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INVITED PAPER

All firms are cooperatives – and so are governments

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ABSTRACT

To both the scholar and the layman, cooperatives often appear to be something of a sideshow in the world of enterprise organization. Properly understood, however, virtually all private enterprise, and democratic governments as well, exhibit the basic form of a cooperative. As a consequence, the study of cooperatives (in the narrower, conventional sense of that term) illuminates our understanding of both investor-owned firms and governments and, conversely, much can be learned about cooperatives by examining other forms of organization. This is already evident when we examine the power and limitations of contemporary economic theories of the firm. At present, however, we know much more about the economic factors that govern the viability of cooperative enterprise than we do about the forms of internal corporate governance and external regulation that also play a critical role.

KEY-WORDS

ENTREPRENEURSHIP, COOPERATIVES, NONPROFIT ORGANIZATIONS, PUBLIC ENTERPRISES, PRIVATE ENTERPRISES, GOVERNANCE, FIRM ORGANIZATION

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1. The structure of cooperative enterprise

We live in a world of global capitalism; even the Russians and the Chinese are now rushing rapidly down the capitalist road. In such a world, cooperatives might seem to many an economic sideshow – a form of organization that is helpful, perhaps, in marketing agricultural products and a few similar special roles but, whatever its appeal as an ideal, largely impractical elsewhere. But this is a mistaken view. Broadly considered, the cooperative is the dominant organizational form in market economies today. Virtually all privately-owned enterprise has adopted the cooperative form, as has most governmental enterprise.

This view of economic organization depends, of course, upon one's definition of a "cooperative". The conventional definition is that a cooperative is a firm that is collectively owned either by its customers (a consumer cooperative) or by its suppliers (a producer cooperative). If we use the term "patrons" to encompass all persons who transact with a firm, whether as sellers of inputs or as purchasers of outputs, then we can say, more generally, that a cooperative is a firm that is owned by (a subset of) its patrons. In saying here that a cooperative is "owned" by its patrons we mean that the patrons share in the two rights that, together, conventionally define ownership: the right to share in the organization's profits and the right to share in control of the organization. In particular, profits in a cooperative are commonly allocated to the organization's patron-owners in proportion to the volume of their patronage (the amount they purchase from the organization in a consumer cooperative, or sell to the organization in a producer cooperative), while control (commonly in the form of voting rights for election of the organization's board of directors) is commonly allocated either according to patronage or simply as one-member-one-vote. Thus, in a workers' cooperative, profits are generally allocated according to the value of the labor each worker-owner contributes to the organization, and votes are allocated the same way or per capita.

2. Business corporations and governments are also cooperatives

With these matters of definition in hand, a bit of reflection shows that, in fact, nearly all privately-owned firms are cooperatives. This includes, in particular, the conventional investor-owned firm – the business corporation, or joint stock company – that we are accustomed to labeling "capitalist". Such firms are simply a subset of producer cooperatives that we might call "capital cooperatives". They are owned collectively by the persons who supply capital to the organization, with an individual owner's share in both profits and voting rights determined by the amount of capital they have contributed.

Nonprofit firms are the only form of private enterprise that is not, in effect, a species of cooperative. Nonprofit firms are not owned by their patrons; indeed, they are not owned by anyone at all. They are characterized by a division between those who control the firm and those who receive the net benefits it confers. There is, moreover, a corresponding difference in the economic role generally played by nonprofit firms and cooperative firms. Nonprofit firms typically serve to protect consumers in situations where the consumers have great difficulty in judging the quality or quantity of the goods or services that the firm produces for them. Cooperative firms, as we will discuss shortly, instead typically serve to protect one or another class of a firm's patrons when the firm has a degree of market power over those patrons, generally because the firm is in a position of monopoly or because the patrons are otherwise locked into dealing with the firm (Hansmann 1980, 1996).

Sometimes the term "cooperative" is applied to firms that are in fact nonprofits – that is to say, to firms whose nominal patron-owners have no meaningful degree of control over the firm's senior managers,

who are effectively self-appointing. Because nonprofit firms, as just suggested, are adapted to play a rather different role than firms that are truly owned – and hence controlled – by their patrons, we can best avoid confusion by confining the term “cooperative” to firms of the latter type.

By these definitions, governmental enterprise, and indeed governments themselves, are – in contrast to nonprofit firms – in effect another species of cooperative. We will return to this issue below.

It follows that nearly all enterprise is organized in the cooperative form, which is to say that nearly all firms, private and public, are owned by one or another group of their customers or suppliers. Why is this the case – that is, why is productive enterprise typically patron-owned?

The reason, evidently, is that ownership by one or another class of the firm’s patrons serves to protect those patrons from exploitation by the firm. The exploitation involved is commonly simple monopolistic exploitation deriving from market power on the part of the firm *vis-à-vis* the patrons. That market power may come from actual monopoly, in the sense that economies of scale lead to domination of the market by a single firm. Alternatively, the market power may derive from *ex-post* lock-in, in the sense that the patrons in question must make transaction-specific investments in their exchanges with the firm that render them vulnerable to opportunistic exploitation in future negotiations with the firm over the terms of their transactions.

As a simple illustration, consider an example from the past. In the United States decades ago, small rural towns commonly had only enough demand to support a single “general store” that sold food and other household necessities. That store was therefore in a position of natural monopoly. To avoid the possibility that the store would use its market power opportunistically to keep prices well above cost, these general stores were commonly organized as consumer cooperatives, collectively owned by the members of the local community who were their customers.

But consumer cooperatives such as this, with individuals as members, are extremely uncommon in the United States today, and in much of the rest of the world too. Owing to better transportation and greater urbanization, markets for food and other household items are today generally quite competitive everywhere. Consequently, consumers of such goods are no longer subject to monopolistic exploitation (Hansmann 1996, ch. 8). Grocery stores, like most other retailers, are today almost uniformly organized as capital cooperatives (i.e., investor-owned firms) rather than consumer cooperatives, since today the providers of capital, rather than customers, are the firm’s most vulnerable patrons.

Why are suppliers of capital vulnerable? The answer begins with the observation that, if a firm is owned by someone other than its suppliers of capital, the firm must borrow the capital that it needs. This borrowed capital, moreover, must be obtained as long-term debt; if borrowing were short-term, the need to constantly renegotiate the debt would expose the firm to holdup by its creditors. But when the firm borrows long-term, the shoe is on the other foot: the lenders are exposed to opportunism on the part of the firm. For example, once a firm is highly leveraged, its owners have an incentive to engage in more speculative projects, shifting increased risk onto its creditors. Potential creditors of the firm, in turn, will often anticipate opportunistic conduct, and raise the interest rate they charge. In the end, the firm will face an inefficiently high cost of capital, but will still only earn a market rate of return on its investments. Ownership of the firm by contributors of capital, in contrast, largely removes this problem by putting the contributors of capital on both sides of the transaction, in the form of equity investors (i.e., shareholders) who are both lenders to, and owners of, the firm.

This is not to say that consumer cooperatives have disappeared from the American economy, or from other developed economies. Rather, most consumer cooperatives today are owned, not by individuals, but instead by other businesses to which they provide inputs. A prototypical example is offered by the Visa credit card network. Visa was originally created and owned by Bank of America. Other, smaller banks purchased

franchises to issue cards under the Visa trademark and to have access to the Visa payment network. The local franchisee bank would then be responsible for selling the credit cards and for providing the credit extended to individuals who purchased the cards. Eventually, however, Bank of America encountered resistance from current and potential franchisees, which were concerned that Bank of America might eventually take advantage of the franchisee banks by imposing upon them ever harsher terms. The result is that, in 1970, Bank of America sold the Visa trademark and payments network to a cooperative collectively owned by its numerous franchisee banks – a form of organization it retained until 2007, when Visa, presumably facing stronger competition, reverted to investor ownership through a massive public offering of stock.

Governments – or at least democratic governments – are another well-established form of consumer cooperative. In effect, a government is a territorial cooperative. Local governments, for example, typically provide services that are local monopolies, such as roads, police, firefighting, and schools. The local residents and businesses that consume these services become locked in by purchasing real estate in the territory served by the local government: if the price charged for government services increases, or the quality of those services decreases, the consequence is a decrease in value of that real estate, leaving the residents worse off whether they remain in the jurisdiction or leave it for another. (Lock-in to a government – as to employers in general – also results, of course, from difficult-to-change employment, established social relationships, etc.). It is therefore sensible to have the supplier of such services owned by the consumers, who can use their control to assure that the prices charged for the services are kept close to their cost.

It follows that the question of economic organization faced by society is not "Should we have more cooperatives?" Rather, the question is "What kind of cooperatives should we have?" That is, which set of a firm's patrons should own the firm? If we put the question this way, we can see a bit more easily what is at stake in matters of ownership.

3. Governance

In determining which set of an organization's patrons should own the firm, there are two basic considerations. The first is: which group of patrons is most subject to exploitation by the firm? The second is: which group of patrons can govern the firm most effectively?[1] So far, we have been focusing on the first of these questions – that is, the problem of opportunistic behavior by the firm toward its patrons. If that were all that is involved, the most vulnerable group of patrons would be the natural owners of the firm. But some patrons are in a better position to control the firm than are others – for example, because they have better access to information about the firm, or because they are easier to form into an effective governing body. And the patrons most vulnerable to opportunism on the part of the firm may not be the patrons best able to govern the firm. So there can be a strong tradeoff in choosing which group of patrons should own the firm.

To see what is involved, it helps to begin by focusing on a classic two-person partnership in which one partner provides the necessary capital while the other partner manages the business. It is common in such firms for the two partners to share ownership equally, so that both must agree upon any significant decision regarding the firm. The result is a reductive form of producer cooperative – a mixed capital/worker cooperative.

When a firm has a larger number of owners, however, it is rare for those owners to include diverse types

[1] The calculus of ownership described here follows that in Hansmann (1988, 1996).

of patrons. A large firm may be organized as a worker cooperative, or as a capital cooperative, but not as both simultaneously. Ownership is almost universally confined to a single class of a firm's patrons – such as workers, customers, suppliers of a particular input, or lenders of capital. Moreover, the class of patrons that owns the firm is typically highly homogeneous with respect to its members' interest in the firm. Successful worker-owned firms, for example, are generally not owned by the entirety of their employees, but rather by a highly homogeneous subset of the employees.[2] The evident reason for this is that, absent substantial homogeneity of interest, the costs of collective decision-making among the owners become very large, both in terms of the effort that must be put into decision-making and in terms of the quality of the decisions made. And this cost of governance frequently overwhelms other considerations in the choice of owners. This is evidently an important reason for the ubiquity of capital cooperatives: it is easy to structure the terms of investment so that all investor-owners have highly homogeneous interests (namely, to maximize the firm's profits per unit of invested capital), while it is much harder to induce such homogeneity among the interests of customers, employees, or suppliers of other inputs.

Discipline is another problem. Even for firms with relatively homogeneous owners, it is often difficult to take action to impose discipline upon individual owners, or to expel owners when downsizing the firm is called for. An important reason for this seems to be that a strong norm of equality of treatment among members of the class of owners is necessary to constrain the costs of collective decision-making, but the same norm makes it difficult to single out individual owners for discipline or downsizing. This seems to explain why collective ownership of a franchisor by its franchisees can be successful where the quality of an individual franchisee's performance has little effect upon the success of the franchise system as a whole – as in credit cards (Visa), hardware stores, and trucking firms, all of which at some point have been characterized by successful franchisee cooperative ownership – but not where bad performance by an individual franchisee can have a negative effect upon the success of other franchisees, as in fast food retailing (e.g., McDonald's). Capital cooperatives are much less subject to these problems, presumably because of greater homogeneity among the owners (and hence less likelihood that one owner needs to be disciplined for the benefit of the others) and because the divisibility of capital contributions (as opposed to, say, retail stores or workers, which are lumpy) allows the costs and benefits of downsizing to be shared equally among all owners of the firm.

Consequently, though many firms have substantial market power toward their customers (or employees or suppliers), they are nonetheless formed as investor-owned firms (capital cooperatives) rather than as consumer (or worker or supplier) cooperatives, for the simple reason that the customers (or workers or suppliers) cannot exercise effective control over the firm. Were it otherwise, Microsoft might be more efficiently organized as a consumer cooperative.

4. The theory of the firm

Viewing organizations in the terms we have been using offers a useful perspective on the strengths and limitations of current economic theories of the firm. The most prominent of those theories is the "property rights" theory of the firm with roots in the work of Grossman and Hart (1986, 1995). In essence, that theory focuses on what the firm owns, and does not directly address the question of who owns the firm.

[2] The Spanish industrial worker cooperatives, including particularly those at Mondragon, have long been a conspicuous and fascinating exception, though their exceptionality is now being severely tested (The Economist 2013).

Our understanding of firms in general as cooperatives, however, demonstrates that the two questions are closely connected.

Consider again the Visa credit card operation. The corporation holding the Visa trademark and central transaction clearing operations had, as we have noted, substantial market power over the many independently owned banks that sold credit cards under the Visa trademark, and provided the credit for the cards they sold, as franchisees. An obvious way to avoid inefficient use of this market power would be vertical integration, with the franchisor – the corporation owning the trademark – purchasing and owning the franchisee banks, and combining them all into one huge bank. But that approach threatens to dampen incentives for the efficient operation of the local banks, whose managers would then be controlled by other managers higher in the consolidated firm's line of control rather than by local controlling owners with good information about the local bank and a direct stake in its profitability.[3] In effect, as Grossman and Hart would put it, there is a question of whether the local bank's assets should be owned by the bank's own (owner–) managers or by the franchisor. Strong incentives for efficient management of the local bank favor its independent ownership, while elimination of inefficient exercise of monopoly power favor its ownership by the holder of the Visa trademark. Under the property rights theory of the firm, efficient organization stops here with the choice of the least costly option: a patron of a firm (or rather, the patron's assets) is either owned by the firm or independently owned and connected to the firm only by contract.

When we view firms as cooperatives, however, we see that it is often possible to choose a third ownership structure that solves both the incentive problem and the monopoly problem. In the credit card example, that solution is to keep the local banks separately owned to maintain incentives for their managers, while removing the incentive for exploitation of monopoly power by the franchisor by having it, in turn, collectively owned by its franchisee banks.

In fact, this analysis of credit card franchise relationships applies, in general terms, to nearly all firms with shared ownership. There is in each case a set of patrons who are subject to opportunism on the part of the firm, and also some reason why that problem cannot be solved by having the firm assume ownership of (the assets managed by) those patrons. Reasons for leaving the patrons independently owned include, beyond giving high-powered incentives to local managers (as discussed in the bank example), the illegality and inefficiency of slavery (which would result if a firm owned its workers) and the fact that a patron of one firm is likely to be a patron of many other firms as well. Yet the patron cannot be owned simultaneously by all its various patrons. Rather, it must relate to most of its contractual counterparties via contract rather than ownership.

In sum, the property rights theory of the firm offers insight into what assets are owned by a single firm, but requires some extension to address the closely related problem of who, in turn, owns the firm.

5. A transitional form?

Over the long term, there seems to be a tendency for capital cooperatives to replace other kinds of cooperatives in any given industry. Or, put in ordinary parlance, there is a tendency for ordinary investor-owned "capitalist" business firms to replace the non-investor-owned firms that are conventionally termed cooperatives. One reason for this is that governmental regulation often develops to mitigate the market

[3] In talking loosely about incentives here, I take some liberties with Grossman and Hart's original model for the sake of intuitive clarity.

imperfections that permit firms to exploit their patrons. Thus, governmental regulation of the reserves held by banks and insurance companies, first introduced in the United States in the middle of the nineteenth century, permitted the replacement of cooperative and mutual savings banks and insurance companies with investor-owned firms. Similarly, the development of the antitrust laws has reduced the incentive to form agricultural cooperatives, and the development of rate regulation has reduced the need for utility cooperatives.

Another reason for the tendency toward investor ownership is that, even without government intervention, experience leads to more efficient markets for firm inputs and outputs over time, reducing the need to protect the patrons who supply those inputs or buy those outputs by making them owners of the firm. One example of this is the evolution of hospital insurance in the United States, which was first developed in the 1920s as a cooperative venture among a group of hospitals, presumably because the cost of providing such insurance was originally unclear, making it an exceedingly risky business for an investor-owned firm, and also because the provider of such insurance in its early days would have substantial market power owing to the economies of scale involved. Similarly, the development of futures markets for agricultural products reduced the monopolistic power of the purchasers of farm products, and thereby reduced the benefits of forming agricultural marketing cooperatives among farmers. And, turning to worker-owned enterprise, American law firms, long owned by the lawyers who practice in them, are arguably now ripe for conversion to investor ownership, in important part because it has become much easier for outsiders to a law firm to evaluate the talents of individual lawyers within the firm, and thus create an active employment market for established lawyers, thereby reducing the extent to which lawyers are locked into the particular firm with which they began their career.

And, as old types of cooperatives disappear, new types proliferate. Patent pools and standard-setting organizations might be seen as important examples.

6. Some implications for research and policy

The importance of the costs of collective decision-making in cooperatives raises a question for policy – namely, can those costs be reduced somehow? There has, of course, been an enormous focus upon this question – under the name of "corporate governance" – regarding business corporations (capital cooperatives) in recent years. Unfortunately, there has been comparatively little systematic research – at least among legal scholars – on governance in non-capital cooperatives, with the exception of territorial cooperatives (which is to say, governments). Through closer study of governance in other types of cooperatives, it should be possible not only to make those alternative types of cooperatives more effective, but also to gain perspective that will permit improvements in the governance of conventional business corporations, and in the structure and management of government at all levels – i.e., in the governance of governments.

The transitional character of non-capital cooperatives suggests that it is important to keep organizational law sufficiently flexible to permit cooperatives of all types to be organized and operated in any industries where they may prove useful, and likewise to permit firms organized as non-capital cooperatives to convert to investor ownership – i.e., to become capital cooperatives – when altered market conditions make that change efficient. Thus it is important to facilitate the formation of cooperative research ventures among firms in high-tech industries that wish to avoid the obstacles created by patent monopolies, just as it is important to facilitate the conversion of consumer retail cooperatives to investor-owned firms when

the latter are more efficient. It likewise seems important that organizational law for cooperatives be kept sufficiently flexible concerning internal affairs to permit firms to adapt to a variety of environments, as for example by allowing diverse voting schemes (one-member-one-vote as well as votes allocated according to volume of patronage) and a variety of approaches to redemption of capital for exiting members (from a right to immediate redemption to any of various forms of staged and conditional redemption).

7. Conclusion

Cooperatives are firms that are owned by one or another class of their suppliers or customers. Once one realizes that nearly all private firms – and democratic governments too – essentially have that structure, it becomes apparent that the principal question regarding enterprise ownership is not whether the firms in any given industry will be owned by their patrons or not, but simply which class(es) of patrons will be made the owners. We have made some progress in understanding the economic factors that bear on the answer to this question. But there is every reason to believe that the answer also depends heavily on the governance structures that firms can and do adopt, which in turn depends on the surrounding legal and institutional environment, including organizational (corporation) law, capital market (securities and banking) development and regulation, and labor law. Recent decades have seen an obsessive focus on these issues, by both economists and legal scholars, regarding capital cooperatives – which is to say, ordinary business corporations. There has been much less attention to these issues as regards the viability of those firms that we more conventionally term cooperatives – that is, non-capitalist and nongovernmental firms.[4] The full potential role of these cooperatives should become much clearer when scholarship regarding their governance and financing becomes both broader and deeper.

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[4] For a concise review of the current state of theory, law, and practice, see Bijman *et al.* (2013).

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