



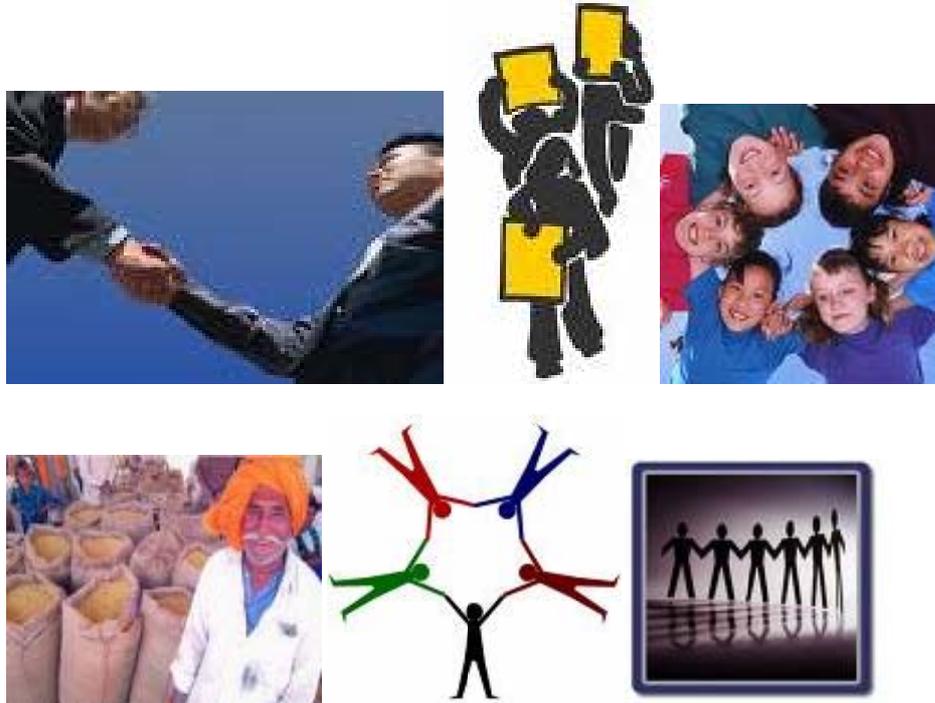
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Co-operatives WA

Cooperative Enterprise

A Discussion Paper & Literature Review



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Foreword

Cooperatives WA commissioned this discussion paper as a preliminary investigation into the cooperative business model and its relevance within the twenty-first century. Predominately a review of the literature, this study examines the current state of play pertaining to the cooperatives movement at an international level, while placing the cooperative business model within its historical and regional context. It focuses on six units of analysis

1. The validity of the cooperative business model in the 21st Century;
2. Member value creation and recognition within the cooperative;
3. Supply chain management and strategic networking within cooperatives;
4. Cooperative leadership and corporate governance;
5. The cooperative as a mechanism for regional economic development; and
6. The financial structure and funding of the cooperative business model.

Each of these six units of analysis has a set of specific research questions which this discussion paper will attempt to address. However, the purpose of this initial study is not to answer all questions in a comprehensive manner, but to identify the current state of knowledge relating to these issues, and to provide recommendations for future research.

The aim of this discussion paper is to provide a framework for the development of academic study into the field of the cooperative business model. In doing so, it also seeks to stimulate debate within academic circles, the cooperatives movement and the wider community over the future of the cooperative as a legitimate business model

Methodology used in the Study

In the preparation of this Discussion Paper the methodology followed has involved a review of the international literature relating to cooperatives drawn from both scholarly academic databases and official reports published by such groups as the International Cooperative Alliance (ICA) and National Cooperative Business Association (NCBA).

An initial analysis identified a series of specific research questions relating to the six areas of research focus. These are summarised in Table 1. It should be noted that the purpose of these research questions is to provide a general framework for the guidance of future research into the cooperative enterprise. It is not the intention of this initial review of the literature to address these questions, although where possible they will be modified or expanded if new lines of inquiry emerge.

Table 1: The Principal Areas of Research Focus and Key Research Questions

PRINCIPAL AREA OF FOCUS	KEY RESEARCH QUESTIONS
1. Validity of the cooperative business model	<ul style="list-style-type: none"> • What are the strengths and weaknesses of the cooperative business model in comparison with the investor owned enterprise (e.g. corporate & franchise structures)? • Is the cooperative business model superior in some conditions and is this contingent on industry, geographic context or political / social environment?
2. Member value creation and recognition within the cooperative	<ul style="list-style-type: none"> • How is member benefit understood within the cooperative business model? • Is member benefit different from that of other competing forms of business model? • What are the most appropriate measures of member benefit within a cooperative business model? • What can international best practice teach us about appropriate business models?
3. The financial structure and funding of the cooperative business model	<ul style="list-style-type: none"> • What are the characteristics of the cooperative business model that serve as constraints to its acquisition of external financing, particularly access to risk capital? • Are the accounting and financial performance benchmarks used within the conventional corporation appropriate for the cooperative business model and if not what are the alternatives?
4. Cooperative leadership and corporate governance	<ul style="list-style-type: none"> • What are the specific challenges facing management of coops and are these different in substance to those faced by investor owned enterprises? • Are there best practice examples of coop management that provide lessons for future business models? • Are there unique requirements for the construction and composition of coop boards of management and the constitution that comprise their articles of association? • Are the requirements of coop board members influenced by industry effects?
5. Supply chain management and strategic networking within cooperatives	<ul style="list-style-type: none"> • What are the characteristics of supply chain relationships at work within coops and are these different from those found in investor owned entities? • What is the impact on corporate resilience of such supply-chain relationships? • Are these relationships influenced by industry or geographic proximity effects? • What is the nature of trust within cooperatives and what are its impacts on supply chain management?
6. The cooperative as a mechanism for regional economic development	<ul style="list-style-type: none"> • What is the role of cooperatives in regional economic development and industry clustering? • Is there an incompatibility between the political and social roles of the coop and its economic and business function and how might these be reconciled?

Executive Summary

Overview of the Findings

Cooperative Enterprise has a long history and can trace its origins back to at least the 15th Century. However, it was the establishment of the **Rochdale Society of Equitable Pioneers in 1844** that is viewed as the foundation of the modern cooperative movement. By 2007 the global cooperative movement employed around 100 million people and the top 300 largest cooperative enterprises turned over US\$ 963 billion.

Despite its importance the cooperative enterprise has been largely ignored within mainstream economic and management theory for much of the past 60 years. This has been attributed to the rise of “neo-classical” economics during this same time period and the perception that cooperatives were socialist or non-profit entities.

While it is true that the cooperative enterprise has strong philosophical roots in socialist theory, it has always been apolitical and non-religious in nature. The great English economist Alfred Marshall, who was a major supporter of cooperative enterprise and an early President of the Cooperative Congress noted in 1889 that cooperatives are both strong, functional businesses, and fervent, proselytizers over their principles.

Defining the Cooperative Enterprise

A cooperative enterprise is a unique form of business entity. It is different from the traditional shareholder owned enterprise or investor owned firm, and also the conventional not for profit or non-profit entity. While numerous definitions of cooperative enterprise exist, the key principles that define a coop are fivefold. First, it must be a voluntary formation of members, as compared to communist collectives or government imposed organisations. Second, it must be governed by principles of democracy in which a “one-member-one-vote” rule exists. This compares to a shareholder owned enterprise in which voting power is determined by the size of the shareholding. Third, the coop must be independent of government control and owned solely by its members. Fourth, the coop can be formed by individuals or organisations (e.g. other businesses). Finally, the cooperative enterprise exists only for the benefit of its members. It cannot be used to benefit the wider community as might a charity, or a political or religious cause.

The fundamental difference between the coop and the investor owned enterprise is the issue of shareholding power. This lies at the heart of many of the strengths and weaknesses of the coop. The inability of any one group to concentrate power through their accumulation of share ownership ensures that the coop will not be easily taken over or have its democracy eroded. However, it also makes the ability of the coop to raise capital difficult as investors will not willingly provide money without influence. Within the investor owned enterprise the shareholder is able to look forward to a capital gain on their investment over time and the payment of dividends based on performance. This is less the case with cooperatives where the benefits of membership are more likely to be realised through patronage.

Since the 19th Century the structure and governance of cooperatives has evolved. Few coops today operate on the basis of the 'traditional' model originally espoused in 1844 at Rochdale. Numerous hybrid forms have emerged that seek to overcome some of the inherent weaknesses of the cooperative business model without losing its fundamental strengths

Theories of Cooperation

The history of the cooperative enterprise is intertwined with the economic and social theories that have shaped the past 165 years of its existence. Compared with Marxism and its liberal free market alternative, cooperative enterprise has remained largely apolitical and pragmatic in nature. However, it has also been weak in terms of the development of strong underlying theory, due in part to its focus on applied and practical outcomes.

Theories of cooperation and competition suggest that human behaviour involving cooperative exchanges is motivated by desires for reward and self-advancement rather than altruism. As such it is consistent with the underlying principles of free market economics based on the concept of self-advancement and reward seeking. In many cases cooperative behaviour can serve as a means of reducing selfishness, free riding and cheating within the system as individuals realise that mutual benefits can emerge by collaborative engagement.

Theoretical foundations of cooperative behaviour can be found in game theory and the notion of "tit-for-tat" responses to free riding or cheating. **Faced with mutual reciprocity that can either reward cooperative behaviour or punish selfishness the individual is more likely to choose a cooperative path.** Reciprocal altruism suggests that individuals who give or share benefits with others expect a return from those who receive such benevolence. Free riding and cheating can damage such reciprocal behaviour and is more likely where the population is highly mobile. In more stable communities such behaviour is quickly punished by having these individuals excluded from further participation in future collaboration.

Cooperation between individuals requires the existence of mutual trust and a sense of procedural justice. Where a minority of individuals behave in a purely selfish manner without any consequences the underlying sense of fairness, morality and mutual obligation breakdown within the community and the majority also begin to behave in a selfish manner.

The participation of individuals in cooperatives can be explained in terms of the *mutual incentives theory* which draws together theories of social exchange and social cooperation. The first suggests that people engage in social relationships after considering the costs and benefits of doing so. The second suggests that cooperation is motivated by a sense of common or shared goals between individuals.

Validity of the Cooperative Business Model

A business model is a conceptual tool that is used to draw together the logic behind a business enterprise that defines how it will create value for its customers, profit for its shareholders, and how it will allocate key resources and employ processes to achieve its purpose. The concept of the business model emerged in the academic literature during the 1990s and was mainly applied to the new technology ventures being developed in the computer and information technology sector.

The business model lies between the firm's strategy, organisational structure and the systems or processes that it uses to fulfil its mission. The key "building blocks" of a business model are the product that is being offered including the target market and how this product or service makes a competitive value proposition to the customer. Then there is the way in which the firm interfaces with the market, including channels of distribution, relationships it builds with customers, and how the firm's resources are configured to provide value. Also important is the way in which the business configures its resources and competencies to execute the business model and how it leverages networks with alliance partners to add value or gain a competitive edge. Finally, there are the financial aspects of the business model, including the cost structure of the enterprise and how it will generate revenues to meet costs and achieve profit targets.

As a business model the cooperative enterprise has a different strategic purpose to that of an investor owned enterprise. The coop is focused on the maximisation of member benefits rather than the maximisation of shareholder returns. It seeks to target the greatest areas of member need rather than the most lucrative market opportunities. The value chain in the coop is also different from that found other types of enterprise. For example, customers or suppliers and typically members and owners of the coop rather than third parties, they therefore seek lower prices as customers and higher prices as suppliers.

Coops offer members enhanced market access and reduced market risk. They can also give members superior financial benefits from enhanced pricing and greater access to resources. Many coops also encourage community capacity building. However, coops also suffer from a potential difficulty in demonstrating the benefits of membership, and a lack of common interest amongst members. This last point is a particular problem where membership is highly diverse.

Five main weaknesses of the cooperative business model have been identified. The first of these is that of **free riding by members**. The second is **the "horizon problem"** where members cannot see long term value in their shareholding or be able to transfer their membership rights to others through sale on a secondary market as with conventional shares. The third weakness is that of **the portfolio problem** is also related to the inability of the membership rights to be transferred or traded. The fourth is **the control problem** caused by member interests not being aligned with those of the coop management. Finally there is the **influence cost problem** in which disputes may arise over future investment in the enterprise versus distribution of benefits to members.

The **New Generation Cooperative** is a form of coop that emerged in the United States in the 1990s and seeks to overcome these inherent weaknesses by focusing on adding value to products and allowing more openness of membership and linking such membership to delivery rights to overcome free riding through rewards to increased patronage. Further, the more patronage a member engages with the coop the greater their voting rights within the enterprise. This is not the only innovative coop business model and it is not without its critics.

As a business model the coop is not without its weaknesses, but it is a valid enterprise form and in specific circumstances with competent management and the ability to maintain the support of its members it can be highly successful. **Coops have been viewed as offering a "third way" between government control and free market capitalism.**

Member Value Creation and Recognition

A major challenge for coops is the ability to demonstrate benefits to members. In a shareholder owned enterprise the return on investment and dividends provide clear and measurable evidence of the value of shareholding. In the coop this is more difficult as member benefits are usually derived from patronage. While the New Generation Cooperative aims to reward patronage directly through voting rights and transferability of shareholding, the more traditional coops must rely on more indirect approaches.

Ownership rights and the distribution of benefits to members remains an area of focus for the future development of the cooperative business model. Different types of ownership and governance structure have been tried with combinations of patronage linked shareholding and dividends paid against the performance of the enterprise. In some cases the coop has created hybrid structures in which part of the enterprise is a traditional form of coop and the rest is an investor owned business. In others there is a dual class of shareholding with the coop members having more traditional voting rights, and shareholders enjoying some of the returns to investment found in standard investor owned enterprises.

In addition to financial benefits the coop can provide additional benefits in the form of lobbying for the interests of its members within a political context. However, the influence cost problem can reduce the capacity of the coop to serve as a lobbying force due to divergence of interests among members. The coop is also not a political entity and its actions in seeking to lobby within a political arena should not be allowed to override the efficient management of its business activities. The loyalty of members to the coop is contingent on the ability of the enterprise to engender trust with its membership.

Financing Cooperatives

Cooperatives are traditionally funded through the initial share capital of members and the retained earnings of the enterprise. Due to their particular ownership and governance model the coop is traditionally equity constrained and any additional capital raised must be through debt rather than equity. However, analysis of the financial performance of coops and investor owned enterprises over time suggests that differences between these two were relatively small. **The coop was also found to have levels of profitability and benefits to members that were superior to their investor owned counterparts.**

A major issue for coops has been to raise capital to fund growth and this is where a lot of attention has been given to find alternative sources of managing and accommodating such financing. Among the variety of funding options employed by coops at least five key types emerge. The first is that of appreciable and/or internally traded shares that allow the member to realise capital growth from their initial investment over time. The second is externally traded subordinate bonds. This allows the coop to issue bonds without the dilution of member control. These bonds offer reasonable rates of interest for investors.

A third form of financing used by coops is to establish a subsidiary company in which there can be investment and shareholding along similar conventions to an investor owned enterprise. However, the coop is the shareholder in the subsidiary and retains the integrity of its structure and member control. Coops have also used the public listing of preference shares and others have de-mutualised and converted into investor owned companies.

The experience of coops seeking to raise financing through altering their structures has had mixed results. If undertaken as a response to market pressures it may place the coop into a vulnerable position. It may also risk the loss of trust from members if the financial restructuring results in a dilution of member control and benefits. Any loss of the coop status can result in the emergence of a free rider problem and/or the dilution or erosion of member benefits. This may also have an adverse impact on patronage.

Leadership Corporate Governance and Strategic Networking

Most coops have a corporate governance structure consisting of three key elements. The first of these is **the General Meeting** in which all members have the right to vote to approve the annual budget, major investment decisions and strategy. The second is **the Board of Directors** tasked with keeping records and administering the coops constitution and bye-laws. The third is **the Supervisory Committee** tasked to oversee the Board and report to the General Meeting.

Traditionally the coop has been viewed as coalition of members with different interests designed to achieve the common goals of these individuals without loss of their own independence. As a result the management of the traditional coop is weak and the system of “one-member-one-vote” does little to strengthen their position. Many coop Boards are composed of members and this has led to criticism that these Boards lack sufficient experience when compared to investor owned enterprises.

Coop Boards typically face three interconnected tensions in their role. The first is their need to represent the interests of members and the interests of the coop as a business. Second, they face a tension between the need to see the coop grow while managing in a prudent way. Finally, they need to balance the need to control the enterprise while supporting the coop executive management. There is a need for enhanced management skills among Coop Board members and for outsiders with expertise in financial, marketing or legal issues to be appointed.

Executive managers within coops also require different skills to their counterparts in investor owned enterprises. The coop is a different type of business to run due in part to its control and ownership structure. Managers who have greater experience of the dynamics of how a coop operates and the culture of such organisations are more likely to succeed than those drawn in from outside the cooperative movement. A delicate balance is required between finding managers with experience in the coop and those with adequate expertise and skills within mainstream business.

Another aspect of the management of the cooperative enterprise is how it handles supply chain relationships. A supply chain encompasses the upstream and downstream linkages that connect the business to its suppliers and customers. **Effective supply chain management is now one of the most critical aspects of business operations. Successful supply chains are defined by flexibility, a strong sense of common purpose amongst members, good coordination and communication, plus the ability to outsource non-core competencies to other parties within the channel.** Properly configured an effective supply chain can achieve faster cycle times and at a lower cost. Ideally such supply chains also encourage innovation through the free flow of ideas that can enhance value adding through the network.

Coops are often structured as supply chains either for producers to sell into, or buyers to purchase from. How well they are configured and managed can be crucial to their success. The actual structure used by coops in the management of their supply chains

varies widely across different industries and within sectors. It can range from a loose “atomised system”, through a “consensual network” that employs sufficient formality to help reduce costs, to formal “strategic networks” in which there is a focal firm (e.g. the coop) and greater control over production and marketing.

The nature of cooperative enterprise whereby members are also the supply chain has been found to strengthen the sustainability of the network in many cases. When faced with political, economic or social pressures, coops have relied upon the common purpose and loyalty of their memberships to strengthen their competitiveness.

The Cooperative as a Mechanism for Regional Development

The cooperative enterprise offers considerable potential as a tool for regional economic development. Throughout its long history the coop has played a significant role in helping to fill gaps caused by market failure or absence of government intervention. Around the world the coop has served the needs of communities from rural producers to the urban poor in providing enhanced access to markets, resources and finances, often at better prices than would have been possible had these individuals acted alone.

Cooperatives are still being used in developing economies as a mechanism for economic self-advancement. They offer the promise of lifting communities off state welfare, providing for greater self-determination, and fostering sustainable economic growth. Their role in this type of economic regional development has placed them within the “social economy”, or the third path between that of government controlled or privately held enterprises. This seeks to find a means of enhancing the economic and social welfare of the community without focusing totally on profit maximisation. It incorporates non-profit organisations, but can also include coops.

A social enterprise is one that is focused on the production of goods or services and is created on a voluntary basis, and at a significant level of risk to its shareholders. Its employees should work for a minimum amount of time on a paid basis and not be volunteers. Coops play a key role in the social economy of many countries, however there remains a tension within the cooperative enterprise over whether to remain true to the Rochdale Principles of 1844 or seek to embrace the profit maximisation aims of the shareholder owned enterprise.

Chapter 1

Origins and Context

An Overview of the Global Cooperative Movement

The cooperative enterprise has not enjoyed the same level of public profile and academic attention in recent years as the investor owned corporation or franchise. Despite this lack of attention, the cooperative business is a major generator of jobs and economic wealth throughout the world. According to the International Cooperative Alliance (ICA) the cooperative movement brings together over 800 million people globally and supports the livelihood of an estimated 3 billion people, while providing direct employment to around 100 million (ICA, 2008).

The Global 300

A research study undertaken by the ICA into the 300 largest cooperative and mutual businesses in the world found that the combined annual turnover of these leading enterprises was US\$ 963 billion (€ 979 billion) with a range from a low of US\$ 600 million to a high of US\$ 53 billion. Ninety-eight percent of these 300 largest cooperatives are concentrated into three industry sectors: financial services (e.g. banking, insurance and credit unions) with 40 percent; agriculture with 33 percent, and retailing and wholesaling with 25 percent. These enterprises ranged in age from 50 to 100 years old and encompassed 28 countries with 63 percent of the group's turnover coming from European based cooperatives. France, Germany and the Netherlands were the EU countries with the largest cooperatives in terms of annual turnover. However, Japan and the United States also had large cooperatives in the Global 300 list (Cronan, 2007).

The Top 10 cooperative and mutual businesses identified in the Global 300 study were broadly representative of countries from all across the world. From Japan were Zen-Noh and Zenkyoren, and from Korea the National Agricultural Co-operative Federation. Also represented in the list were France's Credit Agricole Group and Groupama; Germany's Edeka Zentrale AG; Spain's Mondragon Corporation; Switzerland's Migros; the Co-operative Group from the United Kingdom, and Nationwide Mutual Insurance from the United States (Cronan, 2007).

The Cooperative Enterprise in Economic Thinking

Despite becoming a global movement, cooperative enterprise remains less prominent within the field of economics and management theory than the conventional investor owned firm. For example, Kalmi (2007) examined the treatment of cooperative enterprises within the economics textbooks used within the University of Helsinki over the period from 1905 to 2005. His analysis showed that while there was a strong and vibrant focus on the cooperative enterprise during the first half of the 20th Century, by the 1950s the level of attention declined significantly.

This decline in interest in the cooperative within the field of economics was attributed to the rise of neo-classical theory during the second half of the last century. According to Kalmi (2005) this trend signalled a quiet rejection of collaborative or collective approaches to economic organisation, as well as a top down rather than a grass roots or bottom up approach to solving economic problems.

Kalmi (2005) noted that the economic texts from the first half of the 20th Century viewed the cooperative enterprise as a valuable mechanism for enhancing social and economic society:

In sum, the discussions of cooperatives in early textbooks matched their economic importance, or sometimes even exceeded it. In the early twentieth century, cooperatives were still a fairly recent innovation and many authors (certainly Gide) expected that their importance would grow over time. Worker cooperatives in particular were discussed more than they would have warranted based on purely economic importance; indeed, one of the most debated questions was why they were so rare. This can be understood by their social importance. While other forms of cooperatives provide mainly auxiliary support to the members and their businesses, worker cooperatives are much more encompassing in the sense that they actually provide the primary livelihood for their members. The early authors sensed both the social potential of worker cooperatives and the importance of related theoretical issues. (p. 635)

However, following World War Two the focus on cooperative enterprise declined sharply, with many textbooks omitting any mention of them altogether. While economists in the early part of the 20th Century appeared to understand the benefits of self-help and self-education as offered by cooperatives, this did not emerge in the neo-classical world of the late 20th Century economists (Kalmi, 2005):

The massive increase in the economic role of the state has also had a direct impact on why the role of cooperatives in the textbooks diminished. Government regulation helped to resolve market failures in industries where cooperatives were prominent, such as the retail trade, banking, insurance and housing (Hansmann, 1996). Even though regulation did not make cooperatives redundant, it reduced the need for cooperative solutions in these industries and exposed them to increased competition. (p. 640)

The cooperative enterprise has continued to survive and thrive over a period of 160 years. However, it has largely disappeared from contemporary academic study within the fields of economics and commerce. What then is a cooperative enterprise and why should it be considered for academic study?

This discussion paper is structured primarily around the six principal areas of focus outlined in Table 1 and the various research questions associated with each of these. However, before addressing these focal points directly, some attention needs to be given to a brief overview of the history of the cooperative movement, and to define the nature of what such an organisation is. In doing so it examines the theoretical foundations of cooperation and the potential role of the cooperative enterprise in the development of economic society, a role that has always been viewed as very different from conventional business enterprises.

A Brief History of the Cooperative Movement

Within the United Kingdom the cooperative business enterprise traces its history back to the late fifteenth century with the establishment of the Shore Porters Society in Aberdeen in 1498 (Shore Porters, 2007). However, it was the industrial revolution of the late eighteenth and early nineteenth centuries that saw the emergence of the modern cooperative movement. While the Shore Porters Society was a semi public body under the control of the Aberdeen Town Council until 1850, the first consumer cooperative appears to have been the Fenwick Weaver's Society established in Scotland in 1761. This organisation was set up to encourage professional standards amongst weavers, but soon took on the role of collective purchasing of oatmeal and books (McFadzean, 2008).

In France the cooperative movement is able to trace its origins back to 1750 when a group of cheese makers formed what has been suggested was the first consumer cooperative in the developed world (Williams, 2007). There was also a cooperative bakery *Caisse du Pain*, established in Alsace at Guebwiller in 1828. By 1867 there were some 50 producer cooperatives, 100 credit unions and five or six retail cooperatives operating in France (Gide, 1922).

Philanthropic industrialists such as Robert Owen encouraged the principles of cooperation from around 1810 onwards. An early socialist, Owen inspired a number of cooperative experiments in the 1820s and 1830s with the creation of the London Co-operative Society in 1826, and involved like-minded colleagues such as William Lovett and the Chartists who sought universal suffrage and workers' rights. However, it was not until the 1840s with the Rochdale Society that the modern cooperative enterprise saw its emergence. Established in 1844, The Rochdale Society of Equitable Pioneers was a cooperative mechanism aimed at assisting impoverished weavers. The majority of its founding members were not weavers, but Owenite socialists and ex-Chartists who articulated the "Rochdale Principles" which provided the foundation for today's cooperative movement (ICA, 2008b).

These principles included openness of membership and a one-vote-one-value form of democracy in the governance of the organisation. Profits or financial surplus distributions to members were based on the proportion of trade (patronage), and there were to be some payment of limited interest on capital. The entity was to be politically neutral and to have no religious affiliations. All trading was to be in cash with no extension of credit, and the organisation was to promote the value of education amongst its members (Holyoake, 1908).

According to the principles of the Rochdale Society, the establishment of the cooperative was for the financial benefit of its members, and as an enterprise designed to undertake a variety of different economic activities. For example, not only was it to operate retail stores, but also to offer an opportunity for employment, supply chain procurement from members and cooperative housing. Ultimately, the society sought to create a utopian community that would be economically self-sufficient and worker owned and controlled (Fairbairn, 1994).

This link with socialism helped to spread the cooperative movement throughout nineteenth century Britain and then across Europe and elsewhere in the twentieth century. For example, in Germany during the 1840s Friedrich Raiffeisen led the development of agricultural cooperatives in an attempt to assist impoverished farmers, focusing on the establishment of rural credit unions to help break the grip of loan sharks. While workers

cooperatives in Belgium, Italy and France grew strongly, farmers, tradesmen and small business owners drove the spread of rural and retail cooperatives elsewhere in Europe, as well as in North America and Japan. Although the roots of the cooperative movement lie in socialism, the spread of farmer, retail and credit union cooperatives during the nineteenth century lie predominately with the middle class or *bourgeoisie* (Gide, 1922; Birchall, 2003).

Expansion of the Cooperative Movement

In the second half of the nineteenth century, the cooperative enterprise spread across Europe and into North America where farmers embraced it as a mechanism to enhance agribusiness (Bradley & McMaster, 1980). Cooperatives also emerged as a strong force within rural producers in Canada from the 1890s (Doyon, 2002). A similar pattern followed throughout much of Europe, as well as Australia and New Zealand. For example, cooperatives spread into Russia from the late 1800s and by 1918 there were an estimated 7,000 agricultural, 53,000 retail and 16,000 rural credit cooperatives operating in that country (Williams, 2007: 20). However, the rise of communism in the Soviet Union and fascism in Spain, Italy and Germany during the years following the First World War (1914-1918) saw many cooperative enterprises taken over by the State.

Cooperatives emerged in the United States from the 1840s and were encouraged during the 1930s as a mechanism for economic development. After the Second World War (1939-1945), the cooperative once again spread within Europe, North America and Asia as a means of assisting the economic development of rural communities (Birchall, 2003). According to Williams (2007) the cooperative movement in the United States boomed during the 1960s:

The cooperative movement became a new hope for the generation of Americans who looked toward a new economic order to distribute the nation's resources more equitably. New consumer cooperatives most frequently were a symbol of rebellion against technocracy, hierarchical corporations, and "big business as usual". (p. 21)

By the mid-1990s, the agricultural cooperative sector was significant with the United States, Canada, Brazil, the European Union, Japan and Korea all possessing some of the world's largest agricultural coops that were also among the largest business entities in the world. In the field of retailing, the cooperative enterprise that had emerged in the 1840s reached a peak in the 1950s and began to decline, although it has remained strong in Italy, Switzerland and Japan, while enjoying a revival in the United Kingdom in recent years (Birchall, 2004). For example, there were only 50 cooperatives operating in the UK in 1945, by 2000 this number had grown to around 500 (Williams, 2007).

During the nineteenth and twentieth centuries, credit societies or cooperatives grew strongly in Europe and remain a major force today with 11,000 local and regional cooperative banks including the giant French Credit Agricole, the Rabobank of the Netherlands. Canada also has a large credit cooperative sector, particularly in Quebec. However, elsewhere in Australia, South Africa, the UK and USA the trend during the past twenty years has been towards demutualisation (Birchall, 2004).

The history of the cooperative movement can therefore be seen as taking place in at least four stages. Stage one from the 1840s to the 1870s saw the emergence of cooperatives as a viable and effective enterprise with the capacity to alleviate economic hardship within disadvantaged communities. In stage two from the 1870s to the 1930s the cooperative

movement grew globally as a mechanism of the *bourgeoisie* to enhance their economic power via producer, consumer cooperatives, or credit and insurance mutual societies. Stage three during the 1930s, 1940s and 1950s witnessed the Great Depression, the Second World War and its aftermath. These years of depression and war appeared to impact negatively on the cooperative movement. However, in the fourth stage from the 1960s to the present the cooperative movement grew again, particularly in the 1990s.

The Cooperative Movement for Social and Economic Revolution

From its earliest manifestation the cooperative movement has been viewed as a social and economic mechanism for achieving fundamental change. While the conventional business entity is designed to advance the economic and social well being of a small number of share holders, the cooperative is typically focused on enhancing the welfare of a larger community.

The investor owned enterprise is a business model based upon the principles of economic competition whereby individuals are motivated by a desire to secure an ever increasing share of markets or resources. While economic competition is a major source of innovation and investment behaviour that typically increases the overall wealth in a society, it can also result in monopolistic behaviour in which a small group secures ownership over a disproportionate level of resources, to the disadvantage of the majority.

Williams (2007) in his examination of cooperatives as a movement for grassroots change in the global economy echoed the views of 19th Century cooperative organisers:

What has been learned from all of the discussions outlined above is that *social capital is more important than material capital*. The solution involves the simple principle that social bonds and norms are of paramount importance for all people and communities...Globalisation based on a competitive form of capitalism fosters only a neo-colonial relationship with the developing world, marked by violent conflict and tribal reactionary behaviour both in the developing and developed world. Cooperation, on the other hand, has made an environmentally and socially sustainable, and even global, economy feasible for thousands of communities. (p. 179)

This view of the cooperative movement is wider than a simple business model operating alongside the alternative business structures. It seeks to fundamentally change the way in which economic systems behave. At its heart lies an ideological opposition to the hyper competitive, profit-maximising free-enterprise system. Williams (2007: 175-179) outlines a 10-step plan to achieve a roll-back of what he views as an uncivilised economic society dominated by the likes of Wal-Mart and its allegedly rapacious and greedy corporate behaviour. The key elements of this plan involve:

1. **The re-establishment of common ownership of public goods** such as water, air and other natural resources, restricting private ownership and control;
2. **Reformulate corporate charters** to remove the concept of limited liability and reinstate "common good" as the primary focus of the corporation rather than the benefit of a small self-interested minority;
3. **Restructure intellectual property laws** to restrict private ownership and allow wider access to patents and copyrights;

4. **Widen the scope of cooperative enterprises** particularly in the area of financial services such as the establishment of banks and credit unions tasked to provide micro-financing in the developing world;
5. **Restrict the financial benefits of Corporate Executives** by limiting the annual remuneration of senior executives and corporate owners to no more than six times the salary or wage levels of the average low-level full-time employee;
6. **Focus food production and distribution at the local level** to reduce the dependence on global food supply chains and transportation networks and encourage local producers;
7. **Introduce “social cost accounting” in all companies** with a view to fully reflect the full environmental and social costs of production;
8. **Reduce all military expenditures to the minimum required for internal security** and limit the level neo-colonial militarist expansion by the major powers;
9. **Subject all foreign aid programs to performance monitoring** that is able to direct funds to local communities and away from the corrupt power elites;
10. **Cancel all unjust world debts, allow free trade and eliminate “plunder by trade”** which would involve monitoring labour costs differentials to ensure that stronger countries do not exploit the poor in weaker nations.

This action plan represents a wide-ranging and quite radical manifesto with significant social, political and economic consequences. It is not the purpose of the present study to engage in this agenda. Our focus is upon the nature and operation of the cooperative as a business model, not the fundamental overhaul of the global economy. However, it is worth acknowledging the views of those such as Williams (2007) who remind us that while the cooperative is an alternative business model, it is based on a platform of social, economic and political philosophies that are substantially different to the status quo corporate entity. As the great English economist Alfred Marshall (1842-1924), who was President of the Cooperative Congress movement, stated in a speech given in 1889:

What distinguishes co-operation from every other movement is that it is at once a strong and calm and wise business, and a strong and fervent and proselytizing faith. (Gide, 1922; p. 28)

Let us turn now to the definition of what a cooperative enterprise is and principles upon which such an organisation operates. The following sections define the cooperative as an enterprise and what distinguishes it from the conventional investor owned enterprise. Also examined are the different types of cooperative enterprise that have emerged in recent years.

Defining the Cooperative Enterprise

At the heart of the cooperative business model are the principles of cooperation. These can be traced back to the ideas of Robert Owen in the nineteenth century (Robotka, 1947). The ICA statement on cooperative values states (Prakash, 2003):

Cooperatives are based on the values of self-help, self-responsibility, democracy, equality and solidarity. In the tradition of their founders, cooperative members believe in the ethical values of honesty, openness, social responsibility and caring for others.

In this respect the cooperative has a fundamentally different philosophical foundation to the conventional business enterprise, which is driven by market competition and a desire for individual gain. This deep philosophical differentiation is an often contentious issue for cooperatives, particularly in free market economies where the embracing of socialism is viewed as inappropriate within the operations of a business enterprise.

A cooperative business enterprise can take many forms. They can include agricultural producer supply chains, consumer retail buying groups, financial credit societies and mutual's, housing or building societies, workers cooperatives and cooperatives focusing on health and social care. For these reasons, the definition of what is a "cooperative" enterprise can prove elusive. The definition used by the ICA is:

An autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.

The Principles of Cooperation

According to Birchall (2004) five key features define the cooperative enterprise:

1. **Voluntary** – a cooperative is an association that is voluntary and members are free to enter or leave;
2. **Democratic** – cooperatives are democratic in nature with all members having one vote, one value as compared to corporations in which shareholders voting rights are proportionate to their control over equity.
3. **Independence** – a cooperative is independent of government ownership and is owned solely by its membership;
4. **Associations** – the cooperative is an association of individual persons who can be both real people or "legal persons" that might be other organisations;
5. **Benefit for Members** – a cooperative is for the benefit of its members and is not a charity set up to provide services to others who are not members. It cannot be used for a purpose other than the benefit of its members without ceasing to be a cooperative;

In 1995, the ICA generated a revised set of cooperative values and principles designed to assist in the definition of what a cooperative enterprise is or should be. This highlighted the values of voluntary and open membership, democracy in governance, independence and the need for all members to benefit equally from their participation. It also highlighted the need for the cooperative enterprise to engage in education, training and information dissemination to both its internal community of employees and members, as well as the wider community. In addition, the principles of collaboration amongst cooperatives and a concern for the community were principles that were highlighted (Birchall, 2004).

Differences between Cooperative and Investor Owned Enterprise

According to Bacchiega and de Fraja (2004) the fundamental constitutional difference between the investor owned enterprise and the cooperative is the mechanisms used to make decisions. While voting is the mechanism used in both organisational forms to make decisions, and the majority vote is typically the one carried, there are differences between the two entities. For example, in a cooperative each member has one vote of equal value regardless of his or her actual capital contribution. By comparison, the investor owned enterprise has shareholders with different levels of ownership based on the quantity of share capital they hold. The difference between the cooperative and the investor owned enterprise is:

- **Cooperative** = “one-member-one-vote”;
- **Investor Owned Enterprise** = “one-share-one-vote”;

According to the analysis undertaken by Bacchiega and de Fraja (2004) the constitutional design associated with these entities affects the amount of financial capital available to the enterprise. The level of capital invested by each member who votes is the main factor influencing his or her voting behaviour. In the investor owned enterprise, shareholder motivation is a desire to gain control over the entity or block the future control by other shareholders. However, in the cooperative, this “strategic role of investment” is absent, and shareholding does not influence voting behaviour.

This dichotomy was examined within the context of farmer owned coops by Staatz (1987) who drew comparisons between the coop and the investor owned enterprise. Building on the original Rochedale principles the cooperative business model should comprise some or all of the following (Roy, 1976: 258). Profit within the cooperative is distributed according to patronage and there is limited return to shareholding. Membership is open and this serves to dilute equity amongst the existing shareholders. Cooperatives are independent of any political or religious affiliation and all decision making should be undertaken in an open democratic manner based on the ‘one-member-one-vote’ principle. A cooperative is also generally avoiding of risk and seeks to pass on net profits to members via rebates rather than through discounted prices. There should also be a strong focus on member education in the cooperative way of business.

As Staatz (1987) explains, few cooperatives actually follow all these Rochedale principles and most at least have the characteristics of a limited return on equity capital, democratic control by members and the aim of offering members the best prices. Compared to the investor owned enterprise, a cooperative is an entity that distributes any investment returns based on patronage rather than equity ownership.

Taxonomy of Cooperatives

While the business model of the cooperative is clearly distinctly different from that of the investor owned enterprise, there are many different types of cooperative enterprise (Krivokapic-Skoko, 2002). In an analysis of the nature of cooperative business models Nilsson (1999) identified four generic types or models, the traditional, participatory, subsidiary and new generation cooperative. These are illustrated in Table 2 and discussed in more detail below.

Table 2: The Four Types of Cooperative Enterprise

ATTRIBUTES	TRADITIONAL COOPERATIVE	PARTICIPATION COOPERATIVE	SUBSIDIARY COOPERATIVE	NEW GENERATION COOPERATIVE
Entry	Free	Free	Variable	Variable
Individualised entry	No	Only for investors	Only for investors	Yes
Member equity contribution	Equal	Equal	Equal via cooperative	Yes
Voting rights	Equality for all members	Member – usage investors – shares	Member – usage Investors – shares	Share based
Return on income	Use-based	Member – usage Investors – shares	Member – usage Investors – shares	Share based
Value added services	Limited	Yes	Yes	Yes
Professional management	No	Not always	Yes	Yes

Source: Nilsson (1999)

The Traditional Cooperative

In this cooperative enterprise the ownership is open to all and membership entry is free. Ownership is collective in nature and adheres to the principle of “one-member-one-vote”. Share capital is not traded and members cannot realise changes in the value of their shares. There is no external control over the cooperative and any profits are not paid to members as dividends but as a patronage refund based on their use. Such cooperatives generally do not have professional management and offer little in the way of value added services to members.

The Participation Cooperative

This type of cooperative has both members and shareholding investors. This allows for non-patrons to hold shares, typically in the form of B-Shares or certificates. Purchase of shares is voluntary but the cooperative can restrict ownership to specific parties such as

members, employees, other cooperatives or local citizens. Shares are tradable and can accumulate value and investors may have voting rights. This creates two classes of stakeholder, the members who benefit from their patronage of the cooperative and investors who earn dividends or capital gains from their shares. While not all cooperatives of this kind have professional managers it is more likely given the existence of investors.

The Subsidiary Cooperative

This type of cooperative involves the operation of a large or small part of the enterprise via subsidiaries owned by third parties. There can be external ownership of shares which are able to be traded on secondary markets and earn capital gain. These external equity owners are usually granted voting rights on the Board and at the Annual General Meetings. Any profits are distributed in part to the members via the cooperative and to the external shareholders on the basis of their equity control. Such a cooperative can raise external financial capital more easily and is therefore more likely to offer value added services. It will also have professional management in order to satisfy the interests of its investors.

The New Generation Cooperative

This type of cooperative emerged in the USA during the 1990s. In this model the membership is not open and is usually restricted to individuals who have bought trading rights with the coop. All shares are fully tradable and can realise capital gains over time. Voting is equally distributed but also can be based on equity control. Members make the key decisions but there can be some limited involvement by minority external shareholders. A strict proportional relationship exists between the member's investment and their patronage as specified in contracts. Profits are distributed as patronage refunds, but work like conventional shares with returns based on level of investment. Member contract rights and shares are fully tradable and individual in ownership. Such cooperatives have fully professional management teams.

The emergence of the new generation cooperative (NGC) model in the 1990s has offered a potential to redefine the cooperative business model. These cooperatives require their members to purchase delivery rights and thereby create a two-way obligation between the member and the cooperative for a specific amount of patronage each year. They have closed membership and require significantly higher levels of investment to traditional cooperatives. However, delivery rights are marketable and prices fluctuate according to the performance of the cooperative and its earnings potential (Hardesty, 2005). Despite these developments debate over the need for reform of the cooperative business model continues (Campbell, 2003). It has also forced a refocusing within the cooperatives movement to review the cooperative business model and look to ways in which they can remain competitive while retaining their original commitment to members (Campbell, 2004).

Chapter 2

Theoretical Foundations of Cooperation

Theory and the Cooperative Movement

The history of the twentieth century has been marked by the global struggle between the ideologies of economic liberalism with its free market open competition, and socialism (Hobsbawm, 1994). The later ranging from the Marxist-Leninist ultra left communists, through the moderate social democrats, to the national socialism of the ultra right fascists. As noted above, the foundations of the cooperative movement can be traced back to the social-collectivist ideologies inherent in western society during the nineteenth century. In this regard the cooperative business model has been perceived as having a less than rational basis when compared to conventional business structures.

In searching for the theoretical foundations of the cooperative business model the literature review tracked back to the 1930s, a time in which the Great Depression had put a significant cloud over the future of the capitalist economic system. By comparison the communist system of Soviet Russia and the Fascism found in Italy and Germany seemed to offer alternatives. Into this political and economic maelstrom the journal, *The Annals of the American Academy of Political and Social Science* ran a special edition focusing on the cooperative movement, its principles, social relationships, achievements and present status.

Economic foundations of cooperation theory

Although the cooperative movement can trace its philosophical origins back to the 1840s and the Rochdale Society, its economic theoretical foundations are grounded more firmly in the 1890s with the work of French economist Charles Gide (1847-1932). He viewed the cooperative movement as a branch of the liberal school of economics, focused upon the increase of wealth and reduction of costs in order to achieve enhanced satisfaction to each person. Unlike Marxism, cooperative enterprise accepts the principles of classical economics, and embraces voluntary engagement and democracy with the system rather than revolution (Gide, Rist, Row & Richards, 1915).

However, the cooperative movement departs from the classical or liberal economic view in its basic mistrust of the free market to deal fairly and equitably with all people. For the less powerful the only means of securing equity and fairness is via cooperation. In essence the interests of the individual must be combined with the interests of the wider community (Drury, 1937).

Throughout its history the cooperative movement has adopted a largely pragmatic and rational approach to its activities. Viewed more as a bourgeois movement it avoided the radical approaches espoused by Marxist socialism. According to Gide (1922) the socialist and cooperative movements were largely indistinguishable from the 1840s until the 1870s. However, as the more radical Marxist philosophies took hold within the socialist movement in the later decades of the 19th Century a split occurred between the two movements.

Marxism sought to overthrow the liberal free-market economic system and redistribute wealth through the confiscation of individual property via forced collectivism. By contrast

the cooperative movement sought a more equitable and fair society through peaceful and economically rational approaches. Compared with Marxist socialism, cooperation is based on the principles of individualism, democratic control an openness to all, and political neutrality. In essence an adherence to the Rochdale Principles which have proven the foundation of the cooperative movement (Drury, 1937).

However, the pragmatism of the cooperative movement and its historical departure from the mainstream socialist philosophies has meant that it is relatively weak in terms of its underlying theoretical foundations. Warbasse (1937) observed that there was an absence of theory underlying the cooperative enterprise model. According to Warbasse (1937):

Because of its lack of preliminary theory, because it feels its way as it goes, and because it is a rather simple and direct way of doing things, cooperation sets up no special goal except what might be represented by an expansion of its up-to-date accomplishments. (p. 15)

In this analysis the only “essential” principles that apply to cooperatives from those originally espoused at Rochdale are the need for democratic control of the coop by its members, limited interest on capital invested, and the savings return as a proportion to patronage. The cooperative remains actively engaged in the free-market economics of the capitalist world. For example, the farmer uses the producers’ cooperative to help him lower his input costs and raise his bargaining power within the market to secure premium prices for his produce. Without this he would be at the mercy of the market as a small scale producer. Even the worker who sells his labour uses the consumer cooperative to help lower the input costs of his food and clothing so as to enhance the “profit” generated from the sale of his labour within the open market (Warbasse, 1937).

Economic theories of cooperation

While the cooperative movement lies within the traditions of liberal, free market economics it remains distinct from classical and neo-classical schools of economic thought. In an analysis of the relationship between mainstream economics and cooperative enterprise Albrecht (1937) noted several points of distinction between these schools. The first was in their treatment of capital and profit. While conventional investor owned enterprises are focused on maximisation of shareholder return on capital, the cooperative seeks to limit both the returns and the level of ownership concentration. In a cooperative the focus is on an equitable distribution of dividends based on patronage rather than shareholding.

This approach to ownership and the distribution of profits within the cooperative remains a key issue differentiating the coop from the investor owned enterprise. While the latter is focused on the capitalist who owns the share capital within the enterprise, the focus for the coop is on the member who is a patron of the cooperative enterprise. In this way the coop differs from both the conventional investor owned enterprise and the Marxist collective (Gide, 1922).

According to Albrecht (1937) at least three general types of cooperatives emerged by the early 20th Century. The first he described as “individualist”, the others as “labour types” and those with “social objectives”. Of these the first are what have today become identified as cooperatives with adherence to the Rochdale Principles and the free-market. The second type, found mainly in Europe, were focused on working class issues and closely linked to organised labour unionism. The third type was of a more idealistic political hue.

As an economic philosophy the cooperative seeks to enhance the well-being of a wider community through the collective efforts of individual members. As one writer explained:

The most fundamental economic claim of the champions of the consumers' cooperatives is that it *is* an economic democracy because it is an economic system which automatically tends toward economic equality. By returning to its member patrons as patronage refunds the net profits of the business operations, the consumers' cooperative automatically operates to secure a wider diffusion of money income to the many, and to prevent the accumulation of money power in the hands of a few. Upon this claim, the cooperatives stand or fall. (Miller, 1937: p. 37)

In summary, the economic fundamentals of cooperative enterprise are its focus on the enhancement of benefits to all its member patrons rather than a relatively small number of people who own the share capital of the enterprise. The cooperative also seeks to remove monopoly control within markets and in doing so promote economic equality and prevent economic privilege. By eroding monopoly power, the cooperative seeks to reduce prices within consumer markets, seeking fair prices over the monopolist's premium price setting. The cooperative also serves to enhance the overall quality of goods and services supplied to its member-patrons. It arguably does this via the democratic control it allows to its members who are also its patrons (Miller, 1937).

Game theory and cooperation

As the basis of the free market economy is competition, there is a general perception that cooperation between firms or even individuals is either inefficient or undesirable. However, theoretical and applied research by Robert Axelrod has shown that cooperation is actually a rational process that often leads to superior outcomes even when individuals are motivated by self-interest (Okra, 2008).

Through the application of experimental game theory it has been possible to show that cooperative behaviour amongst individual organisms is desirable (Axelrod & Hamilton, 1981). Despite the individual's motivation for self-advancement, the threat of an action resulting in a counter-reaction by the other actors in a game or society forces these actors into a state of cooperative behaviour out of self-interest (Axelrod, 1984).

At the basis of this theory is the concepts of "tit-for-tat", in which the players in a game initially start to cooperate, then respond in-kind to the actions of each other. If all choose to play "nicely" the game proceeds without excessive competition. However, if one player seeks to take advantage of the others they will retaliate in-kind with the consequences that the game will typically see all losing. If all players refuse to cooperate and the odds of the game are even, the result is likely to be a "death spiral" in which all parties lose (Axelrod, 1997; Axelrod & Dion, 1988).

The Prisoner's Dilemma

The central focus of Cooperation Theory are the lessons from Game Theory as defined by the "Prisoner's Dilemma". This can be illustrated in the following example shown in Figure 1 (BIE, 1995). In this case two criminals Thelma and Louise have been captured by the police for a \$10 million bank robbery. While the police know that they are guilty they do not have sufficient evidence to charge them. They have been placed into separate prison cells and each has been offered a separate deal. Each prisoner must implicate the other and if

they do both will serve a short prison sentence. If one implicates the other but is not implicated they will be released and can enjoy the stolen money while the other goes to prison for a long time. However, if both refuse to implicate the other they both walk free and can split the loot. They are given four options.

		Thelma	
		Clear other	Implicate other
Louise	Implicate other	Louise: \$ 10 m Thelma: \$ -5 m	Louise: \$ 0 m Thelma: \$ 0 m
	Clear other	Louise: \$ 5 m Thelma: \$ 5 m	Louise: \$ -5 m Thelma: \$ 10 m

Source: BIE (1995)

Figure 1: The Prisoner's Dilemma

The best option for each individual would be to implicate the other while not being implicated. This would see them released with the reward of the bank robbery proceeds. The second best option would be for both Thelma and Louise to cooperate and refuse to implicate one another. This way they would both walk free and split the money. The third best option is to implicate each other and both do time in prison, while the worst option is to be implicated by the other while not implicating them. In this case the individual will go to prison for a long time and get no money.

The "Prisoner's Dilemma" game suggests that the cooperative solution is the best option, however, it is not always the one taken by individuals. Further, where the game involves multiple rounds, or an open ended process without a defined final decision, the dynamics change (Neyman, 1999).

In this case the propensity for cooperation increases because of the opportunity for a "tit-for-tat" response, allowing the individual who seeks to cheat or secure an advantage in one round, being paid back in subsequent rounds (BIE, 1995). As noted by Axelrod (2000):

"In an iterated game, a player can use a strategy that relies on the information available so far to decide at each move which choice to make. Since the players do not know when the game will end, they both have an incentive and an opportunity to develop cooperation based upon reciprocity. The shadow of the future provides the basis for cooperation, even among egoists. An example of a reciprocating strategy for the iterated Prisoner's Dilemma is Tit for Tat which cooperates on the first move, and then does whatever the other player did on the previous move." (p.4)

In order for this theory to hold the rules of the game must be known to all players and there must be an equal opportunity for decision making and based on equal information. This is not always possible. For example, not all people have the same access to information or the capacity to analyse the information they receive (Simon, 1955; 1956, 1959).

Such information asymmetries are common in some markets. For example, in the case of used cars the buyer is generally unable to fully assess the quality of the motor vehicle they are buying. The seller has full knowledge of the car's history but is not obliged to disclose this to the buyer. As a result the risk associated with the purchase is high and the price of the used car is forced down. Regulation of the used car market by governments has been designed to reduce these information asymmetries.

Reciprocity – Direct, Indirect and Spatial

The motivation for individuals to cooperate within the "Prisoner's Dilemma" game is the expectation of "tit-for-tat" reciprocity from the other players. Reciprocity, along with social norms, plays a significant role in determining whether cooperative behaviour will emerge amongst individuals faced with game situations (McCain, 2008).

Nowak and Sigmund (2000) examined the nature of human cooperation within the context of reciprocal behaviour. They suggest that reciprocity is the key element to maintaining cooperation over competition or exploitation.

At least three types of reciprocity can be identified. The first is *direct reciprocity* in which the individual receives direct rewards or punishments based upon their behaviour within a game. Many players follow a "Pavlov" strategy in which their behaviour is in direct response to the reward or punishment they received from each "tit-for-tat" response to their actions (Nowak & Sigmund, 2000).

Cooperative behaviour using the "Prisoner's Dilemma" game has been trialled with birds suggesting that the same patterns can be replicated elsewhere in the animal kingdom (Mesterton-Gibbons & Adams, 2002). Amongst humans cooperative behaviour has also been shown to be linked to *indirect reciprocity*, where the individual is not able to receive direct rewards, but gains enhanced reputation or "good standing" within the community (Leimar & Hammerstein, 2001).

For communities that are stable (e.g. membership of the group is durable over time) the probability that cooperative behaviour will occur is higher than in more transient or unstable communities. This creates the notion of *spatial reciprocity* where competitive or exploitative behaviour is more easily undertaken without risk of reciprocity within transient or unstable populations (Nowak & Sigmund, 2000). It is for this reason that deviance and criminal activity are more likely to be found in large, cosmopolitan cities than smaller, tightly-knit communities.

Reciprocal Altruism

The sustainability of cooperative behaviour between organisms has been examined within scientific research leading to the emergence of the theory of reciprocal altruism. This concept suggests that an individual will provide a benefit to another without expectation of an immediate reciprocal benefit. The good standing that the individual generates within its community is such that when the original provider of the benefit seeks to call upon those who were beneficiaries of their benevolence, their initial altruism will be rewarded (Trivers, 1971).

While the original “tit-for-tat” strategy motivating cooperation within the “Prisoner’s Dilemma” game is a rational behaviour it is not sustainable over time. Sustainability of cooperative behaviour is best explained via the theory of reciprocal altruism where those individuals that are enjoying short term abundance of resources, share with others in the expectation that their benevolence will be subsequently rewarded at a later stage when they are in need (Killingback & Doebeli, 2002).

The risks to reciprocal altruism that can work against cooperation are cheating and free-riding. Where an individual is found cheating or free-riding they are typically punished by the other members of the group by being ostracised. This has been found in both human and animal communities (Trivers, 1971). For this reason individuals tend to favour initial benevolence and cooperation to members of their immediate family or kinship group. Trust between individuals is critical to cooperation and cooperation with strangers is potentially risky because the individual has no way of knowing if their altruism is to be subsequently reciprocated.

Mobility and Cooperation

The risk of free-riding or failing to reciprocate is compounded within communities where there is a highly transient population. The refusal of individuals to reciprocate is generally restricted within communities that are immobile or non-transitory. Were they to remain in the community without reciprocating their free riding behaviour would eventually become intolerable and they would face a “tit-for-tat” response. However, where the individual is mobile, it can afford to free ride and then move onto another community after enjoying the benevolence of the original host community.

Enquist and Leimar (1994) undertook an analysis of free riding behaviour within mobile communities. They suggested that within human populations the defences against this behaviour are suspicion and gossip. A free rider’s ability to exploit the cooperative behaviour of their host community is likely to be reduced if they are initially treated with suspicion as to their long term intentions before being granted benefits. The role of gossip is to reduce the information asymmetries by allowing information on the free rider’s behaviour to be disseminated quickly throughout the community. Gossip thereby serves as a control on the free rider and reduces their opportunities.

Cooperation, Trust, Fairness and Procedural Justice

These theories of cooperation suggest that cooperative behaviour is driven as much by individual self-interest as by altruism. In the context of business, the drive to collaborate for mutual self-interest is now a major field of study within the strategic management literature, although the success of such relationships is dependent on much the same factors as occur between people (Kanter, 1994). Most of this focus on cooperation has taken place within the context of strategic alliance formation or strategic networking. It is

driven by the desire of managers to overcome the limitations of strategic outsourcing by forming partnership-like relationships with customers, suppliers or third parties (Jarrillo, 1993).

Inter-firm collaboration is not driven by altruism but recognition that there are benefits to cooperation. The economic advantages of cooperation accrue from a situation in which the various members of the alliance specialise and either ensures that the final cost of production is lower, or their expertise creates value added differentiation (Jarrillo, 1988). Such strategic alliances are only sustainable if there is trust or an equitable fairness in the sharing of any value adding. There is a requirement for alliance partners to trust each other, be committed to the relationship and develop a sense of teamwork (Knight, 2000).

As demonstrated in the prisoner's dilemma case, there can be benefits from cooperation, but for collaborative relationships to exist the partners must have trust in the other's intentions. Trust is an outcome of learning and has been identified as possessing three forms (Zucker, 1986):

1. **Characteristic based trust** – based on the characteristics of the members engaged in the relationship;
2. **Process based trust** – based on the established history of the way the members have previously behaved in relation to each other;
3. **Institutional based trust** – determined by the conventions or rules that control or govern the group's relationship.

There is some evidence to support these constructs of trust, suggesting that the present trust between two parties is contingent on their past track record of behaviour, and that most individuals display initial trust towards each other due a predisposition to trust (Brunetto & Farr-Wharton, 2007).

From an economic perspective the decision to collaborate is often based on the firm's recognition that they can secure an advantage through cooperation. However, collaborative behaviour amongst firms frequently fails because one partner seeks to appropriate all the resources, or to dominate the network. Sometimes the partners become too specialised or overly protective of their own interests (Miles & Snow, 1992).

Fehr and Schmidt (1999) suggest that in addition to trust there must also be a perception of fairness or procedural justice if cooperation is to be sustained. The notion of fairness or procedural justice was espoused in depth by Rawls (1958; 1972) who identified the need for individuals to have equal basic civil and human rights, an equality of economic opportunities, and the focusing of fairness for those who are most disadvantaged within society.

Where there is an absence of fairness cooperation is made more difficult. Cooperation is influenced significantly by considerations of morality, fairness and mutual obligation (Jervis, 1988). As Fehr and Schmidt (1999) explain:

A main insight of our analysis is that there is an important interaction between the distribution of preferences in a given population and the strategic environment. We have shown that there are environments in which the behaviour of a minority of purely selfish people forces the majority of fair-minded people to behave in a completely selfish manner, too. (p. 856)

Mutual Incentives Theory

Birchall and Simmons (2004) postulate a *mutual incentives theory* to help explain why people participate in cooperatives. They point to two often competing schools of thought relating to human motivation. The first is that of *individualism* that draws its origins from social exchange theory. The second is *collectivism*, which draws from theories of social cooperation. It is worthwhile exploring these elements in more detail in order to better understand the foundations of the cooperative.

Social Exchange Theory

The basis of social exchange theory is the assumption that all human relationships are fundamentally driven by a cost-benefit analysis in which the individual assesses the benefits of maintaining a social relationship with others against the costs of doing so. It adopts a largely economic rationalist perspective of human behaviour suggesting that people are motivated to engage with others out of self-interest (Homans, 1974; Blau, 1964).

Key forces motivating the individual to participate in social exchanges are the positive ones of anticipated benefits or rewards, and behavioural habit. Forces opposing such social exchange are anticipated costs of such engagement, the opportunity costs of not engaging elsewhere, and the satiation of individual needs and wants from such exchange (Birchall & Simmons, 2004).

Social Exchange Theory has been criticised for its overly individualistic focus, denying the fundamentals of collaborative behaviour and altruism. It is also viewed as being too narrow and rationalist (Miller, 2005).

Social Cooperation Theory

As noted earlier, the theoretical foundation of cooperative behaviour is the theory of social cooperation. This has its antecedents in the notion of altruism, or the selfless concern for the welfare of others. A behaviour that is often contingent on the individual's economic, social and life stage (Sorokin, 1954). As illustrated in the work of Axelrod (1984) individual decisions to cooperate are not driven entirely by altruism. Rather there is a more rational sense of "tit-for-tat" reciprocity.

Research into human behaviour suggests that cooperation is influenced by the ability of individuals to communicate and develop a sense of group identity. Uncertainties about the environment or social participation by others are also potentially important factors. For example, in the case of grain harvests, individual's concerns over the size of future yields (environmental uncertainty), or the contribution of others to the harvest (social uncertainty) may affect their willingness to cooperate. Also important are resource asymmetries where

the individual has larger shares of resources and choose to contribute more to the common good, or are forced to do so via government taxes (Biel, 2000).

Social Cooperation Theory suggests that individuals collaborate due to a sense of common or shared goals, common or shared values and a sense of community whereby they identify with each other and show mutual care and respect for others in the same group. According to Birchall and Simmons (2004) there is a process they identify as the *participation chain* that moves via three distinct stages:

1. **Resources** – the assets, capabilities, time, money and skills of the participants going into any future collaboration;
2. **Mobilisation** – the factors driving cooperation, such as mutual needs, opportunities and recruitment efforts;
3. **Motivations** – the forces driving collaboration and sustaining cooperative activity.

Mutual Incentives Theory Tested

In a study designed to test the Mutual Incentives Theory, Birchall and Simmons (2004) examined the responses of a sample of participants in a large UK retail cooperative and users of publicly funded services. While both groups had similar resources and an equal desire to participate, the cooperative members were mobilised by different issues. Those who joined the cooperative did so as volunteers and driven in part by ideological factors.

The findings highlighted the importance of member motivations as a key driver of future participation in cooperation. Of these the most important were those of a strong sense of shared community values and goals. For effective and sustainable cooperative activity it is therefore important to generate a strong sense of community identity among members. These members should also share common values and goals within the cooperative. The ability to engender commitment and loyalty from members is therefore dependent on the cooperative enterprise being able to develop these elements and harness them in a strategic way.

Summary and Opportunities for Future Research

In summary the literature suggests that cooperative behaviour amongst humans can be explained in rational, scientifically defensible terms. Cooperation is motivated out of the same desire for reward and self-advancement that underlies the foundations of the mainstream economics upon which neoclassical capitalism is based. Individuals are more likely to cooperate under conditions where there are mutual incentives for such behaviour. Reciprocal altruism, particularly within close-knit, stable communities is likely to result in greater levels of cooperation due to kinship ties and mutual trust.

Cooperative behaviour is not only logical and rational; it may also reduce the risk of exploitation and manipulation by selfish individuals seeking to free-ride or cheat the system. However, such cheating and manipulation can result in a collapse of trust within the community, and if there is a perception that procedural justice is absent, the level of cooperation will decline.

Theories of Cooperative Enterprise

Game theory and cooperation have been well researched over a period of about 60 years with applications in fields of economics, political science, sociology, management and philosophy (McCain, 2008). The application of game theory has been applied to the cooperative enterprise within the field of economics since at least the 1960s. For example, Helmberger and Hoos (1962) examined the cooperative enterprise with a view to placing it within the realm of organisational theory. In doing so they highlighted the importance of open or restricted membership, and the level of control wielded by management.

Carson (1977) sought to develop a general theory of cooperatives, examining workers coops and also producer and consumer types. He drew the conclusion that worker coops were theoretically no less efficient than those organisations not so owned. However, he noted that the governance of cooperative enterprises may be different to that of the convention investor owned enterprise:

In general it will be harder for a co-operative's board of directors to find appropriate managerial success indicators or to supervise professional management than it will be for the owners of a conventional private firm. This disadvantage may grow rapidly with increasing firm size and complexity, and the social or job-satisfaction advantages may correspondingly decline. Together with problems in raising growth capital, this would help to explain why most large companies in Western countries are not co-operatives. (p. 584)

Sexton (1983; 1984; 1986) examined the relationship between game theory and cooperatives using economic analysis, suggesting that the work undertaken to that time had not fully considered the cooperative enterprise within its market context. He raised an important point, namely that simulations in models need to be more complex so as to take into account a wide range of variables likely to influence the behaviour of a cooperative enterprise. Many contemporary econometric assessments adopted a relatively rudimentary definition of cooperative enterprise when evaluating the behaviour of such organisations (Kang, 1988).

During the mid 20th Century, Emelianoff (1942) and Philips (1953) suggested that the cooperative enterprise was not an entrepreneurial business, due to the decentralisation of the decision making and resource allocation amongst the coop members. Helmberger and Hoos (1962) challenged this notion, arguing instead that the cooperative was a real business enterprise that could be understood within the neo-classical economic paradigm. This was due to the ability of the cooperative enterprise to organise a top management team who centralised decision making. However, in the 1980s the cooperative was viewed as either a nexus of contracts (Sexton, 1984; 1986), or as a coalition (Staatz, 1983).

Writing in the *Journal of Agricultural Cooperation* Staatz (1987) outlined a detailed review of the status of theory in relation to cooperative enterprise. He noted that from the 1940s to the 1980s cooperative theory seemed to have "come nearly full circle". He suggested that the coalition theory offered good prospects for future research. Although this debate appears to have declined within the academic literature in the past twenty years, research opportunities continue to exist within the field of game theory, reciprocity and cooperative behaviour (McCain, 2007).

Chapter 3

Validity of the Cooperative Business Model

What is a Business Model?

An important starting point in our discussion at this juncture is to define the concept of *business model*. Despite its common usage the term is poorly defined and is widely without adequate definition. Osterwalder, Pigneur and Tucci (2005) examined the literature relating to the concept of the business model and found its use had expanded significantly over the period from 1990 to 2003. Despite having first appeared in the 1950s (Bellman, Clark, et.al., 1957), the *business model* concept did not emerge prominently within the mainstream academic literature until the 1990s.

According to Osterwalder, Pigneur and Tucci (2005) this rise in the use of the business model concept was due in part to the use of the term within the high technology ventures listing on the NASDAQ stock market index. In particular the online or “dot.com” business ventures were the focus of business model analysis. While the concept remains poorly defined a three tier hierarchy emerges in relation to the way the term is used:

1. **Overarching business model concept** – the business model concept is examined as a generic overarching concept relevant to all businesses;
2. **Taxonomies** – different types of business models are identified and compared to create classification systems;
3. **Instance level applications** – business models for specific firms or instances are used as case examples to illustrate why or how a particular enterprise has worked.

Defining the Business Model

There are few readily accepted definitions of the concept of *business model*. Osterwalder, Pigneur and Tucci (2005) provide the following definition:

A business model is a conceptual tool containing a set of objects, concepts and their relationships with the objective to express the business logic of a specific firm. It is a description of the value a company offers to one or several segments of customers and of the architecture of the firm and its network of partners for creating, marketing, and delivering this value and relationship capital, to generate profitable and sustainable revenue streams. (p. 10)

A distinction should be drawn between the concept of *business model* and *business process models*. The first is associated with the way in which the enterprise seeks to create and commercialise value. The second is related to the way the business case that is developed from the business model is implemented. One is strategic, the other operational (Osterwalder, Pigneur & Tucci, 2005).

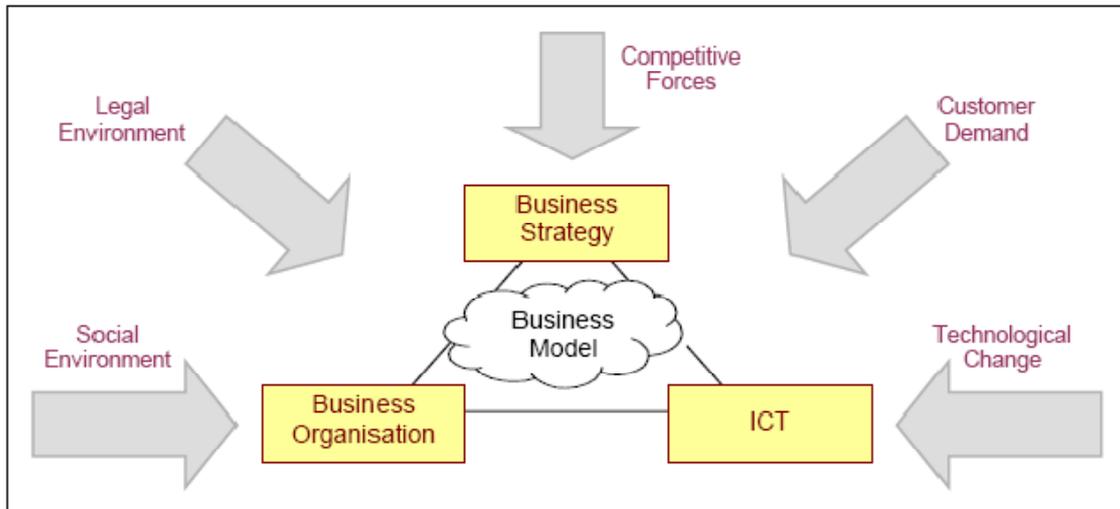
The link between the *business model* concept and the overall strategy of the enterprise is strong and while the two concepts are not identical, many authors use the concepts of strategy and *business model* interchangeably. Johnson, Christensen and Kagermann (2008) suggest that a business model comprises four interlocking elements:

1. **Consumer Value Proposition** – The first relates to what is described as the *consumer value proposition* (CVP). This is the means by which the enterprise has managed to build a process that can systematically generate value for customers. This typically involves lowering costs via innovation in process technologies, or adding value via innovation in product or service;
2. **Profit Formula** – The second element is the *profit formula*, which is a process employed by the enterprise that identifies how it will create value for its own shareholders while also offering value to consumers. It should include consideration of:
 - a. **The revenue model** – what price x volume is required to cover costs to achieve break even and required profit margins;
 - b. **Cost structure** – what are the main costs (fixed and variable) associated with the venture;
 - c. **Margin model** – the contribution or gross profit margin from each sale or transaction, which given anticipated price x volume levels will generate targeted profits and return on investment;
 - d. **Resource velocity** – how rapidly inventory, cash and fixed assets need to turnover in order to achieve required volume and profit targets.
3. **Key Resources** – The third element of the business model is the *key resources* that are required by the enterprise to deliver its value proposition to the customer. These typically involve people, technology, products, facilities, marketing channels and finances; and
4. **Key Processes** – Finally, the fourth element is the *key processes* that the enterprise follows in order to deliver value to both consumer and shareholder. Such processes are embedded in its operational and human resource management practices and controlled via rules, policies, metrics and the organisational culture.

The Business Model and Business Strategy

Business strategy is a complex concept that has attracted substantial academic interest since at least the 1950s (Feurer & Chaharbaghi, 1995). At the corporate level strategy is the process of decision making undertaken by senior managers within the organisation so as to outline the firm's aims, purpose and policies (Andrews, 1971). It is typically long-term in nature and forward focused rather than short term and operational. Business strategy is essentially about how the business creates value for its customers and makes a profit for its shareholders (Lewis, 1999).

The *business model* concept is closely related to the business strategy employed by the enterprise. Osterwalder, Pigneur and Tucci (2005) suggest that the business model lies somewhere between the firm's business strategy, organisational configuration and its use of technological systems such as information and communications technologies (ICT). This is illustrated in Figure 2 where it can be seen that the business model aims to draw the strategy, structure and resources together in order to address the various forces that shape the firm's strategic task environment.



Source: Osterwalder, Pigneur and Tucci (2005)

Figure 2: The Business Model's place in the Firm

Osterwalder, Pigneur and Tucci (2005) identify nine "building blocks" upon which a business model is constructed. These are illustrated in Figure 3 which outlines a conceptual framework developed by Osterwalder (2004). The framework comprises four "pillars" focusing on the product, customer interface, infrastructure management and the financial aspects of the business case. Each of these pillars in turn comprises one or more of the nine "building blocks".

As shown in Table 3 the key building block associated with the product is the value proposition. As described above, the customer value proposition seeks to determine the overall value or benefits offered to the market or customer by the products and services that are being offered by the enterprise. The second pillar focuses on the firm's ability to interface with the target customers and the marketing or distribution channels that will be used to communicate with these consumers and deliver the product or service to them. Of importance is the type of relationship that the enterprise can build up with the customer. A direct relationship allows for greater feedback and market responsiveness, as opposed to being forced to deal indirectly through agents or intermediaries. Customer satisfaction and loyalty to the enterprise and its products or services are also crucial outcomes for a successful business model.

Table 3: The Nine Business Model Building Blocks

PILLAR	BUSINESS MODEL BUILDING BLOCK	DESCRIPTION
Product	Value Proposition	Gives an overall view of a company's bundle of products and services.
	Target Customer	Describes the segments of customers a company wants to offer value to.
Customer interface	Distribution Channel	Describes the various means of the company to get in touch with its customers.
	Relationship	Explains the kind of links a company establishes between itself and its different customer segments.
	Value Configuration	Describes the arrangement of activities and resources.
Infrastructure Management	Core Competency	Outlines the competencies necessary to execute the company's business model.
	Partner Network	Portrays the network of cooperative agreements with other companies necessary to efficiently offer and commercialize value.
Financial Aspects	Cost Structure	Sums up the monetary consequences of the means employed in the business model.
	Revenue Model	Describes the way a company makes money through a variety of revenue flows

Source: Osterwalder, Pigneur and Tucci (2005)

The third pillar of *infrastructure management* is associated with the way in which the enterprise seeks to manage its business operations. Three building blocks relevant here are the *value configuration*, *core competency* and *partner networks*. The first of these is related to the *key processes* concept outlined by Johnson, Christensen and Kagermann (2008). While the second is related to the *key resources* concept espoused by the same authors.

The notion of *core competency* has been widely addressed in the strategic management literature (Hofer & Schendel, 1978; Hitt & Ireland, 1985). It is recognised as the skills and resources possessed by the firm and how these are employed in a manner that offers competitive advantage (Reed & De Fillippi, 1990). Also important is the strategic partner networks that the firm can use to assist its commercialisation activities by enabling it to gain access to markets or key strategic resources.

Finally the fourth pillar of financial aspects focuses on two building blocks relating to the cost structure and revenue model of the business. These are identical to the *profit formula* concept outlined in the business model definition provided by Johnson, Christensen and Kagermann (2008). It is here that the economic viability of the business model is put to its ultimate test. These frameworks help to define the overall concept of the business model and are of universal relevance to all enterprises regardless of industry. However, are they relevant to the cooperative enterprise, and how does the business model of the cooperative differ from that of a conventional investor owned enterprise? The next section seeks to address these questions.

Business Models of the Cooperative & Investor Owned Enterprise

In this section we will investigate the dichotomy that exists between the cooperative and the investor owned enterprise (Hansmann, 1996). This is based on their respective ownership structures and its impacts on their strategic intent as organisations. Compared with the investor owned enterprise, the cooperative has a different strategic purpose and this often appears at odds with or as an anachronism within the contemporary business environment.

Chesbrough and Rosenbloom (2002) have attempted to address the role of the business model within corporate strategy by suggesting that a business model is the way in which a business organisation seeks to create value in the market place. It includes how the business organisation manages and organises its people, products, processes and resources. They suggest that the functions of a business model are to:

- Articulate the *value proposition*, or how the business is to offer benefits to its customers, clients or members;
- Identify a *market segment* or segments into which the business is to target its activities;
- Define the structure of the *value chain* within the business required to create and distribute the products or services, and determine the complimentary assets needed to support the firm's position in this chain;
- Estimate the *cost structure* and *profit potential* of producing the offering, given the value proposition and value chain structure chosen;
- Describe the position of the firm within the *value network* linking suppliers and customers, including identification of potential complementors and competitors; and
- Formulate the *competitive strategy* by which the innovating firm will gain and hold advantage over rivals (Chesborough & Rosenbloom, 2002; 534-534).

Each of these elements is configured so as to justify the investment made by shareholders in the business. How effectively these elements are configured and matched against the needs of the market, and the competitive pressures of the industry within which the business operates, will determine how successful the enterprise is. For a cooperative, the configuration of these six elements is generally quite different to those of other types of business. These differences are listed in Table 4 and discussed in more detail in the following sub-sections.

Table 4: The Business Models of the Cooperative and Investor Owned Enterprise

KEY ELEMENTS OF THE BUSINESS MODEL	INVESTOR OWNED ENTERPRISE	COOPERATIVE ENTERPRISE
Articulate the value proposition	Satisfy customer needs & maximise shareholder returns	Maximise member benefits
Identify the market segments	Target most lucrative opportunities	Target areas of greatest member need
Define the value chain configuration	Suppliers & Customers are outsiders to the firm	Suppliers & Customers are owner/members of firm
Estimate cost & profit potential	Reduce supplier costs & premium price customers	Offer higher prices to suppliers & lower prices to customers
Define position within the value network	Block substitution threats & form strategic partnerships with complementors	Block substitution threats & form strategic partnerships within the cooperative membership
Formulate a competitive strategy	Exploit future opportunities with existing resources	Offer members best value

Articulating the Value Proposition in the Cooperative Enterprise

As discussed above, the customer value proposition is a key element in the design of a business model. In the investor owned enterprise the value proposition is focused on satisfaction of customer needs in a way that will ensure the products and services are purchased, while ensuring that shareholder returns to capital invested are maximised. Business strategy is generally focused on achieving these two objectives. However, this is not necessarily the same for the business model that applies to the cooperative enterprise.

To begin with the *value proposition* of the cooperative is defined by the strategic purpose it has to generate value to its members. For example, if the cooperative is established for retailing, it may be focused on ensuring that its members receive the lowest prices rather than seeking to make a profit by selling higher priced goods, as would be the case with a conventional retail business. However, in the case of a producer cooperative, its strategic aim may be to provide its members with the highest prices. This is typically the opposite of the conventional business which is more likely to seek to keep its supply costs low.

Target Market Segments of the Cooperative Enterprise

The concept of market segmentation has been used within the academic literature since at least the 1950s (Smith, 1956). It involves the separation of customers into pre-defined groups with common needs or wants and allows the marketer to configure the right mix of product or service benefits to satisfy their specific requirements. Effective segmentation of markets enables a firm to make appropriate decisions over which products and services to offer and which ones will generate superior profits (Hoek, Gendall & Esslemont, 1996).

In the conventional business, the targeting of market segments is usually driven by the firm's identification of opportunities where it can secure a profitable niche. This is not the case for the cooperative. The market segment targeted by the cooperative is likely to be determined more by its membership than its sense of where the most lucrative opportunities are to be found.

Williams (2007) notes that cooperatives can be found across many different sectors within the market economy, including producer and value added cooperatives, those involved in supply or distribution, services, retailing and financing, as well as worker cooperatives. Unlike the investor owned enterprise, the cooperative enterprise is focused on providing benefits to its members and therefore its strategic *raison d'être* is to target areas of special need common to its membership. As Williams (2007) observes:

The real bottom line is effective service to the common good, and the accomplishment of goals as outlined in the seven principles. These goals remain challenging in the individualistic and competitive matrix of modern monopoly capitalism. (p. 34).

The cooperative enterprise is therefore likely to target market segments differently to the investor owned enterprise. While both might compete within the same markets, their strategic purposes may differentiate how they view the market segmentation process. Where the investor owned enterprise targets market opportunities, the cooperative often targets areas of market failure.

The Value Chain and the Cooperative Enterprise

The "value chain" is a concept used to describe the various activities taking place within the firm's supply chain and then onto the end-user consumer that help to add value to the product or service being traded. Brown (1997) has defined the "value chain" as:

The value chain is a tool to disaggregate a business into strategically relevant activities. This enables identification of the source of competitive advantage by performing these activities more cheaply or better than its competitors. Its value chain is part of a larger stream of activities carried out by other members of the channel-suppliers, distributors and customers.

For conventional businesses the "value chain" encompasses the management of the firm's supply chain relationships that are typically based on price, as well as the overall strategic relationships between the firm and its networks. In this case the focus is on the firm's ability to instil into its strategic network relations a sense of trust and information sharing to enable each member of the value chain to contribute value added inputs (Walters & Lancaster, 2000). However, in the case of the cooperative, these value chain relationships take on a greater level of significance because the supply chain partners are also the members and shareholders. We will examine this issue in more detail later.

In the conventional investor owned enterprise the value chain analysis often commences with an analysis of the target market segment and an identification of those customers who are most likely to drive value growth for the business model. Key considerations are whether leading customer will pay premium prices for the products or services being offered, whether this segment is large enough to sustain profitable growth over time, and how easily the target segment can be reached. Ideally the target market segments can be

offered products or services at a price and quality that will make the business model viable (Grupp & Maital, 2001).

The ability of the enterprise to offer value to its customers is likely to depend on how well it innovates and its approach to infrastructure management as defined by Osterwalder, Pigneur and Tucci (2005). In particular this involves the firm's ability to enhance the "value configuration" or value chain, with appropriate use of core competencies and strategic partner networks. Value chain relationships in traditional businesses involve customers and suppliers who are independent of the firm.

In the cooperative enterprise the suppliers and customers are often members of the coop. As such the dynamics of the value chain can operate differently to those of the investor owned enterprise. This is most likely to impact on the cooperative's ability to negotiate competitive market prices with suppliers and customers.

Estimating cost and profit potential in the Cooperative Enterprise

In relation to the determination of cost and profit potential the cooperative is again likely to differ from that of a conventional business. A profit-maximising business will usually aim to keep its costs of operations as low as possible while charging premium prices for its products or services. In this way it will be able to secure strong profit margins and high returns to investment. For the cooperative, this is not necessarily the case. As noted above, the cooperative is usually aiming to return value to its members by offering competitive prices to them as suppliers or customers, rather than via profit or dividends to them as shareholders.

The Value Network in the Cooperative Enterprise

The concept of the "value network" relates to the interrelationship between the business and its customers and suppliers on one side, and its "substitutors" and "complementors" on the other (Brandenburger & Nalebuff, 1995). A "substitutor" is another business that can offer an alternative product or service to a customer, and can include both competitors and firms from other industries offering substitutes. For example, Toyota is a direct competitor to Ford in the manufacture and sale of motor cars, but the public transport system is a potential substitute for motor car ownership. By contrast a "complementor" is another business that offers customers complementary products or services to those sold by your own firm, or to whom suppliers sell complementary goods. In the field of computing hardware manufacturers and software producers are complementary actors with respect to each other.

The development of a successful business model is associated with the business being able to clearly identify where it should operate within this "value net" and how or with whom it should build competitive or complementary relationships. The dynamics of the "value net" are often viewed as strategically very important to the success of the firm's business model (Brandenburger & Nalebuff, 1995).

In the case of cooperatives the same dynamics apply, however, there should be increased opportunities for the creation of complementary relationships. This is due to the often dual role played by customers and suppliers, who are also members. A cooperative enterprise should be able to exploit its value network through both horizontal and vertical alliances in a way that is built as much on social (i.e. trust, power) relationships as on economic factors. This theoretically should offer the cooperative enterprise a source of competitive advantage (Garcia-Perez & Garcia-Martinez, 2007).

Formulation of Competitive Strategy in the Cooperative Enterprise

The last element within the business model is the decision by management to formulate a clear competitive strategy for the firm. In the majority of conventional businesses this will involve decisions based on the organisation's ability to exploit future market opportunities using the resources available to it at the time. The strategic aim of most firms is to maximise shareholder wealth. This is achieved either through the establishment of a competitive market position that allows the business to charge a premium price based on product or market differentiation, or to maintain a lowest cost producer position (Porter, 1981).

For the cooperative enterprise the strategic objective is often driven by reasons unrelated to the competitiveness of the market, or the desire to maximise shareholder wealth. Most cooperatives are designed strategically to provide benefits to members and value for these shareholders is derived not from their ownership of equity, but their patronage of the cooperative as either a customer or supplier. This does not mean that the cooperative cannot seek to build a competitive strategy around low cost production or product and service differentiation through value adding. However, the dynamics of its ownership structure are fundamentally different to those of conventional businesses.

Strengths and Weaknesses of the Cooperative Business Model

As discussed above, the business model employed by the cooperative enterprise is not the same as that found within the mainstream investor owned enterprise. This is due to the overarching strategic purpose of the cooperative enterprise, which exists to provide benefits to its members rather than to create wealth for a few shareholders. As a result of these differences the cooperative enterprise suffers from some weaknesses but also has a number of key strengths. In the following sub-sections we examine the nature of these strengths and weaknesses.

Strengths of the Cooperative Business Model

Although cooperative enterprise is strategically different from its mainstream counterparts the cooperative business model has survived for centuries and has created many of the world's largest enterprises. Unlike investor owned firms the cooperative is not strategically focused on shareholder return on investment. Instead the strategic focus of the cooperative enterprise is on *patronage dividends*, or the patron's share of the cooperative business (Bradley & McMaster, 1980). For example, in New Zealand the dairy coop Fonterra has now emerged as one of world's major international players in that sector (Ferrier, 2004). In Spain the Mondragon Cooperative Corporation (MCC) has grown into a global business operation with some 60 production centres throughout the world, employing over 70,000 people (Errasti, Heras, Bakaikoa & Elgoibar, 2003).

In the United States the National Cooperative Business Association (NCBA) seeks to provide leadership for the American cooperative movement. At the 2006 Summit of the International Cooperative Association, representatives from 20 countries came together to identify common issues facing their movements. It was acknowledged that the cooperative was under challenge for both identity and relevancy in the face of an international growth of alternative business models. NCBA President Paul Hazen in a keynote speech noted that the coop was a superior business model because:

1. Coops provide a much wider and more equitable distribution of capital within the community;
2. Coops keep the capital in the local community rather than siphoning it off to a few centres of financial power as is the case in public corporations;
3. Coops “exemplify the ownership-society” rather than a shareholding class;
4. Cooperative governance is more open and democratic than the closed world of the public corporation; and
5. A Cooperative pursues both economic and social objectives while public corporations are driven primarily for profit and shareholder wealth (NCBA, 2006).

A review of the international literature relating to agricultural cooperatives undertaken by Krivokapic-Skoko (2002) found that main benefits identified by members could be grouped into at least five key areas:

1. **Market access and market risk reduction** – members joined agricultural cooperatives in order to gain access to value-added markets, or to establish a local market for their produce. They also sought to reduce market risk by creating the cooperative as a buyer for their produce.
2. **Financial benefits from enhanced pricing** – they also sought a better financial deal from their cooperative membership. They were seeking lower input costs for supplies through price discounts. The cooperative was also aimed at strengthening their bargaining power with buyers so as to secure premium prices for their produce. They also sought access to better services via the cooperative.
3. **Improved productivity** – membership of the cooperative was also viewed as offering members enhanced productivity through the pooling of marketing resources and bulk purchasing. This could provide access to more value added services, as well as increasing farm income, efficiency and productivity.
4. **Access to resources** – the cooperative was also seen as a source of access to enhanced information, knowledge and resources. This might include access to new technology for the farm, or improved networking to help raise the farmer’s circle of information sources.
5. **Community building** – cooperative membership was also viewed as offering a greater opportunity to develop the local community and engage in self-help. Collaboration via the cooperative could provide new services to the community and increase the benefits to members.

The cooperative enterprise is therefore an entity that seeks to generate benefits to its members in the form of enhanced access to markets or to goods and services. It is also designed to offer its member’s financial benefits through improved pricing and to achieve increased productivity from greater economies of scale and scope. A cooperative enterprise should also improve its member’s access to knowledge and information as well as making a significant contribution to the local community in which it is based (Skurnik, 2002).

Weaknesses of the Cooperative Business Model

Using farmer cooperatives as an example, Staatz (1987) argues that the business model employed by the cooperative has two limitations. The first is the way in which individual cooperative members are able to enjoy incentives for membership. The second is lack of common interest among what is often a highly heterogeneous membership. Because so many cooperatives involve a collective of smaller entities (e.g. farm business units) that operate independently of each other, it is usually impossible for the cooperative to leverage fully the potential synergies of the collective membership. The more heterogeneous the membership the more difficult this process becomes. It is for this reason that many cooperatives find it hard to reach consensus amongst members and therefore to set clear strategic goals for the business.

Another key difference between the cooperative and the investor owned enterprise is the relative points of focus for the members. For example, in the typical investor owned enterprise the focus for shareholders is the profitability of the entity and the return on the invested share capital. Prices charged by the investor owned enterprises are important in their ability to deliver superior profits. Shareholders are therefore likely to be interested in the internal control of costs or the distribution of costs within the entity. By comparison, the members of a cooperative are more likely to be interested in cost allocation and pricing in its effects on their own individual participation in the entity. They are also likely to be more interested in the distribution of costs or pricing decisions amongst fellow members. Compared to investor owned businesses these operational issues typically become more important to members and they often create more problems for cooperative managers as a result. At the same time, the cooperative well placed to enjoy enhanced communication flows between members and this can result in the coop being more responsive to member/customer needs.

For these reasons, the cooperative is often more constrained than the investor owned enterprise in proactively seeking to exploit new market opportunities where competitive pricing is required or to raise new share capital quickly to expand the equity base for future growth. Cooperatives are more likely than investor owned enterprises to suffer from risk aversion in decision-making, under financing or under investment, and the absence of a secondary market for the share capital of the members exacerbates this. While the shareholder in an investor owned can sell their shares and secure either a capital gain or loss, the member of a coop is typically unable to do this. Shareholding in a cooperative only returns value to the member while they maintain patronage of the cooperative; this is the "horizon" problem (Hardesty, 2005).

Overcoming the Cooperative's Weaknesses

Given these inherent weaknesses in the cooperative enterprise business model some might wonder how the coop has managed to survive and prosper for as long as it has. This raises the question as to how these weaknesses can be overcome. According to Hardesty (2005) the cooperative enterprise suffers from three key weaknesses and needs several solutions to overcome them. First the cooperative is owned by its members who also use it as patrons. Second, the benefits to members are based largely on patronage rather than investment returns as in the case of conventional investor owned enterprises. Third, the cooperative enterprise is controlled by those who also are its suppliers or customers.

Many of the problems described above originate from these weaknesses, and these are in turn caused by vagueness over property rights in relation to the cooperative enterprise. Cook and Iliopoulos (1999) note that for social efficiency property rights need to be clearly defined, legally enforceable and tradeable within an open market. Where property rights are not clearly defined and the ownership of value assets cannot be assigned there is little incentive to protect the asset. Investment will also be unattractive where ownership rights are poorly protected. As they explain:

Vaguely defined property rights create losses in efficiency because the decision maker no longer bears the full impact of his or her choices...Numerous scholars of cooperative theory (Peterson, Centner, Cook, Iliopoulos, Staatz, Porter and Scully) have observed and identified organizational limitations in traditional cooperatives. These limitations, they suggest, are the result of vaguely defined property rights. According to these authors, the five major vaguely defined property rights cooperative problems include the free-rider problem, the portfolio problem, the horizon problem, the control problem, and the influence problem. (Cook & Iliopoulos, 1999; pp. 528-529)

The Free Rider Problem

The free rider problem emerges where ever property rights cannot be traded, or where they are insecure or unassigned. It is particularly common in cooperative enterprises that have open membership (Cook, 1995). The free rider problem is caused by the fact that while in an investor owned firm the early investors typically buy in at a low price and sell out at a high price after building up the enterprise. Any late entry investors must pay a premium price for the value adding and reduction in risk that the early investors have created. This is not the case for the traditional cooperative, where the value of early or late entry is the same. An important outcome of the free rider problem is the unwillingness of the members of a cooperative to invest in the enterprise.

The Horizon Problem

The horizon problem emerges where the residual claim a member of a cooperative might make over the net income generated by an asset is shorter than the productive life of that asset (Cook, 1995). It is caused by the inability of members within traditional cooperatives to transfer their ownership rights and the absence of a secondary market for their rights such as is common with conventional shareholding.

In an investor owned enterprise, because the investor can see their share equity appreciate in value over time they tend to have a long term horizon. In the case of publicly listed firms they also have the comfort of being able to sell their share equity to another party via the stock exchange. This is not the case for the average coop whose members are more likely to be focused on year by year patronage issues that impact negatively on their capacity to develop strategic vision. The net result is a short term perspective by cooperative members and an unwillingness to invest in the enterprise over the longer term.

According to Cook (1995) this horizon problem often leads to the membership placing pressure on the cooperative enterprise management to make cash flow distributions from profits in the short term rather than reinvesting these back into the business. Members may also seek to redeem their equity rather than retaining profits for long term growth.

The Portfolio Problem

The portfolio problem emerges from the lack of transferability and liquidity of the members' equity in the cooperative enterprise. Any decision to invest in the cooperative by members is tied to their level of patronage of the coop. As Cook (1995) explains:

The lack of transferability, liquidity, and appreciation mechanisms for exchange of residual claims prevents members from adjusting their cooperative asset portfolios to match their personal risk preferences. The cause of this problem is again the tied-equity issue – the investment decision is “tied” to the patronage decision. Therefore, members hold suboptimal portfolios, and those who are forced to accept more risk than they prefer will pressure cooperative decision makers to rearrange the cooperative's investment portfolio, even if the reduced risk portfolio means lower expected returns. (p.1157)

In many coops the members have not invested in the enterprise as part of a wider portfolio, they have invested in their own business and they lack the finance or interest in seeing the cooperative as part of their investment portfolio.

The Control Problem

The control problem emerges from the divergence of interests that takes place between the cooperative membership and its management. Investors in a conventional firm seek to maximise shareholder returns via the successful performance of the enterprise, which is a similar objective for the firm's management. By comparison the members of a cooperative are seeking patronage benefits and lack any “skin in the game” in the form of significant capital investment. While the investors in a convention business have money tied up and are interested in what happens to it, the coop member is less easily engaged or controlled by the cooperative management.

The Influence Cost Problem

For many cooperatives the strategic focus becomes fuzzy and the enterprise seeks to engage in a wide range of diverse activities and can result in disputes over the allocation of costs or profits within the enterprise seeking benefits to them rather than a strategic reinvestment into the business. The extent of this problem varies depending on the level of central authority within the cooperative, the degree of homogeneity or conflict that exists between members, and the governance structure of the enterprise (Cook, 1995).

The New Generation Cooperative – a possible solution

Cook and Iliopoulos (2005) suggest that the cooperative enterprise that wishes to overcome the problems arising from ill-defined property rights will need to offer equity shareholding to members that can be transferred, and that appreciate in value over time. Membership of the cooperative enterprise will also need to be adequately defined, and legally enforceable ownership rights protected via contracts associated with specific terms of patronage (e.g. supply or purchase). There should also be a minimum up front equity investment requirement for all members.

Hardesty (2004) points to the so-called “New Generation Cooperative” (NGC) as the business model that will overcome the generic problems inherent in the cooperative

enterprise. Emerging in the United States in the 1990s the NGC was a response to the severe economic downturn experience in the American agricultural sector in early 1980s that adversely impacted on the viability of many producer cooperatives then operating in the USA (Cook & Iliopoulos, 2005).

The NGC business model seeks to overcome the weaknesses of traditional cooperatives through contracting with members over specific delivery rights based on the number of shares each member holds in the enterprise. The NGC becomes a one-vote, one-member democratic organisation in keeping with the principles of the cooperative, but where earnings are distributed based on shares owned by members. Unlike the traditional coop membership is restricted. The financing of the NGC often involves the issuing of preference shares to augment the capital base of the enterprise and foster community involvement (Downing, Volk & Schmidt, 2005). Table 5 illustrates the differences between the NGC and the traditional cooperative and how the NGC seeks to address each of the five generic problems inherent in the cooperative business model.

Table 5: The Traditional versus New Generation Cooperative

GENERIC PROBLEMS	TRADITIONAL COOPERATIVE	NEW GENERATION COOP
Free Rider Problem	Individual benefits & property rights are not well aligned to assure owner (patrons) bear the full costs / benefits of their actions.	Investment and optimal levels of product flows are determined before the firm begins conducting business.
Horizon Problem	Lack of liquidity through secondary market for investment.	Stock can be traded to allow entry and exit from the co-operative as risk and situation dictates.
Portfolio Problem	The investment decision is tied to the patronage decision. Owners forced to accept more risk pressure co-operative firm managers to rearrange the asset portfolio of the co-operative to be less risky.	Risk is aligned with the owner because the level of investment in assets is decided before the co-operative begins competing. Sale or transfer of ownership is allowed after the co-operative is operational to align risk.
Control Problem	The information and external pressure by public trading is not present in traditional co-operatives.	New generation co-operatives are less complex and seek greater property rights alignment through patronage-based voting.
Influence Cost Problem	Influence depends on centralization of authority and homogeneity of members.	New generation co-operatives are centralized and limited to specific purpose.

Source: Katz & Boland (2002)

According to Katz and Boland (2002) the NGC differs from the traditional cooperative primarily in five ways. First, while the traditional producer cooperative is focused on the marketing of commodities, the NGC seeks to add value to such products to secure better prices. Second, while the traditional producer cooperative seeks to sell largely raw produce into a marketing supply chain, the NGC aims to develop value added products it can target into niche markets. The third difference lies in the restricting of membership in the NGC as opposed to open membership of the traditional coop. This leads to the fourth area of difference. Because the traditional coop is open to all producers seeking to sell

their produce they are often faced with slack productive capacity as producers switch to other supply chains where they feel they can obtain better prices. This does not occur as readily within the NGC where supply chain relationships are controlled by “delivery rights” contracts with producers. Finally, the ownership structure of the traditional coop is one member, one vote in pure democratic terms. This is not the case in the NGC model where members do not have to own the same number of shares and where shareholding is based directly on the level of patronage or supply contracts agreed.

Since their emergence in the 1990s the NGC have been formed in a wide range of different industries including beef, pork, grains, dairy, fruit and vegetables and particle board products (Downing, Volk & Schmidt, 2005). Despite their apparent strengths they have evoked criticism from some for their exclusivity of membership and high up-front investments to new members, which are viewed as against the spirit of true cooperative enterprise (Torgerson, 2001). Not all NGC have succeeded. Like any other business enterprise the cooperative must survive within its targeted markets and the NGC is no different. Competent leadership, sound financials and effective marketing are all keys to their success as with any business (Hardesty, 2004)

Is the Cooperative Enterprise Superior?

We conclude this chapter with a short review of the question of the relative merits of the cooperative enterprise in comparison to the investor owned enterprise, and whether or not the coop is superior under certain conditions. Our review of the literature did not yield many papers that sought to directly address these issues, however, there were sufficient to provide a direction for future research.

The Cooperative versus the Investor Owned Enterprise

As noted in Chapter 3 the theory of the cooperative enterprise has been informed by game theory and the role that reciprocity, trust and procedural justice play in the dynamics of collaborative behaviour. Early theorists (Emelianoff, 1942; Phillips, 1953) viewed the cooperative as a non-entrepreneurial enterprise that was too decentralised to operate as a competitive entity against conventional investor owned firms. However, from the late 1940s to the early 1960s recognition of the cooperative as an enterprise emerged (Enke, 1945; Helmlberger & Hoos, 1962). By the 1980s the cooperative enterprise was viewed as a viable competitor to the investor owned enterprise, although there were significant issues (as discussed above) relating to inherent problems in its design. However, there was also recognition that the behaviour of the cooperative enterprise is likely to depend on the role played by its management team, board of directors and members. Its behaviour is less predictable than for a conventional investor owned enterprise as its strategy is determined by the interplay between coalitions of different interest groups (Royer, 2004).

Sisk (1982) examined the cooperative enterprise within the paradigm of neo-classical economic theory, finding that such analysis was overly simplistic and ignored the influence of technology or management decision making. He noted that the cooperative enterprise under certain conditions was just as likely to secure comparative advantage over other types of enterprise. Writing at around the same time Vitaliano (1983) noted that while there had been a strong focus on the cooperative enterprise within agricultural economics from the early 1940s to the early 1960s, this had effectively ceased during the 1960s and 1970s owing to the rise of neo-classical economics and “managerial theories of the firm”. He drew attention to the five generic problems facing cooperative enterprises and made some critical observations of the state of theoretical development to that time.

Rhodes (1983) examined the competitiveness of large agricultural cooperatives. He argued that under certain conditions the cooperative enterprise was a superior business model to the investor owned enterprise. Assuming that the costs for both types of firm are identical, the cooperative has some potential advantages over the other. First, the rewards paid to shareholders of investor owned enterprises are dividends. However, the coop pays both patronage dividends and the market price paid per unit to its members. Wherever the members can get the same market price and significant patronage dividends from the coop they are likely to choose this enterprise over the investor owned firm. The coop is also more likely than an investor owned enterprise to enter new markets where competitor reactions will be to squeeze prices and margins. The cooperative is theoretically less likely worry about lower profit margins than the investor owned firm so long as its membership is satisfied.

Nevertheless, the cooperative enterprise is still faced with specific weaknesses. They may be more risk adverse due to their management and member-ownership structures. There might also be reluctance on the part of coops to remove unprofitable products or services in the face of member demands (Garoyan, 1983). While the investor owned enterprise is driven by the motivation to maximise profits and shareholder returns, this is not always the case for cooperatives. By contrast the cooperative enterprise may pursue multiple aims simultaneously, while many of these may be rational economic decisions similar to those of the investor owned enterprise, others may be focused on improving member benefits and these many not be entirely rational from an economic perspective (Royer, 2004).

The Cooperative Enterprise in Imperfect Markets

From an economic perspective, the cooperative movement is a pragmatic response to the abuses that can emerge within the free-market system. While it draws inspiration from the socialist theories of re-balancing economic and social injustice, cooperative enterprise is not a political philosophy. It remains an alternative business model capable of offering a “third way” for the organisation of economic society. One area in which the cooperative has found a strong role throughout its long history has been within imperfect markets or conditions of market failure. As discussed in Chapter 1, this was the original motivation for their creation in the 19th Century.

As suggested by Williams (2007), the cooperative enterprise offers a potential for a more humane, equitable and democratic mechanism for the organisation of markets. For example, Mooney (2004) suggests that conventional “purely market driven” economic systems often result in inequality and hierarchical structures and monopolisation that lead to social and economic disadvantages. Cooperative enterprise – particularly within the food production and distribution sectors – offers a potentially “happy medium between public regulation and private power” (p. 87).

This social-enterprise function of the cooperative has attracted considerable interest among organisations engaged in developmental economics. For example, there has been move within the International Labour Organisation (ILO) to use cooperative enterprises as a means to alleviate the worst aspects of globalisation (Levin, 2001). The cooperative is seen as a potential “third way” that offers superior benefits over the investor owned firm in imperfect markets, but also an superiority over government owned or non-profit entities. This has been demonstrated with some success in Italy were cooperatives offering members a number of benefits with investment return only one of these (Mancino & Thomas, 2005).

This social-enterprise role of the cooperative was a key feature of the interest in the coop during the 1930s at the height of the Great Depression (Warbasse, 1937). As a “third way” alternative to free-market capitalism and state controlled socialism, the cooperative seemed to offer many benefits. The second half of the 20th Century witnessed a global expansion of the free-market, neo-classical approach to business and economics. After the ending of the Cold War and the collapse of the Soviet Union in the early 1990s, this expansion of what some view as an “Americanisation” of the global economy increased. According to Schroter (2008) throughout the 19th Century Europe had developed a strong faith in the role of economic cooperation. However, this was challenged and eroded over the course of the 20th Century with the rise of neo-classical, free market economics mostly driven from the United States. During periods of economic crisis (e.g. the 1930s, 1970s) there was a swing back to cooperative approaches.

The Global Financial Crisis of 2007-2008 appears to have ended a long economic boom and risks tipping the majority of the world's economies into recession. It has seen the collapse of many financial institutions and is threatening mainstream industry due to the down turn in consumer and investor confidence. While it is still too early to determine how this crisis will unfold, the Great Depression years of the 1930s may offer some lessons. In those years the collapse of Wall Street and its impact on the world economy generated a high level of disillusionment with capitalist free-market economic systems (Schroter, 2008).

While the cooperative enterprise is unlikely to solve all the world's economic woes, there is an opportunity for the cooperative movement to promote their unique form of business as a potential “third way”. Cooperation between firms via strategic alliances has been shown to be a successful means of achieving superior competitive advantages (Brugue, Moyano, Vargas & Hernandez, 2003).

Summary and Opportunities for Future Research

The focus of this chapter has been on the validity of the cooperative enterprise business model, its strengths and weaknesses and whether it offers any superior benefits over the conventional investor owned enterprise. As discussed above the cooperative enterprise is a legitimate business entity although its business model is significantly different from that of the investor owned firms. The cooperative has strengths, particularly in its ability to enter and service areas of market failure, where its strategic objectives are likely to focus on areas other than maximisation of shareholder returns.

Since the 1980s research into the theory of cooperative enterprise has declined although there remain significant opportunities for exploring the role of the coop in satisfying the needs of imperfect markets and serving as a “third way” between the investor owned and the state owned enterprise. At the micro-level key areas of focus in such future research should be upon the role of strategic network behaviour and coalition formation as pioneered by the likes of Staatz (1983). The role of the top level management in the cooperative and how it interacts with the membership and board of directors is another important unit of analysis. At a macro level the role of the cooperative enterprise in the alleviation of poverty and as a mechanism for social-enterprise are subjects worth of exploration. These issues will be addressed further in Chapter 7.

Chapter 4

Member Value Creation and Recognition

Member Benefits in Cooperative Enterprise

The focus of this chapter is on how membership benefits are understood and identified within the cooperative enterprise, whether member benefits differ from those found in investor owned enterprises, and how such member benefits are measured. As was shown in Chapter 3, the business models of the cooperative and investor owned enterprises are different. Shareholders in an investor owned enterprise are motivated by a desire to make above average returns on their investment. Their benefits are the dividends paid to them by the firm after the distribution of profits. For the cooperative enterprise there are likely to be other benefits not associated with financial goals (Birchall & Simmons, 2004). Royer (2004) has suggested that the objectives of producer cooperatives are typically to maximise the prices paid to growers of raw inputs. However, it might also pursue other goals, such as the efficient utilisation of corporate assets, specific net profit targets, or production quotas. All of these things are likely to be part of an overall aim to maximise member returns.

The Historical Treatment of Membership Rights and Benefits in Cooperatives

The starting point for any analysis of member benefits is the way in which ownership rights are treated within the cooperative. In the traditional cooperative enterprise the ownership rights of members are different to those found in the investor owned enterprise. In the original charter of the Rochdale Principles investment capital within a cooperative was provided by its members but without any expectation for a speculative return, although it should earn a fixed rate of interest, market prices should be charged without credit and profits distributed *pro rata* on a patronage basis (e.g. commensurate with the amount of purchase made by each member). Control within the cooperative enterprise was democratic with a “one-member-one-vote” rule and no gender bias. Management was to be delegated to a team of officers and a committee or board elected periodically. Some profits would be put aside for member education and members would receive regular financial reports on the status of the enterprise (Fairbairn, 1994).

Over the past 160 years since the creation of the Rochdale Principles the way in which cooperative enterprises have interpreted these issues of control, ownership and reward have varied considerably. So varied is their interpretation that there has been substantial difficulty in achieving a clear agreement over the definition of a cooperative enterprise (Hind, 1997). The creation of the ICA in the 1890s and the development of a global coop movement during the early 20th Century saw further development of the Rochdale Principles, particularly ownership rights and benefits. By the 1930s there was agreement to pay fixed rates of interest on investment capital and for the investors to have first claim on profits. Profits would be distributed after meeting expenses and interest charges in proportion to purchases or patronage (Hall & Watkins, 1937).

The issue of how investment returns and profit distribution would be handled within the cooperative enterprise emerged as one of the most important areas for debate throughout the second half of the 20th Century (Fairbairn, 1994).

Distributing profits according to patronage (if distributed at all), and limiting the return on capital, are two sides of the same coin. Patronage refunds and limited returns on capital together express the idea that co-operatives belong to the members as users, not to investors. (Fairbairn, 1994; p. 30)

This treatment of investment returns and profit distribution continued largely unchanged into the 1960s and 1970s. However, by the late 1980s and into the 1990s there was new pressure to modify the principles associated with cooperative enterprise. A particular focus was placed on the treatment of investment with a desire to see more flexibility in allowing greater returns to investment and restrictions over transferability of shareholdings (Fairbairn, 1994). In recent years the range of different cooperative enterprises found around the world is substantial, with many variations on how ownership rights and benefits are handled.

Differing Treatments of Membership Rights and Benefits in Cooperatives

Chaddad and Cook (2004) examined the nature of ownership and control rights in cooperatives and other types of organisation. Their findings are outlined in Table 6 where it can be seen that ownership and control rights in the public corporation are influenced by the separation of the shareholder or investor from the entity. The investor in a limited liability company is legally a different person to the legal entity of the corporation. Their voting rights and power within the firm increase along with their shareholding. Those with majority shareholding have effective control. They can hold their rights so long as the corporate entity continues to exist and can transfer their ownership rights along with any residual claims via the share market.

In the case of the traditional cooperative the member is required to be a patron of the enterprise and cannot separate their ownership of equity from their patronage. The traditional cooperative has a “one-member-one-vote” principle, which means that the member is not able to secure any proportional control in voting and is not able to transfer residual claims. However, as noted earlier, many cooperatives have developed different ownership structures. Chaddad and Cook (2004) point out that those with restricted membership, preference share holdings, or proportional member investment arrangements have rights and control systems that differ from the traditional coop. For example, the New Generation Cooperatives (NGC) typically has non-redeemable and transferable ownership rights that are limited to member-patrons. Some cooperatives also form joint ventures or hybrid structures with investor owned firms.

In the case of New Zealand’s Fonterra, a system of “Fair Exit and Entry” was applied in how the cooperative dealt with membership. Prior to the introduction of this scheme, members entered and exited the group with no change to the price of their membership. Unlike a shareholder who enjoyed growth in the value of their shareholding, the coop member gained no such value other than the benefits accruing to membership that are rather less directly measured. Later entrants to the coop gained benefits from the work and investment made by their predecessors without having to pay a price premium (Ferrier, 2004).

The Fonterra system of “Fair Exit and Entry” requires the purchase of shareholding on the basis of supply volumes, but shareholdings are independently valued by the ratings agency Standard & Poor’s. Based on this independent valuation the Board of Fonterra sets a share value for each growing season. Members enter and exit the coop with some

opportunity for realising their share value rising. Fonterra has controls to protect a major outflow of capital as part of its constitution (Ferrier, 2004).

Table 6: Ownership Rights Structure for Coops and other Enterprises

	OPEN CORPORATION	PROPRIETORSHIP	FINANCIAL MUTUAL	TRADITIONAL COOPERATIVE
Assignment of residual returns	To investors	To proprietor	To customers	To member-patrons
Separation of ownership from other functions	Yes	No	No	No
Control rights	Voting rights proportional to shareholdings	Proprietor possesses all control rights	Customers have no control rights	Non-proportional voting rights
Horizon of residual claims	Unlimited	As long as proprietor	As long as customer	As long as patron
Transferability of residual claims	Yes	No	No	No
Redeem ability of residual claims	No	No	Yes, on customer demand	Yes, but at Board's discretion

Source: Chaddad & Cook (2004)

Cook and Chaddad (2004) identify at least four different types of cooperative enterprise in relation to ownership rights. These are the traditional coop, the proportional investment, member-investor and the NGC. The **proportional investment coop** is characterised by non-redeemable, non-transferable and non-appreciable ownership rights restricted to member patrons who invest in the enterprise on the proportion of patronage. This type of cooperative is the “pure” form of agricultural coop and as its size increases the level of ambiguity over property rights moves it more towards the traditional cooperative. This type of coop typically has to focus its capital management policies so as to protect proportional ownership rights.

The **member-investor type coop** combines patronage and investment shareholding in order to identify ownership rights and benefits. These coops usually pay regular dividends to members on the basis of proportional shareholding and/or the share equity capital gain over time. The Fonterra Group is an example of this type of cooperative (Cook & Chaddad, 2004).

The NGC in its “classic” form recognises ownership rights in the form of tradable and appreciable delivery rights that are limited to member-patrons, who also have to purchase delivery rights on the basis of forecast patronage. There is proportionality in the balance between usage and capital investment. According to Cook and Chaddad (2004) most NGC shares are non-redeemable.

In addition to the four types mentioned above, there are some cooperatives that do not restrict ownership to member-patrons. This type of cooperative is usually seeking to raise additional investment capital and needs to alter its ownership rights structure. At least two

types of “hybrid” cooperatives were identified by Cook and Chaddad (2004). The first were cooperatives with capital seeking companies and the second, investor share cooperatives. The first of these involves the coop setting up a new business entity, which might be a joint venture firm, subsidiary or a trust fund. This becomes the vehicle into which the capital is invested and where the ownership rights for the investors can be recognised and protected. The cooperative enterprise will own a proportion of the new entity and in this way no outside capital is directly brought into the coop.

An example of this **cooperative with capital seeking companies model** is Granarolo of Italy. In 2004 Granarolo offered 20 percent of its shares to Intesa Bank to fund €72 million for a buy out of another business Yomo. This was a short term strategy by Granarolo and the exit plan for Intesa was that the cooperative planned to list Yomo and pay out the bank. This type of funding model is relatively common in the European Union often with coop banks providing the interim funding (Bekkum & van Bijman, 2004). This funding model does risk creating two classes of shareholder (e.g. member-patrons and capital seeking firms). It can lead to tensions between these two groups if not adequately managed.

In the **investor share cooperative** the investors receive both traditional ownership rights as member-patrons and shareholder rights as investors. It typically involves the issuing of two classes of shares. These are non-voting fixed interest preference shares and non-voting publicly tradable ordinary shares (Cook & Chaddad, 2004). A number of agricultural coops have adopted this financing structure in recent years including Dairy Farmers of America (2004), Cenex Harvest States (2001), Pro/Fac Birdseye Foods (1994) in the United States, the Saskatchewan Wheat Pool of Canada (1996), and South Africa's Clover Dairies (2004) (Bekkum & van Bijman, 2004). Due to the fixed dividends, preference shares do not usually affect the performance based incentives to member capital within the cooperative. The preference shareholders also enjoy more security over ordinary share holders in the event of bankruptcy as they rank ahead of these investors.

Nilsson's (1999) taxonomy of cooperative enterprises (see Chapter 1 Table 2), suggests that the key differences are related to the treatment of ownership rights and benefits. This encompasses the same types discussed above referred to as the traditional, participation, subsidiary and NGC. The participation coop allows shareholders who are non patrons, usually via “B-shares” or certificates. These investor shares are individually held and can be traded for capital gain. Non-patronage shareholder investors may have voting rights and receive dividends or interest payments often at a fixed rate.

The subsidiary cooperative is the equivalent of the coop with capital seeking firms. The joint venture or subsidiary entity isolates the cooperative from direct investment capital from non-members. However, as noted above it introduces a blend of conventional investors and coop members who have quite different ownership rights and benefits. The NGC as discussed typically operates on a patronage delivery rights basis to a closed circle of members who have purchased delivery rights. These rights are fully tradeable and member benefits are proportional to patronage (Nilsson, 1999).

A further type of cooperative is the **PLC coop**, a business structure that is legally not a coop but a corporation where members are shareholders with patronage. Control is usually based on the proportion of equity held by each member with profits or dividends returned on the basis of shareholding rather than patronage.

The Cooperative and Wealth Creation

A primary aim of any business enterprise is the creation of wealth. In the conventional firm the principal strategic goal of the shareholders, Board of Directors and the executive managers is to make a profit and maximise the returns to shareholders. The cooperative is also focused on wealth creation, although as shown above, the rights and control of the shareholder-patrons can vary from that of the investor owned firm.

The original purpose of the cooperative movement as outlined in the Rochdale Principles was the creation of wealth for its members, as stated in the 1844 charter:

The objects and plans of this Society are to form arrangements for the pecuniary benefit, and improvement of the social and domestic condition of its members, by raising a sufficient amount of capital in shares..." (Fairbairn, 2000; p. 6)

Here the emphasis is on "pecuniary benefit" suggesting that the coop was to be more than just a supplier of goods at fair prices, but a venture with the capacity to return financial wealth to its investors. Nembhard (2002) examined the wealth creation capabilities of the cooperative and noted that at time of writing there was not research data available on the role played by coops in generating wealth. Part of the problem in determining the wealth created by cooperatives is that shares are not publicly traded and profits are often not set up to distribute dividends, retaining profits in the business for re-investment purposes. The cooperative enterprise is also not separately recorded in official statistics making it more difficult to assess.

Despite these problems there are many examples from around the world that demonstrate how the cooperative can generate wealth for its members. For example, housing coops enable millions of people to secure home ownership and accumulate wealth through this major asset. Credit Unions and Cooperative Banks also serve to assist members to boost their wealth either through more accessible capital for investment elsewhere, or from the growth in share holding within the mutual (Nembhard, 2002). Nevertheless, more work remains to be done in this area with attention to the following questions:

- What economic structures lend themselves to community wealth creation, asset building, and retention of assets and wealth?
- Are some kinds of ownership structures and organizational structures better than others at giving participants/members genuine decision-making opportunities and actual ownership and wealth accumulation?
- What structures make those opportunities real, and what supports are necessary to reinforce and strengthen those structures and outcomes?

These questions are relevant within the context of this study and relate to the overall focus on member value creation within the cooperative enterprise and how this value is recognised and rewarded.

Other Measures of Member Benefit in the Cooperative

In addition to direct financial returns to the investment made by members, the cooperative also provides other means of generating benefits. While the original Rochdale Principles placed an emphasis on pecuniary benefits to members as investors, they also focused on the generation of employment opportunities for the unemployed, the creation of affordable housing and to create a community that was self-supporting (Fairbairn, 2000).

These principles continue into the modern day despite some significant changes to the way in which cooperatives are organized. Bartlett *et. al.* (1992) compared labour managed cooperative enterprises with privately owned firms in Northern Italy. While no significant differences were found in the investment horizons or financial decision making over capital allocation, the coops had higher productivity, more labour-intensive production methods and better industrial relations. The cooperatives also had less difference between the wage levels of the senior managers and the rank and file. There was a stronger focus in the cooperatives towards the local community and a greater willingness to employ those who were out of work.

In the area of financial cooperatives or credit unions Ward and McKillop (1997) found that such coops were focused on promoting savings amongst members. These coops differed in how they behaved, but in general terms their orientation was towards the principles of the cooperative movement rather than that of the conventional financial services firm.

Public Choice Theory and Cooperative Benefits to Members

Another potentially important role played by cooperatives in the delivery of benefits to members lies in their capacity to shape public policy. While the cooperative is traditionally politically neutral, it retains a basic philosophical purpose designed to improve the overall well being of its members. Because it is a socially democratic institution, the cooperative enterprise offers greater potential to promote the interests of a wider cross-section of society than the conventional investor owned firms, which typically push the interests of a relatively small group of dominant shareholders.

In the theory of public choice (Buchanan & Tuck, 1962) the process of political decision making in democratic societies is defined by the aggregation of many private individuals with differing agendas and interests. Rather than a “public versus private” interests debate, political society is an ongoing trade off between rational, rent-seeking individuals in which economic self-interest is a primary motivator. However, the individual is also a cooperative actor willing to collaborate with others in the pursuit of rational mutualism. The political process is not fixed, but can be shaped by the interplay between different groups seeking to advance their individual interests albeit via collective action.

Large corporations lobby governments and politicians in order to secure outcomes that are beneficial to their shareholders. In addition to direct lobbying the large corporation also works via industry associations, chambers of commerce or business councils to achieve its aims via collective action. The role of a CEO in most large corporations is partially that of serving as a spokesperson for the firm within the circles of political power (Goddard, Boxall & Lerohl, 2002).

For the cooperative enterprise the process of political lobbying and engagement within the political arena for the advancement of the membership is equally important. However, as noted by Cook (1995) the “*influence cost problem*” can emerge once the cooperative

grows to a size where the diversity of interests amongst its membership is so large that tensions arise with respect to the strategic direction being taken by the enterprise. It can lead the cooperative to abandon its original purpose and move towards the structure of the investor owned enterprise.

The role of the cooperative is to benefit its members and in doing so may engage in political lobbying on their behalf (Fulton, 1999). However, the cooperative that does engage in this type of political lobbying behaviour risks influence cost problems as there may emerge a conflict between its economic and social roles. Goddard, Boxall and Lerohl (2002) found this to be the case in their analysis of producer cooperatives in Canada. As they conclude:

Although there are a variety of reasons for the transitions occurring in both industries, including massive investment and high debt financing, it is clear that the twin roles of political lobbyist and business enterprise may not make the operation of such companies any easier. Various authors have decried the loss of political voice by some of our traditional cooperatives. The problem in fact may be that the cooperatives should never have focused as much effort on political voice and should have paid more attention to managing the store. (p. 525)

Trust and Member Commitment

In seeking to understand the benefits provided to members by cooperatives attention must also be given to the issues of trust and member commitment. The importance of trust as a foundation for cooperative behaviour was discussed in Chapter 2. According to Fulton (1999) member commitment is a critical element that helps to determine how well the cooperative performs in comparison to the investor owned firm. If the only basis upon which the coop operates is price or investment return it offers little to differentiate it from the investor owned enterprise.

Member commitment is a preference by members for something that is offered by the cooperative and not by an IOF. Historically, the source of member commitment can be linked to cooperative ideology, or the preference that some farmers had for doing business with organizations they owned and controlled. Member commitment was vital to the formation of cooperatives – without member commitment; the threat of predatory pricing by IOFs would have made cooperative formation totally ineffective. (Fulton, 1999; p. 434)

The cooperative enterprise builds its member commitment around trust and there is evidence that the basis of this trust is the ability of the member to identify with the coop as a collective organisation (Ole Borgen, 2001). Where the members strongly identify with the cooperative and its mission, they are more likely to experience trust in and show a commitment towards the enterprise. Identification with the coop can be enhanced via the use of education in cooperative principles. A lack of identification and trust is likely to result in a divergence of member interests and the emergence of the *“influence cost problem”*.

It is important for the cooperative to develop a reputation for being an effective agent for its members. Where the coop can demonstrate its effectiveness in this regard it is likely to see enhanced member commitment. The reverse is true where the coop fails to adequately represent and promote its member’s interests (Fulton & Giannakas, 2001).

This was demonstrated in a study of retail hardware cooperatives undertaken by McClintock-Stoel and Sternquist (2004). They drew upon the merging of social conflict and social identity theory. The first is a Marxist-based notion that individuals and groups with different levels of wealth or access and control over resources, will come into conflict as those with more power seek to exploit those with less. The constant tension between these competing forces is a major influence on how society is shaped. By contrast, *social identity theory* (Tajfel, 1978) suggests that the importance a member attaches to their being a member of a given organisation influences their perceptions of conflict with others from rival organisations, as well as determining how they will behave in given situations.

McClintock-Stoel and Sternquist (2004) found support for the notion that a member's identification with the group strengthened their perceptions of conflict between the group and its rivals. Within retail hardware cooperatives the members are independently owned stores with their own interests and competitive rivalries. However, the study showed that they may still identify with the cooperative as a group and seek to commit to its goals. Yet care must be taken to ensure that the cooperative does not demand conformity – as would be possible in a business format franchise system – as this will risk breaching trust amongst members and therefore weaken their commitment.

Morrow, Hansen and Pearson (2004) provide a good overview of the theoretical foundations of trust within cooperatives. They note that research into how trust works in organisations is an emerging field with some agreement over its definitions. However, they note that there remains more work to do before a full conceptualisation of trust can be agreed. In their view:

We have argued that trust should be viewed as being grounded in both cognitive processes and affective responses. This is an intuitively appealing argument and is consistent with other views of trust. (p. 60)

They found that if the members of a cooperative trust the managers of the coop, there was an increased level of reported satisfaction by the members in their coop. This satisfaction was measured in both financial and non-financial ways. Their research suggests that an important ingredient in achieving member satisfaction and commitment in the cooperative is for the enterprise to build “a sense of family, good feelings and *camaraderie*” that can serve to build trust (Morrow, Hansen & Pearson, 2004).

This study highlights the importance of member education within the cooperative. Where the coop disseminates to its members information about the benefits it has brought on both an individual and collective level, it should be possible for these claims to be tested. This can take place by process of testimonial and should permit the members to double check the accuracy of any claims. Honesty in the dissemination of factual information will serve to build trust and over time loyalty and commitment.

James and Sykuta (2005) link organisational trust with property rights and organisational configuration in cooperatives. Their analysis suggests that there is a positive correlation between property rights, organisational structures that engender a perception of equality and mutual interest and member trust in the organisation. Their research is somewhat counter to that of Cook and Iliopoulos (1999) in that it suggests property rights structures that promote member investment may also prove counter productive to the fostering of member trust in the enterprise. As they explain:

The finding that the effects of property right features on organizational trust and performance are not necessarily complementary is important to recognize for a couple of reasons. First, as noted above, higher degrees of trust have been shown to reduce contracting and organizational costs and therefore might be expected to improve investment incentives. The negative correlation between trust and some investment-supporting property rights suggests organizational trust alone is not necessarily sufficient to support investment in the organization. Second, our findings suggest potential countervailing effects of property right structures intended to promote organizational efficiency. While we are careful to draw conclusions regarding causality, our findings are consistent with the hypothesis that property right structures that promote private incentives toward the organization may reduce the public good of trust within the organization. (p. 572)

There is a potential trade off that emerges when the cooperative begins to move from the traditional form towards the NGC form. The more the cooperative enterprise looks and behaves like an investor owned firm the more risk that might occur to its organisational trust and member commitment. As noted by James and Sykuta (2005) there is more work to be done in understanding this dynamic, but it suggests the possibility that there is a tipping point over which the restructuring of the cooperative in order to strengthen member property rights to overcome free-riding, the more damage that might be done to the spirit of the cooperative.

Summary and Opportunities for Future Research

This chapter has focused on the issue of member value creation and recognition within the cooperative enterprise. It suggests that member benefits are understood and managed somewhat differently within the cooperative than in the investor owned firm. As noted, the cooperative treats member rights in a more democratic and equitable manner than is the case in a typical investor owned firm. The somewhat unique dual role of members as both shareholders and patrons is partially responsible for this. However, the coop is also able to engender member loyalty and commitment through a process of member identification with the overall principles of the cooperative, and trust (built on equity and mutual interest) allow members to receive benefits of a non-pecuniary nature.

Cotterall (2001) has outlined some of the opportunities for future research in this area. In the field of property rights he suggests that research needs to move beyond the conceptual stage into the “real world” with the development of “solid case studies” and quantitative analysis of the way in which property rights have been dealt with via contracts. He seeks a similar approach for the application of game theory to cooperatives with a focus on the way in which cooperatives employ marketing to secure benefits for members. He also seeks empirical testing of the theories associated with membership trust and loyalty.

Morrow and Hansen (2004) who did undertake an empirical analysis of member trust and loyalty suggest that future research in this area needs to consider common method variance and should adopt a multi-method form of data collection to allow for greater external validity. They also suggest the need for the development of reliable scales to measure trust within organisations. McClintock-Stoel and Sternquist (2004) suggest that future research into group identification and member loyalty in cooperatives should involve longitudinal analysis.

Nembhard (2002) in her analysis of the role cooperatives play in the generation of wealth suggests that future research should address the following questions:

- What is an appropriate definition of wealth (i.e. what is coop or collective wealth versus individual wealth?), including any distinctions between income generation and wealth accumulation?
- If wealth creation is not the primary goal of a cooperative enterprise, how do members “legitimately” accumulate it and benefit from it?
- What economic structures lend themselves to community wealth creation, asset building and retention of assets and wealth?
- Are some kind of ownership structures and organisational structures better than others at giving members genuine decision making opportunities and actual ownership and wealth accumulation?
- What structures make those opportunities real and what supports are necessary to reinforce and strengthen those structures and outcomes?

Finally, James and Sykuta (2005) suggest that future research needs to focus on the nexus between organisational trust, member property rights and organisational design. As they explain:

However, the fact is there is not a well-developed theory laying out precisely how and why trust in cooperatives emerges and is maintained, and how trust varies according to various organizational and property right structures, social and group norms, and member characteristics. The literature on cooperatives presents important pieces of the puzzle, such as the relevance of cooperative property right structures and norms of equality and homogeneity as we show in this paper, but more work is needed in putting the pieces together systematically. We hope this study provides motivation for scholars to direct greater attention to the issue of cooperative structure and organizational trust. (p. 574)

The cooperative enterprise is able to offer benefits to its members through a process of value creation in both direct financial and more indirect non-financial means. As a social enterprise the cooperative offers benefits to members from disadvantaged backgrounds in a way that is less likely in a conventional investor owned firm (Nippierd, 1999). It is a means of accumulating wealth and generating economic prosperity within communities who would otherwise not be able to benefit from conventional investor owned enterprise.

Chapter 5

The Financing of Cooperatives

Constraints to the acquisition of external financing in coops

This chapter examines the financing of the cooperative enterprise. As discussed in the preceding chapters the coop is a different business model to the investor owned firm and in many respects it treats ownership rights and benefits to investors differently. While the conventional corporation can seek to raise external financial capital through the issue of share capital via the stock market, the traditional cooperative is more constrained in its fund raising.

Funding of Traditional Cooperatives

The Rochedale Society of 1844 issued one pound shares to its membership to raise the initial funds to establish the cooperative business. Funding of the coop was to be achieved through a combination of accumulated share capital from members, plus the retained earnings from trading (Fairbairn, 2000). It was also noted within its articles of incorporation:

That at each quarterly general meeting the officers in their financial statement shall publish the amount of profits realized by the society during the preceding quarter, which shall be divided thus; interest at the rate of 3 1/2 per cent per annum shall be paid upon all shares paid up previous to the quarter's commencement; the remaining profits shall be paid to each member in proportion to the amount of money expended at the store.

From the time of Rochedale to the present the cooperative has focused on achieving economic success as an enterprise, but in a way that offers fair value to its members. According to Cook and Iliopolous (2005) the financing of the coop in its traditional form is restricted by poorly defined ownership rights, inadequate up-front equity investment requirements, a lack of appreciation in the value of shares and a lack of transferability of these shares. As a result many cooperatives have either abandoned mutualism in favour of becoming investor owned enterprises, or changed their structure to address these problems.

Chaddad, Cook and Heckeley (2005) found that while cooperatives do face financial constraints these can potentially be alleviated through the pursuit of growth strategies and the maintenance of conservative capital structures. However, the traditional cooperative must address the issues of vague property rights, benefits accruing to patronage rather than capital invested and the inability of the shares to be traded or redeemed. This may explain why many cooperatives abandoned their business model and converted into the investor owned firm in order to raise capital (Cline, 2005), or moved to a hybrid structure with two classes of shareholder (Campbell, 2003).

The strategic purpose of cooperatives as business structures designed for member benefit rather than shareholder wealth creation also makes it difficult to apply conventional financial performance measures to them (Guzman & Arcas, 2008). As a result the

economic focus and culture of the cooperative as a business model has been under review for the past thirty years (Hogeland, 2006).

Research into Cooperative Financial Performance

Lerman and Parliament (1990) conducted research into the financing of the cooperative enterprise with a view to determining how such enterprises performances compared to investor owned firms. Their research was undertaken in the US food industries, particularly the fruit and vegetable, and dairy processing sectors, using a longitudinal analysis over the period from 1976 to 1987. Due to the nature of equity control and rights within the coop it was theorised that the cooperative enterprise would be “*equity bound*”, and forced to rely on debt rather than equity in its funding due to the inherent limitations on dividends, voting rights and share ownership transfer. Cooperatives were also viewed as being more averse to risk, and therefore more reliant on debt than equity. They were also considered as more likely than investor owned firms to over invest in assets. This was potentially caused by the cooperative not having adequate alternatives for its retained earnings, and because they do not typically see member equity as investment capital thereby not recognising an opportunity cost for these funds.

A comparison of cooperatives and investor owned firms in the two food industries failed to find evidence to support the hypothesis that cooperatives could be expected to show low profitability relative to higher debt levels and an overinvestment in fixed assets and inventory. According to Lerman and Parliament (1990):

The rate of return to equity in cooperatives was not found to be significantly different from that of IOFs in the comparable industries; the debt-to-equity and the earnings-to-interest ratios for cooperatives were not found to be higher than for the comparable IOFs; and no compelling evidence for overinvestment was found for cooperatives in either industry. The observation that the reported profitability of cooperatives was better than expected and comparable to that of IOFs cannot be attributed to a low equity base in cooperatives. The proportion of equity of the cooperatives was not found to be lower than that of the comparable IOFs. In fact, the dairy cooperatives were observed to have significantly lower debt-to-equity ratio than the dairy IOFs, which indicates a relatively large equity base. These results counter the view that cooperatives are equity bound. (p: 538)

This research suggested that the differences between cooperatives and investor owned firms were much smaller than originally thought to that time. Further, the study concluded that the cooperative enterprise had levels of profitability and benefits to members that were greater than those enjoyed by many investor owned firms within the same industries.

Lerman and Parliament (1991) reported a further study aimed at determining if size and industry effects were the key factors influencing the financial performance of cooperatives. Once again they conducted a longitudinal analysis of 43 coops from within the dairy, grain and food sectors over the period 1970 to 1987. They drew upon financial reporting data. This analysis showed that large regional cooperatives were more efficient in the way they utilized their assets to generate sales, although smaller regional cooperatives showed a higher level of profitability. Growth was not viewed as a guarantee for enhanced financial performance amongst cooperatives. Some differences were found across industries although the findings were ambiguous.

In a third study Lerman and Parliament (1993) examined the relationship between the equity capital structure of cooperatives and whether this led to equity constraints. They

noted that due to the “user-owner” structure of cooperative share capital, there were some differences likely between these enterprises and convention investor owned firms. Using a longitudinal analysis of financial data from US agricultural cooperatives over the period 1973 to 1987, they examined the sources and application of capital. While the theory of cooperative financing had suggested that coops would suffer capital equity constraints, this was not supported by the data. On average the agricultural cooperatives examined in the study financed around 50 percent of their total capital requirement with equity. They were not found to be “equity bound”.

According to Lerman and Parliament (1993), the reasons for this unexpected finding may have been due to the treatment within US agricultural cooperatives of special taxation or adjustments to equity retention and patronage refunds to members. Debt financing by the cooperatives was usually in the form of short term borrowing. It was noted that cooperative enterprises may experience difficulties in securing long term debt due to the reluctance by banks to lend because of their unusual ownership structure. The study found no significant differences between the cooperatives and the benchmarks for investor owned firms in terms of debt to equity ratios. They concluded their paper with the comments:

The observation of high equity financing proportions among the sample of cooperatives does not, however, unambiguously resolve the hypothesis of equity constraints in cooperatives. Because of equity redemption schemes, some cooperative equity may be regarded as loans from members and it is left to future research to more closely examine the composition of cooperative equity with regard to new capital infusion, allocated earnings, and the actual redemption outflows. Also, a more detailed study is needed of the comparative growth rates of cooperatives and IOFs in a wider range of industries than previously attempted. This analysis of growth should link the financing patterns of cooperatives with financing needs and shed further light on the hypothesis of capital starvation in cooperatives. (p. 439-440)

This research suggests that the characteristics of the cooperative enterprise business model are not necessarily significant constraints on the acquisition of external financing as has been thought. Further, there is evidence that the cooperative does not perform that much differently to the investor owned firm, at least in relation to conventional financial performance measures. Parliament, Fulton and Lerman (1989) compared investor owned firms and cooperatives in relation to their financial performance. Key measures used were profitability, the level of outside financing in proportion to member equity (e.g. “leverage”), solvency and liquidity. They examined cooperatives and investor owned firms in the US dairy industry over a period of 15 years examining financial ratios. They concluded that any differences between the two types of enterprise were insignificant. While there did not appear to be any differences between the cooperatives and the investor owned firms in relation to these financial measures, they concluded that there were some non-financial measures that did provide a differentiation. Gathering evidence on these non-financial differences was seen as an area worthy of future research. It was suggested that surveys of coop members and managers be undertaken to elicit directly their perspectives on these issues. Two research questions emerged from this work:

1. Has the standard of financial analysis “forced” cooperatives to adopt the same goals as investor owned firms?
2. Has the emphasis on efficiency and return in the business community had a determining influence on the behaviour of cooperatives?

Equity and Risk in a Cooperative Enterprise

Further research by Parliament and Lerman (1993) was undertaken into the relationship between risk and equity in cooperatives. They noted that while cooperatives raise equity from members' investment, further capital raising can be difficult due to the patronage issues associated with cooperative ownership, plus the lack of transferability and tradability of cooperative stock. This leads to the cooperative seeking to retain earnings and use these funds for re-investment rather than issuing dividends. For many coops these retained earnings are not straightforward profits, but deferred patronage dividends to members. The equity held within a cooperative is not permanent capital but these patronage dividends that form an effective pool of deferred cash dividends that the coop uses as a part of its equity structure.

A longitudinal analysis of a dataset from US agricultural cooperatives over the period 1973 to 1987 was undertaken. This found that the ratio of equity to total assets within the cooperatives was affected by measures of business and financial risk that were often influenced by the type of product or commodity being handled by the enterprise. There was no relationship found between the size of the cooperative (as measured by turnover) and proportion of equity to debt used in funding the coop. Once again the study showed support for the view that no significant differences emerged between US agricultural coops and investor owned firms in relation to most conventional financial performance measures. The managers of cooperatives were apparently following similar financial and investment strategies to their counterparts in investor owned firms. In their conclusion Parliament and Lerman (1993) noted:

Perhaps the common pressures of the competitive business environment and the standard demands of the financial community outweigh the unique features of cooperative equity and account for this similarity in behaviour. (p. 13)

Financing Options available to Cooperative Enterprises

If the evidence of fundamental structural impediments to the financing of cooperatives is weaker than theory might suggest, what is the evidence of how cooperatives have undertaken the actual task of accessing external financing to fund growth? Economists have suggested that cooperatives can aspire to securing competitive positions against investor owned firms within agricultural markets (Helmberger, 1964). Financial analysis has also modelled the way in which equity capital raising by cooperatives using mixed financing approaches is undertaken (Ahmad, Duft & Mittelhammer, 1986). However, there has been less attention given to the experiences of cooperatives in recent years in terms of funding structures.

The exception is the work of Bekkum and Bijman (2006) who examined 50 case studies of how cooperative enterprises throughout the world have attempted to develop workable capital equity structures to finance growth. The following sections are a summary of their findings. Their study spans several countries and a twenty year period from the 1980s and 1990s to around 2005. Six main types of financing option were identified:

1. appreciable and/or internally traded shares;
2. externally traded subordinate bonds;

3. external corporate investors at subsidiary or group level;
4. public listing of preferred stock;
5. conversion into farmer-owned limited liability companies;
6. converted listed cooperatives.

In the follow sub-sections each of these options is described in more detail along with examples and the strengths and weaknesses of each.

Appreciable and/or Internally Traded Shares

The aim of this option is to provide members with the opportunity to allow their investment in the coop to accumulate value over time. This approach enables members to see the value of their original share equity appreciate, and allows them to sell out to new members at a higher price than they bought in. It should allow enhanced capital raising and strengthen member loyalty for long-term patronage. The benefits of this approach are that it builds more value for members and offers the ability to see long term patronage and loyalty returned. It also overcomes many of the problems associated with the traditional cooperative model. Bekkum and Bijman (2006) provided five case examples:

In 1991 the large Dutch dairy cooperative *Campina* introduced a system of supply-linked, non-tradable, non-dividend bearing and non-voting shares. These were subject to annual re-valuation by the coop Board of Directors. Over the 15 years from 1991 to 2006 the value of these shares rose from €4.54 to €5.75, or an average annual increase of 1.9 percent. In 2007 Campina had revenues of €4 billion and an employment base of 7,099.

In 2001 the large New Zealand dairy cooperative *Fonterra* issued supply-linked, non-tradable, interest bearing, voting “fair value” shares. These were re-valued by the Board of Directors using independent expert advice each year. Their value grew from NZ\$3.00 in May 2001 to NZ\$5.44 in May 2005, reflecting an annual increase of 20.3 percent. In 2008 Fonterra employed around 17,400 people and had an annual turnover of NZ\$17.9 billion.

In 1995 the Dutch cooperative *Royal Friesland Foods* issued internally and formally tradable, production de-linked, dividend-bearing but non-voting certificates or B-Shares. These were issued bi-monthly and opened at a value of €45. They peaked at €75 in 1999 and were trading at €61 in 2006, reflecting an annual increase of 3.5 percent over ten years. In 2007 the *Friesland* coop employed some 14,582 people and generated revenues of over €5 billion.

In 2004 the Irish dairy cooperative *Dairygold*, introduced internally traded, non-linked, non-voting, “interest” bearing shares. These shares spiked in price from €1 to €2.35 over two successive days in December 2005 forcing a suspension in trading. When examined for the case study new plans for a company split and partial stock-listing were being considered. In 2007 *Dairygold* generated revenues of €625.1 million

The Dutch cooperative *Avebe*, a specialist in potato starch products and the Swedish coop *Lyckeby Stärkelsen* also issued internally and informally tradeable, supply-linked shares.

According to Bekkum and Bijman (2006) the New Generation Cooperatives (NGC) in the United States are also using internally tradeable, production-linked shares that may appreciate in value over time against the performance of the business.

Externally Traded Subordinate Bonds

Instead of issuing shares some cooperatives have issued bonds, which are technically classified as debt not equity, but are guaranteed or risk bearing capital. This allows the coop to raise external finance without risk of dilution of member control. Bekkum and Bijman (2006) identified several cases. The first was *Campina*, already cited above, which introduced subordinated bonds that were distributed as part of the milk pricing agreement issued in 1997. These bonds had a maturity period of 20 years and were able to generate an annual dividend linked to the state bonds issued by the Netherlands Government with a 1 percent premium. These bonds are tradeable on an informal level within both the coop membership and outsiders.

In 2004, the Danish/Swedish coop *Arla Foods* issued a €135 million non-listed bond loan that generated a fixed dividend of 5.61 percent over the first seven years. Bond holders were offered an option for these to be extended for another three years. In May 2003 *Friesland Foods* also issued perpetual cumulative subordinated notes or permanent bonds. These were listed on the Dutch stock exchange and raised a total of €125 million while generating a fixed interest of 7.125 percent to bond holders.

In 2003 the German cooperative *Südzucker* issued 5 year convertible bonds that were listed on the Frankfurt stock exchange. These bonds provided an interest rate of 3 percent with a conversion option into common shares at a rate of €20.53. Meanwhile in New Zealand, the *Alliance Group*, a meat cooperative and *Fonterra*, listed unsecured capital notes and Australia's *Bonlac* had listed unsecured capital notes prior to its take over by *Fonterra*.

External Corporate Investors at Subsidiary or Group Level

Cooperatives have also allowed external shareholders to buy into the enterprise for various reasons, often as part of a short term re-structure. Several examples were given by Bekkum and Bijman (2006). These included the Dutch cooperative the *Cebeco Group* which issued special "K" shares to investment bank NIB Capital in 1997 in order to raise some €67 million in additional equity. This deal offered NIB Capital a preferred dividend against seven year state bonds offering a premium of between 0.5 and 2 percent. This was conditional on the cooperative meeting specified financial targets and included a 16 percent controlling equity with voting rights.

In 2004 Italy's *Granarolo* offered the Intesa Bank a 20 percent equity stake in the coop in return for €72 million in new equity. This was part of a capital raising design to fund the take over of *Yomo* and involved an exit strategy for Intesa Bank as part of the agreement. Bekkum and Bijman (2006) note that many similar examples can be found in Europe where cooperative banks are often equity partners in agricultural coops. They refer to *Agrana* and *NOM* in Germany and Austria, and France's *Sodiaal*.

Such a financing structure can create problems as it essentially sets up two classes of shareholder. The investors and the members, this can breach equity and fairness principles in the cooperative if not managed properly. For example, the Spanish cooperative *Capsa* has a capital structure where the equity is owned by cooperative banks and two other coops *Central Lechera Asturiana* and *Bongrain*. When faced with a hostile

take over bid of €300 million in 2005 it rejected the offer, but the action caused problems for the management as shareholders saw the real value of their equity.

Public Listing of Preferred Stock

Some cooperative have also issued preference shares. The benefit of preferred stock is that it does not dilute member control and allows the cooperative to also maintain much of its conventional operations. Preference shareholders also have well defined dividends and greater guarantees in the event of business failure. Bekkum and Bijman (2006) note that preference shares offer enhanced control when compared to ordinary shares listed on the stock exchange. Due to fixed dividends, preference shares do not affect the financial performance of the cooperative based on incentives to member capital. In the event of a bankruptcy, preference shares rank ahead of common stock, but behind subordinate bonds.

A number of cooperatives have used this type of financing. In the United States this includes *Dairy Farmers of America* since 2004, as well as *Cenex Harvest States*, since 2001, and *Pro/Fac Birdseye Foods* since 1994. Canada's *Saskatchewan Wheat Pool* has used this form of financing since 1996, and *Clover Dairies* of South Africa since 2004. Canada's *Agricore United* has issued both preference and common stock since 1993, and Germany's *Westfliesch* coop raised mezzanine capital in 2006.

Conversions into Farmer-Owned Limited Liability Companies

For many cooperatives the pathway to raising capital for growth is to essentially convert from a coop to an investor owned business. Unfortunately the history of such transactions suggests that most end up becoming victims of take over in the years following their conversion. Under this type of financing the cooperative becomes an investor owned firm, but remains in the ownership of the farmer producers. According to Bekkum and Bijman (2006) this is usually undertaken with a view to enhancing the overall strategic control of the shareholders and to strengthen decision making at the Board level. It might also be a means of raising share capital, or might be driven by taxation considerations.

However, the conversion from a cooperative to an investor owned firm can have major and negative implications. For example, Bekkum and Bijman (2006) note that the US cooperative *US Premium Beef* went through such a conversion in 2004 motivated by taxation and investment considerations. In 2002 the US based *Dakota Pasture Growers* and in 2004 the *Golden Oval Eggs* of the USA also converted. However, analysis of the track record of such conversions suggests that the majority eventually became takeover targets and are bought up by larger investor owned firms.

Converted Listed Cooperatives

Some cooperatives also form into hybrid structures, but this approach is usually just a temporary step before they give up being a cooperative and become an investor owned firm. In the example of the converted listed cooperative the enterprise converts into a publicly traded investor owned firm. Some coops seek to retain their cooperative structure as a hybrid organisation. The motivation for such a re-structuring is to raise external capital and attempt to "lock in" member value in a one-off public listing.

Australia's *Dairy Vale Foods* listed in 1995 but experienced problems and de-listed in 1998. A similar case was that of *Farmer's Grazcos Cooperative & Panfida Pastoral* also in Australia. This listed in 1987 only to de-list in 1992 following the bankruptcy of its parent

Panfida. Once again the track record of such deals is not a happy one as highlighted in the two examples given here from Australia.

According to Bekkum and Bijman (2006) this form of financial restructuring is essentially an exit strategy for a cooperative. The history of those coops that have gone through this process is that most fall prey to takeovers after listing. Some examples provided are *American Rice* which was taken over by ERLY Industries in 1988 following listing. In New Zealand *Otago Farmers* listed but then received a hostile takeover bid from venture financier Ronald Alfred Brierley that was rejected by the coop's Board of Directors, but accepted on an individual basis by many member shareholders. It was finally merged with *Kiwi Cooperative Dairies* now part of *Fonterra*.

In 1990 *Golden Vale* of Ireland publicly listed only to be taken over by the *Kerry Group* in 2001. New Zealand's *Affco*, which was the largest meat cooperative in that country, listed in 1995. Following the deregulation of the New Zealand meat industry *Affco* experienced financial losses over several years. It had taken over the debt-laden *Waitaki International* and engaged in a financial restructure to raise capital. It raised NZ\$50 million on its initial public offering that allowed it to repay debts. However, within a few years it was forced into a further restructure and it eventually saw producer ownership erode.

Lessons Learnt from Cooperative Financing Options

Bekkum and Bijman (2006) conclude their paper with a series of lessons learnt. First, they caution that cooperatives should not seek public listing out of necessity as this will only expose the enterprise to aggressive takeover threats at a vulnerable time. Second, it is important that the cooperative aim to retain the trust and loyalty of its members who are likely to be uncomfortable with the erosion of their control and potentially their benefits. Third, if the financial restructuring results in the cooperative losing its coop focus and ownership and control structure it can result in the emergence of a "free rider" problem.

A fourth issue is that the management of the cooperative should ensure that there are mechanisms in place for on-going member dividend reinvestments to avoid members' share values becoming too diluted over time. Management should also aim to establish collective, preferential supply and processing contracts, or some form of periodic process of negotiation that can protect member interests. In doing so the cooperative's management should establish clear benchmarks for member price determination that are unaffected by end of year profit determinations. Finally, the management team of the coop should exercise collective control via differential voting rights that respect the relationship of the patron-member and investor.

Summary and Opportunities for Future Research

This review of the literature suggests that while the issues of ownership rights and the transferability of patronage-equity within cooperatives may pose structural complexities that have the potential to limit access to external equity, this is not necessarily a major issue for coops. The performance of cooperatives in terms of conventional financial measures may be little different to those of investor owned firms. Much will depend on the way in which the coop's management team view their strategic goals, but as most coops are forced to compete within open markets against investor owned firms, they are bound to follow similar priorities in terms of financial performance. However, this does not mean that cooperatives should be treated identically to the investor owned counterparts. There

are many non-financial benefits accruing to membership in a cooperative that are not well recognised and assessed in conventional business analysis.

The past thirty years has seen cooperatives adopt a wide range of different methods of raising capital and seeking to address some of the inherent weaknesses associated with the distribution of ownership rights and control. It seems that cooperative managers have sought to adopt strategies designed to reward member patronage and loyalty, while also trying to balance the often competing interests of the member and the investment capital providers.

The two main research questions examined in this chapter were:

- What are the characteristics of the cooperative business model that serve as constraints to its acquisition of external financing, particularly access to risk capital?
- Are the accounting and financial performance benchmarks used within the conventional corporation appropriate for the cooperative business model and if not what are the alternatives?

As noted earlier in this review the traditional cooperative enterprise has a business model that is theoretically constrained in relation to its ability to raise financial capital from open markets. However, as shown in this chapter, many cooperatives have found innovative ways to overcome these challenges. The New Generation Cooperative (NGC) has sought to address the “free-rider” problem through a tighter linkage between patronage and share ownership rights. However, more research is needed into the NGC business model and how best to structure its equity and patronage rights for maximum benefit (Holland & King, 2004). Further, the longitudinal research work of Parliament et. al. (1989; 1993) and Lerman and Parliament (1990; 1991; 1993) suggests that the coop is less restricted in accessing external finance or in overall financial performance than might at first be thought.

Future research should adopt methodologies that allow for longitudinal studies of the financial performance of cooperatives using different financing and business ownership structures. This analysis should aim to examine coops across industry sectors and test both the value of these different financing options, and what additional management issues they created. In addition to producers’ cooperatives in the agriculture sector, there should be attention focused on the financial sector where cooperative banks and credit societies have been a feature since the earliest years of the coop movement where they serve as an important role in filling market niches not serviced by traditional financial institutions (McKillop, 2005).

An important consideration is whether the coop should be assessed purely against the same financial performance measures used for investor owned firms, or whether a set of additional performance standards should be used. As noted in Chapter 4, the cooperative enterprise offers benefits to members that can be measured in both the conventional financial sense (e.g. return to equity investment), and in other ways (e.g. patronage and market pricing). Attention should be given to identifying what these additional measures might be with a view to creating a wider set of performance benchmarks for the coop. This might include attention to what Nha (2006) refers to as “cooperative value” or the set of benefits that members expect from the coop that would not be obtainable from alternative forms of enterprise.

Chapter 6

Leadership, Corporate Governance & Strategic Networking

Corporate Governance of the Cooperative Enterprise

The preceding chapters have focused on the theory of cooperation, the business model of the coop, how member value is recognised and rewarded, and the mechanisms used by cooperatives to fund operations and growth. Much work has been done in all these areas yet the role of the cooperative's Board of Directors and senior management team remains a neglected area within the literature (Condon, 2001). This chapter examines the nature and role of leadership and corporate governance within the cooperative. In particular it seeks to explore how the management of a coop may or may not differ from that of an investor owned firm. Also whether there are any specific requirements for the composition of a cooperative board and if this might differ across industries. It also examines the strategic networking behaviour of cooperatives, in particular the supply chain relationships that underlie the coop business model and whether these operate differently to investor owned firms.

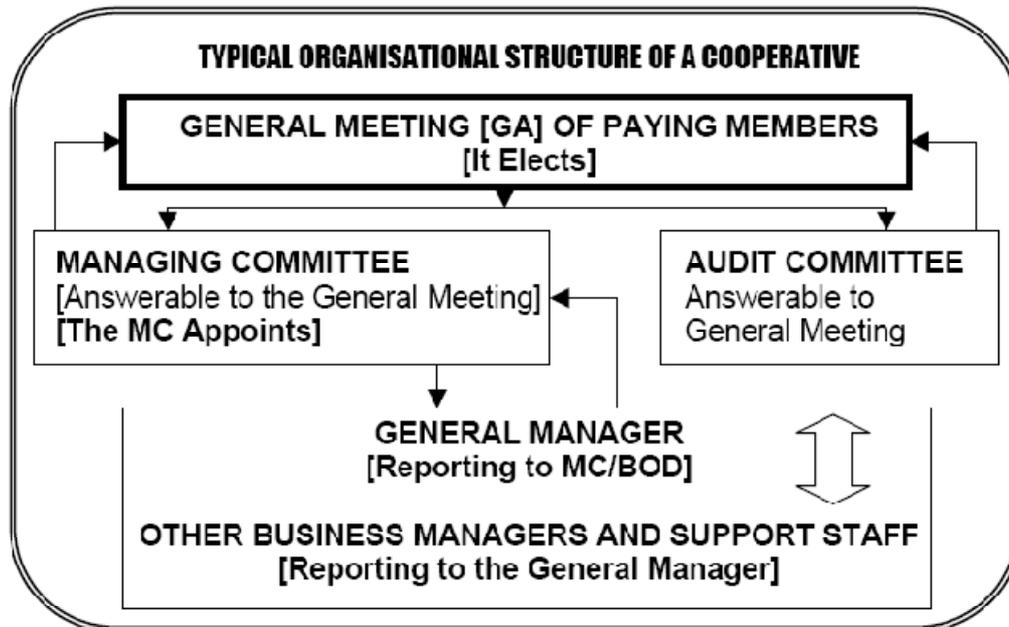
The Role of Cooperative Boards of Governance and Senior Management Teams

While the structure and corporate governance of cooperatives varies across organisations the key features are a democratic form of governance, a dynamic management team and adequate internal control mechanisms. According to Cracogna (2002) there are typically three separate elements that comprise the corporate governance system of the coop:

1. **The General Meeting** – usually comprising all members with an equality of voting rights, the general meeting elects the Board and Committee, as well as appointing such officials as the auditor. It also approves annual budget and principal investments, approves the financial statements issued by the coop and any changes to the constitution, bye-laws and strategic directions;
2. **The Board of Directors** – is responsible for administration of the coop under the framework provided by the organisation's constitution and bye-laws plus resolutions from the General Meeting. The Board also has the task of keeping the coop's records and accounts, and submitting these to the General Meeting as part of the entity's annual reporting. Coop Boards are usually comprised of members;
3. **The Supervisory Committee** – this group is tasked with the function of overseeing the Board of Directors and reporting their findings to the General Meeting. It usually comprises a selection of members as outlined in the bye-laws. In some coops this committee appoints the external auditor.

Prakash (2003) suggests that the cooperative operates within four main spheres comprising the members, the organisational structure, the community and then the coop

Board, senior management and employees. While there are many different types of coop and no uniform structure, he suggests that most of those found within the Asia-Pacific region adopt something resembling the model illustrated in Figure 3.



Source: Prakash (2003)

Figure 3: General Organisational Structure of a Coop

Theories of Cooperative Corporate Governance

In his analysis of the economic theory of cooperative enterprise Emelianoff (1942) put forward the view that a coop was not a firm in the conventional sense but a coalition of members with different interests. The cooperative was designed so as to achieve the common goals of these members without loss of their own independence as separate business units. The management of the cooperative is relatively weak due to the equality of all shareholders and the democratic “one-member-one-vote” system of governance (Robotka, 1947). However, with the evolution of the cooperative business model over the past sixty-five years, and the emergence of large international cooperative ventures the role of the Board and senior management team has similarly developed. More professional skills and accountability were required.

Condon (2001) postulates that while the role of a Board of Directors in a cooperative is consistent with the profit-maximising behaviour of neo-classical economic theory, the way in which the Coop Board is structured is significantly different from that of the investor owned firm. This is due to the way in which the composition of the Board of Directors in an investor owned firm is typically divided between those who are insiders and represent management and major shareholders, and those who are outsiders with no vested interests. These members are usually selected for their expertise in legal, financial or some other specialist field. By contrast with the investor owned firm’s board, the

Cooperative Board structure is often made up of member-patrons who have expertise in their role perhaps as farmers, but with little or no experience in management of a large enterprise (Condon, 2001).

Cornforth (2004) sought to provide a new theoretical framework for understanding the governance of cooperatives and mutual enterprises. In comparison with investor owned firms, the corporate governance of cooperatives has been substantially neglected in the academic literature. The Board of Directors of a cooperative face at least three key tensions. The first is the tension between the need to represent the interests of members and the need to be an impartial expert with the responsibility to do the right thing by the enterprise. The second tension is to see the cooperative grow and achieve performance targets, while making sure that the enterprise operates in a prudent and accountable manner. Finally, there is the tension between the Board's roles of controlling the enterprise while supporting management.

Cornforth (2004) draws upon five interrelated theories which he seeks to build into a framework. The first of these is **Agency Theory**, which postulates that where a *Principal* (e.g. share holder) is forced to hire an agent (e.g. Manager or Director) to represent their interests difficulties arise. These are due to the relative self-interest of both parties and the need for both parties interests to be brought into alignment. A key problem is that of *asymmetrical information* where by the *Principal* has incomplete or inferior information in comparison to the *Agent*. Contracts, reporting and incentive schemes are typically used by the *Principal* to keep the *Agent* working in their best interests. In the case of a cooperative, the members are the *Principals* and the coop managers are the *Agents*. However, in the case of cooperatives the issues that impact most strongly on investor owned firms may not apply. This is because the coop is tasked to benefit members' interests rather than maximise profits, and due to the non-tradability and transferability of the equity.

A counter argument to Agency Theory is **Stewardship Theory**, which argues that if left alone managers and directors will act in good faith as responsible agents for their firms and therefore in the best interests of the shareholders. The role of a Board of Directors is to work with the senior management team to set strategic objectives and guide the firm to higher levels of performance. Board membership should therefore be based on expertise and knowledge. However, this might pose a problem for many cooperatives as the Board is often comprised of members without sufficient expertise in business management. As Cornforth (2004) quoting Sivertsen (1996: 35) suggests:

Co-ops tend to be management driven. Whereas board members in major private companies are elected within the business environment, board members in co-ops are elected among what we would call everyday people. Very often solid, earnest people with good judgement, but without the necessary background to make strategic decisions in the business world. Instead of bringing support and criticism to the Chief Executive they act as passive receivers of information. (p. 35).

A further theoretical foundation is that of **Resource Dependency Theory** (Pfeffer & Salancik, 1978). This suggests that the organisation is forced to adapt to its external environment and configure its resources to meet the challenges it faces. The way in which the firm configures its internal resources is an important determinant in how well it deals with environmental uncertainty. The role of the Board of Directors is therefore to serve as a key interface between the firm's internal and external stakeholders. This involves making sure that critical resources continue to be available to the firm to allow it to successfully operate. From the cooperative perspective the Board of Directors plays a critical role in *boundary spanning*, and membership should be based on an ability to maintain external

links that can be leveraged by the enterprise. According to Cornforth (2004) the election of Coop Board Directors from amongst the membership is a potential limitation, and may need to be supplemented by non-members who are coopted.

The fourth theoretical foundation is the **Stakeholder Theory** of Freeman (1986). This asserts that while the organisation's management and Board of Directors are responsible for acting in the best interests of shareholders, they also must serve a range of other stakeholders. These include employees, customers, government, the wider community and even the environment. Cornforth (2004) points to the Directors of cooperative Boards to be drawn from members who are the key stakeholders. However, where this is deemed to be inadequate the Board may need to coopt onto it other Directors who can be seen as truly representing these wider stakeholder communities.

Finally, there is the theory of **Managerial Hegemony** that suggests the real power in a large organisation lies with its senior management team rather than the shareholders (Berle & Means, 1932). According to Cornforth (2004) and Itkonen (1996) the real power in most large cooperatives is concentrated into relatively few hands and the mechanisms of member oversight of senior management activity are little more than a rubber stamp.

These theoretical perspectives are summarised in Table 7 which Cornforth (2004) has suggested translate into six "models" of corporate governance. Of particular concern is the tension that emerges between the Board of Directors as a democratically elected team who can effectively represent the interests of members, and their role as a team of experts with the capacity to develop strategy and manage external stakeholders to secure the resources needed to run the coop.

While the democratic principles of "one-member-one-vote" that underlie the cooperative business model favour the Board as a representative body for members, the need for managerial and strategic expertise remains. For some cooperatives this has involved a system of training and support for Directors of Coop Boards, while seeking to build up the overall expertise of these teams (Sivertsen, 1996). Drawing onto the Board coopted members with the necessary expertise is another strategy (Cornforth, 2004).

According to Cornforth (2004) there is a need for more research to examine how the behaviour of Boards within coops are influenced by environmental and institutional factors. This requires comparative studies that can examine how different coops operate across different industry sectors, as well as firms of different sizes. He suggests longitudinal and in-depth case studies:

In order to examine these problems and processes we need more in depth and longitudinal case studies, which examine the dynamics of relationship between boards and managers and how they attempt to tackle the problems and dilemmas they face. (Cornforth, 2004: 27)

Table 7: Comparison of Theoretical Perspectives on Organisational Performance

Theory	Interests	Board Members	Board Role	Model
Agency Theory	"Owners-Members" & managers have different interests	"Owners-Members" representatives	Conformance: safeguard member interests, oversee management, check compliance	Compliance Model
Stewardship Theory	"Owner-Members" & managers have shared interests	"Experts"	Improve performance: add value to strategy, support management	Partnership Model
Democratic Perspective	Members/Public contain different interests	"Lay/Member" representatives	Political; represent members, make policy, control management	Democratic Model
Stakeholder Theory	Stakeholders have different needs	Stakeholder representatives	Political: balance stakeholder needs, make policy, control management.	Stakeholder Model
Resource Dependency Theory	Stakeholders & organisation have different interests	Chosen for influence with key stakeholders	Boundary spanning: secure resources, stakeholder relations, external perspective	Co-optation Model
Managerial Hegemony Theory	"Owners/members" & managers have different interests	Owner/members' representatives	Symbolic: ratify decisions, give legitimacy (managers have real power)	"Rubber Stamp" Model

Source: Cornforth (2004)

Cooperative Corporate Governance in Practice

The cooperative movement is now a global one and cooperative enterprises are required to comply with similar standards of financial accounting and corporate governance as do investor owned firms (Jenkins, 2008). For example, in the United States in recent years, new state legislation has altered the structure of equity and ownership control within coops and in doing so changed the nature of corporate governance of these enterprises (Campbell, 2003). These legislative amendments are designed to enhance the coop's access to equity financing, but Coop Boards and senior managers must learn to adapt to this more innovative and competitive business environment raising the need for better education and skills development amongst Board members (Campbell, 2004).

The emergence of the New Generation Cooperatives (NGC) in the 1990s along with other forms of innovative enterprise structure has impacted directly on the role and composition of the Coop Board. Analysis by Cross and Buccola (2004) suggests that the NGC has created a conflict of interests between the needs of member-patrons who desire enhanced cash payment and premium prices for their supplies, and equity shareholders who seek long-run profits and return on investments. They suggest that the appointment to a coop Board of active members will stifle performance. In essence for there to be any real change both the coop financial structure and its corporate governance must change.

Econometric modelling by Bacchiega and de Fraja (2004) indicates that the constitutional design of the coop as a “one-member-one-vote” organisation, versus the “one-share-one-vote” model of the investor owned firm results in underinvestment within cooperatives. It is driven by the voting mechanisms associated with the different corporate governance models underlying the two enterprises. As they conclude:

This difference is due exclusively to the voting mechanisms. The fundamental reason for this result is the strategic role played by a member's monetary investment in shaping the majority of votes: in an investor-owned firm an agent may wish to invest in order to gain control of the enterprise, or in order to prevent another agent from gaining control. This strategic role of investment is absent in cooperatives, where voting is unaffected by the relative shares. (p. 291)

This analysis highlights the need for any reform of cooperative enterprises to commence with a review of the legislative ordinances that regulate the corporate governance of such organisations.

In a multiple case study analysis of French worker cooperatives, Bataille-Chedotel and Huntzinger (2004) explored the nature of corporate governance. An exploratory study, this research identified three distinct types of corporate governance as represented by the Chairman of the coops.

- **Mountain Climbers** – the first of the coop Chairs were those who started their careers from within the lower ranks of the enterprise and who rose to prominence after serving a long term getting to know the coop and its operations.
- **Helicopters** – this type of Chair entered the coop at a more senior management level than the *mountain climbers* and rose faster through the ranks.
- **Parachutists** – this type of Chair were brought into the role from outside the coop and has no long term experience of its history, culture or mode of operations.

Further classification was drawn between *locals* who were home grown coop managers from within the coop movement, and *travellers* who had various careers in investor owned firms before moving into the coop sphere. The larger the coop the more likely the Chair would be a *traveller* (Bataille-Chedotel & Huntzinger, 2004).

The *local mountain climbers* within the case studies were more likely to favour a collective form of decision making. They worked closely with their Board of Directors to make all decisions via a democratic process. By contrast the other types of Coop Chairman saw the Board as more a mechanism to monitor their role and that of the senior management team. As the size of the coop grew there was more likelihood that the Chair would see the Board of Directors as *stimulating opposition*. For the *locals* the Board or Management Committee was viewed as a partner and support. However, for the *travellers* there was greater tendency for the Chair to resist being changed. As noted by Bataille-Chedotel and Huntzinger (2004) the *local mountain climbers* were the most likely to embrace collective decision making:

This collective competence is the result of an organisational apprenticeship: by climbing the rungs of the hierarchical ladder, the local mountain-climber gradually comes to learn, in contact with other employees, how to work with them and the nature of the management machinery of a WCO. They thus become more familiar with the perspectives of others. (p. 104)

This study – while exploratory in nature – suggests that the more time a senior manager or Board Chairman has to work within and learn about the cooperative movement and a specific cooperative, the more likely they will develop skills of collective competence. This can in turn assist them to negotiate with stakeholders both within the coop and outside in a spirit of collaboration. By contrast the *travellers*, particularly those who parachute into their senior management roles, are less likely to engender trust from their Board.

The selection of a senior management team and Board of Directors within a coop is therefore a delicate balance between ensuring that there are people in the team who are experts in business, finance, legal issues and marketing. However, the unique culture and structure of the cooperative enterprise also suggests that such people also need to have a sound understanding of the underlying philosophies of cooperation and the workings of this type of organisation.

Supply Chain Relationships in Cooperative Enterprise

Cooperatives are often created as a result of a real or perceived market failure that unites the members together over dissatisfaction with the availability or terms of trade associated with output purchases, input purchases or other service provision (Goddard, Boxall & Lerohl, 2002). This unity of purpose generates a potentially different mindset in the area of supply chain management and strategic networking to that found in corporate entities. Coops have been found to forge stronger supply-chain linkages that appear to be a mechanism for enhanced survival of the business, and that draw the suppliers into the ownership structure of the coop (Nunez-Nickel & Moyano-Fuentes, 2004).

The Nature of Supply Chain Management

Supply chain management is a strategic activity focused upon seeking to develop a competitive advantage through lowered costs, enhanced speed of delivery, or improved quality. A definition of supply chain management has been provided by Christopher (1992) as follows:

“The supply chain is the network of organisations that is involved, through upstream and downstream linkages, in the different processes and activities that produce value in the form of products and services in the hands of the ultimate consumer” (p.12).

Until the 1990s supply chain management was an embryonic discipline and practice without the strategic focus that it enjoys today. During the 1960s and 1970s most large firms were vertically integrated and international supply chains were rudimentary. However, during the 1980s a growth in total quality management (TQM) and a trend toward international standards of quality (ISO9000) began to take hold throughout most industrialized economies (Chandra & Kumar, 2000).

Over the course of the 1990s the expansion of global trade was accompanied by increasing competition and the need for lower costs of production. Faced with these pressures, many firms began outsourcing supply to lower cost producers, many of which were located in other countries. With the availability of information and communications technologies (ICT) to facilitate data capture and analysis, a new field of logistics or supply chain management was spawned (Motwani, Larson & Ahuja, 1998).

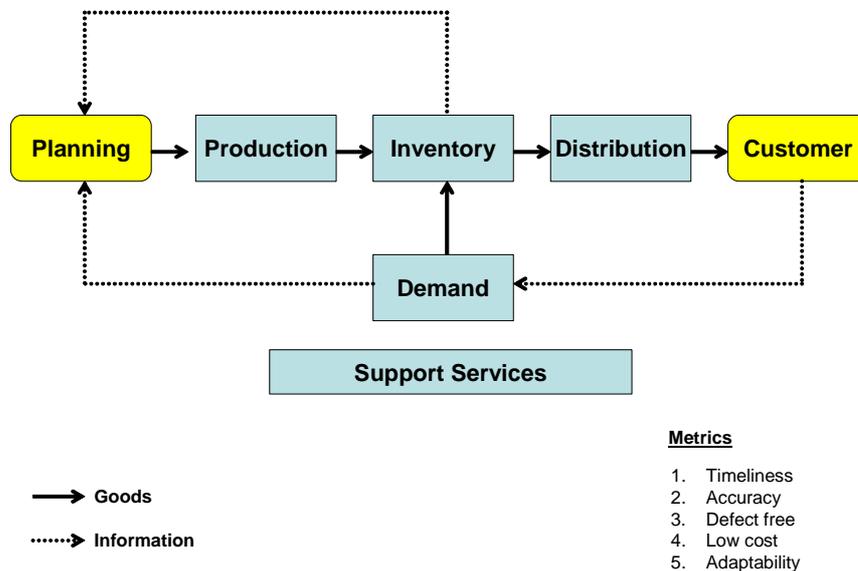
A study by Deloitte and Touche found that 98 percent of firms considered logistics and supply chain management to be critical or highly important (Lau, Pang & Wong, 2002). One of the key issues associated with supply chain management is the ability to source components from a range of suppliers who have been selected on the basis of their cost or quality, and who can deliver on a timely or just-in-time (JIT) basis. The JIT concept has become a major focus of manufacturers which involves configuration of the supply chain to ensure that all activities are synchronized to provide a timely flow of inputs when required. Use of information technologies involving bar coding and automated reorder software allows the creation of a Quick Response (QR) system in logistics management with each activity mapped through the value chain to ensure delivery when and where required (Svensson, 2002). This assists the firm to reduce inventory carrying costs and lower costs of production.

Juran and Dershin (2000) outline a generic supply chain model based on their experience of working with industry groups. This is shown in Figure 4 and shows the need for monitoring demand along the entire value chain commencing with customer demand and using the monitoring of inventory levels to facilitate planning activities. As they point out:

A supply chain is not a single process but is, rather, a system or collection of processes. The processes that make up the system are dependent on one another and must work in a highly coordinated way to meet customers' needs effectively and efficiently. The process of assessment involves identifying the various activities that make up the supply chain, including identifying the customers of each activity. The assessment also includes evaluating the activities with respect to effectiveness and efficiency. (Juran & Dershin, 2000).

Cook, De Bree and Feroletto (2001) apply the principles of supply chain management to the service industry and argue that such concepts continue to be relevant despite the intangible nature of services. They suggest five key tools for the effective management of supply chains. The first of these is the development of good **relationships** between suppliers and customers with mutual benefits to both parties. They argue for the removal of traditional account managers who act as filters between the firm and its customers and suppliers, replacing them with a more multi-faceted relationship in which a range of contacts are maintained. Other key tools include **technology** in the form of inventory control and monitoring systems. In-turn these allow accurate **forecasting** of future demand, and may assist the firm with **outsourcing** and **cost management**.

Generic Supply Chain Model



Source: Juran & Dershin (2000)

Figure 4: Generic Supply Chain Model

Principles of Effective Supply Chains

For a supply chain to work efficiently it is important for member organisations to be highly flexible and to ensure that each is focused on its own operational efficiency. The relationships that exist between the various organisations comprising the supply chain not only need to be efficient, but must also have strong inter-firm relationships built on trust, loyalty and a sense of common purpose. According to Chandra and Kumar (2000) there are eight key issues that all supply chains must address:

1. **Organisational Structures and Flexibility** – all members of the supply chain must be agile and responsive to the needs of the others both up and down the chain, with the ability to increase or decrease production as demand rises and falls.
2. **Organisational Relationships** – a strong sense of common purpose needs to emerge among the supply chain members, with all firms seeking to assist in the enhancement of the overall production process. This can be assisted by the creation of preferred supplier relationships and even the use of key suppliers for services (e.g. transport and shipping), to ensure quality and efficiency are maintained.
3. **Total Supply Coordination** – a large firm serving as the focal point for this supply chain, will have multiple supply chains and these should be coordinated to ensure maximum efficiency and economies of scale. Attention should be

given to market demand rather than size of purchase order when configuring these arrangements.

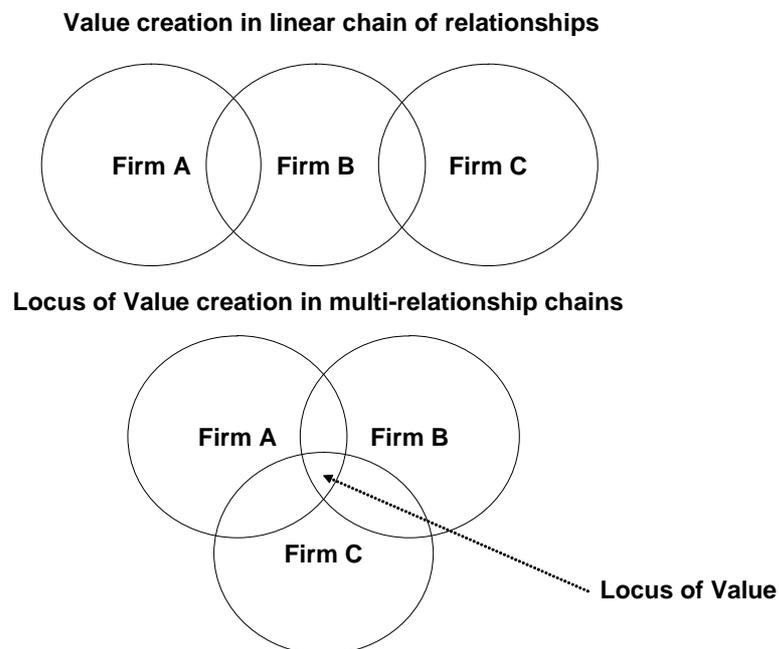
4. **Communications** – the effectiveness of a supply chain is likely to depend on how smoothly information can flow up and down the channel “within and between” members. Where relationships are soundly based it should be possible for ideas to emerge about ways to improve the product or process.
5. **Outsourcing non-core competencies** – as supply chain relationships strengthen it should be possible for firms to outsource those activities that are non-essential to their operations or which are not the basis of their distinctive competence. These tasks can be outsourced up or down the supply chain, or given to new members of the supply chain who can demonstrate their capacity to specialise in this activity.
6. **Build to Order manufacturing strategy** – through the careful use of JIT and QR systems, it is becoming possible for firms to follow a strategy of build-to-order (BTO) whereby the production system does not commence to produce until the customer order is placed. This has always been a feature of smaller batch producers, but was not feasible with large manufacturers until recently. Dell Corporation has used this strategy in computers and Ford Motor Corporation in the United States adopted a BTO strategy in the late-1990s.
7. **Inventory Management** – as noted above, a key focus for supply chain management is to reduce inventory or carry costs so as to improve cost performance within the production system. Modern systems of logistics management allow much more control than before.
8. **Cost Control** – for most firms the key issue for good supply chain management is to keep costs low by out-sourcing production to other firms that are better placed to under take certain activities, lower the amount of inventory to be held and increase cycle times.

To address these issues requires the firm to overcome uncertainty in supply and demand variables operating either side of it within the value chain. Managers need to accurately predict demand, specifically the size of any future orders and also their timing. Not all demand is driven by customer or market factors; frequently it can be affected by institutional factors or even random events. On the supply side it is important to know what quantity is to be supplied, the lead times between order and delivery, and the quality of material to estimate wastage rates. What is required is accurate data on products demanded and supplied, pricing, delivery points and timings (McGuffog & Wadley, 1999).

Supply chains that seek to integrate the various actors throughout the entire business activity system and successfully develop strong partnerships between suppliers and customers are able to benefit from the flow of ideas and information up and down the pipeline. Under these circumstances the supply chain emerges as a potential learning system, with information on market trends or new technologies being exchanged by channel participants.

Supply Chains as Competitive Strategic Networks

Collins, Dunne and O'Keeffe. (2002) suggest that the full benefit from learning within supply chains requires the development of non-linear flows of information that can result in enhanced competitiveness for network participants. As shown in Figure 5, where firms are engaged in a linear chain of relationships there is benefit from knowledge exchange between individual members along the chain. However, such linear flows of information only involve dyadic relationships and may not see valuable information flowing up and down stream. They suggest that the more effective approach is via a non-linear model, in which all firms (customers and suppliers) can interact to develop what they describe as a "locus of value". In practice this would involve three or more firms working collaboratively within a supply chain to achieve common goals and sharing knowledge and information for mutual benefit.



Source: Collins, Dunne & O'Keeffe (2002)

Figure 5: Value Creation and Learning in a Supply Chain Network

Factors likely to determine the structure of a supply chain network are how highly integrated and mutually interdependent the buyer-supplier relationships are, and whether or not there is focal firm present within the channel. Also important are the number of actors in the network and who is viewed as the channel manager and the complexity of management tasks relating to the supply chain. Finally, the structure is likely to be influenced by how formal the contractual arrangements are within the channel (Ellegaard, Johansen & Drejer, 2003).

In addition to the development of close relationships with the customer, good supply chain management must also focus on strengthening links to key suppliers. A primary goal of the supply chain management process should be to align all channel members strategic goals toward the outcome of successfully delighting the end-user customer. However, this may not always be possible where suppliers are only partially engaged in the supply chain, sending more products to other industries and viewing their participation as non-core.

Factors likely to affect supplier partnering can include the level of attention given by firms downstream in the production system to enhancing supplier satisfaction. Where suppliers are treated with an "arms length" approach based solely on price, it is less likely that cooperative goals will be developed. Under these conditions it is more likely that competing objectives will emerge. A study of 139 firms found that supplier satisfaction was likely to be enhanced where customer firms made an open commitment to establishing common strategic goals with suppliers, and engaged suppliers in regular dialogue or "constructive controversy" (Wong, 2002).

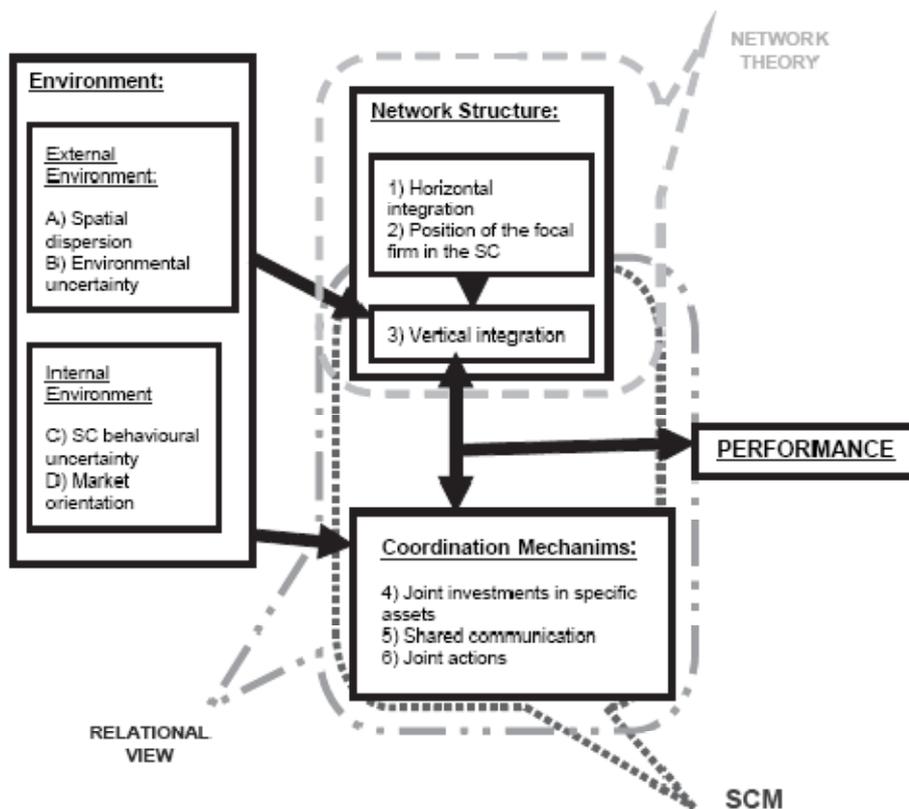
Research into the Cooperative as a Supply Chain Network

By its nature a cooperative is a collection of otherwise independent actors, usually independent producers or small firms, working collaboratively via the enterprise to achieve enhanced supply chain outcomes. Despite the importance of supply chain relationships within cooperatives there is a relative lack of academic research to be found in the field. This review of the literature unearthed some evidence of econometric analysis of the nature of supply chain bargaining within producer coops.

For example, in a conceptual paper Ladd (1974) analysed the behaviour of a cooperative of raw material producers. The cooperative sells a production input to producers, provides a "free" service to members, and bargains with processors for a raw material price. One analysis assumes the cooperative's objective is maximization of the raw material price received by members. Another assumes the objective is maximization of quantity marketed through the cooperative. The cooperative has three instruments to manipulate to attain its objective. First-order maximization conditions for the two objectives are quite different from each other and from "marginal cost equals marginal revenue" conditions.

In a conceptual paper, Garcia-Perez and Garcia-Martinez (2007) proposed a theoretical framework for agribusiness coop supply chains. This draws upon network theory to provide the framework which offers a set of hypotheses and future research suggestions. Their theoretical framework is illustrated in Figure 6 where they seek to overlay network theory with the supply chain management (SCM) body of knowledge. Key elements that need to be examined are the structure of the supply chain network, the mechanisms that the coop puts in place to coordinate the network and the influence of internal and external environmental factors. The model assumes that there is a positive relationship between horizontal integration and vertical integration in the fresh produce sector. It also assumes that a similar relationship exists between the proximity of the coop to the end user customer and the vertical and horizontal integration.

Further hypotheses suggest that as environmental uncertainty increases the greater the need for investment in joint specific assets designed to align member communications and collaborative network activity. Investment in this type of enhanced collaborative supply chain networking is also hypothesized to result in enhanced cooperative performance and financial benefit.



Source: Garcia-Perez and Garcia-Martinez (2007)

Figure 6: Theoretical Framework of a Coop Supply Chain Network

In another conceptual paper Giannakas and Fulton (2005) examined the role of coops and investor owned firms in terms of the level of innovative activity in agricultural supply chains. They suggest that the presence of a member welfare maximising strategy as followed by coops as a replacement for profit maximising within an investor owned firm, can increase the level of innovation and help to reduce the price of agricultural inputs. As they concluded:

While it is the interaction of this complex set of factors and features that will determine the performance and impact of co-ops, the analysis in this article shows that co-ops do possess some potential organizational advantages, not just with respect to pricing as has been previously shown in the literature, but also with respect to investment in innovation activity. Since this investment in innovation affects the prices charged by both the co-op and the IOF, and consequently the profits of the IOF and the welfare of all agricultural producers, the factors affecting co-op innovation activity are of interest to all players in the agricultural industry. (p.421)

A more empirical view was taken by Desrochers and Fischer (2005) who drew upon a database of financial services cooperatives comprising 17,000 organisations across 23 strategic networks over the period 1996 to 2002. Their analysis focused on the strategic

networking of these institutions and the transaction costs that different collaborative network incurred. The study identified three generic types of network:

1. **Atomised systems** – a loose collection of coops with few formal ties to control their activities;
2. **Consensual networks** – an alliance that is driven by a desire to lower costs through economies of scale, and reduce risk through the securing of resource inputs. There is a level of formality over how markets will be shared and may allow some coordination and centralisation in the area of strategic planning. However, all alliance members are independent agents and they retain strategic control and management decision making; and
3. **Strategic networks** – a more formal alliance that sees resources pooled and shared, with a central management taking some responsibility for joint procurement and production. Formal agreements over governance and control guide the decision making of the central core or “hub node”.

The findings of this research support the view that enhanced network performance is an outcome of lower transaction costs and that more formal integration within the network can reduce the likelihood of variability in this performance.

A further quantitative study was undertaken by Palmer (2002) who studied marketing cooperatives in the UK tourism sector. Using a structural equation model he found that the most important factors likely to influence organisational effectiveness were the quality of corporate governance, the strength of member commitment and the diversity of membership. Codes of practice that govern the way in which members behave in their marketing activities were of key importance to the overall success of the network. Good leadership and governance to engender trust within the network was also critical, this was particularly important in standing firm in the face of lobbying from local pressure groups seeking benefits.

Tennbakk (2004) also undertook an analysis of the differences between cooperatives and investor owned firms engaged in Norwegian agricultural markets. This focused on the price paid for producer goods. It suggests that the presence of a cooperative within a market influences the prices paid by the investor owned firm to farmers. In general the prices paid are superior to those that might be paid in a market dominated by investor owned firms.

The nature of the cooperative as a supplier or buyer owned enterprise engenders greater trust in the supply chain than might otherwise be the case for an investor owned firm. Trust is an important element in the success of the cooperative and the loyalty of its members. The members must view the coop management as benevolent towards them and they need to increase their identification with the coop's strategic purpose. There is evidence that trust plays a formative role in the formal and informal organisational process, the stronger a member's identification with the coop, the more they trust the benevolence of the cooperative management. Identification based trust is an important factor in cooperatives due to their size and complexity (Ole-Borgen, 2001).

A longitudinal historical analysis undertaken by Nunez-Nickel and Moyano-Fuentes (2004) in the Spanish olive oil industry examined the performance of cooperatives over the period from 1944 to 1998. This was a highly turbulent period of Spanish history and saw the transition from a Fascist Dictatorship under General Franco, to a Constitutional Monarchy and democracy.

This study sought to address the research question as to whether the cooperative business form and corporate governance model offered any significant advantages over the investor owned firm. They concluded that the answer was yes, the cooperative does appear to offer advantages. This was particularly found in the area of supply chain linkages which offered an enhanced capacity for survival. Because the members who own the cooperative are also the suppliers (in an agricultural coop), the dynamics of the supply chain relationship are different to those found in more conventional businesses.

In the face of the various external challenges posed by Franco's dictatorship the coops proved more resilient than their investor owned counterparts. According to Nunez-Nickel and Moyano-Fuentes (2004) the coop structure provides a buffer against external threats and economic downturns. The cooperative also serves to change the dynamics of the market competing for access to resource inputs via their membership in a way that is not possible for the investor owned firm that typically has only a price card to play. In their conclusion they state:

We have not proved that cooperatives are more efficient than other organizational forms in Williamson's sense (1987), but if survival were synonymous with efficacy, Andalusian cooperatives in the olive oil milling industry would be efficacious. If we add to this success factor their social characteristics of giving more consideration to people (the human factor has priority over the capital one), or their principles such as democracy, equality, equity, and solidarity, then, perhaps, cooperatives would be seen with other eyes. Maybe they are not anachronisms from other eras but a valid alternative to current economic instability or market concentration. (p. 1149)

A similar theme of cooperative supply chain resilience was explored by Mora and Menozzi (2005) in a study of the response by the Italian coop *Italia* to the "mad cow" disease crisis and how it impacted on the food supply chain. The impact of this food crisis on the supply of beef meat throughout Europe during the 1990s and early 2000s was significant. Following a major outbreak of the disease in 2001 the consumption of beef across Europe collapsed. The beef market in Greece fell by 50 percent, Italy by 40 percent, Spain 35 percent and Germany 33 percent. The European Commission introduced strict food safety guidelines to help rebuild confidence.

COOP Italia had long focused on beef as a key component of its supply chain. The "mad cow" disease crisis forced the coop to introduce food safety certifications from third parties and to adopt labelling and packaging initiatives. However, it also moved to introduce its own food brand to reassure the consumer, while simultaneously negotiating supplier contracts with its members to ensure that only certified beef was coming through the supply chain. These supply agreements were a key mechanism in safeguarding the coop brands and market reputation. The ability for the coop to apply adequate enforcements of these supply chain requirements was enhanced by the relationship it had with its members (Mora & Menozzi, 2005).

Summary and Opportunities for Future Research

As discussed in this chapter the cooperative through its ownership structure is a unique management environment for those tasked with its leadership and membership to its Board. The redesign of the cooperative business model in the form of the NGC or hybrid types may provide advantages in enhancing access to external capital but it imposes new challenges for the coop Board of Directors and senior managers. Any changes to the coop

ownership and ownership rights structure must be accompanied by parallel changes to corporate governance and control mechanisms.

There is an opportunity for new research to examine these dynamics and determine how the transition of ownership and control structures from the traditional to the newer forms of cooperative have impacted on corporate governance and management. A case study approach is likely to yield the most useful outcomes and where possible such research should be longitudinal in nature and collect data from a wide range of perspectives.

Cooperatives should ensure that a balance is struck between members and experts when selecting management teams and appointing Directors to the Board. Education of the Board in the skills of management is desirable, and the coopting of non-members with a specific level of expertise or strategic networks is advised. It also would seem that management of a coop is a sufficiently unique environment to justify some promotion from within rather than bringing in outsiders who may lack an in-depth understanding of the way in which a cooperative works.

Future research into the effectiveness of management education and the insider versus the outsider in the leadership or senior management teams of coops area also rich fields for future research. Is the coop a sufficiently unique organisation to warrant special types of management education and training? Currently management education focuses on the needs of the investor owned firm. Future research should examine whether the paradigms of conventional management wisdom applicable to the investor owned firm are entirely appropriate to the coop.

In the field of supply chain management the coop appears to be a unique business model with certain strengths born of its member-supplier structure. There is an opportunity for more research into the strength of cooperative enterprises in the management of their supply chain relationships. Also, strategic network theory and supply chain management wisdom suggests that the coop as a member-client organisation should provide an ideal environment for effective inter-organisational learning and value adding.

However, research into all these fields remains relatively scant and more needs to be done to fully explore these issues. Future research should where possible be longitudinal in nature and select case studies from multiple industries and across multiple legal jurisdictions. International comparative studies are preferred, although the cost of these will be high.

Chapter 7

The Cooperative as a Mechanism for Regional Development

Cooperative Enterprise for Regional Economic Development

Of all the areas where the cooperative enterprise has the potential to make its greatest contribution is that of regional economic development. As has been shown in the earlier chapters of this review, the coop was born in an environment of social and economic disadvantage as a mechanism for self-development. Its utility within rural and regional communities as a vehicle for filling market failures highlights this capability. Historically, the coop has played a key role in fostering economic development in farming communities, and providing both enhanced prices for produce, and lower input costs through collaborative purchasing and mutual finance and insurance. This has been the case in many countries such as Canada where coops have played a key role in regional economic development (Doyon, 2002).

In Spain the coops have been identified as playing an important role in economic development and also proved more resilient in the face of hostile government behaviour than corporate entities (Nunez-Nickel & Moyano-Fuentes, 2004). The French also have experienced an important social-enterprise function for workers' cooperatives (Bataille-Chedotel & Huntzinger, 2004). Further, in South Africa, the coop is being viewed as a mechanism for the economic empowerment of black farmers and workers (van Zyl, 2007).

The coop is therefore an interesting business model for the enhancement of economic development in regional areas where a form of market failure may have occurred. However, such a role also creates a potential tension between the coop as an economic and as a political entity. For example, the experience in Canada is that rural coops can become too concerned with political lobbying to the detriment of their business activities (Goddard, Boxall & Lerohl, 2002).

The Role of Cooperatives in Regional Economic Development

Williams (2007), as initially discussed in Chapter 1, has put forth a strong argument in favour of using the cooperative as a vehicle for grass roots change that can challenge the existing global economic system. While some might view this as either too radical or more a political than an economic manifesto, the reality is that the cooperative movement has always maintained a degree of evangelical zeal in relation to its role within the economy. The comment by the great English economist Alfred Marshall at the Cooperative Congress of 1889 when he referred to the coop as both a "strong and calm and wise business" and "a strong and fervent proselytizing faith" (Gide, 1922 p.28), highlights this.

This "proselytizing faith" element is reflected today in the work of the global cooperative movement to assist regional economies to strengthen via the application of coop principles. For example, US cooperatives have worked with rural coops in Russia during recent years to provide farm credit via cooperative financing systems, management and business development, and other forms of technical support. In 2007 this translated into 90 projects across 40 countries worth some US \$85 million (NCBA, 2007).

The cooperative enterprise is viewed therefore as a mechanism for overcoming economic disadvantage that is focused on self-help not welfare. For example, Davis (2002) argued in favour of cooperative projects that focused on achieving at least four primary goals:

1. Self-help strategies that allow communities to achieve levels of economic and social well being that shift them away from state welfare and enhance their autonomy and independence;
2. Projects that allow the facilitating agencies to remain at a distance from the local communities and require minimal infrastructure investment by the outside. This will foster greater self-determination and local autonomy and control;
3. Concrete formulas for measuring the economic needs of the community and benefits from self-help programs. The aim here is to remove the need for state intervention which is commonly driven by crisis management and which can easily be removed when the political will changes.

This focus on self-determination and local community based enterprise activity is a key feature of the cooperative movement. For these reasons the coop has become a focus of the International Labour Organisation (ILO) and other international development agencies. For example, Birchall (2003) in an ILO policy paper focusing on the role of coops in helping to reduce poverty in developing countries advocated a number of policy recommendations. These included the need to ensure that cooperative organisations were voluntary and not forced by outside agencies. Coops also needed to be member owned and controlled. These organisations also needed to be headed by good leaders and to focus on education programs targeted at their members. Such prescriptions, while emanating from the 21st Century, might just as easily have been written in the mid-19th Century. According to Birchall (2003):

If cooperatives did not exist, they would have to be invented. We might use different names for them – community self-help groups, farmer owned businesses, and so on - but essentially as member-driven business organizations they are building blocks of sustainable development. In fact, they are not so much building blocks as foundations, because all the other bricks in the wall – capacity-building, improvement in literacy and health, opportunities for income generation, connections to existing institutions and public services, political advocacy – depend on there being some kind of organization *of* the poor on which to build. (p. 69)

The cooperative enterprise is therefore viewed as an important tool in the alleviation of world economic disadvantage and poverty. In another policy paper Birchall (2004) advocated that the ICA lobby the World Bank and seek to develop a cooperative development strategy. He also recommended that the ICA work with the ILO and FAO as well as other international development agencies to address the needs of developing economies through support to locally based coops. These were part of a wider set of suggestions as to how the cooperative enterprise could play a key role in the achievement of the millennium development goals. They reflect the key importance of the cooperative as a mechanism for social and economic development.

Developing a Social Economy

The role of cooperative enterprise within the wider economic theoretical frameworks has been addressed within the concept of the *Social Economy*. This is a middle-path or third sector that lies between the private sector, which is dominated by investor owned firms, on one side, and the public sector dominated by state owned enterprises on the other. As a concept social economy has been around since at least the late 19th Century (Rowe, 1893). For example, a paper by Rabbeno (1892) argued in favour of the application of the economic theories of Italian economist Achille Loria (1857-1943) to the challenges of a social economy. Loria's analysis of the ownership of land argued that the relative scarcity of land meant that some people would be disadvantaged in relation to others. Much of the social, economic and political tensions that have driven history throughout the ages are due, according to this theory, to competition for ownership and control by the many for the relatively finite resource of land.

While this theoretical concept may have less resonance in a world no longer as dependent on agriculture as a primary source of wealth creation, the notion of social economy has continued throughout the decades. It was a focus of economic discussion during the Great Depression (Tugwell, 1930) and found its way into the texts written by economists of the time (Opie, 1929). In more recent years the term *Social Economy* has become widely used in the European Union to define those sectors of the economy that lie outside the private and government arena, including the non-profit, volunteer and cooperative sectors.

Hagen (2007) suggests that a definition of the social economy should focus on common view most participants have that money is not the only thing that matters:

What unites people who categorize themselves as working in or for the social economy is their repugnance of a "money only" way of catering for human needs, which translates into their unwillingness to accept that ever more needs remain unmet. Especially in the health and social service sectors growing dehumanization and bureaucratic procedures are increasingly being resented. In general, producers and users want a greater say in the decision making processes concerning their lives. (p. 4)

Under the European Charter of the Social Economy an organisation falls within this arena when it is an autonomous enterprise, where its members join voluntarily, are responsible, have equal rights and obligations, and are focused on self-help interest. Social economy enterprises must also be democratic (e.g. one-member-one-vote), and members must own at part of the assets. They should also be designed to provide services for the exclusive benefit of their members and be member not investment focused. The creation of employment and the enhancement of member welfare and education are also features that define these organisations. Finally, they should be independent and autonomous from the state (Hagen, 2007).

In essential terms the European Union views the social economy and the cooperative as much the same. Yet this is not the same in all jurisdictions. The role of the non-profit and volunteer sector within the social economy has become a point of confusion as it often shifts the focus away from the coop leaving it somewhere between the investor owned "for profit" sector and the non-profit, volunteer sector. However, the social economy has been key feature of government policy in Europe, the UK and other countries during recent decades.

During the economic down turn of the 1930s even the capitalist, free market oriented United States began to focus on cooperative enterprise and social economy initiatives. The great social experiment of the *New Deal* fostered by Democrat President Franklin D. Roosevelt continued into the 1960s. However, during the Republican Administration of Ronald Reagan in 1970s and 1980s there was a shift away from social enterprise and a return to neo-classical, free market economics (Lange, 1985).

When Prime Minister Tony Blair took power in the United Kingdom during the 1990s his *New Labour Movement* commenced a debate about the role that social enterprise and the social economy could play in the development of the wider economy. Estimates of the size of the social economy undertaken in Britain during the late 1990s suggested that coops, mutual and nonprofits employed around 1.7 million people (Passey & Lyons, 2004). The UK Government of the late 1990s fostered the concept of *New Mutualism* designed to help boost the role of the cooperative movement all of which was consistent with Blair's notion of the *Third Way*.

Passey and Lyons (2004) point to the emergence of this as a political counter reaction to the wave of de-mutualisation that swept through the UK economy in the 1980s under the economic rationalism of Prime Minister Margaret Thatcher. The social economy focus of the Blair Government placed an emphasis on fostering philanthropy, the voluntary and community sectors, and social enterprise. It was in the latter area that the coops were found. The UK Department of Trade and Industry (DTI) established a Social Enterprise Unit in 2001. Much of the funding from such initiatives was targeted at socially and economically disadvantaged communities, but support was also provided to the coops via the *New Mutualism* program in the form of funding, corporate governance, marketing and training.

During the Prime Ministerial periods of Australian Labour Party leaders Bob Hawke and Paul Keating in the 1980s and early 1990s high rates of unemployment and economic restructuring saw the focus on large scale employment and training schemes under the *Working Nation* program (1995-1996). These were mostly public sector driven initiatives. With the economic situation improving by the mid-1990s the Liberal-National Party Government of Prime Minister John Howard came to power. The approach taken by Howard was different to that of the Blair Government in the UK. It sought to foster philanthropy via tax incentives, and encouraged volunteering. Many social welfare services that were previously supplied by government were delegated to the non-profit sector through outsourcing contracts. The Prime Minister's Community Business Partnerships program sought to generate a greater collaboration between the business and non-profit sector (Passey & Lyons, 2004).

In Australia the social economy in 2007 was estimated to be worth around AUD\$ 33 billion annually. It was also estimated to comprise 750,000 organisations of which 400,000 are incorporated. At least 35,000 of these organisations are employers and 3,500 employ more than 20 people (Morrow, Bartlett & Silaghi, 2007). However, this sector comprises mostly non-profit and volunteer organisations which lack necessary leadership and management capacities required to fully develop the social enterprise that government policy makers would have of them. It is into this area that the cooperative enterprise is well placed to make a greater impact given its unique structure and strategic purpose. Yet unlike the European and UK contexts, the focus in Australia on the social economy has been more on non-profit and volunteer organisations not the coops.

Social Enterprise and the Role of Cooperatives

Discussion of the social economy in recent years has led to the emergence of the concept of the *social enterprise*. These are organisations such as cooperatives that seek to replace traditional government controlled welfare agencies with a combination of private, public and third sector providers. According to Spear and Bidet (2003), the features that define a social enterprise are fourfold. First, the organisation needs to be **focused on production of goods and services** on a continuous basis and in a direct way. This contrasts with some philanthropic, non-profit organisations that simply provide grants or given policy advice. A second feature of a social enterprise is that **it must be voluntarily created** by people who have autonomy from government or private sector control. They must also be free to enter and leave the organisation at will. Thirdly, a social enterprise must place on its members a **significant level of economic risk**, as compared to a publicly funded agency where no personal financial risk is borne by those who manage it. Finally, a social enterprise must employ those who work within it for a **minimum amount of paid time**. In this way the social enterprise is differentiated from the purely volunteer enterprise.

Most of the features of social enterprise are consistent with principles that underlie the cooperative. This includes a focus on community or member benefit, limited profit distribution, decision making power not based on ownership of equity, and participation in the organisation by its customers or beneficiaries. While not all social enterprises are coops, there is a strong correlation between the coop sector and the social enterprise. It is a well established and generally well recognised sector in Europe where the foundations of social enterprise and the social economy remain strong in countries such as Italy, France, Belgium, Portugal and Germany (Spear & Bidet, 2003). It is less common in the USA where coops have been under some pressure, although the cooperative movement is still strong and holds a sense of identity within the social enterprise community (Ingram & McEvily, 2007).

Mancino and Thomas (2005) suggest that the social enterprise, particularly in the form of cooperatives, have played a significant role in the development of the social economy in Italy, with the model spreading to other European countries, particularly France. In 2003 there were an estimated 7,400 social cooperatives in operation in Italy established under an Act of Parliament of 1991. The majority of these social cooperatives (58%) provide services in the areas of health care, education, home and residential care for the disabled or elderly, as well as child care and environmental protection. Their focus is on the delivery of services to areas of need rather than to benefit members as in a normal coop. Most have around 40 to 50 members who are shareholders (only 10% have over 100 members), and have annual incomes of between €0.5 million and €3.7 billion. At least half of all members in these coops are also employees.

Compared with conventional non-profit organisations, social cooperatives in Italy have shown a greater capacity for strategic networking and partnering with other organisations in their region. They appear to engender more trust in such alliances. For their size they also appear to be able to deliver superior economic benefits, which have been attributed to enhanced synergies and efficiencies. They not only seek to address problems in their communities, but also identify new problems and their members display a greater focus on achieving social benefits as this is their primary mission. Compared to non-profits these social coops also seem to have better access to financial institutions when seeking to raise money (Mancino & Thomas, 2005).

Within the developing world the coop is viewed as an important social enterprise. A key element in the alleviation of poverty in developing economies has been the provision of

micro-financing in the form of small loans for start up capital that enables otherwise very poor people to move into self-employment and break the poverty cycle. With over 2.8 billion people living on less than US \$ 2 a day and 97 percent of the world's population living in developing economies, this type of social enterprise initiative is of critical importance. The cooperative business model is viewed as offering an ideal balance between the objectives of profit and self-interest, with the capacity to provide services where they are required (Patel, 2002).

Levin (2001) as a representative of the ILO suggested that the cooperative movement could play a key role in the alleviation of poverty. However, it required a strengthening of the coop identity through education, plus the strengthening of member services. Coops were also requested to build stronger business alliances at the regional, national and international level. The role of women in the developing world was also acknowledged to be a key area for attention and the coop movement was asked to promote gender equality. Given the right legislative environment for the operation of coops, there was a view expressed that cooperatives could employ the Internet to facilitate education and social networking as well as e-commerce.

For many coops in the developed world the pressures of having to conform to the norms of a free market and investor focused economy have forced an abandoning of many of the traditional values which underlay their original foundations. According to Mooney (2004) this has impacted on the democratic principles of the coop. He argues that the cooperative enterprise remains one of the few institutions in the United States that has a "semblance of democratic governance". The lack of democracy within large investor owned firms means that most minority shareholders have little power and influence, often to their detriment. By comparison the coop, if allowed to retain its fundamental structure and governance, will offer a truly democratic enterprise.

As has been discussed earlier in this review, the challenge facing cooperatives in most developed countries has been whether to remain loyal to the principles espoused by the Rochedale Pioneers in the 1840s or to embrace new hybrid forms that allow conventional share ownership and returns to investment. This tension between the coop as a social enterprise and the coop as a business like any other remains an area of discussion well into the current century (Hogeland, 2006).

Case Examples of Cooperative Enterprise in Regional Economic Development

To illustrate the role of the coop in regional economic development a series of case study examples are outlined in the following sub-sections. These are drawn from the available literature and cover a number of different countries. Those cases selected fall broadly into two categories. The first are those of *Coopérative fédérée* and *Agorpur* of Canada's Province of Quebec, and the rural electric coops of the United States. These examples are an illustration of how a cooperative business model can enhance the economic growth and employment creation within a region. The second set of cases is that of Spain's *Mondragón Corporación Cooperativa*, California's *Cavado* and New Zealand's *Fonterra*. In these examples we see a globalisation strategy for the cooperative that has a variety of consequences which raise important questions as to the way in which the coop may or may not be able to deal with significant growth on a global scale.

The Case of Coopérative Fédérée and Agropur in Quebec, Canada

Doyon (2002) outlines the case examples of two agricultural cooperatives in Quebec, Canada, the *Coopérative fédérée* and *Agropur*. The first of these coops was established in 1922 as a result of a merger between three of the largest agricultural cooperatives in Quebec at that time. This amalgamation was influenced by the Quebec Ministry of Agriculture and it created the impression that *Coopérative fédérée* was a government run enterprise. Other rival coops soon emerged in response and these were eventually merged into *Coopérative fédérée* in 1938-1939 as a truly independent organisation free from government interference. Commencing as a dairy coop, it moved into meat and livestock, fuels and farm inputs during the 1960s and 1970s as part of an expansion of its business model.

In the mid-1980s *Coopérative fédérée* spun off its fuel operations business into a new company *Sonic*, which grew to become one of the largest independent distributors of fuels in Quebec. By the mid-1970s the coop moved into poultry, using a number of brands and soon captured dominant market share in Canada, as well as exporting on a large scale. In addition to poultry, the coop created a significant business in pig meat. By 2001 *Coopérative fédérée* had a membership base of 37,317 and annual revenues of C\$2.43 billion (Doyon, 2002).

Agropur traces its origins back to 1938 when it was founded as *la société cooperative du canton de Granby*. During the 1940s it developed a strong regional network focused on milk and dairy products. Its size and operational scope expanded during the period from the early 1950s to the early 1970s. This growth was facilitated by reforms introduced by the Quebec Ministry of Agriculture that were aimed at promoting greater consolidation in the dairy and farm sector. Due to its size and economies of scale the coop's finances were strong and it recruited competent senior managers who assisted its business success.

During the 1980s *Agropur* diversified into fruit juices, delicatessen lines and food product wholesaling and distribution. While diversification was a growing business trend in North America in that period in history, government regulation of agricultural producer markets was also a feature of Quebec. This affected the relationship between *Agropur* and its members, as government regulation of milk and dairy markets controlled input prices and quality. The impact of these regulatory changes was to open the market up to privately held investor owned firms which began to compete with the large coops. These smaller private firms eroded the market competitiveness of the large coops in the low value add areas forcing plant closures, mergers and business restructures (Doyon, 2002).

In the 1990s the Canadian market began to open to international players with large European and American cooperatives moving into Quebec and competing directly with *Agropur*. The response from the coop was to set up international operations in the USA via acquisitions. By 2001 *Agropur* had 4,732 members and annual revenues of C\$1.85 billion (Doyon, 2002).

These two major coops have done much to generate value for their members, as well as giving Quebec a significant economic asset with national and international reach. However, in the early years of the 21st Century the most pressing challenge for these coops has been the need to raise capital. This led *Agropur* in 2002 to seek a change to its business structure and de-mutualise in favour of becoming an investor owned, publicly listed company. The Quebec Provincial Government was also taking steps in the same period to assist coops to enhance their access to capital. The coop was viewed as a key element in the regional economic development of Quebec. For example, a study by the

Quebec Ministry of Commerce undertaken in 1999 found that the success rate of coops 10 years after foundation was 58 percent greater than that of investor owned firms (Doyon, 2002). They were lauded for their stability and transparency when compared to the conventional privately held enterprise.

By comparison with coops, where investor owned firms took control of former coops and found themselves in a monopoly situation they quickly took advantage of this to the detriment of farmers. This occurred in the take over of *Agrifoods* cooperative by *Saputo*, which forced down farmer input prices across their region through controlling access to the processing plants (Doyon, 2002).

The conclusions drawn from these cases is that cooperative enterprise has an important role to play in regional economic development. While the coop has its unique challenges as a business model, the evidence from these Quebec producer coops suggests that as a form of business organisation the coop can prove more stable, enduring and offer superior benefits to the local communities who make up its membership. As with any investor owned firm, a coop must be responsive to the market, and must be competently managed. Its growth through acquisition and diversification follows a similar pathway to the conventional firm. However, it should retain its focus on enhancing its member's best interests in the maintenance of above average producer prices and local employment generation.

The Case of Rural Electric Cooperatives, USA

Heriot and Campbell (2006) provide the case of the rural electricity coops that emerged in the United States during the 1930s. At that time the majority of rural communities in the USA did not have electric power, telephones, and water or sewerage services. In 1932 as many as 90 percent of rural households lacked access to the electricity grid, and it took the Rural Electrification Act of 1936 to start the roll out of large scale electricity services. This process was led by the Rural Electrification Administration (REA) working via the US Department of Agriculture (USDA), and a large number of rural electric cooperatives who drew loans from the REA to fund the electrification process. Loans to these rural electric coops funded the generation, power grids and transmission facilities. Around 100 such coops had been established by the end of 1936 across 26 states. The success of this program is evidenced by the fact that around 98 percent of all rural households in the USA were connected to the electricity grids by the early 1970s.

In 2006 there were 883 rural electric coops in operation in 48 states across America. This network comprises around half the total national electricity grid and three-fourths of the national land area. Compared to their larger, privately held counterparts, the rural electric coops earn around US\$7,000 per mile of line from approximately 5.8 consumers, rather than US\$59,000 per mile of line from 35 consumers (Heriot & Campbell, 2006). As such they are able to service communities that would otherwise be considered unprofitable by the mainstream, investor owned power companies.

According to Heriot and Campbell (2006) these rural coops demonstrate a successful model for regional enterprise that can be applied to the economic development of poor or disadvantaged communities. The elements required for effective regional economic development are a common or shared sense of community amongst the participants, the ability to supply or transfer technical skills and technology, building up the local business skills through education, training and mentoring, and financing through public-private partnering. The rural electric coops play a key role in facilitating local enterprise.

The *Brunswick Electric Membership Coop* (BEMC) of North Carolina, the *Jackson Electric Coop* (JEC) of Wisconsin, and the *Northern Plains Electric Coop* (NPEC) of North Dakota are three examples of the way in which such coops can play a role in regional economic development. BEMC services 51,849 consumers via some 5,600 miles of electricity grid. It has invested some of its resources in the creation of a local small business incubator and business development centre. The physical facilities made available from this incubator cover approximately 24,000 square feet in one site and a further 16,000 square feet in another site. A total of US\$1.05 million in start up funding was invested and as of 2005 the incubators had 12 small business tenants and had created around 800 new jobs. There was also business assistance program being offered via a local community college.

The experience of JEC and NPEC were similar. As a relatively small coop JEC services 5,564 consumers via 1,300 miles of electricity grid. It has invested in the establishment of an industrial park with a business incubator located within it. This facility encompassed around 10,000 square feet. With an investment of US\$379,000 in start up funds the incubator in 2005 housed 5 small businesses and had graduated 4 creating a total of 100 local jobs. A technical college was also established within the park to foster local education and training. A feature of the JEC approach was to foster local business start ups, but also to attract inbound investment. This has led to the location within the industrial park of some larger tenants from outside the region.

By comparison NPEC services 10,777 consumers via 6,800 miles of electricity grid. It established a local technology centre with business incubator comprising 12,000 square feet. In 2005 there were 12 small firms located within the incubator and two firms that had recently graduated. A total of 53 local jobs had been created from these firms. Additional programs generated by the coop were a Day Care Facility for children and medical services.

The funding for these enterprise development schemes came through the USDA but would not have been accessed without these locally based rural electric coops. Their local community networks, managerial capacity and ability to foster trust and goodwill across the regional stakeholders were essential to success. In summary, these cooperative enterprises were a crucial catalyst in local economic development and job creation. Their contribution historically to the electrification of rural America is by itself an achievement of major significance. This provision of vital infrastructure has had a multiplier effect on the economies of these regions, and may have not been possible if left to the private sector. The willingness of these coops to engage in enterprise development, plus the fostering of education and training infrastructure, is further evidence of their value in enhancing local regional growth.

The Case of Mondragón Corporación Cooperativa, Spain

The success of coops in Canada and the United States as outlined above focuses on the role of coops in enhancing regional economic development. However, what happens when a coop becomes so successful that it outgrows its region? Can the cooperative business model continue to hold true to its principles? Errasti, Heras, Bakaikoa and Elgoibar (2003) provide a case study of the *Mondragón Corporación Cooperativa* (MCC) of Spain. In 2001 the MCC employed 60,000 people and had annual revenues of €8 billion. It was a coalition of 147 smaller cooperatives organised into four groups specialising in industrial, financial, distribution and research & training. Established in 1943, MCC has been successful in raising capital, while also providing employment, economic and social development for its members.

The MCC has expanded its operations globally and by 2004 had around 60 production centres located in South America, Asia and Eastern Europe, which accounted for about 14 percent of total production. An estimated 9,000 people were employed in these international centres owned by MCC. Errasti et.al. (2003) suggest that the factors motivating MCC to go abroad were no different to those of conventional investor owned firms, namely the desire to lower labour costs. However, where the MCC differed was that it maintained employment in its local regional economy while expanding its international labour force.

In undertaking its globalisation MCC has created new business structures to assist it to overcome traditional obstacles to investment and innovation that potentially plague the coop. Within its homeland of the Basque region of Spain, MCC has created a dual system that has a central core of *Coop Members* with a second group of *Temporary Members*, and a third group of *Non-Member Employees*. Overseas the MCC business has employees on contract and affiliated companies. For every ten employees of MCC less than 4 are members of the coop. Errasti et.al. (2003) refer to this new business paradigm as *neo-cooperativism*. They argue that the experience of MCC in its globalisation demonstrates that over the long term, within competitive markets, the coop business model is unsustainable and must be transformed into a more conventional structure. They suggest that this has detrimental impacts on the social economy over the long run.

According to this analysis the experience of MCC is that more consideration needs to be given to how the globalisation of coops can be undertaken so as to avoid losing the value of economic democracy and social enterprise as exemplified by cooperatives. There is no doubt that MCC has generated considerable economic and social value to the Basque region. Its ability to create similar value to other regions in other countries will depend on how it can devise appropriate policies and strategies to ensure that its global partners and employees enjoy the same benefits as its domestic ones. Attempts have already been made by MCC in undertaking ethical business practices in its overseas subsidiaries, but more needs to be done. Whether the globalisation of a coop can be done without loss of the cooperative spirit and values is a field for future study.

The Case of Calavo, USA

To see what such internationalisation can do to a coop we can turn to the avocado industry of California. Stanford and Hogeland (2004) outline the case of the *Calavo* avocado cooperative of California, USA. Established in 1915 as the California Avocado Society, the main aim of the coop was to collectively market what was then an exotic fruit to US consumers. In 1924 the California Avocado Grower's Exchange was incorporated and by 1926 the name *Calavo* had been established as a trading name. Throughout the 1930s the coop grew in size and the scope of its marketing activities expanded. By the 1950s it was the largest avocado producer's coop, which specialised in the Haas variety. During the 1960s there were efforts by the California State Agriculture Department to intervene in the production and marketing of local avocados. *Calavo* aggressively marketed its member's products and found itself at odds with the state sponsored central marketing agency. While the state agency favoured the marketing of unbranded generic fruit, *Calavo* responded by the early 1970s with branded product selected for its quality.

In 1980 the California Avocado Commission (CAC) was established. This was a private association representing all avocado growers and which administered the marketing of the fruit. This led to a shift in the strategy of *Calavo* from a producer focused organisation to a market focused one. Under its branding strategy it expanded export markets into Japan, Europe and Canada, and soon begun sourcing supply from non-member sources in Chile,

New Zealand and Mexico. Most of the world's avocado production is centred on Mexico with around 75 to 80 percent of the total. However, Mexico has not developed its processing and marketing operations. In the 1990s *Calavo* invested heavily in the Mexican avocado industry. It established processing and packing plants for guacamole and whole fruit, which it then exported back into the USA. The irony was that *Calavo* found itself at odds with local Californian avocado growers who were fighting the importation of Mexican product.

Within the USA *Calavo* had a membership of 1,650 growers by the 1990s. It promoted itself as a member-focused coop and yet its international operations saw it move towards the behaviour of a conventional business. During the battles over Mexican imports *Calavo* took a neutral stance and continued to market its branded products into the USA, including Mexican sourced avocados. Throughout the 1990s the American avocado growers fought to keep out Mexican product, arguing that it was likely to risk introducing insect pests and other diseases into the USA crops. The lower production costs of Mexican fruit producers (allegedly 25% lower costs) were also used as an argument. In 1996 *Calavo* and the CAC became embroiled in a dispute over the investment the coop had made in the avocado marketing undertaken by CAC. Rather than funding a generic branding it favoured its own branding strategy.

As *Calavo* expanded its export markets into Canada, Japan and Europe its business grew to around US\$140 million. Supply from New Zealand, Mexico and Chile also became more crucial to keeping its markets fed. It resisted US Government attempts to establish country of origin labelling on avocados. By the late 1990s it was the largest supplier of avocados in the United States and was sourcing around half its fruit from non-members. Under US law this level of non-member sourcing is not allowed for coops. Its senior management had essentially committed the organisation to a de-mutualisation strategy. By 2001 it listed on the stock market as an investor owned firm and ceased to be a coop.

The experience of *Calavo* suggests that as a coop expands globally it can experience tensions between its original role of promoting the interests of its founder members, who are typically regionally located, and the need to pursue an international growth strategy. A global strategy requires the development of a strong marketing orientation based on an investment in branding. Sourcing of supply cannot be easily restricted to local producers as lower cost or more reliable suppliers are identified in other countries. To compete on a global stage requires adherence to the same rules as govern international markets. This may not always be compatible with cooperative principles (Stanford & Hogeland, 2004)

The Case of Fonterra, New Zealand

Another example of a coop engaged in globalisation is that of New Zealand's *Fonterra*. Ferrier (2004) describes the process of change that has taken place in New Zealand's most successful dairy coop. In 2003 *Fonterra* was New Zealand's largest firm with annual revenues of NZ\$12.5 billion. The antecedents of this highly successful and global enterprise can be traced back to the 1870s with the formation of small dairy coops in New Zealand that had expanded to over 400 separate cooperatives by the 1930s. A process of industry consolidation during the 1950s and 1960s saw the number of dairy coops fall from 400 to around 168. By the early 1990s the opening up of trade barriers and the need for larger and more efficient production operations saw further consolidation in the NZ dairy industry. The total number of coops fell to just 13 enterprises.

While the production side of the NZ dairy industry was consolidating and the number of coops shrinking, the international marketing activities of the industry were expanding. The

NZ Dairy Board emerged in the 1980s and 1990s as one of the largest global dairy marketing organisations with around 80 overseas subsidiaries and associated companies by 1995. Traditionally New Zealand had exported much of its dairy product to the United Kingdom, and when Britain joined the European Union there was a shift to more value added products. While butter and cheese had traditionally been exported to the UK, now it was essential for the NZ dairy industry to manufacture powdered milks and other value added products.

In 2001 *Fonterra* was formed from the amalgamation of the NZ Dairy Board, with two of the countries largest coops. With 11,000 members it was reportedly the sixth largest dairy company in the world. During the past eight years it moved into a number of overseas markets, with heavy investment in Australia. The acquisition of *Dairy Farmers*, *Brownes National Foods* and *Bonlac* positioned it as a major competitor in the Australian dairy market. In 2008 *Fonterra* acquired dairy brands from *Nestle Australia* (*West Australian*, 2008).

A key aspect of *Fonterra's* new business structure was its system of "Fair Exit and Entry" for members. This was aimed at overcoming the problems associated with traditional coop structure. Prior to the introduction of this scheme, coop members entered and exited the group with no change to the price of their membership. Unlike a shareholder who enjoyed growth in the value of their shareholding, the coop member gained no such value other than the benefits accruing to membership that are rather less directly measured. Later entrants to the coop gained benefits from the work and investment made by their predecessors without having to pay a price premium (Ferrier, 2004).

As noted in earlier chapters the *Fonterra* system of "Fair Exit and Entry" requires the purchase of shareholding on the basis of supply volumes, but shareholdings are independently valued by the ratings agency Standard & Poor's. Based on this independent valuation the Board of *Fonterra* sets a share value for each growing season. Members enter and exit the coop with some opportunity for realising their share value rising. *Fonterra* has controls to protect a major outflow of capital as part of its constitution (Ferrier, 2004).

While *Fonterra* has enjoyed a highly successful globalisation strategy since 2001 it seems to have experienced a similar fate to that of *Cavalo* or MCC in terms of its need to balance the interests of coop members and the need to source external capital and global markets. In 2007 *Fonterra* announced a plan to restructure, splitting its cooperative business from its mainstream business operations. The coop would continue to own two-thirds of the new business entity, 15 percent would be distributed to producers, and the remaining 20 percent floated on the stock exchange. This move towards partial demutualisation evoked strong opposition from a number of circles and sparked a strong media debate over the pros and cons of the move (Griffiths, 2007).

In 2008 the *Fonterra* Board decided to postpone the capital restructure and committed to a two year consultation period. The debate appeared to divide along lines drawn around those who opposed the move on the grounds that it would see *Fonterra* lose its coop status. These groups represented many farmers, agricultural economists and academics who feared it would not serve the best interests of producers in the longer term. On the other side were representatives from the mainstream business community and the finance and banking sector (ICA, 2008c).

Summary and Opportunities for Future Research

This chapter has examined the role of the cooperative in regional economic development. As outlined above, the coop plays a key role in the *social economy* and many writers argue for the coop to be viewed as major form of social enterprise. Without doubt the history of the cooperative movement demonstrates that the cooperative is formed in circumstances where the conventional investor owned firm or the government sector solution is not viable. Due to its focus on member benefits, local supply or service, and the founding principles of democratic governance that have guided the coop since the 1840s, it is often an effective business model for enhancing disadvantaged communities or regions.

Despite the apparent benefits of mutualism and cooperative enterprise in shaping a social economy, the examples of cases such as *Cavalo* or *Fonterra* suggest that once a coop grows into a large business enterprise and commences a process of national expansion or globalisation it may face pressures for demutualisation. A similar experience faced the major US walnut marketing cooperative *Diamond Walnut* in 2005. Having expanded its operations significantly in the 1990s, it launched a series of successful product brands in both the USA and international markets. After 10 years of rapid growth and a strong shift from a production oriented to a market oriented firm, *Diamond Walnut* sought permission from its 1,900 members for demutualisation and public listing on the stock market (Cline, 2005).

It may not be inevitable for a coop to transform into an investor owned firm as it grows and expands its markets. Further research is needed to examine this aspect of the cooperative business model. Longitudinal case studies that track the history of the coop, its benefits to local communities, and the factors influencing demutualisation decisions are important to enhancing our understanding of the lifecycle of the cooperative enterprise. Researchers may also find fruitful fields of inquiry in exploring the interrelationship between the private and government sectors and the social economy in the overall context of regional economic growth. As noted above, the role of cooperative enterprise was an area of keen interest by the UK Labour Government in the 1990s. The lessons from this era of social enterprise experimentation may provide useful lessons for understanding the role of the coop in the wider economy.

The Great Depression of the 1930s saw a strong focus on the role of the cooperative and the wider social economy (Miller, 1937; Warbasse, 1937). This is not surprising given the nature and scale of that economic crisis. As noted by Kalmi (2007) the study of coops in the field of economics was significantly more prominent during the period up to the 1950s than in the remainder of the 20th Century. As this review is written the world has plunged into what many commentators describe as the worst global economic downturn since the 1930s. For some this is the legacy of poorly regulated financial markets and a degree of failure by the investor owned enterprise business model to take appropriate care of its shareholders and employees. Whether the cooperative business model is an alternative that can provide a more stable and socially convivial outcome for the world's economy, as suggested by Williams (2007), remains to be seen. However, the opportunity appears right for there to be an emergence of interest in the cooperative enterprise within the economics profession and the business schools.

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