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**COOPERATIVES: THE GOVERNANCE
OF PATRONAGE DIVIDENDS
(A CORPORATE FINANCE VIEWPOINT)**

Rodolfo Apreda

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COOPERATIVES: THE GOVERNANCE
OF PATRONAGE DIVIDENDS
(A Corporate Finance viewpoint)

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ABSTRACT

Members of cooperatives are patrons and owners simultaneously, which turns out to be a consequential feature ingrained in that sort of business associations. This paper puts forward some contributions to the subject. Firstly, it defines a primary cooperative, making hence a contrast with cooperatives of cooperatives and shaping up their distinctive incremental cash-flow structure. Secondly, it focuses on some governance attributes depicted by patronage dividends in their quest for cash flows from assets. Lastly, it points out that the pursuit of growth poses a threat to primary cooperatives, entailing both governance risks and costs whenever these organizations increase in size and scope.

JEL codes: G32, G34, R10, Q13,

Key words: cooperatives, patronage dividends, cooperatives governance, incremental cash flows, governance risks, governance costs, patrons.

Institutional disclaimer

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INTRODUCTION

According to the International Cooperative Alliance (2013) the cooperative movement brings over one billion people around the world, a fact that we can hardly dismiss and makes these business associations far from being negligible¹.

Although the ancestors of formal cooperatives can be traced back to the 18th century², it was just in the 19th century, and mainly in England, when their constitution matched a recognizable profile³, attained sound legal entitlements and made significant inroads on fostering commerce and improving workers' welfare. The underlying reasons for the existence and development of cooperatives were not only economic, but also political and sociological. As Professor Perkin (2002a) has pointed out:

The transition from community building to shopkeeping, from the making of utopias to the making of dividends, from a visionary alternative to capitalism into an alternative form of capitalism itself, was more than the progressive betrayal of a great idea. It was the conspicuous example of education by success, of the process by which the only institution with an immediate, practical programme for establishing a new society based on the working-class ideal transformed itself into

¹ The referred source provides the following facts and figures: in the United States there are just about 30,000 cooperatives; in Denmark consumer cooperatives control almost 40% of the retail market; in Japan 90% of farmers belong to cooperatives; in Uruguay, New Zealand, the USA, and Norway they furnish almost 90% of milk production whereas in Korea 70% of fishery; in Canada four out of ten Canadians are members of at least one cooperative, in Norway 40% while in Spain 15% of their population belong to cooperatives. In China the cooperative movement numbers around 170 million individual members, whereas in India 100 million members and in Japan 80 million. Membership in the United Kingdom reaches 12 million members, in France 32,4 million, and Bangladesh shows 11 million. In Brazil 40% of agricultural production is provided by cooperatives, while in Singapore 50% of the population belongs to cooperatives.

² In the United States, it was for Benjamin Franklin to found the first cooperative in Philadelphia by 1752, a mutual fire insurance company that is still running. [Center for Cooperatives, 2012, www.uwcc.wisc.edu]

³ In England, the time-honored Rochdale Society of Equitable Pioneers was created by workers in 1844 who wrote down a set of governance principles which have been guidelines for other cooperatives so far, including democratic control by members, and distribution of earning according to patronage. [Perkin, 2002a, 2002b]

a pillar of capitalist society. As such it was a paradigm of the penetration of working-class institutions by the entrepreneurial ideal. (page 384)

Why have these organizations achieved such a widespread and sustainable success all around the world since the 19th century? From a modern perspective, and with the wisdom of hindsight, we can avail ourselves of the concept of social capital to understand the cooperatives development⁴.

By **Social Capital** we mean an arrangement of social assets, beliefs, and resources that can be outlined this way:

- a) Human beings are embedded in manifold patterns of social exchanges and interactions since they are born⁵.
- b) Such exchanges take place in succeeding informal settings, starting with the family place and, henceforth, evolving towards wider circles among which we find neighborhood acquaintances, church membership, school and clubs networks, close friendship groups and, later on, jobs environments.

⁴ For the forging of this concept into a new tool of social sciences we have to highlight Pierre Bourdieu (1979) among one of the earliest contributors. Let us quote his own definition, out of his paper *The Forms of Capital* (1986):

Social capital is the aggregate of the actual or potential resources that are linked to possession of a durable network of more or less institutionalized relationships of mutual acquaintance and recognition – or in other words, to membership in a group – which provides each of its members with the backing of the collectivity-owned capital, a “credential” that entitles them to credit in the various senses of the word. (page 84)

For further reading about the Economic Sociology approach to social capital, James Coleman (1988, 1994) and Granovetter and Swedberg (2011) make for a promising point of departure. The reader interested in Social Capital may also profit from David Halpern’s book (2005) who tracks down the notion back to Chinese and Greek philosophers, ending up with recent contributions by Putman, Bourdieu, Coleman, and Granovetter.

⁵ On embedding, social relationships and informal transactions, Granovetter (1985) is a sensible starting point.

- c) Social interactions in those informal settings provide the players with skills and techniques, attitudes as well as rules of the game, norms and habits. In other words, by participating in voluntary associations players take advantage step by step of a huge pool of resources and assets springing from social exchanges so as to cope with collective action problems.

- d) As long as this community knowledge is acquired and handed down, people realize that trust, influence, mutuality and loyalty, good faith and reputation, abiding by the community norms, acceptance or rejection of an increasing variety of courses of action, punishment, cooperation, might be regarded as natural payoffs deeply-rooted in their communal life.

It's worth remembering that the 19th century witnessed an outspoken political turmoil and even social outrage about shortcomings and failures either of markets or states. The cooperative movement was regarded as a hopeful alternative, a third approach to those extreme arrangements provided by unrestrained markets or authoritarian governments, both irresponsive to workers needs and claims. Bowles and Gintis (2002) asserted that such standpoint was predicated upon the incentives of social capital for consumers, producers, and workers:

In contrast with states and markets, communities more effectively foster and utilize the incentives that people have regularly deployed to regulate their common activities: trust, solidarity, reciprocity, reputation, personal pride, respect, vengeance, and retribution, among others. (page 424)

Our paper sets forth three contributions:

- i) It defines primary cooperatives and frames the structure of incremental cash flows that makes primary co-ops so distinctive among other business associations.

- ii) It brings to view some governance features inhered in the nature of cooperatives' cash flows, mainly through the linkage between patronage dividends and cash flows from assets.
- iii) It underlies the fact that an increase in size and scope poses a threat to primary co-ops, bringing about governance risks and costs whereby cooperatives may break down and go bust eventually.

We intend to lay down the sequence of our argument into five stages. To start with, section 1 makes a distinction between stakeholders and patrons. Section 2 deals with the notion of primary cooperatives, expanding on their governance and the so-called patronage dividends. It is for section 3 to delve into the structure of cooperatives' cash flows, while section 4 focuses on the governance of patronage dividends. Lastly, in section 5 we forewarn about governance risks lurking behind the cooperatives' pursuit of growth.

1.- ABOUT PATRONS AND STAKEHOLDERS

Corporate Governance experts widely employ the **stakeholder's metaphor** by which any company is regarded as a complex hub of persistent claims, most of them contractual or enforceable by specific regulations. Therefore, it is for individuals, groups and other organizations to stake their requests as well as their involvement with a company, while the latter becomes obliged to meet a manifold set of commitments towards their claimants. Among the most conspicuous stakeholders we find owners, directors, managers, employees, customers, suppliers, trade unions, the government, even communities which may be damaged by environmental risks brought about by the company's regular operations.

There is an alternative viewpoint to the former approach that arises when we focus on those stakeholders who actively engage themselves in the daily transactions that flow into and out of the company. We are talking of course about customers, suppliers, and workers that are broadly denoted as **patrons** of the company, since they purchase the firm's

outputs, or sell inputs to the firm under the guise of products and services including labor⁶. The concept of **patron** proves to be consequential for the analysis of cooperatives; in point of fact, it pervades the nature and functions of such organizational form. It is not surprising that the three broad categories of patrons pave the way to a simple typology comprising namely, consumer, producer, and workers cooperatives⁷, whose main samples are grouped together in Exhibit 1.

<i>Exhibit 1</i>	
TYPES OF COOPERATIVES	
<p><i>Consumer cooperatives</i></p> <ul style="list-style-type: none"> ▪ general retail (food, clothing, house conveniences) ▪ specialist retail (pharmacy, funeral, garage services, travel) ▪ financial (cooperative banks, credit unions, insurance) ▪ housing ▪ health and social care ▪ utilities (electricity, water, telecoms) ▪ public services (child care, cooperative schools, health centers) 	<p><i>Producer cooperatives</i></p> <ul style="list-style-type: none"> ▪ farming, fishery, forestry ▪ wholesaling supply (supermarkets, hardware stores, pharmacy) ▪ shared services for self-employed, small business, and professionals <p><i>Workers cooperatives</i></p> <ul style="list-style-type: none"> ▪ owned and managed by their workers ▪ law, accounting, investment banking, engineering, consultancy ▪ non-professional services

2.- COOPERATIVES

It will be worth making explicit what the expression “cooperative” stands for in the context of this research paper.

⁶ One of the earliest attempts to deal with the notion of patron has been *The Ownership of Enterprise* by Hansmann (1996), whereas the stakeholder’s metaphor as employed in Corporate Governance is expounded in Apreda (2012, 2011). In the realm of political analysis, in what is called a stakeholders society, the classical rendering is Ackerman and Alstott (2000).

⁷ Hansmann (1996) assessed several kinds of cooperatives through a transaction-costs viewpoint.

By a **primary cooperative** we mean a business association and legal entity whose main features are the following:

- *members enter the organization to pool their own resources on a fully voluntary basis for the fulfillment of their mutual interest and benefit;*
- *members are owners and patrons;*
- *each member holds only one vote, regardless of their equity holding;*
- *the profits are shared and distributed to the extent of the use (or patronage) that ultimately each member makes of the cooperative's services, either as consumer, producer or worker;*
- *only members can be appointed and trained as directors;*
- *members live and trade within or in the nearby of local communities.*

Why, it may be asked, have we chosen to define “primary cooperative” instead of “cooperative in general”? Because every other form of co-op evolves out of this primary notion, as Exhibit 2 stands to prove. However, two- and three-tiered co-ops bring up the issue of survival and sustainability, which will be handled later in section 5.

The closer we look into primary co-ops, the more we realize that a key feature of their governance lies in the idea of cooperation, which should be understood in a broader sense than the one usually employed. It was Lindblom (2002) that made this subtle distinction in his groundbreaking book about the market system:

I think we fail to grasp the full significance of cooperation because the common meaning of the term is narrow. Cooperation, we often imagine, is a situation in which A helps B and B helps A, both doing so deliberately and knowingly. [...] With that restricted concept, we mistakenly overlook the larger kind of cooperation, fundamental to the existence of society. A helps B. B helps C, D, ... or Z, perhaps also but not necessarily A. The help may be either intended or unintended, and it may be offered unknowingly, just as it may be received unknowingly. [...] Aggregates of people become societies and people survive and

flourish because of this second kind of cooperation. It is the foundation of social life and at the core of the market system. (p. 21)

COMPLEXITY LEVELS IN COOPERATIVES	
LEVEL	COMPONENTS
One-tiered structure	Primary cooperatives performing as single associations.
Two-tiered structure	Cooperatives built up out of primary cooperatives but on a regional scale.
Three-tiered structure	They arise out of two-tiered structures that join together to expand their range to national boundaries. It also applies to transnational cooperatives.

2.1.- THE GOVERNANCE OF COOPERATIVES

In this section, we move on to consider some suitable variables of analysis to appraise the governance of cooperatives⁸.

▪ Ownership structure

To begin with, cooperatives are business associations with a specific legal identity. In most countries, there is a bill regulating their activities and making them quite different from investor-owned or non-profit companies. In addition, they are usually regarded as civil entities and not commercial in nature; moreover they fulfill a social mission grounded on mutual interest, cooperation and social capital. Likewise, and mainly in Anglo-Saxon

⁸ On the semantics of the expression governance, see Apreda (2006).

countries, cooperatives may also be shaped as corporations, even as limited liability companies.

Owners of cooperatives buy shares but they are held liable only to the extent of the value of their stock. Furthermore, owners are allowed to cast only one single vote, regardless of how much equity they own. On the other hand, regulations or statutes put an upper limit for stockholding (usually 10% of the whole stock) in order to avoid blockholding or concentrated levels of ownership.

There can be lots of members in a primary cooperative and this fact signals to dispersed ownership, albeit such characteristic differs sharply with the one we find in corporations consisting of many owners. In truth, owners in cooperatives are patrons who live in the nearby of local communities and, consequently, they are able to monitor the co-op performance on a daily basis.

- **Board of Directors**

The administrative and supervisory organ may be called Administrative Council or Board of Directors according to the law tradition in each country⁹. The defining purpose of the Board is to become the fiduciary agent of the whole membership in the cooperative. That is to say, directors must comply, and are accountable for, the duties of diligence, good faith and loyalty. To grant coherence with their commitments, in primary cooperatives directors are chosen from the body of members only. Indeed, this becomes a distinctive feature that allows cooperatives to prevent many conflicts of interest from taking place, making a difference to investor-owned firms where Boards enjoy a wider latitude for opportunism and coalition-building in connivance with senior managers.

⁹ Henceforth, we are going to employ the expression “Board of Directors”, instead of “Administrative Council”.

- **Management**

In primary cooperatives, the Board appoints managers for the sake of administrative functions that require expertise and professional skills in carrying out their delegated tasks and duties. Managers must abide by contractual commitments and are held accountable to the Board for their compliance, and they become liable for breaching fiduciary duties. In clear opposition to what is customary in investor-owned companies, managers cannot become executive directors. By the same token, member-owners in primary cooperatives cannot be nominated as managers¹⁰. As a matter of course, the Board discharges the usual tasks of hiring, promoting, auditing, and even firing managers.

- **Accountability and Transparency**

A necessary condition to grant accountability in organizations hinges upon the pursuit of transparency, which amounts to the production and release of timely, accurate, relevant and checkable information. Focusing on cooperatives, it's not surprising that patrons try to ensure strong compliance with transparency and accountability procedures because they are member-owners with one stake on value creation, but another one on the services they are entitled to receive from the business association.

- **Principles guiding cooperatives**

Since its foundation in the late 19th century, the International Cooperative Alliance has been encouraging cooperatives all over the world to agree and comply with a minimum set of seven good practices for their governance:

- i) voluntary and open membership
- ii) democratic member control

¹⁰ This is the pattern of appointment followed by Boards in most cases. Nevertheless, when the cooperatives blend characteristics of limited liabilities companies, or corporations, an overlapping of functions ensues and ubiquitous governance problems arise eventually.

- iii) member economic participation
- iv) autonomy and independence
- v) education, training and information
- vi) co-operation among co-operatives¹¹
- vii) concern for community

2.2.- PATRONAGE DIVIDENDS

By and large, patronage dividends stand out as the key factor that sets cooperatives apart from investor-owner and non-profit companies.

Whenever a member-owner buys his shares, he can claim ownership dividends, that is to say dividends deriving from the fact that he actually owns shares. However, he will not be given cash dividends, but a credit in his equity personal account instead, in proportion to the amount of shares he actually holds¹².

A remarkable feature of cooperatives lies in the peculiar role of patrons who are not only owners but also members as well. From this vantage point, they are going to receive other sort of rewards, called patronage dividends, which display three characteristics:

- they are residual cash flows out of net earnings, whereby they perform as real dividends;
- the more each patron uses the cooperative's products or services, the greater the amount of cash flows he will receive in the end¹³;
- either regulations, statutes or by-laws usually split down patronage dividends in two categories:

¹¹ Nevertheless, this can be a two-edged sword, as we intend to show in section 5.

¹² More on this in footnote 16.

¹³ Patronage refunds seems a better practice than a discount system, mainly because in the latter course of action the earnings are given away before the sales are known, that is to say, whether or not there will be any actual earnings.

patronage dividends = cash patronage dividends + retained patronage dividends

What owner-members will collect as cash patronage dividends adds up, in most cases, a minimum of 20% of total patronage dividends, whereas the remaining will be retained to increase the cooperative's equity, with due credit to members personal accounts. I am going to expand on this topic in next section.

3.- THE STRUCTURE OF CASH FLOWS IN COOPERATIVES

The incremental cash-flow model¹⁴, so widely applied by the makers and users of Corporate Finance, states that residual economic value passes onto the hands of creditors and owners:

$$\Delta \text{ CF (assets)} = \Delta \text{ CF (creditors)} + \Delta \text{ CF (equity owners)} \quad (1)$$

In a primary cooperative, equity owners are actually member-owners. Hence, (1) should be rewritten

$$\Delta \text{ CF (assets)} = \Delta \text{ CF (creditors)} + \Delta \text{ CF (member-owners)} \quad (2)$$

Whereas in a corporation it holds that

$$\Delta \text{ CF (owners)} = \text{dividends} + \text{equity repurchase} - \text{new equity issue} \quad (3)$$

when dealing with primary cooperatives some important distinctions must be brought to light, since dividends split down into two classes: patronage dividends and ownership dividends, a matter that deserves to be settled in detail.

¹⁴ Ross et al. (1995) provides a good introduction to the model, while a comprehensive development in the context of governance risks may be found in Aprea (2012).

a) In corporations, the Board of Directors distributes net earnings between two categories: ownership dividends and retained earnings. Hence:

(4)

$$\text{net earnings} = \text{ownership dividends} + \text{retained earnings}$$

b) In cooperatives, the allocation of residual cash flows to member-owners is a little more complicated than in (4) because there are two kinds of dividends:

(5)

$$\text{cooperative dividends} = \text{patronage dividends} + \text{ownership dividends}$$

According to regulations in most countries (or well-established conventions in others), a fractional amount of patronage dividends are apportioned among member-owners in cash¹⁵ whereas the remaining is kept as retained patronage dividends by means of an allocation mechanism set down by the cooperative by-laws.

Therefore, (5) entails:

(6)

$$\begin{aligned} \text{cooperative dividends} &= \text{cash patronage dividends} + \\ &+ \text{retained patronage dividends} + \text{ownership dividends} \end{aligned}$$

Retained patronage dividends amount to an increase in the cooperative's equity, under the guise of a "reserve account", or a direct credit to each member's equity account what adds up to new shares of equity to be distributed.

¹⁵ 20% as cash patronage dividends is a frequent allocation. Instead of cash, members may receive vouchers to exchange them with goods or services produced by the cooperative.

As regards ownership dividends¹⁶, they are usually not distributed and are kept aside into the individual member-owner's equity account, or a collective reserve account to capitalize the cooperative. Needless to say, any time the member-owner intends to exit, it is for the cooperative to repurchase his equity holding.

The building blocks of cash flows related to member-owners are the following:

(7)

$$\Delta \text{ CF (member-owners)} = \text{cooperative dividends} +$$

$$+ \text{ equity repurchase} - \text{new equity issue}$$

c) This line of argument, mainly through (6) and (7), carries us to the structure of the incremental cash flows linked with the equity structure. Whereas for corporations it holds that

(8)

$$\Delta \text{ CF(equity structure)} = \Delta \text{ CF(retained earnings)} +$$

$$+ \text{ new equity issue} - \text{equity repurchase}$$

when we move on to cooperatives this structure also comprises information conveyed in 6). Let us start with the structure of retained earnings.

(9)

$$\Delta \text{ CF(retained earnings in cooperatives)} = \text{retained earnings} +$$

$$+ \text{ retained patronage dividends} + \text{ownership dividends}$$

¹⁶ In most cases, statutes or by-laws in cooperatives regard this sort of dividend as "interest" and keep them at the lowest level of return, frequently worked out like a constant rate, a decision that deprives ownership dividends of being considered as residual cash flows, at variance with ownership dividends of corporations.

According to (8) and (9), the equity structure for cooperatives amounts to

$$\begin{aligned} \Delta CF(\text{equity structure}) = & \text{retained earnings} + \text{retained patronage dividends} + \\ & + \text{ownership dividends} + \text{new equity issue} - \text{equity repurchase} \end{aligned} \tag{10}$$

Profiting from (10), we can rewrite (7) under a new format, more suitable for cooperatives:

$$\begin{aligned} \Delta CF (\text{member-owners}) = & \text{cash patronage dividends} + \\ & + \text{equity repurchase} - \text{new equity issue} \end{aligned} \tag{11}$$

By taking advantage of (2) and (11), we can now establish the incremental cash-flow model for cooperatives:

$$\begin{aligned} \Delta CF (\text{assets}) = & \Delta CF (\text{creditors}) + \text{cash patronage dividends} + \\ & + \text{equity repurchase} - \text{new equity issue} \end{aligned} \tag{12}$$

4.- THE GOVERNANCE OF PATRONAGE DIVIDENDS

Patronage dividends bear on far-reaching consequences for the governance of cooperatives.

- a) As it is shown in (10), retained patronage dividends are built into the equity structure, which is the specific vehicle for plowing profits back into the co-op.

- b) As (11) highlights, cash patronage dividends turn out to be variable cash flows on behalf of members: the more they use the cooperative products or services, the better the rewards eventually.
- c) Although incremental cash flows depicted in (12) may nurture variegated deviant behavior fueled by conflicts of interests among the main stakeholders, we should not forget that cooperative statutes, by-laws and the regulatory framework enforceable in each country set hard constraints and deterrents to rent-seeking and other opportunistic devices, on the grounds of mutuality and cooperation principles, as well as the nearness of their member-owners who become watchful and faithful gatekeepers at the end of the day.
- d) Whereas (1) allows corporations greater latitude in decision-making over cash-flows from assets, cooperatives must meet exacting covenants attached to their by-laws and statutes. Let us expand further on this topic.

Cash flows from assets measure the expected economic value to be created by the organization along certain budgeted period. Such value ensues from all sources of income less all kinds of costs and expenses, the netting of which provides the EBIT (earnings before taxes and interest on mid- and long-term standing debt¹⁷). By subtracting from EBIT expected taxes and bringing back depreciation charges¹⁸ (that are not actual outflows) we arrive at what is called “cash flows from operations”:

$$\Delta \text{ CF (operations)} = \text{EBIT} - \Delta \text{ CF (taxes)} + \Delta \text{ CF (depreciation)}$$

As a matter of course, cooperatives should set aside, as other business enterprises should, provisions for working capital and also for non-current assets. Having done this, the final residual may perform as a measure of economic value and is usually denoted as “cash flows from assets”:

¹⁷ See Ross et al. (1995), chapter 2.

¹⁸ Side by side with depreciations, the amortization of intangibles receives a similar treatment.

$$\Delta \text{ CF (from assets)} = \Delta \text{ CF (operations)} -$$

– **provisions to working capital** – **provisions to non-current assets**

In opposition to investor-owner companies, there is an essential covenant holding in primary cooperatives: they buy or sell on behalf of their patrons. Insofar as the member-owners exert their control rights in full, they can avoid cash flows from assets going astray.

- e) Therefore, as it was stated in d), there is a common thread that runs through patronage dividends on the one hand, and cash flows from assets on the other. But the linkage is explicitly stronger in primary cooperatives because their Boards are comprised of members only. Instead, the Boards of two- and three-tiered structures are constituted with representatives of primary cooperatives, hence fading away the peculiar nature of patronage¹⁹.
- f) Relationship (11) underlines another factor that makes the governance of cooperatives stick to consistency: the mechanisms open to members when they wish to leave the co-op.

Firstly, any member-owner can leave at will, by selling his shares to the cooperative. Secondly, it is highly unlikely that members could fashion a bid for power or a contest for majority control so as to build up large blockholders, both developments usually forbidden in statutes, by-laws, or directly in the cooperative-law enforced in most countries, in order to guarantee the democratic control of the organization.

- g) Cooperatives can, and usually do, finance their investment decisions by issuing debt, as displayed in (12), either by taking loans with a bank, or placing bonds among institutional investors or secondary markets. In primary cooperatives, creditors are prevented from joining their Boards, and they are not granted control rights whatsoever.

¹⁹ More on this in section 5.

- h) Sometimes, co-ops issue preferred stock to place among investors, even other co-ops. Preferreds distribute constant amounts of money that perform the role of interest payments in conventional bonds, which are called preferred dividends. These securities do not vouchsafe control rights to their holders who are regularly prevented from becoming member-owners²⁰.
- i) However, co-ops usually resort to self-finance since they capitalize their equity out of patronage and ownership dividends, making internal funds available as depicted in (9), on a yearly basis. Every now and then, they may also issue new stock that it will be placed among the incumbent membership or a new breed of member-owners.

5.- HOW THE OUTGROWTH OF SCOPE AND SCALE ENDS IN GOVERNANCE RISKS

The natural habitat for primary cooperatives have always consisted in small, local communities, within which they gained success and recognition, meeting their purposes by tapping into mutualism, cooperation, trust, and patronizing. In other words, they have been availing themselves of countless resources nurtured by social capital.

Nevertheless, as time passed by, the one-tiered level of organization we have labelled “primary cooperatives” was eventually superseded, as we can see in Exhibit 2, by two-tiered structures consisting in arrangements of primary cooperatives playing each of them the role of a single member-owner. Broadly speaking, the cooperative movement stayed to gain in scope and scale when such composites reached regional boundaries, provided they would not forfeit the long-standing tenets of the cooperative ideals. But

²⁰ If preferred stock were issued, then (12) should be suitably reshaped; for instance, by writing:

$$\begin{aligned} \Delta \text{ CF (assets)} &= \Delta \text{ CF (creditors)} + \Delta \text{ CF (preferred stock-holders)} + \\ &+ \text{ cash patronage dividends} + \text{ equity repurchase} - \text{ new equity issue} \end{aligned}$$

growth always conveys risks, and the farther the two-tiered cooperatives stretched out to attain national dominance, the more likely the hazards of misrepresenting the principles of mutuality, cooperation, trust and nearness came to the fore. In other words, the transition from community-based to national-based cooperatives withered the rich variety of assets furnished by social capital.

The last hundred years bear witness to how cooperatives ultimately coped with their problems of growing in scope and scale, mainly by trying four viable alternatives:

- a) Changing their statutes or by-laws to become corporations (or limited liability companies in many countries), a widely adopted decision undertaken not only by credit unions (the name cooperative banks receive in some quarters) but also by some worker cooperatives (for example, investment banks and advertisement agencies) along the 1980s and 1990s, mainly in Europe and the United States. Hence, the impending problems of scope and scale were avoided by closing cooperatives, changing them into other sort of organizations more able to fight against hostile or competitive environments.
- b) Another solution consisted in embedding primary cooperatives in two- or three-tiered structures, a decision entailing the risk of losing social capital resources and triggering off a host of new governance problems like deceitful transparency, fuzzy accountability and rent-seeking managers. As primary co-ops coalesce into more embracing levels of organization, they move on to the conflict-ridden separation of ownership and control which has compounded so many agency problems and costs in investor-owned companies.
- c) Sometimes, corporations may join the two- and three-tiered levels to play the role of member-owners, but this may lead to a cooperative hybrid that lacks identity, because it is very arduous to draw the line between cooperation and outright cooptation.

- d) In some countries we find overwhelming evidence that their governments seek to enhance regional economies by providing cooperatives with lines of credit, and easing their regulatory framework. Regretfully, in other countries their governments carry out an unprincipled political encroachment upon cooperatives. The latter scenario gives rise to the so-called “social cooperatives” which may become vehicles for political clientelism and corruption in disguise.

Briefly stated, as far as cooperatives attempt to grow by superseding the primary units, their founding tenets might be compromised and undermined.

CONCLUSIONS

Primary cooperatives prove to be successful business associations whose strength comes out of being community-based, and because they avail themselves of the surrounding social capital.

Their distinctive feature inheres in the fact that members are patrons and owners of the cooperative, so they benefit from the services provided by the organization while they are entitled to patronage dividends.

From a Corporate Finance standpoint, patronage establishes a deep-rooted mutuality between cash flows from assets (that measures the creation of economic value creation) and patronage dividends.

As primary cooperatives make headway they increase in size and scope, a process that also fosters dysfunctions in their governance, conflicts of interests among patrons, directors, managers, mainly when they merge their activities in two- or three-tiered structures that might jeopardize their founding principles.

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