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by

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Cooperative Principles and Equity Financing: A Discussion of a Critical Discussion

Michael L. Cook

Royer's paper explores hypothesized impacts of the "principles of cooperation" on the current practices of voting, equity acquisition, and equity redemption in U.S. agricultural cooperatives. The author argues that practicing traditional cooperative principles may lead to an increasingly incompatible conflict between the investor-owner role, the user-owner role, and the user-patron role of a cooperative member. The author examines inconsistencies and inequities among alternative cooperative philosophies and practices. Subsequently, he concludes that he has found the solution—proportionality—a concept that calls for the degree of control and benefits derived from an agricultural cooperative by a member to be directly related (proportional) to the amount of risk incurred by the member in the form of equity provided.

Major Points

The major points made in the Royer paper include:

1. Royer observes and agrees with many (Schaars; Robotka; Phillips; Dunn) that some cooperative principles contribute to conflicts or paradoxes in the equitable treatment of user-owner patrons.
2. Royer argues that, to exercise control in a cooperative, equitable voting rights should be allocated according to economic risks assumed, which, in a cooperatively structured business organization, means risks are borne in proportion to patronage. Implicit in Royer's argument is that the "one person—one vote" principle and practice was equivalent to proportional voting in the founding period of cooperatives when the majority of membership exhibited many homogeneous characteristics, especially in net worth and patronage.
3. The paper suggests that a legislative or legal constraint exists in converting to proportional voting because only a minority of incorporation statutes for farmer cooperatives permit proportional voting.
4. In addition to arguing for proportional control he joins a growing list of contemporary cooperative thinkers (Barton 1988, 1989; Cobia) who advocate the concept or "new principle" of equity financing in propor-

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tion to patronage. He additionally goes beyond their recommendations of implementing the proportionally oriented base capital plans to explore a different user controlled business organization structure entitled patron-owned corporations (POC). (See point 8 in this section.) He suggests that POCs alleviate some of the disadvantages of the base capital plan (Moore and Hardesty).

5. The paper details and consolidates the arguments that rewarding equity is legal and is an acknowledged objective of cooperatives, but it is a practice seldom followed. Royer hypothesizes that, because of tax objectives and horizon problems, cooperative boards of directors usually exercise the option of distributing the annually generated benefits in the form of patronage cash and allocated equity certificates rather than rewarding patronage and investment.
6. According to Royer, involuntary provision of equity capital by former or inactive members presents an increasingly important challenge to cooperative boards and management. He suggests that the amount of equity held by the disenfranchised inactive member is increasing and this violates the unwritten but well understood rule of cooperative fairness. His partial solution to this challenge is for cooperatives to improve and accelerate the use of well planned equity redemption plans.
7. Another growing problem in the field of cooperative finance, Royer observes, is the increasing tendency of cooperative members to undercapitalize their cooperative organization. Royer argues that this has fostered the recent increase in development and expansion of the unallocated equity reserve category on many cooperative balance sheets. Royer systematically points out that the most important source of unallocated equity is derived from nonpatronage earnings. But even though leverage and cash flow advantages exist, according to Royer, there are significant economic, control, and legal reasons why unallocated equity may not be the most sound method of enhancing the balance sheet.
8. As the ultimate solution, Royer proposes an alternative organizational structure that would maintain the contemporary user-control, user-benefit, user-ownership principles in addition to adding the proportionality concept. This alternative is called the patron-owned corporation (POC). Listed as the advantages of the POC are the possibilities of (a) appreciable stock and (b) a liquid market for stock, thus facilitating member-owner entry and exit. His paper does not detail nor discuss the disadvantages or conflicts of this alternative structure with traditional cooperative principles.
9. Royer adds to the Schrader list of cooperatives reorganizing to take advantage of investor-owned organization structures by analyzing the United Growers stock conversion and the Suzy Bel tomato grower "third way" organization. His comments on the success of the United Growers initiative is positive, but he reserves comment on the success/failure of other cooperative to corporate conversions.
10. As in many advocacy arguments, the author has reserved a fall-back position in case the patron-owned corporation and proportionality concepts don't foster firm level changes or statutory initiatives. He concludes that the minimum action cooperative leadership must

accomplish, if the "principle of cooperation—equity finance" conflict is to be addressed, is the adaptation of more disciplined equity capital redemption programs.

Contribution to the Field

The Royer paper makes a number of explanatory, innovative, and positive contributions to the cooperative organization literature. Several of these contributions are expanded upon here.

1. Royer provides us with a detailed review of literature and reference list on the subject of cooperative proportionality. His review of Schaars, Robotka, and Phillips on proportionality in cooperative control and financing is particularly informative.
2. The author is relatively successful in combining the disparate parts of control and finance into a comprehensive view of the concept of cooperative proportionality. The melding of USDA's 1987 user-owned, user-controlled, user-benefited contemporary principles *with* Barton's proportional principles *with* the thoughts of numerous cooperative statesmen regarding equity acquisition and redemption *with* Cobia's proposals on control proportionality formulates a challenging set of issues for cooperative leadership. The clarity of his accomplishment will be helpful not only to a "first timer" but also to veterans of the issue.
3. Royer should be congratulated for renewing efforts to explain and clarify to cooperative leaders the complex set of issues that have widespread importance for future collective action forays and for those who are attempting to position their member organizations for the challenges of the next decade. Conversion to proportionality might be a difficult stakeholder education undertaking, and the challenge should be thoroughly discussed. A survey conducted by Barton (1988) reveals that no Kansas local cooperative has adopted the base capital plan (a proxy for proportional financing), and only a very small percentage of the large U.S. agricultural cooperatives have adopted the plan.
4. The paper addresses and expands on the clarification of one of the basic problems in cooperative finance—the provision of sufficient risk capital contributed by current user-members versus the inadequacy of capital reserves to satisfy long-term needs. His proposed dual solution to this well-defined horizon problem (Swackhamer and Maihan; Staatz) is (a) total cooperative proportionality to solve the current risk capital side of the issue and (b) patron-owned corporations (POCs) to address the capital reserves issue. (See below for greater detail regarding the proportionality solution.)
5. Finally, and perhaps most important, Royer implicitly addresses the critical but seldom discussed "original versus current justification" issue. This issue might be explained best by posing the question: Are the economic needs of the current members served best by the organizational structure that was most appropriate for correcting the market failures that existed when the cooperative was founded? In other words, should cooperatives that were initially formed to eliminate the inequities of market failure be maintained to prevent possible future market

failures? If so, how should they be organized to address today's concerns? Royer addresses this "original objective versus current justification" or "maintenance-founder" issue by suggesting that those who argue for maintaining close affiliation with outdated principles should re-examine the historical dynamics of the U.S. agricultural cooperative environment. His point is that total proportionality would facilitate the solving of some of the problems fostered in "traditions" and fixed "institutional" constraints that were important in correcting problems of an earlier and quite different economic period. I would argue that the traditional principles were very appropriate for addressing the market failure situations of the 1920s and 1930s, but continued dedication to rules and principles of that period has led to a relatively high transaction cost organizational structure. That does not bode well in a market environment where survivors will be characterized by organizational structures that minimize the *sum* of *production* and *transaction* costs.

Unanswered Questions

Although the paper makes significant contributions to addressing certain issues, it raises new ones and leaves unanswered a number of others. Briefly these queries might fall into the following categories.

1. There is a temptation when addressing complex cooperative issues, especially those involving purposes, goals, and objectives, to use the same assumptions and criteria for evaluating the performance of cooperatives as IOFs (investor-oriented firms). But as Staatz has pointed out, the scope of optimization may be broader and more diffuse for cooperatives than for an IOF. This more ambiguous set of objectives might have complex behavioral and structural implications for cooperative stakeholders. By addressing these implications under the assumption of proportionality, Royer might have contributed even more to critical thinking on cooperative issues.
2. Mancur Olson, in his classic study on the logic of collective action, concluded that even when all interested members in a group would gain benefits from production of a public good (i.e., the correcting of a market failure), the members may fail to make contributions to the group if the organization relies solely on the value of the public good to induce member contributions. His conclusions were derived from the "Free Rider Principle" and the "Principle of Imperceptible Effect." Royer indirectly addresses the free-rider issue but does not address the imperceptible-effect issue, which is one of size (in large organizations the share of the public good received is so small that it is rational to contribute very little). The examination of the concept of proportionality might have much to say about the Olson assertion that cooperatives will succeed only if they remain small.
3. Royer accepts the results of previous studies on cooperative opportunity cost of capital (Beierlein and Schrader; Snider and Koller; Dahl and Dobson; Fischer). But if Staatz's hypothesis is correct that cooperatives have a broader objective function than the IOFs, then the opportunity cost of cooperative equity using the traditional economists' and accoun-

tants' definition (i.e., short-term Treasury Bills) might be miscalculated. What is the opportunity cost of eliminating a market failure? To increase our understanding of this important measure, perhaps we need to more aggressively explore opportunity cost valuations that appraise total member costs. This measure might fall between the private opportunity cost and the social opportunity cost. Minimal analytical effort has been expended on this subject, and yet no other subfield would benefit more than cooperative finance if research were to be conducted in this area.
4. Given his familiarity with the literature, it would be beneficial to the cooperative finance reader for Royer to suggest further empirical and theoretical work to be done. Questions such as: Does proportionality reduce transaction costs in control, in equity acquisition, in equity redemption? Does the concept of proportionality reduce agency problems caused by the separation of residual risk bearing and decision management? Would the horizon problem be ameliorated if the organization's members pursued wealth maximization rather than utility maximization?
5. Royer's section on the patron-owned corporation is relatively brief. Further explanation is needed on how POCs might alleviate some of the inequities created by a nonproportionality equity acquisition option. A further contribution might include a discussion of the disadvantages of a POC, particularly when over time increasing amounts of stock are acquired by nonpatrons.
6. Identification and description of quasi-proportionality control and financing tools that are currently being implemented in many U.S. agricultural cooperatives would be instructive and perhaps would lend credibility and power to some of Royer's arguments.
7. And, finally, a discussion of the complexity of transitioning from a nonproportional structure to a proportional cooperative structure would be particularly helpful to cooperative management and directors. The economic cost and political challenges of transitioning may be a major factor in explaining why more cooperative firms have not restructured.

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