Case Study: Innovations in Corporate Governance: The Mondragón experience

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The stakeholder co-operatives formed around the town of Mondragón in the Basque region of Spain have been outstandingly successful on a number of measures in comparison with other forms of firms. The control architecture within and between Mondragón firms contains a number of innovations and lessons for developing the theory and practice of corporate governance. This paper outlines the 38 year evolution of Mondragón structures.

The control and incentive architecture of Mondragón firms was custom designed according to the nature of both their activities and their principal stakeholders. The resulting unique control arrangements and outstanding performance supports the hypothesis that the structure of governance is a determinant of sustainable competitive advantages. The evolution of Mondragón firms also illustrates the need to consider corporate architecture as a variable at any one time or over time. The Mondragón experience illustrates how the social research approach of 'action science' can be used to create competitive enterprises. The paper recommends this approach for developing the theory and practice of corporate governance.

1. Overview

At the end of 1992 there were 24,540 partners working in over 150 related co-operatives based around the town of Mondragón[1] in the Basque region of Northern Spain (CLP 1992). Group sales for 1992 were US$3 billion which was divided almost equally between the industrial and distribution co-ops with 25% of the industrial output exported. Over 63% of the co-operators manufacture advanced industrial and consumer products, 30% are involved in food distribution and production with 7% working in financial services. There are 45 educational co-ops, 9 housing co-ops, 12 service and support co-ops in addition to one of the fastest growing and most profitable banks in Spain owned by all the co-operators.

The first co-op was established in 1956 and only three have been dissolved in 38 years (Morrison 1991: 174). Typically, over 75% of new businesses fail during their first five years when established by private entrepreneurs and investors[2], but none has failed in this period at Mondragón. Ellerman (1982: 4) quotes a 80% to 90% failure rate in the US and goes on to say, 'Entrepreneurship has not only been successfully institutionalised and socialized in Mondragón; it has been dramatically improved'. This 'quantum leap over the quality and type of entrepreneurship' provides sufficient reason to analyse the Mondragón system of governance. However, there are six more no less important reasons.

The second reason is that on a number of other measures, the performance of the co-ops has exceeded that of conventional firms owned by investors, families or owner/managers. Thomas & Logan (1982: 109) have shown that 'the cooperatives are more efficient than many private enterprises', and 'there can be no doubt that the cooperatives have been more profitable than capitalist enterprises'. Thomas & Logan (1982: 126–127) conclude:

> Various indicators have been used to explore the economic efficiency of the Mondragón group of cooperatives. During more than two decades a considerable number of cooperative factories have functioned at a level equal to or superior in efficiency to that of capitalist enterprise.

> The compatibility question in this case has been solved without doubt. Efficiency in terms of the use made of scarce resources has been higher in cooperatives; their growth record of sales, exports and employment, under both favourable and adverse economic conditions, has been superior to that of capitalist enterprises.

The objective of creating Mondragón firms was not to achieve sustainable competitive advantages but to create jobs with a fulfilling quality of life. As a result, the control structures have been designed so that the cost of finance is treated as a variable instead of the cost of employment.

This leads to a third reason for studying Mondragón firms which is because they have introduced a number of social inventions. Ellerman (1982) identified four major social inventions: (1) The legal structure of the cooperatives; (2) The bank, *Caja Laboral Popular* (CLP) which is largely owned by worker cooperatives as shown in Figure 1; (3) The direct self-managing membership role of the staff members in all the non-industrial cooperatives such as the consumer, agricultural, educational and superstructural cooperatives; (4) The Empresarial division of the bank which became a separate 'secondary' cooperative in 1991 shown in Figure 2 as LKS. The role of LKS is to sponsor the formation of new cooperatives and reorganise failing co-ops. To quote Ellerman, it is a 'factory factory', which has both 'institutionalised and socialised' entrepreneurship. Other important innovative governance relationships are described within and between firms in the next section.

The fourth reason for studying Mondragón is that it represents a system of social and political governance which is different from either socialism or capitalism. It provides an operational example of either 'Associational Democracy' (Hirst 1994) or 'Communitarianism' (Etzioni 1993) and a new way of 'Democratising The Wealth of Nations' (Turnbull 1975).

A fifth reason for studying Mondragón is that it provides evidence that economic transactions are not governed just by markets and hierarchies but also by 'personal relationships' and 'associations' (Turnbull 1994b). The outstanding durability and growth of Mondragón firms provide a more compelling case for 'relationship investing' (Monks, 1994), than even the performance of firms in a Japanese *keiretsu* does.

A sixth point of interest in that rapid regional economic growth was achieved without incurring the cost of servicing external equity or debt. Mondragón illustrates a new technique[3] for regions to develop on a self-financing basis without public or foreign investment or even a stock-market.

The seventh reason for this case study is that it demonstrates how 'action science' can be used to build world class internationally competitive firms. Action science is the process of researching and 'learning by doing'. This approach would seem to be well suited for developing the theory and practice of corporate governance. Examples of corporate governance action research are provided by CalPERS and Bob Monks in initiating shareholder resolutions to improve corporate performance (CalPERS, 1992; Monks, 1994), the process by which Daniel Tellep, the chairman and CEO of Lockheed, involved shareholders in selecting non-executive directors (Skowronski, W. & Pound, J., 1993), and the establishment of corporate senates in Australia (Turnbull, 1993a; 1993b).

Some background information on the founder of Mondragón is presented in the next section. The manner in which the unique corporate architecture of Mondragón evolved is described in section 2. A description of the internal and external governance structure of Mondragón co-ops is provided in section 4 and concluding remarks are presented in section 5.

2. The Founder of Mondragón[4]

Mondragón was created by a Spanish priest, Father José María Arizmendi who was born on a farm 30 miles from Mondragón in 1915. He died in 1976 having put into practice his social philosophy based on his own interpretation of Catholic social doctrine.

Arizmendi was a prolific writer and teacher but he never articulated a vision or wrote a manifesto. His native language was Basque and he spoke Spanish poorly. This made him an inadequate Spanish orator who spoke in a 'monotone' from the pulpit with 'intricate and repetitive phraseology difficult to understand' (Whyte & Whyte 1988: 28). In private conversations he was a hesitant speaker, often unclear and ambiguous, yet at times he could expound fundamental insights 'in brief and potent sentences'.

The Mondragón inventions were produced by the original thinking of Arizmendi who patiently and persistently harangued, cajoled and manipulated his associates into putting them into action. Often, his associates would only understand and appreciate his ideas after they had put them into practice! They 'learnt by doing' or in the words of

Arizmendi 'we build the road as we travel' (Whyte & Whyte 1988: 241). One gains the impression that the process of road building was more important than having a vision of where it led! While he saw co-operatism as a 'third way' he was a pluralist who thought that 'isms imprison and oppress us without providing any final answers' (Whyte & Whyte 1988: 237).

Mondragón is located in mountainous country 30 miles south of the Bay of Biscay and 40 miles south-west of the French-Spanish border. By the 17th century, Mondragón had established a reputation for manufacturing swords and arms of all types (Whyte & Whyte 1988: 10). After Franco came to power in 1939 the Basque language was banned until 1978. However, 50% of the people were still competent in the language which is un-related to any other. The Basques have always sought autonomy and had established democratic elections for local government as early as the 16th century.

Basques also had a tradition of sharing work on neighbouring agricultural land and through their guilds which promoted collective production and provided health and welfare services. Some of these traditions survived to the 20th century. Arizmendi grew up exposed to these practices and the presence of consumer co-ops, farmer co-ops, and credit unions. Although his family farm was privately owned it was part of a collective described as a 'hauzoa' (Mollner 1991: 66). Producer co-ops were not significant until the establishment in 1920 of the Cooperative Corporation for Marketing and Manufacturing Firearms, known as Alfa. Alfa was located in the commercial centre for the farm where Arizmendi was born and converted its business to manufacturing sewing machines in 1925.

Because he lost the sight of one eye when he was 3 years old, Arizmendi was not accepted by the Basque military for active service in the Spanish civil war against Franco. Instead, Arizmendi edited Basque newspapers for the military. After he gave himself up in 1937 he was questioned by his captors as to how he had been supporting himself. He replied that he had been a soldier in the Basque army and so was classified as a prisoner of war and later released. Many imprisoned with him were executed, including a work colleague who described himself as a journalist.

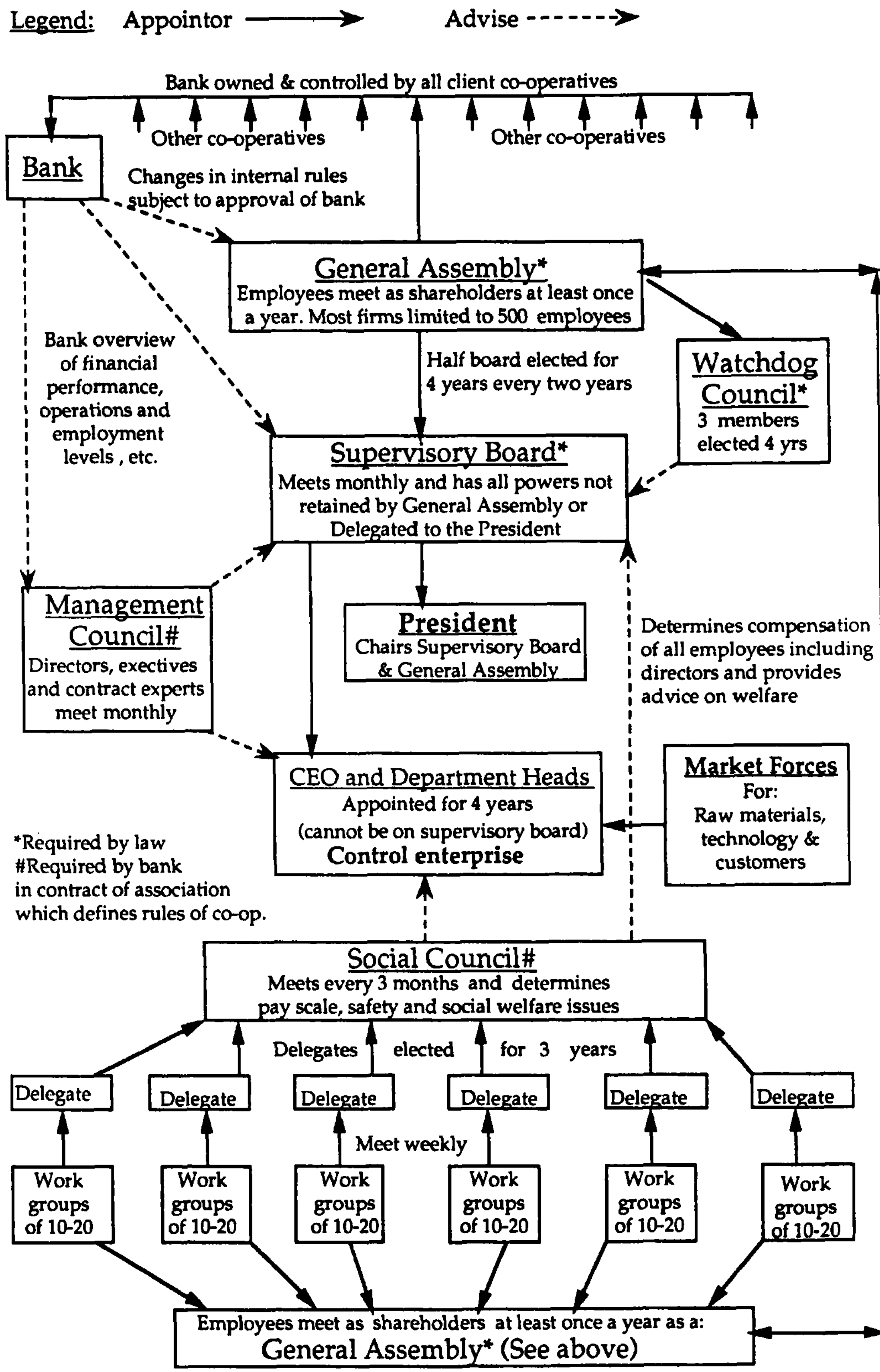
At the age of 26, Arizmendi took up his first duties as a priest in 1941. He was sent to Mondragón where unemployment in the region was 40–50%. At the time, Mondragón had a population of around 9,000 mainly working class people, with the economy dominated by a large foundry and metal working company, the Unión Cerrajera. Arizmendi was invited to provide religious instruction to their apprentices. Management rejected his request that the company teach industrial skills to other boys so he organised his own school, Escuela Profesional Politécnica (EPP) in 1943. The parents association which he formed as part of *Acción Católica,* became incorporated as the League for Education and Culture (LEC) in 1948 and is now known as Hezibide Elkartea. It created the knowledge, culture and relationships to build Mondragón.

3. Building Mondragón

The first graduates of the EPP later became the first members of the working class in Mondragón to obtain a university degree. Some obtained employment in the Unión Cerrajera which rejected Arizmendi's request that employees be allowed to purchase new shares being issued to finance expansion. Arizmendi then organised his parishioners to provide the relatively enormous sum, equivalent to US$361,604 in 1955, to finance the first worker co-op called Ulgor. It began with 23 members in 1956 making a paraffin cooking stove. By the time Ulgor became registered as a co-op in 1959 it had developed the governance architecture shown in Figure 1 but as yet without a management council or banker.

The precursor of the Ulgor Social Council was a social committee established in 1957 when there were less than 50 members. In 1958 the Franco government legalised collective bargaining on the basis that this was negotiated through a *jurado de empresa* (jury of the firm). Free trade unions were banned. The *jurado* was chaired by management and made up of no more than ten workers including technicians, clerical and manual workers in proportion to their numbers in the firm. In 1958, Arizmendi drafted the constitution of the first Social Council which modified the concept of the *jurado* to allow the unique form found in Mondragón to develop.

In 1958, a second co-op, Arrasate, was established to produce machine tools, some of which were sold to Ulgor. The founders of Ulgor rejected Arizmendi's suggestion in 1959 that they form a bank to finance new co-ops. In 1959 Funcor was formed in a nearby town as a co-op to produce foundry products. Later in 1959, Arizmendi forged the signatures of his disciples in Ulgor to incorporate the CLP. Its original shareholders



Sources: Ellerman 1982; Whyte & Whyte 1988; Morrison 1991

Figure 1 Governance of Mondragón Worker Cooperatives were the three newly formed worker co-ops and San José, an established consumer co-op.

Because members of worker co-ops were not considered to be employees under Spanish law they were not covered under the national social security system. The CLP began its existence with two divisions of savings and social security which operated through the offices of *Acción Católica,* and the Schools operated by LEC. The social security division was spun off in 1967 as a separate co-op called Lagun-Aro.

By the early 1960s, Ulgor had grown to one of the largest 100 industrial firms in Spain. Beside sponsoring Arrasate, it created Coprice to produce components for its oil stoves and heaters, and Ederlan to take over its foundry operations. Fagor Electrotécnica was formed to produce electrical equipment for the first three co-ops[5]. In 1967 all five co-ops formed the first co-op Group, or Relationship Association, named Ularco. It later changed its name to the product brand name of Fagor.

When Arizmendi joined the Church he gave up his hereditary right to the family farm to his younger brother. In 1960, Arizmendi's brother requested him to establish a co-op to market milk and timber produced by the farms. Arizmendi convinced the farmers that they should not follow the traditional approach which excluded workers but to form a hybrid governance structure in which workers would have equal rights to the farmers. Lana began in 1961 and by 1982 it had 300 farmers and 120 workers.

A co-op to provide married women with part-time employment was formed in 1965. Once again, Arizmendi met with resistance from males who did not want the traditional role of men being challenged. The co-op now provides hundreds of women with part-time work providing meals to co-op workers, cleaning and child-minding services.

When Arizmendi suggested that US$2 million be spent to create an applied industrial research laboratory in 1974 his suggestion was as usual, initially rejected. The laboratory known as Ikerlan moved into its new building in 1977 and pioneered both the development of industrial robots in Spain and a new governance structure.

The recession in the early 1980s resulted in one third of the co-ops requiring intervention by the CLP. While the bank continued to grow to become one of the most profitable in Spain, there was some introspection on the overall financial stability of the group. To provide additional financial strength an Intercooperative Solidarity Fund (ISFO) was established by placing a levy on all individual members. The Mondragón Congress and its executive arm, the Council of Groups was established in 1987 to manage this fund and co-ordinate the whole system. It also created balance to the dominating power of the CLP.

4. The governance of Mondragón firms

The control architecture within and between Mondragón co-ops is outlined in Figures 1 and 2. The architecture is far more complex than the simple hierarchical control relationships found in most entrepreneurial, family or investor-owned firms. Rather than create problems, the complexity creates operational and competitive advantages by allowing specialisation and the simplification of responsibilities and duties of executives and directors. Other advantages are described in Turnbull (1993c: 235).

Worker co-operatives[6]

Figure 1 illustrates the architecture of a worker co-op which does not have the complication of also directly including consumers in its control structure. The constitution of Mondragón producer co-operatives decentralises control into four formal organs: the General Assembly; the Supervisory Board; the Watchdog Council; and the Social Council. There is also an informal Management Council.

The General Assembly, Supervisory Board and Watchdog Council are required by Spanish co-op law (Thomas & Logan 1982: 26). The Management Council and Social Council are Mondragón innovations. The constitution or by-laws of co-ops are subject to the approval of the bank, the CLP. Only co-ops which have a Contract of Association with the CLP are members of the Mondragón System. Membership of the Mondragón Corporación Cooperativa (MCC) is voluntary which provides a united interface with the external world for most of the Mondragón system.

The General Assembly of each co-op must meet at least once a year and periodically elects by secret ballot directors for four-year terms on a one-member/one-vote basis. Only employees can be elected. To ensure that members have a choice, there must be three nominees for each board position. Nominations are provided by the Social Council, the Supervisory Board and from the body of the General Assembly whose members vote on the outcome (Mollner 1991: 145).

Half the board is appointed every two years. The board appoints the Chief Executive Officer (CEO), the President/chairman and the different department heads who cannot be board members. At the discretion of the board, executives may attend board meetings and speak but not vote.

Governing powers not delegated to the President or reserved for the General Assembly devolve to the Board. The separation of the executive (CEO and department heads) and the board which appoints and monitors executive performance is in the tradition of European multiple boards described in Analytica (1992). The Board is in turn accountable to the General Assembly which examines and approves the accounts, any changes in the financial or management structure of the business or the level of initial capital contributions by new members.

The co-op is legally represented by the President who chairs both the Supervisory Board and the General Assembly and who may convene either at his or her discretion. An Extraordinary Assembly may also be called by a petition from one third of its members or by the Board. There is usually a 12 member Supervisory Board which must meet at least monthly and meetings can be called by any two members.

The Management Council is an informal advisory and consultative body, composed of senior members of both Management and the Supervisory Board. It meets monthly and is composed of the President, department heads, and outsiders who may be contracted for their special experience and skills.

The Social Council reports to both Management and the Supervisory Board. It has wide prescriptive and advisory powers in all aspects of personnel management. It has more power than the workers councils found in Germany or the *Comité d'entreprise* of French firms (Analytica 1992).

The Social Council decisions are binding in such matters as accident prevention, work safety and work hygiene, social security, wage levels, administration of social funds, and welfare payments. Sections of 10 to 20 workers elect delegates for three-year terms, who can offer themselves for re-election with one-third being required to step down each year. Workers in each section meet with their delegate at least once a week and each co-op must hold a general plenary session of the Social Council delegates at least once every three months.

The manner in which the delegates are appointed make them relatively independent of the supervisory board and even more independent of the executive. They may be considered as a loyal opposition to management. As such they perform some of the functions that might be the concern of trade unions.

A most important activity of the Social Council is to determine the labour indices used to fix the rate of pay of each worker. Every job is evaluated on the basis of many characteristics such as the necessary training and experience, decision-making responsibility, social relational skills, physical and mental demands and special hardship factors such as danger, noise, etc. The indices for all blue and white collar workers are published in a manual for all to see.

All co-operatives restrict the ratio of top to bottom pay ratios to the same figure; this was initially three to one and has been increased to six to one with some exceptions (CLP 1991). The Social Council is kept separate from senior management by a by-law which requires its members be workers who have indices in the lower levels.

The Watchdog Council consists of three members directly elected by the General Assembly for a four-year term. Its function is to obtain, monitor, and audit financial information any or other information requested by the General Assembly. The Watchdog Council also reviews the overall conduct of management, the Supervisory Board, the Social Council council and 'also serves the role of ombudsman' (Mollner 1991: 154).

The Watchdog Council may call in the CLP or the Lankide Suztaketa (LKS), an entrepreneurial co-op, to strengthen its position or to monitor and guide management. The CLP has computer access to the accounts of each co-op which allows it to monitor operations continuously and evaluate operations with rights of intervention. The bank has an Intervention Department for helping its clients. The Contract of Association requires co-ops to provide information[7] to the bank and to place their funds on deposit with the CLP.

The functions of the Watchdog Council are much wider than an audit committee formed in unitary boards of Anglo-Saxon firms. It has a somewhat similar role to the *Cours des Comptes* in French State-owned firms or *Censeurs* found in French financial institutions (Analytica 1992). The Corporate Senate developed in Australia was modelled on the Watchdog Council (Turnbull 1994a).

Some co-ops have other operational stakeholders as members besides workers. Individual farmers who supply produce to a processing and marketing operation become members with the workers to form a 'hybrid' supplier/worker co-op. The retail chain store is a customer/worker co-op with 80,000 customer-members and 800 worker-members. The appointment of directors in hybrid and/or secondary co-ops are summarised in the Appendix. Unlike co-ops in the same type of business found elsewhere in the world, hybrid co-ops do not provide patronage dividends. Surpluses are distributed in the same way as in worker co-ops except for the 'stakeholder' co-op described in the Appendix.

Distribution of co-op profits

Technically, the workers are not paid a fixed wage but earn a share of surplus revenues over all non-labour costs. An anticipated part of this surplus (*anticipos*) is paid like a regular wage during the year with a bonus paid at the end of the year after the actual surplus has been determined. Up to 90% of the surplus is retained to increase the equity base of the firm. The level of anticipos is established according to prevailing wage rates in the region.

For the purpose of calculating net earnings under Spanish law, the anticipos is treated as the full wage paid to the workers whereas they are entitled to a 100% of all net earnings. However, at least 10% of net earnings is spent on social and educational expenditures as a 'social dividend' as is required by Spanish law. Of the 90% remaining, at least 20% is retained in a collective account to create a reserve with the outstanding 70% allocated to individual internal capital accounts. The allocation is proportional to the pay index established by the Social Council for each worker.

That part of the surplus which is not considered a wage under Spanish law, can be reinvested in the co-op to finance new investment or placed on deposit with the CLP as required in the Contract of Association. The surplus retained in the collective account increases the equity of the co-op. Members can draw on their individual accounts on retirement and recoup their fixed membership subscription.

However, unlike a membership subscription to a traditional co-op, the amount accumulated in the internal capital account will vary considerably among members according to their pay levels and length of service. Like some pension schemes, the individual accounts are portable between firms, an important feature as diversification and growth in the Mondragón system is achieved through spinning-off additional activities to new co-ops. Portability is also required to facilitate job rationalisation within the Mondragón system.

Traditional co-ops, non-profit and common ownership firms do not allow workers any right to retained earnings. The traditional approach creates an incentive to distribute all profits and so deny equity financed growth. Nor does the Mondragón approach create a barrier to entry for new workers as they do not need to purchase shares at a value which reflects retained earnings. The share price increases with the success of the firm in adding value. Beside creating a barrier to entry, this creates a liability for US ESOP companies which are required to purchase back the shares of departing employees at a fair market price.

The bank and other second order co-operatives[8]

'Second order' or 'super structural' co-operative is the term usually used to describe co-ops formed by other co-ops so that no individuals are members. In Mondragón, this term is used to describe firms which have both workers and other co-ops as members. The second order co-ops in Mondragón are involved in banking, entrepreneurship, industrial research and development, education and work experience, retailing, food production, and the provision of social security and health care services.

The bank (CLP) has a similar architecture to the producer co-ops with some differences. A distinguishing difference is that beside its 1,300 or so worker members, the bank has 150 or so customer co-op members who are party to a contract of association with the bank.

The co-op members may also contribute to both sides of the balance sheet of the bank through their deposits and/or loans. The bank is thus controlled by its lead stakeholders who have an operational interest in its activities as workers, suppliers and/or customers. Of its 12 directors, 8 are elected at its General Assembly by member co-ops and 4 by its workers with half this number being appointed every year for a two year term. The distribution of the 8 co-op representatives is usually 5 or 6 from the industrial co-ops, 1 from the consumer co-op and 1 or 2 from the other second order co-ops.

While the principle of one member one vote is used to elect directors within the two categories of members, the proportion of directors represented by either category is fixed and so not determined by either the relative number or relative size of the financial stake of either category. Nor are the considerable surpluses generated by the bank shared with their members in proportion to their patronage as is practiced with traditional agricultural and consumer co-ops. Instead, allocations to the internal capital accounts of CLP workers are made according to the average profits allocated to all members in their client producer co-ops according to their respective pay index. This approach is also quite different from the practice of credit unions, banks and corporations which distribute profits to their members according to the size of their investment.

The sharing of client profits by CLP employees creates an incentive to establish new co-ops, support them and enhance their profitability. It explains why interest payments of co-ops with trading difficulties may be waived and why this may be extended to principal repayments. When the CLP was founded it was only authorised to make loans to its shareholders and this reinforced the incentive to create new client co-ops.

The incentive to make the cost of finance a variable instead of the level of employment is reinforced by the cost of unemployment benefits being a cost to all co-operators participating in the voluntary social security and health care co-op, Lagun-Aro. The internal accounts of Lagun-Aro workers are based, like the bank, on the average net surpluses of the primary co-ops. This is also a stimulus for their preventive medicine programs. In the early 1970s the bank hived off Lagun-Aro into a separate co-op and in 1991 the entrepreneurial department was spun off into Lankide Suztaketa (LKS).

By 1992, the CLP had over 213 branches and held regional assemblies for its depositors. In its formative stages, it also provided membership to its individual depositors, but this was not continued. Rapid growth of the bank has been achieved even though its branch operations were limited to the four Basque provinces. In 1991 the bank obtained the authority to operate on a national basis (CLP 1992).

The supervisory board of the student work experience co-op, Alecop has equal representation of its three principal operational stakeholders, the students, permanent staff and the customers who purchase its output.

The League for Education and Culture (LEC) oversees the education system which now encompasses many schools including a Polytechnical School, Business School and a Professional College. LEC provided the technical knowledge, cultural values and social networks which created Mondragón.

In 1948, LEC obtained a charter with four classes of members: individual supporters, active members who contributed services or monthly dues, business sponsors who made annual subscriptions, and elected community officials. Each class elected ten delegates to a General Assembly who in turn elected a fourteen member school board. Six board members were representatives of business sponsors and one was the Mayor of Mondragón (Whyte & Whyte 1988: 30).

Inter-firm governance

The control relationships between the co-ops are illustrated in Figure 2. There are 12 'Groups' or 'Relationship Associations' formed by co-ops producing related products or sharing a common geography. Some of these associations represent 'offspring' co-ops formed to take over products or services originally produced by an existing co-op. This process is assisted by LKS which provides a *padrino* or 'god-father' (Ellerman 1982: 29) to act protectively for new offspring[9]. The CLP acts like a 'rich uncle' providing finance and the Relationship Association provides 'family' support.

Relationship Associations provide a basis to obtain 'some of the advantage of both large scale and small-scale operations' (Ellerman 1982: 9). Ellerman goes on to explain that the Association:

> . . . allows small or medium-sized co-ops to have common sales and marketing arrangements, common planning of product development and market strategies, and risk-sharing by a degree of income pooling and job pooling. . . .

As a result, Relationship Associations blur the boundaries of Mondragón firms. Firms in a Relationship Association or conglomerate are likely to be suppliers and/or customers with each other as found in a Japanese *keiretsu.*

The General Assembly of an Association or Group is made up of individuals of the supervisory boards, watchdog committees and management councils of its members. The Assembly approves accounts, budgets and membership of the Association and elects a governing council. The governing council of a group establishes common accounting, legal and administrative systems, negotiates new manufacturing licences and relationships with outside firms and oversees the creation of new co-ops. The plans of the governing council are evaluated by a Central Social Council made up of delegates from each of the Social Councils of each member.

Representatives of the 12 conglomerates or groups meet every three months with representatives from the retail co-op, educational

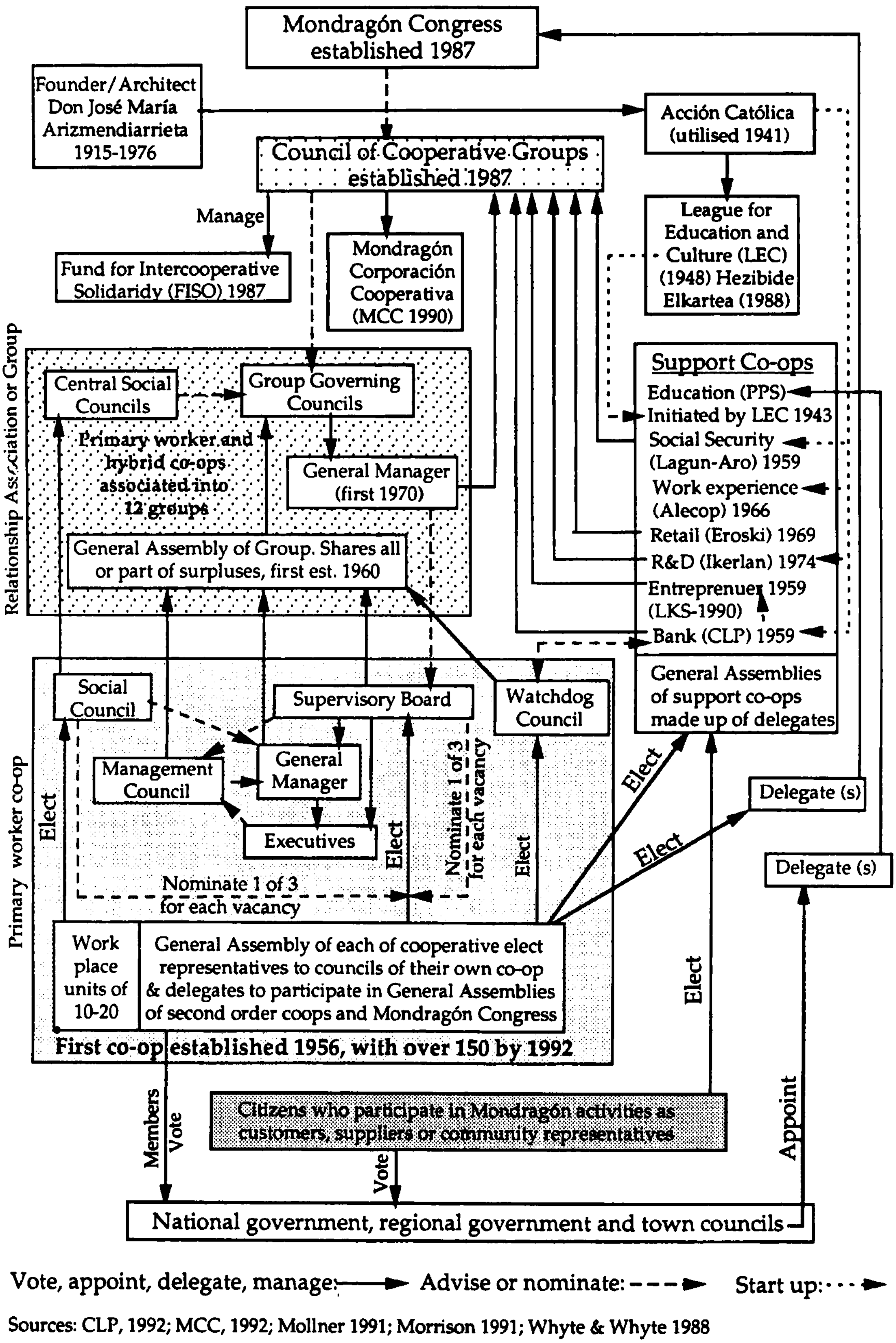


Figure 2 Mondragón Cooperative Social System (with dates of establishment)

co-ops, Social Security Service and Industrial Research Institute as a Council of Groups. This provides a forum for furthering cooperation between the Groups and with the other support activities.

Over-arching the Groups in a similar manner as the boards of individual co-ops over-arch their social councils, there is a Mondragón Congress (see Figure 3). The 350 members of the Congress are appointed by proportional voting by all members of each of the co-ops. The Congress meets every two years and appoints a Standing Committee and members of the Mondragón Corporación Cooperativa (MCC) which could be viewed as a holding company. MCC publishes an annual report which provides a 'balance sheet' (MCC, 1992) with consolidated figures of all related co-ops and the total number of workers, sales, and exports.

Like a holding company, the MCC reports on the activities of its members on a divisional basis. They are grouped into three divisions: Finance with 8 co-ops, Industrial with 73 co-ops, and Distribution with 10 co-ops. There is also a 'Corporate' group of 11 co-ops involved in tertiary activities like education, social security, and industrial research.

5. Concluding remarks

Mondragón firms have survived and prospered during the recessions of the mid-1970s and 1980s. The industrial firms have illustrated their international competitiveness by exporting around 25% of their output. The competitiveness of US firms in relation to those in Japan and Germany has been analysed by Porter. Porter (1992: 13) found that:

> The U.S. system may come closer to optimizing short-term returns. However, the Japanese and German systems appear to come closer to optimizing long-term private and social returns. Their greater focus on long-term, corporate position and an ownership structure and governance process that incorporate the interests of employees, suppliers, customers, and the local community allow the Japanese and German economies to better capture the social benefits that can be created by private investment.

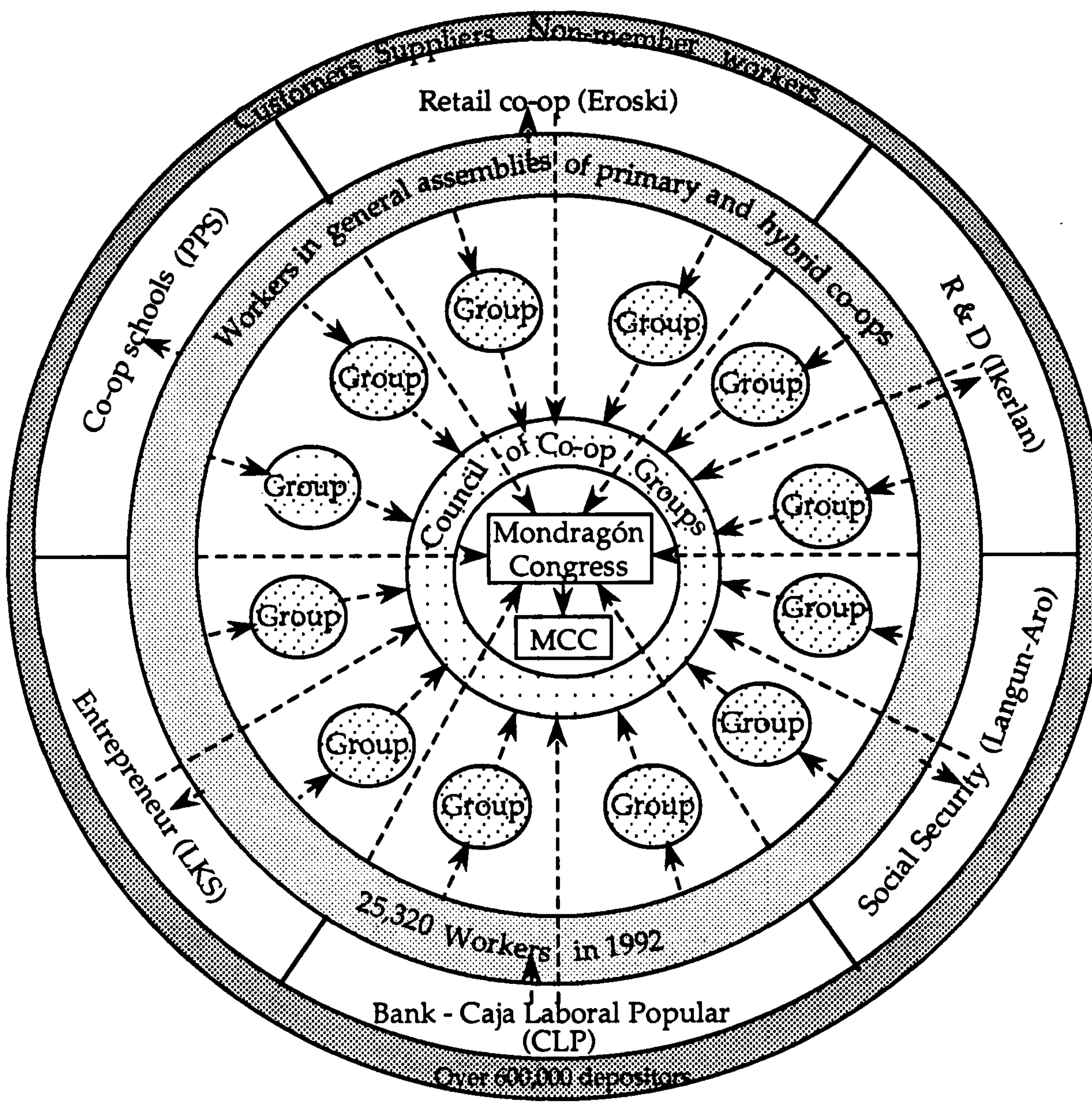
As a result of his findings, Porter recommended that US firms modify their ownership and control structure by 'encouraging long term employee ownership' and to 'nominate significant owners, customers, suppliers, employees, and community representatives to the board of directors'. Implicit in Porter's findings and recommendations is the view that corporate governance is a determinant of competitiveness. The outstanding performance of Mondragón firms and their unique system of governance supports the implicit hypothesis of Porter.

The participation of employees, customers, suppliers and community in the governance of Mondragón firms also supports Porter's findings and recommendations for improving the competitiveness of US firms. However, Porter made his recommendations in the context of unitary boards which are found in countries with an Anglo Saxon culture. Williamson (1985: 298–325) describes why the presence of operational stakeholders such as employees, customers and suppliers on a unitary board would be counter-productive. By only recognising the different type of owners and controllers and not the differences in their control system, Porter's recommendations become flawed. In Porter's own words (1992: 14) 'Many current proposals for improving the U.S. system are counter-productive. They suffer from a partial view of the problem and address its symptoms rather than its causes'.

However, Williamson (1985: 305) recognised the possibility '. . . to invent a governance structure that holders of equity recognise as a safeguard against expropriation and egregious mismanagement'. The Mondragón inventions support the speculation by Williamson and demonstrate a control system which would allow Porter's recommendations to be effective.

The way in which the control architecture of Mondragón firms was custom designed to suit both their activities and the nature of their principal operational stakeholders is summarised in the Appendix. The way in which the Mondragón system grew and changed over time is partially revealed from the dating of various developments in Figure 2.

Growth of Mondragón is fundamentally different from the growth of firms with non-active shareholders. Mondragón has grown through the creation of new firms not through the growth of individual firms. Many of the new firms are 'offspring' created by people and assets being transferred from one or more existing firms. In this way, existing firms are kept to a 'human scale' which is generally accepted to be around 500 employees (Morrisson 1991: 80). The incentive and support structures facilitate this process, especially the entrepreneurial experience of the LKS, the finance available from the CLP, and the sharing of operational services of the sponsoring group.



More than 150 primary worker and hybrid co-ops are associated into 12 groups or relationship associations
Total 1992: Assets US$6.3 bn.; Sales US$3.0 bn.; Exports US$380m.

Sources: Whyte & Whyte (1988); Morrison (1991); MCC (1992)

Figure 3 Control Network of Mondragón Activities

Beside creating new firms, the system intervenes to re-organise firms that may be failing even to the extent of 're-birthing' them into a completely new business (Ellerman 1982: 36). The description by Kester (1991) of how Akai Electric, a major Japanese manufacturer of audio and video equipment was re-organised by other firms in its *keiretsu* led by Mitsubishi bears a striking resemblance to how Mondragón firms in distress are re-organised as described by Whyte & Whyte (1988: 175–183).

The process of re-allocating people and other resources is not determined at arms length solely by market forces or by creditors and their agents but through direct negotiation between the principals as occurs when professional partnerships merge or divide. However, unlike traditional partnerships, there are agents like the CLP, LKS, Lagun-Aro and representatives of the local co-op group to mediate conflicts and trade-offs between the various parties who may have to make sacrifices.

While the various types of basic control architecture of Mondragón firms may not change, the structural relationship between firms and their support organisations continues to evolve. Mondragón is still 'learning by doing'. Arizmendi imparted cultural values to his students which guided the 'trial and error' development of the Mondragón social inventions (Simmons & Mares, 1983: 140). He believed that 'it is better to make mistakes than to do nothing' (Whyte & Whyte 1988: 241).

The students of Arizmendi were involved in 'action learning' or 'action research' and operated in a 'phenomenological paradigm' as described by Easterby-Smith, Thorpe & Lowe, (1991: 27) rather than the traditional 'positivistic' approach. The need for phenomenological research or what Gummesson (1991: 15) describes as the 'hermeneutic' (interpretive) approach becomes particularly relevant when qualitative rather than quantitative measures of performance are involved. It is the qualitative factors which Porter (1992) identified as being the most important for firms seeking competitive advantages. The motivation for creating the Mondragón system was to improve the quality of life. Sustainable business success was a by-product.

Academic research into the theory of the firm has developed in a positivistic paradigm while Arizmendi and his colleagues learnt about the theory and practice of firms using a hermeneutic paradigm as identified by Gummesson (1991: 153). The Mondragón experience suggests that action science offers a promising approach for developing the theory and practice of governance.

Appendix: Outline of Mondragón Governance Architecture

Hezibide Elkartea, formerly the League for Education and Culture (LEC)

There are four membership categories:

(1) Any interested persons,
(2) People who contribute monthly with either money or teaching services,
(3) Businesses who make a minimum annual payment,
(4) Community officials.

Each membership group elected ten representatives to a general assembly who in turn elects fourteen person school board of the Escuela Professional Politécnica, (EPP) established in 1943. Six members of the board are representatives of contributing enterprises and one is the Mayor of Mondragón. Since the formation of EPP, a number of other educational institutions have been established.

Worker co-operatives (See also Figure 1)

Membership open to anyone accepted as an employee. Members as a body elect:

(1) Supervisory board of nine to appoint, direct and control management.
(2) Watch-dog Council of three to audit accounts and governing procedures.
(3) Delegates to represent co-op interests with related Secondary Co-ops.

Groups of 10 to 20 members who are most closely associated in their work-place appoint a delegate to a Social Council to look after the quality of their employment and determine pay indices which determines share of co-op income.

Hybrid co-ops

The governance architecture follows the design of worker co-ops with changes outlined below:

Bipartite worker/consumer

Retail (Eroski, 1969?), Supervisory board with equal number of workers and consumers with a consumer as chairman.

Bipartite worker/supplier

Agriculture (Lana, 1960; Miba, 1963; Barrenetxe, 1980; Cosecheros Alaveses, 1983; Behi-Alde, 1983; Etorki, 1984), Supervisory board with equal number of workers and suppliers (farmers).

Tripartite worker/student/parent
Student work experience co-op (Alecop, 1966). Supervisory board with equal numbers of staff, students and parents.

Stakeholder co-op
Pig farming (Artxa, 1984). Stakeholders appoint representatives to the supervisory board in proportion of the *value added* by each class of stakeholder being the customer (Eroski retail store): pig farmers (Anoga) who fattened progeny of the co-op under contract; a supplier of feed, equipment and veterinary services (Miba), and workers of Artxa. Anoga was not part of the Mondragón system being the Asociación Norte de Ganaderos Northern Livestock Farmers Association).

Secondary co-ops
(Other co-ops as shareholders)

Bank (CLP, 1959), Social Security (Lagun-Aro, 1959), Industrial Research and Development (Ikerlan, 1977). Supervisory board with equal number of workers and clients (bank borrowers, contributors to social security, users of research).

Tertiary governance organs
(Refer also to Figures 2 & 3)

Group Governing Council for 'Relationship Associations' or 'Conglomerates'. General Assembly of each group is made up of members on the Supervisory Boards, Watch-dog Councils and Management Councils of each member. Council represents co-ops with associated business or community activities and may share all or part of their operating surpluses and establish new co-ops.

Central Social Council
Membership made up of delegates elected by social councils of each co-op in group. Council advises on transfer and conditions of redeployment of individuals within the group.

Mondragón Congress
Representing individual members of system who are members of a co-op which agrees to join. Each member of joining co-op makes a small annual contribution to an Inter-cooperative Solidarity Fund, *Fondo Intercooperativo de Solidaridad* (FISO). FISO is managed by the Council of groups to assist co-ops in financial jeopardy.

The Mondragón Congress meets every two years with at least one delegate elected by the General Assembly of each member co-op. Larger co-ops may have additional delegates but not so many that the total number of delegates exceeds 350. The Congress provides a forum for discussion and debate on major issues of policy. Increasing the ratio of top to lowest pay rates from 4.5 to 6 is an example.

Council of Groups
This is the executive arm of the Mondragón Congress made up of the General Manager of each group and the general managers of the support co-operatives. However, the educational co-ops are not represented. The Council of Groups has its own secretariat.

Mondragón Corporación Cooperativa (MCC)
Provides a unified front with external bodies of all operations represented in the Mondragón Congress. The MCC accounts consolidate all income, expenses, assets and liabilities of its members as if they were subsidiaries. The directors of the MCC are the Council of Groups and the MCC reports on its operations not by groups but on a divisional basis in which its operations are departmentalised into more traditional categories each with its own "Managing Director". The categories are: Capital Goods, Automotive Components, Domestic Appliances, Industrial Components and Services, Construction, Household Goods, Distribution, Finance and Corporate Activities such as Education, Business Training and R&D.

Notes

1. In the Basque language, Euskara, the name of Mondragón is Arrasate.
2. In a study of 113,780 new firms established in Australia from 1973 to 1985, Reynolds, Savage & Williams (1993) found that around 74% of them had failed in five years.
3. Other techniques of self-financing regional development are described by Turnbull (1993d).
4. This section is based on information from Whyte & Whyte (1988).
5. Many examples of how communities grew by this process of import substitution have been identified by Jacobs (1985) and popularised by Porter (1990).
6. In this section, I am indebted to Ellerman (1982).
7. The information required is set out in Appendix B of Campbell, et al. (1977).
8. In this section, I am indebted to Ellerman (1982) and MCC (1992).
9. The word "offspring" is used in the same sense by Turnbull (1991) when describing how Ownership Transfer Corporations (OTCs) would finance new activities and/or perpetuate their own activities at the end of their licence to

exist. The offspring firm would typically be owned and controlled by the individuals who were its operational stakeholders rather than by the parenting enterprise.

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