NEW ZEALAND INSTITUTE FOR THE STUDY OF COMPETITION AND REGULATION INC.

THE THEORY OF THE FIRM: NEW INSIGHTS ON CO-OPERATIVES AND NONPROFIT ORGANISATIONS

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JOINT WORK WITH CAROLYN CORDERY

Multidisciplinary

- Law and Economics
- Accounting and Governance

Began with work on Primary Health Organisations

- Government-mandated private nonprofit firms established under the New Zealand Primary Health Care Strategy to receive and distribute government funding
  - 'nonprofit' to "guard against public funds being diverted from health gain and health services to shareholder dividends"

Subsequently expanded into wider inquiry on ownership

- informed by recent work by Evans, Guthrie & Quigley

TOWARDS A 'THEORY OF THE FIRM'

General enough to capture manifestly different forms of voluntary organisation

But specific enough to enable a classification that captures and cogently explains the richness and diversity of organisational forms observed

- with particular emphasis on nonprofit, co-operative firms

Why it matters?

- to an economist – understanding the contracts that the firm is a nexus of, and assessing its performance
- to an accountant – measuring and holding the firm accountable

DILEMMA

‘Nonprofit’ is a statement of objective

But the defining characteristic is an ownership instrument

- the ‘nondistribution constraint’

‘Classical’ explanation too simplistic

- no ‘owners’ to appropriate the proceeds
- fails to take account of 80 years of agency theory research

Can ‘ownership’ literature help resolve the dilemma?

- and how do co-operatives fit with this theory (neither ‘classic’ investor-owned nor nonprofit)

LITERATURE SURVEY

Separation of ownership and control (Berle & Means, 1937)

- (passive) owner-principals enter into contracts with (active) manager-agents, leading to agency costs
- but says nothing about external (trading) activities

The firm is a nexus of contracts (Coase, 1937)

- activities undertaken within the firm when market trading costs exceed costs of direct authority

Direct authority insufficient as does not take account of contracts for voluntary exchange within the firm (Alchian & Demsetz, 1972)

- firm more cost-effective means of monitoring joint, team production

LITERATURE SURVEY (cont)

Emphasis on monitoring too restrictive (Jensen & Meckling,1976)

- firm is a 'legal fiction' entering into contracts with
  - suppliers of inputs (owners of capital, labour, other inputs)
  - consumers of outputs
  - cf. Hansmann (1996)
- need to consider both costs of agency (separation of ownership and control) and costs of risk-bearing (way capital supplied)

But still does not account for firms with no 'equity owners' (Fama & Jensen, 1983a; 1983b)

- separation of decision-making and residual risk-bearing
- separation of decision management and decision control (board)
- distinct from residual risk-bearing ('ownership')
- fiduciary obligations bind decision controllers and beneficiaries

LITERATURE SURVEY (cont)

Contractual incompleteness (Hart & Moore, 1990)

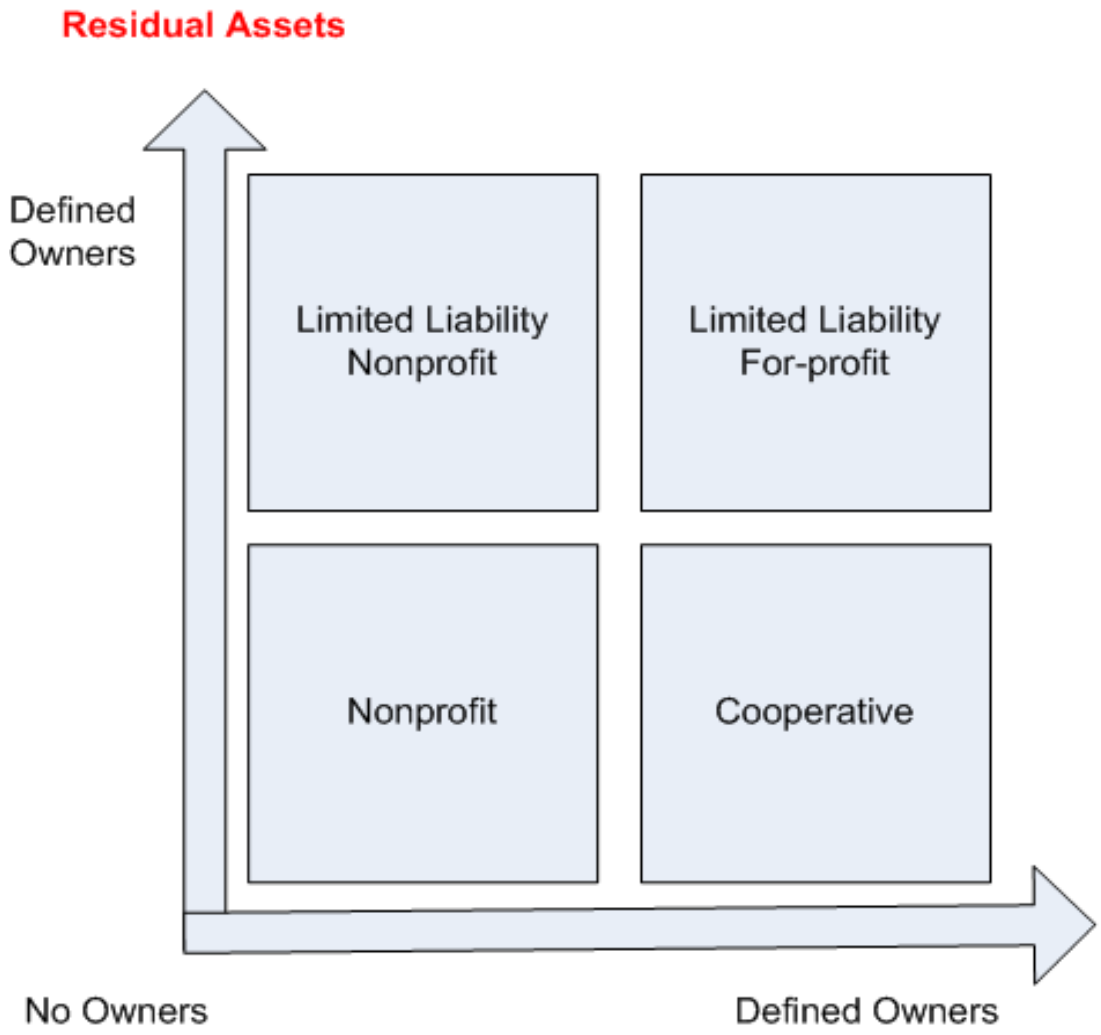
- firm not just a legal fiction entering into contracts, but also a a collection of jointly-owned assets
- in absence of complete contracts, ownership matters as it confers the right to make decisions about the residual assets
- no 'owners' => no assignment
  - fiduciary duties insufficient (as part of 'contractual' agreement)

Suggests any 'ownership' instrument superior to none

What are the assets? And how are the residual rights assigned? (Ben-Ner, 1996 w.r.t. nonprofits)

- can think separately about allocation of residual assets and income streams (profits)

THE ASSETS



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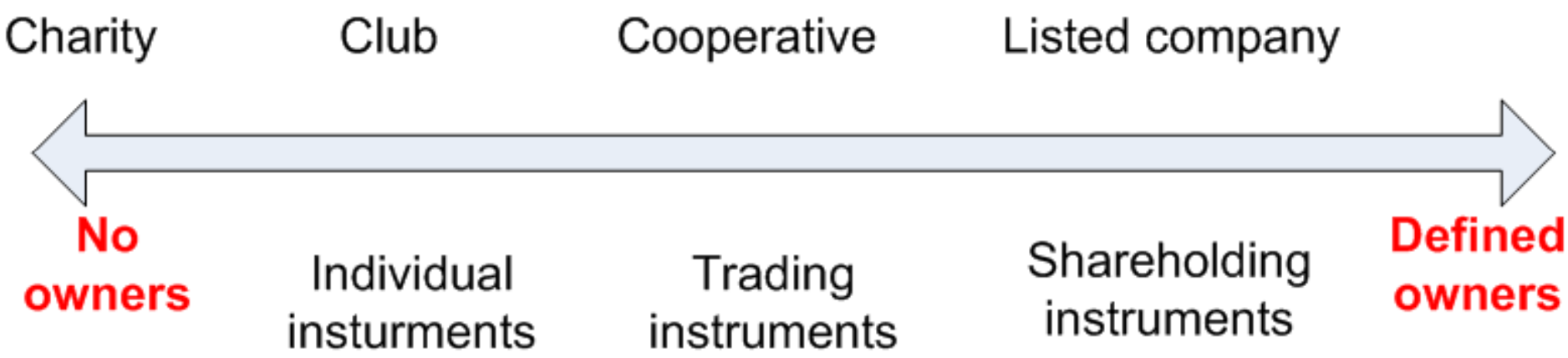
THE CONTROL CONTINUUM



EXAMPLES (PRIMARY HEALTH CARE)

ProCare Limited

- NZ's largest PHO (over 900,000 patients)
- defined owners (GP members) but nonprofit objective

Compass Health

- charitable trust
- "governed by two not-for-profit organisations"
  - Compass Health Wellington Trust (6 Drs and 3 others) and Compass Health Limited (3 Drs and 2 others)

Union Health Clinic

- member-owned co-operative

THE GOVERNANCE CHALLENGE

Who holds residual control rights w.r.t. which assets?

How can control be exercised?

What information supports exertion of residual control rights?

What is the benefit of 'non-ownership' given these findings?

- ***preventing*** change, even when it is of benefit?

YOUR THOUGHTS