

## South Africa's new Cooperatives Act: A missed opportunity for small farmers and land reform beneficiaries

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### Abstract

*Agricultural cooperatives are often viewed as appropriate vehicles to facilitate vertical coordination with, or horizontal integration between, small farmers who would otherwise be excluded from value-adding opportunities and discerning markets. In South Africa, renewed interest in development-oriented cooperatives saw the introduction of a new Cooperatives Act in 2005, along with support measures dedicated to 'emerging' cooperatives. This paper contends that the architects of the new Act discounted important trends in international legislation that would have made development-oriented cooperatives more versatile and given their members better access to capital and expertise through equity partnerships with private agribusiness firms. It is concluded that the new Act should be amended to admit non-patron investors as members, and to allow for non-redeemable and hence appreciable and tradable shares. Such innovations are emerging internationally, usually with a cap on non-patron voting power.*

**Keywords:** Agricultural cooperatives; small farmers; new institutional economics; strategic partnerships; land reform beneficiaries

### 1. Introduction

Agricultural value-adding cooperatives are often rationalised as a way of reducing transaction costs and alleviating hold-up problems caused by asset specificity through vertical coordination of farmers into processing and marketing activities (Cook & Iliopoulos, 1999; Plunkett & Kingwell, 2001). Cooperatives also represent horizontal integration, an extreme form of horizontal coordination in which farmers surrender use rights and decision-making power to a manager in exchange for a different set of property rights, namely benefit and voting rights. In the development context, cooperatives are often driven by hopes that horizontal integration will reduce fixed *ex ante* transaction costs that keep small farmers out of product markets, and which

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are increasing with mounting concerns about food safety and the environment (Poulton & Lyne, 2008). Indeed, horizontal integration was an important part of the thinking behind South Africa's new Cooperatives Act, 14 of 2005. Speaking during his visit to land reform projects in the country's North West province, Deputy Minister of Agriculture and Land Affairs, Dirk du Toit, commented, "It is difficult for individual emerging farmers to survive in this industry. This is why it is important for them to form cooperatives to not only penetrate the market but also be competitive" (BuaNews, 2006).

One of the purposes of the new Act is to ensure the provision of support programmes for 'emerging' cooperatives, a term used to describe development-oriented cooperatives established to promote the interests of previously disadvantaged people. In June 2005, the Minister of Trade and Industry, Mandisi Mpalwha, announced that incentives and capacity building grants had been designed for development-oriented cooperatives, and that government financing agencies (including Khula and SEDA) had been mandated to support cooperatives (GCIS, 2005). The availability of dedicated support suggests that cooperatives will also play an important role in the management of community-owned resources acquired through land reform, including reforms planned for the country's communal areas. The Cooperatives Act explicitly targets black people in rural areas. This study questions the decision to dedicate public support to cooperatives when the interests of their members might better be served by other forms of organisation.

The paper draws on the New Institutional Economics to analyse the type of cooperative organisation predicated by South Africa's new Cooperatives Act, and to assess its worth as a vehicle for development. It is contended that the architects of the Act discounted important trends in international legislation that would have made South African cooperatives more versatile and given development-oriented cooperatives better access to capital and expertise through partnerships with firms in the formal economy. If this hypothesis is true, recommendations can be made to amend sections of the Act in ways that strengthen the empowerment prospects of development-oriented cooperatives and so improve the productivity of public support dedicated to them. The paper sketches the 'cooperative revival' in South Africa and then introduces a hypothetical case to illustrate the institutional flaws that constrain traditional cooperatives. Section 3 describes variations of the traditional cooperative, each involving institutional changes to promote growth. Section 4 explores dramatic changes recently adopted by developed countries seeking to make their value-adding cooperatives more competitive. The final section considers amendments to South Africa's new Cooperatives Act and its related support programmes.

## **2. Renewed support for cooperatives in South Africa**

Mpalwha (2005:1) contends that African intellectuals and leaders favour cooperatives (to empower marginalised communities) because “African society is ideally suited to working in cooperatives”. South Africa’s 2003 Presidential Growth and Development Summit endorsed special measures to support development-oriented cooperatives. Following this commitment, government responsibility for cooperatives was transferred from the Department of Agriculture (DoA) to the Department of Trade and Industry (DTI) (Philip, 2003). The DTI drafted new policy on cooperatives and a Draft Bill that was gazetted in 2003. The Bill was enacted in August 2005.

However, the First Draft Cooperatives Bill was prepared in 2001 by the DoA. This original draft borrowed heavily from Canadian legislation (COSATU, 2001) that introduced innovative changes to help value-adding cooperatives source additional capital (see section 4.5). In particular, section 104 of the First Draft Cooperatives Bill provided for ‘investor shares’ that could be purchased by non-members and which conferred limited voting rights on their holders. This provision was severely criticised by the Congress of South African Trade Unions (COSATU) as it imposed ‘a model of cooperatives that is antithetical to the principles of cooperatives and seems to be crudely imposing a “business conception” of a cooperative’ (COSATU, 2001, section 5.2.5). The offending sections were cut from the DTI’s Draft Bill that was enacted in 2005.

The new Act introduces public support for development-oriented cooperatives. The DTI will treat these initiatives as small and medium enterprises (SMMEs) and, as such, they will qualify for all of the incentive and support programmes offered by the Department and its agencies to SMMEs in the broad areas of training and access to finance. Beyond this, the DTI will also offer dedicated financial and capacity building support to cooperatives. The additional financial support will most likely include incentives to assist start-ups (Mpalwha, 2005).

Ortmann and King (2006:62) recommend that small-scale farmers in South Africa should exploit the wave of support for cooperatives even though future growth of their enterprise may be constrained by institutional deficiencies inherent in traditional cooperatives. However, this approach is expected to waste scarce public resources as few development-oriented cooperatives are likely to survive the initial stages of enterprise development when weak institutions are imposed on communities bereft of capital and lacking in business skills. The historical record of such cooperatives has been dismal in South Africa. Van der Walt (2005) reports that 65 per cent of 54 registered cooperatives sampled in the Limpopo province were not functional.

Widespread failure of agricultural cooperatives in South Africa's communal areas has been blamed largely on poor management (Van Niekerk, 1988; Van der Walt, 2005). Unfortunately, this naïve conclusion seems to have distorted plans for supporting cooperatives in favour of training. Training is important, but it will have little impact if underlying institutional problems discourage managers and members from growing the cooperative business. In their US study, Porter and Scully (1987) estimated that reorganising a randomly selected (traditional) fluid-milk processing cooperative as an investor-owned firm (IOF) could increase its output by 32.4 per cent - without hiring additional inputs. They concluded that tax breaks, interest subsidies and the gratis services of the US Department of Agriculture were keeping inefficient cooperatives in business.

Dedicated support for development-oriented cooperatives is a political reality in South Africa. This support will not be productive if emerging cooperatives are undermined by weak institutions. It is therefore important to establish the origins of institutional problems in traditional cooperatives and the extent to which prevailing legislation can accommodate changes to address these problems. Cook (1995:1159) argues that farmers who reorganise their cooperatives in ways that alleviate the problems created by flawed institutional arrangements have a bright future. His optimism, evidenced by the rapid growth of New Generation Cooperatives (NGCs) in the USA (Harris *et al.*, 1996), is grounded in the argument that cooperatives hold a transaction cost advantage over firms owned by external investors because incentives are better aligned when farmers contract with their own organisation (Sykuta & Cook, 2001).

### **3. What institutional flaws constrain the growth of a traditional cooperative?**

To answer this question, it is useful to consider investments in growth assets that a cooperative needs in order to provide competitive services. These assets, be they tangible (like fixed improvements) or intangible (like product branding), must be financed from equity and/or debt capital. The problems that cooperatives have raising equity capital due to their flawed institutional arrangements (ill-defined property rights in particular) have been well documented (Jensen & Meckling, 1976; Porter & Scully, 1987; Cook & Iliopoulos, 1999, 2000; Sykuta & Cook, 2001). Low levels of equity capital obviously compromise a cooperative's credit-worthiness and hence the amount of capital that it can borrow. In addition, for any given level of equity, a cooperative's ill-defined property rights further reduce its access to debt capital (Hendrikse & Veerman, 2001).

By way of example, consider a cooperative established to manage a common pool grazing resource following implementation of the Communal Land Rights Act (CLaRA), Act 11 of 2004. CLaRA's objectives include a reduction in open access land and the development of agricultural and tourism enterprises (Rugege, 2006). Assume that members of the community pay a small fee to join the emerging cooperative and that this fee finances one share in the cooperative. Livestock owned by shareholders can be added to an aggregate herd managed by the cooperative. Mature animals can be reclaimed by their owner or are sold by the cooperative with the cash proceeds accruing to the owner. In both cases, the cooperative imposes a levy to cover operating expenses. To improve herd productivity and net benefits accruing to member patrons, the cooperative must fence off and supply water to rotational grazing camps. Although some members could invest more equity capital to help finance these improvements, they are reluctant to do so owing to ill-defined benefit rights.

First, a traditional cooperative limits dividends paid on equity capital, distributing most of its profits to members according to their level of patronage. These institutional arrangements stem from the fundamental principles of Voluntary and Open Membership and Member Economic Participation (ICA, 2005) which are widely interpreted as requiring (a) all members to be patrons and (b) distributing profits to patrons rather than to investors. These constraints are specified in sections 3(1)(a)<sup>3</sup>, 3(1)(d)<sup>4</sup> and 44(1)<sup>5</sup> of South Africa's new Cooperatives Act. Residual claims therefore reside with patrons, and this creates an internal free-rider problem. Relatively cash rich members of our grazing cooperative would have little incentive to finance fences and water points because the benefits will accrue largely to other patrons.

Second, the principle of Voluntary and Open Membership also creates an external free-rider problem if our grazing cooperative does not have exclusive use rights to the communal grazing resource. Members would have even less incentive to finance fences and water points if the benefits were appropriated by non-members at, or below, the price paid by members. For the sake of convenience it will be assumed that our grazing cooperative can exclude non-members, or charge them more for using its resources.

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<sup>3</sup> *Membership ... is open to [natural and juristic] persons who can use the services of the cooperative. Note that the word 'can' does not explicitly exclude members who are not patrons.*

<sup>4</sup> *The return paid on member capital is limited to the maximum percentage fixed in accordance with the constitution of that cooperative.*

<sup>5</sup> *A cooperative may allocate and credit or pay to its members a portion of the surplus that is not transferred as a reserve to a reserve fund ... and such portion must be allocated in proportion to the value of transactions conducted by a member with a cooperative during a specified period.*

Third, the founding members of our grazing cooperative would also be reluctant to finance fixed improvements because they cannot realise the full benefit of assets that generate returns beyond their period of membership. This 'horizon' problem arises because members of traditional cooperatives are not permitted to trade shares at their market value. Instead, the cooperative is entitled to redeem members' shares at their original (par) value (see section 25 of South Africa's new Cooperatives Act). Again, these institutional arrangements emphasise the traditional view that profits should be distributed to patrons rather than to investors. The implication is that investors cannot realise capital gains when they leave the cooperative. Ultimately, these gains are captured by free-riders in the form of new members who benefit from improvements without paying market prices for their shares.

Fourth, the members of our traditional grazing cooperative face 'portfolio' and 'control' problems that are aggravated by an 'influence' problem. The latter problem arises due to ill-defined voting rights. The portfolio problem refers to sub-optimal investment by members because they are unable to transact shares and therefore cannot diversify their own portfolios to reflect personal risk preferences. Disincentives created by the portfolio problem become more pronounced when risk-averse members use their democratic voting majority to pressure management into making conservative investments. Outvoted, the more entrepreneurial members of our grazing cooperative would be hard pressed to influence management otherwise, denying the cooperative much-needed capital and expertise. Democratic Member Control is a fundamental principle of traditional cooperatives (ICA, 2005). Section 14(1)(e)<sup>6</sup> of South Africa's Cooperatives Act entrenches this principle, the object of which is to ensure that cooperatives are controlled by users and not by investors (Barton, 1989). Ironically, the control problem refers to the difficult task of monitoring the performance of management when there is no share market to signal changes in the value of the enterprise. To sum up, traditional cooperatives struggle to raise equity capital because ill-defined property rights leave investor-principals without residual claim, without residual control, and without information to evaluate their agent-managers.

Fifth, returning to the issue of debt capital, the institutional problems that constrain levels of equity in traditional cooperatives also constrain levels of debt as lenders prefer their loans to be covered by equity in order to reduce their exposure to loan default. In addition, for any particular level of equity, a traditional cooperative's ability to borrow is adversely affected by the influence problem, especially when the loan is needed to finance relation-specific assets (Hendrikse & Veerman, 2001). Specific assets expose the

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<sup>6</sup> *The constitution of a cooperative must include a provision stipulating that each member has one vote in all meetings of the cooperative, except in the case of secondary or tertiary cooperatives.*

cooperative to hold-up problems (Royer, 1999) and so increase the lender's risk of loan default. There is not much that lenders can do to reduce this risk when transacting with traditional cooperatives because it is difficult for them to influence managerial decisions when members have equal voting power.

#### **4. How can traditional cooperatives be reorganised to promote enterprise growth?**

The arguments outlined in the previous section predict that our traditional grazing cooperative is unlikely to raise sufficient equity and debt capital to finance the fixed improvements needed to improve member benefits. What could be done to improve incentives to invest in this cooperative? A 'solution' adopted by some cooperatives is to insist that members purchase shares in proportion to their patronage. Cooperatives that adopt such arrangements are classified as proportional investment cooperatives (PICs) by Chaddad and Cook (2004).

##### **4.1 Proportional investment cooperatives (PICs)**

PICs are complex to administer and oblige rather than encourage investment. In practice, PICs must assess each member's patronage and continually redeem shares from members that become over-invested. In the USA, some PICs - like Dairy Farmers of America - allow equity to transfer between over- and under-invested members (Chaddad & Cook, 2004). Strictly speaking, it is not member shares that are transferred but 'capital credits' in a separate fund financed from contributions made by under-invested members to bring their total investment in line with their patronage.

Our traditional grazing cooperative could reorganise as a PIC without any need for capital credits or any other form of quasi-equity. Proportionality between patronage and investment could be achieved simply by allowing members to exchange livestock for (redeemable) equity. In this case, the compulsory aspect of investment in a PIC is avoided if members can buy and sell livestock in a reasonably efficient market. This would address the internal free-rider problem but the other institutional problems that discourage member and lender investment would persist as shares in a PIC cannot be traded (portfolio problem) at their market value (horizon and control problems) and voting rights are egalitarian (influence problem). Following Chaddad and Cook's (2004) hierarchical typology of cooperatives, our grazing cooperative might rather consider reorganising as a member-investor cooperative (MIC).

## 4.2 Member-investor cooperatives (MICs)

The essential difference between a PIC and a MIC is that patronage and investment are decoupled and a substantial share of cooperative profits accrues to member-investors rather than to member-patrons. It is interesting that the case studies of MICs presented by Chaddad and Cook (2004) are drawn from the Netherlands, New Zealand and New South Wales (NSW) in Australia, suggesting that these countries have sanctioned significant deviations from the usual condition that a cooperative's distributable profits must be allocated to users rather than to investors. NSW amended its Cooperatives Act in 1992, formalising quasi-equity shares as 'cooperative capital units' (CCUs). Section 269 of this Act defines a CCU as an interest issued by a cooperative conferring an interest in the capital, but not in the (members') share capital, of the cooperative. MICs achieve close proportionality between member investment and returns by distributing profits as cash dividends in proportion to quasi-equity shares, and by permitting appreciation of these shares<sup>7</sup>. Again, this helps to alleviate the internal free-rider problem.

CCUs are treated as personal property and, subject to the rules of the cooperative, are transferable. Some MICs in the Netherlands and New Zealand issue quasi-equity in the form of participation units and redeemable preference shares respectively (Chaddad & Cook, 2004). New Zealand's Cooperative Companies Act, 24 of 1996, further allows the value of shares to appreciate so that capital gains can be realised when the shares are redeemed. Even so, these concessions do not fully address the portfolio, horizon and control problems because the shares can be redeemed at a price approved by the MIC's (democratically elected) Board of Directors. The Board may approve conservative estimates of the share price in order to reduce the cooperative's exposure to redemption risk and hence its need for unallocated reserves. This increases uncertainty about capital gains, reducing the tradability of quasi-equity shares. The influence problem remains because quasi-equity shares held in a MIC do not confer voting rights in the cooperative.

Could our grazing cooperative allocate a substantial share of its profits to member-investors rather than to member-patrons? Section 43(1) of South Africa's new Cooperatives Act provides for 'funds of members' in which individual members can be credited with contributions of their own capital, and section 43(2) provides for payment of 'interest' on these capital credits. Members could therefore purchase a small amount of equity by paying a modest joining fee, and a relatively large amount of dividend-earning quasi-

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<sup>7</sup> Patronage still captures part of net returns in the form of favourable prices.

equity by exchanging cattle or cash for capital credits in a fund of members. In theory, our grazing cooperative could reorganise as a MIC, but the MIC would most probably reduce to a PIC as cash investments would be inferior to livestock investments (which earn both dividend and patronage returns). In either case, the reorganisation would alleviate the internal free-rider problem.

Could our grazing MIC further strengthen investment incentives by offering members transactable and appreciable capital credits? Section 43(2) of the South African Cooperatives Act, which defines the attributes of capital credits does not preclude transfers of capital credits between members and suggests that a cooperative could sanction such transfers in its constitution. However, transferability is unlikely to translate into tradability because capital credits are redeemable. The implication is that neither PICs nor MICs are likely to create strong incentives for member investment. Restructuring as a New Generation Cooperative (NGC), a popular format in the USA, may offer a more comprehensive solution.

### 4.3 New generation cooperatives (NGCs)

In essence, a NGC adds a new set of well-defined property rights to the ill-defined property rights of a traditional cooperative. In a marketing cooperative, these new rights usually take the form of 'delivery rights' that members must purchase in order to access preferred markets secured by the cooperative. These rights are not redeemed by the cooperative and are tradable amongst members. New members have to purchase delivery rights from existing owners at their market price, enabling member-investors to realise capital gains.<sup>8</sup> Capital gains are therefore aligned with investment, as are patronage returns when the delivery right is fully exercised.

Conceptually, our grazing cooperative lends itself to the NGC format. Members could swap cattle or cash for non-redeemable, tradable 'grazing rights'. Like delivery rights issued by marketing cooperatives, these grazing rights would determine the quantity of large livestock units that the member can supply each year depending on the pasture's carrying capacity. The market value of these rights would reflect expectations about the performance of the NGC.

Alignment of investment with capital gains and patronage returns addresses the internal free-rider problem. However, these parallel rights do not fully address horizon and control problems because members' shares remain non-tradable and therefore do not internalise or signal growth in NGC net worth.

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<sup>8</sup> Section 3(2)(a) of South Africa's new Cooperatives Act provides for closed membership provided that restrictions on persons eligible for membership relate to the business of the cooperative.

In addition, these parallel rights have no effect on voting rights and therefore do not address the influence problem. Nonetheless, the NGC format could go a long way towards making our grazing cooperative a more attractive investment opportunity for member-patrons. Considering the support being offered to establish and sustain cooperatives in the developing regions of South Africa, NGCs might well be an appropriate vehicle to nurture horizontal integration for the purpose of conserving, improving and profitably exploiting common pool resources like natural grazing.

#### 4.4 When NGCs are not enough

While this conclusion is consistent with views expressed by Ortmann and King (2006) who support the use of cooperatives to improve smallholder access to input and product markets, it would be naïve to extend this assertion to the management of toll goods (i.e. goods characterised by high excludability and low rivalry) acquired by groups of land reform beneficiaries, including those in communal areas. To illustrate, consider the case of a beneficiary community that has registered the title of its land to a communal property association (CPA) and which would like to develop the property's considerable eco-tourism potential. To exploit this commercial opportunity, the CPA needs to construct and manage lodges and facilities to accommodate tourists. This requires significant capital and expertise – factors of production that the community is sorely lacking but which could be acquired by taking on an experienced business partner. CPAs were designed to hold property and not to conduct business. In reality, they suffer all of the problems associated with ill-defined property rights in traditional cooperative. Moreover, they do not issue shares and may not hold shares other than in a company listed on a licensed stock exchange.<sup>9</sup> Could the CPA lease the eco-tourism site to a cooperative that is able to attract equity capital from community members and an experienced business partner? Neither PICs, MICs nor NGCs accommodate investment by non-members. In these cooperative arrangements, equity and quasi-equity investments are restricted to member-patrons (suppliers of labour in this eco-tourism example) whose incentive to invest is diluted – at the very least – by an influence problem.

Government's response might be to establish a traditional cooperative and then to help it forge strategic alliances with business partners. Chaddad and Cook (2004) summarise several examples of such 'solutions' adopted by marketing and processing cooperatives in the USA, Ireland and France. In the popular 'Irish model' assets are transferred out of the cooperative into a company that raises equity from private investors – a form of 'virtual' de-

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<sup>9</sup> See section 9(e)(iv) of the Communal Property Association Act, 28 of 1996.

mutualisation. It is conceivable that our eco-tourism cooperative could use its lease to finance equity in an IOF shared with a business partner. However, this merely shifts the expected conflict between patrons and external investors to the IOF and does not shield members from problems created by ill-defined property rights in their cooperative. A unitised trust would better serve as a warehouse for members' interests in an IOF as tradable units assigning benefit and voting rights that are proportional to individual investments in the trust can be matched directly to shares acquired by the trust in the IOF.

Outright conversion of marketing and processing cooperatives into IOFs has perhaps been the most dramatic global cooperative trend in recent years. Such de-mutualisation has been most noticeable in countries where government support for agricultural cooperatives has been scaled down or removed altogether. Hendrikse and Veerman (1999) cite cases of leading marketing cooperatives in Ireland and The Netherlands converting to private or listed companies. This parallels the proliferation of NGCs in the US where cooperative status still affords tax breaks, interest subsidies and the gratis services of the US Department of Agriculture. In Canada, cooperatives in the grain, dairy and poultry industries have converted to IOF status despite legislative changes to facilitate the creation of NGCs (FGPD, 2006). In South Africa, deregulation of agricultural markets and reform of the financial sector in the 1990s removed many of the privileges that masked the inefficiencies of marketing cooperatives serving commercial farmers. These privileges included regional monopoly power and the distribution of cheap credit (Ortmann & King, 2006). Since 2000, some of the country's largest agricultural cooperatives have converted to listed companies. Prominent amongst these are OTK, now trading as Afgri Limited (Business.com, 2006), and KWV, now trading as KWV Limited (KWV, 2003). Both of these groups raise equity capital on the Johannesburg Securities Exchange.

Returning to our development-oriented eco-tourism cooperative and its options for attracting capital and expertise, the question may be framed in terms of its ability to reward investors without altering its legal status and foregoing the support dedicated to emerging cooperatives. Could it be reorganised as an investor-share cooperative (ISC) in which non-members would be able and willing to invest?

#### **4.5 Investor-share cooperatives (ISCs)**

Changes made to cooperative legislation in Australia, Europe, Canada, New Zealand and the USA since the early 1990s have challenged the view that Member Economic participation requires profits to be distributed according to patronage rather than investment. Sections 271 and 272 of the 1992 NSW

Cooperatives Act allow non-members to purchase CCUs, but deny them voting rights. Chaddad and Cook (2004) refer to ISCs in France where legislation passed in 1992 permitted outsiders to purchase quasi-equity shares in cooperative societies. However, even if these quasi-equity shares are technically transferable and appreciable, they may not be attractive to investors because uncertainty about capital gains is heightened when shares are non-voting and redeemable.

In Canada, cooperatives in some jurisdictions provide for external investments through a distinct class of shares that are non-voting and **non**-redeemable (FGPD, 2006). Chaddad and Cook (2004) describe the case of the Saskatchewan Wheat Pool, a marketing cooperative that introduced B shares in 1996 that were subsequently floated on the Toronto Stock Exchange. They also refer to Denver-based CoBank in the USA, which completed a private placement of non-voting, non-redeemable preferred stock in 2001. Section 2(1)(a) of New Zealand's Cooperative Companies Act allows non-patron investors to exercise voting power in a cooperative but restricts their collective voting power to a maximum of 40 per cent. In 2003, the Livestock Improvement Corporation (LIC) became the first cooperative in New Zealand to list non-redeemable investor shares on the country's alternative stock exchange, NZAX (ACCORD, 2004). Since these shares are non-redeemable, their prices can be determined transparently in an active market. LIC actively sought to alleviate the control problem, as well as the free-rider, horizon and portfolio problems. In 2004, the Italian cooperative Granarolo also became a hybrid-listed cooperative (HLC) when it offered 20 per cent of its shares to external investors (Bekkum & Bijman, 2006).

Beyond this, Hensley and Swanson (2003) describe dramatic changes to the Minnesota Cooperative Associations Act introduced in 2003 and codified in the Minnesota Statutes as Chapter 308B. This new chapter was introduced because existing cooperative law (Chapter 308A) did not allow for outside equity investments in a cooperative. Chapter 308B was based on the Wyoming Processing Cooperative law which permitted cooperatives in that state to accept equity from non-patron members. Chapter 308B allows non-patron members to receive up to 85 per cent of a cooperative's profits, and to control as much as 85 per cent of the voting power. Together, these requirements effectively cap the share of members' equity held by non-patrons at 85 per cent. However, Chapter 308B also stipulates that patron-member directors must hold at least 50 per cent of the voting power 'on general matters' of the cooperative. Hensley and Swanson (2003) interpret this as meaning that 'special' matters can be influenced by non-patron investors if they constitute a majority of the membership. This provides some relief from the influence problem. The requirement that at least 15 per cent of profits must accrue to

member-patrons was presumably intended to retain some of the transaction cost advantages attributed producer-owned firms in the event of patrons becoming a minority of the membership. Cooperatives established under Chapter 308B may elect to be taxed as cooperatives or as companies.

In essence, the New Zealand, Wyoming and Minnesota models broadened the interpretation of 'participation' (in the principle of Member Economic Participation) to include investment, and sanctioned transferable, non-redeemable and appreciable rights that make it possible for investors to realise capital gains and to influence strategic decisions. Those lobbying for these IOF-like institutions presume that it will be easier for cooperatives to raise equity capital and to establish joint ventures with strategic partners. Purists have questioned the dilution of cooperative principles, and legalists contend that these extreme ISCs may not qualify for all of the benefits and protection afforded to traditional cooperatives (Hensley & Swanson, 2003). It is not the purpose of this paper to make value judgments about what constitutes a cooperative, but rather to address an important question in the South African setting; does the country's new Cooperatives Act allow development-oriented cooperatives to raise much needed capital and expertise by taking on external equity partners?

Earlier it was argued that a cooperative could exploit the Act's provisions for 'funds of members' and reorganise as a MIC. Logically, a MIC could convert to ISC status by extending membership to non-patron investors. Although the Act defines members rather ambiguously as (natural or juristic) persons that can use the services of the cooperative, the removal of provisions for non-member investor-shares in the first draft of the Cooperatives Bill following COSATU's objection (COSATU, 2001) shows that the intention was to exclude non-patron investors. Even if the Registrar did permit external investors to become members of a cooperative on the grounds that it is not impossible for them to patronise the cooperative, neither patron nor non-patron members would have much incentive to invest in a fund of members because capital credits in such funds are redeemable and this impairs their tradability. Section 14(2)(f) of the Act provides for associate members but defines them as non-members and so prevents them from holding member shares or capital credits in a fund of members. South Africa did not follow the trend toward ISCs observed in developed countries and has dedicated public support to development-oriented cooperatives while effectively denying them access to the complementary capital and expertise of strategic equity partners.

## **5. Conclusions**

Policy makers in South Africa recognise the importance of horizontal integration to help poor people access markets and to profit from common pool resources. The government has upgraded cooperative legislation and is providing support to promote and establish development-oriented cooperatives. However, the new legislation perpetuates the notion of traditional cooperatives, ignoring trends in developed countries where cooperative legislation has been amended to encourage investment by patron and non-patron members. Admittedly, trends originating in developed nations may not be appropriate in developing countries, but the underlying problems that these changes sought to address will also constrain development-oriented cooperatives in South Africa.

In developed countries, traditional marketing and processing cooperatives could not raise sufficient capital to finance the tangible and intangible assets needed to compete in global food markets because their institutional arrangements discouraged equity investors. In South Africa, development-oriented cooperatives that require capital to finance fixed improvements like pack sheds, fences and tourist lodges will confront critical shortages of both capital and expertise. Given South Africa's dual economy, an effective way of addressing these twin constraints is to establish equity-sharing joint ventures between communities and strategic partners in the private sector. Unfortunately, South Africa's new Cooperatives Act prevents prospective partners from taking up equity in a development-oriented cooperative, and the idea of using a cooperative to warehouse members' shares in an investor-owned firm does not free its members from the problems created by ill-defined property rights. A unitised trust would better serve this purpose.

One way of promoting development-oriented joint ventures would be for government to amend the new Cooperatives Act in order to (a) admit non-patron investors as members, and (b) allow for non-redeemable shares (capital credits) in funds of members. The first change would enable strategic partners to contribute equity capital to funds of members. The second would strengthen incentives for patron and non-patron members to invest in such funds by promoting the tradability of appreciable capital credits. Given these changes, a South African cooperative could legitimately introduce capital credits that potentially reward investors with both dividends and capital gains - provided that the properties of transferability, non-redeemability and appreciability of capital credits are specified in the cooperative's constitution. Since all members have equal voting power, it is also conceivable that these changes might allow a multitude of non-patron investors to take control of a cooperative and reduce patronage returns in favour of dividends, so losing the

transaction cost advantage of well aligned incentives. In New Zealand, policy makers compromised by capping non-patron voting power at 40 per cent. In Minnesota non-patrons can command 85 per cent of voting rights, but directors elected by non-patrons cannot exercise a majority on all issues voted by the Board. In South Africa, policy makers did not seek a compromise. All provisions made for investor shares in the first draft of the Cooperatives Bill were removed when the Congress of South African Trade Unions objected to the dilution of cooperative principles. This decision needs to be reconsidered. Better still, support offered only to cooperatives should also be extended to development-oriented IOFs.

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