Cooperative Management

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The Cooperative Enterprise

Practical Evidence for a Theory of Cooperative Entrepreneurship

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Practical Evidence for a Theory of Cooperative Entrepreneurship

In Association with Roef van Dijk and Hanniëlle Teixeira (Kucheza) and with Leo Klep and Lee Egerstrøm

Springer

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Foreword

The authors of "The Cooperative Enterprise" have succeeded in collecting and developing the most relevant and modern knowledge of the sector to the interested reader. The text provides a good academic analysis of the relevant theories, but importantly it celebrates the rich practical experiences of the cooperative world. We are well treated with a wide range of illustrations of the recent cooperative business evolutions with a professional insight and analysis of the decision-making. A virgin mind would enjoy a rare view of the cooperative business management, while more experienced individuals could be shown the cooperative logic behind the scene.

The authors celebrate cooperative market orientation, individual commitment and responsibility as well as a dynamic approach to the future development of the sector. Hopefully, this would enable us to bring in those young, talented and professional people that we so much need in the farming sector. Furthermore, developing a training simulation game for farming businesses underlines the importance of this new approach in communicating our cooperative ideas. Involving the African farming community gives us Europeans a new perspective to issues where we have been too complacent.

A word of warning: "The Cooperative Enterprise" will make you think in a cooperative way. And it is fun to read!

Brussels, Belgium

Pekka Pesonen
Secretary General
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Preface and Acknowledgements

On the one hand, a cooperative is an enterprise that has a strong position in the market and can compete in the market on its own terms. On the other hand, a cooperative is an association of entrepreneurs, each one wanting to have a strong position in the market.

At the core, the cooperative has two goals: the entrepreneurial success of both the group business (the cooperative enterprise) and the member business, whereby the business goals of the member are the prime consideration. This is actually exactly the same as in a democracy, where the interests of the citizen prevail above those of the country. Therefore, cooperatives are similar to both society and business at the same time.

In entrepreneurial terms, a distinctive feature of cooperatives is that they have dual or even multiple goals. This is not simply the goal of the cooperative firm itself, but specifically the goal of the entrepreneurs who brought the cooperative enterprise into being. This creates a two-layered enterprise that has to perform an additional function. It is a corporate vehicle that serves the interests of its members, whether they are suppliers or buyers. To put it more simply, it is all about profit—profit for the members, irrespective of how those members define such “profit.”

From the perspective of behavioral theory, the firm is postulated as a coalition of participants. The members of the cooperative are both investors/owners and suppliers or buyers. Cooperative management theory is based on how inducements and contributions between the members and the cooperative firm in the different roles are aligned, and on answering the question of what this means for managing the cooperative as a firm as well as a group. Collective decision-making by the group means the development of democratic policy geared to instrumental interests, both monetary and non-monetary. Therefore, the cooperative development is very important for the democratic well-being of a society as a whole.

In this book, we start from the position that under certain circumstances cooperation creates value. Cooperation by businessmen, for instance farmers, however, is not an easy option. Certain conditions must be fulfilled. The first condition is that from the very start cooperators calculate immediate economic advantages. The most common advantage is lowering costs, from economies of scale for example. The second condition is that the members of a cooperative experience a sense of ownership of the cooperative business. As regards the feeling that a member's opinion matters, it is important that a member experiences himself or herself to be at an equal distance to where decisions for the cooperative enterprise are made, compared to other colleagues. This is not only a requirement for the general meeting, but also for the eligibility in representative bodies of the cooperative such as the member council. Thirdly, a cooperative is based on solidarity and loyalty. However, there should be room for choice and exit. Free association and cooperative membership definitely should not in any respect be felt as obligatory. Fourthly, the business cooperatives as dealt with in this book generally imply integration of two or more sectors in the supply or value chain. Therefore, cooperatives and their members can only survive if both are eager to be market-oriented. Cooperatives intensify competition, and they should be at the frontiers of efficiency and should stick to soberness in management.

This book is an extension and update of "Als 'de markt' faalt—Inleiding to cooperatie" (When markets fail—introduction to cooperation) by Gert van Dijk and Leo Klep, which was first published in 2005. Shortly after this publication, an English version was made with the help of Lee Egerstrøm (Minnesota), which, however, was not officially published. Since then, the translation in English has been made available to many generations of M.Sc. students in Economics and Management at the Mediterranean Agronomic Institute of Chania (CIHEAM-MAICh), Crete. Teaching experience and the many research projects by students from various countries led us to the conclusion that the study of cooperatives as a two-layer entrepreneurial model requires practicing that goes beyond lecturing and textbook analytics. It may not be too difficult to explain the business model of a cooperative; likewise, the legal structure is rather straightforward. Yet cooperatives are difficult to understand when it comes to the multifaceted relationship between the members and the cooperative. Many scholarly efforts have been accomplished to compare cooperatives with investor-owned firms with regard to their economic and technical efficiency. The fundamental difference in the financial mechanism of co-ops and the fact that the members have both a transaction and a financial relationship makes it impossible to make such comparisons meaningful. As a matter of fact, the ownership of members of the cooperative is hard to understand for members—this is also true in countries where cooperatives have been successful since a century.

For this reason, it was felt that the cooperative business models need another approach of teaching and instructing. The opportunity to bring this idea in practice arose when Roef van Dijk, son of the first author, decided to start a social venture to train youth in new business opportunities by getting them to understand differences between cultures and technical practices and how to take advantage of those by letting them play and exchange practices and new ideas. So, the idea was born to add the cooperative as a next level of training entrepreneurs. Together with Mrs. Hannielle Teixeira, a colleague attorney of Roef in their law firm, a computerized training simulation game was developed. Chapter 8 is based on the first and most promising experiences of training all members of a cooperative on real-life data. As all financial data of members and the co-op are integrated, the model appears most instructive and user-friendly. The members of cooperatives are trained on how to manage their business and the cooperative business at the same time. Farmers in various cultures have shown to be able to understand and act in two-level entrepreneurship.

The simulation game approach was also tested on M.Sc. students at CIHEAM-MAICh. In teaching at this level, the main test was whether students were able to link the game situations to the literature. The first results were most promising as students appreciated the gaming approach as a very stimulating method to learn about cooperative entrepreneurship.

In the final stages of this book, we greatly benefitted from the contribution of Mrs. Maria Verivaki at CIHEAM-MAICh who did the English proofreading with great dedication. Also, we acknowledge the assistance of Dr. Giorgios Apostolakis for contributing by searching recent research on the topics of this book.

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Part I
Business Principles in Practice

Chapter 1
Coping with the Invisible Hand

The cooperative is operating in a market (or free market) environment. The cooperative is both an alliance and a corporate vehicle that offers the individual participants greater opportunities in that market. They can achieve more as cooperators than working as individuals. In short, cooperation is a form of economic organization for *when the market fails*. We take the position that, in many cases, businesses are not fit to beneficially participate in the global market business without cooperating and reorganizing. Their partners may be colleagues, even competitors, or other stakeholders in their supply chain or region. They cooperate, as their market will fail from their perspective. Cooperatives, societies, communities and other forms of groups exist because it is necessary to create a buffer or countervailing power that assists to cope with the undesired effects of global market developments—undesired, of course, as seen by the members of those co-ops and communities.

1.1 The Invisible Hand

The invisible hand envisioned by Adam Smith has proven to have real staying power. In 1776, in his *Wealth of Nations*, Smith set out the theoretical basis for the concept of the free market.

Smith argued that the greatest contribution to overall prosperity was made when everyone was free to pursue and promote his own interests. Even those who were seeking solely to feather their own nests would contribute to overall prosperity, albeit unknowingly or unintentionally. This was an attractive idea that continues to hold wide appeal (Smith 1776a, b).

Smith would argue that government intervention was not needed. In fact, interference from above was undesirable because it would only interfere with the invisible hand—the free market. He argued that the market players themselves should decide on how and where the factors of production—labour, capital, means of production—could best be deployed. Inherent in this argument is that each player knows his own interests best.

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The interfering government was a thorn in the flesh to Smith. His theory can therefore be seen as a reaction to the economic politicking that caught on in the 18th century, in which the interests of the still relatively immature national states and governments predominated. Smith was not wholly convinced of the quality and the motives of these new governments. He used his theory to support the hypothesis that their highly protectionist trade policies were counter-productive. He believed that those policies prevented optimum use of the factors of production and, as a result, were undermining the wealth of nations.

The government should withdraw and let the market do its work, say Smith's followers. The ideal of a welfare state, which has been cultivated by those same governments over the years, has missed its goal and must be cut back. The government may well try, in the name of its citizens, to regulate what may and may not happen in society, but it would be much better if that regulation were left to the citizens themselves, through their role as consumers. Together they form that invisible hand which we call the market. After all, if consumers are free to choose, that will compel producers to offer that which is demanded, and at the best possible price. A government agency always has its own agenda. Even when there is a spirit of true democracy, there is never enough flexibility and sensibility to perform the regulatory role to the full. Ineffectiveness and less than optimal fulfillment of citizens' needs are the result. In the longer term, this internal problem only gets worse because the region or the country will suffer competition from other areas that do work efficiently.

In the present free market, the role of the consumer is emphatically at the core. The consumer compels producers to satisfy his needs to the ultimate degree and at the lowest possible price. The cheaper, the better; the consumer can then derive more satisfaction from his income.

The producer, in turn, is assumed to produce as efficiently and effectively as possible. To this end he can use various factors of production: labor, capital, raw materials, expertise, technology and organization. Each bears a price tag, and the important thing is to combine these factors of production in such a way that the required product can be marketed at the right time, in the right place, and as cheaply as possible. If a producer fails in their attempt to do this—if some other producer can make a cheaper and/or better article—the displaced will need to use their production factors for some other purpose, so that they will be used to the best advantage.

This somewhat simplified illustration suggests that producers and workers are actually expected to achieve complete adaptation. Whereas the free market philosophy frowns on the idea of telling consumers to be satisfied with whatever product they can find, there is obviously no objection to telling producers to make what the market demands, and in the most economical way possible. The consumer is free to choose; but the producer has far less freedom.

Our prosperity is measured against our gross domestic product. The underlying principle is that consumers derive satisfaction from that product. This is not to say that human aspirations are being reduced to purely materialistic terms; a product should be taken to mean anything that a person can spend money on. This can include services, culture, healthcare, holidays and sports experiences.

The freedom just mentioned, however, is limited to the individual domain of being a consumer, a consumer in the domain of leisure. As producers, and as workers, we are presumed to put ourselves into the shackles of efficient production to make optimum use of our own production factors. If we do not do so, or don't do it well enough, we will be ousted by our competitors or fired and lose our income.

There is another effect of the free market theory. According to this theory, failure or success is fully the result of the economic actor. In other words, if you succeed it is thanks to your own efforts and talents, and if you fail there is nobody to blame for that apart from yourself. Strictly speaking, it is 'the market' that tells you what to produce, when, where and at what cost. In effect, according to its advocates, markets never fail, almost by definition. When we add to the market theory, at local or national level, the theory of international trade and specialization, it is argued that global markets are instrumental to enhance wealth in all participating countries. Globalization is in other words highly profitable for all. Yet there will always be people and businesses who do not benefit from this global market logic.

We may speak of market failure where businesses face a high transaction specificity of assets. The situation of transaction specificity of assets—also named 'asset specificity of transaction'—was coined by O.E. Williamson who based his transaction cost theory on the phenomenon that assets of a firm derive their value from the reliability of transaction partners (for instance, the buyers). Perhaps the best illustration we have seen is in farming and food production. In many countries farming is a family business. Farming is based on specific cultural conditions and particularly ownership of agricultural land by families. Gradually agri-*culture* has developed into agri-*business*. However, as the conditions of local soil quality, micro-climate and water supplies may vary considerably over short distances, there may also be a natural limit to farm size as well. At the same time the firms that are active in providing inputs to farmers, such as fertilizers, machinery, animal feeds, plant protection chemicals and companies that specialize in processing and marketing, have made full use of economies of scale. As a result, individual farms are relatively very small and are fully dependent on a few suppliers and buyers. In some cases, the assets applied by farms are specific for one specific kind of buyer.[1] A concomitant phenomenon is that these big buyers have access to far better market information than farmers. As a result, farmers see themselves in a lock-in situation, which is a particularly tricky scenario, where the described situation kindles opportunistic behavior by the transaction partners of an individual farm. In this situation, we speak of market failure (Hansmann, 1996).

Farmers have reacted to such conditions of market failure by establishing and joining cooperatives. The cooperative firm may be seen as a buffer between global markets and local farming conditions. The cooperative acts as a global player, allow-

[1] We also of course see differences. In grain production the farm assets are much less transaction-specific than in dairy farming. Grain farming is large-scale and the products, e.g. wheat, are highly standardized and storable. Therefore spot markets are related to futures markets in a meaningful way and both famers and traders make use of the same mechanism. In dairy farming. the product—milk—is delivered twice a week according to specific quality specifications and on the basis of logistic agreements. Prices have no world market price and have various quality indicators.

ing the members to run their individual farms and at the same time become the owners of the cooperative firm. There are some very good examples of cooperative businesses in Europe, particularly in The Netherlands, Denmark, Finland, Sweden, France, Germany, Ireland, Spain and Italy. They are also well developed in the US and Canada, as well as in Australia and New Zealand, where we see similar examples of very successful cooperatives.

Since the first decade of the 21st century, however, there are also examples of other groups in society who have similarly suffered from an inability to take advantageous positions in global markets. Some of these groups have voted for protection at the borders, which is in effect creating the national state as a buffer between global markets and themselves. All sorts of cooperations have been developed to create buffers between themselves and the global market place.

As a matter of fact, all family ties, private societies, cooperatives and communities are established with the aim to create a buffer between the impact of global markets, government regulations and other external impacts which may have an undesired impact on the way of life human beings wish to maintain in their own social environment. In this book we deal with cooperatives that are specifically business-oriented, and thus translate global market developments to individual members' businesses. Business cooperatives therefore deal with external market orientation and transfer this into internal market creation.

As a hypothetical example, consider a baker who has a shop in a busy shopping street and lives in the flat above the store. A new supermarket is built in the square next to the parking lot, and it offers bread at special prices every day to entice people to come in and shop. More and more customers buy their bread from the supermarket. Price is a big reason, of course. But it is also easier for customers to do their entire shopping under one roof; the quality of the bread is also reasonable because the supermarket has an in-store bakery producing bread that is still warm when the customer buys it.

The bakery's income declines. The baker must cut costs and can no longer invest in new equipment, making it more difficult to satisfy the wishes of loyal customers. The result is even fewer customers. The mortgage becomes a millstone around the baker's neck, so he must seek a buyer for the bakery premises. He will have to look for a new job. But the supermarket has a vacancy in the in-store bakery, offering an opportunity for him to remain a baker, albeit if not an entrepreneur.

These days, the example of the disappearing craftsman hardly even raises an eyebrow. That's life. Thousands of people have to look for a new job every day, and from an economic perspective, that is not a problem. In view of the reaction of the customers, there was clearly no real need for our baker any longer. They now buy their bread from a producer who apparently works very efficiently. The money they save as a result can be spent on something else. The supermarket makes a profit that enables it to pay the lease on its premises. The baker's production factors—his labor, his premises, his capital—can probably be used more effectively for their new purpose.

Nonetheless, it cannot be denied that something has been lost. Our baker lost the opportunity to lead an independent life, a life that he enjoyed. Of course, he probably earns more at the supermarket than he did during the last few difficult years before he closed his business. But he can no longer work from home, he no longer has his own business, and he doesn't even do the work he trained for. He derives less satisfaction from what he now does, he is less proud of his work, he has less joy in his life. From his point of view, he has lost much quality of life. But for some reason, this loss is not added to the debit side of the social profit-and-loss account, whereas his extra income is clearly presented on the credit side of the account. In fact, the change in his work has actually increased national prosperity. Besides the rationality of the market economy, there is also the rationality of business continuity, the tradition, the personal effort for the sake of a valuable—in both the emotional and moral sense of the word—good. We are not trying to suggest that a change of professions is always accompanied by some loss of quality of life. But we also know that such bitter competition leads to a great deal of personal suffering, and could literally uproot lives. That, too, is the effect of being slapped by the invisible hand.

1.2 Scope for Individual Choice

We could ask ourselves whether the environment—society—is really happy with the way the invisible hand works. At first sight, it seems it is. The consumers expressed a preference: they chose the supermarket. It is only those consumers who consciously chose to go on buying their bread from the craftsman baker who will actually have their choice restricted. They will have lost their revealed preference.

That is often almost unnoticeable. The marginalization of the baker was also very gradual. It was only in the last couple of years that he found he could not always meet the specific requirements of his customers. The revealed preference was thus being eroded, step-by-step. There is not much more to lose in a business where there are fewer and fewer things happening. The working of the market mechanism is largely invisible. It works automatically, it is self-evident, and it is anonymous. There will be very few customers who will stop and think that perhaps the disappearance of the baker might have had something to do with their actions.

Going back to Smith (1776a, b), his analysis tacitly assumed that 'markets', as he recommends and cheers them, are part of the community of which both producers and consumers are members. Although Smith did not describe the relationship between market behavior and citizenship, it is clear from his writings that markets fit in with a society in which the moral judgement of people leads to a sense of propriety which is fair and decent. However, within the market system, the market is based on equal opportunity. The mechanism is impartial; it involves free choice among market partners based on the economic performance behind the invisible hand steering towards wealth enhancement.

Despite the fact that in Smith's analysis the market is always embedded in a morally-based society that defines the rules and regulations within which the markets function, in later years the market concept developed into more or less independent self-steering systems in which anonymous parties interact. That same anonymity can be seen in the way in which we move our capital around the world. The modern citizen puts his money in the bank or allows some pension fund to invest it, but he has no idea where it is being put to use. Quite possibly, without knowing it, he is investing in matters that he would not consciously choose. He does not know; he is investing anonymously.

The modern citizen holds great store in individualism while at the same time the economy is becoming increasingly impersonal. You no longer visit a shopkeeper, but a shop where there is always someone new to serve you. You don't ask your banker for a loan, you ask a bank. In many cases you have no idea who is actually the owner of the house you think of as yours. At work, you don't have a boss, but you work under a manager, often a temporary one, while the actual owner of the business—or the major shareholder—is totally unknown.

Unless they are entrepreneurs, even those consumers who did have a personal relationship with their baker are unlikely to see the link between their buying habits and the survival of their baker. The consumer has little to do with sorting out the difference between a relationship and a transaction. If your role was as a neighbor, a fellow resident or local city council member, you would probably want to fight for the baker. But in your role as a consumer, you do not take on that responsibility. At the end of the day, there is always the ultimate argument that the fault lies with "the market", the invisible hand. When everyone else starts buying cheaper bread at the supermarket, you would be foolish to go on buying from the craftsman baker. It is easy to adopt that attitude. As just one consumer, you can't hope to keep the man's business going. Before long, what starts out as "an opportunity to many" (the cheap supermarket) ultimately turns into "a necessity for all" (when the baker's business goes under).

We have just now touched on politics. In the political realm, the citizen often appreciates more than consumption habits might suggest. Mr. Citizen complains to the politicians that all this efficient scaling-up only leads to uniformity in our high streets, in our residential areas, the landscape, and so on. He calls for active protection of all those things that evidently have a weak status in the market. That includes people (the lowly paid, unemployed, invalid), historic and cultural monuments (which can no longer be maintained by private owners), the last village shop, and nature. He demands measures to combat child labor, animal abuse, environmental buck-passing and, in Europe at least, excessive automobile use. But these are seldom the issues that the same citizen would get worked up about as a consumer.

Some commentators say that this paradoxical situation is changing. The consumer is becoming more critical, so they say. It is generally predicted that the modern consumer will allow more and more qualitative and normative aspects to influence buying habits. In the same spirit—possibly as a reaction to these predictions—commerce is talking about "socially responsible entrepreneurship". Businesses willingly submit to standards for environmentally friendly and socially responsible conduct. And they do so transparently, by applying for quality certifications and hallmarks that are subject to external audits.

It remains to be seen whether this trend will continue. It may be just wishful thinking that the consumer will be a more critical consumer. The Europe-wide retail price war at the beginning of this new century justifies a degree of skepticism. The battles between independent retailers and large hypermarket chains in North and South America are even greater, with constant merger and acquisition activity. But the political efforts of citizens, as we just saw, are real enough. Therein lies a contradiction. The social desires of consumers are not all reflected in their immediate buying habits. They may ask legislators to prohibit large supermarkets and warehouse department stores on social grounds, but their euros and dollars follow prices. For that matter, this creates a major problem for "socially responsible" entrepreneurs. When consumers fail to put their money where their mouths are, it is risky for the entrepreneur to fight the trends.

It is tempting to see Mr. Consumer as someone different from Mr. Citizen. Of course they are the same individual. It is the choice architecture as conceptualized by Thaler and Sunstein (the nudge theory) that explains their behavior in different situations.

1.3 Social Capital

Entrepreneurs would also welcome a situation in which the standards and values espoused were truly adopted and reflected in the behaviour and actions of both consumers and producers. To express this concept, Francis Fukuyama borrowed the idea of "social capital" from his fellow sociologist James Coleman (1988). Any well-functioning society can rely on "social capital," which is a collection of formal and informal standards and values that enable members of a society to work together. These are standards that ensure that people can rely on each other, that no one's behavior would bring discredit to the group. This demands trust, and that trust must be based on social cohesion (Fukuyama 1995). Conversely, those standards and that trust must form the basis for social cohesion and spontaneous community spirit. In his book *The Great Disruption*, Fukuyama explains that it is precisely this trust, this precondition for the proper functioning of the market mechanism, which is coming under pressure from individualization to the extent that it is even becoming a threat to social cohesion. By extension, this pressure reaches the concept of social capital—society's standards and values (Fukuyama 1995). This view sets social entrepreneurship in a rather somber light.

Analyzing the importance of social capital for the proper collective management of resources, Pretty (2003, p. 1913) stresses the weighting of trust and reciprocity—as basic attributes of social capital—for cooperative performance. Trust is a necessary attribute for the smooth cooperation of the members and the reduction of transaction costs. It is strongly related to reputation. Members who are strongly concerned about their social reputation and participate in a cooperative feel more bound by mutual obligation and reciprocity and are more active in cooperative affairs. Moreover, members easily decide to trust other members upon the existence of their reputation in past cooperative situations.

Ostrom (2007) suggests that "at the core of successful collective action are the links between the trust that one participant has in the others involved in a collective action situation, the investment probability of all participants using reciprocity norms". The co-existence of reciprocity, trust and reputation increases the net benefits of the cooperative.

1.4 Market Failure Experience—Creating a Circle of One's Own

Smith's invisible hand (1776a, b) describes how wealth is created by providing equal, impartial opportunities to all economic actors. We have seen that there may be conditions where markets fail—at least from the perspective of certain individuals or groups, for instance farmers, and how such farmers have developed cooperative businesses, as economic institutions, as buffers between local conditions and global market developments. For a free market ideologist, such economic behaviour is hampering economic progress and wealth creation. Free market ideologists are advocates of competition under all circumstances and eventually look at people acting as each other's rival. In other words, from this ideology certain forms of social or cooperative behaviour of groups is counter-productive. From our perspective, however, economic behaviour should be seen as the outcome of how people want to design individual and social life.

Let's take the example of a specialist baker. He sets himself a specific goal or ambition. The baker wants to be able to work at home, near his family, and in his own house. In this way he wants to be able to practice his craft in a way that makes him and his family happy. Or perhaps, and we don't need to get misty-eyed about this, his talents are limited and baking bread is actually the only thing he can do well. At any rate, it does not alter the situation that at some point in time he has to cope with new conditions that are the result of his customers gaining access to new possibilities.

In the abstraction of the free market, each entrepreneur is constantly engaged in deploying various factors of production as if they were neutral resources. Money, goods and labour all have to be used in the way that has the best effect. The baker does that too, but he has a number of ideals that he is unwilling to abandon. He will not barter his labour, for instance. He wants to continue to be an independent baker. In economic terms, this desire is a handicap.

There are many sorts of handicaps. The shopkeeper who wishes to maintain the historic facade of his premises is handicapped if it would make his shop more attractive were he to alter the shop front. The farmer who refuses to keep his calves in crates will lose out to competitors who have no such qualms. The Indian textile business that ceases to use child labor will face greater expenses. In short, anyone whose personal preferences differ from those of the majority and which form no part of the social capital will find it difficult to flourish in a global, multi-cultural market. In a market where the division of labour, economies of scale and market power play such a significant role, this is almost by definition a handicap. It is for those who want to continue to work independently and on their own terms. There are always gaps in the market, but anyone who wants to run a business on his own terms, with his own goals in mind, will have a hard time in a society that is mesmerized by efficiency.

There is no disputing that the model—or, rather, society's view—of the free market might reflect human nature. Nearly everyone finds it gratifying to be able to derive value from personal talents and assets. But there are other values and passions that play a part in our existence. Besides earning money, most people also value notions such as love, loyalty, beauty and a degree of continuity. People should be able to create their own personal world in any communities.

People must be able to choose to remain where they are, to do or continue to do the work they enjoy doing, to work or continue to work with those whose company they enjoy, to lead or continue to lead the life they most enjoy. They have the right to resist the invisible hand that would exhort them to uproot, disengage and become anonymous—as is the way of the world in the free market. They must be allowed to draw a circle around what is dear to them, even if that leads to a less than optimum allocation of means of production or less wealth of nations. In fact, Smith himself warned us against excessive specialization of labor (op. cit., Smith 5). Smith argues that each person has some degree of ingenuity and invention. Excessive specialization may lead to greater productivity, but it also leads to a loss of the wholeness of one's life. He felt that specialization for specialization's sake would only lead to a loss of quality of life.

From that perspective, it is remarkable that the ideology of the free market should be propagated in such an unbridled way in the modern era. We are living in an era of unprecedented prosperity, and we learned in the past that a full belly makes for good philosophical theory: "*First the fodder, then the ethics*". According to Maslow's motivation theory (1943), now more than ever we should be ready for self-realization, for cherishing our dreams, for formulating our own demands on the quality of our lives. That makes the wholeness to which Smith alluded. But it is at this moment that new technology invites us to choose, again more than ever, to embrace and promote an economic system based on rapid profit and economic behaviour that is as amoral as it is anonymous. Governments are assumed to withdraw from the fray, and our incidental socio-cultural goals are relegated to the private domain.

We may feel like we are in charge as consumers, but we are being manipulated (or at best: 'nudged') like puppets by the invisible hand. We give generously to single-issue movements that champion the environment or the poor, but at the same time—albeit unconsciously—we are detracting from exactly the same issues in our consumerism, our work and our investments. How can this be seen as self-realization? We seem to have cut ourselves off from our factors of production, particularly from the capital that we say we are allowing to speak in a "morally neutral" voice. The links between the classic entrepreneur and his business and staff, or the link between the farmer and his land, also lie outside our range of vision. In economic life, any affection or attachment is seen as a threat to the optimum allocation. We have to be cosmopolitan, mobile, flexible, and detached from any locale or trade. Those are the preconditions for the quality of our lives. The example of an independent baker is an example of freedom to arrange family life and society, and not of making family life the outcome of some prescribed optimal free market behaviour.

This book will not address that quality of our lives as a separate value; we simply show that people—including producers—must be able to draw their own lines of demarcation. A major lesson to be learnt is that we are part of a bigger community, and our choices have their impact on that community.

1.5 Assumptions About a Free Market

People must be able to draw their own circle. Before considering the question of *how* they should do that, let's consider a few of the imperfections of the free market philosophy. The presumed efficacy of the free market concept is based on a number of suppositions that are rather seldom fulfilled. Good examples of where the supposed excellence is realized are the flower auctions in The Netherlands and the stock markets. Imperfections of the market, however, make it more difficult to participate in that market, and at the same time to maintain one's own circle.

1.5.1 Transparency and Access to the Market

One such supposition is that the market is transparent. The "free market" model is best conceptualized as a massive auction where all the bidders are present and simultaneously have all the necessary information about the products being auctioned. Therefore, all enjoy equal opportunities for bidding (Williams 2007a, b). Prices and quality are known factors, and everyone purchases from whichever supplier delivers the required quality for the cheapest price.

This supposition implies trust, but that is not always the case. An important reason for the establishment of the earliest retail cooperatives was the fact that many contemporary retailers were trying to push inferior quality goods on to their customers.

Even today, it is not simply a matter of comparing prices and quality. That is demonstrated by the immense importance that commerce gives to networking. In a world where time is money, so they say, businessmen fly around the world so that they can make contact in person. You need to show your face if you want to inspire confidence. This also applies to reaching the consumer. Advertising is one of the biggest commercial sectors throughout the world. The invisible hand apparently needs a great deal of assistance.

In this context it is interesting to note the rush of international mergers that have little purpose other than to supply a pied-à-terre in a particular market segment elsewhere in the world. Outsiders do not find it easy to establish a foothold.

In a wider sense, there is nothing automatic about access to markets. There are not only social, cultural and political barriers (such as class, language differences and protectionism), but there are also physical barriers. Without the necessary infrastructure and transport, or the money to put them in place, it is often impossible to reach customers. The high hopes cherished for the internet as a world-wide network are rather perplexing in this context, and only history will show whether those expectations can be fulfilled. But just consider how the internet is acclaimed as the democratic and globally accessible medium that will make an enormous contribution to the transparency and accessibility of international markets. Many traders clearly don't have such unbridled confidence in the present level of transparency.

Strangely enough, the role of ever-larger companies is largely ignored in discussions about the internet. These conglomerates, be they the providers or the administrators of landline and wireless connections, invest many billions of euros, dollars, lira and reals in access to this medium. We will be entirely dependent in the near future on a few providers for our exposure in the internet market. That is by no means an insignificant infringement of the concept of unrestricted accessibility. We only need to look at television to see the likely result. Only really big brand names can afford television exposure. Our tradesman baker doesn't stand a chance.

1.5.2 Market Equality

This last point brings us to the inequality of market power. Our market economy is ruled by the motto "big is beautiful". A big company derives many advantages from economies of scale. For a start, it is far more efficient to transport goods over long distances with a large truck than with a small one. At the same time, a company needs to have adequate financial resources to be able to purchase the most efficient means of production such as a giant tanker truck, a blast furnace, the latest machinery, a fiber-optic network, etc. Another major advantage for large companies is that they are able to attract the required expertise. A large workforce makes it possible to achieve an optimum division of labor, not only in terms of production but also in terms of networking, market research and advertising. It is only natural that we should occasionally ask where this sort of scale enlargement will end. Organizations can become so large and unwieldy that scale ultimately becomes a disadvantage. In fact, true technical innovations usually originate in smaller companies. And then those same large companies are the first to show interest in buying out such innovative companies or their innovative ideas.

Last but not least, larger companies have a stronger market position because of their size. Even if they offer their product at the same price as a smaller competitor, they still have more market dominance. They can make demands, because they are better known, because they trade in larger quantities, because they are not dependent on just one customer or just one market, and so on. The hypermarket retail chains constantly exert this market power on food and consumer product manufacturers in Europe and the Americas.

At the same time, customers can benefit from doing business with bigger suppliers for some of the same reasons. The larger suppliers are better known and they also have more products to offer. This doesn't apply just to quantities and a range of qualities; the larger suppliers' dominant position promises greater continuity and that makes them a more interesting partner going into the future.

Free-market ideology makes no effort to deny market dominance. For decades, major international mergers and takeovers have been motivated by "the need to keep a foothold in the market". Indeed, it is no longer only small retailers who succumb to competition from supermarkets. At a national level, innumerable businesses and brand names have been absorbed into larger and more anonymous companies. This form of uprooting is not only the result of unequal competition; it has more to do with differences in market dominance.

Meanwhile, national and international competition watchdogs try to curb excessive infringements of free competition such as oligopoly, monopoly, and cartels. But that does little to neutralize the inequality in market dominance. Having economic power is not, in itself, prohibited. Dutch companies for example only infringe the Competitive Trading Act if it can be proven that they abuse their position of power in the market.

1.5.3 No Individual and/or Social Objectives

Perhaps the most crucial supposition is the one we touched on in the previous section. As producers, people aim to make a profit. In order to maximize that profit, they are unreservedly willing to divide and utilize factors of production in the most efficient way. When people notice that someone else can perform a task better or more cheaply, they will alter the way they work. Market demand is the driving force in this case. That demand also regulates life in society; interference from any government agency would be counterproductive.

To put it briefly, individual and/or social objectives can only exist where there is demand backed up by purchasing power. In a free market the consumer is free to choose. The producer simply follows and does what the consumer demands.

The essence of this abstraction is that the individual is disengaged from the factors of production at his disposal: from his heritage, his environment and even his labor. These are all simply resources that a person can divide or sell depending on what best suits the circumstances. They are all for sale.

1.6 Own Objectives and Society

How can we achieve our own objectives? How can we draw our own circles within our society, and within the market regulated by that invisible hand?

1.6.1 Sectarianism

One way is to simply withdraw from the free market. Those who are self-sufficient do not need to bother about others. There will always be people who try to do that, some alone, and some in a sectarian context.

Further on we shall see that similar sectarian ideals have also held sway with the pioneers of the cooperative movement. They had an idea of creating a different sort of society where people would behave differently towards others (see Sect. 4.1). They envisioned a society that would eventually push aside the "mainstream economy".

1.6.2 Social Capital and Structure

Another option, which ties in closely with the previous one, is the "adaptation" of the prevailing social standards and/or regulations (the social capital, see Sect. 1.3). We have previously seen that anyone who seeks to achieve unconventional objectives in the market will be disadvantaged. If you can make those objectives generally acceptable, in a different politico-cultural climate for instance, you can reduce that disadvantage.

Within the concept of social capital, a distinction is made between socio-political structures on the one hand, and the cultural standards and values internalized by the individual on the other. We shall accept this distinction for now although it is partly a question of form and content: after all, social structures are usually based on cultural attitudes.[2]

Seen from the perspective of today's individualism, and certainly in the previously mentioned context of the objective of drawing our own circle, the social movements of the nineteenth century ultimately overshot their own goals. Quite often the individual did more for the group than the group did for the individual. The predominant idea was that social cohesion—the sharing of standards and values—had to be organized. This often led to far-reaching direction, both from within the socio-political groups themselves and through the medium of the government. Emancipation over-reached itself. Trust, that lubricant of social capital, evaporated. Trade became compulsive

[2]*An example of a conscious effort to form structural "social capital" can be found in the social movements of the nineteenth century, those that would later be described as "emancipation movements". Inspired by the socialist movement, among others, a number of leaders began to form groups under the motto "unity is strength." This was bolstered with sometimes romantic rhetoric and ideology. The group thus formed must become a powerful party within the hard capitalist world, and within the politics of the day. In order to reinforce the strength of the group, there was a great deal of emphasis on mutual solidarity. The groups created a wide range of networks for that purpose, from political parties and publishers to community councils, and in at least one instance, a goat breeders' association. In exchange for solidarity with the group, the group would show solidarity with you. That was no empty promise in economic terms. You could be assured of a regular circle of customers. In terms of the institutional economy, the internal transaction costs were low* (see also Sect. 7.3). *Externally, these socio-political groups clambered on the shoulders of the government in their attempts to promote their interests.*

and inefficient; cohesion, what should have been informal mutual affinity, coagulated, lost its flexibility, and eroded. The most extreme expression of this corporatism is seen in communist states where dictators lead group thinking and nearly every form of individuality is deemed a danger to "the community".

It is worth remembering that the forming of a trade union called Solidarity ushered in the ultimate fall of communist regimes. A Polish trade union initially called for social justice and freedom and was subsequently able to mobilize and nurture enough social capital to topple economic and military rulers. Today, democracy and the free market are seen as the victors following the downfall of the communist regimes. But let us not lose sight of the role played by social capital and mutual trust, nor disregard the question of what democracy really means.

Ideas about what democracy is, or should be, are probably just as numerous and varied as ideas about society. Is it about the interests, the "own circles," of half of the citizens plus one? Is it about choosing a government or a leader who will then rule the country "in the name of all citizens"? Is it about choosing a government that will try to do justice to the needs, the own circles, of all its citizens? Is it about a society in which the invisible hand is free to do its work? What role do minorities play in a democracy? How does a democracy deal with the losers, the weaker elements in society? The old GDR (German Democratic Republic), the almost feudal nineteenth century Western European welfare states, the American two-party system, and the extensively nationalized French economy are all called democracies.

When Fukuyama (1995) draws a distinction between countries with a great deal of social capital and those with less social capital, he puts the USA, Germany and Japan on one side and countries like France, Italy and China on the other. In his view "the family" has such a dominant place in the last three that there is hardly any breeding ground for community spirit and a societal-oriented social life. He draws a parallel between social capital and Protestantism in the western world. Protestantism is characterized by non-hierarchical faith-based communities that extend far beyond the members' own families. Within such communities, a sense of justice and own responsibility play an important part. This basis would be a good model by which to encourage cooperation elsewhere in society, and to form large companies, for instance, that are profitable and have a strong professional character. In cultures such as the Catholic and the Confucian, there is no such model because devotees have a strong sense of attachment to their own family and are literally inclined to keep things "in the family".

1.6.3 Social Capital and Cooperation

In this discussion about democracy, the role of government and the power of the invisible hand, we are more inclined to consider another distinction made by Michel Albert: the distinction between the Anglo-Saxon and the Rhineland model of capitalism (Albert 1991). According to Albert, there is more community spirit in the "Rhineland", an area that includes most of northwest Europe, with more consideration for the environment and for the longer term. In that model, consultation, together with minorities, plays a much more important role than in the "hard liberal" model adopted by the USA and the UK. For the latter Albert makes use of the terms Reaganism and Thatcherism. Although the term 'polder model' (or Rhine delta model) was unknown in 1991, he described it fairly accurately by citing Germany as an example.

This model is characterized by a mixed economic order in which the workings of the market are restricted by a strong collective sector and by consultation between government, trade and industry, employees and citizens. There is a societal ability to draw one's own circle within a free market. In reality, Albert emphasized the one aspect that is perhaps the essential ally of trust—responsibility for others. The Rhineland model incorporates the concept of social entrepreneurship (see Sect. 1.2) and particularly that of the welfare state, one that tries to guarantee a minimum standard of living for all, irrespective of their socio-economic usefulness. That is distinctly different from "everyone knows his own interests best".

As an aside, it should be noted that Germany takes the Rhineland model to further lengths than almost any other country. It locks in stakeholder rights that influence the behavior of companies—private, public and cooperative. Labor, communities and state and provincial governments throughout the Western world are studying these German stakeholder rights. So are some vendor groups in the United States and Canada after investment bankers put pressure on public corporations to increase profits at the expense of employment, quality and long-term strategies. In Chap. 7, we discuss the importance of stakeholder management in cooperative business governance.

1.6.4 Altruism

With his Rhineland model, Albert illustrates a capitalist model in which people are responsible for and show solidarity towards others. This combines egoism and altruism. But can that really be?

The term altruism was introduced by August Comte (1798–1859) to explain that our behavior, in practice, is not only prompted by purely egoistical motives. We do indeed often allow our behavior to be at least partly determined by the interests of others. At the same time, it is often noted that behind that altruism, we are ultimately serving our own interests. This is so in terms of mutuality, as expressed in the maxim "do unto others as you would be done by". You may well look upon such a saying as being prompted by Christian charity, but it is also a wise precaution for those who have already experienced situations in which an eye for an eye and a tooth for a tooth was the order of the day. In fact, that is what Albert's argument boils down to. He argued that the Rhineland model not only has a more social mien; it works better from a purely economic viewpoint over the longer term.

In this respect, Fukuyama agrees with Albert; Fukuyama later adds the pessimistic rider that capitalism will degenerate into individualism (i.e. egoism), which in turn would lead to great disruption. In other words, we cannot escape the severity of the invisible hand. This is a somber perspective, indeed, for Albert's Rhineland model and also for the possibility of drawing one's own circle. That would mean that own objectives could be sustained only with the aid of sectarianism and corporatism or with state intervention.

Or is Fukuyama wrong? Is it possible to work together within a free market without the necessity of coercion from the state? Axelrod (1984), at least, gives a positive answer to this last question, discussed in the following section.

1.7 "Prisoner's Dilemma"—A Cooperative Start

Axelrod asked himself when you would benefit from cooperation and when not. To illustrate his point he used the well-known "prisoner's dilemma".[3] Two men commit a crime together. They swear they will remain faithful to each other and will categorically deny all involvement. They are then captured and kept apart. Obviously, they are both facing punishment for their joint crime (one penalty point). But the one who informs on the other would go free (no penalty points). Betrayal would leave the other to face the music alone (five penalty points). If they betray each other, each will "earn" three penalty points. From an individual perspective, betrayal is the safest. There are, in fact, two options:

- the other remains loyal: self-betrayal would cost no penalty points, and loyalty just one.
- the other betrays you: self-betrayal would then earn you three penalty points, while remaining loyal earns five.

Whatever the other person does, betrayal is more favourable. Egoism pays off. So where's the dilemma? It lies in the fact that the other person will do the same sums, and he will also opt for betrayal. The result is that the two hold each other captive in a situation in which they both get three penalty points, whereas if they work together, they would get only one penalty point each. The choice for individual "rationality" is in fact less than ideal for both.

In this prisoner's dilemma, Axelrod recognized a good model that he could use to explain whether individuals or groups should work together. The 17th-century English philosopher Thomas Hobbes once formulated the same dilemma as follows: man is a wolf to his fellow man (*homo homini lupus est*), and that is ineffective. According to Hobbes, this could only be resolved through strong state intervention by an absolute sovereign (Hobbes 1651), which was about the only countervailing power option of his time.

Axelrod's difficulty with this concept was that people worked together even when there was no powerful government or other controlling agency. People apparently have strategies by which they can avoid the prisoner's dilemma. He sought an explanation to the fact that people continually come across the same other people. It is

[3]The prisoner's dilemma game was developed by Merrill Flood and Melvin Dresher around 1950.

then a more interesting proposition to develop a relationship of mutual trust so that you can share the benefits next time around as well.

In his search for such strategies, Axelrod organized a computer competition in 1980. Participants in this game theory exercise were asked to design a program, an algorithm, which formulates how they would act in a re-run of the prisoner’s dilemma whereby they meet the same players more than once. They just wouldn’t know how many times (and that is true of real life as well). What you—the individual participant—do know is that what matters is the number of points you have scored when you get to the finishing line, but where and when that is remains unknown. What counts therefore is the rationality of the here and now, and also that of the future.

The entries came from mathematicians, sociologists, economists, psychologists and political scientists. Their programs varied from four to 77 lines of instruction. The winner proved to provide the simplest solution: the program “tit for tat”, written by Anatol Rapoport. His strategy was astoundingly simple: start off cooperatively and then always do what your companion did last time.

The winning program and the best parts of other entries proved to have three common basic characteristics: friendliness (in principle, you work together), immediate retribution (when the other betrays you, you immediately do the same) and absolution (if the other is cooperative once more, you also immediately cooperate). The aspect of friendliness (a cooperative start) proved to be very significant. The best-scoring half of the entries was “friendly,” while the worst scoring half did not have that virtue. It was hardly surprising that these friendly programs also scored highly in competition against other friendly programs. After all, those also recognized the benefit of cooperation (just one penalty point).

Absolution, or forgiveness, also proved to be of great importance. Axelrod and Hamilton designed a model strategy whereby a player would only refuse to cooperate if the other had defaulted on two occasions (tit for two tats). This was even more forgiving. Although this model had been sent to all participants, it seemed that it did not inspire most of them. Seasoned strategists obviously gave it no credence. Axelrod issued a new challenge on the same lines, even sending all participants the results, and his analysis, of the first round. Despite all the available information, it was the tit for tat strategy that won once again. Once again, the friendly strategies scored better than the unfriendly strategies. A couple of dozen participants thought that they could take advantage of Axelrod’s apparent gullibility: “If the other participants are friendly, then we can make good use of that”. Nonetheless, they were unable to prevail, although they did lower the scores of the friendly strategies.

Axelrod’s computer exercise from 1980 seems to underline the fact that trust and (societal) cooperation can have added value above vulgar one-upmanship. A strategy of courtesy, forgiveness and, where necessary, retribution will always produce greater benefit. Cooperation pays off.

It should be borne in mind, however, that this is particularly true for the longer term. As a one-off exercise, the laws of probability show that the prisoner’s dilemma will be resolved in another way. In that case, treason pays off. But tit for tat is friendly and cooperative, with an eye to the future. Those who wish to benefit or profit in the long run will have to win trust. Part of the equation is that people discipline their fellows and act immediately if someone infringes the rules of the game. Another important condition is that of transparency. The experiment assumes that the "partners" always know how the other has acted in the past. If that knowledge is lacking, every decision takes on the character of a one-off decision and then non-cooperation would rationally be the strategy of choice.

1.8 Behavioural Theory

In behavioural theory, which is at the core of our treatise of cooperative management, consumers do not know precisely what prices are quoted by other producers.[4,5] Both the employees and consumers, as well as other stakeholders, are 'satisfiers'. Their aspiration level concerning prices, qualities, wages, interests, etc are adjusted slowly on the basis of new information.

Following Coase (1937),[6] companies exist because many core competences that are needed for society can be better maintained and improved on the basis of long-term contracts managed between people than by daily market negotiations of people. Therefore, we should look at the company as a coalition of groups of participants and a nexus of contracts (Douma and Schreuder 2002).

This model consists of the following elements: at the core of the company we define the capabilities of the company, which are coherent according to business logic and can be managed. By the words "can be managed", we refer to a system of capabilities of people and other assets that are capable of improving the performance or efficiency of tasks. It is clear that any company has to make many contracts to keep their core competence going. Among these contracts are: contracts with customers, contracts with suppliers, banks and other financiers, with employees and managers, and of course also with the social and natural environment. All these interests have to be balanced. According to March,[7] an organization is "a shifting, multiple goal, a political coalition; the composition of the firm is not given. It is negotiated." Besides, firms have to make decisions under partial ignorance. They have to make a decision on a proposal, not knowing what will turn up the next day.

In the behavioral theory of the firm (BTF), we release the assumption that the decision-makers know all the alternatives at the time of the decision-making, and that they can compare these, in order to maximize an objective function. In BTF it is assumed that alternatives are evaluated one at a time. Changes may imply changes in programs, business divisions or job designs. Then the managers make a rough

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[4] S.W. Douma and H. Schreuder, 2002. *Economic approaches to organizations*. Prentice Hall 3rd edition p. 97.

[5] See Chap. 7.

[6] R.H. Coase, 1937. *The nature of the firm*. Economica Vol 4. (as cited by O.E. Williamson, 1975. *Markets and hierarchies: Analysis and antitrust implications*. New York, Free Press).

[7] J. March, H. Simon, 1958. Organizations. J. Wiley and Sons, New York.

estimate of the consequences of several alternatives. There is no maximization in the sense of evaluating all possibilities for new work processes at the same time. Rather, they search for an improvement or solution that meets their aspiration level. Managers are not economic people; that is, they do not strive for maximization of utility. They 'satisfice', because they are administrative people. "Most human decision-making, whether individual or organizational, is concerned with the discovery and selection of satisfactory alternatives; only in exceptional cases it is concerned with the discovery and selection of optimal alternatives".[8] According to N.M. Kay,[9] the approach is diachronic. That is, the decision maker reacts to failure to achieve aspiration levels and aspiration levels adjust to changes in the environment. Managers 'satisfice', not maximize. This is the core of the behavioral theory of the firm (see Cyert and March 1992).[10]

Activities of a company are based on the assumption that all these contracts should end in a positive financial result or profit. In Western economies companies are based on defined ownership. In the case of an investor-owned firm (IOF), we take ownership as a function carried out by shareholders. Some of those shareholders have a large part of the shares, for instance the founder families. Another part is dispersed among a great many individual shareholders. They have in common that they expect a decent return on invested capital. Making use of a premium on shares at their exit satisfies some shareholders; others, especially the long-term shareholders, have a strategy of earning dividends. It is of value to make a coherent analysis, although it is necessarily based on a limited aspect of the whole of the firm. Any model will remind us and make us aware that it is only a part on which we base our conclusions and recommendations. Also a company is not making full use of its capacities if the staff and the management are not aware of the essential internal and external relationships of the company. If they are not aware of the bigger picture, it will be very difficult to share values among them. A company without shared values is probably not capable of learning.

In particular, long-term developments require being viewed according to an overall theoretical model. However, as mentioned before, for studying possible efficiency gains and cost cuts, we may make use of partial equilibrium models. Partial equilibrium, a well-known economic concept, means that some changes can be realized assuming that other factors and the entire environment remain unchanged, or are not directly affected by the conditions under study. In doing so we can concentrate on specific work procedures and job-related actions, which are currently highly relevant to the business. Moreover, this is where employees spend most of their time and effort.

Schematically the cooperative (Fig. 1.1) is distinguished from an investor-owned firm (IOF) (Fig. 1.2) with widespread ownership as follows. Both types of companies may be regarded as a nexus of contracts by which the stakes of various stakeholders

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[8]Mouwen, p. 15.

[9]N.M. Kay, 1982. *The evolving firm*. MacMillan Press.

[10]R.M. Cyert and J.G. March, 1992. *A behavioural theory of the firm*. Englewood Cliffs, N.J. Prentice Hall (2nd edition).

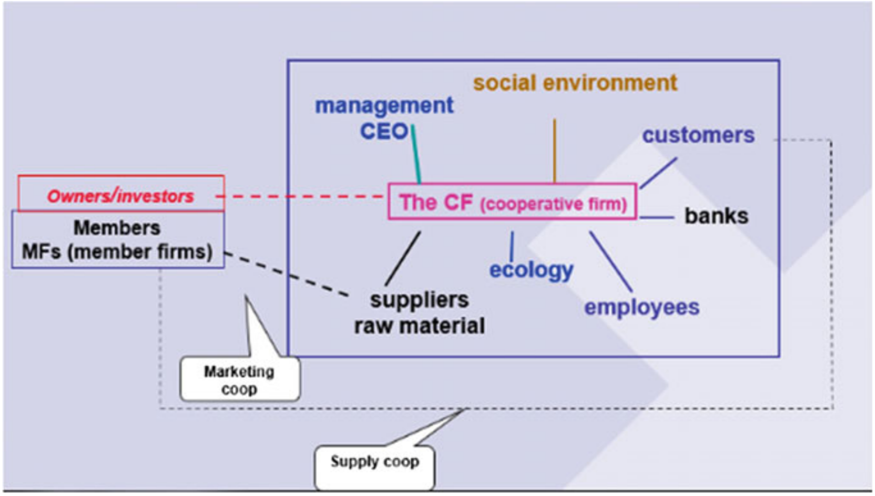

Fig. 1.1 The cooperative ownership model of business as a coalition of groups of participants and a nexus of contracts

are defined. Since the cooperative is defined as member-owned, member-controlled and member-benefitting, the members take the residual claims. Therefore, we distinguish between shareholders/investors in the IOF (Fig. 1.2) and the members of the cooperative firm (CF) from the other stakeholders (Fig. 1.1). We regard the members as business entities, the member firms. They decide on how to allocate the profits, they are responsible for continuity and equity capital formation, and they have the decision-making power in situations where the contracts are not clear. In other words, they exert the residual claims. In cooperatives, members have three different types of relationships: a transaction relationship (members are suppliers in marketing cooperatives and buyers in input supply cooperatives), and a financing or ownership relationship. Both types of relationships refer to the cooperative *as a business* (Fig. 1.1). However, these relationships imply decision-making (voting) powers. The third relationship therefore is that members have a democratic relationship with the cooperative *as a society*.

We note that in both models the owners are placed outside the frame in which the other stakeholders are positioned. In cooperatives, the members regard the transaction relationship as primary. It is also not by coincidence that in the case of the IOF, the management of the firm is also the shareholder for the sake of alignment of interest (Fig. 1.2). In the cooperative, the management is not in the position of ownership or—for that matter—membership.

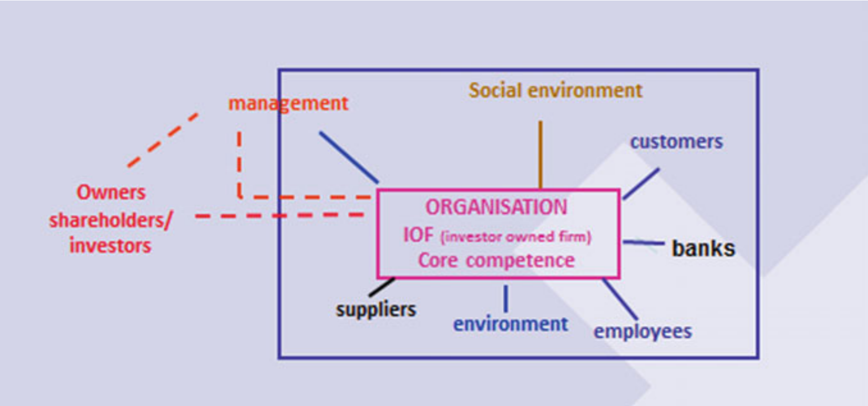

Fig. 1.2 Ownership: the (stock listed) IOF (the firm as a nexus of contracts)

1.9 Cooperation

Earlier in this chapter it was discussed how a free market for citizen producers makes it possible to pursue their own objectives, and to draw their circles around the things that they most want to protect. Two possibilities for drawing such a circle were discussed. People could try to isolate themselves from the world or try to mold that world—their environment, the state—to their own designs. A third option was the possibility of cooperating with like-minded people, strengthening market positions by making mutual decisions. The entries in Axelrod's game theory competition demonstrated that the method was not such an automatic choice for most of the entrants. Distrust, or the need to score points off others, predominated. Ultimately, they arrived at a strategy of approaching others with benevolence, only punishing disloyalty after the fact proved to be the most successful.

This is the context where we see cooperation:

1. An alliance in which the participants try to realize their own objectives: cooperation is a means to this end, but the individual objectives remain the primary concern.
2. A form of cooperation within a free market: there is no intention to withdraw from that market or to manipulate the market by political means.
3. A form of cooperation in which solidarity is based on self-interest: not because you love your neighbor, or because you feel that the group is so important, but because a basis of mutual trust is necessary in order to be able to cooperate.

Cooperating can sometimes have an ideological background, but that is not a precondition. What is deemed essential is that the cooperators have an objective, a circle they wish to draw, and that their alliance creates a firm that contributes to realizing that objective.

That objective will always be based upon independence and autonomy, otherwise the cooperators might just as well sell or rent out their factors of production. Entrepreneurs would thus welcome a situation whereby the standards and values, which we—as a society—profess to hold in such high regard, were truly internalized and reflected in the behaviour and the actions of citizens, consumers and producers.

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Chapter 2
The Added Value of Cooperation

The cooperative was characterized in the first chapter as an alliance designed to achieve certain objectives for the participants—the individual cooperators—within the context of (free) markets. The added value of the cooperative comes from producing benefits for member cooperators that wouldn't be available to the members working alone. This applies only to those cooperatives that have business or economic objectives. Social service cooperatives in some countries are formed for various reasons other than economic gain and may not be completely applicable to the issues discussed here. But within the focus of this book, the business cooperative bears a special burden of always needing to be entrepreneurial on two levels: it must be entrepreneurial in its own right and it must add value to its members by assisting them to become more entrepreneurial individually, or independently.

2.1 Two-Layered Enterprises

The first principle for the operating cooperative is that the members define their group objective. Apart from that, they remain individual and independent within the cooperative (Williamson 2007). They remain in charge of their own factors of production. They are prepared to travel in a flotilla convoy, but each wants to remain captain of his own ship. This means that the cooperative cannot be seen as an "ordinary" enterprise. We have already pointed out that having an individual objective can be a handicap in a free market (see Sect. 2.1.4), and this applies equally to the cooperative. The objective of the individual member is a precondition for the cooperative as a whole. In that sense, the cooperative has two objectives: just as any other company, it must be successful in its markets and—at the same time—it must contribute to the objectives of the individual members. We have already touched on this, and we must come back to it as we go along. The curiosity is—and we will come back to this later in the book again—that the one objective is not necessarily in direct alignment with the other. It is important for that reason to continually bear the "dual objective" of the cooperative in mind.

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The cooperatives discussed in this book are exclusively alliances that have economic objectives. These economic goals are shaped by founding members and by national laws that either empower or restrict the business function of the cooperative firm. In Denmark, for instance, there is no separate cooperative law. This means that member-owned cooperatives operate in much the same way as public stock corporations and individually-owned private firms. Tax laws govern cooperative behavior in the USA and, to a lesser extent, in Canada. Specific business codes or tax laws impact on how cooperatives function in South America and various parts of Asia.

As formulated in Dutch law (since 1st January 1989): "*A cooperative is an association established as such by notary deed. Its objective as set out in the Articles of Association must be to provide for certain material needs of its members on the basis of agreements, other than for insurance, entered into by them in the context of the business that they operate for their common benefit*" (Section 53 of Book 2 of the Dutch Civil Code).

No ideological phrases are contained here; only the requirement that the cooperative should serve the "material needs" of its members. There is no suggestion of higher values of more general social responsibilities. The personal objectives, motives and considerations remain the concern of those who wish to continue to be captain of their own ship. The cooperative enterprise accommodates no more than some joint economic activity. This means that there are two layers of enterprises—those of the members, and the collective enterprise of the cooperative itself. This bears out the previously cited "dual objective".

The same objectives are built into the Canada Cooperative Act, and, to a lesser extent, the Capper-Volstead Act in the United States which defines cooperative structures. In both North American countries, the law narrowly defines cooperative ventures as business entities and not as non-profit organizations that provide services for their members. With this distinction built into the legal codes, organizations focused on providing services are unusually incorporated under separate no-profit organization codes, even when they are structured and operate as a cooperative for governance objectives.

On the extremes of cooperative legal standing, the Danes have created a strong national commitment to cooperation without a separate legal code, and the Italians assured a national commitment to cooperation after World War II by specifically writing support for cooperatives into their new (1947) Constitution (Logue 2005). That constitutional reference, Article 45, clearly points to Italian recognition of value-added objectives of cooperation: *"The Republic recognizes the social function of cooperation characterized by mutual aid and not private profit. The law (sic) promotes and favors the growth of these structures using the most appropriate means and guarantees that their character and purpose will be inspected accordingly"* (ibid.).

2.2 Cooperation Must Make Sense

What true added value can be derived from cooperation? Why should you work together with others to provide for your own material needs? The answer has to be that cooperation makes sense in all those situations where a large party has a greater market opportunity. Cooperation makes sense if, by working together, you become stronger. Without being exhaustive, we shall touch on a number of areas where cooperative value is added.

2.2.1 Countervailing Power

Small market parties can easily be put under pressure, or played off against each other by larger suppliers or buyers. The other party could say: "I can manage without you. Take it or leave it. There are plenty of other offers." But this tune changes after you form a communal purchasing or selling party with others. This can reduce the threat from unilateral competition that would stretch an individual over the proverbial barrel. This is particularly important in poorly balanced markets in which a single buyer or seller operates (monopsony or monopoly), or only a very few buyers or sellers are active (oligopsony or oligopoly). Under such circumstances, a cooperative can make a difference in terms of market access, as well as by insisting on volume discounts. The members could even decide to go into competition with their supplier (or buyer), by producing the raw materials or services (input) themselves in the future, or by processing the end product (output) themselves (Galbraith 1968). Countervailing power is supposed to be so important that it can determine cooperative success or failure (Beverland 2006; Edwards and Shultz 2005).

2.2.2 Transaction Costs

Especially for farmers and horticultural producers, cooperatives are instruments to reduce transaction costs. We will try to explain this theory with the help of Fig. 2.1 which shows the transaction cost as well as the transaction specificity of assets in three different organizational structures, namely "market institutions", "cooperative structures" as well as "hierarchical structures". Apart from the problem of having to pay a monopoly price for the services of a firm due to its simple market power, farmers have to make transaction-specific investments. These costs, for instance the milk tanks on a dairy farm, may be specific and cannot be recouped when the farmer changes to another buyer. Besides, farmers have high fixed costs and are extremely vulnerable for having certainty concerning the daily or weekly delivery of their produce. Evidence (DEFRA 2007) indicates that formal collaborative arrangements are more likely to occur when farmers enter into a cooperative activity with the

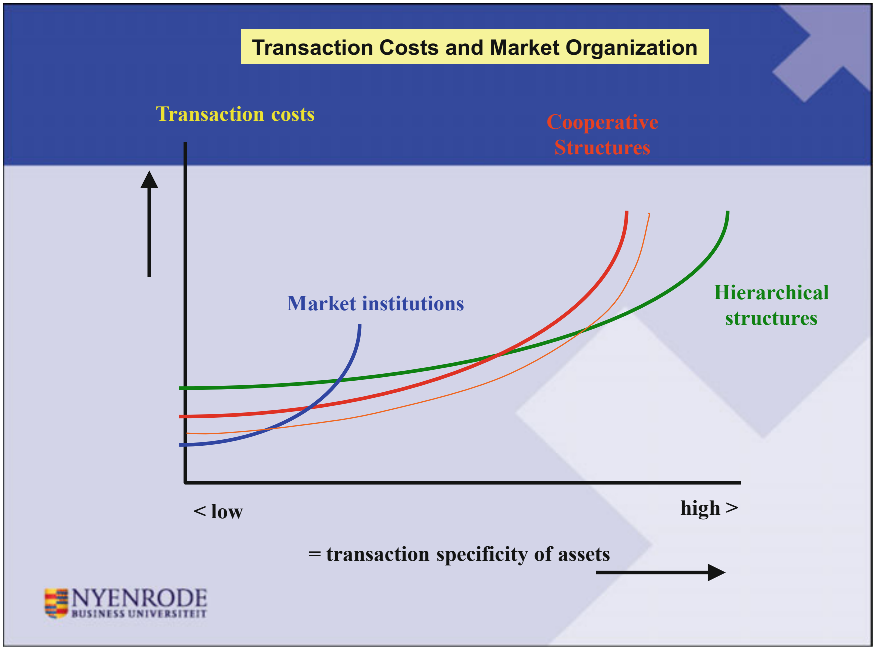

Fig. 2.1 Illustration of differences in transaction costs in relation to transaction specificity of assets by transaction institutions

specific commitment to make financial investment, than in other entrepreneurial forms. The agricultural economist Glenn Johnson demonstrated a long time ago how fixed assets influence the supply function and output behavior of farmers. By demonstrating that factor, markets are imperfect and assets may be fixed—both for the farm and the farming industry—and farmers cannot buy or sell inputs with a useful life of more than one production period for the same price. As a result, individual farmers continue production despite large changes in their earnings, and are therefore vulnerable for the opportunistic behavior of the buyers of their produce (Johnson 1960).

Transaction relationships often exist during a long time period and grow in complexity over time. This means that exit is costly and the consequences cannot easily be overseen for the future (Williamson 2008). According to Williamson (1991), transaction partners' actions are rationally bound, but they may also use their position to behave opportunistically; it is not possible to predict beforehand whether they will do so or to what extent. The lower the exit costs for transaction-specific investments and the lower the exit costs in the short term, the more impersonal market transactions are efficient. On the other hand, if transaction-specific investments are all important, it is more efficient if the firms integrate. In between we see that transaction costs are lowest in cooperative structures (see Fig. 2.1). However, even in cooperative structures, there exists significant variance in the degree of control over members, depending on the degree of uncertainty as well as the nature and finally the degree of specific investments required by the transactions at stake.

Therefore, from a technical point of view, the comparative approach raises significant difficulties (Menard 2007; Joskow 2005; Gibbons 2003). Searching for the lowest transaction cost, firms choose the appropriate organizational configuration or governance structures (Cechin et al. 2013). According to Bijman et al. (2011), "it is a combination of at least market, hierarchy and community mechanisms that determines the efficiency-enhancing function of a governance structure".

2.2.3 Market Access

Cooperation can facilitate and even initiate access into a market. A buyer or seller may not even bother to visit a small player in the market. Moreover, the volume of goods the small player can supply might be so insignificant that transport to a market far away is uneconomical. In that case the small player could arrange and combine transport with others. It might be that the market finds a particular target group too small to justify developing specific products. Small players can join forces as a group to make their demands heard and can produce the desired products when necessary. When expertise is lacking, they can combine resources to train a specialist or hire such talent. If they offer specific services or products, they will probably be a more attractive market party if they can offer a wider portfolio by cooperating with specialists in affiliated companies (i.e., a law firm). Even for no other reason, the opportunity to serve a particular market or to buy particular products means cooperatives represent significant added value (Bijman 2010; Cavicchi 2011). Moreover, market access is highly appreciated by individual members who have difficulties in approaching it and they manage to harvest significant tangible benefits. They also recognize that their efforts to maintain or elevate the quality of their products and production process as a response to customer demands has been rewarded (Cechin et al. 2013).

2.2.4 Market Transparency

As minor entrepreneurs, individuals rarely know all that is going on in the market. They won't have time to keep up with market developments, or the market might literally be a long way from home. The result is that they no longer have a precise idea of what potential buyers want from them; they don't know what their product is worth, or they don't know whether the market knows what they have to offer. They must overcome these shortfalls of the market through the exchange of information from time to time, especially about prices, quality and price-quality ratios. They may also get together with others to hire specialists who can monitor the market for them and advise them on where and how to buy, sell and advertise their product. Another option for small players is to create their own individual or group market (private or public, e.g. an auction, a market, an internet site) in order to promote transparent pricing. Such a market has the added advantage of greater reach. Customers will come from farther away and larger buying or selling customers will be attracted as well.

It should be noted in the context of the above three points, however, that the relationship between individuals and the market can be strongly determined by local circumstances. The international grain market, for instance, has all the characteristics of full competition. But a prevailing monopoly or monopsony exists when there is only one supplier or buyer of grain in a particular area. Classic examples of this can be found in rural areas in the Americas. Despite competition in the grain trade, there is usually only one major grain buyer in rural grain-producing communities within states such as North Dakota, in the United States, and Sao Paolo, in Brazil.

2.2.5 Risk Management

A tremendous added value to cooperation comes to individual business operators who turn to mutual action to share risks. An example in agriculture is the existence of significant trends that differ across farms—not only because of differences in farmers' managerial abilities but also due to the market developments (e.g. price developments of specific products). These differences create different levels of risk for individual farmers (Finger and Benni 2014). The same applies to retailers and others participating in cooperative associations. To a certain extent, any communal business can be considered a "risk spreader". If everyone trades his own account—as in the case of the prisoner's dilemma—first one and then another will be hit or fall flat on his face. This is a big risk for the continuity of a small company. Communal businesses share market risk and they also share investments. In other words, cooperation not only gives them access to activities that are denied to individual businesspersons for technical or financial reasons, but it also allows them to undertake activities that they would not want to risk alone.

Risk management can take on many forms. In the case of perishable goods, it is sensible to have communal capacity so that the shelf life of the product can be extended and no one need be left with unsold surpluses. In the case of less sensitive products, it can be useful if a communal sales or buying organization determines the best time for sale or purchase, irrespective of the current financial situation of individual members.

Finally, a specific example of risk management is the mutual insurance associations in which the members bear risk jointly. Such associations and risk-pooling enterprises are found throughout the world.

2.2.6 Economies of Scale

The greatest benefit of cooperation is found in economies of scale. That is the core purpose of working together. In general, we usually consider cost benefits associated with undertaking activities on a larger scale, such as in storage and transport. But savings can also be made in processing and marketing. Moreover, working together makes it possible to make investments that would be too great for a small company. These investments subsequently make it possible to access new markets. Looking up and down the supply chain, economies of scale can be found in all elements of the marketing mix (Meulenberg 2000).

2.2.7 Professionalism

Professionalism can be seen as an economy of scale. But it is probably a by-product of the fact that people cooperate. Both the scale and the cooperation make it possible for the cooperative to exchange, develop, or hire experts and consulting expertise. This expertise can cover almost any aspect of the individual members' businesses and the cooperative itself.

2.2.8 Chain Development

Markets are subject to change, and those changes are occurring at an increasing rate. Changes within one link of the chain can have major repercussions for preceding and succeeding links in the chain. Entrepreneurs with contacts across neighboring links in the chain can perhaps anticipate these changes better with the aid of internal communications. A key matter in modern business, however, is the necessity to monitor and record the origin of goods in a large number of markets. This task is often easier to arrange and manage within a cooperative.

2.2.9 Communal Interests

Although the above sections emphasized the individual interests of members, cooperatives can also be established with the explicit purpose of serving communal or regional objectives. The focus of such an enterprise would shift from the explicit interests of individual members to the best interests of the group or the regional economy as a whole. Again, examples can be found for regionally focused cooperatives throughout the world, often formed to overcome problems associated with frontiers and lesser economic development (Egerstrom 2001). A company could, for instance, be established in order to foster the regional economy. Such objectives would include the creation of employment opportunities, and at the same time ensure that people in that area retain access to buying and/or selling within a market. Indirectly, this would serve the interests of everyone who is trying to earn a living in that area.

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Chapter 3
Cooperation and the Weighing of Interests

At the core of any cooperative there are various interests. How do members and managers weigh the importance of those interests? There is a special relationship between the cooperative enterprise and its member-owners. As an introduction, we contrast a public stock company with an imaginary investment cooperative. We shall then see three relationships that bind a cooperative firm and its members.

3.1 Weighing of Interests of Shareholders

Cooperation among partners will always be most effective if all partners have the same interests. There will be problems if one prefers to provide as many jobs as possible while another partner wants to make a maximum profit. The overall objective must be clear.

That ideal situation is perhaps best achieved in a large public listed company that operates in a free market. Shareholders in such a company do, in fact, have the same interests. They want maximum return on their capital. They have no other connection with the company. The shareholder-owners are almost literally anonymous. They do not cooperate in any way; the invisible hand performs the work. Managers have to ensure that the company performs as well as possible. This is for profit, profit forecasts, and the growth of profit that the shareholders are dependent on for the value of their shares. There is no reason why shareholders should involve themselves in the running of the company. They just need to keep an eye on share prices, profits and the latest profit forecasts. If that information suits them, they will retain their shares; if not, they will sell them.

The situation is also clear and unequivocal for the management of a profit-oriented company. High shareholder value is a measure of success, and it also provides the opportunity for further investment in new and existing activities.

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We could, actually, look upon a public stock company as an investors' cooperative. The general meeting, often an annual meeting of shareholders, acts like a members' council in a cooperative. In practice this will be a varied group, from institutional investors and people of independent means to persons with modest savings and heavily indebted adventurers. But, as far as their interests in the company are concerned, this is a homogeneous group. There is just one thing that counts: the return on their invested capital. In really large public companies there is not even any true difference between large and small shareholders. Everyone's share is so small that no single person or legal entity has any decisive influence on the management.

For the shareholders, the correlation between an increase in the price of shares and the dividend is totally irrelevant. Shares can be freely traded, i.e. sold at a moment's notice and at negligible cost, and both the profit and the expected profit are discounted in the share price. Not only dividends but also expected dividends can be converted into cash. Even when a company invests heavily in a promising activity – at the expense of dividend pay-outs – that will not necessarily lead to friction between the shareholders. If there is confidence that such an investment is a good idea, long-term investors will be satisfied about future prospects and short-term investors – who may need cash today – will see that this confidence is reflected in the share price, so they can recoup their investment in that way. In the least favourable case – if there is no confidence in the investment – the share value will fall and long-term and short-term investors will be disadvantaged equally.

We could make numerous comments in relation to this simplified example: differences in risks, differences in market insight, the basis of and confidence in the profit forecast, etc. But, in principle, the interests of all investors can be deemed to be the same. They have a common objective, which is to make profit on their invested capital. That objective is combined with the possibility that they have to take advantage of the share price and expectations, and cash in their shares at any time, at negligible cost.

3.1.1 Shareholders Are More Consumers Than Owners

This all means that shareholders function in the stock market more like consumers than owners. In practice, they go window-shopping to look for companies where they can best "spend" their money. If they discover another company that they expect will give greater profit, they will invest in that other company. They will not be interested in what sort of company it is. What they make, whether the people are nice, and where the company is located are all unimportant issues to passive investors. The share market is anonymous and fickle.

It is hardly worthwhile for you, as a shareholder-owner, to become engaged in the running of the company. Why should you? It is up to the managers to do their work; if you are not satisfied, you can sell your shares. Preferably, you do this before your fellow shareholders reach the same decision. For the achievement of your objective—maximising return on your capital—you are not dependent on any particular company. Worse still, feelings of engagement can be dangerous. Those who leave a sinking ship too late just lose money. In this sense, too, the shareholder in a public company remains anonymous. Supervising company management is, in practice, little more than a formality and a question of keeping an eye on the profit forecasts. It is not a question of managing or jointly determining the company's course.

3.1.2 Involvement and Dependence

Shareholders only feel the need to interfere in management and direction when they have some special relationship with the firm or a dependence on the company. Relatives of the founders, and shareholders who are proud of the company in which they have invested, will have different views on this matter. Very large shareholders may well demand clarification if they consider that the management has taken an unwise decision. These relationships are more commonly found among investors who have put money into companies that are closely held and not listed on the stock exchange. They cannot get out of their investment so easily. Moreover, there will be no share price—backed up by an army of financial experts, banks, analysts and journalists—to warn you that something is wrong. These investors have to be far more active in weighing the value of their investments and the course, or direction, of their company.

The same applies to members of a cooperative, except that there are even more considerations to monitor. The primary reason for members founding the cooperative is different. They do not usually set out to achieve maximum return on their invested capital. Rather, they are driven by a goal to fulfil "certain material needs". As there are two layers of entrepreneurship in a cooperative, there is also a more complicated and multifaceted definition of profit. In short, this means a cooperative is not only about the profits that are realized in the cooperative itself, but also about the extra profits that are achieved—thanks to the cooperative—in the enterprises of the individual members.

This second aspect is the most difficult to define. In the first place, you do not know what your own enterprise would have earned without the cooperative. How can you make that comparison? Second, it is not always possible to express that "material need" in terms of money or profit. No matter how difficult this is to prove, the member must try to imagine what the value of membership in the cooperative might be when there may be no buyers or sellers for the member's own production without the cooperative enterprise.

3.2 A Cooperative is not an Investors' Club

For the sake of argument, let us assume that a group of investors could establish a cooperative. In so doing, we are sticking close to the objective of shareholders: maximum return on invested capital. So what are the differences between a cooperative and an investors' club? We'll suggest just a few:

- To start with, you surrender a degree of influence. You take your money to the cooperative, and the cooperative invests it for you. You have some voice in decisions, but you share decision-making with others. If the majority chooses option A, you cannot persist and invest in option B.
- You are willing to go along with the majority if you believe the cooperative has some extra value. There must be a presumption that there is strength in unity. In some cases, you may see a market in which big capital receives a better yield, or greater market rewards; in other cases, there is no opportunity at all for small capital, or small players. You may conclude that risk can be spread and managed better cooperatively, and frequently you have gained confidence, knowing that expertise can be shared among members or hired from outside.
- When you establish a cooperative, you also create obligations. Expenses are incurred (personnel), operational investments are made (office premises), and communal funds are invested to produce returns. After that, it is difficult to withdraw invested funds should you decide that option B was a better choice after all or you need your money urgently for some other reason. Membership also means that you are obliged to contribute your input, otherwise there are regulations that hamper or delay withdrawal of funds or membership. At the very least, the cooperative will consider you disloyal and not be so ready to take you back into the fold. That is a particular problem if the cooperative does indeed have an extra value. These are all issues that are of no concern to passive stock shareholders: they may be as disloyal as they please.
- The previous section emphasized the difference between dividend and share value. One member may be more interested in a good annual payout (for instance, meeting the expenses of children attending schools and universities), while another may be more interested in a long-term investment that will ultimately produce a better yield. This distinction is not relevant to shareholders: anyone who wants to cash in can do so whenever they wish, and to the extent that they wish.
- The advantages of any profit made by the cooperative are exclusive to the members. Anyone who wishes to share in that success must become a member. Whether that is possible depends on the situation. The doors will be wide open if big capital produces more profit, but will close when there is no big capital left.

This example is given to demonstrate that the interests of the members can vary widely, even in relation to a single-minded objective such as achieving returns on capital. Looking at our example objectively, we see a contradiction between the members who need returns in the short term and members who feel that the long term is more important (this is known as the horizon problem, see Sect. 3.4). Phrasing this in general terms, the goals are different. Subjectively, there is also a contradiction since dissension can arise about which strategy the group should follow. Both contradictions are a problem because the cooperative is a democratic association. Members have to be compatible with each other.

3.3 A Triangular Relationship

If we extend this simple example to a "normal", or traditional cooperative, we note three inherent business relationships involving members with the firm:

- A cooperative requires investments. Expenses are incurred that are attributed to the members (or to transactions with the members). When a member leaves, his share of these expenses has to be shouldered by the remaining members. The smaller the cooperative, the greater that problem becomes. In short, there is an investment relationship.
- A cooperative needs to decide on a strategy. The members have a democratic voice in that strategy, but individual members cannot usually determine their own strategy for their own contribution to the whole. That means that there is a control relationship within the firm.
- The third relationship is perhaps the most important: the cooperative must carry out an activity that is of significance to the business operations of the firm's members. It fulfils a "material need" for the members. This core relationship, then, is the fulfilment of a transaction.

The member is dependent on the cooperative for a particular service, input or output. The importance of that dependence, of those transactions with the cooperative, can be very substantial. Oftentimes it means a cooperative will process or trade the entire production of a member's business. This means that membership has much more than just an investment relationship with the firm, and the members' interest is far greater than simply obtaining a return on their invested capital. To a certain extent, return on investment is simply a secondary consideration. It is not without value, of course. But the greater question centres on what extent the service provided by the cooperative contributes to the success or the extra profitability of the members' own business or household.

3.3.1 Proportionality

The transaction relationship must always remain the central consideration when weighing interests within the cooperative. In order to ensure that it does, members invest and have a voice in the cooperative proportionate to the value of the transactions they conduct within the cooperative. This is a standard rule for cooperatives. The member who does much business with the cooperative, and contributes much in the form of investments, gains a stronger voice in the cooperative's affairs. This is also the way to keep interests homogeneous. It removes or lessens conflicts of interest that can arise between member entrepreneurs for whom the transaction relationship is the most important and others who feel that the return on invested capital is more important. This principle is thus known as the "principle of proportionality". It emphasizes the proportionality that exists between transactions or investments with voice and influence in the firm. The term "principle of performance" is also used to show that the performance, the transaction, is the central issue (see Sect. 5.2) (Hansmann 1996).

3.3.2 Three Markets

In terms of the prisoner's dilemma, members of a cooperative will be active in a market in which they can occasionally make a killing, or windfall profit, thanks to personal shrewdness or fortuitous external events such as drought on other continents. Generally speaking, however, members will tend to be on the losing side of markets and trade flows. In response, they pursue cooperation. They place a cooperative between themselves and the market. The cooperative enterprise becomes the active player in the market, substituting its market expertise for the members', and it operates just like any other enterprise in the market. From then on, members transact business through that cooperative enterprise.

It is this market relationship that makes a cooperative a cooperative. The backdoor of the processing and marketing cooperative doesn't even open onto the market. The cooperative does no business with other market parties through the back door, only with the first layer of the enterprise. This market entrance is usually referred to as "the primary enterprise". At the front door, the cooperative is open to the market, just like any other enterprise. The same entrance, then, serves both the members and the members' customers who go in and out of the same door. We call this openness to outsiders "the secondary enterprise." Here, the cooperative is in open competition with other businesses, but always has the interests of its members at heart.

At this point we must mention that lawmakers in most developed countries have made it possible to enter into contracts with third parties that are similar to those of members ("the tertiary enterprise"). This occurs only where the cooperatives' articles of association allow these market relationships, and only to the extent that such contracts would subordinate contracts with members.

The uniqueness of the cooperative form of business stems from the primary enterprise. Members may well have placed a cooperative enterprise between themselves and the market, but the transactions in the primary market also need equitable settlement. One important characteristic is that the primary market is, by nature, a closed market; members and their cooperative enterprise are the only parties involved. Moreover, these parties form part of a two-layered enterprise. On the one layer we have individual members and on the other layer is the cooperative enterprise. These two factors mean that this is not a market where an "objective" invisible hand can determine prices or volumes. Instead, parties will need to consult and negotiate. What would be best for the collective interests? What would be best for the individual members? This consultation becomes more difficult as the individual objectives and/or interests of the collective members diverge. It can become even more difficult if the cooperative enterprise (or its management) acts in a more self-determined manner.

3.4 Weighing Divergent Interests

In the context of decision-making within the cooperative, a number of general problems arise. These are problems that relate to the diverse interests of the members and those of the cooperative enterprise itself, which economists and business academics refer to as "agency theory" problems.

3.4.1 Horizon Problems

When a group of entrepreneurs establish a cooperative, they subordinate immediate results to future benefits. They build something that is intended to produce results in the longer term. There is, then, a time horizon to their plans.

That time horizon does not need to be the same for all members. One member may be short of money, making it difficult to invest. Another member may be financially comfortable and have no difficulty with making the investment. The first member may hope that cooperating will help him resolve an acute problem. The other will want to build up a strong cooperative enterprise because he feels that this will help him develop his own enterprise over time. One member will think only of his own enterprise; another may be thinking primarily about the future of passing down a legacy and opportunity to grandchildren. Even those who feel a specific responsibility for the cooperative enterprise may have their own time horizon ideas. They will then think more in terms of the continuity of the cooperative enterprise, often from a sense of responsibility for their employees. The manager, called an "agent" by academic researchers, may want to secure a particular result (a new factory for instance) before he retires, while the members may want to proceed more slowly (Fahlbeck 2007).

We have already seen that a difference in time horizons in a listed company rarely leads to similar problems because the profit expected in the longer term is usually reflected in the current share price. Cashing in shares at any time can accommodate those who are interested in short-term gains. There are notable exceptions, especially in North America in recent years, where investment fund managers have taken a less passive stance and have forced companies to liquidate assets, merge, or take other steps necessary for short-term gains at the expense of quality or long-term strategies that weaken the surviving enterprise. But that is not usually the case in a cooperative.

Moreover, the transaction relationship is central to the existence of a cooperative. Return on investment is not the only consideration. Depending on their own time horizon, members attribute more or less importance to growth prospects. Someone nearing retirement will be less inclined to support the risks involved in the cooperative, exploring a new market or expanding its presence in an existing market. A younger member, however, may well see that as the only way to achieve long-term growth.

While the horizon problem is very individual, it can also take on structural forms. When a cooperative is established, cooperators usually form a fairly homogeneous group as far as their time horizons are concerned. But as time goes by, the cooperative will inevitably have members who are either just beginning or nearing the end of their careers. This disparity will be magnified whenever issues call for greater risks or greater contributions from members.

In principle, the horizon of the members extends no further than the period of their membership. There are exceptions, of course, when other more ideological considerations are at issue. These might include the interests of children, of the group (solidarity), of their collective socio-economic class, and of the local community. Communal long-term considerations, such as working together to build a better future, can effectively eclipse individual differences in time horizons.

3.4.2 Portfolio Issues

The transaction relationship is central to cooperatives. A certain product, or a service, passes from the cooperative enterprise to its members, and vice versa. That is the core business: it is there that the communal interests are found. In practice, however, it is not so simple for cooperatives to agree about what transactions their core business may include (Tortia et al. 2013). For example:

- **What products?** Imagine that a group of apple growers decides to get together to sell their apples. Some of them also grow pears. Should the new cooperative sell pears as well? There could be advantages; the cooperative would then have a wider range to offer in the secondary market, and this will give it a better market position. There can also be cost advantages; both harvests could be collected from the members at the same time and almost the entire cooperative infrastructure could be used for two products.

  But the apple growers could experience a conflict of interests. They want a cooperative that markets their apples, and not a cooperative that divides its attention over multiple products. Some will even feel that the pears are not so much an addition to their apples, but are in fact competition. How can you then compare the apples and pears, and the profit made on each, within the cooperative? How can an apple grower keep a grip on his cooperative if he has no understanding of part of its activities (pear growing)?
- **What services?** Exactly the same problem applies to service cooperatives. In the case of services, the situations in the members' own enterprise may be a particularly significant factor. An apple seller needs good storage facilities, even if only to be

able to wait for more favourable times to sell the harvest. The cooperative can give its members advice about cultivation, organise the hiring of fruit pickers, and generally run the business. But members who think they have sufficient storage facilities, expertise and staff will have no need of such services.

- **What quality?** A member who grows apples for a hobby would be pleased to find a broker or produce wholesaler who can sell the apples. A commercial farmer-grower, on the other hand, wants a cooperative that will market the apples well and lucratively, especially in proportion to quality. The cooperative may set quality standards for its members, or sell various qualities on the secondary market. In either case, the cooperative will distinguish between groups of members and therefore between their interests.
- **What risks?** A cooperative can take more or fewer risks when choosing its activities. Selling apples is one thing; but that is not to say that all the members will want to launch a private brand of apples for sale in China, or will want to make applesauce. The latter can, of course, be done with the intention of reducing risks, as we shall see later.
- **How much integration?** In the primary market, the cooperative may limit the members' independence by prescribing products, volumes, qualities, services and working methods. The question for members, then, will be to decide how independent they want to be or remain.

The cooperative can expand its activities in the secondary market. To extend its range, it could import citrus fruit or merge with a citrus cooperative. Another option for penetration in the secondary market would be to process the produce itself (applesauce, pear juice) or to operate fruit stores. There are even cooperatives that develop activities in a completely different sector, if lucrative options present themselves, taking advantage of existing means of production or expertise. An example would be dairy cooperatives that expand into the processing and selling of citrus juices because they are servicing the same refrigerated cases in supermarkets. Members must consider whether they can still maintain their grip on the business and whether they want to shoulder the investment involved and its attendant risks.

On one side of all these portfolio issues are the interests of individual members. Do they want to expand the business in this way? Does it suit their business? Do they want to pay the price of entrance and expansion? Do they believe in the business plan? Rarely will all members give all the same answers to these questions. On the other side are the considerations of the management of the cooperative. The managers pick up signals from the secondary market and translate them to the members. They must first ask themselves what is necessary from a marketing point of view. What is likely to succeed? This dichotomy illustrates the dependence of the members when the primary transaction relationship with the cooperative enterprise becomes further diluted. On the other hand, there is the added value of active involvement in a professional cooperative enterprise.

In practice, the cooperative's activities can become so far removed from those of the members that even the transaction relationship becomes a secondary consideration.

3.4.3 Solidarity Issues

Our description of the cooperative suggests that it is an intermediary, forming a buffer between the market and the members' own businesses. That is not to say, however, that members of the cooperative are protected from the market and from price competition, or even from their fellow members. The market impulses are certainly passed on to the members in the primary market. Anyone who is not able to buy or sell at the "cooperative price" will face financial difficulties.

Solidarity between members does not extend to offering special protection to the weakest. That would ultimately lead to a weakening of the collective membership. If stronger members have to help pay for the weaker members, the concept of solidarity and trust will soon be undermined. Stronger members would withdraw, and weaker members would flood in, causing the collective enterprise to price itself out of the market.

But it is possible for the cooperative to act as a buffer. If certain members are unable to keep pace, the cooperative can make efforts to keep them with the group, even though that might be detrimental to profitability in the short term. Sometimes there is a commercial justification in doing so. For instance, this may be so if the cooperative derives market benefit from a constant large volume, or if the rapid shakeout of members would result in over-capacity and financial losses for the cooperative.

How far a cooperative can go to maintain member solidarity will depend not only on commercial margins but also on business objectives. That will sometimes mean an emphasis on helping one's neighbours and providing mutual support. An example of that is mutual insurance (see Sect. 4.2). In that situation members agree on what risks to share, and they don't easily abandon someone who is suffering actual loss. At the same time, this solidarity is still based on "reasonable" risk aversion in the sense that there must be mutual trust.

In general, however, the rule is that there should be no structural transfer of income from one member to another, or from one group to another, within the cooperative. The cooperative will hardly be sustainable if the interests of one member are promoted at the expense of other members. It is for that reason that most commercial cooperatives try to allocate income and expenses to members individually.

Again, this makes it clear that there must be a certain degree of homogeneity in members' interests. If the interests are insufficiently parallel, the promotion of one interest will, almost by definition, be effected at the expense of another (Bijman et al. 2013; Gulati et al. 2005). This is a point that always receives a great deal of attention in the Netherlands. Elsewhere in the world there are many examples of multi-purpose cooperatives that combine purchasing, processing and sales. A few large agricultural cooperatives in the United States are good examples of this, but they too are establishing ways to keep conflicting business missions separate. Most cooperatives in the Netherlands are single-purpose; they concentrate either on supplying or marketing a single product (Van Bekkum and Van Dijk 1997).

Homogeneity of interests does not necessarily mean that members benefit equally from the cooperative. A member who can sell his entire production via the cooperative will naturally have a greater interest in that cooperative than a member who only makes use of its services occasionally. Nonetheless, their interests in that one cooperative will be proportionally homogeneous; one will not benefit at the expense of the other.

3.4.4 Incentive Issues

We have seen that the cooperative and the primary market, which are democratically organized, act as a buffer for the members. As a result, members can receive the wrong signals, or promises of incentives, from the market. This problem comes to the fore when members receive such a good price that they increase production even though commercial demand has not increased. This could be the case if the cooperative, for whatever reason, decides to pay more for members' products than would be realistic on the basis of the operating results achieved. As is natural for increased prices, members respond and produce more than the market can handle. Separately, it should be noted, this has been the worldwide complaint against domestic farm policy subsidies that encourage production.

Structurally, incentives can become an even bigger problem when the cooperative enterprise adds substantial value. Let's imagine, in the case of our hypothetical apple growers, that the cooperative makes a good profit from its applesauce processing plant. That profit is distributed among the members pro rata according to the volume of apples supplied. The price increase persuades the members to produce more apples, but the applesauce plant does not need them. The result is a surplus of eating apples, and this ultimately has a negative effect on profits.

Another variant of the incentive question arises when a cooperative decides to pay members an average price for their produce, with no bonus for better quality, while the differences in quality are factored and reflected in the market. Members are then encouraged to produce the cheapest quality because they will receive an average price.

A different problem occurs when the cooperative fails to take into account the extra expenses it incurs on behalf of certain members. It might agree for solidarity reasons to absorb the extra costs of transportation for members who produce low volumes, live further away from plants or markets, or have no storage facilities. This has been a historical problem for dairy cooperatives in parts of Scandinavia and rural regions of North America. This typical solidarity issue is, at the same time, an incentive issue. When you do not make members bear some or all of these logistical costs, there is no incentive to change or make improvements.

That can lead to considerable tension in the internal democratic structure. A cooperative will strive to add value for its members. But it is important to provide that added value in a way that members are not enticed to act in a way that will backfire on them or their company.

3.4.5 Volume Issues

There is one other complication to consider for our hypothetical apple cooperative. The enterprise might decide to only produce applesauce to achieve the highest possible average price for its members' apples. A problem may then arise that is closely connected to the horizon issue. One grower might find it useful to realise a good income with limited production. But other members may want to expand their orchard business. In doing so, the latter will want to take advantage of economies of scale to reduce apple unit costs. This would allow the expanding producers to realize more total income, even though doing so may lower the price for their apples and for all other members.

3.4.6 Equity Issues

Issuing shares allows a public limited liability company to access risk-bearing capital that it can use at its own discretion, and this capital would not need to be redeemed. Cooperatives also have similar equity, but it comes from the members and former members, and from the assets owned by the cooperative. Members in a traditional cooperative are not allowed to withdraw or sell their shares, but they can avail themselves over time to the fruits of the cooperative. Since this equity does not belong to any particular person, there cannot normally be any claim to any yield from it. Shareholders, in contrast, would have such a claim. As a result, there can be a lack of incentive to seek optimum return on this equity. This can create something of a reverse incentive issue. It needs to be noted that new cooperative business models are being developed in various countries in an attempt to avoid these equity issues.

3.4.7 Free-Rider Issues

Members might leave the cooperative in order to grasp a perceived opportunity for themselves (Carlton and Perloff 2005). It is hard to be critical of such a decision. There can be no appeal from the point of view of solidarity, as the idea of the cooperative is to work together to further the interests of each individual member. When that philosophy cannot be upheld, the retiring member can hardly be reproached. Nor can the cooperative be reproached if now and again a member leaves; at best the cooperative could imply that without the cooperative, those members would have given up far earlier.

The most successful cooperatives are those that can ensure against free riding through the sanctions and incentives aimed at conformance of members towards common goals.

A well-functioning cooperative always acts to correct problems, or imperfections, in the market. When it does, other parties in the market have to follow the cooperative's lead in pricing and service. If others don't meet the cooperative's competition, all primary players in the market would want to join the cooperative. The reverse of this problem comes when competitors respond to the cooperative's position in the market, making the benefits of remaining in the cooperative firm less visible. Non-members begin to enjoy the same market benefits as members of the cooperative. The willingness to remain a member, therefore, can come under severe pressure. Members no longer see any advantage to membership and start to look elsewhere, often playing the cooperative off against market rivals. These outsiders who enjoy the market benefits created by cooperatives are known as free riders. It becomes imperative that the cooperative appeal to its members, arguing on the principle of solidarity. Too many free riders can seriously undermine the success of the cooperative (Iliopoulos and Valentinov 2012).

A more complicated variant of this problem arises as soon as the cooperative needs to invest. It then needs to call on the members. Those members will argue that non-members have no need to invest, while they deal with the same suppliers or buyers at the same price. To a certain extent this can be seen as a horizon problem (some members have no interest in investing), but in practice the problem is often that some members lack insight. They "forget," or conveniently overlook, the benefits that the proposed investment will bring them. This can be compared to the way people often fail to realize that they gain benefits from the taxes they pay. Another variant on the free-rider problem is the possibility that a cooperative can do less well in the market than other parties, even though it may be successful in other ways. This might be the case for a cooperative that is established to improve the competitive standing of small retailers. If a cooperative of village stores can realize substantial savings for its members, it does not follow that the goods in those stores are cheaper than in the supermarket of a neighbouring village. The problem is always a matter of weighing members' situations when gauging the success of a cooperative (see Chap. 4).

3.4.8 Growth and Independence Issues

Many cooperatives have grown into gigantic international businesses. They have done so in order to remain competitive in international markets while at the same time they continue to promote the interests of their members. But this can raise a number of new issues. The central problem is that such a large cooperative enterprise can easily start to lead an independent life of its own, seemingly removed from its members. There are substantial interests at stake, including enormous turnover and vast numbers of employees.

Professional top managers are recruited. Often they are men and women with extensive reputations earned in international business. Their business management knowledge may be great, but many have little affinity with cooperative philosophies. For them, the market is the key and international business the measure. Competitive considerations lead them to discuss strategy with as few people as possible. The members' primary businesses are hardly any larger than they were years before when the cooperative was a smaller enterprise. It is difficult if not impossible for these members to keep abreast of all the ins and outs of international strategic management. The logical result is that members lose their grasp of the enterprise's situation; they delegate decisions or take them on trust, and they relinquish their voice in the cooperative. Consequently, management becomes even more alienated from the central cooperative objective, namely the interests of the members.

In such a situation, a rift may evolve between managers and members. The members may be less willing to continue funding the cooperative. It becomes difficult for members to assess the merits of planned investments. Members become further removed from the running of their cooperative. The managers, meanwhile, start looking for new sources of funding outside the membership. The link between transaction and investment is threatened, and the transaction relationship with members is pushed into the background. These developments have compelled cooperatives to hold serious discussions on management issues such as corporate governance and re-engineering in recent years. In extreme cases, some cooperatives have dissolved, selling their assets to larger investor-owned enterprises. Others have converted to investor-owned firms in which former members list their companies on stock exchanges and share ownership with passive investors and investment bankers or funds.

What should a cooperative do to keep itself on track, nurturing the three relationships it has with its members? The above issues will be addressed in more detail in Chap. 7.

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Chapter 4
Twin Goals and Two Communities: A Behavioural Approach

4.1 Cooperatives Are Businesses

Cooperatives are not ideological cliques trying to detach themselves from the world. In simple terms, they are merely associations of people who establish a business to provide themselves with certain services in order to thrive in the global market. In this sense cooperatives can be compared to a football club. A number of people want to play football locally and they form a club to do this. Everyone makes a financial contribution so that they can build a football pitch and hire a grounds keeper to look after it. The most important thing is the intended service: to be able to play football locally on their own terms. That is the goal. Despite that common objective, a club like this must also be run efficiently.

If the costs get out of hand, continuity (and therefore the essential goal) will be put under pressure. Therefore, people have to follow sound business practices which means once again that the administration, i.e. the board of the club, has two goals: provide its members with the opportunity to play football *and* run a business.

When we talk about cooperatives, we are really talking about commercial enterprises. Dairy farmers who decide to set up a milk processing factory are a classic example of this. The intended 'service' consists of buying, processing and selling milk from dairy farms. At first glance this example would seem to be nothing more than a purely commercial business, and in practice it is true that the most important goal for a cooperative enterprise is to make a profit for its members. The fact is that members see the profit made in terms of a higher price for their milk. This last point is crucial when it comes to defining the true meaning of the cooperative in the eyes of its members. The members did not set up the cooperative enterprise as a 'profit machine', as investors might do, but to make sure they have market access and a distribution channel for their own milk. Just as the members of a football club want to be able to play football, the members of a dairy cooperative want to deliver milk. Their cooperative gives them guaranteed access to a service that they could not be guaranteed if they were each working alone: access to a distribution channel for their milk, access to the opportunity to play football. Not on terms stipulated by a

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rival tender—regardless of whether there is one—but on terms they themselves have made.

The business or association is not the focus but acts as a vehicle to achieve the essential goal. The board will find it difficult to get the members of the football club, for example, to agree to a proposal to rent the pitches out to another club. After all, what the members wanted was to play football. Similarly, the members of a dairy cooperative are unlikely to agree to a proposal by the board to buy milk from other suppliers—or to process a completely different product—because they can make more profit. The fact is that the profit the cooperative enterprise makes is not the members' only main concern. The most important thing for them is their own business and subsequently the profit made by their business, and they need the service provided by the cooperative enterprise to achieve this. The more efficiently the cooperative enterprise does this, the better. But it is the service offered to the members that lies at the heart of it. This means that there is a fundamental difference in the relationship between a company and its shareholders. The relationship between them is purely an investment relationship. So, the shareholder only needs to monitor the profit the enterprise makes, or the return on the capital invested. (If the shareholder is not happy with it, he can always get out). However, the members of the cooperative not only have an investment relationship with their enterprise; they also have a transaction relationship, which forms the core. On the other hand, the cooperative enterprise is an 'ordinary' enterprise whose 'simple' objective is to make a profit. This may be subject to a very specific pre-condition: being able to meet the conditions the members place on their transactions in the best possible way.

If by this we mean that cooperatives have 'twin goals', then we'll be offending many economists. How can you achieve the best if you have two different goals? This can only be done if the one goal can be converted into the other. If this is not the case, some economists would argue, then management will be receiving vague signals. In reality that's what happens: the management of an association or cooperative can study the market as much as it likes, but in the final analysis there are two questions that need to be asked and answered when making a decision: *how will the association or cooperative as a whole be affected 'in the market'*, *and how will individual members and/or their goals be affected*? The first item is decided in the market. However, what the members want, and what conditions they place on (their transactions with) the cooperative enterprise will have to be settled in the 'internal market', in a discussion with and among members. The ultimate question is what is of interest to the members—in other words, what do the members want? Although the members have a say, it also means they have to bear one other goal in mind in addition to the goals they have as shareholders: their own transactions (be it delivering milk or playing football).

We have described the internal discussion within cooperatives and associations mentioned above as a discussion in which individual and/or common goals should be aligned with the way in which the market or 'the big economy' operates. At the end of the day, members can, of course, want what they like, but we're still living in that bigger world. Our aspirations must remain affordable: if the club gets too big for its boots, it will go under; if the same services can be obtained more cheaply elsewhere under the same conditions, it will be the end of the club. In the end what it boils down to is that people together try to form a buffer—out of professional solidarity—between (the individual goals of their members and the compelling effects of 'the big economy beyond'. It can never be more than a buffer. At the same time, both our cooperatives and our numerous associations show where this type of buffer can lead.

Let us start by examining members' "personal goals" more closely. How do these differ from the goals which 'the market' or 'the big economy' already serves?

4.2 Business on the Member's Terms

Let us consider the example of the local football club. Why was it established? A group of friends keen on sport may have started it, or a group of parents wanting their children to do some sport, or a group of prominent people may have decided that the neighbourhood (or village) needed a football club because the neighbourhood next to them also had one. In any event, it could well have been the case that the need to have a club of their own had as much to do with having an affinity for the neighbourhood itself (such as having a feeling of togetherness or wanting to project an image) as it did with playing football. This is what we meant earlier when we said that people wanted to play football *on their own terms*. There may well have been alternatives. There may already have been local authority facilities, or the members may have found the existing club too impersonal, too common or too elitist. Theoretically, they could have decided to play football in the adjacent neighbourhood. In spite of all this, the members decided on something other than what 'the market' was offering at the time, leaving aside the possibility that when the club was established, there was no feasible alternative available. The same is true for the dairy cooperative with the necessary changes. In some cases, farmers started cooperatives because traders played them off against each other. In other cases, they became too dependent on the only milk factory that happened to be in the neighbourhood. In other cases, the main consideration was whether their potential growth as individual dairy farmers depended on whether the quality of their regional milk, butter and cheese was good enough to make it on the export markets. Achieving such high quality depends on what the milk factory does with it.

Were there alternatives? In theory, there are always alternatives. Farmers could have moved to another region, or they could have chosen products for which distribution channels were indeed available in their region. They could have decided to give up their dairy farm and start up a dairy plant. They could have been flexible and responded to the market in a variety of ways. But they wanted to do things on their own terms. They wanted to stay where they were, for example, and they wanted to do the job they chose. Since their regional market did not provide them with any opportunities, they decided to make their own.

In the context of pure market forces, their 'own terms' can be defined theoretically as the desire to maintain a certain combination of production factors. In free market theory the 'invisible hand' ensures that all producers make optimum use of their individual production factors. As such our labour, capital and property are mobile: in theory we are supposed to use our energy in the sector and place that generates the maximum revenue. Separately from that, capital also shoots across the world looking for places that provide maximum revenue. At the same time, we do not baulk at the idea of ever selling our house, our home and our land to start a new life somewhere else. We are flexible and mobile, with no roots, family or nationality. Producers who do not behave in this way (and we are all producers when it comes down to it) will fail to do their best and—sooner or later—will be priced out of the market.

A member of a cooperative will not subscribe to behaviour like this in a hurry. He has his own terms, including the desire to protect a certain combination of production factors. She wants to be able to play football *in her own neighbourhood* or *with her own people.* He wants to be able to produce milk *in his own plant.* She wants to remain independent *in her profession*, just as we want to be able to survive as a nation *in our own country.*

Since particular terms cannot often be maintained for an individual in the market, entrepreneurs look for ways in which they can cooperate with other people in certain areas and under certain conditions. It is already worth noting that this is, of course, no guarantee for success. Market forces are still at work. Those who cannot afford to pay the football club their membership fee will have to leave and the dairy farmer whose business isn't running efficiently enough will probably have to give it up. In that sense the cooperative (or association) is not a *barrier* to the market, but only a *buffer* to the market.

Obviously, how and to what extent signals from the market reach each individual club member will depend on the club—or rather, on the goals of the club, or better still, on the internal discussion going on within the club. The club is, after all, a democracy. Decisions are to be made or at least be prepared jointly. Decisions can also be made about when compromises need to be made and who should make them.

At this juncture we would like to point out that the logic in this story can be reversed. In a cooperative or association, democracy is used to form a buffer to the market. Conversely, we probably do not fully appreciate that democracy is the perfect means to form a buffer, an opportunity to maintain a number of 'individual terms' through joint consultation and cooperation.

4.3 Customer Value

The cooperative is being characterised here as a 'two-layered enterprise'. On the one hand, there are the enterprises belonging to the members: the dairy farmers who want to produce milk in their own plant, or the footballers who want to be able to play football in their own neighbourhood. Although they lead their own lives and are accountable to themselves, 'their club' provides certain services they use. On the other hand, there is the club with its cooperative enterprise, which will have to prove itself 'in the market'. The football club or milk factory is an enterprise which has to operate as efficiently as possible. The total operation must produce the best performance for its members.

But what is 'the best performance'? The footballers want to play football in their neighbourhood 'on their terms' and they would prefer to pay a membership fee that is as low as possible; the dairy farmers want to be able to sell their milk preferably at the highest possible price. In that sense it is about 'customer value'. Nothing special, it would seem, as nearly every commercial business claims that creating customer value is its core business. They do this under the motto that creating customer value is a pre-condition for making a profit. This rhetoric does not diminish the fact that the most important thing a commercial business should do is create shareholder value. Customer value is a means and not an end here.

Apart from this fundamental reversal, something else—something different—is going on in cooperatives. Members are not only customers but owners of a cooperative enterprise. In that sense they will have to keep an eye not only on customer value but also on the return made on their invested capital. After all, their club fee or contribution to the cooperative is an investment.

But it is precisely because the main reason why they made that investment was to assure themselves and their own business of a certain service, that they will have to interpret the return on their investment in two ways: what does the cooperative contribute to their return on invested capital and how does the cooperative contribute to the success of their own business (or the revenues from their own business) or to the attainment of their own goals? When assessing revenue, 'both layers of the enterprise' should be considered as one whole.

From an economic point of view, the reason for this is that the price which has been agreed between the members and the cooperative enterprise is the result of consultation. This makes the revenue generated by the cooperative enterprise somewhat arbitrary. If the membership fee for the football club is high, or members pay high prices for drinks at the bar, then yes, the club will make a lot of "profit"; if the dairy cooperative pays its members a low price for their milk, members can achieve a high return on their invested capital. (Incidentally, this is the reason why cooperatives do not need external shareholders: this only produces an enormous conflict of interest. Whereas the most important objective for members who are also suppliers is to get a high price for their milk, the most important thing especially for financiers is to get a low price.) There is, however, another consideration that members have to think about with regard to revenue: by buying the property of the association or cooperative, they have also—to a certain extent—bought themselves a guaranteed market or guaranteed supply. Investing in your own dairy farm would be pointless if you couldn't find a market or additional markets for your milk. Even though the idea of finding a market may not be obvious for a football club—although it could be seen in terms of training or buying a club shirt—the average dairy farmer makes large 'transaction-specific investments' that depend for their viability on what the cooperative can achieve. This aspect should also be considered when it comes to assessing the 'customer value' or 'property value' of the cooperative.

Finally, we should mention yet again the members' "own terms" here. The final assessment includes the question of whether the cooperative meets the specific conditions the individual member stipulated. Rather, let us use the present tense: what an individual member stipulates. Members' wishes and ideals can change over the years just as circumstances can change both within the association or cooperative, and externally.

All this means that how internal democracy works is extremely important for the continuity of the association or cooperative. Before more closely examining our central theme—the nature of internal democracy—we might pause to consider what has made Dutch cooperatives successful as this sheds light on the issue.

4.4 The Success of Dutch Cooperatives

The Netherlands, and its economic condition, aided by successful cooperative enterprises, offers a vivid case study for business administration leaders, economists, community and cooperative developers, and public policy officials worldwide. While it has a huge economy as measured in GDP and per capita production and revenue, it is a small country in land size and in resources. At the same time, its people and enterprises are trade-oriented and are impacted by all events generally referred to as globalization, including concentration of industry sectors, multi-nationalization of corporate entities, and the global scramble for resources and inexpensive labour.

This means that the Netherlands is coping with issues similar to regions, states and provinces in much larger countries, and with the same global issues facing development regions throughout Africa, Asia and South America. We therefore begin this discussion by saying that Dutch cooperatives belong to the last of the really large companies that are still in Dutch hands. This demonstrates that their success is not insignificant, especially for enterprises operating in an economic sector that diminished considerably in size during the last century, such as the agricultural sector. Not only are fewer farmers needed to provide us with food, but today's consumers also spend much less of their income on agricultural products. Nevertheless, the shrinking number of farmers has managed to keep a very large number of cooperatives on their feet, including FrieslandCampina and FloraHolland, as well as regional communities (such as Rabobank). Why have they been so successful?

4.4.1 Way of Life

In order to find out why, we must first go back to the claim we made earlier that cooperatives should not be 'ideological clubs'. We made that comment because the cooperative way of thinking is often associated with utopian and socialist ideals. For example, it makes us think of communities that focus on self-sufficiency, aiming to achieve equal pay for everyone, at the same time as being detached from the rest of the world.

In north-west Europe, however, it would be more accurate to say that the origins of the cooperative movement were rooted in a belief that could be typified as liberal: if no one looks after you, then you have to look after yourself. And if you cannot do it alone, then you will have to do it together. Whereas members of cooperatives and labourers who were inspired by socialism preferred names such as ‘United we stand, divided we fall’, conservative farmers preferred more sober maxims such as ‘Strength in numbers’. The first agricultural cooperative was symbolically called “Enlightened self-interest[1]”: in the end it is all about self-interest, but if you think about it carefully, it is better to work together.

One important motivating factor behind it was and still is undoubtedly the fact that a farmer wants to carry on being a farmer. ‘Never give up fighting’ is a motto that seems to be more prevalent here than in other professional groups. And there is indeed a vestige of ideology behind it. It often concerns family businesses, which tend to think in generations rather than in years. Then there’s their utter devotion to life outdoors. *I don’t have to follow up orders of a boss*, reasons the one. *I work in perfect harmony with the environment*, says the romantic. *I’m not good at anything else*, says the cynic. The fact is that farmers—just like many other self-employed people running a small business—have always cherished their independence (and their land) and tend to think in the long term. They hold to the biblical passage that seven lean years will be followed by seven fruitful years. Whatever their endeavours may be, farmers have a strong tendency to draw a circle around their way of life. They think they have something to defend: their way of life and the business they wish to pass on to their children. For them, selling and choosing a different profession is not an alternative that immediately springs to mind. The local football club also has a ‘way-of-life’ component. The reason why many people decide to play football in their neighbourhood is because they want to belong to a group of friends that will continue down the generations. The majority of the one million Dutch footballers, and young footballers—and many other sportsmen and women, and club members, besides—belong to clubs where ‘being together and enjoying each other’s company’ is of key importance. This is also a ‘way of life’. What is curious is that people experience being in the company of others whose company they would often not have chosen in the first place if it hadn’t been for the club. Football, the neighbourhood, and even history, is probably what they have in common.

4.4.2 Group Emancipation

There is no doubt that a second ideological aspect of association is group emancipation. Just as Catholics, Protestants, socialists and workers started to join forces at the end of the nineteenth century, farmers followed suit. Apart from the fact that especially Christian groups wanted to protect farmers from “(ideological) socialism”,

[1]The phrase ‘enlightened self-interest’ comes directly from philosopher David Hume, the colleague and sounding board of Adam Smith.

the feeling shared by farmers, that they wanted to carry on being farmers, played an important role here. All of this was reinforced by the fact that the isolated countryside was really trailing behind when it came to being actively involved in 'the market'.

A peak was reached when European agriculture experienced a deep crisis because of fierce competition from the United States: it was suddenly confronted with the 'big economy'. Not only were American companies able to produce goods much more cheaply; suddenly they were also able to market these goods cheaply in Europe on account of the steamship. Whereas other European countries decided to take protective measures, the liberal Dutch State Committee of 1886 advocated self-help: farmers would have to cooperate more and organise themselves better, the Committee argued, and the government could help them with research, education and advice. Supported by the government and the churches, the agricultural sector embraced this wholeheartedly: there have never been as many organisations in any other sector, ranging from local study clubs to national networks. Especially the cooperatives, which started off as local organisations, formed an important part of this network.

4.4.3 Professional Solidarity

Dutch cooperatives have always been characterised by their 'liberal roots'. At the heart of this idea is the realisation that it is about 'enlightened self-interest'. Although people work together with a particular common goal in mind, this does not mean that the 'defecting members should be given preferential treatment at the expense of others. It is helpful to analyse this process from inside the agricultural world. For many decades, collective agricultural organisations have done their best for 'medium-sized businesses'. It was known that small, private businesses would not be able to compete successfully, but the general opinion was that policy—including the policy of the cooperatives—would have to allow medium-sized businesses to compete both nationally and internationally if they wanted to. This policy was actually a mixture of emotionally-charged solidarity ('a colleague won't let you down') and enlightened self-interest ('we need each other'). The ever-present key question was about what suited 'the members' cooperative' or the sector best.

It is interesting to note that the mother of all cooperatives, the Rochdale Pioneers Equitable Society of 1844, also considered professional solidarity to be its starting point. At the time, the issue was about workers who were confronted with unreliable shopkeepers, which led them to open their own shops so that they could be certain of getting reliable quality and prices.

Two of their basic principles were that they would charge the normal market price and that everyone would have to pay in cash. The reasoning behind this was that the profit that resulted from cooperation would be reflected in the reliability of the shop. This means throwing out a sprat to catch a mackerel. If the cooperative shop could do it more profitably than others, this would show later. This formed the basis for the 'stamp' phenomenon, or what became known as "*patronage refunds*" in other countries. Members could get back some of the 'profit' made by the cooperative according to the volume of goods purchased. People just had to do business with one another in a professional way, it was reasoned; otherwise, the only people who would be interested in taking part would be those whose sole aim was to make a profit.

The previous discussion shows that Dutch cooperatives have always been strongly market-driven. The cooperative is neither a semi-government institution, nor a redistribution facility: it is purely a cooperative relationship whose purpose is to function as a buffer, a shared gateway to the market. Its members must ‘feel’ what the market is doing as much as possible, otherwise they’ll be getting the wrong signal. This means that the members who produce what the market wants will also receive a better reward and that members who buy something expensive will also have to pay more for it. In fact, this is no more than “professional solidarity”—as we referred to it earlier—in practice.

This involves an element of negotiation. For example, what if the football club decides to hire a trainer for the first team? Should the footballers who play in their leisure time also pay for the trainer? As soon as the majority of members begin to attach importance to the honour and status of the club, then asking everyone to pay may be justified. As soon as the members adopt a more ‘professional’ attitude, then perhaps it would be a better idea to ask the members of the first team to pay extra, but if that in turn leads to the best footballers transferring to another club, then the arguments can be viewed in another light. The weighing up of interests can also play a role in a ‘professional’ cooperative. For example, if it is important in terms of market strength to keep members living a good distance away in the club, then you can decide to charge the extra transport costs this incurs per head. This will ultimately mean that a judgement about what is fair and just will be inherent in this type of decision-making. It will not only act as a moral judgement; it will result in a feeling among the members that at the end of the day, they will also be treated fairly and justly.

Another aspect of market-oriented, professional solidarity is that the market is more important than political or government considerations. The cooperative is, after all, still run by and for the members. They want a better position in the market. As soon as the cooperative becomes a vehicle of the government or of external political parties, the picture of the interests it represents will become obscure. In this respect, the non-partisan Dutch cooperative has generally avoided getting mixed up in promoting interests other than those of its own core business, i.e. the particular service which led the members to set it up in the first place. Cooperatives getting absorbed in political causes has been a reoccurring problem in some developing economies and in communities under the thumb of dictatorial regimes.

4.4.4 Homogeneity

This brings us to the final aspect we would like to mention: *safeguarding homogeneity of interests*. Once the cooperative is obliged to provide different groups of members with different services, it creates a potential discrepancy of interests that may become extremely counter-productive (Kalogeras et al. 2009a, b; Cook et al. 2004; Hart and Moore 1998). We have already noted that there is a difference between customer value and shareholder value. If some of the members have invested comparatively more money, then shareholder value will be comparatively more important to the group. In this respect, an analogy can be drawn with product groups. If some of the members sell pigs and others sell feedstock for pig-feed, tough discussions will ensue. A similar situation may arise if a sports club offers two completely different sports. It can be done, of course, and is done. But there are moments when solidarity among members is put under serious pressure.

The same applies to the question regarding the extent to which members feel as if they are in the same situation. In the history of Dutch cooperatives, members were told they were not each other's competitors. More likely than not, this was partly an ideological story to promote solidarity. However, it is also partly true because almost all cooperatives have always been export-oriented. In the village the dairy farmers were indeed each other's competitors and cooperation was more or less reduced to the formation of cartels. However, if the goal of the dairy cooperative is to sell locally-produced milk jointly to faraway markets, then dairy farmers do indeed have a common interest.

4.5 Internal Democracy

In summary, a cooperative functions as a buffer between its members and 'the big economy': a buffer in which there is democratic agreement regarding the principles and terms on which members are willing to work.

Members have their own particular interests—they have something to defend—and want to sustain those interests 'in spite of' the market. In other words, members are not only preoccupied with their own interests, but also with the question of how to maintain the market position of their collectively-run cooperative company. The board of the cooperative has solved the problem of maintaining market position by hiring professionals who will manage the business. Nowadays, these professionals are usually executives who have won their spurs in the most diverse areas of business. Naturally, the board of the cooperative forms the supervisory board of the cooperative business. As cooperatives have increased in size, the board has enlisted the help of professionals more and more. It should be noted that the articles of association usually stipulate that the majority of Dutch supervisory boards must consist of members.

At the other end of the spectrum are members whose "group feeling" is not as strong as it used to be. The banner that once belonged to their village cooperative is now on show in the local museum, and after countless mergers, their headquarters are now situated a hundred kilometres away. Moreover, they themselves have increasingly taken on the role of 'manager' as well. Their businesses have become more complex and require more attention to be paid to an increasing number of areas, including technology. Even the family has become ‘more complex’. A son succeeding his father is no longer a foregone conclusion. Spouses may have their own careers. A family’s circle of friends is more disparate and all those in their immediate vicinity require time and attention on an individual basis. In other words, the modern farmer is just as busy, individualistic and emancipated as any other citizen.

The big question is how these modern members should keep their management board and the board of directors on the right track. This question is all the more pressing because professionals at the top of the company ladder are watching the market and are using as their main frame of reference fellow professionals in all kinds of companies who have one objective: shareholder value. In a situation like this, you need to stand firm so that you can keep the cooperative ideal (which is the promotion of the second goal) firmly in focus. The same goes for the administrators with the necessary changes. They too are in danger of gradually speaking the language of managers and of losing sight of the original goal. ‘Our cooperative is an ordinary company’, they say—and the members nod in agreement until they no longer believe it.

We are not being accusatory of our cooperatives’ boards of directors, or supervisory boards. Generally speaking, it looks as if they will succeed very well in keeping the cooperative philosophy imprinted on the back of their minds. However, there is concern of insufficient internal debate, as is also the case in our democracy nationally. If members are no longer concerned with why the cooperative relationship exists, there’s a likely chance that the managers won’t be able to assess what’s going on, which is exactly what happened on more than one occasion over the past few years to politicians who were taken by surprise by completely unexpected reactions from their ‘followers’. It was not only the European Constitution, but also the rise of the one-issue politicians, which were unexpected events because the social debate was not transparent for the political leaders.

4.6 Exit and Voice

Democracy is a strange thing. One expression of this is the peculiar phenomenon that we often show ourselves in a very different way ‘in the market’ than we do in democratic debate. Farmers know this better than anyone: for example, they know the difference in buying behaviour between the ordinary citizen and the consumer. Consumers flock to buy the cheapest pork chop produced by the bio-industry, yet in their role as ‘citizens’, they push for a ban on or drastic legislation against the same bio-industry. In other words, we use our democratic rights to discipline our own market behaviour. For this discussion, it is irrelevant whether or not it is consistent or logical—that’s just how it works. In actual fact, it demonstrates again that the claim that “the market is always right” is not true from a democratic point of view.

What is important is that a different form of discipline is valid in “the market” as opposed to a democracy. In the market you make a ‘yes or no’ decision. You engage in a transaction with a person—you buy or invest in something—or you decide not to. If you are not satisfied, you go to another bidder or you sell your shares. You get out. Exit. If a lot of customers do that, the company will lose its competitive advantage to others who can respond better to what the average consumer wants. So, social production capacity should be used to satisfy society's needs in the best possible way. In a democracy you use your voice and influence: in short, your voice. You enter into discussion. You try to suggest improvements. You negotiate, just as we do in parliament, in the club or in society in general; we negotiate in what we have called the 'internal market' of the cooperative. This is the path you follow if you need other people, if you like other people, or if you do not want to let the collective, or 'the group', down. Broadly speaking, democracy becomes interesting if you have a second goal (regardless of whether it is a social goal). As soon as you no longer have—or no longer want—the flexibility and mobility that free-market theory imposes on you, then democracy—that is, the act of discipline through voice rather than exit—becomes important. As a person you can decide to emigrate or 'flee the country'. However, for most people, this isn't the most obvious alternative, simply for emotional reasons.

In most cases, the difference between voice and exit is not so clear-cut. The example given by A. O. Hirschman—the social economist who first coined the terms 'voice' and 'exit'—is that of the state school which a number of parents are not satisfied with. These parents can talk to the board and suggest improvements. They can also, however, decide to look for a private school or set up a school themselves. This would be more expensive, but better. This could have drastic consequences for the old school. Not only will the old school lose a number of pupils, but what remains for the pupils still at the school is an institution that the parents who made the most fuss about quality have now left.

A similar comparison can be made with our local football association. If the members are not given (or do not take) the opportunity to effectively influence how the club is run, they will run the risk of losing precisely the most active and involved members and hence the core qualities of the association. On the other hand, it may also be dangerous if a small group of very committed people push the club in a direction that the 'silent majority' does not like. This, too, may result in a large number of people leaving the club at any given time.

In practice, there should be a 'healthy' combination of voice and exit possibilities. There should be a transparent democratic discussion with the possibility to 'get out' in reserve. For example, according to Hirschman, as an incentive, the possibility of exit is still an important way of making voice, i.e. democracy, effective.

We would like to add at this point that in our democracies, whether they are countries or associations, provision has in effect already been made for a 'reverse exit'; that is, the possibility for citizens or members to fire the board. Yet a voice mechanism should underlie this, too: a social or collective balancing of individual and collective interests or goals.

4.6.1 Active Citizenship

The voice mechanism assumes active citizenship focusing both on the government, or the public sector, and the market. In brief, the focus is on the "multiple goals" we discussed earlier. Both the cooperative and the association sail like a ship of state over the world of international economics. Either you're together in the same boat or you choose the same boat together. Together you will have to make sure the ship stays afloat and together you will also have to set a course. Of course, the forces of the ocean cannot be underestimated. And the passengers will have to listen carefully to the captain and his professional crew. But that is not the same as allowing the professional crew to determine the course and the destination because the goal of the trip is not to demonstrate their expertise. It is in fact what those on the trip decide—and expertise may not enter into the equation at all. The problem will not be solved even if all the passengers have a mini-voting booth to enable them to constantly choose a certain wind direction individually. There would be so much turning that the professional captain would actually have no other choice than to take over. No, we as passengers will have to do battle amongst ourselves to formulate conditions for which the strategy or the course must comply. In a democratic context, passengers have significant powers of decision in this. They follow the advice of the professional crew, of course; but once they can no longer be influenced, they will simply dismiss both the captain and his crew.

In the literature, the concept known as 'civil society' is often used as a synonym for 'crew'. An old-fashioned term for this would be 'the people'. Nowadays we would probably call it 'society'. What is meant by this is 'we the people' (or 'we the members'), people who allow themselves to be regulated by two mechanisms: (public) administration on the one hand, and the market on the other. Both mechanisms are coercive in nature. The market forces us up a one-way street towards the 'best allocation of our individual production factors', but public administration, in turn, is inclined to 'arrange' things for us. If we do not keep the 'ideological debate' alive, we will be kept in tow. This was also the fear expressed by a much earlier observer of modern democracy, De Toqueville, who in the mid-nineteenth century was afraid that the government would set itself up as the guardian of scattered sheep, sheep that would look to the government to protect all their interests and solve all their problems like a saviour-shepherd. One symptom of this is the recent aggrieved 'surprise' of a prime minister about the discontent of the people. In his rational opinion, the country is doing fine, but his sheep expect his government to find solutions to all kinds of problems apart from those he had anticipated in his 'professional capacity'. One-issue politicians, too, who see themselves as an alternative to the present government, have the same opinion about public administration: "Just tell me and I'll sort it out" is their message. This thinking stems from the idea that public administration can sort things out all on its own. A government should be a professional business that delivers what the 'emperor's market' wants.

But voters are not a 'market'. They are not people who make their demands and can then leave afterwards if they don't like it. They are not consumers. They are citizens who, because of their loyalty to each other, have to develop a vision with regard to what the relationship is between their middle-class goals and their consumer goals with regard to the kind of society they want to work in. They will do that not because it is their ambition to set up a public administration; rather, they choose to act as a sounding board for that public administration, so that it will thrive, not to replace the market, but as a correction to the market. This means having a special attitude towards public administration, one that means taking responsibility and being able to think along the same lines. If the citizen's attitude towards government services is purely that of consumer, then that responsibility will evaporate. The citizen will then become a consumer who won't have to worry about the bidding party. If he doesn't like it, he can decide that he doesn't want to be a customer any more. Exit. And since he actually cannot disappear, he floats. This is an extremely unsatisfactory situation. In actual fact, proof that this consumer attitude is present on a large scale can be found in the nation-wide political (zap) behaviour, for example. The voting public 'zap' from one party to the other, both in terms of membership and in terms of voting behaviour. People are making much less effort to start a discussion about democracy in their own party—which in principle consists of like-minded people—so that they can send representatives with a common, coherent programme to parliament. No, they prefer to zap whenever it suits them, or so it seems. The consumer exit mechanism prevails over the use of the democratic voice.

In that sense we are inclined to argue that a democracy gets the public administration it deserves. Any public administration will want to make itself important, as has already been mentioned. However, if we want to set limits to it, we the people, as a civil society, will have to offer something in exchange. Public administration is actually entitled to it. What can we expect from an administration if we do not make the effort to say what we expect from it? The business community would like that too. On more than one occasion we have been asked—especially by companies that depend on the telephone for their business—to explain why we do not buy from them. As consumers, we don't think we should have to explain it. If another supplier does something better, we go there. Full stop, exit. But in a democracy, we have to do business with each other and we are faced with different objectives. In this case, reciprocity must be possible, and if it is, then an explanation is indeed necessary.

Thus, public administration and the market operate by the grace of a civil society. In other words, there is more than just a market and public administration. Both systems have a compelling rationality. Citizens will therefore have to be actively involved to remain conscious of their goals. The same goes for cooperatives and other democratic associations with the necessary adjustments. On the one hand, they are an important part of civil society; on the other hand, associations should have a middle ground in which discussions about important issues are kept alive.

4.7 Loyalty and Involvement

Whichever way you look at it, involvement must be included in the discussion. In the early cooperatives, it was symbolised by the banner on the wall behind the committee table, just like the national flag always flies in the United States. The Dutch, for instance, may not be much of an anthem-singing nation and they are much less demonstrative in their patriotism, because Dutch people are afraid (and rightly so, in our opinion) that where there is a demonstrative show of patriotism, there's an absence of criticism. They have structures and a culture of consultation that is based on solid trust and on the assumption that one should first put forward the own viewpoints and talk about them *before* you let the community down. This culture originates from the time when people as a community literally had to defend their region against another 'big economy' which always looks for the lowest-lying piece of land. Unilateral involvement will not last. Involvement must be maintained by both parties. That is why the equality ideal is so important in a democracy. Ultimately, it is extremely important that everyone knows they will have to bear it in mind. Those who really want to achieve something are handicapped by the fact that every time a decision is made there has to be a majority vote. What is even worse is that, even if decisions have been made on the basis of a majority vote, the minority cannot simply be left to fend for itself. The minority must also be able to live with the decision: 'be satisfied with it'.

After hesitating for a moment, we would like to say something about one-issue movements under the heading of 'loyalty'. Basically, one-issue movements can be viewed as a kind of emancipation movement whose objective is to put particular goals—which are often concerned with interests that are weaker and long-term—on the social agenda. In this sense they make a valuable contribution to civil society. Essentially, cooperatives can also be seen as one-issue movements.

However, on behalf of the civil society, the pursuit of that issue does not exempt members from giving the one issue a place in a larger context, and from forming a picture of the interests they have championed in relation to other interests. As soon as you put yourself and your objectives above the objectives of others, it is impossible to weigh opinions or have discussions to any serious degree. Therefore, member loyalty and commitment is supposed to be a fundamental ingredient for sustainable and successful cooperation among members as it helps to alleviate the problems of free-riding and property rights, as well as horizon differences (Iiro et al. 2012).

4.7.1 Transparency

A second condition necessary for the proper functioning of a civil society is transparency. Decisions, arguments and differences of opinion must be clear to everyone. It must be clear why a decision was made. And everyone should know that they can comment on it.

Traditional board members of cooperatives have always made a great deal of effort in this area. They have often expressed this verbally by maintaining that ‘explaining things’ is one of their essential roles. Every year the members of the board visit all the circles and departments to explain how the cooperative is doing. That sounds patriarchal, but explaining things properly is just like writing: it forces you to substantiate and justify your claims. If in a situation of conflict, you ignore important goals, your members will notice it. The obligation to justify policy on a regular basis therefore helps to avoid becoming alienated from your members. Furthermore, you cannot expect your members to contribute reasonably to any discussion if they are not being given the facts and points which need to be considered.

However, the nature of civil society goes beyond this. The people or the civil society must also ensure that the facts and points for consideration that they are given by managers can be assessed and checked. In other words, they must also keep themselves informed and not rely solely on the administration to give them information or to remind them of what facts need to be taken into consideration. Ideas must be allowed to develop freely and must be discussed without the administration having to say yes or no to them.

In a democracy, for example, having a free press and being able to gather news freely is essential. But speaking at a more abstract level, the social functioning of civil society is certainly just as important: meeting each other, hearing things from each other, knowing that you are not the only one who thinks the way you do or has had a particular experience. In the agricultural tradition, this was made possible partly because there was a great deal of overlap in the relationships between organisations. Members also met each other in local councils, in study groups, in regional groups, in village politics, and so on. Their supporters were not necessarily a “scattered herd”. That means, however, that this point needs to be given extra attention in the modern age of individualism. How do members pay attention to the lesson? If they only act as ‘consumers’, nothing much will come out of such a debate.

In this respect it is worth noting that educating members was a prominent part of the Rochdale principles: that is, of what turned out to be the first viable cooperative of the modern era. Although education was not purely intended as an extra activity to ‘uplift’ the members, the main goal was to ensure that members would be able to control their managers and enable them to develop a long-term perspective on the state of affairs. In principle, this type of education is a task that the civil society itself should also be performing. However, at the same time, it also shows that a skilful board should organise its own opposition. This might not be such a nice task in the short run, but in the long run it is necessary for the survival of civil society or its cohesion.

Finally, we would like to note on this point that freedom of expression is a precondition for this. If unwelcome facts, disagreements or conflicting analyses are declared taboo in advance, then that will silence any form of open discussion. By doing this you rob groups of people—possibly important groups—of their voice, which gives them de facto no other choice than to leave sooner or later. Sometimes that’s not a bad thing. This cannot be stated often enough.

If certain groups or individuals simply don't want to be included, sooner or later they will either have to start their own club or leave. If, for instance, a member of a cooperative wants to withdraw from the cooperative because he thinks he has more opportunities as an individual enterprise to achieve his goals, it might be better for him to go. But in a civil society that should happen in a transparent way, and it shouldn't go unnoticed.

Sometimes we are under the impression that managers place too much emphasis on how 'dangerous' disagreements might be: dangerous both for policy and for unity. We would like to counter this argument by saying that it is also an important source of information: it makes opposition transparent. It might even be the case that you were the one who was not transparent, that something in the policy did indeed go unnoticed, that something should have been explained better, or that it was all just a storm in a teacup. At least you still have something to work with.

4.7.2 Reciprocity

The above discussion has highlighted a number of aspects that involve the notion of reciprocity. Reciprocity has long been believed an essential universal element of the human social system that highly reinforces human behaviour (Price and van Vugt 2014; Rilling and Sanfey 2011). In democratic decision-making there are two sides, just as there are in market transactions. The same is true for the balancing of mutual interests in civil society and for the relationship between public administration and the people. Reciprocity can be seen more clearly in the transaction relationship. Earlier we described the cooperative as a means to achieve self-discipline: people make agreements with each other which both parties are expected to adhere to. Cooperatives, for example, make agreements regarding quality or delivery times. Football clubs, on the other hand, make agreements with regard to volunteer work.

In the investment relationship, the members have to agree that the contributions they make to the financing of the cooperative are in proportion to their transactions. On this point we have our doubts about the historical development of complete 'unlimited liability' for members. On the one hand, the cooperative enterprise is assumed to operate as a risk-bearing business in the market; on the other hand, members no longer run any visible financial risk. This creates an unequal relationship. There is a danger that members will feel less accountable because of it. There is also a risk that they might start referring to the cooperative as 'them' (and ultimately in terms of '*Let them do it*'). On the other hand, there is also a danger that the management of the cooperative enterprise will enjoy the distance it creates: members won't be breathing down their neck as much, and they will be able to concentrate on the market. All this could subsequently put the mutual exchange of information provision and transparency under pressure.

However, the key issue is mutual involvement, a feeling shared by people that they represent something, and that they are both prepared to make a mental and civil effort to achieve it, not just as a critical consumer but as an active citizen who works

	Conventional theory	Reciprocity theory
Agents	Wealth maximisers	Emotional/moral reciprocators
Collective behaviour	Unique equilibrium	Multiple equilibria
Promoting cooperation	Incentives	Trust
Variability of preferences	Homogeneous	Heterogeneous

Fig. 4.1 Adopted from Kahan (2002) "The logic of reciprocity: trust, collective action and law" (p. 3)

together with other people to achieve something or to keep something going. This behavioural picture of human motivation implies that reciprocal commitment is an efficient mechanism for solving (or avoiding) problems without cost. Mauss (1969), in his famous work *The Gift*, stresses that high levels of reciprocity in the various exchanges of goods and services among members in a society produce not only remarkable social attributes like trust, commitment, and solidarity, but also strong economic ties, reinforcing the collective action norm.

Behavioural economic theory clearly explains the most important differences among collective actions with members that show a "reciprocal" behaviour and collective actions with "conventional" members (see Fig. 4.1).

According to the conventional theory, the agents behave like wealth maximisers who tend to free-ride and refuse to contribute to collective goods. Concerning the collective behaviour, the conventional theory treats defection or free-riding as a dominant strategy and predicts a single collective behavioural equilibrium: universal non-cooperation. In promoting cooperation, conventional theory suggests incentives (either rewards or punishments that bring their members' interests into alignment with their collective ones) as a solution to collective action problems. Finally, regarding the variability of preferences across members, this theory believes that the disposition to free-ride in collective action settings is relatively homogeneous.

According to the reciprocity theory, the members are moral and emotional reciprocators. They value the opinion of others and are willing to contribute their fair share to ensure the cooperative's benefits. However, in case they understood the existence of free-riders, they easily hold back to avoid feeling exploited. In collective behaviour, members similarly tend to contribute if they believe that the other members do the same thing or change into free-riders in case the other members intend to free-ride. According to many scholars[2] like Kahan, "*the incidence of littering, recycling, smoking in public, safe sex, and other types of behaviour that affect collective welfare are likewise subject to feedback effects and multiple equilibria—generating dramatic variations in their incidence across space and over time*". Regarding the

[2]Example: Timur Kuran and Cass R. Sunstein, Availability Cascades and Risk regulation, 51 Stan. L. Rev. 683, 688–89, 746 (1998).

policy prescriptions, an alternative policy is suggested, the "promotion of trust". Finally, regarding the variability of preferences, the reciprocity theory suggests that the disposition to cooperate varies.

More recent researches have concluded that "*interacting with others in a social norm without reciprocal behavior greatly reduces the likelihood of successful cooperation*" (Fowler and Christakis 2010). This happens because the greater the member's reciprocal behavior, the greater is the motivation to cooperate with other members, as well as to boost the sustainability of the cooperative (Fowler and Christakis 2010; Eser and Peek 2006).

Construal Level Theory is a well-known theory that deals with the attributes that influence the individual's decisions. It signifies that reciprocity is a major element for the successful cooperation of members in a collective norm. This happens due to the fact that reciprocity can be developed progressively in commitment and trust, supporting the cooperative's well-being (Didier et al. 2012; Bijman et al. 2011; Eser and Peek 2006).

Sometimes, while the members' commitment may be high initially, it tends to fade away over time (White and Siu-Yun Lui 2005; Gulati and Singh 1998). This may occur because the intensity of competition among economic organizations in a business sector, as well as information asymmetry, usually creates favorable conditions for opportunistic behavior and a low degree of transparency, which hinder the market mechanism. This situation creates high transaction costs (White and Siu-Yun Lui 2005; Gulati and Singh 1998), especially for small-scale farmers who lack the appropriate size of information to correspond to the fast-changing environment. In such cases, the existence of strong cooperatives based on reciprocal, preferential, mutually supportive actions is determinative for the members' viability in cases where it may guarantee the long-run dedication to its members.

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Chapter 5
A Multifaceted Relationship

A cooperative enterprise, as we have seen, must operate in the same free market as other firms with different ownership structures. The cooperators cannot withdraw from the market, but will try to improve their position in the market by putting the communal cooperative enterprise between themselves and the market. This creates an "internal market" between the cooperative enterprise and the members' businesses, or the primary enterprise (see Sect. 3.3). The primary enterprise of the cooperative will either be purchasing or sales if the members formed the cooperative to provide those services. At the same time, purchasing or sales are not the primary enterprise of the members. Hence, an internal market develops. The internal market is, by nature, a market of negotiation or a market of agreements. A forum is created for the various interests of the members and the cooperative itself in which the various interests must be weighed against each other. The member users of the forum can bring influence to bear on that forum. Meanwhile, the cooperative enterprise is there for all members and belongs to them. This chapter will look at the relationships between members and their cooperative that emerges with the internal market.

5.1 Members Are Users—The Essence of Relationships

Cooperative enterprises revolve around three issues: user-owned, user-controlled and user-benefitting (Barton 1989). This means that members are users of the cooperative. They have certain interests that they want their cooperative to mind. This is important in the multifaceted relationships between members and the cooperative. As a result, the relationships can be described in this way:

1. A transaction relationship. Depending on the type of cooperative, the members will either be the suppliers of raw materials or the buyers of the product of the cooperative enterprise. The transaction relationship is at the core of the "use" that members make of the cooperative. This is where they derive their user-benefit, and that is quite different from profit. Anyone who, as a consumer, is a member

G. van Dijk et al., *The Cooperative Enterprise*,
Cooperative Management, https://doi.org/10.1007/978-3-030-16279-5_5

of a cooperative bakery will expect to get bread there and not be told the bakery has no bread left. It won't help to say the bakery made a good profit.

2. A financial relationship. The member-users provide the cooperative's capital. That makes them owners. The cooperative enterprise is thus user-owned. From this relationship, members derive their influence on the cooperative, and have a vantage point to check that their interests are being served. The substance of that relationship is determined by the members' objectives. It could well be that the cooperative bakery could produce bread much better, more quickly and cheaply if investments were made. But if the members, or most of them, do not have the funds for such investments, then the investment is probably not even desirable.
3. A control relationship. The cooperative is an association in which the member-users have a voice. The cooperative enterprise is therefore user-controlled. That means the members must be able to monitor and influence the cooperative's activities. Shareholders in a publicly traded company can rely on the market, carrying out a reasonable degree of monitoring. Members of a cooperative have to manage this monitoring themselves, using whatever resources they have available.

5.1.1 Two-Layered Enterprise

All this means the cooperative enterprise has less freedom in its market function than other enterprises with different ownership structures. On the member side of the equation, there is the primary market with the threefold relationship. The cooperative enterprise is considered to be a dependent, or at least not a wholly independent enterprise (Emilianoff 1942; Kaarletho 1956). This seems at first glance to be a disadvantage, or an exceptional handicap, especially in a world of free-market advocates. But that overlooks the reality that every enterprise is dependent on a market, be it suppliers, buyers and/or financiers. More important still, if it draws a tight circle around the enterprise and uses the input of its members, the cooperative is in fact truly independent.

The essential difference is that a cooperative is a two-layered enterprise. There are two departments, in a sense, and the departments are just as dependent on each other as two departments in any other enterprise. Goods and services are exchanged between the departments. When one department observes new opportunities in the market, it is dependent on the question of whether the other department has seen the same opportunities. Fine-tuning and consultation remain of utmost importance.

It must also be borne in mind that one of the departments is actually the "boss," which is the department formed by the members. They determine the framework of the business strategy and judge the other department—the cooperative enterprise—on its merits. It ponders questions, such as, "Does the cooperative enterprise serve the entrepreneurial goals of the members? Does it add the expected value? Does it provide the goods and services that are needed by the members?

This can become a sticky problem, especially as the one department (the cooperative enterprise) becomes bigger. Staff within the cooperative enterprise can probably see plenty of opportunities to make extra profits, and they begin to view the bosses (the members of the cooperative board) as a millstone around the neck of their enterprise. Those members are seen to have insufficient interest in the enterprise, have insufficient funds, or simply don't understand the nature of the cooperative; but the staff will complain they must talk to their members and persuade them until they are blue in the face. When this attitude sets in, the cooperative enterprise would rather get on with its business independently of the members.

We cannot ignore that independence of this nature can sometimes be prudent. Any healthy company—cooperative or not—will discuss issues of this nature. The point to remember here is that it would turn the world upside down to declare a cooperative enterprise independent of its members. In principle, the firm is no more than a service division of a larger whole.

5.2 The Transaction Relationship

Cooperators establish a cooperative with the intention of achieving a specific, shared goal. This common approach is often mandated in national legislation. This is done through enabling legislation, spelling out conditions and requirements of enterprises seeking legal stature by incorporation under various national business codes. It can also be done through tax legislation that distinguishes between cooperative enterprises and other investor-owned firms. The United States of America, for instance, does both—primarily through its Capper-Volstead Act which is often called the "magna carta" for American cooperatives. Denmark is the most notable exception. It doesn't have a separate cooperative business code; rather, it merely accepts cooperative members as another form of investors regardless whether the investment comes from payment for shares or from use. Dutch legislation, meanwhile, speaks of the "material needs" of the members. This underlines recognition that the goals are not idealistic. At the same time, it confirms that the primary aim of the enterprise is not to accrue profit from invested capital. There must be more than a purely idealistic goal and more than a purely financial relationship. That makes the transaction relationship the core reason for cooperating, and it explains why influence and funding are linked.

The collective interest in cooperation can express itself in four aspects of the transaction relationship. The first can be that the cooperative makes certain transactions possible. Other important issues are price, quality and volume. Before we consider these points in more detail, we shall first consider the differences in the intensity of members' involvement in the cooperative.

5.2.1 Intensity

There can be great differences in the intensity of cooperation. The interest that anyone has in the cooperative or transactions with the cooperative vary widely within different cooperatives, and by individual members. We shall look at just a few examples:

Emotional involvement. Involvement is the lubricant of any association. It influences how much the member is inclined to put into his membership of the cooperative, both in terms of labor and money and in terms of collegial benevolence. This involvement can take many different forms. Members take pleasure in helping other members. Members can be fanatical because they want to prove themselves among their peers, or because they have a substantial vested interest. Members can also be passionate because they feel that the cooperative's mere existence is of fundamental importance. All these forms of involvement can contribute to a feeling of belonging to a group, a feeling that can inspire others. Not only does this perpetuate emotional ties to the cooperative or group; it reinforces emotional ties to the group because a successful club is more inspiring. In reverse, an underlying feeling of belonging can contribute greatly to emotional involvement. Historically, group feelings (the farmers, the village, the church) and ideological considerations (anger at exploitation and injustice, the desire for a "better world") have always been the driving force behind the founding of cooperatives.[1] In the case of consumer cooperatives, author Oosterhuis (2000) noted a striking distinction between the various socio-religious groups. In Socialist circles the emphasis seems to be on "Forwards!" and "The Future" (which will rule the world tomorrow). In Protestant circles, the emphasis is on helping, both you and each other.

- *Individual dependence*. The economic interest that members have in the cooperative depends on their own situation. Specialized members may well conduct 100% of their transactions through the cooperative, while it might be a sideline for others. The latter group will have fewer vested interests and less influence in the cooperative, and they will likely feel less involved. This aspect affects nearly all consumer cooperatives. No matter how well the cooperative is functioning, whether a bakery, a shop or a bank, for many members it may simply be one of the many transactions they make in the course or their work or lives.
  The individual dependence can also be shaped by the role the cooperative plays in providing market access or professionalism for the member. While some members would succeed on their own, others are utterly dependent on the cooperative. The cooperative represents graduated benefits for the first group, but it is crucial for the success of the second.

[1] An inventory of the 1475 dairy factories that have operated in the Netherlands provides a good insight into this ideological background. The vast majority were named after the village or geographical area, and almost 10 percent have inspirational names such as "Harmony," "Together," and even "Union is Strength." One notable exception, however, was "Time Will Tell" from Krommeniedijk (Willemsens and de Wuit 1995).

- *Collective dependence.* Another question arises over what extent the members—-collectively—need the cooperative. The added value of the cooperative is proportionate to those economic interests. For one member, it can mean a slightly improved position in the market. For another, it can represent the sole opportunity to obtain a particular service or an opportunity to continue operating the member's private business. As the market changes over the years, so does the members' dependence on the cooperative. One example is Avebe, a large potato starch cooperative based in Veendam, which is the only channel through which farmers in the fenland district of Groningen can sell their industrial potatoes. The same applies to sugar beet cooperatives in Minnesota and North Dakota, in the United States of America, and specialty crop cooperatives throughout the world where there is no independent market except that made by the members themselves. Without these market-making cooperatives, there would be no market. And this represents the extreme form of collective dependence.

5.2.2 Delivery and Supply

The first thing cooperators want from their cooperative is the opportunity to conduct certain transactions. They want to sell their own products or buy a particular product or service. That can be an absolute requirement. For fruit growers in remote African villages, where there is no local demand for fresh fruit, a market cooperative with means of transport can make markets reachable. The reverse is also true. A cooperative purchasing organization, also with transport, can bring means of production, food and other requirements back to the village. Cooperation can also be the answer if certain products or services cease to be available. If insurers no longer cover a particular risk, potential clients can set up a mutual association. When a village factory is threatened with closure, local people can decide to continue operating it as a cooperative venture. Examples of this are the potato growers' Avebe and sugar beet growers' American Crystal Sugar Co., mentioned above, when no other market alternative exists.

Generally, the market situation isn't that black and white. There are usually alternatives, at least in appearance, and people start cooperating in search of a better price, better quality, or better volume. There is also a fourth aspect to cooperating for people seeking assured delivery or supply. By joining forces to buy or sell, cooperative members can be assured of regular deliveries or sales. They will no longer be dependent on the right seller or buyer at the right moment. This is an issue that is particularly important to the producers of perishable commodities. At the same time, even a cooperative cannot offer 100% assurance. The cooperative also has to go to the market. It is probably more accurate to think of cooperatives as mutual delivery insurance. Members share the risk that they incur when buying or selling their products and services. Every cooperative becomes a mutual association (see Sect. 4.2). This brings up members' rights and obligations in terms of deliveries, which will be discussed later in the book.

5.2.3 Price

The benefit of cooperating is usually measured on the basis of the price that cooperators pay or receive for their transactions. That benefit stems from the cooperative adding market power, or savings on costs, or because cooperation leads to a better quality that is worth more in the market. We shall also return to the point of quality later.

5.2.4 Price Leadership

Cooperation leads to a better price if the cooperative can influence the market. When the market is working well and there is sufficient competition between buyers and sellers, cooperation does not have much to add. At the same time, the comments made earlier (see Sect. 1.5) about the relevance of the size of the business continue to apply. Whatever the case, most cooperatives try to obtain a price advantage for their members, an advantage that becomes manifest in the transaction relationship. As soon as the cooperative is able to obtain a better price for its members, competitors in the market are forced to respond by offering their suppliers better prices as well. The mere presence of a cooperative can therefore determine the distribution of profits between players in the supply chain, from cooperative members on through to end users, and from the cooperative enterprise and its peers and competitors.

Van Dooren (1986) offers a curious example of price leadership from the former Dutch colony of New Guinea in the 1960s. Chinese traders bought copal, a resin-like substance, for 50 cents a kilo while the world market price was 140 cents. The government established a “cooperative” that would pay 100 cents. The traders quickly increased their offer. And when the cooperative offered a price of 140 cents, the traders offered more again. They wanted to be rid of the cooperative. The government realized this, and did not increase its offer. Producers turned once again to the traders. But the cooperative continued to exist. The cooperative buying office demonstratively opened its doors for a couple of hours a week. It continued to be a market-correcting device by its mere presence. This was a small investment by government and cooperative members to force the traders to pay a fair price. The example illustrates that price leadership calls for perseverance. In this case, it was made possible because the government was behind the plan. In most cases, however, what is needed is insight and solidarity.

That is because cooperatives often attach great important to transparency in their efforts to provide market corrections. If prices are clear to everyone, especially the relationship between price and quality, then third parties will find it more difficult to cheat suppliers and buyers, or to play them off against each other. The cooperative auctions and countless purchasing and sales cooperatives were established with the express purpose of creating a fair and transparent market price.

In some sectors, the cooperative's price leadership has led almost all players to become members. Examples are frequently found among specialty crop producers or narrowly defined service providers and professionals for whom a negligible market exists. Specialty nut and exotic fruit producers from California and Mediterranean areas are prime examples. Another example is the cooperative for Dutch veterinarians, AUV, which was established as a purchasing cooperative in 1969 with 100 members. Nearly all veterinarians in the Netherlands had become members within 25 years. Problems can arise, however, when competitive firms hold out against the cooperative. The members then no longer see an advantage in cooperation, as non-members are getting the same price. This skepticism is difficult to refute because the cooperative must then try to explain that market prices would be far less favorable without the cooperative, a point that is virtually impossible to prove after the fact. This has proven to be a problem with the grain marketing "pools," or cooperatives in the western provinces in Canada, and to a lesser extent for CHS Inc., the large grain marketing cooperative in the United States. To appreciate both the price leadership and market-correcting roles of their firms, current members must have a clear image of market imperfections overcome by grandparents when they formed those cooperatives.

5.2.5 Free Riders

Apart from the above problems, many non-members believe they can take advantage of the success of the cooperatives—sometimes consciously and at other times unconsciously. This is often frustrating for members. The complaint is "We make the effort, and they get just as much benefit". But it is even more frustrating when members themselves start to exhibit free-rider behavior. When they no longer see the benefits of the cooperative, members will try their luck elsewhere, sometimes occasionally and sometimes permanently. If that happens on a large enough scale, it can seriously undermine the position of the cooperative, including its price leadership. A side effect is that the cooperative will have fewer options in its own actions. When members cannot see a clear difference between themselves and non-members, it becomes more difficult to fund new investments. This can lead the cooperative to pursue a protective and defensive policy, weakening its ability to add value for members and impose price leadership.

The free-rider issue was discussed earlier in Sect. 3.4. It occurs mainly in sectors where members have relatively more chance to obtain an incidental advantage for themselves. The meat and livestock sectors are good examples in most developed countries (see Sect. 4.3). On the other hand, we find that sectors in which cooperatives have been particularly successful, such as dairy and horticulture, are far less susceptible to free riders. These sectors produce perishable products that cannot be stored for any length of time and must be marketed quickly and regularly. In such cases, producers prefer to rely on a well-organized marketing agency rather than risk their relationship with the cooperative for the sake of a quick profit.

5.2.6 Price Competition

Even though the cooperative is the price leader, members will still be subject to competition in terms of price and other aspects of their market. The cooperative can act as a buffer and achieve a better price, but if members cannot meet the standards of the market, they will still fail on a personal level.

5.2.7 No Redistribution

Although cooperatives have been eager to promote members' social capital—the feeling of solidarity and involvement—they have insisted on strict business-like practices from the start. Even at Rochdale, one of the first basic rules was that members paid cash and paid the prevailing market price for products or services. That may seem heartless in retrospect, considering that so many members were poor and unemployed. But experience shows that deviation from business practices inevitably leads to the failure of the cooperative. That led to the rule that members should first pay the market price and later, once the cooperative had financial success, they could share the success through a proportionate value of their transactions with the cooperative.

The price members receive is part of the financial relationship within a cooperative. At this point, we shall look at the linkage between prices and the transactions with members. The price paid must be the same for all members. Any suspicion about unequal treatment undermines solidarity and puts the cooperative concept at risk. Another basic rule is that the personal treatment of one member must not be detrimental to other members. The ideas of the Rochdale Pioneers and all subsequent philosophies can be expressed in the maxim, "Every man for himself, and the cooperative for all of us." In this case, self-help serves solidarity. A cooperative is not an instrument for redistribution. The organization ceases to be sustainable the moment it becomes an instrument for redistribution, whether it falls under the guise of charity, social policy or a replacement for government. This creates inequality among members and is a potential and continual source of discontent.

The principle of equal treatment forms one of the pillars on which the democratic structure of the cooperative is based. The fact that the cooperative is democratic presupposes that equal treatment can be discussed internally. An organization that wants to maintain unity must take into account minorities. But the argument for mutuality will take precedence over self-interests.

In most national experiences, a business-like attitude has always held sway, especially where it is understood that the cooperative must maintain its competitive position within markets. But there is opportunity for social welfare policies on the margins. Methods have included advice and sanctions to protect members from disasters. The Raiffeisen Banks and the Farm Credit Banks in several countries are proud of rarely being the instrument causing member bankruptcies. The effort these banks put into helping members and avoiding bankruptcies is easily justified to other members.

It is a mutual insurance in terms of pure profit and loss. Bankruptcies cost a bank a great deal of money.

Over the years, there seems to be a noticeable shift from the concept of mutuality to a better-understood concept of self, or own interest. Business-like dealings are gaining the advantage, especially in agriculture. Cooperatives are inclined to strip social aspects from their budgets. This is undoubtedly linked to increased competition at the cooperative level and to increased competition at the member level. It is remarkable that a number of definitions of cooperatives state that members are not in competition with each other. But in reality, they were, are and will remain competitors. This recognition is gaining greater prominence today. It becomes a question of what gives the individual a better chance at success, working together to create added value or eliminating competitors.

5.2.8 Allocation of Income and Expenses

The 'solidarity versus own interest' debate still plays an important role with regard to allocation of income and expenses to individual members. Advocates of solidarity always emphasize the principles of proportionality whereby the cooperative enterprise pays in proportion to the volume of transactions. Advocates of a more business-like approach prefer a slight modification: the cooperative enterprise pays in proportion to the volume of transactions, which are considered to be of equal value as they arrive at the cooperative's premises. This is sometimes referred to as the performance principle.

Transport costs are a useful example. Per kilo or pound of goods, it is much cheaper for the cooperative enterprise to collect or deliver a container full of a product rather than one sack or basket. It also makes quite a difference to costs whether the member lives next door or in some remote place. These days, transport costs of this nature are invariably allocated to the individual member, but that has not always been the case. In the earliest days, the problem hardly ever arose. This was because the members were expected to bring their goods to the factory, or to collect their purchases themselves. As these were usually local factories, especially in the dairy produce sector, this was not a big problem. Transport costs were not high between the members and the cooperative enterprise. Even when the factory worked with bulk milk collectors, members were usually charged a standard or average price for transport. In the earliest stages, in particular, when the feelings of solidarity are emphasized, a cooperative would be reluctant to embark on the discussion of such a difficult and relatively unimportant subject. It would, in fact, have been very difficult to calculate and charge the exact costs for each individual member.

Nonetheless, there are cooperatives that ultimately decided to allocate these individual costs (Robotka 1959). They often started with quantity surcharges and discounts. This grew to a more refined and almost exact system of allocating costs. Needless to say, this policy also led to emotional discussions within the cooperative. The term 'quantity discount' itself suggested that larger members were getting an 'unfair' advantage. From the point of view of the cooperative entity, however, it can be seen as a form of equal treatment. The principle that everyone receives the same treatment must also apply at the doors of the cooperative. If one member has to incur expenses for another, this is effectively a transfer of costs.

A system whereby transport costs were not allocated to the members individually was used by Cosun, the Dutch sugar processing cooperative. When discussions were held about the location of a new factory, the question of transport costs threatened to swamp all other issues. The members eventually selected a location that was the most favourable economically on the condition that members would pay the cost of collecting sugar beets from all members jointly. In essence, this became a businesslike argument for solidarity. But this example demonstrates how every decision can give rise to conflicts of interest. One consequence of mergers is that distances to processing sites change, and with it the costs for individual members.

5.2.9 Quality

Price and quality are closely linked. A cooperative will also need to develop its quality in order for its products to remain marketable and obtain the best market price. Conversely, many cooperatives were established for the purpose of ensuring members they would have access to high quality products or services.

5.2.10 Good Means of Production

We have already seen that the first buying cooperatives (such as Rochdale and farmers' fertilizer cooperatives) were created for the express purpose of assuring members of good quality and reliable products. The market correction was not only aimed at price. It was intended to ensure that traders could not exploit any lack of skill or ignorance on the part of individual customers. The Rochdale Pioneers, for example, felt that members should feel secure to send their children to the store to make purchases. Following the same rationale, the fertilizer cooperatives joined together to hire experts to check the composition and soundness of the offered products. The relatively recent veterinary cooperative (AUV 1969) was founded specifically to assess and monitor the quality of medication purchases. Even the credit cooperatives can be seen as a response to quality issues. The actual cost of credit was one consideration. But members also wanted transparency of the credit system to preclude arbitrariness and exploitation. The financial products offered also had to serve the target group. Farmers, for example, needed long-term credit. Workers formed cooperative credit unions primarily for short-term credit. In fact, quality of credit services is an important aspect in nearly all consumer and service cooperatives.

That brings us back to the issue of homogeneity. Members needed to agree on the question of which qualities were necessary and in which qualities they should invest.

As the wishes of the members become more individual, there is more emphasis on individual transactions whereby each member must pay for each service separately.

The history of the Dutch wholesale cooperative De Handelskamer, which owns several factories producing goods under the brand name HAKA, offers some insight into this problem. Its products were good quality, inexpensive, responsible and sound. But customers began asking for the much advertised major brands. That led to lengthy discussions in which the board stuck - rather too long - to its own ideas of quality. Ultimately they would have to submit to the wishes of the member-customers (Oosterhuis 2000).

5.2.11 Quality and Market

Quality was also an important factor behind the founding of marketing cooperatives. Members were either looking for a way to market their special quality products, or inadequate quality was seen as a communal handicap preventing them from gaining a foothold in far-away markets. Many well-known regional wine and cheese brands from France can be traced back to cooperative initiatives, and we already saw in Sect. 4.3 how quality was a central motive for establishing dairy cooperatives. Successful dairy farmers had vested interests in quality transparency. The price differentiation between good and poor products should be visible in the market.

In fact, while striving to achieve market correction, many marketing and consumer cooperatives have contributed to the raising of average quality standards. You could say that they not only played the role of price leader, but also that of “quality leader”. If they placed a premium on quality, the competition would have to follow suit. Messing around with butter, fertilizer, cattle feed and credit was banished slowly but surely.

National legislation and government controls have also played an important role in establishing quality standards, but the influence exerted by the cooperative sector is also generally acknowledged. As noted before about market leadership, a problem arises when that leadership becomes less visible because the competition falls into line.

5.2.12 Instilling Discipline

The importance of maintaining quality places considerable demands on internal democracy. Mutual control is necessary. It is in everyone’s interest for members to fulfil established standards. When a cooperative is first founded, you can agree on standards in advance, but as the market and technology changes, member products can become subject to new requirements. Those requirements can affect various aspects. For instance, the product might need to be more attractive, larger, smaller, tastier or healthier. When the cooperative wants to present itself as the supplier of such new qualities, this will invariably have consequences for the members' businesses and their production processes. That raises a thorny problem. It seems that the cooperative is elbowing in on the independence of the members.

As long as the changes are not drastic and there is transparent collective benefit, new quality requirements can generally be discussed productively in a cooperative context. Anyone who finds it difficult to adapt can probably receive assistance and be persuaded to remain part of the group. It might take quite a lot of time and energy, but you could look upon it as one of the added values of the cooperative buffer. It becomes more difficult when the impact on the members' businesses is of greater economic consequence.

An example of a radical change was the introduction of milk tanks on dairy farms. The tradition of putting milk cans at the farm gates for collection became old-fashioned and did not meet food safety regulations in many countries. Farmers had to have refrigerated tanks built on their farms so that the cooperative milk tankers could come and collect the milk less frequently. On the one hand this was a question of hygiene and quality; on the other hand, it would represent a substantial cost saving for the cooperative enterprise. It would even save the farmers a lot of work.

Regardless of the motivating force, the investment required was enormous. The tank itself was part of the cost, and it became greater if modifications were needed to the milking stalls and other buildings. The entire plan was a non-starter for many members, and most of them went out of the dairy business. After all the arguments for and against had been heard, the milk tank was eventually made compulsory. These technological changes were a factor in their decision to exit the business.

Quality requirements for member businesses can put great pressure on the internal democracy of a cooperative. It will inevitably lead to the formation of "parties" or factions. Members who can easily fulfil the new requirements will see an opportunity to improve their position, while those same requirements can mean leaving the business for others. This makes a precarious and painful discussion within the enterprise. Everyone realizes that the signals sent by the market will, sooner or later, affect the individual members of the cooperative. But in the cooperative they face these facts in public, eye to eye with fellow members. It is quite different when the invisible hand imposes change or exodus anonymously.

It should be noted that the horizon of the members (see Sect. 3.4) plays a dual role in these discussions. Older members will be reluctant to make further investments in quality, which is particularly important for younger members. On the other hand, the simple fact that many members are approaching the end of their working lives makes this a good moment to establish new quality parameters. The only thing that is needed is to agree on a transition period for the older members.

Whatever the case, it will always be difficult for an existing cooperative to continually maintain and live up to its quality leadership role. The conflict of interests can be substantial, and the members will only be prepared to alter their working methods if they can see good economic reason to do so. Unfortunately, the necessity will only become evident when it is too late. An extra complication arises with the possibility of the loss of members through resignation. That can happen when it isn't clear that profit made from enhanced quality will compensate for the loss of market power or economies of scale for the members.

5.2.13 Homogeneity

It is generally acknowledged that major differences in the quality of members' product can give rise to significant solidarity problems. This is one of the reasons why sales or marketing cooperatives are usually found in the domain of bulk products. Bulk products, or commodities, are homogenous by nature. The individual producer can do little to add extra quality. Sugar is sugar, and milk is milk. Insofar as there is a difference between the product of farmer A and farmer B, the difference disappears by the time the cooperative factory has bottled the milk or made the cheese. If there is a clearly discernible difference in the quality of product produced by the members, and that difference is relevant for the market, it would be less sensible to throw all those products into one basket or tank. That is why market gardeners derive their power from the auction as a communal market place, rather than from communal marketing and sales.

At the same time, the solidarity problem we have sketched out here seems to have contributed to a culture in which there is more emphasis on price and quantity—on saving costs—than on quality. This becomes a culture of "same is better". This translates itself, for the members, in a quality standard formulated in terms of minimum requirements for protein content and purity. Over the years, those requirements are gradually raised (cell count, germ count, etc.), but there is little incentive to encourage the members to really improve their product.

Where possible, most quality requirements become differentiated. A sugar beet grower is paid in proportion to the sugar content of his beets, less a reduction for the amount of sand and other pollution attached to the beets. But even this differentiation is prompted more by the principle that income and expenditure should be allocated to the individual member than by any desire to improve quality. This phenomenon has always been carefully restricted to easily measured aspects of production and processing and can objectively be linked to the costs or revenues of the cooperative.

5.2.14 Differentiation

Different quality classes were formulated early on in the fruit and vegetable sectors that produce consumer products, often in consultation with traders. Independent inspectors classified the products: shiny apples in A, slightly damaged apples in B, overripe apples in C. The apples came to auction pre-sorted, and prices were then determined by the buyers. This process effectively makes quality differences more transparent. But that is not so welcome for the members whose products end up in the lower categories. They worry that they will receive a permanently lower price, once again creating a clear conflict of interest between group members.

This sort of issue also regularly prompts discussions at auctions. Those who deliver the best quality products know that they are in the minority. They can threaten to leave—literally a loss of quality for the cooperative—but if they do, they in turn will lose the channels, the market power and probably even the price leadership offered by the cooperative. Conversely, the remaining members will have to be careful not to chase away any more quality producers. Only the lesser producers would remain.

Besides the difference in interests, the collective interests as a whole also play an important part in the considerations. It becomes a matter of weighing benefits derived from the power of the cooperative in the market against costs. The more classifications and separate product flows, the greater the costs. This theme is understandably unpopular in cooperatives that are focused on reducing costs.

One remarkable example is the fairly recent development whereby members of cooperatives turn to organic or other environment- or animal-friendly production methods. Some do so on the basis of an ideal or market consideration, and some in an effort to distinguish themselves in the market. In agriculture, and certainly within the cooperatives concerned, these initiatives are not always greeted with enthusiasm. Members look upon it primarily as new competition, both direct and indirect. They fear damage to the reputation of their own product, which may then be seen as "less healthy" or "less animal-friendly". There is also the practical problem of having to set up a separate production line, for organic milk for example. Nonetheless, these changes do happen. Influenced by all the publicity about organic agriculture, dairy enterprises could actually no longer survive without some organic products in their portfolio.

Members have to fight to get new quality initiatives adopted within cooperatives. But such initiatives often depend on other members' willingness or reluctance to invest in the initiatives of others.

5.2.15 Quality in the Chain

The previous section may have left the impression that there is no room for quality in sales cooperatives. Nothing could be further from the truth. Up to now we have been looking at the opportunities for the member businesses to earn more by delivering better quality to the cooperative. For the cooperative as a whole, however, the situation is different.

To illustrate the point, let us return to the Friesland farmers who started cooperating so as to win back their market in Britain by offering better quality. The solution at the time was to establish communal dairy factories where their milk could be processed. The quality had to be discernible in the exported end product. The flag of the province of Friesland flew proudly over the factory, and beneath it they developed quality policies. That quality of the export product was then translated into requirements that the farmers must fulfil.

The process seems to be ongoing: extra quality and production innovation are expected from the cooperative enterprise, but not explicitly from the members. This seeming ambiguity does not need to be a problem. It depends on where the members have drawn their circle.

Most farmers are happy with a successful cooperative that tells them what the market wants. They can then channel their creativity and skills to fulfilling those requirements. But there is less space for the creativity necessary to discover for themselves what the market wants. The same phenomenon can also be seen in retail cooperatives. The stricter the "format" imposed by the cooperative, the less scope there is for creativity on the part of the individual retailer.

5.2.16 Quantities

One of the main interests that members have in a cooperative is the opportunity to extend their market for selling or for buying, including the number of transactions they can complete. This applies in both absolute terms (without a cooperative there is no supply or no demand), and in relative terms. A member business can develop by growing or by increasing productivity. But then you have to be able to sell the extra produce or buy more raw materials. Thanks to the cooperative, members can tap into markets further afield from their core business. This, typically, is a marketing activity that could not be undertaken by a single business, both because it requires special expertise and members already have their hands full developing their own business.

The next chapter will go into this in more detail, but here is a simple example. Let us imagine that Pete makes 1,000 products a year; they cost him one euro each and he sells them for two euros. That is a profit of one thousand euros. He would like to increase production to two thousand products. Higher production would normally entail lower average costs (economies of scale). But let us assume that his average costs remain at one euro per product. The next question becomes finding a market for Pete's extra production. If the cooperative is able to find a market at anything more than one and a half euros, Pete will be better off. He will earn more than a thousand euros, even though his sale price is almost 25% lower.

5.2.17 Free Admission and Transaction Obligation

Surprisingly, the aforementioned individual member's objective (the growth of Pete's own business) accords well with a cooperative that clusters purchasing, sales and/or processing on behalf of its members. More production gives economies of scale and hence lower costs. In a market where countervailing power counts, more production can even lead to a better price. This is a situation where collective strength really applies. This probably also explains why free admission and the right to deliver unlimited quantities of product have always been more the rule than the exception for cooperatives, so much so that many manuals mention free admission as an essential characteristic of cooperation.

Incidentally, it is not the case that free admission is balanced out by free withdrawal. When investments have been made in a cooperative and production capacity has been created, the co-operators need to be able to rely on each other to ensure sufficient volumes of deliveries or sales. Otherwise, the remaining members will have to cover the cost of under-utilization. In other words, members have to be subject to an obligation to deliver their products. The more capital-intensive cooperatives have quite strict resignation procedures based on compensating the losses that the other members would suffer. Some have even imposed an additional financial penalty (Minderhoud 1957).

In more recent years, the necessity for a resignation (or exiting) penalty has been tempered by the fact that cooperatives now have equity capital that is accrued by the members themselves and which is not repaid on resignation or retirement. That "capital in the dead hand" is effectively an implicit resignation penalty (see Sect. 4.3).

We saw earlier that a purchasing obligation on the part of the cooperative represents mutual delivery insurance for the member; the obligation to deliver represents a substantial reduction of risk for the cooperative enterprise. An obligation to deliver is also an important factor in combating free-rider behaviour (see Sect. 3.4). The disadvantage to such obligations is, of course, that they restrict a member's autonomy.

It could be difficult to reconcile such an obligation with the principle that the cooperative exists to support its members in the realization of their own goals. Moreover, you run the risk that the cooperative enterprise, or its management, will become lazy. After all, there will not be much need to expend energy on maintaining member loyalty. Such arguments have always been pivotal in cooperative practice. Members should not be restricted any more than is strictly necessary. That necessity is greatest in the case of capital-intensive processing cooperatives, but somewhat less acute in capital-intensive marketing cooperatives. It is a less urgent matter in consumer cooperatives such as retail shops, banks and feed producers.

As a general rule, there is less solidarity among members in cooperatives where there are no transaction obligations. The circle around the cooperative enterprise plus the transactions with the members is no longer clear. This becomes especially acute in many consumer cooperatives. Many of these cooperatives are quick to start doing business with non-members. If a feed processing factory is built, and members do not buy all the feed, trade with non-members becomes an attractive prospect and may be necessary for survival. The same happens in many retail cooperatives. In the long run, the only difference between members and non-members was that members received dividend stamps on the basis of which they received a share of the profits. Even Rabobank and other large cooperative banking systems have evolved to where they are no longer just credit cooperatives and have become cooperative financial services providers.

5.2.18 Transaction Rights

A transaction obligation implies no more than that members are obliged to exercise their transaction rights. It is important to make that clear. The primary reason to become a member of a cooperative is to acquire transaction rights. The word "right" indicates that membership of the cooperative has some value. It is because of the value of that right that people are prepared to become members, to invest and even to give up a degree of autonomy in exchange for a transaction or other obligation. The first value element of a delivery right is the obligation to purchase on the part of the cooperative enterprise. We have already pointed out that the value of this right represents a mutual delivery insurance. The value of such a delivery right becomes more explicit as the cooperative has a more exclusive position within the market. It can make good "profits" for the members, or it represents the members' sole channel for sales. The position of the cooperative can, however, change over the years. If its operations are weak, or if it has strong competition, the members might decide to leave the cooperative. Their transaction right with the cooperative then has no further value. But if the cooperative has become the only real option, or becomes an ever-stronger partner for the members in some other way, then it can literally cost more money to become a member. Good examples of this are the agricultural processing cooperatives where delivery rights (membership portions) are negotiable. This means that members must buy into the cooperative.

5.2.19 New Generation Cooperatives (NGCs)

In the USA, in particular, many cooperatives have been started in which members have to purchase delivery rights in advance. These are being called New Generation Cooperatives (NGCs). The delivery rights go hand in hand with delivery obligations. But that doesn't mean that non-producers may not purchase delivery rights. If members do not deliver, the raw materials are then purchased from the market at the expense of the member in question. Members who do deliver raw materials receive a normal market price. If the cooperative makes a profit, this is shared among all members in proportion to the delivery rights they own.

In fact, this is exactly the opposite of what the classic or traditional cooperative does. The older-model cooperatives work according to the Rochdale Principles, with a market-matching return on invested equity and the distribution of profit on the basis of transaction volumes. In that case, the transactions are settled at market prices and the profit is distributed on the basis of capital equity. In most established cooperatives, the order is of little importance as long as the proportionality between investment and amount of delivery product—i.e. between the financial and the transaction relationship—remains intact. The order of business does become important when there are external shareholders.

NGCs are built out, or as an extension, from the members' original objectives. In general, they are primarily aimed at stimulating the regional economy by keeping more of the production value at home. The suppliers do so with capital and raw materials, the investors with capital and by covering their share of the necessary raw materials. Such a communal interest frequently arises in remote areas where the benefits of cooperation are visible to most, if not all, community residents. If no cooperative existed, suppliers would be in a less favourable situation, located too far from buyers. In addition, employment opportunities would be lost. The communal interest lies in the presence of a local cooperative enterprise that offers employment, and when it produces something that local people need or has a higher marketplace value that enhances the local economy. At the same time it contributes to the continuing presence of the member-suppliers. The investment in the cooperative enterprise is the core issue for both objectives. That investment forms the criterion on which any profit will be distributed. Thus, the enterprise leads to profits for investors and for the "regional family": the local community.

The future will have to show whether dissimilar communal objectives are robust enough to be sustainable. There are already examples of NGC failures, but their failure rate in the decade from the mid-1990s to 2005 was less than 10% in the mid-western U.S. states of Minnesota, Iowa and North Dakota. In contrast, there is a 50% failure rate for all new forms of enterprise, cooperative or not, within three years of starting up.

5.2.20 Transaction or Investment?

We will end this section with a special case of "premium membership". This is a situation that involves cooperative enterprises' activities that have no direct link with the transaction relationship with members. We will first give a few examples.

> *Avebe is a cooperative enterprise that extracts starch from its members' potatoes. It does so in the name of its members: farmers in the fenland communities who have little choice other than to grow industrial grade potatoes. It is surprising enough that Avebe can keep going, because potato starch has lost out to competition from cheaper varieties of starch in nearly all markets. One of the secrets of Avebe's continuing success was the forward strides the company made in the starch markets. It started to produce other varieties of starch itself, cheaper and more competitive varieties such as tapioca starch. It already had starch-extracting technology; the company could now take a wider variety of starch derivatives to the market for both the food and the non-food industries and it made good profits. Now that Avebe is a leading player in the world market for starch products, it continues to be able to sell its members' products.*

Avebe and many other cooperatives decided for marketing reasons to extend their activities beyond their core business. Fruit and vegetable markets, for example, were quick to ensure that more exotic varieties of fruit and vegetables were available. Royal Friesland Foods started to make lemonade alongside its traditional milk and chocolate milk products. Land O'Lakes and most other major North American dairy food cooperatives began processing and distributing fruit juices to assure their niche in the supply chain, allowing them to supply refrigerated supermarket cases for both milk and juice products. Along another path, wider use of its skills and available know-how enabled Campina to set up a division that uses milk protein for the fabrication of computer monitor screens.

Another form of "expansion" is the trend for cooperatives to begin international operations, prompted by increasing international competition (see Sect. 4.5). This often takes the form of mergers with foreign businesses. Finally, there are the increasing investments in sales, in the development of consumer products and their marketing. All of these business expansions emphasize the added value that can be created in the cooperative enterprise even though success is not dependent on transactions with the members.

This development can lead to a curious situation in which cooperatives are busy creating extra added value while they have no need for extra transactions with their members. In situations like that, the right of delivery is more important than the obligation to deliver. In addition, the right of delivery becomes a costly one. Many extra investments must be made on the supply side of the cooperative. Also, new investments must be made on the demand side. Members are allowed to receive a share of the added value that is generated without regard to the member transactions, at the same time that they are still being rewarded in proportion to those transactions.

Thus, there are two problems in need of solutions. The first is the incentive problem. Members are receiving a higher reward than their transaction is worth to the cooperative enterprise. This will send out false signals. A second problem is that the transaction relationship increasingly becomes an investment relationship. The delivery right becomes expensive because of the high investment component, and this can be a great drawback for the transaction-dependent members. This is often overlooked because, for the member business, the transaction remains the central issue for membership.

5.3 The Financial Relationship

A cooperative enterprise must be funded. This is done in most investor-owned, public stock companies by issuing shares that are bought by people who: (a) clearly have capital at their disposal, and (b) want this capital to earn as much as possible for them. It’s all about the potential profit per unit of capital. The case is frequently different for private individuals who set up a business. They are not passive investors who only want to see a return on their capital. They are trying to make as much profit as possible on their proposed business activities while building an enterprise that is durable and sustainable. They see funding as a straightforward cost item. If they do not have the required funds themselves, they can try to persuade the bank to lend them money. If that fails or proves to be too costly, they can try to persuade third parties to invest in their business. They may well have to give up some of the profits, but if the business is dependent on risk-bearing capital, they won’t begrudge it. Where the interests are homogeneous, there could be no objection to drawing investors into the business. It might mean sharing the profits, but the investors have the same basic interests as the entrepreneur: earning the best possible profit from the economic activity. After all, more profit on the economic activity means better returns on the invested capital. Nonetheless, there is a catch. Problems can arise when the external investor decides that the capital is not bringing sufficient returns. He can walk away or demand that the business strategy be changed. In doing so, he is interfering in the activity of the original entrepreneur and the latter will probably not like that idea: “Come on, Van Gogh, those paintings aren’t bad, but why don’t you start creating something that there’s actually a demand for?”

In the case of a cooperative enterprise, profitability-induced interference would be absolutely undesirable since the concept of profitability has a different meaning for members of a cooperative than for investors. At this point we must remind the reader of the dual objective of the cooperative. True, a cooperative must operate as well as possible as a business, but the interests of the members remain the primary consideration. These are not the interests (or the profit) of the cooperative enterprise itself. Such member interest is served via the transactions with the members and this is therefore the central activity.

In principle, the external investor is not interested in the members' interests. If more profit can be made from other activities or transactions, or from more or fewer transactions, then he will opt for that. He is only interested in the profit of the cooperative enterprise itself. As far as he is concerned, the cooperative must simply make a profit. To do so, the enterprise must provide added value to its customers or its suppliers (members, for example), but that is simply a means to an end: making a profit.

And that brings us to an even greater problem: how much profit does a cooperative enterprise actually make? If you consider only "user benefit", and see the cooperative only as a means to achieve a better transaction price for the members, then the cooperative enterprise itself makes no profit at all. It is a task-oriented organization. Before we go on to consider the funding of a cooperative enterprise, we shall first consider the cooperative surplus and its allocation to the cooperative enterprise. In doing so, we shall briefly consider relevant the fiscal aspects.

5.3.1 The Cooperative Surplus

In the literature, particularly the German literature, cooperatives are often described as "not-for-profit organizations". Draheim (1952) used the descriptive term *Kostendeckungsbetrieb* (business covering costs): the cooperative enterprise should be seen as an extension of the members' businesses. It is, as it were, a department of the member business that must provide a particular service at the lowest possible cost. The cheaper that can be done, the more profit the primary business (i.e. the member business) can make. In the case of a marketing cooperative, for example, the members entrust their products to the cooperative enterprise. The cooperative must then do something with that product (package, adapt, process), and sell it in the market on behalf of the members. Any costs incurred are deducted from the earnings from those sales, and the difference—the net result—is divided among the members in proportion to their deliveries to the cooperative. We have previously seen that account is taken of costs and earnings which can be directly attributed to the individual member (see Sect. 4.2), but that does nothing to diminish the principle that this surplus is allocated to the members in its entirety and in proportion to their own transactions.

This surplus actually consists of two components: a reward for the members' product and the value added by the cooperative enterprise itself. The members are entitled to share in the first component as producers of the delivered product, and in the second component as owners of and investors in the cooperative enterprise. For most of the members of the cooperative, this distinction will be of little interest, at first sight at least. Call it price, cooperative profit, or dividend, they receive it anyway, and what they receive is proportional to the value of their transactions with the cooperative. The result usually means that success of the cooperative enterprise is tied to the difference between the price members receive and the price non-members receive. But we can still add some notes in the margin concerning such a carefree attitude:

- In the first place you can never be sure what the market price would have been if there was no cooperative. We have already discussed the phenomenon of price leadership (in Sect. 4.2): if the effect of the cooperative is that other buyers also start to offer higher prices, the cooperative will seem to have no added value.
- Secondly, the "profit" from cooperation can lie in the fact that new markets have been accessed, by organizing exports for example. This is a volume effect, one that cannot be seen directly in the price received. It is quite possible that other buyers pay their suppliers the same price or even more, but they may not do so for the volume of products that can be sold to the cooperative.
- Finally, members have to ask themselves what membership in the cooperative costs them. The member may receive the same price as other suppliers, but might have had to invest more to get it. These costs are not only measured in money investments, but also in terms of organizing the cooperative, making agreements and complying with long-term contracts. In other words, the member incurs transaction costs and has every right to expect something extra in return. On the other hand, being a member of the cooperative means making those agreements with a voice in the conditions and in having a contract in the first place, and thus, the certainty of selling products. That is a benefit in itself, a profit if you will, of the cooperative enterprise. It might even be a reason to be satisfied with a slightly lower price.

This just shows how difficult it can be in practice to attribute the surplus to the members or to the cooperative enterprise. It is difficult to define exactly what performance has been provided by the cooperative and what by the members. But it is precisely that point that becomes the focus of discussions when cooperatives become involved with external investors. What profit should be allocated to the investors, and what to the members? Nevertheless, it remains worthwhile—with or without external investors—to determine as accurately as possible what added value the cooperative realizes. This will be looked at further in Chap. 6. It becomes particularly important when members want to assess how well the cooperative enterprise is performing. What return or benefit is it offering? How does that compare to the returns of other cooperatives or competitors?

Benchmarking like this is relevant, for example, when attempting to assess the management of the cooperative. Conversely, it also forces the members to formulate the criteria they wish to use to define how "successful" their cooperative is. That, in turn, is in the interests of the management, as they will then know how they will be judged. When the members need to approve substantial investments, it is even conceivable that the rate of return on invested assets should be an important criterion. Members, after all, have to decide whether they are better off investing in their cooperative, in their own business or in something different altogether.

A warning note is appropriate here. It is important to keep the dual objectives of the cooperative in mind when developing assessment criteria. Fixation on the profitability of the cooperative enterprise alone can lead to the subordination of the central objective, i.e. the interests of the members. Conversely, fixation on the prices to be received in the short-term can obscure the necessity to ensure that the cooperative enterprise remains strong.

5.3.2 *Fiscal Aspects*

Another party that is interested in the difference between "member profit" and "cooperative profit" is the tax authorities. How much profit does the cooperative make, and how much corporation tax do the members have to pay as a result? The cooperative answer is simple, as we have already seen. A cooperative does not make a profit. It realizes a better price for its members. So any tax burden falls on the members' businesses. But the taxman is not always satisfied with this answer. This book is not the place to go into the specifics too deeply, in part because cooperative taxes are applied and administered differently in different countries. But we shall make a few general comments.

For the taxman, the central question revolves around to what extent the cooperative enterprise is truly an extension of the members' businesses and to what extent it is an independent enterprise. If the latter is dominant, then the cooperative may be expected to pay taxes like any other independent enterprise. The taxman will also want an answer to the question of what earnings can be attributed to the cooperative enterprise (the "independent" profit) and what earnings can be attributed to the members (the "extension" profit).

Dutch law tries to make a distinction by determining a "market price" for the members and then attributing part of the business profit to the members as "extension" profit on the basis of a special formula (Jansen, in: Galle and Van der Sangen 1999). The cooperative must pay corporation tax on the remainder. In the cooperative setting, it is generally beneficial for as much fiscal profit as possible to be attributed to the members. The members are generally liable to pay tax at a tariff lower than corporation tax rate. Non-cooperative competitors keep a close eye on this issue, as they will not want cooperative enterprises to pay less tax or to have any other fiscal advantage. For that reason, the question of tax and cooperatives is a regular topic of discussion which is easily nurtured.

Variations of the above apply in most developed or industrialized countries. Part of the friction between ownership structures of business entities comes from cooperatives having separate codes of incorporation and separate tax codes. This is especially so in the United States with its Capper-Volstead Act that clearly defines cooperatives as for-profit ventures, not non-profit organizations, and then extends "single" or one-time taxation on most profits that are cash "patronage" payments, or dividends, that are returned to members. Critics of cooperatives, however, ignore that American cooperatives do pay corporate income taxes on the "retained earnings," or profits, which are not distributed to members but are retained as unallocated funds for future enterprise activities.

We have already seen that there is plenty to be said about the "market price" paid to the members. In practice this is a price that has to be "estimated" and is not exactly an objective method. Another question that can only be answered subjectively is to what extent the cooperative is an extension of the members' own businesses. If the cheese produced by cheese-making farmers is delivered to a cooperative cheese factory, you could indeed say that part of the members' business has been incorporated into a cooperative enterprise. But can you still say the same thing if the cooperative makes new types of cheese? Or low-fat butter? Or vanilla custard? The tax authorities must decide where to draw the line.

As already mentioned, Dutch law uses a standard formula that considers the percentage of overall costs that relate to the efforts of or on behalf of the members. In practice, these "member costs" are usually based on the sale of basic products and first-line processing. The same percentage of the cooperative's profit is then designated "extension" profit. It will be clear that this simply moves the goalposts of the discussion. What specific costs can actually be said to relate to member performance?

A subsequent problem arises in most countries as the extension profit is only deductible for the cooperative enterprise as it relates to the current financial year. That means that if cooperative A disburses all the calculated extension profit to the members, it may deduct the entire amount from the cooperative's profit, and so will pay no corporation tax on it (although the members will of course pay income tax on their share). But if cooperative B decides to retain the extension profit in the cooperative that year to enable it to make an investment, it will be liable to corporation tax. If, a couple of years later in year X, the cooperative disburses that profit to the members, it will no longer be designated as extension profit as it was not earned in financial year X. The members will pay income tax on their share as usual, but the cooperative will also have paid corporation tax on it as well. This produces a problem of double taxation.

Besides the fact that double taxation will never be "nice", we must mention in the spirit of this chapter that this double taxation is actually a disincentive for the members to put money into the cooperative enterprise. It is as if the member is paying the taxman twice. In other words, tax treatments stimulate short-term thinking. The higher the effective disbursement here and now, i.e. the less money is left in the cooperative enterprise, the lower the burden of double taxation.

This makes the arbitrary line between member profit and enterprise profit an important fiscal problem. An unpleasant consequence is that quite often complicated and artificial constructions are designed to avoid undesirable fiscal burdens, especially double taxation: constructions, for example, by which the money may well be disbursed officially, but then made available to the cooperative again in some form or other. This cat-and-mouse game is not good for the transparency of the financial relationship between the members and their cooperative enterprise.

In the United States, cooperatives are only charged an advance on corporation tax, which is then refunded as soon as tax has been levied on the members. Cooperatives in various EU countries also enjoy a relatively accommodating tax regime. Denmark, for example, assumes that cooperatives do not make a profit. Taxation is limited to a levy of 14.8% on the cooperative's equity capital. This favourable treatment does, however, come to an end when more than a quarter of the turnover is realized through non-members. This explains why international merger partners of Danish cooperatives (such as Arla) are keen to choose Denmark as their home base.

5.3.3 *Self-financing*

From what was said in the introduction to this chapter about the interests of external financiers, it will be obvious that cooperatives—by definition—prefer to be self-financing. They want to be sure that the transaction relationship is at the core of their business and that the capital only serves that relationship. For the same reason, the proportionality principle should also—by preference—be applied to financing. Members contribute pro rata to their transactions with the cooperative. Otherwise, discrepancies will arise between the members other than as a result of the transaction relationship, in the sense that one member will be more of an "investor" than another.

Once more, we would like to emphasize that a cooperative is not a vehicle by which to make capital profitable, as it would be in a limited company. The primary objective is to fulfil "material needs", in order to carry out some communal economic function as an aid to the operations of the members' businesses. Recruiting capital is not an end: it is simply a means. But it remains necessary, so how should it be done?

5.3.4 *Pre-financing*

A first option is a form of pre-financing. In this case, members put a certain amount in the kitty, preferably in proportion to their intended transaction volume. If the investment is relatively small, as it might be in a consumer cooperative or an ordering association, collecting the subscribed capital or charging a membership fee can achieve it. We have already seen that this was the principle used in Rochdale. In order to prevent the subscribed capital taking on too prominent a role, there was a maximum limit to members' subscriptions and a fixed rate of interest. In the early years, the Rochdale cooperative managed to satisfy its financial needs by buying on credit from its suppliers while demanding cash payment from its member customers.

A second option for acquiring working capital is to get members to lend funds to the cooperative, in proportion to their transactions. This can also be done as trade credit, if the members agree to defer payments. In practice, however, a more common method is for members to accept an advance on their price at a relatively low rate and to receive a supplement at a later date once the annual results are known. By analogy, the Rochdale approach can also be seen as being based on buyer's credit. Members pay a predetermined price—in the case of Rochdale, the market price—and receive a retrospective discount once the annual results are known. Those results could, of course, be disappointing. Then the "discount" will be negative, and members will have to make an additional payment. In cooperative practice, it has always been the custom to make cautious calculations. That is important for the cooperative's financial situation, and also so that members are not confronted with financial setbacks after the event.

A third method of acquiring funds is to borrow on the capital market. To do so, the cooperative enterprise will have to provide the lender with the necessary guarantees. The fewer guarantees provided, the more expensive the loan. If the risks are too great, no banker will be willing to provide the necessary capital. A new cooperative that has not yet accrued any equity capital to serve as collateral can channel the guarantee through its members. Members will have to accept liability for the debts of the cooperative. Liability in this case is a provisional obligation to furnish capital. The members do not need to deposit funds in the cooperative immediately, but they accept guarantor status in the event that something goes wrong. That is why the term 'potential equity capital' is used here. Once again, it will be obvious why agriculture, in particular, has spawned so many cooperatives. With their land, buildings and livestock, farmers have fairly substantial assets, and together they are quite capable of taking on the role of guarantor.

5.3.5 Liability

Dutch law demands that the question of liability should be arranged in the articles of association. In principle, there are three options in the Netherlands:

- *W.A.—statutory liability*. If the articles of association do not provide otherwise, the cooperative will have statutory liability. This is unlimited, and applies to each member in equal proportions. That means to say that in the event of dissolution or liquidation, the liability will be shared among all members equally. The members' liability applies to the entire value of the deficit. If redress cannot be obtained from any member, then the other members' liability will be increased by an equal share of the amount not obtained from that member. Statutory liability expires one year after a member withdraws from the cooperative, so that members cannot avoid liability simply by pulling out when a financial crisis looms.
- *G.A.—modified/adjusted liability*. It is possible for a cooperative's articles of association to deviate from this general rule. In such a case, we say that the cooperative has modified liability. In the first place there might be a particular reason for sharing liability among the members in another way, pro rata to their participation. Then the members have unlimited liability for unequal proportions. A second possibility is the unlimited joint and several liabilities of the members (this is also known as 'several liability'). In this case, if the cooperative cannot meet its obligations, each member can be sued for the entire deficit. The members named in the suit must themselves arrange how they will obtain money from the others. This option was often used in new cooperatives that enjoyed little external confidence. It hardly needs to be said that the more wealthy members in particular were not very happy with this liability arrangement. In practice, they will be the first to come under fire. These days, unlimited member liability is hardly ever found. As long ago as 1925,

amended legislation allowed liability to be restricted or even excluded altogether. In the case of a limited liability cooperative (*beperkte aansprakelijkheid*, B.A.), the member liability is limited either to a specific amount or to a percentage of the annual turnover (again, in equal or unequal proportions). This now seems to be the pattern in most developed countries.

- *U.A.—excluded liability*. Members of cooperatives that exclude member liability can never be held liable for the cooperative's debts. At most they can lose any money they have contributed (subscribed capital, the balance on member accounts, or loans provided).

It is not only necessary to specify the chosen form of liability in the articles of association under Dutch law; it must also be quoted in all correspondence. If that is not done, liability will revert to statutory liability (W.A.). As already mentioned, this liability only means that the members would have to contribute to cover their cooperative's deficit in the event of dissolution or liquidation. If they are also required to contribute to interim deficits, that must be expressly stated in the articles of association.

Generally speaking, providers of capital (such as banks) are not enamoured of liability arrangements. It is far more important to them that the enterprise is healthy and financially sound. They undoubtedly dread the trouble they would have, in the event of liquidation, if they had to collect the debt from all those individual members. Conversely, joint and several liability is not a pleasant prospect for the members themselves. The cooperative is a business that they run at arm's length, and it could all go wrong at any time.

Both considerations have led to the subordination of the importance of liability in practice. The majority of cooperatives these days have excluded member liability: no less than two-thirds of the current top 30 cooperatives in the Netherlands (see Sect. 4.5) have done so. The remainder have some form of limited liability. Some people feel that this might have a disadvantage: the spectre of liability can mean that members feel more involved with the cooperative and follow its economic affairs more closely.

5.3.6 Transaction Liability

In their appraisal of risk, capital providers attach great importance to the opportunities and potential of the enterprise. In this respect, the cooperative holds an interesting trump card: the transactions with the members. In the first place, members have an obligation to deliver. If a group of farmers decide to set up a cooperative sugar factory, for example, and the members undertake to deliver their sugar beets to the factory, this will effectively cover a major potential failure factor. In principle, the cooperative enterprise will have a long-term contract with its members that will safeguard the supply of raw materials (or the purchase of its products or services). What is even more interesting, from a financial point of view, is that these long-term contracts do not mention prices. That means a cooperative enterprise with committed members can permit itself to pay less to its members for their assured input during difficult economic times. It also means the larger the cooperative, the greater the annual payout and the greater the amount of capital that could be retained in the short term (see also Sect. 7.4).

A cooperative enterprise does not need equity capital to hedge risks if its members have an obligation to deliver. Whether the results are disappointing or favourable, they can be discounted in the members' transaction price. In other words, the cooperative enterprise effectively "uses" the equity capital of the member businesses as its own equity capital. If the cooperative enterprise's results are inadequate, the members will receive lower prices. The members function as a buffer.

5.3.7 The Formation of Equity Capital

From the previous section it will be obvious that there are a number of reasons why a cooperative enterprise should want to have some equity capital. In the first place it needs working capital. It is utterly impractical to have to go hat in hand to members and say that funds are needed "for a while". In the second place you need equity capital as collateral when borrowing from third parties. That aspect becomes even more important as the liability of the members is reduced. Thirdly, it is desirable for the cooperative to have its own equity capital when it needs to accept more risk. The greater the risk, the more expensive (and perhaps more difficult) it becomes to obtain credit. In that sense, the formation of equity capital can also help to reduce costs. Unlike borrowed capital, equity capital does not need to be paid back. Precisely for that reason, it can support more risks. The term 'equity capital' is therefore often used as a synonym for risk-bearing capital.

The most important way in which cooperatives form equity capital is the same way individuals do it. They decide to keep some of the current year's surplus funds in the cooperative as part of a potential disbursement kitty. Members thereby waive their right to part of their "direct and personal claim" to the surplus for the year in question.

The equity which is formed in this way can consist of various components: deposits in the authorized capital of the cooperative (in principle, this is then a "gift" from the members), personal participation in the cooperative's risk-bearing capital, or a short- or medium-term loan on specific conditions. In the first case, the funds are incorporated into the cooperative enterprise's equity capital. In the last case, the funds are actually borrowed: a debt owed by the cooperative to the members. We shall now consider a number of variations on this theme:

- unallocated capital
- debt to members
- members' capital
- cooperatives based on shares
- combinations of the above.

5.3.8 Capital in the Dead Hand

Members can agree that part of the money to which they are entitled should be deposited into the general reserves of the cooperative. The capital that is so created is known as the "capital in the dead hand", and has the character of authorized capital. In earlier chapters we saw that the Rochdale cooperative declared this cooperative capital to be "indivisible". Members could no longer lay claim to the capital that the cooperative enterprise had formed (see Sect. 4.1). The cooperative's equity capital is subject to collective decision-making and is no longer owned by any specific member. This is possible because the cooperative is a legal entity and the members have no individual title to its capital. If they resign their membership, they no longer have any claim to these reserves and their rights to the capital cannot be devised by will or transferred. In other words, co-operators enjoy *usufruct* on this capital, but only for the period that they remain members. Each generation adds to this authorized capital.

Depending on the wording of the articles of association, it is possible for the cooperative to eat into the general reserves and draw down the capital in the dead hand. It can do so by paying members a higher price for their products and services—or by charging a lower price—than would be justified from a commercial point of view.

In the period when a cooperative is being built up, the collective will nearly always have a tacit agreement that the cooperative's capital must be spared and kept intact. This is done with the understanding that something was being built up, from the desire to reduce the burden of liability on the individual members, and in the conviction that the communal enterprise should primarily offer the prospect of continuity. This is for the benefit of both the cooperative and the members' businesses as well.

This "unselfish" choice was linked to the collective conviction that capital, and whatever it might yield, should not play a dominant role in the cooperative. The transaction relationship and continuity should be the central consideration. Continuity concerns would be pressing if a majority of the members, or even a sizeable number, were to reclaim their capital. That could mean the end of the cooperative. The "founding fathers" of many cooperatives were well aware of this risk, and rightly so. When young entrepreneurs get together to form a cooperative, there is a good chance that they will reach the end of their working lives more or less simultaneously and will want to withdraw their money from the cooperative simultaneously. In the case of longer-established cooperatives, the ages of members will be more varied.

The apparent "selflessness" of these founding fathers should be seen against the background of their time. Besides their own interests, many cooperatives were also concerned with the emancipation of a particular population group or with achieving a structural improvement of circumstances for that group. In other words, cooperatives were originally endowed with an important social task. The cooperative should serve the sector as a whole, and its future prospects, and should have an open mind to the admission of new members from the sector. Once this aspect became less important, the capital in the dead hand was seen more and more as equity *for* the existing members. As this idea took hold, so too did the members' desire to at least be able to withdraw the nominal value of their share of the equity on retirement, preferably with a bonus to allow for growth in the value of the enterprise.

In agriculture, another aspect besides the deeply felt sectoral identity also came to the fore. Farmers were well used to capital in the dead hand, namely the land on which their family business was built. This was land that you could not sell, but only pass on to your children. In their minds they held that business literally "in usufruct". You worked the land and the farm, added to it if you could, and in leaner times you could consume some of the assets. Ultimately, you passed it on to the next generation. The inherent nature of succession—thinking in terms of generations—perhaps explains why farmers in particular are so aware of the need for continuity *and* why cooperatives have always been so popular with farmers.

Nonetheless, the phenomenon of capital in the dead hand has become less self-evident in modern times. Members do, of course, enjoy the usufruct, as shareholders enjoy their dividend. But when their membership comes to an end, they want to be able to reclaim some of the assets to which they have contributed over the years, just as shareholders want to be able to sell their shares at some time or other, preferably at a higher price.

To some extent, the declining acceptance of capital in the dead hand can be linked to the general increase in individualism in society. People are less inclined to practice self-denial for the benefit of the future generations of their professional group. On the other hand, the "horizon" of many members has changed. For many farmers, for example, it is no longer self-evident that their children, or even other members of the family, will take to farming or continue to make use of the cooperative in some other way.

A laudable but at the same time dangerous aspect of the capital in the dead hand is that it is ostensibly "free of charge". It was, after all, a "gift" from previous generations. In principle, no interest needs to be paid on it. In that sense it is a very attractive business practice. The cooperative will have a comparative advantage over businesses that have to borrow "expensive" capital. But members who have to appraise the cooperative enterprise on its performance will have the task of ensuring that sufficient benefit is drawn from this "dead capital". If the success of the cooperative is based solely on a lack of interest payments, it is likely that the cooperative has a weakness in comparison with the competition. Members should be aware of this prospect.

5.3.9 Debt to Members

The alternative is to consider the discount on the transaction price as a personal loan from the member to the cooperative. The cooperative then enters the discount as a credit entry on the "member debt account" in the name of the member. At the moment the entry is made, a note is added to show when the cooperative will redeem this debt. Many cooperatives use a revolving fund to operate this member debt system; the amount that was withheld X years ago is disbursed to the members. Normally, some interest payment is included in the disbursement. It goes without saying that with this system the cooperative does not actually accrue any equity capital. But the system does give the cooperative a fairly permanent working capital so that it becomes less dependent on outside funding.

5.3.10 Members' Capital

A more recent alternative is the so-called member capital account, also known as the personal reserves, participation reserves or registered equity. This account is also supplemented by withholding a proportion of the surplus, and the account also has interest added to it. There are, however, two major differences with the debt to members. In the first place, members' capital is only repaid when a member resigns or withdraws on lawful grounds and in a lawful way. But even more important is the fact that the members' capital is under the direct management of the cooperative. This means that the cooperative can, if necessary, withdraw funds from this capital. This means that the members' capital *can* be seen as part of the cooperative's equity capital. But this is limited to a certain level. If a member resigns, his portion must be repaid.

5.3.11 Cooperatives Based on Shares

Lawmakers throughout the industrial world have been making it explicitly possible to convert parts of cooperative enterprises into another non-cooperative legal form. That gives the option, in principle, of launching or acquiring some particular and often more risky activity in which other investors are involved. Subsidiaries of cooperatives are, of course, sometimes funded with borrowed capital. Sometimes this is done because of a lack of members' capital or equity capital, or because the party selling the acquisition will remain a shareholder for a while, or because the enterprise being taken over is listed on some foreign stock exchange. In most cases, this kind of funding situation is short-lived.

Some cooperatives literally opt to incorporate the cooperative enterprise, or at least part of it, into a so-called corporate cooperative. As a rule, all shares are held by the cooperative association, with the Board of Directors of the cooperative association acting as the Board of Supervisors for the cooperative enterprise. In practice, there is seldom a clear reason for choosing this construction. For the members there does not need to be any great difference with the cooperative's legal form as far as risk or effectiveness is concerned. If the cooperative enterprise is incorporated, however, legislation sets limits on what it considers realistic principles of association. One important reason for opting for incorporation of the cooperative seems to be that a "regular" company is more easily recognizable in international dealings. The cooperative form is slightly less well known and moreover the legal and fiscal regulations for cooperatives are by no means universal around the world. This may well be important in international trade and for attracting international funding.

In general, the shares in corporate cooperatives or in cooperatives based on shares are not freely transferable. The marketability (and then only of depositary receipts for shares) remains limited to the circle of members or is linked to a delivery right and/or an obligation to deliver. We have already pointed out that the earliest cooperatives were heavily focused on keeping admission fees for new members as low as possible. This was intentional because they were dealing with people who had little money (Rochdale). It was also important to the success of the cooperatives, in terms of market power and economies of scale, that as many people as possible participated. Financial barriers had to be as low as possible. In many cases, subscribers only needed to make a small partial payment on the shares. In other cases, such as grain marketing cooperatives in North America, members only needed to show up and use the marketing services to become a member. In the event of a setback of even liquidation, the liability of the members went no further than the need to pay up their shares. This was a typical form of connecting liability (and/or "shares") as potential equity.

However, at a time when market strategy and added-value strategies are receiving extra attention, shares are considered important as a form of real equity capital. Usually, cooperatives have issued these emphatically as participating preference shares, often tied with delivery rights or delivery obligations. This allows the cooperative enterprise to work with a predetermined volume of raw materials and equity capital, and the members buy the right to deliver those raw materials. These cooperatives are not "open to all". New members have to buy shares (rights) from existing members. Members can also trade their shares among themselves and so increase or decrease their delivery rights or delivery obligations. It is a limited market, one in which supply and demand determine the price. That price is a reflection of the expected or realized returns of the cooperative enterprise. The proportionality between transaction, funding and voice remains unchanged in a construction of this kind. The Dutch Avebe and Cosun are examples of the cooperatives based on shares described in this section. In Sect. 4.2, we also designated the American form of these enterprises as "New Generation Cooperatives".

It is not unknown for cooperatives to float their commercial enterprise on the stock exchange. There are some well-known examples of dairy cooperatives like this in Ireland, with Kerry being a prime example. Kerry wanted to invest in new products and new markets, and issued freely negotiable shares to its members for this purpose. Many of the member-entrepreneurs soon sold their shares to third parties. The same has happened to grain cooperatives in the Prairie Provinces of Canada. This had the side effect of eroding the ownership and the voice of the members. More recently, the Swiss dairy cooperative Emmi also sold shares in 49 percent of its business.

A new form of registered equity, which closely resembles the equity capital or share capital of an investor-owned company, is the so-called “B share”. B shares are risk-bearing, not redeemable, and not compulsory; but they are negotiable (to a degree), and do not need to form part of the current assets of the members: they can form part of the private assets instead. In this way, members have the opportunity to invest some extra funds voluntarily in their cooperative enterprise. Royal Friesland Foods for example offers members this option. B shares may not be traded outside the circle of members, but former members may hold them. On the death of a member, however, they have to be put on the market within one year. B shares carry no voting rights and are not necessarily issued in proportion to transaction volumes.

Such shares can be issued through a subsidiary or a foreign division, and the determination of profit, or the determination of dividend, is usually unrelated to the price paid for raw materials. If the B shares are issued by the cooperative enterprise, the price must be in line with the market. This holds, regardless of whether the enterprise is incorporated as a private or a public limited company, and the valuation must be independent of the parent cooperative’s company policies. If not, there is a risk of a conflict of interests between members with B shares and those without, especially when there are substantial differences of proportionality between share ownership and transaction volume.

5.3.12 Many Mixed Forms

The plethora of names used to designate registered equity (i.e. member capital) reflects the fact that there are, in practice, many different ways that capital can be made available by members. Just as the cooperatives found their own way of defining “limited liability”, so too have they found different ways of designating this capital. Agreements are made about fixed or floating interest rates, the degree to which the cooperative is at liberty to use the funds, and about redemption conditions. Repayment of registered equity on resignation or withdrawal is sometimes deferred for X years, and the “debt” owed by the cooperative to the member is often subordinated. This means that repayment to members will only be effected after other creditors have been paid. This more or less gives the debt to members the character of registered equity capital. Another variant is that the members buy bonds that are freely negotiable—but sometimes only after a specific waiting period—outside the circle of members. If these bonds are perpetual, this variant can be considered to represent equity capital.

But, taken by and large, the general reserves (the dead hand) and any shares issued form the only true equity capital in the cooperative. While it is true that these are assets that never need to be redeemed, in principle, there is always the chance that members will demand a rather too favourable transaction price for a number of years and that this will deplete the reserves of the cooperative. So even in the case of general reserves, it is still unclear to what extent this is truly “equity capital”. All these mixed forms lead to a multifaceted mixture of assets, which sometimes leads to subtle differences on the fiscal front.

5.3.13 Doing the Splits of Finance

As we have pointed out, equity capital is necessary as a basis on which to borrow other capital and also for the funding of risk-bearing investments. Over the years the requirements that cooperatives have to fulfil to receive assistance from banks have become similar to those that private individuals are subject to. It must be mentioned, however, that cooperative banks were not usually insensitive to the "semi equity-capital components" described above. In practice, cooperatives adopted various rules of thumb, such as 25% in the dead hand, 25% registered equity and 50% borrowed capital, and rules to maintain the value of their equity capital. This was done either on the basis of value (the growth of the dead hand reserves to keep pace with inflation) or on the basis of prosperity (to keep pace with wage increases).

Today, however, the hot issue is usually the fact that market conditions change drastically. Competition continues to increase, primarily due to liberalization and internationalization/globalization. However large the cooperative is, there always seems to be even greater competition. And however efficient the cooperative might be, there are always areas—oftentimes vast areas—where it is cheaper to produce, because the production factors of labour and land are cheaper. It therefore becomes a question of distinctiveness besides price. Research, product development, brand policies, patents, advertising and clever marketing strategies are becoming more important. All of these factors are also more capital-intensive and more risky than reducing costs. When the traditional cooperative invests in cost-reduction, it could start earning back those investments within days, at least in principle. But when it comes to creating a market profile, or product development, the cost has to be paid long before any benefit can be reaped. These are long-term investments that literally embody more risk. These investments include running the risk of developing a new consumer product that has little chance of ever making it to the supermarket shelves.

All these problems have meant that processing and market cooperatives, in particular, have found themselves doing the splits as far as finance is concerned. With one leg, their need for risk-bearing equity capital is growing. They need capital to fund high-risk, long-term investments in research and innovation, for example. But their other leg is pointing in another direction, as members have become more critical when it comes to approving investments for types of activities that are far removed from the members' core businesses. That makes it more difficult for members to gauge either the usefulness or the risks involved. This problem is compounded because management doesn't want to openly discuss every strategic investment with the members. More important still, the expected benefit will only be derived at some time in the distant future. Investments of this sort are thus hampered not only by the portfolio problem but also by the horizon problem. Members will have little incentive to support investments when they themselves will not derive the resulting benefit.

One solution for the latter problem can be found in certain types of registered equity that are linked not only to discharge but also to a disbursement of profits (see also Sect. 7.2). But, as we have already seen, the problem with registered equity capital is that the cooperative cannot really consider it to be risk-bearing capital.

This is not to say that cooperatives find themselves facing financial problems because their members have no wish to invest. A quick scan carried out among the 26 largest European cooperatives showed that the unregistered equity capital of these cooperatives had risen by 70% in the period from 1993 to 2003 (from 1.7 to 2.9 billion euros), while the registered equity had risen by only 30% in that same period. This accounted for an overall reduction of the share of registered equity in the total equity capital from 16 to 13%. During that period, the unregistered equity capital per member rose from 8883 to 21,864 euros. The growth of equity capital kept pace with the growth of borrowed capital (70%) as well. Here, too, there was an overall reduction in the share of registered equity (on designated member accounts and member debt accounts) from 21 to 10%. In comparison, the balance sheet totals increased by 60% during this period, from 6.9 to 11 billion euros.

So members seem to be willing enough to leave extra funds "in the dead hand". There is a rather remarkable inconsistency in the dairy industry, however. The unregistered equity capital in that sector grew by no less than 77% in the period between 1993 and 1998, but by only 3 percentage points in the subsequent five years. Perhaps this was a "correction" to the very heavy growth in the preceding period. Members of dairy cooperatives have always been relatively big investors. The unregistered equity capital in the sector is 40,958 euros (double the average for the Top 26); including registered equity, this averages out at 57,827 euros per member. That comes down to 31% of their turnover, and that is a substantial amount for businesses of this size. For the purposes of comparison, small and medium-sized businesses in the construction sector spend an average of 10–15% of their turnover on marketing and sales activities.

5.4 The Control Relationship

A cooperative is first and foremost a democratic association. In legal terms, it is an association whose object is to provide for the material interest of the member-users. That also applies to the cooperative enterprise, at least as it is accommodated in the legal form of a cooperative. Dutch law, and that of a few other industrialized countries, allows considerable leeway for cooperatives to deviate from these statutory principles in their articles of association and other internal regulations. This can sometimes happen at the expense of the democratic character of the cooperative.

The democratic nature of the cooperative often surprises outsiders. It shouldn't, given the multifaceted relationship that the members have with the cooperative enterprise and the specific objective of the cooperative. It is an enterprise, just like a private or public stock company, in the sense that it combines the factors of labour, knowledge and capital to generate added value. But the members are co-entrepreneurs and the added value is a special one that provides the members with material benefit. This objective, which is usually prescribed by law, is of great importance both for the actual day-to-day management (in the material sense) and for the entire administrative organization (in the formal sense) of the cooperative enterprise. In that regard it is normative: board members, officers, managers and supervisors can be judged on how they perform in the fulfilment of their objectives.

5.4.1 First- and Second-Generation Cooperatives

In principle, the cooperative is a closed corporation. This is not only a result of the legally prescribed objective of the cooperative, as already noted, but also a result of the legally prescribed way in which that objective must be pursued. It must be "of, for and by" the members. In that sense, the cooperative can be compared to a partnership. A group of people join together to operate a common enterprise with a view to joint enjoyment of the economic advantages of that enterprise. The main difference as opposed to a partnership is the scale, and hence the form of association. For that reason, national laws of associations are often applicable to cooperatives. Family businesses are also an example of enterprises that are, in fact, closed corporations. Characteristic of these closed corporations is the intertwining of the various relationships that the members—shareholders, employees or other involved parties—have with the corporation. Most enterprises, larger ones at least, are completely independent in the sense that they do not operate for the benefit of a specific interest group. The legislator therefore considers them to be independent entities. That independence is reflected in their economic activities, and in their freedom in all markets (labor, capital, means of production). The cooperative enterprise, on the other hand, is not free in at least one of those markets. It is the market that we previously described as the primary enterprise, the market that exists between the members and the cooperative enterprise. This explains why the cooperative is sometimes described as a non-independent enterprise.

The non-independence of the enterprise is also underlined when the cooperative is deemed to be an "extension" of the members' own businesses. When farmers started to pool their milk and process it themselves, for example, this was a collective activity that was previously undertaken on the individual farms. We find the term "extension cooperatives" used in the literature for those cooperatives that are only involved in communal purchasing. That is the collection and sale of products on behalf of the members, clearly with a view to creating a countervailing power, and in first-line processing. By first-line processing, we mean the processing that makes a product suitable for sale on a large scale, such as packaging, for example. Bottling of milk is a form of packaging. Even the processing of milk to make milk powder could be considered a kind of first-line processing. After all, powdered milk can be kept longer than liquid milk and it has far less volume. This makes it easier to sell in markets further afield. Exactly the same trend could be seen at the other end of the scale because purchasing cooperatives were quick to start processing their products.

Feed processing cooperatives started mixing the raw materials they had bought to create products that the farmers could feed straight to their cattle. This is also seen as a first-line activity, at least for the first generation cooperatives.

One characteristic of this type of cooperative is the fact that these activities are closely linked to the activities of the members. That, in turn, means that they are reasonably equipped for democratic decision-making.

The examples of the milk powder and mixed feed are illustrative of a transition towards activities that are further removed from the business of farming itself. When the cooperative moves towards vertical integration and tries to draw on the added value achieved in other links of the chain, we are then suddenly confronted with activities that are truly beyond the scope of the members' businesses. These are what are known as second-generation cooperatives. (You might be persuaded to think that this is the true meaning of "extension" of the members' businesses, whereas what happens in the first-generation cooperatives is no more than a clustering of activities. But we shall adhere to the terminology currently being used.)

The transition is gradual. Even the earliest dairy cooperatives made cheese, something that had previously been carried out on individual farms. Later they added custard, for instance, which at the time was simply a way to sell more milk. The essence of the second-generation cooperative is that the cooperative enterprise starts making strategic plans for the next link in the supply chain. As a result, the cooperative becomes more detached from the members and, to a certain degree, more independent. This development has far-reaching consequences for relationships with members.

The first change we see in the transaction relationship is the character of the internal market (the primary enterprise). The members' product forms the basis of "extension cooperatives". Selling that product at the best possible price is the cooperative enterprise's challenge. There is a degree of two-way traffic. We have already mentioned that cooperative enterprises sometimes had to persuade members to introduce quality and efficiency improvements, the latter through the principle of "he who causes cost, pays the cost". This is effectively the cooperative enterprise steering the members' businesses to give their product a better chance in the market.

But when the cooperative enterprise penetrates further into the column, its efforts to revalue the product take on a different character. It becomes essential to follow a marketing strategy. The cooperative enterprise examines the requirements of the market and the consumer, and then invests in and markets products, which might first be further processed, and services. The focus of such a strategy is no longer the price, but the added value. It is a subtle harmony of investing in market research, innovation, advertising, qualities and quantities. Demand, not supply, is at the heart of this approach. For the cooperative enterprise, it means that that demand has to be fed back to the members. Certain products or qualities are in greater or lesser demand, and the members need to align their production accordingly. The cooperative enterprise will thus take a more independent stance in the primary market: "with its back to the farmer and its face to the market", as explained, for instance, in Van Dijk (1989). This process sometimes leads to a choice for a standardized product specification with which all the members' businesses must comply. In other cases, it can lead to the cooperative enterprise acting as a marketing organization for a number of larger or smaller chains in which different groups of members are involved. The most difficult point, however, is often that of quantities. Economies of scale are only one of the factors that need to be taken into account in a demand-driven strategy. Surplus supply is undesirable. At some stage it will become necessary to regulate the total quantity of available product or to restrict access to sub-chains in some way. It can be onerous for the functioning of the internal market and for democratic decision-making, if only because restrictions on production only serve to highlight potential competition between the members. One member will benefit from another member's lower production.

The nature of the financial relationship in a second-generation cooperative also changes. Members are assumed to be willing to invest in activities that are further removed from their actual businesses and that involves greater risks than the activities of the extension cooperative, which are based primarily on reducing the cost price. But as business activities evolve, it is difficult to find a direct link with the members' product in many cases. That can be the case, for example, if the cooperative enterprise engages in mergers so as to provide itself with access to specific domestic or international markets, or if the expertise that is available within the cooperative enterprise is used for other products.

Last but not least, the control relationship is under pressure in the second-generation cooperative. Where transactions are concerned, the cooperative enterprise will want the members to grant it more delegated authority so that it can discipline the members (qualities, quantities), as well as to be able to have more flexibility to make business decisions about matters such as acquisitions. The cooperative enterprise will be more demanding in financial terms as well. When it comes to expertise, members will feel that they are less capable of evaluating the cooperative strategy. For a large part of the membership, the strategy is aimed at a market with which they are not personally familiar. At the same time, it is more important than ever for the member to maintain a vigilant attitude. The risks are indeed greater, and the virtual distance between the cooperative enterprise and the members—and thus between the enterprise's objectives and the members' objectives—can easily become too great. It was not without reason that we described the cooperative enterprise as operating from a different link in the chain. The sounding board and reference point of delegated cooperative managers can all too easily shift from the members to the colleagues and competitors in the next link of the national or international commercial chain. This is not an unreasonable development. That is, after all, the stage on which the cooperative enterprise is a player, and it is from that same stage that new managers and experts will need to be recruited. But a process of this kind requires extra safeguards, that the collective interests of the members, and thus the primary objective of the cooperative itself, do not become subjugated.

Finally, we hasten to point out that speed and flexibility are essential factors in competition and modern business management. It is usually undesirable to publicize tactics in advance. Unfortunately, both these aspects are difficult to reconcile with an open and democratic discussion of, for and by the members.

A state of mutual confidence needs to exist between management, members and board, based on a clear and transparent agreement about the main lines of strategic policy.

5.5 Administrative Bodies

5.5.1 The Members

The cooperative is constituted of, for and by the members. That makes the assembly, or the general membership meeting, the body in which all members have a voice. It is the highest body of the cooperative. The law requires that the one-man-one-vote principle be applied. The situation in practice, however, is usually different. In many diverse cooperatives, in particular, the one-man-one-vote system will sooner or later cause friction. This is mainly the case where some of the members are little more than "hobbyists." These are members who are not really entrepreneurs, but are engaged in some activity whereby the cooperative becomes useful to them. In general, their behaviour will be the same as that of much older members. It will become manifest in a lack of long-term vision, such as the horizon problem we mentioned earlier. Members who are not really entrepreneurs will not look at the future in terms of vested interests, and they will not be interested in investment or improving quality. As the membership ages, a sort of entrepreneurial conservatism can creep in, and that could be disastrous for the future of the cooperative.

For that reason, most cooperatives regulate voting rights according to the member's transactions with the cooperative (the principle of proportionality), while maintaining the statutory basis by giving each member at least one vote. Many also institute an upper limit to a member's voting rights.

Most large cooperatives in Europe make use of the statutory possibility of having what is known as a member council. The membership is then often divided into regional or geographical groups—known as districts, circles, branches or departments—which then appoint one or more members to the member council, thus creating a hierarchal organization. This is a practical solution because otherwise the individual voice would be lost amid the clamour of a thousand or more members' voices (upholding the right to voice an opinion). On the other hand, it remains conceivable that the demands of a significant minority of the membership will not be heard in the highest member council because these members form a minority in each of the divisions or districts. This is an important point to bear in mind in an organization where the members' objectives are the central consideration.

The assembly, or the member council where they exist, has a number of specific governance tasks to perform. In the first place these include the appointment, dismissal and/or suspension of members of the board of directors and/or the board of supervisors. This statutory requirement can be pushed aside, but for the purposes of this chapter we shall consider only the most common organizational structure. In addition, the assembly has the legal authority to dissolve the cooperative, prolong its existence, or decide to merge or split the cooperative. Furthermore, it adopts the Articles of Association, and the amendments to those Articles, and draws up the annual accounts (profit and loss account and balance sheet). It also serves as the body that considers appeals in the case of expelled members, or when a candidate for membership wishes to appeal against the board's rejection of a membership application. Finally, the assembly has what is known as a residual competence. All responsibilities that do not devolve to any other body by law or by the Articles of Association are considered vested in the general meeting.

In practice, the assembly operates and checks matters after the fact. When the annual report is being considered, the policies and actions of the board of directors and the board of supervisors are first evaluated and, if found satisfactory, the boards are granted discharge. On the basis of statutory regulations, the law of associations also allows the assembly to be involved in the formulation of policy. The assembly can have the right, for example, to appraise proposed policies or important decisions in advance. It is quite customary for the Articles of Association to determine that the board of directors must submit strategic plans, investment budgets, long-term plans and social plans to the assembly for initial consent. In that case, there is a double preventive check in some countries, as such important matters normally also require the approval of the board of supervisors.

The practice of retrospective checks is, in fact, based on members' confidence in and the delegation of responsibilities to the board members. If the assembly continuously puts itself in the place of the board of directors, that will continuously give rise to difficulties, not least of which is duplicated work. But this does not alter the fact that the assembly (or member council) has the power to determine the main lines of the cooperative's policies, or the identity of the cooperative. This can be clearly seen in the general meeting's right to draw up articles of association and to appoint and dismiss board members.

5.5.2 The Board of Directors

The board of directors is the central body in the cooperative organization and is found as the governing body in almost all countries. National laws require that a board of directors govern the cooperative, and the cooperative enterprise. This board manages the organization. This means representing the legal entity in legal situations, and also conceiving, initiating and implementing strategy and policies, and taking all the decisions involved in those processes. The board can therefore take initiatives that go much further than simply managing day-to-day affairs. The board's management is based on the objectives of the cooperative. Those objectives are usually formulated in a mission statement that also indicates the preconditions necessary for achieving the objectives. In this context, these managers can be equated to entrepreneurs. The board acts as an entrepreneur.

The members, either through the assembly or through the member council, elect boards of directors. It is also possible for some of the board members—but always less than half—to be appointed in some other way than through the Assembly. Generally speaking, there is a limited degree of co-optation: the board can itself propose candidates for seats on the board and the assembly can—if it chooses—propose other candidates; the latter is certainly not unknown.

The rule is that the board speaks as one: a collegiate board. This means that they take decisions as a body. Once a decision has been taken, all members will defend that decision, irrespective of how each individual voted. The ultimate consequence for any "nay" voter who cannot or will not defend a decision is that he would have to resign. While it is not unknown for members to try to lure board members into expressing an opinion that differs from board policy, in principle this is "not the done thing".

It certainly makes life uncomfortable for board members. Those who had been put forward as a rival candidate by rank-and-file members will find it especially difficult; they feel that they are representing a particular lobby and will not want to let them down. But this is not desirable in a collegiate board. Members are expected to act as part of an independent body, one that is not bound by instructions. It is not always clear, however, whether this also applies in countries where members are appointed as delegates from a district or branch to a central member council. Some cooperatives seek to avoid problems of this nature by including a passage in the Articles of Association directing members of a member council to act independently and without instructions. This gives the meetings at district or branch levels the status of a sounding board where no decisions will be taken.

Accordingly, the management culture within the cooperative is not one of confrontation but of cooperation. It is a true model of democratic consultation. A culture in which the board can itself propose candidates for seats on the board, and in which board members are also assumed to work without interference or instruction from others, is only possible when the board is well balanced and truly has and retains the confidence of the members.

In the context of board affairs, this balance is achieved by investing a great deal of time and energy in involving members in the policies of the cooperative. The strategy pursued by the cooperative must be transparent, unequivocal, and spelled out. "Sudden" events must not be allowed. Decisions must be in line with general expectations. Members must be kept appraised of what is going on, and the members of the board should communicate this themselves so that they have a chance to pick up signals from the responses of the members. On the whole, discussions with the members will not be limited to the annual members' meetings or other assembly meetings, but will be accommodated in more frequent informative evenings at local and district levels.

This method of management can only be sustained if members are really involved in the cooperative's policies and take an active part. If they are not, the managers can easily become "regents" in the sense that they manage without any feedback from their member base. That is another reason for board members to continue to attend district meetings. It is also important for them to remain active in the recruitment and training of young, interested members.

In general terms, then, the cooperative has a statutory board of directors that has the same tasks as the board of a public or private limited company. The only difference is the way the board is composed. In the case of a limited liability company, board members (with the exception of a number of "quality" posts) are elected by the shareholders, or—depending on the regulations governing the company—by a board of supervisors. An exception is when a designated number of board seats are set aside as "quality" posts, or outside directors. In the case of the cooperative and other associations, board members are chosen by and from the members.

Companies where board members are normally known as directors usually have an executive board or committee consisting of full-time managers and key board members. The managers are usually employees of the company. This can also be the case in cooperatives, certainly in larger ones; but being a member of the board of a cooperative is more often an ancillary position. Most board members, after all, have their own businesses to run.

5.5.3 Executive Board or Managing Board

Both investor-owned companies and cooperatives can employ professional managers. They are responsible for the management and the day-to-day running of the enterprise within the parameters of the strategy determined by the board. They have a derivative function. Strictly speaking, the executive board or committee is not part of the cooperative's organizational structure. Its members are officers of the company. As in any other organizational model, it is important that tasks and responsibilities are clearly defined and demarcated. The board of directors manages the cooperative and they can be held to account if they fail in that task. The manager, on the other hand, has a derivative task and cannot be held accountable in the same way. In the event of non-performance, however, the manager can have a personal liability vis-à-vis the cooperative. This also applies to members of boards of directors and supervisors. Against this background it is therefore imperative to have a clear and formal line of demarcation between the responsibilities of the manager and the board.

Most nations' business codes allow generous scope for delegation of responsibilities, but the responsibilities are explicitly only delegated. The person's own responsibility for the specific tasks, either on the board or as a manager, remains intact. Nowadays, it is becoming common for managers to be part of boards of directors in many countries, although this isn't common or even allowed in most North American cooperatives. This is a deviation from the principles set out in the law. Members of the executive board can be appointed by virtue of their specific expertise, and generally speaking—unlike members of the board of directors—they will be fulltime employees. Partly for this reason, the executive board is usually responsible for preparing and documenting the decisions of the board of directors.

We have already mentioned numerous factors that contribute to management having a more central and independent role in the cooperative enterprise. This was undoubtedly the case in the past as well, especially when the bookkeeper or manager had a strong or dominant personality. But it is a more structural phenomenon these days. The gap between the member and the cooperative has become greater. This is partly due to the growth of the cooperative. It also partly results from management becoming the domain of specialists who are able to respond quickly and flexibly, and are capable of handling complicated personnel and marketing policies.

In that context, agency theory is also important in the context of cooperatives. This theory considers the situation that arises when decision-making within an enterprise is left to an appointed manager, the agent. Classic economic thinking assumes the manager, the owner-entrepreneur and the manager-entrepreneur are each other's equal and that they share the goal of achieving maximum profit. If their roles are disentangled, the risk arises that the manager takes decisions in his own interest that may not be in the interest of the owner or the owner-entrepreneur.

The problem can also arise between the board members, who are also members of the cooperative, and the rank-and-file members. This problem can be lessened by ensuring that there is adequate supervision by the members as a whole and by the members on the board. But that supervision itself becomes more difficult when the agent (the manager) has more information at his disposal than the owners. The importance of this issue increases accordingly as the independence of the management increases. Agency theory will be discussed in more detail in Sect. 7.3.

5.5.4 Supervision

In many countries, especially in northwest Europe, cooperative enterprises had and still maintain a supervisory board. Such boards are used by some cooperatives in Canada, but rarely in the United States. It appears that these are another means of democratic checks and balances. Supervision was considered to be in the interest of the members. Usually, the underlying idea was that there should be some way of forestalling impulsive decisions, and that it could do no harm to subject proposed board decisions to a critical review. There is no standard composition for supervisory boards in cooperatives. Sometimes older and more experienced members who are deemed capable of setting aside day-to-day considerations are appointed, and they are expected to keep an eye on the more general affairs within the enterprise. Sometimes the supervisory board is used as a training ground for younger members to prepare another generation for the board of directors.

Not all cooperatives are actually free to determine the composition, tasks and authority of supervisory boards. Since 1989, Dutch enterprises of all types (limited liability companies, cooperatives and mutual insurance companies), whose assets and workforce exceed certain levels, must have a board of supervisors, in the same way as large public or private limited companies. The law also prescribes the way in which supervisors should be appointed and how the board should function. The rules are intended to ensure that supervision is independent and carried out in the interests of all concerned, including the interests of third parties such as vendors. The law does, however, take account of the specific character of the cooperative, in particular the so-called member dominance. This allows the members to have more influence on their cooperative, and the board of supervisors of a cooperative has fewer powers than its counterparts in limited companies. Nonetheless, this regulation has given rise to some highly critical discussions in the past.

Cooperatives retain a closed character by limiting the number of "outsiders" to no more than one-third of the supervisors. That is exactly what the legislature was trying to avoid when the two-tier regulations were introduced. At the moment, the position and the actual function of the boards of supervisors are receiving great attention by groups of investors, other stakeholders, academics and government officials considering questions of the corporate governance of large companies.

5.5.5 Management/Administrative Hierarchy

Typically, the management/administrative hierarchy of cooperative enterprises consists of either two or three bodies: the board of directors (on behalf of the members), the executive board (or the management team) and, where employed, the board of supervisors. In some situations, the board of directors actually runs the enterprise and there is little scope for the executive board. A board of supervisors can, in principle, restrict its supervision to the board of directors. In most cases, however, the board of directors will have delegated the day-to-day running of the cooperative enterprise to an executive board. That produces a three-layered management structure.

5.5.6 Three-Layered Model

In many cases, the executive board of the cooperative enterprise has a high level of independence. It is in charge of day-to-day operations and—in consultation with the board of directors—it draws up the enterprise's strategic plans. The board of directors is mainly concerned with checks and balances. It represents the members' interests and tests the executive board's proposal against the strategic objectives and the interests of the members. In this model, the board of directors is always superior to the executive board. This power is evident in its ability to determine salaries and propose new appointments, and also because its monitoring role is decisive. The board of supervisors is responsible for supervising not only the functioning of the cooperative as a whole, but also the functioning of the cooperative enterprise as a separate entity. This board is expected to consider not only the interests of the members, but also the interests of the employees. As a result, the board of supervisors must supervise both the board of directors and the executive board.

This can, however, be somewhat confusing for the executive board. It may be forced to account for its policies and actions twice, once to the board of directors and then to the board of supervisors. In addition, the board of supervisors is often relatively under-informed. The day-to-day involvement of the board of directors in the affairs of the organization will give that body far more insight into what is going on. Supervisors, especially the external supervisors, have a tendency to fulfil their supervisory role formally and strictly, or they assume that the board of directors protects the cooperative function of the enterprise. If the organization is to avoid one or other of these bodies, feeling it is continually under attack, it is essential that there should be a good level of understanding among and about the three bodies.

In this context, the board of directors must be member-oriented and monitor the enterprise specifically in terms of the interests and objectives of the members. If the board of directors tends to act like a "general" board of supervisors, this will give rise to irritation because of the double supervision, and it will be more difficult for the board of directors to keep the issue of member interests high enough on the agenda of the two other bodies. Instances have occurred where a board of directors has withdrawn completely from an uncomfortable three-cornered relationship and has allowed the executive board to represent the cooperative as a whole vis-à-vis the board of supervisors.

It is an unfortunate fact of life in the three-layered model that although the board of directors is formally responsible for operations, the actual management and the necessary professional expertise is embodied in the executive board. For that reason, many cooperatives have sought ways to reduce the hierarchy to just two levels.

5.5.7 Two-Layered Model

The most common solution is to achieve a legal separation. The entrepreneurial activities are conducted through a public or private limited company, for example, with the cooperative as sole or principal shareholder. The board of directors of the cooperative promotes the interests of the members and, together with some members from outside the cooperative, forms the board of supervisors of the separate company. This establishes two layers, but it still retains the required three lines of representation.

Sometimes the choice is made to devolve some of the powers of the board of directors to the executive board, with the more legally oriented tasks being delegated to the board of supervisors. This model does have its limitations, because of the requirement of keeping management and supervision strictly segregated. One disadvantage is that the members no longer have a voice at the level of the board of directors. The executive board is effectively the managing board of both the cooperative-as-a-business and the cooperative-as-an-association. The promotion of members' interests may well be delegated to a member council, but this body does not have its own chairman because that would effectively create three layers once again. The chairman of the board of supervisors then acts as chairman of the member council. This chairman would have higher recognition within the cooperative, but it is far from optimum in management terms. The "two-to-three" layered model is therefore often called a hybrid or mongrel model.

A third example is the model in which the chairman of the member council is also chairman of the executive board, creating a personal union at the board level. The decisive factor must be whether this person has the professional qualities necessary to lead the enterprise. The board of supervisors monitors, advises, and explicitly checks how the members' interests are being promoted. This model is found in many corporations, especially in Germany, but not yet in any significant number of cooperatives.

Finally, there are also instances where the member council has a special committee to bring issues affecting the members before the executive board or the board of supervisors.

The management of cooperatives is a question of finding a good balance between the interests that are manifest in any enterprise, plus that extra interest that is unique to cooperatives—the interest of the members.

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Chapter 6
When Members Fail—The Case of Rabobank, The Netherlands

Up to now we have discussed the cooperative model and have laid emphasis on the board and the management. In the present chapter, we draw attention to the role of members. Present-day cooperatives were historically built on a foundation of communal *self-reliance*, a concept which F. W. Raiffeisen also stressed. By joining hands, a group of individuals developed countervailing power and opposed the opportunistic business behaviour of major companies. Are such notions still valid in today's world? We believe they are. However, especially in North Western Europe, the cultural and particularly the political conditions have changed considerably.

6.1 Member Performance

A cooperative is an open system. As such, developments within a cooperative—such as Rabobank—reflect broader developments in society. However, it is essential that such broader developments are critically assessed rather than adopted in a neutral or passive manner, for the explicit aim of a cooperative is to serve the interests of its members and/or support their self-reliance. Simply put, a cooperative's *raison d'être* rests on the question of whether and how broader economic (in legalese: 'material') developments may be counteracted in the interests of the cooperative's members. Where there is no need to oppose external developments, a cooperative has no reason to exist, since society and the market economy provide sufficient means to serve its members' interests.

It is our observation that this 'cooperative calling' has been effectively shelved in many cooperatives, particularly in larger organisations.[1] This is due in part to a tendency to reflect and accommodate external changes. As a result of up-scaling developments in the globalizing economy, economic and social trends are often

[1]However, it is worth emphasizing that this is not a problem that *only* affects larger cooperatives.

G. van Dijk et al., *The Cooperative Enterprise*,
Cooperative Management, https://doi.org/10.1007/978-3-030-16279-5_6

considered *faits accomplis* within a cooperative company: “This is the way the world works,” or: “If you can’t beat them, join them”. The interests of other major companies become the main point of reference when strategies and policies are determined, and the interests of members are disregarded. As a result, many cooperatives have effectively become ‘normal’ companies. This development accelerates as cooperative businesses grow in size and the interests of the organisation take on a more important role. Over time the company may grow to be, as it were, a state within the cooperative state: the interests of the company overrule the interests of the cooperative and its members. When the interests of members are reduced to merely financial or economic matters, it is inevitable that the company continues to exist autonomously.

As a result of the same social circumstances, the members of various cooperatives have become ‘normal’ participants in the economic and social order. They take a ‘customer’ attitude towards their cooperative and passively wait to see what they are offered: they expect a money-back guarantee and a customer-first treatment, without active engagement or shouldering of responsibilities. This trend is related to the idea of the welfare state and was first seen half a century ago, with the curtailing of members’ legal accountability. Self-reliance was increasingly seen as an entitlement: “I should be able to fall back on the system”. The idea of a reciprocal commitment was lost.

6.2 The Modern Marketplace

These developments, which affect the management and members, are related to the fact that our economic order is increasingly based on the type of mechanical materialism propagated by Bentham, including the idea that freedom for all equals wealth for all. In this day and age, we hardly dare to question the aspect of materialism, but we do wish to draw attention to the *mechanical* element. Typically, the existence of any story that does not fit neatly into broad analyses of economic developments is simply denied.

This may be illustrated by an example dating from Raiffeisen’s time, when there was unwarranted asymmetry of competitive power in the rural economy. We like to think that such economic imbalances no longer exist. Yet we cannot deny that even today, the efforts of competition authorities notwithstanding, asymmetry between competitors is often accepted and even promoted. We nod approvingly when a multinational with a revenue of billions merges with a similar multinational in order ‘to compete on the global market’. Without objecting, we relinquish a crucial marketplace like the internet to a small number of global players that are almost impervious to monitoring. At the other extreme, we take care to ensure that two local bike repair shops do not engage in unlawful price fixing, without taking account of the fact that the two stores are actually owned by one and the same chain company, because their market power is assessed on a different level.

The financial market has clearly promoted and facilitated this development, as the international economy and financial speculation have taken on a leading role. The language of the real economy (metaphorically: the regional dialect) has been made subservient, supposedly because consumer needs should be met as cost-efficiently as possible. It is our opinion that such developments should be a key topic of debate in cooperative organisations such as Rabobank, which was, after all, founded to counteract economic power relations and allow the members' regional economy a fair competitive chance.

6.3 Counter-Democracy

The consumerist attitude of members may be likened to the idea of 'counter-democracy' as put forward by French historian and political scientist Rosanvallon.[2] This term denotes the idea that modern citizens, voters and members only step forward when they *oppose* certain developments or policies. They do not rally around shared trust, but around shared *dis*trust. Legislative authorities cater to this need by imposing more and more rules, monitoring and checks, which are a form of organised distrust. We fear that both the members and the management of Rabobank have been unduly swayed by this trend. Partly as a result of external developments, more and more monitoring functions have been created. This has not only led to an organised rise in distrust, but also to a neglect of trust: the members, members' council, member circles and communities were no longer acknowledged as the pillars of the organisation. We therefore advocate a revival of cooperative democracy. The input and engagement of members is essential if the bank is to remain true to its cooperative mission.

The democratic functioning of both governments and cooperatives is marked by passive indifference. Feeling unable to understand matters, citizens and members fail to act as monitoring agents or learn about the precise nature of the facts. Instead, they rely on the (supposed) reputation of authority figures, politicians and executives. Managers adapt to this situation and focus on material results: "When all's said and done, it's the bottom-line figures that count" is the unspoken motto in many cooperatives. Yet in the case of unwarranted or unlawful behaviour, direct action is propagated: a scapegoat will be found and someone is made to pay. This is the modern mode of an ancient, quasi-religious phenomenon: the people are appeased by a sacrifice that is to end a crisis and restore the balance in social relationships. This primitive phenomenon has been described as *mimetism* by R. Girard.[3] It is manifested, for instance, in the actual or symbolic expulsion of selected victims, often innocent ones. In the context of imitation, mimetic behaviour is also part of identification with celebrities. This kind of identification is not based on content or argumentation but on an emotional need to imitate others and thereby gain in

[2] P. Rosanvallon, 2006. Le contre-démocratie. La politique á l'âge de la défiance. Points essais, Paris, quoted in: P. Rosanvallon, 2012. Democratie en tegen democratie. Boom | Internationale Spinozalens.

[3] R. Girard, 1986. De zondebok. Kok, Agora Kampen.

reputation. It is a surface phenomenon that may be expressed through imitation of a certain life style or clothing style, but also through parroting the expressions of a leader. As Wassenberg notes in his book *Capitalist Discipline*,[4] this is how groups come to use misunderstood or incantatory expressions that are detached from reality. For instance, when one speaks of innovation, leading sectors, market competition, entrepreneurship and leadership, one is always in the right; how such concepts fit in the broader picture of reality is no longer an issue. For instance, how could the Libor case occur? What world do the instigators of such a scandal inhabit? Such questions were never asked. Instead, the emphasis was on the reputation of the managers and the bank. One executive protects his personal reputation by quitting, while another is dismissed in order to safeguard the bank's reputation. However, the position of the cooperative bank was never brought into question, even though cooperatives are meant to position themselves always within the wider context of which they are a part.

6.4 The Age of Monitoring

As described by Rosanvallon, a counter-democracy is based on a general sense of distrust, which is expressed institutionally by a strong focus on monitoring measures as a response to disillusionment with the democracy. According to Rosanvallon, the problem is that voters have relatively weak ties with elected parties and are unable to force them to keep their promises. Therefore, a counter-force is necessary to induce stability and act as a corrective force. Rosanvallon describes how monitoring authorities have gained in power and scope in recent times, surreptitiously diminishing the influence of the elected representatives of the people. Democracy has become a matter of monitoring. On a side-note, it may be that 'Brussels' also functions as such an external monitoring agency, although Rosanvallon does not make this point.

We distinguish three types of monitoring: vigilance, assessment and appeal. These mechanisms pose a threat to the reputation of those in power. They broaden and facilitate the range of possible interventions open to citizens or members, who may develop disruptive power. Disruptive power is often attractive as it yields concrete and visible results. When you succeed in *blocking* a policy or decision, the outcome of your action is equal to your aim. On the other hand, if you participate in a democratic debate, you usually have to settle for a compromise. In addition, it is more difficult to mobilise a majority vote for positive change than to create a coalition with a negative goal, since the latter does not require agreement on all points. As a result, the sovereignty of the people increasingly takes the form of a right to reject. As Rosanvallon indicates, today's citizens no longer see elections as a means of authorizing politicians to take decisions. Instead, they prefer to act with a power of veto in between elections. In tandem with the current 'legalisation of society', citizens

[4] A. Wassenberg, Capitalist discipline. On the orchestration of corporate games. Palgrave MacMillan, London.

and citizen groups rate the monitoring power of legal procedures more highly than elections. In the same context, modern times have seen an explosion of audits, evaluations and assessments by monitoring institutes, all of which are forms of communal distrust. It is worth noting that there is a wide gap between the society of citizens and the monitoring institutes. The problem of monitoring agencies, Rosanvallon writes, boils down to the age-old question: who monitors the monitoring institutes? Who, as Socrates once put it,[5] is concerned with the proper development of their souls?

The counter-democracy is hampered by a limited global understanding of problems related to the organisation of the communal world. We have left behind the days when a strong governmental power, bound by democratic decision-making, was seen as a force for the good. Trust has been replaced by distrust. Elections as a reflection of the will of the people have been replaced by various institutes and mechanisms intended to express social commonality. Consequently, a modern society is no longer governable in the way that older societies were. It can only be governed from Friday afternoon through Monday morning, when the financial markets take over again.

It is true that there are also positive sides to a counter-democracy in terms of monitoring, disruptive power and the legalisation of society. Managers and politicians are held accountable for their actions, and new opportunities for citizen participation emerge. Yet when there is a lack of organised trust to counteract the sense of distrust, excessive monitoring is the outcome. Excessive monitoring results when the primary process of 'organizing trust' is disrupted. In our opinion, this is a problem that not only affects our society as a whole, but also has an impact on individual cooperatives. Counter-democracy is a fertile soil for populist politics and consumerism, which are paralleled by *free riders* in the context of cooperatives. Members often leave without explanation, speaking not with words but with their decision to exit. Hirschman[6] describes this phenomenon as exit without voice: instead of engaging in a debate, members simply turn their backs on a cooperative.

Political consumerism is a general trend which means that citizens, or groups of citizens, isolate themselves in a shared identity, which may be national, religious or racial in nature. As a result, the political process focuses on fulfilling the needs of separate groups rather than on serving the common interest. Citizens focus on their own interests or the interests of their group while higher-level common interests stay out of sight. Groups are cemented by their shared condemnation of social scapegoats and take on an attitude of indifferent acceptance towards most other issues.

We believe that this development has a strong impact on the democratic aspect of cooperatives. Cooperatives may also be affected by consumerism, when members are no longer actively and positively engaged in their cooperative organisation. They lose their sense of ownership and respond to problems by feeling deceived and calling for retribution. This is typically backed up by a demand for more transparency, which has almost become an obligation of the system. It is, however, an illusion to think that more transparency will put an end to the proliferation of monitoring functions.

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[5] Wikipedia.

[6] A. O. Hirschman, 1970. *Exit, voice and loyalty*. Responses to decline in firms, organizations and states. Harvard U.P. Cambridge Mass.

6.5 Individualisation

Over the past decades, discussions about cooperatives have often centred on the increasing individualism among members. In this context, former Rabobank CEOs discussed the ‘completed emancipation’ of members; others highlight a tendency to conceive membership in business terms. Put bluntly: the modern customer-member is mainly interested in serving his own interests. Such analyses end by stressing that this development threatens a concept essential to the functioning of a cooperative: solidarity. Solidarity, subsequently, derives its meaning from diversity and voluntariness to participate in the voice mechanisms.

However, we believe it is a mistake to argue that individualisation deals a fatal blow to cooperative business and democratic government. Our cooperatives, many of them operating in the rural sector, are an excellent example to illustrate this. Historically, farmers have often been of a self-willed cast of mind; accordingly, their cooperatives are not so much built on a notion of solidarity, as they are based on the simple fact that you stand stronger together: unity is power. In other words, such cooperatives are a manifestation of ‘enlightened self-interest’. Individualism is not the most important threat to cooperatives. This is underscored by the recent emergence of various new cooperatives, many of them initiated by self-employed professionals, who typically choose to carry out their professional activities in their individual manner of choice. Such professionals cooperate to remain active as independent entrepreneurs. This is in fact, as Bulgakov once wrote,[7] the essence of human economic activity.

For the sake of honesty, we should note that in newly emerging cooperatives it is often easy to maintain a visible and tangible relation between the common good and self-interests. New cooperatives are often founded by like-minded individuals: professionals who meet shared goals and find themselves in similar phases of their careers. With the passing of time, it is inevitable that their separate ambitions will begin to diverge. Up-scaling may also lead to an impoverishment of individual members’ commitment to the cooperative. In this context, the Rabobank organisation has made a daring and unusual move by maintaining a type of cooperative at the management level: a cooperative consisting of regional cooperatives where the members have to work together and, to a certain extent, know one another.

History has shown that a cooperative is never ‘finished’. Due to the democratic basis of a cooperative, there is a continuing process of change and adaptation with respect to typical cooperative issues, such as member heterogeneity, the horizon problem and the portfolio problem. Although some cooperatives have operated on the basis of the same set of principles for as long as a century, even in such cases

[7]“The economy, sufficiently broadly understood, is no sub-jugular work of a cattle but a creative activity of rational creatures who by the nature of the things materialize in it their individual beginnings, while individuality is characterized by liberty; even more than this—it must be mentioned that it is liberty; and if liberty is a creativity then individuality is the true creative principle in us, which cannot be extinguished and eliminated even in the economy.” S. Bulgakov, Philosophy of Economy: A Speech on Doctoral Thesis. 1912. Cited in K. Stanchev, Sergey Bulgakov and the Spirit of Capitalism, *Journal of Markets & Morality*, 11.1 (Spring 2008), 149–156. http://www.marketsandmorality.com/index.php/mandm/article/viewFile/764/pdf.

governance has been revised at least once, due to changes in the democratic context. It is worth considering whether such changes have indeed made cooperatives more fit to deal with changing times. In most cases, we would argue that they have achieved this aim. However, it is another question whether, in this process of change, cooperatives have also remained loyal to their original mission. We believe that, in many cases, they have not done so.

There are two more reasons to question the incompatibility of modern individualism with the cooperative business model. A cooperative may be defined as an extension of individuals or companies, who are not required to give up their independence. Is it not a fact of history that many cooperatives have been founded in those markets—for instance dairy farming—where members are considered 'ultimate' capitalists? Moreover, it is generally true that people by no means wish to change everything. They also wish to keep things intact, draw a circle around them and make them last.[8]

6.6 Member Certificates: An Example

The Rabobank member certificates were replaced by Rabobank Certificates, which are subordinated bonds that may be traded on the stock market. Though these are not the first securities to be admitted to trading, they have made Rabobank the subject of analyses in the financial press, much as if it concerns a 'normal' listed company. It is worth noting that many of the members and certificate holders acted in a similar fashion. They were concerned about whether Rabobank would be able to secure the stock market price of the certificates; when they found that many were offering their certificates up for sale, this quickly led to a surge of certificates on offer. Interestingly, this was not the result of insecurity regarding the bank's ability to keep its promises, for if this were the case, the inflow of savings would also be jeopardised.

We are convinced that the rise in member certificates on offer was not the result of a lack of trust in the bank, but due to the official announcement that these were high-risk products, being subordinated bonds. In the Netherlands, banks are obliged by the financial monitoring authorities to make such an announcement. This obligation fits in with the context of 'organised distrust' as described above. Clearly, the description of these certificates as 'high-risk products' came as a surprise to members, many of whom thought their 'product' was a type of savings with an attractive rate of return. Apparently they had not studied the nature of the product at the time of their purchase. It was not regarded as a necessity at the time, as they all had trust in 'their 'bank.

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[8]G. van Dijk, L. Klep, 2005. Als 'de markt' faalt. Sdu, Den Haag.

6.7 Banking and Knowledge

An essential aspect of banking is risk management, which presupposes the existence of knowledge and the ability to engage in knowledge management, a neglected aspect of our economy. Modern means of communication have certainly not solved the information and knowledge problem as described by Hayek[9]: the knowledge required to make efficient economic decisions is never a complete whole and often contains internal contradictions or opposing goals. Fragmented and individualised perspectives—possibly communicated through email, Twitter, or occasional 'public consultations'—hardly contribute to solving this problem. By definition, decision-making in relation to heterogeneity, the horizon problem and the portfolio problem requires a careful assessment of the importance of different information and aims. We would argue that effective management of the economic knowledge problem is the core task of cooperative companies, particularly banks.

In the first phase of a cooperative bank, members have to deal with a hostile financial market, which is difficult to access and where many market players behave in an opportune fashion. The first gain of a cooperative bank will be that members are no longer pitted against one another. Yet this stage does not last very long: the market, consisting of all competitors, will soon adapt to the new situation and reach out to members with competing offers. The members will reap profits only when the cooperative has reached its aim of becoming the market (and price) leader. This requires competitive power, which is the product of the processes of trial and error. The added value of the cooperative lies in the continuous examination of knowledge, experience and interpretations. With efficient management, this will lead to a superior type of knowledge-sharing and development, which evolves in an environment where others are also trying to manage and understand their own circumstances.[10]

A cooperative bank which decides on a knowledge-intensive strategy of banking does not distinguish itself from other banks using a similar strategy. Neither can a cooperative bank distinguish itself, we feel, by developing as a social organisation offering banking services for its members.[11] It only takes a minor verbal change—members > customers—to apply this definition to normal banks. We must seek the crucial difference elsewhere. The key differentiating feature of a cooperative bank lies in the fact that members bring external knowledge into the organisation. This takes place in the so-called third tier of cooperative governance, namely the examination process.[12]

Economic theory about cooperatives has often focused on the economic optimisation of the aims of members and the organisation, while the democratic foundation and working methods have been neglected. The lack of member engagement in large and established cooperatives seems to be partly due to a democratic deficit, and

[9]F. A. Hayek, 1949. *Individualism and economic order*. London, Routledge & Kegan Paul.

[10]Zie G. van Dijk, 2012. Microfinanciering in ontwikkelingslanden. Inaugurele rede, Nyenrode Business Universiteit, Breukelen.

[11]Commentary Financieel Dagblad, 25 March, 2014.

[12]On the third tier, see also Sect. 8.8.

Rabobank is no exception to this rule. Though legally everything is perfectly fine, there is a psychological distance between the high ideals of the Rabobank Group and the day-to-day reality of its members. In effect, even the management is unable to change this, since there is no general interest or common will of 'the members'.

What is the best way to manage such conflicts of interests? In light of the previous discussion about counter-democracy, organised distrust cannot be the answer. Similarly, a reliance on the reputation of executives and monitoring authorities is no more than a temporary foil that will not divert the general trend towards organised distrust. The only viable option is to raise awareness and acknowledge the diversity of perspectives and aims. This type of awareness will be the product of knowledge sharing, reciprocity and co-creation between members, and between members and the cooperative organisation. The focus should be on a serious consideration of the third tier of cooperative governance (apart from management and monitoring): examination.

We discuss the crucial role of the 'third tier' in Chap. 8, Sect. 8.8.

6.8 Conclusions

Despite its democratic foundation, the cooperative bank has been swayed by broader developments towards counter-democracy. As a result of changes in society, there has emerged an unchecked tendency towards organised distrust, layers of monitoring and reputation-based rather than content-based judgements. Legal organisation was prioritised, while the members no longer provided content input. Consequently, while legal procedures were perfected, the content aspect suffered from neglect and was stripped down. To paraphrase E. Krijnsen in a recent interview: soon we will be reformed, commercialised and organised according to the requirements of the law—yet will we also remain relevant to our own members?[13]

This essay is not intended as an indictment of the bank as an organisation or business; rather, it aims to draw attention to the consumerism of its members. In particular, those individuals and organs that are responsible for effective member influence have surreptitiously joined the broad path of organised distrust. Meanwhile, the straight and narrow path towards disciplined trust and cooperative organisation has been abandoned. Yet this path, though narrow, is the only way forward: it consists of restoring the examining function of members and reviving reciprocity as the foundation of disciplined trust.

Reference

Van Dijk, G., Klep, G., & Egerstrom, L. (2005). *When market fails: An introduction to cooperation* (p. 12). Nationale CooperatieveRaad: Breukelen.

[13]Interview with E. Krijnsen (PWC) in *Het Financieele Dagblad* (Dutch business daily).

Part II
Business Principles in Theory

Chapter 7
Cooperatives in Economic Literature—*Capita Selecta*

There is no universally recognized economic theory of cooperation. Ladd (1982) is of the opinion that it would be impossible to formulate a general, all-around cooperative theory. He states that the variety of cooperative objectives, environments and problems is so great that it is not feasible to develop a general theory. And even if it could be done, it would be unwieldy. So, according to Ladd, we'll have to manage with various specific theories. Even then, we would soon learn that they are too complex.

The variety that Ladd recognized is indeed great. Some researchers point out that there are basic differences in the socio-ideological principles of cooperation, and that the cooperative business concept has developed almost chameleonic properties (Diepenbeek 1990). The actual organizational form is strongly influenced by the market structures in which cooperative enterprises and member businesses operate, according to the specific dual objective they are pursuing at the moment.

The result is that nearly every general statement and thus every theory about cooperation, can be put into perspective with practical examples. Even practical cooperative principles such as the principle of proportionality and the original principle of "at cost" are no longer universally applicable. Such cooperative principles have become weakened or have disappeared from many of the so-called consumer cooperatives. But this does not diminish the need for a theoretical framework, even if it is only a means to explain existing varieties of cooperatives. A theoretically independent concept is important as a guideline for research and for forming hypotheses that can then be tested by means of empirical research.

Looking at existing literature, however, we note that there are few if any studies that consider the cooperative in the light of organization theory. There have been more studies in recent years from the point of view of organization and management, but these are almost entirely limited to the efficiency and the effectiveness of the cooperative as an organization or as a link in the organizational chain. The core of the cooperative, the dual objective or other normative approaches, are ignored completely.

G. van Dijk et al., *The Cooperative Enterprise*,
Cooperative Management, https://doi.org/10.1007/978-3-030-16279-5_7

In this part of the book, we review a number of the main issues highlighted in the cooperative literature. Where possible, we will take into account what we have already discussed. But some overlap is inevitable.

7.1 The Tragedy of the Commons

In his book "*The Logic of Collective Action*", Olson (1965) describes the situation in a football stadium where everyone has to stand on his or her toes to see the match. Most people would likely find the event even more enjoyable if they could sit, and if everyone did sit down, they might all see the game even better. But no one will sit down if there is no guarantee that everyone else will do the same. The same sort of problem is highlighted in Hardin's famous article "*The Tragedy of the Commons*" (1968). He explains tragedy in the case of communal use. The example he uses is common grazing rights in Africa. It is in each individual's interest to make the best possible use of that right. The user probably realizes that this will ultimately mean that the communal rights will be used up (the grazing land, the fish stocks, the environment), but if he is too modest (in Olson's example: if he sits down), he has no guarantee whatsoever that the others will do the same. The tragedy is that there is nothing you can do about it, even if you are aware of the problem. The communal rights will ultimately be lost, even to you.

What we have here is an "economic rationality" which is decidedly not economically rational for the group concerned nor, ultimately, for the individual. At least, not if that individual is dependent on the collective rights for the long term.

The answer to this dilemma is that users of collective rights have to be disciplined in one way or another. Their freedom has to be restricted. In the literature we can find a great deal of discussion about the question of whether people can impose that discipline on them, or whether some central authority should impose it.

More than 300 years ago, the English philosopher Thomas Hobbes held that the state of nature—which predated governments—was determined by egocentric individuals who competed in such a way that the condition of man could be characterized as "solitary, poor, nasty, brutish and short". Man is a wolf to his fellow man (*homo homini lupus est*) and the state of nature is consequently a war fought by all against all (*bellum omnium contra omnes*). Cooperation between people, what Hobbes termed a commonwealth of members, cannot exist without some central guiding agency (Hobbes 1651, 1962 edition, quoted by Axelrod 1984).

Olson, too, concluded that people—members of groups—had the tendency to behave like free riders. He considered it necessary for a central authority to guide people towards cooperation. At the same time, Olson himself admitted that central authority was not the only possible solution. He indicates that free-rider behaviour will be relatively less prevalent in small groups as it is easier in such circumstances to reward desired behaviour.

The Nobel prize winner Elinor Ostrom in her well-known book "Governing the Commons" (1990) exploited a series of reasoned presumptions about how it is possible that some individuals organize themselves to manage and govern common-pool resources, while for some others it is not (the problem of natural resource depletion). Her main aim was to comprehend which attributes can enrich or weaken the capabilities of individuals to form collective action related to providing local public goods. There is no reason, Ostrom once said, to believe that bureaucrats and politicians, no matter how well meaning, are better at solving problems than the people at the spot, who have the strongest incentive to get the solution right. According to Ostrom there are eight design principles for managing a Commons:

1. Clearly defined group boundaries.
2. Congruence between appropriation and provision rules, local needs and conditions.
3. Collective choice arrangements: Ensure that those affected by the rules can participate in modifying the rules.
4. Minimum recognition of rights: Ensure that the rule-making rights of community members are respected by outside authorities.
5. Create a system, carried out by community members, for monitoring members' behaviour.
6. Develop graduated sanctions for rule violators.
7. Conflict resolution mechanisms: Offer accessible, low-cost means for dispute resolution.
8. Nested enterprises: Build responsibility for governing the common resource in nested tiers from the lowest level up to the entire interconnected system. It is not so much a question of who is in control, but of how the process of control is structured.

Ostrom showed that common resources can be successfully managed without government regulation or privatization. Individuals can achieve results that are better than rational. This can be realized on the basis of conditions in which reciprocity, reputation and trust are internalized. These factors can help to overcome the temptation to pursue self-interest and short run goals. We argue in Sect. 8.8.7 that gaming can speed up this process, as without this technique it would take too long before the results come into effect. According to her experience, the success or failure of such collective actions depends heavily on coping properly with free-riding, solving commitment problems, arranging for the supply of new institutions and monitoring individual compliance with sets of rules.

Adam Smith, the founder of economic liberalism, had little confidence in any central authority regulating economic life. He advocated the right of the individual to compete. That—individually or collectively—would result in the most prosperity. In Smith's eyes, man is "*homo economicus*", focused only on his own interests. Even before his *Wealth of Nations* was published (1776a, b), he had published the *Theory of Moral Sentiments* (1759) in which he portrayed man as needing to be genuinely appreciated by his fellows. He assumes the existence of basic virtues such as empathy and the capacity to understand the needs of others, and even the capacity to take pleasure in the pleasure of others. In other words, he assumes the existence of some basic virtues in society. This is the basis of social loyalty which is also necessary if a barter-based economy is to function. Fukuyama was to highlight this aspect once more in his 1995 book entitled *Trust*, which bears as its subtitle "the social virtues and the creation of prosperity" (Fukuyama 1995).

On studying the then emerging American democracy, around 1830, the French historian and political thinker Alexis de Tocqueville asked himself whether people would be able to cope with the freedoms that democracy offers. Or rather the other way round: democracy could threaten these freedoms and degenerate into nameless despotism, "*une égale tyrannie pour tous*". He considered that the risk became greater when individualization tended towards anonymity. In that case, people became more susceptible to mass media and charismatic leaders. At the same time, De Tocqueville observed that democracy reminds people that there are shared interests, and that they are less "separate" from their fellow citizens than they thought. That encourages people to enter into alliances which not only enable them to realize communal goals but also render them better able to resist possible state coercion or state-ideological manipulation. It is through mutual cooperation that people develop their moral and intellectual capacities (De Tocqueville 1969). Civil society thus forms the basis for a free democracy.

De Tocqueville is balancing between hope and fear: democracy can work, but it also needs to lead to social alliances. That alone is not enough to persuade people to work together, without duress, when a prisoner's dilemma arises as described in "The Tragedy of the Commons": if you take a negative attitude you may well lose out, but if you take a positive attitude (cooperative) you could just as easily lose out. You remain dependent on the behavior of others.

Behavioral economics theory explains adequately the significance of reciprocity (tit for tat: an eye for an eye, a tooth for a tooth) for the survival of collective action norms. It seems to regulate human bahavior as people want to ensure mutual and continuous benefits joining in a team (Chen et al. 2010; Gächter and Herrmann 2009; Perran et al. 2007; Ekeh 1974; Gouldner 1960; Nahapiet and Ghoshal 1998). Some of these benefits refer to member well-being (e.g. information flow, exchange of experiences, lower transaction costs) and some others to group well-being (economic motives, member commitment, vivid participation etc.). In situations where the level of reciprocal behaviour among members in collective actions is very low, the chance of fruitful cooperation fades away as there are no incentives for cooperation with other members. The consequences denote the cooperative failure (Davies et al. 2004; Eser and Peek 2006a, b; Fowler and Christakis 2010; Vanni 2014; Sergaki et al. 2015). The same meaning appeared in the famous "Edda", a 13th century collection of Norse epic verses: "A man ought to be a friend to his friend and repay gift with gift. People should meet smiles with smiles and lies with treachery".

Douma and Schreuder (2002) have highlighted the differences between behavioural theory and standard microeconomics in relation to the participants' attributes. According to the behavioural theory, employees obtain several miscellaneous inducements including monetary and non-monetary remuneration. Moreover, each participant has all the necessary information regarding potential available scenarios. The firm is a coalition of groups of participants and each group also partakes in other roles and interests outside the firm. The different groups of participants are usually referred to as stakeholders (because each group has a specific "stake" in the firm). Stakeholders are investors (shareholders), employees, customers and suppliers. The behavioural theory declares that "…a firm can survive only if its managers take care of the interests of all stakeholders, not just the shareholders…" (Douma and Schreuder 2002: p. 97). In contrast, the standard microeconomic theory declares that managers should only serve the interests of the shareholders.

In "The Evolution of Cooperation", Axelrod (1984) sets out that cooperation can come about, even in a group of egotists without any central leadership. Axelrod reasons that in a re-run of the prisoner's dilemma game, defection or non-cooperative action would be a wicked strategy. In fact, in an actual tournament, the reciprocity strategy proved to be the most successful strategy time and again. That is to say: work together, do not if the other does not, and work together again as soon as the other proves more cooperative (see also Sect. 1.1.7). Axelrod's optimistic conclusion was that readiness to forgive will be the winning combination.

Axelrod's game theory model included the condition that players would recognize each other, and remember the other players' choices on previous occasions. To put it differently, it is a question of direct mutuality or reciprocity. The condition is soon fulfilled in small groups where the members have regular contact with each other. Participants then have the opportunity to estimate each other's behaviour, motivation and capacities.

Psychology theory uses the term "equity theory"[1] which supports that in interpersonal or social exchange, the perceived value of "inputs" will tend to equal the perceived value of "outcomes" in the subjective sense. According to this theory, the greater the benefits that a member receives from a cooperative, the heavier will be the guilt sanction that will be enforced upon indifferent members (Lin and Yang 2010).

Nowak and Sigmund (1993) declared that—even in a non-policed society, i.e. one without a central authority—cooperation could arise even by indirect reciprocity. Indirect reciprocity refers to the interactions in which X's altruism toward Y is reciprocated but by a third party (not by Y). It is a game of two players only, the donor and the recipient, but it has to be played within a greater group. It is located somewhere between public goods and direct reciprocity (Lin and Yang 2010).

Vaarkamp (2001) later showed by experiments that this was indeed possible, but found that structural cooperation was only possible if there was an atmosphere of confidence which can be incorporated in the simulation model by means of an image or reputation score. In this context Vaarkamp indicates that the concept of confidence could be brought into the domain of rationality, whereas Fukuyama felt that trust cannot be explained in economic terms. Incidentally, Adam Smith himself had an explanation. In his view, Dutch merchants were more reliable than English merchants, and they in turn were more reliable than Scottish merchants. His explanation was that those who conduct larger numbers of transactions have a greater need to maintain their reputation. Hardin felt that in larger groups it would ultimately need to be more

[1] See Adams (1963). Akerlof and Yellen (1990) explain the "social exchange theory" in the field of sociology which is similar to equity theory.

a question of central direction and coercion from some form of social order that would, preferably, come about on the basis of consensus (Hardin 1982).

Taylor (1987) defended the hypothesis that social order was also possible without a central authority. People in the complex reality of everyday life are far less able to know and recognize other peoples' feelings and behaviour than they would be in a small group, but he feels that it should be possible to replace that "direct knowledge" with values shared within the community. These values then need to be affirmed in the direct relationships between the individuals. Etzioni has similar ideas. Harking back to the example of the spectators at Olson's football match, he noted that—in practice—most people remain seated. The reason he suggests is that many people have internalized certain values (Etzioni 1994). Taylor argues against a strongly directive state: if the state intervenes too forcefully, that can undermine the community's shared values and destroy existing forms of altruism.

The theoretical problem is, therefore, the question—as Schofield (1985) puts it—of what an individual must at least know about the objectives and values of someone else before he will and can cooperate with that person. Nobel prize winner Douglass North disagrees. Just like Taylor, he observes that cooperation is certainly not exclusively found in small groups where people have regular contact with each other and consequently know about each other. Just look around you at the globalization of trade and specialization of labour against a background of high tech and IT. That is by no means a small group that is in regular contact with each other. They don't know much about each other. This is more like impersonal, almost anonymous, cooperation, the exact opposite of what game theory says is a precondition for cooperation.

North represents the institutional approach to economics. He expands on Taylor's ideas with the hypothesis that the economy—and its success—is determined primarily by the interchange between the players (people and organizations) and the rules of the game or institutions created by those parties. In that respect he differentiates the formal institutions (statutory rules and prescriptions such as property rights and contracts) and the informal institutions (socio-cultural phenomena such as standards and values, confidence and general learned skills). Such institutions have a major effect on individual behaviour, because they demarcate the package of individual choices (North 1990). According to North, these institutions act as an effective outside force. On the one hand, most developed nations are not in a state of anarchy. On the other hand, history has taught us that a prominent and coercive state is usually detrimental to economic growth. He uses that effectiveness as a stepping stone to the transaction cost theory (see Sect. 7.7.3). Costs are incurred for every contact, and every transaction. Acquiring information about the other party is such a cost, for example; so people look for formal and informal institutions through which they can keep those costs to a minimum. The better those institutions work, the lower the cost of working together, the lower the transaction costs. As soon as the transaction costs rise, parties will look for other institutions. This conceptual process seems to allow North to rationalize the phenomenon of institutions in economic terms, just as Vaarkamp was able to do with confidence. It must be noted, however, that North observes that there is a multitude of evidence that people are led by many other considerations than solely rational and non-cooperative behaviour.

North's view brings up the universal discussion on the question of whether altruism is no more than a form of egotism. Margolis (1984) for example formulates a double-utility model for individuals: S preferences, aimed at serving the self-interest of the individual, and G preferences, aimed at serving group interests. In his view, the correlation between these two utility domains is ultimately the result of self-understood self-interest. Individuals just need a share of group interest (G) in order to survive. His research focused on the circumstances that were needed to occasion a shift between the two types of preferences.

Etzioni (1994) goes one step further. He bases his ideas on Kant's philosophy that people are both sentient and thinking beings who can make moral choices, as a result of which they are able to rise above their pleasures and obligations. This enables people to explicitly reject certain "pleasures" on the grounds of moral objections.

Etzioni assumes multi-utility as the basis for personal action: people, and thus economic actors too, strive for pleasure—and thereby serve self-interest—and at the same time, they try to live in accordance with their moral obligations. People are not, in fact, isolated persons. They live and act in the context of communities; it is in the context of communities that moral obligations are formed. Although pleasure and moral obligation do sometimes work in tandem, often they are incompatible. So it is not rational to want to reduce these two objectives to a single objective. Even Etzioni—who would come to be known as a "communitarian" and as one of the advocates of 'The Third Way' in western politics—struggled with the question of what actually was a good balance among market, state and group or community. State and market are incapable of honouring the both emotionally and affectively crucial "me-thee" relationships, and the reciprocity that defines them: for that, you need the group/community (Etzioni 2000).

Concerning this, Etzioni warns that the influence of group morality can at times become so great that people are no longer able to change their individual behaviour or pursue their own goals. Conversely, community awareness leads to lower transaction costs. Tipping the scales in favour of the neo-classical paradigm can reduce community awareness and consequently raise transaction costs to such an extent that the capacity to sustain a market economy is undermined.

The literature discussed here frequently interfaces with sociological literature about social capital in the civil society. Even before Fukuyama's (1995) book about trust, Putnam had placed civil society firmly on the economic/sociological agenda with a book about the differences in economic success between North and South Italy (Putnam 1993). Putnam seeks an explanation for the success of northern Italy in the fact that for many centuries the region's inhabitants had organized themselves and formed networks with a view to achieving specific goals. This created a culture of mutual confidence and tacit mutual agreement.

Robinson and Lifton (1993) investigated the significance of networks of communities in the decision-making that surrounds collective objectives. In 1986 the grape growers of New York State were considering setting up a joint promotion campaign for New York wines in collaboration with the state government. This campaign would be funded from a collective levy imposed on all producers. A condition for implementation was that at least two-thirds of the growers had to voluntarily agree to the levy. The vote stranded at 55% in favour, and the plan had to be abandoned. A survey of 480 producers indicated that there was a strong correlation between a positive vote and the degree to which growers participated in all sorts of associations and networks. The researchers also found a significant correlation between a positive vote and the degree to which the growers felt they were really part of the sector, even though the sector is highly fragmented.

Several authors declare that the role of trust for a cooperative's well-being is crucial (Veerhes et al. 2015; Nilsson et al. 2012; Nwankwo et al. 2009; Sodano 2006; van Dijk et al. 2005). Trust reduces transaction costs for members as well as the barriers to adopt innovation. The impact relies on the effect of trust on social capital which is strongly connected to members' well-being.

Kahan (2002) also investigated the role of trust and reciprocity in collective actions. He concluded that members are rather emotionally motivated for reciprocal behaviour even if this attitude engenders material disadvantages. This behaviour explains the significance of promoting trust and commitment. Conspicuous rewards and punishments facilitate the presence of free-riders, which weakens members' commitment. Therefore, he concludes that "*manipulating material incentives may not only be an inefficient regulatory strategy for solving collective action problems; it may often be a self-defeating one*".

Cechin et al. (2013) investigated empirically 148 farmer-members of an agricultural cooperative in southern Brazil. Their main target was to investigate the link between member commitment and the organizational mechanisms used to govern the cooperative-member relationship. They found that commitment is positively correlated with "the member's experience on market incentives" as well as with "hierarchy control within the cooperative". The results also denoted the role of democratic rules for the proper government of collective action norms, as "the members who acknowledge community involvement and observe the cooperative as a democracy are more committed to collective action" and therefore multiply the chances for successful progress of the cooperative.

Pigou turned his attention to the macroeconomic meaning of cooperatives. He came to the conclusion that efficiency is an important factor. He deduced that the societal task of cooperatives is to eliminate the disharmony of both a monopoly and "simple competition" (Pigou 1950). Apart from that, Pigou feared that cooperatives could be easy victims for insufficient capitalization and poor management. Alfred Marshall confirms this view. He recognizes the advantages of cooperation—economies of scale on the one hand, and the fulfilment and social benefit of small business on the other—but he is clearly not very taken with farmers. According to his opinion, the boldest, the most energetic *and* the most reliable farmers have long abandoned the rural areas. Those who remain are a reluctant and suspicious folk. And yet, cooperation hinges precisely on that mutual confidence (Marshall 1940).

Abma (1956) examined the factors that determine which farmers will become members of an agricultural Dutch cooperative. The larger, prominent farmers in the Netherlands were usually the founders of cooperatives. These members created agricultural cooperatives which were also originally gentlemen's clubs. Gradually the "farming class" was eroded as the agribusiness advantages overcame any tendency towards social exclusivity. The development of increased institutionalization came from the fact that the farmer-to-farmer contacts became less important, while the farmer-to-cooperative contracts increased and became more impersonal. This important change permitted farmer-members to better control the cooperative affairs and increase active member participation.

Bonus (1986) concluded that the dual character of cooperatives as described by Draheim in 1950, namely that it is both a business and a social group, was still relevant in his day. The members are interested not only in the cooperative well-being but also for their own well-being because the benefits in remaining independent are noteworthy. Otherwise, they would merge their businesses. The element of confidence is another crucial parameter for letting a cooperative manage their interests. The cooperative spirit allows the sharing of knowledge, experiences and problems, transforming them into communal dependencies. And that makes you even more dependent on each other. In order to conduct their transactions with a cooperative, members must recognize some advantages. At the same time, however, they clearly see advantages in remaining independent. Otherwise, they would merge their businesses. Consequently, if independent entrepreneurs are willing to allow some other entity to conduct their transactions, there must be a sense of confidence, both in each other and in the cooperative as a whole. Therefore, the existence of a cooperative spirit is determinative for the duration of this relationship. Vanni (2014) adds that it is complex to measure empirically the benefits that come from the exchanges of members with the cooperative as it is a multidimensional phenomenon relating social, institutional and economic parameters.

Santos and Pacheco (2011) note that the existence of confidence significantly raises the success probability among the members of small groups. The main reason that explains this relation is the fact that decisions taken within small groups with significant confidence level—especially when high risk levels are present—substantially increase the opportunities for coordination and escaping the "tragedy of the commons".

7.2 The Neo-Classical Theory of Cooperatives

Neo-classical theory focuses mainly on how the firm's optimal production choice varies according to the various levels of input and output and it is helpful to understand the aggregate behaviour of an industry. Moreover it studies the consequences of strategic interaction between firms once the assumption of perfect competition has been dropped (Hart 1995). The central question in the neo-classical theory is what decision criteria are relevant to managers. Although the neo-classical theory is no longer the analytical instrument for the study of decision-making in firms (after the emergence of the institutional economic theories), its abstract and mathematical basis retains its explanatory powers.

The theory's underlying principle is that consumers strive for maximum utility while producers strive for maximum profit. A second important aspect is that the theory incorporates marginal analysis. The consumer estimates how much extra utility he will gain from an additional unit of product, and weighs that against the extra costs involved. In his turn, the producer weighs extra income against extra costs.

One important abstraction is that all the conditions for free competition are fulfilled including rational choice, stable preferences and equilibrium structures of interaction (Eggertsson 1990). Additionally, neo-classical economics assumes zero transaction costs and complete information. The manager, therefore, is aiming to minimize costs or maximize profits subject only to the production and input constraints. Since managers have complete information when developing contracts, there are no coordination, monitoring or enforcement costs. Included is the idea that it is known in advance what that extra utility, the extra costs or the extra income will be. We begin with a number of the relationships that the theory assumes to be known.

7.2.1 Average and Marginal Cost Curve

In the first place, there is an average production cost curve as shown in Fig. 7.1. This describes the relation between the total production and the cost per unit of product, as it exists within a business. The average total costs (ATC) are usually represented by a positive or upward parabola (see Fig. 7.1). Average costs are lowest when you produce exactly the quantity of product that the business intended to produce, i.e. the "optimal situation". If you produce less, you are operating sub-optimally and the average costs are higher. If you want to produce more, you will need to make a relatively greater effort (or incur extra costs) to produce those extra units. The extra costs involved to make one extra unit of product can be visualized with the marginal cost (MC) curve. This cuts across the line of the average at its lowest point, understandably because it is only when the costs of the units of extra product are higher than the average costs that the overall average costs will rise. The overall average costs are determined by the average fixed costs (AFC) plus the average variable costs (AVC). Point q* in the figure indicates the point at which further production is no longer worthwhile, i.e.

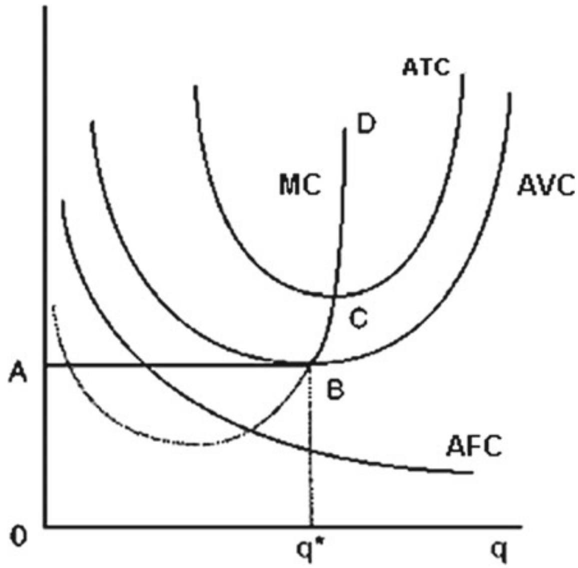


Fig. 7.1 The overall average costs as determined by the average fixed costs (AFC) plus the average variable costs (AVC). *Source* Saccomandi (1998, p. 11). Note, however, that this applies to a given business setup. In other words, it is for the short term. If you alter your business in a structural way, by introducing more efficient equipment for example, or by adopting a more efficient division of labour, or by hiring a genius, you could reduce the overall cost level of the business. Then you would have a different and lower cost curve

where the variable costs exceed the average returns, the price; this is indicated by the line AB.

7.2.2 Price/Costs

Traditionally, such efficiency benefits are gained by increasing production, taking advantage of economies of scale. Figure 7.2 shows this in graph form: if you are able in the long term to grow your business and make the necessary investments in a more efficient business arrangement, your cost curve will descend. Although your average costs may well rise in the short term if you increase production, costs could well decline in the long term. This is illustrated in Fig. 7.2 by the line LTAC. We have already mentioned, more than once, that these economies of scale alone can be a reason for cooperation. If you are a small business and unable, or unwilling, to achieve a larger scale of production, it can certainly be worth considering joining forces with others to achieve the same end: then you can work more cheaply. In that sense, we can see the LTAC as the cost curve of a cooperative with a growing membership.

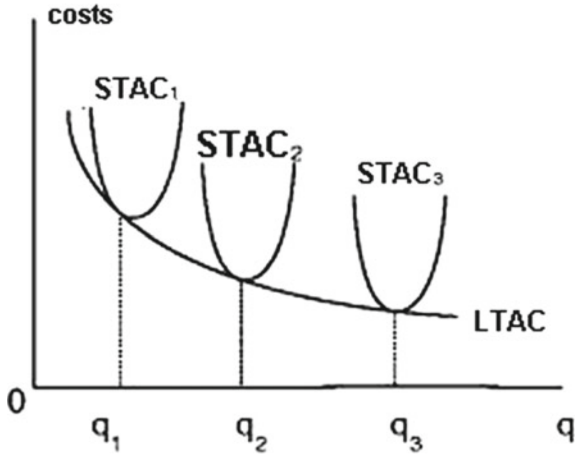


Fig. 7.2 The long-term average cost curve. *Source* Saccomandi (1998, p. 13) supply curve (S)

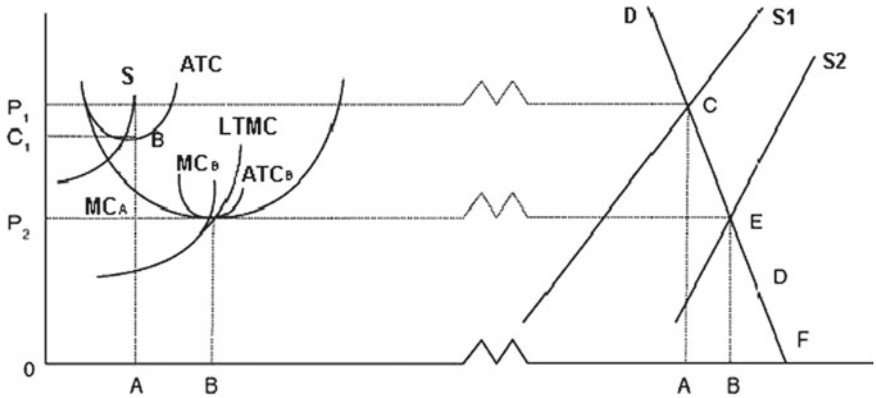


Fig. 7.3 Supply and demand curve derived from the costs. *Source* Saccomandi (1998, p. 38)

7.2.3 Supply Curve (S)

How much do you want your business to produce in the short term? That depends on the price that you can get in the market, *and* on your marginal costs. As long as the marginal costs—the costs for an extra unit—are lower than the market price, you will be earning more. In other words: in the short term, your marginal cost curve will determine how much product you can put on the market. The total supply on the market is determined by the aggregate of the marginal cost curves of the individual businesses. This curve is a rising line: no one can make it for a very low price, but everyone will want to supply it for a very high price (see Fig. 7.3).

7.2.4 Demand Curve (D)

Generally speaking, the demand for a product will be greater if the price is lower. According to the theory, this happens because you receive less and less extra utility from more and more of the same product. The demand curve is therefore a descending line. The price that is ultimately paid is dependent on the quantity available on the market. If supplies are low, the consumer will be prepared to pay more. That means a high price. When prices are high, the producers will produce more. The equilibrium—and thus the pricing—is found where the supply and demand curves in Fig. 7.3 cross each other.

7.2.5 Returns (R)

It is fairly easy for a small player in the market to determine his own production volume. He is confronted with a market price (average return) that is not affected by the volume or quantity he himself produces. He is too small to have any impact. That means that his marginal return is constant: each extra unit returns the same price. And so he expands his production until his marginal costs (his individual supply curve) are just as high as the marginal returns, the market price.

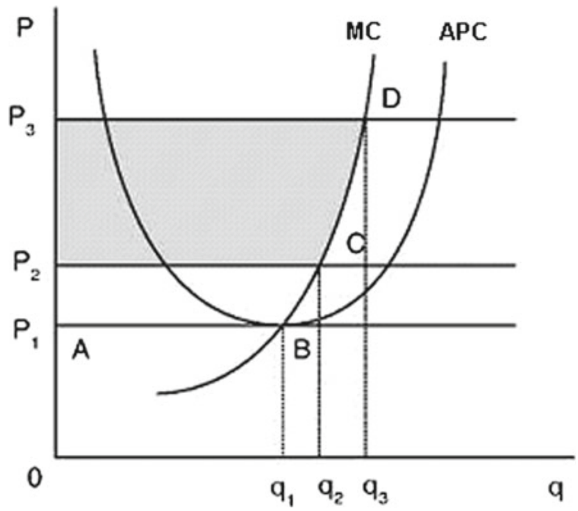
Figure 7.3 illustrates how supply and demand curves are affected by marginal and average total cost. When the market price is P_1, producer A should have a production volume/quantity of q_a. At this production level, his average costs are C_a. The profit per product is therefore $(P_1 - C_a)$ and the total profit is $q_a \times (P_1 - C_a)$. Producer B has a larger, more efficient business. At market price P_1 he can produce a larger quantity, Qb, and his profit per unit of product $(P_1 - Cb)$ is also higher.

If the market price falls below P_2, producer B can still make a profit: $q \times (P_2 - Cb_2)$. At that price, however, fellow-producer A makes a loss, because the price is simply lower than his average cost. A then has 2 options. He can reduce his costs, such as through expansion and/or modernization, or he can cease production. In a free market, their more efficient competitors put the least efficient producers out of business.

At the same time, it is quite conceivable that a loss-making entrepreneur will continue to produce goods for a while because that will enable him to recover some of his fixed costs. The costs of land and buildings (and his own labour) still have to be paid, whether he produces or not. In that case, it would be sensible to produce for as long as the marginal variable costs are lower than the price (Samuelson 1948).

Figure 7.4 demonstrates how vulnerable small suppliers can be in a market with perfect competition. They are completely dependent on the market price (price takers), not only for the price that they receive but also for the quantity that they can produce for that price. If the price falls from P_3 to P_2, this means that producer B_2 will see a serious drop in returns (at P_2 the hatched area, and at P_1 the coloured area).

Fig. 7.4 Costs and returns in perfect competition. *Source* Saccomandi (1998)



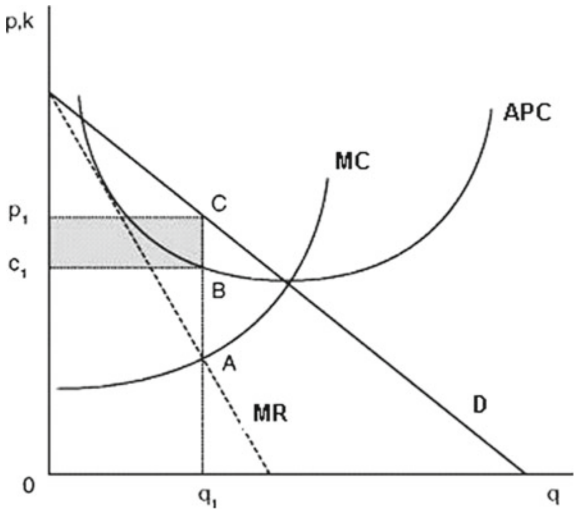
Once again, it should be noted that the example is about small suppliers, where the quantities each can supply have no effect on the market. This means that the disappearance of any other supplier will also have no effect on the market price. If that *were* to be the case, producer B in Fig. 7.3 above would benefit if producer A was to cease production: there would be less supply on the market and the price would rise accordingly, so producer B would benefit in terms of both price and quantity. If it is *not* the case, however, A and B will not consider each other to be competitors and they will be more likely to be willing to cooperate.

The situation changes if there are only a few suppliers in the market. Let us consider what would happen if there were only one supplier in the market, a monopoly situation in which one producer has a unique or exclusive product. This producer is not confronted with a single market price but with a declining demand curve: the more he supplies, the less utility the consumer derives from the last unit. The higher his production, the lower the price or the lower the average return (see Fig. 7.5). The marginal return (MR) will decline even more sharply than the average return. (If, for example, one unit returns 10 and the second 9, the marginal return for that second unit is $(2 \times 9) - 10$, i.e. only 8.)

Even in a monopoly, the optimum situation for the producer is one, whereby the marginal returns equal the marginal costs. The price per unit then equals p_1 and the costs are c_1. Profit is then maximized and equal to the rectangle $q_1 \times (P_1 - c_1) = c_1Bcp_1$.

The above set of instruments allows us to illustrate how a cooperative enterprise should behave. In doing so, we distinguish between purchasing and sales cooperatives (consumer cooperatives) which sell to their members, and processing and marketing cooperatives that buy from their members. We base our illustration on the overviews designed by Royer (2004) and LeVay (1983).

Fig. 7.5 Marginal and average costs as demand declines



The case of supply cooperatives (Fig. 7.6)

1. *Profit maximization for the cooperative enterprise* (Q_1). The foregoing applies to any "ordinary" enterprise. Q_1 is the most profitable level of production. At that point, marginal costs (MC) equal marginal returns (MR). One extra unit of product would cost more than it returns, and one unit less would be a lost profit opportunity. The difference between the average return (P_1) and the attendant average costs (C_1) is the profit per unit. $Q_1 \times (P_1 - C_1)$ is the profit. By analogy, $Q_1 \times (P_1 - C_1)$ should also be the maximum profit for a cooperative enterprise. Per product, the cooperative can then distribute $P_1 - C_1$ as profit to its members. For the cooperative enterprise, profit maximization has a number of evident advantages. Maximum profit allows the cooperatives to pay out more to their members. The total potential disbursable sum is then the greatest. At the same time, the enterprise will find it easier to allocate funds to reserves without having to make an explicit call on the members. On the other hand, it should always be remembered that the cooperative enterprise's primary function is not to generate profit but to serve the interests of its members. In that context, the cooperative enterprise may choose to give other criteria priority (see Royer).
2. *A threshold net price for the members* (Q_3). It is perhaps more logical to consider the lowest payable net price for the members. If we assume that the cooperative enterprise's profit ($P - AC$) is disbursed to the members, the net price that they pay will be the lowest if the cooperative's average costs are also kept to a minimum. After all, their net price is $P - (P - AC) = AC$. And those average costs are at their lowest in the middle of the cost curve, by a production quantity of Q_3. The profit disbursement ($P_3 - C_3$) may then be lower, but the price that the members have to pay (P_3) is also lower.

3. *Maximum profit for cooperative plus members* (Q_4). If the cooperative enterprise increases its turnover past point Q_3, its profit disbursement ($P - AC$) per product will decline, but the members will also pay less. Nonetheless, the net price for the members increases (because the average costs increase). Overall, however, the total aggregate profit also increases because production is higher. That increase remains possible until the cooperative enterprise's marginal costs exceed the price that members (want to) pay. The cut-off point on the demand curve is at point Q_4.
   Enke (1945) calculated that at this precise point, the reduction of members' benefits as a result of lower cooperative profit is actually equal to the increased benefit they enjoy because of the lower price. In other words: the extra loss as a stakeholder is equal to the extra profit as a member-buyer. Royer (1982) also considers this to be the most ideal solution for cooperatives.
   But there is one important problem. Members will be inclined to look at the net price, i.e. at the price less their share of the profits. They will be paying a lower price and will therefore be more inclined to increase production. That is a possibility (see Q_5), but compared to Q_4 it is less than optimal. Q_4 is only in stable equilibrium if the members see the profit disbursement as a dividend, quite separate from the purchases that they make (see also the incentive issue in Sect. 3.3.4).
4. *Maximum turnover* (Q_5). In principle, the turnover can be increased still further, even though that would be at the expense of the aggregate profit for the cooperative enterprise plus the members. Each extra unit would, in fact, cost more than the members pay, or would want to pay. But it is possible, as long as the average costs for the cooperative enterprise remain under the actual price received. The break-even point is Q_5. Beyond this point, the product costs more than members pay, and that represents a loss. The aim for maximum turnover—accompanied by a low price—can be a strategy for building up market power, in the context of a long-term growth strategy for example. It might also be a way to take the wind out of the sails of potential competitors, in the form of a barrier to entry into the cooperative's market. New market players will have additional initial costs (investments, advertising), and they may be put off by the low price of the existing player.[2] It should be noted, though, that this would not be a profitable strategy for the cooperative enterprise. This is precarious, especially since the members are not paying the lowest price either.
5. *Maximum profit per product for the cooperative enterprise* (Q_2). Another extreme is when the cooperative enterprise makes a maximum profit per unit of product. That point lies to the left of Q_1. If you move to the left of Q_1 the average price rises, but the price that members are willing to pay rises even more sharply. That means that the cooperative enterprise's profit per product actually grows in comparison with point Q_1. Q_2 marks the limit: to the left, the cooperative enterprise's profit per product ($P_2 - C_2$) then declines. In that case, the total sum to be disbursed by the cooperative is sometimes less than by Q_1. Taken per product, however, and

[2] Stigler, G. J., 1968, p. 68.

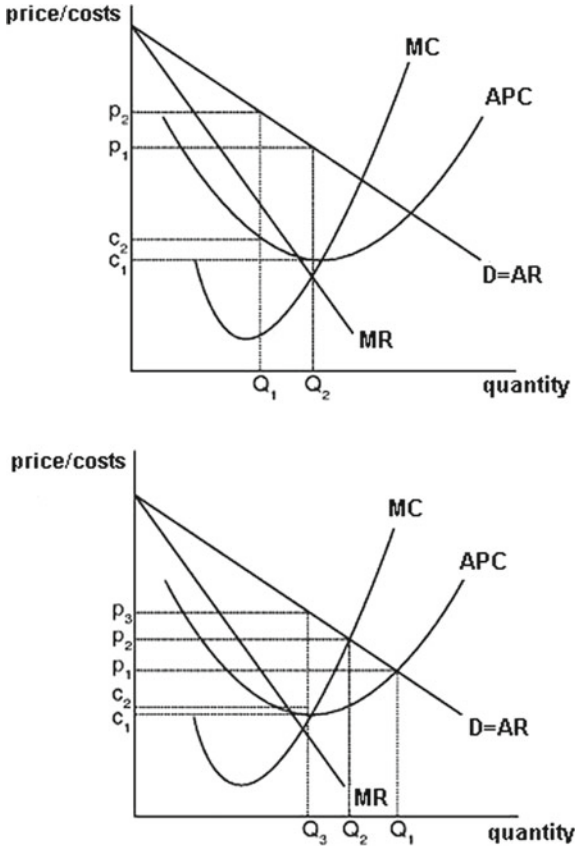


Fig. 7.6 Five strategies for supply (consumer) cooperatives

that is what the members will consider, it is greater than by Q_1. But the members will not be paying the lowest price and production volume will be limited.

7.3 The Case of Marketing Cooperatives

For marketing cooperatives, we shall take the example of a cooperative that buys the raw product produced by its members, processes it and then sells the end product to consumers. The central issue in our analysis is: what is the average net return on the products that the cooperative enterprise sells? That is the price for which the product can be sold in the market (and is dependent on the demand function $V = P = AY$) less the average costs (AC) that the cooperative incurs for processing and marketing the product. In other words: $P - AC$. The average net return actually consists of two components: the price that the members receive for their product from the cooperative enterprise, plus the "profit" made on each product by the cooperative enterprise. Generally speaking, the average net return will be graphically represented as a slanted negative or downward parabola. When production is low and average costs are high, the average return is also low. When production is high, the average costs also increase, while the price that can be obtained becomes lower. The graphs use a slanted demand curve, to illustrate the fact that the marketing cooperative can influence price through the level of supply. If the cooperative also operates in a market with full competition, the demand curve will be horizontal: D = P = MC.[3]

Besides the demand from the market, the cooperative enterprise also has to contend with the question of the price to be set for the delivery of a specific quantity by the members. We have already seen that the answer will depend on the marginal cost curves of the individual members. Their supply curve represents the average price at which they, as members, can deliver a product: the average costs to the members (ACM), and, by analogy, the marginal costs to the members (MCM).

1. *Profit maximization for the cooperative enterprise* (*Q_1*). If the cooperative processing and marketing association pursues a profit maximization strategy, it will opt for a production volume whereby the marginal net return for the product (NMRP = net marginal return product) is equal to the marginal costs (MFC = marginal factor costs) for the cooperative enterprise. This will be at quantity Q_1. The price for the members (ACM = average costs members) is then R_1 and the net return N_1. The amount that can potentially be disbursed is $N_1 - R_1$ per unit and $(N_1 - R_1) \times Q_1$ in total (see Fig. 7.7). The net price for the members is then $R_1 + (N_1 - R_1)$, i.e. N_1. With consumer cooperatives we saw that profit maximization within the cooperative enterprise was not a primary goal for the cooperative. Therefore, we again have four alternatives (Fig. 7.7).
2. *Maximum net price for the members* (*Q_3*). A maximum net price for the members is achieved at the top of the average net return curve at point Q3. The average member costs are then higher (R3) and the potential disbursement (N3 − R3) slightly lower. But this results in the maximum value for the sum (N3 − R3) + R3.
3. *Maximum profit for cooperative enterprise plus members* (*Q_4*). As turnover increases to the right of Q3, the average member costs also increase but both the average net returns and the potential profit disbursement from the cooperative enterprise decrease. As long as the marginal net returns of the cooperative enterprise remain higher than the average member costs, the overall member benefit (cooperative profit plus member profit) will increase. The limit is reached at production volume Q4, at the intersection of the two lines (NMRP and ACM). Disbursable profit is then still (N4 − R4) per unit (Fig. 7.7).
4. *Maximum production volume* (*Q_5*). Production can in principle still be increased beyond Q4, but this will be at the expense of the disbursable profit and member costs will increase at the same time. Disbursable profit falls to zero at point Q5.

[3]A third possibility is an oligopoly (with a kink in the demand curve) whereby competitors will follow a reduction in price but not a rise in price; see Sweezy (1939).

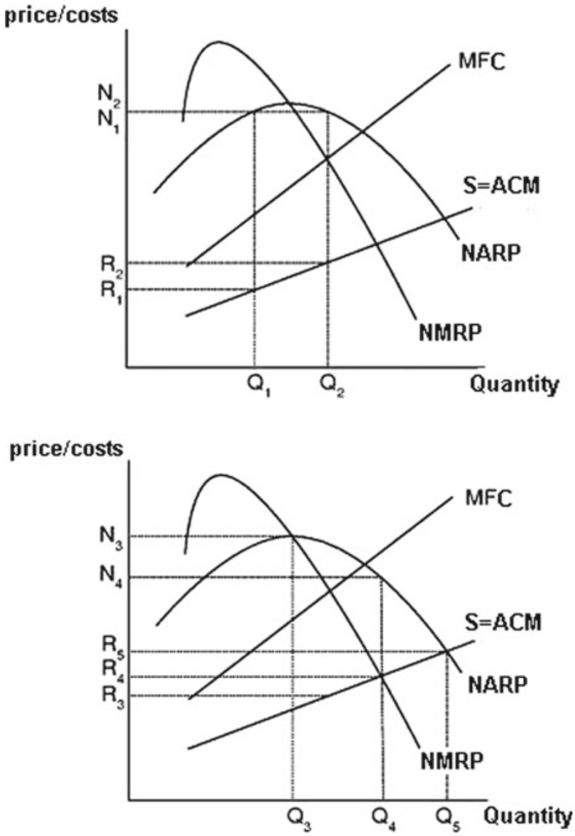


Fig. 7.7 Five strategies for producer (marketing & processing) cooperatives. *Source* Royer (2004)

5. *Maximum potential disbursement* (Q_2). The potential disbursement per product is at its highest when the marginal returns for the cooperative enterprise are equal to the marginal member costs (MMC). The member price is then R2, the potential disbursement N2 − R2.

The incentive problem is also found in marketing cooperatives: members tend to increase production beyond the optimum quantity Q_4. After all, at Q_4 they "perceive" the net price N_4, not the disbursement price R_4. If just one member increases production, the net average return on product (NAYP) will only decrease slightly, so it could be worthwhile for that individual member to produce more. But if all members do so, the production will have increased beyond level Q_5, the point at which the cooperative enterprise no longer makes any profit. It is only at this point that equilibrium is reached, because there is no longer an incentive for members to produce more. This means that if the members include profit disbursement when considering their decisions about production, and if the cooperative has sufficient power in the market to achieve added value, albeit declining, the cooperative will itself be encouraging higher production. As a consequence, the price to the consumer will decrease, and the cooperative enterprise's profit will melt away. This danger is particularly relevant when the cooperative's membership is open. Possible preventive measures include a stop on membership, penalty discounts, persuading members to accept a quota system and/or the introduction of delivery rights. The last option is the basis for many New Generation Cooperatives (NGC) (see Sect. 5.5.2). Another option would be to disconnect the profit pay-out from the quantity or volume of product supplied. That would, however, imply abandoning the principle of proportionality.

LeVay pointed out that while this form of over-production does lead to lower consumer prices, it also reduces overall prosperity in society. This is because there is an over-valuation of, and thus excessive demand for, the raw materials: in this case, the members' products. He therefore advocates limiting output to Q_4 (LeVay 1983). Helmberger was one of the founders of the neo-classical approach to cooperatives. He saw the cooperative as an independent enterprise with objectives that could be measured at the level of the member businesses (Helmberger 1966; Helmberger and Hoos 1962). He suggested that individual entrepreneurs would benefit especially from cooperation when they wished to initiate activities in a neighbouring link in the supply chain. They can, in particular, circumvent forms of monopsonistic exploitation. In a monopsony, with just one buying party, that party can choose the seller with which it will do business while the sellers as a whole have no alternative. The buying party will simply choose the quantity that gives him the most profit. That makes him, the buying party, the price maker, while his suppliers can only accept the situation. They are the price takers, and they have nowhere else to go.

In terms of Fig. 7.7, the buyer determines that he wants quantity Q_1, with the accompanying pay-out of R_1, a level at which the suppliers will no longer make a profit as they are getting no more than their average costs. But if the buyer himself was also subject to full competition, he too would be obliged to adopt a production level at which profit would no longer be possible. In Fig. 7.7 this is production level Q_5, with the accompanying pay-out price of R_5. For the suppliers, the monopsonistic exploitation translates into both lower turnover ($Q_5 - Q_1$) *and* a lower price ($R_5 - R_1$). The market power of the monopsonist depends on his capacity to determine the price for each quantity of product he buys. A less complicated measure is the Lerner index, which defines market power as the margin divided by the realized price. In our example, $(R_1 - R_5)/R_1$ (Saccomandi 1998).

As monopsonistic exploitation becomes stronger, the initial price advantage offered to the members by the cooperative becomes greater. But once the cooperative has made a correction to the market, that advantage will become "invisible" in the sense that the "old" monopsonist(s) will be obliged to pay the same price as the cooperative. At that moment, the members will be inclined to feel that their cooperative is less important and they may be swayed by short-term advantages. LeVay (1983) feels that this is the reason why the literature pays so much attention to member commitment and loyalty (free-rider behaviour, see Sect. 3.3.4).

It is interesting to note that the engaging mathematics of the neo-classical theory fail to provide an answer to the question of what might happen if a cooperative—as a monopolist or monopsonist itself—were to join battle with a monopsonist or monopolist. Both parties would formulate their own preferred method to achieve maximization of profit, but these methods will not necessarily be the same or even similar. That would lead to an impasse that could only be resolved by negotiation.

The reason this would happen is that in such circumstances neither party would be disciplined by true competition. Under these circumstances, the market no longer has a direct effect and the parties have to work it out among themselves (Williamson 1975).

The situation then becomes an issue for institutional economics, for the transaction cost theory in particular. Can you obtain information about the other party? What does it cost? What do the negotiations cost? What does internal management of our own production cost? And, finally, the fundamental question: whether it would be better to make than to buy, or better to process than to sell. Phillips (1953) was the first to describe proportionality in neo-classical terms, although the idea seems to originate with the German Robert Liefmann. According to Phillips, the core issue in cooperatives is not equality but proportionality. Man is equitable but not equal. All aspects must be based on proportionality and only then can the cooperative achieve an optimum. That proportionality must not only apply to costs and returns, but also to the voice of the participants. He sees no grounds for the “one man, one vote” rule. In his “Theory of Proportions”, Phillips (1953) assumes that the cooperative distributes its profit promptly and in full to the members, and that all costs, including overheads, can be proportionally allocated. Roy (1981), who adopts this theory in his textbook, feels that this principle makes the cooperative more attractive to the bigger members. Cotterill (1987) looks upon price formation as the central issue for the cooperative. After all, the financial results of the cooperative cannot be entirely divorced from the price formation. He sees price formation as the determining factor for the structure, the strategy and the internal organization of the cooperative.

The analysis of the influence that cooperatives have on competition in the market is also an aspect of neo-classical theories. The central idea is that by applying the “at cost” principle, cooperatives compel businesses that concentrate on profit maximization to become more price-competitive. The parties that profit most from this situation are not only the members, but also businesses that do business with other businesses (see the free-rider issue in Sect. 3.3.4) and, of course, the consumers. The theory also considers the desirability of a restrictive membership policy in the same light. In this context, Helmberger (1966) pointed out that a restrictive membership policy is undesirable because of the lower output and the ensuing higher prices for consumers. On the other hand, LeVay (1983) posits that there can be over-production without a restrictive membership policy and that, even with a restrictive membership policy, cooperatives still contribute to the amelioration of competition. LeVay points out that the cooperative can also render those resources productive which, without the cooperative, would remain unproductive. The agricultural sector is an example where cooperatives have themselves taken the institutionalization of the sector in hand. It is no exaggeration to state that privately-owned processing facilities have made no contribution whatsoever in this respect. Without cooperatives, external factors such as EU subsidy policies and the labor market policies in other EU member states would have given the Dutch agricultural sector’s competitors a strong advantage. Cooperative enterprises have a vested interest in combating and correcting false competition of this nature. That is because cooperatives are so closely bound to the establishment of their members and the regional function they fulfil. Cooperative enterprises are not free to set themselves up at will, i.e. they are not footloose. But other agribusiness enterprises are: they can easily turn to other suppliers for their raw materials. Banks, too, have traditionally had more empathy for the profitability of large agribusiness enterprises than for the primary sector.

7.4 Institutional Economics

New Institutional Economics extends neoclassical economics by relaxing the restrictive assumptions of neoclassical theory. The basic core of neoclassical economics is preserved, but the supporting assumptions of zero transaction costs and full information are relaxed.

Decisions in uncertainty, and margins for negotiation

Until the 1930s, the role of enterprises was analysed in economic theory in a "purely neo-classical" context, in which all parties acted in an economically rational way and were fully informed. Moreover, by assuming perfect competition, the decision-making process within an enterprise could be reduced to a question of minimizing costs and maximizing profits (Kay 1982). In the 1930s, Robinson (1933) and Chamberlin (1933) were working on a theory of imperfect or monopolistic competition, and their lead was followed by a number of new classes of economic theories, particularly management theories and behavioural theories. The management theories were based on the segregation of ownership and management of the larger corporations. Profit maximization, sales maximization, and maximum growth were no longer the only principles to be considered. It was assumed that because of the segregation between ownership and management, there could also be objectives that were not profit-oriented. Circumstances allowed the management to pursue their own objectives with the enterprise. Although these theories did use the neo-classical approach, that is to say that the important aspects were still the efficient allocation of production factors and the maximization of stated objectives, there was a better understanding of the empirical reality of the enterprise.

The same can be said of behavioural theories. Behavioural theories are also based on the segregation of ownership and management of the enterprise and on the management's own objectives. In addition, though, behavioural theory calls maximization itself into question. In Cyert and March's standard work (1963), they elaborate Simon's theory (1957) that suggests that top decision makers have a limited cognitive capacity: they are rational, but have bounded rationality. In uncertain situations, there can be no assumption of maximization but it must be assumed that the set objectives or aspirations are at least fulfilled. Decision-making in an enterprise is based on subjective rationality. This principle differs fundamentally from the unbounded or objective rationality that forms the basis for neo-classical economic theory. Nonetheless, for the purposes of mathematical formulation, many aspects such as price theory, cost and indifference curves, factor price formation and isoquant analysis are still based on neo-classical principles. This approach lends itself much better for elegant mathematical abstractions.

A number of different models have been developed for the analysis of decision-making in uncertain situations. These include not only the behavioural theories of the firm, developed by Simon (1957) and Cyert and March (1963), but also transaction cost theory (Coase 1937; Williamson 1975), agency theory (Jensen and Meckling 1976) and applications of game theory.

7.5 Transaction Cost Theory of Cooperatives

Transaction cost theory builds on the behavioural theory approach and on the work of Coase (1937), who posed the simple but fundamental question: "Why do businesses and enterprises exist?" According to Coase, it is because there are costs involved in the pricing system that acts as a coordinating mechanism. It is either the price mechanism or the enterprise that directs the allocation of production factors. Coase addresses the circumstances under which one coordination mechanism takes preference over the other. When we switch from the market to the enterprise, we do so because of the costs connected with the use of the market (price) mechanism. Coase gives two examples of such costs. When the enterprise, and not the price mechanism, organizes the cooperation between production factors, a single contract can replace the multitude of contracts that are connected with the price mechanism. Within the framework of a contract of employment, businesses can do away with the need to negotiate a separate contract for each separate activity of the production factors. In the second place, the enterprise can swap a series of short-term contracts for the supply of a product for a command or an entrepreneurial decision. The market can, in principle, conclude a long-term contract, but the difficulty of accurately forecasting demand will make it more expedient to work with a series of short-term contracts. A business uses a different coordinating system than the market. A business fosters cooperation between production factors via long-term contracts and hierarchy. It depends on the nature of transactions whether the transaction costs of the price mechanism are a reason to establish a business. The competing coordination mechanisms are: the market versus the enterprise, with x, y or z types of organizations, or organizational forms between enterprises.

Alchian and Demsetz (1972) added that if two production factors form an integrated team in a production process—perhaps two men who together load a truck—it is not possible to determine the marginal productivity, and hence impossible to determine the correct reward for each. Since there is no quantifiable marginal output from the individual production factors, there is also no clear basis for the reward of the production factors if the market forms the coordination mechanism. In short, there is a problem of measurement in terms of productivity and reward. If the ownership of the production factors is not in a single hand, the individual owners of production factors will tend to profit from the results of other production factors and allow them to determine the price. An individual owner of a production factor enjoys the advantages of teamwork: he is a free rider. If an enterprise forms a team, the enterprise can monitor the behaviour of this team closely so that its contribution can be more accurately determined. This is a basis for reward. In short, according to Alchian and Demsetz, the fact that certain tasks cannot be segregated is an extra reason for the existence of enterprises.

Williamson (1975) elaborated these principles on the basis of six core concepts:

1. bounded rationality;
2. uncertainty and complexity;
3. opportunism, people striving for their own interests (scheming and deceiving, if thought necessary);
4. conditions for opportunism: having a small number of people involved;
5. information impactedness: information is crucial in situations where information is not equally shared among the parties; and
6. mood or atmosphere, because the transaction relationship itself influences the satisfaction or dissatisfaction of the parties involved. One example is the fact that people appreciate being members of a group.

An important factor in explaining why one organizational form or coordination mechanism is preferable above another is the specificity of business resources (asset specificity). Are business assets being used that are specific for a particular transaction? How often do such transactions take place? That means that those business assets would have a much lower value without the transaction for which they were purchased. That leads to dependence on the transaction and on the transaction partner. Such aspects determine the transaction costs and the organizational form. The form of contracts and ownership determine the possibilities of coordinating the production process to keep the transaction costs as low as possible.

Hansmann (1996) elaborated transaction cost theory and drew parallels with the desired forms of ownership. He centres his theory on an enterprise being a nexus of contracts. Those contracts do not provide for all possible situations. The owner is the party who is "in charge" of the business assets in situations for which the contracts do not provide. The owner also holds the results of the enterprise after all contractual obligations have been fulfilled (residual claims). Ownership theory shows how the transactions costs change—increase or decrease—for a specific group of transaction partners as one group or another takes the position of owner. Ownership of an enterprise is also connected to costs, i.e. the administrative and governance costs. Hansmann uses the above theoretical building blocks to explain the existence of cooperatives.

Ménard (2004, 2007) has considered cooperatives in the transaction cost theory as a hybrid form comprised by a mix of autonomy and interdependence with three main aspects: pooling of resources, coordination through contracts and combining competition with cooperation. Numerous researchers have dealt with the benefits of the existence of cooperatives in the market (Veerhes et al. 2015; Ritossa and Bulgacov 2009; Petersen 2004; Seigel and Heffernan 1997).

As an example of countervailing power against the monopolistic position of the supplier, Hansmann cites the electricity cooperatives in the U.S. These electricity cooperatives have monopsonistic market dominance. By taking on the position of owner, the members can avoid two types of costs. The first is that the customer avoids having to pay a monopoly price for electricity. The second is that usage is disrupted by overly high prices, an example of social costs.

A second example is the lock-in situation. This occurs when a partner in a transaction relationship needs to invest in business assets that are specific for that relationship, and the value of the investment cannot be recouped if the transaction relationship is broken. The partner cannot then break the relationship without incurring substantial costs. This situation explains the existence of vertical integration. A group that is in danger of getting into a lock-in situation can avoid the risk by taking an ownership position. This is the only option when the circumstances are so unpredictable that a contract specification offers no guarantee against the lock-in risks.

The third reason occurs when two parties with a long-term contract both individually run uninsurable large risks while such risks do not exist if they work together. By giving the partners ownership, the risks are made manageable. What the partners lose as customers, they gain as owners—and vice versa. Mutual insurance is a good example, one that also removes an important incentive for opportunistic behaviour. Members of a mutual health insurance cooperative for instance realize that it is in their best interest that they collectively reduce damage.

A fourth reason for transaction partners to take on the ownership role is the issue of asymmetric information. This can be the case when the customers have more information than the enterprise, or vice versa. One reason might be when the quality of the product to be supplied is difficult to appraise. The formation of fertilizer and feed cooperatives is a prime example. On the other hand, a processing enterprise could have insight into the selling market and exploit this insight to the disadvantage of the suppliers of the raw materials. The formation of marketing cooperatives is an example. Strategic negotiation as a way of avoiding this risk could be too expensive, as neither party will be inclined to put all their cards on the table. Putting the raw materials suppliers in an ownership position will create a situation in which parties are more inclined to exchange information openly.

A fifth circumstance is in communicating partners' preferences. An example of this is when a bank wants to close a branch office and the customers want to keep it open. If the customers are the owners, they will be more willing to express their true preferences in the choice between high costs and convenience than when there is no relationship of ownership.

A sixth example of preference for cooperative ownership is known as the sense of alienation. The theory is that people gain an important degree of satisfaction from participating in an enterprise with others. They do not enjoy this satisfaction when they simply have a customer relationship with the enterprise.

In terms of transaction cost theory, the existence of cooperatives in the agricultural sector can, for instance, be explained on the basis of the "contract costs" for the marketing of agricultural products. An individual farmer runs the risk that a buyer will behave opportunistically and offer a price that is below cost. This is especially

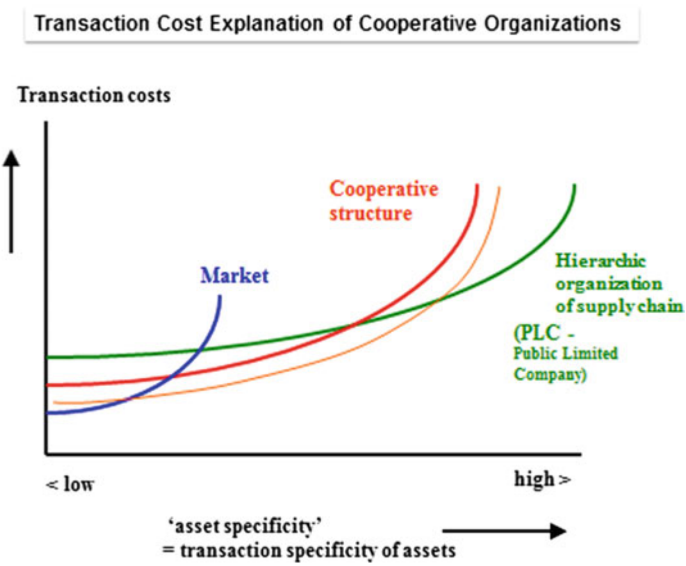


Fig. 7.8 Transaction cost in relation to transaction specificity of assets by cooperative organizations as compared to market institutions and hierarchies

risky if farmers have invested in assets that are specific for that transaction contract. While the buyer can easily approach other suppliers, the producer cannot easily do so, especially when he has a limited amount of time to take his product to the market. The producer is not in a position to explore market opportunities alone.

The agricultural cooperative is a type of hybrid organization that operates in the market. Hybrids are non-standard modes of organization in which the partners pool strategic decision rights as well as some property rights (often substantial), while simultaneously keeping distinct ownership over key assets (they jointly develop new assets without merging together). As depicted in Fig. 7.8, markets are characterized by assets with high transaction specificity. Hybrid organizations (as agricultural cooperatives) are more efficient than (spot) markets. In cases where transaction specificity of assets is extremely high, hierarchical forms of coordinating the supply chain are most efficient (see Fig. 7.8).

Economies of scale in processing agricultural products have led to consolidation and oligopolistic competition. Cooperatives came into being as part of the battle of farmers against these developments, occasionally associated with the formation of cartels. Analysis of cooperative developments in various U.S. markets has led to the conclusion that the cooperative form is an especially appropriate option to cope with monopsonistic situations. In cooperatives farmers could internalize transactions in an enterprise that was user-owned and user-controlled.

US legislation specifically allows cooperatives to form a countervailing power. This is the purpose behind the Capper-Volstead Act. Under this law, price fixing via a cooperative does not infringe anti-trust legislation, as long as no selective boycott practices are employed. There is no restriction on cooperative growth, and agreements between cooperatives are also allowed. That, in essence, leads to the same result as when cooperatives merge to form a single organization.

7.6 Agency Theory of Cooperatives

Agency theory fits nicely with the general model of a cooperative being an intersection or nexus of contracts. There are usually multiple business relationships between the member businesses and the cooperative enterprise, between the members themselves, between managers, staff, board members and other stakeholders. The nature of all these implicit and explicit contracts determines, for example, the extent to which the members or the managers pull the organization's strings. The costs involved in monitoring management activities (particularly in order to ensure that managers work in the interest of the collective action) is one of the most important (Richards et al. 1998; Klein et al. 1997).

Agency theory poses the question of how a contract form (and/or an organizational form) and the attendant incentives and control mechanisms influence the behaviour of the stakeholders. The theory was originally developed as a way of describing the relationship between an employer (principal) and an employee (agent) (Fama 1980). More generally, this relates to the relationship between a principal and any agent accepting the principal's instructions. Examples are owners and shareholders as principals with managers or stewards as agents, the patient with the doctor as agent, or the supervisor with the board as agent. In cooperatives, the members are the principal and the board or supervisor the agent (Douma and Schreuder 2002). The nature of the relationship is that the agent takes decisions on behalf of the principal, and that those decisions have an impact on the interests of the principal. Three factors are of special importance in this relationship:

1. The situation is one of asymmetric information. The agent has the most information. He has insight, for example, into the day-to-day operations of the business, the market situation, the behaviour of transaction partners and external risks. The principal is in a relatively uncertain position: he does not have a complete description of the world that he takes to be the reality. This asymmetry gives the agent a degree or freedom of action.
2. The agent can exploit this freedom of action opportunistically. That would give rise to a conflict of interests. In fact, agency theory presupposes that every agent in an organization serves his own interests.
3. The principal can only partially monitor the actions of the agent because the results are influenced not only by his conduct but also by external factors.

The agency problem arises when the agent uses his position (as supervisor or decision-maker) to further his own interests and consequently damages the interests of the principal. This problem will mainly occur when the principal can no longer oversee the agent's level of effort and cannot appraise the true circumstances (asymmetric information) nor prevent the agent working against the principal's own interests. A core concept of this theory is the agency costs. The principal incurs costs to keep an eye on his agent (control costs), and the agent incurs costs to persuade his principal that he is serving the principal's interests (bounding costs). And since the control is minimal, the agent can put the principal at a disadvantage (residual loss) simply by not functioning properly, by demonstrating free-rider behaviour or by consciously having his own agenda (adverse selection).

As it would be too expensive to monitor and direct the agent all the time and everywhere, the principal has to accept that the agent will sometimes not be working in his interest (Nilsson 1998a, b). Here we come back to the concept of trust, a concept that plays such an important role in cooperative literature. It is, in fact, a special sort of implicit contract, where the parties assume that they voluntarily refrain from opportunistic behaviour. An act of trust is therefore the voluntary release of explicit control in the expectation that this will motivate the other to refrain from opportunistic behaviour (Ripperger 1998). On the one hand, trust is based on information, but on the other hand it works as a compensatory mechanism when there is a lack of knowledge (Schmidt 2004). Trust as a concept cannot truly be explained; it is a mixture of knowing and not knowing.

McCahery and Vermeulen (2008) further develop Nilsson's statement by reporting that the problem of corporate governance has vertical and horizontal dimensions. In the vertical dimension, we see great distance between managers and shareholders. The managers are not always loyal to shareholders' expectations. The horizontal dimension is between "dominant shareholders and dispersed outsiders who are invited to control inside stockholders". This problem is more intense in big cooperatives, in particular with heterogeneity among members. This may even lead to splitting the cooperative into smaller parts (Soegaard 1994). Hansmann (1996) likewise argued that members' homogeneity is necessary for efficient governance of the cooperative.

One characteristic of many businesses is that they need to make substantial investments in dedicated business assets. If they are then dependent on borrowed funds with a fixed interest rate, there is little flexibility. If they are not able to fulfil their obligations on time, they will have creditors on their doorstep, and perhaps even the threat of bankruptcy. In such situations, both creditors and owners tend to negotiate strategically. There are, in other words, substantial transaction costs involved in the owner-creditor relationship. Those transaction costs can be largely avoided if the lender is given an ownership position, for example, and becomes a shareholder. Funding with pseudo "own" equity capital also prevents the owners acting opportunistically vis-à-vis the lenders by failing to build up reserves during the good times and by shifting the risk of bankruptcy onto the creditors.

In terms of agency theory, a cooperative is defined as "an economic organization (or enterprise) where the ownership or property rights are vested in a group that is also the user or transaction partner of the enterprise, given the totality of contracts that determine the enterprise, and where the board members are also chosen by the same group" (Vitaliano 1983). Four themes stand out in agency literature about cooperatives:

1. The problem of anonymous equity. The cooperative's equity (the equity held in the "dead hand" (general reserves), over which the members enjoy the right of usufruct) is a form of social capital. Formally speaking, it is not even a communal possession. As no one is the explicit owner, there can be a lack of incentive to continually use the equity to achieve optimum returns. Legally, the cooperative's equity capital is subject to various restrictions. These are sometimes so rigid that the equity and the assets cannot be used effectively and flexibly in new ways. An extra agency problem in the case of anonymous equity is the lack of proportionality between the degree to which the members have usufruct over this equity and the degree to which they have contributed to the accumulation of the equity. A new member can make "free" use of the equity that others accumulated (the internal free-rider problem).
2. The horizon problem. The horizon of shareholders is, in principle, unlimited as they always have the opportunity to cash in their shares on the basis of the profit forecast. Members of a cooperative, on the other hand, only have profit rights as long as they remain members. In that sense, cooperative members have a more limited horizon than the cooperative enterprise itself (Cook and Iliopoulos 2000).
3. The portfolio problem (see Sect. 3.3.4) arises when the activities and investments of the cooperative enterprise are no longer in accord with the interests and the risk profile of the members. This is more of a problem because members, other than shareholders, are not directly able to alter their position.
4. The follow-up problem arises when members are not able to effectively influence the decision-making process within the cooperative and when, individually, they see little advantage in trying to do so.

By "shirking", such members then conveniently rely on the fact that others will perform this function (Nilsson 1998a, b).

Hansmann (1996) submits that members of cooperatives are often insufficiently motivated to actively monitor their own cooperative. This is because the cooperative enterprise often generates the vast majority of the member's income. He pinpoints a number of aspects that make collective decision-making easier or where—in terms of the theory—the agency costs of collective decision-making can be kept reasonably low. One positive factor is, for example, a homogeneous product. In the case of integrated processing of multiple product groups, it is difficult to find an objective measure for the allocation of costs and returns across the various activities. That problem is much less acute when the various product lines can be dealt with in separate enterprises. But that would make the entire operation less efficient than integrated processing. That is to say, you have to incur costs to avoid the allocation problem. Hansmann nominates sufficient homogeneity of the member group as the second aspect (see also Sect. 3.3.4). In cooperatives, problems can arise if some members are capable and/or large enough to serve the market in their own right.

According to the agency theory, the collective of cooperative members can lose the incentive to actually exercise influence. Boettcher (1986) states that this can happen if members receive insufficient compensation for their involvement. The result is that the director takes over the running of the cooperative. Eschenburg (1971) supports that the manager will soon be looking to achieve extra growth and prestige. Nilsson (1998a, b) implies that the reward structure for managers is a relevant factor in this respect: in general, managers of larger enterprises obtain more generous salaries. According to Condon and Vitaliano (1983), the managers of cooperatives have relatively great powers. Members find it difficult to assess their performance and are reluctant to replace them, even though all managers are not appropriate to govern a cooperative.

Vitaliano (1983) deals with the agency problem by ascertaining that property rights in cooperatives are vague and unspecified. In a listed private firm, the shareholders have a claim on any surplus but they are also in a position to trade their property rights (i.e. their shares) at a market price. That market price reflects the market value of the enterprise, inclusive of its profit forecast.

The existence of a market for property rights has plenty of consequences. One basic consequence is that shareholders have a conferred interest in the long-run prospects of the business which is expressed in the value of their shares. This does not happen, in principle, in a cooperative. All member-users wish to receive a share of the annual surplus expressed in the form of a better price, lower cost or better service. However, their interest in the long-term success of the business is limited because the absence of a market for property rights leaves no opportunity to capitalize on the profit forecasts of the cooperative enterprise. Another interesting point is that shareholders can choose how much risk they can afford. If they feel that a business is taking too many or too few risks, they can redeem their investment and choose another. Members of a cooperative do not have this choice, and therefore cannot spread their risks as shareholders can. This lack of option is exacerbated by the fact that the cooperative is often linked to their own business. In principle, members have put all their eggs in one basket. This is one of the reasons why members support risk-avoiding strategies (Van Dijk et al. 2004).

The absence of a share market also implies the absence of an external instrument by which members can appraise the value and the relative success of their cooperative enterprise, and hence of its managers. The price of shares is also influenced by the evaluation of analysts and experts who are continually monitoring and comparing companies. In the case of a cooperative, this management incentive is also lacking. There are no share options to be granted, and members cannot punish management for its policies by selling their shares. In addition, there is no chance of an external take-over, so that incentive is also missing.

Nilsson and Germundsson (2000) describe a Swedish starch cooperative. It is an example of a NGC with tradable delivery rights. The ownership of this cooperative has been fully individualized. The delivery rights are traded among the members and the value is determined by the cash flow that the members expect to receive from the cooperative. In that sense, there is thus a market for property rights. The cooperative determines the number of shares and therefore has complete control over the amount of raw materials.

Although this cooperative also has anonymous equity, that equity is in fact also individualized because it is capitalized in the delivery rights. As the anonymous equity actually contributes more to the returns achieved on the delivered raw materials, so the value of the delivery rights also increases. Accordingly, any new member also pays for the accumulated equity and there is no free-rider problem. Bou-Jawdeh (2002) draws a similar conclusion in a study in the negotiability of shares-with-delivery-rights at the Dutch starch cooperative Avebe.

A study carried out by Cook and Iliopoulos (2000) demonstrated that the form of the cooperative property rights had an impact on the members' willingness to invest. That willingness was positively affected by a closed membership system, marketing agreements, the tradability of shares, opportunity for growth of value, and in structures in which there was less chance of free-rider benefits or horizon and portfolio problems.

Kalogeras et al. (2007b) have examined empirically the members' preferences for attributes related to internal organization and strategic behaviour of Dutch marketing cooperatives. They found that members on average prefer a more market-oriented management as well as an internal cooperative structure closer to an investor-owned firm (IOF) rather than the traditional proportional type.

Kalogeras et al. (2007a, b) investigated the marketing cooperatives' structure from a members' perspective. They used a conjoint experimental design in 120 producers of a Dutch horticulture cooperative (VTN/The Greenery) in order to find out the utility that producers attach to attributes related to the cooperative's internal organizational structure and strategic behaviour, and are assumed to be significant for members' commitment. They proposed that the cooperative structure consists of two classes of attributes: organizational attributes (control, equity formation and benefit allocation mechanisms) as well as strategic behaviour attributes (the cooperative's strategic choices in developing and implementing a plan for success in the market). According to the results, both sets of attributes are significant drivers of members' utility. In particular, members estimate the strategic attributes as very important and favour a more individualized cooperative structure. For instance, members prefer to participate in a more entrepreneurial and market-oriented organization which will permit them to be involved in long-term relationships and develop a more direct link between its members and market sections. Members also prefer that their MC's equity structure shifts from the proportional type of financial arrangements to a more investor-oriented one, showing a turn from the traditional cooperative paradigm. These results are in line with the previous results of Cook and Chaddad (2004) who claim that several market-driven food cooperatives adopt more individualized organizational structures (like IOFs) and customer-driven strategies.

Hansmann (1996) explains why in cooperatives the internal governance mechanisms differ rather markedly from those of IOFs of similar size. The main reason is that cooperatives are more closely controlled by their members than in the case of IOFs. This happens for two main reasons: firstly, members are strongly involved in internal governance due to the lack of the market for corporate control in cooperatives, and secondly the benefits that the members receive from transacting are regulated by the price and the quality of the co-op's services. Consequently, they have a strong motive to closely control the cooperative. The mechanism is more vivid in cases of member homogeneity.

7.7 Capitalization

Capitalization is the amount of money that a cooperative needs in order to start and operate. It is created by direct investments, retained patronage, refunds and per unit capital retains (Uduma et al. 2014; Bijman et al. 2012). The majority of cooperatives rely on internally generated equity rather than on borrowed capital. Just as in any other business, the cooperative enterprise has to find the optimum equity structure for its investment structure: a situation where the cost base of the equity is as low as possible and the value of the enterprise is thus as high as possible (Dorsman 1999).

The distinction between own and borrowed capital is relevant here. Borrowed capital has to be redeemed, but own equity does not. Cooperatives are traditionally based on the self-funding principle. On founding, the liability of the members is often an important instrument by which the cooperative can lay claim to the equity capital of the members (see Sect. 5.5.3). Reserves are subsequently built by withholding profits. This equity "in the dead hand" forms the cooperative's true equity capital. It is completely risk-bearing and permanently available. The members have the right of usufruct over the equity, but cannot exercise full owners' rights: they cannot lay claim to it. From a funding point of view, this equity capital has the same significance as the share capital and the reserves of a limited company (investor-owned firm). In particular, it serves as a guarantee.

If a cooperative disburses its profits or surplus to the members, the question must then be asked about what "costs" should be allocated to the cooperative's equity. Some argue that this equity should be inflation-proof. In that case, the cost base is equal to the value of monetary depreciation. It is more customary to use the capital market's interest base rate. Others try to make a rational calculation of what reward shareholders would expect. Or they follow the rule of thumb that the ratio of own-to-borrowed capital should remain constant even as the enterprise expands. The reward issue actually seems to be a non-starter. If the cooperative's equity capital is seen as being free of charge, a question arises over how much profit needs to be reserved to bring that equity up and maintain it at the desired level. (This reservation policy will have a different psychological effect than an "objective" cost allocation.) If members want to appraise the success of their cooperative by commercial standards, it will be important to determine what returns they want to see from the capital that they have made available. Given the character of a two-layered enterprise, the returns on investment (ROI) in the members' own businesses could be a good benchmark. In practice, that ROI varies widely, both between sectors and within sectors. Estimates made in the 1990s suggest ranges from 4 to 21% in arable farming (Van Dijk and Poppe 1992).

In principle, the costs of the equity capital (a risk-free base rate interest plus a profit margin) are higher than the costs of borrowed capital. More equity capital therefore means higher (opportunity) costs. As borrowed capital increases with the obligation to redeem, so too do the risks, which fall squarely on the shoulders of the providers of the equity capital: the shareholders, or—in cooperatives—the member/owners. According to the literature, there is thus a ceiling beyond which the ratio between borrowed and own equity cannot be raised. The chance of insolvency increases, as do the agency costs: the position of the providers of both the own equity and the borrowed capital worsens, so both parties will demand extra information and guarantees. That means extra costs: not only for the enterprise but also for the financiers who will convert that into a demand for higher returns (Dorsman 1999). The conclusion is that any business—a cooperative or an investor-owned company—must recognize and adopt the optimum equity structure.

The members in cooperatives share the financial ups and downs in proportion to their transaction relationship. From his research into Dutch articles of association, Van der Sangen (1999) concludes that the articles offer a range of options for obligatory financial contribution. Alongside a theoretical exposition, Van der Sangen also offers an overview of new funding forms that are used to encourage members to invest more in the cooperative. The most widely used system is for cooperatives to establish a relationship between the member's transaction volume and his total contribution in the funding. The cooperative can make an extra withholding on disbursements until the desired ratio is achieved. Moreover, new members are often asked to deposit a specific amount in advance. In exchange they receive member certificates or participation certificates which, in principle, do not increase in value. Occasionally the board of directors will determine their value from year to year. Another form of capital formation is a subordinated bond with a fixed interest rate. These bonds are tradable. "Cooperative capital units" are an alternative intermediate form. These are nominal and non-negotiable, but a fixed rate of interest plus a profit-based dividend (bonus interest) are paid on them.

New Generation Cooperatives (NGCs) go a step further with their negotiable delivery rights (see Sect. 5.5.2). The enforceable delivery agreements in combination with the differential price policy the cooperative uses can contribute to the constant supply of products bearing specific quality standards as well as the good synchronization of the value chain (Jia and Huang 2011; Goldsmith and Gow 2004). A crucial factor for their success is that the market for delivery rights must be functioning well. Most of these cooperatives also admit shareholders who have no delivery rights. For their holders, such shares then have no other status than shares in listed companies. Ordinary cooperatives can also issue shares that are not linked to delivery rights. They can be purchased voluntarily, and entitle the holders to a dividend or a share of the profits. This is only desirable if no conflicts of interest arise between shareholders and members as a result (see Sect. 5.5.3). The profit declaration should be completely independent of the pricing policies for the members. Those prices can be determined by conforming to prevailing market prices. For example, cereal crops have a transparent world market price. Prices can also be linked to those of other parties in the market, or can be set with a statutory minimum price declared by the government.

Cooperatives that seek to attract equity capital from third parties usually convert the business into a company; non-members can then participate in the company. The most extreme is the model where the cooperative enterprise is converted into a public limited company. In such a situation, it is possible that after a time, the cooperative members will represent only a minority portion of the share capital.

It can also happen that cooperatives have external "capital members" with cumulative preference shares, earning a fixed share of the dividend but bearing no voting rights. Such capital members contribute risk-bearing capital that does not need to be redeemed and so is permanently available. Because of the fixed dividend, they are not entirely dependent on profit. The "cumulative" aspect of the dividend rights means that if no profit is made in a particular year, and no dividend can be disbursed, the shareholder can still receive his dividend as soon as the cooperative enterprise is able to pay it.

Finally, it is possible to convert the cooperative in its entirety into a publicly listed company. In most examples, the original members of the cooperative continue to be a collective shareholder. This type of organization is known as a "listed cooperative". A next step in the process is that the cooperative becomes fully demutualized and becomes a regular listed company.

According to Moody's Global Credit Research, the significance of member involvement cannot be over-emphasized. This institution appraises the solvency of companies on behalf of equity capital providers (Moody's 2002). Moody's observes that the financing of cooperatives can be particularly flexible because they can vary the payments to their members: either as a return on capital or in the price of products. But even this flexibility is limited. If the cooperative is not generous enough in its pay-outs, it could lose its most important "asset": the involvement of the members (Barraud et al. 2012). By and large, financial flexibility is greatest in successful marketing cooperatives that are able to add extra value to the products of their members. This means that the higher the added value, the greater the profit margin that can be retained without risk to the normal market price for the members.

Besides that margin, Moody's also specifically considers the potential consequences of limiting the percentage withholding on the pay-out price. In that sense, turnover is of major importance. A successful cooperative that returns as much profit as possible to the members in the pay-out price will have only a small margin. But if the total paid-out amount runs to billions of euros, that can be adjusted quite easily. Just one percent will make a big difference. The members represent a substantial equity buffer for the cooperative enterprise. But that assumes they are committed and involved. Commitment can be expressed in structural contributions to the equity capital, and also in agreeing to temporary price reductions the moment that proves necessary.

Moreover, the ownership structure of a cooperative greatly affects member incentives to invest in their cooperative (Cook and Iliopoulos 2000; Kalogeras et al. 2007a, b). In traditional cooperatives, the members usually hesitate to provide significant equity capital for investment reasons. On the contrary, in re-engineered cooperatives the ownership principles activate members to make long-run investments (Nilsson 2001; Benos et al. 2015). Consequently, members' involvement in the governance and the financial structure of cooperatives is of vital importance for its competitiveness.

Cook and Chaddad (2003) assume that market developments compel cooperatives to make substantial investments, mainly in branding policies and internationalization. In an effort to encourage willingness among the members, new organizational and funding forms are created and come into existence. In particular, these relate to new forms of property rights and control rights. Theoretically there are obstacles in the fact that property rights:

- remain restricted to the members;
- are neither tradable nor redeemable, and do not increase in value; and
- are linked to the transaction relationship, i.e. operating results are distributed in proportion to the use that the members make of the cooperative.

The authors conclude that the introduction of tradable property rights in cooperatives could provide a stronger incentive for the members to invest in their cooperative. They add, however, that systematic research is required to check whether this hypothesis is correct.

However, members' participation in the governance of cooperatives is often weak (Chaddad and Iliopoulos 2013; Osterberg and Nilsson 2009; Fulton and Giannakas 2001). Reasons are the large size of cooperatives and the complexity of business activities as perceived by members (Liro et al. 2012; Veerhes et al. 2015). Business strategies of horizontal and vertical integration have created a distance in the sharing of meaning between the members and their cooperative managers. As a consequence, the interests of some members are often not enough attended to. Moreover, there is increasing heterogeneity among members and a wide geographical dispersion (Osterberg and Nilsson 2009). Therefore, members at large do not understand the strategies and developments in their cooperatives, and have limited information about or experience with them; thus they are alienated from them. Free-riding behaviour and denial to invest in the cooperative are common problems of many cooperatives (Osterberg and Nilsson 2009).

7.8 Comparing the Performance of Cooperatives and Investor-Owned Firms

On the basis of statistical analysis, Soboh (2004) concluded that the turnover elasticity of the equity capital was the best benchmark for the comparison of cooperatives as well as for comparing cooperatives and investor-owned firms. The formula used is the percentage change in total revenue, or turnover, divided by the percentage change in equity capital. The underlying rationale is that the risk-bearing and permanently available equity is the determining factor for realizing a growth in revenue that is in tune with the objective of the members. The criterion can only be upheld in the long term if returns are sufficiently high.

Soboh et al. (2011) evaluated the financial performance of 170 cooperatives and private firms in the European dairy sector. They concluded that cooperatives are on average less profitable but operate more efficiently and present a stronger financial position than private firms. Moreover, dairy cooperatives show more heterogeneous results among countries than private firms. A few years earlier, on the basis of statistical analysis, Soboh (2004) concluded that the turnover elasticity of the equity capital was the best benchmark for the comparison of cooperatives, and possibly also for comparing cooperatives and companies. The formula used is the percentage change in total revenue, or turnover, divided by the percentage change in equity capital. The underlying rationale is that the risk-bearing and permanently available equity is the determinative factor for realizing a growth in revenue that is in tune with the objective of the members. The criterion can only be upheld in the long term if returns are high.

Ling and Liebrand (1998) constructed the extra-value index which is defined as "net savings after subtracting an interest charge on equity". A positive extra value indicates that the cooperative's management has created value for members. However, they found no significant difference between cooperatives and IOFs' performance. A few years later, Ling (2006) studied the performance of 21 dairy cooperatives in the US over the periods 1992–1996 and 2000–2004 using the same extra-value index. No significant relationship between size and profitability was found.

Challita et al. (2014) studied the impact of French firms' governance on their financial performance and structure. From a panel data of 6,654 French cooperatives contrasted with traditional investor-owned firms from 2004 to 2012, they found that cooperatives have lower returns with lower volatility than comparable firms. Moreover, their governance significantly affects their financial structure.

Fulton et al. (1995) tested whether Gibrat's Law applied to cooperatives. According to this law, the autonomous growth of enterprises in the long term (apart from incidental mergers and acquisitions) is independent of their size. The researchers found only one exception to the rule among the seven large North American cooperatives they studied. From the statistical analysis they carried out over several years, they concluded that all but two of the cooperatives had not been hampered from growing by a lack of or restricted access to their own equity capital. That does not alter the fact that the actual growth measured was very modest (from 2.5 to 9.6%). As the authors suggest, this may have been a conscious choice. Investors in companies, they reason, are interested in profitable investments with continued growth so that they can keep reinvesting. Members of cooperatives do not need to have this motivation: their goal can be to keep a "guard dog" in the market, or to maintain their access to a certain service or a certain product which others cannot provide. As they do not primarily view the cooperative enterprise as an investment opportunity, they will be less interested in growth.

According to Wiles (1977), the characteristic difference between cooperatives and investor-owned companies is the equity-bearing factor: the factor on which the equity capital depends. In a normal company, that is the invested capital, but in a cooperative it is the reinvested capital plus another factor. In an employee cooperative, it is their labour; in a marketing cooperative, it is the member product; in a consumer cooperative, the customer value, and so on. The members are more than shareholders; they also have a specific goal.

Peterson and Anderson (1996) drew up a theoretical overview of twelve possible strategies for cooperatives. The strategies were put to 21 senior managers of various cooperative enterprises in north-eastern U.S. states during in-depth interviews. Six of these are primarily focused on added value (returns strategies) while the other six are aimed at safeguarding that added value for the future (risk management strategies):

- *Competition benchmark strategy*. The cooperative is in direct competition with other companies—mainly in terms of costs—and eliminates any monopoly profits.
- *Countervailing power strategy*. The cooperative negotiates with other, larger parties in the market, mainly over prices.
- *Deal cost strategy*. The cooperative identifies strongly with its members. Good communications, monitoring, contract forms, etc. can lead to substantial savings on transaction costs.
- *Agency cost strategy*. The cooperative utilizes the fact that, given their transaction relationship with the cooperative, the members possess a great deal of relevant information and are willing to participate in decision-making and monitoring of the management.
- *Member-demand driven strategy*. The cooperative focuses on the specific needs of the members. Without the cooperative, certain services would not be offered, or certain products and services would not have the required specifications.
- *Consumer demand strategy*. The cooperative ensures that consumer demands are communicated better to the members so that they can serve the consumers better.
- *Pooling*. The cooperative averages out the purchasing and/or marketing risks. By determining the purchasing and/or marketing policy jointly, the individual members are less dependent on fluctuations in the market.
- *Savings bank strategy*. The cooperative can set aside buffer stocks or make savings in good times to enable it to make payments in bad times.
- *Maintaining the market strategy*. The cooperative continues to serve a market whereas non-cooperatives would desert it. This is possible because the cooperative allows the members to generate a profit in their own businesses. This can offset a loss in the cooperative.
- *Conservative investment strategy*. The cooperative invests exclusively in projects that are definitely in the interests of the members.
- *Diversification strategy*. The cooperative serves multiple markets in order to spread the risks for the members. In this way, the income flow from the cooperatives becomes less dependent on a single market.
- *Vertical integration strategy*. The cooperative integrates both up and down the chain. This will generally help to stabilize returns, especially if prices have a tendency to fluctuate: after all, input prices of one link (costs) are selling prices (returns) for another link.

The principle underlying all these strategies is that they produce added value—differential returns—for the members. It should be noted, however, that this is a combination of the members' and the cooperative enterprise's profit. All the cooperatives studied pursued a combination of returns and risk strategies. The countervailing power strategy was mentioned least often. Most cooperatives specialized in trade service and procurement claimed that they fulfilled member demands that other companies could not match. Half the managers felt that the company would be more efficient if it had not been a cooperative. The managers were almost unanimous in their opinion that the member-executives were too cautious and slow to take investment decisions. That slowness was felt to be detrimental to profit opportunities. Nearly half also felt that the board members did not have the required level of expertise. The researchers concluded that their strategies were usable and easily recognizable. It was sometimes difficult to determine whether the cooperative in question was managing risks for the benefit of the collectivism of members or for the benefit of the management.

New Generation Cooperatives (NGCs) have become particularly prevalent in North Dakota and Minnesota as a response to changing conditions in agriculture. They adopt a more offensive attitude towards adding value to their assets (Cook and Chaddad 2004), therefore enabling members to have more business opportunities in the production chain within the cooperative (Williams 2007). These cooperatives require the members to make upfront investments in the cooperative; in exchange, they receive delivery rights. This maintains the proportionality between transaction and investment. If a member is unable to deliver his full share of product, the cooperative is entitled to buy in the deficit from elsewhere—for the account of the member in question. Delivery rights are linked to the capacity of the cooperative. Characteristically, membership is restricted. Moreover, you can only become a member if you can afford the investment. Since delivery rights are negotiable, this cooperative form indulges the wishes of older farmers, in particular, to share in the increased value of the cooperative enterprise. But if that aspect becomes over-dominant, there is a big chance that the “member value culture” will make way for a “shareholder value culture”.

In such agribusiness cooperatives, “big” members are motivated to invest more in the collective allocated equity as they realize that their investment strategy is now represented and rewarded proportionately to their patronage and financial contribution (Chaddad and Iliopoulos 2013). Members’ willingness to further invest in cooperative activities allows for the creation of more market-driven cooperatives (Royer 1995). Consequently, NGCs are extremely market-oriented: the volume of production is attuned to demand. A few NGCs have achieved top positions in the market in the U.S., in the sugar and pasta sectors for example. Others remain typical niche players, such as wheat and bakery cooperatives and the North American Bison Cooperative. Torgerson (2001) concluded that there was no alternative: the members must themselves provide risk-bearing and equity capital. The admission of non-member capital will give rise to conflicts of interests, and the exclusive right of the members to govern their cooperative will be lost, along with much of the cooperative character (Egerstrom 2001). That can also happen if members are not productive, or no longer productive. Torgerson illustrates this with an example from the sugar industry where members leased out their delivery rights in anticipation of a further increase in value. This study is based on the principle that the farmers can try to correct their weak market position with the aid of two strategies: horizontal cooperation in order to achieve better ex-farm prices, and vertical cooperation in order to achieve added value in the chain after the product leaves the farm.

In Europe very few NGCs exist. Avebe, a NGC engaged in the starch potato sector with a 100% market share, is one of them. Kalogeras et al. (2007a, b) investigated the factors that influence the price formation process of the delivery rights, based on empirical observations. They concluded that the main factors that influence the demand for delivery rights are explained by the members' strategy at the farm level and differences associated with the cost-efficiencies of large- vs small-sized members. The main attribute that regulates the supply for delivery rights is the return on shareholders' equity. Moreover, Avebe members consider the acquisition of delivery rights more significant than their prices, and the price determination process is mainly carried out through negotiation by a bilateral agreement.

Professional managers are expected to stimulate market orientation in cooperatives (Russo et al. 2000). The decision-making in traditional cooperatives is rather time-consuming, it reduces flexibility and it creates obstacles for the quick reaction to changing market needs (Nilsson 2001; Meulenberg 2000). Moreover, the assignment of decision rights to hired managers is expected to stimulate market orientation in cooperatives. Professional managers are expected to be aware of the importance of being market-oriented and retain more resources for the cooperative (Russo et al. 2000). Adequate resources and an awareness of their importance seem to suffice in rendering the cooperative more market-oriented (Meulenberg 2000). Furthermore, re-engineered cooperatives are expected to allow more entrepreneurial freedom to their management using their flexibility which stimulates market orientation (Van Dijk 1999; Jaworski and Kohli 1993).

Cooperative enterprises are faced with the same basic challenges as non-cooperative enterprises. Members cooperate to reduce market risk and to lay claim to space for independent entrepreneurship. While non-cooperative processing businesses consider their need for raw materials as secondary to their profit objective and market position, cooperative processing enterprises also have a quantitative objective that derives from the objectives of the members.

It is not only the members who draw benefit from their cooperation. As an enterprise, the cooperative firm itself also benefits from cooperation with its suppliers or customers. Given the necessity for market investment, the processing enterprise will draw benefit from the cooperative transaction relationship as well as from a stable shareholder base, so it is able to set long-term strategy (Veerhes et al. 2015). Together with the lower transaction costs, it is this that gives the cooperative its competitive power. For the so-called open or consumer cooperatives, cooperative banks and input suppliers, cooperation is an efficient way of using more instruments to create customer value and generate customer loyalty. For cooperative banks, membership policies represent an activity that is consciously directed by the banking operations themselves (Van Dijk et al. 2005)

7.9 Measuring the Economic Sustainability and Patronage Value of Agricultural Cooperatives

USAID (2016, p. 1) defines cooperatives as "member-owned businesses whose primary function is to provide goods and/or services to their member-owners, leveraging self-governance and the combined buying, selling, and servicing power of their members to achieve economic betterment through either the distribution of profits or increasing value of its members' equity based upon its members' usage".

During the financial crisis that started before the decade of 2010, cooperatives proved their resilience by surviving this significant economic shock (Kontogeorgos et al. 2016), particularly in the financial sector, according to a report by the International Labour Organization (2013). This success was due partly to their long-term strategies and partly to the accumulation of reserves. After this success, the cooperative movement regained a privileged place among policy makers and international organizations. As a result, the year 2012 was declared by the United Nation as the "International Year of Cooperatives".

There are several measures that evaluate economic sustainability as well as the patronage value of agricultural cooperatives. Each of them has specific advantages and limitations. Some of the most commonly used ratios are the "*return on equity*", the "*return on assets*", the "*asset turnover ratio*", the "*current ratio*" and the "*debt to equity ratio*" (USAID 2016). The use of the appropriate indicators to measure sustainability is extremely important as it substantiates the usefulness of agricultural cooperatives. Moreover, it helps decision-makers in cooperatives to adopt the appropriate strategic attributes in order to improve the financial sustainability and patronage value of cooperatives.

The literature review elevates two main metric categories. The first one refers to the financial indicators and the second to the patronage indicators. As regards the financial indicators, the most common are the "*return on assets*" (revenue/total assets), followed by the "*gross profit*" (sales revenue-cost of goods sold). The main advantages of the first indicator are its applicability across a wide range of agricultural cooperatives as well as the fact that it correlates positively with profitability and the ability to manage risk (unexpected market shifts, climate changes etc). The gross profit ratio captures both external and internal performance. It is endorsed by the majority of agricultural cooperatives and it is feasible in terms of data collection. Moreover, the gross profit ratio or sales revenue less cost of goods sold is preferable. Net profit or gross profit less overheads and interest payable is not as well defined because net profit is less accurate due to the challenges among agricultural cooperatives in developing countries in calculating operating costs.

USAID (2016) performed 41 interviews with cooperative managers and cooperative experts. The researchers concluded that metrics related to gross profit, revenue and volume of production are the most widely applicable indicators for economic sustainability.

As regards the patronage indicators, the most common is the "*in-selling*" (the value of product sold by members to the cooperative/total value of product sold by members or the average sales per member). The most important benefit is the positive correlation of in-selling with member satisfaction, social capital and cooperative performance. Moreover, the number of active members may become a very interesting and reliable patronage metric in agricultural cooperatives.

During 2011 and 2012, a large European research consortium carried out a survey in all the 27 Member States of the EU, named "Support for Farmer's Cooperatives". This large survey aimed to provide a detailed description of the current level of development of cooperatives in Europe. Taking into consideration the assumption that a cooperative's performance is related to three parameters: (a) position in the food supply chain, (b) internal governance, and (c) the institutional environment, the authors tried to present and explain cross-country differences in the agricultural cooperatives of eight main agricultural sectors (dairy, pig meat, sheep meat, wine, olive oil and table olives, fruits and vegetables, sugar, and cereals). One of the measurements that they used was the "market share of cooperatives and its evolution" as a proxy of cooperative performance.

The research reveals that cooperative market shares differ significantly across sectors (dairy cooperatives have the highest score—almost 60%) and between Member States. Cooperatives in general hold around 40% of agricultural products at farm gate value. In Mediterranean and New Member States we meet socially-oriented cooperatives, while in north-western Europe we meet successful cooperatives with an international orientation. As a concluding remark, it seems that there exist quite diverse national issues and challenges that lead to heterogeneous results among cooperatives influencing their competitive level. Similar data from US agri-food cooperatives (2010) reveal that processing and marketing agricultural cooperatives hold a market share of around 30% and slightly less in the supply of inputs (almost 25%). The net value of products marketed by cooperatives was $94 billion and the total net income was $4 billion (USDA 2010).

Another interesting measure for the measurement of cooperative performance can be "members' satisfaction". Narciso Arcas-Lario et al. (2014), based on a sample of 277 members of fruit and vegetable marketing cooperatives in Spain, examined the determinants of members' satisfaction with their cooperative as well as the effect of members' satisfaction on their desire to continue as cooperative members. They found that there is a positive relation among trust, information sharing and control on members' satisfaction. Moreover, members' satisfaction with the cooperative has a positive impact on members' desire to continue as members of that cooperative.

During the last decades, private firms are interested in boosting social responsibility as an indicator of stakeholders' satisfaction. However, the majority of the private firms continue to focus on shareholders' maximization of profits. Nevertheless, several researchers have proven that cooperatives' stakeholder governance can better serve the interests of stakeholders while being successful and competitive. Therefore, cooperatives might be better servants of the stakeholders' vision of an enterprise (Soboh et al. 2009).

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Part III
Lessons Learnt

Chapter 8
Lessons Learnt

In the previous chapters, we have discussed various aspects of cooperation, with an emphasis on business cooperatives. We have shown that the cooperative has been studied from many points of view. In this book we have laid emphasis on the work by economists, public choice theorists, sociologists and philosophers of the civil society. However important and illuminating these scientific approaches are, the best proof is where cooperatives function in practice. Initiators of cooperatives have neither the time nor the means to study cooperatives thoroughly, and even if they had, it would still be too difficult to find the right mix of ingredients. Therefore, we include in the third part of this book some of our practical experience that has taught us how to start a cooperative business and how to apply the basic ingredients. We select those ingredients which we regard as essential for cooperative initiatives.

We also draw conclusions from various practical experiments showing the outcomes of these experiments with regard to the business plan of the cooperative, its governance and its internal democratic functioning.

We postulate that the need for cooperation, especially for farming and developing economies, is as important as ever. The traditional reasons for cooperation still do apply in our era. We would like to add to those traditional reasons for cooperation the fact that farmers increasingly face a scarcity of essential resources. Among these are water supplies, land resources and access to capital. Besides, the development and dissemination of knowledge is a key role of cooperatives. As the founding fathers of the cooperative methods knew so well: cooperatives are based on continuous learning. A special form of such learning is how to spark new entrepreneurship among members and how to make a cooperative firm a successful business.

In the 21st century, globalization has become the major trend, but not all sectors have been able to benefit from it. For various small and medium enterprises, globalization does not give them the opportunity to benefit from it without organizing themselves in new ways. Such a new organization aims at creating a buffer or interface. In the past, cooperatives also acted as an interface between markets and people who were not able to economically survive on their own. Although they had their own skills and talents, a business and their social circumstances, they could not face the competitive conditions of their markets without cooperation.

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This is a global phenomenon. Cooperatives can counter such market failures (a market failure as it is experienced by individuals or firms) by joining the forces of the members. Inherently to the structure of cooperative businesses, cooperatives face the essential need for efficient collective decision-making. In this book, we have therefore laid strong emphasis on the danger of democratic deficiency in cooperatives. We have also argued that there is a serious democratic deficiency developing in most societies; yes, even in western democratic countries. This problem can only be solved by introducing democratic mechanisms throughout societal institutions and communities in the country. Naturally, cooperatives have to play a crucial role.

8.1 The Advantage of Cooperating

This section reviews the advantages and benefits to members of cooperatives. We have already described the cooperative as a buffer between a group of cooperators and the market. This buffer—the cooperative enterprise—must serve two objectives. The primary objective is to serve the interests of the individual members to the fullest. Their "material needs" are the focal point. The secondary objective is to successfully operate the cooperative enterprise. These dual objectives are explicit in the transaction relationship between the members and the enterprise. The intention of the cooperative is to facilitate and/or expedite transactions between the group of cooperators and the market. Those transactions relate to activities that the cooperators would otherwise have to carry out for themselves, either in their own business or in their own household. That means that qualitative demands are made in the way the cooperative enterprise operates.

The business or service activities in question must link up with activities that are important to the members' businesses or households. The advantage for the members should therefore be evident within the cooperative enterprise, and it should also be evident within the members' businesses or households. In this case, the cooperative firm becomes an example of the enterprise whose being is greater than the sum of its parts.

This description suggests that the benefits derived from the cooperative do not need to be equal for all members. After all, their businesses or households are not equals, either. Accordingly, each decision within the cooperative will have a different impact on the individual members (see Sect. 3.4).

The simple marketing cooperative offers one example. A marketing cooperative takes products from its members, processes them, and then sells those products in the market. The higher the price the cooperative can pay its members, the greater the benefit for the members. Although this is a frequently heard rationalization, a few notes can be made in the margin, particularly in the context of the cooperative's dual objectives. The following comments are a partial list.

8.2 Members' Business and Cooperation

A marketing cooperative does more than just sell its members' products. The products of the members have to be brought together, in the case of producers such as farmers, or services and talents, in the case of workers and professional cooperators. These goods and services are then collected, packaged, and often processed in order to make them suitable for transportation and/or specific purposes. Products are often processed into consumer products and sometimes the cooperative opens secondary production lines to allow some synergy to be created with the existing production or marketing activities of the cooperative enterprise.

In many regards, these activities are delegated to the cooperative enterprise in the sense that they are transferred from members' own activity to the enterprise. They do this because such activities can be conducted better or more efficiently as a cooperative venture. A clear example of delegation is found in something that both the Rochdale pioneers and most early agricultural cooperatives did for members, which was buying or selling their own inputs or outputs. Without doubt, this was something that any enterprise would do. But in many cases it was more economical to do it together. It would be more efficient to cooperate, for example, and together they could monitor quality more easily or develop more market influence.

If we consider the benefits of cooperating for the individual member, the first question to answer is whether the member would be able to sell his product himself. One producer will be better able to do so than another. Those who have a good local market, who are good business operators and have an affinity for selling, will have less need of the cooperative than those who don't. Those who already "have" will derive less direct benefit from cooperating than the "have-nots".

Again, using Dutch experiences, although the issue is universal, this difference in market position was the reason why western provinces of the Netherlands were the last to establish dairy cooperatives. There was a large local market for fresh milk in that densely populated area, so farmers had plenty of opportunity to sell their milk. In contrast, cooperative meat producers have always had difficulties operating their abattoirs (slaughter and packing plants) efficiently. This pattern has many parallels in the United States, Canada, Australia, New Zealand, Brazil and Argentina. Farmers and consumers were far more likely to form cooperatives on their respective frontiers than in populous urban areas where markets existed and competed for their patronage (Egerstrom 2001). Moreover, opportunistic traders have surrounded cooperative members in more developed areas to offer lucrative deals, luring them to break ranks from the cooperative.

Generally speaking, any cooperative enterprise will opt for a degree of streamlining and standardization, both in terms of products and services and in terms of qualities. Pressures to achieve efficiencies or strengthen marketing positions will encourage these practices. This, too, will suit some members more than others. One grower will be better able to produce a particular variety, for instance. Another grower may be better at producing large quantities at low prices, and yet another may excel at fine-tuning production for quality. This will be more onerous for some personal businesses than for others if the cooperative decides to adopt a blanket quality control system (see Sect. 5.2). This is so even if one member specializes in just one product while other members produce a variety of products. It has already been mentioned that dairy farmers were required to have a refrigerated tank installed on their farms, as an example. In all these cases, it becomes clear that some members have to make greater efforts and incur more expenses in order to fulfill the cooperative's standards.

Nonetheless, standardization within the cooperative can also have an undesired effect. It is not inconceivable that members will be able to produce new products, or higher quality products, and that these will not fit into the cooperative business plan. That is exactly what happened when some dairy farmers switched to organic milk, a market segment that commands higher prices. It is quite difficult for the cooperative to make the strategic decision to handle and market such a new product. Is there a big enough market to justify investing in production facilities? And can enough members deliver the required raw material? This discrepancy between the development of their own business and that of the cooperative enterprise is a problem for innovative farmers. Worse still, it can put a brake on the innovation-mindedness of members in general. There is little point in producing the tastiest milk or tenderest meat if it is mixed with other inferior products within the cooperative. Average becomes the standard. This will actually represent a loss for some members because their innovative potential is not being used. A problem of this nature also arises when farmers try to develop new specialty products, perhaps with the "regional" or "animal-friendly" label. The cooperative can then be more of a millstone than a stimulus.

The cooperative's policies can also give rise to differences in cost levels between individual members. We have already seen that it is customary for cooperatives to allocate direct costs incurred on behalf of individual members to those members (Sect. 5.2). An example of such direct costing is the cost of transportation to and from the cooperative enterprise. Those members who live farther away from the factory will pay more. Relocating the factory gives rise to a true conflict of interests. Beyond that, when the cooperative arranges the transport of produce, or provides certain other services, these services will suit one member more than another. One member will be pleased that a problem has been taken off his hands. Another would rather transport, sort, and do bookkeeping, or whatever else, because either he enjoys it or because by so doing, he uses his own time more productively. Another historical example of internal conflicts of interests occurs when a purchasing cooperative decides to build its own warehouse. This represents a significant individual saving for one member. But it means another's own warehouse, or storage facility, is no longer needed and it will be either an extra expense or a loss of income.

Starting with this last point, we can summarize by saying that members should first look at their own net prices when deciding what benefit they derive from the cooperative. This is not just the prices received. They should also look at costs incurred or avoided in the cooperative. Dekker (1996) relates how other farmers were amazed at the prices a dairy factory paid farmers in the 1920s at a factory in the south of Holland. But they did not consider that members had to take their milk to the factory themselves. The same disparity in operating costs impacted dairy prices in earlier years in those US states that were close to big markets. The burden of transport could not be maintained on members of dairy cooperatives in more sparsely populated areas of the maritime provinces of Canada and the central United States, such as the large dairy state of Wisconsin. Historically, trying to cover transport costs for remote farmers in Scandinavia was a significant problem for dairy cooperatives.

At the same time, members need some benchmark by which to compare net prices. They could look at the average price that some other enterprise pays, but it would be more relevant to consider what price they could achieve if they were marketing independently. What income would they then receive, and what expenses would they incur? That is a difficult comparison to make. It forces a comparison between an actual situation and a hypothetical alternative. And even that difficult choice must weigh interests in the present against potential in the future. At the moment, earnings might be greater with a specific product, but what will the situation be like in the longer term? It is a question of weighing the risks in one's own business against the risks of being part of the cooperative enterprise. Members must bear in mind that they probably have more opportunity to adapt to new market demands by being part of a cooperative. That comes from sharing the risks.

8.3 Extra Cooperative Activities

When cooperatives expand their field of activities, it is usually to gain a presence in another link of the supply chain and not a direct extension of the members' own domain. Such activities are often intended to strengthen the cooperative's market position in the supply chain, often by substituting or creating competition for middlemen such as wholesalers. When other traders were seen as being too powerful, not transparent, discouraging cheapskates or inexpert, the cooperatives stepped in to take over the supply chain activity. This had two advantages: it united members as stronger players in the market (economies of scales) and it allowed the members to capture the wholesaler's profit margin.

In the case of trading, these extra cooperative activities can be looked on positively as falling within the context of the members' businesses. Again using Dutch examples, Avebe (potatoes) processes its own potato starch into biodegradable plastics; FrieslandCampina (milk) has a factory that produces an industrial ingredient for making electronic monitor screens from casein, a protein found in milk; and Vion (meat) once was one of the world's biggest suppliers of gelatin capsules for medication (produced from offal). In other words, cooperatives have penetrated markets for new products and specialized ingredients that even reach the top end of the consumer market. In doing so, the cooperative gives its members a market reach that the individual would rarely achieve working alone.

No longer is a direct relationship often found between the product a member-business supplies and the market success of the final product. The member-business supplies only raw materials—often just one raw material—for the cooperative's product. Minimum quality is sufficient. The extra quality—the added value—is created within the cooperative enterprise itself. This creates a gap between the member-business and the "meaning" of the cooperative enterprise: the cooperative enterprise—and its management—is doing the actual work.

In the second place—and perhaps more importantly—there is no longer any relation between the quantity of product the member-businesses deliver and the success of the final product. This is something of a break from traditional marketing cooperatives. Many cooperatives were founded on homogeneous basic products where success largely depended on the scale of operations. They acquired market power when they had such volume that buyers could no longer ignore them. Hand in glove with this market power, the cooperative could reduce costs to make extra profit in a homogeneous market. In the case of more specialized products, however, more is not always better. Over-supply can then force a lower price. And that can mean less profit.

While the principle for standard and widely available basic products is to produce as much and as cheaply as possible, the principle for specialties is to keep that product exclusive. Campina will earn little more from its monitor screen casein even if it were to process all its millions of liters of milk for that purpose, and therefore it does not do that. The cooperative decides on business arguments to market part of the raw materials in a highly lucrative manner. That added value is then distributed over all the raw material its members supply. Everyone earns a little extra.

Let us do some sums. Member-entrepreneurs together produce one hundred units of product. For that product, they would normally receive one currency unit per production unit in the market. (For convenience, we will use the Euro for this purpose.) But thanks to ingenuity, efficiency, business acumen and market power, the cooperative can get 10% more: €1.10. This is a successful cooperative: €100 becomes €110.

Coop.	100@1.10	110.00
Market	100 @ 1.00	100.00
Advantage for member :		10.00

Subsequently, the cooperative sees an opening in the market for a special product: 10% of the turnover can be sold at no less than 20% profit. The "profit" then rises from 10 to 11%.

Coop.	10@1.20	12.00
	90@1.10	99.00
	100	111.00

Members now receive €111 for their products. Surely there is every reason to be satisfied. Within the cooperative, however, voices will soon be heard that say it is actually a pity so many products are being sold at "only" €1.10. A debate might arise about whether the members are actually stronger in unity. If a number of members were to withdraw from the cooperative, this might even lead to an extra rise in the price paid by the cooperative, nudging it up from €1.11 towards €1.20. Such a discussion can happen, but is not likely to get out of hand. Normally, the economies of scale offered by the cooperative in terms of marketing the "standard" product remain applicable.

In the example offered here, the problem becomes more obvious when the cooperative enterprise has to sell the last of its "standard" products at substantially lower prices. That is not uncommon and is more the rule than the exception with agricultural marketing cooperatives. The cooperative enterprise is dependent on the product of its members and does not have the mechanism to adjust the volume of supply to the volume of demand prevailing at any particular time. Powdered milk is a well-known example in the dairy industry. Once the market for fresh milk is served, the cheese vats are full and specialties are produced, the cooperative must look at lesser value products. For a dairy cooperative, the only option for the remaining milk is to produce feed products or process surplus milk into milk powder that has a long shelf-life and can be sold on markets much further away, including exports to developing countries. Prices are not great, but it's better than pouring the milk down the drain.

One of the greatest successes of the agricultural marketing cooperatives has been the active and creative ways in which they find markets for the last of their products. They prefer distance markets so that their own markets (for fresh milk and cheese) are not overrun with the surplus. And since even the "standard" product will not be sold at a standard price, the sums we stated above become slightly more complicated. For example:

$$\begin{array}{lll} Coop. & 10@1.20 & 12.00 \\ & 80@1.11 & 88.80 \\ & 10@1.02 & 10.20 \\ \hline & 100 & 111.00 \end{array}$$

This makes the question of whether you should be satisfied with the sale of the leftovers even more pointed. Only 2% profit can be made on those last few units of product, whereas 11% is made on the standard product and 20% on the specialty.

The figures shown above illustrate the big advantage of cooperating. A privately owned enterprise would only be interested in the first two segments. The third just about breaks even and may be a frequent loss-maker. That means the enterprise will want to take fewer raw materials from the farmers.

In that sense, the cooperative enterprise takes on the character of a mutual insurance for the members. They run the risk that at certain times they will be unable to sell all their products, or will receive a low price for it. And they all run the same risk, because there is little if any connection between the quality of the member's product and the end product of the cooperative. By linking their fates, they effectively average the risk and act as guarantor for each other.

This situation remains in force when the price for that third product segment, with alarming frequency, falls below 100, i.e. even lower than the "normal" price that the members could have received outside the cooperative. The element of mutuality is then even more obvious. The cooperative is fulfilling its role as a buffer between the market and the members, individual and communal. On the one hand, it covers the members' risk and offers a mutual insurance in the form of guaranteed sales. On the other hand, the cooperative enterprise's market dominance and inventiveness can cushion incidental losses by generating extra profits in other marketing segments.

"Incidental losses" is perhaps not the right term because the last segment disposed of will always yield a price below the "normal" market price. For the cooperative that has volume handling objectives for its members, it is time to take off the rose-tinted glasses.

$$
\begin{array}{lll}
\textit{Coop.} & 10@1.20 & 12.00 \\
 & 80@1.11 & 88.80 \\
 & 10@0.92 & 9.20 \\
\cline{3-3}
 & 100 & 110.00
\end{array}
$$

In this case a loss was realized on a portion of the member products. This means that the cooperative enterprise will have to score well in the other markets if it is to maintain member loyalty. But we will take advantage of this scenario to show that the price paid by the cooperative enterprise is not the only benefit for members. This is another example of how the cooperative works like a mutual insurance in providing guaranteed sales.

Imagine that in the above situation the members suddenly need to sell twice as much product. That would have a disastrous effect on the price they receive. After all, that extra raw material would mainly fall into the third segment:

Coop.	10@1.20	12.00
	80@1.11	88.80
	110@0.92	101.20
	200	202.00

That is only €101 for 100 units. The benefit for the member—still compared to the €100 per 100 units he would receive in the market—is rapidly melting away: from €11 to €1 net profit per 100 units.

The impact of this development will depend on the members' own business situation. Assume that it costs the members €0.90 to make one unit; i.e. 100 units cost €90. In the old situation, they would have made €111-90 = €21 profit. Now let's assume that in the new situation, the costs remain the same: €180 for 200 units. In the new situation, they receive €202, less €180 costs, leaving them with €22 profit. In other words, although the cooperative enterprise's profit is down by €9, the members are ahead by one euro. And that is only because the cooperative makes it possible for its members to produce more. This aspect becomes even more significant when most member-entrepreneurs—and the cooperative enterprise as well—increase production, reducing their cost price.

Nonetheless, a few comments can be made in respect of the last calculation. In the first place, we assume that the market in the third segment is more or less unlimited, e.g. powdered milk, and that it pays more than the average cost price of the members. There is no guarantee that this market exists in fact.

In the second place, it must be borne in mind that the average cost price for the member business is no more than a statistical average. In reality, the cost price varies widely from member to member. Perhaps the difference is as great as from 70 to 110 cents per unit. That disparity would be quite normal in agriculture. That means that the more expensive, or less efficient, members can go on happily producing, thanks to the buffer action of a cooperative that manages to pay them €1.11 per unit. They would have gone out of business long ago if they received just €1.00 in the free market. So this increased production, and the lower price of €1.01, is critical for some members. That illustrates the fact that competition between the members comes into play even when the cooperative acts as a buffer.

This illustrates an interesting conflict of interests between members, or groups of members, who are solely concerned with the situation in their own businesses. For members who see the advantages of scaling up, increasing production and reducing costs in their own businesses, the cooperative represents a guaranteed market. In the most extreme case—when there are no other marketing options—these producers might even accept a price that is below the prevailing market level as long as the price they receive covers their costs. But for members who are less ambitious, and/or have higher production costs, the primary interest is the highest possible price. This means that member objectives are hardly homogeneous and can put democratic decision-making and mutual solidarity to the test. Worse still, this is a typical situation in which one member's interests can only be promoted at the cost of another member's interests. Perhaps that is the reason why internal discussions in cooperatives frequently focus on the price paid to the members as a yardstick for central member objectives. It often seems that the discussion owes more to obscuring member differences than to any sense of business reality.

In any event, the situation becomes precarious when marginal returns in the third segment fall below the cost price of most members. At that moment, no juggling of figures will give the members any benefit. If they produce too much, their costs will exceed what the cooperative can get for the products. Neither the cooperative enterprise nor the members derive any benefit. The last calculation illustrated that point. Thanks to the prices in the two higher segments, the cooperative is able to pay €1.01 per unit for the lowest segment (average cost price: €0.92 per unit). It will be lucrative for the members whose cost price is less than €1.01 to increase production, even for members whose cost price is higher than 92 cents. Earlier, we called this the incentive problem (see Sect. 3.4).

It is a difficult problem to resolve. One fairly neutral measure the cooperative could take is to accept no new members. It is more difficult politically to introduce quantity sanctions. That would happen in order to interfere in the development possibilities of individual member businesses. There are also market strategy factors to be considered, factors that depend heavily on competitive situations and how markets are developing. Here are just a few considerations:

- The "third segment" of the cooperative's product serves a distant market. This could be seen as an investment in a new market with growth potential.
- The collective interest of members is competition with non-members. If, in order to maintain its buying price, the cooperative discourages further development of the members' businesses, than it can eventually impede competitiveness. Conversely, higher production, even temporary, can be a problem for competitors (see price leadership, Sect. 5.2).
- If the cooperative considers that there are growth opportunities in its first and second segments, it then becomes reasonable to stimulate their members to increase production.

An important problem in the highest segment—the segment we have dubbed "specialties" for the purpose of this Section—is that the cooperative enterprise will be confronted with competitors who are not obliged to accept raw materials that can only be sold at lower prices. Competitors can restrict themselves to buying exactly the quantity of raw materials that they need for their products in the highest segment. In fact, they may well pay their suppliers far more than the cooperative can afford to pay. In the calculations above, their buying price could be nearly as much as €1.20 per unit. If that is not necessary, of course they will not pay that much, but it remains a possibility. When this happens, the cooperative is no longer the price leader and becomes the price base. The cooperative's buying price will represent the lowest price that the competitor (private enterprise or other cooperative) can afford to pay its suppliers (i.e. €1.01). In developing and marketing value-added products, the cooperative finds itself operating in a different market where price leadership can no longer be taken for granted.

Another feature of this market is the distance between the products and the products produced by the members, both in terms of quantity or quality. This applies even more strongly to "modern" consumer products where packaging is often more important than the contents. That situation is quite different from when the early cooperatives turned to making cheese as a way of using surplus, or leftover milk. They did so because it was lucrative and could be seen as a way of "preserving" fresh milk, and also because such a lot of milk is needed to make cheese. The move allowed them to substantially increase sales for the members. A fruit-flavored dessert, however, is quite different. In that case, the added value lies more in the image, the packaging and the technology. It's not a matter of using more milk. While making cheese makes it possible to increase both sales volume and price, many of the new specialties are marketed to earn more money from higher prices and are almost entirely disconnected from the member product. It has more to do with the funding relationship than with the transaction relationship. These products add indirectly to member assurances that they can sell their produce because of the less profitable sales, as we saw from earlier calculations.

That raises the question of whether the cooperative should become involved in these special products. There is, after all, a risk that the enterprise will become so focused on these added-value products (or, to put it another way, on the profit the cooperative enterprise can make from them) that the central cooperative objective of selling the members' product at the best possible price becomes a secondary consideration. In a setting that is profit-oriented, it runs the risk that the member product will be seen as a handicap. Other suppliers of raw materials are no longer seen as direct competitors. Comparisons now turn to measuring success against other producers of consumer products, and *they* do not need to worry about marketing members' products.

Going by the hypothetical calculations, we might say that member products become a "handicap" when a structural proportion of the cooperative's sales yield less than the average cost price to the members. At that moment, members *and* the cooperative enterprise are taking a loss on any extra production. It may be a little absurd to speak of a handicap in other situations or of a poorly functioning cooperative. The success of the cooperative should not, after all, be measured against a commercial production company. Rather, it should be measured against alternatives for the marketing of the members' product. There will be individual members who can find buyers prepared to pay more for their product, but the question is what that buyer would be prepared to pay if there was no cooperative.

Finally, it must be said that many marketing cooperatives partition separate activities that add higher value into subsidiaries to distance them from the central cooperative volume handling objectives. The subsidiary activity can then be assessed on its own merits, confronting questions over whether the cooperative's investments in the subsidiary are worthwhile or not.

Besides specialties that add value to the members' products (or at least some of them), the cooperative can also start marketing other types of products in an effort to strengthen its position in the market. Competitor suppliers to retail chains, other foodstuff suppliers for example, draw their strength from a broad range of products. This can stimulate cooperatives to do the same. Along this path, Royal Friesland Foods, Arla Foods, Land O'Lakes and other dairy cooperatives around the world offer various products, such as chocolate milk, fruit juices and drinks made by other firms. Another variation on the theme is the strategy adopted by Avebe. It uses its expertise to make other starch derivatives (see Sect. 5.2) to broaden its starch supply portfolio to better serve its customers.

But in some cases, cooperatives decide to keep focused on what they do best. In the early 1930s, the Cosun sugar cooperative debated an option of expanding into a wider, more diversified cooperative. Cosun was always successful in the sugar industry. But the question arose over whether it should expand into new arable crops for its members. At the time, many arable farmers were seeking a "fourth crop", a new crop that would support its agronomic crop rotation schemes involving grains/cereals, sugar beet and potatoes. Ultimately, the members decided that their cooperative would remain focused on sugar beet. Somewhat later, Cosun would start producing inulin, and later still it acquired Aviko, a prestigious potato products company. Finally, it expanded into the development of alternative vegetable oil-based fuels. But these companies were founded on commercial principles. The sugar beet growers continue to dominate their cooperative.

8.4 The Objectives of Cooperating—Doing the Sums

A cooperative will pursue more than one objective. There are the objectives of the members, or the members' businesses, and then there are the objectives of the cooperative and the cooperative enterprise. Since the cooperative is characterized as being of, for and by the members, the objectives of the members' businesses have primacy. In their own businesses, the members combine the factors of labor, capital and input to produce a product. That product is transferred, as it were, to the cooperative enterprise that adds value and markets it for the best possible price and at the lowest possible cost.

In the classic, or traditional approach, this was clear from the jargon used in cooperatives. The firm was an "extension cooperative", a "task-oriented organization", a "non-independent enterprise", and a "self-sufficient business"—an interim stage in adding value to products of the member businesses. The cooperative enterprise's prime aim was to cover its own costs and pay the best possible price to its members. In this perception, the "success" of the cooperative was measured solely against the price the members received for their product. That was, and continues to be, logical from the point of view of the members' objectives. The member businesses cooperate to have a better position in the market and that translates into a better price for their products. In this chapter we have tried to offer an analysis of the success of the cooperative phenomenon. This is intended to help explain the consequences of changes in modern markets.

8.4.1 Price

If we want to consider the success of cooperating in a vacuum, we must look at the price that members would receive if the cooperative firm didn't exist. In modern terms, that means the market price. The credit for the market price, then, should go to the cooperative. But there remains the problem of estimating, or calculating, this benefit when the cooperative is exercising price leadership with markets (see Sect. 5.2).

8.4.2 Quantities

A second element in the cooperative's success is the quantity that the member can sell to the cooperative. This was discussed extensively earlier in this chapter.

8.4.3 Quality

The quality aspect is actually a variation of what has been observed about price and quantity. It is possible in a cooperative setting. Members share confidence in each other, and they work towards improving quality as a step towards getting a better price.

The added values of the cooperative enterprise are traditionally the economies of scale (i.e. reduction of costs) and its countervailing power in the market. In addition, there has always been a demand for reliable quality. The accent in quality control, in particular, is increasingly being transferred to the cooperative enterprise via the processing and finishing of the members' product to the end user or the customer's specifications. It is in that process that the most added value is created. The shift not only occurs because of the added value itself, but also because the supply-driven market is making way for a demand-driven market. The firm must recognize the demand to supply it.

The result of this development is that the position of the cooperative is changing. The consumer is king in an over-supplied market. This position change also alters the balance between the two layers of entrepreneurship within the cooperative. With just a little imagination, it could be said that the member businesses have taken the character of self-sufficient businesses and that the potentially lucrative entrepreneurship—the combination of labor (creativity), capital (risks) and means of production to create new products—is mainly taking place within the cooperative enterprise. As a consequence, the best opportunities for adding value to the product are found in the cooperative enterprise. The farm or member's business is becoming an extension of that enterprise.

That makes this an appropriate time to look at how to deal with change. At this moment, directors are itching to have the freedom to become "entrepreneurs" and are looking at proposals for ingenious ways to channel members' money into the cooperatives. This is understandable, perhaps, but the cooperative cannot lose sight of the entrepreneurship that has primacy within the cooperative.

In an over-supplied market, a member should certainly worry about the continuity of his own business. He should ask himself if he ought to invest. And if so, will he want to invest in his own business? His own business will assure his continuity and determine how much he can produce; it is in his own business that he is an entrepreneur. After all, he will not have much use for a flourishing cooperative if he fails to survive in his own enterprise.

These are not new problems. They are becoming more urgent in modern, global markets. Members can continue to discipline their cooperative to be cost-conscious, to pursue efficient policies, and to assess its value on the price it pays. But it might be better to look beyond being a classic raw materials cooperative and to take more risks in trying to penetrate farther into the supply chain. If such a choice were made, the members (farmers, in this case) would need to rethink their place in the market. Who (which other farmers) are their competitors? What risks do they run, and what risks do they want to take? What long-term objectives do they have? And, on the basis of those answers, what strategy do they expect from their cooperative? Actually, fruitful debate on issues such as funding, corporate governance, international mergers, etc., can only begin after the cooperative's parameters have been redefined.

Summarizing, we can say that the benefits members receive from a cooperative go beyond the net price they receive for their products. It is essential in cooperative ventures that benefits are evident within both the cooperative enterprise and at member businesses. Members must continuously compare the benefit they reap from their cooperative with the imaginary situation in which there is no cooperative.

8.5 Perspectives

We have set cooperation up as a way for a business to retain independence—by drawing a circle around certain things that a member wants to do or wants to keep—and as a way of keeping in touch with the market. The aim of cooperation is to create a link between the market and independent entrepreneurship.

That has become increasingly more difficult as markets and production processes have developed and become more international. We have seen that cooperatives were established around the time that industrialization occurred. With the application of large-scale technology and division of labor, industrialists could work more efficiently, so the position of small independent entrepreneurs became increasingly weaker. The latter had three options. They could try to become bigger entrepreneurs, with all the attendant consequences for their own livelihood; they could give up their independence and go to work for someone else; or they could reinforce their independence by working together with others in a similar situation.

Agriculture has traditionally been the most successful sector for cooperation in Europe, and among the most successful on other continents. Farmers produce relatively homogeneous raw materials. This allows economies of scale to be tapped in industrial processing and also in international trade. Moreover, cooperation can also be applied to a wide variety of aspects within the business, such as internal organization, quality control, logistics, research and development, marketing and product development. Meanwhile, there has always been a strong emphasis on independence at the individual member-entrepreneur level, and that proved to fit well with cooperating. A farmer wants to go on being a farmer. It should also be noted that farmers tend to have a strong sense of solidarity and their position in society. That formed a good basis for the indispensable "cooperative spirit" (Madhok 2005). A further favorable precondition was that the farmers had sufficient equity capital, in the form of their land and farm buildings, to be able to underwrite the risks inherent in starting a cooperative venture.

Cooperation could prove to be an attractive option in many other sectors as well. The first thing that springs to mind is globalization and the attendant increase in competition and traded quantities. Despite all the rhetoric about the advantages of the free market, entrepreneurs are finding it increasingly difficult to keep their heads above water in the choppy seas of international trade. Suppliers are also becoming larger and more powerful in the sales channels for non-food items, and retailers, such as retail chains, continue to gain market power. The demands on a business that wants to compete in terms of price, quantity, quality, product qualifications, service and delivery options are greater than what any small or medium-sized business can fulfill independently. Cooperating makes it easier to approach potential buyers and/or suppliers and to develop new markets, products or services, or carry out research. By joining together, they can invest and share risks. In that way, cooperation can contribute to a high quality, broad-based, professional marketing strategy for individual businesses[1].

Conversely, globalization, liberalization and the declining role of the government in markets call for an answer to the question of how the environment (nature), regional and even religious identity, and the standards and values for which a business stands for can be kept intact in an increasingly homogenized world market. It is for these reasons that business trend lists include regionalization and individualization alongside liberalization. People want to make demands on the quality of their lives, and they want to be in control of their own destiny. These days, the number of freelancers, small businesses, regional initiatives and NGOs is greater than ever. This is creating a new desire for cooperation and for a collective market buffer. New member objectives are giving rise to new forms of cooperation. Some of these objectives are aimed at taking over functions that are, or until recently were, the domain of the government, including education, housing and the environment, and nature management to name a few examples.

8.6 Avoiding Failure

There is a natural tendency to initiate a co-op by copying as much as possible successful cooperatives. Thus, many airplanes and coaches are loaded with new entrants preparing for cooperative leadership who visit the most successful co-ops in the world. Although this may be stimulating, we should not forget that these successful co-ops have behind them many years of experience, adjustments, merger, failure and reengineering. Moreover, these cooperatives function in special legal conditions, markets and co-op cultures. Therefore, the simplistic copying of successful models abroad is often a major reason for disappointment.

Co-op managers and leaders of such successful examples are inclined to transfer their model to new cooperative initiatives. Again, such an approach is apt to fail as members cooperate to master their own specific challenges. New cooperatives have to develop their own competences. The first is a clear view on market demand that the cooperators have to face. In this book it is stipulated that cooperatives may be able to act as a buffer to global markets, but of course this does not mean that they can change market demands. To the contrary, co-ops can only develop incentives to the members if those incentives are derived from external markets which they want to supply. The importance of the translation of market demands to incentives to members therefore cannot be overrated.

Co-op business provides members with opportunities to respond adequately to markets. It is key that cooperative businesses pass on effective incentives to members. This translation of the (global) market to the members is the outcome of a collective decision-making process by the members. How to contribute to collective decision-making as an individual member? When members do not comprehend the importance of collective decision-making, they may easily lose trust in the co-op. In established and successful cooperatives, this problem may be hidden for some time, but it will not disappear. Members do not automatically develop commitment and loyalty to their cooperative.

What do members expect from their cooperative? Which problems do they encounter that they would like to solve with the help of their cooperative? In many situations, managers and boards of directors have a very vague idea only. They get their information on the satisfaction and trust of members only via superficial indicators. It is a mistake to think that from the atmosphere of general meetings of members, you will find out what members try to achieve in the context of the co-op. It would require special sensitivity and skills—or a sixth sense—to come to the right conclusions from the general meeting of members. Even if the problems of individual members are clearly voiced at such meetings, it is quite difficult to explain to members in what way the policies of the cooperative will contribute to solving the problems as perceived by members.

There is the popular thought that it is the role of the professional executives of the cooperative firm to develop the strategy of the co-op firm *including* the concomitant prices or incentives to members while the boards, consisting of member representatives, have the function to "sell" that cooperative strategy to the members. We regard it as a dangerous approach. This method ignores that the internal market has to be based on the collective decision-making of the members. Of course, this holds also for the cooperative strategy itself. The voice mechanism, that is the democratic system, is crucial for the board of directors and the management of the cooperative business. Free riding and coop failures often stem from translative failures, i.e. the leadership fails to translate the 'cooperative systems' to the day-to-day operations of members.

In many cases the success of co-ops is based on the high performance of the co-op firm despite the fact that there is a lack of a voice mechanism employed by that co-op. So we may conclude that many if not most cooperatives could have done much better still.

It is often assumed tacitly that members do not need to understand the financial management of the co-op, nor do they have to understand how the financial management of their own farm is related to that of their cooperative. From experiments, we conclude, however, that members are often falsely given the impression that the financial management of the co-op is too complicated for "ordinary people". By experiments with training games, we found out that farmers, once they understand the financial basics of their own, have no difficulty in understanding the financial basics of the co-op business either. Therefore, the asymmetric information between members and directors, or even managers of the co-op firm, is unduly large. To reduce such asymmetric information, it is necessary to involve members in collective decision-making as a process. Such processes need experience both in communities of members and in circles of managers. Such is the best road to building trust.

8.7 New Instruments for Success

As we have seen in this book, traditional cooperatives to a large extent have derived their success on the basis of homogeneity in their membership. We saw, for instance, that a sugar co-op would not admit farmers who produce potatoes. Likewise, a dairy co-op is designed for dairy cow farmers whereas producers of goat milk cannot become a member. Another form of homogeneity is the distance from the market in transaction terms. In other words, in a marketing and processing co-op, the members deliver the same farm gate product to their cooperative. Often we hear that small farmers and big farmers do not get on very well with each other in cooperatives.

In recent years, cooperative experiments have been carried out with regard to accepting heterogeneity. These experiments are called multi-stakeholder cooperatives. In South Africa, cooperation between new emerging smallholder farmers with a large commercial farmer proved to be not only possible, but also successful. Moreover, such heterogeneity appeared to be an advantage. By heterogeneity, where smallholder farmers and large commercial farmers join in the same co-op, this co-op can realize advantages for both types of members. For instance, smallholder farms can take advantage of the procurement capacities, that is the buying power, of the large farms, while in this way, the buying power of the larger farmers is further increased as well. A very important advantage stemming from heterogeneity is sharing and dissemination of knowledge. The knowledge base of both the new farmers and the large commercial farmer is enlarged. In the large commercial farms, there is commonly over-capacity in agronomic expertise, and smallholder farms can take advantage of their guidance. In this way, the large farms, by conducting experiments and by learning from differences in farming systems, also increase their knowledge. So, while smallholders avoid costly experiments and can refrain from trial and error on the one hand, agronomic specialists in commercial farms can validate their best practices and fine-tune them on the other hand.

The advantage of sharing knowledge in the procurement of input can hardly be overrated. Inputs contain embodied knowledge, for instance, in fertilizer, plant protection chemicals, seeds, packaging or animal feedstuffs. The successful large farms can better distinguish price-quality relationships than can the newly established farms.

On the selling side, there are beneficial effects for both large- and smallholders: they can cooperate in post-harvest handling, storage, transport, grading and branding. For branding, quality control is a key concept for all levels, particularly in the administrative systems. Smallholders don't have to set up or invent new administrative systems, as they can make use of the existing, well-developed systems of large-holders.

It was discovered that apart from these advantages of cooperating, between large- and smallholders, it also sparks off more specific forms of corporate social responsibility programs of various trade partners in the farm-food supply chain. Although such programs may at first be based on ethical considerations, it is also in the best interests of those participants as it will stimulate the resilience of the sector as a whole.

Corporate social responsibility programs of companies may start as rather general activities as they are directed at communities and serve general purposes for the communities in which these companies conduct their business. When CSR is linked to smallholder trade partners, however, these programs are more specific for a target group, in particular the weaker partners in the supply chain.

The role of capital and access of smallholders to the desired forms of capital is important for cooperatives of emerging farmers—especially in the context of regional development. We have seen that in the USA and Canada, NGCs were developed so that external partners could participate in equity capital to the co-op. In practice, this capital was often linked to businesses specializing in value-adding activities for the farm products. So, the capital of the NGC was usually linked to innovative processing and marketing activities. When in existing value chains access to capital for farmers is made possible, the positive effects may be expected to be greater because the capital enables farmers to grow their farms more towards entrepreneurial business and at the same time develop qualities that the markets require. In that sense this latter method of providing access to capital will yield more positive effects. Of course it is important that such opportunities for access to capital should not intervene with the trade relationships of the beneficiaries. For instance, they may not prescribe to whom they should deliver their products.

When farmers who apply for capital operate with a proper administration system, this will make capitalization much easier. Especially when their administrative system is linked to a cooperative, the assessment of risks and defaults of interest payments will be more insightful for capital providers. From experiments, we also learnt that commercial banks without special knowledge of farming could be accessed for capitalization of agriculture when risks are made more insightful.

In the American New Generation Cooperatives, external capital was provided to cooperatives. Commonly these external shareholders were buyers of products of those cooperatives. One of their goals was to stimulate the regional economy. The reasoning behind this collaboration is that if you add more value to the farm product by business activities in the same region, more jobs will be created. If more jobs are created, more vocational training is necessary and both factors combined will result in a more resilient community in which sources of services and community activities are created. It has been proven that this concept of creating a center function has a very positive effect. We have seen examples in several European countries - Spain provides some good examples, and so do Africa and Asia.

The stimulating effect of concentration is enhanced by the availability of new technology in communication. Here we mention the application of advance warning systems for crops, the accessibility of GEO data as input for what is now called smart farming practices. It should be kept in mind, however, that these new technologies are much more powerful when there is regional concentration of knowledgeable people and where farmers can meet and discuss experiences. The regions with a center function have shown to generate very positive effects on strengthening the competitive edge as well as in providing good soil for innovation and startup businesses.

The tremendous wave of new communication and information technology leads to tangible, productive innovations when farmers are not only able to apply them, but when they are also able to internalize the new concepts in their business administration. It is precisely this aspect that (new generation) cooperatives should reckon to their core competence. The core competence of cooperation is increasingly on the issue of developing new knowledge by combining heterogeneity and variety in the experiences of the members. Despite the advantages of all great innovations that may be sooner or later applicable in farming, there is a need for farmers who can judge the benefits of one strategy in comparison with another solution. This so important because conditions of soil, water, microclimate, and incidence of disease or pests can be very different at rather small distances. The effect of farming practices has to be combined with differences in resource conditions. Farming after all is a place-based business of complex processes.

In the course of business development, especially with regard to cooperative business startups, it is important to maintain the overview processes that unroll over time. What we did yesterday is often lost in the darkness of the past and what we ought to do for the new season is darkness too. Businessmen must be reminded that there is a time lag between the execution of a measure and its effect. Especially in farming, events do not have their immediate and visible effects. They do of course have some visible and immediate effects but they also have long-term repercussions. By consequence, farmers must learn that they cannot do only one thing or cannot adopt only one new technology. Whether they want it or not, each step they take will affect many other things. There are always side effects and farmers have to cope with it. This is not only true for the agronomic aspect of the business but of course we see the same complexity in their business economics.

It may be true that in developed countries farmers and their cooperatives have had the chance to learn all this over many years, decades or even centuries. Over the decades, many businesses went bankrupt or were merged into other firms. Especially in wealthier countries, many administrative and technological buffers were created, some by private initiatives, but most with the help of public bodies. However, with new technology developing at a very high speed and markets interacting with various political decisions, the consequences for the business are hard to be taken into account—even for well-developed businesses. New farmers do not enjoy such enabling environments and they do not have the luxury of acquiring insight spanning many decades. The practice of gathering experience over the long run will not be allowed to today's farmers. Therefore, new innovative training methods are required.

In recent years, such innovative training methods have been developed by applying simulation games. In cooperation with Kucheza, a Netherlands game developer, such games were tested in practice.. The data contain realistic agronomic and technical coefficients as well as realistic prices of inputs and outputs. These data allow simulating the real-life conditions in which the farmers operate. The game simulates various internal and external events with which the farmer-player has to cope. Every consecutive year is appraised according to investment decisions and is subsequently evaluated by cash flow and income statements, and the balance sheets. As a result, farmers can play games and exercise farm and cooperative strategies on the basis of real financial data too. After some time of exercising their farm business game, the cooperative is introduced. From that stage onwards—that is, after they have decided to become a member—farmers will play both at their own business level and at the level of the cooperative. From that level of play onwards, the player becomes acquainted with the relationships between their farm and the cooperative as shown by the financial statements at the farm level and at the cooperative level. Especially the issue of investing in the cooperative versus investing in one's own farm requires insight in the effects for the longer term. Eventually players have to discuss on the basis of facts and relationships.

The advantage of this approach is that time passes as quickly as the player decides. Also, on a computer, distances do not exist. The simulation game can make the effects of decisions and long-term strategies transparent. Also, the effects of a strategy with regard to participating in a cooperative can be illuminated. For instance, if one and only one member decides to adopt a free-rider strategy, it will hardly affect the cooperative and the other members. When it is simulated, however, that a growing proportion of members is following the same (defective) strategy, it becomes clear that the cooperative will soon fail to realize its goals and may even go broke. In this way, farmers can develop a greater sensitivity to reality. We apply this argument not only for the farmers' core business, namely the production of crops and animals, but we particularly like to apply this argument for how to become a successful co-op.

In the cooperative, it is very hard to pinpoint errors that are made on the basis of proposals by the management or on the basis of collective decisions. The occurrence of crisis in co-ops may be rather uncommon. This then is good news, but the unfortunate effect of this is that there are rarely occasions for members to bring experience gained in one crisis to another crisis of the same kind. As a result, mistakes in a concrete situation cannot be of much value to the members. From gaming simulations, a particular type of crisis—for example free-riding behavior—can be introduced time and time again on the same day.

In a cooperative, individual insight with regard to collective interests will become more effective when such insight is put into words and discussed by members. Therefore, training by gaming cannot stand on its own. For training by gaming to deliver a vast potential, any co-op would need a structure that enables members to reach collective decisions. Here, we come back to the observation that was made quite a few times earlier in this book, namely that most cooperatives do not pay due attention to arranging a workable member democracy. Yet, a workable democracy is necessary to organize voice and to collectively prepare strategic decisions. Such a workable democracy should be part and parcel of the co-op governance model. Even in the discovery of governance models that are effective in this respect and which are acceptable for members and workable for managers, the gamification approach has proven to be of great value.

8.8 New Approach to Cooperative Governance

In the previous section, we introduced gamification for both the training of members and managers and also, for that matter, the other partners or stakeholders of a cooperative. Among these stakeholders, we also include government agencies and public organizations.

Experiments with new methods of democratic decision-making showed that for collective decision-making it is essential that members are aware of the value of the cooperative business. By playing collective decision-making, members evaluate different possible outcomes. It stimulates creativity rather than being funneled into one proposed solution. As a combination of play and learning, this method is appreciated above getting the necessary information by reading or lecturing. Gaming is a form of edu-tainment (education and entertainment).

We experienced that in the cooperative part of the game, playing in several small groups, is an effective way of conducting the game. The debate within the groups and among the groups is easily sparked off. For collective decision-making, we allow more time to the players. In fact, like in real-life situations, the debate in a cooperative is never finished. In large cooperatives where you cannot possibly have all members participating, collective decision-making in small groups provides indispensable insight.

As we have seen in previous chapters, cooperatives normally have various member representation schemes. Increasingly the member council is a common phenomenon. There are several ways of selecting members for the member council. Some cooperatives have local committees elected by local membership and a few members of the local committee are subsequently elected to represent the local members in the regions and so on. This is not the place to discuss the merits of different methods of election. Generally speaking, methods where members in a member council were selected randomly are not favoured by boards or by managers. The boards and the management often believe that members are only eligible for election in the member council when he or she has been trained. According to that view, members need to have a certain level of training or should possess certain business capacities in order to be an acceptable candidate for the council. We do not favour this approach. The disadvantage of it is that it will lead to homogeneity in the member council. People that have the same training and the same knowledge are likely to have the same vision with regard to the prevailing strategy. As a result, they can at best reach a level of becoming a sounding board for the management. This however should not be the key task of a member council.

Instead random selection has many advantages. Random selection means that there is random selection within certain categories. These categories in the membership should be represented in the council. Therefore, random selection is stratified random selection. Common strata or categories are gender, age within gender, types of farms and regions, and in some cases, economic sectors. By following these methods, the member council will be a good representation of the entire membership. By random selection, there will be a great variety in background, formal education and attitudes with regard to their cooperative. Perhaps the most important advantage of this method is that members feel at an equal 'social distance' when it comes to participating in the governance of the cooperative. Apart from illiteracy, which makes participating very complicated, it was found that participation in game-based training was not hampered by this method of selection. To the contrary, this approach appears to yield excellent results.

By using new methods of communication, the management of a cooperative can nowadays easily organize polls among their members. However, the answers to a poll and its conclusions are largely defined by the quality of questions that are asked. In order to ask the right questions, the manager of the cooperative not only has to understand the challenges for the cooperative business, but he or she also has to understand what the members care about. With regard to this latter aspect, the role of the member council is a special one, namely to bring that raw reality from outside in. This role will help the management to understand the problems which the members (have to) encounter and how the cooperative leaders can help to reconcile farmers' possibilities and ambitions with those of the cooperative as a firm. The member council has the essential role to represent and voice the world of experience of the members. This, we discovered, sounds simple but is not an easy task at all. Members in a council often expect to be informed by the co-op leadership about the cooperative business. They often think that it is their task to give advice or their consent. Sometimes, they regard themselves as a sounding board; some behave even as if they are the supervisors in the last resort.

Because the functioning of the council as the third tier on the governance is most essential, we pay special attention here to some characteristics of the council meeting. First of all, the issues brought from outside in have to be weighted on the relative importance of each one of them. This can only be done by discussing it among themselves. This process of 'weighing by discussion' should not be disturbed by the view and preferences of the cooperative management. Therefore, it is necessary that the chairperson of the council is independent. The chairperson should not be a member of the board, nor should he or she be a manager.

We arrived at the following rules for an open and democratic debate in the member council:

1. *In meetings of the council, any issue may be brought up for discussion. However, discussions should not divert attention from the core task in the members' council. On speaking in the board, members of the council serve a representative function.*
2. *How issues are dealt with depends on the following four factors:*
   a. discussion in the members' council,
   b. the domain: does it lie in the scope of the council's responsibilities?
   c. the viability of the proposal, and
   d. administrative considerations: does it lie within the scope of the cooperative?
3. *All members of the council have the duty to provide and request information. The members of the council are individually responsible for the influence and effectiveness of the council. The agenda of the members' council should include three types of subjects:*
   a. they have the formal and statutory position to give discharge to the management, to appoint and to fire board members,
   b. they can bring outside information in on behalf of the members and prepare collective decisions, and
   c. a council may formulate items for the agenda of executives.

Finally, we conclude, generally speaking, that members of the members' council stay too long in their position. It is commendable to refresh the council with new members after a few years: a minimum of one third or one fourth should be replaced each year. This approach further reduces the aforementioned social distance.

Communication by the (executive) management and by (non-executive) board members to members is not an easy task. The managers have to explain how to comply with business rules and regulations. The complexity is often underestimated. Cooperative executives (managers) perform their job in a culture and a systemic world that is fundamentally different from the live world of the members. They also have different ways of communicating about the short-term and long-term effects of their strategies. Therefore, a reply to a question raised by the members' council is not as easy as it seems. Systemic thinking is a key function of managers. Members conduct their business in a different system. So, in communication, the concepts and causal relationships of the one system must be translated into those of the other. This task is made more easy if farmers are trained on the basis of the same cooperative business systems. We take this as an important reason for game training of all members.

To effectuate collective decisions, the executives need the mandate to run the cooperative company in accordance with these collective decisions. A cooperative firm would of course soon be bankrupt if everything in the daily business had to be subject to collective decision-making. Collective decision-making is necessary to agree on long-term strategies, but the day-to-day tactics must be left to one or only a few individual executives. In cooperative practice, it suffices when one chief executive officer or just a few executives who are responsible for the daily running of the cooperative business communicate regularly, for instance every fortnight, with non-executive board members. The collectivity of members is however in particular represented by the member council.

The non-executive board members are commonly elected from the membership. Executives and non-executives make up the executive committee (EC). We may call the EC the first tier of the cooperative. The relationship between executives and non-executives in the EC will be more effective when the member council is functioning well. The member council, the third tier, is the heart of democracy in a cooperative.

Finally, we acknowledge that in all governance systems, a second tier is necessary. This second tier has the function to control and to exert supervisory tasks. This supervision concerns the functioning of executives and non-executives in the first tier. Therefore, control and supervision are necessary. We believe that this function is best carried out by representatives of the council supported by external professionals. The important tasks there are the supervision with regard to finance, the audit and the salaries for executives and non-executives in the first tier.

Up to now we discussed governance from the point of view of the members, how they are represented, and how they voice their issues with the co-op. We suggested forms of how democracy in cooperatives can be made effective. At the same time, we looked at the co-op firm as one entity which is represented by the executives or the management. In doing so, we did not pay attention to the internal cooperative dynamics as a business. From the management literature and business economics, we know however that firms are also vivid coalitions of business units, management circles, professionals and administrators. Moreover, in cooperatives, members often neglect or only pay scant attention to the role and significance of employees in the cooperative. Employees are commonly regarded as having nothing to do with the core business of the cooperative. There is a serious shortcoming in this approach for the following reasons: First we should acknowledge that there are various employees in the business who are in direct daily contact with members. Second, employees have a better eye for situations where the cooperative firm failed to deliver value to the members—and they know better than the top management whether there are situations of failed members, for instance when members behave as free-riders. Thirdly, if you adhere to democratic principles where it concerns members, why should you follow the principles of simple hierarchy where it concerns employees in the cooperative enterprise? After all the practicing of good voice mechanisms in an organization creates value. Co-ops would benefit if they followed more democratic management approaches within the cooperative firm, similarly to the voice mechanisms with regards to members.

Note

[1]The R&D cooperatives in the semi-conductor industry are an interesting example. See Browning (1995).

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Chapter 9
Concluding Remarks

All over the world governments face the question of how to make sure that sufficient new capital is invested in new technology and entrepreneurship in domestic agriculture. Do markets provide incentives for such investment? When do established farmers or young farmers feel safe enough to invest? How to avoid the notorious 'pig cycle': periods of overinvestment followed by (long) periods of oversupply and depression? Is farming attractive for young talented professional people to enter the farming industry? Are our farmers not farmers because there are just no alternatives for them—that is, they are not "farmers by default?"

There is today hardly any government that is able to fund market and price policies that can realize those targets. Norway and Switzerland are examples where society regards agriculture almost as a public service. But both countries also face the problem of how to keep farming attractive for young professionals. What stimulation is there for new technology? Which competitive balance can be sought?

In what way is the food and farming system coordinated? Farming is a central part of the food chain. The food chain is described as 'from farm to fork' or 'the food and farm system'. The food chain starts with seeds or animal genetics as basic inputs for farms and ends with retailers selling consumption-ready foods. Post-harvest, the farm products are stored, transported, graded, processed and marketed at the wholesale and retail levels.

Both upstream and downstream the farm gate, all businesses have grown into bigger companies, many of them even with global impact. Farms are the weaker partners. For the most part, they are relatively very small. Therefore, farmer cooperatives have been established. The marketing and processing co-ops are (vertical) integrations of farming, processing and marketing. The supply co-ops integrate input suppliers and farming. Agricultural and horticultural cooperatives always integrate at least two levels of the value chain.

Basically there are three types of coordinating mechanisms for the value chain: the 'free market' system, a centrally planned or hierarchical organization, and hybrids where people cooperate either formally—as described in this book—or on the basis of informal networks and mutual relationships. Market coordination means that the activities of the various participants in the chain are coordinated by the price mech-

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anism. For price discovery to function well, there have to be market institutions. No doubt the price and market system is very efficient. It is also one-dimensional, however. Additional arrangements are necessary.

Cooperative structures are a hybrid solution, an 'in-between' to coordinate the farm and food system. Agribusiness cooperatives have proven their value, especially the strategies of market access and countervailing power development by cooperatives, as farmer-owned businesses have been successful in the past. Examples are cooperatives in buying inputs such as fertilizers, animal feed and plant protection chemicals, and various cooperatives in processing and marketing.

Various cooperative models have been developed in different countries. The successful farmer-owned co-ops in capitalist countries have become equivalent partners in the value chain. In the EU a study was carried out that can illustrate the effect of such strategies of co-ops on farm price. The most well-known case is taken from the dairy sector. In countries where co-ops process more than 50 percent of domestic milk production, farm gate prices are 10–15% higher than in countries where the market share of cooperatives in domestic milk production is lower than 50 percent. Apparently, where farmer cooperatives play a role in value chains, a rise in farm prices is put more successfully on the agenda than in value chains without the strong presence of farmer-owned businesses. This price performance is not only due to countervailing power, but also due to the fact that through their co-ops, members have become shareholders in successful brands. This position enabled co-ops to be the first to put a price increase for the raw material on the agenda. It should be reminded, however, that it took more than one generation of farming to reach this position.

A competitive food system requires efficient farms, agribusinesses and trading firms. As in agriculture, the unit of competition is the value chain; the question is how the economics of the food supply chain provides its participants with the 'right' prices. Are costs and prices in balance with value added by the various actors in the supply chain? Such an outcome will not be automatically brought about by 'free markets'. Therefore businesses need additional organization to regulate the conduct of business partners.

History provides many dramatic incidences of exploitation at the cost of farm development. The 'old farmers' drama' is that price formation for products leaving the farm gate cannot be left to the forces of the free market. Why prefer banks to give loans to agribusinesses rather than to farmers? Why do even social investors choose to invest in agribusiness downstream or upstream the farm gate rather than in farming itself? The reason is that farmers are 'price takers' and operate with highly fixed assets. They react with the least elasticity to price developments. Their profits are dependent on prices 'made' by their transaction partners: agribusinesses. This problem can be solved neither by government policies nor by hierarchies. So we pose the question: How can we ensure that farming becomes or remains a sustainable business?

The historical and present practices of cooperative development in Western countries cannot guide the large number of smallholder families out of the poverty trap. Instead, we believe that new forms of cooperation between the players in the agro-food chain are necessary. It would help if governments would put pressure on the strong partners in the chain by making this a societal license to produce. The key value for such license is social inclusion of smallholders, particularly for smallholders and new farmers. For obtaining the license to produce, the present leaders of the agro-food chain have to change their market conduct.

The long-term prospects of the transaction partners of the new generation of farmers in developing economies are not good as long as they do not realize that it is their calling to take co-responsibility for the new generation of farmers. By the very nature of farming, it is given that a farming business cannot be footloose, but is bound by the land and water resources. For this reason, farmers are residentials and will be part of the local community. This means that they are to play an important role in the local communities and that these communities have to be involved in the struggle for a thriving agriculture. The same holds true for ecological sustainability—the resilience of soil fertility, water resources and biodiversity in flora and fauna. In farming in particular, there is the threat of exploitation of unpriced values and resources. The external effects are then rolled off on the ecological environment and on local communities. Under income pressure, it is inevitable that soil fertility will not be properly maintained, that water systems will not be looked after, and that animal health and welfare will not meet the standards of good herdsmanship.

We have seen through various examples that in such situations there may be many diversified cure—and prevention-oriented public actions and policies. However, we argue that such public policies are not sufficient to solve the problem. Instead we think that all participants in the chain and the transaction partners that are connected with it need to contribute to prevention policies to make them effective. In particular, the residents should be given voice so that they can build their own destiny and environment. Therefore, they need strong links with market partners. To realize economic sustainability, the link with world markets is a most important factor. It will support incomes, create new jobs, stimulate education and reward new skills.

How can companies that are transaction partners, but not residentials, contribute to local economic welfare? To answer this question, it should be realized that a transaction relationship is admittedly of great value. However, it is not enough. Economic transactions are rather one-dimensional in the information that they share. The business partners of the value chain—even (and in fact just) if they are global players—need to involve the community, of which farmers are an important part, in the planning for the future of their companies. To such effect, the community needs personalized relationships. Who, which persons, represent the global company in the community? How do they participate in the public and private knowledge systems of that community?

International companies have their public affairs officers that lobby the public institutions and governments. These officers lobby decision-makers in the environments of the businesses for their interests. They lobby the governments and the local leaders. Complementary to this type of lobbyists, there should be local community affairs officers who lobby the other way: in the interests of the community for the decision-makers in their own company. There is a need for business officers who lobby for the farming community, their cooperatives, and for the interests of the local community. In this way the voice of the farmers is heard in the headquarters of international companies. Such a lobby is also necessary on behalf of public agencies. A similar plea is in place with regard to the conduct of NGOs.

Giving voice to farmers, their business, their private and public societal communities are necessary routes to change the conduct of the big partners in the food and farming value chain towards long-term co-responsibility. The positive effects will be reinforced if there is also cooperation with local schools, health services and so on.

Economics is more than just about generating financial profits. It is important that the economy contributes to unlocking people's talents, to give them room for choice. People who can apply their talents and contribute, by giving voice to the local cooperatives and other communities, will be happier. Both these aspects of voice and happiness are forgotten goals of economic development. Therefore, rephrasing the famous book by Hirschman, quoted several times in the previous chapters, we make a plea for "entry, voice and happiness" as the tagline for global companies. Doing business with new farmers implies that you also enter personal relationships. These relationships are made meaningful for the market conduct of your company if the farming communities are assisted in developing 'voice'. Voice means reducing the democratic deficit in so many countries, regions and companies. Democratic deficit is the root cause of the one-sided emphasis on the financial targets of businesses and the ill-omened aid programmes by NGOs. Having more opportunity to contribute to the commonwealth of the world around us is the agent of people's happiness.