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Cooperative Firms in Theory and Practice

1. INTRODUCTION

Cooperatives are not, as everyone at this conference knows, just a peripheral or incidental or anachronistic or culturally limited form of organization. Rather, they are big business of a distinctly modern type. They represent a substantial share of the economy in most developed market economies. For example, in the United States – which many people take today to be the epitome of a capitalist economy – cooperatives dominate important industries, such as basic agricultural products and supplies, and have a large market share in others, such as wholesaling and production of business supplies and services, electricity generation and distribution, housing, banking, and insurance.

More generally and more strikingly, the overall share of economic activity accounted for by cooperatives is larger in advanced market economies than it is in less-developed economies. And, more striking still, the market share of cooperatives in economic activity has grown throughout the 20th century. Indeed, this conference, which celebrates the organization of the Finnish cooperative movement 100 years ago, reminds us that cooperatives are a distinctly modern form of business organization. They developed only in the late nineteenth century, well after investor-owned business corporations were already well established as a form for organizing business.

It is interesting to ask whether we should expect this trend to continue, with cooperatives representing an ever larger share of economic activity in the future. I'll return to this question

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later. First, I want to make a few observations about the structure, role, and behavior of cooperative enterprise in general.[1]

2. THE STRUCTURE OF COOPERATIVE ENTERPRISE

It is common to think of cooperatives as something very different from investor-owned business corporations. But this is misleading.

To see this clearly, it helps to have a term with which we can refer to all persons who transact with a firm, either as purchasers of the firm's products or as suppliers to the firm of some factor of production. For this purpose, I'll refer to such all of the firm's customers and suppliers – whether they're individual human beings or other firms – as the firm's "patrons."

Firms in all industries are typically owned by persons who are also patrons of the firm. This is conspicuously true of those firms we conventionally refer to as producer and consumer cooperatives. A consumer cooperative is by definition owned by its customers. The firm's earnings – and often votes in the firm's governance as well – are distributed among its owner-members in proportion to the amount that each member purchases. Likewise, producer cooperatives are collectively owned by one or another class of persons who sell a factor of production to the firm, whether it is milk, wheat, lumber, or labor.

The same is true of the standard business corporation, which is a firm that is owned by persons who supply capital to the firm. In fact, the conventional investor-owned business corporation is nothing more than a special type of producer cooperative – namely, a lenders' cooperative, or capital cooperative. A business corporation is different from a dairy cooperative or a wheat cooperative or a workers' cooperative only with respect to the particular factor of production that the owners supply to the firm.

Indeed, turning to matters of law, we can view the statutes under which business corporations are formed as simply specialized versions of the more general cooperative corporation statutes. In principle, there is no need to have a separate business corporation statute at all. Business corporations could just as well be organized under a well-drafted general cooperative corporation statute, just like other types of cooperatives. Presumably we have separate statutes for business corporations simply because it is convenient to have a form that is specialized for the most common form of cooperative – the lenders' cooperative – and to signal more clearly to interested parties just what type of cooperative they are dealing with. For simi-

1 The material on the structure and role of cooperatives in Sections II and III draws on my book, The Ownership of Enterprise (The Belknap Press of Harvard University Press, 1996).

lar reasons, some jurisdictions have special statutes for agricultural cooperatives or for consumer retail cooperatives.

In short, ownership need not be, and frequently is not, associated with investment of capital. Rather, lending capital is simply one of many types of transactions to which ownership of a firm can be tied. Once we recognize this, we are then naturally led to ask several questions: First, why it is that ownership of firms is generally tied to transactions? Second, why is ownership generally given only to one narrow group among the firm's patrons – such as suppliers of a particular factor of production or consumers of the firm's products – rather than being shared among several or even all classes of a firm's patrons? Third, what factors govern the particular class of transactions – whether lending capital, supplying wheat, or purchasing the firm's products – to which ownership is tied in any particular case? These are the questions to which I want to turn next.

3. THE ROLE OF COOPERATIVE ENTERPRISE

In theory, a firm could be owned by someone who is not a patron. Such a firm's capital needs would be met entirely by borrowing; its other factors of production would likewise be purchased on the market, and its products would be sold on the market. The owner would simply control the firm, and receive its (positive or negative) residual earnings after all output was sold and inputs paid for.

Such firms are rare, however. Rather, ownership is commonly assigned to persons who have some other transactional relationship with the firm. The reason for this, evidently, is that ownership can be used to mitigate some of the costs that would otherwise attend these transactional relationships if they were managed through simple market contracting – that is, by handling the transactions in question simply as a matter of contract between parties acting at arms' length, without either party having any ownership interest or other form of direct control rights over the other party.

More particularly, market contracting can be especially costly in the presence of those conditions that are loosely called "market failure," such as monopoly or a severe disparity in information between the contracting parties. In the face of market failure, the total costs of transacting can sometimes be reduced by, in effect, merging the purchasing and the selling party through ownership, so that one party owns the other. The advantage of ownership is that it reduces or eliminates the conflict of interest between buyer and seller that underlies or aggravates the costs of market failure.

Monopoly provides an obvious example. Suppose a firm that sells supplies to the farmers in a given region has so little competition that it is effectively a monopolist where the farmers are concerned, giving seller the power to charge very high prices for the supplies it sells. If the farmers who are customers of the supply firm were themselves to own the supply firm collectively, they would largely eliminate the problem of monopolistic pricing. The farmer-owners of the supply firm would then have no incentive to let the firm charge monopolistic prices, since they would simply be exploiting themselves. In simple terms, when you are on both sides of a transaction, you can always trust the other party.

These observations, taken by themselves, suggest that ownership of a firm should be assigned to that class of the firm's patrons – whether investors of capital, customers, workers, or whoever – for whom the costs of market contracting would otherwise be highest. Ownership can itself involve substantial costs, however, as I'll discuss in a minute. These costs of ownership can be quite different for different classes of patrons. Efficiency is best served if ownership is assigned so that total transaction costs for all patrons, including both costs of market contracting and costs of ownership, are minimized.

To give this theory more substance, I'll briefly review here the most significant costs of market contracting and ownership, respectively. Because most of these categories of costs are familiar, I'll be brief, emphasizing only those considerations that have not been well analyzed before and that have special bearing on problems of collective ownership.

The Costs of Market Contracting. First, let us consider the costs of market contracting – that is, the costs that create a positive incentive to give ownership of the firm to one class of the firm's patrons over another. Although a variety of factors can make market transactions costly, there are several characteristic types of problems that arise commonly and that can often be mitigated by assigning ownership to the patrons involved. For the sake of brevity, I'll confine myself here to three of these.

The first of these costs of contracting is *simple market power*. Frequently, owing to economies of scale or other factors (such as cartelization or regulation) that limit competition, a firm has market power with respect to one or another group of its patrons. The affected patrons then have an incentive to own the firm and thereby avoid price exploitation. For example, firms often have a degree of monopoly power in dealing with their customers, and this is a common reason for organizing the firm as a consumer cooperative. Monopsony – which involves market power vis-a-vis the firm's suppliers rather than its customers – is sometimes also a motivation for patron ownership. This once was, and may still be, an important reason for the widespread success of agricultural marketing and processing cooperatives.

A second important cost of contracting is what we might term *ex post market power*, or "lock-in." This concerns problems of monopolistic exploitation that develop *after* a person begins patronizing a firm. These problems arise where two circumstances are present: First, after entering into the transactional relationship the patron must make substantial transaction-specific investments – that is, investments whose value cannot be fully recouped if the transactional relationship with the firm is broken. Second, the transactions are likely to extend over such a long period of time, and are sufficiently complex and unpredictable, that important aspects of future transactions cannot be reduced to contract in advance but rather must be dealt with over time according to experience. In such circumstances, the patron becomes locked in, to a greater or lesser degree, once she begins patronizing the firm: she loses the protective option of costless exit if the firm seeks to exploit her.

Employees may often be subject to lock-in after they've spent a number of years with a given firm, and this may help explain why some firms are organized as workers' cooperatives: if the workers own the firm, the firm is less likely to take advantage of the fact that they're locked in. Lock-in also provides an explanation for some consumer cooperatives. A conspicuous example is the common practice, which I'll return to below, of making franchisees the collective owners of their franchisor.

A third important cost of contracting is what economists term *asymmetric information.* This problem arises when the firm has better information than its patrons concerning matters that bear importantly on transactions between them – or, conversely, when the patrons have better information than does the firm. For example, a firm often knows more than its customers about the quality of the goods or services that it sells. This is especially common when the contracted-for goods or services are complex or difficult to inspect.

In the United States, this type of problem provided the original incentive for formation of some of the first agricultural supply cooperatives early in the twentieth century, which concentrated on fertilizer and seed grain. It was difficult in those days for farmers to determine and evaluàte the content of fertilizers and bags of seed grain, and the investor-owned suppliers exploited this lack of information. The farmers, in turn, formed farmer owned suppliers they could trust.

The Costs of Ownership. As I said before, however, we cannot look just at the costs of ownership in determining the most efficient assignment of ownership in a firm. We must also look at the costs of ownership. The most significant costs associated with the exercise of ownership can conveniently be grouped under three headings.

The first cost of ownership is the *cost of monitoring.* If a given class of patrons is to exercise effective control over the management of a firm, they must become informed about the operations of the firm, communicate among themselves for the purpose of exchanging information and making decisions, and then induce the firm's managers to do as the patrons have decided.

These costs can vary widely among different classes of patrons. The costs are most likely to be small, relative to the value of the patrons' transactions with the firm, where the patrons involved are relatively few in number, live close to each other and the firm, and transact regularly and repeatedly with the firm over a prolonged period of time for amounts that are a significant fraction of their budget.

To the extent that the owners of the firm fail to exercise effective control over its managers, the managers are free to engage in self-dealing transactions and exhibit slack performance. As the economics literature on agency costs has emphasized, the costs from such managerial opportunism are sometimes smaller than the costs of effective monitoring, and thus it may be efficient for the owners to bear these costs rather than to seek to impose discipline on the firm's managers.

An equally important but less familiar point is that, for a given class of patrons, the costs of managerial opportunism may be worth bearing as an alternative to not having ownership at all. That is, just because a given class of patrons cannot monitor effectively, and thus cannot exercise much control beyond that which they would have simply by virtue of market transactions with the firm, it does not follow that there is no substantial gain to those patrons from having ownership of the firm.

The reason for this is that, by virtue of having ownership, the patrons in question are assured that there is no *other* group of owners to whom management is responsive. It may not be pleasant to deal with managers who are nominally your own employees, but whom you can't effectively control and thus have substantial autonomy. But that may be much better than transacting with a firm managed by persons who are under the close supervision of some other group of patron-owners that has interests clearly adverse to yours, and that will encourage the managers to exploit you actively.

In short, patrons who are poor monitors may nonetheless be efficient owners. For example, this was apparently the case with life insurance companies in the middle of the nineteenth century, and helps explain the rapid expansion of mutual insurance companies at the time.

Moreover, the same argument presumably helps explain why so many large firms are owned by the patrons who contribute capital to the firm. It is often better that those investors own the firm, no matter how incapable they may be of monitoring the firm's management, than it is that the firm be owned by some other class of patrons who have the ability to induce the firm's managers to take advantage of the firm's investors.

Let us now turn from monitoring costs to the second of the important costs of ownership – namely, the *cost of collective decision-making.*

When ownership of a firm is shared among a class of patrons, a method for collective decision-making must be devised. Most commonly a voting mechanism of some sort is employed, with votes weighted by volume of patronage – although some cooperatives adhere to a one-member-one-vote scheme instead.

As means for aggregating the preferences of a group of patrons, such voting mechanisms often involve substantial costs in comparison to market contracting. Little attention has been devoted to these costs in the literature on corporate control and the economics of organizational form. Nevertheless, there is good reason to believe that they are crucial in determining the efficiency of alternative assignments of ownership.

Although a variety of factors influence the costs of collective decision-making, a fundamental consideration is the extent to which the patron/owners have divergent interests concerning the conduct of the firm's affairs. Where the patrons involved all have essentially identical interests – for example, where they all transact with the firm under similar circumstances for similar quantities of a single homogeneous commodity, as in the case of many agricultural production or supply cooperatives – the costs associated with collective decision-making are naturally small. Absent such circumstances, however, the costs of collective decision-making may be large relative to the costs of market transactions. The costs of collective decision-making can come in several different forms.

To begin with, even if no patron acts strategically, collective decision-making processes may yield decisions that are collectively inefficient in the sense that they do not maximize aggregate patron surplus. Thus, if voting is employed, and if the preferences of the median voter are not those of the mean, a majority voting mechanism may yield decisions that are not only inefficient, but that are inferior to those that would be reached if the patrons simply contracted as individuals with a profit-maximizing firm.

More serious problems can arise if one group of patrons self-consciously seeks to use the collective choice mechanism to exploit another group – for example, by raising prices or cutting quality for services consumed primarily by the disfavored group. The latter group may, as a consequence, be no better off as owners than if they dealt with the firm through market contracting. And in fact they could be much worse off than they would be in dealing with an investor-owned firm if becoming an owner requires making a transaction-specific investment that is at risk (such as a contribution of capital that is not easily recouped when the patron withdraws from membership in the firm).

Further, the process of collective decision-making itself can have high transaction costs in the face of heterogeneous interests. For example, there is a strong incentive for individuals to form coalitions to shift benefits in their direction. Consequently, efforts to form and break such coalitions may consume substantial effort.

The essential distinction between ownership and market contracting here is that, when patrons deal with the firm simply through market contracting, they have no leverage over firm policy beyond the threat of withdrawing their individual patronage. With a collective decision-making mechanism, in contrast, subgroups of patrons with particular interests can often achieve disproportionate influence.

On the other hand, even where patrons diverge considerably in interest, the costs associated with collective decision-making may be low if there is some simple and salient criterion for balancing their interests. For example, where it is easy to account separately for the net benefits bestowed on the firm by each individual patron, then, even if the nature and the volume of the transactions with individual patrons differ substantially, dividing up net returns according to such an accounting is likely to be both natural and uncontroversial. The empirical literature indicates strongly, however, that, in the absence of such a clear focal point for decisions, agreement may take a long time to reach, and often in fact is never reached.

There are, to be sure, also some potential *advantages* to collective decision-making over market transactions. As albert Hirschman has pointed out, there are many circumstances in which voice can be more effective than exit as a method of communicating patron preferences to the management of a firm. The available evidence suggests strongly, however, that collective decision-making is more costly than markets in this respect in cases of even modest heterogeneity of interest among the class of patrons in question. Indeed, a very strong indication of this fact is the nearly complete absence of large firms in which ownership is shared among two or more classes of the firm's patrons – such as customers and suppliers, or investors and workers. If simply reducing the costs of market contracting were at stake, then it might be worthwhile to arrange for ownership to be shared among **all** the patrons of the firm

Now my discussion of the costs of ownership has so far focused only on the costs to patrons of exercising control over the firm. But an owner, besides controlling the firm, also has a right to receive the firm's residual earnings. And receiving payment in the form of residual earnings rather than in the form of a contracted-for price or wage can also be a source of costs.

The most conspicuous among these costs is the cost of bearing the risk of the enterprise, which is typically reflected in the firm's residual earnings. One class of a firm's patrons may be in a much better position than others to bear such risk – for example, through diversification. Assigning ownership to those patrons can then bring important economies. Thus, the *costs of risk-bearing* are a third important form that the costs of ownership can take.

Risk-bearing is a familiar explanation for the prevalence of investor-owned firms. It is not true, however, that lenders of capital are the only low-cost risk-bearers. For example, consumers can also be in a good position to bear the risks of enterprise, particularly where the goods or services involved are a small fraction of the consumers' budget, or where the consumers are themselves firms that can pass the risk on to customers of their own who in turn are good risk-bearers.

Now, to repeat, the efficient assignment of ownership in a firm is that which reduces the sum of all of the costs incurred by the firm's patrons. These include the costs of contracting for those partons who are not owners, and the costs of ownership for those patrons who *are* owners.

If the patterns of ownership that have evolved in reasonably stable economies have been selected out to some degree by the forces of efficiency – that is, if historical evolution reflects efficiency to some substantial degree – then the patterns of ownership we see in different industries should tell us something about the relative importance of the costs of contracting and the costs of ownership that I've described here.

And, when we look around, we can indeed make some interesting general observations about the relative importance of the different costs.

First, we see something that is already well known: market power is an important determinant of ownership. Asymmetric information, in contrast, is less important; it is more a factor in the formation of *nonprofit* firms.

But the costs of market contracting, in any case, generally appear to be far exceeded in importance by the costs of ownership. Where costs of ownership are particularly low for a given group, that group often ends up as the firm's owners, even if the costs of market contracting for that group are relatively low. Many agricultural supply cooperatives may today be an example here.

Moreover, among the costs of ownership, the problem of heterogeneity is of partcular importance. It is very rare to see a cooperative in which ownership is shared by a group of patrons that exhibits any substantial diversity. This suggests that the costs of collective decision-making are very high for a heterogeneous group of owners. Indeed, this seems to be a real bar to forming cooperatives in many industries. If a highly homogeneous class of patrons – besides investors – doesn't exist in a given industry, firms in that industry are very unlikely to adopt the cooperative form in place of investor ownership.

This suggests, in turn, that homogeneity of interest among investors of capital, rather than risk-bearing or even the need to accumulate capital, may be the real reason that modern economies are so heavily dominated by investor-owned firms.

A useful example of the tradeoffs among the costs of contracting and the costs of ownership be found in agricultural supplies. The early supply coops were formed in response to problems of market power and asymmetric information. Today, however, thanks to regulation and mandatory labeling rules, as well as to the growth of competition among manufacturers and suppliers of farm supplies, the costs of contracting seem not much different in agricultural supplies than they are in many other industries that, in contrast, are dominated by investor-owned firms.

There is, however, one type of farm supply for which the market in the united state is conspicuously non-competitive – namely, heavy farm equipment, such as tractors and harvesting combines. Here, two companies, Deere and Case, have well over 80% of the market, and Deere alone has over 50% of the market. But neither of these two firms, nor any other supplier of agricultural equipment, is organized as a cooperative in the u.s.

It is sometimes said that the capital intensity of equipment manufacturing is the important bar to forming cooperatives in that industry. Yet there are a variety of reasons to believe that isn't so. For example, some of the larger farm supply cooperatives in the u.s. now own and operate their own oil refineries, which are very capital-intensive operations. Rather, I suspect that the absence of farm equipment cooperatives has more to do with the costs of consumer control in that industry. The sporadic nature of equipment purchases removes both the incentive and the opportunity for farmers to engage in continuous monitoring of suppliers of that equipment. And the widely varying types and vintages of equipment used by different farmers make for heterogeneity of interest, creating the potential for substantial disagreements among members of a cooperatively owned vendor concerning such matters as the types of inventory to carry, the type of service facilities to maintain, and the type of financing to offer.

Conversely, it is noteworthy that it is the most homogeneous of farm supplies, petroleum, in which cooperatives have the largest share in the U.S. Although the market for petroleum products in the U.S. is quite competitive today – in contrast to the era when the petroleum supply cooperatives were formed – and despite the high capital costs involved, the cooperatives compete quite effectively with investor-owned firms. Presumably, then, the cooperatives are succeeding not because their costs of contracting are significantly lower than are those of investor-owned firms, but because their costs of ownership are lower.

There is a great deal more that could be said about why it is that cooperatives are found in one industry rather than another. Nevertheless, I would like to move on to some other topics, the first of which involves governance in cooperatives.

4. GOVERNANCE IN COOPERATIVES

The internal governance mechanisms of cooperatives tend to differ rather markedly from those of investor-owned firms of similar size. In particular, cooperatives are commonly much more closely controlled by their member-owners than are investor-owned firms.

In the United States, for example, the largest farmer-owned marketing and supply cooperatives – some of which are among the 100 largest firms in the United States – are very tightly member-controlled, in conspicuous contrast to investor-owned firms of the same size, whose shareholders exert very little influence over the selection of the corporation's managers and the policies those members adopt.

To be sure, this is not universally true. Some large consumer cooperatives, as well as many mutual banks and insurance companies (which are also cooperatives of a sort), exhibit a strong separation between ownership and control. But, overall, the pattern of high member responsiveness is quite clear. The board of directors of a typical cooperative, no matter how large the firm is, is commonly very well informed about, and very attentive to, the opinions of the cooperative's members.

This is no accident. Cooperatives self-consciously adopt various techniques to promote this responsiveness. In the United States, for example, the largest agricultural cooperatives commonly have a federated structure, in which individual farmers belong to relatively small regional cooperatives, which in turn are the members of the national cooperative. This assures that the national cooperative will be highly responsive to the regional cooperatives, which in turn are highly responsive to their local individual members.

Moreover, members of the board of directors of the national cooperative are commonly not elected at large in a single firm-wide election, as is the case in the typical investor-owned firm, but rather are chosen by region, so that most seats on the board represent a particular local constituency. It is also common for a cooperative's charter or bylaws to require that most members of the board of directors also be members of the cooperative (so that they will identify more closely with the interests of the members in general). And cooperatives also commonly require that all or nearly all of the cooperative's directors not be hired managers of the cooperative – again, in strong contrast to investor-owned firms in the united states.

It is natural to ask what is responsible for this strong difference in governance between cooperatives and business corporations.

It is tempting to respond that cooperatives are so responsive to their members because they *can* be. In many cooperatives, transactions between a typical member and the cooperative represent a substantial fraction of the member's income. This means that it is quite worthwhile for the member to invest heavily in becoming informed about the cooperative's affairs, which in turn permits the member to participate thoughtfully in elections to the board and other matters of cooperative governance. This is not the case, on the other hand, with all but the largest shareholders in a substantial-sized business corporation.

But this cannot be the principal explanation, for it begs an important question. One must ask, after all, why the typical cooperative member does such a large volume of transactions with the firm in proportion to the member's wealth, while this is generally not true for shareholders in large investor-owned corporations.

One suspects that, in fact, the unusual responsiveness of cooperatives to their members, and the members' large financial involvement with the cooperative, both have a common cause or causes. There are at least two causes that seem likely.

First, there is no market for corporate control in cooperatives that can serve as a source of discipline for a cooperative's managers. In contrast to the typical large business corporation, the membership interests in cooperatives generally are not tradeable. Nontradeability, in turn, presumably results in large part from the awkwardness of tying membership rights to a fixed volume of patronage. But even if membership rights in cooperatives *were* tradeable, it would make little difference for governance purposes. Whether or not membership interests are tradeable, no single member is likely to be able to account for a sufficiently large fraction of the cooperative's business – say, 20% or more – to have enough votes to achieve effective control of the firm. Almost of necessity, control in a cooperative is broadly diffused among its members.

The result is that, if managers are to be induced to act in the interests of the firm's owners, strong direct member control is far more important in a cooperative than it is in an investor-owned firm. And this means, in turn, that cooperatives, in contrast to business corporations, are likely to thrive only where such control is possible.

A second reason why member control is so strong in cooperatives is probably that the benefits that the members of a cooperative receive from the firm come not just in the form of regular monetary dividend payments, but also in the form of higher quality goods or services. But this means that managerial performance cannot be judged simply by examining the firm's net financial earnings, in contrast to the case with a business corporation. The result is that, to discipline managers, members must know much more about the firm and its services than the shareholders of a business corporation must know. Moreover, if managers are to meet the quality needs of the cooperative's members, they must be well-informed about the character of those needs, which may require substantial input from the members themselves.

Some evidence of the importance of both of these causes together in producing the characteristic link between the cooperative form and strong member control can be found in financial mutuals, such as mutual banks, mutual insurance companies, and mutual investment funds. In financial mutuals, transactions with the firm commonly represent a relatively small fraction of the members' income, thus giving little incentive for the members to invest heavily in informing themselves about the firm's affairs and the quality of the firm's management. But, at the same time, the returns to members of financial mutuals are reasonably easily calculated in monetary terms, so that there is a single measurable standard by which the firm's performance can be evaluated in comparison with other firms, whether those other firms are organized as mutuals or as investor-owned firms.

5. THE PROBLEM OF EXIT

I said before that homogeneity of member interests appears to be essential to the long-run success of a cooperative. In particular, it's important that members all be alike in their business interests vis-a-vis the cooperative. A cooperative that simply purchases a given type of grain, such as corn or wheat, from its farmer-members is the prototypical example.

But this kind of homogeneity isn't sufficient. There is a special problem that cooperatives face as a consequence of the fact that their members enter and exit the cooperative at different times. This in itself results in a heterogeneity of interests that can cause substantial difficulty in the smooth functioning of the cooperative.

The place this comes up most acutely is in the equity redemption policies of cooperatives. When a member of a cooperative leaves the cooperative – which commonly happens when the member is leaving the industry he's been engaged in, as in the case of a farmer retiring from the farming business – there arises the question of whether and when he will have refunded to him the equity capital that he has invested in the cooperative. That equity investment might have been made either in the form of an outright purchase of stock – for example, upon joining – or in the form of accumulated retained earnings attributable to his patronage. The retiring member generally wishes to have his entire equity share redeemed in full, and immediately, upon his retirement. Or, if he can't get it redeemed immediately, he at least wants to be paid a market rate of interest on the amounts that the cooperative continues to hold.

The members of the cooperative who aren't retiring, on the other hand, are generally reluctant to redeem equity in full for retiring members. For one thing, immediate redemption may create problems of liquidity for the cooperative. But even if that problem is solved by redeeming a retiring member's equity over a period of years, continuing members tend to be reluctant to redeem equity in full even in the long run, or to pay a market rate of interest on the amounts the cooperative does not redeem immediately.

To be sure, redemption in full might encourage, or at least permit, opportunistic exit from the cooperative. A cooperative is generally dependent on economies of scale. As one member leaves, the costs per unit borne by the remaining members tend to rise. So withdrawal imposes an externality of sorts. Still, few cooperatives – at least in the u.s. – seem to engage in any principled effort to calculate the mount of the externality involved and devise a redemption penalty that is tailored to that externality.

Rather, it appears that – at least in substantial part – the reluctance of cooperatives to redeem equity in full upon retirement arises because non-redemption serves the interests of non-retiring members. When equity is not redeemed in full, the amount not redeemed is effectively a free contribution of capital to the cooperative that is available to be used by the continuing members at no cost to them. In short, equity that is not redeemed is essentially equity that is transferred from the retiring member to the continuing members.

Of course, when members of a cooperative decide not to redeem equity capital in full for currently retiring members, they must realize that the same policy will apply to them in the future – that is, that their own equity will not be redeemed in full when they retire. One might think that this realization would be sufficient to make all members vote in favor of full redemption.

But in fact members who expect to remain with the cooperative for many years to come will not bear the costs of the non-redemption policy to the same extent that currently retiring members will. The reason is straightforward: for the continuing members, the cooperative's appropriation of their equity upon their retirement won't occur for many years, so the present value of that loss is relatively low. On the other hand, the present value of the extra benefits they will receive from the cooperative as a consequence of appropriating the capital of currently retiring members will be relatively high, since those gains will start flowing in immediately.

Consequently, in a vote among current members of the cooperative on redemption policy, the members closest to retirement are likely to find it in their interest to vote for redemption in full, while the members who do not expect to retire for many years will find it in their interest to vote for only partial redemption – or, in the extreme, no redemption at all.

It is not surprising, then, that even the largest, most successful, and most financially sophisticated of American cooperatives often do not redeem equity in full upon retirement, and indeed sometimes follow no stable and systematic plan for equity redemption.

It is also not surprising that redemption policy is a constant source of disputes within cooperatives. In the united states, it is by far the most largest source of lawsuits involving cooperatives.

Cooperatives might, of course, seek to solve the problem themselves by adopting initial charter provisions that bind the firm to a consistent and fair redemption policy. And one might think that newly forming cooperatives would have an incentive to adopt such a charter provision, since at its inception a cooperative's members are all affected relatively equally by any redemption policy, so there's little incentive for opportunism.

But, in fact, newly forming cooperatives don't have much incentive to adopt such a provision. In their early years, cooperatives often have trouble raising capital. They have poor access to the public equity markets, so they must raise capital from their members. Yet the members and prospective members of a newly-forming cooperative are often relatively young and capital-constrained themselves – whether they are individuals or businesses. Consequently, a policy that favors accumulation, and tends to take capital from the better-off members – which is to say, from the members whose patronage volume is high and who have been members for the longest time – and to lend that capital to the less well-off members has substantial appeal.

Thus a policy of full redemption may handicap many newly-formed cooperatives. And then, when a cooperative is mature and can afford a more equitable redemption policy, the internal politics of the firm weigh against any effort to amend the charter to require such a policy.

It follows – if I may be allowed to put on my hat as a professor of law – that this is one area of cooperative activity where law could play a particularly useful role. It would probably be counterproductive to require that all cooperatives always redeem members' equity in full when the members retire. But it might be very helpful if the law were to require redemption in full in any cooperative that has not adopted, after careful and informed deliberation, a specific well-thought-out plan of equity redemption in which any deviation from redemption in full has been undertaken for specific and reasonable purposes that redound to the benefit of the cooperative's members as a whole.

Unfortunately, at least in the United States, law has in fact done very little in this regard. Rather, the courts have generally been unwilling to review the reasonableness of a cooperative's redemption policy, leaving it to managers and controlling members to adopt whatever policy they wish.

6. WILL THE MARKET SHARE OF COOPS GROW OR DECLINE IN THE FUTURE?

This is a very interesting topic for speculation. And thinking about it helps us refine and test our theories of the role of cooperative enterprise. I will offer here, however, just a few brief thoughts on the issue.

My own belief, needless to say, is that the future growth or decline of the cooperative sector depends on the way that future technologies affect the two competing considerations that determine ownership: the costs of contracting and the costs of control.

Speaking very generally, the tradeoffs between the costs of ownership and the costs of contracting tend to produce cooperative enterprise where there is either (1) a number of patrons – persons or firms – purchasing the same homogeneous good from a single supplier, or (2) a number of persons or firms supplying the same homogeneous good or service to a single firm. The question, then, is whether there will be more or fewer industries with these characteristics in the years to come.

One important factor is *antitrust enforcement.* As antitrust enforcement becomes stronger, there is less need for coops. Absent antitrust enforcement, firms tend to form cartels, and this creates an incentive for the persons with whom they contract to form cooperatives (i.e., to cartelize themselves).

Antitrust enforcement has long been relatively strong in the United States, though it was not always so. The early farm marketing cooperatives clearly formed to break the power of cartels that had been left unmolested by the U.S. antitrust authorities. But antitrust policy has been weaker in Europe until recently, thus creating a strong incentive to form coops in some industries that were heavily cartelized. Perhaps, then, with stricter enforcement there will come fewer cooperatives.

Another potentially relevant factor is that *current technologies seem to be tending toward greater divisibility.* It's easier today to contract over output at substages in production. This makes those substages subject to production by separate firms, and hence subject to competition. And it reduces market power at the final assembly stage, since it's easy to enter the assembly business. You don't have to invest in manufacture of lots of parts, or become vulnerable to opportunistic contracting by suppliers to whom you get locked in. Thus we see assemblers like Dell computers entering the computer business easily and competing well with established firms like IBM, or even Compaq.

On the other hand, with greater divisibility, there is the prospect of having many commodities produced by a multitude of small firms, which then could have an incentive to band together to own their customers collectively.

Yet another factor is the problem of *homogeneity of interests among the patrons of a firm.* Products seem to be becoming more diversified these days. One reason for this is that affluence produces a taste for nonstandard consumption items; another is that current production technologies seem to facilitate greater product differentiation. And the general rate of product development has become so rapid that maintaining homogeneity of either supply or demand in a firm is difficult.

These tendencies may even strike agriculture, which in the future will perhaps focus less on producing large quantities of standardized crops like basic grains, wheat, and vegetables, and more on producing designer foods based on elaborate genetic engineering.

This suggests that cooperatives may tend to decline in importance. At the same time, however, some forms of *contractually-induced* homogeneity of interest among patrons of a firm are becoming much more widespread. The most obvious example here is franchising. Many franchisors are organized as franchisee-owned cooperatives. This form of organization is very common in the U.S., for instance, among hardware stores, grocery stores, pharmacies, and moving companies. More striking and more modern examples are offered by Mastercard and Visa, which are both cooperatives that are collectively owned by the thousands of local banks that market the credit cards that have the franchise's brand name.

These cooperatives are largely a response to the problem of lock-in that characterizes franchises. The franchisees get locked in to the franchisor by virtue of investments specific to that franchisor, thus exposing themselves to exploitation by the franchisor. Cooperative ownership of the franchisor by the franchisees removes this problem.

It's quite likely that this form of cooperative will spread rapidly in the years immediately to come. Franchises in general have been spreading rapidly as a business form – partly in response to greater mobility among individuals, and partly in response to the increasingly efficient techniques for national advertising. Franchises already account for one-third of all retailing in the U.S., and they are likely to spread widely in Europe and elsewhere in the future – particularly as the European Union develops a truly continental market in Europe.

There is, of course, no way to know whether a large percentage of future franchises will be organized as cooperatives. But rapidly changing technology and tastes won't necessarily as big an obstacle to the cooperative form here as they might be in other industries. The homogeneity of interest among the franchisees who deal with a common franchisor is itself, by its highly standardized character, a strong source of homogeneity of interest among the franshisees. That franchise contract, moreover, can be revised frequently as the business changes. Indeed, franchisors that are cooperatively owned by their franchisees may have an *advantage* over investor-owned franchises in changing their practices over time, since they will not be inhibited by suspicions that they are acting opportunistically toward the franchisees in making those changes – suspicions that might lead to restrictive regulation of the franchisors, or simply to an inability to attract franchisees.

In any case, as this discussion of franchises suggests, the future is likely to be interesting for cooperatives. Even if the traditional fields of cooperative activity – such as agricultural products and supplies – do not remain as important in the future as they have been in the past, there are likely to be many new fields in which cooperatives play an important role by providing an attractive tradeoff between the costs of contracting and the costs of ownership.