Power and selection of contract terms: The case from the Brazilian orange juice sector

Nobuiuki Costa Ito
Insper – São Paulo/SP, Brasil

Decio Zylbersztajn
Universidade de São Paulo – São Paulo/SP, Brasil

RESUMO

Poder e seleção de termos contratuais: o caso do setor de suco de laranja brasileiro

O objetivo é propor um modelo para explicar como os termos contratuais são selecionados na presença de poder: poder de contrato. O setor de suco de laranja ilustra a análise, indicando os efeitos do poder de contrato na organização econômica do setor. Poder de contrato é definido como a capacidade de explorar lacunas ou falhas contratuais, que são deixadas incompletas estrategicamente. Evidências empíricas a partir da análise de conteúdo de documentos de defesa da concorrência suportam a lógica do poder de contrato de três formas: evitando a mudança no método de pagamento de peso para conteúdo de sólido (qualidade); utilizando informações assimétricas para manipular índices na fórmula de cálculo do preço da laranja; e atrasando deliberadamente a colheita da laranja e, consequentemente, reduzindo seu peso e preço. O artigo contribui para o entendimento da seleção dos termos do contrato, bem como as formas de atuação de escritórios de defesa da concorrência sobre este tópico.

Palavras-chave: contrato, poder, custos de mensuração, *agribusiness*.

Nobuiuki Costa Ito, Professor Auxiliar no Mestrado Profissional em Administração do Insper (CEP 04546-042 – São Paulo/SP, Brasil)
Endereço:
Insper
Rua Quatá, 300
04546-042 – São Paulo – SP
E-mail: NobuiukiCI@insper.edu.br

Decio Zylbersztajn, Professor Titular do Departamento de Administração da Faculdade de Economia, Administração e Contabilidade da Universidade de São Paulo (CEP 05508-010 – São Paulo/SP, Brasil).
E-mail: dzylber@usp.br

1. INTRODUCTION

During the 1990s, citrus growers accused juice processor industries of using contract terms as a vehicle for economic power in order to raise profits, which started litigation in the Brazilian antitrust office. In reality, markets and contracts are imperfect. Frequently, economists assume that contract terms are competitively selected in order to maximize the expected value of cooperation, neglecting issues of bargaining or surplus division (Barzel, 1997, Allen & Lueck, 2002). In this competitive perspective, agents are only some kind of contract term "takers" because they cannot influence the process of terms selection. In this paper, we address situations in which competition is not a

sufficient mechanism to coordinate the process of contract terms selection. When competition fails, contract failures take place and economic power can influence the choice of terms. The research question is: how does power affect the selection of contract provisions in the orange juice sector?

Under traditional analysis (Williamson, 1979, Grossman & Hart, 1986, Hart & Moore, 1990, Barzel, 1997), contractual problems arise because of some kind of incompleteness due to bounded rationality, measurement difficulties, information asymmetries and the presence of opportunism. Although recognizing contractual incompleteness, this study investigates the influence of power in the selection process of contract terms. In other words, contracts present both incompleteness and failures. Contractual failures, as with market failures, enable agents to influence term selection through contract power. We define contract power as the ability to exploit contractual gaps or failures of contractual provisions, which are strategically left incomplete.

The theoretical model exploits the ability of an economic agent to impose measurement costs over a commodity's attributes, grounded in the Economic Analysis of Property Rights (Barzel, 1997). Following Barzel (2002: 18), power is the ability to impose costs. If higher measurement costs unveil fewer attributes of a commodity, as imposition of measurement costs become higher, fewer attributes will be specified in the transaction. In a contractual perspective, selection of contract terms that impose higher measurement costs leaves deliberate contractual gaps or unspecified attributes. These unspecified attributes could be consumed with no marginal payment, because no legal rights are assigned. Thus, contract power does not minimize transaction costs, nor does it maximize net surplus of cooperation or redistribute value.

The Brazilian orange juice sector illustrates power in contracts. During 1990s, citrus growers accused juice processors of concerted action, using contract terms in order to deliberately raise profits. Transactions of oranges between citrus growers and juice processing firms were performed using standard contracts for the whole sector from 1986 to 1995. The Administrative Council of Economic Defense (CADE), the Brazilian antitrust office, accepted those accusations, showing the evidence of power exertion on these contracts. More recently, between 2011 and 2014, the creation of a Council for Orange Producers and Orange Juice Industries (Consecitrus) was negotiated between citrus growers and juice processors. The economic power of juice processors influenced Consecitrus' negotiation process, because the definition of a price formation mechanisms was debated. The CADE is playing a key role in Consecitrus' creation, because it arbitrates negotiations between citrus growers and juice processing firms.

This paper is organized in five sections including this introduction. The second section presents theoretical background based on economic analysis of property rights (Barzel, 1997) as well as a theoretical model of contract power.

Third section presents data and methods. Section four presents evidence of contract power in the orange juice sector at two different times: between 1986 and 1995; and between 2011 and 2014. Finally, in section five, concluding remarks are made.

2. THEORETICAL BACKGROUND AND MODEL

The analysis of an institutional structure of production rests on the classical work of Ronald H. Coase (1937), which reveals the nature of the firm as a more efficient arrangement that saves costs by using price mechanisms, called transaction costs. Moreover, in a world of positive transaction costs, the structure of property rights influences the final allocation of resources (Coase, 1960) and externalities come into existence in the market, as firms cannot internalize all market transactions. Thus, in a world of positive transaction costs, institutions − formal and informal rules that limit human interactions (North, 1990) − shape governance structures (Williamson, 1991, 1985). This institutional structure of production (Coase, 1992), therefore, is directly related to how property rights are allocated (Zylbersztajn, 2010).

Barzel (1997) presents the two main definitions of property rights: one is the ability of an agent to use the property; and the other is the right that the State grants to a person. When faced with these two definitions, Barzel (1997, p. 3, italics in original) defines the first as economic property rights (hereinafter economic rights), i.e., "*the individual ability, in expected terms, to consume the good (or the services of the asset)*". The second one, according to Barzel (1997, p. 4, italics in original), refers to legal property rights (hereinafter legal rights), which is defined as "*the rights recognized and enforced, in part, by the government*". These two categories are not mutually exclusive types of rights", because according to Barzel (1997: 3) "economic rights are the end (that is, what people ultimately seek), whereas legal rights are the means to achieve the end". Thus, economic rights are the end of all transactions, which can or cannot be done through legal rights (means).

In this perspective, a commodity is a bundle of attributes (Barzel, 1982, Barzel, 1997) and transactions are the transference of property rights over attributes. These attributes carry inherent quality variability and, given bounded rationality and imperfect information (Simon, 1961), there are costs to assess quality. It is necessary to specify attributes and evaluate quality in order to transfer ownership. These measurement costs are also called transaction costs. For Barzel (1997), transaction costs are therefore costs associated with the transference, capture and protection of property rights.

For instance, the orange (fruit) can be broken down into several attributes, such as acidity, color, concentration of soluble solids, absence of pesticides that affect health, maturity level at harvest, harvesting and transportation responsibility, among others. It is possible to assign marginal payments for attribute variation, i.e., it is possible to price those attributes.