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The Journal of Socio-Economics 37 (2008) 2168–2177

The Journal of Socio-Economics

www.elsevier.com/locate/soceco

Defining the co-operative difference

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Received 9 May 2007; received in revised form 6 January 2008; accepted 6 February 2008

Abstract

The paper argues that co-operative firms play a set of roles in market economies, based on the co-operative values and principles that are rarely noted in economic literature. Among other, those roles are to internalize market externalities, to serve as laboratories for social innovation, to espouse social entrepreneurship, to promote ethical business practices, and to aid in development. While economic literature has been focused primarily on the ownership and control structure as a source of the difference, we argue that this focus paints an incomplete picture. The principles of co-operation may supply additional insights in addressing questions why co-operatives may thrive in areas of low labour mobility, prevalent market failures, oligopoly markets, and labour intensive industries. They may also offer insights into strategies and survival in global markets of successful co-operative firms.
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JEL classification: L13; L21; L22; M14; M20; P13

Keywords: Co-operative firms; Co-operative principles; Externalities; Social entrepreneurship

1. Introduction

Economics literature often treats co-operative firms as labour-owned entities, whose successes and failures relate primarily to the organizational structure arising from the type of ownership and control. This is the property rights focus, where the nature of ownership defines objectives and behaviour of economic agents. The predominant type of firm in market economies is investor-owned. Firms are maximizing profit, either as a return to the private owner, or the return on investment of shareholders in case of corporations. Other types of organizations are marginally present in the marketplace—they include non-profit organizations, as well as co-operatives where capital is jointly owned by members. Hansmann (1996) maintains the ownership focus in describing those alternative organizational forms, but he distinguishes between different types of member owned firms and mutual organizations.

A number of issues arise from labour ownership, and most are well documented in the literature. There is the "horizon problem" (Furubotn and Pejovich, 1970, Porter and Scully, 1987, and others) and the resulting under-investment in co-operative firms (Vanek, 1970). The horizon problem arises when a member's residual claim on an asset is shorter than the life of that asset, so that members have no incentive to invest in their co-operative since they cannot withdraw its full value upon departure. The principal-agent problem results from the separation of ownership and control in any type of firm (Rees, 1985; Milgrom and Roberts, 1992). In co-operatives, agency problems are potentially present between managers and co-op members (Cook, 1994). Managers may have different goals from the members, who

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doi:10.1016/j.socec.2008.02.009

control the co-operative. The free rider problem, due to joint asset ownership (Sen, 1966), plagues co-operatives since members do not bear the full cost of their actions. Then there are governance issues stemming from democratic nature of co-operative organizations and a lack of expertise in Board members (Cook, 1994), and the stability and viability problems when a co-op can hire non-members (Ben Ner, 1984). All these issues lead to the marginalization of co-operative forms of organization (Hansmann, 1996). Dow (2003) provides an excellent and extensive summary on the subject of why labour-owned firms are so rare in market economies.

Agricultural economics literature, on the other hand, deals with industrial organization of an industry dominated by producer co-operatives. The focus there, besides governance and property rights issues, is on explaining the role of co-operatives in imperfect agricultural markets, and the interplay between regulation and the role of government, market imperfections and co-operatives (Chaddad and Cook, 2003; Fulton and Sanderson, 2003; Cook, 1995; Milford, 2004). Other fields of research look at other forms of mutual organizations in finance, insurance, and other industries (Lotti et al., 2006).

As evidence shows, many co-ops are remarkably successful and growing, while some face demutualization, but the fact is that co-operatives are present to a much greater extent in market economies than has been suggested in the literature, if one takes into consideration all types of co-operative organizations, and not just the worker co-ops.

What do all co-operatives have in common? One defining characteristic is that they are democratic organizations, owned and controlled by their members/users. Another feature of co-ops is that they all apply co-operative principles and rely on co-operative values (ICA, 1995) in their daily functions. This latter aspect of co-operative organizations has not been overly emphasized in the literature, in part because only some of the principles are also legal requirements for incorporation of co-operatives. A co-operative is therefore not required to fully adhere to the international co-operative principles, so that the ownership focus may be justified as a legal constraint. Increasingly, co-operatives see the advantages of applying the principles and values fully, particularly in light of the successes of co-operatives who do that, and of the international spotlight on the corporate social responsibility and business ethics issues. We therefore venture to explore some features of co-operatives that are embedded in the co-operative principles and that profoundly define the co-operative form of organization. Our focus is specifically on how principles inform the co-operative difference[1] in cases of market power, market externalities, and social entrepreneurship.

The paper is laid out as follows. Section 2 describes the co-operative principles and their application in addressing some of the agency and incentives problems of co-operatives in general. The subsequent sections focus on specific aspects of those roles. Section 3 discusses co-operatives in monopsony and oligopsony markets, Section 4 looks at the externalities, and Section 5 deals with the social innovation and entrepreneurship functions. Section 6 concludes.

2. Roles for co-operative principles

Co-operative forms of organization are based on the internationally recognized statement of co-operative identity (ICA, 1995), and co-operative principles and values. The ICA statement of co-operative identity includes the definition of co-operative firms:

> “A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.” (ICA, 1995)

The ICA also lists co-operative values, as well as personal values of co-operative members:

> “Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity, and solidarity. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility, and caring for others.” (ICA, 1995)

The principles are means by which co-ops can apply the co-operative values. There are seven ICA principles, but co-ops are free to change them as needed. The Mondragon Corporacion Co-operativa (MCC), for example, applies ten

[1] We look at the principles as the enabling factors, rather than constraining, but they may in fact constrain the growth of co-operatives particularly if they rely on members-users as a sole source of finance. Institutional solutions may alleviate this problem, as in the case of Mondragon, for example. See Bateman et al. (2006). Carruthers et al. (2007) discuss co-operative principles in the context of co-operative expansion in global markets.

principles of their own to emphasize the importance of labour control over capital and their mission of job preservation (see Appendix A). The seven ICA principles are seen to be evolving with the needs of the co-op members, and presently stand as:

> "Voluntary and Open Membership: Co-operatives are voluntary organisations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political, or religious discrimination.
>
> Democratic Member Control: Co-operatives are democratic organisations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives members have equal voting rights (one member, one vote), and co-operatives at other levels are also organised in a democratic manner.
>
> Member Economic Participation: members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; supporting other activities approved by the membership.
>
> Autonomy and Independence: Co-operatives are autonomous, self-help organisations controlled by their members. If they enter into agreements with other organisations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.
>
> Education, Training and Information: Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives. They inform the general public – particularly young people and opinion leaders – about the nature and benefits of co-operation.
>
> Co-operation Among Co-operatives: Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional, and international structures.
>
> Concern for Community: Co-operatives work for the sustainable development of their communities through policies approved by their members." (ICA, 1995)

Co-operative firms reliance on the co-operative principles is rarely mentioned in the economic literature, probably because firms are not legally constrained to apply them. Legal requirements typically end with the nature of common capital ownership, and democratic control of these firms, but do not specify other aspects of co-operation. It has become increasingly evident, however, that the survival, competitiveness, and successes of co-operatives as a business form rest with the application of the principles. The most publicized success stories of the MCC, producer and consumer co-operatives in the Italian North and the UK are probably a case in point. All of them place adherence to the co-operative principles as their strategy very highly on the list of reasons behind their success. We do not have any consistent documented evidence on this claim, but believe it is a question worth adding to the agenda for future research.

Borgen (2004) provides a framework for the analysis of incentive problems in co-operatives from the perspective of the property rights theory and agency theory in economics. Among factors contributing to incentive problems are member heterogeneity, varied financial contributions, misalignment of goals of members and the organization, as well as the degree of member involvement in decision-making. Borgen argues that the outlined problems are based on the assumption that co-op members behave as *investors*, and he revisits the same issues assuming that members behave as *users* instead. From the user perspective, decision-making has to be placed in the social context, he argues. Instead of free riding, users may view common assets as a form of risk reduction and insurance, and the leverage for debt financing. Co-op membership may offer advantages that are not available otherwise. If we add the principle of reciprocity (McCain, 2007) the horizon issue changes as well, viewed from the user perspective. Members may invest in a co-op with an understanding of the intergenerational transfers of funds, as well as include the transaction costs of the alternatives when they make a decision to invest in a co-op (Borgen, 2004, p. 391).

Borgen also maintains that the portfolio problem is eliminated if a member is not behaving as an investor who considers his risk preference, but a user who optimizes patronage and market access instead. And lastly, the user perspective gives the governance structure a different value, since consensus building slows the decision-making in the short run, but turns into an advantage in the long run (see Lotti et al., 2006) because members align their goals and build

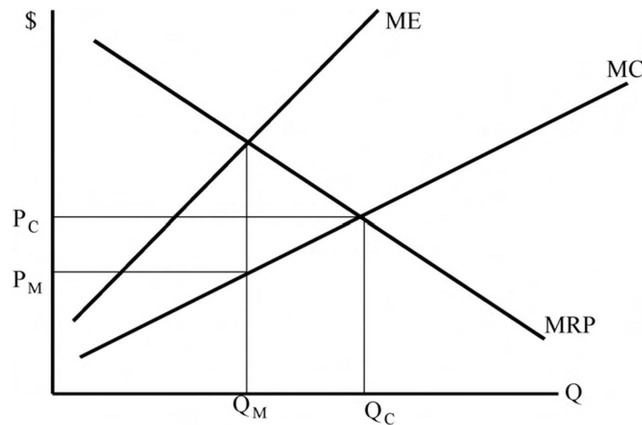

Fig. 1. Monopsony pricing. MRP = marginal revenue product; MC = competitive producers' supply; ME = marginal expenditure by monopsony firm; P_C = competitive price; P_M = monopsony price.

up cohesion in the process. We argue that this user perspective is captured in the principles. In other words, principles of co-operation have the potential to guide strategies and practices that can be turned into a co-operative advantage.

Smith (2001) compares La Lega co-operatives in Italy to the MCC co-operative network, in the context of network externalities. He emphasizes the importance of the MCC co-operative principles (see Appendix A) for the survival and success of the network, and suggests that the principles function as a constraint, i.e. an "exogenous organizational variable around which an organizational co-operative advantage had to be found to adapt and survive in the market." (Smith, 2001, p. 8).

We wish to make a case that, if adhered to, co-operative principles can be seen to play an economic, managerial and social function[2]. We proceed by looking at three specific areas of their application that can describe in part how co-operatives differ from other organizations.

3. The "competitive yardstick" role and monopsony pricing

When many producers supply the product to a single buyer in the region, as is often the case in agriculture[3], a profit-maximizing monopsony buys less output at a lower price than the competitive market would sustain, thereby making a profit on the difference between the price it pays per unit and the marginal (buyer) expenditure. Agricultural producers are worse off, receiving low price for their output as Fig. 1 illustrates.

In an oligopsony market, more output would be purchased than Q_M, and a price higher than P_M would be paid to producers. However, it would not amount to the competitive price levels (Milford, 2004, p. 19).

Milford (2004) looks at monopsony and oligopsony coffee markets within the fair trade system, and gives a detailed analysis of the impact of co-operative presence in those markets. The study confirms the assertion that co-operative firms have a "competitive yardstick" effect in oligopsony markets (Sexton, 1990), forcing investor-owned firms to offer higher prices for agricultural output. A similar result for the Canadian wheat market is presented in Zhang et al. (2007). Competitive agricultural producers often organize in a co-operative to sell their agricultural produce at a higher price then a monopsony or oligopsony private firms are ready to pay. Co-op members/producers optimize their total incomes, resulting in part from the sales of output to the co-operative, and in part from their share of earnings from co-operative operations. Under the competition from co-operatives, other firms in the market are forced to increase their purchasing prices. Co-operatives therefore push the price in the market closer to the competitive price level.

In a co-operative monopsony market setting, Milford (2004) compares co-ops that maximize profit to the income maximizing ones, as well as the output maximizing, open co-operatives.

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[2] As emphasized in the introduction, firms may incorporate as co-operatives yet not fully apply the co-operative principles, given the disparity between the legal requirements of incorporation as a co-operative and the ICA (1995) definition.

[3] The labour market may be another example. See Mikami (2003) for a discussion of the efficiency of different corporate forms in imperfect markets.

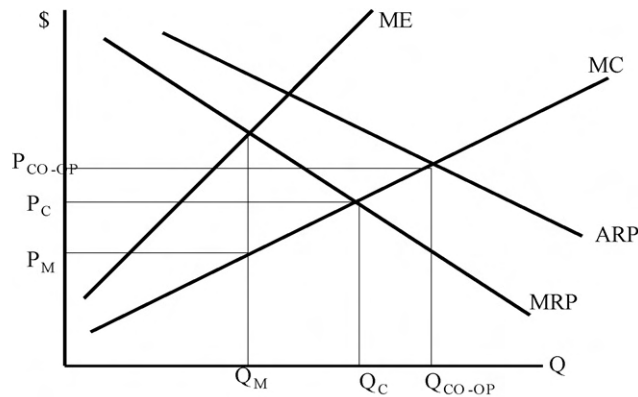

Fig. 2. Output level of a monopsony co-operative firm with open membership policy (Qco-op). The co-op produces more, and pays a higher price than the competitive market, or a closed membership co-operative, since producers increase their supply as long as there are excess profits, i.e. until ARP = MC.

The profit-maximizing co-ops are likely to produce the least among the three co-op types, while open membership co-ops increase output to the socially optimal level. Since we consider co-operatives that adhere to the co-operative principles, the only relevant case for our purposes is the output maximizing one, since co-ops would subscribe to the open and voluntary membership (see Appendix A). Fig. 2 illustrates the open co-op's output and price levels in a monopsony market using Milford (2004) framework[4].

Therefore, co-operative principles may inform membership policy, and affect co-op behaviour, as well as its impact on the industry. In case of oligopsony markets, this policy would confirm the competitive yardstick effect of co-operative firms, since the co-op would offer a higher price than the competition, forcing the competition to do the same, or lose the market share. A number of studies indicate that open co-operatives have a stronger pro-competitive effect on the industry than the alternative forms of organization, while providing a lower income to its members than a closed membership co-op would (Milford, 2004, p. 22).

Open membership, as Milford (2004) notes, also implies costs in the form of membership entry fees (member capital participation), which may in part serve as a deterrent to entry of new members.

While the benefits of open co-operatives in terms of the welfare gains are clear, making the case for the promotion of co-operative firms as a policy, we would also argue that in order to account for the full impact of the co-operative presence in the market one needs to take into account other social benefits. Losses in personal incomes to members due to open membership may be gained in the provision of social goods.

4. Dealing with externalities

Novkovic (2006) reports on survey results of a small sample of Canadian co-operatives, but the findings are applicable to a much wider spectrum of co-operative organizations. The study focuses on the co-operative values and principles, their role in the decision-making, and their perceived impact on costs, capitalization and productivity. The results confirm findings of the agency theory regarding the impact of co-operative organizational structure on access to capital and costly decision-making. The study also indicates that the seventh principle – concern for community – goes beyond the typical understanding of "social corporate responsibility" which represents donations of a part of profit to charitable causes, and community development projects. While commendable, these efforts do not bring about socially optimal outcomes that internalize the externalities, i.e. they do not alter the supply decisions of firms, nor do they include the preferences of those affected by the decisions.

Co-operatives however, mitigate market failures as they maintain presence in locations that are not profitable to investor-owned firms, they use costly practices to address environmental concerns, offer employment to the marginalized

[4] As a side-note, the framework offered here follows the seminal model of Ward (1958) and Vanek (1970), where co-operatives are assumed to maximize member incomes. The model has been disputed for a number of flaws (see Dow, 2003 for example), but it serves our illustration purposes.

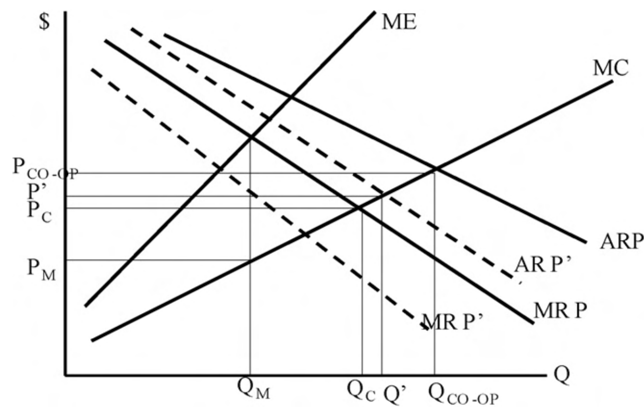

Fig. 3. Monopsony outcomes when co-operatives internalize the externalities. Costly practices will reduce the marginal revenue product and average revenue product. The price differential from monopsony price is smaller (P' compared to Pco-op).

population left out of the labour market (Novkovic, 2006), they buy locally produced goods at higher prices to ensure food safety, local development and other goals (Harvey, 2003; Novkovic and Power, 2005), they sell at reduced prices in low income communities, and offer many other examples of internalization of community concerns into a co-operative business. In other words, the supply decisions are fundamentally altered in light of co-operative social goals.

The forms of support for the community by co-ops also include various donations of their time, goods, and services, involvement in community development, financing community development projects, scholarship funds, and other charitable functions (Novkovic, 2006) but those do not constitute the co-operative difference in our view. Tassinari (2006) provides a detailed account of co-op Italia's costly practices that go well beyond SA8000 certification standards for social responsibility. The co-op is engaged in fair trade, labelling and tracing food products in the supply chain, subscription to ethical production practices by their suppliers, and so on.

We stress again that not all co-ops internalize the externalities, and not all care for the community on equal terms, but adhering to the principles, we conjecture, would produce significant behavioural differences between co-operatives and other organizations.

How do externalities affect co-ops in monopsony/oligopsony markets?

Under the assumption that co-ops adhere to the principles and internalize the externalities, one can assume that these practices would be costly for a firm, causing a downward shift of the marginal revenue product and average revenue product curves. This effect is comparable to the case of a less efficient co-op (Milford, 2004, p. 29). Fig. 3 illustrates. This may reduce the yardstick effect, but if properly accounted for, social impact would be included in the benefits of co-operation. In a way, the fair trade premium serves that function—it is an indication of the value that the consumers place on the product's "social" qualities reflected in the fair trade label.

We also need to stress that the model used here is static, illustrating one-time shifts in the MRP and ARP curves. In a dynamic framework, one would need to include the shifting demand for ethical products, and the positive price impact that would produce, so the end adjustment would depend on the relative size of the two effects.

5. Social entrepreneurship

Lastly, we question whether co-ops, as principles based businesses, have a potential to be the architects of social innovations, particularly through the creation of networks necessary to implement social change. We also ask whether the co-operative form of organization creates an environment conducive to social entrepreneurship. But what is social entrepreneurship, and what do we mean by social innovation?

Social innovation is typically referred to in two ways: one that talks about innovation in teams (group innovation, rather than individual innovation), and the other that refers to innovative ways of delivering social goals.

In line with Schumpeter's definition of entrepreneurship as creating value through innovation, we define social entrepreneurship to be creating *social* value through innovation. Social entrepreneurship has been described in the literature as a trait of individual visionaries, who against all odds, and with very little resources, force social change. Light (2006) takes issue with this approach, arguing that the focus on one individual entrepreneur neglects numerous

individuals, groups and organizations that are behind many innovative solutions to social problems. Light argues that this way, the focus is . . . "not so much about pattern-breaking change, but about pattern-breaking individuals" (p. 48). He continues to define social entrepreneurs (p. 50):

> "A social entrepreneur is an individual, group, network, organization, or alliance of organizations that seeks sustainable, large-scale change through pattern-breaking ideas in what or how governments, nonprofits, and businesses do to address significant social problems."

The author emphasizes that this definition recognizes that social entrepreneurship occurs in teams, in many different types of organizations, and that many social entrepreneurs are unrecognized.

We see a parallel between this approach and co-operative firms, where knowledge is built in teams; individual members affect each other and make joint advances in organization, technology, and services offered to their members, or to consumers. McElroy (2002) makes a case that innovation is a social process, which brings the co-operative firm to the forefront once again. Innovation, according to McElroy, is a result of social learning and networking; it is an unmanaged process and a self-organizing one. The author also states that a firm gains comparative advantage (higher economic value) by facilitating self-organization around innovative activities, rather than purely administrative control of R&D functions. He asserts that social innovation inside firms is not a manageable administrative process, but a self-sustaining one, provided that it receives the right support[5].

In this context, we see a co-operative organizational form as a potential breeding ground of social entrepreneurship and social innovation. At issue for co-operative firms, however, is how to measure intangible assets, particularly the social capital. Typically, intellectual property (patents, trademarks, copyrights) are used as a proxy measure of innovation activity of a firm. Intangible assets (social capital) are reflected in the market value of firms. Since co-operatives do not trade their shares on the capital market, it is not easy to quantify the value of their social capital. Adherence to co-operative principles may serve as one such measure[6].

Leadbeater (1997) talks about social entrepreneurship with the individual entrepreneur delivering welfare services in mind. He states that the most important contribution of social entrepreneurs (in addition to their delivery of measurable benefits) is their ability to create and invest social capital. The author recognizes that teams of people stand behind the social entrepreneur, and looks for common characteristics in entrepreneurial organizations. Entrepreneurship thrives in organizations with flat management structures, flexible, short lines of communication, and a creative culture. More innovative organizations interact with their environment in a complex and fluid manner; they evolve, and revisit and reinvent their mission.

All these characteristics have been recognized in successful co-operative organizations. In the co-op literature social innovations and entrepreneurship have been recognized in a number of ways. Bateman et al. (2006) and Ellerman (1982, 2006) for example, discuss the expansion of MCC as social entrepreneurship. Foote-Whyte and Foote-Whyte (1988) terms Mondragon's creation of individual capital accounts a "social innovation" since it resolved the horizon problem arising from the non-alienability of the social capital in co-operatives. The contribution to social capital by mutual organizations has been discussed by Matthews (2002)[7] and others. Smith (2001) looks at network externalities as organizational innovations of the MCC and La Lega co-operatives.

Applying the co-operative principles implies networking, team work, participatory management, democratic decision-making, transparency, and information-sharing, that all contribute to increased probability of social innovations and social entrepreneurship[8].

There are some obstacles to increased innovation by co-operatives that we need to address. First, product innovation requires large investments, which small co-operatives typically lack. This may be solved by a creation of networks, such as Mondragon, or co-ops in the Italian North, as Smith (2001) contends. Second, social innovation may not have the support it needs, for various reasons, such as a lack of recognition or visionary/strategic thinking, if management

[5] The author lists four areas of needed support to the innovation-friendly environment: learning, knowledge processing, connectedness and ethodiversity.

[6] Principles can be applied to governance, management, production relations, team work, and networking.

[7] However, in light of changing market conditions, mutuals often fail to re-invent themselves in response to new needs (Matthews, p. 3). They often fail, and demutualize as a result.

[8] These are not explicit in the ICA principles. One can argue however, that co-operative values cannot be fully applied unless management has the human focus, regardless of the type of co-operative firm.

and boards lack appropriate motivation and skills. Third, the democratic process may be an obstacle—it takes longer, it is more difficult, and outcomes are uncertain. On the other hand, the democratic process may be a facilitating factor of social innovation (Lotti et al., 2006). Fourth, the ICA co-operative principles and values need not be fully utilized in co-operatives.

We therefore conjecture that co-operative forms of organization can be seen as conducive to social entrepreneurship and social innovation if they apply the co-operative principles, and practice co-op values. For example, among the four McElroy (2002) conditions that support social innovation – learning, knowledge processing, connectedness and ethodiversity – all components can be found in co-operative principles (education, democratic decision-making, co-operation among co-operatives, open and voluntary membership). However, the effectiveness of the application of those principles can be questioned in some co-ops. McElroy, 2002 also states that social innovation needs the right management support. This support may be lacking in co-ops where management and members do not share a common vision[9], do not apply the principles, or when lines between management and governance are blurred.

6. Conclusions

Co-operative firms are businesses known to contain a social component, rooted in the co-operative principles and values. They are democratic organizations, serving their members' interests. This paper outlined some characteristics of co-operatives that constitute the key elements of the co-operative difference, and are based in the principles. Adherence to the principles serves a number of economic, managerial, and social functions. We explored here how principles inform the co-operative difference in cases of market power, market externalities, and social entrepreneurship.

In case of monopsony and oligopsony markets, such as the agricultural markets, or labour markets in some communities, co-operative entry serves as a "competitive yardstick" by increasing the price it pays for output of its members. This effect increases incomes of non-members as well, as investor-owned competitors are forced to pay higher prices to compete. Co-operative presence therefore increases social welfare, reduces social costs and increases farmers' incomes. Co-operatives will be open to new members, if they adhere to the principles, and push the price they pay to members to the point where no economic profit is made. This type of co-op has the largest effect on the competing firms and on the industry. Membership fees, in line with the principles, may serve as a deterrent for further entry, and help maintain incentive-compatible profitability.

Deeply rooted in the communities where they operate, co-operatives are firms that internalize market externalities. They resort to costly practices to ensure the fulfillment of their social function. Driven by members, and educated by the principles, co-operatives undertake costly practices to care for the environment, engage in the fair trade chain, employ marginalized population, provide social services, and so on.

We also examined the ways in which principles-based co-operatives have the organizational advantage in promoting social entrepreneurship. We conclude that they indeed may serve as laboratories for social innovation and social entrepreneurship, due to their features based on the principles, such as democratic nature, governance structure, education, and learning, networking, and community focus. Co-operatives possess all the elements conducive to social innovation. They have flat management structure, encourage participation, social learning and networking, and promote self-organization.

There are some obstacles in fulfilling this role, however, and they are in part vested in capitalization and agency issues, and in part in the possibility of not utilizing the principles and values to their full potential.

Appendix A. Mondragon Corporacion Cooperativa co-operative principles (Smith, 2001, pp. 16–21)

1st principle: open admission.
2nd principle: democratic organization.
3rd principle: labour sovereignty.
4th principle: instrumental and subordinate nature of capital.
5th principle: participatory management.
6th principle: payment solidarity.

[9] Principles-based management may mitigate some of the agency problems (Novkovic, 2004).

7th principle: inter-co-operation.
8th principle: social transformation = a commitment to development.
9th principle: universality = networking with like-minded organizations.
10th principle: education.

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