

Worker Cooperative Startups: Capital and Cooperative Values

Mike Leung
Draft 10/2011

Abstract

This paper examines the losses in the startup phase of a worker cooperative. The startup operating losses are shown to translate into capital losses for the founding members, which are ignored or misinterpreted under the standard accounting treatment. The losses mean the fixed price buy-in (capital contribution) is inherently equal, as later members experience no reduction of their investment. The startup losses raise fundamental questions about the interpretation and implementation of core values like worker ownership, and what qualifies as a valid (non labor based) return on capital.

Worker Cooperative Startups

Worker cooperatives are worker owned, democratically managed businesses. Worker ownership means that members appropriate any profit or loss the coop incurs. Outside investors are limited to a fixed rate of return. Democratic management means one member, one vote in the governance of the cooperative, giving the workers control.

The standard worker cooperative model has internal capital accounts comprised of member investments, a collective reserve account of unallocated retained earnings, debt, and preferred equity (non-voting, non-convertible, fixed value, fixed return shares).

This paper focuses on the special case of a worker cooperative startup. Startup worker cooperatives are expected to have an initial operating loss. After the startup period worker cooperatives are generally expected to be profitable, barring unforeseen circumstances.

Worker cooperatives create a unique investment situation where initial members are required to make an investment that is *expected* to decline in value, something unprecedented in mainstream finance due to the concept of goodwill in typical market valuations of business investments.

Loss Appropriation

As owners of the cooperative, members must appropriate any profit or loss that results. In the startup phase where operating losses are occurring, falls on the members. The operating losses most frequently manifest themselves as an investment loss to the founders when the capital they contribute is used to cover the loss.

The expenses that contribute to the operating loss are the issue, not expenditures on durable or capital goods. Expenses include things like rent, marketing, utilities, and insurance. Expenses reduce the tangible assets owned by the cooperative. The purchase of capital goods like land or equipment does not affect the asset level of the cooperative. In a market transaction, a capital good purchase is merely the exchange of cash for a physical asset of equal value.

To insure that members can bear a loss, they are typically required to contribute capital when they join the coop. This buy-in, which is credited to the members' internal capital accounts, is first to absorb any losses. The subordinate nature of the internal capital accounts means the capital is at risk. The principle value of the debt in the internal capital account can be reduced to offset losses. This effectively looks like an investment loss to the members.

The upfront capital contribution or buy-in in a worker cooperative is a practical convenience, not a theoretical requirement. A worker coop could alternatively be entirely externally debt financed with no member investments. In that situation the members would appropriate a loss by having the cooperative charge the members after it occurred. This is analogous the standard method of operation for democratic governments which have the authority to tax their citizens.

Whether the members of a startup bear the operating losses through a reduction of their internal capital accounts or through payments after the losses occur does not change the fact that they are required to contribute capital to the cooperative. In this sense members of a startup worker cooperative are required to be investors.

Standard Loss Treatment

How are losses typically treated in a worker cooperative startup? Surprisingly, startup losses are not usually deducted from the members' internal capital accounts. This is despite the underlying reality that the member investments must be declining in value.

There are two common ways which the losses are accounted for. One approach is to create a negative equity account to which the losses are attributed. During startup, member internal capital accounts are held at their original value and all losses are added to the negative equity account. This negative equity account must later be credited with profits until a zero balance is reached before any profits can be distributed to the members.

The negative equity account is a façade that makes it appear the member investments are not declining in value as startup losses occur. It should be obvious that negative equity can't actually exist. Investment losses during startup do actually occur and the negative equity account does not make them vanish.

To see what is actually happening, consider the case where a coop files bankruptcy during this period. The negative equity account does not mean the member internal capital accounts get repaid in full. The member investments (internal capital accounts) would bear any losses that occurred.

What is actually occurring despite the negative equity account is that the internal capital accounts are declining in value as losses occur. The internal capital accounts are later credited with profits until they return to their original level, corresponding to the elimination of the negative equity account.

An alternative scheme capitalizes the startup cost (the startup cost appears as an asset on the balance sheet) and then depreciates it over a period of time. In this situation the internal capital accounts also appear to be held constant in value. In the U.S. the startup costs can be amortized over 15 years with up to \$5k deducted the first year, depending on the size of the startup expense. (But check with your accountant.)

The capitalized loss has the same function as that of a negative equity account, but with more flexibility as the capitalized loss can be written down over a longer period of time. With the negative equity account the initial profits first go to eliminate the negative equity. Under a capitalized loss scheme some of the profits can be paid out to the members before the capitalized loss is fully eliminated.

Member Departure

The negative equity account and capitalized startup loss create a problem when a founding member leaves the cooperative before the negative equity or capitalized loss is eliminated. In that case the founding member is paid out the original value of their internal capital account (buy-in), which according to the negative equity or capitalized loss accounting has not changed in value. The assumption is that the coop will be successful and fully eliminate the negative equity or capitalized loss with future profits, justifying the prior payout to the previous member.

The transaction where the departing member is paid out at the level of the buy-in is an unjustified transfer of the departing member's loss to the remaining members of the cooperative. The departing member should be paid the reduced value of their internal capital account adjusted for their share of the loss.

Under these two accounting models the worker cooperative capital structure fails to accurately account for a situation where a cooperative is started, a founding members departs, and then the cooperative fails. In this case the loss falls disproportionately on the remaining members of the cooperative, while the departed member bears none of it.

Interest Expense

Another problem arises when interest is paid on the internal capital accounts. With negative equity or capitalized loss accounting, members are paid interest on the initial value of their internal capital account, unadjusted for losses. This creates interest payments on phantom assets that don't exist. The added interest expense to the cooperative is real even if the underlying assets are not. If interest is being paid, it should be paid on the real (loss adjusted) value of the member investments. Or in other words the coop should pay interest on its tangible assets, not the intangible ones.

The practice is for worker cooperatives to treat startup losses as debt that has to be repaid. When this is done the total interest expense for the coop becomes assets plus accumulated losses, where the loss component represents an intangible asset. The accumulated losses are independent of the assets of the cooperative so there is no compelling reason they should be summed to determine interest payments.

Unrecognized Loss

The main problem with the negative equity and capitalized losses schemes is that they fail to recognize the founding members' losses, and thus fail to provide adequate compensation. The founding members are required to effectively make an investment that is expected to decline in value, a situation that is unique in the investment world. Investments are typically expected to only increase in value, or else they would not be made.

Compensation for intentionally bearing a loss is different from compensation for the risk of default. The interest payments on the internal capital accounts are the compensation for the risk of default. Here we are dealing with a separate issue, a requirement for members to contribute capital to cover losses.

The negative equity and capitalized loss account treat the founding members' investment as a debt-like security that does not change in value, instead of an investment that is expected to decrease in value as losses occur. This discrepancy between the treatment of the investment as fixed value loan, and the underlying reality of the decrease in value is the primary reason for the under compensation of founding members.

Wage Difference

Members in a worker cooperative startup often have reduced wages during the startup period when the coop is not profitable, usually with a negative cash flow as well.

How should the coop address the topic of reduced wages and lack of patronage during startup? One currently employed solution is to utilize the total compensation levels (wages plus patronage) after founding member investments are returned to their original level. Then, pay a wage bonus based on the difference in wages between startup and the total compensation level (at the period following complete founder investment compensation) times a wage loss factor. The wage loss factor accounts for the risk of working at reduced wages with uncertain future compensation. The bonus is paid for an equal period of time that the member worked during startup.

Example: Wage loss factor = 2. Startup wages are \$15/hour for 3 years until coop is profitable. Total member compensation after capital losses are fully compensated = \$20/hour. Then, pay founding members extra \$10/hour ($2 * [\$20 - \$15]$) for 3 years. The members would have to stay with the cooperative to receive the wage bonus. The wage difference can also be increased by some factor to account for the delayed compensation of the founding members.

The wage bonus can be adjusted for changing wages during startup by taking the wage difference each year during startup. The bonus for members joining at different times during startup is adjusted by only giving the bonus for years worked until profitability.

The wage bonus alone also fails to address the investment loss of the founders. While it does negate some costs to the founders, it represents an incomplete analysis of the problem and thus represents only a partial solution.

Compensation Matching

There is another way to equalize the compensation of founding members, without giving them a bonus based on wage differentials. Each new member's compensation could be initially capped at the same level that the founding members received during the startup period. In the compensation matching model new members would have the financial effect of being paid as if they were going through the startup phase themselves. After that period they would be compensated at the going rate with the usual patronage distribution members receive.

For example, if the founding members made \$10/hour the first year, \$15/hour the second year, and \$20/hour the third year before the coop became profitable, that would also be each new members first three years of compensation.

There are some advantages with the compensation matching model. First, it would eliminate the time delay that founding members face under the wage differential model where the wage bonus comes later in time but new members get high wages immediately. With the compensation matching each member would get the initial reduced compensation when they join.

The compensation matching model also provides a natural incentive for membership growth. Existing members effectively get a bonus for each new member that is added. The size of the bonus is determined primarily by current profitability and the number of new members added. The bonus is also finite in duration as it last only as long as the initial startup period. Further, the incentives for growth remain in place regardless of the size of the coop. This would help overcome the practical problem of worker cooperatives being reluctant to expand membership.

The compensation matching scheme also provides an incentive for lower membership turnover within a cooperative. Since the financial compensation increases with the duration of membership, it will make more sense to join for an extended period of time. This would reduce training costs.

Member Investments

There is widespread recognition that founding members of a cooperative (broadly referring to those members that join prior to profitability) are disadvantaged relative to the later members who join after the cooperative is profitable. The systems described above try to shift how future profits are distributed in a way that offsets the burden on the founding members. In a sense, they all succeed to some degree in shifting the startup costs to later members.

However, the problem only partly diagnosed by identifying reduced compensation (wages and patronage) as a problem. The investment loss on founding members' capital

contributions is largely ignored. Analyzing wages and patronage alone is insufficient. The problem with the wage loss and compensation matching models is that they fail to address the *nature* of capital contribution the founders are required to make.

The convention has been to treat salary and wages separately from patronage or profit distributions (positive or negative). However, it is necessary to treat both the wage/salary level and earning/loss distribution simultaneously. The case of wages or salary during the startup period is a good example. During that time, any increase in the wages or salary of the members results directly in a larger loss to the cooperative. And a larger loss to the cooperative means that the members need to make larger capital contributions to absorb that loss. So there is no advantage in choosing to pay higher wages in the startup period when the cooperative has negative earnings. Paying higher wages during startup while a worker cooperative is not profitable has the net effect of taking money from one pocket and placing it in the other.

It follows that the least expensive way to start a cooperative would be to not pay any wages or salary until the cooperative is profitable. This is because the members are receiving no net benefit, and are in fact being penalized to the extent that they need to borrow money to make the original capital contribution to cover their salary or wages. Of course current income is important, and salary and wages are bounded below by minimum wage laws in many cases. But while minimum wages laws are certainly beneficial to employees in non-cooperative businesses, it remains unclear what the utility is in a business where all the workers are owners.

Members of a money losing worker cooperative have no intrinsic right to a salary or wage, even if contributing labor. That notion is a carry over from employee based businesses. Until profitable, the members of a worker cooperative are only obligated to appropriate any losses that arise, not be compensated for their labor.

It is insufficient to focus solely on salary or wages while ignoring the “earnings”. This is the central fault of wage loss and compensation matching models, which correctly identify the reduced compensation as a problem, but ignores the magnitude of the losses during the startup period.

It should be noted that in practice the initial member investments in some new worker cooperatives are insufficient to cover the startup losses. If worker ownership is to be applied consistently with regard to earnings *and* losses, the capital contributions from the founding members must be sufficient to cover startup losses.

Loss Factor Model

In this proposed model the members who join during the startup period receive additional compensation based on their net loss. The members would receive no interest on the loss and would be compensated when profits arose for repayment. This compensation would be in the form of contributions to members’ internal capital accounts.

The coop profits would first go to rebuild member investments value based on a loss factor times the member's net loss. A member's net loss is defined as their investment loss minus the member's total compensation during the startup period. If a member's investment started at \$15000 and decreased by \$9000 (to \$6000), but they were compensated \$2000 in wages during that time their net loss would be \$7000. If there were a loss factor of 2 then the member would be have \$14000 of future profits credit to their internal capital account for a total of \$20,000.

The net loss (investment loss offset by salary or wage compensation) is used instead of the investment loss alone because it is the total change in member compensation that matters. There is no compelling reason that members of a money losing cooperative should be entitled to compensation through salary or wages during that time. Their obligation is to appropriate the full value of the loss, in a manner of their choosing. This may include current wages offset by larger investment loss.

The loss factor compensates founders for making an investment that is expected to decline in value. Later members who join once the cooperative is profitable are not required to make such an investment.

There is some arbitrariness in how the loss factor is chosen, and currently no precise way to calculate it. However, it should account for the expected decline of the investment, for the lost interest payments as the investment declines, and the unknown length of time and uncertainty that future profits arise. What is known is that the loss factor does not equal one (which treats the investment like debt), it should be greater. How much greater than one must be determined.

The selection of a loss factor is somewhat balanced because the financial incentives for founding members to select a large loss factor are offset by their ability to recruit later members should the loss factor be too high.

The loss factor model solves the problem of the cooperative paying interest on intangible (nonexistent) assets. With the loss factor model interest payments are based on the tangible assets because the losses are no longer treated as debt. The interest expense becomes independent of the accumulated losses, which were never related to the asset level of the coop in the first place. Instead the loss compensation is paid if and when profits arise. The loss factor model is a more robust because it matches the payments to coop profits, instead of piling on fixed rate debt with scheduled payments.

The important point about the loss factor is that the founders' investment return is bounded and predetermined, and the share of future profits is dependent on continued membership, keeping with cooperative principles. The loss factor entitles founding members get a specific predefined return based on an actual loss they suffered.

Loss Vesting

A founding member of a worker cooperative who leaves before profitability bears a disproportionate loss in the scenario when the value of their internal capital account is

reduced to reflect startup expenses. This can be mitigated by reimbursing those losses at a later time should profits arise. This would be a sort of vesting that would ensure the founding member would bear their share of the loss in event of default, but also not be unduly punitive if the cooperative later succeeds.

With loss vesting a founding member is paid the reduced value of their internal capital account when they leave. Those losses are reimbursed back to the original level if and when later profits arise. Outside the loss reimbursement they would have no claim on later profits as they are no longer members.

Similar problems for worker cooperatives also arise in cyclic industries such as agriculture. For example take a farming worker cooperative where there are both financial costs and labor involved with the initial planning but no profits until the harvest is sold. A member who was only around for the planning season but left before the harvest would bear the upfront costs but would not participate in the profit as they would no longer be a member. A similar vesting system could be implemented where the initial member would bear the planting costs and have their internal capital account drawn down, but later be credited if there was a successful harvest. This would also hold the initial members responsible for planting mistakes that reduced the later harvest.

Comparison

Differences in the two models for treating member investment in a worker cooperative startup are shown in the table below.

	Current	Proposed
Model	Negative equity or capitalized loss	Loss factor
Member Investment	Nominally fixed	Declines
Interest	Paid on original, nominal value	Paid on actual reduced investment value
Member Departure Payout	Original buy-in	Reduced investment value
Profit goes to	Eliminate negative equity or capitalized loss	Member internal capital accounts via loss factor

Where does the money come from to compensate the founding members? The short answer is that the future profits of the cooperative are preferentially distributed to the founding members for their investment losses.

In practice, determining the loss factor comes down to an issue of fairness. On one hand, actual investment losses arise from being a founding member. On the other hand, systems are generally designed to the advantage of the original members, and to the detriment of newcomers. A balance must be achieved. However, the technical challenge of determining a fair loss factor should not be an excuse for failing to acknowledge that losses are taking place.

Cooperative Values

The loss factor model poses some difficult questions regarding the interpretation of fundamental cooperative values. In particular, at what point does compensation become tied to capital and become independent of labor?

The loss factor model is merely a redistribution of profits among current members of the cooperative. That is not much different than having different wages among the members which is already standard practice in many worker cooperatives. But the profit distribution is no longer entirely dependent on their labor contribution. Capital and more specifically appropriated losses come into play.

Does the loss factor model reward capital contributions with more than a fixed return? In the loss factor model compensation is structured so that the return is bounded, but with no guidance on what a reasonable bound is. Similarly a cooperative may take a predatory loan with a very high interest rate. Since the rate is capped, high interest loans are theoretically permitted, even if they are a poor choice in practice.

Phrased another way, is compensation in the loss factor model tied to profits? The timing of the payout in the loss factor model clearly depends on the timing of the profits. But the question refers to the level of compensation, which it is not. The returns in the loss factor model ultimately result from the labor of the members. But this is true of all returns including interest payments on debt. The interest payments on debt are already a non labor based return to capital. By analogy there does not seem to be any conflict here.

Do some people get more of a return based on their capital contribution? The loss factor model permits a return at some future point in time, based on a realized loss. An effective interest rate can be calculated after the member is compensated, but the effective interest rate is not known before hand. However, the effective interest rate is capped by the loss factor (so long as it is finite) and the fact that the minimum repayment time is bounded below by the length of an accounting period (the repayment time is not arbitrarily close to zero). The effective rate may end up be greater or less than interest on coop debt depending on how long it takes for profits to occur. But not all interest rates need to be identical. A single coop may have multiple loans outstanding with different interest rates. Bank loans, credit card debt, and member capital will likely carry different interest rates. The founding members will have incentive to achieve profitability faster with the loss factor model, as this increases their effective interest rate.

While the loss factor model may pass certain tests, it is certainly not obvious that doesn't conflict with cooperative values. Give the distinct break with the traditional treatment of worker cooperative capital, some serious reflection and debate about cooperative principles is probably in store. Incidentally, the inequality of treating all member investments the same comes up in all types of cooperative startups where there is an initial loss, not just worker cooperatives.

Why not just treat the capital contribution of founding members as debt with a higher rate of interest in recognition of the loss and avoid the cooperative values interpretation altogether? This could be done. But problems will arise when the accounting is

inconsistent with the underlying transactions, and not all of them will be obvious. The loss transfer from departing members was one problem. The financial disincentive for founders is another.

In practice, worker cooperatives already accept non-interest based return on capital. The return on capital (or right to future profit appropriation), is determined by the amount of money lost by the members during startup. It just happens that by convention the future profit appropriation rights are set equal to the amount of capital lost. But these rights are already entirely capital based and independent of labor. While the transaction in worker cooperatives is obscured by the accounting fiction of treating losses as debt, there seems to be no serious concern with this practice as it currently stands. From this perspective we are now dealing with technical issue of whether rights to future profits are equal to the amount of the loss, or something more or less than that amount. The values component has gone away.

Worker Ownership

One of the underlying principles behind worker cooperatives is worker ownership. With the standard cooperative definition this has often been interpreted to mean that outside investment returns could not be tied to the revenue or profit of the cooperative.

The other common interpretation of worker ownership is that only members of a cooperative could appropriate any profit or loss. Members in this case are taken to mean current members and not past or future ones. This latter interpretation has never been strictly applied in practice. By accepting the given accounting framework, losses in startups are in practice appropriated by future members of the cooperative.

There is often a temporal mismatch between the period of membership in a cooperative where labor is expended, and the duration of a production function where expenses are incurred and profits are realized. This can make membership timing an overriding factor in determining the financial fortunes of the member, largely independent of their labor contribution. The problem is present in startups that have an extended production cycle, though the duration of the startup cycle is difficult to define. It is also present in cyclical businesses such as agriculture that require an oscillating labor supply.

The question is one of a strict interpretation of worker ownership where profits or losses only go to current members, or the spirit of the worker ownership where participants in a productive activity collectively share the profits based their labor. The spirit of worker ownership is impeded by a structure that enforces a strict implementation in certain circumstances.

It is easy enough to sum profits or losses over an extended period and distribute them later based on labor contributed during that time. However, that alone is also insufficient. There is an asymmetry in the production process where expenses are paid upfront and profits are realized later. The earlier members disproportionately bear those expenses through capital contributions to the cooperative. It is not possible for those expenses to be covered by those who have not yet joined.

Member Investors

It is often said that members of a worker cooperative have three roles. They are the workers because they are the ones contributing labor. They are the managers because they govern themselves and make the decisions. And they are the owners because they appropriate the profits of losses of the business. But there is a fourth role that is never mentioned but equally important. Members are sometimes required to be investors who contribute capital to the cooperative.

Founding members are required to cover losses, forcing them to invest capital. This is a requirement later members are not theoretically required to make, even if a fixed buy-in is artificially imposed.

The mantra of the worker cooperative community and larger labor movement (at least historically) has been profits based on the contribution of labor, not capital. It seems the answer is not quite that simple. Capital contributions are required by some members in a worker cooperative, and the unique nature of these loss bearing contributions have been largely ignored. The capital issue never really disappears in worker cooperative; it merely gets bundled with labor, management, and ownership as part of the membership package.

It is the nature of the capital contribution that the members make which is most relevant, and most ignored. There are two fundamentally different types of investments. The first type is backed by tangible assets owned by the cooperative (standard debt); the second is used to cover losses. It is an artifact of the accounting system that this distinction disappears with the inclusion of intangible assets on the balance sheet.

The interpretation of events changes dramatically when intangible assets are excluded from the balance sheet. This forces the recognition that certain startup investments will decline in value. It is these declining investments that the proposed loss factor model seeks to address.

It is often said that equality is achieved by requiring equal capital contributions from members regardless of when they join. This perceived equality is simply untrue. A buy-in from a founding member is different than an equal dollar buy-in after the cooperative is profitable. The founder suffers a loss on their buy-in (which is unsecured by tangible assets), while the latter member's investment is backed by tangible assets and doesn't decline in value. Treating them equivalently as debt is both inconsistent with the underlying transaction and unfair.

Market Value Membership

Another solution that has been employed is to allow members of a worker cooperative to sell their membership to newcomers at a market price uncorrelated with their current investment in the cooperative. This type of situation was prevalent in the plywood cooperatives in the Pacific Northwest. In these cases the founding members of a cooperative could capture the value of future profits when a new member purchased their membership in the cooperative for more than the value of the current investment. The

market price was determined by the future profits that a member of the cooperative could expect to earn.

The problem with this model illustrates the key difference between worker cooperatives (member owned and managed businesses) and conventional businesses. The value of a worker cooperative can only be its net asset value, namely the value of its assets minus its liabilities. The net asset value *is* the market value of a worker cooperative. When a member joins a worker cooperative and pays the buy-in, the net asset value increases by exactly the amount of the buy-in. When a member leaves and has the value of their internal capital account paid back to them, the net asset value of the cooperative decreases by exactly that amount. Members cannot buy or sell the future profits of the cooperative because those belong to the future members, by definition.

The market value of a non-cooperative business is typically different from its net asset value. The market value of a non-cooperative business is determined by its expected future profits, discounted to the present value. This is the value at which all non-cooperative businesses are traded, on the stock market or in private transactions.

A profitable non-cooperative business will have a market value that is *greater* than its net asset value. The difference between the market price and the net asset value is called goodwill. Goodwill is an intangible asset representing the future expected profits that the firm may earn. It is attributed to a range of factors that people anticipate will result in future profitability.

The idea that membership in a cooperative can be traded based on the future expected profits is inconsistent with member profit appropriation. There is no justification for a departing member of a worker cooperative to be paid presently for the uncertain future profits that may or may not materialize. The transaction rests on the ridiculous assumption that a new member should pay upfront for the future profits from their labor. Correct market pricing would leave the new member with zero financial benefit.

The fiction of goodwill is not that there is no additional value (above the net assets) to having an existing business. There is obvious value to having existing workers, customers, operations, suppliers, etc. in a going concern. The point is that according to the principles behind worker cooperatives, that value cannot be monetized. The only way to monetize goodwill is to cheat the future members of their profit rights.

Belief in the existence of goodwill is pervasive as it is taught to every business, economics, and finance student. Its acceptance is practically a prerequisite for graduation. The notion of goodwill will likely be a major conceptual battle to defeat, even within the worker cooperative community.

Business Valuation

Making an investment that is expected to decline in value is unprecedented in non-worker cooperative businesses. If a business' worth is based on the discounted value of expected future profits, the rising expectation of future profits can occur even in the presence of

operating losses. Hence a non-cooperative startup can have a continuously increasing market value from its founding, even as the net asset value declines.

Since investments will only be made when an expectation of increasing market value is in place, the issue of a declining net asset value can be safely ignored in a conventional business.

The entrenchment of the idea that investments in startups can increase monotonically in value has influenced the worker cooperative treatment of investments as well. This is likely the origin of negative equity and capitalized startup loss ideas which hide founding member investment losses, and probably had some influence on the focus of wages as well. But as the analysis has shown, the investment losses in a worker cooperative startup cannot be ignored if we hope to create a structure that treats the founders fairly.

Complications

Determining fair compensation in a worker cooperative is difficult because decisions in one period, will affect members in other periods. The choices of the founding members in determining what to purchase and what contracts to engage in will be felt even after they leave the cooperative. And actions of future member may determine the timing of compensation past members receive. The vesting model is a prime example. Fair compensation in this broader sense is messy and hard to address. It is one of the added challenges worker cooperatives face.

Startup Rate

Ignoring investment losses under the current models hinders the formation of new worker cooperative startups. Entrepreneurs considering starting a worker cooperative would have to accept making a money-losing investment as part of the deal. It would be far more beneficial to join an existing cooperative or chose a non-cooperative business model.

It is likely that entrepreneurs considering a worker cooperative model are aware that the structure is unfavorable, even if they cannot articulate that the investment losses are the reason. This will likely play a role in the selection of business entity for all except for the most committed.

This is not to say that worker cooperatives should try to mimic the financial incentives of non-cooperative businesses. The financial incentives for starting a non-cooperative business will always be greater, due to their willingness to ignore the rights of the employees.

The object is to design a structure that is internally consistent and fair to all members of a worker cooperative including the founders, not necessarily to out compete non-cooperative businesses with a higher startup rate. A sole focus on worker cooperative growth is an incomplete strategy as far as furthering labor rights are concerned. By historical analogy, a focus on having worker cooperatives out compete slave plantations should not supplant a principled stand for the abolition human ownership. And today we

should not neglect a principled stand for the abolition of human rentals, even while fostering worker cooperative growth.

Financing

How does recognizing the member investment loss influence worker cooperative financing? The recent trend has been a push to finance worker cooperatives directly without personal loans or guarantees. But if we are to take worker ownership seriously with regard to both the profits and losses, a different approach is needed. The issue is not direct business financing, but personal lending to founding members who can then invest in the cooperative they are starting. This obviously puts the members at financial risk. But if we are to argue with any integrity about worker ownership and responsibility, we must be willing to treat the losses with equal rigor as the profits. In some cases this means members will bear responsibility for personal loans.

The financing issue becomes one of lending to people who possibly have poor credit, limited assets, and an uncertain income stream. These larger credit issues remain unresolved. But the implication is that worker cooperatives do not face the traditional startup and small business lending problem, but more of a personal lending one. However, if a worker cooperative startup is suitable to finance it should matter little in theory whether the loans are routed through the business or the members.

Summary

While there is much discussion about external factors hindering worker cooperative development, little effort has been expended on examining internal structural issues that are relatively trivial to modify.

The special nature of the capital contributions of founding members in a worker cooperative needs to be acknowledged and compensated for in the startup process. The situation is particular to worker cooperatives, where operating losses result in a decreased net asset value that translates directly into investment losses for the members. This is a unique situation because it is possible for non-cooperative businesses to have an increase in market value while the net asset value declines.

Current models for worker cooperatives ignore the effects of the startup losses, resulting in financial penalties for founding members. Typically, the internal capital account is treated as fixed in value which fails to address the underlying decline of the investment. The result is a financial disincentive for any entrepreneur considering a worker cooperative structure.

Compensation based on the net loss founding members face is proposed as a way to distribute future profits and negate the impact of startup losses on those members. This needs to be used in combination with a way to address the reduced compensation. A compensation matching model is proposed as a way to do this that has built in incentives for worker cooperative growth through increased membership.

Together these models can rectify the inverted incentive scheme for founders, something that is very difficult if not impossible under the current structure. Getting the financial incentives properly aligned is a positive indication, despite the interpretation of some core cooperative values being at stake.

There are likely multiple solutions to this problem as well as numerous variations on the proposed models. Much experimentation will be needed to determine what works in practice.

Overall there seems to be little theoretical guidance on how to properly deal with investments that are expected to decline in value. This is true not just of conventional financial theory that avoids the issue through goodwill, but of the worker cooperative literature as well. Hopefully a broader discussion will provide some further insight on the matter.

References

Ben Craig and John Pencavel, “The Behavior of Worker Cooperatives: The Plywood Companies of the Pacific Northwest”, *The American Economic Review*, Vol 82, No 5, (1992).

David Ellerman, “Goodwill: A Present Property Right or Only an Anticipated Future Right?” (2008).

Statement of Financial Accounting Standards No. 142 – Goodwill and Other Intangible Assets, Financial Accounting Standards Board (2001).

Mike Leung, “The Worker Cooperative Capital Structure”.