

**Co-operative Capital:
What it is and Why Our World Needs It**

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Abstract:

Over the years the claim is made that co-operative businesses experience difficulty in attracting capital. The consequences include calls for ‘demutualization’ and the imposition of financial reporting standards designed for investor-owned companies. At the heart of the problem has been the failure of those not involved in co-operatives, and some involved in them, to understand the fundamental difference between capital in a co-operative and capital in an investor-owned business.

The intent of this paper is to provide a broad overview of how capital in a co-operative business differs from capital in an investor owned business both conceptually and in terms of behaviour and the implications of ‘the co-operative capital difference’. The paper will look at: the characteristics of ‘co-operative capital’ and ‘capitalist capital’ both from the perspective of a firm and an investor; the changing need for capital in co-operative businesses; issues in attracting capital; the impact of non-co-operative capital; implications for public policy treatment of co-operative capital, and possibilities for co-operatives to take new approaches especially given the financial collapse of 2008 and continuing weakness in global financial systems.

Introduction

“We have so many beliefs we know are not true.”¹

A central challenge for anyone seeking to understand the dynamics of co-operative business is to understand both the context in which co-operators and co-operatives exist and the profound differences between co-operatives and other forms of business. Co-operative businesses are islands in a sea of investor-owned firms. As islands they take on the language and concepts of the world around them even when they know they are not true for them and do not fit. Co-operatives are profoundly different from investor-owned firms, and that difference is the key to meaningful understanding any aspect of co-operative business. Exploring the nature, role and behaviour of capital in a co-operative is no different.

The Evolution and Nature of Co-operatives: Co-operatives evolved in a number of countries in the mid nineteenth century in response to the development of the Industrial Revolution and the upheavals this caused on society (Birchall, 1997). The rules adopted by the Rochdale Equitable Pioneers Society in 1844 have been very influential in the development of co-operative thinking and form the basis of the principles adopted by the International Co-operative Alliance.

Industrialisation and the development of the market economy tore society apart. This occurred in many countries, not just Britain as is sometimes implied². In Britain, landowners used their absolute political power to enclose the common lands, forcing the landless to find their subsistence through wage labour. In Birchall’s words:

“One by one, all the customary rights that working people had had were stripped away: the right to gather firewood and to hunt game, the right to have their wages set by a magistrate, the right to ‘poor relief’ if they were unemployed or laid off from agricultural work in the winter, and so on. ... Now, for the first time, it was thought acceptable to allow people as individuals to take their chances within a volatile new market economy, that could not guarantee survival. As Polanyi

¹ Steinbeck, John, *Sweet Thursday*, (1954). p34

² Birchall, Johnston. *The International Co-operative Movement* (1997) provides an extensive coverage of the worldwide development of co-operatives.

puts it, whereas previously the market had been an adjunct to society, now society became an adjunct to the market.”³ (Birchall, 1997, p2) The response from the affected members of society was the development of mutual organisations (trade unions, friendly societies, and co-operatives) whose common feature was to ameliorate the injustices of the market economy and its emphasis on the primacy of financial capital.

Mutuality was not a new concept; it lay at the heart of partnerships as a business form. Partnerships have existed as long as businesses have operated.⁴ Many of the features still found in partnerships were adopted by the founders of co-operatives, e.g. capital was contributed equitably (not necessarily equally), profits were shared in proportion to agreed upon ratios (not necessarily in proportion to financial capital), members withdrawing from the partnership would be paid out their recorded capital.

Accountability was also an early value of co-operatives, as it was in sole traders and partnerships. The Rochdale Pioneers’ rules of 1844 provided for quarterly general meetings at which members would receive audited financial reports (Birchall, 1994, p54).

From this brief summary of the development of co-operatives it can be concluded that:

1. Co-operatives exist to provide benefits to members through their active participation in the co-operative’s activities.
2. Members of co-operatives benefit from the strength and solidarity that mutuality confers in markets.
3. Capital is contributed equitably by members, normally in proportion to the use that members make of the services of the co-operative.
4. Interest may be paid on capital contributions – but it should be limited and fixed.
5. Members’ capital is repaid by the co-operative when the membership ceases.
6. As democratic organisations co-operatives operate on the basis of equal voting rights rather than voting in proportion to the amount of share capital held.

The nature of an investor owned business: The development of the limited liability company in the mid-nineteenth century was designed to facilitate the investment of financial capital.

The United Kingdom Joint Stock Companies Act 1844 contained a number of provisions including the keeping of books of account, the regular preparation and publication of balance sheets and the appointment of auditors. These ‘oppressive provisions’ were subsequently removed in 1856 on the grounds that they were ‘officious interference of the State.’⁵

Consequently company directors were left relatively free from legal obligations of accountability towards shareholders. Historically, directors have resisted any requirement to disclose detailed financial information. The disclosure of profit and loss reports was not required until after the Royal Mail Steam Packet Company collapsed in 1929. By utilising undisclosed secret reserves and transfers from off balance sheet entities the directors were able to present the appearance that the company was profitable for more than seven years.

³ Polanyi, K. *The Great Transformation: the Political and economic Origins of Our Time*, Boston: Beacon Press (1957) cited in Birchall (1997).

⁴ See, for example, de Roover, FE. ‘Partnership accounts in twelfth century Genoa’ in Littleton AC and Yamey BS. *Studies in the History of Accounting*, Sweet & Maxwell, 1956, pp 86-90.

⁵ Johnston, T and Edgar, G. *Law and Practice of Company Accounting in New Zealand*, Butterworths, 1963, p7

Although there has been a move in recent years towards triple bottom line reporting the overriding purpose of investor owned companies remains the maximization of profits, often to the exclusion of any social or other considerations. This, not surprisingly results in an amoral attitude to business. For example, when asked about the havoc his currency speculation caused to Far Eastern economies in the crash of 1997, George Soros replied, “As a market participant, I don’t need to be concerned with the consequences of my actions.”⁶

To the extent that social responsibility is accepted in investor-owned companies, it is not simply the making of profits, it is to continually increase the profits that are made⁷. This may involve replacing employees by automation or by shifting production to lower cost economies. When faced with a need or wish to exit the company an investor must seek an external buyer for the shares held⁸. That sale may be more or less than the equity originally invested and more or less than the net asset backing of the shares.

The key point to note is that the exiting shareholder exerts little direct influence on the company to perform. Indeed, more influence may be exerted by customers boycotting a company’s products – because of changes to traditional taste (opponents of the so-called New Coke forced the return of the traditional formulation after only a few months in 1985)⁹. In 2009 Cadbury’s decision to replace cocoa butter with palm oil sparked a similar protest and the decision was reversed within weeks¹⁰.

Equally there is little, if any, direct incentive for the shareholder to transact with the company.

Because voting is normally related to the level of shareholding the organisation is essentially undemocratic. Voting is based on the principle of one dollar one vote rather than on person one vote. The organization responds to the needs of capital rather than the needs of people and communities. An investor owned business may meet human and community needs but that is not its purpose.

At this point it may be helpful to summarise some key co-operative differences before we discuss aspects of co-operative capital.

Co-operative differences

1. The very idea of co-operation rests on some assumptions about the nature of humanity. There must be an assumption that people are generally good and wish to do good. That does not include any naive notions about people being perfect but might be stated as a faith that, given an opportunity to make the world a better place, people will mostly choose to do so. If one did not hold this belief then co-operative activity would be foolish. A second key assumption is that people are both individual and social and that these two essential aspects of human nature need to be in some reasonable balance.

Investor-owned businesses are based on a belief that the overriding motivation of people is economic rationalism. It is assumed that individuals act in their own best interests and seek to maximize the return on their financial resources. The best interests of humanity are

⁶ Clarke, N. Profile (George Soros) *New Statesman*, 2 June 2003, p32.

⁷ Friedman, M. ‘The social responsibility of business is to increase profits’ *New York Times Magazine*, Sept 13, 1970.

⁸ In some private company situations existing shareholders may be given a pre-emptive right to purchase the shares. In other cases the directors may have the power to refuse a transfer of shares.

⁹ See http://www.thecoca-colacompany.com/heritage/cokelore_newcoke.html

¹⁰ See <http://www.environmentalleader.com/2009/08/18/protests-push-cadbury-to-drop-palm-oil-from-milk-chocolate/>

reduced to financial interests. Consequently the owners of investor owned companies must treat labour and materials as input costs to be minimized, if return on financial resources is to be maximized.

2. Co-operatives are open to all persons 'able to use their services and willing to accept the responsibilities of membership.'¹¹ Mutuality and participation are central to co-operation.

Investor-owned businesses require no commitment to the activities of the business.

3. Co-operatives require members to '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 the capital subscribed as a condition of membership.'¹²

Investor-owned businesses invite the purchase of share capital as a speculation where the compensation may have no limit. Control of the capital is in proportion to the amount invested.

4. Almost without exception co-operative businesses were established to respond to unfairness in dominant business arrangements. Often they were started as a direct result of exploitation of people by other types of business. The purpose for which people create co-operatives is to meet member and community need. Businesses exist for people, not the other way around.

Co-operatives are about justice and fairness. It is not an accident that co-operatives all over the world accept (even if they may fail to put them into perfect practise) a set of values and principles, predominantly those adopted by the ICA.

"Cooperatives keep capital in the community where it was generated, while stock companies export capital elsewhere. Since they give surplus revenue back to their members, cooperatives keep wealth in their communities. Stock companies do the reverse. By distributing profits to shareholders, they take capital out of the community."¹³

Investor-owned businesses arose in an environment of laissez-faire where the concept of caveat emptor (=let the buyer beware) was the accepted standard for behaviour.

Writing at the time, Adam Smith warned of the dangers to society of schemes proposed by the promoters of investor-owned companies:

'The interests of [those who live by profit] ... has not the connection with the general interest of society as that of...[labourers and landlords]. The proposal of any new law or regulation of commerce which comes from this order [those who live by profit], ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but also with the most suspicious, attention. It comes from an order of men whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.'¹⁴

Writing today Cliff Mills offers the following assessment of the investor owned firm:

¹¹ 1st Principle: Voluntary and Open Membership. International Co-operative Alliance, *Statement on the Co-operative Identity*.

¹² 3rd Principle: member Economic Participation. International Co-operative Alliance, *Statement on the Co-operative Identity*.

¹³ Gutknecht, David, (2008) Thinking Outside the Coop, *Cooperative Grocer*, May June 2008 #136

¹⁴ Smith, Adam, *Wealth of Nations*, Part 1, Ch xi, paras 8-10.

“A system designed to pursue one goal only is likely to achieve that goal; but it may do so at the expense of other potentially legitimate – maybe even more important goals. What economists call the, negative externalities’ – the downstream costs of exploiting natural and human resources in the pursuit of profit – are becoming more recognised and better understood.”¹⁵

“While this ownership model provides a powerful driver, it also creates a problem. Being effective at delivering private benefit is all very well, but an economy based on the quest for the private benefit of some does not seek the common good of all. ... This is even more significant when seen in the context of today’s global issues – diminishing natural resources, climate change, and global poverty. It makes little sense to attempt to solve these problems without acknowledging that the pursuit of growth and the maximisation of private gain might at best hinder these endeavours, and at worst be a major part of the problem. There is now an urgent imperative to find a different and fairer basis for business – and for business ownership – that does not ignore today’s social and environmental concerns.”¹⁶

This, of course, implies a need to create a better fairer type of capital

Co-operative Capital

Co-operative scholars, managers, staff, board members and members – all of us are surrounded by currently dominant investor owned business and our thinking, even the language we use, is shaped by that environment. Mills puts his finger on a key obstacle for us to overcome. “Having become used to one way of trading and one way of living and thinking, it is difficult to put that to one side and accept the need to search for an alternative. Contemplating a different way of living and a changed basis for society requires a leap of imagination.”¹⁷ That is the challenge for our thinking about capital. When we say co-operatives need capital we have in our heads the concept of investor capital whose only purpose is to maximize return. We want to suggest that co-operatives have to develop the concept of and co-operators and the public about another species of capital, co-operative capital.

Co-operative capital must behave in such a way as to not erode the co-operative business model comprised of its purpose, values and principles. None of these considerations are essential to other business models. In contrast, in the investor-owned business model any considerations such as these are essentially secondary and must be reconciled with and be subservient to maximizing the return to capital.

The purpose of capital in a co-operative and the purpose of the members or others providing the capital has as its primary focus meeting member and community need. Members and others who invest in co-operatives expect, as long as the co-operative is successful, that they will be able to get their money back and that they will get a limited return of the investment. They also expect that member and community needs will be met in a fair and equitable manner consistent with co-operative purpose, values and principles.

¹⁵ Mills, Cliff (2009) *Funding the future: An alternative to capitalism*, Mutuo <http://www.mutuo.co.uk/latest-releases/funding-the-future-an-alternative-to-capitalism-by-cliff-mills/> p 2

¹⁶ Mills, Cliff (2009) *Funding the future: An alternative to capitalism*, Mutuo <http://www.mutuo.co.uk/latest-releases/funding-the-future-an-alternative-to-capitalism-by-cliff-mills/> p 1

¹⁷ Mills, Cliff, (2009) p 7

Co-operative capital is equity, in the traditional accounting sense. It is the claim of the members of the entity to the net assets of the entity. The members of a co-operative are entitled to be paid back their equity when they leave the co-operative in exactly the same way that members of a partnership receive their equity (whether designated as 'capital' or 'current' account) when they leave the partnership. Co-operators should not find their capital 'locked in' to a co-operative after they have left.

The obligation to pay a limited amount of interest on capital and the obligation to redeem co-operative capital are two important disciplines on the managers and directors of co-operatives. Capital is not free and must therefore be subject to a capital-rationing that aims at meeting members' needs. The obligation to redeem capital puts managers under pressure to minimize capital expenditure and encourages the co-operative to attract new members and capital and satisfies the needs of existing members.

In summary, an investor in a co-operative business, based on the purpose, values and principles of co-operatives, should expect that his or her investment will be in an organization that:

- Makes possible meeting a human need in a fair and equitable manner.
- Conducts its operations in a manner that respects the co-operative values and principles, specifically: Equality; Equity; Mutual self-help; Self-responsibility; Democracy and, Solidarity.
- Conducts its operations in a manner that respects the personal co-operative values: Openness; Honesty; Social responsibility and, Caring for others.
- Operates in a manner that reflects the Co-operative Principles: Open and Voluntary Membership; Democratic Member Control; Member Economic Participation; Autonomy and Independence; Education, Training and Information; Co-operation Among Co-operatives; and Concern for Community.
- Returns equity upon request unless it puts the co-operative in financial jeopardy.
- Pays a limited return or fair return and not expect a windfall at the expense of others.
- Allows the creation of a pool of capital that is owned collectively by the members and is the indivisible common property of the membership.
- Respects the values and principles, does not act in such a way that it would inflict suffering on others through pollution or damaging the environment or community.
- Respects the values and principles, acts in a manner that will respect the dignity of its workers and give them a meaningful way to contribute to society

For example, the co-operatives in the Mondragon group in the Basque Country limit the gap between the highest and lowest paid to 9 to 1. As a result the per capita income in the valleys dominated by these co-operatives is the highest in Europe and the income gap the lowest.¹⁸ They have managed to combine a fair return on capital with a fair wage to the worker members who created the co-operatives to provide themselves with work. In the process they have had a major impact on stemming the outflow of people from the Basque Country. They have also managed to provide safe and secure work with excellent benefits. Capital in the Mondragon co-operatives has been used very efficiently not to maximize return to investors but to meet member and community need. It is an excellent example of robust financial health and robust co-operative purpose.

“One hallmark of the Mondragon model is its use of capital. Rather than flowing into the pockets of executives and outside investors, a company's profits are distributed in a precise, democratic way; set aside as seed money for new cooperatives; distributed to regional nonprofits; or pooled

¹⁸ Lezamiz, Mikel, Presentation to MMCCU Student Group, 16 October, 2009

into shared institutions like the university and research center. In other words, each individual cooperative gains long-term benefits from the financial assets of the whole.”¹⁹

This is a formidable list of benefits available to those who invest in a co-operative. An investor-owned business, by contrast, offers a very limited capacity to offer anything but to deliver a maximum return on invested capital. As the world learned in September 2008, as the value of investor owned publicly traded shares dropped by 20-40%, the ‘unlimited return’ may be negative as a result of the unregulated pursuit of narrow self interest. Co-operative financial institutions did not create any of the ‘toxic paper’ nor did the value of co-operative shares decline. The absence of co-operatives from this massive malfeasance and their stability in the face of market turmoil are additional benefits of deploying capital as co-operative capital. Those benefits accrue to both individuals using co-operatives to meet their needs and to the public generally. They are public policy benefits.

Co-operative Financial Institutions – The Challenges

Credit unions around the world have assets in excess of \$1.2 trillion dollars²⁰ US. Credit unions started small and started as consumer savings and loan societies. They were created because ordinary people, farmers, fishers, workers of all kinds often could not get credit to make large purchases, build a home or finance small family businesses. Many people found it obviously unfair that they had put their savings in banks but when they needed to borrow money they found they did not qualify for loans.

In addition mutual and co-operative insurance companies around the world were begun because insurance was not available to many millions of ordinary people. Just the 400 distinct members of the International Co-operative and Mutual Insurance Federation have “assets approaching USD 1 trillion.”²¹ In addition there are a considerable number of other strong co-operative financial institutions such as the Rabobank Group, an international financial services provider that, in terms of Tier I capital, is among the world’s 25 largest financial institutions, CoBank and the National Co-operative Bank in the USA, a network of co-operative banks in Italy, the Caja Laborale Popular in Spain’s Basque Country the Co-operative Bank in the United Kingdom (part of Co-operative Financial Services) and many others. It is safe to estimate that together co-operative financial institutions have assets well in excess of \$2.5 trillion USD.

For the most part the capital in these financial institutions is not available for co-operative development. Often when it is available it is available on the same terms as if it were available to an investor owned firm – it is available, as investor owned capital or more likely debt rather than equity. In large part this is a result of many credit unions doing limited commercial lending until recently and beginning commercial lending only after they had become large and their co-operative roots had become somewhat distant history. In part it is because regulators were leery of investments that were not ‘traditional’. In some cases it was because managers brought in from banks brought with them practices that worked well in investor owned financial institutions.

¹⁹ Schwartz, Judith D (2009) In Cleveland Worker Co-ops Look to a Spanish Model, *Time Magazine* Dec., 22, 2009, <http://www.time.com/time/business/article/0,8599,1947313,00.html#ixzz0il0JZ9vA>

²⁰ World Council of Credit Unions, (2010) <http://www.woccu.org/memberserv/intlucusystem>, February 24

²¹ International Co-operative and Mutual Insurance Federation, (2010) http://www.icmif.org/index.php?option=com_content&view=article&id=21%3Aabout-us&catid=14%3Ageneral-information&Itemid=64&lang=en, February 27

The reasons also included some history of non-financial co-operatives believing they ought to get a loan just because they were a co-operative business regardless as to whether the purpose of the loan made good business sense. Finally, the early years of commercial lending by credit unions in Canada were not without some credit unions failing or being bailed out of bad commercial loans. We arrived at where we stand today, with over \$2.5 trillion USD in assets held by co-operative financial institutions, because a lot of good people built strong, successful financial co-operatives.

The question now is, 'where do we go from here'? Can our sophisticated co-operative financial institutions devise sound ways to invest in the further development of other types of co-operative business?

The challenge for financial co-operatives is that their members expect them to be responsible custodians of their savings and insurance premiums. At the same time an increasing number of their members want to invest their savings in ways that are consistent with their values and not destructive of the world they are leaving their children. Increasingly people are making the connection between how their savings are used and economic activity that is destructive of society, the environment and their children's future.

A number of financial co-operatives have experimented with investment strategies that are profoundly co-operative and have met with considerable success. In the mid 1990's the Co-operative Bank in the UK began to vigorously position itself as an ethical lender. Most of the expectations listed above were met. The result was that it went from having a below average financial performance to a financial performance considerably above average. See figure 3. Its ethical positioning served it well as the British banks suffered through the financial meltdown of 2008. In the first nine months of 2008 when British banks were looking for bailouts the 1-3 year term deposits in the Co-operative Bank rose by 80%. There was hunger for co-operative capital investment opportunities then and since 2008 the opportunity has become significantly larger.

The Caja Laborale Populaire has had from its inception the goal of not just providing the workers in Mondragon's co-operatives with a sound financial institution but to finance and make possible the growth and development of worker owned co-operatives in the Basque Country. The founders of the Mondragon co-operatives wanted to create workplaces that were participatory and to stop the drain of people from the region. Since launching its first co-operative in 1956 the Mondragon group has grown to a workforce of 92,700 in 2008. The Caja has successfully participated in the growth of the Mondragon co-operatives while achieving solid success as a financial institution. In 1988 it administered €1.3 billion and by 2008 that had grown to €13.9.²² It has also allowed people in the Basque Country to invest in their own future and that of their children.

In the U.S., the National Cooperative Bank, is a federally chartered organization with the mission to support and be an advocate for America's cooperatives and their members, especially in low-income communities, by providing innovative financial and related services. Toward that end it created NCB Capital Impact, an organization focusing on providing high-quality health care, housing, education and eldercare, using its depth of experience, cooperative approach, and diverse network of alliances to generate critical investments that create a high quality of life for low income people and communities.

²² Caja Laborale Populaire, (2010) <http://www.mondragon-corporation.com/ENG/Economic-Data/Historical-Evolution/Resources-administere> February 27

In New Zealand the PSIS Ltd is a financial services co-operative that uses the tag line in its logo “A co-operative way of banking”. It has operated successfully since 1928.

In 1997 the Board of Directors adopted the following statement of values. The show a focus on people, an intention to develop a long-term relationship with members and an intention to keep the profit motive subservient to meeting members’ needs:

1. PSIS is a financial services co-operative with a primary focus on the provision of services to employed and retired New Zealanders and their families.
2. Its co-operative ethos implies that, while it is subject to normal market disciplines, it is not primarily motivated by the need to profit from transacting members. However, the business must operate **profitably**, and trading needs to enhance the value of the business, in order to safeguard members’ savings, expand services and keep abreast of changes in the range and quality of services that members expect.
3. The needs of members will typically alter over the life cycle of participation in PSIS, with some oscillation between savings and borrowings, and variation in the use of ancillary financial services. PSIS accordingly avoids any bias in its pricing structures that would favour any particular type of transaction in the belief that during a term of membership the typical member will access the full range of benefits on offer.
4. PSIS believes that members should expect to see their relationship with PSIS as a long-term one (and vice versa). PSIS therefore believes that membership interests in PSIS are ongoing, and not limited to the immediate interests of members undertaking transactions at a particular moment in time.
5. In essence, PSIS as a co-operative is a product of its history, and a resource to serve the collective interests of its current and future members²³.

Because of its focus on mutuality, and its avoidance of speculative but profitable financial engineering practised by investor-owned finance companies, the PSIS avoided losses in both the 1987 financial crisis and the 2008 meltdown.

Regulation of Capital – Implications for Co-operatives

Abuse of trust has been a fairly repetitive issue in the raising of capital for investor-owned business and it has led to a strict regulation of financial industries and stock markets. While there have been problems from time to time with co-operative financial institutions there have not been the equivalent of the savings and loan scandal of the 1990’s, the Enron/Worldcom collapses or the toxic paper fiasco of 2007/2008. Co-operatives need, and for the most part see the need, to have some level of oversight and regulation but it hardly seems reasonable to gear co-operative regulation, either in scope or form, to respond to the repetitive abuse of privately held investor-owned business.

The co-operative business world has a powerful vested interest in ensuring that it behaves in a responsible manner since a co-operative business or ethical failure reflects on the business model. Co-operatives, with their community base and local, regional and national organizations, also tend to know each other and are sensitive to ethical issues around financial matters. That said no significant effort has been made by either co-operatives or governments to devise a regulatory system for co-operatives that was appropriate to their significantly lower level of risk.

Regulators often do not have an understanding of the co-operative business alternative. This is not surprising since few educational institutions include the co-operative model in their

²³ Cited in Boyce, G. *Over half a million careful owners – a 75-year history of PSIS, 1928-2003*, Dunmore Press, 2005, p7.

curriculum.²⁴ The inclusion is even more rare in university business schools. Even in countries where co-operatives are a significant part of the economy they are virtually invisible in university business schools. In this context it is not surprising that regulators too often see co-operatives as some kind of aberration or a defective business model. Not is it surprising that they should use the same regulatory approach that they see as necessary for investor-owned business. New approaches are needed.

The Evolving Need for Capital in Co-operatives

Cooperatives are not the exception to the rule that any enterprise must have ownership capital to conduct day-to-day operations, to provide the necessary infrastructure, and to create a base for obtaining external financing—often bank debt. In the cooperative form of enterprise, such capital is provided by members through initial capital investments, retained margins, member deposits or subordinated member loans. The importance of capital furnished by members cannot be overlooked or understated. Lenders view the amount of member sourced capital as a measure of the member’s commitment to the venture. The more capital provided by members’ equity, the less that needs to be obtained from other sources. Consequently, a greater percentage of equity included in the capital structure results in not only the need for less debt but also the debt will likely carry a lower price (i.e., interest rate).

The first co-operatives and credit unions began with a few members and many started in an era when their business was not capital intensive. As they progressed and grew and often merged, and as their businesses became more capital intensive their need for capital grew. This is a pattern not markedly dissimilar to many investor centred businesses. The nature of co-operative capital however often left them with significant capital drains when an age class of members reached an age where their use of the co-operative ceased or sharply declined. For worker, fishery and agricultural co-operatives this often presents a serious problem sometimes leading to failure or demutualization. In their study of the demutualization of Lilydale, Hailu and Goddard concluded:

“In conclusion, cooperatives that wish to remain so must operate in a manner that generates enough capital to meet their equity redemption needs and debt associated with asset acquisition. This study’s findings provide evidence that financial leverage is one of the crucial factors in the growth of cooperatives. Over-reliance on debt necessitated a change in business structure for Lilydale.”²⁵

“The National Cooperative Grocers Association reports that at least 50 percent of food co-ops in the U.S. are undergoing some form of expansion. The capital needed for buildings, equipment, and inventory is far beyond these co-ops’ ability to finance growth through retained earnings. To finance this immense natural growth, food co-ops need to look at acquiring substantially higher levels of capital.”²⁶

²⁴ Chamard, John, (2003) Education for Management of Co-operatives and Credit Unions, ASBBS 2003 Conference, Las Vegas Nevada.

²⁵ Hailu, G and Goddard E, (2009) Sustainable Growth and Capital Constraints, The Demutualization of Lilydale Co-operative Limited, *Journal of Co-operatives* Vol. 23, pp116-129, p128

²⁶ Thompson, David (2009) Remember the Member: Coops are in capital revolution, *Cooperative Grocer*, # 140, January-February, 2009.

For differing types of co-operatives the sector specifics differ. The rise in industrial agriculture in North America let Fulton and Hueth to make the following observation in an overview of conversions and failures.²⁷ “The pattern described above suggests that a structural shift may have indeed taken place in agriculture, one with which it is increasingly difficult for cooperatives to deal. As agriculture becomes more industrialized, the need for capital at the processing and marketing levels increases.”

Co-operative Structure and Capital: For consumer co-operatives the level of member investment often does not keep pace with the increasing capital intensiveness of the business. In most co-operatives around the world there is only one class of member. In consumer co-ops you must be a consumer to be a member, in a worker or producer co-op a worker or a fisher or a farmer to belong. But people in their lives are interdependent. Farmers are also consumers and consumers are workers. Consumers depend on farmers; farmers on workers and all depend on having access to capital to meet their needs. Consumers, farmers and fishers and workers also need to save money for their retirement, children’s education, major purchases, etc. We each play many roles in our lives and, while we are each uniquely individual we are at the same time completely interdependent.

In the same way it is possible to see providers of co-operative capital, as opposed to investor capital, are users of the business. They are people who wish to use their savings to meet human need, respect co-operative business purpose, values and principles and provide a clearly limited financial return. Investors of co-operative capital are interdependent with farmers, fishers, consumers and workers. Seen another way they are workers, fishers, consumers and farmers. The purpose of their investment is multifaceted.

The single class of member co-operative does not reflect this interdependence. It also means that a single class of member must be the sole source of capital for the co-operative. Co-operative structures that have been evolving in such diverse places as the Basque Country of Spain, Northern Italy, Canada and the USA offer a co-operative model that better reflects our interdependence and offers co-operatives a broader range of sources of capital. These are the so-called ‘solidarity co-operatives’. The very name resonates with an important co-operative value. Some examples:

- The Caja Laborale Populaire, Mondragon’s powerful and enormously successful financial institution has co-operatives which are members as well as worker members, and, Eroski, Mondragon’s retail system has a board elected by both consumer and worker members.
- The Weaver Street Market in North Carolina has both worker members and consumer members. (Cooperatives owned by both producers and consumers are not unusual in the U.S.).
- Italian social co-operatives often have workers and consumers of their services as members – for example social workers and former prison inmates.
- Canada has numerous solidarity co-operatives, especially in Quebec and the federal co-operative act allows for multiple classes of members including investor members.

A paper by Co-operative Action in the UK devotes an entire chapter to a very similar concept it calls ‘stakeholder’ co-operatives.

²⁷ Fulton, Murray and Hueth, Brent (2009) Cooperative Conversions, Failures and Restructurings: An Overview, *Journal of Co-operatives*, Vol. 23, 2009, p. i-xi

Impact of Capitalist Capital on Co-operative businesses

All sources of capital including debt exert an influence on the businesses that hold them, and co-operatives are no exception. A co-operative unable to meet its payments on a bank loan will find itself under pressure to act differently and potentially to act in ways not consistent with its co-operative business model.

What happens to a co-operative business when it employs non co-operative capital especially forms of equity capital, which does not behave in a manner consistent with co-operative purpose, values and principles? The greatest potential source of tension relates to investor expectations of return. If the co-operative cannot offer benefits that are attractive enough to compensate for the lack of high or maximum return it may feel that an excessive or unlimited return is the only option. If the member benefits are not sufficient to compensate for the lack of unlimited return or if members are not likely to have available capital resources to meet the amount needed a co-operative may, especially if the need is urgent, be in a position where it has no alternative but to seek purely investor driven capital.

Once launched on this path the co-operative is on a slippery slope. When members realize the co-operative now must maximize the return to a group of investors or provide them with a higher return than members are receiving for their co-operative capital the perceptions of member benefits are more likely to decrease than increase. Any further need for capital is more likely than before to have to be met from outside the membership. The cost of capital is not likely to decline.

If the outside capital is tradable on traditional stock exchanges, then the ability of the co-operative to offer competitive returns compared to capital owned business will be reflected in the share prices. It is likely that only in a weak market will co-operative shares have much chance to increase in value and if the market is very weak the co-operative's shares are likely to follow the market down. It is difficult to imagine a scenario where the logic of the market will favour the price of co-operative traded shares as long as the co-operative does not make return to investors its overriding goal.

These considerations suggest that there will be an inevitable pressure on any co-operative that seeks investor driven capital to seek to maximize the return to capital as the overriding goal of the business in place of co-operative business purpose, values and principles. That of course means ceasing to be a co-operative.

Further pressure would come from asset strippers seeking to "unlock value" by demutualising the co-operative as has happened with building societies in the UK and credit unions in Australia and the United States.

Issues in Attracting Capital

Narrow Limited Return vs. Multiple Returns: Co-operatives have generally made offers for capital that really focus just on the financial return and are in direct competition with investment offers and opportunities in investor-owned companies. In that competition they see themselves as hobbled by the co-operative limited rate of financial return, which they see simply not competitive, if rate is all that is on offer. Co-operatives need to learn to frame their investment offers offering a 'multiple return' outlined above. The limited return needs to be contrasted with the 'casino' type returns that have characterized publicly traded shares over the past decade with the possibility of more instability ahead.

Let's examine a real life example of the rate of return offered by 'investor type' credit union ethical funds compared with the return one might expect from a limited rate of return investment in a co-operative business. "The Canadian credit union system founded the family of **Ethical Funds** by purchasing the [Ethical Growth Fund](#) from Vancouver City Savings Credit Union. Along with this fund, Credit Union Central of Canada purchased four more small investment funds owned by individual credit unions across the country, expanding the product line to five socially responsible funds."²⁸ In late 2009 the Desjardin group in Canada acquired The Ethical Funds and merged them with their socially responsible investment funds. A recently examined portfolio composed of Ethical Income Fund, Ethical balanced Fund, Ethical Special Equity Fund, Ethical Canadian Dividend Fund and Ethical Growth Fund produced a compounded rate of return over 14 years (1994-2008) of 1.055%.

Although the Ethical Funds were not as badly damaged as many non-ethical investor-owned mutual funds in the 2008 collapse²⁹ a compound return of 1.055% falls far below the impact of inflation on invested capital and the ethical investors have become financially poorer. This is not a suitable basis on which to attract capital.

Perhaps those seeking to attract financial capital into co-operatives need to recall the policy of the Rochdale Pioneers – and pay a “varying and commercial rate of interest”³⁰.

Risk – Lessons from September 2008: Part of the multiple return means co-operatives need to eschew 'playing with the big guys' and offer their members and the public investments that are significantly more solid and real. For the most part an examination of the 2008 debacle shows that they did, with only very minimal exposure, indeed eschew the 'toxic paper'. Investments in co-operatives did not collapse in September 2008. They may not have grown as fast over the previous decade but they did not lose 25-35% of their value overnight. Co-operatives offer a patient capital alternative. They are, in the words of the Co-operative Banks in the UK “Good with money” in both the sense of using it carefully and using it to do good.

In looking forward, the global investor driven economy's stability is very difficult to predict. The toxic paper/housing credit failure in the USA brought the global economy to the brink of a depression. There are current concerns about a long line of issues that have the potential to result in significant global ripple effects: European economic stability issues related to the weakness of several countries; the very high rate of credit card debt in several rich world economies; the energy crisis as markets seem incapable of ensuring a smooth transition from fossil fuels; the food crisis; the ability to manage rapid and sustained urbanization; etc. The crisis of 2008 has been narrowly averted by massive government spending.

This level of government spending, and resulting debt, has in itself been cited as a possible cause of future instability. At the very least, the current debt levels raise significant doubts about the capacity of governments to respond to a future crisis. The stabilizing calm of the co-operative part of the economy looks more and more like a large quiet blessing and source of hope.

²⁸ <https://www.ethicalfunds.com/en/Investor/OurStory/InTheNews/Pages/CorporateMilestones.aspx#1986>

²⁹ The Ethical Funds, Statement of Account 0003553, 31 December 2008

³⁰ Birchall, J., *Co-op: The people's business*. Manchester University Press, 1994, p56.

Future Directions

The Provision of Co-operative Capital: Co-operative financial institutions need to educate and inform their regulators about the social and economic benefits of, co-operative capital as described in pages 6 --8 above.

Regulators should be open to the possibility that there are very significant positive public policy benefits from an increase in co-operative capital related to meeting basic human needs, promotion of democracy, stimulation of rural economies, etc. Regulators and financial co-operatives should also take into account the stable performance of co-operative capital. There are significant public policy benefits for governments that encourage the growth of co-operative capital as a percentage of the global economy.

In this it must be remembered that the funds under the direction of co-operative financial institutions are the funds of members or users who expect not to lose those funds. Co-operative financial businesses have enormous expertise to examine the potential risks and benefits associated with significant shifts toward becoming more energetic suppliers of co-operative capital. They also have the level of sophistication to explore risk sharing at a global level as a natural extension of co-operation among co-operatives.

The Need for a Co-operative Capital Fund: One possibility for expanding the availability of co-operative capital could be the creation of co-operative capital funds. Co-operative financial institutions on a regional or national basis could create such funds where a percentage of the funds under their direction could be invested. The resulting pool of funds could be made available for investments consistent with co-operative purpose, values and principles. Possibilities that could be considered could include shares and loans to co-operative business, home mortgages, loans to not-for-profit businesses and social economy businesses.

It is essential that the risk level of such funds be along the same cautious lines that credit unions and other co-operative financial institutions have traditionally used. These funds are not meant to be charitable foundations but custodians of member savings who ensure those members that the funds are used for 'good' purpose and receive a fair return that quantifies not only the financial return but also the "social" return. A selection of funds with varying levels of risk and varying (but not excessive) levels of return or varied purpose may be a reasonable option. It is also reasonable that the deposit of such funds receive favourable tax treatment in light of the public policy benefits.

Meeting Member Savings Needs and Social Responsibility: Members of co-operatives have investment needs around education for their children and especially around retirement. For the most part they have no option but to invest in investor owned business. Even when they use co-operative businesses like credit unions or insurance or co-operative banks for their retirement funds, their savings are mainly channelled into investor-owned companies and banks. We referred to the Canadian Credit Union Ethical Funds above. Visits to their website and that of the Co-operative Financial Services confirmed significant investments in the fund portfolios of investment offerings of banks in Canada and the UK.³¹ These funds, while better than funds with no social responsibility screens, are not sufficient.

The 2004 paper by Co-operative Action provides an excellent examination of the growing number of people who wish to find socially responsible outlets for their savings. (Co-operative Action 2004, Chapter 4) This growing interest is not confined to the UK. Ethical funds have appeared more and more frequently from modest beginnings in the mid 1970's. The Co-operative Bank in the UK made its debut as an ethical financial business in the mid 1990's.

Canada's credit union ethical funds began in the 1980's. There is growing interest among people in ideas like local investment, fair as opposed to windfall returns, investing in not-for-profit businesses, investing in co-operatives and investing in socially responsible business (excluding weapons, tobacco, heavy polluters, environmentally and socially irresponsible business).

The crash of September 2008 also increased the appeal of 'slow capital' and movements of people wishing to find a less exploitive and more stable place for their investments. Financial co-operatives need to become creative and innovative in providing people with co-operative capital investment opportunities and to educate their members and the general public of the many positive benefits to be obtained from using savings as co-operative capital.

Subsequent to September 2008 millions found their retirement savings decimated and their faith in capital centred investments eroded. Co-operative financial institutions experienced significant growth as people looked for ethical and more responsible investment opportunities. There was also an increase of interest in ideas like "slow capital" that both fosters stable development and does not seek rapid windfall gains. All of this presents an opportunity for the co-operative business model.

Co-operatives need to explore options for funds that do not invest in banks and investor-owned business but rather, are designed to invest in meeting human need. One or several funds might be created – a Co-operative Business Capital Fund; a Social Enterprise Fund; a Green Investment Fund a Local/Regional/Community Fund. Each would have some or all of the following characteristics:

- Stable limited growth - this could vary depending on risk but there would be no 'windfall' or unlimited returns.
- Rates that are fair to the investor, the user of capital and the community. This allows people with retirement or other savings to obtain a reasonable return for the use of their savings without windfall gains that are exploitive. It also assumes a higher cost of capital in situations of higher risk and provision of sharing gains with the community when returns on an economic activity are very high.

³¹ For the Co-operative Bank see: http://www.co-operativeinvestments.co.uk/cfscombi/pdf/invest/CIS_Sustainable_Diversified_Trust.pdf

For the Canadian Credit Union Ethical Funds see

[1https://www.ethicalfunds.com/EN/INVESTOR/INVESTMENTS/FUNDSANDSOLUTIONS/E](https://www.ethicalfunds.com/EN/INVESTOR/INVESTMENTS/FUNDSANDSOLUTIONS/E)

- Co-operative capital investments in various types of co-operative businesses with requirements for reporting on adherence to co-operative purpose, values and principles or on social responsibility.
- Exclusion of investments in economic activity that is destructive of community, society and the environment. (Some co-operatives such as the Co-operative Bank in the UK exclude investments in weapons, tobacco, heavy polluters and environmentally and socially irresponsible business.)
- Positive investment strategies for environmentally and socially responsible products that meet human and community needs. (There is significant need for 'green investment' funds and funds for social economy businesses.)

A single co-operative capital umbrella fund might look at investing in all these differing enterprises or a set of different financial co-operatives might each wish to spread the initial risk by developing a specialized fund each and promoting each other's funds. The risk for the funds could be shared nationally or even internationally. Would such funds be viable? Could co-operative financial institutions co-operate to create these investment options? Would the administration costs be higher than in investor-owned mutual funds? Could risk-sharing mechanisms at national or international levels reduce risk? How close could these funds come to a promise of full stability? Could these attributes be effectively explained and conveyed under existing securities laws? These are all questions requiring much further exploration but the creation of a co-operative capital fund would appear to be meritorious.

Finally, these co-operative capital funds should be, when reasonable, members of the co-operatives in which they invest. As members of these co-operatives their role would be to ensure that the co-operatives in which their capital is invested are not just operating in a financially responsible manner but in a manner that reflects co-operative purpose, values and principles.

Tradable Co-operative Capital? The 2004 paper by Co-operative Action also raised the possibility of creating a separate exchange for some types of co-operative shares. The ethical exchange concept that they put forward for discussion, would offer those wishing to invest in co-operative shares, presumably including co-operative capital funds, the possibility to increase the liquidity of their investments. That said exchanges for trading shares have two functions for maximum return focused capital. The first is to provide liquidity although, it must be noted that if an investor owned firm is in financial difficulty the shares may be of little or no value. The second function is to allow speculation as to the value and make possible speculative gains to the investor.

It is of value to co-operators who wish to invest in co-operatives that their investments are as liquid as possible. Member shares are liquid but only as long as the co-operative is in sound financial condition. Introducing a speculative component to investment in co-operatives, to conjure up the possibility of evading limited return, does not seem possible without subjecting the co-operative to pressure to act in ways that will maximize tradable share values. The effect is to convert the co-operative into a business form where maximization of shareholder value increasingly becomes the prime driver of the business. This is an assault on the very fundamentals of what it means to be a co-operative. The purpose of the business has begun to change.

Is it possible to design an ethical exchange system that would not erode the co-operative nature of the business? It may be but it is an endeavour that is fraught with great risk. If the gain in attracting investment to co-operatives results in an increased likelihood of the co-operative demutualizing or acting like an investor-owned business in response to that capital then the gain

is not worth the cost. If people wish to invest in investor owned business with its particular risks and narrow range of benefits they will do so. If co-operatives structure themselves to attract capital that is structured and behaves like investor-owned capital it will begin to limit the ability of the co-operative to function as a co-operative.

Conclusion:

If co-operative business is no different from investor-owned business it is difficult to develop a rationale for its existence. The greater the difference based on co-operative purpose, values and principles the stronger the rationale and the greater the contribution to meeting human need and making the world a better place. The financial collapse of 2008, the growing income disparity between and within countries and our growing environmental crises underline the need for constructive alternatives. We need capital that is socially constructive rather than destructive and more stabilizing rather than destabilizing. We need capital that is restrained, limited and controlled and directed to meeting human need rather than human greed. Co-operative capital is constructive, stabilizing and restrained. The world needs more co-operative capital and ways of diverting savings from becoming investor to becoming co-operative capital.

Just as co-operatives have agreed on a shared purpose, values and principles they need to apply the purpose, values and principles to the expectations for the behaviour and characteristics of the capital they use. This paper suggests a starting point for developing a shared understanding of the distinct nature of co-operative capital and a set of expectations of co-operative capital that their members and the public could share. In a world with a shaken faith in its business system and an increasing hunger for values driven business, the emergence of co-operative capital as an alternative is a significant business opportunity.

Co-operative financial institutions need to develop more and better strategies to provide co-operative business with the capital it needs and to provide co-operative members with expanding opportunities to have their savings used in a manner consistent with co-operative purpose, values and principles.

There is need for a growing number of co-operatively inspired co-operative capital funds, green investment funds and social economy investment funds. The risks associated with such new investment vehicles can be mitigated by risk sharing among such funds at the national and even international level.

The creation of some form of tradable co-operative capital may be possible but represents enormous risks for undermining what makes the co-operative business model a valuable alternative in our increasingly fragile global economy.

Finally, as businesses that are based in communities, and where governance is democratic, co-operatives are much better suited to provide the capital needed to meet local and community needs. As co-operatives and co-operators become more familiar with the idea of co-operative capital their ability to meet local needs will improve as will their ability to assist members to use their savings to provide capital for local and regional needs. Co-operators, rather than being forced to invest their savings in obscure financial instruments that offend their values and finance investor capital endeavours in distant places, will be able to see their savings used to meet real economic needs closer to home.

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