Joining the Club. Mutual Home Ownership and the Extension of Owner Occupation

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Introduction

This paper draws on some fundamental economic concepts in order to explore the nature and possible role of co-operative home ownership. After some brief comments on why such a form of ownership might be of increasing interest to policy makers currently and after an attempt at a definition of a co-operative and of 'mutualism', the main part of the paper considers three issues.

The first is whether a consideration of the theory of clubs offers insights into the basic nature of co-operative housing. The second is the significance of membership agreements and arrangements ('constitutions') in an organisation that provides jointly consumed services but may require individual investments to vary. The third is the appropriate financing of the co-operative as an organisation and the determination of the value of individual members' investments in such 'non-market' housing.

The paper concludes by identifying some questions and issues that we believe are worthy of further debate and research.

Why be concerned?

Among the reasons why the role of co-operatives are may be of interest to policy makers at present are the following:

i. A continuing desire for homeownership in context of severe credit market constraints
ii. Continuing concerns over expanding opportunities for ownership for key worker and other groups marginal to owner occupation
iii. The uncertainty over future course of house prices means that households (may) wish to be insulated from speculative risks
iv. A reawakening of interest in some quarters in alternative forms of ownership, given concerns over outcomes of individualistically based housing markets – 'mutualism' is seen as an alternative

Co-operatives and Mutuals – Characteristics

The main features of co-operatives, as taken from the Principles of the International Co-operative Alliance[1] might be taken to be:

- Voluntary and open membership
- Democratic member control
- Member economic participation
- Autonomy and independence
- Education, training, and information

[1] Available at http://www.ica.coop/al-ica/

- Cooperation among cooperatives
- Concern for community

'Mutualism' can be defined as:

- Oxford English Dictionary: "The doctrine that individual and collective well-being is obtainable only by mutual dependence" OR
- New Mutualism (Kellner) – "the precise opposite of 'no-such-thing-as-society' … asserts that we have both rights and responsibilities, and that institutions work best when all of their members respect each other."

Housing Co-operatives - Issues

There are clearly many different forms of co-operative, including:

- Tenant co-operatives: the co-operative as a landlord renting to tenant at e.g. 'cost rent'
- Ownership co-operatives: the co-operative as a company in which residents are shareholders with claims to equity redeemable to various degrees within or through the co-operative or in the market. This form of co-operative is the concern of this paper.

Note that in this context Clapham (1995) and Stephens (2003) distinguish between western European/USA expectations of co-operatives and the previous experience of many CEE countries in this respect, where co-operatives were a 'marketisation' response to the inability of state to fulfil housing aspirations of the whole population.

The experience of the UK with 'co-operative' co-ownership 1960s to late 1970s was very mixed – '*a cheap form of owner occupation dressed up superficially as the more collectivist Scandinavian model*' (Clapham and Kintrea, 1987, p166)

The key issues this paper intends to address are:

i. Ownership and membership of the co-operative seen as a club
ii. Constitutions, decision making and efficiency in co-operatives
iii. Finance and redeemable property rights/shares

Issue (i): The Co-operative as a Club

Previous work has referred to the theory of clubs in a housing context. For example, Manzi and Smith-Bowers (2005) have argued that gated communities can be seen as club goods providing a range of scarce goods such as *'...secure parking, enhanced security, common standards for property appearance and rules governing the use of managed communal areas'* (p348). More generally, Webster and Wai-Chung Lai (2003, especially pp119-130) use the theory of clubs as analytical tool to examine the supply of (impure) public goods and neighbourhoods in urban areas.

Here we use the same approach from a rather different perspective. Start by recalling that the classic theory of clubs (Buchanan, 1965) analyses the trade off between the cost savings from increased membership and the potential congestion generated from increased membership.

‘Congestion’ can be conceived of as actual crowding or as the diminution of other benefits – social relations, quality of the club experience, decision making costs – as membership increases.

Is co-operative housing a club with an optimal size? A distinction needs to be made here for analytical and practical purpose between co-operative housing as a group of residential units – a block of flats/apartments – and the co-operative movement.

- *Ex post*, any housing development clearly has a physical limit. *Ex ante*, the decision has to be made as to the size of housing development that optimises in a Buchanan like way in respect of efficiencies in the production of housing units and associated facilities, and member participation and decision making. To the extent that the last of these is a key consideration, there may be a different trade off between scale economies production and size in housing than if participation was not an issue. Interestingly, Buchanan notes:

‘...an economic theory of clubs can strictly apply...only if choices are made on the basis of costs and benefits of particular goods as these are confronted by the individual. In so far as individuals join clubs for camaraderie [positive intra-membership relations?] *as such, the theory does not apply.’* (Buchanan, 1965, p2, n1)

- In terms of co-operative housing as a movement, the larger the movement (number of members and individual housing developments) the greater the possibility of organisational arrangements that allow for the movement to provide services to members and their individual co-operatives – e.g. financial management and major repairs – which are required but which cannot be efficiently provided by the individual co-operative.

In this sense there may be an optimal size for a housing co-operative but not for organisationally provided services – additional ‘centrally’ provided service organisations can always be created if membership increases sufficiently.

The logically prior question is why should anyone want to join the co-operative club? What advantages do they have over (apparently) otherwise similar forms of owner occupied housing provision? The most similar form is arguably owner occupied condominium (leasehold) provision in the ‘mainstream’ market. These provide (arrange) for their residents:

- Common facilities
- Management services
- Repairs and maintenance to common parts
- Similar forms of housing
- Group decision making arrangements

However, what they do not necessarily provide (from the Principles of International Co-operative Alliance above) is:

- Full democratic member control and participation
- Cooperation with other cooperatives (with other condominiums)
- Concern for community

- Low cost homeownership

Hence, potential co-operative members must be attracted by the ethos and practice of mutualism and/or by the reduced costs of housing available through membership. Less credit constrained households who self select to join co-operatives must have a preference for mutualism and/or value the greater certainty over the future value of their investment in housing that new forms of co-operative housing are argued to provide (discussed below). Thus, members are joining the co-operative club because they have preferences for a bundle of housing and housing related services that are different from that available elsewhere, a bundle that contains benefits from consuming and investing in housing services, and external benefits in consumption (network externalities) from co-operative activity (see also the discussion in Birchall and Simmons 2004)[2].

However, notwithstanding the differences between open market condominiums and co-operative housing, there is a at least one set of issues common to both – that surrounding efficient decision making in respect of jointly consumed services.

Issue (ii): Constitutions, Decision making and Efficiency in Co-operatives

The literature on constitutional design and group decision making under a given constitution is vast. A valuable starting point for the purposes of this presentation is the approach taken by Hart and Moore (1996 and 1998) in distinguishing between organisations that have outside owners and co-operatives[3]. Owners have residual rights of control over assets while the ownership of the assets of co-operatives are lodged in the co-operative and controlled by members who take decisions in a democratic manner (one member one vote in their 1996 paper). Unlike members, owners do not consume the 'output' of the co-operative[4]. Both outside owners and members may have the same motivation to maximise the value of housing assets – the motivations of the two groups need not necessarily be different since a member's willingness to pay to join the co-operative might be expected to increase as the volume of housing and 'co-operative goods' increases – but while owners' preferences are homogenous in this respect, members preferences as to investment and particularly consumption might be expected to vary. Further, the number of votes that each outside owner – i.e., each shareholder – has is dependent on the number of shares that they hold. The greater the number of shares the greater their interest in the value of their investment and the greater their voting power.

Using the median voted theorem, Hart and Moore's insight is that the greater the variation in co-operative members' preferences – the more skewed that they are – the less likely members are to

[2] As, for example, Valentinov (2008) has pointed out, the fact that members forego 'profit maximising' activities or the receipt of market based returns does not mean that they are 'irrational' in a utility maximising sense.

[3] Srinivasan and Phansalkar (2004) also provide an extended discussion of the differences in governance and contractual relationships in co-operatives and other organisational forms, but their treatment of (producer and consumer) co-operatives is concerned with the non-transferability of claims, which does not reflect the transferability possibilities in homeownership co-operatives.

[4] Owners seen as owner occupiers of housing are free to determine their optimal mix of investment and consumption without the issues discussed here arising. They are neither outside owners nor subject to (majority) decision making in respect of their housing.

take optimal (maximising) decisions, since the 'average' will not be the same as the median preference. The implications for our purposes here are that:

- In the absence of a mechanism that also incorporates strength of preference (involving, e.g., side payments and compensation[5]), co-operatives are less likely to take the optimal (benefit or value maximising) decision than are outside owners (shareholders).
- To the extent that co-operatives realise that this is the case, the more likely it is that members or founders will impose some controls on the type of person/household allowed to become a member in order to limit the degree of member heterogeneity
- There will be some limits over the extent and type of voting, and 'qualification' for voting, that is allowed under the co-operatives 'constitution'

Although mainly concerned with analysing non-housing co-operatives, Rey and Tirole's (2007) work comes to some similar conclusions – that a co-operative's decisions and decision making will involve discrimination between new and existing members, where members of the co-operative are also investors with redeemable shares, because of the greater investment of the those existing members.

In two early but important papers, Barzel and Sass (1990) and Ellickson (1982) argue along similar lines and find evidence to support these hypotheses in their studies of condominiums and homeowner associations, respectively. Drawing directly on the seminal work of Buchanan and Tulloch (1962), Barzel and Sass identify the two 'costs' associated with voting:

- Risks of adverse wealth transfer: if these risks are present members' willingness to pay for a share in the co-op will be lower
- Decision making costs – administration and information seeking.

Thus, members' valuations will depend partly on '*their expectations of how deciding majorities will vote in future periods and on their own expected expenses in attempts to affect those voting decisions.*' (Barzel and Sass, 1990, p752)

Because members are consumers as well as investors, there will be greater unanimity on decisions regarding increasing/creating wealth through asset enhancement than in respect of other, collective consumption, decisions (echoing Hart and Moore's point above). Joining the co-operative is voluntary, but exiting in the face of adverse voting decisions taken subsequently is costly because of transaction costs and the capitalisation of the adverse decisions into the value of the members' share if redeemed external to the co-operative. So again these risks will lower members' willingness to pay to join. Low willingness to pay lowers the viability of the co-operative. Thus, the empirical work of both Barzel and Sass and Ellickson suggest that the co-operative's constitution would need:

- To clearly assign voting rights in a way that minimises the risks of wealth transfer - e.g., would severely limit changes in voting rights and define the assignment of charges for common parts and expenses (Ellickson, 1982, p1532 *et seq*): or

[5] Alternatively, if the decision making (membership) is small enough then formal or informal negotiation and agreement, and concerns for the stability of the co-operative may be enough to mitigate problems of wealth expropriation through voting (or, indeed, more generally, free riding). This would be an argument both for careful selection of members and for keeping the co-operative relatively small.

- To (potentially) assign voting rights in a way that reflects members' different wealth holdings where value is to be enhanced but where wealth creating amendments may also result in net losers
- To ensure an assignment of votes that requires a 'supermajority', rather than a simple majority, where decisions are primarily non-pecuniary but heterogeneity is high among members
- To incorporate features that would be outside the voting domain so that '*the greater the likelihood of divisiveness of a project* [e.g. an investment or facility provision]*, the higher the likelihood of developers undertaking them in advance'* (Barzel and Sass, 1990, p770)

Reflecting these considerations, Ellickson (1982) found that the constitution of one homeowners' association required a 90% vote in favour of major changes for the first 20 years after its foundation and 75% subsequently. Ruonavaara (2005) points out that in Finnish housing companies – ownership co-operatives – legislation specifies that major decisions require unanimous decisions, two thirds majorities or explicit agreement by those affected and that, in contrast to tenant co-operatives in Finland[6], in those companies the number of votes is dependent on the number of shares held which in turn depends on the size of the flat. This is not unreasonable if, as appears to be the case, many common service charges are a function of property size.

However, Ruonavaara (2005) also notes that in practice there are no dividends from owning shares, all residents have an interest in keeping costs down and in housing companies, as in tenant co-operatives, '*interests are usually common: if the roof is leaking it is in every resident's interest to have it fixed as efficiently and economically as possible*.'(p232) Further, it might be suggested that the very ethos of co-operatives implies give and take, and 'communalism', rather than solely self-seeking behaviour.

Nevertheless, it would clearly be risky for a member to rely on the goodwill of other current and (unknown) future members to preserve and enhance her/his housing consumption and the value of her/his investment. Consequently we would expect that owners in a co-operative would require a clear constitution and set of decision making procedures that follow from it, and controls on new members.

Issue (iii): Finance and Redeemable Property Rights/Shares

Two aspects to consider here:

- First, financing the co-operative housing development itself
- Second, valuing the members' shares when that member wishes to exit

[6] And in contrast also to such co-operatives in the UK – see Co-operative Development Services at: http://www.cds.coop/tenants/information-store/general-co-op-information/2018housing-co-operatives-2013-where-the-tenants2019-are-in-control2019

Financing the Development

Since co-operative ownership is a form of low cost home ownership (LCHO), some form of subsidy is required. In the case of UK ownership co-operatives this principally takes the form a subsidy on the price of land through grant, the donation of public land or the transfer of the community's planning gain (land value from development) through agreements with private developers (e.g., section 106 agreements in the UK).

The justification for this subsidy is the same as for LCHO generally – the wider benefits to society of enabling lower income households to access the tenure - but with the added benefit that the subsidy will be locked in for the benefit of future members/generations (see below) which has not been a feature of UK LCHO schemes to date. Further, there is an argument that participating in a co-operative increases members' social capital and their broader involvement in the locality (see, e.g., Saegert and Winkel, 1998, and Saegert *et al,* 2002).

One form of financing co-operative development that has found favour in the United States and has a number of advocates in the UK is through a 'Community Land Trust' (CLT). A CLT is:

'*...a corporate body which... is established for the express purpose of furthering the social, economic and environmental interests of a local community by acquiring and managing land and other assets in order to provide a benefit to the local community.*' (Rodgers, 2009 p13)

The process in outline is (see Conaty *et al* 2009 for a full discussion):

1. A CLT is given (or leased) the land at a zero or heavily subsidised price. Note this gives the CLT an asset (equity holding) equal to the market value of the land.
2. The CLT leases the land to an ownership co-operative which raises a mortgage for the construction of the properties. Given the objective of ensuring affordability, this mortgage is ideally a long term (60 yrs) 'low start' (e.g., index linked) loan. The security for the loan is the value of the property, the land held by the CLT and the stream of members' payments.
3. In the UK further security can be provided for approved co-operatives by a loan guarantee from the Co-operative Housing Finance Society for (currently) an annual 0.25% charge on the co-operative's outstanding debt.
4. Members pay a 'rent' (in addition to a down payment or deposit in some formulations) which consists of repayments on the co-operative's mortgage and charges for repairs, management and maintenance. In the form of co-operative ownership most actively under discussion at the moment (Conaty *et al*, Chapter 3), this rent is a fixed percentage of members' incomes – e.g., 30-35%. Note that in the UK, since this rent payment is not in itself a mortgage repayment, an unemployed or low income member may be eligible for assistance with their rent through the welfare system (Housing Benefit/Local Housing Allowance).
5. The portion of the co-operative's mortgage that is amortised by a member's rent entitles that member to an equivalent amount of equity (or shares in the co-operative's equity).

Work undertaken by us for Co-operative Development Services (unpublished but referred to in Rodgers, 2009, p17) indicates that a financial model along these lines works in a technical sense. However, the attractiveness of the scheme to members will depend at least in part on the value of their share and the ease with which it can be realised on exit.

Valuing Members' Shares

In respect of the value of a member's share, Davis (2006, Chapter Three) has provided a comprehensive list of formulae which have been used in the USA to determine the value of a member's share on exit. All of these are based on the amount of the co-operative's mortgage redeemed by the member's payments during their residence (plus any original down payment) not on the value of the individual or group of co-operative properties.

The formulae discussed by Davis include:

1. *Indexed Formulae*: these link the value of the owner's share to a specified index, such as average earnings (known to be favoured by some of those active in the co-operative movement in the UK) or a consumer price index. This does lead to the possibility that, if over the member's period of occupation house prices are falling but the chosen index is unchanged or rising, the member may gain more in equity than an otherwise identical 'market' owner occupier. Conversely, where house prices are rising faster than the chosen index the member will gain less than market owner occupiers. In this latter instance the (relative) affordability of co-operative housing is enhanced. Losing and gaining less when house prices fall and rise, respectively, is argued by some to benefit members by isolating them from the 'vagaries of the housing market' (Co-operative Development Services, Personal Communication)
2. *Itemised Formulae*: most commonly these adjust the value resulting from some form of indexing by adding an allowance for a member's 'value enhancing' investment in their property or an allowance for repairs and maintenance expenditure, but adjusting for depreciation (usually 2% p.a.). Assessing changes in the value of equity in such ways is both difficult and potentially contentious in practice.
3. *Appraisal-based Formulae*: the value of a member's share is adjusted by a specified percentage of the estimated (professionally assessed) change in the market value of her/his dwelling.

Whichever of these formulae is chosen the co-operative as an organisation would require some influence over the process of sale and the choice of buyer. Unrestricted sale by the exiting member increases the risk of the 'adverse selection' of a new member from the co-operative's perspective and the possibility of the member selling her/his shares at more than the formulae determined value at a time of rising house prices. It would thus be expected that co-operatives would require the shares, where the co-operative is structured in this way, to be 'sold' back to the co-operative or their agent, which also gives the co-operative the opportunity to sell some of these shares to existing members. This also obviates the problem of other LCHO schemes where the owner has to find a single buyer willing to purchase the whole of their equity[7].

Some Concluding Questions/Issues

1. The attractiveness of long term loans to co-operatives by institutional investors in current financial climate
2. Resolving the investor/consumer dichotomy in ownership co-operatives through constitutional design – is it really that difficult?
3. What do models of ownership co-operatives from outside the UK have to teach British policy makers/co-operative sponsors?
4. Is the potential attractiveness of co-operative ownership in separating the value of equity from housing market price movements of long term interest to a sufficient number of potential members?

[7] There is the possibility, in principle, of a co-operative becoming non-viable financially - 'melt down' – as the result of a critical number of members leaving simultaneously with formula enhanced equity claims that exceed the value of the co-operative's equity as a result of falling property prices. This would severely constrain the ability of the co-operative to refinance in order to redeem exiting members' equity entitlements if the shares could not be rapidly transferred to a new buyer. It is at this point that the initial donation of subsidised or zero priced land becomes particularly important in providing collateral for additional financing.

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