The Political Economy of Co-operative Governance

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WINS Seminar, Humboldt University
April 21, 2016

Governance

Has emerged over the last decade or two as the defining feature of what makes systems and organizations work

- Governance is a key issue in international development, with the World Bank and other international organizations identifying better governance (e.g., judicial and public administration reform, anti-corruption initiatives) as key to achieving goals such as poverty reduction (Grindle 2002)
- As a result of Enron and the 2008 financial crisis, there has been a focus on corporate governance, with policy makers passing legislation (e.g., Sarbanes-Oxley) or introducing best practices (e.g., Basel III) in an attempt to improve corporate governance and performance

Corporate Governance

- The key focus of the corporate governance literature is to ensure the manager operates in the best interest of the organization and not in her/his own interest (Schleifer and Vishny 1997)
- The governance problem is seen as a principal-agent problem that can be addressed using a combination of incentive contracts for the managers and the allocation of power to investors
- Investors are given power through regulation (e.g., protection of minority share-holder rights) and by giving large investors significant control rights

Governance is Complex

Good governance involves getting the entire system or organization to work well

- Good outcomes involve various groups and individuals working together in the right way
- In the corporate setting, groups/individuals include senior leadership, managers, employees, input suppliers & customers
- Governance includes the allocation of authority – e.g., Is a system/firm centralized or decentralized? What control rights are provided to different players?
- Governance is both economic and political. It is concerned with the way that political issues (e.g., ownership, power & authority) interact with issues of incentives (economic benefits and costs)

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What is Governance?

In simple terms, governance is concerned with "Who gets to decide what."

Governance determines who has power, who makes decisions, how other players make their voice heard and how account is rendered.
(Institute on Governance 2015)

Governance Takes Place in Organizations

Herbert Simon (1991) – We live in an “organizational economy”

- Organizations exist because they do some things better than people operating individually (Coase 1937, Arrow 1974)
  - Deal with opportunistic behaviour (Williamson)
  - Aggregate and interpret information (Loasby, Arrow)
- Organizations require organizing, and involve incentives and authority
- Thus, governance, which is about “Who gets to decide what,” is fundamentally about the allocation of power and authority, and how that allocation affects incentives and information provision, and hence economic outcomes

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Governance – The Economic Dimension

Governance must address incentive and information problems

- Numerous strategic interdependencies exist between the various players in an organization – these may take the form of agency problems, prisoners' dilemmas, coordination problems, & multi-tasking problems
- Need to get incentives correct so that problems of information asymmetry and opportunistic behaviour can be addressed (Garicano and Rayo 2016)
- Need to deal with problems of bounded rationality and other cognitive limitations (Garicano and Rayo 2016)
- Need to deal with the Knightian/Schumpeterian problem of making inferences about the future

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Governance – The Political Dimension

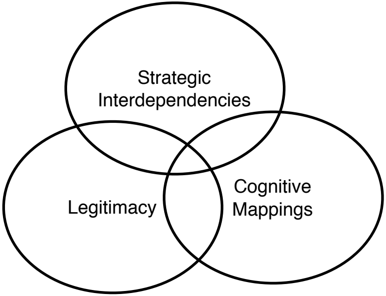
Allocation of authority affects economic performance

- Need to allocate authority (e.g., centralization versus decentralization) in a way that the organization makes best use of the information that can be collected, and in a way that provides incentives for the proper information to be collected
- Need to allocate authority so that groups with power do not block initiatives that are beneficial to the organization
- Need to allocate authority in a way those subject to authority believe is legitimate

Governance – The Substantive Performance Issues

Three key elements required

1. Deal with strategic interdependencies through different forms of incentives and authority allocation
2. Develop beneficial cognitive mappings via incentives and authority
3. Establish & maintain the legitimacy of the incentives & authority



Strategic Interdependencies

Creating the right economic and social incentives

- Standard principal-agent relationships between vertical players (members or investors, boards, CEOs, employees)
- Free rider problems among horizontal players (members, board members, employees)
- Coordination problems
- Solved in part by economic incentives
  - Easier to do in investor-owned firms (IOFs) than co-ops
  - Best suited for easy-to-observe goals
- Solved in part by social incentives
  - Creation of identity and mission, and the building of trust
- Both economic & social incentives involve power & authority

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Cognitive Mappings

Creating and communicating beneficial & valuable inferences

- Organizational success depends on how bounded rationality and biases are ameliorated - What information is collected? How is it interpreted? How it is communicated?
- Organizational success also depends on the ability to properly anticipate an uncertain future (in the Knightian sense)
- Dealing with uncertainty requires the development of inferences and cognitive maps
- Good organizational performance occurs when inferences more or less anticipate what actually happens
- Cognitive maps also convey power and authority, and are contested

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Legitimacy

Power and authority are only effective if they are viewed as legitimate

- "The decision as to whether an order has authority or not lies with the persons to whom it is addressed and does not reside in 'persons of authority' or those who issue these orders." (Barnard 1938)
- People don't have to actively support the authority and power. But they do have to acquiesce at least – i.e., accept the situation without engaging in exit
- Similar to the idea of social license, but for an organization
- Is an integral part of power and authority
- Is often overlooked, because its impact is not felt until it is not present

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The Determination of Incentives and Authority

Exogenous and Endogenous Forces

- Most incentives are not introduced from the outside by a third party – instead, they are influenced and determined internally by the parties with the authority and influence to do so
- While some elements of authority are determined exogenously (e.g., variety of capitalism; general corporate governance regulations), other elements are determined endogenously
- Some of these endogenous elements are structural – e.g., the determination of whether a co-operative will convert to an investor-owned firm (IOF)
- Other elements are operational – e.g., how board members are selected, the information provided to boards

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De Jure Sources of Power and Authority

Multiple levels exist and play a role

- Institutional level
  - Rule of law
  - Varieties of capitalism – liberal market economies versus coordinated market economies
  - VOC has different impact on co-ops than on IOFs
- Regulatory level – e.g., legislation (SOX) and best practices (Basel III)
- Organizational level
  - Co-op structure – open versus closed membership; federated versus centralized; tradable shares; supervisory committees
  - Bylaws that determine voting mechanisms, board composition, membership of key committees

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De Facto Sources of Power and Authority

Varies among the various players/parties

- CEO
  - Reduce board training & close down member relations
  - Resist hiring of outside directors, using in-camera sessions
  - Develop and express own cognitive model
- Board of directors
  - Push back on the items listed above
  - Slow down the decision making process
  - Require outside views on major infrastructure decisions
- Members
  - Make views about organizational performance known to the board and management
  - Take business elsewhere

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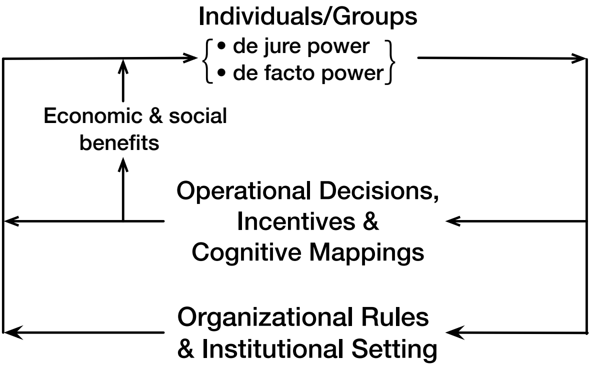
The Political Economy of Governance

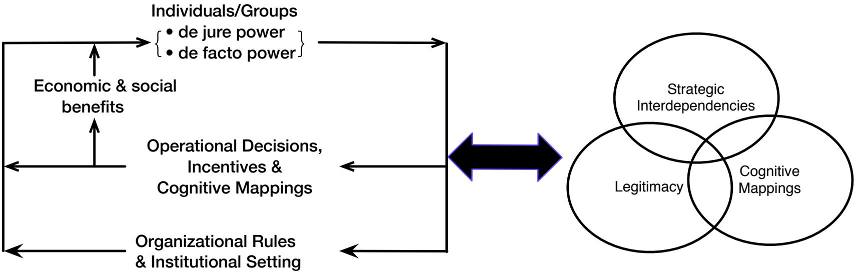
"Who gets to decide what" determined by political & economic factors



Adapted from Acemoglu and Robinson (2006)

Political Economy and Substantive Performance

"Who gets to decide what" has to be meshed with addressing key performance issues



The Case of the Saskatchewan Wheat Pool (SWP)

A governance failure

Largest co-op in Canada; long & successful history; played a dominant role in public policy debates

Change in de jure and de facto power, caused in part by changes to the external environment and in part by actions of a new CEO, resulted in numerous negative performance outcomes:

Strategic Interdepend.	Board failed to oversee senior management
Cognitive Mapping	Hubris and overconfidence on the part of senior management led to excessive investments in ill-founded projects
Legitimacy	Loss of member and investor confidence because SWP was not believed to be acting in their interests
Result	Series of bad investments, rapid build-up of debt, dramatic loss of market share, severe financial problems, termination of the CEO, and conversion to an IOF

Saskatchewan Wheat Pool – Key Events

- Early 1990s — Weaker financial performance; outdated elevator system; major policy changes (NAFTA, loss of transportation subsidy, change in marketing system)
- 1994 — New CEO hired
- 1994–1996 — New financial structure designed to support new investments
- April 1996 — Pool shares trade on Toronto Stock Exchange
- 1999 — CEO fired because of poor financial performance
- January 2003 — $405 million debt restructuring plan that saved SWP from bankruptcy and altered board governance
- February 2005 — SWP's board approves recapitalization; Pool transformed from a co-op to a business corporation

Key Period — 1996–2000

- Project Horizon — $270 million investment in 22 new large inland grain terminals
- First foreign direct investments
- Major investments in grain processing, farm input supply, and hog processing and production
- Long-term debt rose from $93.6 million in 1996 to more than $518.7 million in 1999
- Grain handling market share in SK fell from 61% to 33% in the ten-year period 1993-2003.

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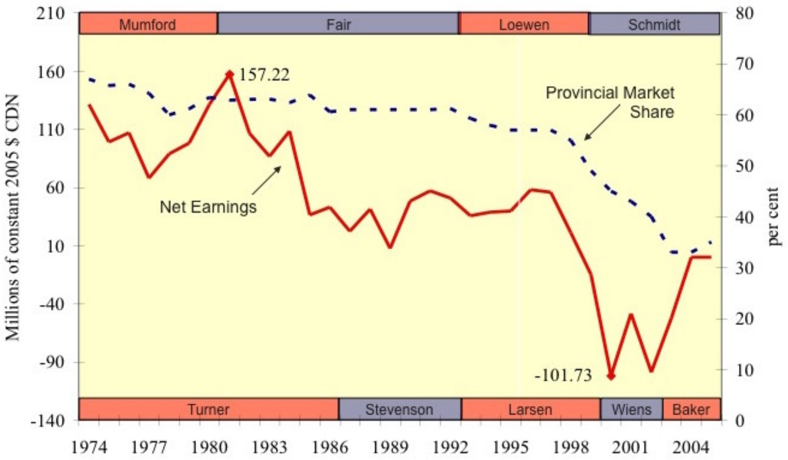
SWP Net Earnings and Market Share, 1974-2005



Strategic Interdependencies – The Economics

Lack of incentives for oversight

- With its restructuring in 1996, the SWP operated with an A-B share structure. The voting A shares were held by farmers; the non-voting B shares were held by investors. Farmers generally did not hold B shares, and investors could not hold A shares
- Since farmers no longer owned SWP, they had little incentive to monitor its performance
- Investors had no legal means to influence the board, and hence no incentive to do so

Strategic Interdependencies – The Politics

Shift in power and authority from the board to the CEO and senior management

- There were two principals – the farmer-members and the investors – and only one agent – the CEO. This structure allowed the CEO to play one group off against another.
- "You could see the gradual change where the board became almost dependent as opposed to being the final decision-making body. They basically became dependent on management to tell them, 'Here's what you should do and here's why you should do it."'

Cognitive Mapping – The Economics

Creation of a "do or die" mentality

- CEO: "If we don't become a strong, global force, we will just be eaten up by the American [multinationals]. Quite frankly, they'll eat our lunch."
- Board member: "The argument that was being made was that if [the Pool] did it first, no matter what we paid for it, we would prevent our competition from doing it and then we would be successful."

Cognitive Mapping – The Politics

- "There were a lot of things shared with the President that never got adequately shared with the rest of the Board. Getting things done became more important than sharing information."
- Senior management: "The amount of information we supplied was information overload at time." "It was more that the board did not know the questions to ask."
- The volume of proposals and expected promptness for decisions to be made "would have been difficult even for a competent Board to stay abreast and do a fair job of assessing what was coming in"
- "Ideas did not get . . . proper and adequate evaluation, if [the CEO] wanted to do it everyone would find a way to make it happen."

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Legitimacy

- Key factor in SWP's poor performance was loss of market share.
- Since farmers no longer shared in profits as members, they lost the economic reason to patronize the co-op.
- In addition, farmers lost trust in the organization. They no longer believed it had their best interests in mind
- A key event was the SWP's purchase of Humboldt Flour Mills for an exorbitant price, a purchase that was motivated by the desire to keep another co-op out of the market
- Investors also lost faith in the SWP
- Loss of faith one reason for the drop in SWP's share price from \$24.00 to \$0.10.

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The Saskatchewan Wheat Pool: A Short Summary

- The poor performance of the SWP, which lead to its conversion from a co-op, occurred for a number of political and economic reasons
- The decisions made to the governance structure re-allocated authority and altered incentives in a way that failed to address the substantive performance issues required for successful organizational performance – i.e., strategic interdependencies, cognitive mappings, and legitimacy
- The changes to the governance structure were not imposed by outside parties, but were implemented from within, and reflected the changes that a small group of people thought were desirable

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The Governance Problem

- In short, the SWP case illustrates one of the ways that the political economy of governance can manifest itself
- In other cases, the political economy will play out in other ways

The political economy of governance

- Governance needs to be expanded beyond the agency problem to consider other strategic relationships in the co-op, to capture how information is collected & interpreted, and to understand how power & authority are kept legitimate
- "Who gets to decide what?" is critical, since different people will make different decisions (some better, some worse) about these issues
- Individuals and groups take actions to become the ones that decide. Some of these actions are political, in that they affect the rules of the organization and the policies of the country. Others are economic, in that they directly affect economic outcomes.

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Thank You