ASSIGNMENT III

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CONTENT

1 COMPARISON

1.1 Contradictions

The approaches of Daniel Spulber and Henry Hansmann to the separation criterion basically fit in the same framework. However, there are three important contradictions between them: First, Hansmann considers the firm mainly as a locus of contracts (Hansmann, Kraakman, 2000, p. 809) whereas Spulber only accepts the firm when it fulfills the separation criterion (Spulber, 2008, p. 1). Second, in Spulber's analysis, owners aim consumption, managers aim profit[1] maximization (Spulber, 2008, p. 13). Hansmann's owners in return are driven by profit maximization and his managers desire only a good career and sometimes opportunism (Hansmann, 1988, p. 277). Third, Spulber sees nonprofit organizations as owned in common but Hansmann states that nonprofits are without owners at all (Hansmann, 1988, p. 270 / 268).

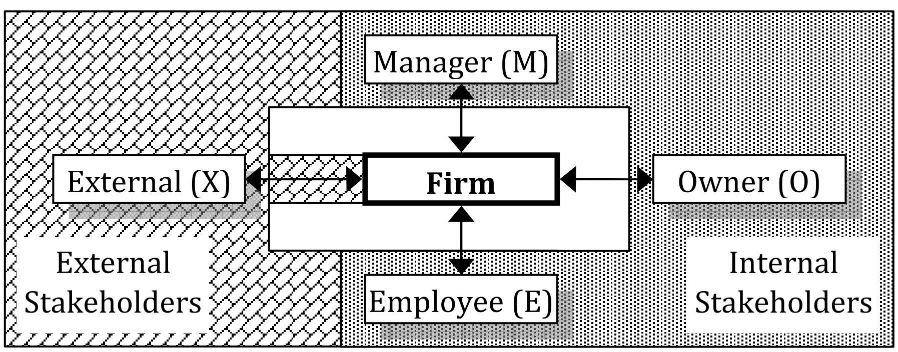
1.2 Reconciliation

These three contradictions are related: Hansmann's firm is more general so that his approach is not an opposite to Spulber's statement for a group of special firms within the general firm area. Also the third contradiction is not very strong: both define the ownership in a different way: the Spulber owner seeks consumption (Spulber, 2008, p. 13) whereas the Hansmann owner is driven by the right of control and the right to appropriate the firm's residual earnings (Hansmann, 1988, p. 269). With this different

[1] The term "profit" is used to reflect the argumentation of Hansmann, Kraakman, and Spulber, and means revenue.

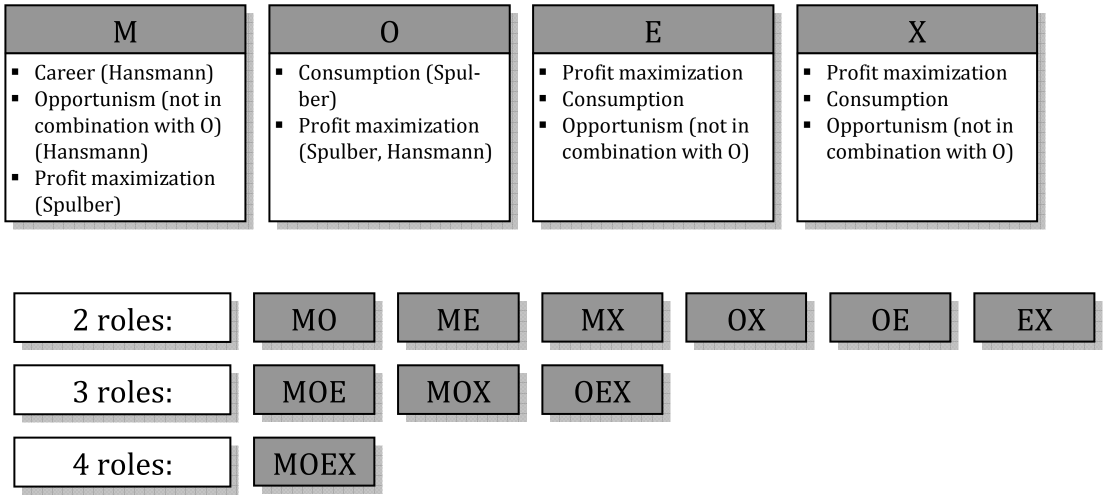
definition of ownership, they can apply ownership differently. The second statement treats incentives of owners and managers: Hansmann's view that managers don't really want to maximize the present value of their firm because they are not affected by additional revenue, is pessimistic. Spulber in return accepts owners as income maximizers but for consumption purposes which goes one step further than Hansmann's thesis. So both authors differ in the end only strongly in what the incentives of managers are.

Both authors can be put into a static process engineering model on a contractual basis. The separation criterion approach cannot work without the contractarian background. Spulber himself sees his analysis as advancement of the contractarian approach (Spulber, 2008, p. 6).



Graphic 1: A static process engineering model on a contractual basis.

Each subject, manager (M), owner (O), employee (E), and external stakeholder (X), is considered as a role tied to the firm by a contract. A real person can hold several roles. For example a manager is mostly also an employee at the same time. External stakeholder can be investors, customers, and suppliers. Manager and employee are always protected by a limited liability whereas the owner can be either way. The firm as juridical person is in every case liable to external stakeholders.



Graphic 2: Roles, their incentives, and possible role combinations.

If certain roles are combined, the incentives change. For example, a manager being owner at the same time may be less likely to engage in opportunism. The firm itself as being a juridical person may also be seen as a role in this context. In fact, Spulber assigns goals to the firm directly (Spulber, 2008, p. 1). It has complete liability and the same goals and incentives of its managers.

Hansmann, Kraakman (2000)	**Hansmann (1988)**	**Spulber (2008)**
M/ME: Manager	M/ME: Manager	M/ME: Manager
O: Owner	MO/MOE: Manager Ownership	MO/MOE: Manager Ownership
	O: Owner	O: Owner
	OX: Investor Ownership	
	OE: Worker Ownership	
	X: External Investor	

Graphic 3: Performed role combinations.

The analysis could be extended much more by including the skills and tasks of each role as well as analyzing the sense of seemingly unrealistic role combinations.

2 ANALYSIS

2.1 The Organizational Law

The organizational law provides the base and limits for the activities of an organization. It also partitions authority and earnings to the stakeholders of the firm (Hansmann, Kraakman, 2000, p. 807). This partitioning provides the possibility of separating ownership from management through allowing separate pools of assets (Hansmann, Kraakman, 2000, p. 807). Hansmann and Kraakman further state that the most important contribution of organizational law is to allow creditors claim on bonding assets prior to owners (Hansmann, Kraakman, 2000, p. 810). The firm becomes owner of assets as a juristic person and its law becomes a handbook of property law. The two reasons for organizational law to be are the enforcement of the firm as juristic person and the creation of the base of separation between management and ownership (Hansmann, Kraakman, 2000, p. 812). This separation rooted in the organizational law is an advancement of the pure contractual approach (Spulber, 2008, p. 78). However, organizational law is not essential to ensure limited liability whereas it is a condition sine qua non for creating the juristic person (Hansmann, Kraakman, 2000, p. 815).

2.2 The Firm

In general, there are two possible ways of performing economic transactions between two or more individuals: contracts between the parties and indirect contracts with a third party, i.e. the firm (Hansmann, Kraakman, 2000, p. 808). The contractarian approach sees the firm as “nexus of contracts” (Jensen, Meckling, 1976) with the two attributes of decision-making and providing pools of assets (Hansmann, Kraakman, 2000, p. 809). Spulber in return sees the firm as a kind of independent transaction engine which has a tradable value and separate goals from the owners' goals (Spulber, 2008, p. 1 / 18). Furthermore, property rights allow the firm to gain from trade, possess own assets, define and distribute rights of management, and last but not least, property rights ensure the market through completeness, exclusiveness and transferability (Spulber, 2008, p. 14 / 18). Property rights and the impersonal existence of a firm create revenues in a sense of an advanced limited access order (North, Wallis, Weingast, 2006). As being a transferable asset, a firm can live forever, which is essential for its reputation and brand value (Spulber, 2008, p. 26). Spulber's owners want the firm to maximize its value because the owners can consume more by this.

2.3 The Ownership

Hansmann holds a very strict opinion towards nonprofit organizations: they have no owners at all because ownership is tied to two defined attributes: an owner has the right of control as well as the right to appropriate the firm's residual earnings (Hansmann, 1988, p. 268 / 269). Ownership is also associated with costs: the owner usually wants to monitor the managers although it might not always be worth it (Hansmann, 1988, p. 275 / 276). The combination of the preferences of several owners, usually through voting, might also cause costs (Hansmann, 1988, p. 278). Plus, ownership is always related to a certain risk (Hansmann, 1988, p. 280).

A very good point in Hansmann's analysis is the definition of efficiency as criterion of quality (Hansmann, 1988, p. 268). Depending on the transaction costs of the market, the firm is more efficient from a certain level onwards (Hansmann, 1988, p. 272). For Hansmann, ownership has not to be tied to capital transfers – owners are either non-patrons or patrons who are assigned to the firm through a transactional relationship (Hansmann, 1988, p. 270 / 272).

Another point of Hansmann is the phenomenon of lock-in which decreases opportunism (Hansmann, 1988, p. 283). For example, a manager who has his entire life around a firm may have high opportunity costs. Ownership can also occur through concrete collateral (Hansmann, 1988, p. 282).

2.4 The Separation Criterion

The separation within firms means primarily the creation of separate pools of assets (Hansmann, Kraakman, 2000, p. 810). By this, the firm allows a shift of risk from the creditors to the owners (Hansmann, Kraakman, 2000, p. 810). Separate assets mean also formal different departments, which make it easier for investors to focus on certain branches (Hansmann, Kraakman, 2000, p. 811 and Spulber, 2008, p. 20 / 58). By this, the costs of credits can be reduced.

Spulber goes one step further than Hansmann and defines the firm by the separation criterion. A firm has a certain ability to separate its goals from those of its owners and can thereby separate ownership from control (Spulber, 2008, p. 1 / 19). The separation criterion divides between shareholder property rights and corporate governance (Spulber, 2008, p. 1). This opens a firm to the market of corporate control where specialized managers can be found (Spulber, 2008, p. 6 / 19). These managers have more incentives to maximize the profit of the firm because they are not limited by the time and capital by the owners of the firm (Spulber, 2008, p. 20).

2.5 The Cooperatives

A firm tries to flee the market on the one hand but must interact with it through contracts to some extend on the other hand. The cost of contracting through the market can be diminished by applying investor ownership (Hansmann, 1988, p. 281 / 297 / 299) because owners have always an incentive for profit maximization, but external investors not per se. An important reason for investor-owned firms is the better position of patrons to control the managers (Hansmann, 1988, p. 301).

Another form of cooperative is to assign the role of ownership to employees. Worker-owned firms are common for service industries compared to investor-ownership in non-service industries (Hansmann, 1988, p. 291). The higher the homogeneity among employees, the higher the efficiency of employee-owned firms (Hansmann, 1988, p. 296). Higher homogeneity means that it is easier to measure each one's output.

In general, ownership is finally a good way out of the dilemma of incomplete contracts (Spulber, 2008, p. 63).

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