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Rethinking incentive problems in cooperative organizations

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Preface

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The purpose of the paper is to review the way incentive problems in cooperative organizations tend to be addressed in cooperative studies. Recently, many observers have underscored that cooperatives are plagued by substantial incentive problems, so that members do not bear the full impact of their individual choices. It is argued that incentive problems are inherent in the cooperative form. The idea to be advanced in this working paper is that the validity of the critique raised from agency theory and property right theory rest with their *ex ante* assumptions about the nature of cooperative membership. The pivotal point is whether members are essentially ascribed the properties, reasoning and strategies of a rational investor or a rational user.

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Leif Forsell

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Abstract

Many students of cooperative organizations have underscored that cooperatives are plagued by substantial incentive problems, so that members do not bear the full impact of their individual choices. It is argued that incentive problems are inherent in the cooperative form. I claim that the critique needs further clarification. The idea to be advanced here is that the validity of the critique raised from agency theory and property right theory rest with their ex ante assumptions about the nature of cooperative membership. The pivotal point is whether members are essentially ascribed the properties, reasoning and strategies of a rational investor or a rational user.

1 Introduction ¹

Make everything

as simple as possible,

but not simpler.

Albert Einstein.

Incentive problems have come to the forefront in cooperative studies. Increasingly, students of cooperative organizations have applied property rights theory (PRT) and agency theory (AT) as theoretical frameworks for identifying incentive problems within the cooperative form (Vitaliano, 1983; Porter & Scully, 1987; Nilsson, 2001; Cook & Iliopoulos, 2000; Harte, 1997). These contributors converge on a set of interrelated incentive problems that are thought to plague cooperatives more fundamentally than other organization forms such as investor-owned firms. There are many types of incentive problems, and their common core is the assumption that members do not bear the full impacts of his/her choices and actions. As shall be explained in the following, some incentive problems are investment-related (common property/free rider, horizon, portfolio) whereas other incentive problems are decision-related (control, follow-up, influence-cost). Notwithstanding the fact that incentive problems are often unfolding in cooperative organizations, I shall here claim that the critique raised from the perspectives of property right theory (PRT) and agency theory (AT) should be more concerned with the conditions under which incentive problems are most likely to arise. The description of incentive problems is the result of a set of assumptions with respect to members' goal orientation and perceived self-interest. My point of departure here is that incentive problems emerge only under certain conditions, and the challenge is to specify these conditions clearly in order to assess the validity of the critique. The upshot is that the problem description presented by agency theory and property right theory must be examined in light of the properties of man and economic activity that are presupposed by these theories. The conclusions to be drawn from AT and PRT are the results of a particular way of describing the cooperative membership; i.e. the role of investor. A more careful consideration of the conditions under which incentive problems emerge as problematic is required.

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The article proceeds as follows: First, a brief overview of incentive problems in cooperatives is presented, as seen through the lenses of agency theory and property rights theory. Thereafter follows a discussion of the particular assumptions of human behavior that is taken for granted in these theories. These assumptions are thereafter criticized, and some alternative assumptions are suggested. From this basis, an alternative look at incentive problems is suggested.

2 Incentive problems in cooperatives

Fama and Jensen (1983) claims that two categories of contracts are fundamental in organizations: (1) Contracts that regulate the residual rights and (2) contracts by which decision processes are designed. The former is particularly concerned with the obligations, rights and risk of the residual claimants; i.e. the duties and liabilities that follow from the role as investor. Within this category, three investment-related incentive problems are commonly assumed to be of particular relevance for the cooperative form; i.e. the “common property”-problem, the “horizon”-problem and the “portfolio”-problem. Here, these incentive problems shall be briefly presented, predominantly from the perspective of property right theory. Particular focus is on the reasons why these problems are assumed to be more problematic in cooperative organizations than in IOFs (investor-owned firms) or other competing forms. The latter category (decision-related incentive problems) relates to the contracts by which decision processes are designed. Four interrelated incentive problems—the monitoring problem, the follow-up problem, the influence cost problem and the decision problem—shall here be briefly presented, predominantly from the perspective of agency theory. Here too, particular emphasis is on the reasons why these problems are perceived of as more problematic in cooperatives than in IOFs.

2.1 Investment-related incentive problems in cooperatives

Investment-related incentive problems are predominantly conceptualized from the perspective of property right theory. Property rights provide owners with a claim to the residual returns of the firm and assign them a more or less influential role in the decision process. Three property rights are commonly distinguished; the right to use an asset (“usus”), the right to reap the benefits generated by use of the asset (“usus fructus”), and the right to transfer part or all of these rights to others (“abusus”) (Furubotn and Pejovich, 1972). Three types of investment-related incentive problems

dominate in the literature; the common property problem, the horizon problem and the portfolio-problem. Each shall be briefly presented below.

The **common property problem** is concerned with the disparity between the members' contribution to the financing of investments and the distribution of benefits that results from members' investments. The disparity between a members' contribution of equity and his/her benefit from the equity is assumed to lead to free rider behavior between members and non-members, and between existing and newly entering members. In other words, the free rider problem is intimately linked to the fact that the equity is collectively owned (common property). Further, the distinct nature of this "common property problem" refers to the lack of a system for valuing and trading residual rights (the right to acquire the cooperative net surplus). As observed by Vitaliano (op.cit., p.1082):

"Upon admission to membership in a cooperative organization, a new member-patron acquires the same rights to the organization's residual cash flows based on patronage and the same rights to participate in the organizational decision process as those held by existing members. New members are rarely required initially to pay fees or make investments approximately equal in amount to the value of these rights."

Vitaliano calls attention to the adversarial consequences of this common property problem. He holds that the common property aspects of the residual claims of a cooperative give rise to differences in the preferences of various subgroups of its members, based upon the length of time their claims have been held. The cause of the problem is that the individual cooperative member has no direct or personal control over "his" respective part of the unallocated capital. The capital is in everybody's hands, but not in anyone's hands. So why should cooperative members engage in issues (s)he can not impact? The pessimistic assumption is that common ownership fosters apathy among members (Nilsson, 2001). The adversarial consequences of common property are expected to be read off both in the form of inefficiency and weak membership commitment.

A second incentive problem is the so-called **horizon problem**. Following property right theory, the horizon problem stems from the fact that residual claims of cooperatives are contingent rights to cash flows whose validity expires when a member ceases to patronize the organization. As argued by Vitaliano (op.cit, p.1082):

"Residual claimants can capture the benefits of investment decisions only over the time horizons of their expected membership in the organization. This can be expected to give rise to additional differences in subgroup preferences among members, based on differences in such horizons, with a general tendency for them to favor investment decisions with short payoff horizon. Horizon problems of cooperative residual claims therefore have implications for cooperative investment behavior and organizational growth..."

Consequently, members are expected to become preoccupied with myopic perspectives on their cooperative membership. "Here-and-now" actions are assumed to dominate a long-term, strategic perspective on the purpose of the cooperative. A system of tradable owner shares is expected to solve the horizon problem since members with short payoff horizon could sell their ownership shares to members with a longer payoff horizon.

The **portfolio problem** refers to the situation that members have diverse risk/reward-profiles. As long as cooperative members have unequal time horizons there will be different viewpoints with respect to their cooperative's risk/reward-profile. From the

perspective of agency theory, cooperatives should ideally have an investment portfolio that reflects the members' preferred trade-off between risk and reward. Vitaliano (op.cit) holds that the root cause of the portfolio problem is that the restriction of residual claims to the patron group in cooperatives deprive members of the opportunity to diversify their risk by holding the claims of many organizations, either directly or through mutual stock funds etc. Such portfolio problems can give rise to further differences in preferences among subgroups of members, with a general tendency for them to favor decisions with lower levels of risk. Here too, the portfolio problem is assumed to be particularly problematic in cooperatives due to the lack of a trading system of residual rights. Such a system would have allowed members to develop an investment portfolio that corresponds to their preferred risk/reward-profile.

2.2 Decision-related incentive problems

Another group of incentive problems are related more directly to the decision mechanisms in cooperatives. Since these decision-related incentive problems are drawn and derived from agency theory, a brief presentation of agency theory is necessary. Modern agency theory has many ancestors. Its roots may be found in the works of Ross (1973), Jensen and Meckling (1976), Fama and Jensen (1983), Holmström and Tirole (1988), Grossman and Hart (1986), Hart and Moore (1986), Furubotn & Pejovich, (1974) and Alchian and Demsetz (1972). These contributions originate from different perspectives such as the theory of the firm, theories of incomplete contracts and information economics. Agency theory address problems within organizations where ownership and leadership are separated (Eisenhardt, 1989). More specifically, a principal-agent relationship arises when a principal contracts with an agent to perform some tasks on behalf of the principal. The principal delegates authority to the agent, and the welfare of the principal is affected by the choices of the agent. Agency relations can be found both between firms (for instance franchising and licensing) and within firms (manager vs. subordinate, employer vs. employee, cooperative members vs. the management of a cooperative firm). Agency theory is particularly concerned with those situations in which the agency relation is problematic. Organizations are viewed in terms of conflicts of interests between principals and agents. Relations between principals and agents tend to be complex because no contract is perfect, and contracts are costly to draft, maintain and follow up. Barney and Hesterly (1996) conclude that the delegation of decision-making authority from principal to agent is particularly problematic under three conditions: when the interests of principal and agent diverge, when the principal cannot perfectly and costless monitor the actions of the agent, and when the principal cannot perfectly and costless monitor and acquire the information that is available to or possessed by the agent. Control costs occur because the principal must use resources to direct and control the agent. This is done by establishing a contract and by controlling and ensuring the fulfillment of the contract. However, since the agent has the freedom to make independent decisions, there is some risk that he will not manage the organization in a fashion that best benefits the principal. The principal has rights to the surplus created by the organisations activities (residual rights), but the agent is able to direct the organization so that the surplus of the organization is influenced. Two generic problems can occur as a consequence of potentially differing interests: moral hazard (hidden actions), and adverse selection (hidden information) (Arrow, 1985). Moral hazard involves situations in which the actions of the agents are either hidden from the principal or costly to observe. This makes it either impossible or costly for the principal

to fully monitor the actions of the agents. For instance, owners may find it prohibitively costly to fully monitor the behavior of their top management team. The employment relation is one in which effort and ability are typically difficult to observe. The employee (agent) possesses information that is unobservable or costly to obtain by the employer (principal). Consequently, the employer cannot fully ascertain whether or not his interests are best served by the decisions of the employee. Guidelines may be spelled out and the agent may to some extent be monitored, but the agency relationship is nevertheless characterized by the freedom to independently determine activities and contracts.

The overriding theme in agency theory is how to harmonize the conflicting interests of principals and agents. What is the optimal level of control that principals must effect to be assured that agents act in their true interests? According to agency theory, the strategy to counteract agency problems is to establish a system of efficient financial rewards that specify how the principal can align the agent's interests with his own interests, and to clarify how the principal can direct and control the agent. Agency theorists are particularly focused on inefficiency of the decision-making process, poor business strategy implementation and high influence costs. More specifically, a number of intimately related decision problems are commonly found in cooperative organizations, such as the monitoring problem, the follow-up problem, the influence cost problem and the decision problem (van Bekkum, 2001).

The **monitoring** problem stems from the fact that decision management is allocated to decision specialists who are not residual claimants. There is therefore a risk that agents will make decisions in such a way as to lower the value of the firm's residual claims, which gives rise to agency costs. Monitoring devices available to the traditional cooperative may be inadequate to gather sufficient information in situations where the cooperative engages in highly complex operations.

The **follow-up problem** is expected to occur if there are many members, each unable to significantly influence decision-making processes or supervision of the management, and individually capturing only a small fraction of potential benefits from such activities.

The **influence cost** problem occur when there are different group of owners of the cooperative with opposing interests, each entitled to share in the distribution of benefits and engaging in internal lobby activities to promote their own selfish interests.

Finally, the **decision problem** relates to the situation of a large and heterogeneous membership, making it challenging for the management to decide how to weigh different member opinions.

3 Under what conditions do incentive problems unfold?

I have now presented a short review of the nature and causes of incentive problems in cooperatives, as seen through the lenses of property right theory and agency theory. A fundamental question is *when*—i.e. under what conditions—these incentive problems are most likely to unfold. As already indicated, there are some suggestions available in the scholarly literature. Nilsson (2001) has emphasized that incentive problems can appear as more or less problematic in cooperatives depending on such variables as the degree of *homogeneity* of the membership body, the amount of *financial contribution* from members, the degree of *contingency* between members goals and cooperative goals, as well as the degree of *members' involvement* with their cooperative.

Cook and Iliopoulos (1998) have suggested a number of criteria that partially overlap with Nilsson (op.cit). Their first criteria is *singleness of purpose*, since homogeneity of economic interests eliminates free rider, influence and portfolio negative externalities. The second criteria is *control of supply*, since the ability of cooperatives to control quantity and quality variability in premium produced output creates organizational boundaries which allows for the development of a more clearly defined set of incentives for risk capital investment. The third criteria is *incentives for Risk Capital Investment*, since these will create incentives for users to contribute to growth-oriented risk capital acquisition and reduce the organisational inefficiencies generated by the horizon and portfolio problems. Fourth, incentive problems may be ameliorated through creating a *sense of belongings* to the cooperative. Finally, the design of contractual arrangements defining responsibility of obligation may reduce quantity variability, quality variability, and pool earning dilution along with free rider issues. (p. 551).

In the following, my focus is also on conditions under which incentive problems are most likely to emerge and develop in cooperative organizations. The idea I advance, however, is that the validity of the critique from agency theory and property right theory rest also with their *ex ante* assumptions about the nature of cooperative membership. The pivotal point is whether members are essentially ascribed the reasoning and

strategies of a rational investor or a rational user. In its simplest form, this message is presented in Figure 3.1 below.

		Ownership structure	
		Coop	IOF
Membership strategy	user	(I) Match	(II) Mis-match
	investor	(III) Mis-match	(IV) Match

Figure 3.1 Match/mismatch between ownership structure and membership strategy

The underlying question—well-known from the scholarly strategy literature—is whether or not there is a reasonable match between an organizations structure and its strategy. The special case here is that mismatches may occur between the ownership structure that patrons choose and their overall strategic intent. Meritoriously, agency theory and property rights underline that the quadrant III in Figure 3.1 is problematic, which is read off in the form of incentive problems. However, the analysis from these two perspectives seem to presuppose that members think and act like investors rather than users. This underlying premise is contestable. Members in cooperatives are—de facto—users rather than investors. This fact should imprint the exploration of incentive problems more than have so far been the case. My contribution here is to try and rethink the incentive problems, given that members are ascribed a “user logic” rather than an “investor logic”.

4 Incentive problems revisited

To what extent incentive problems plague cooperative organizations depend—inter alia—on the assumptions made about the nature of cooperative membership. For instance, the role as user of an agriculture cooperative refers to the fact that members enter the cooperative in order to achieve a secure market outlet for their products. Their goal function is normally multidimensional, but the overall objective qua user is to secure market access over time, at best possible product prices. In accordance with the argument from Transaction Cost Economics, the underlying motivation for a member (qua user) to enter a mutually binding agreement with a cooperative is to reduce uncertainty related to market access, and thereby protect specific investments. This is different from the perspective of a capital investor. The objective of the latter is to maximize return on invested capital, given his risk-reward profile. His capital is mobile, and should in principle be moved between different investment options according to relative changes in their respective profitability score. In principle, the strategic rationale of a user deviates from an investor, e.g. when it comes to phenomena such as perceived self-interest and derived concepts like risk-taking and mutual obligations over time.

I assume that incentive problems are essentially the result of a mismatch between the ownership structure (here: cooperative) and strategic intent (here: a clearcut investor strategy). In the real world, the roles are commonly intertwined, but in order to clarify the argument, I shall here separate them and give them an idealtypical content. The further point I want to make is that—if the strategy of a member is more in tune with the role as user, it is less likely that incentive problems unfold in cooperatives. Agency theory and property rights theory ascribe the members a too simple version of self-interest; i.e. a replication of the well-known “Economic Man”-image which is predominantly occupied with isolated individuals. This conceptualization may suffice if the task at hand is to model the very essence of investment behavior. But it is incomplete if the task is to capture the strategic reasoning and acts of a cooperative user. This debate is too wide to raise in any detail here, and I shall confine myself to briefly mention a few other conceptions of self-interest that may show useful in order to better understand

the rationale of a user. Etzioni's "I and We" paradigm (Etzioni, 1988) highlights that individuals act within a social context, that this context is not reducible to individual acts, and, most significantly, that the social context is not necessarily or wholly imposed. Instead, the social context is to a significant extent perceived as a legitimate and integral part of one's existence, a "We", a whole of which the individuals are constituent elements. The "I and We" paradigm assumes that people have at least some significant involvement in the community, a sense of shared identity, and commitment to values; a sense that "we are members of one another". Hence, adhering to shared values is often a matter not of expedient conformity, but of internalization of moral values, at least in part (Wrong, 1961, p. 186). This extended image of self-interest stands in a striking contrast to the assumptions of man made by agency theory and property right theory that either do not recognize collectivities at all, or sees them simply as aggregates of individuals without causal properties of their own and as external to the person. The individual is seen as being detached from the community and from shared values, calculating whether or not to be a member and whether or not to heed the value dictates. So-called stewardship theory (Davies, Schoorman and Donaldson, 1997) has much in common with Etzionis reasoning. The *ex ante* assumptions of a steward is that (s)he is motivated by higher order needs of growth, achievement, and self-actualization, and by intrinsic rewards. Pro-organizational, collectivistic behavior has a higher utility than individualistic, self-serving behavior. (S)he accepts responsibility and accountability for the organizational community. An earlier suggestion in the same spirit is the "club theory", as suggested by Buchanan (1965). In the following I shall try and exemplify these arguments more. My discussion is structured around the typology of incentive problems that was presented earlier.

4.1 "Collectively owned equity" and "the free rider problem" revisited

Agency theory and property rights theory are predominantly concerned with the disadvantages that collective residual rights represent for cooperative members. But given that members think and act strategically qua their role as user, members should be ascribed the capability to conduct a more balanced assessment so that both advantages and disadvantages are taken into account. First, risk adverse members may appreciate that collectively owned equity capital serves as an alleviation and absorber of external shocks; i.e. unexpected and potentially damaging contingencies that cannot easily be dealt with by members individually and separately. Common responsibility may be especially important in a situation where members' collective interests are threatened. The "insurance function" that is related to collectively owned equity may reduce exogenous uncertainty for members and ameliorate their need for individual insurance arrangements. Collectively owned—and therefore stable—equity may also set cooperatives in a good negotiation position vis-a-vis providers of loan capital (bank and other financial institutions). Furthermore, the free rider-problem—that a new member come too easy to benefits developed by other members—is more complex than assumed by AT and PRT. A rational user should weigh the disadvantages related to no compensation when exiting the cooperative against the advantages of free entrance (costless entry). Over time, the individual member will probably shift from being an "underperformer" to being an "overperformer". From the perspectives of rational user (i.e. enhanced self-interest" and generalized reciprocity), this can be a normal and acceptable situation. The more fundamental underlying condition is whether or not

members' advantages qua user is made explicit and embedded in a cooperative ideology that envision members' rights and duties over time. For instance, such a cooperative ideology may maintain that collectively owned equity manifests a collective protection-shield around members' financial investments and associated immaterial values (brand name etc.). The ideology may further maintain that these collective investments have a wider scope than values provided by investor-owned companies.

4.2 The Horizon problem revisited

The objective of a rational investor is to maximize his portfolio of financial investments, in accordance with his risk/reward-preferences. AT and PRT pose the appropriate critique that the cooperative form is not the adequate structure for people that pursue the logic of a rational investor. It is, however, too far to claim that the horizon problem reflects an in-built disadvantage of the cooperative form. A user may conduct a more balanced assessment of advantages and disadvantages of the cooperative membership. If a user plans to cease to patronage the cooperative in three years from now, will he necessarily vote down all collective investments with a longer time horizon than three years? It may be the case, but not with any necessity. As a rational user, (s)he may be aware that (s)he earlier—as a newcomer—has benefited from the “overinvestments” made by preceding members who are no longer active members. The “role” as underachiever and “overachiever” change over time, which is a normal situation in a cooperative, in tune with the principle of generalized reciprocity. Whether the net total over time is perceived of as negative or positive is essentially an empirical question. A parallel decision criteria is that the disadvantages associated with no compensation when exiting, must be weighed against the advantage associated with free entry. Moreover, the user may weigh potential disadvantages of “overperforming” etc. in a certain period against the increased transactions costs associated with establishing an alternative market outlet. What are the alternative costs in terms of search costs, information costs and control costs associated with establishing an alternative to the cooperative membership? The factual significance of such heuristic decision rules may of course vary, but they should not be ruled out at the outset as have up till now been done by agency theory and property rights theory.

4.3 The Portfolio problem revisited

AT and PRT address the problems and disadvantages associated with different risk-reward-profiles. As discussed above, however, the fundamental issue is whether members conceive of their membership as a capital-investment at all. Is cooperative membership essentially about (1) optimizing patronage and secure market access or (2) optimizing financial investments as judged by the individual's risk/reward preference? Indeed, users also invest in their cooperative firm. But the underlying rationale differs from that of an investor. Members' investments in the form of retained earnings are predominantly made to increase the cooperatives capability to serve as an efficient market outlet. Retained earnings in year 1 is therefore expected to be remunerated by satisfactory product prices in year 2. The specific outcome of this type of calculation may of course vary, but this type of decision structure is more adapted to the features of the cooperative form. To patronize a cooperative is essentially a strategy to set up an effective system for market access, which is—at the end of the day—a vehicle for

optimizing product prices. Normally, membership of a cooperative is motivated by that feature, whereas IOF's are expected to be more attractive than cooperatives when it comes to return of capital investments.

4.4 Decision-related incentive problems

From the perspectives of agency theory and property rights theory, much has been said about various decision problems in cooperatives. It is clear that the degree of homogeneity is a vital factor to explain high levels of transaction costs associated with decision problems. But again, there are advantages of the cooperative form that should be explored further. For instance, the cooperative board and management are expected to be highly sensitive to members' interests—qua users (Hansman, 1990). Decisions processes in cooperatives may be slow, but they tend to be transparent and invite to active participation. Subsequently, they may be followed by substantial discipline when it comes to implementation. A member is more loyal to decisions to which he has participated actively than to decisions that are imposed on him.

Furthermore, a rational user is presumably able to compare the costs and benefits of collective decision-making within the cooperative with the costs and benefits of alternative modes, such as conducting market transactions on his own risk and fortune. Probably, members (read: users) that obviously benefit from the cooperative in terms of reduced transaction costs (one overall market outlet) are inclined to tolerate some level of corporate control costs. Again, the specific outcome of this type of balanced reasoning is an empirical question.

5 Conclusion

My theme is whether or not agency theory and property rights theory offer a reasonable image of incentive problems in cooperative organizations. I am skeptical. I think that the assumptions underlying agency theory and property rights theory first and foremost capture the rationale of an investor, to the neglect of the role that should be more familiar role of user, in cooperative organizations. However, the contributions based on agency theory and property rights theory make a useful description of a mis-match problem: That a specific choice of ownership structure (read: cooperative) do not match a specific strategic intent (read: investor). This is an elementary insights, but seems not to have been taken sufficiently into account when cooperative organizations are explored from the perspective of agency theory and property rights theory. One reason may be that what we find in practice are various blends of the two roles. An illustrative example is found in new-generation cooperatives, characterized by active users and active investors. It is consistent with my reasoning above that this type of hybrid organizations (“partly coops and partly IOFs”) now lay so much effort on developing a matching governance structure; partially following the logic of member as user, and partially following the logic of member as investor. Future research on incentive problems from the perspective of agency theory and property rights theory should take this development into account.

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