

2. Cooperatives Defined

2.1 Cooperative Principles

2.1.1 Cooperative Origins

Birchall (1997, 1998) traces the birth of modern cooperatives to Britain at the end of the eighteenth century. Friendly societies emerged in Britain among working class groups wanting to protect themselves against life's hazards through mutual insurance, numbering over a million by 1834. They were seen as a self-help movement, being a response to the insecurities of reliance on wage labour arising with the industrial revolution. Building societies provided a fund through which members could save towards the cost of building a house. Legislation in 1834 enabled societies to engage in any activities 'not contrary to law', meaning early manufacturing and retailing societies could also register as a special category of industrial and provident society. In 1862 they secured the same limited liability that joint stock companies – which had only become available without special legislation from 1844 – had achieved in 1855. Agricultural cooperatives developed much later. Cooperatives in the British colonies flowed from these developments, but independently evolved elsewhere. For example, housing cooperatives flourished in Norway and Sweden, cooperative banks and mutual insurers in Germany, and agricultural cooperatives in Denmark.

2.1.2 Rochdale Principles

The Rochdale Equitable Pioneers' Society was organised in England in 1844 by 28 weavers working in the cotton mills in the English town of Rochdale. Unable to afford food and household goods due to low wages and poor working conditions, they sought to achieve better buying prices for flour, oatmeal, sugar and butter by pooling their buying power. While not the first cooperative, the Rochdale Society is credited as popularising the modern cooperative model by spreading its cooperative principles, summarised in USDA (1997) as:

- 1) open membership;
- 2) one-member-one-vote;
- 3) cash trading;
- 4) membership education;
- 5) political and religious neutrality;
- 6) no unusual risk assumption;
- 7) limitation on the number of shares owned;
- 8) limited interest on investment;
- 9) goods sold at regular retail prices; and
- 10) net margins distributed according to patronage.

2.1.3 ICA Principles

The International Co-Operative Alliance (ICA) is the world's largest non-government organisation, formed in 1895 to represent cooperatives internationally. In the spirit of the "Rochdale Pioneers", the ICA adopted the following seven cooperative principles in 1995:¹

- 1) voluntary and open membership;
- 2) democratic member control;
- 3) member economic participation;
- 4) autonomy and independence;
- 5) education, training and information;
- 6) co-operation among cooperatives; and
- 7) concern for community.

In the main these principles, like the Rochdale principles, are self-explanatory. The third ICA principle means that members contribute and democratically control the cooperative's capital. They earn limited investment returns, with at least part of the cooperative capital being held in common. Surpluses are to be allocated to (among other things) benefit members in proportion to their transactions with the cooperative. The fourth ICA principle refers to the idea that cooperatives are autonomous self-help organisations.

2.1.4 US Principles

Hardesty and Salgia (2004) identify three basic cooperative principles that have been incorporated in US government regulations, and federal and state tax codes. Analogous to certain of the Rochdale and ICA principles, they are:

- 1) user-ownership;
- 2) user-benefit; and
- 3) user-control.

2.1.5 Principles Contrasted with Investor Ownership

Economic activities organised according to principles such as these tend to differ markedly from investor ownership by virtue of democratic control (instead of voting rights being proportional to investment stake),² and returns being predominantly via distributions proportional to patronage

¹ www.coop.org.

² Although Hansmann (1996, p. 15) notes that one-share-one vote (as opposed to one-member-one-vote) did not become the norm in US IOFs until the twentieth century.

rather than as a return allotted in proportion to invested capital. They also can have a wider range of objectives, for example taking in concerns for community, member education, and fostering of other cooperative organisations.

2.2 Functional Definitions

There are many cooperative definitions and no consensus on any particular definition. The ICA, for example, defines a cooperative as: “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.”³ This is clearly a very broad definition with functional as well as political elements. It also places little obvious emphasis on the fact that cooperative owners are also patrons of the organisation deriving benefits from membership in proportion to their patronage, although this is made explicit in the third ICA cooperative principle.

A less political and more functional, though still very broad, definition of a cooperative is provided in USDA (1997): “a business owned and democratically controlled by the people who use its services and whose benefits are derived and distributed equitably on the basis of use.” In this definition it is made clearer that cooperative members derive benefit from their membership as a function of the extent to which they patronise the organisation.

In each of the above definitions democratic control is emphasised. Hansmann (1996), however, notes that in many organisations in which owners are also patrons – securing returns in proportion to their patronage instead of as a return on invested capital – one-member-one-vote is often, but not always, the rule. Hence a cooperative definition that seeks to encompass the observed range of such organisations should admit of more general control options than one-member-one-vote.

Accordingly, we propose the following functional definition of a cooperative:

A cooperative is an organisation in which those who transact with (i.e. “patronise”) the organisation also own and formally control the organisation, and derive significant benefits from those transactions over and above any financial returns they derive from their investment in the organisation.

This definition captures the patronage-based returns aspect that appears to distinguish cooperatives from other forms of organisation. We distinguish formal control – or the right to control – from effective control, which can lie with others, to recognise that when organisations are managed by parties other than their owners there can be a separation between formal and

³ www.coop.org.

effective control.⁴ We make no assumption as to the specific form of formal control, which may be one-member-one-vote, one-share-one-vote, voting proportional to patronage, or some other variation. For clarity, while preserving generality, we allow for cooperatives to distribute investment-based returns to their members (we shall see this is a hallmark of NGCs), but emphasise that they must also derive at least a significant part of their total return from the organisation by way of patronage returns. It is this latter feature that particularly distinguishes cooperatives from IOFs, in which returns are distributed in accordance with investment only. While IOF owners might also patronise the firm – e.g. by working for it, selling it inputs, or buying its outputs – these types of return do not provide an impetus for ownership.

It should be noted that this functional cooperative definition makes no assumption as to the cooperative's legal form. It could be equally satisfied using a standard company that is operated cooperatively, or through some specific cooperative legal form. The distinguishing features of a cooperative are patron ownership and returns based more on patronage than from investment. Under this approach many electricity distribution companies in New Zealand can be classified as cooperative, despite their legal forms. Typically such businesses are operated through ordinary company structures, but with those companies owned by trusts. Those trusts, whose trustees are elected by distribution company customers, commonly distribute the returns from their investment in the distribution business to electricity customers either via direct payouts, or via price rebates, based on electricity consumption. The substance of such ownership arrangements is, according to our definition, cooperative, despite their particular legal form.

2.3 Comparative Legal Definitions

2.3.1 New Zealand

Main Legislation and Application

Recognising that cooperative activities can exist regardless of their particular legal form, in New Zealand as in many other countries explicit legislation has been enacted to create distinct legal cooperative structures. This most notably takes the form of the Co-operative Companies Act 1996, which serves as a companion act to New Zealand's general Companies Act 1993, as well as the Industrial and Provident Societies Act 1908. Each piece of legislation is discussed below, followed by a brief summary of tax provisions relevant to cooperatives and mutuals such as IPSs, as well as a comment on the application of international financial reporting standards (IFRS) to cooperatives. We also briefly touch on the application of securities laws to cooperatives in New Zealand, and agriculture-specific legislation having implications for agricultural cooperatives, namely the New Zealand Horticulture Export Authority Act 1987, and Commodity Levies Act 1990.

⁴ See, for example, Fama and Jensen (1983a, 1983b).

For reference purposes, the New Zealand Co-operatives Association (NZCA) as at May 2005 had 49 members, with legal forms as follows:

- 1) Co-operative companies – 35 members, including New Zealand’s largest company, dairy processor and marketer, Fonterra Co-operative Group Limited;
- 2) Industrial and provident societies – 11 members, most of which are involved in trades and retail services;
- 3) Companies registered under the Companies Act 1993 – two, including grocery retailer, Foodstuffs (Auckland) Ltd; and
- 4) one each are registered under the Incorporated Societies Act 1908 (pipfruit growers’ association, Pipfruit New Zealand Inc.) and the Mutual Insurance Act 1955 (rural financial services provider, Farmers’ Mutual Group).

Co-operative Companies Act 1996

The purpose of the Co-operative Companies Act is to allow cooperative owners to conduct business on a mutual basis, where they engage in “co-operative activity”. It defines a “co-operative company” as being:

- “(a) A company, the principal activity of which is, and is stated in its constitution as being, a co-operative activity and in which not less than 60 percent of the voting rights are held by transacting shareholders:”

Section 3 of the act defines “co-operative activity” as being one or more of the following activities, conducted either directly or indirectly:

- “(a) Supplying or providing the shareholders of the company with goods or services, or both:
(b) Supplying or providing the shareholders of the company’s holding company with goods or services, or both:
(c) Processing or marketing goods or services, or both, supplied or provided by its shareholders:
(d) Processing or marketing goods or services, or both, supplied or provided by the shareholders of its holding company:
(e) Entering into any other commercial transaction with the shareholders of the company:
(f) Entering into any other commercial transaction with the shareholders of its holding company:
(g) Supplying or providing goods or services, or both, that are ancillary to, or that otherwise facilitate, the carrying on by the company or its holding company of a co-operative activity referred to in any of paragraphs (a) to (f) of this subsection.”

Section 4 defines a “transacting shareholder” as a shareholder that, having regard to the nature of the co-operative activity carried on by the company, does one or more of the following:

- “(a) Supplies or provides goods or services to the company or, having ceased to provide goods or services to the company, is, in the reasonable opinion of the directors of the company, likely to resume doing so:
- (b) Purchases or acquires goods or services from the company or, having ceased to purchase or acquire goods or services from the company, is, in the reasonable opinion of the directors of the company, likely to resume doing so:
- (c) Enters into other commercial transactions with the company or, having ceased to enter into other commercial transactions with the company, is, in the reasonable opinion of the directors of the company, likely to resume doing so:
- (d) Has incurred an obligation to do an act referred to in any of paragraphs (a), (b), and (c) of this subsection.”

A company registered under the Companies Act can only use the term “co-operative” in its name if it is also registered under the Co-operative Companies Act, but a co-operative company so registered is not obliged to use that term. Such a registration allows the co-operative company to have shares with a nominal value, and to issue (including from reserves), or accept surrender of, shares at that nominal value – features not provided for under the Companies Act. Special provisions are made enabling shareholders to seek to surrender their co-operative company shares – including a right to surrender where they cease to be a transacting shareholder during a specified period, or lose their capacity to be a transacting shareholder. A co-operative company can also seek the surrender of a shareholder’s shares in certain circumstances, and hold shares for future allocation without those shares being cancelled for tax purposes. Only transacting shareholders may vote on co-operative company resolutions, unless the company’s constitution specifies otherwise.

The act also modifies provisions of the Companies Act which would otherwise impede cooperative activity. Importantly a co-operative company may give its transacting shareholders rebates unless its constitution provides otherwise, which reverses the Companies Act provision that requires a board resolution for shareholder discounts to be offered on the company’s goods or services.

Co-operative companies must provide the Companies Office with an annual board resolution confirming that the company has carried on its co-operative activity in the reporting period. It must provide shareholders with an annual report and hold an annual shareholder meeting. It must also have its accounts audited, and file an annual return, along with those audited accounts, with the Companies Office. In other respects a co-operative company is equivalent to a company registered under the Companies Act.

Industrial and Provident Societies Act 1908

The Industrial and Provident Societies Act also enables the formation of an organisation for the mutual benefit of its members, where they carry on an industry, business or trade (other than banking). In contrast to the Co-operative Companies Act, which is silent on cooperative purposes, the primary purpose of an IPS must not be for the profit of its members, although an IPS can still make distributions to its members (generally related to their participation in the society). Also, under a 1939 amendment to the act, an IPS must be either “a bona fide co-operative society”, a society where its activity “will improve the conditions of living or the social well being of members of the working classes”, or be for “community benefit”. Voting rights in IPSs are generally one-member-one-vote, which is a restriction not apparently shared with co-operative companies. An IPS thus has many of the characteristics of a co-operative company, but faces additional requirements and constraints.⁵

Cooperative and IPS Taxation

In terms of taxation, co-operative companies and IPSs enjoy no preferential treatment vis-à-vis ordinary companies. Income from members and non-members is treated as the cooperative’s gross income, with certain rebates treated as deductible expenses to the cooperative and assessable income in the hands of their recipients. Like companies, co-operative companies can attach imputation credits and dividend withholding payments to non-deductible rebates and non-cash rebates, eliminating the double-taxation of cooperative income streams at the member level. IPSs suffer an apparent disadvantage in this regard, but given their not-for-profit constraint this should not prove a disadvantage in practice.

International Financial Reporting Standards (IFRS)

One issue deserves special mention in the New Zealand context, being the country’s move to adopt IFRS by 1 January 2007. New Zealand’s Co-operative Companies Act provides for owner-patrons to redeem their cooperative capital – more formally, to “surrender shares” – at their discretion in some circumstances. Under IFRS this requires such capital to be classified as debt rather than as equity. While the substance of a New Zealand cooperative’s capital structure is not altered by such a treatment – financiers will continue to assess the bankability of cooperatives on the strength of their cash flows and expected share surrenders – it does alter its legal form (affecting, for example, how the solvency test under the Companies Act 1993 is applied, raising liability issues for cooperative directors). It should be pointed out that even the shareholders of an IOF can discretionarily redeem their equity capital simply by liquidating their company, so the economic substance of cooperative and IOF equity is not entirely dissimilar in this regard.

⁵ A comparison of the Co-operative Companies Act and Industrial and Provident Societies Act is provided in *Co-operative Organisations: Establishing a Co-operative Company or Industrial & Provident Society*, available at www.companies.govt.nz.

However, this technical matter under IFRS may have real economic implications for cooperatives, possibly warranting changes to IFRS, or to New Zealand companies and other relevant laws to modify their application in the light of the current IFRS implications.

Securities Law

Since cooperatives issue financial securities, such as shares and debt, they must comply with relevant securities legislation. In recognition that investment in cooperatives is often incidental to the primary motivation for owner-patrons to join a cooperative – to benefit from the services it offers – cooperatives enjoy certain exemptions from securities law requirements.⁶ These are mainly aimed at reducing cooperatives' costs of complying with securities law requirements, for example enabling the issuance of "evergreen" prospectuses. Where cooperatives issue debt or other securities that are listed on New Zealand's dominant, regulated stock exchange, NZX, they must also comply with additional securities law requirements, such as continuous disclosure requirements and restrictions on insider trading.

New Zealand Horticulture Export Authority Act 1987

This legislation creates a form of de facto producer marketing board structure for horticulture exporters. It imposes an export licensing scheme in the event that specified government ministers determine that this would be in the interests of the export marketing of a particular horticultural product, should the producers of that product seek such a determination. If horticultural products become prescribed under the Act, then their exporters must be licensed, and (among other things) the Horticulture Export Authority (HEA) works with industry to develop an export marketing strategy to which all licensed exporters must comply (subject to possible exemptions). The Authority's primary function under the Act is to promote the effective export marketing of horticultural products. Given its coordinating functions, ability to levy producers, and governance mainly by industry, the HEA can be construed as a form of marketing cooperative, albeit potentially imposed rather than voluntary (since consent is not required of all industry members before a horticultural product can be prescribed). As such, it either competes with or displaces cooperative organisations that might otherwise be formed, or enables cooperative-like coordination where cooperative formation would not otherwise be economic. It enjoys at least one statutory preference relative to cooperatives, in that the HEA is exempt from income tax. Accordingly – at the margin – its existence, or the threat of its intervention, may discourage cooperative formation in horticultural products.

⁶ Securities Act (Co-operative Companies) Exemption Notice 2002, www.sec-com.govt.nz. Similar exemptions apply to IPSs under the Securities Act (Industrial & Provident Societies) Exemption Notice 2002.

Commodity Levies Act 1990

Similar to the HEA legislation, this Act provides a means of coordinating industry activities in specified spheres, as might a cooperative (if it could be formed). It is intended to allow the imposition of levies to finance “industry good” activities for which voluntary funding would lead to a “free rider” problem (i.e. which assumes an ownership solution, such as through the formation of an IOF or cooperative, would not suffice). Unlike the HEA legislation a referendum of affected parties is required, in which at least half of those affected must favour the imposition of a levy for the relevant activities. To a lesser degree than the HEA legislation – but potentially across a wider range of sectors (i.e. other than just horticulture) – this legislation can also compete with or displace cooperative organisations, discouraging their formation. Alternatively, it facilitates the development of a cooperative-like solution, at least in the relevant activities, where cooperative formation is infeasible.

2.3.2 Other Jurisdictions

Cooperative laws from a sample of other jurisdictions reveal many similarities, and some differences, with New Zealand cooperative law. We have focused on a selection of countries sharing New Zealand’s English law origin (Australia, Canada, South Africa, UK and the US), that are export competitors (Argentina, Chile), or are countries where cooperatives are a prominent form of organisation (Italy, Denmark, Germany and Spain).

Special Cooperative Legislation, Policy Stance and Taxation

Countries with a federal structure, such as Australia, Canada and the US, tend to combine federal legislation for cooperatives operating across states or provinces with state- or province-level cooperative legislation for those operating within a state or province. In the US the 1922 Capper-Volstead Act facilitated cooperative development, allowing cooperative members to act together without falling foul of anti-trust legislation, provided they do not act anti-competitively.

Some countries have cooperative legislation only for certain cooperative types. Spain, for example, has legislation enabling worker cooperatives, in which the cooperative owners patronise the cooperative by providing their labour services. Its constitution requires public authorities to encourage cooperatives and promote them through local legislation. Curiously, the country in which cooperatives, and agricultural cooperatives in particular, are dominant – Denmark – has no specific cooperative legislation. It relies instead on Denmark’s constitutional freedom of association to enable cooperative formation. The UK enables cooperatives through its Industrial and Provident Societies Act 1965.

In some countries cooperatives face a neutral policy position, being just another type of organisation. The UK and Germany fall into this category, with the US neutral in respect of worker cooperatives. Others adopt a supportive policy stance. Canada, South Africa and the US actively support cooperative development, as do Argentina and Spain for worker cooperatives. In France and Italy, cooperatives have enjoyed privileges in terms of securing government contracts (e.g. in construction).

As in New Zealand, many jurisdictions tax cooperative returns at the member level only, eliminating the double taxation of cooperative income that would arise with cooperative- and member-level taxation of that income. In countries such as Argentina and Italy this is achieved by exempting cooperatives from taxation. In others, like the US, as in New Zealand, cooperative rebates are taxed in the hands of their recipients and are a deductible expense to the cooperative. Unlike in New Zealand (and Australia, the UK and South Africa), where ordinary companies can use dividend imputation to eliminate the double taxation of company income in the hands of shareholders, US companies do not have access to a general imputation scheme meaning that US cooperatives may enjoy a tax benefit relative to US IOFs. Other countries, such as Denmark and Germany (agricultural cooperatives) and Germany (worker cooperatives) apply a lower tax rate to certain cooperatives than that applicable to ordinary corporations, or other forms of cooperative.

Cooperative Definition and Use of the Term “Cooperative”

Cooperatives are defined in various ways depending on the relevant jurisdiction. Many have adopted cooperative principles as a basis for their definition, with countries such as Canada and Chile basing their definition on the Rochdale cooperative principles. Others, such as Australia, South Africa and the UK, draw on the ICA cooperative principles in their cooperative definition.

Cooperative legislation often enables use of the term cooperative, as in New Zealand, but in some countries a cooperative is required to identify itself as such. Countries in the latter category include Canada, Chile, Germany and South Africa.

Control Provisions

Unlike New Zealand cooperative legislation, many jurisdictions impose the requirement of one-member-one-vote, ruling out other voting schemes (e.g. voting rights also being affected by member investment or patronage levels). This is the case in Australia, Canada, South Africa and the UK, and also in Argentina, Germany and Spain (worker cooperatives). Some countries, such as Australia, South Africa and Argentina, further require cooperative shares to have a nominal value, whereas this is simply an option under New Zealand law. Moreover, cooperative shares can only be issued to members (South Africa), voting rights are restricted to members (Canada), and

no shareholder may own more than 20% of issued shares (Australia). Such limitations – not required under New Zealand cooperative law – favour traditional cooperative forms over more recent variants.

Like New Zealand, however, many jurisdictions allow cooperatives to issue equity securities to non-members, and to appoint non-members to their boards of directors. In New Zealand this includes the issuance of voting shares to non-members provided that no less than 60% of voting rights are held by transacting shareholders.

New Zealand Compared

New Zealand's main cooperative-specific legislation, the Co-operative Companies Act, is similar to that in other jurisdictions, albeit with less reference to cooperative principles than in many other countries. Cooperatives – like IPSs – are permitted and facilitated, but face no particular preferences relative to other organisational forms, either in policy or taxation terms.⁷ Indeed, New Zealand cooperatives do not enjoy access to subsidies and other assistance that their counterparts enjoy in countries such as Canada and the US, but face comparable treatment to those in the UK. New Zealand's legislation is more flexible than that in some jurisdictions, favouring no particular form of cooperative over another, and enabling innovations in cooperative design while preserving cooperative status.

2.4 Features and Criticisms of Traditional Cooperatives

2.4.1 Features

Traditional Cooperatives versus IOFs

Chaddad and Cook (2002) present an ownership rights typology of cooperatives, with the traditional cooperative at one extreme, the IOF at the other, and five intermediate cooperative types in between. One of these variants, the NGC, is discussed in Section 2.5, and the remaining types are discussed in Section 2.6. Chaddad and Cook identify three defining features of what they term a traditional cooperative:

- 1) Ownership rights are restricted to member-patrons;
- 2) Rights to residual returns are non-transferable, non-appreciable and redeemable; and
- 3) Benefits are distributed to members in proportion to patronage.

⁷ Official government policy regarding cooperatives in New Zealand appears to be little more than a statement of commitment to the cooperative model, and of no intention of changing cooperative legislation unless the NZCA sought such change. See "Committed to the Cooperative Model", speech by Commerce Minister Lianne Dalziel, 5 December 2003.

By contrast, the polar opposite of the traditional cooperative, the IOF, is characterised by:

- 1) Unrestricted, transferable, non-redeemable residual claims;
- 2) Shareholders not being required to patronise the firm in ways other than via investment;
and
- 3) Residual claims being freely alienable in secondary capital markets, and being rights in net cash flows for the life of the firm.

With these contrasts in mind, we can examine the defining features of a traditional cooperative in greater detail.

Residual Rights of Control

In a traditional cooperative ownership is restricted to those who patronise the organisation – either by supplying it with inputs, such as milk from dairy farms, or labour services in worker cooperatives, or by buying its outputs, such as fertiliser from an agri-chemicals cooperative. Following the property rights approach of Grossman and Hart (1986), ownership is taken to mean residual rights of control, or the ability to determine how the organisation is to operate when its various contracts do not completely specify what it must do in each state of the world (i.e. where contracts are incomplete).

This suggested feature of traditional cooperatives in practice means that the right to vote for the cooperative's directors, even to be a director, and to vote on major cooperative resolutions at shareholder meetings, can only be held by owners who patronise the cooperative. Moreover, traditionally such voting rights have accrued to cooperative owners on a one-member-one-vote basis. These features are to be contrasted with IOFs, in which multiple classes of shareholder are possible, each with voting rights to some degree, and where voting rights are typically assigned on a one-share-one-vote basis.

An important implication of this feature is that traditional cooperatives traditionally have constrained access to equity capital, being able to raise it only from owner-patrons. Capital is raised directly from owner-patrons, via accumulated retained cooperative earnings, or by making capital charge deductions from patronage returns. IOFs, by contrast, can access equity capital simply by issuing new shares to investors.

Residual Return Rights

Residual return rights refer to the rights of owners to receive any surplus generated by the cooperative once its committed or contracted payments have been met. In the case of traditional cooperatives, this right is expressed in terms of the right to receive some share of the cooperative's surplus, where that share is determined on the extent to which the relevant owner has patronised the cooperative. For example, if a cooperative has generated an excess of revenues over expenses, it may retain some proportion of that surplus for investment or other future requirements, and pay any balance to its owner-patrons as a patronage-based return. In a dairy cooperative, for instance, an owner-patron might receive an end-of-season payout based on its relative share of milk-fats supplied to the cooperative that season.

In a traditional cooperative the right to receive such a payout is tied to an owner-patron owning a share or shares in the cooperative. Conventionally these shares have had nominal values, being simply a form of "entry right". Unlike shares in an IOF, members can seek to redeem their interest in the cooperative, requiring the cooperative to repay some amount reflecting the member's contribution to the cooperative. The redeeming member may or may not participate in any accumulated surpluses that the cooperative has generated, depending on the cooperative's constitution or rules. It is unusual, in traditional cooperatives, for the amount paid on such redemption to reflect the current market value of cooperative membership, or the present value of expected future cooperative net cash flows. In this sense the value of these residual return rights are not "appreciable". Where the cooperative accumulates reserves that are not allocated to particular owner-patrons, instead of this accumulating value being reflected in the value of owner-member cooperative shares, they form a pool of equity that is essentially a "commons", or "common property" – being cooperative value not attributed to its owners (except, perhaps, on liquidation or demutualization, when there is typically debate about ownership).

In an IOF, by contrast, shareholders typically have no right to demand that the company redeems their shares. But IOF shareholders can typically sell their shares, and if they do so they would usually expect the consideration received to reflect the present value of the company's future expected net cash flows. Moreover, in an IOF an ownership claim is a proportional claim to the firm's future expected net cash flows over the life of the firm. In a traditional cooperative the right to the cooperative's residual cash flows is tied to ongoing patronage, typically by an individual. Thus traditional cooperative residual return rights cannot be transferred to third parties, and they have a finite horizon tied to the owner-patron's patronage instead of the life of the cooperative.

Patronage-Based Returns

The final feature of traditional cooperatives reflects common cooperative principles. Since those joining a traditional cooperative often pay only a nominal sum for the share or shares they must

acquire in order to become a cooperative member – as opposed to the true market value of a proportional ownership stake in the cooperative – they commonly derive little by way of return on their investment. This feature is exacerbated by the fact that membership is open in traditional cooperatives, meaning new owner-patrons can join the cooperative and access the benefits it offers without paying the full value of their entry. Conversely, in an IOF a joining shareholder would typically pay the market value of any shares they buy, and since they receive little by way of returns from their company based on their patronage of the company (which may be nil), they would usually expect to receive a market rate of return on their entire investment sum.

Thus in a traditional cooperative the economic returns to ownership are derived by sharing in the cooperative's surplus (if any), which conventionally is tied to the owner's level of patronage of the cooperative. In a cooperative that the owner supplies, the owner expects to receive a price on its supplies – including any patronage-based share of the cooperative's surplus – in excess of what they would receive by selling their supplies to others. Where the owner makes purchases from the cooperative, it would expect to pay a price for those items – net of their share in the cooperative's surplus – that is less than that they would expect to pay to third parties.

2.4.2 Criticisms

Cook (1995) and Cook et al. (2004b) summarise five key criticisms made of traditional cooperatives. These criticisms arise because the residual rights of control and residual return rights are poorly aligned in such cooperatives. Notably many of these criticisms tend to arise to a lesser extent (if at all) in respect of IOFs, where voting rights on shares and the right to participate in a firm's residual cash flows are commonly (but not always) proportional to the number of the company's shares that a shareholder holds, and hence aligned. Each of the five key criticisms is discussed below. In many respects these are simply applications of established economic and financial theory to features that happen to coincide in traditional cooperatives.

Free Rider Problem

An *external* free rider problem arises in traditional cooperatives, where the nature of their ownership claims means that the benefits and costs faced by cooperative members and non-members are poorly aligned. For example, where a cooperative is successful in shifting the market price and terms for the inputs that its owners supply towards competitive levels (i.e. in an industry otherwise lacking competition), other non-member suppliers may get to enjoy the same price and terms without paying for membership. The same, of course, can be said where an IOF with market power sets prices and its competitors follow its pricing lead.

Conversely, an *internal* free rider problem arises where new members of the cooperative enjoy the same patronage returns as existing members, or can access the cooperative's capital without paying the full cost of the benefits they derive (i.e. where the cooperative's capital involves an element of "common property," and/or cooperative shares are not priced at market value). If new members can join the cooperative without paying the full costs of their membership – because the price they pay for their cooperative shares does not reflect, for example, extra capital investments the cooperative may need to make to process the extra patronage they bring it – then other cooperative members effectively subsidise their entry. This dilution of existing member returns creates an intergenerational conflict between new and old members, and a disincentive for older members to invest in the cooperative. It also exposes the cooperative to takeover by third parties prepared to realise some of this common property equity, particularly if cooperative members can be tempted to trade patronage benefits for the realisation of accumulated equity that was potentially created before they even joined the cooperative.

Horizon Problem

This problem arises when the owner-patron's claim on the cooperative's residual earnings is short-lived compared to the productive life of the cooperative. It results because the owner-patron's ownership claims cannot be traded at market value, being tied to its patronage of the cooperative. Hence the value of any long-lived investments the cooperative makes is not fully reflected in the owner-patrons' ownership claims, particularly where the investments involve intangibles assets, creating a disincentive to invest (e.g. in R&D, brand development, etc). In an IOF, by contrast, the value of long-lived investments is in principle fully reflected in the firm's share price, and so an investor does not forfeit that value simply by choosing to sell out of the firm.

Portfolio Problem

The inability of owner-patrons of traditional cooperatives to separate their ownership and patronage decisions gives rise to a "tied-equity" problem. While their risk preferences might dictate that they diversify their investment portfolio risk by selling some or all of their ownership claims in the cooperative, they are unable to achieve this due to the requirement to bundle ownership and patronage. They benefit from any extra returns created from their patronage, but otherwise are confronted by a sub-optimal investment portfolio allocation, bearing more risk or generating less return than they would otherwise prefer. This in turn means cooperatives face pressure from their owner-patrons to adopt investment policies that mitigate this owner-level lack of diversification, even when this is not optimal for the cooperative activity itself.

Control Problem

Traditional cooperatives lack some of the means available to IOFs for mitigating the problems arising when there is separation between an organisation's owners and those who manage the organisation on their behalf (i.e. managers) – the classic principal agent problem.⁸ Because of this separation it is predicted that the interests of owners and managers will diverge, giving rise to agency costs from mechanisms to minimise these divergences (e.g. costs of monitoring mechanisms), and from the inability of owners to perfectly align their managers' interests with their own (e.g. through incentive-based remuneration tied to hard-to-measure value creation). Particularly due to the lack of transferable ownership claims with an observable current market value, cooperative owners lack important mechanisms for monitoring manager performance enjoyed by some (i.e. listed) IOFs, and means to enable managers to share in cooperative returns so as to align their respective interests. Additionally, where cooperative voting is restricted to one-member-one-vote this hampers the formation of owner blocs with concentrated interests, which blocs are often found to provide useful governance disciplines on management. Such control problems are predicted to worsen with cooperative size and complexity.

Influence Costs Problem

The wider a cooperative's range of activities, or the greater the heterogeneity among its members, the greater the scope for the interests of its owner-patrons to diverge. This in turn gives rise to incentives for interest groups to form and seek to influence the cooperative's operation to their benefit and at other owners' expense. Banerjee et al. (2001) present evidence on the costs of such behaviour in Indian sugar processing cooperatives, where larger owners face an incentive to reduce the price paid on inputs, to the detriment of smaller suppliers, instead securing benefits from the cooperative in other ways (e.g. influencing cooperative contributions to community projects so as to increase their personal prestige).

2.5 The New Generation Cooperative (NGC)

Many of the criticisms levelled at traditional cooperatives are resolved with variations to the nature of cooperative ownership claims, and certain other variations. This can be achieved while preserving other important cooperative features, such as patronage-based returns. For example, in the 1990s a new form of cooperative – the so-called new-wave, or new generation cooperative (NGC) – quickly gained popularity in the US agricultural sector. Its popularity has spread, with the model being adopted elsewhere, including in New Zealand.⁹ This section examines NGCs and

⁸ See, e.g. Jensen and Meckling (1976), Fama and Jensen (1983a, 1983b).

⁹ For example, Tatua Co-operative Dairy Company – see Ohlsson (2003).

explains how their particular features help to resolve the problems commonly attributed to traditional cooperatives.

Nilsson (1997a) characterises the most prominent features of NGCs, distinguishing them from traditional cooperatives, as:

- 1) Delivery contracts setting out members' rights and obligations to deliver products of a specified quality and quantity; and
- 2) Closed or restricted membership, or even selected membership.

Other NGC distinctives are argued to flow from these, representing an integrated whole:

- 1) *Production-related distinctives* – NGCs are market driven and focussed on “value-added” processing. To reduce costs or improve quality they often place extra requirements on producers, such as demanding certain grower practices. They require sufficient scale to be significant players in their market, and use efficient production techniques. Members must pay for any shortfalls on contacted delivery amounts or quality.
- 2) *Ownership-related distinctives* – producers must make sizeable capital investments to fund value-added processing facilities, with shares being linked to units of production. Member equity usually makes up 40 – 50% of capital, with the balance financed from banks. Membership is closed, with shares tradable among members at share values that vary along with the cooperative's prospects.¹⁰ Such tradability makes the NGCs equity permanent, which means banks offer financing on more favourable terms. New shares are sold if equity is required for expansion, or in proportion to delivery volumes where equity is required for other purposes. *Profits are distributed as patronage refunds, but since patronage and investment are proportional, this amounts to proportional dividends on invested capital.* Non-voting securities can be sold to non-members also.
- 3) *Management/Control-related distinctives* – NGCs apply one-member-one-vote, despite investments being proportional to patronage. Heterogeneity among members is reduced by NGCs operating in narrow business fields (versus other agricultural cooperatives often diversifying). Directors are chosen from among members. Senior management are professional and high quality, and advice is taken, with thorough feasibility studies before NGC establishment.

¹⁰ Typically such share trading is not as free or transparent as listed IOF shares, with board approvals sometimes required for transfers, and share prices set at assessed rather than open-market values.

According to Nilsson (p. 4): “The NGC model is constructed in such a way that the agency theoretical problems are not higher than in comparable [IOFs] but rather lower.” This suggestion is consistent with the observations in Hansmann (1996), who argues that even traditional cooperatives enjoy such an advantage over IOFs.

Nilsson further argues that NGCs resolve common traditional cooperative problems as follows:

- 1) *Horizon problems* – removed by tradable shares: members thus focus on maximising the present value of long-term NGC net cash flows;
- 2) *Free-riding and common property problems* – are reduced since value of unallocated capital is reflected in tradable share prices, and investment/patronage signals are not distorted by artificially setting equity values as in traditional cooperatives;
- 3) *Portfolio problems* – are minimal because NGCs’ narrow business focus reduces conflicts over investment policy, members are fairly homogeneous and projects are thoroughly scrutinised before NGC establishment.

Finally, Nilsson argues that NGC membership tends to consist of the best farmers, (p. 5): “Less efficient members will find that the sale value of their shares exceeds the profits they can make by remaining on as suppliers, while more efficient farmers will find it profitable to pay a higher price for the same shares.”

2.6 A Cooperative Typology

Chaddad and Cook (2002) provide an ownership rights typology of cooperatives to illustrate where five non-traditional forms of cooperative, such as the NGC, fit within the spectrum bounded at one end by traditional cooperatives, and at the other by IOFs.

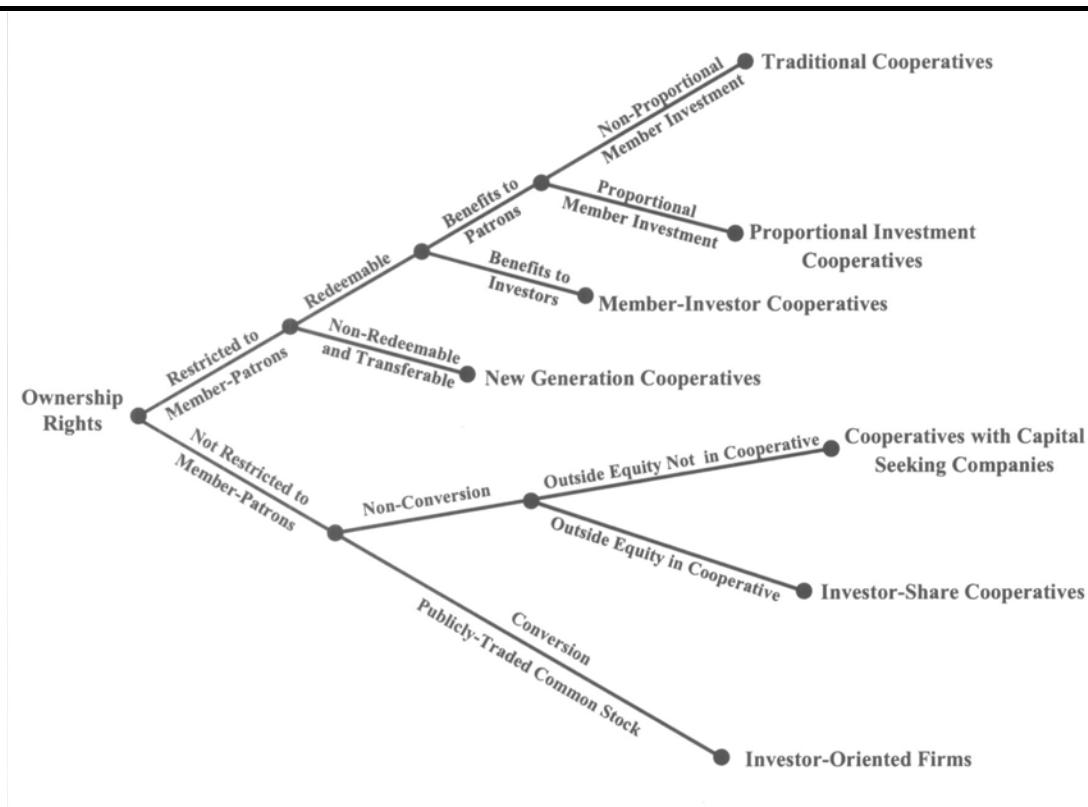
Figure 2.1 portrays the suggested spectrum of cooperative types. The upper branch of the figure characterises three non-traditional cooperative models in which ownership rights – as in traditional cooperatives – are restricted to owner-patrons. In the lower branch there are two more non-traditional cooperative types, this time allowing non-owner patron ownership and outside equity at either the cooperative or some subsidiary level.

The five non-traditional cooperative types can be characterised as follows:

- 1) *Proportional Investment Cooperatives* – differ from traditional cooperatives in that owner-patrons are required to invest in proportion to their patronage;

- 2) *Member-Investor Cooperatives* – owner-patrons receive returns in proportion to both patronage and investment, with either dividend payments in proportion to shareholdings, or by allowing appreciable share values;
- 3) *New Generation Cooperatives* – ownership rights remain restricted to owner-patrons, and in fact to specific owner-patrons, but are both appreciable and transferable. In addition, owner-patrons are required to patronise the cooperative in proportion to their investment;
- 4) *Cooperatives with Capital Seeking Companies* – allow non-patron equity participation, enabling access to outside capital, but restrict this participation to be via subsidiary companies, strategic alliances, etc, rather than directly in the cooperative; and
- 5) *Investor-Share Cooperatives* – allow direct non-patron equity participation in the cooperative itself, usually involving the issuance of multiple classes of financial instrument (such as non-voting, or “investor” shares).

Figure 2.1 – Cooperative Ownership Rights Typology



Source: Chaddad and Cook (2002).

The first three of the five models, like traditional cooperatives, preserve patron control of the cooperative at the expense of restricting the cooperative's access to external capital (other than

non-voting capital, although equity constraints can limit cooperatives' bankability). The latter two reverse these tradeoffs, enabling access to external capital – importantly equity capital (which then enhances the cooperative's debt capacity) – but at the expense of ultimately diluting patron control to some degree. Chaddad and Cook suggest that the latter two non-traditional cooperatives carry an inherent tension – in that different owner classes will have conflicting objectives regarding profit maximisation and patronage return maximisation. Conversion to an IOF represents an “exit” away from the cooperative model.

2.7 Cooperatives in New Zealand Agriculture

With the functional and legal definitions of cooperatives in mind, as well as the range of cooperative arrangements that might be adopted, it is useful for later sections to set out a snapshot of the types of cooperative activities relevant in New Zealand agriculture.

Worker cooperatives are not a significant feature in New Zealand, as they are in countries such as Spain and Argentina. Nor are bargaining cooperatives, which have a significant presence in the United States, and through horizontal integration seek to secure better prices and terms for agricultural producers in their dealings with parties downstream in the agri-food supply chain. In each case this is possibly a reflection of peculiarities of each of these countries, such as the anti-trust exemptions afforded to bargaining cooperatives under the Capper Volstead Act in the US.

Other cooperative types common overseas are also relevant to New Zealand agriculture. These combine some or all of the following activities:

- 1) *Handling* – such as warehousing storable farm outputs like grain or wool, or perishables such as pipfruit in coolstores;
- 2) *Processing* – purchasing farm outputs for processing into either commodity or more refined consumer products, particularly where processing requires large capital facilities and/or farm outputs are highly perishable, both of which can expose farmers to any market power held by third party processors;
- 3) *Marketing* – particularly where farm outputs are storable and/or not significantly processed for ultimate sale, possibly offering pooling and staged selling to reduce risk when market price are volatile, avoid market flooding, negotiate better selling prices and/or to secure economies of scale in marketing and brand/market development;
- 4) *Farm supplies* – particularly, but not exclusively, for specialised farm goods or services which might not otherwise be available, where the quality of critical inputs (such as

stock genetics) or specific farm attributes (such as farm lending risk or insurability) are important but hard to discern, and/or where suppliers have market dominance (such as in fertiliser supply);

- 5) *Property right development, enhancement and protection* – compensating for lack of enforceable, or insecure, property rights through cooperation to avoid over-exploitation or exploitation by third parties, for example in fisheries, and irrigation schemes;
- 6) *Advocacy and representation* – improving the interface between farmers and regulators, policy-makers and government on matters of common interest to industry members, such as in negotiating export market access (which often requires inter-governmental engagement);
- 7) *Social services delivery* – where local knowledge and/or personal relationships are important in delivering and identifying the need for social services, such as in primary healthcare; and
- 8) *Industry good activities* – such as research and development, where industry members have a common interest in the outcome but individually lack the resources or incentive to undertake such activities separately.

Specific examples of cooperatives operating across these types of activities in the New Zealand agricultural sector are provided in Section 5.

2.8 Policy Implications

- 1) New Zealand provides a relatively less-favourable legislative and policy environment for cooperatives than do many overseas counterparts (i.e. countries with English law origins, other major export competitors, and other countries where cooperatives are significant).¹¹ However the New Zealand environment is relatively neutral regarding alternative organisational forms.
- 2) New Zealand's main cooperative legislation, the Co-operative Companies Act 1996, is relatively flexible and not tied to specific cooperative principles, providing New Zealand cooperatives with ample scope to modify their particular form and objectives as needs or desires dictate.

¹¹ Indeed, the NZCA advises that the New Zealand government has opted not to introduce measures to implement the International Labour Organization's *Promotion of Cooperatives Recommendation, 2002* (www.ilo.org).

- 3) The New Zealand government has stated it is receptive to considering changes to cooperative legislation if the NZCA should recommend change, adding to the flexibility provided by current legislation. Such receptiveness may well be useful if IFRS rules are not modified to better reflect the economic substance of cooperative equity and continue to treat redeemable equity as debt, in which case amendments to legislation such as the Companies Act may be warranted (e.g. clarifying the application of the solvency test for cooperative companies).
- 4) If government sought to regulate cooperatives as a class it would face some difficulty, firstly because New Zealand has no requirements for cooperatives to identify themselves as such, and secondly because cooperatives arise functionally across a variety of legal forms.
- 5) The types of cooperative assistance offered in comparable jurisdictions create a preference for the cooperative form.
- 6) The cooperative model is subject to various criticisms (as is the IOF model, it should be noted), hence the continuing presence and even growing use of cooperatives suggests that:
 - a) There are barriers to cooperative members adopting superior ownership forms – discussed further in Section 3;
 - b) Cooperatives offer counter-veiling benefits that mean they remain a superior alternative to other types of organisation – discussed further in Section 3; or
 - c) These criticisms are poorly founded – empirical evidence is discussed in Section 4.