Boards in Agricultural Cooperatives: Competence, Authority, and Incentives

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Boards in Agricultural Cooperatives: Competence, Authority, and Incentives

George W.J. Hendrikse*

Abstract

This article addresses three observations regarding the board of directors in agricultural cooperatives. First, many scholars and practitioners worry about the competency of the member dominated board of directors in agricultural cooperatives. Second, it is sometimes stated that cooperatives seem to behave like ordinary enterprises. Finally, it is argued that cooperatives may have advantages compared to firms with publicly exchanged shares. These observations are analyzed from various contract theoretic perspectives.

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1 Introduction

A widespread and important governance structure in many agricultural markets is the co-operative. For example, the European Union has 132.000 cooperatives with 83.5 million members and 2.3 million employees in 2001 (Commission of the European Communities, 2001), the United States of America has 47.000 cooperatives with 100 million members in 2001 (USDA, 2002), and China has 94.771 cooperatives with 1.193 million members in 2002 (Hu, 2005). A cooperative is a horizontal arrangement between many independent farmers (horizontal relationship), often jointly owning an upstream input company or a downstream processor (vertical relationship). These producer-owned organizations are usually not stock-listed, and have distinguishing features (Commission of the European Communities, 2001, p12) like 'an orientation to provide benefits to members and satisfy their needs, democratic goal setting and decision-making methods, special rules for dealing with capital and profit, and general interest objectives (in some cases)'.

This article will address a number of features regarding the governance of the board of directors in agricultural cooperatives. Governance concerns the organization of transactions. It matters because contracts are in general incomplete, due to the complexity of the transaction or the vagueness of language. An incomplete contract is completed by allocating authority to somebody to decide in circumstances not covered by the contract. A governance structure consists of a collection of rules structuring the transactions between the various stakeholders (Hendrikse, 2003). A cooperative is an example of a governance structure. Other examples are investor owned enterprises, worker-controlled firms, franchises, mutuals, joint ventures, networks, and public enterprises.

A standard way of delineating a governance structure is to distinguish decision and income rights. Decision rights in the form of authority and responsibility address the question 'Who has authority or control?'. They concern all rights and rules regarding the deployment and use of assets (Hansmann, 1996). For example, a cooperative has to decide how much discretion is assigned to the board of directors regarding investments. Important themes regarding authority are its allocation ('make-or-buy' decision), formal versus real authority, relational contracts, access, decision control (ratification, monitoring), decision management (initiation, implementation), task design, conflict resolution, and enforcement mechanisms. Section 3 uses the distinction between formal and real authority to address the value of a competent board, while section 4 provides a rationale for the observation by various practitioners that cooperatives and stock-listed enterprises behave in a similar way.

Income rights or incentives address the question 'How are benefits and costs allocated?'. Income rights specify the rights to receive the benefits, and obligations to pay the costs, that are associated with the use of an asset. For example, a cooperative has to choose a compensation package for the CEO and the other members of the board of directors. Section 5 addresses differences in compensation packages of CEOs between firms with publicly exchanged stocks and cooperatives. Other important themes regarding income rights are payment schemes like member benefit programs, cost allocation schemes like pooling arrangements, and the effects of horizontal as well as vertical competition.

This article is organized as follows. Section 2 introduces two ways in which simple incomplete contracts can be extended. Section 3 addresses the value of having a competent board. Section 4 provides a rationale for the claim that the choice of governance structure does not matter for the incentive to invest. Section 5 addresses the advantage of stocks of cooperatives not being publicly exchanged for the compensation package of a CEO. Finally, section 6 concludes.

2 Beyond simple contracts

An important issue in organizing the enterprise is the allocation of control and authority. Standard incomplete contracting indicates that the ownership of assets should be allocated to the party whose relationship specific investments are most important (Grossman and Hart, 1986). This result is determined in a three stage game. The allocation of decision power in the first stage of the game identifies a governance structure with a distribution of bargaining power. A governance structure is characterized by a slope of the line thru point ($-k_f$,$-k_p$) in figure 1. For example, a cooperative, i.e. forward integration, is presented by the horizontal line thru point ($-k_f$,$-k_p$).[1] Specific investment decisions by the farmer and the processor (k_f, k_p) are determined in the second stage. They determine the bargaining positions, i.e. point ($-k_f$,$-k_p$), reflecting the worsening of bargaining positions associated with specific

[1] The vertical line thru point ($-k_f$,$-k_p$) represents the governance structure backward integration, whereas the 45° line represents the governance structure market exchange.

investments (due to hold-up in the third stage of the game). Renegotiation decisions are determined in the final stage.

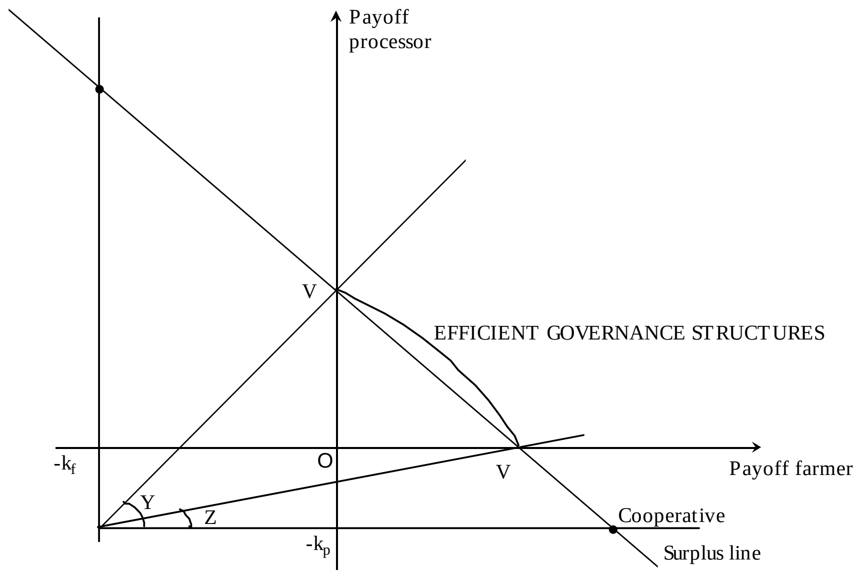


Figure 1: Two hold-up problems and governance (Hendrikse and Veerman, 2001b)

The above result of Grossman and Hart may be at odds with a basic feature of the firm. Crucial to the notion of the firm is the centralization of decision making power, i.e. the employer, not the employee, is the owner of the firm. Similarly, the core of an agricultural co-operative is member control over the infrastructure at the downstream stage. Formal ownership by the input suppliers over the downstream assets is the essential feature of a co-operative. However, bosses (and members as owners of downstream assets) are problematic from an efficiency perspective when the relationship specific investments of the employee (or the relationship specific investments at the downstream stage of production in a co-operative) are most important.

The developments in agricultural markets seem to increase the importance of specific assets at the downstream stage of production, i.e. k_p increases. This puts pressure on cooperatives in favor of market exchange. Wierenga (1997, p53) states that a '… drawback of co-operatives is that their locus of power (and perspective), even if they have integrated processing and distribution facilities, is close to primary production and far moved from the market. This does not make them very suitable for taking the guiding role in an AVAP (Agrifood Value-Added Partnership) the very purpose of which is to derive competitive advantage from adding those values that consumers want.' The implication seems to be to abandon the cooperative structure.

A way to deal with the problem of allocating formal decision rights to subordinates, and the pessimism regarding the efficiency of the cooperative in the previous citation, is to consider a richer class of incomplete contracts than the type of contracts considered by Grossman and Hart. Their conceptualization of the allocation of ownership can be viewed as a simple long-term contract. It is simple because it is non-contingent, i.e. it is not allowed to make the allocation of authority contingent on the circumstances or the results. However, contingent long-term contracts allow for this possibility.

An application of this extension is the distinction between on the one hand formal and on the other hand informal or real authority (Aghion and Tirole, 1997 and Baker e.a., 1999). Formal authority resides at the top, whereas informal authority can be either centralized or decentralized. Control over the operational activities by a professional management may be efficient when it has superior knowledge. So, the efficiency of a relationship may be enhanced by giving up some control, i.e. giving real authority away, even though the formal control stays at the top. This idea will be used in the next section to determine the value of a competent board of directors.

Another possibility is to consider various long-term contracts, informal as well as formal. Section 5 will focus on informal or relational contracts to address the irrelevance of governance structure for investment behavior.[2] Richer incomplete contracts create therefore various additional degrees of freedom. This may result in restructuring the cooperative in order to make the traditional cooperative more responsive to market demand, rather than abandoning it.

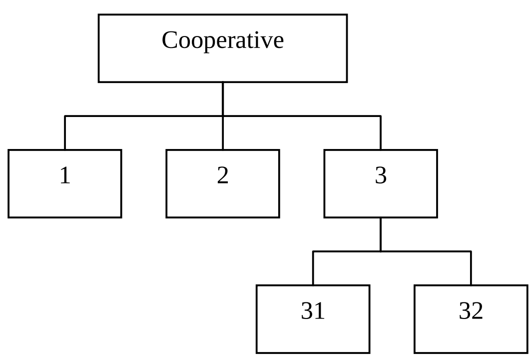
3 On the value of a competent board

Agricultural and horticultural markets change rapidly, which is due to increasing competition and the trend towards product differentiation. Many scholars and practitioners worry about the competency of the member dominated board of directors in agricultural cooperatives to deal with these developments. For example, LeVay (1983, p19) states 'Agricultural co-operative management is often, though not universally, castigated as weak.' More recently, Cook and Chaddad (2004, p514)

[2] A third possibility to create an additional degree of freedom is by introducing a third party (Bolton and Scharfstein, 1998). This possibility will not be explored in this article.

write ‘Another agency problem in cooperatives is that the board of directors consists, almost exclusively, of members (non-management agents) who often lack valuable organization-specific information for practicing decision control effectively. However, control over short-run decisions can be exercised more competently by cooperative boards since they possess sufficient information to evaluate the near-term impact of management’s decisions. This may not be true, nevertheless, with respect to long-term decisions.’

The value of a competent board will be addressed from a contingent contracting perspective. Traditional cooperatives experience problems due to changing market circumstances. However, this does not mean that they are abandoned. Nowadays many cooperatives are restructured internally. The internal organization of the twenty largest cooperatives in the Netherlands in 2003 (Hendrikse, 2004) consists of several units. A representative structure is presented in figure 2. It reflects the observation by Pellervo (2000, p21) that ‘Quite often the Cooperative is a holding company and the subsidiary is responsible for those fields of business most closely related to the activities of the members.’ The observation is therefore that the separation between strategic and operational decisions is nowadays common in cooperatives.[3] However, the above citation illustrates that the quality of the board of directors to perform their task well regarding strategic questions is regularly questioned. This section addresses the value of having a competent board of directors.



[3] The standard explanation for the success of the M-form is formulated by Chandler (1966, 382-383): ‘The basic reason for its success was simply that it clearly removed the executives responsible for the destiny of the enterprise from the more routine operational activities, and so gave them time, information, and even psychological commitment for long-term planning and appraisal…. [The] new structure left the broad strategic decisions as to the allocation of existing resources and the acquisition of new ones in the hands of a top team of generalists. Relieved of the operating duties and tactical decisions, a general executive was less likely to reflect the position of just one part of the whole.’ The separation of strategic and operational decisions entails of course also that the operational management has more freedom to take local decisions.

Figure 2: Divisionalization in cooperatives (Galle, 2004)

Hansmann (1996) bridges the gap between strategic and operational decisions and contingent contracting approaches (Aghion and Tirole, 1997 and Baker e.a., 1999). He defines a co-operative in general as a ‘patron-owned firm’ (p16), where patron refers to ‘all persons who transact with a firm either as purchasers of the firm’s products or as sellers to the firm of supplies, labor, or other factors of production’ (p12). Owners are characterized as (p11) ‘… those persons who share two formal rights: the rights to control the firm and the right to appropriate the firm’s profits, …’.

The reference to ‘formal’ rights in this definition is important. Formal control does not mean effective control. Formal control in incorporated enterprises involves usually only the right to elect the firm’s board of directors and to vote directly on a small set of fundamental issues, such as merger or dissolution of the firm. Moreover, in large business corporations the shareholders, who hold formal control, are often too numerous and too dispersed to exercise even these limited voting rights very meaningfully, with the result that corporate managers have substantial autonomy. Hence, it has long been common to speak of the ‘separation of ownership from control’ reflecting the substantial autonomy of corporate managers.

The distinguishing feature of an agricultural cooperative is that control over the downstream stage formally resides with the farmers. However, the downstream management often has superior local information, which argues for more flexibility in the form of control. Formal authority does not preclude that operational control is delegated.

The difference between an incompetent and a competent board will be conceptualized by the number of cognitive units available to the decision maker (Rubinstein, 1993). A cognitive unit serves the role of splitting a set into two subsets. For example, a cognitive unit applied to a set of investment projects may result in a subset consisting of all good projects and a subset consisting of all bad projects. The simplifying assumption is made that an incompetent board has zero cognitive units available, whereas a competent board is characterized by one cognitive unit.

The degree of competence of a board determines the nature of delegation: unconditional or conditional (Baker, e.a., 1999). Delegation by an incompetent board entails that proposed projects can’t be assessed before they are ratified. All proposed projects will be ratified by an incompetent board, even if they are not in the interest of the members. The reason is that an incompetent board is not able to distinguish good projects from bad projects. Delegation is therefore unconditional. (The results from the project are observed only after it has been ratified and implemented.)

A competent board is able to assess a project before it is ratified. This allows for conditional or contingent delegation. Contingent delegation entails that the board of directors delegates its formal rights regarding operational activities and financial decisions to the professional management as long as it does not encounter implemented projects which are bad for the members, while these rights go back to the members when abuse is observed. A competent board of directors should therefore take some distance from the policy of the professional management as long as everything goes well. They should limit themselves to the role of investor. Members should only use their formal power to direct co-operative decisions during structurally bad times.

An incompetent board may be more efficient than a competent board from an incentive intensity perspective. Bad projects may be accepted by an incompetent board, whereas a competent board restrains the CEO in proposing projects which are bad for the members. Such projects are proposed by the professional management because they like choosing and working on pet projects which are not necessarily completely aligned with the interests of the members. An incompetent board is attractive because it strengthens the incentives of the professional management to search for, and develop new projects in every period, but it increases the probability that bad projects are implemented. Similarly, a competent board (reflected in frequent, one-sided directives from the members, including financial decisions) frustrates the blossoming of the downstream operational activities.

Unconditional delegation is attractive and feasible when it improves the search incentives of the professional management substantially and when it is not too important to prevent the implementation of projects being bad for the members. Preventing bad projects is not that important for the members when either the loss associated with a bad project is not too large or the members are sufficiently patient. An incompetent board may therefore be more valuable than a competent board. It entails a commitment not to intervene.

4 Irrelevance of governance structure

Governance structure, and therefore board of directors, may not matter at all. CEO's of cooperatives state once in a while that governance structure does not matter much in the daily affairs of their enterprise. For example, CEO Jos van Campen of sugar cooperative Royal Cooperative Cosun in the Netherlands, as quoted by Griffioen (2004, p8), remarks 'More important than the governance structure are really the way people deal with each other every day at the interface between enterprise and cooperative. This is what determines whether things run smoothly or not. This way of dealing with each other, giving each other some discretion regarding their field of expertise, making clear agreements, and having sufficiently many discussion meetings to deal with problems, are much more important than the governance structure.' Similarly, CEO Hans van der Velde of Visa International EU views a cooperative as an association of parties in order to solve a problem. He states (Klep, 2004, p9) 'These <the organization or the allocation of decision authority> are secondary: they can always be rearranged, within every governance structure. It is much more essential that there is agreement about the problem that has to be solved. There is no discussion in Visa about whether they should be a cooperative or not. We just cooperate because it is a necessity.' Cooperatives behave like ordinary enterprises according to these CEOs.

This observation is also formulated in scientific journals. For example, LeVay (1983, p5) states '… whatever the formal basis of association, co-operatives may behave no differently from other types of enterprises.'. A more recent example is Nilsson (1999, p468): '… traditional cooperatives may let some branches be run within a firms that have resemblance to member-investor firms.' A rationale for the irrelevance of governance structure, and therefore authority and board of directors, will be formulated from a relational contracting perspective.

A governance structure consists of formal and informal rules. The formal structure is roughly described in the organizational chart, like figure 2. Formal rules can be represented by the decision rights of an incomplete contract in the property rights approach (Grossman and Hart, 1986). The allocation of decision rights determines who decides in circumstances not covered in formal agreements. Formal decision rights allocate the right to intervene selectively. The models in the property rights approach are usually limited to one period of interaction and the allocation of formal decision rights. A general feature of short-run interaction problems is the unattractive prisoners dilemma outcome. Underinvestment is a prominent example.

However, relationships in the real world usually last more than one period. This holds of course not only within enterprises, but also between parties in a market setting. Multi period interactions between the same parties opens the possibility to build a reputation, which might overcome the unattractive prisoners dilemma outcome when there is only one period of interaction.

The informal structure is roughly the way things really work. Informal agreements and unwritten codes of conduct (within and between enterprises) are widespread and important, due to the nature of knowledge. Knowledge, and its location, is important in enterprises. Teece (1998, p75) writes: 'The essence of the firm is its ability to create, transfer, assemble, integrate, and exploit knowledge assets. Knowledge assets underpin competences, and competences in turn underpin the firm's product and service offerings to the market.'

The nature of knowledge has changed in the course of time. Knowledge used to be explicit, or at least codifiable and transmissible in a formal and systematic language, in the past, whereas it isn't nowadays (Drucker, 1998). Knowledge which is personal, implicit, or hard to codify and to express in the formality of language is called tacit knowledge. It is costly to transfer to outside parties and usually resides with a limited number of individuals. A problem regarding the tacitness of knowledge is that formalization of major components of, agreements regarding, and understandings about, the relationship become impossible due to the unverifiability of this knowledge by third parties.

Informal agreements or contracts and unwritten codes will be called relational contracts. The role of relational or implicit contracts is to utilize the parties' detailed knowledge of their situation in an informal way in complex or new situations. The fundamental incentive problem in relational contracts is that each party may see opportunities to increase its current returns by behavior that hurts the other party but that cannot be effectively deterred through normal, court-enforced contracts. Meaningful relational contracts have therefore to be self-enforcing, i.e. each party has to face incentives such that abiding the informal agreement is attractive.

A feature of relational contracts is that the involved parties have to decide every period about the continuation of their good behaviour. Meaningful or credible relational contracts are self-enforcing when the value of maintaining a reputation for good behavior outweighs the gain from reneging on the promise. Knowledge can therefore be brought to value in a relational contract by the concern to maintain a reputation for honouring informal agreements.

Meaningful relational contracts, i.e. credible informal agreements, have to be designed in such a way that the reputation of each party is sufficiently important to maintain. This can be made more precise by modelling a relational contract as a (infinitely) repeated game. It enables us to be more specific about self-enforcement and reputation. The main result in the theory of repeated games, i.e. the Folk theorem (Fudenberg & Maskin, 1986) specifies the circumstances for implicit contracts to be self-enforcing. First, the future has to be sufficiently important. If the benefit of defection is larger than the costs, then it is predicted that the relational contract will fall apart. Second, the environment is not too volatile or uncertain. A volatile environment may make the short-run gain of defection more attractive than the adherence to the long-run implicit contract. Third, the observability of decisions is important for the stability of long-term relationships. Cheating on implicit agreements becomes more attractive when the observability of decisions decreases. This argues for frequent meetings of the board of directors in order to discover the professional management's eventual deceitful or incompetent behavior in an early stage. Fourth, the history of the relationship is important. A relationship is hard to restore once it is damaged.

Farmers like the processor to take (unobservable) actions that improve the (unverifiable) value of the good in the downstream production process, regardless the choice of governance structure. Relational contracts may be helpful in such a setting because the concern for ones reputation may induce the desirable behavior. When both parties agree on a certain course of action in an informal, self-enforcing way, then the formal aspect of the relationship does not affect the distribution of bargaining power. Every governance structure induces therefore the same distribution of bargaining power, i.e. the incentive to invest is identical in every governance structure (Baker, e.a., 2002). The important relational contracting result regarding the choice of governance structure is that the distribution of bargaining power is identical for all governance structures.

There is according to this relational contracting perspective no difference in investment behaviour between various governance structures. It entails in the terminology of figure 1 that every governance structure is characterized by the same slope. This is depicted in figure 3, where the upward sloping line represents the distribution of bargaining power of all possible governance structures, and the downward sloping line the surplus.

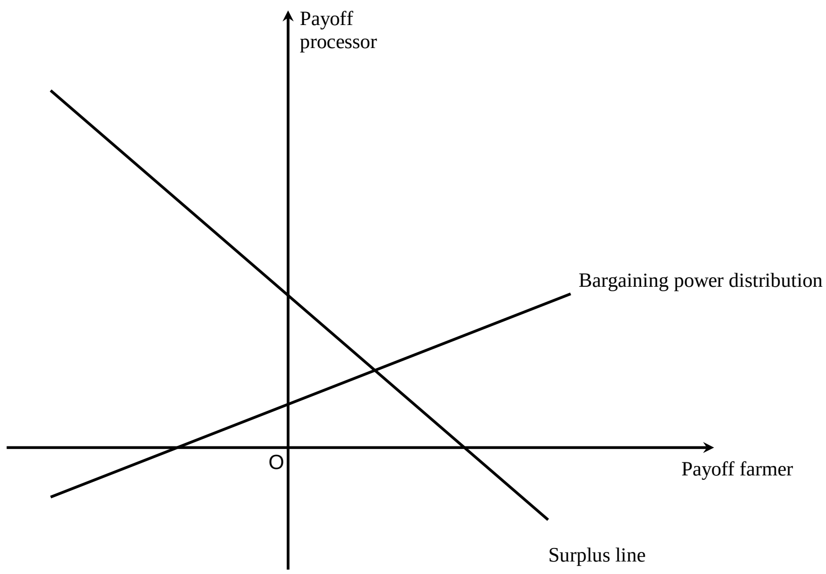


Figure 3: Incentive to invest is independent of relational governance structure

The above figure illustrates the irrelevance of the choice of relational governance structure for the incentive to invest. However, it is incomplete because the location of the upward sloping line is not identified. Bargaining positions will distinguish different relational governance structures. They differ because the identity of the party making a promise differs between various relational governance structures. The farmers in a cooperative may promise the CEO at the processing stage of production a bonus, or to allocate capital in a certain direction. Other examples of promises are promotions, task allocations, and internal audit transfer payments. The identity of the party making a promise differs when the downstream processor is an independent contractor rather than an employee. A processor as independent contractor makes promises to farmers. For example, the processor may promise to always buy the produce of a certain group of farmers. Relational governance structures are therefore not distinguished by their distribution of bargaining power, but by their bargaining positions (Baker, e.a., 2002).

Promises, and therefore reputations, only mean something when they are self-enforcing because they are vulnerable to renegotiation. For example, the upstream farmers may not pay the bonus, or the downstream producer may buy his inputs somewhere else. The identity of the party tempting to renege is therefore determined by the specific relational governance structure. This is important because a key difference between a cooperative and market exchange is that the processor does not have an outside option available in a cooperative because the farmers own the downstream assets and products. The processor in a cooperative has to take the produce of the owners of his assets as inputs, whereas inputs can be bought somewhere else when he is an independent contractor. The input's value in its alternative use affects the reneging decision under independent contracting or relational outsourcing, but not under a cooperative or relational employment. This has an effect on the choice of (inefficient) actions to improve ones bargaining position.

Figure 4 presents a situation where upstream ownership of the downstream assets, i.e. a cooperative, is advantageous to the farmers as well as processor. Ownership of the downstream assets by the cooperative has the advantage of eliminating efficiency reducing activities of the processor in order to improve his bargaining position. The activities (a) of the processor improve his bargaining position from 0 to P(a), but reduces the surplus from Q^* to Q(a). The cooperative is more attractive for the processor than being an independent contractor because the worsening of his bargaining position is more than compensated for by the elimination of his efficiency reducing actions to improve his bargaining position.

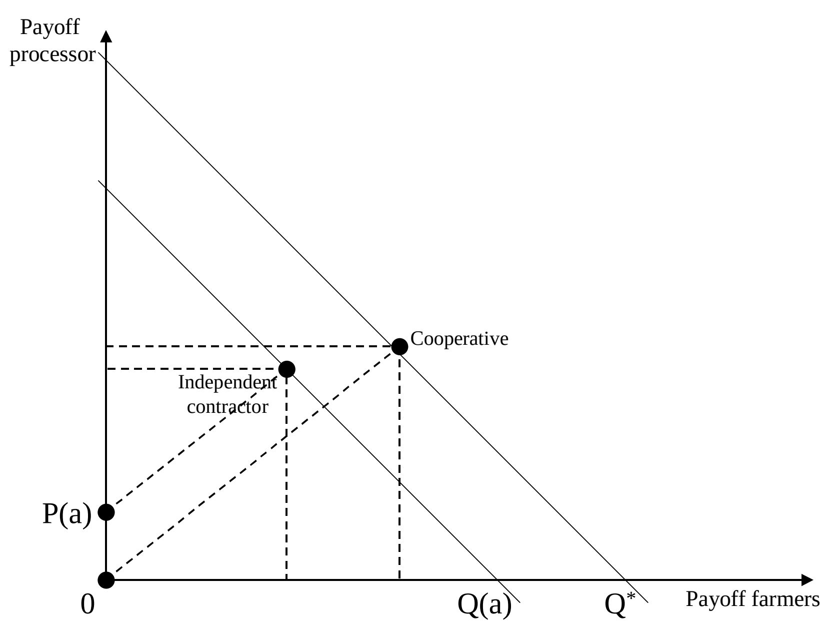


Figure 4: Relational governance structures and efficiency

5 CEO power

The lack of public exchange of the shares of cooperatives has advantages as well as disadvantages (Van Bekkum, 2004, p20). Advantages of a stock-listing are the transferability of shares, reporting obligations, decisions are scrutinized by and published in the financial press, and the stock price is an easy measure to determine the quality of management. Disadvantages are a short-run focus, the imprecise relationship between the share price and the state of the enterprise, and a dominant focus on money. It will be argued that cooperatives may have advantages compared to enterprises with publicly exchanged stocks in limiting the rent extraction tendencies in the design of the compensation package of the CEO by the board of directors.

The standard analysis of the relationship between members and the cooperative considers a two-party relationship: members (as a group) and the management of the cooperative. In the terminology of the standard principal-agent model, members are the principal and the Chief Executive Officer or the professional management is the agent. This characterization is relevant in many situations, but sometimes this relationship is more complicated. An example is the relationship between the members of the cooperative and the CEO. There are usually many, small members, making it hard for them to design and choose an appropriate contract for the manager. The standard way to overcome the coordination and motivation problems between many members is to install a board of directors representing the members. Installing a board of directors entails the introduction of a third party in this relationship. LeVay (1983, p9) observes ‘The main groupings within a co-operative are the rank and file membership, its board of directors and the management.’ Figure 5 depicts the relevant players in the cooperative.

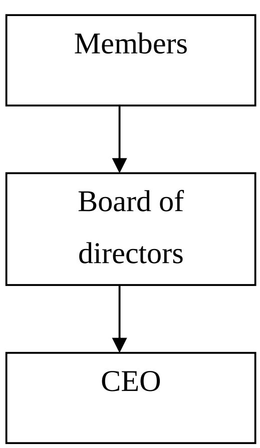


Figure 5: Members, board of directors, and CEO

The introduction of the board of directors may not be unproblematic. Directors of the board are supposed to act in the interests of the owners, like formulating compensation packages for the CEO, in order to bring the money of the owners to value. However, the compensation package for the CEO is often less than optimal from the perspective of the owners. There are at least two reasons for this managerial power of the CEO. First, the CEO has superior information about product markets. Superior information regarding the output market may result in the choice of investment projects having a high personal value for the CEO. The lack of a stock market listing with publicly exchanged shares may prevent that bad choices become immediately visible.

Second, the CEO has probably also superior information about the compensation packages for his position. It is hard for directors to formulate an alternative payment scheme than the one proposed because they usually lack easy access to independent information and advice regarding compensation packages. Directors' limited time forces them to rely on information prepared by the human resources department of the company and compensation consultants, all having incentives to favour the CEO in the provision of information to the directors.

A number of aspects of the performance of the board of directors has been addressed, but this does not say much about the performance of the cooperative as a governance structure. The relevant question is the performance of the cooperative compared to alternative governance structures. Will the performance of the processor improve when it is governed by investors rather than members? Bebchuk and Fried (2003) address the impact of the distinction between shareholders and the board of directors in stock-listed enterprises. They argue that there is substantial scope for managerial power due to actual incentives of directors being geared towards the interests of the CEO rather than the interests of the owners.

First, directors of the board like to be re-appointed. It entails not only an attractive salary, but also prestige and valuable business and social connections. CEOs are favoured by directors of the board in the design of compensation packages because they play almost always an important role in the renomination process of directors to the board. The CEO may also have some discretion regarding the directors' compensation and perks, and they often become a fellow board member in the future. Second, directors have usually only limited, or no, shares in the enterprise.

Third, directors do not only lack the expertise of developing an appropriate compensation package, but their concern for developing a reputation for haggling with the CEO over compensation may even discourage to propose alternatives. Finally, the market for corporate control does not work sufficiently strong to assure optimal compensation packages.

The overall implication of the incentives facing the members of the board of directors is that executives may have considerable power over their own compensation arrangements. However, governance structure choice probably serves as an important moderating variable. Hendrikse and Veerman (2001a) have identified a number of differences between cooperatives and investor owned firms. First, each member will have a considerable share of his crop processed by a particular cooperative. This financial stake provides strong motivation for members to acquire substantial information in order to evaluate policy decisions. These incentives are further enhanced by the fact that member farm level assets may be totally dependent on the success of the cooperative (no market alternatives, highly specialized technology of the cooperative, etc.). This is important for the functioning of the board of directors because the majority of the board of directors in a cooperative consists of members, whereas the financial involvement of directors of the board in a stock listed enterprise is usually (very) limited. Boards of directors in cooperatives face therefore stronger incentives to perform their job well than boards in stock listed enterprises.

Second, shares of a cooperative are not traded in the stock market. Stockholders can easily get out of the enterprise by selling their stock in the market, whereas members in a cooperative cannot. Members therefore pay more attention to the way the cooperative is being run. The lack of the market for corporate control enhances the incentives for the board of directors in a cooperative even further. Third, a similar incentive is provided by the lack of a market for inputs. The absence of a market for inputs eliminates for a cooperative the possibility of comparing its own performance with those of rivals. It becomes therefore more attractive to put forth effort in the internal control system in order to compensate for the absence of the yardstick of the market. Finally, the lack of a stock listing of a cooperative precludes a source of information for the design of the compensation package of the CEO. The stock price of a cooperative cannot be used in the remuneration scheme of the CEO because there is not a stock price.

Managerial power is limited by three variables according to Bebchuk and Fried (2003): outrage costs, outsiders' perception of a CEO's compensation, and 'camouflage'. The extent of rent-extraction by the CEO depends on how much 'outrage' a proposed compensation arrangement is expected to generate among relevant outsiders. Directors and managers will try to prevent embarrassment and reputational harm in the formulation and approval of compensation schemes. Managers have a substantial incentive to obscure and try to legitimise, i.e. camouflage, their extraction of rents in order to avoid or minimize the outrage that results from outsiders' recognition of rent extraction.[4]

Cooperatives may be advantageous in limiting managerial power compared to stock listed enterprises for two reasons. First, outrage costs are likely to be higher in cooperatives than in stock listed enterprises. The considerable financial involvement of the members in the cooperative and the regular member meetings may discipline the compensation package awarded to the CEO. Second, the lack of a stock listing is often considered as a disadvantage of cooperatives because a stock price summarizes a lot of varied information. However, a stock listing is not necessarily advantageous for the design of an executive compensation package. An example is a conventional option plan when the market or sector rises substantially. It does not benchmark and therefore fails to filter out industry and general market trends.

6 Summary and further research

This article has addressed three observations regarding the board of directors in agricultural cooperatives. First, many scholars and practitioners worry about the competency of the member dominated board of directors in agricultural cooperatives. The value of an incompetent board, which may be positive, is addressed from a contingent contracting perspective. An incompetent provides a commitment not to intervene, which strengthens the search incentives for good projects of the professional management. Second, it is sometimes stated that cooperatives seem to

[4] An example is the use of compensation consultants for reasons of legitimisation. Consultants may supply useful information and contribute expertise on the design of compensation packages, but they also can help in camouflaging rents because they have strong incentives to use their discretion to benefit the CEO. Evidence suggests that compensation consultants are often used to justify executive pay rather than to optimise it. For example, consultants argue that pay should be related to performance when things go well, whereas they focus on peer group pay when firms do poorly. Other examples of camouflage are gratuitous goodbye payments to departing executives, and stealth compensation practices like pension plans, deferred compensation, post-retirement perks, and consulting contracts.

behave like ordinary enterprises. All governance structures entail the same bargaining power distribution in a relational contracting setting. Governance structure is therefore irrelevant from an investment incentive perspective. However, they differ in their bargaining positions. Finally, it is argued that cooperatives may have advantages compared to firms with publicly traded shares in limiting the rent extraction tendencies in the design of the compensation package for the CEO. The lack of publicly traded shares of cooperatives may be an advantage of cooperatives in bargaining with the professional management.

This article is to be positioned at the level of Governance in the terminology of Williamson (2000).[5] A few aspects of the governance structure Cooperative have been addressed, but much work remains to be done, even along the lines explored in this article. For example, the level of competence is addressed from a strategic delegation perspective in this article, but worries about competence and cognition in the governance structure Cooperative is most often viewed along the lines of LeVay (1983, 20) '… presumption that most farmers cannot see any further than the farm gate and that directors of agricultural co-operatives, unless the executive or outside expertise are co-opted onto the board, are production, rather than market, orientated.' This may make unconditional delegation even more attractive. It is also of interest to investigate the irrelevance and CEO-power claims from this production orientation perspective, theoretically as well as empirical.

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[5] Research regarding the relationship between the Institutional environment and cooperatives is actual, given the transition in Eastern Europe and China. The relationship between Resource allocation and cooperatives has always received considerable attention due to the Common Agricultural Policy in Europe, and similar policies elsewhere.

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