



Organizational structure, redistribution and the endogeneity of cost: Cooperatives, investor-owned firms and the cost of procurement

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ABSTRACT

As an organizational type, cooperatives are in general not the dominant form of enterprise. Nevertheless, cooperatives and cooperative-like organizations do play important roles in a number of sectors, suggesting that in some circumstances they are more efficient than other business forms. This paper explores the importance of membership goals on the relative efficiency of the cooperative form of organization. The cooperative cost (and hence production efficiency) advantage is directly linked to the goal alignment between the cooperative and its members, and is influenced by the extent of income redistribution between members and the degree of rent seeking that takes place in the organization. When there is no aversion to income inequality, the members produce at their first best levels. However, as aversion to inequality rises, the production profile of the members converges to the production profile generated when the members face an IOF. Regarding rent seeking, if the more (less) efficient members are able to get their profits valued more, total output is increased (decreased). As a consequence, consumers may benefit from the lobbying that occurs inside a cooperative where the powerful members are the most efficient agents.

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1. Introduction

As an organizational type, cooperatives are in general not a dominant form of enterprise. Nevertheless, cooperatives and cooperative-like organizations play important roles in a number of sectors. Professional employee partnerships in areas such as law and accounting have long been important and farmer-owned cooperatives play a substantial role in a number of agricultural sectors in most developed countries. In countries such as the United States and Canada, consumer-owned utilities supply services such as power and telephone, credit unions provide financial services to a significant portion of the population, and mutuals provide a large portion of life and other forms of insurance. Businesses also have formed cooperatives to supply them with credit card services (e.g., VISA) or important inputs (e.g., Dairy Queen).¹

Hansmann (1996) argues that cooperatives emerge when the costs of contracting with a firm's suppliers or customers exceed the costs of these suppliers/customers owning the firm.² Included among the costs of contracting are market power and asymmetric information. The costs of ownership include the agency costs of controlling management and the cost of

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¹ See Hansmann (1996) for an excellent review of the sectors in which cooperatives have operated and the form that these cooperatives have taken.

² Barzel and Sass (1990) outline a somewhat similar approach to the determination of a general theory of voting.

collective decision making,³ of these various costs, Hansmann identifies the cost of collective decision making as particularly important in explaining the pattern of cooperative ownership that is found in different parts of the economy. He argues that cooperatives only emerge as a viable organizational alternative when the cost of collective decision making is low. An important factor in determining the cost of collective decision making is the degree of homogeneity in the goals possessed by different members. As the degree of goal congruence falls, the costs of collective decision making rise and the cooperative form is less likely to possess an advantage over other organizational forms and particularly one in which the investors are the owner. *Hart and Moore (1996)* reach a similar conclusion, arguing that outside ownership by investors becomes relatively more efficient when the variation in membership becomes more skewed (or, more precisely, when the median member is different from the average member).

The purpose of this paper is to explore formally the importance of membership goals on the relative efficiency of the cooperative form of organization. The explicit comparison point for this examination is the investor-owned firm (IOF). More specifically, the paper models the situation where a processor buys an input from a group of agents (e.g., farmers), processes it, and sells the resulting product to downstream consumers. Regardless of whether the processor is an IOF or a cooperative, the processor must procure the product from each farmer while ensuring that each farmer participates and chooses the contract designed for him/her. It is assumed that an information asymmetry exists between the processor and the agents—the agents know their individual productivity while the processor does not. For the IOF processor, the goal is to extract the maximum surplus from both farmers and consumers. For the cooperative processor, the goal is different. The farmers, who own the cooperative, are interested in maximizing the returns from each of their own operations plus their share of the profits generated by the cooperative. If the cooperative processor acts to maximize this objective, then the resulting alignment of objectives between the processor and the agents results in the cooperative being a potentially more efficient organizational form.⁴

The pricing decisions of the cooperative are not straightforward, however, since the terms of the contracts effectively redistribute rents among the farmers. The returns that the farmers earn on their own operations, as well as their share of the cooperative's profits, depend on the contract offered to each of the agents. The need to redistribute income among the members, and hence the need for specific types of contracts, arises for a number of reasons. Voting procedures (see, for instance, *Zusman, 1982; Hart and Moore, 1996* and *Albæk and Schultz, 1997*) and internal rent seeking (see, for instance, *Banerjee et al., 2001; Cook, 1995; Bourgeon and Chambers, 1999* and *Zusman and Rausser, 1994*) are two important sources. Redistribution also occurs if individuals in the group care about relative income and are free to choose the group to which they belong—maintaining membership under such conditions requires redistribution so that the distribution of payments is less dispersed than the corresponding distribution of productivities (*Frank, 1984*).

Regardless of the cause, the analysis in this paper shows that redistribution activities affect the efficiency of the cooperative organization. Within the contracting structure outlined above, the IOF faces information costs because its objective is not the same as the objective of the agents with which it is contracting. The cooperative emerges as a potentially more efficient organizational form because of the greater alignment in objectives; this greater goal alignment means that the cooperative can avoid the informational costs that an IOF incurs as it extracts rents from its suppliers. However, this goal alignment becomes less and less perfect when the cooperative uses its procurement policies to redistribute income.

Specifically, the paper shows that the procurement costs of the cooperative rise when the redistribution activities are based on an implied objective of the cooperative that is not congruent with that of the average member. In the extreme case where the income is redistributed to the member with the lowest income à la Rawls, the cooperative's costs approach those of the IOF. This redistribution affects other groups in the economy. Compared to the IOF, the cooperative always produces more output, thus providing a benefit to consumers. Cooperative output is also greater, the greater is the redistribution of benefits towards the most efficient cooperative members. Thus, consumers have a preference for the type of organizational structure present in the market, with a secondary factor being how decisions are made within that organization.

The results of this paper shed further light on the importance of the costs associated with collective decision making. The paper shows that cooperatives do have some potential advantages, particularly in situations where information asymmetry is important. However, given that the members of the cooperative are not homogeneous, the cooperative form of ownership implies the need for mechanisms for collective decision making by the members, mechanisms that almost inevitably end up having re-distributional implications. Not only are these mechanisms costly in and of themselves (see *Hansmann, 1996* for a discussion of this point), they also give rise to greater procurement costs. Both of these factors can be expected to make the cooperative organizational form less efficient and less likely to emerge as an alternative to the IOF.

In addition to developing new insights into the relationship between organizational structure and costs, the paper also departs from usual assumptions made in the literature on incentives. A standard result in the incentive literature is that the

³ Cooperatives, for instance, are thought to possess a number of cost disadvantages compared to IOFs because of the poorly defined property rights that the cooperative structure creates. *Bonin et al. (1993)* provide an overview of these different costs for producer cooperatives, while *Cook (1995)* and *Vitaliano (1983)* discuss these costs in the case of agricultural co-ops.

⁴ *Bonin et al. (1993)* examine the objectives and behavior of producer cooperatives, while *Sexton (1984)* and *Le Vay (1983)* provide an overview of the objectives of agricultural cooperatives. This literature, and particularly the latter two papers, examine the case where the processor offers a single price (rather than a menu of contracts) to all the agents. In this case, the cooperative is found to be more efficient than the IOF because it internalizes the costs of procuring the input from the farmers and in doing so avoids creating a margin at the farmer level (both organizations create a margin at the consumer level in an effort to extract surplus from consumers).

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