrary to Williamson's conclusion, should be the rule and not the last resort. It is not necessarily true however, that set-up costs will be higher in the case of equity finance than that of debt. Irrespective of the form of finance, a firm always needs a board of directors, a body which has to be elected, to appoint the management, and set rules for auditing and monitoring internal performance. The size of management depends mainly on the project size and not necessarily on the type of finance and governance. As a matter of fact, under debt relations the firm's management might find it difficult to reconcile the "rules" that it sets for itself, with the *legally-obligatory* rules that are imposed by its creditors.

II.1 The Alchian-Woodward's Critique Of The TCE Approach

Alchian and Woodward (1988) distinguish two types of opportunism: hold-up and moral hazard. Hold-up refers to a situation where an owner of an associated resource(s) tries to extract some quasi-rent by refusing to pay or serve. Moral hazard, on the other hand, "arises in agreements in which at least one party relies on the behaviour of another and information about that behaviour is costly" (Alchian and Woodward, 1988). Alchian and Woodward contend that the *type of asset specificity* (which is a function of the *type* of opportunism that could be involved) is at least as important as the *degree* of asset specificity. They explain that asset *plasticity* (the range of discretionary, legitimate decisions within which the user may choose) and monitoring costs bring about moral hazard costs, and thus raise the costs of debt. A drug company (more plastic) could face higher debt costs than a public utility company (less plastic). They argue that "The theory of debt financing rests on the degree of asset plasticity as an explanation of debt-equity ratio". They contend that this argument forgets other (probably more important) factors such as tax and bankruptcy laws and variability of sales and cash flows, that influence debt-equity decisions. But the Alchian-Woodward argument (on asset plasticity) cannot be generalized because an individual investing in a particular company may not be as shrewd as a banker in terms of investigating the company's plasticity and other factors. Arguably, if firms with high degree of plasticity are apt to be financed with equity (to avoid the higher cost of debt), less plastic firms should be apt to be financed with equity for a different reason. When the degree of exploitation is lower, and the degree of return risk is also lower, one wonders if debt holders are not forgoing a possible expected higher rate of return.

II.2 Rules vs. Discretion

Because there is more discretion in profit-sharing arrangements, there is necessarily more provision (safe-guarding) for unforeseen contingencies. As a matter of fact, profit-sharing (i.e. equity finance) combines both rules and discretion. To see this, assume that one party is to provide the finance and the other is to work on the

investment, with profit (if any) to be divided according to some agreed-upon percentage for each party. This implies that shares of *expected* profit are determined *ex ante*, while the actual rate of return on investments is to be determined only *ex post*, on the basis of realized profits. The former is in the nature of a rule in the sense that it is predetermined at the time of the contract, while the latter is in the nature of discretion in the sense that the real rate of return is to be determined by the circumstances that take place. Since debt requires regular, predetermined interest payments, business difficulties may create pressures on the firm's cash flow, forcing it either to forego what could otherwise be some further profitable ventures, or borrow further (and may be at a higher interest cost), or sell some of its existing assets to meet liquidity requirements. Equity finance does not require such prescheduled, mandatory payment of interest (dividends), and thus does not create such pressures. When this is the case, the cost of adjustment to any contingency is lower in the case of profit-sharing than in the case of debt.

A firm financed by equity can plan for its cash flow so that it could provide for a source of funds (to meet some *liquidity standards* of its own), while at the same time provide for a *sinking fund* that shall be used for the purpose of replacing investments. Under equity finance the firm can thus provide for two of the most important rules of debt finance (liquidity and sinking fund). The major difference, though, lies in the degree of flexibility in applying these "rules". The general business practice and/or the general assembly of shareholders can force such "rule" on the management. Obviously, such "rules" do not result in the foreclosure of the firm's assets by an outsider in bad times of business.

II.3 Analogy Between Sale Of Information And Sale Of Money

Confusion about the role and nature of the financial sector in the economy stems from confusion about the special nature and the peculiarities of money, which is the object of financial relations. Awareness about such peculiarities and special nature is necessary to understand and appreciate the difference between debt and equity relation.

Financial contracts have some elements that are similar to the processing and selling of information. Kenneth Arrow speaks of a "fundamental paradox in the determination of demand for information: that its value is not known by the purchaser until he has the information, but then he has in effect acquired it without cost" (Arrow, 1982, p. 616).

We should note here that a similar "fundamental paradox" exists in contracts involving the "sale" or renting of the 'use' of money, in the sense that *the value of its use is not known until the investment comes to an end or until the loan contract expires, whichever comes first*. But if the value of the loan-use is known with certainty beforehand, then either the lender would not offer the loan, if the profit rate is certainly known to be higher than the interest rate, or the borrower would not ask for a loan if the case were the other way around. In both cases, profit-sharing (equity financing) would replace interest-based debt.

The peculiarity of information does not stop there for

“... even if it has been “sold” it remains in the possession of the producer or the seller who may know its content after the sale. Information does not fit into the image of a “normal” commodity which changes hands from seller to buyer in a straightforward manner”. (Hodgson, 1988, p. 163).

Needless to say that information to the seller, after sale, may be of a lesser (i.e. discounted) value than before sale.

Of course, the rental of money is also different from the sale of information in the sense that in the latter case the seller still retains the good whereas in the rental of money the lender is deprived of the ability to use this asset for the duration of the loan. We shall return to the issue of property rights once again in this paper.

But it should also be noted that just as in the sale of information, when a lender sells the “use” of his money, he still keeps a title (a property right) to the object of money regardless of how good or bad the investment turns out to be. Thus it can be concluded that *there is an analogy between information and money in the sense of the existence of a “fundamental paradox” in the sale of each, and in the sense that none of them fits the image of a ‘normal’ commodity.*

The above paradox is traceable to opportunism. For when interest-based lending is permissible, each party will be involved in a comparison of the market interest rate with the expected rate of profit. Exaggerated expectations of future prospects may not be limited to debt finance, but greed and opportunistic tendencies may be *enhanced* by the availability of debt. The locus of opportunism in debt finance is to be found in the inverse relationship between the interest rate and the price of a bond. This opportunism is exemplified by the business practice in the United States in the 1980’s. Felix Rohatyn (1989) writes “Junk bonds appeared in the early 1980s as a way for companies without a long history of earnings or sales, or those with a low credit rating, to obtain financing. They have now become widely used as a way to raise money for takeovers and LBOs (leveraged buy-outs). These bonds carry interest rates ranging from 13 to 18 percent, often more than the average return on the investments of the underlying business. When businesses combine issuance of these bonds, with high debt-to-equity ratio, many are burdened with interest costs that are so heavy that they probably could not be sustained during a recession.” The largest leveraged buy-out in history, of R.J.R. Nabisco, is a case in point, as it was financed with “junk” (low-price, high-interest) bonds. No inverse relationship exists between the profit rate and the price of an equity share, and profit is not a guaranteed income to the lender, nor does it provide the borrower with the so-called “financial leverage”.²

What we see, then, in debt finance is a market mechanism that may invite and facilitate opportunistic tendencies. Such a mechanism is coupled with the moral hazard problem, explained earlier by Alchian and Woodward, where the financiers rely on the behaviour of the agents (the borrowers) and information about that behaviour is costly. When it comes to equity finance, it is admittedly true that the second source of opportunism (of moral hazard) may be existent, but there is no market mechanism to facilitate it, since there is no strict and explicit rate of return that

is negotiated in advance. Bankers or financiers in general will have to be more careful in evaluating projects and applicants for financing when it is going to be done on some equity basis. Since bankers shall have no guaranteed (interest) income and cannot be lured by instruments such as junk bonds, the room for opportunism should be (or is expectedly) narrower than that under debt finance.

II.4 Stability And Continuity

The above discussion brings up the matter of stability and continuity in relationships. Interest-based debt contracts involve (or imply) a preemptive comparison of the interest rate with the expected rate of return on investments (before allowing for interest charges). The spread between the two rates reflects the degree of inability to make a sound judgement (bounded rationality) on the part of either side of the contracting parties. Alternatively, in an equity financing contract, no such preemptive comparison exists. The interests of all the involved parties are more aligned from the very beginning where no one's return is a contractual burden on the other. The actual rate of return of all *sharing* parties will be determined *ex post* in accordance with the actual performance of the business venture. This implies that the sharing (equity) arrangement economize on, *but may not eliminate*, the bounded rationality of all parties when it comes to decide on which financing instrument to go for.

The unforgiving nature of debt makes it more of a burden on the borrower when circumstances change for the worse. Whenever there is a possibility of reopening the contracts, several things may happen. If the market interest rate goes down, and refinancing is possible, the debtor will not hesitate to take advantage of the lower market interest rate, call back and redeem some, or all, of his bonds, or convert the debt into an equity whenever possible. The latter (equity) is a more permanent or longer-term relationship. Interestingly enough, some empirical work (Mitchell, 1987) has suggested "that increasing uncertainty about future nominal interest rates caused the decline in debt maturity (of the U.S. corporate sector): managers moved away from long-term debt to avoid rolling over the debt at highly uncertain future rates". This is, of course, a testimony to the instability and lack (or weakness) of continuity in debt relations. This higgling and haggling in the case of debt is, however, not without cost, especially if it gets to the refinancing of a loan. The possibility of refinancing brings about an uncertainty; for both parties, as to the nature of the future terms of the contract. It might also be noted that a debtor's (borrower's) uncertainty about his tenure in his business may induce him to liquidate, through the depletion of his resources, as much as he can of the present value of these resources, before foreclosure prevents him from saving his own equity. This is especially true for those who cultivate natural resources (Ciriacy-Wantrup, 1952). *This is a manifestation of opportunism*. When an owner of funds gets into a partnership on the basis of profit-sharing there is less incentive for reopening the contract even if the expected average gross rate of return (the basis upon which they split the shares) changes. This

is because for the entrepreneur (or borrower) there are no fixities (interest payments) and no strict obligation of principal repayment. As for the lender, the actual return to his investment will be in accordance with the actual market conditions.

We may note, however, that recourse to the law and courts, or even to arrangements between individuals (governance structures) may not be enough to sustain the stability and continuity of contracts. *A recourse to ethics and social values is always necessary to maintain such stability.* Hodgson (1988) argues that for a system (or sub-system) to function well, there has to be (an) element(s) of impurity, in the sense of giving secondary dimensions or objectives, "which are not typical of the whole, but which are nevertheless necessary for the system to function". In other words, in material relations, such as financial contracts, even though the subject and intent of that relation is a materialistic one, the implicit (or explicit) provision of non-materialistic elements, which may sound "foreign" to the contract, such as social and moral values, may help not only the successful carry-over of the contract but also its recurrence in the future. In comparison with debt-finance (that is, stricter, unforgiving and maybe forcing foreclosure in case of business failure), profit-sharing contracts provide such a hidden impure element of "gift", in the sense that the money owner is willing to internalize more risk, and since these contracts are more flexible and forgiving in the case of an uncontrollable failure of the business. This is especially obvious under situation of complete separation of ownership and management. When the managers are not salaried, but share in profits, a safeguard can be provided to the fund-owner by stipulating that he shall have a progressive share of profits, the lower the realized profits are. This is an arrangement that should encourage the borrower to exert more effort in his endeavor and should lessen the moral hazard problem of underreporting profits. The above relationship is represented in Figure 1, where the lender's profit share is a decreasing function of profits. The intersection point represents a 50-percent share for each. Figures 2,3,4, and 5 present some variations of the relationship where some constraints on the relative shares of each party are introduced. The broken lines represent the situation in the absence of such constraints and the solid lines refer to the situation assuming the enforcement of constraints. This is a preferred-partner arrangement, and is somewhat similar to a preferred-stock financing, except that the return is obligatory only in the case of profits and cannot be rolled over to subsequent periods. This arrangement may be a better alternative than Williamson's (1988) "dequity" (debt-equity) governance structure (akin to preferred stock) that he suggests as an intermediate apparatus between debt and equity.

Interestingly enough, long term contracts, that try to "bypass the market" usually bring about more binding restrictions (Alchian and Woodward, 1988). But equity finance, which is one long term contract that tries to "by-pass the market", brings about much less restrictions in comparison to debt. Thus, equity financing can be expected to have lower transaction costs associated with it and, if implemented, a more efficient mode of business than debt financing. In all contracts (but especially in financial ones) moral deterrence is no less important than the legal protection from the

law. There is no question that for equity finance to pervade the market, it requires and implies a higher level of moral standards.

Figure 1. Variable Profit Share of Borrower and Lender of Realized Profit.

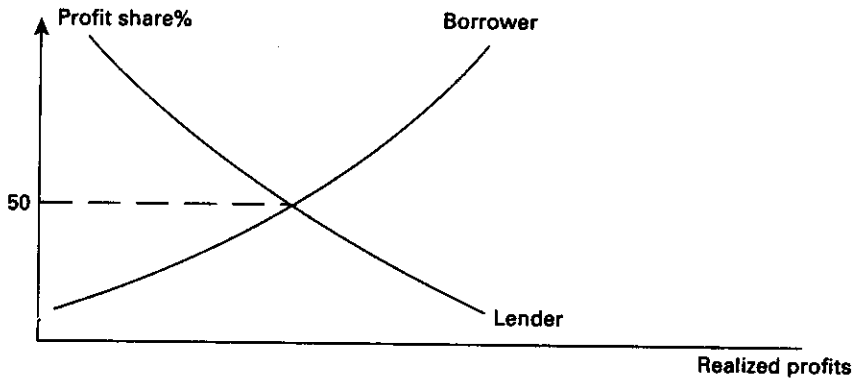


Figure 2. A Borrower Allowed an Upper Limit of Profit Share Somewhere Beyond 50%.

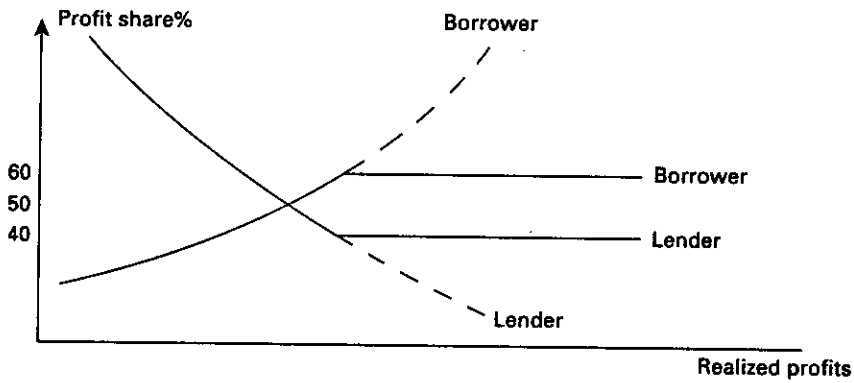


Figure 3. A Borrower Allowed an Upper Limit of Profit Share Somewhere Below 50%.

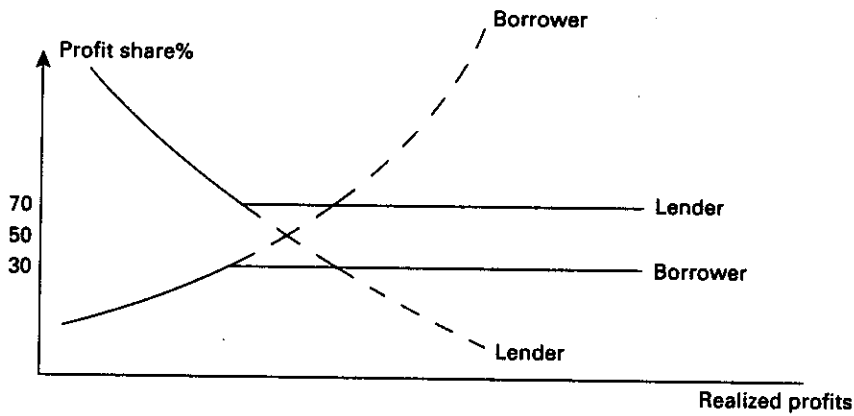


Figure 4. A Borrower Allowed a Lower Limit of Profit Share Below 50% and an Upper Limit of Profit Share Above 50%.

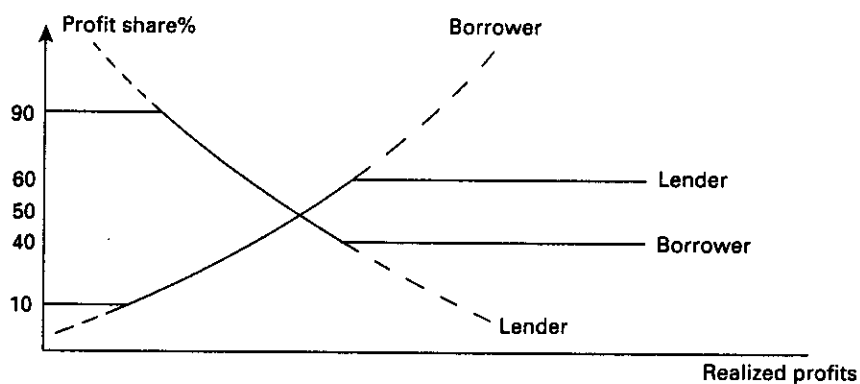
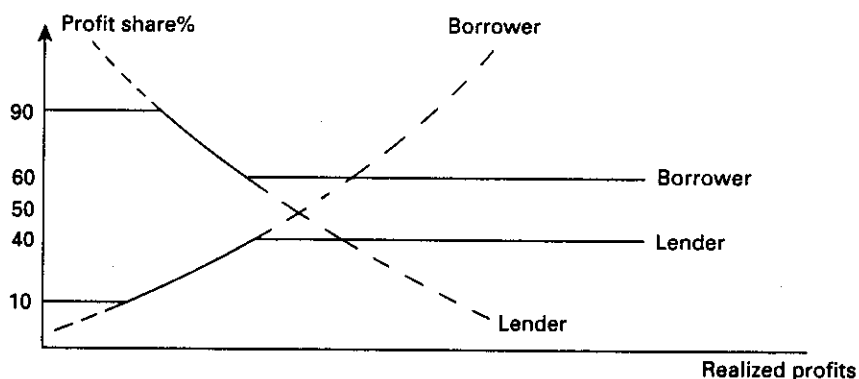


Figure 5. A Borrower Allowed a Lower and Upper Limit of Profit Share Somewhere Below 50%.



III. A Property-Right Approach

The issue of property rights is, in the first place, a matter of law with both economic and social implications. Confirmation of rights thus comes from the law, whatever its source, and not from the "natural" endowment of individuals. Furubotn and Pejovich (1974) explain that the function of the legal allocation of property rights is to provide, for an *ex ante* incentive, an alignment for all contracting parties, that is supposed to mitigate friction arising out of conflicting interests. (in the sense of eliminating, or at

Usamah A. Uthman: *Debt and Equity Contracts in the Theory of Social Economy*

least minimizing, the source of conflicts or objectives) *It would be reasonable to inquire about a maldistribution of property rights as a possible cause for economic malfunctioning.* Furubotn and Pejovich (1974), speak of three kinds of rights that come with the ownership of an asset: the right to use the asset, the right to collect returns from the asset, and the right to change the form and/or substance of the asset. "The crucial task for the new property rights approach is to show that the content of property rights affects the allocation and use of resources in specific and predictable ways". (Furubotn and Pejovich, 1972).

III.1 Implications Of Property Rights In Debt And Equity Finance

In an interest-based loan the lender maintains a permanent, *ex ante*, title (a property right) of ownership to his principal, the right to returns from the asset and, the right that his principal and interest be paid back in like kind (same form and substance). It should also be noted that these rights are enforced over a specific time period. Needless to say that in cases of business failure, the lender has the right to order liquidation. This structure of rights implies that the lender has the same, well-specified, *ex ante* and *ex post* property rights. On the other side, the borrower shall have the *temporary* right of use of the asset (money), be allowed to change its form and substance in the interim, and appropriate a *residual* income after the payment of principal and interest. The borrower, of course, will have to bring the assets back to their original (monetary) form and substance. Thus, there is an *imbalance* and *asymmetry* of rights between the two contracting parties; as one party (the lender) has some permanent and contractually-guaranteed rights, while the other (the borrower) has only some temporary and residual rights. Such imbalance and asymmetry of property rights may entice opportunistic behaviour on the part of the borrower in several forms such as the misappropriation of funds, the untimely depletion of resources or the forgoing altogether of what could otherwise be a profitable venture. On the part of the lender, guile may cause him, should difficulties develop, to foreclose and liquidate what could be a better business in a longer run. The "*unforgiving nature*" of the lender's property rights implies that he wants to eat his cake and keep it at the same time!

The stricter the rules of debt and the more unforgiving it is, the stronger the attenuation of the property rights of the borrower. Under situation of non-separability of assets, debt attenuates the owner's (borrower's) property right, not only in the debt received and the assets financed via that debt, but also in his own property and equity.

In an interest-based contract there is a demand for a peculiar type of "insurance". The borrower provides a contractually obligatory promise of returning the principal at the expiration date of the contract plus a mark-up, regardless of the circumstances of profit and loss, short of insolvency. Yet, the "insured" (the lender) does not pay for that "insurance". It may be said that since the interest paid is usually less than an average rate of return, if capital was alternatively invested on the basis of equity

participation, the lender is actually paying for his "insurance". But if lower risk is "bought" in return for a lower rate of return, then what is the payment for the insurance of the principal? In the usual insurance contract, the insured pays for his insurance, and is reimbursed only in the case of a catastrophe, with no mark-up over and above the value of the insured asset at the time of the accident.

Of course, the loan contract may not fully insure against loss but this is not the *intent* of the contracting parties. Here, we distinguish between the *intent* of a contract and the *motive(s)* of the contracting parties, for the intent is affected by the nature of the contract itself, regardless of the personalities of the contracting parties. Motives, however, is a psychological factor that differs from one person to the other. Madkur (1969, p. 511) explains that one seller's motive for selling a good, for example, may be the urgent need for income for consumption purposes. while for another seller it may be the reduction of unintended inventory, but still for a third may be avoiding taxes by converting his assets from one from to another. We may note that the *intent* of a debt contract is to enable the borrower to use a specified sum of money for a specific period of time and collect *residual* return (if any) over a fixed, contractually guaranteed mark-up for the lender by the end of that period. There are two basic motives, however, for a debt contract. First, interest results from a contract between two capitalists: one wishes to avoid risk (via a guaranteed return), the other wants to have control together with the speculative possibilities and the risks brought along with it (Hadley, 1984). Second, the fulfillment of some expectations in some endeavours, gives the illusion that fulfillment of another may be practically certain (Boulding, JPE, April 1951). Such an illusion may motivate the two parties to recontract once again.

III.2 The Overlap Of Property Rights

Under a debt contract there is an *overlap of rights*. For even though the borrower can claim that the assets are (temporarily) his for the duration of the contract, the lender has actually never permanently relinquished his rights. The rights of one are the burden and cost of the other. The asymmetry and imbalance of property rights, the overlap of these rights, and the unforgiving nature of debt financing are all sources of friction and conflict between the lender and the borrower. The foregoing implications are clarified further if we examine the provision of funds through an equity financing contract. Under this contract, the capital provider (who is also a partner) maintains, *conditional-upon-business-survival*, the rights of use, return appropriation, and changing the form and substance of his asset. There are no *ex ante* guarantees of any kind of rights for either party. The actual allocation of *ex post* right are to be determined *ex post* of the survival and fruition of business. The terms of such conditional rights, such as who-gets-what, may be determined *ex ante*.

It has to be remembered that even when property rights are well-defined in a contract, it is not necessarily the case that an overlap is precluded. For not all rights are to be enforced at the same time and the enforcement of some may be contingent upon

the circumstances. The lender's right of liquidation and foreclosure, for example, is conditional upon the failure of the borrower to pay. When comparing an interest-based contract with other contracts one has to be careful to analyze the motives of each contract and the special provisions that come with each.

Using the property rights approach, one might argue that the "hire" of money is just like the hire of a house; a price is paid for the services used. The comparison is not accurate, because tenants have greater certainty about the amenities (the uses) of a house, while the terms of the contract are fully determined according to the agreement between the parties. This is not so in the "money-hire" contract where the borrower has much less certainty about the value in use of the money hired. This use depends not only on the terms of the loan contract (the cost of capital), but also on future market conditions involving buying and selling (the uncertainty regarding the demand for real goods and services). The profits (use) if any, to be made are only a residual. This is not the case with the amenities (use) of a house.

The services of a house cannot be divided into separable units over time, yet the use of time for the purpose of charging rent for the use of the service is still justifiable. This is because a house, and all real assets, have a limited lifetime that can be estimated. Therefore it is reasonable to spread the value of the house services over a definite period of time. Money, however, does not have such a limited lifetime. There is no natural wear and tear on it over the passage of time. Thus, it is inappropriate to measure the value of money services only against a time yardstick. The uses of money, in terms of profits, are just not proportional of time; they fluctuate and are ever-changing.

Let's sharpen the point further. Leasing real assets involves physical services, and not value units, that are priced and hired. This is not the case with debt. The former case may have little (or no) spillover effects on other markets, while the latter, which involves the pricing and hiring of value units (money), the spillover may be an economy-wide one. This is because, in the TCE terminology, *money is not specific* to any particular use and, hence is the most liquid economic asset.

It may be appropriate to explain here how a muddled theory of interest can have an effect on the contractual allocation of property rights. Bohm-Bawerk's theory of interest rests on the claim that present goods are always superior in value to future goods. An important implication of this theory is that the capitalist (rentier) *always* has a "natural" right to an *agio* (premium) over and above his capital. This is a theory that links the capitalist more to his assets than it relates him to other individuals. Contractual interest thus becomes a "natural" thing to stipulate in a debt contract. But profits – so-called "natural" interest – enjoy no such "natural" right as they cannot be contractually stipulated. The act of lending and borrowing is a relation between persons (natural or juridical) that involves no exchange of commodities for commodities. It is an exchange of abstinence (from use of consumption) for a promise. The neoclassical theory considers production an exchange with nature (Hodgson, 1988) if natural forces are actively involved in deciding what human beings can get. It is true that natural endowments represent a constraint (at least in

the long run but probably not in the very long run) on what we can do. Yet in a nutshell, the outcome that we obtain is essentially driven by the higgling haggling of persons, which is a function of who can establish what of property rights. "It is obvious that nature has no property rights to exchange" (Hodgson, 1988). Implicit in the interest-based debt contract is a trial to break away, and abstract from, the laws that The Lord embedded in the business life which is characterized by much uncertainty and irregularity. This is manifested by the *ex-ante*-stipulated rate of return for one party (the lender), and the acceptance of speculative possibilities by the other (the borrower).

III.3 Property Rights And Accounting

To further illustrate the effect of debts vs. equity on the contractual allocation of property rights, assume a firm is heavily indebted, doing poorly, and thus ready to be liquidated. The market value of the firm's assets will be forced down on two accounts. First, the fact that the firm is losing money means that the value of its assets will decline. Second, the value of the assets will be further driven down due to the urgency of liquidation, creditors will scramble to get out of a failing business. Now assume that some kind of agreement between the firm and its creditors is reached whereby the creditor's debt is converted into equity shares. The creditors are willing to enter this agreement because they expect that the firm may be worth much more in the future. What happens then? First of all, interest costs can be eliminated, bringing down the firm's costs and losses. Second, the creditors, i.e., new shareholders, by virtue of the agreement, will not be anxious to immediately liquidate the firm, preferring to do that gradually over a longer period of time if necessary. Both of these elements will tend to slow down the decline in the firm's market value, if not reverse the trend altogether, thus enhancing the market value of the firm. It may be argued that the interest rate measures the opportunity cost of capital regardless of whether it is owned or borrowed. But even if we grant this for the sake of the argument, the difference remains, though, that in the case of equity finance shareholders owe it (the opportunity cost of capital) to themselves and not to an outsider. The importance of this is clearest in the case of business difficulties. Hence, the removal of explicit interest cost is not without a clear advantage. As a real-world example, The *Wall Street Journal* reported how the FSLIC (Federal Saving & Loan Insurance Corporation) in Dallas, Texas acquired assets from failed thrifts, sold some of the thrifts' assets, and converted some bad loans into equity in the process.

"It took four years for the FSLIC's Dallas regional office of make a deal to sell 1,981 apartments along the Interstate Highway 30 corridor northeast of Dallas, and the FSLIC's stake in the properties still isn't fully liquidated; as part of the deal, it must retain a 34% interest. FSLIC officials describe the deal optimistically; 'Instead of just trying to sell it for today's value at a substantial discount, we entered into a *nine-year equity partnership*,' (emphasis added) says Thomas Procopio, Dallas regional director. He hopes that the FSLIC will recover about \$50 million on the apartments, but even that represents a loss of about \$200 million." (WSJ, June, 1988, p. 14)

Usamah A. Uthman: Debt and Equity Contracts in the Theory of Social Economy

In spite of the expected losses, the point is clear: a debt relationship has been converted into a long-term equity partnership to avoid further losses. This happened, as the WSJ story says, but what is the further implication? Shifting to equity finance did (or may) save the enterprise in question. This is not an isolated incident. In a more recent article, the WSJ reports about the rush in the U.S. financial market for new stock offerings.

“After piling up debt in the 1980s, corporate America is on its greatest equity-building binge in years, selling new stock at a record pace. Since the beginning of the year, U.S. corporations sold \$13.27 billion of new stock – nearly as much as they issued in all of 1990. And more than 100 new issues are in the pipeline. The stock-market rally and investors’ thirst for equity is adding momentum to the avalanche of new stock issues Investors, caught up in the new romance with equity, are piling into new stock issues. Part of the allure is the overnight success of stock offerings, such as battery maker Duracell International Inc., which rose 38% in its first day of frenzied trading, or Medical Marketing Group Inc., sellers of drug-buying information to doctor, which soared 64% in its first day. And stocks keep looking better as interest rates drop on competing investments, such as money market funds and certificate of deposit.”

Since Jan. 1, 59 investment funds, have made their public debuts in IPOs (initial public offerings) totalling more than \$2.8 billion. Ten of those were companies, such as *Duracell, that were taken private in leveraged buy-outs and are returning to the public market to unwind their debt* (emphasis added). They raised more than \$743 million in well-publicized deals.

The IPO queue is growing quickly, however. Through early June, 56 more companies are scheduled to raise more than \$2.4 billion in initial offerings, says Securities Data Co. Another 58 established companies have said they plan to sell additional stock totalling \$3.6 billion.

Hungry for fees, Wall Street is working overtime to sell new stock to institutions and small investors. In a \$100 million stock offering, a securities firm typically pockets \$4 million. Investment bankers, schooled in the art of takeovers, junk bonds, and bankruptcies over the past eight years, are now being redeployed into back-to-basics stock issuance In Washington, regulators also were overwhelmed. “We’re swamped,” says Charles Bennet, director of corporate financing for the National Association of Securities Dealers, which must approve all underwriting agreements. His office has seen a nearly fourfold increase in the number of filings since January” (WSJ, May 13, 1991, p. 24)

Sometimes economic and financial “miracles” may happen by the mere reshuffling of accounting entries and as a result of a reallocation of property rights. When property rights are badly allocated, antagonism results, and bounded rationality and opportunism are enhanced. *Efficiency is not property-right neutral.*

IV. Conclusion

Interest and profits are the results of vastly different financing contracts. Interest is a contractual, permanent flow that is derived from ever-changing, transitory profits. Asset specificity is not the only, and sometimes not the most important element with respect to finance decision-making. The more advanced an economy is, the more specialized labour and capital are, and hence the more specific become the firm's assets. In an advanced economy, and in accordance with Williamson's rule (of using more equity the more specific the assets are), equity financing (and contrary to Williamson's conclusion) should be the rule and not the last resort. Profit-sharing (equity finance) provides more flexibility in meeting contingencies. Implicitly, it combines both rules and discretion. While the respective shares (of expected profits) of partners are determined *ex-ante*, the actual returns are determined *ex-post* on the basis of realized profits. Equity finance can provide for two of the most important rules enforced by debt contracts. Some liquidity standards (of the firm) can provide for a source of funds and the requirements of a sinking fund for the purpose of replacing investments. It is not necessarily true that the set-up costs associated with equity are higher than those with debt. There is an analogy between information and money in the sense of the existence of a "fundamental paradox" in the sale of each and in the sense that none of them fits the image of a "normal" commodity. Debt provides a market mechanism that may invite opportunism in addition to the usual moral hazard problem. Equity has no such mechanism and hence there is less room for opportunism. Debt contracts are less stable as debt is unforgiving and brings with it some restrictive rules. Equity financing contract provide for a hidden element of "gift"; they are more flexible and forgiving in the case of uncontrollable failure of business.

The property-right approach shows that there is an imbalance and asymmetry of rights between the two contracting parties; as one party (the lender) has some permanent and contractually guaranteed rights while the other (the borrower) has only some temporary and residual rights. In an interest-based contract there is demand for a peculiar type of "insurance". The lender principal is to be paid back in full amount and like form plus some additional mark-up, with no fees of that "insurance" to be paid by the "insured". The unforgiving nature of debt and the imbalance of right are sources of friction and conflict between the contracting parties. Some recent real-world experiences support the supremacy of equity over debt finance. The former has shown to be the solution of the problems of the latter.

Notes:

1. "It is absolutely true that contractual relationships that originally were rare or completely missing are multiplied as labour in society is divided up" (Durkheim, 1984, p. 154). The classicals argue that the reverse is also true; that (interest-based) lending leads to the specialization of the borrowers in the production of goods. This is not accurate however. Labour specialization is not conditional upon this particular contract. An interest-based debt contract *per se* leads to no division of labour whatsoever. In this contract there is only

Usamah A. Uthman: *Debt and Equity Contracts in the Theory of Social Economy*

the shifting of labour and risk from one party (the lender) to another (the borrower). This is true even with the evolution of a very sophisticated financial sector. As the financial sector becomes more sophisticated and complex, so does the nature and identity of the rentier, although the latter does not disappear. This is not to say that the banking system is unimportant, or has no real function in the economy. Not at all. The banking system plays a very important intermediary role. But this is not necessarily related to, or subject to, interest-based lending per se. For banks can be converted into investment houses that intermediate between savers and investors (businessmen) and deal with everybody on a profit-sharing (equity financing) basis. Interest-based contracts are not necessary for the division of labour to take place.

2. It is true that a decrease in the interest rate depresses the prices of both stocks and bonds (with, may be, different elasticities), but while stockholders may be compensated through higher profits, no such compensation exists for the holders of outstanding (old) bonds. Thus opportunistic tendencies are expected to be (much) stronger in the case of debt than in the case of equity finance.

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مَجَلَّةُ
بَحْثِ الْاِقْتِصَادِ الْاِسْلَامِيِّ

المجلد ٣ العدد ١ ١٤١٤هـ/١٩٩٤م

مَجَلَّةُ الْجَمْعِيَّةِ الدَّوْلِيَّةِ
لِلْاِقْتِصَادِ الْاِسْلَامِيِّ