

Heterogeneity and Contractual Forms in the Informal Sector

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Abstract:

Theoretical literature on cooperatives and partnerships sustains the argument that the heterogeneity of the agents decreases efficiency of these organizational forms mainly through two channels (1) distorting ex-ante incentives and, (2) causing costs of governance and collective action. However, empirical studies and critical approaches to free-riding problem emphasize that mutual learning, mutual monitoring and residual claimancy effects could dominate. In this paper, I compare the relative merits of these efficiency arguments with regards to partnerships and capitalist firms in the informal sector of Turkish economy. The preliminary results point out that partnerships do not suffer from heterogeneity and earn more on average than the capitalist firms.

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1 Introduction

Why are cooperatives and partnerships so rare in both developed and developing countries? (Dow, 2002, Kremer, 1997) Does the heterogeneity of agents pose an insurmountable hurdle for these types of organizational form? Are there compelling reasons to expect for more cooperatives and partnerships in the informal sector?

Jonathan Levin and Steven Tadelis (2002) argue that partnerships can be desirable in human-capital intensive industries where product quality is hard to observe; a feature of informal sector products, which are usually non-standardized. The quality of non-standardized products is hard to assess by a typical customer. Partnership in a sense signals quality for reputation. Another straightforward argument for the partnerships and cooperatives in the informal sector is its characteristic low capital requirements, which eases the credit constraints for the agents.

Additionally, informal sector is governed not by ‘anonymous market rules’ but by informal social networks in which social preferences may play important roles. Marthe Nyssens and Bruno Van der Linden (2000) show that in Santiago de Chile popular-economy firms including worker associations and cooperatives thrive in the informal sector. A further reasoning for expecting more partnerships and cooperatives in the informal sector is their advantageous position in terms of risk sharing. In cases where there exists structural high unemployment rates, when there is no unemployment insurance program and purchasing social insurance individually is costly, agents could diversify their risks sharing the benefits and costs of the joint projects they engage in. However, we have counter arguments that point out to the relative disadvantages of the partnerships and worker owned firms in general.

The literature on worker-owned firms and partnerships emphasize the fact that there might be ex-ante and ex-post problems with these forms of organizations (Hansmann, 1996; Farrell 1988; Hart and Moore, 1994). Ex-ante, the potential partners are more selective in terms of seeking for homogeneity in preferences and abilities of the agents and ex-post given the level of heterogeneity the democratic and egalitarian nature of the decision-making process and the control of the organization may lead to inefficiencies due to bargaining or incentive-distortion (Kremer, 1997; Hansmann, 1996; Benham and Keefer, 1993).

As an important empirical test Hamilton et. al. (2003) analyzes the productivity effects of heterogeneity in ability of team members in a garment plant. They measure the heterogeneity in ability on the team as the ratio of the maximum to the minimum average productivity levels of the team members. They find that more heterogenous teams are more productive, with average ability held constant. They also show that increases in team size are not associated with decreases in productivity, which indicates that free-riding is not problematic in their setting. They substantiate their findings by claiming that team work can benefit from both technical and collaborative ability. And heterogeneous agents enhance the effectiveness of collaborative abilities. An alternative explanation is mutual learning. Accordingly the teams that are more heterogeneous will perform better because high-ability workers pull up the productivity of low ability workers.

In this paper, we compare the relative merits of these efficiency arguments with regards to partnerships and capitalist firms in the informal sector of Turkish economy. The preliminary results point out that partnerships do not suffer from heterogeneity and earn more on average than the capitalist firms.

This paper is organized as follows. The next section summarizes the arguments involving the effect of heterogeneity on control costs and incentive distortions. The third

section discusses the parallel arguments in the provision of public good literature. What are the effects of diversity on the quality and quantity of public good? The fourth section introduces a simple model incorporating the negative and positive aspects of heterogeneity of agents in a firm. The fifth section is an empirical comparison of the effects of heterogeneity on economic performances of partnerships and small capitalist firms in Turkey. The last section concludes.

2 Control Costs and Incentive Distortions in Different Organizational Forms

Henry Hansmann (1996), the most prominent advocate of the costs of collective choice hypothesis adopts a transaction cost approach and suggests that heterogeneity of worker preferences raises the cost of reaching decisions in worker owned firms and partnerships. To be more precise, in contrast to the capitalist firm where the basic decision is how to distribute the wealth from profit maximization the workers have to decide over a high dimensional policy space with diverse preferences. First implication is that bargaining costs under private information would be higher as the heterogeneity of the workers increases. Moreover, the time devoted to come up to a collective decision is lost, and it has an opportunity cost of foregone production. Although, Hansmann (1996) does not deny that conflicts of interest among capital suppliers arise time to time, he nevertheless argues that the costs of collective choice are greater for worker owned firms, placing these firms at a competitive disadvantage. He predicts that “if costs associated with collective self-governance were not a problem, employee ownership would be far more widespread than it is” (1996:92).

Benham and Keefer (1991), analyzing three cases of employee-owned firms (Mondragon, San Francisco scavenger coops and Hutterites) argue that in order to compete

with the conventional capital firms, cooperatives have to put some limits to the democratic decision-making process within the firms. Basically their argument resonates that of Hansmann (1996), “differences in time horizon and other heterogeneous preferences, with no limitations on the agenda can intrude on business decisions increasing the likelihood that no decision, or the wrong decision, will be reached” (p.707).

Heterogeneity of worker-owners might be multidimensional. As Hansmann (1990) and Holstrom (1999) claim age differences might be important. Age differences would be reflected in differences in time horizons and job/leisure preferences (Benham and Keefer 1993). Differences in educational level may also make having a consensus on firm policies harder. Benarjee et. al. (2001) focus on the wealth differences, and the differences of control power that is a by product of wealth inequality. Platteau and Seki (2000) and Kremer (1997) consider heterogeneity in terms of abilities of the worker owners, though the latter is a purely theoretic treatment.

In any variant, all the accounts of heterogeneity affirm that since heterogeneity of worker owners imposes additional governance costs, it makes worker-owned firms competitively disadvantageous. There maybe three interrelated but separate mechanisms how heterogeneity might negatively affect efficiency

- 1) *By distorting ex-ante incentives due to the egalitarian rewarding system usually employed in worker owned firms.* Given the fact that high ability partners would have to share the gross output equally with the low ability partners, why should the first join a partnership or a cooperative in the first place. There would be a tendency to almost perfectly sort candidates according to their ability levels as Farrell and Scotchmayer (1988) demonstrate. Therefore the partnerships or cooperatives would be inefficiently homogenous and may be smaller than the efficient minimum scale.

- 2) *By decreasing the effectiveness of peer pressure and mutual monitoring.* As Lazear (1992) and Hansmann (1990) demonstrate in order to have an operational and feasible peer pressure structure, the partners should know what each other are doing. That requirement may lead to inefficient specialization within the firm and pursuit of homogeneity in acquiring new partners at the expense of foregone skills. However, La Ferrara (2003) reports that in her sample of informal sector cooperatives in Nairobi the more heterogeneous coops let their members to handle more diversified tasks.
- 3) *By increasing the likelihood of conflicts and rent-seeking activities that cause higher governance costs.* Muller and Warneyard (2001) argue that worker-partners explicitly make rent-seeking investments to capture a higher portion of the total surplus generated. The more heterogeneous the workers, the higher would be total rent-seeking expenditures and hence the greater the inefficiency.

The empirical studies with regards to the aforementioned theoretical predictions are scarce. To my knowledge with the exception of the work by Platteau and Seki (2000) which compares fishing partnerships in Japan, there are no direct tests at the firm or group level, of the argument that heterogeneity of workers would make the firm inefficient in the literature except the common casual observation that partners and cooperative members are indeed relatively homogenous compared to conventional firms (Pencavel, 2002; Hansmann, 1996). Actually one of the aims of the paper is to question the common wisdom given the fact that solid empirical evidence is yet to be found confirming that observation.

Hart and Moore (1994) discuss the issue theoretically for the consumer cooperatives and Kremer (1997) uses this argument in general to explain the puzzling rarity of the cooperative form of organization.

Abhijit Banerjee et. al. (2001) is the only empirical piece indirectly confirming the above argument, linking heterogeneity to rent seeking and hence inefficiency. They argue that sugar cooperatives in Maharashtra, India with more heterogeneous suppliers have distorted incentives and relatively inefficient production compared to those with more homogenous suppliers.

The proponents of the worker owned firms, on the other hand argue that those inefficiencies can be overcome by the efficiency gains due to ‘mutual monitoring’ and ‘residual claimancy’ advantages. For them, main obstacles arise due to the coordination failures in the credit markets, the absence of membership markets and the dynamics of innovation related to risk aversion (Dow, 2002; Bowles, 2003). Indeed, a recent econometric study by Hamilton et. al. shows that mean-ability preserving heterogeneity might enhance team-level productivity, hence efficiency thanks to mutual learning and status concerns.

In the next section we will discuss the related strands of arguments in the context of provision of public goods in heterogeneous communities.

3 The Provision of Public Goods and Diversity

Roberto Alesina and Eleina La Ferrara (2002) claim that economic outcomes may be influenced by the observed diversity in three ways. First, diversity might be a part of individual preferences. Individuals may attribute positive utility to the well being of members of their own group and negative utility to that of members of other groups. Secondly, diversity can affect economic outcomes by influencing the strategies of individuals. Even when individuals have no taste for or against homogeneity, it may be optimal from an

efficiency point of view to transact preferentially with members of one's own type if there are market imperfections. Informal credit arrangements generally depend on group enforcement where the groups might be formed by very similar individuals (in terms of occupation, age, or geographical origin).

Finally, diversity may enter the production function. When the task at hand necessitates different perspectives diversity may increase the likelihood of success. Andrea Prat (2002) accordingly formalizes the insight that in teams where jobs are complementary heterogeneity may have negative effects. Edward Lazear (1999) identifies a trade off between the productive benefits of diversity and the possible costs that arise due to difficult communication between people with different languages, culture, etc. This trade-off also emerges from recent studies on organization performance. These studies find a positive effect of racial and gender diversity on creativity and task completion. For example, Charles O'Reilly, Katherine Williams and Sigal Barsade (1997) analyze 32 project teams and find that more diversity leads to more conflict and less communication, but controlling for the latter it also leads to greater productivity.

Rafael La Porta et. al. (1999) and Alesina et. al. (2003) could show that the ethnic fragmentation is negatively correlated with measures of infrastructure quality, literacy and school attainment and positively correlated with infant mortality. Khwaja (2000) analyzes 132 community-maintained infrastructure projects in the Himalayas. The author finds that, *ceteris paribus*, socially heterogeneous communities have poorly maintained projects and that the relationship between maintenance and inequality in project returns is U-shaped. Miguel (2000) and Gugerty and Miguel (2001) examine the effect of ethnic diversity on school funding and school organization in Kenyan villages. Both studies find that ethnic fragmentation is associated with worse outcomes. Karlan (2001) analyzes the impacts of

members' composition on savings and repayment performance in group lending programs offered by a Peruvian organization. The author focuses on geographic and cultural dispersion (Western versus indigenous) and finds that both types of heterogeneity increase the probability of defaulting on group loans. As for savings, which can be viewed as a form of 'collective' good to the extent that capital is lent back to the members, geographic distance among the members significantly reduces saving rates, whereas cultural dissimilarity has a negligible effect. La Ferrara (2002) uses an original dataset on production cooperatives in the informal settlements of Nairobi and has information on all members of the surveyed groups, which allows her to construct exact measures of group composition in terms of income, education, age and ethnicity. She finds that ethnicity matters for gaining access to group resources, especially in the form of cheap loans: members who share the same ethnicity as the chairperson are 20 to 25 percentage points more likely to borrow from the group or from other members. She also finds that inequality in individual earnings from the group significantly reduces the ability to borrow from the group as a whole.

4 Empirical Analysis

The data are from the 2000 "Urban Areas Small and Unincorporated Enterprise Survey" that was collected by the State Institute of Statistics in Turkey, in the first three quarters of 2000. The survey covers 20,000 microenterprises, defined as firms of less than six individuals, and was carried out in four major metropolitan cities. Out of those 20,000, there has been specified 6371 as informal units, defined as unincorporated microenterprises (individual ownership or ordinary partnership) engaged in urban non-agricultural economic activities and paying lump sum tax or not paying any tax at all. The survey examines reasons for becoming self-employed in the sector, sub sectors, incomes, capital structures, costs,

enterprise problems, credit need, migrant status, social security coverage and employment patterns, inter alias.

The main variables of the dataset I will be using are summarized in Table 1. The basic unit of analysis as mentioned above is an informal firm defined as “a firm engaging urban non-agricultural economic activities, legally specified as a simple partnership or sole proprietorship, employing less than ten workers (waged or unwaged) and either paying its taxes on a voluntary basis through simple taxation method or does not pay any taxes at all”. This definition is consistent with the commonly accepted ILO definition of informal sector enterprises.

Table 1: Summary Statistics: Averages of Selected Variables (Standard Errors are in parentheses)

	<i>Capitalist Firms (691)</i>	<i>Partnerships (168)</i>
<i>Net Income*</i>	438.021 (425.438)	472.72 (343.06)
<i>Age</i>	37.89 (11.06)	36.83 (11.32)
<i>Years of Education</i>	6.55 (3.02)	6.00 (2.58)
<i>Capital Stock*</i>	843.46 (1209.5)	568.36 (632.15)
<i>Firm Life</i>	7.15 (7.25)	6.46 (8.45)
<i>Hours Worked</i>	10.92 (2.25)	11.12 (2.62)
<i>Age of the Worker (Partner)</i>	27.11 (10.7)	36.1 (10.84)
<i>Education of the Worker (Partner)</i>	6.31 (2.79)	6.20 (3.05)
<i>Wage</i>	157.05 (83.98)	-
<i>Age Difference</i>	13.43 (9.41)	8.32 (7.65)
<i>Education Difference</i>	2.21 (2.87)	2.23 (2.68)

** in 2000 \$ (based on the average exchange rate reported by the Central Bank of Turkey)*

The average monthly net income of partnerships is significantly higher than the capitalist firms. The average age of the employers in the capitalist firms and the average age of the partners do not differ. The average education level as well is almost the same for the two organizational forms. The capital investment however is significantly higher in the capitalist firms than in the partnerships. The heterogeneity variable calculated based on the differences in the years of education of the employers and workers in the capitalist firm on the one hand and the differences in the years of education of the partners in the partnerships do not show any statistically significant gap. Nevertheless, the average of age differences in the capitalist firms is statistically higher than of the partnerships (13.43 versus 8.32).

4.1 Effects of Heterogeneity on Survival

As a head start we analyze the effect of heterogeneity and other important variables on the survival rate of each organizational form. We define a dummy variable, STAY, that would be 1 if the answer to the question “What are your plans for the development of your business in the next five years?” is “Continue with the current business”; otherwise the STAY takes value of 0.

We find that heterogeneity (implied by age and education level differences) do not have statistically significant effect on the likelihood of survival for the partnerships (See Table 2; in this table and in the following tables we report mostly the variables with significant coefficients). The capitalist firms on the other hand might suffer from age differences among the employer and the worker. Interestingly, the difference of educational level in the capitalist firms contributes to the likelihood of survival.

Table 2: Dependent Variable: Probit Regression of STAY Dummy =1

	<i>Capitalist Firms</i>	<i>Partnerships</i>
<i>Age</i>	<i>.019**</i>	

	(2.34)	
<i>Years of Education</i>		
<i>Capital Stock*</i>		
<i>Firm Life</i>		
<i>Hours Worked</i>		
<i>Age of the Worker</i>	<i>-.018**</i>	
<i>(Partner)</i>	<i>(-2.95)</i>	
<i>Education of the Worker</i>		
<i>(Partner)</i>		
<i>Wage</i>	<i>.001**</i>	
	<i>(1.80)</i>	
<i>Age Difference</i>	<i>-.018**</i>	-
	<i>(-2.24)</i>	
<i>Education Difference</i>	<i>.048**</i>	-
	<i>(2.09)</i>	
<i>Social Security</i>		<i>.855***</i>
		<i>(3.76)</i>
<i>Gender</i>		

*Legend: ** p<0.05, *** p<0.01*

4.2. Effects of Heterogeneity on Capital (as a Public Good)

As we have mentioned before our main focus in this paper is to provide an indirect way of comparing the two contrasting views on the effects of heterogeneity on economic performance. Focusing on informal sector firms, we could largely overcome the selection bias towards more conventional firms due to credit market constraints. Even though the average capital requirement to initiate an informal business might be out of some agents' reach, it should be plausible that the problem is less acute compared to the formal sector firms. However some important shortcomings of my approach should be clear.

Testing the heterogeneity-rent seeking argument would ideally require a panel or a longitudinal dataset in which one can control for every variable but the heterogeneity of agents, contractual form and either productivity or profits reflecting efficiency. Our dataset is cross-sectional and we have limited number of variables. Moreover, our dependent variable is log net incomes per month, which might be open to severe unobservable

influences. Furthermore, our proxies for heterogeneity might not be exactly the most appropriate ones and thus could raise some concerns. Though, this problem will be a concern to any empirical study that will focus on heterogeneity in preferences or abilities among agents.

Assuming that the capital stock has the public good feature, we estimate OLS for the log K in order to see whether differences in age and/or education influence the formation of capital stock. The difference in education among partners is indeed associated with a decline in capital stock in partnerships, whereas the age differences influence the capital stock in capitalist firms.

Table 3: Dependent Variable: Log of Capital (OLS Regression with Robust Standard Errors)

	<i>Capitalist Firms)</i>	<i>Partnerships</i>
<i>Age</i>	.01282132*	
<i>Years of Education</i>	.03635482**	
<i>Firm Life</i>		
<i>Hours Worked</i>	.04134528**	.08013416*
<i>Age of the Worker (Partner)</i>		
<i>Education of the Worker (Partner)</i>	.03364283*	-.09579328*
<i>Wage</i>	.0047182***	----
<i>Age Difference</i>		
<i>Education Difference</i>		
<i>Social Security</i>		
<i>Gender</i>		
<i>Marriage</i>		
<i>Space Dummy</i>		-.72375044*
<i>Sector Dummies</i>	<i>Included</i>	<i>Included</i>

*Legend: * p<0.05; ** p<0.01; *** p<0.001*

4.3. Effects of Heterogeneity on Income

We then analyze the effects of heterogeneity on net income. Neither in capitalist firms nor in partnerships have the differences in age and/or education had statistically

significant coefficients (see Table 4). The age variable has a significant positive impact in the capitalist firms reflecting the expected positive effect of experience. More interestingly more established firms (with a higher firm life variable) earn more than the newer firms among the capitalist firms; but the firm life does not play any role among the partnerships. Being covered by a social security organization is associated strongly with higher average net incomes both in the capitalist firms and in the partnerships.

Table 4: Dependent Variable: Log Net Monthly Income

	<i>Capitalist Firms</i>	<i>Partnerships</i>
<i>Age</i>	.00593344*	
<i>Years of Education</i>	.02114178*	.04175322*
<i>Firm Life</i>	.00935623**	
<i>Log Capital</i>	.33046075***	.25119384***
<i>Hours Worked</i>		
<i>Age of the Worker (Partner)</i>		
<i>Education of the Worker (Partner)</i>		
<i>Wage Age Difference</i>		
<i>Education Difference</i>		
<i>Social Security</i>	.11293113*	.39521715***
<i>Gender</i>		
<i>Marriage</i>		
<i>Space Dummy</i>		
<i>Sector Dummies</i>		

*Legend: * p<0.05; ** p<0.01; *** p<0.001*

The returns to human capital and physical capital differ between conventional firms and partnerships. If we assume that the differential returns to labor (human capital) in partnerships is a proxy for the ‘residual claimancy’ effect then one can conclude that this effect might offset the ex-post inefficiency effect due to heterogeneity.

We then use the pooled sample and try to understand whether partnership form has an effect on net income per se as well as coupling with heterogeneity variables. Partnership has a statically significant and a robust positive influence on net income. The significant and negative coefficient of the interaction term of partnership and age difference implies that given partnership form the higher the differences in age the lower the net monthly income.

In using the pooled sample we switch to a different specification of the model due to the endogeneity problem. The unobserved qualities that may affect the net income of a firm may indeed also affect the choice of organizational form (in our case the partnership form). The Heckman censored selection model would serve to control for this endogeneity problem. The coefficient of the Inverse Mills Ratio turned out to be insignificant; meaning that the endogeneity problem might not be severe.

Table 5: Dependent Variable: Log Net Monthly Income (Heckman Selection Model)

	<i>Pooled Sample</i>
<i>Age</i>	
<i>Years of Education</i>	.02507285**
<i>Firm Life</i>	
<i>Log Capital</i>	.31345878***
<i>Hours Worked</i>	
<i>Age of the Worker (Partner)</i>	.00582681**
<i>Education of the Worker (Partner)</i>	
<i>Wage</i>	
<i>Age Difference</i>	
<i>Education Difference</i>	
<i>Partnership Dummy(PD)</i>	.37899654***
<i>PD*Age Difference</i>	-.01401062*
<i>PD*Education Difference</i>	
<i>Social Security</i>	.18355706***
<i>Gender</i>	
<i>Marriage</i>	
<i>Space Dummy</i>	
<i>Inverse Mills Ratio</i>	

*Legend: * p<0.05; ** p<0.01; *** p<0.001*

The Partnership Dummy has a positive and significant coefficient implying that the organizational form of partnership would increase the average income of a typical firm in our sample. However, the interaction term of partnership and the age difference has a negative and significant coefficient confirming the predictions of the strands of the literature arguing for the negative effects of heterogeneity.

5 Conclusions

We have discussed and evaluated the arguments put forward to explain the positive and negative consequences of heterogeneity in the firms and within a community. Then we use a unique dataset to compare (although indirectly) the explicit hypotheses derived from these arguments. We first find that the heterogeneity variables do not influence the survival probability of partnerships. Next we find that even the age differences might play a negative role in the provision of capital goods, the overall effect on the net income is insignificant.

When we control for endogeneity and use the pooled sample we find that the partnership indeed may increase the net income of an agent with average characteristics. The policy implication of our research may depend on a more thorough understanding of the relative costs and benefits of choosing the partnership form. If capital goods mean higher productivities in the future then the partnership form may have disadvantages if the firm is established by heterogeneous agents. However, if the net current income is a better reflection of entrepreneurial ability and productivities the partnerships may not suffer from any negative effects of heterogeneity.

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