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# Legislative Perfection of Governance Structure of Farmer Professional Cooperatives in China

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**Abstract** The development of modern agriculture can not be separated from the development of farmer professional cooperatives, and the core of sustainable development of the cooperatives lies in the formation of relatively perfect governance structure. Chapter IV of *Law on Farmer Professional Cooperatives of People's Republic of China* stipulates the organization structure of cooperatives. However, because of historical reasons and limitation of legislative techniques, there is much omission in the institutional regulation of cooperative governance. Due to inadequate system supply of farmer professional cooperatives and deficiency in related rights and obligations, normative guidance can not be provided for the governance practice of farmer professional cooperatives in China, thereby leading to the inefficiency of cooperative management. Therefore, it is imminent to revise the law.

**Key words** Farmer professional cooperatives, Law on farmer professional cooperatives, Democratic control, Supervision and restriction, Incentive measures

## 1 Introduction

In modern industrialized countries, agriculture is relatively weak in market economy. Farmer professional cooperatives aim to integrate diffused individual power of farmers to increase farmers' income and maintain farmers' legitimate rights and interests, and they are inevitable products of economic development<sup>[1]</sup>. Besides the economic function, farmer professional cooperatives also undertake certain social and even political function, such as maintaining rural social stability and promoting rural democratic governance. Since the 21st century, farmer professional cooperatives have developed vigorously in China, and relatively perfect governance structure is the core element of its existence and development. In society with the rule of law, the formation and improvement of governance structure of an economic organization can not be separated from related laws. In the *Law on Farmer Professional Cooperatives of People's Republic of China* (hereinafter referred to as *Law on Farmer Professional Cooperatives*) issued in October 2006, relevant regulations on the governance structure of farmer professional cooperatives are obviously insufficient, and it needs to be revised.

## 2 Shortcomings of governance structure of farmer professional cooperatives

**2.1 Control of insiders** According to an investigation, nearly 70% of farmer professional cooperatives were founded by rural competent people in China<sup>[2]</sup>, and the development mode can lead to the control of professional cooperatives by few sponsors easily. At first, when the objective utility functions of various cooperative members can't be exactly the same, competent people often control

the daily operation of cooperatives. Secondly, in delegation-agent relation, there may be exist divergence and even conflict between an agent and a principal in terms of objective utility functions. As a result, cooperatives change into private or partnership enterprises of few sponsors, and the principal status, rights and interests of peasant households as producers can not be protected fully<sup>[3]</sup>. In the *Law on Farmer Professional Cooperatives*, there are specific regulations on cooperative members. That is, citizens having capacity for civil conduct, as well as enterprises, public institution or social groups engaging in production and operation activities related to farmer professional cooperatives, who can use services provided by farmer professional cooperatives, admit and observe rules of the cooperatives, perform admission procedures, can become cooperative members. However, there is no specific regulation on the scale and composition of directors of cooperative governance structure center. In the Article 26 of the *Law on Farmer Professional Cooperatives*, it is stipulated that a member can be appointed as the president of a council, and a council can be set up in a farmer professional cooperative, while the president can be as the legal representative of the legal representative. At the same time, the president of a council can also be as a manager. If supervision organs are absent, the president will monopolize a cooperative and may damage the benefit of cooperative members, which violates the democratic control of the cooperative.

**2.2 Weak supervision system in legislation** Shortage of effective supervision and restriction is also one of important abuses. There exists a certain problem of location of supervising organs in legislation. For instance, in the second part of Article 26 of the *Law on Farmer Professional Cooperatives*, it is stipulated that an executive supervisor or a board of supervisors can be set up in a farmer professional cooperative. Therefore, the board of supervisors can be any organ, which can lead to the anomie of manage-

ment behavior caused by shortage of effective supervision in practice<sup>[4]</sup>. In the *Law on Farmer Professional Cooperatives*, regulations on a board of supervisors are too simple, and there is no regulation on functions and powers of supervisor or a board of supervisors, while it is difficult to give play to supervision mechanisms due to the shortage of necessary safeguard measures and remedy measures when supervisors or a board of supervisors exercises right of supervision. In the institution system of farmer professional cooperatives, member meetings are the highest authority and undertakes great responsibility for supervising and restraining operators. However, due to the property of conference body of member meetings, it is impossible to give full play to its supervision functions, because the calling and resolution procedures of member meetings are complex, which will weaken its supervisory roles greatly; when member meetings perform supervisory duty, the dilemma of collective action will appear. In the *Law on Farmer Professional Cooperatives*, it is not demanded that audit system and social disclosure system should be established, so the transparency of operation of cooperatives is low, and it is difficult to protect the rights of cooperative members.

**2.3 Absence of incentive measures in legislation** There exists absence of incentive measures in China's legislation. According to the Article 37 of the *Law on Farmer Professional Cooperatives*, at least 60% of divisible surplus of farmer professional cooperatives is returned according to the proportion of trade volume of cooperative members and cooperatives, while the rest is distributed according to the proportion of contribution to investment. In addition, the law does not consider the unconformity of investors (namely cooperative members) and actual entrusted operators and have no regulations on incentive measures of operators as well as negligent act in the process of management and related liability system of economic organizations.

### 3 Related theories and legislation

The mechanism of a system is functional structure that depends on certain economic laws and is realized in certain forms and by certain mediums<sup>[5]</sup>. The governance structure of an agricultural cooperative shows this kind of institutional functional structure.

#### 3.1 Democratic control of farmer professional cooperatives

Cooperative members as special enterprises pursue self-help, democracy, equality, justice and other value ideas. To realize the value ideas, most cooperatives implement self-management of cooperative members. Pursuing justice by farmer professional cooperatives is one of ultimate goals of organization existence, and here justice should be shown in form, results and essence. Moreover, justice exists both inside and outside of an organization. To benefit farmers, farmer professional cooperatives must solve the problem of democratic control to ensure the principal status and rights of cooperative members, and it is key to set up effective democratic control right. The explanation for the democratic control of members by International Cooperative Alliance explains that the guidelines and major issues of cooperatives are determined by cooperative members.

**3.2 Effective restraint measures** According to an investigation of 526 farmer professional cooperatives in Zhejiang Province, Xu Xuchu *et al.* suggest that the stronger the internal supervision of cooperatives is, the higher the performance of cooperatives is<sup>[6]</sup>. Due to the tedious procedure of member meetings and hitchhike of some members, its supervision performance weakens, and supervisor system has supervision and restriction effects on daily operation of the council of a cooperative. In the *Law on Cooperatives* (revised in 2002) in Taiwan, a board of supervisors must be set up. According to the regulations of Germany laws, a board of supervisors in a company should enough members with independent features. Under the guidance of this idea, the reform of supervision system of a company in Germany and other member states of European Union demands members of a board of supervisors to be independent.

**3.3 Incentive and responsibility safeguard measures** External professionals are refused to enter the management level of traditional cooperatives, and specialization degree is low in business practice, thereby lowering the efficiency of cooperative operation. To adapt to the needs of economic marketization and integration of world economy, enhance efficiency and realize justice, countries in the world revise the law on cooperatives. For example, professional managers can be engaged by cooperatives in America and Germany. According to the modern enterprise theory, residual rights of control and residual claim are highly complementary and should be unified, otherwise enterprise efficiency will lose. Because of incompleteness of contract and asymmetry of information, operators of an enterprises share some residual rights of control of the enterprise objectively. If operators of an enterprise are not given corresponding residual claim, they have low enthusiasm, initiative and creativity for operation, and they may utilize their rights to erode residual assets of the enterprise. In essence, giving operators residual claim aims to use their egoistic motivation to realize the goal of benefiting others, namely transforming the maximization of pursuing self-interest into the maximization of pursuing principals' interest.

Based on the above analysis, it is necessary to improve the incentive mechanism of operators in current laws on farmer professional cooperatives. For instance, a certain proportion of divisible surplus of an agricultural cooperative in a certain period (the working period of operators) is used as payment for operators, and the proportion can be determined by member meetings or be stipulated by rules to prevent operators from controlling it. No matter it is determined in what way, the proportion should be reasonable. According to the *Law on Cooperatives* in Taiwan, 10% of net profit of a cooperative at the end of a year can be as payment for directors and technicians of the cooperative<sup>[7]</sup>.

### 4 Improvement of legislation

In Chapter IV of the *Law on Farmer Professional Cooperatives*, the organization structure of cooperatives is stipulated. However, due to historical reasons and limitation of legislative techniques, there

is much omission in related provisions and no guidance of cooperative governance. Based on the practice of cooperative development in China, some legislative suggestions will be proposed according to the omission of legislation to promote the improvement of governance structure of cooperatives.

**4.1 Setting up cooperative member congress system** In farmer professional cooperatives with many members, it is difficult to avoid members' "free rider" in the process of taking part in cooperative affairs, so it is very necessary to establish member representative system. The Law on Farmer Professional Cooperatives specifies that cooperative member congress system can be set up if the quantity of cooperative members exceeds 150. The arbitrary regulation should be changed into mandatory provisions, and farmer professional cooperatives having more than 150 members should set up cooperative member congress system.

**4.2 Improving provisions of cooperative members' basic rights** China's *Law on Farmer Professional Cooperatives* specifies the basic rights of cooperative members, but there is still deficiency in provisions of cooperative members' rights. For instance, the law does not specify the lawsuit right of cooperative members, and regulations on their right to know are not incomplete, which is adverse to the protection of rights and interests of cooperative members and performance of their enthusiasm. Only by stipulating perfect rights of cooperative members can the enthusiasm of cooperative members to participate in member meetings and exercise their rights increase, thereby protecting their legitimate rights and interests. The active participation of the majority of cooperative members is the basis for the existence and normal operation of farmer professional cooperatives, that is, without the active participation and management of cooperative members, cooperatives will become water without a source. If the rights of small households can not be strongly protected by laws, large and strong households can easily infringe upon the rights of other cooperative members, and there is no corresponding relief means when the rights and interests of small households are violated. In the current situation of China, the occurrence of the above situation may even influence rural stability and governance.

**4.3 Introducing independent supervisor supervision system** Objectively speaking, the cooperatives controlled by a few core members can greatly reduce the coordination cost among cooperative members and facilitate the collective actions of cooperatives. However, if the control right of a few core members lacks necessary constraints, the problem of internal control will generate. Although the *Law of Farmer Professional Cooperatives* has already set limits on the proportion of capital contributions of large investors and the right to vote, in reality, it is unavoidable for a few people to control the cooperatives. When internal control emerges, due to the nature of self-interest and the propensity of opportunistic behavior, a few core members may exploit their actual control rights to encroach on the interests of ordinary members<sup>[8]</sup>. Under such circumstances, it is more meaningful to strengthen the supervision over the core members of farmer professional cooperatives. An in-

dependent supervisor can be introduced into a farmer professional cooperative with a certain scale to strengthen the supervision over cooperative managers. An independent supervisors of a farmer professional cooperative refers to an external supervisor who does not hold any position other than a supervisor in the farmer professional cooperative and have no relationship with the farmer professional cooperative and its core members or the management layer that prevents them from making independent objective judgments. From the practice of corporate governance, the elected supervisors should not only possess the basic management ability and business but also have fully independent personality standards. The *Law of Farmer Professional Cooperatives* stipulates that the supervisors of cooperatives must be elected from cooperative members by cooperative member assembly, which rigidly excludes independent supervisors from the cooperatives and is not conducive to the proper supervision of cooperative operation and management.

**4.4 Establishing rational interest distribution system** Establishing rational interest distribution system and salary system for a cooperative to enhance material incentives for cooperative operators will further mobilize their enthusiasm, encourage them to participate in management and then promote the development of cooperatives. For directors of farmer professional cooperatives, their professional management ability and management enthusiasm should be given material incentives equal to their value and contribution to cooperatives. However, limited by the aims and system of cooperatives, farmer professional cooperatives are impossible to completely copy the incentive system of a company.

Based on the principle of limited compensation for farmer professional cooperatives, the incentive system for stock options in a company can not be implemented in farmer professional cooperatives. According to the nature of farmer professional cooperatives, payment incentives for cooperative directors include fixed salary, year-end bonuses, etc. As the salary level of cooperative directors is determined, it is necessary to give full consideration to the management purpose of farmer professional cooperatives. Farmer professional cooperatives aim to provide preferential services for their members instead of profit-making. Based on the the distribution principle of dominant distribution according to trading volume and limited basic remuneration stipulated by the *Law of the Farmer Professional Cooperatives*, the directors of cooperatives have certain rights to obtain remuneration according to their operation performance, which is helpful to the improvement of cooperative members' enthusiasm and promote the development of cooperatives.

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