

## Was wir meinen

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# Social Benefits of Cooperatives - An Economic Perspective

## Sozialer Nutzen von Genossenschaften – eine wirtschaftliche Perspektive

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Why and how are cooperatives beneficial to society? The answer is simple: first and foremost, because they are useful for the members. Cooperatives enable them to cooperate and operate economically. Members benefit because they can pool resources, save on transaction costs and hold their own against companies with market power. The purpose and democratic governance protect against exploitation, even in the face of the high opportunity cost of terminating membership. What should the state do? Cooperatives should be supported by structuring their legal form in a way that is appropriate to their purpose and practical. Financial support for cooperatives is recommended if external effects are internalized or more targeted alternative redistribution instruments do not exist.

## 1 Welfare, common good and cooperatives

The question of the impact of cooperatives on social welfare will be answered here from an economic perspective based on common concepts. The measure of social welfare aggregates indicators of individual well-being for members of the social group considered relevant. An example of the concept social welfare is the -weighted or unweighted - sum of individual utility (or alternatively happiness indicators). In the remainder of this paper, I assume that all individuals and organizations noticeably affected by the cooperative's activities are considered, and that individual well-being is positively correlated with income and negatively correlated

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with the prices of consumer goods. In empirical statements, I refer primarily to cooperatives in Germany (Münkner 2013; DGRV 2022). Not all findings can be readily applied to cooperatives in Southern European countries, for example.

For the social evaluation of cooperatives, suppliers, employees, customers and competitors, but above all the members have to be taken into account. From this list of stakeholders, it is immediately apparent that an explicit common good orientation is neither sufficient nor necessary for welfare-enhancing effects of cooperatives. Rather, member benefit is primarily decisive for the self-help association (Picker, 160 et seq.), although not exclusively so. The fact that certain cooperatives provide services free of charge or at a discount to third parties and promote "social or cultural concerns" of members through explicit common good orientation will play a major role in their social evaluation, but does not contradict the primary importance of member welfare for cooperatives.

## 2 Fundamental social value of cooperatives

The cooperative as a legal form is no less and no more than another option for organizing a business operation. In the spectrum of possible forms of organization, the cooperative is a special variant of hybrid forms of enterprise (Ménard 2004), which can be classified between market and firm (Coase 1937). (Williamson 1975, Pereira 2016). As "societies of non-closed membership whose purpose is to promote the employment or the consumption of their members or their social or cultural interests through joint business operations" (translation of § 1 German cooperative law), they combine hierarchical and price-based regulatory elements with democratic governance by members. Principles and values of cooperatives (ICA 2015) provide an independent framework for the association and cooperation of several individuals. On the one hand, the legal form enables additional actors to engage in business activities and, on the other hand, offers an alternative design to pool resources (Ménard 2007). The expansion of actors' scope for action is welfare-enhancing per se, provided that they act rationally and the existence of a cooperative does not have a negative impact on third parties due to specific circumstances. In this context, the state has the fundamental task of designing and adapting the legal form of the cooperative in such a way that it can fulfill its purpose in the best possible way.

### 3 Economic theory of producer cooperatives

The reasons for the existence of producer cooperatives, their characteristics, and their effects have been studied and referenced by an extensive theoretical and empirical economic literature (including Cook et al. 2003, Tortia et al. 2013, Grashuis and Cook 2018, van Dijk et al. 2019, Candemir et al. 2021). By pooling member resources, cooperatives can leverage economies of scale and scope, increasing member competitiveness and profits. Vertical integration through cooperatives avoids double marginalization, i.e., multiple inefficient pricing at each other's downstream production stages. Producer cooperatives enable members to resist abuses of market power by monopolies and monopsons or oligopolies (Normak 1996, Cook 1995), thus reducing market failures in the face of imperfect competition. Cooperatives set standards and thereby limit the market power of for-profit firms by means of the yardstick effect (Carletti et al. 2018, Liang and Hendrikse 2016). Moreover, in terms of contestable markets theory (Baumol et al. 1982), the very option of forming cooperatives reduces the abusive potential of for-profit firms. To the extent that cooperatives limit the pricing latitude of for-profit firms with large market shares, they increase the allocative efficiency of resources and enhance social welfare. On the other hand, by creating market-dominant cooperative enterprises, cooperatives also enable cooperation for the benefit of members but at the expense of third parties (Bergman 1997, among others). Whether cooperatives reduce or induce allocative market failures through imperfect competition is ultimately a question to be resolved empirically. The specific conditions of production and sales in the relevant and related markets are decisive for the direction of welfare effects. For producer cooperatives in the agricultural sector, however, substantial market power in the downstream retail sector suggests that they mitigate, rather than exacerbate, market failures (Sexton 1990).

The advantages of producer cooperatives can also be interpreted as savings in transaction costs (Williamson 1991, Pereira 2016, Elliott and Olson 2023). Compared to markets, search, information, and contracting costs are lower; compared to firms, adjustment and bureaucratic costs are lower. Producer cooperatives are used for transactions in which they are superior to markets and firms, respectively, in terms of the combined dimensions of frequency, uncertainty, and specificity of assets used (Williamson 1991, Pereira 2016). Cooperatives tend to have an advantage in more frequent and regular transactions with lower uncertainty and higher specificity (Pereira 2016). Unlike one-time market transactions, membership in a cooperative is a voluntary commitment that is on the one hand more binding than purchasing a company share, but on the other hand more flexible than forming a partnership.

The design of ownership rights in the cooperative legal form implies a free-rider problem, a horizon problem, a portfolio problem, and governance problems (Tortia et al. 2013). The causes are that the costs of using common resources are shared, internal benefits are not limited to acting members in open membership cooperatives, the cooperative usually exists longer than the individual membership lasts, membership rights cannot be traded and usually expire without replacement at the end of membership, investment and membership cannot be decoupled, and the members as principals, who usually have comparatively little expertise, are limited in their ability to control and steer boards - the agents. These incentive problems entail further constraints – for example, on access to debt (Shaffer 1987). The disadvantages must be weighed against the advantages of cooperatives mentioned above. However, they should not be overstated, as mechanisms exist to enforce efficient use of commons resources (Ostrum 1990) that can be transferred to cooperatives, and informal control mechanisms such as trust, reputation, socialization can complement and replace formal control, as has been discussed extensively in the literature on cooperatives. (Hansmann 1996, Ménard 2004, Chaddad 2012, among others).

## 4 Economic theory of housing cooperatives

Although the positive effects of consumer cooperatives on allocative efficiency were discussed early on (Enke 1945, Sexton 1983, among others), the economic theory of consumer cooperatives is less sophisticated than that of producer cooperatives. However, methods and insights from the economic theory of producer cooperatives can be partially applied to other forms of cooperatives, including housing cooperatives.

Housing cooperatives provide housing for their members; housing construction and management are part of their activities. In addition to housing cooperatives, it is mainly state-owned and for-profit housing companies that provide housing in buildings with multiple apartments such as multi-story buildings. Regardless of legal form, multi-unit housing associations will take advantage of economies of scale in the construction and management of housing, make financial provisions for maintenance and adaptations to changing regulations, and partially internalize tenant externalities. Housing associations with larger housing portfolios can take advantage of economies of scale and pool risks, unlike owners of individual properties. Because housing cooperatives limit the market power of developers vis-à-vis landowners, on the one hand, and of for-profit housing corporations vis-à-vis tenants, on the other, they provide a corrective to imperfect land and housing markets.

Due to the high monetary and non-monetary costs of changing tenants and housing in the form of search, relocation and maintenance costs, as well as the effort required to adjust social relations, owners and users of housing are interested in long-term contracts. However, in order to respond appropriately to external shocks and changes in preferences, these contracts must allow users flexibility in terminating their tenancy and owners flexibility in adjusting prices. In connection with the conclusion of the contract, but also during the entire term of the contract, owners and users of housing make high housing- or location-specific investments. On the owner's side, these are maintenance and modernization expenditures; on the user's side, they are investments in social relations, including choice of workplace. These investments increase the cost of terminating the contract. As a consequence, the contracting party with the higher costs of contract termination may be exploited by the other contracting party (hold-up problem), which in turn results in too little specific investment. In tight rental housing markets, the tenant will usually have less bargaining power and must fear rising rents in existing leases. Rent increases for existing tenancies are therefore restricted by law – and not only in Germany. However, if rents or their development are fixed in a binding way for the long term (e.g., through graduated leases), the risk of exploitation of the tenant by the landlord decreases. Housing cooperatives avoid the hold-up problem at the expense of users, since they can credibly commit to stable low rents due to the focus on member benefit and democratic control in setting the user fee. However, analogous to government regulation of existing rents, this creates a lock-in effect (Arnott and Shevyakhova 2014) that lowers spatial mobility, as moving would be associated with sharp rent increases.

## 5 State subsidies for cooperatives

States promote cooperatives in many ways through tax breaks, monetary transfers, subsidized loans, direct participation by municipalities (Meister et al. 2020), and preferential consideration in contracting or, as in the case of housing cooperatives, the allocation of state land. Like all subsidies, those for cooperatives should be seriously evaluated for appropriateness and necessity, especially since subsidies may protect against competition and enable inefficient processes (for U.S. credit unions, see DeYoung et al. 2022). From an economic perspective, government subsidies should aim for efficiency and equity. From an efficiency perspective, subsidies from which cooperatives benefit not because of their legal form but because of the services they provide are justified if they internalize positive externalities irrespective of their legal form, for example in the generation of renewable energy. Pecuniary

externalities, on the other hand, are only viable to a limited extent as a justification for targeted subsidies for cooperatives, and then especially in the start-up phase, because the relationship between cooperatives and market power under imperfect competition is complex and heterogeneous. Furthermore, government subsidies for cooperatives can be an efficient and targeted instrument of redistribution if monetary payments to individuals or households entail too many deadweight losses and the members or third parties supported by the cooperative represent the desired target group relatively well. Conversely, however, this means that those cooperatives are unsuitable for support whose members or beneficiaries need this support less than others.

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