A New Institutional Economics Approach to Contracts and Cooperatives

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Abstract

This article discuss about agricultural cooperatives capital structures with the New Institutional Economics Approach, in particular the Transaction Cost Economics point of view. At the end, it is possible to conclude that the cooperative enterprises, as a consequence of the financial and social structure governance costs, present a wider structure of transaction and agency costs, when compared with other forms of business organization. Our objective in the above discussion is to advance a conceptual framework using new institutional economics theories that draws attention to the importance of the organizational structure of contractors for the design of the proliferation of contracts increasingly governing agricultural production. Understanding the interplay between organizational form and contract structure is a necessary step in understanding why and how contracting is occurring, where and when it does. This article also shows that Transaction Cost Economics theory is an efficient tool to explain the organizational capital structure and the micro-analytical details not yet appreciated by the usual analyses.

Keywords: *Transaction Cost Economics (TCE), Cooperatives, Property Rights and Behavior Organization*

1. Introduction

The cooperatives present a particular structure of organization, as compared to other organizational architectures; the cooperatives do not initially intend to obtain business profits, and at the end of the account period they present only operational surpluses, which are distributed "pro-rata" and are proportional to the operations of each associate during this period. "*Consolidation and increased coordination throughout the agro- food sector are rapidly reshaping the role of cooperative organizations in agriculture. Increased concentration, both up and downstream, raises the specter of the traditional cooperative role of counter-balancing market power. However, increasing demands for coordination among players throughout the agro- food system point to a different role in which cooperative organizations may have a unique advantage*" (Sykuta M and Cook M, 2001).

2. Conceptualizing Business Co-operation

While a rich body of literature has developed that seeks to explain the nature of business cooperation, two broad streams of economic analysis can be distinguished that have been of particular importance. The first applies neo-classical microeconomic theory to human behavior (Becker 1976). Starting from the premise of methodological individualism, that the individual actor is the relevant unit for analysis, Becker assumes that individuals make rational choices according to their self-interest, although their rationality can be bounded due to lack of information. Neo-classical economists have usually argued that voluntary co-operation for the management of common property resources is infeasible and that either privatization or external intervention is necessary.

Second, in contrast to the neo-classical conceptualization, Williamson (1985; 1991) focuses on transaction costs, giving rise to what is often referred to as 'new institutional economics.' For Williamson, the core problem for all participants in an economic system is to ensure that the contracts laid down between two actors will be fulfilled. According to this school, cooperation can be understood as a form of hybrid organization between markets and hierarchies (enterprises and bureaucracies). The choice of co-coordinating mechanism is conditional on the institutional environment in which it is located so that changes in the latter (property rights, contract laws, the credibility of the judiciary, norms, customs etc.) induce changes in the comparative costs of markets, hierarchies and hybrid organizations

(Williamson 1998).

Granovetter (1985), in his seminal paper, criticized these economic conceptualizations of co-operation. For Granovetter, an understanding of embeddedness requires detailed attention to be paid to the mechanisms and processes of the social construction of institutions. Several commentators have argued that there is a growing need to understand how and under what circumstances social structures assist or impede local economic performance (Uzzi 1996; Rowley *et al.* 2000).

3. The institutional nature of the cooperatives

To analyze cooperatives, it is necessary to understand some important factors in the formation and the maintenance of economic collaboration. Basically, cooperation only is established among the agents when it is more interesting for the group as a whole. So, the institutional point of view of property rights, division between property and control, transaction costs, and agency problems, could be a sufficient tool to analyze this organization.

Zylbersztajn (1993) describes that the co-operatives are organizations with property rights above the corporations, since each member has the power to interfere in the company performance, not proportionately to his participation in the capital or as a stockholder, but according to the principle that each individual has only one vote – the doctrinal principle "one man one vote". The agricultural co-operatives transactions occur with geographic specificity characteristics, since the agricultural products need a certain combination of ecological factors for their development. Thus, frequent transactions with high specificity of assets determine a bilateral or unified governance structure for these contractual relationships. The institutional environment is also important in the co-operative characterization. Cook (1995) defines five stages since appearance, then growth, and finally extinction of this form of organization, by means of an institutional reading.

> *"Every transaction relationship involves three basic institutional economic components: the allocation of value (or the distribution of gains from trade), the allocation of uncertainty (and any associated financial risks), and the allocation of property rights to decisions bearing on the relationship" (Sykuta M and Cook M, 2001). "Given their producer-owned and producer- governed nature, cooperatives have an inherent producer orientation »*

The property rights theory can perform a central role in the institutional theory and property rights means the right to have power, to consume, to obtain an income or transfer assets. In cooperatives, the associates withhold residual rights in the income flow generated by the organization. However, the assets property rights are divided among several people, and there is not a complete separation, the owners are not allowed to take complete possession of the flows arising.

> *"This property rights perspective forms the basis of the arguments Cook makes regarding the evolution of cooperatives and the rise of the "new generation" cooperative structure. He defines five "vaguely defined property rights" problems devolving from the traditional cooperative organization's division of residual claims and control rights: Free Rider Problem[1], Horizon Problem[2], Portfolio Problem[3], Control Problem, and Influence Costs Problem" (Sykuta M and Cook M, 2001).*

New institutional economic theories of agency, property rights, incomplete contracting and Williamson's transaction cost economics have been advanced to provide a finer theoretical focus to analyze the structure of transactions and their governing institutions.

> *"…These theories suggest how the rights and responsibilities incumbent to the transaction are allocated will depend on the characteristics of the transaction, the costs of monitoring and enforcement, the relationship of the trading parties, and their respective negotiating skills or bargaining position, which might be influenced by control rights over complementary assets…"* Bombaj F, 2010.

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[1] The Free Rider Problem results when gains from cooperative action can be accessed by individuals that did not fully invest in developing the gains, whether those individuals are new(er) members or non-members.

[2] The Horizon Problem results from residual claims that do not extend as far as the economic life of the underlying asset.

[3] The organization's investment portfolio may not reflect the interests or risk attitudes of any given investor/member, but members cannot withdraw and reallocate their investments.

Agency theory addresses information asymmetry and incentive incompatibility between trading parties.

The institutional analyses allow apprehending that the doctrinaire principles, in which cooperativism is grounded, influence directly the enterprise success. In our eyes a) the principle of democracy demands high transaction costs, when decision making occurs by means of general assemblies; b) the equality principle, one man one vote, implies directly in high costs of agency derived from the lack of incentives for the productive activities; c) the principle of solidarity, and the non-existence of profits, makes impossible a clear delimitation of property rights, leading to high costs not only for agency but also for transaction.

4. The capital structure and the Transaction Economics Costs (TCE)

The Transaction Economics Costs – TCE approach, based in the characteristics of the transactions and assets, could understand the financial corporation analysis. The assets specificity characteristics influence the investments, the capital structure, and the financial governance. TCE analysis tends to focus particularly on the roles of asset specificity and bounded rationality, in the context of opportunistic decision behavior, as the key determinants of organizational form.

The general implications are that as assets involved in a transaction are more specific to the transaction, as the potential for opportunistic behavior increases, and as the need for coordination between parties increases, the more likely hierarchical mechanisms will be used to govern the transaction. In the context of contractual governance mechanisms, this suggests more fully specified terms with more decision rights vested in the contractor.

To develop TCE analysis, Williamson (1996) assume that there are a capital structure characterized by the situations, enterprises with open capital in stocks exchanges, or the situation in which the enterprise financing exclusively by the bank loans. These two opposite situations must be associate the idea of financial governance. A hierarchical governance, due to the process of opening the capital called "equity" - in which the necessary financial resources are obtained inside the company by shareholders - and a governance via market called "debt", when the firm is financed by means of loans. In the case of governance via market – "debt" - the financial agent, bank, settles a certain interest rate for the operation, and the capital cost is also embedded with the transaction costs of the operation. The agent also considers the period to pay the loan, the liquidity of the business, and the guarantees, in order that, in case of non-payment the operation can be duly honored.

Williamson (1996) assumes that probably occur, for more specialized business, a growth of assets specificity used in the transformation process. This implies, directly, in a certain degree of impossibility to use these assets in other activities and a lower level of liquidity in the market. That is, in case an asset has to be sold it probably will worth less than its actual financed value, since it cannot be used in alternative activities with the same grade of utilization and generation of income. In case of non-payment or bankruptcy of the firm the assets would be non-effective guarantees of the financial operations, and can also need complementation, as a function of worth difference and uncertainty of the situation. Thus, if it were considering, at first, a competitive financial market the financial agents will have approximate operational costs and, second a competitive economic situation, the firms, of a particular economic sector, would also present approximate income levels. Loans as a financial operation are different due to their cost, among other aspects, due to the uncertainty that the financed amount is paid back, a direct function of the guarantee liquidity and, as a consequence, of the assets specificity.

Financial governance costs through the market – "debt" - is positive and grow financial governance costs through the market – "debt" - is positive and grows proportionately to the growth of the assets specificity - k, that is, inversely proportional to the guarantee liquidity. Defining these costs as D(k), has:

$$d(D(k))/d(k) > 0$$

On the other hand, in an opposite situation, financial governance totally inside of the organization boundaries - financing operations by means of open capital – could be distributed property rights and business risks and the composition of the transaction costs is different. The importance of the assets specificity for determination of the transaction costs is diluted in consequence of a greater number of investors, and of the proportional participation in the business income. Since each invested amounts are reduced – divided among many investors – some costs are also reduced, due both to the uncertainty of the operation and the possibility of failure of the firm. This characteristic only exists because IOF's[4] have a different distribution of property and the decision rights inside the company. Thus, following

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[4] IOF : (Investitor – Owner – Firm)

Williamson's (1996) arguments, one can notice that, as the assets specificity increases, a more adequate capital structure can appear according to the transaction costs and contractual relationships aspects in the enterprise.

In the structure called "equity" – E(k) - the transaction costs increase proportionately to the growth of the assets specificity, so:

$$d(E(k))/d(k) > 0$$

Comparing the two structures, "debt" and "equity", both grow according to the assets specificity, but some differences can be observed. When the assets specificity is very small, there is high marketability for them due to the existence of n+1 possibilities of alternative applications in several different economical sectors; the uncertainty is very small considering the differential between worth of these assets, the invested value and the market value, implying in a high level of security for bank operation. These characteristics reduce the financial costs. As a consequence, the operation can be more adequate, presenting lower costs than the owned capital that, in many cases, can be used in other applications with higher financial results. Consequently, one can consider that D(k) < E(k) when k=0. Therefore, when the company has a low level of assets specificity, the structure "deb is more efficient under the transaction costs point of view. As this specificity grows, the costs of the structures "debt" and "equity" are modified, and behave like this:

$$d(D(k))/d(k) > d(E(k))/d(k)$$

Transaction costs associated to the capital structure "equity" grow proportionately less than the financial and transaction costs of a structure based exclusively in bank financing, when the assets specificity varies. Williamson (1996) modeling and comments this situations, and describes that when assets present a high potential of reutilization will be financed, preferentially, with loans – "debt" – and those which can not be redeployable in other alternative activities, preferentially, with owned capital – 'equity'.

Figure 1 shows the representation of the transaction costs variation, as a function of the assets specificity, given a certain level of financial governance. When E(k) = D(k) , there is k' representing a boundary between the financial governance structures "debt" and "equity".

On the other hand, the cooperatives also would be located in the curve D(k) in a function of the difficulty to capitalize and grow with owned capital, scarce among the associates, and, consequently, their direct dependency from "debt" to finance. In other size for profits enterprises – IOF's - can be characterized by another similar curve. Thus, it is possible compare IOF's financial strategies and cooperatives strategies in function of the costs of capital in particularly situations.

Figure 1
Financial governance costs as a function of assets specificity. D(k) – debt; E(k) - Equity
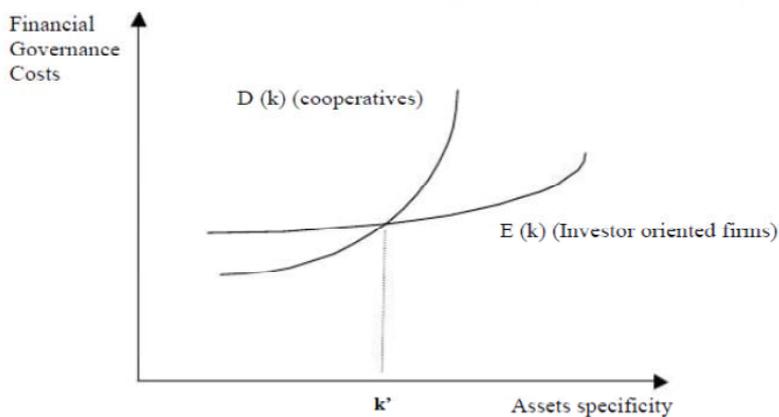
Adapting the model of Williamson (1996), it is possible to analyze the financial governance costs of the cooperatives organizations when it is compared with the IOF's. This situation is a generalization of strategies but could explain the cooperative debt structure.

> *"A common theme across all of these approaches is that transaction costs are positive; information is imperfect, costly, and frequently asymmetric; the allocation of decision rights (or property rights more generally) affects performance; and governance structures are designed to mitigate the hazards, or minimize the costs, involved in effecting economic transactions. While the frequent focus is on firm boundary questions, the concepts also directly apply to alternative contractual governance forms" (Sykuta M and Cook M, 2001).*

5. Conclusions

The mainstream conclusion is that the New Institutional Economics, Transaction Economics Costs, could offer instruments that complement the analyses of the capital structure of the cooperatives, explaining details not yet clear enough to the usual theoretical analyses, particularly the concepts of financial governance. Our objective in this article is to advance a conceptual framework using new institutional economics theories that draws attention to the importance of the organizational structure of contractors for the design of the proliferation of contracts increasingly governing agricultural production. Understanding the interplay between organizational form and contract structure is a necessary step in understanding why and how contracting is occurring, where and when it does.

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