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Cooperative organizations and members' role : a new perspective

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Working Paper

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**Cooperative organizations and members' role:
A new perspective**

George Apostolakis^{*} and Gert Van Dijk^{**}

Working paper CIRIEC No. 2018/04

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Abstract

The theoretical structure and management of a cooperative organization have not changed much during the last decades. Most importantly, the role of the members' council in corporate governance remains neglected in the contemporary cooperative literature. In this paper, we offer a new perspective on how cooperative organizations can cope with future challenges by re-establishing the role of the members' council and the members in cooperative organizations.

Keywords: cooperative models; members' council; random selection; deliberative democracy

JEL Codes: P13; D23; D72; L30; L31

1. Cooperative Theory

Neoclassical economic theories assume, a priori, that individuals are rational decision makers and utility maximizers. By contrast, behavioral theories contend that decision makers have bounded rationality and attempt to make the best choices given the available information and their limited cognitive capacity (Cyert & March, 1963). Douma and Schreuder (2002), who provide the foundation for the behavioral theory of the firm, perceive agents as satisficers that attempt to find the most satisfactory alternative rather than being maximizers.

Olson (1965) argues that rational individuals will always seek to act as free riders in public actions. However, self-interest is not the only motivation that influences collective decision making; altruistic motives also influence decisions. Both homo reciprocans and homo economicus exist in society (Fehr & Gächter, 1998). Ostrom (1990) argues that there is a specific class of social dilemmas in which people's short-term selfish interests are at odds with long-term group interests.

Social capital entails the notions of trust and reciprocity. A well-functioning civil society requires loyalty and involvement, transparency, and reciprocity conditions (van Dijk & Klep, 2008). Social capital is an instantiated, informal norm that promotes cooperation between two or more individuals. It can be understood as networks of trust and the sine qua non of stable liberal democracy. A broader definition of social capital is shared norms or values that promote social cooperation. However, the level of social capital fluctuates over time and differs across societies (Putnam, 1995).

Fukuyama (2001) argues that, in the economic sphere, social capital reduces transaction costs and, in political sphere, promotes the type of associational life necessary for the success of limited government and modern democracy. The cause of this difference is the social capital, component of human capital, which allows individuals to trust one another and cooperate in forming new groups and associations (Coleman, 1988). Axelrod (1984) contends that even self-interested individuals often find ways to cooperate because collective restraint serves both collective and individual interests. An iterated prisoner's dilemma game offers an explanation for cooperation and a reason to form social capital (Fukuyama, 2001; van Dijk & Klep, 2005). While social capital often arises spontaneously as in prisoner's dilemma games, it also is a byproduct of religion, tradition, shared historical experience and other types of cultural norms (Fukuyama, 2001).

2. Cooperatives

A cooperative is a member-owned, member-controlled, and member-benefit organization. The International Co-operative Alliance (ICA) offers the following definition: “A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically-controlled enterprise.”¹ The core values of cooperatives are self-help, self-responsibility, democracy, equality, equity, and solidarity. The nature of the cooperative firm can be defined by the ICA’s 1995 Statement on the Cooperative Identity and the Rochdale Principles:

1. Voluntary and open membership
2. Democratic member control
3. Member economic participation
4. Autonomy and independence
5. Education, training and information
6. Cooperation among cooperatives
7. Concern for community²

According to the US National Cooperative Business Association, members form cooperatives when the marketplace fails to provide needed goods and services at affordable prices and acceptable quality. Cooperatives empower people to improve their quality of life and enhance their economic opportunities through self-help. “A cooperative can be defined as an economic organization whose residual claims are restricted to the agent group that supplies patronage under the organization’s nexus of contracts (i.e., the member-patrons) and whose board of directors is elected by this same group” (Vitaliano, 1983, p. 1079).

Nilsson (2001) notes that cooperative business has been studied from several theoretical perspectives: institutional theory, neo-classical economic theory, transaction cost theory, game theory, property rights theory, and agency theory. Viewed from an agency theory perspective, following Jensen and Meckling (1976), members are considered the principal and the board/supervisor the agent (Douma & Schreuder, 2002). Three main factors characterize this relationship: asymmetric information, opportunistic behavior, and partial supervision. Cook (1995) and Iliopoulos (2005) posit that cooperatives face two sets of constraints, generally referred to as agency

¹ <http://ica.coop>, What is a co-operative? (ICA, 2016).

² <http://ica.coop>, Co-operative identity, values & principles.

theory problems, such as investment constraints and collective decision-making constraints. The first set of constraints includes the free rider, horizon and portfolio problems, while the latter refers to the control and influence cost problems. van Dijk and Klep (2005) cite anonymous equity, the horizon problem, the portfolio problem, and the follow up problem as the problems related to agency theory.

3. Cooperative Models

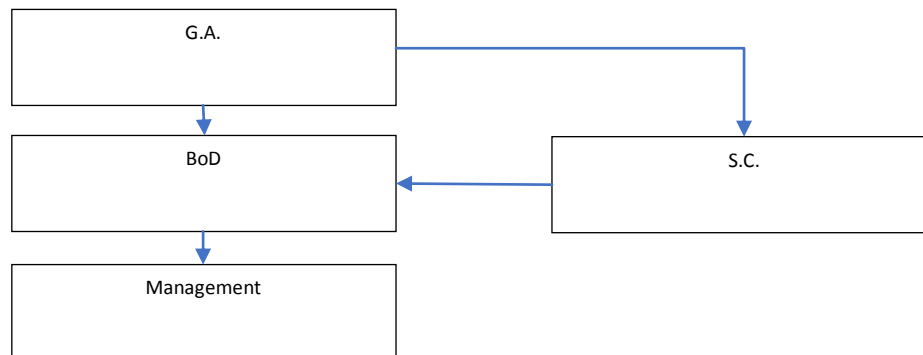
Chaddad *et al.* (2002) posit that cooperative models are defined by a set of organizational attributes, including ownership structure, membership policy, voting scheme, governance structure, characteristics of residual claims, distribution of benefits, and competitive strategy. Cook (1995) proposes the following taxonomy for cooperatives: Farm Credit, Rural Utilities, Sapiro I (Bargaining Cooperatives), Sapiro II (Marketing Cooperatives), Nourse I (Local Supply and/or Marketing), Nourse II (Regional Supply and/or Marketing), and New Generation Cooperatives. Hansmann (1996) elaborates on transaction cost theory and draws parallels with the desired forms of ownership. Chaddad and Cook (2004) analyze the emergence of five nontraditional cooperative models from an ownership rights approach, control rights and corporate governance. Chaddad and Iliopoulos (2013) extend and build on Hansmann's theory of ownership by examining property rights under different governance structures.

Cook (1995) suggests the formation of a new generation cooperative (NGC) in the third transitional option of cooperatives in stage 5, i.e., exit, continue, and transition, and classifies it as the Sapiro III value added cooperative. In the NGC model, ownership rights take the form of tradable and appreciable delivery rights restricted to current member-patrons. The advantage of this model is to give incentives to members to contribute risk capital to the cooperative, while the success of the model depends on the demand in and the proper functioning of the secondary market for the delivery rights (Chaddad & Cook, 2004). According to Chaddad and Iliopoulos (2013) in NGCs, which generally adopt the extended traditional governance model, the costs of managerial opportunism seem to be partially mitigated by the monitoring effects of the secondary market for delivery rights.

The general assembly chooses the members of the board, and the financial control committee and has the power to replace them. Members of the board and the financial control committee are nearly always members of the members' council. One explanation is that their own financial interest coincides with that of the other members (Hendrikse & Veerman, 1997).

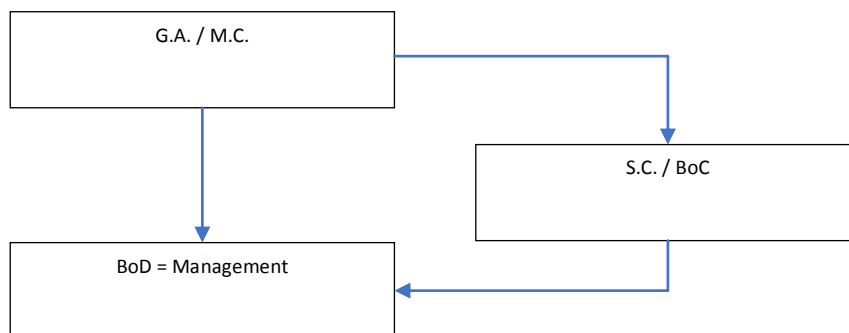
Bijman *et al.* (2013) discuss changes in corporate governance by presenting three models and focusing primarily on the role of the board of directors (BoD). They identify three corporate governance models: traditional, management and corporation. Direct participation of members in decision making is generally confined to approving major structural changes, such as merger and dissolution (Feng & Hendrikse, 2008).

Figure 1 - Traditional model



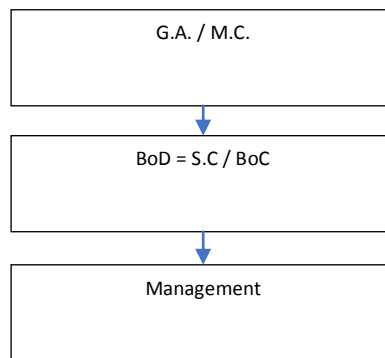
Note: Cooperative model of governance, G.A = general assembly, BoD = Board of directors, S.C = Supervisory committee, From Corporate Governance in Agricultural Cooperatives: A Perspective from the Netherlands.

Figure 2 - Management model



Note: Cooperative model of governance, G.A = general assembly, M.C = Members' council, BoD = Board of directors, S.C = Supervisory committee, Board of Commissioners. From Corporate Governance in Agricultural Cooperatives: A Perspective from the Netherlands.

Figure 3 - Corporation model



Note: Cooperative model of governance, G.A = general assembly, BoD = Board of directors, S.C = Supervisory committee, Board of Commissioners. From *Corporate Governance in Agricultural Cooperatives: A Perspective from the Netherlands*.

However, the role of the members' council in corporate governance remains neglected in the contemporary cooperative literature. Chaddad and Iliopoulos (2013) discuss the different governance models from a geographical perspective and examine members' control using these models. However, they do not emphasize the role of the members' council. Hendrikse (2005) examines the dominant role of members on the boards of directors of agricultural cooperatives. Bijman and van Dijk (2009) provide a description of the role of the members' council in cooperative governance. The authors find that 16 of the 30 cooperatives they study have established a members' council, primarily to have a group of members who are more actively involved in decision making than the general assembly usually is. They argue that a members' council implies a shift in the relationship between members and the cooperative that can strengthen the influence and, thereby, the commitment of members.

Bijman *et al.* (2013) identify 6 changes in the organizational governance of the Dutch agri-cooperatives. The fifth change is related to the composition of the board of commissioners/supervisory council (BoC/SC). Van Dijk (2006) finds that 26 of the 40 largest cooperatives had outside experts on the BoC/SC. This incorporation of external experts into the BoD and the BoC/SC can be seen as a trend toward greater professionalism in the governance of the cooperative.³ The sixth change in organizational governance, according to Bijman *et al.* (2013), relates to the implementation of a members' council. They argue that in large cooperatives, members are usually organized in

³ van Dijk (2006): Externe toezichthouders bij coöperatieve ondernemingen.

geographical districts, with the chairman of the district board becoming a member of the members' council.

Management and members should be engaged in a relationship of trust. This can be achieved via involving members and transparency. Management must be able to build a relationship with members and create a culture of openness by listening to what the members have to say. Management should create a culture that allows members to bring the harsh reality of everyday life from the outside to the inside. Trust and involvement are important for the sustainability and development of the cooperative.

Verhees *et al.* (2015) argue that the benefits of members' trust are "very strongly" related to commitment and loyalty. Nilsson (2001) contends that, historically, the degree of trust may have fallen as cooperatives grew and expanded, causing increased heterogeneity. Members' involvement with the cooperative is a prerequisite for spending time on the governance of the cooperative and actively participating (van Dijk & Klep, 2008; Verhees *et al.*, 2015). Österberg and Nilsson (2009) examine the level of trust and commitment to cooperatives in relation to members' perceptions regarding participation in governance. They find that differences in members' commitment to and trust in directors are due to the profitability of farm operations, age and experience as directors. The authors argue that members attach substantial importance to their participation in the democratic governance system and believe democratic control to be crucial. Finally, they suggest that cooperatives should spend resources to create a well-functioning democracy for members.

4. The Role of the Members' Council

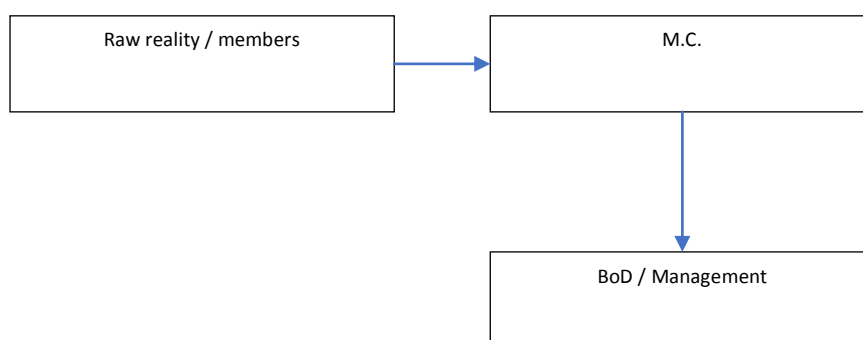
The third layer in the cooperatives is their weakness, the representation of the members: The most vulnerable element of cooperation lies in governance, especially the element of governance whereby members are given 'voice'. Often, members' councils have an unclear mission statement. The problem is that these councils are closer to the board and the company than is the traditional general assembly. The members' council is not as independent as it is supposed to be, and the agenda under discussion is influenced and sometimes predetermined. It seems that the role of the council is often subject to the will of the board and regulators.

The task of the members' council is to keep the cooperative aligned with the collective objective and not to supervise or control the cooperative. The task of the members' council is to (continuously re-) evaluate the collective objective.

The world is changing, as are the members, and that should be reflected in the objectives and principles of the cooperative. The key task of the members is therefore to disseminate their "reality" from the outside in and thereby provide the board with criteria on the basis of which government governing policies can be "tested". A discussion of objectives, especially among members, must be mutual. The members' council meeting is primarily intended to facilitate discussion among members' representatives. The members' council meeting is a matter of collecting and retrieving information that will become knowledge.

The key aspect of this is bringing the *raw reality* from the outside to the inside. To achieve this task, new procedures for appointing members of the members' council are required. Introducing this reality should not be biased by any influence, and this can be achieved by utilizing random methods in member selection and deliberative procedures in the meetings.

Figure 4



Note: Raw reality into knowledge.

5. Two Case Studies on the Members' Council

Members in a cooperative have both rights and obligations. Membership comes with responsibility. Members benefit from a cooperative and should also provide a service: taking responsibility, investing time and, above all, sharing information. For instance, at the cooperative bank 'Rabobank,' members enjoyed the benefits, but gave insufficient consideration to cooperative needs. Performance begins with the members sharing knowledge by being open about financial circumstances, which also holds the costs of the cooperative layer down. Healthcare insurers can increase awareness of their responsibilities. We can convince pension beneficiaries that the individual benefits from living healthier lives are aligned with collective benefits by decreasing healthcare costs and insurance care premiums. We can achieve this

by promoting healthier living and introducing initiatives in the field of the sports movement. As a member, by considering one's own health and being responsible for one's lifestyle, an individual can also help the collective.

5.1. Rabobank Case Study

Rabobank's members' council

The financial crisis of 2010-2012 deteriorated the financial position of European banks in particular. Governments had to bail out banks using public funds and by injecting billions in market capital. These circumstances initiated a discussion about increasing the monitoring mechanisms through new European regulation on banks. Under this new framework, the role of the ECB is strengthened and centralized.⁴ The recapitalization process also involved banks that were supposed to be market leaders. During the crisis, Rabobank maintained its dominant national market shares in savings during the crisis, despite a slight downward trend (40% in 2009 against 41% in 2007), at 36% (2013, DNB).

The Libor scandal of late 2013, which involved many large banks, including Rabobank, can be viewed from the perspective of the deteriorated role of members and the transformation of the cooperative toward behaving like a business-oriented firm. The scandal raised questions concerning the effectiveness of the organizational culture, as Rabobank operated as different divisions (Rabobank Netherlands and Rabobank International).

During 2014, Rabobank began an internal debate over its governance structure, which was partly motivated by the financial crisis and the new banking regulations that followed. The starting point was the merger of the local banks and the central Rabobank into a single cooperative 'Coöperatieve Rabobank'. Stricter supervisory rules from ECB for systematic banks were the main reason for this change. However, the outcome of this debate was more focused on adjusting to the new monitoring rules rather than being regarded as an opportunity to strengthen the role of the members.

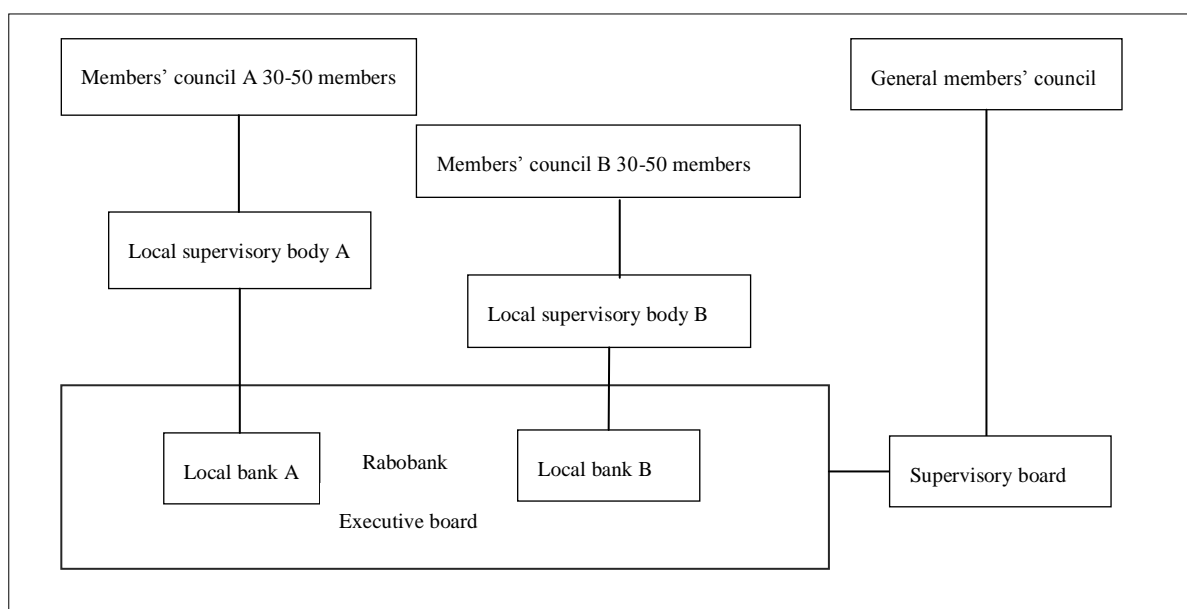
With the merger of local banks into a single unit, members of the old local banks are now members of the single cooperative, but they are now linked to 'departments'. Local assemblies from each department elect the members of the Local members' councils, consisting of 30-50 members. Each local member

⁴ A systemic bank is a bank for which bankruptcy will endanger the financial system and cause considerable damage to the real economy. Consequently, systemic banks are subject to stricter supervision by the DNB (Minister of Finance, 2011, page 16).

Rabobank has a members' council to ensure that member control and influence are strongly and structurally embedded. Members of every local bank are represented in the new general members' council by the chairman of their local supervisory body (therefore, consisting of approximately 100 members).

In January 2014, Rabobank member certificates were converted into Rabobank Certificates (RC), which are subordinated bonds that may be traded on the stock market. RC, after being issued by "Stichting AK Rabobank Certificaten," are traded in the secondary market on Euronext Amsterdam. The day after the RC were issued, members exercised their exit right, not because of a lack of trust but because the monitoring authorities classified the RC as high-risk investment products (RC have a higher risk profile and no fixed maturity date; as such, RC represent a high risk for which an adequate payment is made (6%)).

Figure 5 - Rabobank's new organizational structure



Note: Groeneveld (2016).

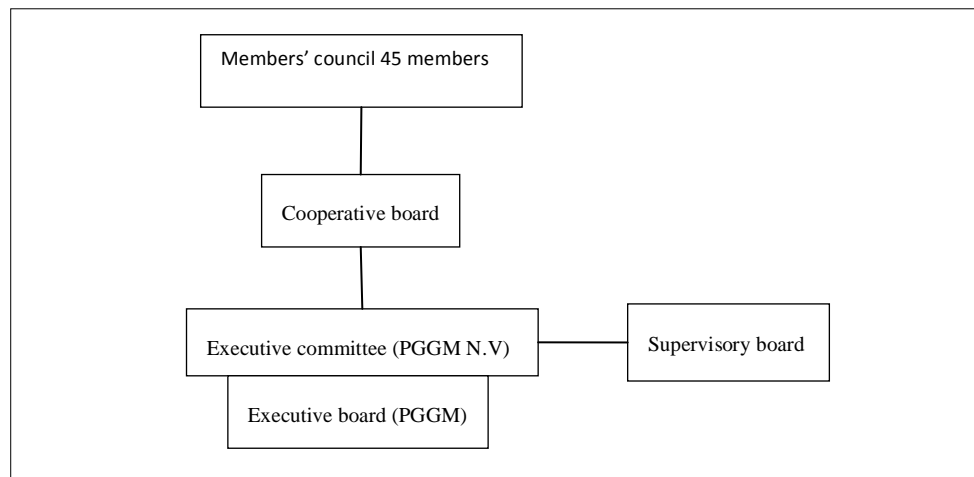
5.2. PGGM Case Study

PGGM's members' council

The Dutch cooperative pension administrator organization 'PGGM' has a close relationship with the Dutch pension fund 'PFZW' that specializes in health and wellbeing. The members' council has 45 members: 15 representatives from employers' organizations, 15 representatives from employees' and pensioners' organizations and 15 directly appointed members. The Members' council

oversees the cooperative board, which in turn supervises the executive committee. The members' council links the cooperative's executive board and the members. Furthermore, the members' council is responsible for increasing members' influence and commitment, in order to assure that members of the cooperative have a direct influence on PGGM's policy.⁵

Figure 6 - PGGM organizational structure



Note: PGGM cooperative is the 100% owner of PGGM N.V., which acts as a service provider. The members' council consists of 15 representatives from employers' organizations, 15 representatives from employees' and pensioners' organizations and 15 directly appointed members.

6. Rethinking Members' Role in Cooperative Organizations – Reducing the Democratic Deficit

“Nothing is more wonderful than the art of being free, but nothing is harder to learn how to use than freedom.” — Alexis de Tocqueville, *Democracy in America*

In democracy, where the people or ‘demos’ rule and decide the most important matters, citizens have both rights and obligations to uphold. In ancient Athens, a direct democracy, active citizenship meant that citizens not only participated in the Assembly and voted for public issues, but also that they could serve as officials selected at random to implement the decisions of the

⁵ <https://www.pggm.nl/english/who-we-are/Pages/About-PGGM.aspx>

Assembly. People had the responsibility to manage public affairs. Two of the most important principles of Athenian democracy were 'isonomia' and 'isegoria,' the equal right of all citizens to exercise their political rights. Every citizen had the right to speak at the People's Assembly and make proposals (Bouricius, 2013).

"...It is true that we are called a democracy, for the administration is in the hands of the many and not of the few. But while there exists equal justice to all and alike in their private disputes, the claim of excellence is also recognized; and when a citizen is in any way distinguished, he is preferred to the public service, not as a matter of privilege, but as the reward of merit. Neither is poverty an obstacle, but a man may benefit his country whatever the obscurity of his condition. There is no exclusiveness in our public life, and in our private business we are not suspicious of one another, nor angry with our neighbor if he does what he likes; we do not put on sour looks at him which, though harmless, are not pleasant. While we are thus unconstrained in our private business, a spirit of reverence pervades our public acts; (Thucydides (c.460/455-c.399 BCE): Pericles' Funeral Oration from the Peloponnesian War (Book 2.34-46))."

Pericles described the role of active participation by Athenian citizens in his oration at a funeral for the fallen soldiers of the Peloponnesian War. Institutions and political culture provide an explanation for the Athenians' rational-cooperative social behavior. Pericles noted that although people have diverse interests, they are free to make choices. He expected all responsible, self-interested citizens to participate in the decision-making process out of a desire to improve their personal position while simultaneously serving the common good (Balot, 2012). Citizenship was not understood as a separate activity from private life, in the sense that there was no distinction between public and private life. The obligations of citizenship were deeply connected to one's everyday life in the polis. Other characteristics of ancient democracy are the high levels of attention devoted to and interest in political matters and the ability to decide matters in favor of the general interest rather than solely aiming to advance one's own selfish interests. As a result, Athenians with heterogeneous interests were free to make choices (Balot, 2012).

Consumers may decide to use exit via prices in markets and voice in democracy. Hirschman (1970) postulates that there is a dichotomy in consumer exercise of power between exit, similar to Adam Smith's freedom of markets where we find investor-owned firms (IOFs) and voice, which is expressed via other corporate forms (i.e., cooperatives) where members are given a voice. Voice assumes active citizenship in civil society (κοινωνία πολιτική), as Aristotle describes it in his works. The issue is that people, as consumers or members, often prefer to exit rather than use their voice (van Dijk & Klep, 2008). Hirschman (1970) argues that a firm's decline can be corrected by market forces, meaning exit, or by voice and loyalty. His theory is nevertheless vaguely applicable to cooperatives: giving voice to members to influence the firm, which can in turn expect loyalty from members because they have been given 'voice'. In democracy and democratically governed organizations, such as cooperatives, members should be given voice together with the option to exit.

In the cooperative literature, little attention has been devoted to the role of the members. Members of cooperatives have both rights and an obligation to play an active role, i.e., to control, suggest, and contribute. Members should be actively involved and exercise their rights of voice and exit. The interests of the members should prevail over those of cooperatives as organizations, as in a democracy where the interests of the citizens are above those of the country (van Dijk & Klep, 2005).

What sets cooperatives apart from other companies is their ownership structure, cooperative values and democratic governance. How members bring the raw reality into perspective is an issue for further examination. It is typical for the members' council to be elected by the general assembly. A different perspective is offered from the view of public governance that held in ancient Athens. In the next paragraph, we explore the contemporary role of the members and offer insights into how we can strengthen democratic governance in cooperative organizations.

7. Random Selection / Sortition as a Method for Selecting Members of the Members' Council

"The suffrage by lot is natural to democracy, as that by choice is to aristocracy" Montesquieu, *The Spirit of the Laws*, (1748).

In ancient Athens, most governmental decisions were made by representatives of the people, and selection by lot was an essential feature of Athenian democracy (Bouricius, 2013; Hansen, 1991). In essential democratic institutions, such as the Vouli (Parliament), representatives of all citizens were elected by lot (Aristotle, 1984). Sortition was the primary method for appointing political officials, and its use was regarded as a principal characteristic of democracy for avoiding corruption and avoid aristocracy. Those who were picked to serve as officials were subjected to scrutiny to determine whether they had the skills necessary to be appointed to an office and received a salary for their services (Bitros & Karayiannis, 2013).

Besides Athens, other cities historically used selection a lot as a rule, such as other Greek city-states. Random selection was also used in Florence and in Venice in the 13th century, Parma, Vicenza, San Marino, Barcelona and some parts of Switzerland for selecting mayors until 1837, and in England in 1500 (Carson & Martin, 1999). At present, we find citizen participation via a random selection process in the judicial systems of several countries.

Levy (1989) argues that the randomization process was central to Athenian democracy and offered advantages in the collective choice procedure. Statistically, random selection models and random sampling are used to gain power to generalize findings. Furthermore, a random selection process offers an equal opportunity to all of being selected, thereby providing unbiased representation of a group.

Selecting officers and political leaders by lot has been a longer-standing tool of democracy than elections. David van Reybrouck contends that trust in politicians has reached a record low, and party membership and the number of voters are declining. People's affiliation to parties in Europe's is in decline, at 2.5% in the Netherlands and 5.5% in Belgium (van Reybrouck, 2013). He proposes sortition as a neutral procedure that reduces the risk of corruption and helps to focus on the purpose of debate, which is to identify solutions for the common good. He suggests a bi-representative system to remedy democratic fatigue syndrome.

Pluchino *et al.* (2011) argue that the introduction of a well-defined number of random members into the parliament would improve the efficiency of this institution through the maximization of overall social overall welfare, which depends on its acts and the number of laws passed, which is in line with Athenian democracy and the finding that adopting random strategies can improve the efficiency of hierarchical organizations as an answer to Peter principle (Pluchino *et al.*, 2011). In contrary, Socrates considered it absurd for

the Athenians to appoint officials by lot when they never would have considered choosing an architect that way.

8. Deliberative Democracy

In deliberative democracy, authentic deliberation adopts elements of consensus decision making and is the primary source of legitimacy for the law. Deliberative polls recreate the ancient Athenian practice of using selection by lot to fill many government posts. According to Fishkin and Luskin (2005), a deliberative discussion should be informed, balanced, conscientious, substantive, and comprehensive. Fishkin argues that in deliberative poll, a random sample ensures an equal opportunity of being selected.

In Ontario and British Columbia, Canada, citizens' assemblies were created to deliberate the issue of electoral reform (LeDuc, 2011; Warren & Pearse, 2008). In the Netherlands, 142 people participated in the Dutch citizens' assembly. The recommendations from the Netherlands' citizens' assembly (Burgerforum) went to the Dutch national parliament, where they were adopted as law (Campos & André, 2014; van der Kolk, 2007).

Burnheim (2006) envisions a form of government that, among other changes, includes the dissolution of the state and a large number of citizen juries, selected by lot, that make decisions on public policy issues. He names this new form of government 'demarchy'⁶. By having randomly selected groups for making decisions, demarchy is compatible with either small-scale private enterprise or more collective institutional forms such as worker cooperatives. The solution is to disconnect decisions in each major policy area from those in other areas and place the power of decision in each area in the hands of those whose legitimate interests are most substantially affected by those decisions. Demarchy is best characterized as governing by a large number of committees that are representative of those with an interest in their decisions.⁷ Burnheim argues that people with direct interests should be involved in the decision-making process (Gastil, 1993).

Two examples of organizations with a cooperative structure and members' council are 'PGGM' in asset management for healthcare and the healthcare insurance provider 'Menzis'.

⁶ The term 'demarchy' is derived from Friedrich Hayek's *Law, Legislation and Liberty* (1973). Hayek first used the term demarchy to name his proposal for a (according to him) better form of government.

⁷ Burnheim (2011).

In an experiment in democratic membership, members were selected from the total membership pool of PGGM according to gender, age, and geographical criteria. From this pool, a members' council was selected randomly and represented PGGM's member population. This new members' council has been organized and designed to function differently from a traditional members' council. The board does not a priori define the meeting agenda, but members bring in their own views and their colleagues view to the discussion table. Therefore, the agenda is thin (a general theme of discussion, and members of the members' council are prepared by getting to know the views of their colleagues on the issue), and the discussion is based on raw reality. How does the members' council function? The members bring new issues, and you talk with neighbors. No conclusions are drawn, but the raw reality is being brought to the board, which then decides.

Cooperatives are democratic governed organizations based on members' democracy. The random selection process aims to strengthen members' influence. We suggest that future empirical research should examine the application of this new concept of governance where members are randomly selected to the members' council in order to provide information which will become knowledge via mutual exchange and discussion.

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