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Cooperative Change and the Myth of Rationality

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Abstract

Much of the current research on agricultural cooperatives is biased towards weaknesses of the cooperative organization form. The literature says very little about the strengths and advantages of the cooperative form and what is necessary to develop the form's uniqueness into a sustainable competitive advantage. We argue that for cooperatives to remain viable and competitive, the advantages of the form must be clearly manifested. There is now a lack of systematic theorizing in this field. Typically, the weaknesses of the cooperative form are compared to the strengths of the investor-owned firms. Our point is that the cooperative form is based on a logic which is different from that captured by the image of rationality, seemingly prevalent in many current studies of cooperatives. There is a call for a more coherent theory of the competitiveness of the cooperative form. So far, the contributions based on agency theory and transaction cost economics (TCE) are essentially met by an optimistic but incomplete cooperative ideology.

Introduction

The cooperative form is currently subject to much scholarly critique where focus is set on its weaknesses. The weaknesses are typically identified through a comparison with the strengths of the investor-owned firms (IOFs). Among others, Harte (1997) argues that the traditional cooperative form is based on an outdated business strategy (vertical integration), that cooperatives have an inefficient governance structure, and that they are kept alive by the support from a third party (*i.e.* the state). He further claims that greater awareness of these limitations has led to a strong preference for market mechanisms over internal governance structures. Internal organizational costs (funding, managerial and monitoring) tend to be underestimated. His empirical evidence is from Ireland, where so called "Coop PLCs" (Public Companies with farmer cooperatives as majority shareholders) have been established. Harte concludes that the ongoing transition to Coop PLCs in Ireland is part of a fundamental shift away from the cooperative organization form.

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Van Bekkum and van Dijk (1997) also take as their starting point that the market economy paradigm has gained wide acceptance in both economic and political circles. They argue that agricultural cooperatives must be run according to these sound economic principles too. This means, according to van Bekkum and van Dijk, that social activities of the cooperatives should be clearly separated from their commercial activities. "Economie social" should not be used to let market and non-market functions blur efficiency, effectiveness and incentives. Therefore, all ideological, historical and other non-economic and non-business considerations should be entirely disregarded. Cooperatives should be more active in propagating efficient business methods and introducing restrictions on those cooperative practices that inhibit the efficiency and effectiveness. Other discussions of the weaknesses of the cooperative form can easily be found. Cooperatives lack professional boards, are plagued by ambiguous goal structures, lack decisional efficiency and have collective capital without real owners, they accumulate too much collective capital at the company hand, they lack resource mobility, and are dominated by the agents rather than the principals (LeVay, 1983; Vitaliano, 1983; Fama and Jensen, 1986). The federate structure of many agricultural cooperatives is also under critical scrutiny (van Bekkum and van Dijk, 1997). The federate form demonstrates its weakness when exposed to free market forces. There are three main reasons for this: 1) the long distances between the members and their business activities; 2) prices to members do not reflect proper product values; and 3) members are alienated from the cooperative by losing control of the downstream vertically integrated cooperatives.

There is, in fact, a methodological problem inherent in the current literature since perceived weaknesses of agricultural cooperatives tend to be compared to perceived strengths of investor-owned firms. A question that is rarely raised in the literature is: "What are the strengths and uniquenesses of the cooperative form that can be developed into competitive advantages in a period of rapid transition?". This question should be of utmost interest for any systematic comparison of cooperatives and IOFs. Presumably since we so far lack a sufficiently systematic, rich and viable theory of cooperative organization, there is now a clear tendency to overemphasize the weaknesses of the cooperative form and ignore its advantages, strengths and potential.

Here, we take the abovementioned critique as a starting point for our analysis, and evaluate some of the premises and conditions on which the critique is grounded. Indirectly, this discussion sheds some light also on the potential competitive advantages of the cooperative form. Particular focus is set on the significance that is placed on opportunistic rather than loyal behavior. We agree that opportunistic behavior has explanatory power in certain situations and under certain conditions. But often the behavior of man can be explained better by applying other logics, or several logics in simultaneous interaction, *e.g.* the logic of "experience", "identification", "imitation", "conviction" and "ideology" (March, 1995b). Our major point in the following is that the cooperative form is based on another logic than is captured by the image of rationality that seems to be so prevalent in the current studies of the cooperative form. Therefore, these theories should be applied with much caution in studies of cooperative organizations.

Critique from the agency perspective

Much of the current critique of the cooperative form is based on agency theory. Agency theory addresses problems within organizations where ownership and leadership are separate. The core of this theory is to analyze organizations in terms of a conflict of interest between principals and agents. Consequently, the core unit of analysis is the relation between principal and agent. The agent is assigned to carry out something for the benefit of the principal. The agent is assumed to be in position to make independent decisions regarding issues that affect the principal's wealth. The relationship between both parties can of course to some extent be specified by formal contract. Nevertheless, it may be difficult for the principal to hinder the agent from acting in the agent's own interest, and not in the interests of the principal. Agency theory specifies a number of conditions that affect compensation decisions, such as goal incongruity, uncertainty, information asymmetry and risk aversion on the part of the agent. These conditions create potential problems and make it difficult to develop efficient and effective contracts.

Smith (1999) is correct in her observation that most of the work from the agency perspective has not dealt directly and systematically with the cooperative form as such. Nevertheless, the theory has recently been applied as a framework to identify several problems that are poorly dealt with in the cooperative organization form (Harte, 1997; Nilsson, 1998). For instance, the so-called horizon problem emerges in cooperative organizations because members are expected to be occupied with short-term perspectives on their cooperative membership. Since cooperative members have different time horizons, there will be different viewpoints regarding the risk/reward-profile of the cooperative. Following agency theory, all owners should have an investment portfolio that reflects the members' preferred trade-off between risk and reward. But efficient allocations of this type are assumed to be unattainable in cooperative organizations. Most cooperative organizations lack a trading system that would allow the members to develop an investment portfolio that corresponds to their preferred risk/reward-profile. Agency theory also emphasizes problems in the decision-making process which stem from the fact that in a situation where members are increasingly diverse and specialized, they may gradually lose their interests in overall, strategic issues in the cooperative. Diversity and fragmentation may inhibit active participation. If certain groups of members experience that the cooperative works insufficiently hard to promote their specific interests compared to the interests of other member groups, their engagement and commitment to the cooperative is likely to decrease. Active member participation is assumed to be less attainable in large cooperatives than in small ones. This is so because it is more difficult to get access to relevant information and less natural for the rank-and-file member to engage in strategic issues. It becomes more difficult for members to identify with the cooperative.

However, this critique of the cooperative form from the agency perspective is not universal and the described problems are not omnipresent. Nilsson (1998) argues that agency problems are negligible when: 1) the members are relatively homogenous; 2) the financial contributions from members to their cooperative are relatively small; 3) the activities of the cooperative are closely related to the operations of the members; and 4) the members are involved, engaged and committed to the collective thinking and strategies of their cooperative. Here, we shall explore the last condition, since this most explicitly addresses the question of opportunistic *vs.* loyal behavior.

As argued by Metzger *et al.* (1986), the original concept of agency was a legal concept that defined agency as "a two-party relationship in which one party (the agent) is authorized to act on behalf of and under the control of the other party (the principal)". The laws of agency imposed a specific duty of loyalty on the agent, "a fiduciary duty of loyalty conceived in order to help deter abuse of managerial discretion" (Metzger, *et al., op. cit.*). However, as economists began to address the concept of agency, the notion of loyalty was dropped. It was probably necessary to do so because the economic view of human nature that they adopted was the view of the self-interested rational maximizer, which tends to be incompatible with any conception of a loyal agent.

Ghosal and Moran (1996) hold that the notion of opportunism is also necessary for transaction cost economics (TCE) in its attempt to explain the existence of organizations. TCE originally developed as a positive theory to explain a firm's boundaries; *i.e.* why firms exist and persist in the markets (Coase, 1991 and Williamson, 1975). The basic assumption of TCE is that markets and firms are alternative instruments for completing a related set of transactions. Whether a set of transactions ought to be executed across markets or within a firm depends on the relative efficiency of each mode. The costs of writing and executing complex contracts vary with the characteristics of the human decision makers who are involved with the transaction on the one hand, and the objective properties of the market on the other (Williamson, *op. cit.*). The human characteristics that most affect the governance choice are bounded rationality and opportunism. In fact, it is only in the case of opportunistic behavior that hierarchical control mechanisms such as fiat, monitoring and incentives represent the only reliable safeguard for effective exchange. However, organizations are not mere substitutes for structuring efficient transactions when markets fail. Therefore, TCE is limited because it fails to recognize the sources of the organizational advantage. This leads Ghosal and Morans (*op. cit.*) to argue that TCE is "bad for practice". TCE is not only inapplicable to most decision-making situations in organizations, but if so applied, are also likely to adversely affect their performance.

Clearly, human beings are sometimes self-interested or opportunistic and will not always look out for the interests of others. But there are also times when they will set aside their interests to act on behalf of others. Opportunism allows for "strategic behavior", that is the making of false or self-disbelieved threats and promises in the expectation that individual advantage will thereby be realized (Williamson, 1975:26). Agency situations were presumably set up to guarantee those times when people are predominantly opportunistic. But to build a theory on this premise only is to treat worst-case as if this situation was the normal case. The assumption is that a person will always put his or her own interests ahead of the interests of others whenever (s)he can get away with it. If people act on that assumption, the worst case scenario becomes self-fulfilling. This assumption has been described as an extreme caricature even by those students who have contributed substantially to advance the explanatory framework of TCE (Milgrom and Roberts, 1992:42).

Obviously, the interesting question is under what conditions opportunistic behavior will most likely emerge. As clarified by Ghosal and Moran (1996), opportunism is influenced by "prior conditioning" that includes all the attitudes and values formed through exposure to conscious as well as subliminal stimuli, and possibly due to heritability. Furthermore, opportunism is influenced by what we describe as the "feeling for the entity", which represents the individuals' favorable or unfavorable assessment of the specific transaction partners, the group or the organization. Typically, a positive feeling for the entity would reduce opportunism whereas a negative feeling would enhance. Thereby, agency theory can at best only explain a very minimal level of cooperation since the ways in which social controls are likely to be most effective are inaccessible to the logic of this theory.

The exclusive focus in agency theory and TCE on rational control, incentives and opportunism severely restricts the viability of alternative social controls. No amount of emphasis on opportunism alone can unlock the initiative and tap the motivation that large, complex organizations increasingly require from their members. Following Ouchi (1979), rational control is based on information and the use of formal administrative mechanisms to limit deceptive or self-interested behavior. On the contrary, social control is based on people, their preferences and the use of informal mechanisms to build their motivation and commitment. Finally, agency theory also ignores the significance of historically developed trust which may be a major advantage of the cooperative form.

In sum, agency theory is one-sidedly preoccupied with the weaknesses of the cooperative form. This is not surprising given the initial premises of its explanatory framework. Agency theory tends to be put forth as if its assumptions were no more than technical adjustments between principals and agents without any inherent moral debate. But cooperatives have built-in strengths and mechanisms to mitigate agency problems, which secure that this kind of debate is put to the forefront. Cooperatives cannot be sufficiently understood as a realignment of monitoring costs among principals and agents. It is good reason to be skeptical to the assumptions of self-interest and maximizing behavior on the part of the principal and the agents, and on the monetary or pecuniary rewards each seeks. Neither principal nor agents are hyperrational in this straightforward way. For the cooperative members, a transaction is only a momentary episode in a continuous relation. In cooperatives, stable and long-lasting relationships should be the primary focus of study, and constitute a central place in a more comprehensive theory of the competitive advantages of the cooperative form. However, the tendency in the current literature to emphasize the weaknesses and ignore the advantages of cooperatives is not without empirical relevance. To make the point clear, let us distinguish between two overall strategies for cooperatives:

Strategy A: to separate the member organization from the business organization. This seeks to eliminate the perceived weaknesses to efficient business performance imposed by the demands from the member organization. The member organization is frequently perceived as a hindrance to necessary organizational innovation.

Strategy B: to develop the member organization into a competitive advantage. The member organization is viewed as a facilitator for increasing competitive strength and fostering necessary innovation.

Fuskeland and Krogvig (1999) illustrate these options in their study of four different meat cooperatives in Denmark, Ireland, Sweden and Norway. Among the questions they investigated were: Which of the strategies A or B have the cooperatives chosen? To what extent have the comparative strengths of the cooperative form been evaluated and taken into consideration in periods of transition? They found that the case of Swedish Meat illustrates a typical A-strategy. In Denmark, however, the cooperative form is recognized as compatible to efficient business performance and the B-strategy is implemented. Dairygold (Ireland) is the only case where development in recent years has moved the organization toward a B-strategy. In Norway the meat cooperative (Norsk Kjøtt) is in the midst of a restructuring process. This is the organization that is most likely to choose a B-strategy. But here too, there are elements of strategy A. (Fuskeland and Krogvig, *op. cit.*). Clearly, different cooperatives pursue different strategies. But it seems that the strategic thinking is highly influenced by the A-strategy. Cooperative managers are predominantly concerned with eliminating perceived weaknesses of the cooperative organizational form. Implementation in the abovementioned cases range from departing from the cooperative form altogether, formally converting into

PLCs, *via* so called cooperative/PLCs, to cases where internal structural changes are implemented with the main purpose to concentrate power by separating the business activities from the membership organizations.

Competitive advantages of the cooperative form

A more comprehensive view of the cooperative form is required in order to understand its potential and advantages. What are the valuable aspects of the cooperative form that are not captured by organizational economics? A richer theory of cooperatives must leave the under-socialized conception of man that dominates agency theory and transaction cost economics (Wrong, 1961; Granovetter, 1985), and include the significance of loyalty and solidarity relations as important aspects. Our contribution here is to suggest some core components which should be included in such a theory.

The cooperative organizational form is the structural consequence of a distinct strategy that reflects the problems, goals, situations, and thinking of the founders. At the outset, it is clear that cooperatives are implicitly based on strategy B above, that the business organization and member organization mutually support each other. This is analogous to say that the cooperative form links vertical integration and horizontal integration. The former is represented by the business strategy, whereas the latter reflects the organizing strategy. The two types of integration constitute a whole. The core success criterion from the members' perspective is to enable them to play the role as integrators in the vertical production-distribution chain. Obviously, it is not a straightforward task to get many people, differing in their situation, experiences, attitudes and outlooks, to organize and voluntarily delegate authority to a collective body. It is even more challenging to develop commitment and to enforce compliance and loyalty. A coherent theory of cooperative organization must take into account the significance of such strong relational bonds. The much cited cooperative principles (ICA, 1995) play a crucial role in specifying the nature of these relational bonds. The problem is, however, that the cooperative principles are not explicitly linked up to the business strategy. In his discussion of the cooperative principles, Dunn (1988:82) describes the problem as follows:

> cooperative principles should be viewed as guideposts or goals, not as absolute acid tests. Flexibility in the application of these principles is necessary. On the other hand, business pragmatists among cooperative directors, managers, and advisors must learn to recognize the values and strengths inherent in the unique features of cooperatives. Their creative and competitive efforts may then be directed toward refinement of the methods and mechanisms that contribute to strong cooperative business performance without compromising the spirit of basic principles.

No explicit connections are specified between the values and principles on the one hand, and the consequences on member loyalty, market demands and internal organizational weaknesses, on the other. One of the cooperative principles says that "democratic procedures applied to economic activities are feasible, desirable and efficient" (ICA, 1995), but gives no answer to the crucial questions of "Why?" and "How?". The cooperative values and principles offer only a very general specification of the relational dimension. From this follow theoretical and normative misfits and conflicts, which are rooted in the differences between the social and economic philosophies of cooperation (Torgerson *et al.*, 1997).

Loyalty-based solidarity

We think, however, that loyalty-based solidarity deserves a prominent position in this theory, a point we shall briefly motivate now. Successful vertical integration presupposes successful horizontal integration of the members, and a crucial determinant of horizontal integration is members' capability to coordinate and to act with solidarity with respect to the other members. Strong group coherence can also mitigate agency problems, since members are in a position to make active use of their formal rights to control the agent. Furthermore, since compliance is a prerequisite for efficient vertical integration, the success of the cooperative strategy depends on member loyalty, *i.e.* members' willingness to comply with the wants, needs, rules and decisions of the organization. Loyalty is a much celebrated concept, particularly due to Hirschman's (1970) work. He underlined the positive effects of loyalty on the stability of both transactions and volume, which facilitates business planning. Loyalty has a substantial impact on transaction costs. Many capitalistic firms now invest significant resources to promote employee and customer loyalty. Many different instruments are used, including membership systems, partnerships, loyalty cards, customer boards, advertising and image building. The idea of viewing customer relations as partnerships has been developed within the discipline of marketing research (Garbarino and Johnson, 1999). Trust and commitment are seen as features that distinguish partners from customers with an orientation towards single or repeated transactions. Patrons with strong relationships benefit from higher levels of trust and commitment and these features become central in their attitudes and belief structure. Loyalty is the willingness to support the organization by membership and to comply with the duties and responsibilities of the organization. This concept has some resemblance to the concept of commitment which is defined by Garbarino and Johnson (1999) as "an enduring desire to maintain a valued relationship" and by Stryjan (1987) as "...the willingness of people to do what will maintain the group because it provides what they need". Loyalty can be based on many factors, including power, habits, traditions and solidarity. Power-based loyalty stems from an uneven distribution of authority between the organization and the member, with the subsequent threat of sanctions. Power-based loyalty is unstable and risky because the members tend to leave the organization as soon as another alternative is perceived as better. Too much control can actually lower trust, provoke resentment and reduce the stage of personal development of the members. This leads to more individualistic motivations and less trustworthy, less pro-organizational behavior (Argyris, 1964). Habit-based loyalty refers to the situation when the person is, and continues to be, a member without having any clear opinion or awareness of why. Compliance is by habit. Typically, this member has a low level of organizational knowledge and has very modest interests in the cooperative's strategy and future prospects. Management and the membership's leaders might view this category of members positively. Their benefit to the organization is simply their volume of trade. These members are neither complaining nor demanding, but still loyal. However, the group is potentially unstable because there is nothing besides "habit" that binds them to the organization.

Solidarity is the willingness to sacrifice and participate for the benefit of the organization in order to secure its future existence and well being. Hence, solidarity-based loyalty is based on the individual who, for one reason or another, is willing to make some personal contribution to secure the organization's future. There are close links between tradition-based loyalty and loyalty based on solidarity. Tradition-based loyalty is the result of a group phenomenon where people, through social interaction, reach some form of consensus on the nature of reality (pattern of belief and concepts), their core interests, the main problems to be solved (problem definition) and the strategies to solve the problems (policy). These kinds of social activities result in a collectively agreed upon strategy that simplifies and directs the choices facing the individuals and the group. When cooperative organizing is the outcome of this type of process, a firm basis for individual loyalty is established. The very existence of the cooperative is explained and collectively supported. The existence of the organization and its rationale is confirmed and reconfirmed through on-going social processes. Socialization and social pressure are core mechanisms that enforce member loyalty. The underlying motivating factor is the members' need for social identity.

The irony is that what might generally be called "the cooperative rationale and strategy" finds strong support in modern management theory and practice. This is illustrated by the popularity of phenomena such as strategic alliances, network organizations, meta-organizations, federate cooperation, joint ventures, relationship marketing, voluntary chains, etc. Leadership "gurus" are now shifting the focus from control and surveillance to the need for delegating power for "optimal" autonomy (Kotter, 1996). It is recognized that efficient cooperation depends on shared identity, loyalty, shared experiences and learning among the involved partners (Argoth and McGrath, 1993). The critical factors for maintaining efficient and sustainable partnership are trust, shared learning, and shared commitment on collective goals (Dodgson, 1993). As an example of the consequences of not maintaining these factors, Parkhe (1993) cites the fact that strategic alliances have a high mortality rate. The reason is that actors follow their own opportunistic interests. One solution to this problem is to develop personal relations as a means for building mutual trust. Mutual trust is fundamental because it, rather than power, defines the boundaries of cooperation. Trust cannot be substituted by control in the relationship between independent actors (Sabel, 1991). Fairholm (1994) listed factors that are crucial to the development of trustful relations, including the acceptance of differences and diversity; an attitude of caring and openness; ethical behavior related to mutual moral values and a culture and expectations of openness; trust, honesty, and spontaneity. Ideally, it all adds up to the norm of generalized reciprocity that serves to reconcile self-interest and solidarity. Individuals who act in a system of reciprocity are characterized by a combination of short-term altruism and long-term self-interest: I help you out now in the (possibly vague and uncertain) expectation that you will help me out in the future. Reciprocity is made up of a series of acts each of which is short-run altruistic (benefiting others at a cost to the altruist) but which together typically make every participant better off.

Summary and conclusion

Critics from the agency theory and TCEs perspectives tend to be biased towards emphasizing the weaknesses of the cooperative form. A more systematic analysis is called for which also explores the benefits of the cooperative form. We have suggested that solidarity-based loyalty deserves a prominent position in a revised theory of cooperative organizations. The cooperative values and principles, as revised and stated by the ICA, aim at promoting loyalty founded on culturally based group strategy and member solidarity. In our view, the competitive edge of the cooperative organizational form is captured by these two bases of loyalty. This essential point is ignored in the current critics of the cooperative form from the perspective of TCEs and agency theory. The cooperative principles were developed in order to structure the setting for facilitating and promoting member loyalty. This ideology is probably somewhat unfamiliar to most contemporary business leaders, and its opportunities are not estimated seriously. Even in the cases where it is politically *comme il faut* to be a cooperative, the principles and values are normally used mainly for the speeches at historical events. It is reasonable to ask why the myth of rationality and the metaphor of "the economic man" has almost become a general ideology in itself. March (1995a) claims that modern social and economic science has become as ideological and dogmatic as Marxism before 1980. We have ended up with a myth of calculative rationality that is powerful and important but without content. It has lost its meaning both theoretically and morally. Often, the behavior of man can be explained better by applying other logics, or several logics in simultaneous interaction, *e.g.* the logic of "experience", "identification", "imitation" or "conviction" and ideology (March, 1995b). The cooperative form is based on another logic or rationale, different from that captured by the predominant meager image of rationality. No wonder that the cooperative form tend to be perceived as "impossible", "outdated" or even threatening by the believers of this paradigm of rationality.

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