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Role of Cooperative Entrepreneurship in the Modern Market Environment: Introduction and Summary

In modern societies the bulk of all economic activity – production of goods and services and their distribution is carried out by firms that combine the efforts of many people. In a textbook the firm is typically understood to be owned by investors i.e. the suppliers of capital, whose only objective is to maximise the value of their investment.

However, not all firms are of this type. There are also non-profit organisations and many types of cooperatives ranging from agricultural cooperatives, cooperative banks and mutual insurance companies to partnerships and franchises organised on cooperative basis. In these firms the owners – to the extent there are owners – seek also or even primarily other types of benefits from the firm than maximum value to their usually small investment.

More importantly, these alternatives to investor owned firms (IOF's) are not just marginal phenomena. In many countries and in many branches they are major if not dominant players. In the European Union there are well over 30,000 farmer cooperatives with some 12 million memberships with very considerable market shares in mostpart of the major agricultural products. The turnover of the top 30 agricultural cooperatives in the EU is over Euro 50 billion. In the United States the total number of all cooperatives is over 47,000 with over 120 million members. This represents 40 percent of the U.S. population. For instance US farmer

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cooperatives produce and/or handle more than thirty percent of the commodities, products produced and processed, and inputs purchased in the agri-food chain – equivalent to more than USD 100 billion annually. Furthermore, 6 of the 10 largest insurance companies of the world are mutuals.

Finland is one of the most cooperative countries in the world with almost 60 percent of the population being members in one or several cooperatives. In Finland cooperative banks account for 33 percent the banking market, cooperative retailers 39 percent and mutual insurance companies 40 percent of their respective markets. 96 per cent of dairy products and 69 per cent of meat products are produced and marketed by cooperatives. In the forest industry one of the three big Finnish forest industry companies the majority is owned by forest owners with a 33-percent market share in timber purchased from private forests.

These alternative forms of firm organisations have received relatively little attention in economic research until recently. Two developments, however, have started to change this situation of benign neglect. First, in the past two decades economic research has become increasingly interested in issues that usually go under the name economics of organisation and more specifically corporate governance. In a broad sense corporate governance covers the mechanisms – internal and external to the firm – through which the firm's operations are controlled by the owners. The analysis of governance structures has made the differences that exist between investor owned companies and the alternatives an intriguing subject: something can perhaps be learned by examining different organisational forms.

Second, deregulation, globalisation, rapidly advancing development and application of information technology are changing the corporate environment in a pervasive way. Competition intensifies leading to major restructurings in many branches. Firms are recurrently merged and broken into pieces in the quest for increased efficiency and investor value. In this process the capital market has come to play a major role: purchase and sale of shares or a threat of such are instrumental in pulling through the restructuring. This has naturally raised the question, how organisations that do not have shares to be priced and sold in the market, and thus cannot share the market information, can cope with such pressures to change.

This special issue of the Finnish Journal of Business Economics examines the role of cooperative enterprises in the modern market economy from several angles. The articles published here are based on the presentations delivered at an international cooperative seminar in Helsinki, June 11, 1999. The seminar was organised by Pellervo Confederation of Finnish Cooperatives and Pellervo Economic Research Institute in collaboration with the Helsinki School of Economics and Business Administration and the Finnish Economic Association to commemorate the 100th anniversary of Pellervo Confederation, the central organisation of the Finnish cooperative movement.[1]

An academic seminar on cooperative en-

1 The organising committee of the seminar included the following persons: Mr Samuli Skurnik, CEO of Pellervo Confederation of Finnish Cooperatives (chairman); Professor Seppo Honkapohja, Univ. of Helsinki; Professor Eero Kasanen, Rector of the Helsinki School of Economics and Business Administration and editor of the Finnish Journal of Business Economics; Dr Jaakko Kiander, Research Director, The Governement Institute of Economic Research and editor of the

terprises was considered by the organisers the most appropriate way of celebrating the anniversary. The idea of cooperative enterprises was namely brought to Finland at the turn of the century by an academic, Dr *Hannes Gebhard,* who pursued studies in cooperative thinking in various European countries in the late 1890's on an award given by the Finnish Economic Association. He wrote about his findings in a book entitled *"Maanviljelijäin yhteistoiminnasta ulkomailla"* (The cooperation of farmers abroad), published in Finnish early 1899. Both Dr Gebhard and his book played a central role in the Finnish cooperative movement for decades to come.

The seminar examined cooperative enterprises from three different perspectives. First, the fundamental reasons for the cooperative as an organisational form. Second, the emergence of cooperation from historical perspective in different industries. Finally, the prospects of cooperative enterprises in the rapidly changing environment.

Cooperative Firms as a Way Organising Economic Activity: A Theoretical Perspective

In the first paper Professor *Henry Hansmann* from Yale University has as his point of departure the fact that investor ownership has nothing special to it that would make it in all circumstances the most natural or efficient organisational form. Ownership – i.e. the formal right to control the firm and appropriate the residual earnings – can, in principle, be assigned to any group of persons who transact with the firm or "patrons" in Hansmann's terminology. Patrons and thus potential owners include those who provide different inputs to the production process – employees, suppliers of raw materials and, of course, suppliers of capital – but also purchasers of the firm's products. From this point of view the conventional investor-owned business corporation is according to Hansmann nothing more than a special type of producer cooperative – namely, a lenders' cooperative, or capital cooperative.

The relative advantages of different patrons as owners depend on the costs that are associated with ownership on the one hand and with market transactions of the patrons on the other hand. The costs of ownership include costs of monitoring, collective decision making and risk bearing. Market transactions in turn involve costs of market power, "lock-in" or ex post market power, and costs of asymmetric information. Investor ownership is an optimal solution only to the extent to which it performs better relative to other ownership arrangements.

Agricultural cooperatives for instance have in many countries emerged in response to the market power of the firms that have either sold inputs to farmers or bought their products. Through ownership of dairies and slaughterhouses or seed distributors farmers have been able to eliminate the market power that could otherwise either reduce their revenues or increase their costs.

Empirical evidence suggests according to Hansmann that sufficient homogeneity of interest among any potential class of patrons is a

Finnish Economic Journal; Mr Lauri Kontro, Director, Pellervo Confederation of Finnish Cooperatives; Dr Jukka Pekkarinen, Managing Director, the Labour Institute of Economic Research and Chairman of the Finnish Economic Association; Dr Vesa Vihriälä, Managing Director, Pellervo Economic Research Institute. The seminar recieved generous support from the Finnish Cultural Foundation and Yrjö Jahnsson Foundation.

major determinant of the costs of collective decision making. Employees and raw material providers – say milk producers – may often have rather different interests among themselves. In contrast, investors have relatively homogenous preferences – their interest lies singularly in the maximisation of the value of their investment. Hansmann argues that this rather than supply of capital is likely to be the major reason for the dominance of investor owned firms in modern economies.

Professor *Bengt Holmström* from the Massachusetts Institute of Technology shares with Hansmann the view that the costs of collective decision making play a central role in determining who are efficient owners. He notes that a stakeholder can affect a firm's decisions either by exit or by having a direct say, "voice". Voice should be given to the group of patrons who can most effectively make use of it and who cannot be cheaply protected by exit. Holmström also agrees that homogeneity of interests is a crucial facilitating factor of an effective use of voice. Maintaining a sufficient alignment of owner interests is a reason for cooperatives to constrain their activities to narrow lines of business. This may also be a serious handicap, should circumstances require something else.

Holmström continues by discussing in length the reasons for the recent restructuring wave and, in particular, the crucial role the capital market has taken in it. Although most funds are still allocated internally in corporations, the impact of the capital market has become much more significant.

Holmström argues that this is so because in current circumstances moving capital "long distances", from – say – the metal industry to telecommunication, has become more important than in the past owing to deregulation and the emergence of information technology. Capital markets in turn are better placed to make such moves for several reasons. First, markets have naturally a broader knowledge base. Second, the decisions of the market are not delayed or biased by the influence activities that often plague firms' internal decision making. Third, markets are naturally directed towards the future and are unbiased in evaluating future opportunities, and finally markets are better at experimenting because of portfolio thinking.

Given these advantages of the capital market, the greatest challenge to cooperative firms is to find alternative ways to undertake a fundamental change. The main difficulty of the cooperative to cope with this challenge is that change most probably increases tensions among the members, as it upsets established ways of behaviour and may make preferences to diverge. To overcome these difficulties may require substantial adjustments in the cooperative structures. Holmström, however, notes that cooperative constitutions can take – and have already taken as the other articles published in this volume show – many shapes and this is likely to help the adjustment process.

Sufficient homogeneity of member interests, whose importance is emphasised by both Hansmann and Holmström may be achieved in many ways. It may sometimes be quite naturally based on – even short-term – economic benefits. But, it is more probable when there is a strong commitment to the cooperative idea on the part of the members.

Member commitment and its role is analysed in the third article by Professor *Murray Fulton* from the University of Saskatchewan. Even though for instance a purchasers' cooperative can, in principle, eliminate the market failure of monopoly pricing of some product, such a cooperative may not emerge or it may not survive unless there is sufficient purchasers' commitment to the cooperative idea.

An incumbent monopolist can often undercut the cooperative's prices for a while in order to force the cooperative out of business and restore monopoly prices. To avoid this the members of the cooperative have to be sufficiently committed to using cooperative services despite short-term benefits from doing business elsewhere. Similarly, a successful operation of cooperatives requires sufficient participation of the members in the exercise of control over the management. Without commitment free rider problems could make this participation inadequate.

Commitment is a concept that links the more narrow economic arguments for the existence of cooperatives to broader sociological and political explanations of cooperative enterprises. The establishment of cooperatives late last century was, at least in part, motivated by ideological viewpoints: the existing capitalistic economic order was considered not only economically deficient from the point of view of some people but also "unfair". Organising economic activity on the basis of cooperative principles was seen by the proponents of the cooperative idea morally superior to the capitalistic firm. This sort of ideology created a strong basis for commitment to the cooperatives.

Emergence and Evolution of Cooperative Enterprises: Interpreting History

The second session of the seminar considered several examples of cooperative enterprising in order to examine in what ways different theoretical arguments about cooperatives – known today much better than earlier when cooperative principles and early practice were formulated – appear to have influenced the formation and evolution of cooperatives in different environments.

Dr *Antti Kuusterä*, docent at the University of Helsinki, currently in process of writing the centenary history of Finnish cooperative banking movement, provides an economic historian's analysis of the factors that led to the formation and growth of cooperative banks in Finland. The general ideological factor noted above was in the Finnish case supplemented by another, clearly political motivation, nationalism. Cooperatives controlled by a large number of Finns were seen as a roundabout way of strengthening the Finnish nation in the small Grand Duchy of the Russian empire, when Finland's autonomy was threatened by increased repression at the turn of the century.

Yet, in the case of cooperative banks Kuusterä emphasises the important role of the economy. Although savings banks and commercial banks had existed for decades and money was widely used as a means of exchange in the vast rural areas, where the majority of the population was still living, capital formation and with that, economic progress was clearly held back by poor access to credit. This was hampered by the small scale of individual credit needs and a risky environment to the lenders: potential lenders in towns knew very little of the borrowers in the countryside and did not consider it worthwhile to invest in information gathering or monitoring activities. Financial intermediation was plagued by problems of asymmetric information.

The cooperative bank – formed along the lines of the German rural credit movement spearheaded by Friedrich Raiffeisen – provided a solution to the problem. In the cooperatives the members knew each other, and thus the board of directors of the cooperative banks knew exactly the economic backgrounds of their borrowers and could also in enforcement rely on the social control of the village people. Yet, although handling fundamental information problems was important for the emergence of credit cooperatives, they probably had not grown very fast had they had to rely on internally accumulated funds only. This is where the state provided an important contribution. The state lent early on substantial amounts of money to the central organisation – Okobank – of the Finnish cooperative banks. Thus an economic rationale was supported by a nationalistic ideology and government intervention.

Professor *Jerker Nilsson* from the Swedish University of Agricultural Science studies in his paper how the emergence of the cooperative organisational models can be seen as reflections of the business environments. In Nilsson's taxonomy the tree main models are: the traditional cooperative model, the external-investor cooperative model and the member-investor cooperative model. The first model largely implies collective ownership and governance and is excellent when it comes to collection and primary processing of agricultural commodities. In more advanced and more capital intensive businesses the models implying individual ownership by external investors and members are better. Especially in the case of outside investors both the amount of capital and the degree of commercial thinking increases making the differentiation strategy possible. In member-investor cooperatives the members invest in tradable shares that are proportional to their deliveries to the cooperatives. The legal form is either a cooperative society ("New Generation Cooperative") or public limited company (Plc cooperative). This model is designed for a focus strategy. The number and market strength of both external-investor cooperatives and member-investor cooperatives can, according to Nilsson, be expected to increase – especially the former group.

Professor *Gert van Dijk* from Wageningen Agricultural University and Nijenrode University – Netherlands Business School studies the evolution of business structures and marketing policies in EU farmer cooperatives. He considers a co-operative as a two-layer entrepreneurial system in which the cooperative firm (c.f.) is owned, used and controlled by member firms (m.f.), and where the c.f. maximises member value or customer value. A key question is, who has the entrepreneurial lead in the cooperative system. In his paper van Dijk is mapping out the four broad strategies that European farmer cooperatives have chosen in answering the strategic and financial challenges of the modern market environment. One has been to change into an i.o.f. structure. The second has been to maintain the legal form of the cooperative at the level of the parent company (c.f., dealing with the transactions towards the members), but accepting non-members equity in subsidiaries (s.f.) and in some cases having the subsidiaries stock listed. In most cases the entrepreneurial lead has in these cases been shifted so that while the c.f. takes on a part of organising tasks, essentially the s.f. is taking care of the entrepreneurial lead. The third possibility has been the differentiating model chosen, for instance, by the North-American New Generation Cooperatives, in which the value of the shares has been directly linked to the added value for the raw material produced by the m.f.'s. The fourth model has been merging the cooperative firms cross-border.

In the last paper of this section Professor *Risto Tainio* from the Helsinki School of Economics and Business Administration deals with the strategic change in the evolution of cooperatives in an environment characterized by a transition from nationally oriented, production-driven industrial era to a global, investment-driven financial era, where the most significant change has been the restructuring of the ownership of the companies. According to Tainio Finnish cooperatives have been typical examples of companies with strong CEOs and relatively passive owners, while modern cooperatives would need both active and competent management as well as active and competent owners with governance structures which enable an active involvement of both these core groups, when necessary.

Thus one of the first challenges of Finnish cooperatives seems to be to design their governance structures in a way that serves the new demands of active owners, potential or real, by rethinking the necessity of supervisory boards and by redesigning the role and the composition of the boards of directors. The renewing of the roles and composition of the board of directors can help to keep the destinies of co-operatives in their own hands. As the new boards cannot ignore the new global reality, the simple imitation of the corporations in the leading countries may also make cooperative companies vulnerable. The challenge for cooperative boards is to create wider options and special solutions for new kinds of value creation in the future.

How will Cooperatives Cope with the Challenge of Today and Tomorrow?

The third and last session of the seminar discussed in more practical terms the current challenges faced by cooperatives and how some successful cooperatives have met them.

The first paper by Mr *Olle Hakelius* Chairman of the Board of SLR and Cerealia as well as President of Cogeca and Vice-chairman of LRF discusses the challenges faced by traditional producers' cooperatives in the rapidly changing agricultural policy environment. He argues that as agricultural policy loses importance as the main factor affecting the income to the farmers, the need for cooperatives will increase. To meet the rapid changes cooperatives have to be creative in finding solutions in the following areas:

- The decision-making processes have to be speeded up and made more transparent
- The farmer-owners as well as the people employed in their cooperatives have to become more market oriented
- Motivation for the owners of the cooperatives to invest in the market has to be created to be able to raise risk capital for market investments
- The relevant markets have to be identified and cooperative solutions created across national borders to exploit those markets to the benefit of the farmer-owners.

Mr *Jorma Vaajoki*, president and CEO of Metsä-Serla Plc, describes the evolution and rapid restructuring of Metsäliitto, the forest owner's cooperative in Finland, and discusses how the strategic needs of Finnish forest owners have been served. Metsäliitto has been transformed in a relatively short time from its original role in handling the export of logs to a diversified, yet focused, group with operations in Europe and a wide range of forest industry products marketed worldwide. The structure of Metsäliitto Group has been streamlined during the 90s so that for the moment the companies in Metsäliitto Group are amongst the major players in the specific branches it has chosen to be active in not only in Europe, but in part even on a global scale. As the forest industry is continuing to consolidate rapidly and the main challenge of Metsäliitto is to maintain its position in the industry and to be one of the survivors that come through this stormy consolidation process. In this process one key issue of Metsäliitto as a cooperative is to get the best use, as a source of competitive advantage, of its capacity of being a major European forest industry company owned and controlled by the forest owners.

The second case of Rabobank is introduced by Mr *Henk Vlessert,* corporate strategist of Rabobank Nederland. He discusses how to strike a balance in strategy and corporate governance in a cooperative organisation that comprises a large variety of different units: local cooperative banks in the Netherlands, a central organisation including Rabobank International and subsidiaries for special financial services, both national and international. Rabobank – the only bank globally with the highest financial ratings – is providing a broad range of financial services in the Netherlands and specialised financial services for food & agriculture, healthcare and financial institutions globally. Rabobank defines as its objective the provision of customer value. Rabobank aims at realising this through a distinctive orientation toward customers. Based on their expertise and the 100 years of collective experience of the cooperative organisation, the Rabobank employees try to find solutions the customer feels are appropriate. In doing this, the Rabobank organisation is regarded as a network whose core is formed by the affiliated banks.

The third case is developed by Professor *Michael L. Cook* and Dr *Constantine Iliopoulos* of the Graduate Institute of Cooperative Leadership and Agribusiness Research Institute at the University of Missouri, Columbia, Missouri, USA. The authors describe the emergence of a new form of cooperative organization – the new generation cooperative. Since 1990 in the northern part of the United States, several hundred new agricultural cooperatives with more than 2 billion dollars (US) in assets have been incorporated.

The authors argue that operating inefficiencies caused by vaguely defined property rights in traditional cooperatives created an economic environment in the United States whereby agricultural producers commenced the search for alternative collective action solutions. The paper continues by presenting the results of recent theoretical and empirical research suggesting that several forms of collective action and particularly the new generation cooperative ameliorate a number of the property rights problems of traditional cooperatives. Particularly important are the concepts of defined membership, transferable and appreciable delivery rights or equity shares, and well-defined member contracts.

The paper concludes with a detailed description of the Dakota Growers Pasta Case – a US new generation cooperative that adapts many of the clarification of property rights measures discussed in the theoretical and empirical literature. The case demonstrates the ability of individual producers to design relatively efficient cooperative organizations by improving the clarity of cooperative residual control and residual claim rights.

Concluding remarks

A popular belief has been that cooperation is long on practice but short on theory. In light of the articles published in this volume, this perception appears rather inaccurate. Recent developments in the theory of economic organisations have brought about many important insights, which make it understandable that "what works in practice can work also in principle". At the same time, theoretical work has highlighted the potential weak points of the cooperative form of enterprise, in particular the problems of heterogeneous member interests and inability to change.

The cases discussed not only show that theoretical arguments really help understand the evolution of cooperatives, but they also provide examples of the different paths cooperative enterprises have already taken to meet the often tough challenges of the modern market environment. In this regard the North American new generation cooperatives are particularly interesting, as there cooperative theory seems to directly guide practical organisational solutions – even if the Upper Midwestern U.S farmers surely were not aware of this interesting fact. ■