

THE INSTITUTIONAL STRUCTURE AND ECONOMIC RATIONALE  
OF CO-OPERATIVE ORGANISATION IN CYPRUS

by

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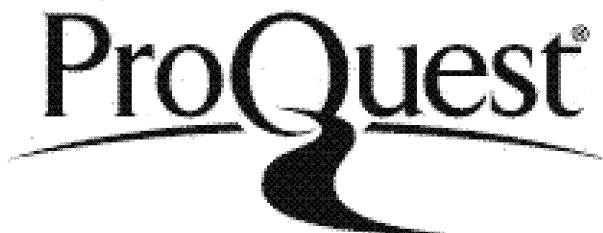


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## Abstract

### **Title: The institutional structure and economic rationale of co-operative organisation in Cyprus**

This thesis presents an examination of the role of co-operatives in the economic development of pre-independent Cyprus and also in the economic reconstruction effort following the war events of 1974. The provision of credit is a key element of the contribution made by the co-operative movement during these two different phases of the island's modern economic history; first agricultural credit and then housing credit.

Government involvement is treated as a very important variable in the co-operative function and various types of such involvement are examined in the course of the thesis, ranging from zero to maximum government input. This maximum type relates to a situation where the initiation, financing and control of co-operatives are tightly in the hands of state agents. In this respect various aspects of institutional theory are applied in order to explain empirical findings.

Another important variable of the co-operative function relates to political party involvement. Existing beliefs about the ill-effects of politicisation are put to the test using highly sensitive empirical evidence from Cyprus, available to the author only due to his special relationship with the co-operative movement. The effects of such politicisation are also studied in relation to member participation.

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## CHAPTER ONE : INTRODUCTION

The great number of failures recorded in co-operative endeavours in many developing parts of the world have cast doubts on the appropriateness of co-operation as an effective instrument of economic development and as a vehicle of economic transformation and integration, especially in rural areas. Chambers, for example, notes that many social scientists who have studied co-operatives in Africa have found them to be inefficient, captured by the local elite to the exclusion or exploitation of smaller farmers, poorer people and women, suffering from poor repayment records, failing to pay their members, and having a high turnover of both staff and funds which tended to disappear simultaneously.<sup>1</sup> Braverman and Guasch cite empirical evidence which suggests that co-operative failures greatly outnumber successes.<sup>2</sup>

Yet national governments and international relief organisations continue to divert scarce resources into co-operative projects which they consider to be the only real hope for the deprived rural masses of the developing world. By resolution 49/155 on 23 December 1994 the General Assembly of the United Nations encourages governments to consider fully the potential of co-operatives for contributing to the solution of economic, social and environmental problems and to develop programmes aimed at improving statistics on the contribution of co-operatives to national economies and facilitating dissemination of information on co-operatives.<sup>3</sup>

The above resolution appears to take for granted that successful co-operatives are net contributors to economic development, especially in the case of rural areas in the developing part of the world. Some development economists however appear to hold a different view. Williams, for example, notes that co-operation imposed from above has rarely recouped its administrative costs in increased output and in some cases the more powerful members of a community have turned it to private advantage. He also claims

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<sup>1</sup> R. Chambers, **Rural development**, London, 1995, p31.

<sup>2</sup> A. Braverman and J. L. Guasch, **Institutional analysis of credit co-operatives**, in P. Bardhan(ed.), **The economic theory of agrarian institutions**, Oxford, 1991, p352.

that co-operation has rarely enhanced the well-being of its members and has usually subjected peasants to outside direction confirming their suspicion of state plans.<sup>4</sup>

Unfortunately there appears to be a general absence of any research attempts to measure the macro-economic contribution of co-operation in terms of GNP and employment both in a developing but also in a developed economic environment. This absence may be due to the co-operative sector appearing to have a small macro-economic impact in relation to other factors. Success or failure of co-operative attempts has so far only been defined and measured in terms of each individual co-operative's financial fortunes. The widely held assumption that co-operation helps to alleviate poverty and social inequality does not appear to be supported by what ever limited empirical evidence there is available. And yet the essence of co-operation from a policy maker's point of view should be its macro-economic potential and the resulting socio-political impact.

Failure to understand and take seriously such potential may lead some policy makers to view co-operatives as vehicles for attracting short-term injections of foreign aid but no more than that. Others may see co-operatives as important political instruments through which foreign aid is channelled through to government or party supporters. In both cases the self-help criterion for successful co-operation is failed.

Another subject area generally ignored by existing literature is the process of transformation of co-operatives within a changing socio-economic and political environment. Existing research on co-operatives has tried to establish causes of failure or success in a static environment ignoring co-operative behavioural patterns in a dynamic environment. This static approach is evidenced by the apparent absence of any coherent attempts to explain the various relationships between members, management, elected Boards, and state agents. Also inter-co-operative relationships appear to be ignored. All such relationships may prove to have an important bearing on the economic success or failure of a co-operative.

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<sup>3</sup> UN Document 95-76561, A/RES/49/155, 7 February 1995.

<sup>4</sup> G. Williams, *Taking the part of peasants*, in J. Harris(ed.), **Rural development**, London, 1992, p389.

The large amounts of valuable resources devoted to co-operative development in some developing areas, and the assumed potential of co-operation as an important economic policy tool, makes it important that there is a clear understanding of the economic nature of co-operation and the various forces at play during the planning, implementation, and development stage so as to establish the real causes of success or failure and suggest possible mechanisms for avoiding such failure which, according to existing literature, is the case in the majority of co-operative endeavours, especially in the less developed part of the world.

Most research on co-operatives has concentrated on establishing the technical causes for economic failure or success of various co-operative endeavours, paying scant attention to theory. Unsurprisingly, most of these findings seem to arrive at similar conclusions which include: lack of sufficient start-up capital; trying to do too much too soon; high levels of illiteracy; too much government interference; inappropriateness of western models of co-operation for some cultures; and failure to comply with internationally accepted co-operative principles.

The economic history of co-operation in Cyprus appears to tell a rather different story to the overall gloomy picture of co-operative failures, especially within the developing world. Not many decades ago Cyprus was still a developing nation with an economic structure not dissimilar to that of many developing countries today. However in the case of Cyprus it is often claimed that co-operation has succeeded in meeting its overall social and economic objectives.<sup>5</sup> Surprisingly, this apparent success has not attracted any serious academic research despite the fact that other features of Cyprus have repeatedly attracted the interest of political and economic scientists during the last thirty years.

The relatively small size of the island's economy offers a unique opportunity to study the macro-economic effects of co-operation within certain parameters. Its turbulent economic and political history provides the interested student with an excellent

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<sup>5</sup> See for example Ministerial comments in the daily Press; "ΣΗΜΕΙΝΗ" 13/12/1995, "Ο "ΑΓΩΝ" 4/7/1995.

opportunity to test some of the existing theories. Co-operation in Cyprus developed at a time when the island's economy was still in a backward state, with nearly 80% of its population relying on agriculture and in a very similar economic position as many of the developing areas around the world today. This means that lessons and conclusions drawn from the Cypriot experience could be used beyond the limited boundaries of a small island. The fact that Cyprus, in less than half a century, passed rapidly through several stages of economic development, offers the opportunity to draw conclusions about co-operation both as a tool of economic development in a developing country and also as an important player in a developed economy.

This introductory chapter explains the objectives of the thesis as well as the methodology used. Section 3 goes through the relevant theoretical framework by carrying out a literature review. Section 4 gives a brief historical background on Cyprus and section 5 describes the layout of the thesis.

### **1.1 Objectives/hypothesis testing**

Co-operative research so far appears to concentrate almost exclusively on establishing the causes of so many failures of co-operative endeavours, ignoring questions like the potential level of contribution to the economy, the effectiveness of co-operation as an instrument of economic development, and the role of co-operation after the economy has reached a certain stage of development.

One of the main objectives of this thesis is to test the effectiveness of co-operation, as compared to other economic policy tools, at various stages of economic development in the context of the modern economic history of Cyprus, and identify and analyse the various economic, social and political factors influencing this effectiveness.

Such factors will include the transformation from a developing rural based economy to a developed service oriented economy, segmental market inefficiencies, attitudes of a colonial administration, policy measures of a newly independent state, attempts by the state to use co-operation as an instrument of economic reconstruction following the

war of 1974, the role of government agents, the influence of party political agents, and organisational aspects within a specific legal framework.

## 1.2 Methodology

Traditional methods of research will be employed but the writer will also make extensive use of his own experiences as a Principal Auditor of co-operative societies in Cyprus for a number of years.

There are factors affecting co-operative behaviour which can not easily be comprehended by the pure research student or the international consultant. This is evident in many of the propositions put forward regarding the general causes of failure or success of co-operatives. So much of the same kind of advice has been offered without much success that it should have, by now, become obvious to the interested parties that perhaps some of the fundamental assumptions underlying the various studies are incorrect. To quote one angry commentator working for the co-operative movement in Africa, 'in the last thirty years in Africa I have listened to so many experts on co-operatives talk who in fact have not have the vaguest idea of what a co-operative looks like from the inside'.<sup>6</sup>

But it is not simply lack of personal experience that prevents easy comprehension or even that leads, sometimes, to miscomprehension. Firstly, in the same way that private business organisations are reluctant to part with what they consider as sensitive information, co-operatives can also be reluctant to give out such information voluntarily. Secondly, unlike business enterprises, the main objective of co-operative management decision making may not be based primarily on profit-making criteria but, rather, on various other motives, some of which are socially and politically acceptable in official discourse but some may not be so publicly acceptable. Not only do such motives remain unrecorded but hardly anyone is prepared to talk about them. Thirdly, co-operators tend to see themselves as good missionaries out to protect the lower middle classes and the working classes from the inequalities produced by the system,

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<sup>6</sup> Ph. K. Heinrich Bechtel, *The role of co-operation in the development of working funds supply and marketing in the agricultural sector of the third world*, in Johannes Worz(ed.), *Co-operation as an instrument for rural development in the third world*, Witzenhausen, 1983, p113.

capitalist or communist. As such, some have convinced themselves that the rest of society is out to get them. This creates a certain mistrust of all outsiders to the movement. This mistrust probably dates back to the initial days of co-operation when private money-lenders and merchants used all means at their disposal to stop co-operation from spreading.

The above mistrust and tendency for secrecy violates one of the most fundamental co-operative principles; that of democratic control. It is hard to imagine how such control can be effectively exercised by grass-root members unless there is the greatest degree of transparency.

### 1.3 Theoretical framework/Literature review

Most of the existing literature on co-operation deals with the causes of failure or success of co-operative attempts, mainly in the developing part of the world, through the study of individual cases, paying scant attention to the theory underlying the empirical evidence. Thus, a large volume of this literature resembles a technical manual repeating the same kind of instructions many times over.

The findings of most of these studies and the resultant recommendations resemble each other to such a degree that the reader can easily be fooled into believing that they have originated from the same source. And yet, these findings have been recorded decades apart and relate to different countries and people. They even relate to different types of co-operation; agricultural co-operatives, production co-operatives, and service co-operatives.

The fact that most of the weaknesses highlighted are common to all types of co-operatives is, perhaps, an indication that the basic nature of co-operation does not depend so much on the type of co-operative association and therefore the same analytical approach could apply to all the various forms of co-operation. In other words, what may matter is not the purpose or type of a co-operative endeavour but the nature of the co-operative act itself and how this is affected by the actions of various agents.

On a number of occasions co-operative literature appears partial, due perhaps to the fact that it originates from within the co-operative movement. Even worse, however, there appears to be a general absence of attempts to explain co-operative behaviour using tools of analysis taken simultaneously from a number of social sciences. The preferred treatment so far has been for each group of social scientists to study the co-operative function in complete isolation from other fields of the social sciences. This purely static approach may lead to erroneous conclusions. It is however useful at this stage to make a note of any such theories, which will inevitably form part of the testing material at a later stage of the thesis.

A good starting point to this theoretical exploration would be the assumed relationship between the so called principles of co-operation and the co-operative function. Many writers attempt to explain co-operative failure in terms of failure to abide by these principles. The approach is usually technical and assumes full validity of these principles.

On a more academic level economists like Valenti, Hanusch and Mariani have attempted to define the co-operative function in terms of market failure. Emelianoff, on the other hand, has defined co-operation in terms of the economic behaviour of its constituent parts, i.e. member households. This last approach can not be looked at in isolation from existing theoretical work on collective action. Emelianoff's doubts about the catalytic role of co-operation in reducing class differentiation and in assisting marginal groups appear to be confirmed by empirical evidence cited by Hanel and Khan.

The co-operative function has also been the subject of a much wider political debate between the socialists and anarchists on one side and the liberals and the conservatives on the other side. From a socio-political perspective socialists and anarchists see co-operative behaviour as far more appropriate and consistent with human nature, contrary to liberal and conservative philosophies which espouse the virtues of competition.

The emergence of the co-operative function has not escaped completely the attention of a third group of social scientists, sociologists. From a purely sociological perspective Craig describes a number of theories which attempt to explain the emergence of co-operative behaviour.

Finally, on a more practical level, writers like Mather, Larson, Mellor and Dobyns use empirical evidence from co-operative attempts around the world to explain certain properties of the co-operative function.

### 1.3.1 Co-operative Principles

Co-operation is generally held out to be an “ideology” based on a number of “co-operative principles” or “ideals” which were first pronounced by the Rochdale Pioneers in 1844. These principles were contained in the objectives as stated in the Statute of the Rochdale society which included democratic control, freedom for new members to join, payment of limited interest on capital, distribution of the surplus among members in proportion to their purchases, cash trading, purity and quality of the products, promoting the education of members, political and religious neutrality, sale at market prices, and voluntary membership.<sup>7</sup>

These principles were last revised at the ICA’s Centennial Congress and General Assembly in Manchester in September 1995. The new version consists of the following seven principles; voluntary and open membership, democratic member control, member economic participation, autonomy and independence, education, training and information, co-operation among co-operatives, and concern for community. The new version of the co-operative principles is to be contained within a “Statement on the co-operative identity”, which also identifies the basic co-operative values as self-help, democracy, equality, equity, and solidarity. Co-operators, it says, believe in the ethical values of honesty, openness, social responsibility and caring for others.<sup>8</sup>

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<sup>7</sup> John G. Craig, *The nature of co-operation*, Montreal, 1993, p32.

<sup>8</sup> Message from the International Co-operative Alliance, 73rd International Co-operative Day, 1 July 1995.

There is a general tendency in existing literature to assume that divergence from co-operative principles is the main cause for a great number of observed failures. What is lacking is a satisfactory explanation based on theoretical analysis of empirical evidence as to why divergence from traditional principles leads to failure and whether compliance can overturn the trend. It is also not clear in which existing economic, social and political systems compliance is possible or whether compliance is possible within all such systems. These deficiencies are not surprising, considering the scant attention paid to the theoretical framework, especially in the case of social scientists other than economists.

But even attempts to explain the nature of co-operation from a purely theoretical economic perspective have been few and appear to suffer from absence of supporting empirical evidence.

### 1.3.2 Economic functions

Professor Ghino Valenti, writing in 1902 points out that the co-operative movement is an organic part of the existing system of the exchange economy, and not an alien socio-economic ingredient designed and destined to replace this system. According to Valenti, a co-operative association is an institution which within the existing system of free competition aims to correct wholly or partly the natural imperfections of the distribution of wealth. He only recognises the co-operative character of those associations, which in their actual work compete with the capitalistic or speculative enterprises. The consumer stores are co-operative to Valenti, in as much as they correct the economic advantages of retailers and of wholesalers; the marketing associations are co-operative as the opposing bodies to other capitalistic agencies in the market. Valenti refuses to recognise the co-operative character of such organisations as livestock insurance co-operative societies, cow testing associations and some other similar co-operative organisations for the single reason that in their respective fields capitalistic or speculative enterprises do not operate and therefore there is no actual conflict of interests. In the words of Valenti himself "there is no antithesis which determines a co-operative function."<sup>9</sup>

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<sup>9</sup> I. V. Emelianoff, **Economic Theory of Co-operation, Economic Structure of Co-operative Organisations**, Michigan, 1942, pp17-20.

Valenti's theory, according to Emelianoff, fails to be convincing since in most lines of their economic activities co-operative associations do not actually compete with capitalistic enterprises.<sup>10</sup> This claim by Emelianoff does not seem to hold true in the case of the Cypriot co-operative movement as will be seen later in this study.

Hanusch analyses market failure from three different perspectives; the macro-economic level, which relates to a violation of the conditions guaranteeing full employment, the meso-economic level, which relates to welfare losses due to monopolisation tendencies, and the micro-economic level, which relates to market failure due to the inability of the market supplier to exclude consumers from the use of a good more commonly known as public good.

Co-operative solutions for correcting market deficiency are considered inappropriate in the case of macro-economic problems as a country's economic policies are the business of the central government. In the case of the micro-economic level, co-operation has a small part to play. This is mainly found in the housing construction sector. It is at the meso-level of national economic activity that co-operation is thought to have a major part to play. Through voluntary union, producers or consumers aim to benefit from the advantages of size or the spread of certain economic risks over a large number of persons.<sup>11</sup>

Both Valenti's and Hanusch's theories touch upon the very important issue of the relationship between co-operative development and the state of the market. During the course of this study an attempt will be made to establish whether such a relationship exists and to what extent.

One of Valenti's followers, Italian economist Mariano Mariani, believed that the economic behaviour of co-operators is dictated by considerations of the immediate economic benefits from participation in the co-operative associations compared with

<sup>10</sup> Emelianoff, 1942, pp19-20.

<sup>11</sup> H. Hanusch, Market and bureaucratic failure as a problem of self-help development, in E. Dulfer & W. Hamm(eds), *Co-operatives in the clash between member participation, organisational development and bureaucratic tendencies*, London 1985, pp59-62.

the economic sacrifices of membership involved. The following definition is given by Mariani:

“A co-operative association is a voluntary association of the purchasers or sellers of labour and of other goods with the aim to improve the purchaser’s and sellers’ prices, and achieving it by an organisation of their own enterprise respectively for buying or for selling.”

According to Mariani the mission of the co-operative movement is to counteract the extremes of economic differentiation in different lines and in various degrees. For instance, the members of co-operative credit associations concentrate the functions of the organisers and of the patrons of credit; in marketing associations the functions of manufacturing are fused sometimes with the functions of producers of raw materials and of middlemen; the consumers’ co-operatives with complete potential restoration of production for consumption in some lines of activities at least, can bring in the most radical change of this kind. Mariani believes that co-operation is capable to a certain degree of softening and abbreviating social conflicts which result from economic differentiation.<sup>12</sup>

One of the weaknesses in Mariani’s theoretical approach is that he fails to ask the question as to what stage of its development and under what circumstances does co-operation assist in the reduction of economic differentiation and whether there is any possibility at some stage of the reverse occurring. In the case of the former USSR, for example, co-operatives were seen as the vehicle of transformation from a centrally planned economy to a free market economy. One of the main reasons for the strong popular opposition to the co-operatives during the perestroika period, 1987-1991, was said to be the fact that co-operatives were seen to increase economic differentiation.<sup>13</sup> This study on Russian co-operation, however, does not offer any theoretical explanation as to why co-operation may lead to economic differentiation.

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<sup>12</sup> Emelianoff, 1942, pp20-23

<sup>13</sup> A. Jones and W. Moskoff, **KO-OPS, the rebirth of entrepreneurship in the Soviet Union**, Bloomington, 1991, p94.

Emelianoff uses retailers co-operatives, which were meant to increase the competitive position of small retailers, as an example to illustrate the fallacy that co-operative organisation is a specific economic instrument of the underprivileged classes.<sup>14</sup>

### 1.3.3 Co-operatives and class structure

Alfred Hanel observed that poverty is particularly concentrated in Asia and Africa, and there again in rural areas. It was in these countries that rural co-operatives were set up with great expectations but failed. Particularly since the beginning of the 1970s there has been considerable criticism in the developing regions of organisations legally registered as co-operatives. They had been expected to integrate sufficient members from poor segments of the population, and to change socio-political power structures to the advantage of these persons. In fact they supported the wealthier members, thus increasing income differentiation and exacerbating dualistic structures and social conflicts in the rural sphere. Hanel also observed that criticism concentrated on the officialisation of co-operatives leading to slender chances and incentives for financially weaker members to take part effectively in target setting, decision and control processes, and the promotional services of the co-operatives.<sup>15</sup>

Writing about co-operation and marginal groups Khan says that co-operatives are unable to bring about any structural changes which should enable them to service the needs of these marginal groups. Hence, he thinks it is natural and logical that co-operatives in an inappropriate setting tend to reproduce the existing social structures among rural communities with their power and elite control effecting the decision-making process. The control of co-operative committees and management will rest with the better-off elite, the dependency between the rich and the marginal groups will tend to perpetuate and rather strengthen, and the inequalities between the haves and have-nots will increase.

Khan concludes that a co-operative is, by definition, neutral to various systems, class interests, types of activities and stages of rural development. A co-operative

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<sup>14</sup> Emelianoff, 1942, p168.

<sup>15</sup> A. Hanel, Self-help promotion by governmental and semi-governmental organisations, in Dulfer and Hamm(eds), 1985, pp252-253.

organisation can serve the interests of marginal groups provided they have catalytic support from outside.<sup>16</sup> This proposition is extremely important with regards to efforts in the developing world to promote rural development and social integration through co-operation and will be tested in a later chapter on the basis of empirical evidence from Cyprus.

One of the first attempts to explain co-operative behaviour using a purely economic analytical approach came from Ivan Emelianoff in the 1940's. His main argument was that co-operative organisations were not business enterprises but merely aggregates of economic units. Because of the erroneous assumption that a co-operative organisation is an enterprise, i.e. an acquisitive economic unit, most of the external structural characteristics of co-operative associations, according to Emelianoff, are misapprehended and misrepresented.<sup>17</sup> Emelianoff's style of writing about co-operation at times appeared to be "disrespectful", especially with regards to the "fathers of co-operation" and the "co-operative principles". This, accompanied possibly by failure to understand the theoretical content in Emelianoff's writings, attracted loud and at times abusive criticism from co-operative circles but also from academic circles sympathetic to the so called "ideology of co-operation". One of these abusive criticisms came from Davidovic who described Emelianoff as a man who hated the co-operative movement because as a Russian refugee after the communist revolution he hated all kinds of progressive movements<sup>18</sup>. But despite strong criticisms from co-operative circles and possible weaknesses in his theoretical analysis, his approach can be described as unique in that he was the first scholar to have looked at the problem from a purely economic perspective. This perspective is further explored later in this chapter.

#### 1.3.4 Co-operatives and theory of collective action

Relevant to the subject of the nature of co-operation is Mancur Olson's work on the theory of groups. His theoretical analysis suggests that the notion that groups of individuals act to achieve their common or group interests, far from being a logical

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<sup>16</sup> M. A. Khan, Co-operative organisation in the service of marginal groups, in Dulfer & Hamm(eds), 1985, pp119-128.

<sup>17</sup> Emelianoff, 1942, p251

<sup>18</sup> G. Davidovic, The character of co-operative enterprise, in P. Andreou(ed.), **Co-operative institutions and economic development**, Nairobi, 1977, pp390-391.

implication of the assumption that the individuals in a group will rationally further their individual interests, is in fact inconsistent with that assumption unless the group in question is small or unless there is coercion or some other special device to make individuals act in their common interest, or unless they see their individual interests to be identical with their group interests. This means that large groups will not form organisations to further their common goals in the absence of coercion or separate incentives. In small groups, according to Olson, there may very well be some voluntary action in support of the common purposes of the individuals in the group, but in most cases this action will cease before it reaches the optimal level for the members of the group as a whole.<sup>19</sup>

Olson's work is relevant to the theory of public goods. A public good may be defined as any good such that, if any person in a group consumes it, cannot feasibly be withheld from others in that group. Within the context of consumer co-operatives this can best be illustrated in terms of the competitive pressure exerted on prices of consumer goods due to the existence of co-operatives. The absence of co-operatives may lead to the market being dominated by a few oligopolists, thus causing prices to rise at the expense of consumers. And yet, not all consumers see fit to join the co-operative. Olson explains such behaviour in large groups by the fact that a member's own efforts will not have a noticeable effect on the situation of his organisation, and he can enjoy any improvements brought about by others whether or not he has worked in support of his organisation.

Olson's theory contradicts the traditional theory which assumes that, when there is a need for a large association, a large association will tend to emerge and attract members, just as a small group will when there is a need for a small group. His theoretical analysis will be employed later on in this study in order to explain possible causes of failure or success of large or small co-operatives in Cyprus.

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<sup>19</sup> M. Olson, *The logic of collective action*, Massachusetts, 1971, pp 2-3.

### **1.3.5 Theories of competition and co-operation**

Socialists believe that since human beings are social animals the natural relationship amongst them is one of co-operation, rather than competition. This is contrary to the Liberal and Conservative philosophies which regard competition amongst human beings as natural and, in some respects, healthy or merely inevitable. They see it as natural because human beings are thought to be self-interested, and healthy in so far as it encourages each individual to work and develop whatever skills or abilities he or she may possess.

Socialists, on the other hand, believe that competition fosters only a limited range of social attributes and instead promotes selfishness and aggression. Co-operation, however, makes moral and economic sense. Individuals who work together rather than against each other will develop the bonds of sympathy, caring and affection. Furthermore, the energies of the community rather than those of the single individual can be harnessed. The Russian anarchist, Peter Kropotkin, famous for his book on mutual aid, suggested that the principal reason why the human species had survived and prospered was because of its capacity for mutual aid. Socialists believe that human beings can be motivated by moral incentives and not merely by material incentives.

The socialist commitment to co-operation has stimulated the growth of co-operative enterprises, designed to replace the competitive and hierarchic businesses which have proliferated under capitalism. Both producers' and consumers' co-operatives have attempted to harness the energies of groups of people working for mutual benefit. Anarchist conclusions can be reached by pushing the ideas of socialist collectivism to their limits. In essence collectivism is the belief that human beings are social animals, better suited to working together for the common good than striving for individual self-interest. Collectivist anarchism stresses the human capacity for social solidarity, that human beings are naturally sociable, gregarious and co-operative.

Kropotkin attempted to provide a biological foundation for social solidarity. He set out to re-examine Darwin's theory of evolution, which had been used by social thinkers such as Herbert Spencer to support the idea that humankind was naturally competitive

and aggressive. Kropotkin did not accept that biology favoured competition and struggle, but argued instead that successful species were ones which had harnessed collective energies and possessed the capacity for “mutual aid” or co-operation. The process of evolution had therefore strengthened human sociability, favouring co-operation rather than competition. Kropotkin suggested that mutual aid was best reflected in the structure of city life in Ancient Greece and Medieval Europe.

The belief in social solidarity can justify various forms of co-operative behaviour. At one extreme, it has led to a belief in pure communism, but it has also generated the more modest ideas of mutualism, associated with Pierre-Joseph Proudhon. His libertarian socialism stands between the individualist and collectivist traditions of anarchism. Proudhon came up with the famous statement that “property is theft”, and condemned a system of economic exploitation based upon the accumulation of capital. Nevertheless, unlike Marx, Proudhon was not opposed to all forms of private property. He admired the independence and initiative of smallholding peasants, craftsmen and artisans. He therefore sought a system of property ownership which would avoid exploitation and promote social harmony.

Mutualism was a system of fair and equitable exchange, in which individuals or groups could bargain with one another, trading goods and services without profiteering or exploitation. Social interaction would therefore be voluntary, mutually beneficial and harmonious, requiring no regulation or interference by government. Proudhon’s followers tried to put these ideas into practice by setting up mutual credit banks in France and Switzerland, which provided cheap loans for investors and charged a rate of interest only high enough to cover the cost of running the bank but not so high that it made a profit. Proudhon’s own views were largely founded upon his admiration for small communities of peasants or craftsmen, notably the watchmakers of Switzerland, who had traditionally managed their affairs on the basis of mutual co-operation.<sup>20</sup>

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<sup>20</sup> A. Heywood, **Political ideologies**, Hong Kong, 1993, pp206-207.

### 1.3.6 Theoretical reasons for emergence of co-operatives

John Craig describes five different theoretical approaches as to why co-operation emerges. The mutual aid theory, developed by Peter Kropotkin around the turn of the century, and based on Darwin's theory of evolution and the basic drive for survival, points out that man has been living in clans and tribes since the dawn of the early stone age and that, from that time, people have continued to build co-operative relations built on mutual aid. But the growth of the state has reduced and in some cases eliminated, mutual aid, as the people in power have sought to control the behaviour of the masses. When state control weakens, mutual aid institutions reappear in all societies.

The socio-biological theory attempts to explain mutual aid as the result of genetic similarities between members of human and other animal species. Individuals provide mutual aid to each other because it increases the survival chances of the gene pool. Thus, co-operation which is basic to humans and animals, is due not to culture or learning, but rather to biology.

Behaviour theory assumes that most behaviour patterns in animals and humans are not predetermined but can be changed by a schedule of reinforcements. Behaviour theory is a response to stimuli in the environment. If the response results in a positive effect, that particular form of behaviour is encouraged or reinforced, and it will probably continue. If the effect is negative, a change in behaviour will likely occur. In relation to co-operative behaviour, this theory suggests that people learn, through trial and error, that what they can not do individually can best be done by working with others. When individuals respond to a situation by co-operating and this behaviour is positively reinforced, they will co-operate in similar situations in the future. If, however, co-operative response produces negative reinforcement, people will tend to avoid co-operation. Thus, co-operative behaviour occurs in situations where the environment encourages co-operation and where the failure to co-operate may have unfavourable consequences.

Exchange theory is also a learning theory, but the explanation of why people co-operate is different from that put forward by behaviourists. Social exchange is seen as a basic human process, in which unspecified obligations result from social acts that help the entire group. It is understood by all that reciprocity will occur, but it is unknown when and in what form others will discharge their obligations. Social exchange of aid and assistance thus depends on trust and, in the process, helps to build trust both within a group and between groups. Provided that an atmosphere of trust and social exchange exists, co-operation will take place between individuals or groups. Because an act of co-operation helps others as well as the initiator, a pattern of co-operative behaviour will develop and continue over time.

Finally, functional theory suggests that the source of co-operative behaviour rests with the perceived needs of individuals and their group. If the perceived needs of a group are not being met, attempts will be made to rectify the situation. If individual action proves inadequate, the group may turn to co-operation as a means of satisfying these needs. Similarly, co-operative activity will not occur if it fails to meet individual and group needs or if they are already being met in some other way.<sup>21</sup>

Mutual aid theory, developed by Kropotkin, is relevant in the study of the relationship between co-operatives and the state. This relationship is said to play a major role in the success or failure of co-operative ventures. In fact, most of the literature blames many co-operative failures on too much state intervention. At the same time, however, a lot of the literature on promoting agricultural co-operatives in the developing world is critical of the limited support the state offers to these organisations.

A major weakness of this theory, in trying to explain co-operation and mutual aid as the result of the basic drive for survival, lies in the fact that it fails to explain the timing of the birth of co-operation. The exploitation of workers by industrialists, and of farmers by money lenders, had been going on for many years before the discovery of co-operation as it is known today.

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<sup>21</sup> Craig, 1993, pp5-8

Socio-biological theory may explain why co-operation is said to have more chances of success where there is homogeneity of membership. This homogeneity may relate to colour, race, nationality, social and economic background. In economic terms, the need for such homogeneity can best be explained in terms of Emelianoff's analysis of aggregates of economic units.

Behaviour theory seems to suggest that where a co-operative venture has met with initial failure people lose faith and therefore future co-operation among those people is less likely. This is in fact true in some of the case studies mentioned in the literature. However, examples may be found where this is not valid. One such example will be mentioned later in this thesis, when discussing the origins of the Cypriot co-operative movement.

Exchange theory depends on the existence of trust. Although this may have been true in the past it is very doubtful whether such trust constitutes the basis of co-operation today. The question of trust becomes more difficult when a co-operative has a large membership base.

Functional theoretical perspective is important when discussing the role of co-operatives within a market economy. It is especially important to answer the question as to whether co-operatives can still exist once market imperfections have been cleared.

### 1.3.7 Empirical evidence on emergence of co-operatives

It is said that most modern rural co-operative activity arose in response to low prices for farm products and high prices for inputs, wide marketing margins, excessive transportation costs, and in general, lack of farmer bargaining power.<sup>22</sup>

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<sup>22</sup> L. L. Mather, *The Principles, Functions, and benefits of co-operation: the traditional model*, in K. R. Anschel, R. H. Brannon, E. D. Smith(eds), *Agricultural Co-operatives and markets in developing countries*, New York, 1969, p14.

Underlying the establishment of agricultural co-operatives is the belief that individual farmers working together can enhance their economic position while at the same time effecting some positive influence on the marketing system.

Writing about American agricultural co-operatives, Adlowe Larson classifies objectives into primary and secondary. The first such primary objective is increased productive efficiency which may be the result of new technology, improved storage facilities, and economies of scale due to larger volumes. The second primary objective of a co-operative is the lessening of the degree of monopoly by effectively cutting excess margins through the control of flows of products to markets. A third possible primary objective is innovation, which may take the form of the introduction of a new enterprise or the development of new markets for existing products.

Secondary objectives include such things as, the establishment of credit agencies which permit greater productive investment of accumulated capital funds, aid the building of other institutions, the lack of which are major inhibitors to the economic and social development of the country, and assist in the development of leadership skills.<sup>23</sup>

John W. Mellor, writing about agricultural product and input markets in South Asian small holder agriculture, explains how national policy fostering co-operatives and quasi-co-operatives may derive primarily from a concern for increasing political integration, developing new alliances and groupings of rural people which contribute to economic growth, and other objectives that are not defined in the narrowly economic terms of business efficiency and competition. However, experience suggests that these broad objectives can not be met unless co-operatives also provide direct benefits to farmers through lower marketing margins and, consequently, higher prices or larger markets or both.

According to Mellor, farmers co-operatives in South Asia have, in general, been unsuccessful. The environment for formation of co-operatives is favourable if marketing margins are high due to collusive behaviour within the private trade or if

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<sup>23</sup> A. Larson, *Universalities of co-operation*, in Anschel, Brannon, Smith(eds), 1969, pp31-35.

there is marked inefficiency in the private trade tracing from other than collusive patterns. If marketing margins are low or if services demanded by consumers require a large resource input with commensurate high costs and the private trade is handling them efficiently, then the environment for formation of co-operatives is relatively unfavourable.<sup>24</sup>

Henry F. Dobyns looked at the propositions of sociology and anthropology with regards to engineering successful co-operatives.<sup>25</sup> The first proposition emphasises that the co-operative movement was invented by participants in western civilisation. It began, in other words, in that part of the world whose population has been conquering and colonising the rest of the world. Thus, the adaptation of agricultural co-operatives to conditions in underdeveloped nations that were formerly colonies of European powers may sometimes require an ideological disassociation between the co-operative organisational model, and its cultural area of origin. This proposition is very relevant to the Cypriot co-operative movement which has its origins in the period of British administration.

The second proposition looked at by Dobyns was originally put forward by Daubers who described the innovators who organised at Rochdale as rebels, in essence, against the early capitalistic system which favoured monopolies. They sought to defend their purses and family economies against the rapacity of the mercantilist system in which they lived. The economic co-operative movement is essentially idealistic in seeking a common good. It is a specific form of felt need. Rebelliousness continues to constitute an essential ingredient in co-operative formation. A great deal of pressure for establishing co-operatives stems from a belief that marketing agencies exploit farmers. Under exploitative conditions, the scale of profits achieved by monopoly organisation favours farmer co-operatives because it provides an economic margin while the co-operators gain in experience and efficiency.

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<sup>24</sup> J. W. Mellor, Agricultural product and input markets in South Asian small holder agriculture, in Anschel, Brannon, Smith(eds), 1969, pp107-109.

<sup>25</sup> H. F. Dobyns, Sociological and anthropological approaches to engineering successful economic organisations, in Anschel, Brannon, Smith(eds), 1969, pp163-182.

A third fundamental proposition put forward is that successful co-operation requires a significant minimum degree of like-mindedness. In anthropological terms, a co-operative institution must possess a charter, i.e., a system of values in pursuit of which its members organise and to which members are unanimously committed. Relevant to this like-mindedness is the need for class unity. So-called upper class individuals may feel degraded if they have to co-operate with persons they look down upon as occupying a lower status position.

A fourth proposition suggests that one factor in engineering successful co-operative-type economic organisations in developing regions is the supply of coinage and currency and credit arrangements. These will provide a quantitative measure of success or failure in the co-operative that is highly visible and fairly readily comprehended by literate people. The need for a system of accounting is also relevant in this respect. Where corruption and inefficiency are common, local interest in the economic co-operative falls. Corruption is difficult to detect without records, and inefficiency difficult to measure.

Another proposition studied by Dobyns is that of amoral familism. This relates to a society whose members seek to maximise short-run material advantages of the nuclear family and hence, inhibits engineering successful economic organisations. He places great emphasis, for the engineering of successful co-operatives, on attitudes towards thrift, production, and consumption by a co-operative's members and management, as well as their future orientation and planning.

Finally, along with a number of other writers on co-operation Dobyns believes that a marketing system already operating on narrow margins does not offer a new economic organisation the same kind of niche that a system operating on wide, exploitative margins does.

### **1.3.8 Theoretical reasons for success or failure**

Turning to the question of failure or success, Emelianoff offered a number of propositions based on his theoretical analysis of the economic nature of the co-

operative. Firstly, as an aggregate of economic units is not the independent economic unit but the group of functioning economic units, acquisitive or spending, the enterprises and the households involved in aggregation must have common tasks and common interests strong enough to overcome their independent action.

Secondly, being supersensitive to potential encroachments upon their freedom and individuality, economic units may only be, as a rule, successfully organised into an aggregate if the potential friction within the aggregate is completely eliminated and the maximum of independent individual activities is guaranteed.

Because of this inherently explosive nature of the aggregate of economic units, Emelianoff believes that the chief secret of success of organisers of aggregates lies in the thoughtful planning of the aggregates and in a sagacious execution of these plans. Usually, therefore, very definite purposes of organisation and very simple lines of co-ordinated activities for aggregates are stated in advance. Attenuated plans or complicated lines of intended activities through the proposed aggregates usually hinder the process of their formation and undermine their stability.

Emelianoff explains how the economic stability of aggregates of economic units is inherently low. Every aggregate of economic units is saturated with disruptive forces and is kept together only by the pressure of external necessity. As to the size of aggregates, there is a certain minimum of membership of every kind of aggregate of economic units which is necessary for its vitality, and a reasonable maximum to prevent the dangers of hardships and friction, which grow progressively with the increase in size of aggregates.

Emelianoff concludes that households may be more easily co-ordinated into an aggregate and may be easier kept together in the aggregate if they are economically homogeneous, mostly because of their disruptive nature.<sup>26</sup>

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<sup>26</sup> Emelianoff, 1942, pp105-108.

Emelianoff's theoretical approach is extremely useful as an analytical tool in trying to explain why some co-operatives fail and why others succeed and will be used as such in later chapters. However, it will become evident later on that success or failure, even from an economic point of view, does not entirely depend on economic behaviour. Sociological and political influences may in fact be as, if not more, important on deciding the future of a co-operative or the co-operative movement as a whole. Emelianoff's analysis fails to deal with the problem of inter-relationships between the aggregates and how these may affect the nature of a single group of aggregates independently of the behaviour of member economic units. These inter-relationships will be studied in depth at a later chapter.

Looking at the role of government Davidovic claims that the initiation and financing of co-operative action by the state has proved to be effective and fruitful only when it has been organised in such a way that it stimulates self-help action of the people, encourages their initiative, awakens their energies, leads to the mobilisation of their efforts, their work and their resources no matter how modest they are. He believes that the results are inevitably poor when state officials, instead of being the guides, helpers and educators of people in co-operative action, become actors and operators of co-operatives, and supplant the people instead of supplementing their efforts. Then co-operative members become passive, disinterested onlookers. They take state help for granted and become inclined to consider co-operatives as a matter of the state and not their own business. They become used to non-involvement and passivity under the mighty wing of the state. They come to accept the domination of co-operatives by state officials as a permanent state.

Davidovic warns that dependence of co-operatives on the state brings other dangers as well; firstly, politicians are tempted to take advantage of the co-operative movement for their own political ends rather than for the economic aims of the people. Secondly, state officials often see in co-operative policy and co-operative activity a field for the advancement of their own careers.

Davidovic describes Nehru as an example of a "co-operative philosopher" whose co-operative conception was based on his unshakeable faith in people, in their ability to

go their own way, and solve their problems alone. The co-operative economy as visualised by Nehru, is based on the spirit of self-help, on the stimulation of people's initiative, on the mobilisation of their energies, on the building of their self confidence and self reliance. But these, according to Nehru, need to be achieved voluntarily, by democratic methods and based on people's involvement in economic activities, on the idea of simultaneous development of human and material values, on the parallel raising of economic, social and moral standards.<sup>27</sup>

Such rhetoric is not monopolised by Davidovic and the International Co-operative Alliance but is very commonly met in most of the co-operative literature. Assuming however validity of the proposition that a co-operative function is more likely to emerge where there is some kind of market failure, Arrow's work on such failure and the role of government should be taken into account. Arrow considered market failure from the point of view of transaction costs being prohibitively high. Such transaction costs may relate to exclusion, information or disequilibrium. Arrow concluded that the state may frequently have a special role to play in resource allocation because, by its nature, it has a monopoly of coercive power which can be used to economise on transaction costs.<sup>28</sup>

#### 1.4 Cyprus

According to one writer co-operatives have been seen as the optimal organisational form to develop agriculture in such diverse countries as Israel, Algeria, India, Kenya, Tanzania, China and Thailand. Yet popular wisdom by international aid experts in industrialised countries, and politicians in less developed countries, is that they do not work. Literally tens of thousands of co-operatives were organised during the past 25 years and the vast majority were dismal failures.<sup>29</sup> However, the Cypriot experience is held out to be different. According to Professor Paris Andreou co-operatives are regarded by many people in Cyprus as the vehicles of transformation and advancement in the island's economy. The prestige of these organisations is high and improvements

<sup>27</sup> G. Davidovic, The emerging State of Co-operation, in Andreou(ed.), 1977, pp113-118.

<sup>28</sup> K. Arrow, The organisation of economic activity: issues pertinent to the choice of market versus non-market allocation, in R. H. Haveman and J. Margolis(eds), **Public Expenditure and Policy Analysis**, Chicago, 1970, pp68-69.

<sup>29</sup> Craig, 1993, p1.

in producers' prices have been attributed to their activities. According to Andreou, they enjoy both political support and the confidence of the people.<sup>30</sup> As one co-operative student remarked, the Cypriot co-operatives are not only successful but "are the most progressive in the Commonwealth".<sup>31</sup>

Thus, Cyprus is one example where co-operation is believed to have worked, at least for some specific period of the island's economic history. In 1995, the Cypriot co-operative movement continued to play a major role in the economy of Cyprus. Characteristically, it controlled more than 30% of all bank deposits, 90% of all agricultural loans, more than 80% of housing loans and a large proportion of personal expenditure.

What appears to be the economic success of the Cypriot co-operative movement is usually attributed to effective management, membership allegiance, appropriate legal framework, and the right attitudes of the political establishment. However, there has been no attempt to explain this apparent success using any kind of analytical tools of from the three relevant social sciences; economics, sociology, and politics. This lack of academic interest is very much in line with academic attitudes towards co-operation in the rest of the world due perhaps to the disappointment felt by the large failure rates observed. The small size of the island and its economy, and until 1994 the absence of a locally based academic establishment, has perhaps contributed to this lack of interest.

The economic history of Cyprus of the twentieth century is a story of transformation from a mainly backward agricultural economy into a modern economy based mainly on the service sector. During this process of transformation the co-operative movement has developed and transformed accordingly. When it was first started in 1909 and during its first years of development Cyprus was very much in the same economic stage of development as a large number of less developed countries today in the African, Asian and American continents. Lessons can therefore be learned from the Cypriot experience. Both the initial period but also the later period of development of

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<sup>30</sup> P. Andreou, An empirical investigation into the main factors that led to the successful operation of the co-operative marketing associations in Cyprus, in Andreou(ed.), 1977, p135.

<sup>31</sup> M. Digby, *Yearbook of Agricultural Co-operation 1970*, Oxford, 1970, p12.

the movement offers an excellent opportunity to draw conclusions on the nature of co-operation.

#### **1.4.1 Brief historical background**

Cyprus is the third largest island in the Mediterranean after Sicily and Sardinia comprising a total area of 3572 square miles. The island lies 40 miles south of Turkey, 60 miles west of Syria, 230 miles north of Egypt, and 200 miles east of the island of Crete. The fact that it lies in the cross-roads of three continents made Cyprus attractive to its more powerful neighbours who looked for strategic and trading advantages hence 4000 years history of constant invasions and occupations. Its rulers included the Egyptians in the 14th century BC, the Phoenicians in the 12th century BC, the Macedonian Alexander the Great and the Ptolemies in the 3rd century BC, the Romans in the 1st century AD, the Byzantine Empire in the 4th century, the English and the Lusignans in the 12th century, the Venitians in the 15th century, the Ottoman Empire in the 16th century, and the British Empire in the 19th century.

Cyprus became an independent Republic in 1960 but following inter-communal violence in 1963 and 1968 as well as outside Greek and Turkish intervention in 1974 nearly 40% of the island was occupied by Turkey and an equivalent percentage of its population were made refugees. Until this day the island remains partitioned with a mainly Greek population living in the southern part, recognised internationally as the Republic of Cyprus, and a Turkish population in the northern part.

The examples used in this study after 1960 will mainly relate to co-operatives in the Republic of Cyprus due mainly to availability and access to relevant data.

#### **1.5 Thesis Layout**

Chapter 2 will look at the economic rationale of agricultural co-operation in Cyprus, a small peasant economy, during the first half of the twentieth century. A critical analysis will be made of various theories on usury and causes of excessive indebtedness.

Chapter 3 will take the form of performance evaluation after explaining the meaning of success in Co-operation. Among other things an attempt will be made to measure the contribution of co-operative credit to agriculture. Also, a critical assessment is made of the two most important slogans among co-operators; self-help and mutual aid.

An effort will be made in chapter 4 to measure the effectiveness of the co-operative movement as a mechanism of economic reconstruction following the war of 1974. An attempt will be made to measure the macro-economic effect of co-operation in terms of GNP and employment in Cyprus. The adaptability of co-operatives to sudden changes in the surrounding social, political and economic environment, and their ability to transform accordingly, will be tested in this chapter by analysing the empirical evidence obtained from individual case-studies.

Chapter 5 will analyse the events that led to the near collapse of the co-operative movement in Cyprus in 1980 and the role of the state and other political agents. It will also look at rescue mechanisms employed by the state with special emphasis on issues like financial support and enactment of more appropriate legislation.

Chapter 6 will concentrate on organisational aspects of co-operatives with special reference to the relationship between grass-root members, elected board of directors, appointed management and political agents.

Chapter 7 will be a summary of all conclusions with special reference to the implications regarding a number of theories put forward by co-operative literature on the nature and applicability of internationally accepted co-operative principles.

## CHAPTER TWO : THE ECONOMIC RATIONALE OF AGRICULTURAL CO-OPERATION IN A SMALL PEASANT ECONOMY

### 2.1 Introduction

One common characteristic of Mediterranean countries before 1914 was failure to industrialise, with resulting low levels of per capita income and a high incidence of poverty. The two main reasons offered by Cameron for this state of things is low literacy rates and lack of any meaningful agrarian reform, with consequent low levels of agricultural productivity.<sup>32</sup> Cyprus was no exception to the rule. Cypriot children left school usually before reaching the age of eleven and after a few years' work on the land retained only such part of their education as enabled them to write their own names and to do a little arithmetic.<sup>33</sup>

Agrarian reform involves a change in the system of land tenure. Cyprus, along with the Balkan states inherited their systems of land tenure from the period of Turkish rule, but no serious efforts were made to alter them. The main characteristic of this system was large numbers of small peasant proprietors with fragmented land holdings, more of which will be said later in this chapter.

A report in 1945 to the Fabian colonial bureau on co-operation, presents a very depressing picture of the state of co-operation in the colonies. Cyprus is mentioned as one of the very few exceptions to this gloomy picture. And yet, Cyprus appeared to possess the same economic characteristics as a large number of other colonies at the time due to its Mediterranean origins but also due to its Ottoman past; an economy largely dependent on agriculture and on the operations of large numbers of small producers working on their own account. In fact, the report ranks Cyprus second in co-operative success only to the Jewish population of Palestine.<sup>34</sup>

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<sup>32</sup> R. Cameron, *A concise economic history of the world*, New York, 1993, p262.

<sup>33</sup> B. J. Surridge, *A Survey of rural life in Cyprus*, Nicosia, 1930, p19.

<sup>34</sup> A report from a special committee to the Fabian colonial bureau, *Co-operation in the colonies*, London, 1945, p14, 124.

This chapter is about those economic, social and political forces that give rise to a co-operative function within a small developing peasant economy. The exact nature of transactions between production and capitalist agents is analysed and theoretical propositions are put forward relating to the economics of usury including causes of excessive indebtedness and usury. The results of government response to the problem of rural indebtedness are analysed and explained within the context of a peasant market economy.

Section 2 explains the importance of agriculture on a macro-economic level. Section 3 establishes the size of peasant operations in Cyprus and land tenure patterns that affect these operations. Section 4 is a theoretical perspective of the peasant economy. Section 5 analyses the usury phenomenon and section 6 discusses alternative intermediaries.

## 2.2 Why agricultural co-operation

From an organisational and historical point of view, by far the most important place in Cyprus belongs to the system of agricultural co-operative credit. Agricultural co-operative credit societies, catering primarily for the credit needs, but also for the marketing and agricultural inputs needs of farmers, have always been considered the backbone of the Cypriot co-operative movement.<sup>35</sup> This is not surprising bearing in mind the dependence of the economy on agriculture, and more specifically on peasant farming, until recent times. This dependence is emphasised in every single annual report on Cyprus prepared by the British throughout the period of their administration of the island.

National Income statistics before 1950 do not exist officially although some attempts have at times been made to arrive at rough estimates of Gross Domestic Product. For 1883, Christodoulou estimates the share of agriculture in GDP to be as high as 70%,

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<sup>35</sup> Co-operative credit societies (Συνεργατικές Πιστωτικές Εταιρείες) in Cyprus are a form of multi-purpose societies which do not only accept deposits and supply both agricultural and housing loans, but also act as the local marketing agency, supply farmers with agricultural fertilizers and equipment, and in the absence of a local co-operative retail store will act as a retail agency serving the needs of the community. Additionally they act as the government's paying agents for a number of farm subsidies and as the collecting agents for a number of state taxes like road, VAT and other professional taxes.

as compared to 48.8% in 1946 and 27.4% in 1950.<sup>36</sup> But the heavy reliance on agriculture can also be established on the basis of occupational distribution, gross sector output, and trade statistics. The heavier the reliance the more important the role to be played by the agricultural co-operative movement, assuming a positive relationship between agricultural and co-operative development.

### 2.2.1 Occupational distribution

The numbers of adult male workers who reported as their main occupations being in agriculture and manufacturing production, and their proportions in the economically active male population according to the censuses of the period are shown in table 2.1:<sup>37</sup>

Table 2.1: Adult male occupational distribution, 1911-1960

Year of census	Agriculture		Manufacturing		Other
	Total	Percentage	Total	Percentage	Percentage
1911	49700	64	11400	15	21
1921	53600	63	13500	16	21
1931	55300	56	16900	17	27
1946	55200	41	28500	21	38
1960	43300	26	54300	34	40

As can be seen from the above table, at the time of the passing of the co-operative societies Law, in 1914, well over 60% of the male population in effective employment had agriculture as their main occupation. Any measure, therefore, that would improve the lot of the agricultural classes would have an effect on a relatively large proportion of the population. And as will be seen later in this chapter the British Administration was very keen to see such a measure work not only for economic or social but mainly for political reasons.

### 2.2.2 Production by Sector

Gross Domestic Product statistics begin to appear officially in 1950. Before that year only estimates of total production of the main sectors of the economy can be made based on incomplete data found in the Annual Reports on Cyprus. Sir Ralph Oakden estimated the average total agricultural production for the five year period 1929-1933

<sup>36</sup> D. Christodoulou, *Inside the Cyprus Miracle*, Minnesota, 1992, ppXXXI-XXXIV.

<sup>37</sup> St John-Jones, *The population of Cyprus*, London, 1983, p143.

at £1,430,000.<sup>38</sup> This compares with £347,000 for mineral production and £413,000 for manufacturing.<sup>39</sup> Christodoulou estimates the contribution of agriculture to GDP for the same period to be 40%.<sup>40</sup>

The economic transition of the island from primary to secondary and tertiary sectors during the pre-war and post-war periods is easily noticeable by looking at the employment statistics in the previous section; however, despite the significant decrease of agricultural production as a percentage of total production it still remained a significant contributor to the overall production. In 1950, the first year of an official measurement of Gross National Product, the value of agricultural production was estimated at £12,570,000<sup>41</sup> as compared to £5,698,000 for mineral production and £14,348,000 for manufacturing production.<sup>42</sup> In 1950 value added by agriculture contributed 28.2 %<sup>43</sup> to the National Product.

### 2.2.3 Foreign Trade

Similarly with occupational distribution and national output, agriculture played a major role in the island's export trade. However, unlike in the case of these two sectors where the share of agriculture naturally exhibited a declining tendency, being an inverse function of economic development, in the case of foreign trade the share of agriculture appeared to be rising, especially at times of reduced foreign demand for Cypriot mineral products. To this day agriculture remains an important component of foreign visible trade income and marketing co-operatives handle a significant amount of this trade.

<sup>38</sup> R. Oakden, **Report on the Finances and Economic Resources of Cyprus**, London, 1935, p11

<sup>39</sup> These estimates have been computed on the basis of data contained in the Annual Colonial Reports, 1929-1933.

<sup>40</sup> Christodoulou, 1992, p53.

<sup>41</sup> Cyprus: **National Income, Product, income, expenditure**, 1950, BLEPS Ref. S564(R37), appendix J.

<sup>42</sup> Cyprus: **National Income, Product, income, expenditure**, 1950, appendix I.

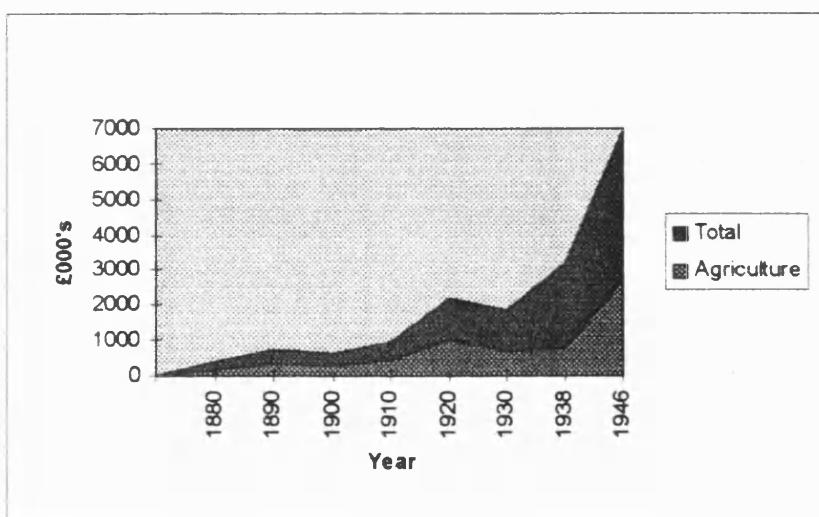
<sup>43</sup> Cyprus: **National Income, Product, income, expenditure**, 1950, p7.

Table 2.2: Visible exports, 1880-1946

Year	Agriculture	Mining and quarrying	Manufacturing	Other	Total
	£000's	£000's	£000's	£000's	£000's
1880	169	1	10	30	210
1890	346	2	13	39	400
1900	296	2	8	32	338
1910	437	3	31	41	512
1920	1033	57	45	2	1137
1930	691	375	35	44	1145
1938	804	1493	65	24	2386
1946	2741	713	678	70	4202

Sources: The above are estimates prepared on the basis of data recorded in the Blue Books and Annual Reports on Cyprus.

Figure 2.1: Visible exports



### 2.3 Land tenure and size of peasant operations

As mentioned earlier every single Annual Report on Cyprus produced by the British colonial administration monotonously repeats the fact that Cyprus is mainly an agricultural country of small landed proprietors most commonly referred to as peasant farmers.

Once the importance of agriculture has been established in the overall economy of the island during the first period of co-operative development it is important for the purposes of our analysis to establish the normal size of agricultural operations in Cyprus. And as land is the single most important factor of production, especially in an

undeveloped farming environment as that in pre-independent Cyprus, the relative size of agricultural operations can be defined as a function of the relative size of land-holdings assuming uniform land fertility.

Christodoulou believes that much of the malaise of the rural areas and a serious obstacle to modern agricultural techniques was the size and fragmentation of peasant holdings, mentioning that at different times it had been estimated that an average Cypriot family to support itself exclusively from agriculture needed 70 donums (1 acre approximately equals 3 donums) of all kinds of land. Although the figure was a hypothetical one he points out that more than two-thirds of the holdings were under 70 donums and comprised more than one third of the agricultural land. Christodoulou further believes that in a badly eroded country like Cyprus, with a low and hazardous rainfall and a dearth of water, such holdings do not provide a reasonable standard of living, evidenced by the fact that the average gross income of a person engaged in agriculture in 1957 was £72 or less than half the average for Cyprus.

Fieldwork conducted by Peristiany in the village of Alona in 1954 provides further evidence to Christodoulou's estimates of a peasant's income. He found that the average net income of each villager from agricultural activities was under £77 per year. From this income the villager had to pay his taxes, feed his family, buy shoes and clothes, provide a dowry for his daughter and pay fees for his son's education. On some occasions the villager had to sell part of his estate in order to meet the last two types of expenditure requirements.<sup>44</sup>

Uneconomic holdings led farmers to look for more land to cultivate in order to mitigate the underemployment which is marked in rural areas of both labour and draught animals or machinery. This may result in an increase in the demand for more leased or free-hold land. On the question of leasing and sharecropping Christodoulou draws attention to the fact that the 1946 census showed that only 5% of all agricultural land was leased for over two years, 4.9% was leased for two years or less, and 6.2%

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<sup>44</sup> J. G. Peristiany, Honour and shame in a Cypriot highland village, J. G. Peristiany(ed.), **Honour and shame: The values of Mediterranean Society**, Chicago, 1966, p174.

related to sharecropping.<sup>45</sup> These statistics together with the table that follows on large land ownership leads to the conclusion that most land in Cyprus was owned on a free-hold basis and cultivated by small peasant proprietors.

According to Christodoulou, holding of land by small cultivators must have existed in Cyprus since the beginning of agriculture. The end of feudalism by the Turkish administration introduced into Cyprus virtual peasant proprietorship with reasonable security of tenure. Side by side with the numerous small units of cultivation were the large estates belonging mainly to religious institutions. The process has been mainly one of dissolution of estates and of subdivision of holdings. From the General Survey of 1909-29 out of 4,175,324 donums of alienated land the following large holdings are taken:<sup>46</sup>

Table 2.3: Large holdings of land

Owners	Total area	Percentage of total agricultural land
Sees, Monasteries, Churches	donums	%
	222,296	5.3
Tekkes, Evqaf, Mosques		0.6
Large Estates	24,826	
	69,210	1.6
	316,332	7.5

Meyer and Vassiliou, writing about the role of agriculture in the economy of Cyprus, concluded that land tenure and usage of rival water were the most serious problems facing Cyprus agriculture. Historically, Cypriot farmers divided their land according to Islamic and Ottoman land decrees. These called for division of land among several surviving heirs, with the resultant over-fragmentation. Economic growth, while creating more non-farm occupations, did not really check the process; nor did efforts of the colonial government which were viewed with suspicion by villagers. By 1946 the average farm holding on the island was 19 acres, and 70% of the island's farmers owned less than the average. By 1959, government agriculturists estimated that the average holding had shrunk to 15 acres, half of which lay fallow each year. Worse still, the holdings were often widely dispersed, into an average of twelve plots per owner.

<sup>45</sup> D. Christodoulou, *The evolution of the rural land use pattern in Cyprus*, Cornwall, 1959, pp80-81.

<sup>46</sup> Christodoulou, 1959, pp73-74.

This resulted in many farmers spending much of their working day bicycling or walking from plot to plot. Finally, Meyer and Vassiliou thought that a bright spot in the Cyprus land picture was the absence of really exploitative feudal and absentee ownership of holdings. Only some 7% of the island's farmland was estimated to be in the hands of town-dwellers, and sharecropping was rare. The Cyprus farmer at least was still his own master.<sup>47</sup>

Land fragmentation could be a sensible strategy allowing access to more than one source of water and reducing other forms of risk. However in Cyprus plots were not only small, about 1.8 acres, but there was also multiplicity and confusion of ownership of plots and the trees standing on them. This state of affairs had its origins in the Ottoman Land Laws of 1858 together with the laws of inheritance. Both of these laws were repealed in 1946. Under these Land Laws, immovable property was divided into various categories, each subject to separate and distinct laws as regards possession, dealings and succession. Land fell into one category, trees and buildings into another, the latter forming the subject of separate and independent ownership. As a result of this, in thousands of cases the land belonged to one owner or group of owners and the trees or buildings standing thereon to other owners; this is what is meant by dual ownership.<sup>48</sup>

Some of the problems facing agriculture in Cyprus at the time, due to over-fragmentation, were highlighted in a report on land utilisation in Cyprus in 1946. According to the findings of this report for the vast majority of holdings, modern scientific power-farming was impossible, for, by the time the would-be farmer got his tractor up into gear it was over the boundary and well out into the next property.<sup>49</sup>

Extra evidence on the predominance of the small peasant farmer was given by Lanitis. Based on an interview with the director of agriculture in 1940 Lanitis estimated that about 79% of total cultivable land was owned by peasant proprietors, 15% by the

<sup>47</sup> A. J. Meyer and S. Vassiliou, *The economy of Cyprus*, Cambridge 1962, pp29-31

<sup>48</sup> Government of Cyprus, *The proceedings of a conference on land use in a Mediterranean environment*, held in Nicosia, Cyprus, 16-17 April, 1946, Nicosia, 1947, p19.

<sup>49</sup> R. R. Waterer, *a report on the land utilisation in Cyprus*, Nicosia, 1946.

church, the Evqaf and chiefflick (large estates) owners, and only about 6% by money-lenders and other town-dwellers.<sup>50</sup>

Employment patterns also confirmed the view that Cyprus agriculture was dominated by small peasant proprietors. The 1931 population census found that of the 134,279 persons practising occupations, 34,546 were farmers and cultivators, 22,654 were described as agricultural labourers (though it is possible that most of these owned land and went out to work for part of the year), and 8,861 were shepherds.<sup>51</sup> These numbers show that the majority of people who have agriculture as their main occupation are self-employed but says nothing about land-ownership patterns and therefore it is not possible to make inferences about scale of operations. Some light is shed by the agricultural census of 1946. The results of the census are shown in the table that follows:

Table 2.4: Agricultural census of 1946

Size in donums	Number of holdings	Percentage of total number of holdings	Cumulative percentage of total number of holdings	Total area of holdings in donums	Percentage of total agricultural land	Cumulative percentage of total agricultural land
1-4	3,902	6.5	6.5	9,200	0.3	0.3
5-9	5,930	9.8	16.3	41,500	1.3	1.6
10-19	10,546	17.4	33.7	151,100	4.6	6.2
20-39	13,939	23.0	56.7	399,500	12.3	18.5
40-59	8,568	14.2	70.9	419,300	12.9	31.4
60-79	5,562	9.2	80.1	383,300	11.8	43.2
80-99	3,637	6.0	86.1	323,700	10.0	53.2
100-199	6,722	11.1	97.2	904,300	27.8	81.0
200-499	1,533	2.5	99.7	414,000	12.8	93.8
500-999	101	0.2	99.9	71,700	2.2	96.0
1000-	47	0.1	100.0	128,400	4.0	100.0

Source: Agricultural census of 1946.

Analysing the results of the 1946 census a number of interesting points may be made. First, only about 15.4% of total land belonged to large or very large owners. Nearly half of this land belonged to religious institutions leased out to smaller cultivators. Second, although inequities clearly existed, the scale of such inequities was not even near those in other developing countries at the time. In neighbouring Egypt for

<sup>50</sup> N. C. Lanitis, **Rural indebtedness and agricultural co-operation in Cyprus**, Nicosia, 1992, p9.

<sup>51</sup> Oakden, 1935, p8.

example, 1% of the landowners owned 40% of the arable land, while at the other extreme, 80% of the landowners owned only 20% of the land.<sup>52</sup> In India two-thirds of the agricultural population cultivates only one-sixth of the total land, and all in less than 5 acres (about 15 donums) units. On the other hand, 5.6% of agriculturists cultivate more than one-third of the land.<sup>53</sup>

It is evident from the above analysis that the agricultural economy of Cyprus during the British Administration of the island was very much dependent upon small peasant proprietors.

#### 2.4 Theoretical perspective of the peasant economy

Influenced probably by the work of Physiocrats like Francois Quesnay, classical economists in England during the 19<sup>th</sup> century were outspoken opponents of peasant farming, which they saw as a waste of resources. Most of them considered the method of large-scale farming, dominant in England, as the most efficient method of farming. John Stuart Mill was one of the few economists at the time who voiced his concern about this treatment of peasants by economists, basing his argument on the fact that with the exception of a few developed economies, elsewhere custom was far more important a factor in determining economic outcomes than competition.<sup>54</sup>

Empirical investigations of the peasant proprietor in twentieth-century economic literature have drawn from work done by people like Chayanov in the mid-1920s.<sup>55</sup> Unlike most other economists who treated peasant farmers as a single class, Chayanov proposed a detailed classification of the peasantry. Conveniently enough for the purposes of this study, he then looked at the relation between each class of peasants and the co-operative function.

<sup>52</sup> H. Holmen, *State, co-operatives and development: Egypt 1908-1988*; in B. Gyllstrom and F. Rundquist(eds), *State, co-operatives and rural change*, Lund, 1989, p92.

<sup>53</sup> S. K. Goyal, *Co-operative farming in India*, London, 1966, p11.

<sup>54</sup> E. L. Forget, The peasant proprietor in classical economics; in E. L. Forget and R. A.

Lobdell(eds), *The peasant in economic thought: 'A perfect republic'*, Aldershot, 1995, p14.

<sup>55</sup> Forget in Forget and Lobdell(eds), 1995, pxi.

The theory of differential optima and co-operatives in the peasant economy, as proposed by Chayanov,<sup>56</sup> classifies peasant households into six basic social types; the classical kulak, the semi-capitalist, those that hire outside labour on a part-time basis, those that do not hire outside labour but rely exclusively on the family labour, those that hire out part of their labour and those that hire out all of their labour.

The classical kulak household may at times conduct its agricultural work without hired labour, but derives the bulk of its income from the trade turnover, from credit based on usury and, in particular cases, from the hiring out of stock and other implements of production to poor households on conditions amounting to slavery. Here the sources of capitalist income are either the trading profit or the income from the circulation of capital in enterprises belonging to others. In general, such households are few in number; but in terms of their influence they represent a major force in the countryside.

The kulak household in Cyprus is the 'dreaded village money-lender'. Together with the peasants' assumed improvidence he has been made the scapegoat for all evils accruing on the peasant farmer during the pre-independence period, by nearly every writer on Cyprus and relevant reports of the British Administration. The majority of these money-lenders, according to Jenness, were wealthy landholders or merchants who as part of their business speculated in grain and other produce, lending seed to needy farmers at the planting season and recovering it at harvest, at an 'immense profit'.<sup>57</sup> Unfortunately, Jenness does not explain why he thought the profit was immense and neither does he offer an explanation as to the causes that allowed such high profit.

When Consul Lang was writing about his own experiences of farming in Cyprus, he gave his own account of the kulak class; ' The horse-leech which bleeds the peasant is the usurer from whom he borrows to pay his taxes and to subsist until his crop is mature. These advances he procures at an almost fabulous cost. Not only does he borrow at an interest of two and sometimes three per cent per month, but the lender

<sup>56</sup> A. Chayanov, *The theory of peasant co-operatives*, first published in Moscow in 1927, translated by D. W. Benn, London, 1991, pp24-28.

<sup>57</sup> D. Jenness, *The Economics of Cyprus, its present resources-a survey up to 1914*, Montreal 1962, p125.

insists upon being paid in kind...'. Lang then describes the various accounting and weighing malpractices of the money-lender which result in the cost of credit rocketing above 40%.<sup>58</sup>

A Cypriot teacher addressing an open letter to the High Commissioner cited instances of extreme exploitation of the peasants by the money-lenders. He ended his letter by claiming that he was in a position to prove that there were villages where the inhabitants worked as hard as slaves, day and night, but the results of their labour fell in the hands of the greedy usurers.<sup>59</sup>

But the activities of the merchant-money-lending class did not escape the notice of the official Administration even from the early years of the British arrival. This is how one report described their operations; " If a peasant wants seed corn, he usually obtains it on the following condition. The usurer supplies him with the corn on condition of receiving half the crop in return. As a bushel of barley will produce 16 bushels in a good harvest, the usurer gets 800% return within 6 months. If from any cause the crop is lost, the peasant is bound to repay in money at the rate of 30 or 40%. Sometimes the barley is lent at a certain value, say 20 piastres a bushel together with interest. Thus the account of a peasant borrowing would stand as follows:

10 bushels & 20 piastres	200 piastres
Interest at 20%	<u>40 piastres</u>
	<u>240 piastres</u>

When the harvest comes the creditor arrives at the threshing ; there is no market yet, or the peasant cannot get to it, and the creditor repays himself in barley at the rate, say, of 8 piastres a bushel. He thus carries 30 bushels in payment of the 10 he lent. When therefore the government valuation is laid at, perhaps, 12 piastres, the cultivator feels that he is paying 12 when only got 8 from the merchant who was his creditor."<sup>60</sup>

<sup>58</sup> R. H. Lang, *Cyprus-its history, its present resources, and future prospects*, London, 1878, pp254-255.

<sup>59</sup> ΚΥΠΡΙΟΣ, Nicosia, 31 May 1903.

<sup>60</sup> BPP LXV 1881, C-2930, Correspondence respecting the Affairs of Cyprus, June 1881, Major-General Sir R. Biddulph to the Right Hon. Earl of Kimberley, 6/5/1881, p121.

What is clear from the above account of the Cypriot kulak class is an intense feeling that they were in a position to severely exploit the rest of the peasantry, especially at hard times. No effort was made, however, to explain why these people found themselves in such an advantageous position, and what forces influenced their profit margins. This will require a theoretical analysis of rural credit. Such analysis is necessary as the most important contribution of co-operation in Cyprus has been made, as shown later, in the provision of rural credit. More specifically, co-operatives' widely reported success took the form of reducing the role of the Kulak in the peasant economy. It is therefore important to understand the economic behaviour of this class in relation to the peasant economy and examine the process of substitution. But before embarking on such an analysis the remaining peasant classes should be defined.

The second class relates to households which do not engage either in usury or in trade but which have to be classified as semi-capitalist because in their agricultural or extra-agricultural work they employ hired labour on a large scale, usually in addition to their own labour, in order to obtain an entrepreneurial income from such employment. Households of this type are particularly developed in those regions which have a large number of land-holdings and which specialise in producing commodities for export. In these regions such households are more numerous than those of the first type, but their social influence is always less and they themselves may become the victims of exploitation by the kulak household.

As has already been established on the basis of land tenure patterns, Cyprus agriculture during the British Administration has been mainly in the hands of small peasant proprietors. If Christodoulou's assumption that an average Cypriot family to support itself exclusively from agriculture needs 70 donums of all kinds of land is accepted, and if a further assumption is made that in order to be able to afford to employ constantly hired labour at least three times as much land must be owned, then it follows from the previous table that such a rural class is very small in numbers, especially if religious and other foreign investors' interests in land are excluded.

The third class contains farmers who run their households through the labour of the members of their own family. Sometimes they are not economically inferior to

households of the second type, especially when they use modern technology and have large families. Such households will sometimes hire labour on a day-to-day basis in order to help the family at a busy period. Such households are usually exposed to capitalist exploitation only as the result of market relationships, or when some of their members engage in off-farm labour.

The fourth class contains households which do not employ hired labour and which do not hire out their own labour to other households, but which, owing to the small size of their families or to the shortage of land, are unable to develop into robust households of the third type. Households of this type were the commonest type of self-employed family peasant farms in the county-side. Apart from the customary kinds of market exploitation, they may be exploited by households of the first group, who lend them stock or cattle for productive purposes or grant them credit at commercial interest rates.

The fifth class contains households that, because of shortages of the means of production, hire part of their manpower to households of the second group or to other employers. Despite the alienation of a part of their manpower, these households nevertheless continue to run a fully fledged agricultural enterprise with a developed commodity sector. This type of household, if one excludes those whose members earn money outside agriculture, develops in a manner parallel to that of households of the second type and is very often the victim of all kinds of exploitation enumerated above.

Finally, the sixth group relates to agricultural labourers. These households nevertheless have their own farming activities, usually on a very small scale and nearly always for their own consumption.

By looking at the previous table and following the same logic as for the second group it becomes apparent that the majority of peasant farmers in Cyprus in the period under examination qualify to be members of the third, fourth and fifth groups. This is relevant to co-operative development in the following sense; The first group will not only be unable to bring its specific characteristics into co-operative work, but is sharply antagonistic to such work. The whole purpose of co-operatives involved in credit,

marketing and the handling of machinery is to deprive this type of household of its basic functions. According to Chayanov, it is no accident that credit co-operatives in Germany developed and became consolidated as the direct result of their confrontation with usurers.<sup>61</sup>

The above idea seems to be in line with Valenti's theory that a co-operative association is an institution which within the existing system of free competition aims to correct wholly or partly the natural imperfections of the distribution of wealth. He only recognises the co-operative character of those associations, which in their actual work compete with the capitalistic or speculative enterprises. Valenti refuses to recognise the co-operative character of such organisations as livestock insurance co-operative societies, cow testing associations and some other similar co-operative organisations for the single reason that in their respective fields capitalistic or speculative enterprises do not operate and therefore there is no actual conflict of interests. In the words of Valenti himself "there is no antithesis which determines a co-operative function."<sup>62</sup>

Regarding the sixth group of households they will remain outside the ambit of co-operation because they do not have the possessions which are needed for participation in a co-operative. These possessions may either be land of a minimum value that can be put on mortgage in order to obtain co-operative credit, or surplus agricultural production that can be sold through a marketing co-operative.

All the remaining groups, which constitute the overwhelming majority of households in the Cypriot rural areas, have possessions which are sufficient for co-operative activities.

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<sup>61</sup> Chayanov, 1991, p29.

<sup>62</sup> Emelianoff, 1942, pp17-20.

## 2.5 The economics of usury

During the pre-independence period, and especially before the strengthening of the co-operative movement, usury was widely practised in Cyprus. This is not only alleged by the local Press and politicians but is also confirmed by official reports. One such report gives details about the exact methods of transactions between the villager and the merchant, emphasising the usurious nature of such dealings.<sup>63</sup> An understanding of the exact nature of transactions between agricultural production agents and capitalist agents is very important for the purposes of this study, as it relates to co-operation's major contribution at the pre-independence period, said to be the economic extinction of agricultural usury.

The course of business was for the farmer to draw on the merchant for money and supplies, and in repayment to deliver to the merchant a proportion of his produce. Sometimes the farmer was under express contract to deliver his produce to the merchant. If there was no such contract, he was obliged to do so, otherwise the merchant could press for payment of his debt, and the farmer being unable to find the cash could be sold up and ruined. Apart from a high interest rate charged on outstanding amounts the Commission also found that on delivery of the produce by the villagers to their merchant-creditors excessive amounts were deducted for tare, and that a high proportion of the merchants' weighing machines were faulty, all errors being in favour of the merchant. As regards the price, it was found to be fixed by the merchant when the account was struck between the parties when there was no express contract as to price. There could be no bargaining because the farmer was bound to deliver his produce. There was no check on the merchant as regarded the price he fixed.

Regarding interest rates the report found strong evidence that village money lenders frequently charged excessive rates. Some of them admitted charging 3 shillings and 4 shillings in the £1 (20 shillings = £1) over the life of the crop, usually nine to twelve months. Others as shown by contracts appeared to be charging much more. Sometimes a moderate interest was charged and a large commission for getting the loan.

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<sup>63</sup> Report of the Commission on the extent, causes and effects of indebtedness in Cyprus, Nicosia, 1918.

Sometimes the loan was treated as a payment in advance for produce, which was to be delivered at a price below market price, so that the money lender would obtain interest much in excess of what was allowed by the law. The interest charged in kind was found on certain occasions to be over 50%. The report also argues that due to their illiteracy, peasant farmers could not check that transactions were correctly recorded in their account in the merchant's books.

Such dealings between money-lender and peasant as described above are consistent with the theory of credit inter-linkage which highlights the additional advantages to be gained by a money-lender who is capable of intervening in some other market that the borrower is active in.<sup>64</sup>

The Report of the Commission concludes that the real causes of high rural indebtedness in Cyprus are the improvidence of the farmers and the usurious rates charged by unscrupulous merchants. Similar opinions were expressed by Lang<sup>65</sup> when describing the rural situation in Cyprus at the time of the British arrival, and, at least with respect to the improvidence of the farmers also by Lanitis writing in 1944<sup>66</sup>.

It is argued later in this chapter that improvidence and usurious rates in the context of a peasant agricultural economy are mere symptoms and not causes. Treating them as causes of high rural indebtedness can result in the wrong medicine, with results opposite to those desired.

### 2.5.1 Lender's Risk Hypothesis

A fairly vivid picture has already been drawn about peoples' perceptions of money-lenders. Yet the usurious rates they charged appear perfectly compatible with the lender's risk hypothesis which allows for the possibility of credit default. If the cost of this risk of default is deducted from the nominal interest rate, the result is the effective interest rate which is equal to the urban interest rate. Since the interest rate observed by field workers is the nominal one, the lender's risk hypothesis attempts to provide an

<sup>64</sup> D. Ray and K. Sengupta, *Interlinkages and the pattern of competition*, in Bardhan(ed.), 1991, p245.

<sup>65</sup> Lang, 1878, pp239-240.

<sup>66</sup> Lanitis, 1992, pp35-36.

explanation for the exorbitantly high interest rates that have been observed in the unorganised credit markets of less developed economies.<sup>67</sup>

On the basis of available information this risk of default must have been high in the case of the Cypriot peasant if it is assumed to be a directly dependent variable of the rate of peasant insolvency. At the time of British arrival in Cyprus one in twenty five of the total population in the Limassol district were sued for debt, and all over the island prisons overflowed with debtors who were being maintained at the expense of the state.<sup>68</sup>

The Commissioner of Nicosia reported in 1889 that “a series of bad years, falling prices, failure of export trade, and, I fear, in many cases, the inflexibility of the Government revenue demand, has thrown large numbers of peasant proprietors into the clutches of the usurer, and brought them to a condition of almost hopeless insolvency. But the remedy for this state of things is not, I hold, to be sought for in the establishment of agricultural banks and similar projects. Many are too far involved to be affected by any remedial measures that would be devised”.<sup>69</sup>

Various criticisms have been made of the lender's risk hypothesis. Empirical studies in India confirmed that the rate of actual default was not sufficiently high to be able to explain the high rural interest rates.<sup>70</sup> The problem with these results and any similar studies is the subjectivity involved in measuring risk expectations. In addition, what is that rate of default that would justify such high interest rates?

In defining risk in terms of the probability of monetary loss, some measure may be obtained of this risk, even subjective, by comparing the outstanding amount of debt at a given time to the security offered for that debt at that time. This security could take the form of mortgaged property, or a floating charge on the farmer's output and personal belongings, or the personal guarantees of some credit-worthy acquaintances

<sup>67</sup> K. Basu, Rural credit markets: the structure of interest rates, exploitation and efficiency, in Bardhan(ed.), 1991, pp148-149.

<sup>68</sup> Jenness, 1962, pp125-126.

<sup>69</sup> BPP LVI 1889, C-5812, Report by Commissioner of Nicosia, 22/1/1889, Further Correspondence relating to the Affairs and Finances of Cyprus, August 1889, p46-47.

<sup>70</sup> Basu, 1991, p149.

of the debtor, or finally, a combination of these three methods. Of the three types of security it is reasonable to assume that the safest and the only one which can be assigned a value is mortgaged property. Trying to put a measure on the other two types of security would involve a high degree of subjectivity since it is impossible to predict an agricultural household's annual output due to the highly uncertain nature of agricultural enterprise, as will be shown later in this section, and similarly with trying to put a value on a personal guarantor's credit-worthiness.

Conveniently enough for the purposes of this study a survey of rural indebtedness in Cyprus was completed in 1930 which, among other things, estimated the amount of indebtedness of rural Cyprus based on fieldwork investigations, and also put a value on debts secured on mortgaged property based on Land Registry records. According to the results of the survey total rural indebtedness in Cyprus amounted to about £1,800,000 of which £1,600,000 was recorded in the department of Land Registry. The total value of properties in accordance with reported government assessment amounted to £12,450,000. Surridge estimated the forced values of these properties to be approximately £11 million. In other words debts in 1930 represented approximately 16% of agricultural property.<sup>71</sup>

Based on the above estimates, and assuming that debts recorded in Land Registry records do not include capitalised interest, it would appear that the vast majority of debts in Cyprus at the time were fairly secure. The fact that interest rates in the unorganised agricultural credit market were reported to be excessively higher than in the organised market can hardly therefore be fully explained by the lender's risk hypothesis. It could perhaps be argued that the amount of risk as perceived by the money-lender included some estimate of the costs involved in liquidation including opportunity costs of delayed receipts, as well as the possibility of sudden reductions in the property market values, bearing in mind the fact that liquidation in Cyprus has always been a long and time-consuming process. But, serious doubts are cast on the lender's risk hypothesis by the fact that 20 years before the time of the survey transactions between debtor and creditor were mainly in the form of current account

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<sup>71</sup> Surridge, 1930, pp42-43.

and the security of immovable property was not demanded.<sup>72</sup> And yet the same level of usurious rates were extracted if one judges by the results of the Report and the Survey already mentioned.

Temporarily ignoring the very legitimate objections raised above on the validity of the lender's risk hypothesis, and assuming, not without reason, that risk of default is at least part of the reason for the existence of usurious rates, a very valid statement can be made about the appropriateness of agricultural co-operatives in tackling the problem of high risk, if such high risk exists. The co-operative alternative can greatly reduce this risk through joint and unlimited liability. The money-lender no longer transacts directly with individual peasant households but rather, invests his capital in the operations of these households through a co-operative intermediary. The large number of members of this intermediary as compared to his previously limited client portfolio results in the spread of risk which is further reduced by the fact that members, in a Raiffeisen type co-operative, carry joint and unlimited liability.

#### **2.5.2 Exclusion of peasants from the organised credit market**

As an alternative to the lender's risk hypothesis some theoreticians blame the very high interest rates charged in the rural credit markets on simple demand and supply forces. Taking the acute need for credit by peasants for granted, the theory differentiates credit markets into organised and unorganised markets. The first relates to a network of credit relationships which absorbs unused capital and puts it in the hands of economic organisers who need funds. On this market, capital is assumed to be a depersonalised commodity which has a uniform price for all similar credit transactions, in the form of a rate of interest on loans. It further assumes that owing to a considerable volume of capital that has been accumulated, its price proves to be low, varying between 3% to 7%.

According to the same theory the small peasant producer, who works far from the centres of market credit and who is unable to satisfy many of the conditions which credit centres usually impose upon their clients, is almost always denied the

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<sup>72</sup> Surridge, 1930, p45.

opportunity to avail himself of cheap organised credit. He meets his inherent need for funds from local sources, from the unused capital at the disposal of his more prosperous neighbours. Credit of this kind remains unconnected with the organised credit market; and the conditions of this market, including the low rate of interest on capital loans, have no influence on it. The acute need for funds and the small volume of locally accumulated capital drive up the price of capital to an extraordinary degree.<sup>73</sup>

One explanation as to why peasant producers are excluded from the organised credit market is based on the assumption that loan processing has strong positive scale economies. Estimated costs for small loans are said to be in the range of 15-40% of the loan value. These cost differentials, plus the typical lack of collateral and the higher perceived risk of the small agents, induce a bias against them in credit allocation. Interest ceilings and limited budgets further strengthen the bias. The alternative action for these small agents is to use the informal credit markets. In addition, arbitrariness, patronage, and corrupt practices frequently undertaken by the financial intermediaries, further limit access to credit of the small farmers.<sup>74</sup>

The exclusion of the Cypriot peasant farmer from the organised credit markets, at least other than the kulak and the large scale producer in the second group as defined by Chayanov, is quite obvious from the reports at the time. Surridge for example reported that the money-lender was still the only avenue of credit for agriculture in Cyprus.<sup>75</sup> This exclusion meant that the local merchant-money-lender, large enough and wealthy enough to qualify for organised credit market finance, was in a position to act as an intermediary between the organised market and the peasant. His reward was the difference between interest on the organised market and interest on the unorganised market. In a competitive environment the level of the difference is set by pure demand and supply forces. However, the fact that debtors in a village were usually reported to be at the absolute mercy of one or not more than a few money-lenders who place the whole village trade under their economic and political control<sup>76</sup> tends to reject this

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<sup>73</sup> Chayanov, 1991, pp72-73.

<sup>74</sup> A. Braverman and J. L. Guasch, Institutional analysis of credit co-operatives, in Bardhan(ed.), 1991, pp341-342.

<sup>75</sup> Surridge, 1930, p45.

<sup>76</sup> Report of the Commission on the extent, causes, and effects of indebtedness in Cyprus, Nicosia, 1918.

competitive supply and demand proposition, i.e. the money-lenders were able to earn monopoly profits. They managed to preserve their local monopolies by exploiting their strong bargaining position in relation to the peasants. If an indebted peasant tried to go elsewhere for business his existing creditor would call in all his debts and would therefore force him to sell up his mortgaged property.

Basu rejects the idea that rural money-lending is competitive and puts forward his theoretical proposition that it rather resembles perfect discrimination, achieving Pareto optimality but with all surplus accruing to the creditor. In practice he thinks that such perfect exploitation may not be possible for two reasons; first, he may have inadequate "a priori" information about the borrowers, and the transaction cost of such elaborate bargaining may be too high. Second, such a discrimination may cause dissent among borrowers.<sup>77</sup>

It would appear from the reported behaviour of a large number of money-lenders that neither of Basu's reservations would be contributory factors in Cyprus. High levels of reported illiteracy among the peasant farmers and a very inelastic demand curve for credit, an essential element of exploitation, gave a free hand to the money-lender. In fact, it is hard to see how a rational profit-maximising money-lender would refrain from perfectly exploiting his debtors provided conditions existed that enabled such monopolistic discriminatory economic behaviour. Such behaviour could perhaps, up to a certain degree, be constrained by considerations of kinship.

But a more serious objection to Basu's theoretical base of arriving at Pareto optimality through perfect discrimination arises in the case of credit supply to peasant producers. A Pareto optimum is a point from which you cannot make one consumer better off without making another one worse off.<sup>78</sup> This theorem, however, could be relevant in a static world but not so relevant in a dynamic agricultural environment. Overall total economic welfare could be increased if the peasant farmer is able to obtain cheaper credit and thus spend more on agricultural inputs, machinery and irrigation works, especially in the case of a backward agricultural setting. An equilibrium is reached

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<sup>77</sup> K. Basu, pp153-154.

<sup>78</sup> C. E. Staley, *A history of economic thought from Aristotle to Arrow*, Oxford 1994, p258.

where the marginal revenue productivity of such investment expenditure equals the marginal cost of capital, in other words interest. In the case of the Cypriot peasant this equilibrium was reached at a non-optimum level due to a number of market imperfections like high transaction costs and imperfect knowledge.

Another characteristic of the unorganised rural credit market is a tendency to break down due to exogenous factors, the main actors being unable to hedge against risk. One such example was the severe drought for the period 1901-1903 when money-lenders refused to make any further advances to the peasants. In the absence of such credit and in the face of a starving rural population the Administration used the savings in the Public Work Vote to afford employment on road works, giving about one-third the usual prices for labour.<sup>79</sup> This break-down in the market for rural credit and the subsequent need for government to lend a helping hand at a time of a hands-off economic policy, casts certain doubts on the ability of market forces in a state of economic development similar to that in Cyprus at the beginning of the century and not dissimilar to that of a number of developing countries today, to produce the best possible results for the economy as a whole in the case of exogenous shocks like drought, war, earthquake or locust attacks.

### 2.5.3 Inelastic demand curve for agricultural credit

Money-lenders could not have acquired such high exploitative powers unless the demand curve for credit by peasant farmers was inelastic. This meant that money-lender income followed the same direction as price of credit, at least up to a certain maximum level. The more inelastic the demand curve was the higher this maximum level of income. The fact that nominal interest rates in the unorganised credit market were reported to be significantly above the effective rate in the organised market is a clear indication of a very inelastic demand curve. Various reports at the time including that of Lang<sup>80</sup> and also of the Commission appointed to enquire into the extent, causes and effects of indebtedness, forty years later, wrongly blamed the improvidence of the Cypriot peasant for the unhappy situation regarding rural indebtedness. Rather, the

<sup>79</sup> BPP LXVI 1902, C-1434, Sir W. F. Haynes Smith to Mr Chamberlain, 17/2/1902, Correspondence respecting the drought in Cyprus, p1.

<sup>80</sup> Lang, 1878, p239.

whole situation was created, and this was not unique to Cyprus, due mainly to the presence of exogenous forces outside his control.

#### 2.5.3.1 Forces of nature

The first such force was the not infrequent occurrence of droughts and generally the large fluctuations in rainfall which greatly affected agriculture in the face of insufficient irrigation works. Reporting in 1934 on the water supplies of Cyprus Sir Ralph Oakden came to the conclusion that “the fundamental bar to increased agricultural productivity in Cyprus is not human or soil deficiency, but a deficiency of water supplies.”<sup>81</sup> Christodoulou, writing in 1959, describes Cyprus as a thirsty land and its agriculture mainly dependent on dry farming.<sup>82</sup>

The absence of any serious irrigation works meant that the success or failure of crops depended on the prerogatives of the weather. This absence was noticeable in the agricultural census of 1946 which found that only 3,46% of all reported agricultural land was under various types of perennial irrigation. And as unfavourable weather conditions were not unknown in Cyprus peasants experienced significant variations in their income. Table 2.5 and accompanying graphs show annual rainfall and production of wheat and barley, two of the most important items of production in Cyprus, for the period 1881/82 to 1902/03:

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<sup>81</sup> Oakden, 1935, p133.

<sup>82</sup> Christodoulou, 1959, p114.

Table 2.5: Annual rainfall and production of cereals, 1882-1903

YEAR	Rainfall recorded in Nicosia	Production of wheat	Production of barley	Total average production
	mm's	bushels 000's	bushels 000's	bushels 000's
1882	184	1356	872	1114
1883	308	1554	1672	1613
1884	504	1350	1772	1561
1885	501	1804	1954	1879
1886	306	1361	1575	1468
1887	199	1577	1682	1630
1888	158	857	1364	1111
1889	273	1370	2247	1809
1890	404	1872	2655	2264
1891	396	2144	2472	2308
1892	170	2071	1963	2017
1893	371	1386	1870	1628
1894	418	2336	2397	2367
1895	280	2366	1833	2100
1896	317	1778	1695	1737
1897	243	2088	1851	1970
1898	280	1328	1862	1595
1899	201	2077	2258	2168
1900	292	1550	2001	1776
1901	239	2081	2664	2373
1902	135	1265	1663	1464
1903	278	870	1332	1101

Sources: (1) Statement of Rainfall from October to March inclusive during the years 1881/82 -

1902/03, Cyprus Gazette, 3/7/1903.

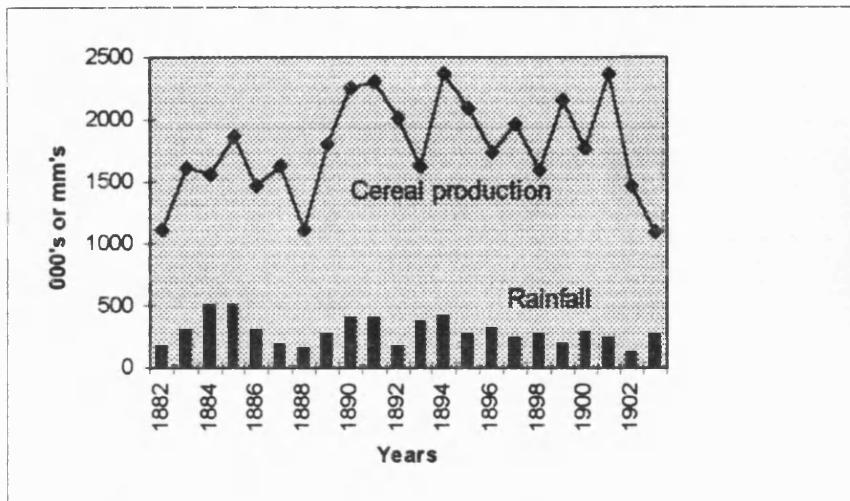
(2) Wheat and barley production, Cyprus Blue Books for the years 1887/88 - 1902/03

(3) Wheat and barley production 1881/82 - 1886/87, Lord Knutsford to Sir Henry

Bulwer, 22/3/1890, Further Correspondence relating to the Affairs and Finances of

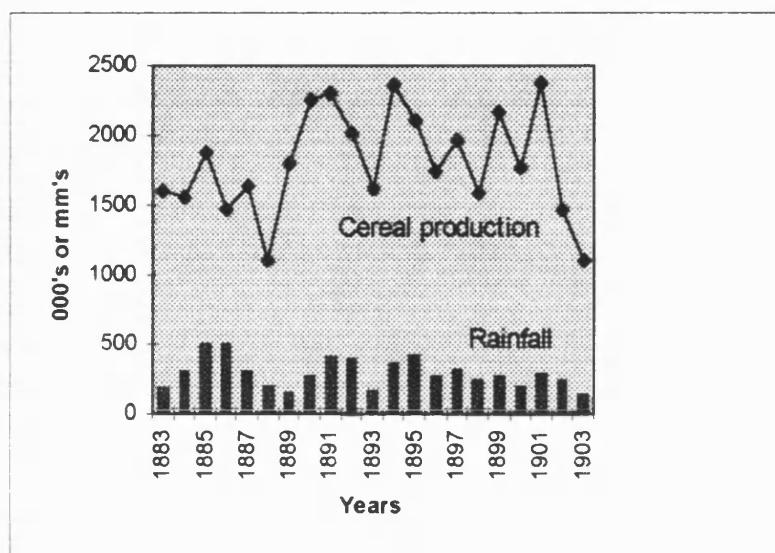
Cyprus. April 1890, BPP XLIX, 1890, C - 6003, p.25.

Figure 2.2: Annual rainfall and production of cereals



Rainfall and production appear to move in similar directions subject to the one-year time-lag between rainfall and production. This is only natural since most rainfall in Cyprus comes in the months of December to February and the harvesting period begins in June and finishes in July where as financial years during the period under review ended in March. Adjusting for the one-year time-lag the following diagram is obtained:

Figure 2.3: Annual rainfall and production of cereals as adjusted for one-year time-lag



The correlation coefficient between rainfall and average cereal production as adjusted for the one-year time-lag is 0.42 as compared to 0.31 without adjustment. This coefficient may not be as high as would have been expected mainly because production is not only dependent on the total annual rainfall but also on the distribution of this rainfall between winter and spring months.

It is clear from the above that variations in the level of rainfall, very much present in the agricultural scene of Cyprus, were accompanied by equally significant variations in the level of production of two of the main crops of the island at the time. These variations naturally resulted in equally important fluctuations in the incomes of a great number of peasants. Taking the value of the average production of cereals for the period 1929-1933 as an example, and based on data contained in Sir Ralph Oakden's report, it is estimated that cereals made up £566,970 or 40% of an estimated average total agricultural production of £1,430,000.<sup>83</sup>

The other important natural cause was the ravages of agricultural pests. One such pest was the locust. Locust attacks seemed to have been a constant threat to crops in Cyprus. In the year 1867 the attacks by locusts were reported to be so bad that they ate up every green thing, including even the leaves of the trees. The Turkish ruler Pasha destroyed them by turning out every male inhabitant, rich or poor, to help in their destruction. Every landowner, great or small, had to furnish a bushel of eggs, and after this the destruction appeared to be complete. But since 1867 they gradually increased again their reproduction being a large ratio of geometric progression.<sup>84</sup>

According to one writer, at the time of the British occupation the attention of the authorities was chiefly devoted, so far as agriculture was concerned, to combating the locust pest, which from year to year devastated the island and caused damage to the crops.<sup>85</sup> Such was the importance attached to the successful outcome of this action that in 1879/80 expenditure on locust destruction amounted to 3.2% of total government expenditure following a large outlay for the purchase of material for traps

<sup>83</sup> Oakden, 1935, pp11-13.

<sup>84</sup> BPP. LXV, C-2930, Correspondence respecting the Affairs of Cyprus, June 1881, Major-General Sir R. Biddulph to the Right Hon. Earl of Kimberley, 23/5/1881, pp130-131.

<sup>85</sup> Orr C. J., *Cyprus under British Rule*, London, 1918, pp142-143.

from England.<sup>86</sup> Thereafter, the Administration levied a separate tax called locust destruction tax with revenues going into a separate fund and not in the general revenues of the island.

Every single annual report of the department of agriculture contains evidence of several other agricultural pests and animal diseases. The reports for 1924 and 1925, for example, blame the poor crop of cotton on the ravages of the cotton boll worm where as the 1923 report blames animal disease for the death of 25% of the sheep population on the island. The report for 1930 blames the poor crop of grapes on the fungoid disease. It also blames the drop in the export of poultry on the outbreak of poultry disease. The production of grapes was also a poor one owing to disease in 1931.

#### **2.5.3.2 International market situation**

The second most important exogenous factor beyond the Cypriot peasant's control which was causing serious fluctuations in his income was the state of the international markets regarding prices and trade controls. As has already been explained the average Cypriot farmer was a small-scale operator and therefore had no influence over the prices established either in the local or foreign markets. This externality was of course true for farmers throughout the world, but due to the marginal level of his income, as already mentioned above, and due to the slow rate of adapting to new market conditions as a result of limited and expensive finance capital, the Cypriot farmer was at a great disadvantage as compared to his counterparts in the developed world.

On an international level, agriculturists before 1870 had not been troubled by overseas competition as transportation costs on overseas shipments of bulky, low-value commodities such as wheat and rye had effectively protected them. In the 1870s dramatic reductions in transportation costs brought into production vast new areas of virgin prairies. For the first time Europeans faced strenuous competition in their own markets.<sup>87</sup> This increase in supply coming mainly from the New World naturally put pressure on world prices, resulting in the return to protection. Such protectionism did

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<sup>86</sup> BPP XLIX 1880, C-2629, Correspondence respecting the Financial State of the Island of Cyprus, 1880, Major-General Biddulph to Earl Granville, 21/5/1880, p2.

<sup>87</sup> Cameron, 1993, p281.

not leave Cyprus unaffected. French restrictions on imports of wine, for example, were causing serious problems on the wine industry of Cyprus.<sup>88</sup> In 1933 wine exports to Egypt, Cyprus main trading partner in wine, decreased to less than 50% of the previous year's value as a result of heavy protective tariffs in that country.<sup>89</sup>

It has already been shown that during the period of the British Administration agriculture in Cyprus was very important both in terms of National Production and foreign trade. The Cypriot farmer was extremely sensitive to international market price fluctuations mainly because a sizeable proportion of his output was targeting markets abroad, through local merchants. Sir Ralph Oakden reported that of a total estimated agricultural production averaging £1,430,000 over the 5-year period 1929-1933, £535,400 or 37% related to exports.<sup>90</sup> If the value of a single product, wheat, is removed from these estimates the percentage becomes significantly higher; the average value of wheat production for the same 5-year period on the basis of aggregate production value data supplied by Oakden<sup>91</sup> is estimated at £376,102 of which only £6,559 related to exports. Ignoring these two numbers the above percentage becomes 50%.

The exclusion of wheat from the estimation of the above percentage may be excused on the grounds that the local price of wheat was very much affected by prices on the international markets since large amounts of this product were imported as flour in order to satisfy total domestic demand. As an indication, over the same period 1929-1933 average imports of wheat are estimated at £175,032 or 47% of total consumption. Downward pressures put on local market prices forced the local Administration to impose a limited degree of protection measures in the form of import duties on imported flour.<sup>92</sup> However, these measures could not stop the downward trend in the price of wheat and wheat related products as a result of competitive price pressures from imports. Table 2.6 shows this downward trend for the period 1920-1933:

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<sup>88</sup> Cyprus: Annual Report of the Department of Agriculture for the year 1929, Nicosia, 1930, p19.

<sup>89</sup> Oakden, 1935, p14.

<sup>90</sup> Oakden, 1935, p11.

<sup>91</sup> Oakden, 1935, pp12-13.

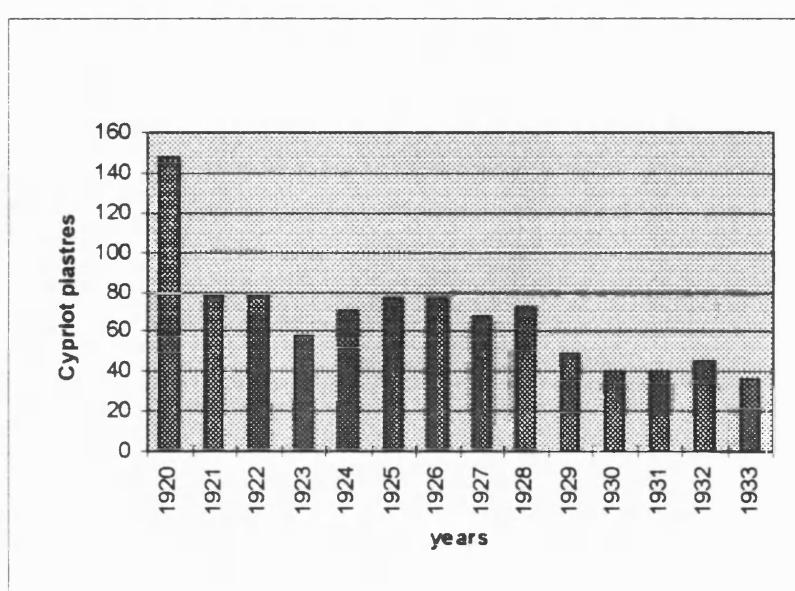
<sup>92</sup> Oakden, 1935, pp157-158.

Table 2.6: Price of wheat and bread, 1920-1933

Year	Local price of wheat per bushel	Price of bread per loaf
	cp	cp
1920	148	7.50
1921	78	4.50
1922	78	3.25
1923	58	3.00
1924	70	3.75
1925	76	3.75
1926	76	3.50
1927	67	3.25
1928	72	3.25
1929	49	3.00
1930	40	2.50
1931	40	2.25
1932	45	2.00
1933	36	1.75

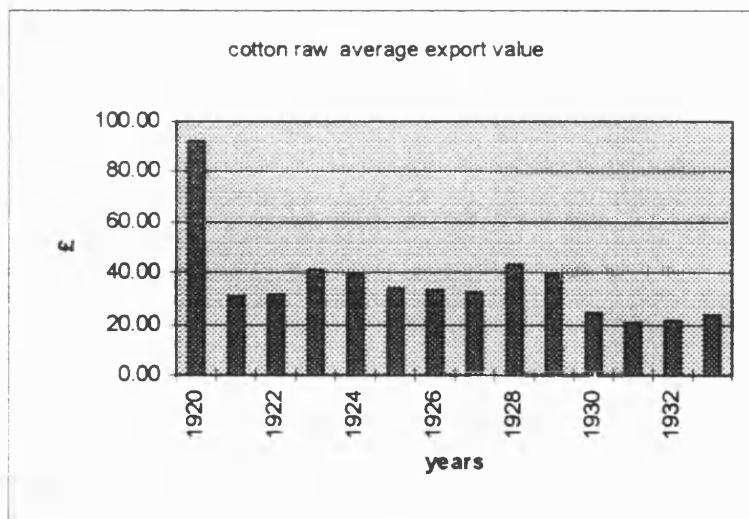
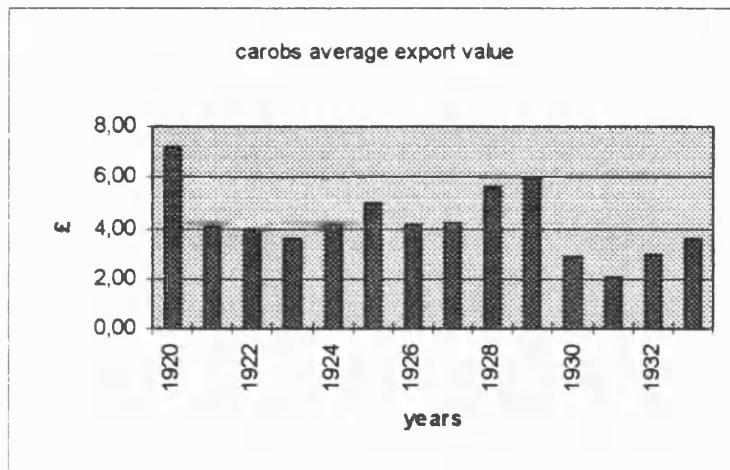
Source: Report on the Finances and Economic Resources of Cyprus, by Sir Ralph Oakden, 1935, p159.

Figure 2.4: Local price of wheat per bushel

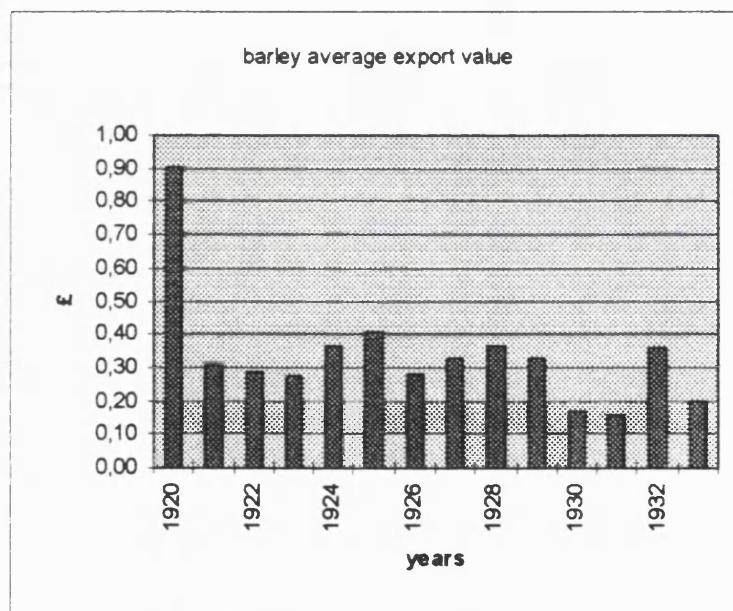
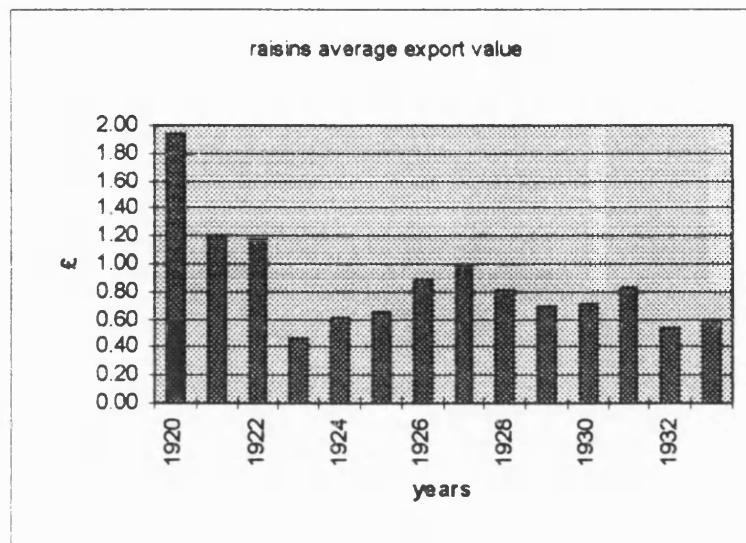


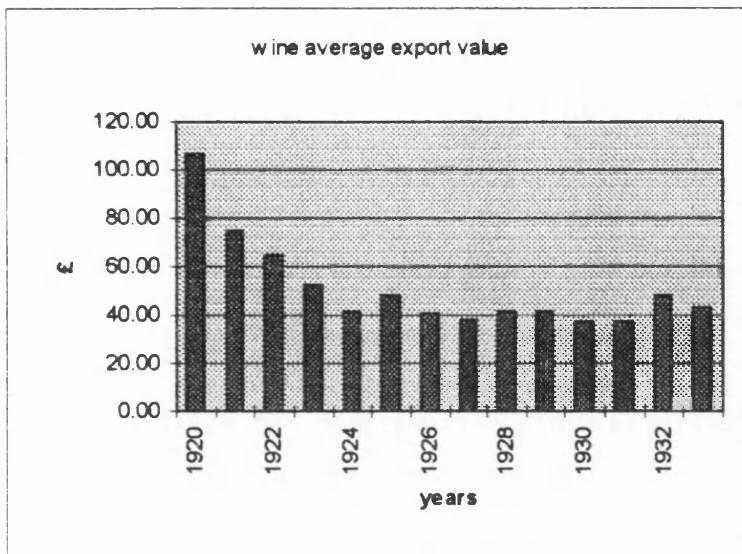
During the same period average export income per unit of quantity exported for five of the most important export income earners of the island showed the following trend:<sup>93</sup>

Figure 2.5: Most important export income earners



<sup>93</sup> Cyprus: Blue Books.





It should be noted that average values used above are in nominal and not constant price values.

Regarding the effect of falling prices on the agricultural classes the Committee appointed in 1931 to study the Conventions and Recommendations adopted by the International Labour Conference noted that falling prices of agricultural products were causing more holdings to be sold up on account of debt.<sup>94</sup>

#### 2.5.4 Causes of excessive indebtedness and usury

Having established that farmers incomes, at least in the case of Cyprus at a time when no subsidies were available, experienced significant fluctuations due to at least two exogenous factors, and ignoring the time-lag production factor characterising agricultural production, it is necessary to analyse the effect of these fluctuations on the demand curve for credit, starting with Chayanov's division of a peasant farmer's income.

A market oriented peasant family household's income is divided into three parts; first, the value of the renewal of the material means of production, second, the family's personal consumption, and third, sums set aside for the purpose of capital

<sup>94</sup> Cyprus: Report of the Committee appointed to study the Conventions and Recommendations adopted by the International Labour Conference, 1932, p10.

accumulation.<sup>95</sup> Regarding the renewal of material means of production this shall be taken to include the replacement of fully depreciated fixed assets, as well as the purchase of agricultural inputs like seed and fertilisers. As for capital accumulation, this relates to sums set aside for future investment in order to increase the future earning capacity of the farm unit.

The first obvious group of expenditure to go in the case of a drop in the income of the household, due to an exogenous shock, is amounts set aside for capital accumulation. On a short-term basis this does not appear to the farmer to create serious problems, although detrimental to the future development of his standard of living on a long-term basis.

Problems begin to arise when a further drop in his income takes place. There are certain levels of expenditure below which neither consumption nor replacement of capital can fall without serious repercussions on the survival capacity of the family. Surridge estimates that 75% of the peasant proprietors do not earn much more than a wage-earner's income.<sup>96</sup> According to the 1930 Blue Book on Cyprus the average daily wage-rate of an agricultural labourer, was 2 shillings or about £32 per year. This is exactly the same amount as Surridge's estimate of the minimum total cost of living required by a peasant family of five. In other words, the majority of peasant households in 1930 are said to have been living very close to the minimum standard of living.<sup>97</sup> What was quite noticeable in the budget of the peasant family was the very high share taken up by bread. In the above minimum standard budget of £32 at least £16 was spent on bread. In an average standard budget of £60 about £20 was spent on bread and in a maximum standard budget of £90 about £22 was spent on bread.<sup>98</sup> It should be noted that a farmer's income was net of a certain amount of necessary expenditure for agricultural inputs. Surridge estimated this input expenditure at about £45.<sup>99</sup>

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<sup>95</sup> Chayanov, 1991, p65.

<sup>96</sup> Surridge, 1930, p33.

<sup>97</sup> A number of older people confirm the validity of this statement even for later periods.

<sup>98</sup> Surridge, 1930, p33.

<sup>99</sup> Surridge, 1930, p37.

Certain important conclusions may be drawn from the above estimates. First, the minimum net income after subsistence costs of a farmer in any year, not including unforeseen emergencies, could not be allowed to fall below £45 otherwise capital replacement would have been impossible. Regarding consumption, an amount equal to £32 would reduce the farmer to the state of an agricultural worker. A total gross income of £77 would therefore be considered a minimum below which the farmer would experience real hardship. In a good year total gross income was estimated to be about £135. A margin of £58 or 43% existed before the well-to-do peasant household would start to feel the effects of poverty. Assuming however that the previous year the peasant household started from an average position of £105, the percentage margin dropped to 27% only. Assuming the household's income was heavily dependent upon income received from grain and also assuming constant quantities, that would have meant a change in annual income from year one to year two by approximately the same percentage as the change in the average price of grain. The price of wheat in 1930 was 20% lower than that of 1929 but 45% lower than that of 1928. Bearing in mind that a fairly large number of peasant households were already on the border-line it is no wonder that every time there was a serious drought large numbers of peasants were reported to come close to or even experience starvation but for a number of relief measures taken by the government.

It was in order to avoid starvation and also obtain the necessary agricultural inputs to ensure a living the following year that peasant farmers were forced to accept usurious interest rates and other, equally harsh obligations under contract. This is where the demand curve for credit became very inelastic, and the money-lender found himself in such a perfectly exploitative condition. Surridge, Lanitis, and a number of other writers put a lot of emphasis on the improvidence of the peasantry in good years, mainly due to their desire to acquire more land by obtaining loans from money-lenders which they could not service. True, such loans may have contributed towards the very high rate of indebtedness of the peasant population of Cyprus, but such contribution should not be over-emphasised. It is very doubtful whether on such loans the money lender was in a position to extract rates much higher than the effective rate. Under these circumstances the demand curve for credit became far less inelastic and therefore the money-lender was no longer in a position to perfectly exploit his clients.

Both Christodoulou and Lanitis, trying to explain why the Cypriot peasant was so heavily in debt, mentioned among other reasons land-ownership patterns. True, small scattered plots created inefficiencies due to diseconomies of scale. However, in the face of such income variations as noted above, it is unlikely that a possible 10 or 20% increase in efficiency would result in a much less depressing situation for the Cypriot peasant. Reporting on fragmentation and consolidation of holdings in 1946, the Land Utilisation Committee recognised that, except in certain restricted areas, fragmentation had not in Cyprus proceeded to a point where individual cultivators' holdings had become so small and so widely dispersed as to render their cultivation utterly uneconomic; the evils of fragmentation were thus not self-evident and were as yet not generally appreciated by the village people. The situation in Cyprus was compared to that in Punjab where land consolidation measures had become necessary because land holdings had been reduced to a situation where effective cultivation was not possible.<sup>100</sup>

Going back to the point where the transaction between the farmer and his money-lender took place at a point on the inelastic curve, the peasant's income for the following year will not only have to cover for the expenditure of that year but also for the deficit income of the current year plus a percentage of that deficit income as interest, or commission, or difference in the purchase and sale price. The formal description of this percentage is irrelevant; what matters is the amount. The lower the elasticity of demand for credit the higher the percentage of return to be extracted by the money-lender. Especially where the farmer faced two bad years in a row it is not hard to imagine that he could easily fall into the clutches of his usurers for good. Christodoulou estimated that in the late fifties, with an already developed co-operative movement, and no doubt with a far more developed agriculture, one year of drought would require some three or four years to overcome the resultant indebtedness.<sup>101</sup>

Needless to say that faced with the above situation, not much attention was paid to capital accumulation, at least by the middle three groups of peasant households as

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<sup>100</sup> Cyprus: *Report of the Land Utilization Committee*, Nicosia, 1946, p5.

<sup>101</sup> Christodoulou, 1959, p94.

defined earlier on. As a result agriculture was reported by various writers to be at a very backward state, even nearly as late as the time of independence.<sup>102</sup>

Based on the results of his Survey Surridge reported that only 18% of the peasant proprietors were not in debt as compared to 17% in the Punjab. Regarding the average value of debt he estimated this to be £37 in the case of Cypriot proprietors as compared to £30 in the case of the Punjab.<sup>103</sup>

The estimated average amount of the debt probably represents the average net income of the majority of the peasants for a whole year, based on the assumption that the majority earned an income not much greater than that of agricultural workers. Even, however, for those peasants that earned twice as much as the agricultural class, they would still find it impossible to repay their debts even after two continuously good years, both in terms of weather and market conditions, an event not so common in Cyprus. But what was even worse for the indebted peasant was the requirement imposed on him by his money-lender to market all his output through him, thus extracting maximum surplus. This requirement was imposed on the peasant through the threat of selling up his property for outstanding balances which would be impossible to be met on call.

The above line of argument which links heavy peasant indebtedness to a number of important external factors cannot be considered complete unless an important inherent factor giving rise to variations in peasants' income is dealt with. This is known as the time-lag factor.

#### 2.5.5 The time-lag factor

The time lag between the time of planting and the time of sale could be a period of six to eight months for vegetables, less than one year in the case of cereals, and several years in the case of young trees or livestock. During this time-lag the peasant has to feed his family, buy seed and fertilisers, maintain his livestock and meet all other expenses of the farm. This, according to Lanitis and other agricultural economists

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<sup>102</sup> Christodoulou, 1959, p93.

<sup>103</sup> Surridge, 1930, p43.

gives rise to the need for short-term credit for which co-operatives are best suited since no mortgage is required by these institutions for such credit. According to Lanitis, co-operative credit societies cannot make advances on long-term for they depend for their working capital on deposits and/or advances from joint-stock banks, which are made for a shorter period than that for which long-term loans to agriculture are usually made. Further more, Lanitis states that long-term credit to agriculture must be mortgage credit; which cannot be provided for by co-operative societies whose constitution is such that they can only advance credit on personal security.<sup>104</sup>

Whether co-operative societies are best suited only for short-term credit has nothing to do with their constitution since that is a controllable factor, and in fact most short-term credit supplied to agriculture at present in Cyprus is mortgage credit, as already shown. Lanitis's belief that for long-term finance farmers should turn to the Agricultural Bank has been tested in Cyprus and has failed for reasons explained later. Finally, there is no logical reason why banking institutions in the organised credit market should not be prepared to provide long-term loan facilities to co-operatives, bearing in mind the reduction in risk and processing costs achieved by lending through such an agent. The overall question of short-term finance to agriculturists through co-operatives will be revisited at a later chapter as the experiences from the Cypriot co-operative movement do not seem to comply with this theoretical framework.

Although the time-lag factor does mean that net proceeds to the farmer do not come at short regular intervals, assuming a mainly grain producing dry-farming country with an average time-lag factor not over 12 months, and also assuming absence of significant capital investment and externalities of the type mentioned earlier in this chapter, it is hard to see any vital role that can be played by co-operative credit other than to mitigate for instances of improvidence, as the peasant farmer himself can assume the responsibility of his own income stabilisation especially in a patriarchal society where the children can fall back on the father's income for sustenance during the first year of going on their own.

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<sup>104</sup> Lanitis, 1992, p51.

Mitigating against improvidence through co-operative credit may in fact prove detrimental both to the farmer in question who is encouraged to continue with his improvidence but also to the co-operative effort as a whole if large amounts have been given out to such improvident farmers with a low probability of recovery. The only possible excuse for such a line of action under the assumed state of the peasant economy outlined above would be to provide a learning process to the improvident peasant on thrift. The experience of a number of attempts to set up an Agricultural Bank which would come to the rescue of peasants, without such a learning process, ended in failure as will be shown later.

## 2.6 Alternative intermediaries

Even under Turkish Administration the need to provide access to peasants to reasonably priced credit was an issue. Following a terrible drought in 1869 and its devastating effects on the peasantry the local Administration, probably fearing public unrest, decided to set up the first known agricultural bank of Cyprus. The funds for this bank were to come from a new tax imposed on the peasants in the form of an annual contribution of two bushels of barley and one bushel of wheat. When the capital of the bank were to reach a certain amount, applications were to be received from needy cultivators for loans bearing 8% interest. Although the tax was rigorously exacted and the grain was rapidly converted into money a year passed before the organisation of the bank was sufficiently complete so as to start accepting loan applications. As a result of the fraudulent actions of its agents the agricultural bank ceased operations after the third year.<sup>105</sup> Commenting on the failure of the bank the British Commissioner of Paphos writing in 1889 blamed it on the fact that it was a Turkish government undertaking.<sup>106</sup>

Arrogant the Commissioner's comments may have been, but it is obvious that the setting up of an institution to deal with the rural indebtedness problem was very much on the minds of both the British and the Turkish Administration. Regarding the failure of the first agricultural bank a number of interesting points may be made. This was an

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<sup>105</sup> Lang, 1878, pp292-295.

<sup>106</sup> BPP LXXIII 1889, C 5812, Remarks by Commissioner of Paphos on proposed Agricultural Bank of Cyprus, 19/10/1888, August 1889, p17.

attempt to substitute the private intermediary in the market for agricultural credit with a state intermediary. The attempt failed due to the actions of agents of the state intermediary. The actions of these agents were not supervised by the providers of the bank's capital, the peasants themselves, but were left largely uncontrolled. Therefore, a first attempt by the Turkish government of Cyprus at setting up a self-help institution ended in ruins due largely to the exclusion of the direct beneficiaries and providers from the control and monitoring function as well as the initiation process. This message is very relevant to the theory of co-operation, especially regarding issues like top-down approach and a number of co-operative principles to be discussed later.

But the failure of the first agricultural bank did not stop calls for the re-establishment of such an institution, even from official members of the British Administration in Cyprus. And who more official than the High Commissioner himself, Sir Henry Bulwer, who made several attempts in the period 1888-90 to convince foreign investors to set up an agricultural bank in Cyprus. However, due probably to the uncertain political status of the island following the 1878 agreement between the Sultan and the British, foreign investors proved very reluctant to invest in Cyprus, especially on a long-term basis, without some form of government guarantee.<sup>107</sup> However, any mention of a government guarantee brought instant negative reaction from London on the grounds that "...a government guarantee would be virtually that of the Imperial Treasury, and to incur a contingent financial liability of such a nature in the colonies would be entirely opposed to the long established practice of this country. No scheme involving a government guarantee of this kind could be brought before the Lords Commissioners of the Treasury with any prospect of success."<sup>108</sup>

The reply from London left no room for doubt. The problem of agricultural indebtedness was not a problem that would be solved using government money. Neither could it be solved through legislative measures intended to restrict peasant exploitation. Such measures were tried in the form of maximum interest rates fixed at

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<sup>107</sup> BPP LXXII 1888, C-5523, Sir Henry Bulwer to Lord Knutsford, 18/5/1888, Correspondence relating to the affairs of Cyprus, August 1888, pp151-152.

<sup>108</sup> BPP LVI 1889, C-5812, Lord Knutsford to Sir Henry Bulwer, 29/3/1889, Further Correspondence relating to the Affairs and Finance of Cyprus, August 1889, p54.

9% in 1882 and 12% in 1919<sup>109</sup> but failed miserably since there were so many other ways open to the money-lender to extract his desired return. Further more, it should be remembered that due to the nature of agriculture, as already explained, expensive credit was better than no credit at all. This was well understood by the local government if one judges by the complete lack of efforts to enforce the law.

It was only in 1906 that the government of Cyprus managed to convince the Anglo-Egyptian Company to set up an agricultural bank on the island without a guarantee for minimum profits. The only guarantee provided was that no one else would be allowed to set up a similar bank within the next 50 years. The bank would charge interest at 9% and have a minimum capital of £100,000. Lending would be on security of immovable property.<sup>110</sup> By 1919 the bank had lent £141,106 and it ended its activities by the end of 1923. Nearly all outstanding loans were long-term. Land held on security when sold did not pay for the loans. The bank neither reduced indebtedness nor put the farmer on his feet.<sup>111</sup>

This second failure can be explained purely in terms of business failure. The bank was set up by private capitalists whose purpose was to maximise return on capital employed. It was an effort by an agent of the organised international credit market to penetrate the rural unorganised market of Cyprus without intermediaries. Diseconomies of scale regarding loan processing proved too high for the bank to survive. These diseconomies would probably have taken the following form; First, as individual loan applications were for relatively small amounts, and as the offered security was not in the proximity of the bank's loan department, the bank needed extra effort to evaluate such loan applications raising the average cost per loan application processed. Secondly, the bank would have to implement a system of collecting arrears. Such a system would be hampered by poor means of communication and long distances between the locality of the closest branch of the bank and the debtor.

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<sup>109</sup> Christodoulou, 1959, p93.

<sup>110</sup> *Cyprus Gazette*, 18/5/1906, The Agricultural Bank Agreement, p5903.

<sup>111</sup> Christodoulou, 1959, pp94-95.

As mentioned earlier in this chapter estimates show that for small loans, processing costs can range from 15% to 40%. A large proportion of these costs did not exist in the case of the money-lender. His own personal knowledge of his clients' economic situation and the fact that he usually lived not very far from them meant that much of the loan processing expenditure mentioned earlier in the case of the bank was not applicable in his case.

Based on the earlier assumption that the agricultural bank was a profit-seeking agent in the organised credit market, and assuming that a decision to leave Cyprus would only be taken in the case of returns being below normal, in other words those that would be established on perfectly competitive international credit markets, and accepting Chayanov's estimate at approximately the same period that interest rates on the organised markets varied between 3% and 7%,<sup>112</sup> a very interesting proposition may be put forward. A rate of return nearly twice as much as the average rate of return on the organised markets would still not be enough to make the entry of an agent of such a market into the rural credit market of Cyprus attractive. And the main characteristic of the Cypriot rural credit market is the small size of the potential clients.

The idea that government can act as an intermediary in the agricultural credit market as part of its overall policy of rural development has frequently come under criticism.<sup>113</sup> State credit programmes, according to Braverman and Guasch, generally aim to reach small farmers, however, despite the remarkable expansion of credit throughout the rural areas of developing countries over the last three decades, few farmers in low-income countries seem to have received or benefited from such credit. The two authors then develop an analytical framework arriving at the conclusion that co-operative credit societies are a far more effective answer to meeting the credit requirements of small farmers than any kind of state action, provided the necessary conditions are met.<sup>114</sup> Contrary to these conclusions, however, state sponsored credit to Cypriot peasants did not fail due to peasant differentiation, especially as such differentiation, on

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<sup>112</sup> Chayanov, 1991, p73.

<sup>113</sup> J. Harris, *Rural development as policy and as process*, in Harris(ed.), 1992, p16.

<sup>114</sup> A. Braverman and J. Guasch, *Institutional analysis of credit co-operatives*, in Bardhan(ed.), 1991, pp340-353.

the basis of land ownership patterns, was not a serious problem in Cyprus as in other developing areas.

Following the failure of the second attempt at setting up an Agricultural bank using private capital, and following strong public demands for the setting up of such an institution all over again due to the agricultural indebtedness crisis facing the farmers in the post-first-world-war period with falling export prices, the government decided to set up the third Agricultural Bank of Cyprus in 1925. The finance for this attempt came partly from a commercial bank and partly from loan stock issued on the London Stock exchange under the guarantee of the government of Cyprus. All loans to be issued would be on land mortgage repayable in seven annual instalments and were issued to farmers through co-operative societies.

More about the bank and its relationship with co-operative societies is said in the next chapter. What is important for the purposes of the current discussion is the fact that this new attempt also failed to meet the original plans which meant that the problem of rural indebtedness continued to haunt the local Administration.

Writing a brief historical account of the third Agricultural bank Agastiniotis, a high ranking official in the co-operative movement of Cyprus during the period 1927-1965, blamed this new failure on the fact that too much importance was placed upon long-term finance ignoring the need for short-term agricultural credit.<sup>115</sup> The strong influence of Lanitis's ideas as explained in his original book on rural credit, originally published in 1943, is evident in Agastiniotis's writings.

The failure of this third Agricultural bank attempt coincided with long periods of drought as well as general trade depression in the period 1929-31 which incapacitated the peasants to meet their obligations to the bank. However, despite the fact that loans were advanced through the local co-operative credit societies, the fact that all such loans were individually approved by the bank meant, effectively, that another agent of the organised credit market was attempting to penetrate directly the unorganised

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<sup>115</sup> K. M. Αγκαστινιώτη, Ο Συνεργατισμός-γέννησις και ανάπτυξις του σε Κύπρο, Λευκωσία, 1965, pp64-66.

market. But this time, however, low business returns were not a problem since private suppliers of capital had their returns guaranteed by the government.

The fact that a few years after the setting up of the Agricultural Bank more than 65%<sup>116</sup> of loans advanced were in arrears is a strong indication of the recipients attitude towards this type of finance. They could not have had any significant arrears owing to the private money-lenders as repayment was in the form of their yearly output. The threat that the private money-lender would sell them up meant that priority was given to repaying debts owed to him first. This is also confirmed by Oakden, although he then criticises absence of cheap short-term credit and improvidence, for the peasants' predicament.<sup>117</sup> His line of argument, in fact, bears close resemblance to Lanitis's arguments written a decade later and Agastiniotis's arguments three decades later.

Looking at the provision of short-term and long-term credit in the organised agricultural credit market of more recent times in Cyprus seems to reject this short-term credit syndrome even though fluctuations in farmers' incomes may still be significant. Also, a simple analytical approach in the next chapter, using farmers' income estimates from the time of Surridge's report will establish the irrelevance of this short-term versus long-term credit theory.

It is therefore proposed that arrears to the Agricultural Bank reached such high proportions not because the Bank only provided long-term loan finance but for some other reason. And this can only be the fact that due to political considerations it was undesirable for the government to be seen to enforce execution of mortgaged debts. It was therefore natural that whether long-term or short-term, such loans received second priority in the repayment schedule of agriculturists. It is exactly such political considerations which lead to inability to collect overdue debts that make government efforts to act as intermediary between the organised and unorganised credit markets doomed to failure. And such political considerations are far more important to a government which is already facing growing anti-colonial unrest. Political

<sup>116</sup> Αγαστινιώτης, 1965, p65.

<sup>117</sup> Oakden, 1935, p109.

considerations, however, were also very important in the development of co-operation in the post-independence period and these will be examined in detail later in the thesis.

## 2.7 Conclusion

Significant income fluctuations due to exogenous factors like unstable weather conditions and the state of the world market for agricultural products during the pre- and inter-war years created an urgent need for agricultural credit in Cyprus. This need, however, could not be satisfied directly by the organised credit market due to the very high transaction costs involved, as clearly shown by the failure of a private Anglo-Egyptian company, member of the organised credit market, to operate successfully in the business of providing agricultural credit in Cyprus even at rates twice as high as those prevailing on the world markets.

State attempts to solve the agricultural credit problem by acting as intermediary between the organised credit market and the peasants also failed due to the inability of state agents to enforce the repayment of loans granted to the peasantry because of the political cost involved.

In the face of state and organised credit market failure to satisfy the peasants' urgent need for credit an unorganised credit market was in operation. A very inelastic demand curve due to exogenous factors meant that despite the existing usury laws setting maximum interest rate at 12%, suppliers of scarce capital were in a monopolistic position able to perfectly exploit the peasants by linking the supply of this capital to the marketing of the peasants' output, thus able to extract maximum returns for themselves. It has been suggested by at least one writer that Pareto efficiency could still be reached provided the merchant-money-lender was in a position to exercise perfect discrimination. This proposition, however, can only be made in a static environment. The very high cost of capital facing the peasant farmer prevented him from taking investment decisions which could have dramatic effects on the overall economic surplus. Further more, it is doubtful whether a farmer will try to maximise his current output if he expects nearly all of it to end up with his money-lender.

Agricultural co-operation can act as an intermediary between the organised credit market for agricultural credit and the peasant farmers. It can also act as an intermediary for the peasants' purchases of agricultural input and marketing of output. In other words it can act as a substitute for the private intermediaries distributing surplus in a way favourable to the producers rather than the capitalists. Whether, and under what circumstances such substitution can take place successfully is the subject of study of the next chapter. What is important to understand at this stage is that co-operation first emerged as a substitute for an economic agent, who carried monopolistic powers due to market imperfections. It is also important to understand the role of co-operation in transferring surplus from the capitalist to the producer. An antithesis therefore exists that determines the co-operative function.

## CHAPTER THREE: PERFORMANCE EVALUATION

### 3.1 Introduction

It is often claimed that the successful operation of the co-operative movement in Cyprus significantly contributed to the economic and social advancement of the agricultural population at a time when agriculture was still the most important component of the economy. Writing in the mid-1970s Professor Paris Andreou said that “co-operatives are regarded by many people in Cyprus as the vehicles of transformation and advancement in the island’s economy.”<sup>118</sup> Christodoulou writing in 1957, praised the co-operative movement for a good supply of short-term credit. He thought the movement was strong and helped rural areas in numerous other ways, such as marketing and bulk purchase. What is more, he believed that it had become the spearhead for progressive ideas and techniques and held out hope to remedy many of the ills of the country-side, the alternative being more revolutionary and drastic social changes.<sup>119</sup> Agastiniotis writes in 1965 that the agricultural population of Cyprus feels proud because despite strong reaction, an unfavourable political situation, and an undemocratic colonial Administration, it managed to create its own co-operative structure which also spread its beneficial influence to urban, professional and working classes.<sup>120</sup>

And yet the experiences of many other developing areas in a similar state of economic development as that of Cyprus in the first half of the twentieth century, tell very different stories about their co-operative efforts. According to Bechtel the history of co-operatives in the third world often presents itself as a chain of failure and incompetence, abuse and embezzlement, mismanagement, political and tribal influence, and ignorance and stupidity. Bechtel puts part of the blame on colonial Registrars who tried to implement co-operation in the third world by starting off with the idea of a co-operative so successful in Europe, to solve all the social and economic problems

<sup>118</sup> P. Andreou, An empirical investigation into the main factors that led to the successful Operation of the co-operative marketing societies in Cyprus, in Andreou, 1977, p135

<sup>119</sup> D. Christodoulou, 1959, p96.

<sup>120</sup> Αγαστινιώτης, 1965, p37.

associated with country districts in the Third World, ignoring the many and considerable set-backs encountered by European co-operatives.<sup>121</sup>

In those countries attempting to establish a government based upon popular support and attempting to limit the hegemony of a traditional elite or colonial power, co-operatives have been envisaged as a means for shifting economic power.<sup>122</sup> But experience so far suggests that co-operative efforts in the developing world failed to reach the majority of the rural population for whose needs these efforts were originally designed. Khan says that co-operatives are unable to bring about any structural changes which would enable them to service the needs of marginal groups, tending to reproduce the existing social structures among rural communities. The control of co-operative committees and management will rest with the better-off elite, the dependency between the rich and the marginal groups will tend to perpetuate and rather strengthen, and the inequalities between the haves and have-nots will increase.<sup>123</sup>

The fact that informal credit markets continue to be very important in developing countries confirms Khan's theoretical stand. In India, for example, in terms of volume and even share of the total credit market, institutional credit has grown sharply. However, there is overwhelming evidence that institutional credit continues to cater for the better-off farmers, whereas poorer farmers are forced to turn to the informal credit market.<sup>124</sup>

On the question of government sponsored credit programmes, these generally aim to reach small farmers. However, despite the remarkable expansion of credit throughout the rural areas of developing countries over the last three decades, few poor farmers in low-income countries seem to have received or benefited from such credit. An estimated 5% of farms in Africa and about 15% in Asia and Latin America have had access to formal credit. Moreover, there seems to be a high correlation between credit recipients and size of land-holdings. On average, 5% of borrowers have received 80%

<sup>121</sup> Bechtel, in Worz, 1983, pp112-113.

<sup>122</sup> L. L. Mather, The Principles, Functions, and benefits of co-operation: the traditional model, in Anschel, Brannon, Smith(eds.), 1969, p13.

<sup>123</sup> See above, section 1.3.3

<sup>124</sup> K. Basu, Rural credit markets: The structure of interest rates, exploitation, and efficiency, in Bardhan(ed.), 1991, p163.

of the credit. This, according to Braverman and Guasch, has led small farmers to setting up co-operatives, but, without much success in terms of participation, productivity, volume of credit, and repayment rates.<sup>125</sup>

The objective of this chapter is to look behind the rhetoric of co-operative success in Cyprus to see whether, or to what extent, Cypriot co-operation managed to overcome the barriers to progress encountered in other agricultural economies. An attempt is first made to define success in the context of agricultural co-operation. Once the parameters of the optimum co-operative solution are set the results of the first co-operative experiment at the turn of the century are analysed using these parameters. Next, the need for a specific legal framework in the development of co-operation in Cyprus during the pre-independence period is discussed. Section 5 looks at the effectiveness of direct government measures to promote co-operation through the establishment of an Agricultural Bank. Within the context of evaluating arguments put forward to explain the failure of the Agricultural Bank experiment, the appropriateness of long-term as compared to short-term loans is tested in section 6. Section 7 examines the process of achieving self-help and section 8 looks at the role of government as a catalyst. Section 9 deals with the sociobiological theory in the context of ethnicity and membership base. Section 10 analyses the exact mechanics of a transition to self-help, including mutual aid and the Central Co-operative Bank. Section 11 is an attempt to evaluate the contribution of co-operative credit to agriculture. Finally, sections 12 and 13 analyse the empirical results of two test-cases.

### **3.2 Defining co-operative success**

The first question that needs to be addressed with regards to agricultural co-operative performance in Cyprus is whether it has been as successful as often claimed. It is a very difficult task to define success in the context of co-operation. By successful operation of co-operatives different people mean different things. Some measures of success are said to include profitability, number of members, number of active societies, and percentage of total volume of agricultural products handled by the local co-operative.

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<sup>125</sup> A. Braverman and J. L. Guasch, *Institutional analysis of credit co-operatives*, in Bardhan(ed.), 1991, pp340-341.

Any attempt to establish whether a certain line of action was successful should begin by clearly setting the objectives of that action. Success can then be measured in terms of how far those objectives have been met. Not surprisingly such objectives can be more than one and therefore should be placed in order of priority. By giving them weights, perhaps, an imaginative mathematician could work out an optimum solution. The degree of success of a specific effort can then be measured against this optimum solution.

However, agricultural co-operation has already been shown in the previous chapter to aim at substituting private intermediaries between the producer, the capital markets, the input markets, and the product markets. This does not mean that the main objective of an agricultural co-operative is to get rid of all intermediaries, but rather, to eliminate any abnormal profits made by these intermediaries due to various market imperfections so characteristic of rural markets in the developing world. Peasant exploitation was not the result of the existence of money-lenders-usurers, but rather, the absence of competition on the supply side and a very low elasticity on the demand side due to prohibitively high transaction costs, difficult access to information, and various other externalities.

The optimum co-operative solution will therefore be at that point where only normal profits are possible. As such profits are usually associated with perfect competition, a co-operative solution will be considered successful if it acts as counter-weight to market imperfections. This leads to the very interesting conclusion that a co-operative may be facing financial difficulties or even the prospect of dissolution and yet be considered a success. Alternatively, a co-operative may show a high rate of profitability and yet be considered a failure, using the market imperfections scale of measurement. But such conclusions have very serious repercussions on the validity of one of the most commonly professed notions associated with the co-operative function; that it is the sum of individual members' enterprises.

Emelianoff defined a co-operative as an aggregate of economic units, acquisitive or spending.<sup>126</sup> This could lead to the conclusion that where a co-operative has failed the members have suffered. And yet, as will be shown later by taking the example of the co-operative consumer movement in Cyprus during the last decade, it can hardly be claimed that its gradual demise has been accompanied by a loss of members' economic welfare. On the contrary, after having served successfully for a number of years as a defensive weapon against monopolistic exploitation, the rationale of a co-operative function no longer existed once market imperfections that had earlier given rise to such powers of exploitation were removed. The market had now moved closer to perfect competition and abnormal profits greatly reduced.

This apparent paradox can be explained by analysing the system of inter-relationships between co-operative members, the co-operative and the non-co-operative agent. Provided a co-operative household member has access to both co-operative and non-co-operative suppliers, it will opt for that mix which will maximise its own utility. The co-operative and non-co-operative agents will therefore become competitors in the same market. Opponents of Emelianoff's analysis of a co-operative in terms of constituent household members may use this kind of analysis to discredit his theoretical stand, although as mentioned in the first chapter their attacks have so far been of an abusive nature avoiding to tackle the underlying theoretical issues. The same analogy may be relevant here as in the case of a firm which has to decide whether to produce some part of its product within the organisation or whether to sub-contract work outside the firm.

Following the logic of the above analogy, household acquisitive units that are members of a co-operative, have to make decisions as to whether to produce in-house, i.e. co-operatively, or whether to sub-contract work. The mere fact therefore that a member has to make a decision between using the services of a co-operative and those of a non-co-operative agent can not form a strong argument against Emelianoff's analysis.

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<sup>126</sup> See above, section 1.3.2

Economic success for the co-operative can be explained in terms of the market adjustment period. As the co-operative agent starts from a position of no abnormal profits, merely servicing the needs of its members, it immediately acquires a serious competitive advantage since the non-co-operative agent has to adjust from an abnormal profit position to a normal profit position. This adjustment may require a painfully long and costly transition period during which the co-operative agent will appear to be doing well, especially since no abnormal rates of return are expected from its operations. Once the transition period is over, and provided the non-co-operative agent can survive in the market at a normal profit position, the co-operative agent may begin to show signs of economic exhaustion due mainly to factors inherent within the organisation. Organisational considerations are considered extremely important with regards to co-operative development and will be dealt with later. The co-operative agent may no longer enjoy the full loyalty of member households, if the comparative advantage is no longer so obvious. And yet, despite its economic decline, the co-operative may be considered a success for having acted as a catalyst in bringing about the transition period.

In order to facilitate analysis the assumption is made that a co-operative's ability to remove market imperfections is directly proportional to members' loyalty during the transition period. This indirect approach is taken because it is impossible to obtain direct measures of the rate of profit of all actors in a market. Loyalty is taken as an indirect indicator of advantageous financial returns offered by the co-operative, which itself is taken to be an indicator of the existence of excess profits among capitalist suppliers in this same market. In the case of agricultural credit co-operatives this loyalty could be a function of members' deposits, members' loans, members' purchases of agricultural inputs from the co-operative or members' disposal of agricultural output through the co-operative. In other words, success of the co-operative attempt is assumed for the purposes of the following analysis to equate with success of one or more financial aspects of the organisation itself.

### 3.3 The first experiments

Representatives of the British Administration in Cyprus thought about some form of co-operative solution as far back as the 1880s when the Receiver-General put forward a proposal for the establishment of a co-operative or people's bank based on the system adopted in Italy.<sup>127</sup> The proposed requirements, however, that the accounts would be kept in the Government Treasury brought the Executive Council's rejection.<sup>128</sup> This reaction by the government was in line with the response to all efforts to introduce some government sponsored measures to deal with the problem of rural indebtedness and very much consistent with the laissez-faire policy strongly advocated by the Imperial government.<sup>129</sup> This attitude of the British government was to be blamed more than 40 years later for the poor showing of co-operation in other colonies,<sup>130</sup> although not in Cyprus.

The idea that co-operative development in rural based developing nations depends on state action and support has been put to the test in Cyprus. Analysing the nature of this action and the resulting effects leads to some interesting conclusions.

The first government sponsored attempt took the form of encouragement through the work of one of its officials, W. Bevan, Secretary of the Cyprus Loan Fund and later, Assistant Director of Agriculture. In 1905 Bevan became actively involved in the promotion of agricultural banks in the poorest area of the island, Paphos, based on the Raiffeisen principles after having published a propaganda leaflet in Greek in 1904 on the virtues of such co-operation.<sup>131</sup> No government finance appears to have been offered to these banks, at least based on the information contained in the published financial statements of government.

Within a few years twenty-two such little banks were set up in the district of Paphos but no sooner had their instigator left the district to take up higher office in Nicosia the

<sup>127</sup> BPP LVI 1889, C-5812, Sir Henry Bulwer to Lord Knutsford, 26/6/1889, Further correspondence relating to the affairs and Finances of Cyprus, August 1889, p 137.

<sup>128</sup> BPP XLIX 1890, C-6003, Lord Knutsford to Sir Henry Bulwer, April 1890, p23.

<sup>129</sup> Co-operation in the colonies, 1945, p21.

<sup>130</sup> Co-operation in the colonies, 1945, pp15-16.

<sup>131</sup> W. Bevan, *Γεωργικαὶ Τράπεζαι* (Raiffeisen), Nicosia, 1904.

whole experiment failed, despite the initial reported success.<sup>132</sup> Wolff blamed this failure on lack of direction but others blamed it on lack of capital.<sup>133</sup> Later developments were to prove that state capital injections not only failed to assist the cause of co-operation but, instead, hampered its development. Additionally, if reliance is to be placed on Wolff's sources these banks were an initial success with total deposits exceeding those of the government savings bank although no specific amounts are being mentioned. The turning point appeared to coincide with the departure of Bevan from the district of Paphos.

Some interesting conclusions may be drawn from Bevan's experiment. First, in a rural based developing society with low literacy levels the traditional theory that need will create its own response fails unless there is a substitute for the literacy inefficiency to act as a catalyst. This need is explained in the paragraph that follows. The speed with which the numbers of these banks increased after inauguration, and assuming validity of the learning theory, such increase would not have been possible had the initial results of Bevan's experiment been other than encouraging. Unless a solution is found to the problem of illiteracy the need for a substitute will continue. In the event of its withdrawal the results will be those experienced in Paphos.

The relationship between co-operative development and levels of literacy appears to confirm the overall view that low levels of literacy constitute one of the most important factors in the slow development process of the third world, as mentioned at the beginning of this chapter. This dependence on literacy can be explained as follows; an agricultural co-operative, unless fully subsidised by the state, relies for its survival on the loyalty of its members. Its trading operations, for example, will be successful if a sufficient number of members buy their inputs and sell their output through the co-operative. Its banking operations will be successful, in the absence of government finance, if members place their deposits and take their loans from the co-operative.

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<sup>132</sup> H. W. Wolff, *People's Banks- a record of social and economic success*, third edition, London, 1910, pp508-509.

<sup>133</sup> Αγκαστινιώτης, 1965, p45.

A very important pre-requisite for such member loyalty is the ability of the co-operative's management to inspire confidence about the bona fide nature of transactions through public accountability. Such public accountability is only relevant if the public is educated enough to understand what is presented to them or at least if an independent authority exists, perceived as such by the public, which is entrusted with the supervision and auditing function on behalf of the public. In the case where there is lack of educated people among the ordinary membership and where an independent authority for supervision and audit does not exist there is likely to be a lack of confidence unless the management function is under the control of a person that carries the general approval and trust of the members. This person becomes the literacy substitute.

Literacy skills are essential in carrying out duties of management or management control and supervision. Knowledge of some basic book-keeping is essential both from an accountability but also from a business point of view. The calculation of interest on loans and other credit arrangements and the maintenance of records of transactions are indispensable parts of the business operations of the co-operative. Finally, literacy is essential in negotiating contracts.

This analysis of co-operative success as a function of literacy has another important aspect. Assuming that success depends on the ability to act in accordance with co-operative principles, it is then considered necessary that at least the leadership of the co-operative have a good understanding of these principles and are able both to implement and communicate them to others. It is doubtful whether such role can be effectively fulfilled by people who completely lack even basic literacy skills. The need to abide by these co-operative principles as a condition for success will be examined later.

But does it follow from the above that successful co-operation is not possible in areas where there are no literate people? The initial success of the Paphos experiment has shown that a substitute is required that can work to fill the gap. This substitute can be provided by the government as part of its rural development policy. The need for government to invest in co-operative education in order to facilitate co-operative and

hence rural growth has been well understood by students of co-operation but also by representatives of the colonial government itself, judging by the activities of Bevan as far back as the beginning of the century.

Another problem associated with low literacy levels of members and the need for public accountability is the danger that one or two educated leaders of the co-operative may be tempted to take advantage of their position. It is therefore considered essential that independent supervisory and audit services should be provided. The question of independence is very important and in people's perceptions such independence can only be achieved where neither the management nor any of the members have any influence over the appointment of supervisory and audit agents.

These conclusions are in line with the findings of the report on co-operation in the colonies which found close correlation between the establishment of separate state co-operative departments and co-operative success.<sup>134</sup>

The successful development of an agricultural bank at the village of Lefkonico which started its operations in 1909 at the instigation of a local politician and banker, under the management of a local school master,<sup>135</sup> showed that co-operation could work under certain circumstances. The instigator of the Society was a local politician and a lawyer who also possessed banking experience. The day-to-day management of the Society was left in the hands of a local school-teacher. Both of them possessed relatively high standards of literacy and were thought of highly among their fellow villagers who recognised them as their natural leaders.

The joint and unlimited liability of all members made the Society credit-worthy enough to obtain overdraft facilities from the organised credit market without the need for State guarantees. Effectively the Society became an intermediary between the organised credit market and the members thus eliminating the market inefficiency factor due to high loan processing costs already dealt with in the previous chapter.

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<sup>134</sup> Co-operation in the colonies, 1945, p124.

<sup>135</sup> Wolff, 1910, pp509-510.

The success of the Lefkonico attempt lies in the fact that market inefficiencies in the local credit market giving rise to usurious transactions with all accompanying adverse social but also economic side-effects, already discussed in chapter 2, came under attack. The successful outcome of this attack was confirmed by a well-known mainland Greek journalist who described the school-teacher that ran the co-operative as the Hercules who had just killed the lion. The lion symbolised the usurer.<sup>136</sup>

The important role played by two prominent members of society in the successful establishment of a co-operative at this early stage of co-operative development in Cyprus is very much in line with Guthardt's conclusions about initial co-operative success in the developed world. Guthardt believes that in all examples of initial co-operative success in western Europe and North America, personal initiative of individual people was of considerable importance.<sup>137</sup>

### **3.4 Need for a specific legal framework**

Following pressure from local politicians and mainly from John Economides, the lawyer and member of the House of Representatives, instigator of the Lefkonico agricultural bank, a Co-operative Societies law was passed in 1914 which set up a legal framework for co-operation in Cyprus. This was followed by the Co-operative Societies Law of 1923. Both of these were consolidated in the 1939 Law for all types of societies, based mainly on the Ceylon Co-operative Societies Law.<sup>138</sup>

It has earlier been suggested that literacy and leadership skills are very important components of the co-operative success function. The idea that the right legal environment is contributory towards the successful development of co-operation can also be put to the test using data from the Cypriot experience.

A detailed analysis of co-operative legislation is not considered necessary at this stage as the same legal provisions of the 1914 Act could still be found in the legislation of post-independent Cyprus. In other words, the legal variable was not a variable at all in

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<sup>136</sup> Γ. Κλόκκου, *Αευκόνικο-το καμάρι της Μεσαορίας*, Λεμεσός, 1978, p23.

<sup>137</sup> H. Guthardt, The structure and operational mode of the co-operative bank organisations in W. European and N. American countries, in Dulfer and Hamm(eds.), 1985, pp170-171.

<sup>138</sup> Co-operation in the colonies, 1945, pp124-125.

the success equation but rather a constant. This suggested treatment of the legal framework as a constant is further supported by the fact that identical legal frameworks existed in other colonies but with very different patterns of co-operative development.

The rate of successful establishment of co-operatives following the enactment of the 1914 Law was not impressive. In fact very few villages followed the example of Lefkonico, and those, without much economic success. Following the previous analysis on the need for a literacy substitute this lack of success was most probably the result of unavailability of such a substitute. Whereas the existence of a literacy substitute led to success in the Lefkonico case outside any kind of specific co-operative legal framework, the existence of such framework did not prove a driving force in the history of the co-operative movement of Cyprus where the literacy substitute was absent.

Following the passing of the co-operative law in 1914 and up to 1925, year of the establishment of the Agricultural Bank, only 29 co-operative credit societies were established with less than 2000 members.<sup>139</sup> And yet, with similar legal provisions as in 1914, the pace of growth in the number of co-operatives following the establishment of the Agricultural Bank increased significantly showing the degree of irrelevancy of the legal environment in the development of co-operation in Cyprus, at least in those early stages of development.

The above experience leads to the conclusion that a special legal environment does not necessarily lead to co-operative success. On the contrary, attempts to set up a legal environment specifically applicable to co-operatives may have adverse effects as a result of inefficiencies introduced in the workings of the market. The aim of co-operation is to clear the market of such inefficiencies rather than to create new ones.

Political implications of co-operative legislation may be important where too much power over the operation of co-operatives is handed over to state agents. The

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<sup>139</sup> Cyprus Blue Books.

relationship between state agents and co-operatives is the subject of study of a later chapter, however, some writers on co-operation have already warned of the dangers of too much state involvement. Holmen for example, warns that for co-operatives to successfully function as agents of change and instruments of development, a basic precondition is that they are permitted to function as self-help organisations, i.e. be established as a response to a felt need, without undue control from local or central authorities.<sup>140</sup>

### 3.5 State-help: The Agricultural Bank

The economic history of co-operation in Cyprus offers a unique opportunity to test the effectiveness of various forms of government policy towards co-operation. As already discussed the laissez-faire attitude of the British government during most part of the pre-second world-war period was unlikely to lead to any form of state intervention in the affairs of the co-operative movement. This policy attitude was more than obvious in the standard colonial legislation which entrusted most powers of decision-making with the members with only minor exceptions. Yet, in the case of Cyprus the British Administration appeared to be taking an active interest in the growth of the movement as far back as the mid-twenties. This apparent inconsistency had a significant impact on the rate of co-operative development in Cyprus and may have something to do with the question asked earlier in this thesis as to why co-operation in Cyprus appears to have taken a different pattern of development compared to most other parts of the developing world.

This inconsistency in British policy appears to stem mainly from political considerations. Solving the agricultural indebtedness problem was thought by the British Administration to be one way of stopping the pro-Enosis movement, i.e. union with Greece. This was based on the belief that the nationalist cause for Enosis was mainly driven by the clergy and the class of merchants and money-lenders who saw the rights they enjoyed under Ottoman rule being taken away by the new Administration.<sup>141</sup>

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<sup>140</sup> H. Holmen, State, Co-operatives and development: Egypt 1908-1988, in B. Gyllstrom and F. Rundquist(eds), 1989, p91.

<sup>141</sup> G. Hill, *A history of Cyprus*, Volume IV, Cambridge, 1952, p495.

In a despatch to London in 1929, Nicholson, the acting governor, expressed his views on how the money-lending classes succeeded in monopolising power among the Greek members of the Legislative Council. In his opinion the Greek elected members owed their seats to the influence which they had on the ignorant and debt-ridden electorate and to the use of wholesale bribery at the elections. According to Nicholson the peasant would give his vote in favour of the candidate supported by his creditor otherwise he could be in trouble.<sup>142</sup>

Political considerations like the above, prompted the British Administration in 1925 to embark on a third attempt at setting up an Agricultural Bank, this time with more active state participation in the risks involved. The Agricultural Bank was constituted in 1925 with a paid-up capital of £50,000 and an agreement, dated 17 June, 1925, was entered between the Government and the Bank which regulated the operations of the Bank and provided for a Government guarantee of a profit of 4% on the paid-up capital. Following strong pressure from the local Administration for reasons already explained above a second agreement was entered into on 26 January, 1929, authorising the Agricultural Bank to raise a further £ 200,000 by means of bonds at 5%. For the bond issue the Ottoman Bank, which was closely concerned with the original establishment of the Agricultural Bank, acted as financial agents. The Agricultural Bank made advances almost exclusively through co-operative credit societies and charged interest at 8%. Loans were made on mortgage security and were normally limited in amount to 60% of the Bank valuation of the security tendered. In addition, the members of the co-operative credit society to which the loan was made bound themselves in a joint and several liability for payment.<sup>143</sup>

First Oakden, and then Lanitis and Agastiniotis described this new attempt as another failure due mainly to the fact that the Bank only issued long-term loans ignoring farmers' need for short-term credit finance. This failure, according to all three authors, was evidenced by the fact that only a few years after the bank's creation the majority of loans issued to farmers were over-due. Oakden stressed the need for short-term finance by farmers and cites evidence that most of the loans obtained were used for

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<sup>142</sup> G. S. Georghallides, **Cyprus and the governorship of Sir Ronald Storrs**, Nicosia, 1985, p163.

<sup>143</sup> Oakden, 1935, pp118-119.

paying-up over-due debts to private money-lenders.<sup>144</sup> Eventually, once the farmers used up their loans in repaying their money-lenders they had to go back to them for new loans to survive the next unfavourable weather or world market conditions.

The idea that the Agricultural Bank failed in its destination due to the fact that it only provided long-term credit and that agricultural credit co-operatives could only succeed if they provided short-term credit is not new. Such was the propaganda in favour of this idea that later co-operative efforts concentrated for a long time on the provision of short-term credit.

This short-term idea was based on the belief that as farmers' incomes were cyclical, a form of stabiliser was needed to cancel the cyclical effects. This stabiliser, according to supporters of the above idea, could only be in the form of short-term finance or the so called emergency credit.<sup>145</sup>

Efforts to explain failure of the Agricultural Bank in terms of long overdue debts due to its refusal to grant short-term agricultural credit make little, if any sense at all. Failure of the Bank was indeed evidenced by the large amounts of arrears, but blaming these arrears on the Bank's policy to grant only long-term agricultural credit completely ignores fundamental business principles underlying the workings of any lending organisation.

If failure of the Bank is directly associated with the percentage of overdue debts then success can be assumed to be a function of debt recovery, or the ability of collecting debts. Braverman and Guasch cite empirical evidence to back their theoretical stand that the viability of any credit organisation is strongly linked to its success in recovering loans. Strong punitive measures and a proper set of incentives ought to be implemented to induce high repayment rates; according to the two authors those elements seem to be lacking in most credit co-operatives in the developing world and hence the high failure rates.<sup>146</sup>

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<sup>144</sup> Oakden, 1935, p121.

<sup>145</sup> K. Phylaktis, **The Banking system of Cyprus**, London, 1995, p37.

<sup>146</sup> A. Braverman and J. Guasch, Institutional analysis of credit co-operatives, in Bardhan(ed.), 1991, pp352-353.

Braverman and Guasch's analysis appears to be appropriate in the case of the Agricultural Bank of Cyprus and the co-operative credit societies associated to this institution until 1938 when a complete restructuring took place separating completely the business of the Agricultural Bank from the business of the co-operative credit societies. It was weakness in the ability to collect debts due mainly to political considerations that seems to have led to failure, if failure can be defined in terms of parameters already described. Such political considerations are usually present in any form of state finance. Receivers of such finance tend to consider it as state grant knowing all too well that the state is not likely to go to extremes to enforce its claims. If the majority of debtors decide to pay up, the project is likely to be a success.

But the chances in every such project are that Olson's theoretical objections to the soundness of collective action without a catalyst will in practice come true. His theoretical analysis suggests that the notion that groups of individuals act to achieve their common or group interests, far from being a logical implication of the assumption that the individuals in a group will rationally further their individual interests, is in fact inconsistent with that assumption unless the group in question is small or unless there is coercion or some other special device to make individuals act in their common interest, or unless they see their individual interests to be identical with their group interests.<sup>147</sup> In the case of credit co-operatives this coercion takes the form of debt recovery enforcement. It is only where such enforcement is possible that large groups will form organisations like credit societies to further their common goals. In small groups, according to Olson, there may very well be some voluntary action in support of the common purposes of the individuals in the group, but in most cases this action will cease before it reaches the optimal level for the members of the group as a whole.<sup>148</sup>

This third Agricultural Bank experiment also offers the opportunity to test the case where co-operatives are set up directly at the instigation of government with working capital provided by the state. Following the establishment of the Agricultural Bank a

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<sup>147</sup> Olson, 1971, pp2-3.

<sup>148</sup> See above, section 1.3.4.

large number of co-operative credit societies were set up in order to take advantage of the loan finance provided by the newly established Bank. The following table shows the rate of increase in the number of co-operative credit societies and membership before and after the creation of the Bank:

Table 3.1: Number of co-operative societies and membership, 1921-1930

Year	No. of societies	Membership
1921	9	738
1922	9	767
1923	25	1256
1924	29	1564
1925	29	1957
1926	49	3432
1927	97	5482
1928	268	10730
1929	320	14404
1930	326	15202

Source: Cyprus Blue Books.

In most cases farmers saw their membership with the local co-operative as a means to obtain loans from what was seen as a state agent bearing a much lower interest than other forms of credit and with less onerous conditions of repayment. These societies proved to be mere agents of the Agricultural Bank and were seen as such by the members. Characteristically in his annual report on co-operation for 1937 the Registrar of co-operative societies mentions the fact that of the 262 societies only 49 had any deposits of their own. He also referred to the poor state of a large number of co-operatives whose sole purpose of existence was limited to collecting over-due debts on

behalf of the Agricultural Bank.<sup>149</sup> Total deposits at 31 December 1936 amounted to £26,748 as compared to total loan balances of £301,793. This was evidence enough of the absence of the underlying self-help principle of co-operation.

This is how Ralph Oakden described the first years of co-operation following the setting up of the Agricultural Bank. "Most of the societies were formed in the years 1928-29, and in those years of rush very little attempt was made to instruct members on co-operative lines. Almost any group of men exceeding twelve was registered as a society without much regard to their knowledge either of the principles of co-operation or of their duties and responsibilities as members of the co-operative credit society. It is true that they usually understood the principle of joint liability, but, with the prospect of ready money dangled before their eyes, they thought little of it. The results of hasty registration became apparent as soon as difficulties arose. Non-payment of dues soon became a habit with many societies, and even those members who could pay in full, and those who could pay something, frequently paid nothing, and consequently were not in a position to bring pressure to bear on their fellow members. They did not realise, except in rare cases that they were the society, and that its welfare was their welfare."<sup>150</sup>

Valuable conclusions may be drawn from Oakden's findings. A co-operative brought into existence by the state based on capital supplied by the state is more likely to be viewed as a state-aid organisation rather than an economic entity. Once state money runs out this form of pseudo-co-operative is very likely to end up in disaster unless the state is prepared to finance its operations indefinitely. But even then, the creation of an inefficient organisation is unlikely to satisfy the success criteria used above. It is hardly surprising therefore that various attempts in the last few decades to assist the starving rural populations of third-world countries by providing foreign start-up co-operative capital failed. Once the members of the newly established co-operative see their membership as a means to obtain state-aid the destiny of that co-operative is sealed. But even today in countries closer to Cyprus like Greece, agricultural co-operatives do

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<sup>149</sup> Annual Report of the Department of co-operation for the year 1937, Nicosia, p7.

<sup>150</sup> Oakden, 1935, p121.

not exist other than in the pseudo-form discussed above acting merely as agents of the state Agricultural Bank.<sup>151</sup>

### 3.6 Long-term Vs short-term loan advances

Turning back to the question of long-term versus short-term and the causes of failure of the Agricultural Bank there are further arguments against opinions that this failure was the result of the Bank's refusal to make loan advances other than long-term. For the purposes of this analysis it is assumed that effective debt-collection mechanisms are available to the Bank and the co-operative movement. With a repayment period of six years at 9% and a maximum loan of £200 the agriculturist would have to pay approximately £48 per year in order to be within the terms of his loan contract. With an average loan amount of £100 annual instalments would be £24. Using some of Surridge's income data analysed in the previous chapter, it becomes clear that even farmers at the upper end of income groups earning £90 a year<sup>152</sup> would find it difficult to keep up with annual instalments even of loan amounts half the maximum. This situation becomes even worse in years of unfavourable weather conditions or price fluctuations. Considering that 75% of farmers in 1930 were estimated to be at the lower end earning on average £32 it should come as no surprise that the Agricultural Bank was there mainly for the benefit of the better-off farmers bearing in mind the diseconomies of scale involved in advancing small amounts due to high loan processing costs.

This simple arithmetic analysis may offer an alternative explanation to that of Khan's, mentioned in the introductory section of this chapter, regarding empirical evidence suggesting that institutional credit in the developing world seldom reaches the majority of the peasants who are at the lower scale of income groups. Farmers at the lower end are unlikely to benefit unless repayment periods are made long enough so that repayment amounts are not prohibitively large.

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<sup>151</sup> As reported to the author by officers of the Greek Confederation of co-operatives and the Greek Agricultural Bank during the October 1995 visit of representatives from the Cypriot co-operative Movement to Greece.

<sup>152</sup> See above, section 2.5.4.

Following the logic of the above argument, the problem with arrears in a credit institution with efficient debt recovery mechanisms could be that repayment periods are too short and therefore instalments excessive compared to the annual income of the recipient, and not the absence of short-term credit.

Another important issue in the argument of long-term versus short-term is the purpose of the loan. Trying to cancel the cyclical effects of farmers income through short-term credit can only be a temporary measure not aiming at the real causes that produce such variations in income. In the case of Cyprus it has already been shown in the second chapter that agricultural backwardness, especially with regards to irrigation works and capital equipment, was one of the main causes of farmers' inability to meet effectively weather and world market fluctuations. Following this argument through, what the Cypriot peasant farmer really needed in order to lighten his debt burden was a way to finance long-term investment requirements, either in terms of fixed capital outlay or higher level education. Both these purposes required long-term loan finance.

Lanitis proposes that long-term finance should be provided by a Land Bank, similar to the Agricultural Bank, but run on a sounder managerial basis. He considers that co-operative credit societies cannot make advances on long-term for they depend for their working capital on deposits and/or advances from joint-stock banks, which are made for a shorter period than that for which long-term loans to agriculture are usually made. Lanitis also rejects the ability of co-operative credit societies to advance loans on mortgage because their constitutions will not allow them.<sup>153</sup>

Lanitis's objections to co-operative credit societies being involved in long-term finance, originally raised in the forties and republished in the early nineties, have proved totally wrong in practice. His objections, along with those of other people, originate from a basic misunderstanding of the co-operative principle of self-help through mutual aid, explained in more detail later in this chapter. It will suffice here to say that individual deposits may be for the short-term but the pool of deposits in a co-operative, like in a commercial bank, is there for the long-term, either because of a

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<sup>153</sup> Lanitis, 1992, p 51.

process of constant substitution of new deposits for old ones, or because of a tendency by the majority of depositors to renew their contracts with the co-operative once they have expired. Finally, Lanitis's assertion that the constitutions of co-operative credit societies do not allow them to make loans on the security of mortgaged property is simply not true and one may dare say exhibits lack of careful research on the part of the author.

### **3.7 Achieving self-help**

It is clear from the above that neither government funds nor a specific legal framework were enough to spark a successful development of co-operation in Cyprus. On the contrary, such measures may have negative effects if they fail to produce the expected results, assuming validity of the behaviour theory. When individuals respond to a situation by co-operating and this behaviour is positively reinforced, they will co-operate in similar situations in the future. If, however, co-operative response produces negative reinforcement, people will tend to avoid co-operation. Thus, co-operative behaviour occurs in situations where the environment encourages co-operation and where failure to co-operate may have unfavourable consequences.<sup>154</sup>

For a co-operative organisation to be considered a success it must reduce or even eliminate market inefficiencies at intermediary stages of a transaction economy without use of state funds which, as explained earlier, tend to reproduce inefficiencies rather than eliminate them. And as already explained in this chapter this ability in the case of co-operative credit societies will be assumed to be a function of economic growth of co-operative organisations measured in terms of deposits, reserves and loans. Deposits and reserves are good indicators of the ability of a co-operative to finance its operations without the use of state aid. The total amount of loans is an indicator of the contribution made by the societies towards meeting the credit needs of the population, whether rural or urban.

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<sup>154</sup> See section 1.3.6.

Table 3.2: The initial growth of the Agricultural Co-operative Credit Movement

Year	Number of Societies	Membership	Loans	Deposits	Reserves
1925	29	1957	7	0	N/A
1926	49	3432	43	0	N/A
1927	97	5482	87	0	N/A
1928	268	10730	140	0	N/A
1929	320	14404	230	0	N/A
1930	326	15202	267	0	N/A
1931	331	16465	289	N/A	N/A
1932	334	16650	299	N/A	N/A
1933	326	16639	309	13	N/A
1934	324	16035	313	20	23
1935	273	15035	336	22	25
1936	266	14700	302	27	29
1937	262	14600	284	36	33
1938	282	17400	84	51	39
1939	227	22100	122	71	37
1940	264	26300	128	79	42
1941	247	28955	140	87	45
1942	253	29000	N/A	159	52
1943	284	35533	170	373	62

Sources: Annual reports of the department of co-operative development.

A number of important observations can be made from the above table. First, a large decrease in the number of societies took place in 1935. This coincided with the appointment of a new Registrar, B. J. Surridge, as head of the newly established department of co-operation.<sup>155</sup> Surridge was a well known advocate of co-operation as the only real answer to the problems facing peasant populations regarding credit and related services like purchasing of inputs and marketing, and attached great importance to the co-operative movement's ability for self-help. This he thought would only

<sup>155</sup> Annual Report of the Department of Co-operation for the year 1935, Nicosia, 1936.

become possible through the exercise of thrift. He strongly believed that Raiffeisen ideas on co-operation were the most suited in the case of the developing world.<sup>156</sup>

As soon as Surridge became the Registrar of co-operative societies in Cyprus he embarked on a clean-up operation of all those societies with a poor record of management. This explains the large decrease in the number of registered societies from 324 in 1934 to 273 in 1935. Surridge himself confirmed in his Annual Report for 1935 that the sole purpose of existence of the great majority of societies up to that point in time was to take advantage of loans offered by the Agricultural Bank. Co-operative societies were acting as the agents of the Bank and had none of the characteristics of true co-operative institutions. Most of them did not even accept deposits. The rush to take advantage of the Bank's loan facilities meant that the movement had grown too rapidly without first establishing a sound infrastructure on which to base expansion.

Surridge's task was said to be the revision of legislation, reorganisation of societies on sound lines and the teaching of the real meaning of co-operation. According to one of his successors, societies were taught the importance of thrift, were encouraged to accept more deposits and to give short-term credit, not on the security of immovable property, but on personal securities of members or on chattel mortgage.<sup>157</sup> In 1936 an arrangement was made whereby the long-term loans due by societies to the Agricultural Bank were transferred to the individual borrowers who would pay direct to the Bank. This explains the apparent drop in loans from £284,000 in 1937 to £84,000 in 1938.

In 1937 the Co-operative Central Bank was founded. The Bank was a Co-operative Union with limited liability with societies as members. It started operations in 1938 with 71 societies as members and the necessary finance was provided by Barclays Bank. The Central Bank provided short and medium term credit to its member

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<sup>156</sup> Bechtel, in Worz(ed.), 1983, p 113.

<sup>157</sup> R. N. Henry, The development of co-operation in Cyprus, in Government of Cyprus: **The Proceedings of a Conference on Land Use in a Mediterranean Environment**, Nicosia, 1947, p29.

societies, accepted deposits from societies and provided them with such essential commodities as fertilisers, sulphur and seed potatoes.

As a result of the above arrangements the co-operative movement began to work on the principle of self-help and this becomes obvious by the fact that as from 1938 loans issued by societies were mainly financed by deposits and reserves. The creation of the Central Co-operative Bank (CCB) in 1937 which accepted deposits from member co-operatives with surpluses and made advances to member co-operatives short of liquidity, ensured that another important co-operative principle, that of mutual aid, was put into effect. The role of the CCB in the development of co-operation in Cyprus is analysed at a later section of this chapter. This is a convenient point to embark on a detailed analysis of the role of the state in the initial development of the Cypriot co-operative Movement.

### 3.8 A State Catalyst

It has already been shown in the case of W. Bevan how a state agent acted as a literacy substitute. However, the temporary actions of one state official could not solve permanently the information inefficiency inherent among rural society in Cyprus which prevented the growth of a truly self-help movement. The attempt by government to accelerate this growth through the Agricultural Bank not only failed to produce the desired outcome but also put a serious brake on the development of the idea of self-help. Eight years after the setting up of the Bank, agricultural credit societies still depended exclusively on the Bank's finance for their operations.

Worried about the growing indebtedness problem, which was made worse by the economic depression of the late twenties and early thirties, and the possible link between economic deprivation of the peasantry and anti-colonial pro-Union with Greece feelings,<sup>158</sup> the local British Administration under the Governorship of Sir Ronald Storrs embarked on a campaign to solve the agricultural credit problem. After prolonged negotiations with a hesitant Colonial Office, he secured an increase in the capital of the Agricultural Bank from £50,000 to £250,000 in 1928. He believed that

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<sup>158</sup> CO 67/225/39293, Minute by Ormsby-Gore, July 27, 1928.

this would boost co-operative development as Agricultural Bank loans would be advanced through the local co-operatives.<sup>159</sup> Clearly the Administration had misunderstood the objectives of co-operation and the underlying principles.

These principles and objectives were, however, well understood by Sir Ralph Oakden who was asked to produce a report on the Finances and Economic Resources of Cyprus in 1934. Oakden blamed the poor showing of co-operatives mainly on their link with the Agricultural Bank and suggested that this should be taken over by the Government. In its place he proposed the creation of a Central Co-operative Bank. He also recommended that a separate department of co-operation should be created which would no longer be under the aegis of the Agricultural Bank. In his report he draws attention to the fact that the Registrar of Co-operative Societies is the mainspring of the Movement, the success of which depends entirely on his personal qualifications and activity. Oakden also stressed the importance of the audit of co-operatives being in the hands of appropriately trained people.<sup>160</sup> It was the implementation of Oakden's recommendations that prepared the ground for the co-operative take-off in the late thirties.

The idea that a government department would play such a crucial role in the development of co-operation does not in any way contradict the earlier position that direct government control and finance represent threats to the development of co-operation. The Cypriot co-operative movement was lucky enough to have Surridge as the first head of the newly-established department of co-operative development in 1935. He appeared to fully understand that his role was one of supervision, audit and education. In other words, he and his department became the new literacy substitute.

In his first annual report, Surridge expressed the belief that systematic inspection should be kept distinct from audit and that in due course all credit societies should pay audit fees. Without regular inspection and patient teaching Surridge thought it impossible that sound co-operative societies could exist. A sound co-operative was one that operated as a true self-help organisation. Surridge criticised the lack of

<sup>159</sup> Georghiades, 1985, pp151-153.

<sup>160</sup> Oakden, 1935, pp122-123.

commitment on the part of members to deposit even minimal amounts with the societies. Characteristically he estimated that of total saving deposits with co-operatives not more 10% belonged to members. The remaining belonged to labourers and women who had joined a special savings scheme whereby they made weekly deposits of 3 Cypriot piastres for a three-year period<sup>161</sup>.

On the basis of annual reports produced by the department of co-operative development the two main activities of the department were to impress upon committees their obligations with respect to debt collection and to perform the annual audit of the accounts of societies.

It has already been explained that the success or failure of agricultural credit co-operation or in fact any kind of credit co-operation heavily depends upon the existence of effective debt-recovery mechanisms. Not only during the first years of its creation but even today, the co-operative department acts as a serious reinforcement to the societies' debt recovery procedures. This reinforcement is not only the result of the Registrar's powers to remove incompetent committees, but also the result of constant propaganda by officers of the department regarding the serious threat to the society in case arrears get out of control.

But another important contribution of the department is the fact that committee members, usually unable to exert too much pressure on their fellow members to pay up, due perhaps to kinship, friendship or patron-client relationships, are able to use as excuse the pressure exerted on them by state officials in order to enforce debt collection. On many occasions, representatives from the Registrar's Office are present when debtors are asked to pay up or face a court order. The fact that they act as state agents carries extra weight on how people perceive the seriousness of the claims made on them. These representatives are usually strangers to the locality of the society and therefore do not face the same kind of constraints as local committee members.

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<sup>161</sup> Annual Report of the Department of Co-operation for the year 1935, Nicosia, 1936.

The second most important function of the department of co-operative development was, until 1987 when a separate Service was set up by law, the audit of societies' accounts. Events that led to the separation will form the basis of a separate chapter and will therefore not be discussed here. The importance of auditing however as a variable in the function of co-operative economic success needs some further analysis.

A proposition put forward by Dobyns suggests that one factor in engineering successful co-operative-type economic organisations in developing regions is the supply of coinage and currency and credit arrangements. These will provide a quantitative measure of success or failure in the co-operative that is highly visible and fairly readily comprehended by literate people. The need for a system of accounting is also relevant in this respect. Where corruption and inefficiency are common, local interest in the economic co-operative falls. Corruption is difficult to detect without records, and inefficiency difficult to measure.<sup>162</sup>

The first problem with Dobyns analysis arises where a high percentage of members or potential members are not literate, like in the case of pre-second world war Cyprus. The co-operative department can then take on the role of the literacy substitute as already explained. But this role should not be confined only where a certain number of members are illiterate. It should also apply to situations where members, although literate, do not have that special accounting knowledge to be in a position to audit the books of transactions of the society in order to ensure proper stewardship of funds, which after all belong to members.

The audit function becomes all the more important where the number of members involved becomes larger and therefore a divorce inevitably takes place between management and ownership. In this case, even if members possess the right level of expertise to audit the books of the society, it would in practice prove very difficult and detrimental to the interests of the society and hence the interests of the members, to allow general access to the books; not only from a time and resource wastage point of view but also from a business point of view. Especially in the case of societies that

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<sup>162</sup> See above, section 1.3.5

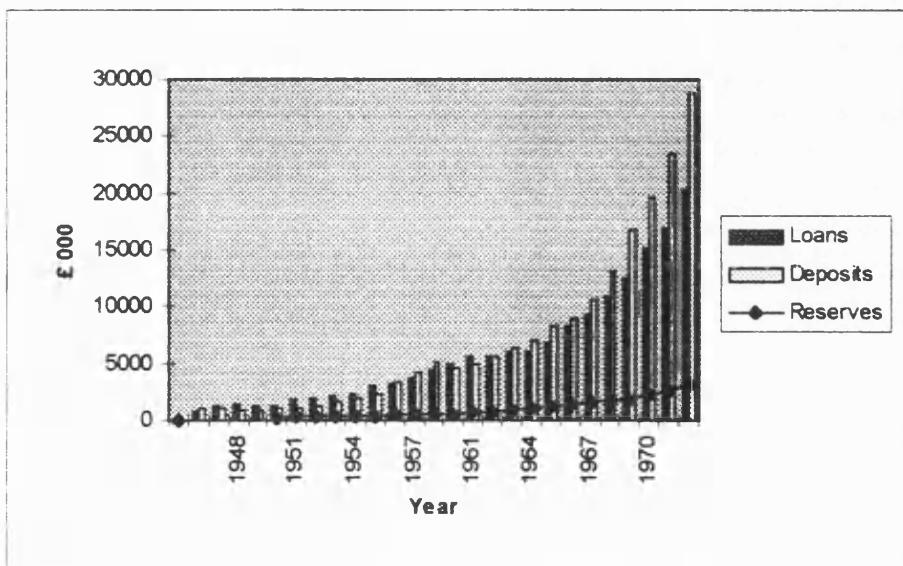
accept deposits and advance loans to members, confidentiality is of extreme importance without which the society is unlikely to survive, and therefore the auditing function should be performed by agents who are seen to abide by the rules of confidentiality.

Another important attribute of audit agents, if they are to play their literacy substitute role effectively, is their ability to convince members of their independence. It is not enough to be independent. They must also appear independent. The fact that the department had a monopoly over the audit function and was not subject to reappointment by the Annual General Meeting, like in the case of the corporate sector, helped significantly in convincing members of the true independent approach of these state officials; especially in a country like Cyprus where state corruption both under the British Administration, but also during the post-independence period, was not so common as in some other parts of the developing world.

One of the factors that must lead to co-operative failures in some of the developing areas where state corruption is not unusual, is inability to convince participating actors in the co-operative that corruption is either absent from the operations of the co-operative, or will be discovered, if such corruption exists, by an independent audit agency. This proposition will be tested in a later chapter when the effects of corruption are introduced in the co-operative equation.

As a way of confirmation that the appropriate role of the government was that of a supervisory agent rather than a financing agent, co-operation in Cyprus began its impressive upward trend in the forties, after the complete break-up of any link with state funding through the Agricultural Bank, and after the setting up of a separate department for co-operation. The state finally took over the role of a literacy substitute acting as a catalyst in the whole network of co-operative activity. The upward trend is clearly shown in figure 3.1:

**Figure 3.1: The growth of agricultural co-operative credit movement**



It should be noted that the above time-series diagram does not include 1959, as reasonably accurate data about credit societies is not available due mainly to the political changes that took place in that year. This was a transition year for the island, preparing the ground for full independence in 1960. Data for the period until 1958 includes Greek and Turkish Cypriot co-operative credit societies with unlimited liability, catering mainly for agriculturists. After independence the two communities operated their own societies with separate co-operative development departments and separate co-operative central banks. Data after the split refers only to non-Turkish Cypriot co-operatives due mainly to lack of access to reliable data.

### **3.9 The socio-biological theory and ethnicity**

Although the post-1960 Turkish Cypriot co-operative movement is ignored for the purposes of this thesis the fact that even before independence, when the two communities still used to live together, different national groups set up their own separate co-operative societies, provides some evidence in support of the socio-biological theory which may explain why co-operation is said to have more chances of success where there is homogeneity of membership. This homogeneity may relate to

colour, race, nationality, social and economic background.<sup>163</sup> The bi-communal character of the island's population was such that although both Greek and Turks were citizens of the same state they both saw themselves as different to each other, not only from a religious and cultural point of view but also from a national perspective.<sup>164</sup>

In economic terms, the need for such homogeneity can best be explained in terms of Emelianoff's analysis of aggregates of economic units. Dealing with the question of failure or success, Emelianoff offered a number of propositions based on his theoretical analysis of the economic nature of the co-operative. Because of what he called "the inherently explosive nature of the aggregate of economic units", Emelianoff believed that households may be easier co-ordinated into an aggregate and may be easier kept together in the aggregate if they are economically homogeneous, mostly because of their "disruptive nature".<sup>165</sup> There is no reason why Emelianoff's economic homogeneity analysis should not be used in the case of non-economic forces like religion or ethnicity which may also give rise to friction among the co-operating units.

It has already been mentioned in Chapter One that one of the weaknesses in Emelianoff's analysis of co-operative success as a function of homogeneity is that he concentrates exclusively on the economic perspective. His approach, however, was only natural since he was making an attempt to set up a purely economic theoretical framework, excluding all non-economic considerations, in order to examine the co-operative as an economic phenomenon. But the experience of Cyprus may provide sufficient evidence to explain the importance of homogeneity not only as an economic variable of the co-operative function but also as a non-economic variable of the same function. The importance of ethnicity and religion as a non-economic variable in the case of Cyprus is evidenced by the fact that on most occasions even in mixed villages each community had established its own society. There were reported cases where due to the prohibitively small size of the population of certain Turkish villages they were grouped with nearby societies controlled by the Greek community, but following the

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<sup>163</sup> See above, section 1.3.2

<sup>164</sup> K. Χατζηδημητρίου, *Ιστορία της Κύπρου*, Λευκωσία, 1985, p299.

<sup>165</sup> See above, section 1.3.2

inter-communal troubles in the summer of 1958 they left to join up with the nearest society controlled by the Turkish community.<sup>166</sup>

In order to make the ethnic issue relevant to the homogeneity concept it is necessary to analyse the relationship between membership control and decision making mechanisms in a co-operative registered under the Cypriot co-operative legislation at the time. The main features of this legislation were first, the very extensive powers entrusted with the General Assembly of members, second, the power of the General Assembly to delegate most of its powers of decision making to an elected Committee and third, the democratic way of electing Committee members, usually five in number, on the majority rule basis.

Based on estimates of total number of societies by type and membership from various Annual Reports of the department of Co-operation, the average number of members per credit society during the pre-1974 period was less than 400. This merely reflected the fact that in Cyprus during the period under review a large section of the population lived in villages, some urbanisation taking the form of daily commuting to work in the towns from nearby villages. In the year of independence, 1960, only 36% of the population lived in towns.<sup>167</sup> The rest of the population lived in approximately 600 villages. According to the population census of 1973, of a total population of 632 thousand, 267 thousand or 42% lived in towns and 365 thousand or 58% lived in villages.<sup>168</sup> The following population distribution by villages was recorded in that same census:

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<sup>166</sup> Cyprus: *Annual Report of the department of co-operative development for the year ending 31 December 1958*, Nicosia, 1959, p 4.

<sup>167</sup> L. W. St John-Jones, *The population of Cyprus*, London, 1983, p 126.

<sup>168</sup> Republic of Cyprus: *Demographic Report 1994*, Nicosia, 1995, p 30.

Table 3.3: Rural population distribution

Number of inhabitants	Number of villages	Cumulative	Total Population	Cumulative
			000's	000's
Under 200	137	137	16	16
200-499	219	356	71	87
500-999	147	503	103	190
1000-1999	67	570	92	282
2000-4999	27	597	76	358
5000-9999	1	598	7	365
	598	598	365	365

Source: Demographic Report 1994

According to 1960 census the Turkish community made up 18% of the total population of Cyprus. It is natural therefore to assume, with some possible exceptions, that where villages were mixed the Greek Cypriots were in the majority. As the election law for co-operative committees was based on the majority rule rather than on proportional representation, it was possible for the community with a majority to elect all five members of the committee from its own ranks unless some kind of consensus was reached. Such consensus was difficult to arrive at in a country with a history of ethnic violence like Cyprus. Until 1958 there were at least 80 co-operative societies in Cyprus with a mixed membership.<sup>169</sup>

Following inter-communal violence in the summer of 1958 the Turkish minority members of societies with a mixed membership withdrew, setting up their own societies. The Co-operative Societies Law was changed in 1959 facilitating the creation of two separate departments of Co-operation, one Greek and one Turkish. This was followed by the split in two of the Central Co-operative Bank in 1960.<sup>170</sup> The separation into two co-operative movements was now complete. And yet this was the year of establishment of an independent, unified Republic of Cyprus.

The fact that all members of the Committee could be elected by one of the two communities meant that only the interests of that community would be represented on that Committee. As loan applications and other services provided by the co-operative

<sup>169</sup> Cyprus: Annual Report of the department of co-operative development for the year ending 31 December 1958, Nicosia, 1959, p 4.

<sup>170</sup> Κυπριακή Δημοκρατία: Ετήσια Εκθεσις Ελληνικού Τμήματος Συνεργατικής Αναπτύξεως διά το έτος 1959, Λευκωσία, 1960, σελ. 1.

were at the complete discretion of the Committee it is hardly surprising that members of the minority community, usually Turkish, would feel uncomfortable about their economic interests being dependent on the benevolence of the majority community. Especially when the relationship between the two communities was so strained as in the case of Cyprus.

### **3.9.1 Membership base**

But ethnicity was only one aspect of homogeneity. The fact that on average membership did not exceed 400, coming from communities with a small population, usually less than 2000, meant that homogeneity was also important in terms of place of origin. The tendency was, and still is, for every village to have its own co-operative institution, whether credit, or marketing, or other forms of co-operation. Economies of scale could have saved the co-operative movement of Cyprus significant amounts of needless expenditure. And yet neighbouring villages with inhabitants of the same ethnicity, religion, education and primary occupation would rather have their own co-operative institutions. Of a total number of credit societies exceeding 400 in 1973 not more than three served more than one locality. The danger that one of the partner-localities would have control over the Committee was reason enough for the members of the other partner-localities to reject such partnership.

But despite the loss of economies of scale due to the extensive fragmentation of the co-operative movement there were some advantages emanating from the small membership base of most societies. These advantages could be explained in terms of Olson's theoretical analysis of group behaviour in voluntary organisations. According to this analysis group goals could only be achieved by small groups or in the presence of a catalyst. In the case of a village co-operative with a small membership base, where members know each other personally, it is more difficult for each member to act as a free rider due to the high probability of detection and possible cost of social discredit in such a small community. The lower the number of participating actors the higher the probability of detection and the higher the cost of social discredit.

Co-operative marketing of agricultural output is a good example in this case. Loyalty of member producers is very important, especially in the face of fierce competition from private merchants. During years of good market prospects private merchants may offer better terms to producers in order to break their loyalty with the co-operative. However in bad years, disloyal producers try to go back to the co-operative which usually offers the best terms.<sup>171</sup> This shift in disloyalty may be impossible to detect where there is a very large membership base but easier to detect and penalise with a smaller membership base. This is an instance where adherence to the important co-operative principle of free entry and exit may be unrealistic.

Another example where size of membership base may affect the efficiency of operations is in the credit sector. Care is usually taken by Committees to lend money only to credit worthy members. The smaller the membership base the better will be their ability to assess the risk involved with each loan application on the basis of the personal character of the loan applicant and his financial position. According to the Manager of a village co-operative on average one in four loan applications are rejected on this basis. He stressed the importance attached to the applicant's ability to service the loan rather than on the security offered.<sup>172</sup> More importance was attached on the security offered by Committees of larger co-operatives with membership exceeding 5000 as it was impossible for Committee members to know personally all loan applicants.<sup>173</sup> It is common knowledge that arrears in the repayment of loans are much higher as a percentage of total loans in the case of co-operatives with large membership base than in co-operatives with small membership base.<sup>174</sup> The fact that the large majority of co-operatives in Cyprus up to this date have a small membership base is perhaps one of the reasons for the apparent economic success of the credit movement, especially with regards to its transition to self-help.

### 3.10 Transition to Self-help

In a brief historical account of nineteenth century co-operative thinking Professor G. Davidovic describes how in the early days of co-operation there was considerable

<sup>171</sup> Interview with the Manager of SEDIGEP Chlorakas in October 1994.

<sup>172</sup> Interview with the Manager of SPE Frenaros( 1800 members) in March 1995.

<sup>173</sup> Interview with the Manager of SPE Strovolou( 25000 members) in March 1995.

<sup>174</sup> Annual Reports of the Co-operative Societies Audit Service for the years 1989-1995.

controversy about the way co-operatives should be financed.<sup>175</sup> He starts his account with Robert Owen (1771-1858) who was said to believe in help rather than in self-help. He undertook his co-operative crusade with his own resources and personal efforts, without thinking of the self-help of people in need, or without dreaming of the significance of mutual aid. On the other hand, the Rochdale Pioneers, several of whom were Owen's disciples or were influenced by his ideas in initiating their famous co-operative venture, resolutely took the opposite direction, following the road of self-help. Yet their initiative was not only successful but gained world-wide recognition and became one of the great prides and moral assets of Great Britain.

But it was in Germany that Davidovic sees the sharpest controversy taking place between Ferdinand Lassalle (1825-1846), the founder of the German Socialist Party, and Hermann Schulze-Delitzsch (1808-1883), the founder of urban credit co-operatives in Germany, over the question: should co-operatives be promoted with or without state help. Lassalle insisted on the promotion of co-operatives with state help, whereas Schulze held the view that co-operative development is possible only on the basis of self-help. Karl Marx argued that the capitalist state would not help co-operation; on the contrary he thought it would strangle it and therefore he, also, expressed support for self-help.

But the problem for or against state help to co-operation had concrete, practical consequences, according to Davidovic, particularly in the dispute between Schulze-Delitzsch, the builder of urban credit co-operatives in Germany, and Friederich Raiffeisen, the "father" of agricultural credit co-operatives. Both of these early successful builders of the co-operative form of enterprises, initially based their co-operative activity on help rather than on self-help, on charity, rather than on mutual aid. At that time, this was the fashion of the day in Germany. Well-to-do people of good will and good heart joined "co-operatives" and made contributions which were used for giving loans to poor people. The members of co-operatives were the donors, not the recipients of loans. But both Raiffeisen and Schulze came to the conclusion that this kind of co-operation could hardly be a lasting solution. They realised that it

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<sup>175</sup> G. Davidovic, Automatic Transformation of State Help Co-operatives into Co-operatives for self-help, in Andreou(ed.), 1977, pp174-176.

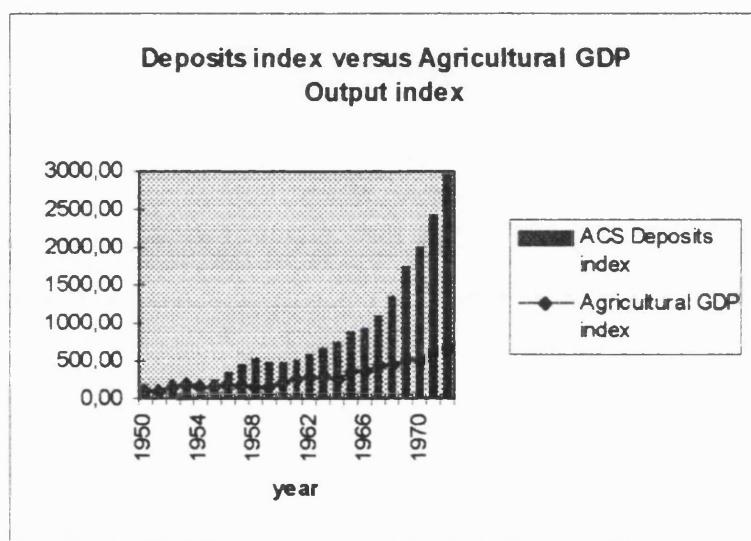
could not effectively improve the position of the debt-ridden peasantry. Neither could it be a solution for the workers and other categories of urban population whose very existence was increasingly threatened by the rising tides of young capitalism. For, in the course of years, the good-hearted people became tired of making donations and contributions. Here both Raiffeisen and Schulze came to the conclusion that the solution was in self-help rather than in help. However, the two German builders of co-operation were in sharp disagreement as to the manner in which co-operatives based on self-help should be organised. Raiffeisen was for small, Schulze for large co-operative societies; Schulze wanted co-operatives with large capital, Raiffeisen excluded any capital and based the financial foundations of his co-operatives on unlimited liability of co-operative members; Schulze insisted on short-term credit; Raiffeisen on medium and long-term credit. And, last but not least, Raiffeisen, although insisting on self-help, saw no harm in accepting state help to co-operation, provided that co-operative independence and self-management were safeguarded. Schulze, on the other hand, excluded any outside help, from whatever source, state or private.

The results of the British Administration's attempts to promote co-operation in Cyprus through the Agricultural Bank, a government controlled institution, have already been analysed and a clear conclusion has been reached about the adverse effects of such state action. It is reasonable therefore to assume validity of the self-help principle as a pre-requisite for co-operative success and it is important to show whether the Cypriot co-operative movement has managed to transform into a self-help institution and more importantly the mechanics of that transformation.

The transition into a self-help institution, at least in the area of agricultural credit, can easily be established by comparing deposits and reserves to loans as shown in the diagram of the previous section. It is more difficult to establish the precise mechanics that brought about this transition. These need to be thoroughly analysed and the possibility examined that lessons extracted from the Cypriot example be used in the case of many of the less developed parts of the world today. Before embarking on this analysis, however, it is useful to look at co-operative growth in relation to economic contribution.

The following diagram is an attempt to show a possible relationship between agricultural output and deposits of agricultural credit societies. In order to facilitate comparison both deposits and agricultural GDP have been indexed with 1950 as the base year. Original data has been obtained from the Cyprus Statistical Abstracts of 1955, 1959 and 1993.

Figure 3.2: Agricultural output Vs agricultural co-operative credit deposits



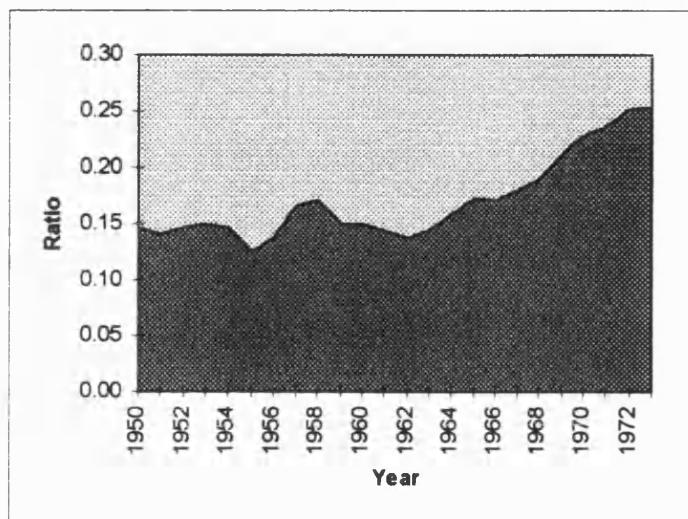
If the relationship of the two sets of time-series data is expressed in terms of the correlation coefficient, the very high value of 0,96 is a strong indication that deposits in this particular sector of the economy, and hence the ability for self-help among the population of this sector is related to patterns of macro-economic growth. The existence of such strong relationship may at first appear natural, however, an in-depth analysis may lead to different conclusions. In relation to bank deposits as a whole the co-operative movement presented the following pattern of development:

**Table 3.4: Agricultural Credit Societies and Saving Bank Deposits in relation to commercial bank deposits**

Year	Commercial Bank deposits a	ACS & Saving Bank deposits b	Ratio b to a
1950	£ 000 9423	£ 000 1377	0.15
1951	10606	1495	0.14
1952	12171	1793	0.15
1953	14006	2093	0.15
1954	16805	2450	0.15
1955	24080	2992	0.12
1956	30025	4139	0.14
1957	31968	5300	0.17
1958	37600	6453	0.17
1959	37728	5670	0.15
1960	38751	5809	0.15
1961	43556	6300	0.14
1962	53938	7412	0.14
1963	58937	8477	0.14
1964	61834	9801	0.16
1965	67036	11624	0.17
1966	75818	13044	0.17
1967	85472	15356	0.18
1968	98334	18552	0.19
1969	113347	24096	0.21
1970	123178	28110	0.23
1971	148238	34992	0.24
1972	179465	45272	0.25
1973	203884	51839	0.25

Source: Cyprus Statistical Abstract for 1993, Nicosia, 1995.

**Figure 3.3: Ratio of co-operative to commercial bank deposits**



The first question that needs to be answered is whether the increase in the deposits of the unlimited liability agricultural credit societies during the period currently under review was due mainly to the advancements of agriculturists or whether the increase was mainly the result of advancements by the non-agriculturist segment of the population. Surridge's criticism that only 10% of deposits belong to farmers appears to indicate that at least during the first stages of co-operation it was the non-agriculturist members of the agricultural credit societies that produced the self-help effect. In that same Annual Report Surridge talks of the farmers inability to fully comprehend that the purpose of existence of a co-operative is not just to give out loans.<sup>176</sup>

It appears, however, both from commentaries in later annual reports of the department of co-operation but also on the basis of a review of deposit ledgers by occupational class in five randomly picked agricultural credit societies, performed by the writer in March 1996, that the situation was not any different even today.<sup>177</sup> Characteristically, Secretaries of all five credit societies commented that farmers will take on as much credit as is made available to them and even demand more. There were only few instances when any of these farmers had any deposits with the co-operative. And yet the incomes of most of these farmers were thought to be much higher than the average in that area. Deposits, according to the same co-operative official came mainly from salaried people who travelled to work in the nearby City and also from various classes of professionals.

A very important conclusion from the above empirical findings is that self-help in the context of a single co-operative depends on intra-community transfers. The local co-operative, unless financed by an outside agent, state or otherwise, acts as a credit intermediary between non-farmers and farmers of the same community. This transfer of funds is described by co-operators as the principle of 'mutual aid'. Such transfer however, would not have been made possible had the right financial motives not been given to the non-farming sector, like for example a competitive rate of interest on their

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<sup>176</sup> Cyprus: *Annual Report of the department of co-operation for the year 1935*, Nicosia, 1936, p16.

<sup>177</sup> The personal ledgers of SPE Peristeronas, SPE Daliou, SPE Frenaros, SPE Lymbion and SPE Germasoyia were reviewed in detail for the main occupation of depositors and borrowers.

deposits. This is evident from the fact that until co-operatives in Cyprus began to offer attractive rates on savings accounts in the late thirties, savers are reported to have deposited their surplus funds with the local money-lenders.<sup>178</sup> The need for a financial motive before the act of transfer can take place casts serious doubts on the relevance of mutual aid as an important ingredient of the co-operative function, especially if Kropotkin's analysis of such aid is used.

### 3.10.1 Mutual Aid

Russian anarchist Kropotkin analyses mutual aid as being wider than love or personal sympathy—an instinct that has been slowly developed among animals and men in the course of an extremely long evolution, and which has taught animals and men alike the force they can borrow from the practice of mutual aid and support, and the joys they can find in social life. He defines mutual aid in terms of human solidarity and the close dependency of every one's happiness upon the happiness of all; and of the sense of justice, or equity, which brings the individual to consider the rights of every other individual as equal to his own.<sup>179</sup>

Kropotkin's analysis of mutual aid closely resembles co-operators' understanding of mutual aid, as can at least be inferred from some of their favourite slogans. Idealism however may ignore some hard economic realities. Transaction costs involved in the supply of credit on a person to person basis are extremely high due mainly to the very high risk of default as well as the very high loan information and processing costs. These very high transaction costs together with a low elasticity of demand for credit by farmers provide ample opportunity for credit intermediaries to charge excessive rates taking full advantage of their natural monopolistic position, as already explained in chapter 2. The co-operative intermediary, provided it offers depositors enough security for their deposits, can be the cheapest vehicle in transferring excess funds from the non-farming section to the farming section of the community. The main proviso is that there is a sufficiently large non-farming population with steady incomes who are persuaded to practice thrift and can entrust the results of such thrift, usually small amounts of deposits, with the co-operative agent. The implication here is that

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<sup>178</sup> Oakden, 1935, p121.

<sup>179</sup> P. Kropotkin, *Mutual Aid*, London, 1907, ppxiii-xiv.

agricultural co-operatives require a supply of funds from the non-agricultural sector. The niche therefore of agricultural co-operative credit success based on the self-help principle, lies in the ability of the co-operative movement to inspire confidence in the minds of potential depositors and at the same time offer competitive rates. According to a great number of Cypriot co-operators today including the Registrar himself, such confidence was, and still is inspired by the unlimited liability concept.<sup>180</sup>

### **3.10.2 Limited Vs Unlimited liability**

The successful development of limited liability co-operative savings banks in Cyprus indicate the fallacy of any arguments in favour of unlimited liability. The earlier history of the Cypriot co-operative movement provides strong evidence in support of the literacy substitute theory developed earlier in this chapter as opposed to state support. As already shown such substitution was provided by the state in the form of loan recovery supervision and audit. The experience of Cyprus but also of other developing countries regarding state funds support is that it can only lead to the creation of a kind of pseudo-co-operation which can be of no real value to developing regions with serious constraints on the availability of a steady flow of public funds, even where the liability of members is unlimited. In the case of countries which are able to maintain a continuous flow of public funds towards the maintenance of a non-self-supporting co-operative movement, like in the case of Greece, this can only lead to economic inefficiencies and corruption irrespective of members' liability.

Supporters in Cyprus of the principle of joint and unlimited liability believe that it serves two purposes. First, the fact that all members carry joint and unlimited liability provides an extra safeguard to depositors who are naturally sensitive to how secure their deposits are. Second, the fact that all members are under joint and unlimited liability makes them eager to proceed with stricter loan recovery procedures.

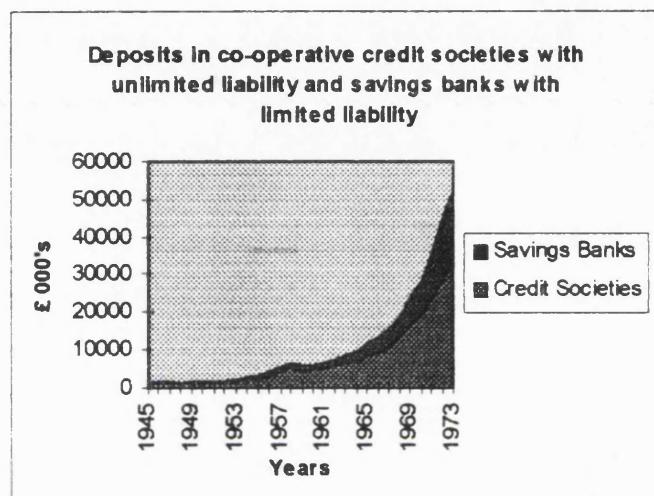
The Cypriot example certainly proves the irrelevance of the unlimited Vs limited liability concept. As far as the depositors are concerned they seem to choose co-operative credit societies with unlimited liability as much as they choose co-operative

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<sup>180</sup> Speech by the Registrar of co-operative societies on the occasion of a visit by a Cypriot co-operative delegation to Greece in October 1996.

savings banks with limited liability, as it is shown by the slopes of the two sets of depositors.

Figure 3.4: Limited Vs unlimited liability



On a great number of occasions depositors also become members in order to be able to have access to temporary short-term credit facilities. If they really thought of the joint and unlimited liability to be of any significance it is doubtful whether they would consider joining the co-operative in the first place. Why put all their property at risk for a small overdraft facility which, provided they are prepared to lose a few interest points, can most certainly cover from their existing deposits. The same kind of reasoning may act as a disincentive for wealthy farmers to join the co-operative if the amount of loan finance they require is small compared to the total value of their property.

Regarding the opinion that joint and unlimited liability would be a good incentive for members to press for tougher measures on loan arrears the experience of the co-operative movement in Cyprus is anything but proof of this. The only real incentive for harsher measures on loan recovery appears to be provided by the constant probing and threats of representatives from the department of co-operative development. Provided the threat is not an immediate one, committee members will take into account other considerations such as friendship, family relationships, political affiliations, and other interests of a financial or other nature. Patrons and clients type relations are very

important variables in the context of the co-operative equation and will be looked at in detail at a later chapter.

Finally, the joint and unlimited liability element can act as a disincentive for members to pay up their debts to the society if they think that the society will soon cease to be a going concern. This was the case in 1935 when the Registrar, commenting on reasons for arrears in the repayment of loans, stated in his annual report that "...members also hold back on account of the unlimited liability as they realise that there will be a deficit on some loans which they expect to be called upon to make good. They then try to accumulate a little money in order to buy back their own properties at forced sales which they see are bound to come sooner or later."<sup>181</sup>

Having established the irrelevance of the limited liability concept as a variable in the co-operative deposits function, the question that needs to be addressed is what happens when not enough savers can be found in an agricultural community in order to satisfy demands for credit by agriculturists in that community.

### 3.10.3 The Central Co-operative Bank (CCB)

It is not always possible within the boundaries of the same community, especially due to size of population, to find a sufficient number of steady income earners to make credit finance available to farmers. The small size of the co-operative may also prevent access to the organised credit market. These problems created by diseconomies of scale do not however make the local farmer any less in need of credit which he is more likely to purchase locally at a very high price. High costs of credit finance may result in going concern problems for the family agricultural enterprise giving rise to the very well known social problems associated with poverty. Even in communities with large populations it may not always be possible to have a sufficiently large section of non-farming steady income earning population which is prepared to forego current consumption for the sake of future consumption, especially at rates of interest in the range of one to three per cent.<sup>182</sup>

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<sup>181</sup> Annual Report of the department of Co-operation for the year 1935, Nicosia, 1936, p5.

<sup>182</sup> Various Annual reports of Co-operation.

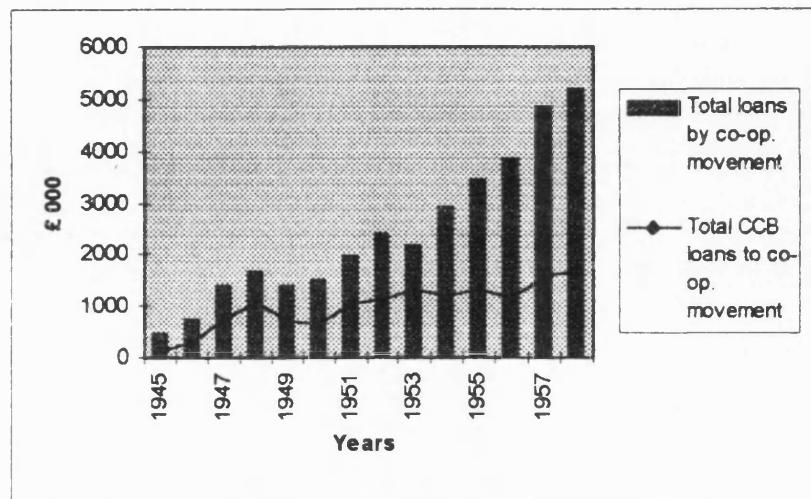
In situations like the ones mentioned above it becomes necessary to look for loan finance outside the local community, either in other areas within the national boundaries or on the organised credit market. It is doubtful whether co-operatives of small average size with non-expert management will be able to gain access to the organised credit market due mainly to high transaction costs similar to the ones discussed in the previous chapter in relation to individual farmer's ability to gain access to the organised credit market.

Even where the target lending agents are fellow co-operative societies with surplus funds, high transaction costs are still present acting as a serious obstacle to such inter-co-operative transactions. Conceptually, for such inter-co-operative credit transactions to be made possible on a regular basis an information network must be set up similar to the one employed by commercial banks. Such a network in Cyprus has been set up in the form of a Central Co-operative Bank whose main function is to bring co-operatives with excess funds together with co-operatives in need of funds, as well as to act as an intermediary between co-operatives and the organised credit market.

The setting up of the CCB has given rise to significant reductions in transaction costs due to economies of scale. The economies of scale mentioned above may arise for example in dealing with the organised credit market as the CCB is in a position to conduct negotiations and enter contractual agreements on behalf of the whole co-operative movement thus reducing significantly the transaction costs involved per individual transaction. It would have been financially impossible for the majority of co-operatives in Cyprus, even today, to employ that level of expertise needed to assess and enter such agreements.

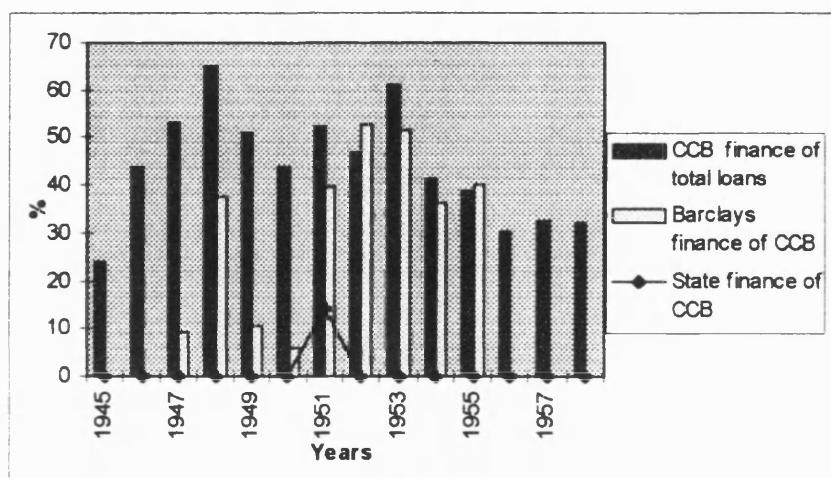
The following diagram shows the development of the Central Co-operative Bank in Cyprus as a main source of finance for the co-operative movement of the island during the post-war period and before independence.

Figure 3.5: Central Co-operative Bank finance of the co-operative credit movement



It is evident from the above diagram that the CCB was a major source of finance for the co-operative credit movement. What is more important to know, however, is how much of this finance was generated internally through the system of surplus transfers described earlier on, how much was due to the organised credit market, and how much was state finance.

Figure 3.6: Outside finance of CCB



The above diagram makes the answer to the previous questions obvious. State finance of the CCB was nearly non-existent during the post-war pre-independence period and the bulk of outside finance came from the international organised credit market in the form of overdraft facilities provided by Barclays Bank. The role of the CCB as an intermediary both for access to the international capital markets but also as an adjusting agent is evident. As from 1956 the CCB becomes fully self-financed showing how the needs of various co-operatives for loan finance were met through a system of internal transfers. The fact that self-sufficiency was achieved so abruptly was due to the significant increase in the deposits of co-operatives with the CCB in the 1950's due mainly to increased agricultural output in the 1950's and hence increased deposits with agricultural credit co-operatives.

CCB economies of scale permitted the hiring of such levels of expertise that made possible entry into agricultural credit related operations like the provision of agricultural inputs and the financing of the collection and marketing of certain agricultural products. The establishment of an extensive credit network through the relationship of the CCB with a great number of member co-operatives provides a ready-made distribution network for agricultural inputs. The CCB even to this day is a major importer of agricultural inputs which are supplied to farmers through local co-operatives. This distribution network with the existence in practice of two intermediaries, the CCB and the village co-operatives, and the ability to purchase in bulk, aim in theory at reducing abnormal intermediary profits achieved by private intermediaries. This aim is based on the assumption that the user farmer is the owner of the local co-operative and the local co-operative is the owner of the CCB since all the shareholders of the CCB are co-operatives. The CCB is therefore there to service the needs of co-operative societies' members.

### **3.11 Contribution of co-operative credit to agriculture**

Both in terms of deposits and loans and also in terms of self-help the Cypriot agricultural co-operative credit movement during the post-second world war period appears to have been successful on the basis of success parameters discussed earlier. Co-operation can only be a desired policy instrument if its overall contribution, either

in terms of the economy as a whole or in terms of its social impact is considered to be more than the economic and social costs involved.

For the purposes of this analysis a social cost and benefit analysis will be avoided by assuming lack of non-economic externalities and therefore equating overall contribution to economic contribution. There are problems in quantifying even this contribution due to data constraints. The first such constraint is unavailability of precise data as to how much of the loan advances of co-operatives truly relate to agriculture. So far the description agricultural credit co-operatives has been used synonymously with Συνεργατικές Πιστωτικές Εταιρείες, translated into Co-operative Credit Societies. These are multi-purpose societies of unlimited liability and are based very much on the German Raiffeisen model whose main objective is the supply of agricultural credit. Until 1974 they were wholly based in the rural areas of Cyprus. The assumption is being made that all loan advances made by these societies related to agriculture. The problem with this assumption is that there were members of societies who lived in villages but worked in towns and who obtained loans for reasons other than agricultural. Any distorting effects, however, can be safely ignored when comparing CCS loans to loans advanced by commercial banks to agriculture, since the calculation of these amounts for the period under review were based very much on similar lines.<sup>183</sup>

A comparison between agricultural credit supplied by CCS and similar credit offered by commercial banks suffers from a further limitation that separate data on loan advances made by commercial banks only becomes available after 1963. Before that year loan advances by commercial banks by sector combined agriculture with mining and quarrying. Another problem in the way of such comparison is that data on loan advances by co-operatives is not as readily available after 1963 as that for commercial banks. This is due to the fact that only loan advances by commercial banks are shown in the statistical abstract on a time series basis whereas loan advances by co-operatives are not included in the statistical abstract which only shows co-operative loan balances at 31 December of each year. This omission should not come as a surprise as co-

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<sup>183</sup> Interview with senior officer the Government Statistics Department.

operative loan issues data would normally be obtained from the annual report of the co-operative department but such reports after independence, were produced only once every three years. The movement of loans was only shown for the last year of each report. For a number of years therefore during the period 1963-1973 there is no data available for loans issued by co-operative credit societies. In order to overcome this problem the time-series data used for the purposes of this analysis relates only to those years for which loan advances data was available for both the commercial bank sector and the co-operative credit sector.

Table 3.5: Loan advances to agriculture

Year	Commercial Banks	Other financial institutions	Co-op. Credit Societies(CCS)	CCS contribution to agr. credit
	£ 000	£ 000	£ 000	%
1963	7282	77	3809	34
1966	9466	233	7468	44
1969	10474	658	13131	54
1972	13011	593	21619	61

Sources: Cyprus statistical abstract and annual reports of the department of co-operative development.

The above table shows the rapid increase of CCS contribution to the total credit needs of agriculture although by 1973 it had still not reached the 80% estimate made as early as 1970 by the department of co-operative development in the 1967-1969 report. In their calculations they appear to include loan advances by saving banks. Most of these, however, had nothing to do with agriculture. These limited liability co-operative saving banks originally catered for the saving needs of wage earners in mining areas but later became very popular among civil servants and other professions.<sup>184</sup>

But how can one explain this significant rise in the share of co-operation in rural credit? It has been shown in the second chapter that high loan processing costs acted

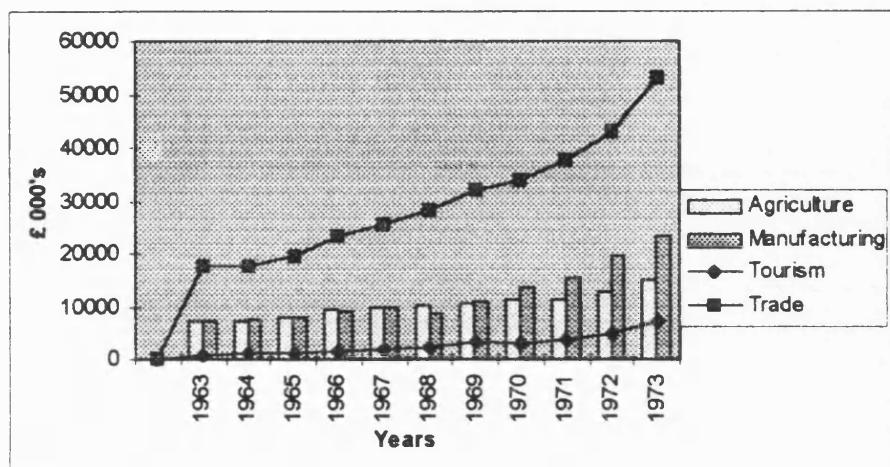
<sup>184</sup> Various Annual Reports of the department of Co-operation.

as a serious barrier to entry by agents of the organised credit market. It was this imperfection in the market that gave rise to usury before the development of agricultural co-operation. The growth of the co-operative movement is confirmation that for a co-operative function to exist there must exist market imperfections. The fact that co-operatives continued to grow in importance as the main suppliers of rural credit is the result of such market imperfections continuing to exist.

By the end of the British Administration in Cyprus some of the transaction costs that gave rise to the above market imperfections became unimportant. These included a far more extensive road and telephone network and a highly literate population. What is more, commercial banks started setting up branches in most of the main rural centres. All these changes must have had a reducing effect on the loan processing costs, however, the continuing rise in the share of co-operation in agricultural credit is a clear indication that some imperfections still existed. A law passed in 1944 fixing the maximum lending rate at 9% and still valid today, in a fast developing country like Cyprus greatly in need of investment capital to finance growth, especially in trade and other service and manufacturing sectors, has led to the persistence of a serious market imperfection in both agricultural and non-agricultural credit.

Commercial banks are mainly interested in profit margins for their share-holders. The high loan processing costs involved in rural credit as compared to other sectors of the credit market acted as a disincentive for agents of the organised credit market to become very much interested in this market especially bearing in mind the interest rate restriction and the ever increasing demand for credit by the non-agricultural sectors of the economy as shown in figure 3.7 that follows:

Figure 3.7: Commercial Banks loan advances to agriculture and other economic sectors



Sources: Historical data on the Economy of Cyprus 1960-1991, Department of Statistics and Research, Ministry of Finance, General Economic Statistics, Series III, Report no. 1, Nicosia 1994, pp 127-128.

The next stage of the analysis is to evaluate the importance of credit to agriculture in terms of national income statistics and the importance of agriculture to the economy as a whole in order to see the real dimensions of co-operative credit contribution.

Table 3.6: Importance of credit to agriculture and other economic indicators

Year	Total loan advances to Agriculture £ 000's	Gross Agricultural output at current prices £ 000's	Ratio of total credit to output %	Agricultural share of GDP at market prices %	Employment in Agriculture %
1963	11168	30500	37	18	41
1966	17167	38500	45	18	38
1969	24263	55500	44	19	37
1972	35223	71200	49	17	35

Sources: Cyprus statistical abstract 1993 and annual reports of co-operative development.

The above figures clearly demonstrate the importance of credit to agriculture and hence to the economy as a whole. But credit was not the only service provided by CCS to agriculturists. The theoretical framework relating to the relation between agricultural credit and other agricultural services has already been explained in chapter

two. Services like the supply of agricultural inputs and the pooling, processing and marketing of agricultural products may prove very costly if tied to a usurious money-lending agency. The main contribution of co-operation in this respect is that by freeing the farmer from his debts to private money-lenders also enables the farmer to shop around for the cheapest inputs and best prices for his output. He is no longer under any obligation to buy his inputs and market his output through a pre-determined intermediary.

The important conclusion from this analysis is that the main contribution of co-operation to farmers in a Cypriot-type agricultural economy is the provision of credit. Once the credit problem is solved market forces in the remaining agricultural services will eventually drive away abnormal profits. The natural question that follows from this conclusion is whether co-operatives can provide the above intermediary functions, other than credit, in a way that is most beneficial to agriculturists.

It is commonly held that the co-operative way is the cheapest way for farmers to buy their inputs and dispose their output. This view is based on the belief that since co-operatives are non-profit organisations no profit margins are made at the intermediary stage and hence the co-operative solution is the cheapest for the farmer. Although this may be true during the initial stages of market demonopolisation, when private intermediaries are still trying to adjust to new market conditions, there is no obvious reason why the co-operative way is the best solution for the farmers in a free and competitive market. In fact, as will be shown later, organisational inefficiencies may lead higher intermediary service charges being set by the co-operatives than by efficient merchants working in a competitive environment.

Turning to the question of success, a serious problem arises because of the assumption made that success is a direct function of loyalty. In other words, a co-operative handling agricultural inputs and output has always been assumed to be a success if it establishes member loyalty which is a function of volume of transactions. This assumption lies at the heart of the problem of evaluating co-operative success. The real objective of setting up a co-operative of any sort should not be to replace private intermediaries, as this could lead to monopolistic situations which, as will be shown

later, may prove as bad as private monopolies. The real objective of setting up a co-operative intermediary should be to remove market imperfections thus promoting conditions of free market competition. Once abnormal profits have been removed from the market and the credit problem has been solved through co-operation the members of a co-operative may feel that the time has come for the operations of a co-operative in the input/output market to come to an end. This should not be taken to mean that the co-operative attempt has failed. Provided the farmers' co-operative effort has transformed a very inefficient market prone to monopolistic exploitation into an efficient competitive market, it is a success.

The conclusions of the above analysis should hold true for any type of co-operative activity. Once the logic of the above arguments is accepted a great misunderstanding about co-operation can be cleared. This misunderstanding is contained in the words of nearly every senior co-operative official interviewed; "Our main objective as real co-operators should be to establish and maintain a strong co-operative movement." This kind of philosophy may lead the movement into serious trouble when "strong co-operative movement" is also accompanied by power bases for people in the leadership of the movement and may lead to inefficiencies and possibly corruption. But such thoughts need further analysis and will become the main subject of study of later chapters.

### **3.12 Test-case 1: Wholesale and Retail Trade**

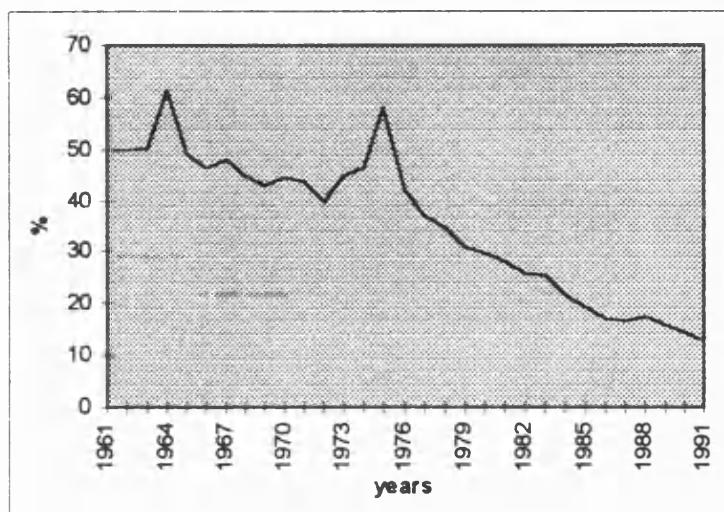
The first test-case for the above analysis relates to wholesale and retail trade in Cyprus. The wholesale and retail co-operative movement began its impressive development after the second world war during which time the government used co-operative societies as distribution agents for its rationing policy.<sup>185</sup> Following a process of market transformation co-operative share begins to fall as shown by the diagram that follows. It is clear that cost reductions due to inherent advantages may be more than off-set by certain disadvantages which may also be inherent in the case of co-operation. One such disadvantage is high overhead costs due to over-generous terms of employment. A second disadvantage arises from the fact that due to the nature of

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<sup>185</sup> Annual Report of the department of Co-operation for the year 1946, Nicosia, 1947.

decision making mechanisms within co-operatives, private competitors are able to conduct their business in a much more flexible manner.

Figure 3.8: Percentage share of co-operation in wholesale and retail trade



Source: Cyprus: Statistical Abstract 1993.

Assuming the market transition period has come to an end, problems may arise for the co-operative suppliers as competitors, through more efficient and cost-effective management and through incentives in the form of better prices or more flexible credit arrangements, try to lure members away from co-operatives. If they manage to attract a significant number of members the volume of business remaining to individual co-operatives may not be enough to meet standard operational expenses. Continuity of this specific co-operative service will now depend on subsidisation which in the case of Cyprus is usually done through a system of multi-purpose societies where the credit society also offers other intermediary services. Subsidisation usually comes from the credit sector of the co-operative. As the wholesale and retail sector becomes unable to meet operational expenses a decision may be taken either to continue to operate at the expense of the credit sector, or discontinue its activities. In the case of independent consumer and wholesale societies which can not meet operational expenses there is no alternative but to seize operations.

The two peaks in the above diagram in 1964 and 1975 are extremely interesting. Both periods relate to significant political events in Cyprus which led to inter-communal

violence in the first instance and full-scale war in the second. During these periods people returned to their local co-operative stores for their supplies. This can be explained by the fact that co-operatives, during periods of severely depressed economic conditions are far more willing to extend credit to their members, unlike their private competitors who prefer to tread far more cautiously. A plausible explanation for such economic behaviour by the co-operative agent as compared to the private agent relates to perceived costs of possible bad debts. The expected loss from each credit transaction as far as the co-operative is concerned is the product of the probability of failure in recovering the debt and the amount of the debt. The total expected loss to the co-operative is the summation of expected costs of individual transactions. This total expected loss should then be divided by the total number of members of the co-operative. Each individual member will therefore expect only a small amount of personal loss. In the case however of a private agent his personal expected loss equals the total expected loss of his enterprise. This analysis becomes stronger if it is assumed that during times of war, supervisory bodies and members are less willing to impose sanctions against the managing committee for acting in a lenient manner with respect to credit extension.

In the face of a continuous reduction in market share, except for the two instances mentioned above, but also of decreasing turnover in the case of a large number of individual consumer societies, a significant number of such societies in the wholesale and retail sector have had to close down.<sup>186</sup> In 1993 there were 143 consumer societies left as compared to 173 in 1983, 247 in 1973 and 311 in 1963. This downward trend coincided with an increase in the number of private players in the market, especially supermarkets, which began to make their appearance in the 1970's but increased significantly in numbers and size in the 1980's and 1990's. This large increase is evidenced by the fact that total capital formation of the wholesale and retail sector were CY£7.8 million in 1977, CY£23.6 million in 1983 and CY£56.9 million in 1993. Number of establishments in wholesale and retail trade and similar sectors increased from 10,867 in 1967, to 13,150 in 1972, to 14,293 in 1981 and 21,527 in 1989.

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<sup>186</sup> Annual Reports of the Co-operative Societies Audit Service for the years 1989-1995.

Number of employees in these sectors increased from 24,053 in 1967 to 58,508 in 1993.<sup>187</sup>

If the discontinue option is elected the private intermediaries may now find themselves in a position of monopoly thus going back to an abnormal profits position. It is this monopolistic prospect that may lead some private intermediaries while in competition with the co-operative to sell or buy at a loss in the short-term so as to drive the co-operative out of business, especially where the market is small like in the case of Cyprus, and where there are inherent barriers to entry. These barriers in the case of the retail and wholesale trade may take the form of requirement for high initial capital outlay in order to set up an extensive system of distribution, storage facilities, and the ability to grant extensive credit facilities. These constraints however did not prove strong enough to keep large numbers of competitors out of the market. On the contrary, increased competition drove many co-operative agents out of the market. This development is in perfect compliance with the theoretical framework developed earlier.

### 3.13 Test-case 2: Pooling and marketing of agricultural products

It has already been explained in the second chapter that dependence on the money-lender system for agricultural credit usually leads to a further dependence on the same agent for the purchase of agricultural inputs but also for the marketing of agricultural output. It is this dependence that creates monopolistic and monopsonistic situations that in turn leads to peasant-farmer exploitation. Relevant to this conclusion was the history of the Pedhoulas society for the marketing of cherries.

In 1935 a first attempt was made by the Registrar of co-operative societies to set up a marketing society at Pedhoulas for cherries. The attempt initially failed due to the reaction of grocers in the village who were the main suppliers of credit to producers. Due to this reaction it proved impossible to find any applicants for registration.<sup>188</sup>

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<sup>187</sup> Cyprus: **Statistical Abstract 1993**, Nicosia 1995.

<sup>188</sup> Annual Report of the Department of Co-operation for the year 1935, Nicosia, 1936, p10.

In 1946 a new attempt was made to set up a marketing society for cherries at the Pedhoulas village, this time with success.<sup>189</sup> This attempt came after the successful setting up of a co-operative savings bank in the same village in 1937 which helped liberate the producers from their debt liabilities to the grocers. Nearly every cherry producer in Pedhoulas marketed his produce through the new society.<sup>190</sup>

The story of the Pedhoulas cherries producers marketing society is consistent with the theoretical framework developed so far in this thesis. First, the initial failure indicates the strong relationship between two separate markets, that of credit given for winter food supplies, and that of cherries. This, however, was not a relationship between two independent markets. Rather, the state of the cherries market proved completely dependent upon the state of the credit market. This was the reason initial efforts to tackle the problem of marketing directly, failed so miserably. This problem could be and was solved through the indirect method of solving the credit problem by setting up a co-operative savings bank.

The above findings add support to Emelianoff's criticisms of co-operators having misunderstood the exact nature of co-operation and more specifically thinking of a co-operative as an enterprise rather than as a mere aggregate of economic units. The dependence of the cherries market on the credit market was the result of these economic units taking part in the working of both markets. As far as these individual units were concerned it was possible to survive even if they had to market their produce through a perfectly exploitative intermediary but it was not possible to survive without credit. This is why it was important to solve the credit problem first and then turn to other intermediary problems.

On the basis of earlier theoretical analysis in this chapter, once the real source of monopolistic power is successfully destroyed, and after some transition period the co-operative will start giving away part of its share to private competitors operating at a normal profit position. A position may in fact be reached when the co-operative can no

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<sup>189</sup> Annual Report of the department of Co-operation for the year 1946, Nicosia, 1947, p7.

<sup>190</sup> Interview with Mrs Androniki Petsa, an old cherry producer from Pedhoulas and one of the first members of both the marketing society and the co-operative savings bank.

longer compete against the private sector due to higher overhead costs. This situation however does not appear to be the case with the Pedhoulas society which to this date continues to dominate the cherries marketing scene in Pedhoulas which is the main producing area in Cyprus. This apparent inconsistency can be explained in terms of barriers to entry. The cherries society of Pedhoulas employs only a part-time employee for a period of approximately one month a year at a cost of about CY£500. Sales in 1993 were about CY£50,000 and net profit CY£1,000.<sup>191</sup> The price of cherries is set by the cherries market on a Pancyprian basis and therefore the society can be assumed to be a price-taker. The highly perishable nature of cherries does not allow for their storage and sale at a later date, either by the producers or by the intermediary. Therefore, there are no possibilities for marketing advantages which can be exploited by a more efficient private intermediary. Regarding organisational inefficiencies, total overhead expenditure is so small at CY£500, that if any such inefficiencies exist they are negligible for all purposes. Finally the surplus of CY£1,000 is considered too small by current economic standards in Cyprus to withstand any form of further division between existing and new market participants. The small size of the market therefore acts as a barrier to entry.

One important conclusion from the Pedhoulas test-case is that an independent co-operative intermediary in non-credit agricultural services can survive and continue to be dominant in the market provided it is a small-scale operation with the proportion of organisational expenses being small as compared to total revenue thus allowing little room to potential investors to exploit any potential co-operative inefficiencies.

### 3.14 Conclusion

The main objective of agricultural co-operation should be to eliminate any abnormal profits made by intermediaries due to various market imperfections so characteristic of rural markets in the developing world. The optimum co-operative solution will be at that point where only normal profits are possible. It is for this reason that success for the co-operative should be explained in terms of market transformation and not simply

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<sup>191</sup> The cost, sales and profit figures have been obtained from the audited financial statements of the society for 1993. The rate of exchange of CY£ 1 at 31 December 1993 was GB£ 1.34.

market share. This analysis may lead to the conclusion that despite its economic decline, the co-operative may still be considered a success.

Once the real objectives of co-operation have been defined and its positive overall contribution established it is important to study ways and methods of promoting this type of institution. The Cypriot experience has proved that state capital injections not only failed to assist the cause of co-operation but, instead, hampered its development as farmers saw their membership with the local co-operative as a means to obtain loans from what was seen as a state agent bearing a much lower interest than other forms of credit and with less onerous conditions of repayment.

A co-operative brought into existence by the state based on capital supplied by the state is more likely to be viewed as a state-aid organisation rather than an economic entity. This will lead to problems with adhering to contractual obligations towards the co-operative like rate of loan recovery. A low rate will mean failure for the co-operative. Braverman and Guasch in fact cite empirical evidence to back their theoretical stand that the viability of any credit organisation is strongly linked to its success in recovering loans.

Failure in the recovery of loans has been explained in terms of Olson's theoretical analysis of collective action and the need for a catalyst in the form a powerful debt-collection mechanism has been stressed. Of course, if this mechanism is really powerful, it will seldom be seen in action. The threat will be sufficient to guarantee repayment. In the case of a state sponsored credit agency political considerations make the use of such mechanism extremely difficult.

The role of the state was then analysed within a theoretical framework of co-operative success as a function of literacy. The initial success and then failure of the Paphos experiment showed that in a rural based developing society with low literacy levels the traditional theory that need will create its own response fails unless there is a substitute for the literacy inefficiency to act as a catalyst. This substitute can be provided by the government as part of its rural development policy.

The role of the literacy substitute was then analysed in terms of supervision and audit. Part of the supervisory role was to put pressure on the management of co-operatives to carry out properly their duties and responsibilities especially with respect to loan recovery. Loan advances no longer came from state funds but rather from a system of mutual aid and self-help. Fears of a political cost therefore no longer entered the debt-collection equation.

Mutual and self-help are two very important principles of co-operation. In the context of agricultural credit co-operation these have been analysed in terms of the intermediary concept, using the results of empirical evidence. Following this analysis a co-operative credit society has been defined as a credit intermediary which brings farmers, constantly in need of credit, together with other occupational classes with a propensity to save. In the same way the Central Co-operative Bank acting as a credit intermediary brings together societies with excess liquid funds and societies in need of such funds. A credit network is therefore set up, co-ordinated and enhanced by CCB's access to the organised credit market.

The niche of agricultural co-operative credit success based on the self-help principle, lies therefore in the ability of the co-operative movement to inspire confidence in the minds of potential depositors about the security of their deposits. One of the risks associated with the co-operative network mentioned earlier is that failure of a single participant in the system may have serious consequences on all the participants of the system.

A commonly heard argument as to why credit co-operation in Cyprus has achieved such high degree of financial independence relates to the joint and unlimited liability concept as originally advocated by Raiffeisen. The successful development of limited liability co-operative savings banks immediately indicate the fallacy of this argument, not to mention a number of other theoretical objections as well as examples from the history of the co-operative movement in Cyprus. One specific example was mentioned where joint and unlimited liability acted as a negative factor in the further development of co-operatives in Cyprus.

Objections raised to the provision of long-term finance by co-operatives have been shown to originate from a basic misunderstanding of the co-operative principle of self-help through mutual aid. Contrary to common belief and using very simple individual income data it has been shown that if anything, loan periods offered by co-operatives in the 1920's and 1930's were too short. Based on the same income analysis an alternative explanation to that of Khan's was offered, regarding empirical evidence that suggests that institutional credit in the developing world seldom reaches the majority of the peasants who are at the lower scale of income groups. This explanation ignored the existence of social class distinctions among farmers and concentrated on differentiation purely in terms of income. It also assumed free entry and exit, freedom to stand for election, secret ballot, as well as one man one vote. Even under these circumstances farmers at the lower end are unlikely to benefit unless repayment periods are made long enough so that repayment amounts are not prohibitively large.

The next variable in the co-operative equation to be studied was the legal environment during the pre-1974 period. The fact that no significant changes were made during this period meant that the legal environment could be treated as a constant for the period under study. Further more the fact that identical legal frameworks existed in other colonies with very different patterns of co-operative development added weight to the decision to treat it as a constant.

The experience of Cyprus may provide sufficient evidence to explain the importance of homogeneity not only as an economic variable of the co-operative function but also as a non-economic variable of the same function.

The important conclusion from this analysis is that the main contribution of co-operation to farmers in a Cypriot-type agricultural economy is the provision of credit. Once the credit problem is solved market forces in the remaining agricultural services will eventually drive away abnormal profits.

## CHAPTER 4: CO-OPERATION AS AN ECONOMIC RECOVERY MECHANISM AND THE RATIONALE OF URBAN CO-OPERATIVE RESIDENTIAL CREDIT

### 4.1 Introduction

Chapters 2 and 3 have looked at the rationale and effectiveness of co-operation in a mainly rural economic environment. This chapter is a study of the rationale and effectiveness of co-operation in a mainly urban environment. As will be shown later in this chapter the transition from mainly rural to mainly urban acquired sudden momentum in 1974 due to exogenous forces. It is therefore possible to make comparisons and draw conclusions about the nature of co-operation and its functional characteristics in two different socio-economic environments within an exceptionally short time-span, including its effectiveness as an agent of economic recovery.

The role of co-operation as an agent of macro-economic policy, especially in the field of recovery following a serious external shock to the economy, appears until now to have eluded studies reviewed during the course of this thesis. This could be explained partly by the kind of empirical evidence available but also by the specific line of theoretical reasoning used. Policy makers until now appear to view co-operation as an income redistribution mechanism at a strictly localised level. And yet Emelianoff's retailers example, as well as the fact that reported failures greatly outnumbered successes,<sup>192</sup> place this whole theory of redistribution into serious doubt.

Co-operation in a rural economy has been shown to be the antidote to a number of inherent transaction costs causing market failure which led to overall economic stagnation. It could be argued that as agriculture was the single most important sector of the Cyprus economy at the time, co-operation acted as the catalyst not only for a specific market but for the economy as a whole, thus introducing an element of doubt over the general belief that co-operation is not suitable as a mechanism of macro-economic policy. An important hypothesis to be tested in this chapter is that co-operation can act as a mechanism of macro-economic recovery at a time of externally produced market failure.

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<sup>192</sup> See above, section 3.1.

Professor Horst Hanusch analyses market failure from three different perspectives; first, the macro-economic level, which relates to a violation of the conditions guaranteeing full employment. This type of market failure was brought about in Cyprus by the devastating effects of war in 1974; second, the meso-economic level, which relates to welfare losses due to monopolisation tendencies. Such failures are a common phenomenon in rural credit markets of developing areas and in relation to Cyprus have already been dealt with in chapters 2 and 3; third, the micro-economic level, which relates to market failure due to the inability of the market supplier to exclude consumers from the use of a good more commonly known as public good. Hanusch considers co-operative solutions appropriate only at the meso-level where through voluntary union, producers or consumers aim to benefit from the advantages of size or the spread of certain economic risks over a large number of persons. He does not believe in co-operative solutions either in the case of the macro-level or the micro-level.<sup>193</sup>

Also ignoring the ability of co-operatives to offer viable solutions other than at the meso-economic level, Valenti recognises the co-operative character only of those associations, which in their actual work compete with the capitalistic or speculative enterprises. The consumer stores are co-operative to Valenti, in as much as they correct the economic advantages of retailers and of wholesalers; the marketing associations are co-operative as the opposing bodies to other capitalistic agencies in the market. Valenti refuses to recognise the co-operative character of organisations in whose respective fields capitalistic or speculative enterprises do not operate and in which there is therefore no actual conflict of interests. In the words of Valenti himself "there is no antithesis which determines a co-operative function."<sup>194</sup> This theory clearly implies that the role of a co-operative is to correct individual market imperfections that give rise to an "unfair" distribution of income, although do not necessarily lead to increased economic welfare. Valenti's theory would suggest that attempts to promote

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<sup>193</sup> H. Hanusch, Market and bureaucratic failure as a problem of self-help development, in Dulfer & Hamm(eds), 1985, pp59-62.

<sup>194</sup> Emelianoff, 1942, pp17-20.

co-operative development as part of an overall expansionary policy, aiming to increase national economic welfare, would be outside the scope of such development.

This chapter will examine these theoretical propositions about the role of co-operatives in macro-economic policy within the specific context of the post-1974 Cyprus economy.

The Turkish invasion of 1974 caused a serious upset to the Cyprus economy including a serious break-down in the labour market. As part of its overall policy for economic reconstruction the Cyprus government passed relevant legislation and committed a limited amount of public funds in order to maintain confidence in the co-operative banking sector. Empirical evidence from co-operative banking in Cyprus will be used to investigate the possibility that certain forms of state-co-operative interactive association may prove successful contrary to widely-held beliefs that any state input may prove detrimental to the final outcome of the co-operative function.

Section 4.2 deals with macro-economic developments in Cyprus following the near collapse of the economy as a result of war in 1974 and the fast rate of recovery that followed. A good understanding of the whole process of economic reconstruction during the period under examination is necessary before testing any hypothesis that relates to specific mechanisms of reconstruction at the macro-economic level.

Section 4.3 analyses the forces of transition within the economy and sets the scene for the hypothesis testing that follows in the next section.

Section 4.4 contains the test-findings of the hypothesis that co-operation can act as a mechanism of economic reconstruction. Empirical evidence relates to the role of co-operative banking in the residential housing market following the economic crisis of 1974. The analysis of the results assumes validity of the theory of reconstruction of the Cyprus economy as put forward by R. Zetter and as explained in section 4.2.

Section 4.5 is an attempt to analyse the test-findings of section 4.4 in terms of the theoretical framework relating to market failure and the co-operative function. Section

4.5.1 is a purely theoretical approach towards market failure in the banking sector of the economy and section 4.5.2 analyses empirical observations using this approach.

Section 4.6 analyses empirical evidence on the role of the state as a variable in the co-operative function during the crisis of 1974. The role of the state in the development of co-operation during the reconstruction period will be analysed in detail in a later chapter.

## 4.2 Crisis and economic recovery

It is claimed that war in Cyprus in 1974 brought economic and social chaos.<sup>195</sup> This appears to be a fair statement when comparing economic indicators for the two-year period 1974-75 to the year immediately before the war. During 1974-1975, GNP at constant market prices dropped by no less than 34.2% in total and unemployment increased from 1.2% in 1973 to 31.6% in 1974 and 33.5% in 1975.<sup>196</sup> In fact Christodoulou estimates the figures for unemployment during those two years to be much higher, considering that registering was pointless as payment of unemployment benefits was suspended.<sup>197</sup> He also estimates the loss to the economy of the Republic from the Turkish invasion to be in the region of 70% of productive capacity in terms of agriculture, industry, mineral resources and tourist assets.<sup>198</sup> This is in line with government estimates of the economic loss due to the invasion.<sup>199</sup> Similar figures are quoted by Hudson and Dymiotou-Jensen who draw attention to the fact that the economy was deprived of most of its infrastructure including the Nicosia International Airport (the country's sole civilian airport), its largest port, in Famagusta, and a number of schools and hospitals. They point out that as a result of the invasion both external and domestic demand fell as exports of goods and the tourist industry were affected, whilst, simultaneously, the purchasing power of the domestic market diminished and investment activity virtually collapsed. Domestic savings fell considerably and were totally inadequate for financing the investment urgently needed

<sup>195</sup> N. Crawshaw, *Cyprus: The political background*, in J. T. A. Koumouides(ed.), *Cyprus in transition*, London, 1986, p 11.

<sup>196</sup> Department of Statistics and Research, *Historical data on the economy of Cyprus 1960-1961*, Nicosia, 1994, p 19.

<sup>197</sup> Christodoulou, 1992, p42.

<sup>198</sup> Christodoulou, 1992, pXXII.

<sup>199</sup> Republic of Cyprus, *Economic Report for 1981*, Department of Statistics and Research, Ministry of Finance, Nicosia, 1981, p 9.

for the reconstruction of the economy. According to the two writers reliance on foreign aid and foreign savings was so dramatic that economic collapse looked imminent, and yet, what followed in the years 1974-78 has been described by many as a small economic miracle.<sup>200</sup>

A “Country Study” for Cyprus by the Washington Research Division emphasised the devastating effects of the Turkish invasion on the economy due to the loss of 37% of the landmass of the island to the occupying forces, fragmentation of the market, displacement of about a third of the island’s population, and loss of important natural resources. The study then describes how the government responded by replacing the pre-1974 policy of balanced budgets with an expansionary fiscal and monetary policy aimed at stimulating economic activity. These included incentive plans to encourage private economic activity as well as housing and employment programs for refugees who had fled areas seized by the Turks. The study finally assesses the outcome of these measures as being phenomenally successful.<sup>201</sup>

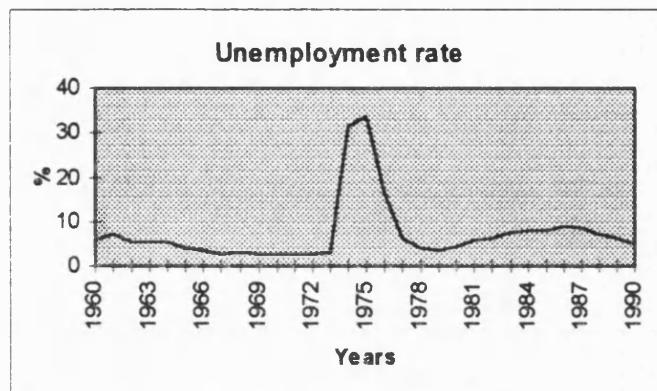
The severity of the situation immediately following the Turkish invasion and the astonishingly rapid rate of economic recovery can easily be demonstrated through a time-series analysis of a few key economic indicators; rate of unemployment, GDP at constant market prices, fixed capital formation at constant market prices and gross domestic savings.

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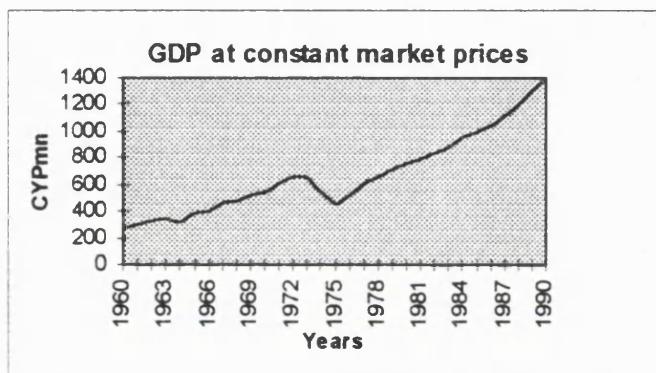
<sup>200</sup> J. Hudson & M. Dymiotou- Jensen, **Modelling a Developing Country**, Aldershot, 1989, p 17.

<sup>201</sup> Cyprus: “A Country Study”, Washington Federal Research Division, Area Handbook Series, edited by Eric Solsten, 1993, p 108.

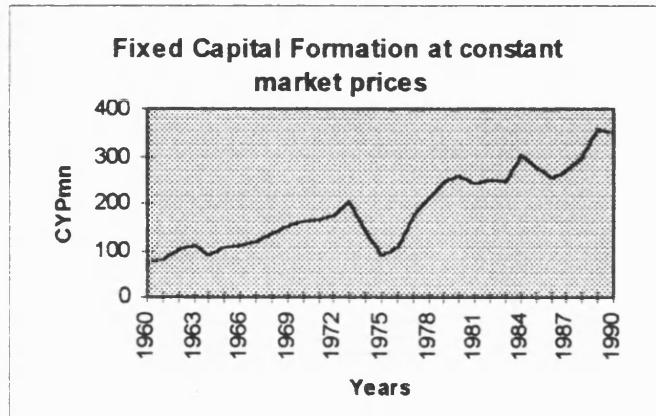
Figure 4.1: Near collapse and recovery of the economy of Cyprus



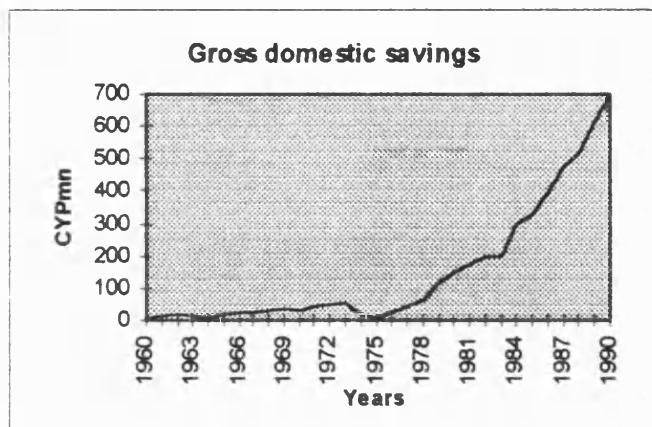
Source: Republic of Cyprus Statistical Abstract 1993.



Source: Republic of Cyprus Statistical Abstract 1993.



Source: Republic of Cyprus, Statistical Abstract 1993.



Source: Republic of Cyprus, Statistical Abstract 1993.

The fast rate of economic recovery that followed the great destabilising effect of the Turkish invasion on the economy of Cyprus was unsurprisingly hailed an economic “miracle”.<sup>202</sup> A detailed analysis of the factors that led to this recovery is not considered necessary for the purposes of this thesis, however a few words of explanation will assist to understand the process of economic transformation and how it may have affected co-operative development in the post-1974 period.

In an attempt to explain the Cyprus economic “miracle” Hudson and Dymiotou-Jensen describe the role of government as of crucial importance. Through a policy of greatly expanded fiscal deficits the state boosted consumption in the years immediately after the invasion but also provided the private sector with new infrastructure mainly in the form of new airports, extension and enlargement of existing ports, new major irrigation projects aiming at relaxing the constraint to growth stemming from water shortages, improvements in the road network and telecommunication systems, and the creation of new industrial areas. Through the numerical expansion of the civil service a more direct role was exercised by the state in solving the unemployment problem. This new expansionary fiscal stance was seen not only to have direct effects through the injection of money and purchasing power into the economy initialising the multiplier effect but also providing indirect support to the private sector through the provision of generous tax incentives and guarantees particularly in relation to export oriented industries, grants and loans to agriculture and to small industries. A selective monetary policy

<sup>202</sup> The Economist, 27 August 1977.

attempted to direct credit to areas of high priority while an attempt was made to provide training for new sectors and skills.

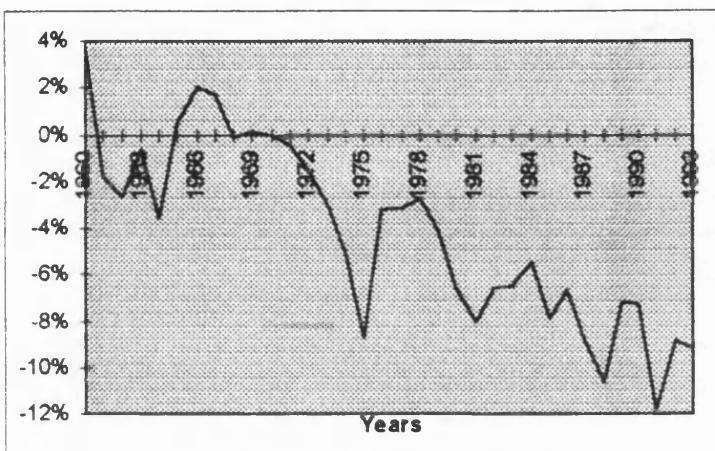
Although Hudson and Dymiotou-Jensen considered these government efforts important they doubted whether the reactivating effort could have been successful in the absence of a series of external developments that directly or indirectly benefited Cyprus through the creation of demand for Cypriot output at a time when domestic purchasing power was very weak. These favourable external developments included favourable weather conditions during the first three years after the invasion accompanied by buoyant international prices, significant expansion of neighbouring Arab markets for Cypriot exports as a result of the two oil shocks of 1973-74 and 1979, increased traffic of Lebanese visitors running away from civil war, and the transformation of Cyprus, after 1976, into a centre of significant offshore activity previously based in Lebanon. Hudson and Dymiotou-Jensen conclude that the whole success story was only made possible through the existence of a highly educated, versatile and dynamic labour force prepared not only to undergo pay cuts and move into different industries but also to travel and work abroad.<sup>203</sup>

The true scale of the expansionary policy administered by the government following the Turkish invasion of 1974, which naturally led to large public deficits as compared to any of the previous periods, becomes evident when analysing public surplus or deficit in terms of GNP:

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<sup>203</sup> J. Hudson & M. Dymiotou-Jensen, 1989, pp25-31.

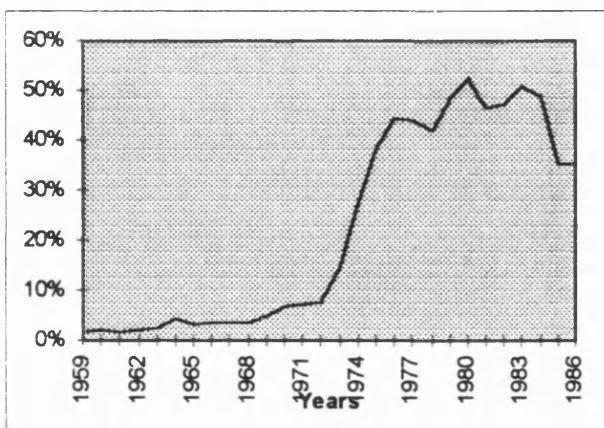
Figure 4.2: Percentage of Public Surplus/Deficit to GNP



Source: The Republic of Cyprus, Statistical Abstract 1993.

An expansionary fiscal policy of the above magnitude, without the beneficial effect of a series of favourable external factors, could have led the Cyprus economy into serious inflationary and other related troubles. The first such factor was an expanding Arab market for Cypriot manufactured goods. Just how significant this was can easily be established by looking at the percentage share of domestic exports to the Arab market.

Figure 4.3: Share of exports to Arab countries

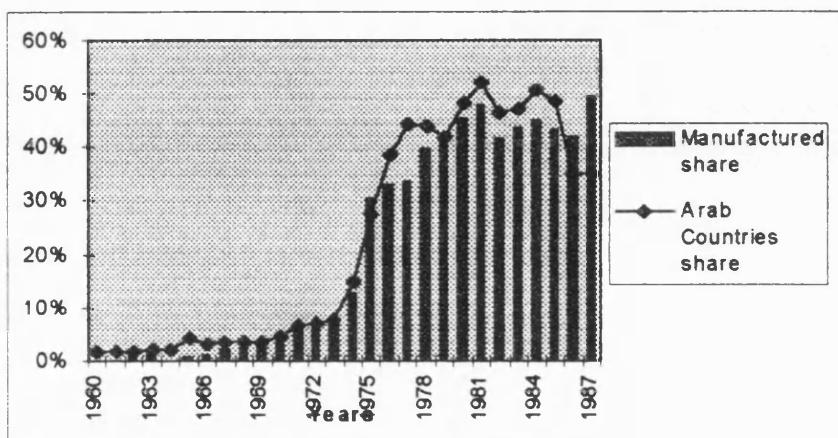


Source: Republic of Cyprus Historical Data on the Economy of Cyprus 1960-1991.

The very convenient timing of the expansion of Arab demand for Cypriot exports is illustrated by the significant rise of this demand after 1972. This expansion, which related mainly to manufactured products like footwear and textiles, led to a significant increase in the importance of the manufacturing sector during the post-1974 economic recovery period. The strong relationship between exports to the Arab countries and

manufacturing exports is shown by a high correlation coefficient for the period 1972-1987 at 0.92.

**Figure 4.4: Share of exports by area of destination and by type**



Source: Republic of Cyprus Historical Data on the Economy of Cyprus 1960-1991.

An increase in the share of the manufacturing sector may be considered to be a natural occurrence within the whole process of economic development of a newly independent state. What was not so natural however was the rate of this increase between 1974 and 1981. The very steep slope represented a very large increase in the production and export of manufactured goods which was made possible mainly by a sudden and sizeable increase in the export of manufactures, especially to a voracious Arab market, accompanied by a government policy of export guarantees.<sup>204</sup> The significant increase in production was facilitated by a large pool of labour created by the displacement of more than one third of the population. Such production consisted mainly of labour intensive processes that required mostly unskilled labour on the assembly line.<sup>205</sup> This suited well the urgent employment needs of the economy bearing in mind that a large percentage of the displaced population came mainly from an agricultural background without any relevant experience in factory work.

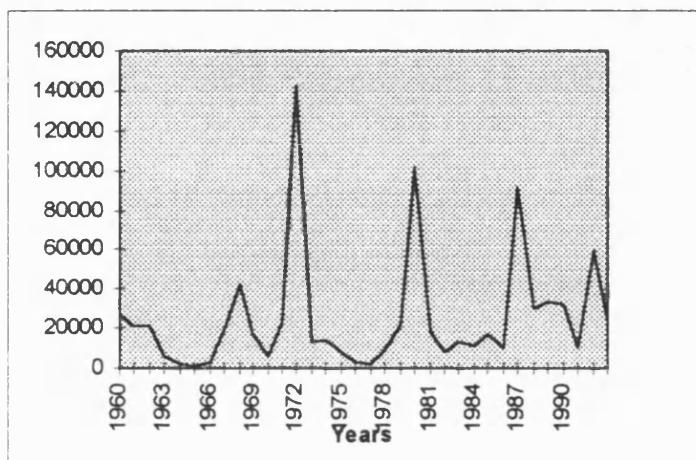
In his discussion on the role of human resources in the post-1974 economic recovery of Cyprus, Christodoulou puts great emphasis on the willingness of the work-force to

<sup>204</sup> Christodoulou, 1992, p100.

<sup>205</sup> Republic of Cyprus, **Emergency Plan of Economic Action 1975-1976**, Nicosia, 1975, pp 14-15.

accept the necessary sacrifices in remuneration and benefits.<sup>206</sup> Industrial peace must have also contributed positively towards the effort of economic recovery in the years immediately following the Turkish invasion and is reflected in the number of man-days lost due to labour disputes;

Figure 4.5: Labour disputes - Man-days lost



Source: Republic of Cyprus Statistical Abstract 1993.

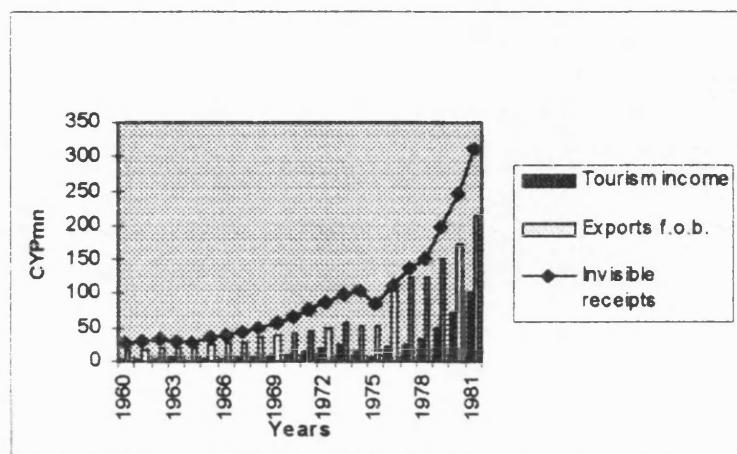
Regarding the importance of invisible earnings from war stricken Lebanese to the post-1974 recovery of the Cypriot economy, it is worth noting that where as in 1973 arrivals of visitors from Lebanon made up only 4% of total arrivals, in 1976 they made up as much as 43% of the total.<sup>207</sup> This had a very beneficial effect on income from tourism in the years immediately following the Cypriot and Lebanese crises. This meant that despite the danger that events in both Cyprus and Lebanon at the time might seriously have affected revenue from tourism during the second half of the decade, except for 1974 and 1975 such revenue resumed its upward trend by as early as two years after 1974, at a time when only a few hundred miles away in Lebanon one of the longest, bloodiest and most widely news-reported civil wars was underway.

The importance of income from tourism in the case of Cyprus can be well understood by comparing it against total value of exports and total invisible receipts which include such income;

<sup>206</sup> Christodoulou, 1993, p13 & p42.

<sup>207</sup> Percentages calculated from data obtained from the Statistical Abstract, 1993.

Figure 4.6: Tourism income as compared to visible and invisible export income



Source: Republic of Cyprus Historical Data on the Economy of Cyprus 1960-1991

The correlation coefficient between tourism income and invisible earnings for the period 1960-1980 is calculated at 97% showing a strong relationship between the two variables.

A rather different explanation about the economic “miracle” in Cyprus is offered by Roger Zetter who uses the Cypriot refugees as an example to challenge the assumption that large scale influxes of refugees and forced migrants burden the economic development of host countries. Zetter examines the role of construction and in particular re-housing the refugees and contends that this was the catalyst for the reconstruction of the economy. He argues that a highly interventionist economic policy with its emphasis on housing for refugees, stimulated a demand-led recovery. This emphasis is shown by the fact that in the period covered by the first three emergency plans, 1975-1981, government expenditure on housing totalled CYP117mn, or about 40% of public sector development expenditure. Overall, in the 1975-86 period, over CYP203mn of public sector development expenditure had been invested in the refugee housing programme - just under 30% of the total. Zetter points out that it was the urban housing programme that provided the dynamics for the efficient interaction of the strategies of full employment and an economy firmly rooted in the urban-industrial

sector. And it was the government which activated this process through economic plans, provision of capital, fiscal policies, and as the agent for refugee housing needs.

Zetter concludes that these initiatives reconciled demand with the supply of resources by which both the private-sector-dominated construction industry was re-established, and also a restructured economy was satisfactorily established within less than a decade of the disaster. The housing programme, according to Zetter, together with the provision of urban employment have been dominant elements in the economic rebuilding process in which the refugees have been rapidly incorporated from a predominantly agrarian into an urban economy, and into a form of housing which reflects the technocratic needs of a mass programme.<sup>208</sup>

It is not intended in the confines of this thesis to test the findings or the hypothesis put forward by Zetter or any other hypothesis regarding the economic reconstruction of Cyprus other than to evaluate the role of co-operation in this reconstruction and to draw conclusions about the economic behaviour of co-operation in circumstances similar to those in Cyprus after 1974.

Zetter's findings and conclusions about the role of housing in the post-1974 economic reconstruction can only be doubted in terms of the order of importance he assigns to this particular sector in the overall process of economic reconstruction, but based on the percentage of public development expenditure and the percentage of GDP it involved there can be no doubt that it was among the major driving forces behind reconstruction. This is also recognised by Christodoulou in his effort to explain the Cyprus economic "miracle". Emphasising the important role played by the housing industry in the post-1974 economic reconstruction of Cyprus Christodoulou mentions that the contribution of housing in 1978 was 5.9% in terms of GDP and 10.1% in terms of employment. He also points out that housing activity until 1981 led in the rate of growth, averaging 18% in real terms. Christodoulou explains this fast rate of growth

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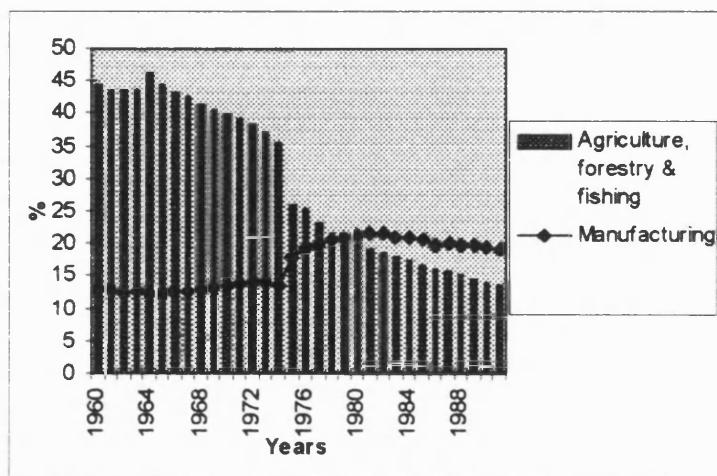
<sup>208</sup> R. Zetter, *Refugees and forced migrants as development resources: The Greek-Cypriot refugees from 1974*, *The Cyprus Review*, Spring 1992, Volume IV, No. 1, 1992, pp10-26.

both in terms of need but also in terms of opportunism as property speculation was always the most favourite mode of investment in Cyprus.<sup>209</sup>

#### 4.3 Economic transition

One of the main effects of war in 1974 and the displacement of a third of the island's population was to facilitate economic transition and the further loss in importance of the primary sector in favour of the secondary and tertiary sectors. Whereas in the case of developed countries it usually took over a century to have that shift in the population necessary to accommodate such transition,<sup>210</sup> in the case of Cyprus it happened overnight.<sup>211</sup> Although the majority of refugees came from agricultural backgrounds they suddenly became proletarianised joining the labour pool of the secondary and tertiary sectors.<sup>212</sup> This proletarianisation is obvious when looking at statistics on the percentage of the gainfully employed population in the agricultural and manufacturing sectors. In 1975 this percentage for agriculture was 25.8% as compared to 37% in 1973, a decrease of more than 11% of the total gainfully employed population.

Figure 4.7: Percentage distribution of gainfully employed population in Agriculture and Manufacturing



Source: Republic of Cyprus, Historical Data on the Economy of Cyprus, 1960-1991.

<sup>209</sup> Christodoulou, 1992, pp 116-119.

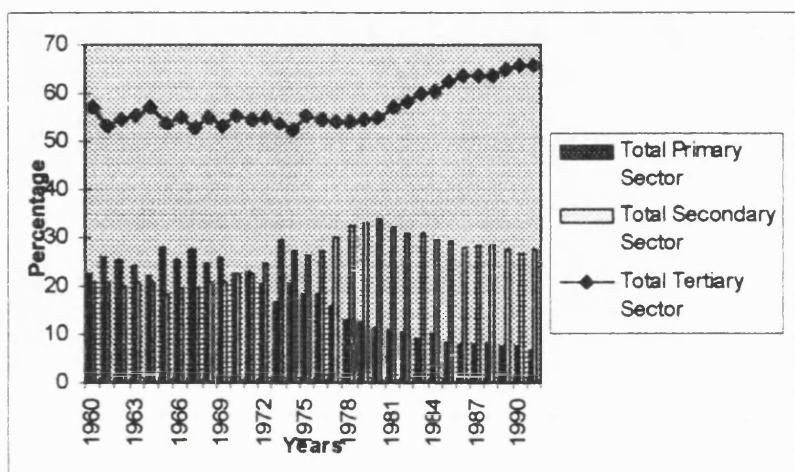
<sup>210</sup> N. Harris, **The end of the Third World**, London, 1986, pp 12-13.

<sup>211</sup> P. Strong, Thesis Workshop in Economic History, LSE, 24/1/1996.

<sup>212</sup> Christodoulou, 1992, p214.

It was this sudden change in the sectoral distribution of available human capital that made possible the spectacular transition of the Cypriot economy. The fast rate of transition since 1974 becomes obvious when analysing data on the distribution of GDP by sector.

**Figure 4.8: Distribution of G.D.P. by sector**



Source: Republic of Cyprus, Historical Data on the Economy of Cyprus 1960-1991.

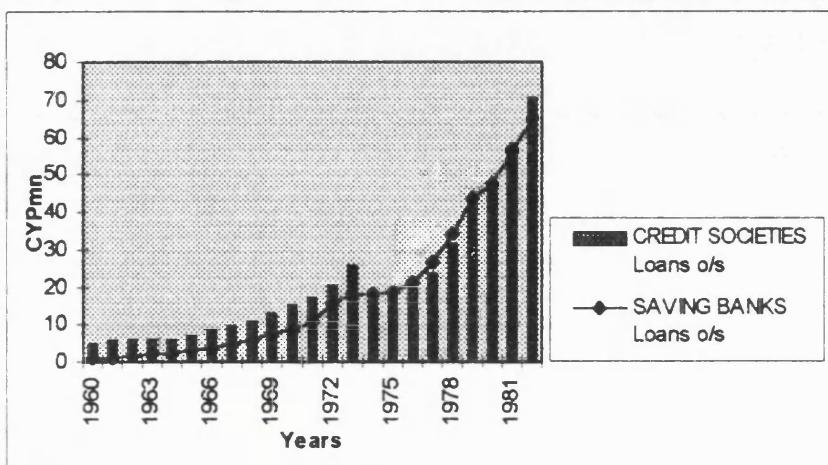
Now that transition and recovery of the economy have been established it is possible to analyse the contribution of specific types of co-operative activity during the recovery process within a transformed economic environment and thus test the hypothesis that co-operation can act as a mechanism of economic recovery at the macro level. The specific type of co-operative activity to form the basis of the testing in this section relates to co-operative banking. Other types of co-operative activity will form the basis of such hypothesis testing in chapter 5.

#### 4.4 Co-operative banking as a mechanism of economic reconstruction

The transition of the Cyprus economy and the sudden population movement could not have left the co-operative movement unaffected. During the pre-1974 period, co-operation in Cyprus was based mainly on the rural community, except in the case of a small number of urban based co-operative savings banks which catered for the needs of civil servants, a small class of professionals and other urban dwellers. The sudden shift in the sectoral distribution of employment and the overall transition of the Cyprus

economy led to an equally sudden shift in the importance of urban based versus rural based co-operatives. This shift can easily be demonstrated by comparing loans outstanding to credit societies versus loans outstanding to savings banks.

**Figure 4.9: Co-operative Credit Societies Loans V Savings Banks**



**Source:** Republic of Cyprus, Statistical Abstract 1993, Nicosia, 1995.

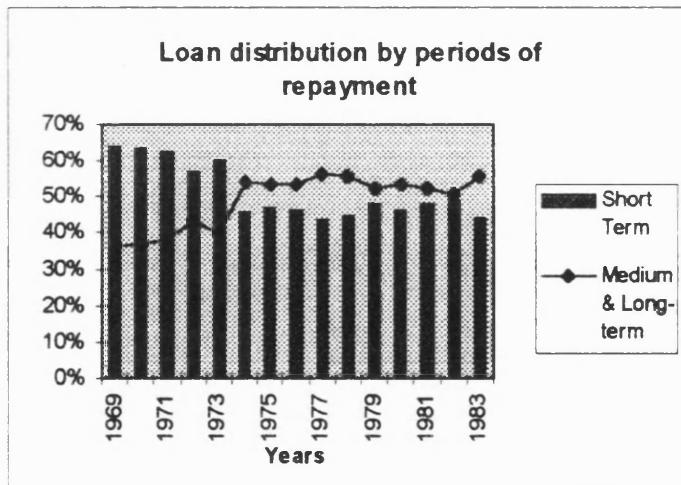
The above analysis assumes that until 1974, credit societies catered mainly for the needs of a rural based population.<sup>213</sup> In terms of number of co-operative institutions, this assumption may be considered to be valid even today as the majority of these institutions are still based in small villages. However an important qualification about the post-1974 period must be made. The sudden displacement of nearly 40% of the population of Cyprus from mainly rural areas and their relocation mostly to town areas or the periphery, led to the urbanisation of a number of rural districts which already had a local co-operative credit society catering until then mainly for the needs of a rural population. These co-operatives, numbering less than 20 out of a total of 294 in 1977, proved to be the main spearhead of the expansion that was to follow in the coming years. Taken together with the largest 10 out of a total of 39 urban-based co-operative savings banks, they were to make up nearly 90% of all loans and deposits with co-operative institutions.<sup>214</sup>

<sup>213</sup> This assumption is based on evidence obtained from two senior officials in the Cypriot co-operative movement; K. Panayi and P. Leonidou.

<sup>214</sup> Data obtained from the Co-operative Societies Audit Service records.

Aggregate data about the break-down of loans by purpose do not exist for the period before 1981, however a review of the accounting records of 10 of these largest credit institutions showed that between 1976 and 1981 60% of all loans on average were for housing and the remainder 40% for agricultural, business, educational, medical and other purposes.<sup>215</sup> In fact the percentage of housing loans was found to be very similar to the percentage of medium and long-term loans even though not all housing loans were medium and long-term loans and vice-versa. Any differences were however ironed out by the effect of housing loans issued for periods other than for the medium and long-term. Such differences were in any case too small to have any serious effect on the validity of the current analysis. It would therefore be safe to assume that the percentage of medium and long-term loans moved in the same direction and was of the same magnitude as housing loans. Based on the review of the accounts of the same co-operatives as before, but this time for the five-year period before 1974, the assumption that medium and long-term loans relate mainly to housing still appears to be valid.

Figure 4.10: Housing loans



Sources: Various Annual Reports of the Department of Co-operative Development.

The fact that loans before 1974 were mainly for the short-term is a clear indication that co-operative credit during that period catered above all for the needs of the agriculturist. The transition of co-operative banking after 1974, away from agriculture and in line with the transition in the rest of the economy, was now complete. And this

<sup>215</sup> Aggregate percentage estimates have been computed on the basis of disaggregated data obtained from past records of individual co-operatives. These ten co-operatives are Strovolos, Latsia,

despite present-day claims by the Registrar of Co-operative Development and other senior officials that co-operation in Cyprus continues to exist mainly for the benefit of the agriculturist.<sup>216</sup>

But if 60% of loans issued by large co-operative credit institutions related to housing the percentage for both large and small can not be much less than 60% as these large societies constituted the bulk of co-operative banking activity in Cyprus. For the purposes of this analysis, in order to take account of any possible error margins this percentage is reduced to 55%. From 1977 up to 1981 a total of CYP394mn in loans was issued by the co-operative movement.<sup>217</sup> Total gross output of residential buildings in the same period amounted to CYP412mn<sup>218</sup> of which approximately 40% came from the public sector.<sup>219</sup> The co-operative movement is therefore estimated to have contributed CYP217mn in loans for housing which amounted to 53% of the total gross output or 89% of all private expenditure on housing. This last percentage is very much in line with current co-operative loan contribution to the housing sector, the remaining percentage covered mainly by state financed credit institutions.

On the basis of the above estimates and assuming even part-validity of Roger Zetter's thesis about the importance of housing in the post-1974 reconstruction it would appear that co-operation played a major role in the recovery of the war stricken economy of Cyprus. It is therefore important both from a theoretical but also from a practical point of view to develop a very good understanding of co-operative behaviour in a transitory environment as this is the current state of most developing nations today.

#### **4.5 The economic rationale of co-operative banking in an urban environment**

Government economic policy in the years immediately following the tragic events of 1974 was essentially designed with two main target areas in mind; re-housing the displaced and putting the unemployed back to work. The analysis of empirical evidence

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Aglandzia, Lakatamia, Deftera, Aradippou, Germasoyia, Polemidia, Ypsonas, Ayios Dometios.

<sup>216</sup> The Registrar Mr. E. Chlorakiotis repeatedly expressed this view on a number of public occasions also attended by the writer of this thesis.

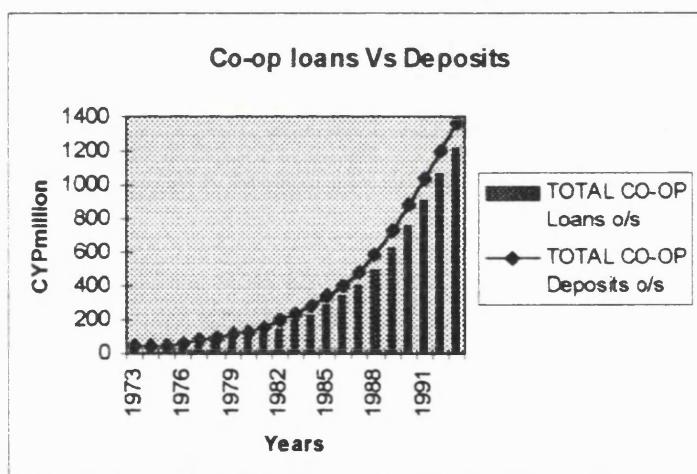
<sup>217</sup> Report of the Department of Co-operative Development for the years 1978, 1979, 1980, 1981, Nicosia, 1982, p 20.

<sup>218</sup> Republic of Cyprus, *Statistical Abstract 1993*, Nicosia, 1995.

<sup>219</sup> Zetter, 1992, p12.

in the previous section clearly demonstrated how urban co-operative banking acted successfully as one of the most important mechanisms in dealing with these two specific problems facing post-war society in Cyprus. A very important advantage of this mechanism was the fact that housing loans issued by co-operative institutions required no special government guarantees or subsidies unlike many of the business loans issued by commercial banks at the time. They were ordinary mortgage loans and what is more, the co-operative movement financed this type of lending out of its own pool of funds as it had already developed to a stage of self-sufficiency. This becomes evident when comparing co-operative loans against co-operative deposits for the period 1973-1993.

**Figure 4.11: Self-sufficiency of the co-operative movement**



**Source:** Republic of Cyprus, Statistical Abstract 1993.

Following the events of 1974 and the sudden displacement of nearly 40% of the island's population, demand for housing and related finance increased significantly. This sudden increase in demand, as would be expected, had a twofold effect; a significant rise in property prices, especially after 1975 when the refugee problem appeared to be more of a permanent nature and the political situation looked to be stable and second, an increased pressure on the money supply given the existence of a legislated ceiling on the rate of interest.

In the case of the property market, prices did rise in response to increased demand through the normal working of the market mechanism without outside interference. As

already explained in chapter 2, section 3, Cyprus was never a place of very large estate holders. The property market was made up of a large number of buyers and sellers and the government abstained from any involvement in the working of the market apart from ensuring the efficient operation of the Land Registry Department thus creating an even better transaction environment for the private sector. Inherent or externally created market inefficiencies that would give rise to monopolistic power were thus missing. Therefore, the right circumstances that would give rise to the co-operative function, according to the market inefficiency theory, were simply not there. This may explain why very few attempts were ever made to set up co-operatives dealing in land; and those without much success.<sup>220</sup>

In the case of finance required for the purchase of residential property, this constituted part of the overall urban credit market, also known as official credit market. As already explained in Chapter Two, in a rural society inherent transaction costs of a mainly informational nature give rise to market inefficiencies which may constitute breeding ground for monopolistic tendencies. Such inherent transaction costs are usually absent from urban credit markets. The operation of these markets however is severely constrained by aspects of the monetary policy implemented by the state as part of its overall economic and social policy.

In the case of Cyprus such constraints took the form of a legislated ceiling interest rate accompanied by strict capital movement controls and various other credit controls enforced by the Central Bank of Cyprus. The latest amendments to the interest rate law date back to 1944 and stipulate a ceiling of 9% on the rate of interest that can be charged on any type of loan. This law aimed originally at rescuing the rural population of Cyprus from the exploitative practices of private money-lenders. Its effect on the urban credit market will be analysed later in this section.

Chapter 2 included an analysis of the reasons why agents of the official credit market elected to stay out of the rural credit markets of Cyprus. Similarly, the same agents chose to stay away from the urban housing credit markets which were developed in

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<sup>220</sup> Various Annual Reports of the Department of Co-operative Development.

parallel to the process of transition of the Cyprus economy from rural to urban. This unwillingness by commercial banks to finance urban housing is definitely not unique to Cyprus. For example, until recent moves towards complete de-regulation of financial markets, both in the USA and the UK this specific market was completely dominated by non-commercial credit institutions. Such behaviour patterns can only be explained in terms of expected profitability and are further analysed in this section.

Absence of the commercial banking sector from the residential market due to a number of market inefficiencies again leads to a situation where the co-operative function comes into existence and continues to survive due mainly to some form of market failure. This time, however, market failure was not caused by inefficiencies that are mainly inherent in the market, as in the case of rural credit markets, but caused instead by inefficiencies external to the market, usually produced by state agencies as part of the overall economic and social policy.

Writing about Abbey National's conversion to PLC Margaret Reid explains that Building Societies in the UK had the home loans arena so much to themselves because banks were effectively fenced off from entering the field by the lending curbs through which governments then helped influence the economy. Foreign financial groups were also excluded by exchange controls from playing in the UK market. All this changed with the elevation of Margaret Thatcher's Conservative government and the gradual shift of world financial markets towards competition and de-regulation. Thus, freed at last to compete in the enticingly safe and potentially lucrative mortgage market, the banks invaded it in strength and by 1981 had captured 26% share of new lending.<sup>221</sup>

The current official credit market in Cyprus is even more heavily regulated than the one in the UK before Thatcher, although voices are now getting louder demanding de-regulation and harmonisation with European Union Banking Directives in anticipation of full European membership.<sup>222</sup> Although the exact techniques of market regulation employed by the Cyprus monetary authorities may differ to those used in Britain, due

<sup>221</sup> M. Reid, **Abbey National-Conversion to PLC**, London, 1991, pp 12-13.

<sup>222</sup> See for example Presidents' Annual Reports of all three listed banks, published in their annual financial statements. Also for Press comments see "Αλήθεια", 16/1/96 and "Φιλελεύθερος", 10/9/96.

mainly to the absence of sophisticated financial instruments in the case of Cyprus, the outcome has turned out to be the same; a housing finance market completely dominated by the non-commercial banking sector.<sup>223</sup>

The rationale behind this dominance requires further analysis so as to establish institutional appropriateness. In the American housing credit market for example the government has become involved in financial intermediation in two basic ways: first, by setting up federal credit agencies that directly engage in financial intermediation and, second, by supplying government guarantees for private loans.<sup>224</sup> In the case of Cyprus however it has already been pointed out that one important advantage of co-operative housing finance is self-sufficiency.

#### 4.5.1 Theoretical approach

In a perfectly competitive world with no restrictions on interest rates, credit limits, or liquidity ratios, a financial intermediary will choose to hold a combination of loan investments that will maximise total expected returns in accordance with basic principles of the Portfolio theory and the Capital Asset Pricing Model.<sup>225</sup> Total expected returns for a lending institution are the sum of all expected returns from the various loan projects undertaken by the bank. The expected return of an individual loan project is a function of the risk assigned to that project and the agreed rate of interest. This rate contains a premium to compensate for the systematic part of each loan's risk. Subject to a maximum amount of available funds for investment Portfolio theory analysis would suggest that the bank will invest in both high-risk high-return projects and low-risk low-return projects so as to maximise overall expected returns. Housing finance loans, also known as mortgage loans, are generally considered to be low-risk low-return investments due to their low systematic risk. This can partly be explained by the fact that collateral, i.e. property promised to the lender if the borrower defaults, reduces the consequences of adverse selection because it reduces the lender's losses in the event of default.<sup>226</sup>

<sup>223</sup> Αντώνης Λοίζου & Συνεργάτες, Chartered Surveyors, Χρηματοδότηση κατοικίας, Ο Οικονομικός Φιλελεύθερος, 18/8/1996, p 4.

<sup>224</sup> F. S. Mishkin, **The economics of Money, Banking, and Financial Markets**, New York, 1995, p 357

<sup>225</sup> Mishkin, 1995, pp95-104.

<sup>226</sup> Mishkin, 1995, p 216.

In a competitive financial market environment with no government intervention, mortgage loans have to compete against all other types of loans to become part of a bank's portfolio. Their share in the portfolio and the rate of interest charged will be determined by the market mechanism until any excess demand or supply is cleared. If the competitive assumption is now altered slightly and banks, either voluntarily or through local banking legislation, invest a certain minimum percentage of their funds in low-return risk-free government bonds or similar financial instruments, usually known as bank liquidity, then the availability of funds for more low-risk projects like housing loans is limited even further. This availability is an inverse function of the level of required liquidity.

Moving a step further away from the initial competitive assumption and empowering the Central Bank to exercise a stricter supervisory role over the activities of local financial intermediaries, including the fixing of maximum credit allowances each year, it should be expected that in years of stringent monetary policies housing loans are among the first to be pushed out of commercial banks' loan portfolios.

If the competitive credit market assumption is completely abandoned and interest rates are considered fixed with no free movement of capital, financial intermediaries will be deprived of one of the most important variables, i.e. rate of interest, from their profit equation. They will therefore have to pay more attention to the remaining variables of the profit equation, namely, interest paid on depositors accounts, administrative overheads, and other revenue.

In the case of interest paid to depositors this appears to be outside the control of each individual bank as it is usually determined by the market. One of the main participants in this market is in fact the state through the issue of government bonds and similar financial instruments. But if a bank can not make effective use of the rate of interest in order to attract deposits the alternative is to compete on the quality and variety of services it provides to its customers. This means that a serious constraint is imposed on the bank's ability to reduce administrative overheads.

The last remaining variable in the profit equation is other revenue. This includes various bank charges but in actual fact these charges may be used to raise the effective rate of interest thus overcoming to a certain degree the provisions of the relevant law. Interest rate substitution in this manner, however, can only be applied to a limited extent due to the expected reaction of the public and the Supervisory Authorities. Public reaction in fact tends to be stronger when overcharging relates to housing finance which is seen not only as a safe form of investment for the banks but also as a social issue which affects a large proportion of the population. Borrowers from the business community are expected to be more willing to accept such overcharging, especially when business returns on the borrowed money are expected to more than cover the real cost of finance.

Assuming the existence of constraints on the ability of commercial banks to overcharge and provided the legislated interest rate is fixed at a point of medium risk, the banks will have an incentive to exclude high-risk high-return investments from their loan portfolios. This makes matters even worse for the residential credit market as banks will see no reason, from a Portfolio risk point of view, to invest in low-risk low-return projects other than the amounts imposed upon them by the Regulatory Authorities.

This kind of theoretical analysis would suggest a restricted percentage of loanable funds to be made available to the residential housing market by the commercial banking sector, provided some degree of intervention and supervision is exercised by the Central Bank Authorities as part of the overall monetary policy. The higher the degree of intervention the lower the amount of priority that will be assigned to such loan projects. By the logic of this argument commercial financial intermediaries may become totally disinterested in the residential loan market at a certain level of intervention. This was in fact the case in the UK during the pre-Thatcher period. With deregulation, commercial banks in the UK started getting interested in the residential credit market. Even part de-regulation, however, is a recent phenomenon and as yet applies to a limited number of countries.

#### 4.5.2 Empirical evidence

The availability of adequate shelter is generally accepted by social scientists to be one of the most important basic human needs.<sup>227</sup> As such, democratically elected governments accountable to their voters, but also non-democratic governments in fear of serious social unrest and revolution, attach great importance on the provision of adequate housing facilities to the maximum possible number of people. What is considered adequate, however, depends very much on local customs, traditions, but also on the level of economic development.

The fact that governments around the world are not prepared to allow the housing issue to be tackled by market forces alone is obvious from the fact that where housing is not directly provided by the state, usually a separate institutional framework is set up in order to finance residential housing. The provision of housing for all, especially in the case of developed nations, is such a sensitive social issue that even a very small minority of homeless may be causing serious political embarrassment to the government of the day. This is the reason that in nearly every developed country in the world the state makes special provisions regarding the supply of residential housing credit. These provisions may take the form of legislated institutional frameworks which favour non-profit-making residential credit agencies, or outright credit subsidies. In the USA for example Savings and Loan Associations and Mutual Savings Banks have been the primary lenders in the residential mortgage market. The Federal government has played an active role in the mortgage market via government agencies that provide funds to the mortgage market by selling bonds and using the proceeds to buy mortgages.<sup>228</sup>

The official credit market situation in Cyprus until this day fits the situation of fixed interest rates, no capital movements, minimum liquidity ratios and maximum credit allowances set by the Central Bank. For the period 1972-1992 minimum liquidity ratios fluctuated between 23.5% and 34.5%.<sup>229</sup> Given the existence of credit limits imposed

<sup>227</sup> B. Ingham, **Economics and Development**, Berkshire, 1995, pp 236-237.

<sup>228</sup> Mishkin, 1995, p 31.

<sup>229</sup> Phylactis, 1995, pp78-80.

by the Central Bank Authorities and a legal maximum interest rate, commercial banks are severely limited as to their investment opportunities. They look for investment opportunities that will maximise their total returns at what they consider as acceptable credit risks. Low risk investment decisions are forced upon the commercial banking sector through Central Bank imposition of high liquidity percentages which, except for a few years after the Turkish invasion of 1974, never fell below 25%.<sup>230</sup> It was therefore unlikely that the banks would choose to invest any more of their funds in low risk low return markets like the housing finance market, especially since they were prevented from investing in high risk high return by the legislated ceiling on interest rates. Instead they preferred medium risk medium return investment opportunities like the tourist industry and other trading sectors. They have usually been able to obtain a return higher than the 9% ceiling from these sectors despite the existence of the relevant legislation through the use of a number of bank techniques.

First, a number of bank charges are levied each time a new loan is issued in the form of study fees and commissions. The shorter the average duration of loans therefore the higher the income from these returns. Housing loans by nature are usually for the medium-term or the long-term whereas business loans usually tend to be for the short-term or medium-term. Second, in the case of trading customers the supply of loan finance is usually accompanied by the provision of related facilities like the issue of bank guarantees and letters of credit which usually carry 1-2% commission. Thirdly, as already explained the business community is far more prepared to accept annual charges on bank accounts, called ledger fees, than private home-buyers are. These ledger fees in Cyprus usually total 2% of a customer's balance per annum.

It is therefore clear that despite the existence of the 9% interest rate ceiling for all types of loans, banks have found other ways and means to overcome this restriction, even though they are constantly under criticism for breaking the law. The average effective rate of return on the issue of loans by commercial banks, not taking into consideration fees from other services provided by the banks, is estimated at

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<sup>230</sup> Phylaktis, 1995, pp65-67.

approximately 11.5%.<sup>231</sup> In the case of loans issued by co-operatives, the average effective return is calculated at 9% or 2.5% less than the average return on commercial bank loans.<sup>232</sup>

But if commercial banks and co-operatives do not compete in the same loan market, they certainly do compete in the deposits market. A bank has to compete against all other banks but also against co-operatives. A co-operative has to compete against all other co-operatives but also against all banks. Until 1994 urban co-operatives have been paying an average rate of interest on deposits of 7.5% as compared to 7% paid by commercial banks. The difference therefore in the case of co-operatives between average return on loans and average cost on deposits was 2% as compared to 4.5% in the case of banks. And yet net profit as a percentage of total assets approximates 1% for both co-operatives and banks.<sup>233</sup>

The results obtained from this financial analysis would suggest a much more efficient co-operative sector. A closer look, however, at the operational environment of the two sectors would cast doubts on the initial impression.

First, commercial banks are under the supervision of the Central Bank. This means that they have to follow certain limiting rules on their lending policies, which include a minimum liquidity ratio. Liquid assets usually earn the banks 3 percentage points less than the legal rate on ordinary loans. Co-operatives on the other hand are not bound by any provisions of Central Bank regulations but instead come under the Co-operative Societies Law. Regarding minimum liquidity ratio there is a memo sent to all co-operatives by the Registrar recommending a minimum of 25% but this is not taken very seriously. Experience during the last ten years has shown that banks on average maintain a liquidity ratio of at least ten percentage points higher than co-operatives. In the case of banks penalties are levied when their liquidity ratio falls below the level set

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<sup>231</sup> Estimates of various bank charges and average return on loans are based on analysis of published financial information of the three main banks in Cyprus which show a split between interest income and other income. The rate calculated have been confirmed with the Financial controllers of the three banks.

<sup>232</sup> Average return on co-operative loans is calculated on the basis of aggregated financial information prepared by this writer on behalf of the Co-operative Societies Audit Service.

<sup>233</sup> Calculations based on 1994 published financial information for both co-operatives and banks.

by the Central Bank. No such action can be taken against co-operatives. This has led to the constant violation of the 25% threshold recommended by the Registrar. Profitability is an inverse function of Bank liquidity as returns from loans are much higher than returns from funds kept in what is considered liquid form.

Second, the Central Bank issues guidelines on maximum lending by the banks. These guidelines are also brought to the attention of co-operatives through the Registrar's office but very rarely have they been known to be obeyed. A situation may arise where a bank has liquid funds well over the minimum liquidity ratio and yet not be able to utilise those funds other than in the form of low return balances with the Central Bank. This is not known ever to have happened in the case of co-operatives.

Third, banks are subject to a one-off mortgage tax which is usually 1.5% of the amount of the secured loan. Co-operatives are exempt from this tax. Costs are therefore further reduced in the case of co-operatives as compared to commercial banks.

Fourth, co-operatives are exempt from corporation tax as opposed to banks. Until the late 1980's corporation tax amounted to nearly 50% of taxable profits. At present, the rate of corporation tax amounts to 25%.

The significant number of advantages enjoyed by the co-operative movement is a clear indication of the way state authorities view co-operatives as an instrument of implementing and achieving certain aspects of social policy objectives. Re-housing the refugees after 1974 was the prime social objective of government policy for a number of years. The role played by co-operation in achieving this objective has already been emphasised.

The fact that lending institutions never saw the need to charge below the 9% ceiling and bearing in mind the levels of post-1974 international interest rates, the equilibrium point within a liberated market would have more likely have been at a point above 9%. In the same way that co-operatives came in to fill a gap within the agricultural credit market due to the inability of the market mechanism to overcome certain constraints

created by high transaction costs, urban co-operatives now came in to fill the gap created by legal constraints on the workings of the market. The legal ceiling on interest rates plus a number of other such constraints led to co-operatives becoming the only real actors within the housing finance market.

The fact that co-operatives were able to take advantage of market imperfections in order to provide loan finance to home-buyers at below natural equilibrium interest rates would obviously be one example of the social role of co-operatives in redistributing income. Lower interest rates on loans mean lower interest rates on deposits. Therefore at least in theory, some surplus is transferred from the better-off depositor to the less well-off working and lower middle-class home-buyer. Similarly, cheaper agricultural co-operative credit led to a transfer of surplus from the rentier class to the peasants. Christodoulou points out that during the pre-1974 period the high cost of building and the high cost of housing was seen to adversely affect middle and low-income groups, especially since there was no financing mechanism to help them.<sup>234</sup>

The ability of certain kinds of co-operation to give rise to such surplus transfers is totally dependent upon whether the right parameters exist that would give rise to the co-operative function. Such parameters in the case of Cyprus have so far been shown to exist only where the market can not function properly due to various types of transaction costs and inefficiencies, either inherent in that specific market or the result of outside intervention to the workings of the market. Social effects of this specific co-operative activity appear to be symptomatic and not the direct outcome of the activity.

On the basis of this theoretical framework a government may consciously set up barriers to the efficient working of the market expecting co-operative agents to act as indirect agents of its social policy, provided surplus transfers go the right way. Emelianoff for example uses retailers co-operatives, which were meant to increase the competitive position of small retailers, as an example to illustrate the fallacy that a co-operative organisation is a specific economic instrument of the underprivileged

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<sup>234</sup> Christodoulou, 1992, p118.

classes.<sup>235</sup> In the specific circumstances of the official credit market in Cyprus however, co-operation did in fact act as a mechanism for income redistribution.

But apart from the role of the state as a source of market imperfections, empirical evidence from the history of Cyprus would suggest another important aspect of state contribution to the development of co-operation in the credit market of the island; this was the assumption by the state of the role of a fall-back agent or lender of last resort in times of crisis.

#### 4.6 The state as a fall-back agent

The immediate effects of war in 1974 on the co-operative movement of Cyprus were the loss of Cy£31.5mn assets at book value, estimated by the department of Co-operative Development at current market value to be worth Cy£100mn, belonging to 227 displaced co-operatives of various types.<sup>236</sup> Table 4.1 shows displaced co-operatives by type, and their lost assets as at the time of their displacement:

Table 4.1: Lost assets by displaced societies in 1974

Type of co-operatives	Number of co-operatives	Total Assets	
		Cy£mn	
Credit Societies	122		19.1
Savings Banks	6		1.5
Consumers Societies	71		2.0
Other types	28		8.9
	227		31.5

Source: Annual Report of the Department of Co-operative Development 1973-1977.

Non-displaced co-operatives in 1974 amounted to 557 and owned assets at book value totalling Cy£83.9mn.<sup>237</sup> In other words, the immediate effect of the 1974 events on the co-operative movement was the loss of 27% of its total book assets. As far as membership is concerned out of a total co-operative population of 267,300 in 1972, 69,600 or 26% were displaced.<sup>238</sup>

<sup>235</sup> Emelianoff, 1942, p168.

<sup>236</sup> Annual Report of the Department of Co-operative Development, Years 1973-1977, Nicosia, 1978.

<sup>237</sup> Annual Report of the Department of Co-operative Development, Years 1973-1977, Nicosia, 1978.

<sup>238</sup> Annual Report of the Department of Co-operative Development, Years 1973-1977, Nicosia, 1978.

In the case of displaced credit societies and savings banks, deposit balances were estimated at Cy£16.9mn and loan advances outstanding by members at Cy£15mn. The repayment of deposits was naturally dependent upon the recovery of the loans. But creditors were refugees who had just lost their employment as well as all their assets, including any mortgaged property that had acted as security for the loans. This made the collection of loans by displaced societies quite impossible in most cases and therefore the repayment of deposits also became problematic.

Things became worse as unemployed refugees without any assets demanded their deposits in order to meet some of their every-day living expenses. In the face of the serious social problems created by the Turkish invasion the government had to step in guaranteeing the safety of displaced people's deposits, first by announcing its intention and then, four years later, by enacting Law 46 of 1978 which was to govern the mode of repayment. By 1981 the government had contributed Cy£5.7mn for the repayment of such deposits through the Central Co-operative Bank who also bore part of the cost of meeting displaced co-operatives' deposits liabilities.<sup>239</sup> Loans outstanding by displaced persons were frozen following the passing of Law 24 of 1979 as amended by Law 78 of 1980. A new law in 1995, N65(I)95, regarding loans of displaced persons, enabled their complete write-off.

Of the displaced societies no more than 12 were reactivated in the government controlled areas. Members of displaced co-operatives not reactivated were either accommodated by existing co-operatives at their new places of settlement, or where such co-operatives did not exist new societies were set up to facilitate such accommodation.<sup>240</sup> The fact that membership of non-displaced co-operatives increased from 212,900 in 1977 to 261,966 in 1981<sup>241</sup> whereas total population increased by just

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<sup>239</sup> Report of the Department of Co-operative Development for the years 1978, 1979, 1980, 1981, Nicosia, 1982, p 6.

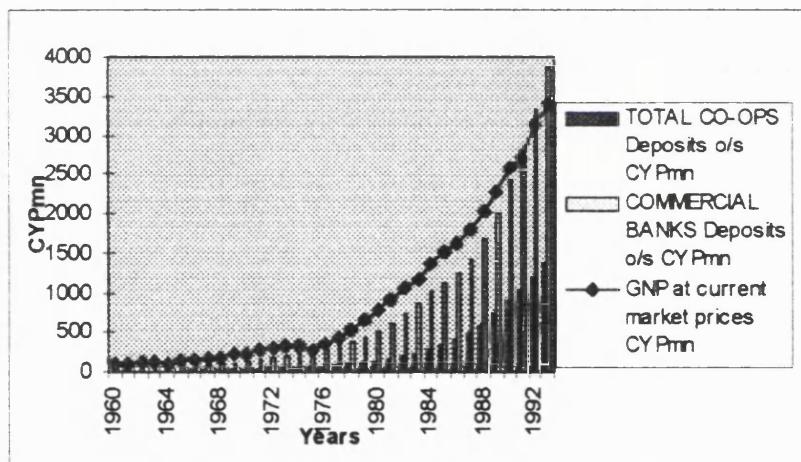
<sup>240</sup> Annual Report of the Department of Co-operative Development, Years 1973-1977, Nicosia, 1978.

<sup>241</sup> Report of the Department of Co-operative Development for the years 1978, 1979, 1980, 1981, Nicosia, 1982, p 9.

under 20000<sup>242</sup> would suggest that attempts to reactivate displaced co-operative members met with success.<sup>243</sup>

Despite the fact that co-operative war losses appear to be far more severe than those of commercial banks due to reasons explained later in this section, the economic recovery of Cyprus appears to have affected co-operative banking by as much as it affected commercial banking, at least over the medium term. The correlation coefficient of commercial bank deposits to GNP for example for the period 1960-1993 was 98% which is exactly the same as the correlation coefficient between co-operative deposits and GNP. About the same percentage is obtained in the case of loans.

Figure 4.12: Commercial & Co-operative Bank Deposits Vs GNP

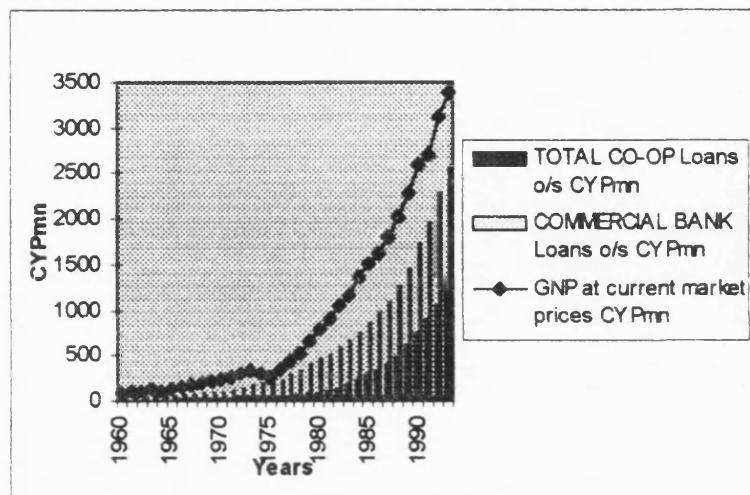


Source: Republic of Cyprus Statistical Abstract 1993.

<sup>242</sup> Republic of Cyprus, **Statistical Abstract 1993**, Nicosia, 1995.

<sup>243</sup> The President of Aglandjia credit co-operative at the Annual General Meeting on 19 October 1996 reminded his audience that since 1974 priority has been given to applications for loans by displaced persons.

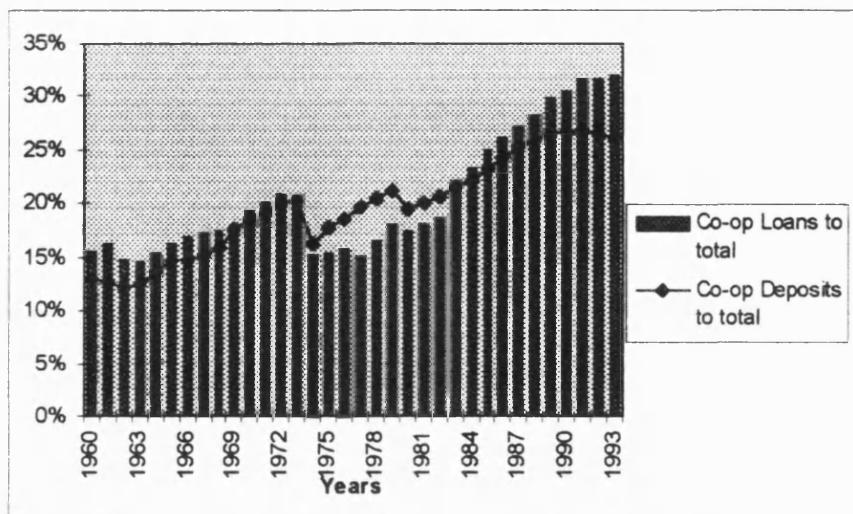
Figure 4.13: Loans o/s by co-ops & commercial banks Vs GNP



Source: Republic of Cyprus Statistical Abstract, 1993.

In order to see more clearly the effect of the war on co-operative deposits and loans it is necessary to calculate their share as a percentage of total deposits and loans in the economy.

Figure 4.14: Percentage of Co-operative to total Loans & Deposits



The decreased share of deposits and loans during the period 1974-1981 can partly be attributed to the fact that although small, a large number of independently functioning rural-based co-operatives became non-functioning overnight. The same argument

would not hold true for commercial banks and their displaced branches since they only had such branches in urban centres, suburbs and large villages where as the displaced population came mainly from rural areas.<sup>244</sup> It should also be noted that the agricultural sector, which formed the main basis of co-operative life at the time, suffered the heaviest losses in terms of lost output.

Another reason that must have contributed to the initial decrease in the share of co-operative deposits was the loss of some confidence as to how secure co-operative deposits were. This loss of confidence stemmed mainly from the fact that displaced credit societies operated independently on a strictly local basis not having any safety fall-back mechanism. This fall-back mechanism was clearly visible in the case of commercial banks due to their nation-wide basis of operation and their association with the Central Bank of Cyprus, a state agent. The fact that depositors of displaced societies were asked to postpone calls on their deposits at a time immediately after the Turkish invasion added to fears of both displaced and non-displaced co-operative depositors that due to lack of a central fall-back mechanism no real security for deposits existed.

The falling trend was reversed once the government announced its intention to guarantee deposits with displaced societies. This role of the government as a fall-back agent on behalf of the co-operative movement was repeated in 1980 when confidence in the security of co-operative deposits was again shaken, this time due to serious internal scandals that led to the near collapse of the Central Co-operative Bank. The events that led to this near-collapse will be analysed in a later chapter.

The need for a fall-back agent in the banking environment of Cyprus is discussed by Dr. Phylactis in relation to the stability of the national banking system. Dr. Phylactis argues that before the establishment of the Central Bank of Cyprus in 1963 foreign banks on the island retained one large advantage over their local rivals - they were more stable. She quotes Press reports from the time of the second world war to show that at times of banking crisis there were runs on the local banks mainly because they

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<sup>244</sup> Christodoulou, 1992, p11.

were independent economic organisations with no support by broader banking institutions and therefore lacking lender-of-last-resort facilities. Dr. Phylactis concludes that these facilities are the Central Bank's function in a crisis.<sup>245</sup>

In the case of commercial banks and their association with the Central Bank of Cyprus, that institution's direct relationship with the state allowed depositors to feel more secure about their savings. In the case however of the co-operative movement the societies' association with the Central Co-operative Bank, a non-government institution, was not seen to provide a fall-back relationship. It was the government's response after the 1974 crisis that reassured depositors about the safety of their deposits. This was a clear case of the government stepping in to fill an institutional gap which prevented the remaining parts of the institution to function properly.

And yet in earlier times the co-operative share of deposits kept growing without any such government assurances and in the absence of a clearly defined fall-back arrangement. This was probably due to the fact that until 1974 the majority of co-operative depositors were members of small, village based co-operatives with carefully selected memberships and with no past history of default on any significant scale. The two sets of theories that are relevant in this respect are the Behavioural and the Exchange theories.<sup>246</sup>

Behaviour theory suggests that people learn, through trial and error, that what they can not do individually can best be done by working with others. When individuals respond to a situation by co-operating and this behaviour is positively reinforced, they will co-operate in similar situations in the future. If, however, co-operative response produces negative reinforcement, people will tend to avoid co-operation. Thus, co-operative behaviour occurs in situations where the environment encourages such co-operation and where failure to co-operate may have unfavourable consequences. Following the events in 1974 the fact that displaced co-operatives could not meet their obligations to depositors on demand, produced a negative reinforcement leading to a decline in the share of co-operative deposits. The effects of this negative reinforcement were made

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<sup>245</sup> Phylactis, 1995, p15.

<sup>246</sup> See 1.3.6.

worse by the resulting loss of trust on which, according to the Exchange theory, co-operation depends. The Turkish invasion of 1974 administered serious blows to any amount of trust that existed until then. In order to revive it the creation of a fall-back mechanism in the form of government guarantees proved necessary.

The need for government to act as a fall-back agent at least on two occasions has wider implications with respect to the general discussion over the relationship between state and co-operation which has already been partly dealt with in Chapter Three. The question being asked in the context of the current discussion is whether state finance can effectively support co-operative banking at a time of crisis and whether such a policy can effectively be used by government as an economic recovery mechanism.

Craig describes how Mutual aid theory, developed by Kropotkin, is relevant in the study of the relationship between co-operatives and the state. This relationship is said to be in the form of an inverse function between state involvement and co-operative success. Craig in fact points out that most of the literature blames many co-operative failures on too much state intervention but at the same time, however, a lot of the literature on promoting agricultural co-operatives in the developing world is critical of the limited support the state offers to these organisations.<sup>247</sup> This apparent inconsistency shows the amount of confusion that exists in relation to the topic under discussion as a result of conflicting empirical evidence.

It is very doubtful whether after the events in 1974 co-operative banking in Cyprus would have had any future had the government not stepped in to lend a helping hand. The obvious question to be answered is whether this would constitute solid evidence to disprove Kropotkin's inverse function hypothesis. Such a conclusion would be very hasty bearing in mind the nature of events that led to the need for government action. In order to be able to compare the response of co-operative banking to that of commercial banking a similar operational framework should have existed, at least with respect to the existence of a lender of last resort. Had there been such an institution in

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<sup>247</sup> Craig, 1993, pp5-8

the case of co-operative societies perhaps there would have been no need for any government intervention, at least in the case of 1974.

The fall-back agent or lender of last resort, in the case of co-operative banking in 1974, would have acted to redistribute losses arising as a result of the need to provide for bad debts, from displaced to non-displaced societies. The provision would have had to be equal to outstanding balances owed by displaced members which in 1974 stood at about CYP15mn. The total revenue reserves position of the Cypriot co-operative movement would have made possible the complete write-off of this amount by 1981, i.e. only six years after the occurrence of the bad debts in 1974. Total revenue reserves of co-operative societies at 31 December 1981 stood at CYP15.5mn.<sup>248</sup>

#### 4.7 Conclusion

The potential role of co-operation at the macro-economic level appears until now to have escaped the attention of researchers. Some writers even went as far as to dismiss outright the possibility that co-operation may be of any use at the macro-economic level. And yet the analysis of empirical evidence from the co-operative movement in Cyprus would suggest otherwise. Given that residential construction played a major part in the overall economic recovery of the island following the devastating effects of the war in 1974, urban co-operative credit appears to have made a significant contribution to the whole process of economic reconstruction.

In the case of rural credit markets, co-operation was shown in Chapter Three to have led to the significant reduction of the exploitative powers of local money-lenders thus confirming Valenti's theory that a co-operative function comes into existence as a result of an antithesis. Valenti does not recognise the co-operative character of organisations which are not in direct competition with capitalistic enterprises in the same market. However in the case of urban credit markets state monetary interference led to the creation of a significant gap in the residential lending market as the commercial banking sector showed no interest in competing in that market. This gap

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<sup>248</sup> Report of the Department of Co-operative Development for the years 1978, 1979, 1980, 1981, Nicosia, 1982, p 20.

was filled by co-operative credit societies and co-operative savings banks. Co-operative institutions in this case found themselves to be the sole players in the market.

Some examples have been given of developed countries where state involvement in the residential lending market takes the form of committing state funds towards financing special state-inspired agencies which have to fill the market gap created by monetary policy. Housing is considered a very important aspect of social policy and it is unlikely in most cases that a government will allow such an important issue to be decided by the forces of an imperfect market. The same attitude would be expected by most governments, at least in the developed part of the world, even where urban credit markets work with very few imperfections. It should therefore come as no surprise that successive governments in Cyprus have been prepared to allow co-operative institutions certain advantages as compared to other lending institution of the private sector, especially as they required no other form of direct state aid.

Whether these lending institutions are co-operative in character can only be verified through the application of a number of minimum test-criteria originally set by the Rochdale Pioneers, also called principles of co-operation. The most important of these criteria include the following; first, a co-operative should be democratically controlled, i.e. one member one vote; second, owners of the co-operative should be the same people as the patrons of the co-operative; third, membership should be open; fourth, the operation of the co-operative should be based on the principles of self-help and mutual aid. Co-operative credit societies and savings banks in Cyprus clearly meet all of these criteria. Valenti's criteria therefore about the need for the existence of capitalistic competitors in the same market are not relevant, at least where market imperfections are introduced by the state as part of its overall economic and social policy.

Another important conclusion drawn from the analysis in this chapter relates to the possibility that state interference in the workings of a market may give rise to the co-operative function. This implies that where co-operation is expected to act as an agent of income redistribution the government may interfere with the normal workings of the

market so as to boost the chances of co-operative success. Co-operation can therefore take on the role of an agent of social policy.

But apart from giving rise to the co-operative function through interfering with the workings of the market empirical evidence examined in this chapter would also suggest that the state can act to fill important institutional gaps. Failure to fill some of these gaps may prove catastrophic for the whole movement as shown by the 1974 crisis. At times of shattered confidence, either due to an exogenous or an endogenous shock, the government has acted successfully as the fall-back agent for the co-operative movement preventing a run on co-operative deposits. Another such instance will be discussed in a later chapter and relates to events in 1980.

But state interference in both rural and urban co-operative credit activity was mainly of an institutional and infrastructural nature. In the case of rural credit markets examined in earlier chapters the state assumed the role of a literacy substitute which included audit and supervision. In the case of urban credit markets this role was extended to include lender of last resort. Such state involvement is very different to direct state-sponsored co-operative activity. The effects of this type of action by the state will be analysed in a later chapter. What this chapter has shown is that certain types of state involvement can lead to successful co-operative activity which may have been impossible in the absence of such involvement.

## CHAPTER FIVE: CO-OPERATIVE SUCCESS AS A FUNCTION OF STATE INVOLVEMENT

### 5.1 Introduction

A major obstacle to co-operative development in the developing countries is usually associated with institutional considerations which relate to state involvement in co-operative affairs. In view of the apparent failure of the existing literature to analyse the behaviour of the co-operative function in terms of institutional and organisational theory, it is the main objective of this chapter to test the hypothesis that through direct government planning and implementation and given a specific institutional and organisational framework, co-operation can effectively act as an economic policy tool. The focus in this chapter is on co-operation as a function of direct government involvement as compared to the indirect role played by the government in previous chapters.

An important theoretical issue raised in the context of the above hypothesis relates to co-operative success as a function of the degree of state involvement within a specified institutional and organisational framework. An attempt is made to establish some of the properties of this function using empirical evidence from co-operation in Cyprus during the post-independence period and especially after the war of 1974 which resulted in market failures on a macro-economic level prompting the government to embark on a hands-on economic policy.

Pitelis summarises the explanations provided by three different schools of thought about the connection between market and institutional failure. First, neo-classical theory which views the state's existence in terms of market failure. The theory views the consumers as the principals and the state as the agent. The aim of the agent is to maximise the utility of the principals and therefore states grow because the demand for their services by principals also grows. Second, in Marxist theory the state exists in order to ensure the maintenance of the capitalist mode of production. The principals in this system are the capitalists and the objective is to derive maximum possible profits. The state will grow because the needs of the principals for state functions do. Finally, a

third school of thought, described by Pitelis as the new right or anarcho-capitalists, views state functionaries including politicians and bureaucrats, as the principals whose main objective is the maximisation of their own personal utility functions. This often leads to state partiality in favour of powerful groups, as well as inefficiently high levels of outputs and supply-side driven growth of the state sector. Therefore the conclusion from this is that the government alternative is inferior to the competitive market. Finally, Pitelis emphasises Hayek's reservations that any government interference with the spontaneous order can be productive. Although a spontaneous order can be improved through revision of the general rules on which it rests, and organisations can supplement its results, it is not possible to improve the results by commands that deprive the members of using their knowledge for their purposes.<sup>249</sup>

The fact that co-operative failures, especially in developing countries, far outnumber successes and the fact that such failures are usually blamed on government interference and corrupt practices, would suggest that at least some serious thought should be given to the new right proposition and that Hayek's reservations should be taken seriously.

In the case of Cyprus, disequilibrium on a macro-economic level was brought about by a very significant external shock produced by the war of 1974. Following the major economic dislocation brought about by these events the government of the Republic embarked on a hands-on policy for economic reconstruction through large budget deficits but also through the provision of a number of financial and business incentives to the private sector, as already described in chapter 4.<sup>250</sup> It was during this period that certain co-operative institutions in Cyprus failed.

The hands-on economic policy by the Cyprus government naturally meant an increase in the role of the state and state power. Harris observes that the process of accelerated economic growth in newly industrialised countries appears to be everywhere associated with the expansion of the public sector and the role of the state. However,

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<sup>249</sup> C. Pitelis, **Market and Non-Market Hierarchies: Theory of Institutional Failure**, Oxford, 1991, pp 94-113.

<sup>250</sup> Section 4.2

the growth of state power appears to be common both to those countries which grew swiftly and to those which did not, so that state power alone cannot necessarily be said to be the source of growth.<sup>251</sup>

In relation to the increase in state power and bureaucracy, Gruber notes that throughout the western world elected officials find themselves dependent upon appointed ones to achieve their political ends. The challenge for these officials is to find ways to control bureaucrats without losing the benefits that bureaucratic action brings.<sup>252</sup>

In the case of Cyprus during the post-1974 period, finding work for the displaced population, one third of the total population of the island, was the primary objective of the government. Within this context the government was prepared to allow plenty of room for manoeuvre to state bureaucrats in order to promote its expansionist policies. Co-operation, considered one of the most important sectors of the economy, was one of the most obvious mechanisms for economic expansion due mainly to the fact that funds to be used were self-generated but also because traditionally a state agent, the Registrar of co-operative societies, was well known for the significant amount of influence he was able to exercise over co-operative affairs.

The accumulation of so much power in the hands of a single state agent is often claimed to be the result of certain provisions of co-operative legislation as it stood at the time, dating back to colonial times and giving rise to a system of interaction between state and co-operatives which favoured specific modes of distribution of power among the various actors. However, before any valid conclusions can be drawn about co-operation as a function of state input, it is necessary to analyse this system of interaction in the context of certain institutional and organisational theoretical parameters. It is also worth noting that the same legal provisions were in existence for the last fifty years and yet no serious threat to the survival of the co-operative movement was ever encountered before as a result of corrupt behaviour on the part of

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<sup>251</sup> N. Harris, 1986, p145.

<sup>252</sup> J. E. Gruber, **Controlling Bureaucracies: Dilemmas in Democratic Governance**, London, 1988.

the Registrar. The question then arises as to whether it was only time before the “wrong” man was appointed.

Section 5.2 gives a theoretical as well as an empirical perspective on the role of the state as a variable in the co-operative function on the basis of existing literature. Section 5.3 gives a brief historical background to the events that led to the near collapse of the co-operative movement in Cyprus in the late 1970’s. Section 5.4 analyses the forces that give rise to co-operative inter-sectoral and intra-sectoral linkage and how such linkage affects the co-operative function. Sections 5.5 and 5.6 analyse the ex-colonial legal system of Cyprus mapping out those provisions that constitute the power base for the state bureaucracy. Section 5.7 deals with the theory of state bureaucracy and explains the difference between primary and non-primary co-operatives. Section 5.8 is a discussion of the political economy of corruption in relation to organisational and institutional structures.

## 5.2 Institutional considerations

Williams notes that co-operation imposed from above has rarely recouped its administrative costs in increased output and in some cases, the more powerful members of a community have turned it to private advantage. He also claims that co-operation has rarely enhanced the well-being of its members and has usually subjected peasants to outside direction confirming their suspicion of state plans.<sup>253</sup>

These observations are consistent with Craig’s theoretical analysis of structures in social movements and the emergence of a hierarchical leadership. Especially where the movement espouses an egalitarian philosophy, Craig sees a real danger that a small elite will develop which may exert extraordinary influence over the membership. Eventually organisations may become monolithic, with decision-making authority concentrated among a few individuals at the top of the hierarchy. Such a situation contradicts the basic values of the movement but Craig thinks it may be very difficult to prevent.<sup>254</sup>

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<sup>253</sup> G. Williams, *Taking the part of peasants*, in Harris(ed.), 1992, p389.

<sup>254</sup> Craig, 1993, pp21-22.

Seetharaman and Mohaman claim that in most developing countries the pace of co-operative development in the past has not been very encouraging due mainly to the problem of building a suitable organisational and institutional framework in the face of a competitive environment. This problem is said to stem mainly from the fact that a co-operative is a business organisation with a social purpose, where the social and cultural backgrounds of the members very often become the limiting factors.<sup>255</sup>

It is common belief among students of co-operation that co-operatives can work only if controlled by local people. They claim that efforts by outside agencies to plant co-operatives in communities in order to create employment and wealth, have almost always failed. They blame this failure partly on the fact that investors live elsewhere and their interest is in maximising their own financial returns.<sup>256</sup>

And yet existing institutional theoretical analysis would suggest that state supports in the form of registration and tangible resources may improve the chances of survival of young organisations, but only up to a certain stage.<sup>257</sup> Moving from a theoretical to an empirical level Guthardt observes that in the case of German co-operative banks, state support and influence has proved valuable at the initial stages.<sup>258</sup>

There appear to be conflicting views about co-operative success as a function of state aid and involvement from the time of the first co-operative philosophers. Even the two co-operative pioneers, Schulze-Delitzsch and Raiffeisen for the artisan and agricultural sectors respectively, had different views on the way in which self-help should be implemented, as already noted in Chapter Three. Raiffeisen thought that government aid was not incompatible with the self-help principle provided that self-management of co-operatives was guaranteed. On the other hand, Schulze-Delitzsch was adamant against any assistance from outside, whether from government or private sources.<sup>259</sup> Schulze-Delitzsch obviously believed that any amount of state aid would probably be

<sup>255</sup> S. P. Seetharaman and N. Mohaman, *Organisation building in co-operatives - A framework*, in Dulfer and Hamm(eds.), 1985, pp 201-202.

<sup>256</sup> B. Fairbairn, J. Bold, M. Fulton, L. H. Ketilson, D. Ish, *Co-operatives and community development: economics in serial perspective*, Saskatchewan, 1991, pp 12-15.

<sup>257</sup> W. Richard Scott, *Institutions and Organisations*, California, 1995, pp 109-110.

<sup>258</sup> H. Guthardt, in Dulfer and Hamm(eds.), 1985, pp 180-181.

<sup>259</sup> See above, section 3.10.

accompanied by some degree of state control. This last position is in line with Kropotkin's criticism of state power which he considers to be inversely related to mutual aid institutions. According to Kropotkin, when state control weakens, mutual aid institutions reappear in all societies.<sup>260</sup>

Contemporary institutional theory views the role of the state as an agent of enforcement expected to behave in a neutral fashion. However, problems may arise when enforcement is undertaken by agents whose own utility functions influence outcomes. The state then develops its own interests and operates autonomously from other societal actors.<sup>261</sup> Put in another way, if the state has coercive force, then those who run the state will use that force in their own interest at the expense of the rest of society.<sup>262</sup> This kind of analysis may explain what happens when legislation enables state agents to become leading actors rather than just regulators and agents of enforcement.

Vyas draws attention to the fact that primary co-operatives in the developing part of the world are nothing more than extensions of the state system. Their main attribute is said to be their dependence on state bureaucrats whose main concern is to exploit their relationship with the co-operative movement in order to advance their own careers and acquire a power base.<sup>263</sup> Autonomy from government is therefore considered a crucial factor of co-operative success. This is also evidenced by a number of studies quoted by Craig.<sup>264</sup>

Vishwanathan observes that in developing countries, the involvement of government in co-operatives is inevitable. Problems arise when the state, in the name of protecting financial resources which it has invested in co-operatives, starts to control and influence adversely the democratic management of co-operatives, and this it does

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<sup>260</sup> Craig, 1993, pp5-8.

<sup>261</sup> Scott, 1995, pp36-37.

<sup>262</sup> D. C. North, **Institutions, institutional change and economic performance**, New York, 1996, p59.

<sup>263</sup> V. S. Vyas, **Participatory Management in sponsored co-operatives**, in Dulfer and Hamm(eds.), 1985, p240.

<sup>264</sup> Craig, 1993, p154.

through the implementation of restrictive legislation, whereby initiative and leadership are stultified.<sup>265</sup>

The first part of Vishwanathan's observation can be explained by the theory of the literacy substitute proposed in Chapter Three of this thesis. In relation to the second part of the observation, empirical evidence from Cyprus will be employed in order to ascertain those institutional and legal mechanisms that enable state or other agents to exercise a significant amount of influence over the management of co-operatives. This is considered a necessary step in the analytical exploration of the institutional and organisational properties of the co-operative function.

In a background paper at the meeting of the ICA Central Committee in 1978 Rajaguru describes co-operative attempts as part of the overall effort by governments of developing countries to accelerate the pace of growth of their economies through the involvement of as large a section of the population as possible in the development effort. Although he believes that the co-operative form of organisation provides a satisfactory institutional form for the involvement of the people in the national effort and also a means of injecting development finance into the weaker sectors of the economy, Rajaguru points out that autonomy and independence is lost somewhere between the good intentions of state support to, and collaboration with, co-operatives and the actual operation in practice. He then quotes a number of extracts from various reports to show the great differences that exist in opinions about state support systems. Some reports suggest that co-operative success is inconsistent with any form of state involvement while others suggest that withdrawal of government support and assistance has on occasions led to co-operative failure.<sup>266</sup>

Studies by the United Nations Research Institute for Social Development have shown that by the end of the 1970s, most of the government-directed initiatives had created co-operatives that were dominated by the government's logic and not seen by the members as their organisations. In the face of strong competition, co-operatives in the

<sup>265</sup> Vishwanathan B. S., *Co-operatives and the state: A report of the discussions held at the meeting of the ICA Central Committee 11-13 September 1978*, Copenhagen, 1978, p 12.

<sup>266</sup> Rajaguru R. B., *Co-operatives and the state: A report of the discussions held at the meeting of the ICA Central Committee 11-13 September 1978*, Copenhagen, 1978, pp41-48.

developed countries merged into larger units in order to survive. This led to management practices following closely those in the private profit-seeking sector and the distinctiveness of the co-operative organisation being lost. In the developing countries the picture was also not encouraging as government sponsored co-operatives were often inefficient and not respected by the members.<sup>267</sup>

In the case of Cyprus, the rapid increase in the number of financially healthy co-operatives following a more active interest by the Administration in co-operative affairs, as evidenced by the establishment of a separate government department to promote co-operative development in the mid-1930's, may be said to add validity to both Raiffeisen's and Guthardt's propositions. However, the events that led to the near collapse of the whole co-operative establishment in the late 1970's appear to suggest that a point had been reached in the development of the co-operative movement in Cyprus such that any further state involvement was seriously detrimental to the development of the movement as a whole.

Assuming therefore all other factors to be constant, co-operative success as a function of state involvement, could look like an inverted U-shape curve and the state variable can be measured in terms of intensity. The state intensity axis could be imagined to move from a low position of no government intervention, to a higher position of indirect government involvement and from there to a maximum position of absolute government control. Provided the inverted U-shape theory is valid the point of maximum co-operative success lies somewhere between no intervention and absolute control, depending on the exact shape of the curve. A government may increase or decrease the intensity variable through the enactment of relevant legislation.

State control as a function of legislation is one of the topics analysed in this chapter. Before this can be done, however, it is necessary to provide some relevant empirical background which will act as a point of reference for the theoretical analysis that follows.

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<sup>267</sup> Craig, 1993, pp39-40.

### 5.3 Empirical background

In the aftermath of the Turkish invasion in 1974, the co-operative movement, at the instigation of the Registrar of co-operative societies Mr. Andreas Azinas, a senior state agent, and in line with government policy for the reorganisation and the reactivation of the economy, decided to establish a number of co-operative industries, mainly in the Paphos area. For this purpose a new multi-industrial co-operative organisation was established in 1976 under the name “The Central Co-operative Industries (Cyprus) Ltd”. Members and owners of this co-operative were four island-wide co-operatives; SEVEGEP, a canning industry established to cope with the industrialisation of fruits and vegetables, SOGEK, a general importer of goods, SEDIGEP, an export marketing union of agricultural produce, and SOK, a reactivated tobacco producers’ society. This project involved eight different industries. These were paper mill, carton box, edible oil (extraction, refining and bottling), bituminous, aluminium foil, tin manufacturing, bolts and nuts, and bricks and tiles. It was estimated that the capital needed for the plant, machinery and installation of these industries, excluding working capital, was in the region of CYP35 million. As the share capital contributed by members was only a few thousand pounds it was left to the Central Co-operative Bank to provide the rest of the capital required in terms of short-term and medium-term loan facilities.<sup>268</sup>

The project proved to be a complete business failure, leading the CCB and the rest of the movement into a very serious crisis, even more serious than at the time of the Turkish invasion. Once the news about the CCB being in trouble broke out, members of credit co-operatives throughout Cyprus started withdrawing their deposits aggravating the situation as the falling liquidity of credit co-operatives caused a further reduction in the liquidity of the CCB, already at dangerously low levels. Soon it became clear that the CCB and the rest of the co-operative credit movement could not survive unless assisted by the state.

What was more urgently needed however, was not so much financial assistance, as measures to restore the public’s confidence in the security of their deposits with co-operatives. Such confidence boosting could only be brought about through the

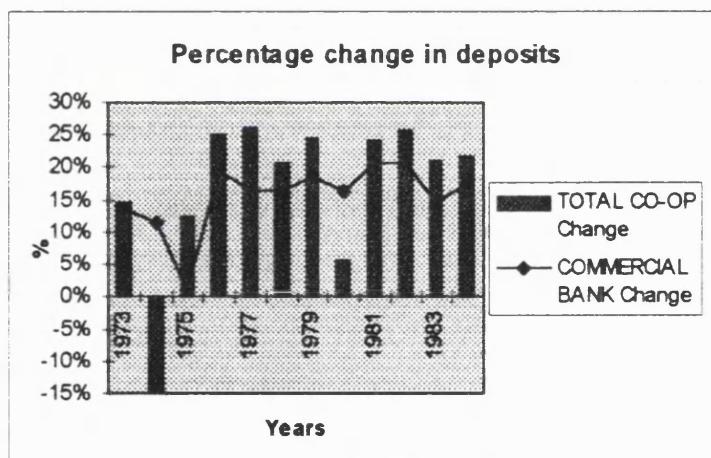
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<sup>268</sup> Report of the Department of Co-operative Development for the years 1978, 1979, 1980, 1981, Nicosia, 1982, p 3.

involvement of the state. Like in 1974, once again the government in 1980 was acting as the fall-back agent of the movement, first, by announcing its intention to guarantee the safety of depositors' savings and second, by making available to the movement significant credit facilities at extremely favourable terms.<sup>269</sup>

The high degree of success of the state rescue operation, further analysed in chapter 6, is shown by the fact that despite all the bad publicity in the daily Press, deposits with co-operatives during 1980 were hardly affected other than for a period of a few months which merely led to a decrease in the rate of growth of these deposits during the year of all the adverse publicity, as clearly shown in figure 5.1.

Figure 5.1: Effect of the Azinas affair in 1980 on co-operative deposits



Source: Republic of Cyprus Statistical Abstract 1993, Nicosia, 1995.

Before the government of the Republic of Cyprus would commit any state funds towards the rescue operation, an independent investigation was ordered into the affairs of the co-operative movement and the events that led to the crisis. The report drafted by the Commission of Enquiry provides valuable information for the purposes of this study.<sup>270</sup>

<sup>269</sup> Report of the Department of Co-operative Development for the Years 1978, 1979, 1980, 1981, Nicosia, 1982, p 7.

<sup>270</sup> Κυπριακή Δημοκρατία, Έκθεση της Ερευνητικής Επιτροπής για το Συνεργατισμό, Λευκωσία, 1981.

In its report, a 144 page-long document, supplemented by a 37 page-long appendix listing 741 separate items of evidence produced during the enquiry, the Commission describes the whole co-operative movement as being in a state of economic collapse and blames this situation primarily on the activities of the Registrar of Co-operative Development, a high-ranking state official. He was primarily accused of personally initiating millions of pounds worth of investments without first conducting appropriate feasibility studies for any of the projects involved. Questions were also raised over the bona fide nature of his involvement in the purchase of high value plant and equipment for the new factories. The Ministry of Trade and Finance was strongly criticised by the Commission for failing to exercise proper control and supervision over the activities of one of its most senior employees.<sup>271</sup>

But apart from criticising the business sense of the decisions themselves, throughout the report there are clear hints that funds must have been misappropriated at the Registrar's instructions. Many instances are quoted for example when the purchase price of either land or other equipment paid by the Central Co-operative Industries was too high as compared to independent expert valuations obtained by the Commission of Enquiry. The conclusions of the report leave no room for doubt that such behaviour by the Registrar was a clear case of corruption where use appeared to have been made of an official position for personal gains.<sup>272</sup>

The Commission also found very poor management over the affairs of the newly established organisation, frequent interference by the Registrar into its affairs, very large initial capital outlays financed mainly through large credit facilities drawn on the Central Co-operative Bank without any thought of ability to repay, and finally, over-staffing.

By 1981 it was found that potential losses to the CCB, arising mainly from new projects instigated by the Registrar exceeded CYP62 million. This was nearly twice as much as the total book value of assets lost by co-operatives during 1974, 40% of total

<sup>271</sup> Εκθεση της Ερευνητικής Επιτροπής για το Συνεργατισμό, 1981, pp136-139.

<sup>272</sup> A. Doig, From Linsky to Nolan: The Corruption of British Politics and Public Service, in M. Levi and D. Nelken(eds.), **The corruption of politics and the politics of corruption**, Oxford, 1996, p 36.

deposits with co-operative credit institutions at 31/12/1981,<sup>273</sup> 75% of co-operatives' deposits with the CCB at 31/12/1981,<sup>274</sup> and more than six times the total reserves of the co-operative movement as at 31/12/1982.<sup>275</sup> Clearly therefore, had the government not come to the rescue of the CCB once the news broke out on these potential losses, there was no hope of survival, either for the CCB or for the movement as a whole. As the danger was mainly coming from a possible loss of public confidence in co-operative banking rather than from the actual losses themselves there was urgent need for the services of lender of last resort. These were duly provided by the government of the day.

The surplus funds redistributing agent that since 1938 acted as an important catalyst for the impressive development of the movement was now in serious danger, plunging the whole co-operative establishment into serious trouble due mainly to the activities of the Registrar Mr Andreas Azinas, a state bureaucrat acting as the unquestioned leader of the co-operative movement.

A number of important theoretical issues are raised with respect to the above story and the remaining of this chapter explores these in detail.

#### **5.4 Inter-sectoral and intra-sectoral linkage**

As already explained in Chapter Three, a basic function of co-operatives in rural and urban credit markets is to act as agents of redistribution of surplus funds at a local level. The CCB has been shown to act as a leading agent of this function on a national level. Such redistribution until the mid-1970s involved mainly the transfer of funds between urban and rural credit markets. However, during the second half of the 1970s an economically booming co-operative credit sector acted, at the instigation of the Registrar, as the supplier of venture capital to a number of industrial projects in the manufacturing sector through the surplus funds redistributing operations of the CCB.

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<sup>273</sup> Percentage computed on the basis of statistical data obtained from the Report of the Department of Co-operative Development for the years 1978, 1979, 1980, 1981, Nicosia, 1982.

<sup>274</sup> Percentage computed on the basis of statistical data obtained from the Audited Financial Statements of the Central Co-operative Bank for the year ended 31/12/1981.

<sup>275</sup> Κυπριακή Δημοκρατία, Έκθεση του Τμήματος Συνεργατικής Αναπτύξεως 1982-1986, Λευκωσία, 1988.

When it became clear that the new venture was a complete business failure, both the CCB which was the direct lending agent but also all the other co-operatives in the banking sector seen to be part of the redistribution network, found themselves in serious trouble giving the impression of being in a state of economic collapse, despite the fact that they had not lent directly any money to their fellow co-operatives in the manufacturing sector. This system of inter-sectoral and intra-sectoral linkage requires further explanation.

Co-operative credit societies, which have always formed the backbone of the Cypriot co-operative movement, with a significant portion of their monetary assets deposited with the CCB were in serious danger of losing these liquid assets in the event that the CCB went bankrupt. Once details about the size of potential losses of the CCB were made public, a run by depositors on all credit societies looked imminent. Even credit societies with very small amounts deposited with the CCB felt the pressure despite the fact that they were not in any way financially connected to any of the potential losses of the CCB, a clear sign of intra-sectoral linkage due to the existence of a non-financial, psychological side to the inter-sectoral and intra-sectoral linkage problem.

In the course of a survey on public perception and image of co-operatives in Malaysia, Mooi and Devi noted among other things the effects of this psychological element in the case of the financial collapse of a small number of deposit-taking co-operatives in Malaysia at about the same time as events in Cyprus. In the liquidity and solvency crisis that ensued, members and the public were not able to recover all their deposits. This is said to have severely tarnished the reputation and image of co-operatives in general, and co-operative leaders, in particular.<sup>276</sup>

In the case of Cyprus the amount of loyalty exhibited by members to their societies, following the Azinas affair, could give the wrong impression that Cypriot co-operators behave differently to their Malaysian counterparts. Unlike the case of Malaysia where the state avoided any serious involvement, the government of Cyprus stepped in guaranteeing the safety of depositors money and thus acted as the fall-back agent or

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<sup>276</sup> S. T. L. Mooi and S. Devi, *Public Perception and image of co-operatives in Malaysia, The world of co-operative enterprise 1997*, Plunkett Foundation, Oxford, 1997, p10.

lender of last resort for the credit movement. Had there been any direct loss suffered by even a single Cypriot depositor it is highly unlikely that Cypriot members of co-operatives would have behaved any differently to their Malaysian counterparts. Characteristically, according to the findings of a survey conducted by the Research Unit of the Cyprus College on behalf of Dhali Co-operative Credit Society,<sup>277</sup> a medium size rural multipurpose society, even though more than 15 years elapsed since the Azinas affair, people still voiced their reservations about the intentions of central leadership, although still expressing their full support and loyalty to the management of their local co-operative.<sup>278</sup>

Another point of interest in the linkage issue is that co-operative sectors such as retail and wholesale do not appear to have been affected by events in 1980, as clearly indicated by the following co-operative sales data:

Table 5.1: Effect of the Azinas affair on the co-operative retail and wholesale sectors

YEAR	RETAIL CY£ 000	WHOLESALE CY£ 000	TOTAL CY£ 000
1977	13277	6719	19996
1978	15183	6307	21490
1979	16426	6932	23358
1980	18764	7689	26453
1981	20181	7905	28086
1982	22639	7654	30293

Source: Republic of Cyprus, Statistical Abstract 1993, Nicosia 1995, p 324.

The absence of any such effect indicates lack of psychological inter-sectoral linkage between these sectors and the credit sector. Such linkage is present where the nature of the act of transaction between a member or a third party, and the co-operative, is such that the expected conclusive outcome of the transaction is not immediate, but rather it

<sup>277</sup> ΣΠΕ Δαλιού.

<sup>278</sup> Report by the Research Unit of the Cyprus College on the marketing potential of Dhali Credit Society within the community of Dhali, Nicosia, 1996.

is seen to depend largely on the ability of the latter to inspire confidence in its potential to meet its future obligations arising from the terms of the contract. Bank deposits would fall under this type of transactions. A bank would receive no deposits unless its clients feel confident about its ability to return them at some specified or unspecified time in the future. This is also related to the idea of a fall-back agent as explained in chapter 4. In the case however of retailing, wholesaling or the supply of agricultural inputs, and given minimum literacy levels that enable comprehension of simple terms of sale contracts, members are able to feel fairly confident about the final outcome of the transaction as in most cases it does not depend on future circumstances but instead, obligations of both sides to the contract are fulfilled by the conclusion of the contract.

Analysing inter-sectoral relationships from a different angle, the significant economic decline of the co-operative retail sector in the late 1980s and 1990s due to increasing competition from private market players had no effect on the credit or other sectors of the co-operative movement. This would suggest that, provided financial losses arise in the ordinary course of business and not seen to be transferable through a common agent from one sector to another, then no loss of confidence would be expected to occur in the non-loss-making sectors and therefore no inter-sectoral linkage. Things could have been different had the retail sector been heavily indebted to the credit sector or had these business losses been the result of the actions of an inter-sectoral linkage agent, such as the Registrar. In the first instance the economic decline of the retail sector would lead to serious financial losses to the credit sector. In the second the actions of an inter-sectoral linkage agent would probably activate the psychological element of linkage and therefore have an effect on the credit sector. There would be no reason for members to suppose that a corrupt Registrar tampering with co-operative funds in one sector would feel constrained to that sector only. Even the existence of effective controls in other sectors might not be considered sufficient security by members outside the every-day running of the co-operatives. However, the amount of perceived inter-sectoral linkage depends on the nature of the transactional environment. For reasons already analysed above, the credit sector, which in the case of Cyprus is the backbone of the co-operative movement, is extremely sensitive to the psychological element introduced by such linkage.

Empirical evidence in Cyprus would suggest that given the specific legal framework at the time, both the Registrar and the CCB were perceived as agents of co-operative inter-sectoral and intra-sectoral linkage, at least with respect to sectors with specific transactional characteristics. What is more, the CCB management, according to the Commission's report, seemed to obey blindly the wishes of the Registrar. Provisions in the legislation and other institutional and organisational characteristics that gave rise to the amassment of so much power in the hands of the Registrar are dealt with later in this chapter. For the time being it will suffice to say that in the case of the Registrar, he was empowered to act both as the supervisory authority but also as Commissioner of the movement. The Commission's Report does in fact give examples of some co-operative managers who thought of the Registrar as their overall boss. In some cases elected committees appeared to play only a passive role in the management of their societies. Even today, despite the introduction of significant changes in the co-operative legal framework curtailing some of the Registrar's powers, a great number of Secretaries still refer to the new Registrar, Mr. Chlorakiotis, as their boss.<sup>279</sup>

Such were the powers entrusted with the position of the Registrar that the whole co-operative establishment looked like a single organisational network with the Registrar's department seen to act as the head-office in charge of all important decision-making. The whole structural set-up appeared to give the impression that the hundreds of co-operative societies in existence were mere branches of the Central Co-operative Bank with the Registrar acting as the supreme head.

The formation of a very large business entity through a series of horizontal and vertical integrations would mainly aim at the exploitation of economies of scale and the reduction of the overall business risk through diversification. However, in the case of co-operation in Cyprus neither of these objectives were being achieved. First, there could be no exploitation of economies of scale, as every single co-operative, large or small, was a completely separate entity both from a legal but also from a management,

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<sup>279</sup> Even today "Μάστρος" is a word very commonly used by a great number of Secretaries meaning "the boss" and referring to the Registrar. It should be noted that to this day, the vast majority of Secretaries in the co-operative movement were appointed at a time when Azinas was still the Registrar, i.e. before 1981.

administrative and operational point of view. Second, not only was there no risk reduction but on the contrary, the perceived image of all co-operatives as part of a single organisational set-up under the leadership of one man, and the transactional peculiarities in the nature of banking explained earlier, forming the bulk of the movement's business, meant that trouble in one sector could be followed by trouble in other sectors of the movement. These effects could develop into a chain reaction affecting the whole co-operative movement, especially if a linkage agent was seen to be the main source of this trouble.

This theoretical analysis could possibly explain why a strong state/co-operative relationship has often led to co-operative failures in a number of developing countries where state agents have a big say in the affairs of co-operatives. The greater the amount of power assigned to state agents, also perceived to be agents of inter-sectoral and intra-sectoral linkage, the stronger the forces of such linkage and therefore the more likely it is that problems in one sector of co-operative engagement, caused by these agents' actions, will affect other sectors, even though they have not directly or indirectly had any specific exchange with those sectors.

The level of such linkage may sometimes be dependent upon the exact nature of the co-operative activity. However, complete perceived independence of any specific sector from the rest of the movement is unlikely, as any form of co-operative activity is up to a certain degree dependent upon the belief of members that co-operation can work successfully to their advantage. Once belief turns into disbelief then no matter what the nature of the co-operative transactions involved, it will be hard to prevent a decline.

But apart from the role of state agents as agents of inter-sectoral and intra-sectoral linkage, the 1980 experience also provides valuable empirical evidence which can be used for the study of the institutional and organisational framework as constructed within the context of a British colonial co-operative legal environment, so common in the developing part of the world today.

## 5.5 The legal environment

The effectiveness of the government intervention or intensity variable depends very much on the organisational structure of co-operatives and the distribution of power among the various participants in this structure. The effectiveness of intervention given the same amount of intensity will be different between a primary and a non-primary co-operative, a Secretary-controlled and a director-controlled management team, a Secretary or director-controlled and political party-controlled management team. Until 1985 co-operative legislation in Cyprus like that in many other developing countries today, was still very much based on the original British colonial legal system. It is through certain provisions of this legislation that state agents were able to gain so much influence and power of intervention in the affairs of co-operatives. The fact that British colonial legislation gave increasing powers to the state was very much in line with the expansion of public bureaucracy in Britain underpinned by legislation. Johnson offers specific examples to show how governments of all political colours in Britain used the civil law to grant themselves new powers.<sup>280</sup>

Even in the developed part of the world, co-operative legislation is found to be more regulatory than ordinary corporate legislation. Co-operatives under a western type legal framework are allowed to design their own structure of democracy to fit specific circumstances. Nevertheless, the minimum requirements of democracy are protected by imposing equality of voting and the ability to vote for, and remove directors at a general meeting. Although a co-operative may allow for a more participatory style of democracy, the legislation insures nothing more than an elite style that places the decision-making power in the hands of relatively few. Based on experience it is said that the basic premise on which the law is based is that the members surrender virtually all of their management powers to the directors when they elect them.<sup>281</sup>

The first co-operative Act in Cyprus was passed in 1914 and later went through a number of amendments in 1925, 1926, 1928, 1929, 1932, 1936 and 1937, each time moving higher on the state intensity scale. In 1939 an overall revision of all co-

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<sup>280</sup> P. Johnson, *The Role of the State in Twentieth-Century Britain*, in P. Johnson(ed.), **20th Century Britain, Economic, Social and Cultural Change**, London, 1994, p480.

<sup>281</sup> Fairbairn, Bold, Fulton, Ketilson, Ish, 1991, pp72-76.

operative legislation took place on the basis of existing legal frameworks in other parts of the British Empire like Ceylon and India, and giving more powers of intervention to the state. The law of 1939, later renamed Act of 1959 with very minor alterations merely to accommodate the new independent status of the island, continued to be in force until the events of the late 1970's revealed the need for a new co-operative legal framework taking away some powers from the Registrar. A point on the intensity axis had therefore been reached when the success curve was down-sloping after having passed the maximum point and even moved to a negative success point.

A new Act was finally passed in 1985 in the hope of moving back the intensity of state intervention to a point of positive co-operative success, and as close as possible to the highest point on the curve. At this point it is interesting to note that the intensity variable is not only a function of the legal system but also of some other variables. This conclusion may be drawn from the fact that under a constant legal framework for over 45 years the intensity did not remain constant. On the contrary, with the passing of time it appeared to experience an upward trend.

## 5.6 The Registrar

It is said that corruption arises from allowing administrators too much discretion.<sup>282</sup> The most important feature of the colonial co-operative legislation was the great number of powers reserved for the Registrar who did not merely act as a state agent overseeing the workings of the movement but acted more like the chief executive of an organisation. The strong hand of the Registrar is said to be a creation of the colonial administration aiming to prevent co-operatives from becoming a true expression of members' desires. However, many newly independent states have not rescinded the Registrar's powers.<sup>283</sup> In the case of Cyprus the Registrar's executive role was confirmed by the colonial government in 1953 by adding to his old job title of Registrar of co-operative societies, the new title of Commissioner of co-operative development.<sup>284</sup> Under the first Co-operative Act of the newly independent republic in 1959, both titles were retained, i.e. Registrar of co-operative societies and

<sup>282</sup> M. Levi, D. Nelken, *The corruption of politics and the politics of corruption*, in Levi, Nelken(eds), 1996, p9.

<sup>283</sup> Craig, 1993, p154.

<sup>284</sup> Order in Council 2590, Cyprus Gazette 7.1.1953

Commissioner of the department of co-operative development, together with all his previous powers.<sup>285</sup>

The intention of the government of the newly established republic was therefore to retain all the powers vested in the position of the Registrar. This behaviour is fully consistent with Craig's observation that with independence the educated elite of the native population moved into the positions of power vacated by the colonists and the laws and the legal institutions that supported the old colonial system were left in place.<sup>286</sup>

The man who became Registrar soon after independence, Andreas Azinas, was one of President Makarios' proteges. He had a diploma in agriculture from Reading University and in 1953 he was elected to the post of Secretary-General of PEK, the rightwing farmers' union. He was soon to become one of the founder members of EOKA, the guerrilla organisation which Colonel Grivas set up in 1955. As the first ministerial and other high-ranking positions went to leading members of EOKA Azinas was at first rewarded with the post of Deputy Minister of Agriculture and then with the very influential post of Registrar of co-operative societies.<sup>287</sup>

Among the provisions of the Act that made the Registrar so powerful were the obligation of co-operatives to obtain his approval before the appointment or dismissal of Secretaries, his right to dismiss members of elected committees, approve pay increases and other terms of employment of the Secretary and other employees, be exclusively in charge of both the supervisory and audit function, approve investments in fixed assets, preside over general meetings of members and appoint receivers and liquidators.<sup>288</sup> Some of these provisions are still valid today, the main difference being with respect to the audit function which is now completely independent of the Registrar's department.

<sup>285</sup> Εφορος Συνεργατικών Εταιρειών και Διοικητής Συνεργατικής Ανάπτυξης.

<sup>286</sup> Craig, 1993, p189.

<sup>287</sup> S. Mayes, *Makarios: A Biography*, London, 1981, p43, 143.

<sup>288</sup> Co-operative Societies Law(Cap. 114/1914, 28/1959), Nicosia, 1959.

The above provisions meant that all salaried staff, and especially Secretaries, felt their career prospects very much depended upon the wishes of the Commissioner. The fact that his department was responsible for the audit and supervisory function also meant that he had full knowledge of co-operatives' internal affairs, as the law enabled him to have unlimited access over co-operatives' records, as well as to be present at committee sessions and members' general meetings. The intentions of both the British Administration and the government of the newly-independent republic were therefore to keep the co-operative movement under close watch, with motives probably not unrelated to the existing political situation on each separate occasion.

There are at least two possible explanations as to why the colonial administration decided to exercise so much control over the affairs of co-operatives. The first possibility relates to a genuine desire by the British authorities to see co-operation work and their strong belief that this could only be made possible through the close involvement of the state in co-operative affairs, especially following the experience of the first 30 years of stagnating co-operative activity in Cyprus. Perhaps of some significance is the fact that the hands-on approach by the British Administration in Cyprus became evident at approximately the same period as the replacement in Britain of the market oriented economy of the inter-war years by a centrally managed economy in which the state allocated the most important resources.<sup>289</sup>

The desire to see co-operation work would not be unrelated to the movement's perceived potential to assist in the economic development of the impoverished peasantry, comprising a significant portion of the population, and thus make them less vulnerable to nationalist or communist propaganda, as well as satisfy public opinion at home calling for a fairer treatment of all British subjects. The stories of peasants being dispossessed by money-lenders and consequently made easy prey to communist and nationalist propaganda are often quoted in official papers.<sup>290</sup> Similar fears led to the setting up of co-operatives in Singapore by the British in the aftermath of the second world war.<sup>291</sup>

<sup>289</sup> P. Howlett, *The War Economy*, in Johnson(ed.), 1994, p283.

<sup>290</sup> For example see *Cyprus Report 1954*, *Communism in Cyprus*, Nicosia, 1954, p 3.

<sup>291</sup> R. O. Daniel, *Co-operative Societies in Singapore 1925-1985*, Singapore, 1987, p 11.

A second possibility could relate to fears by the British Administration, under constant nationalist pressure, that a prosperous co-operative movement might be turned into an important source of funds for the anti-colonial movement. The fact that both the supervisory and the audit functions were performed by state agents, and that appointment and career advancement of Secretaries/General Managers of all societies required the blessings of these same agents, meant that the Administration was in a position to have full knowledge of all disbursements made by co-operatives and step in when considered necessary. Hanel offers examples from Africa where the British colonial governments often hindered the development of modern co-operatives in regions where a relationship between the co-operatives and political independence movements existed, or where these were feared to grow.<sup>292</sup> In the case of Cyprus and on the basis of all the relevant colonial documents reviewed during the course of this thesis, this second possibility appears to be less likely.

There are at least three possible explanations for the decision of the government of the newly-independent republic, in 1959, to continue with its authoritative powers over the affairs of the co-operative movement. First, it is possible that little attention was paid to the question, and that the existing legal framework was simply replicated in the new republic. Second, in view of the government's determination to use co-operative development as part of its overall economic development programme, thus leading to political stability, perhaps it was believed that such authoritative powers were essential, possibly in line with earlier British attitudes. A third possible explanation may relate to the government's anticommunist stance, always suspecting that a large number of co-operatives, already under the control of left-wing committees, might become important sources of funds for an already strong communist movement. It was perhaps such anticommunist fears that prompted the first President of the newly established republic of Cyprus, Archbishop Makarios, opposed until then by the communist party, to appoint Andreas Azinas, a political client of his<sup>293</sup> and a well known anticommunist, whose brother is reported to have been killed by communists during the Greek civil

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<sup>292</sup> A. Hanel, The development of rural co-operative organisations in "Third World Countries" with reference to economic system-related policies, in Worz(ed.), 1983, p65.

<sup>293</sup> Mayes, 1981, p43.

war of 1945-1949,<sup>294</sup> as the Commissioner of co-operative development and Registrar of co-operative societies, soon after independence. It is no accident that until the end of the Azinas regime not a single left-wing supporter was appointed either in the department of co-operative development or in the audit department, both under his authority at the time.<sup>295</sup>

### 5.7 The theory of state bureaucracy Vs types of membership

Co-operatives have been used by most governments around the world as instruments for development. As a rule, these organisations are started by the government, the initial investments and a part of the current expenditures are provided from public funds, and frequently state employees are even given the job of management.<sup>296</sup> State bureaucracy therefore, plays a very important role as a variable in the co-operative function.

The existence of a body of public officials with its own professional standards is said by Albrow to create sectional interests. An identity of values between officials and the public cannot be expected and the problem of bureaucracy is inherent in the situation. Based on this line of thinking Marxist and sociological analyses of bureaucracy see the conflict between democracy and public administration as inevitable in differentiated societies with distinct administrative staffs.<sup>297</sup>

Traditional theoretical analysis has shown an inherent tendency of bureaucracy to accumulate power until it reached the point where it controlled the policy and action of the organisation it was supposed to serve. Worz, writing about the role of co-operative and non-co-operative organisations in agrarian reform and rural settlement in the third world, emphasises the apparent impossibility of reducing government control at a later stage through developing participation, self-help, self-responsibility and autonomy of

<sup>294</sup> P. Loizos, **The Greek Gift**, Oxford, 1975, p 161.

<sup>295</sup> The party political affiliations of the work-force in the two departments, numbering more than 120 at the time of Azinas, was no secret. On the contrary, all members of the two departments interviewed during the course of this research confirmed that from their own experience Azinas used to carefully screen all new appointments so as to exclude any candidates believed to be left-wing or come from left-wing families. Such political screening of civil service candidates is not unknown in Cyprus even today, based on the writer's own recent personal experiences.

<sup>296</sup> J. Kuhn, Basic requirements of farms for co-operation with co-operative organisations, in Worz(ed.), 1983, p39.

<sup>297</sup> M. Albrow, **Bureaucracy**, London, 1994, pp 113.

the land recipients' organisation. He believes that government bureaucracy dislikes vacating its spheres of influence and action.<sup>298</sup>

State involvement in the affairs of co-operatives has come under strong criticism by nearly every student of co-operation. State agents are sometimes accused of misappropriating co-operative funds to their own advantage or mishandling co-operative affairs to enhance their own career prospects. What appears to be missing from these criticisms is any attempt to explain these observations in an analytical way, making use of existing theories on bureaucratic behaviour and corruption. What is also apparently missing from the large volume of literature dealing with the "evil" powers of the state in relation to co-operatives is an analysis of co-operative legislation to explain how state agents find themselves in such powerful positions of control over the affairs of co-operatives, given a British colonial co-operative legal system, still valid in many developing regions today, and what the effects would be of introducing a different co-operative legal environment.

The analysis of the pre-1985 co-operative legislation in Cyprus and the consequent empowerment of state agents should be preceded by a clear understanding of the two existing types of memberships by emphasising the distinction between primary and non-primary co-operatives. A primary society is one whose membership consists exclusively of natural persons. In the case of non-primary co-operatives, membership consists mainly of primary and other non-primary societies. The distinction between a primary and a non-primary society is a very important one with respect to defining the distribution of power over the affairs of the society between state, political parties, members and co-operative agents.

Although co-operative legislation recognises the General Meeting of members as the highest authority within a co-operative, the right to take strategic and operational decisions is usually reserved for the elected Committee and the appointed management of a co-operative. This feature is not unique to Cypriot co-operative legislation, as explained elsewhere in this chapter, but found in corporate legal environments in most

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<sup>298</sup> J. Worz, The role of co-operative and non-co-operative organisations in agrarian reform and rural settlement in the third world; in Worz(ed.), 1983, p128.

parts of the world which adhere to the principle of corporate democracy. This means that where the Registrar was able to exercise controlling influence over the management of co-operatives he was also able to influence important decision-making in these co-operatives.

As already explained, the Registrar was in a position to exercise significant influence over Secretaries, therefore, where managerial power lay mainly with the Secretary the Registrar could exert significant influence over the affairs of the co-operative. This influence became very strong in the case of second and third tier co-operatives since members were co-operative societies represented at the Annual General Meeting usually by those societies' Secretaries, which meant that elected committees were also made up of Secretaries. In other words, in the case of non-primary co-operatives both elected and appointed management were co-operative employees who saw their career prospects very much dependent upon their relationship with the Registrar.

In the case of primary societies the amount of influence exercised by the Registrar appears to have been far less effective although still significant, as a result mainly of the composition of elected committees and membership. Members of primary societies were ordinary citizens outside any system of dependency in relation to their co-operative's association with the Registrar. Committee members were elected by these members and performed their duties without any monetary compensation. Losing their place on the Committee would merely have meant losing a certain amount of power of patronage which that place provided them with, as explained in Chapter Six. The amount of influence the Registrar was able to exercise over these committees depended therefore on how important such patronage power was to the committee members and also on the distribution of power between Secretaries and Committee members.

It is hardly surprising that in the absence of an independent system of accountability, second and third tier co-operatives were managed as if they were the private business affair of the Registrar. It was only natural that non-primary co-operative committees made up mainly of primary co-operatives' Secretaries became obedient servants to the wishes of the Registrar and looked upon him as their real boss. The same did not hold true in the case of primary co-operative committees. Members of these committees

were directly elected by the user-members and being unpaid officers of the society their main objective was to maximise members' economic surplus, including their own. The degree of their obedience to the Registrar depended very much on the distribution of power between Secretary and elected committee members. In societies with a very powerful Secretary, the Registrar must have been able to exercise a much greater amount of influence over the affairs of the society than in the case of co-operatives under the strong influence of committee members. But even where the Secretary was the most influential man on the scene, the mere existence of five committee members, elected through a procedure outside the control of the Registrar, listening and being informed about the affairs of the society meant that some degree of accountability did exist. The powers of the Registrar were therefore somewhat restrained and this may explain why no serious malpractice was reported by the Investigating Commission in the case of the sample of primary co-operatives whose affairs were investigated. It is also no accident that the Commission decided to look selectively into the affairs of only 12 primary societies out of a total of over 500, and all 19 non-primary societies in existence at the time. The results of the investigation appear to have fully justified the Commission's selection.

The above analysis explains why all instances of suspicious behaviour by the Registrar, as reported by the Commissioners, relate to non-primary co-operatives. For nearly every single one of these 19 co-operatives Azinas is accused of forcing upon their committees dubious investment decisions without any prior feasibility studies and lacking any real business logic. The Commissioners' report offers many examples of such instances. Azinas reply to the Commissioners, as recorded in their report was that all major investment decisions had the consent of the Ministry of Trade and Industry and were in line with government policy on economic reconstruction.

The Registrar's ability to divert funds from the primary co-operative sector to non-primary societies was made possible by the existence of a central redistributing agent, the Central Co-operative Bank, whose role in the development of co-operation in Cyprus was earlier seen in this thesis to be crucial. Relevant legislation obliges co-operative societies to have all their excess monetary funds, otherwise known as liquid funds, deposited with this redistributing agent which is also acting as the Central Bank

of the co-operative banking sector. Membership of the CCB is made up exclusively of primary and non-primary societies and therefore is vulnerable to the same kind of state agent involvement as in the case of other non-primary co-operatives. It provides the link between the primary and the non-primary co-operative sector and an avenue of funds transfer from the one to the other. The Registrar's main strength lay in his ability to exercise absolute control over the make-up of the Committee of the CCB and therefore over its decisions. It was, after all, funds made available by the CCB to other non-primary societies that appear to have been misappropriated.

### 5.8 The political economy of corruption

Rose-Ackerman discusses corruption in the context of political economy. She proposes both an informed electorate and a comprehensive set of interest groups must be present in order to provide sufficient protection against corrupt activity.<sup>299</sup> In the Azinas affair the flow of information in the case of non-primary societies was under the absolute control of the same agency that controlled the audit and supervisory functions, as well as the committee electoral outcomes.

The situation was rather different in the case of primary societies, where this agency was not in control of the electoral outcome. Where however there was a very powerful Secretary in relation to the committee, the Registrar was in a position to exercise significant influence over both the flow of information and the electoral process through his significant influence over the Secretary who may have been in control of both the flow of information and the electoral outcome.

The fact that non-primary co-operatives were specifically selected by the Registrar for his corrupt activities may be explained using Rose-Ackerman's theoretical analysis; the threat of legal and administrative sanctions is likely to encourage secrecy and may convert corrupt transactions into bilateral bargains. Shopping around will often be costly because bureaucrats will need to develop trusting relationships with customers before making pay-off requests.<sup>300</sup>

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<sup>299</sup> S. R. Ackerman, **Corruption: a study in political economy**, London, 1978, p 29.

<sup>300</sup> Ackerman, 1978, p166.

On the basis of this analysis, secrecy is an inverse function of the number of people involved in the corrupt arrangement. What is more, payoffs are also an inverse function of the number of people involved in the deal. This explains why committees of different non-primary societies involved in the Azinas affair were made up of a small number of the same co-operative agents. Fourteen non-primary societies were effectively run by five people, each of whom was a member of the management teams of eight different co-operatives simultaneously. The Commission's report does in fact point out that as each of these agents was simultaneously member of a large number of co-operative committees, he had no time to exercise properly his duties as member of management. The report also blames poor management on these agents' lack of any relevant qualification, calling them mere decorative elements.<sup>301</sup>

In the case of primary societies, committee members and Secretaries were different in each case. Therefore, the number of people that would have to be involved in a possible fraudulent deal would be prohibitively high. In addition, no matter what the amount of influence the Secretary exercised over the members of the Committee there was always the possibility that one or more of these unpaid officers would be hit by the honesty syndrome and pass the word round.

Secrecy considerations may be one of the reasons why, despite the existence of a similar legal environment at the time of the British Administration in Cyprus, no corrupt activities by any of the British Registrars were ever recorded. Most of his subordinates in the department and the various management teams of co-operatives around the island were of a different nationality to his. In fact he knew that they looked upon him as an agent of an occupying country and therefore the slightest mistake on his part would be extremely difficult to cover. The cost therefore of developing trusting relationships in the case of the British Registrars was extremely high. This may also explain the general observation by Bechtel regarding the Third World that in the years prior to 1960, that is, when the colonial period was coming to an end, registrars and administrative bodies alike took delight in the increasing number of co-operatives.

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<sup>301</sup> Κυπριακή Δημοκρατία: Έκθεση της Ερευνητικής Επιτροπής για το Συνεργατισμό, Λευκωσία, 1981, σελ. 138.

After independence these partly successful beginnings were destroyed by party politics, abuse and mismanagement.<sup>302</sup>

Regarding public policy consequences of corruption and political payoffs Rose-Ackerman concludes that bureaucrats will design programs in ways that permit them to appropriate the gains that would otherwise be received by nominal beneficiaries. Thus corrupt bureaucrats will favour programs with complex, special purpose inputs that can not be bought off the shelf in competitive markets making it difficult for outsiders to determine whether costs have been padded by kickbacks. Similarly, they are likely to favour capital intensive inputs if they believe that suppliers of capital are more likely to have excess profits to use for payoffs than suppliers of labour.<sup>303</sup>

This analysis explains some of the empirical evidence from the Azinas affair. It is clear from the Commission's report that most of the misappropriation of funds must have taken place during the purchase of land and machinery. This became evident once the investigating Commission asked for an independent valuation of a number of purchased fixed assets, which showed that on certain occasions land and machinery had been bought at grossly overvalued prices. One such example relates to the purchase of a piece of land in the eastern part of the town of Paphos by the Central Co-operative Industries. Although a contract had originally been signed between the seller and the co-operative at CYP19000, Azinas asked the co-operative to pay CYP38000, exactly double the originally agreed amount, on the pretext that the seller had later changed his mind about the agreed terms of the contract. Needless to say the Commission of Enquiry thought that there was something wrong with the deal.<sup>304</sup> Incidentally, the seller on this occasion was the local church, widely known for the secretive, if not dubious manner it conducted its business transactions. The Report also draws attention to the fact that nearly every major contract of purchase of land and machinery in the case of the new industrial projects was negotiated personally by Mr. Azinas.

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<sup>302</sup> Bechtel, in Worz(ed.), 1983, p114.

<sup>303</sup> Ackerman, 1978, pp81-82.

<sup>304</sup> Κυπριακή Δημοκρατία: Έκθεση της Ερευνητικής Επιτροπής για το Συνεργατισμό, Λευκωσία, 1981, σελς. 122-123.

### **5.8.1 Co-operation as a function of accountability**

The question is now being asked whether a different legal environment to the one in existence before 1985 in Cyprus would have made any difference. This question aims at the possibility of isolating and removing those features of the law that enabled members of the state bureaucracy to misappropriate a significant amount of co-operative funds thus leading to co-operative failure .

Conveniently enough, following the events of the Azinas affair the House of Representatives passed a new co-operative law in 1985 which removed some of these features. The empirical evidence of the ten-year period after 1985 can therefore be utilised in order to tackle the above issue.

The main difference between the old and the new law was the complete separation of the supervisory and the audit functions through the establishment of the Co-operative Societies Audit Service, completely independent from the Registrar's department. In order to safeguard this independence all five members of its ruling Committee are appointed by the Council of Ministers, two being general directors of ministries of Finance and Trade and Industry, the Auditor General of the Republic, and two representatives of the Pancyprian Co-operative Confederation. The Committee of the Audit Service is presided over by the Auditor General of the Republic, an independent civil officer.

As Professor Hans-H. Munkner commented on one of his visits to Cyprus, the structure and constitution of the Audit Service is unique among co-operative movements around the world.<sup>305</sup> Apart from its legal obligation to express an independent opinion on the truth and fairness of financial statements and their compliance with the relevant legislation, its agents spend most of their audit time on examining both the business rationale and the bona fide nature of all managerial decision-making. At the end of each audit an explicit report is prepared on all findings, whether of a financial, law compliance or other nature. This report is addressed to the members of the co-

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<sup>305</sup> Minutes of an official meeting between Professor Hans-H. Munkner of the Institute for Co-operation in Developing Countries at Philipps-Universität Marburg and senior officials of the Co-operative Societies Audit Service of Cyprus, 26/9/1996.

operative and by law has to be read to them at the Annual General Meeting. It also goes to the committee of the co-operative, the Registrar, the Ministries of Finance and Trade and Industry, the Auditor General of the Republic and at the end of each year any significant matters are incorporated in the Annual Report of the Service to the House of Representatives.

Most other provisions of the old law effectively remained in place except that it was no longer at the absolute discretion of the Registrar to determine the career prospects of Secretaries, although he still has a say. It should also be noted that in a symbolic gesture, the title of Commissioner was withdrawn from the Registrar in the new law. This clearly indicated the House's determination to put a stop to the ability of the Registrar to manage the affairs of co-operatives, whether primary or non-primary.

Experience in the last 12 years has shown that the Registrar is still in a position to exercise a significant amount of influence over the electoral outcomes of non-primary societies including the Central Co-operative Bank. However, his control over the flow of information in these co-operatives is no longer as absolute and is in fact shared with the Audit Service. All managerial decisions of both non-primary and primary co-operatives now come under the investigating eye of the auditors who see themselves as the guardian angels of the co-operative movement.

The severe antagonism seen to exist between the department of the Registrar and the Audit Service is perfectly consistent with Kaufman's analysis of the behaviour of competing bureaus. Such competition is said to constitute an important barrier against the assumption of power by the bureaucracy.<sup>306</sup>

On the basis of the above analysis and the experience of the past one and a half decades of co-operation in Cyprus, it is proposed that co-operation from above in the case of non-primary co-operatives failed to succeed due to lack of accountability, either to grass root membership or to some other independent authority. This deficiency appears to be the result of legal and institutional weaknesses specific to the co-operative system

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<sup>306</sup> B. C. Smith, **Bureaucracy and political power**, Sussex, 1988, p42.

in Cyprus at the time. The lack of accountability made co-operative venture decisions taken at levels other than the primary stage prone to corruption. This proposition seriously questions the soundness of several writers' explanation of co-operative failure due to direct state involvement.

Davidovic for example blames state initiated co-operative venture failures mainly on the passivity of the people once state officials take over.<sup>307</sup> Kotter suggests that co-operatives appointed from above find little response at the grass-root level and blames this on the fact that models are imported from different socio-cultural environments and that very quickly they are adulterated and become instruments of the ruling elite.<sup>308</sup> Hanel on the other hand blames failure of co-operation from above mainly on the conflict between members' interests and government policy.<sup>309</sup>

All these various attempts to explain failure of co-operation from above cannot be sustained in a situation where state officials can be made fully accountable both in relation to the bona fide nature of their actions and with respect to the business logic of these actions. In a number of under-developed areas with very low literacy levels only members of the state bureaucracy may be in possession of the minimum required levels of education in order to maintain such business logic. It is in fact argued that co-operative ventures initiated by the state using either co-operative or state funds, can turn out to be successful given a strong system of accountability which will act as an anti-corruption mechanism as well as to ensure the good business sense of management's decisions. Such examples can be found today in Cyprus; non-primary co-operatives like SOPAZ, SYNERGAZ, and SEVEGEP, which nearly went into liquidation under the Azinas's regime, today appear to be doing well according to their audited published accounts. The Committees of these co-operatives are still made up of primary co-operatives' Secretaries and the Registrar is still in a position to exercise some amount of influence over their decisions. These decisions however will be audited by an independent agency not in any way dependent on the function of the Registrar.

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<sup>307</sup> G. Davidovic, *The Emerging State of Co-operation*, in Andreou(ed.), 1977, p53.

<sup>308</sup> H. Kotter, *Objectives and Strategies of Agricultural Development in the Third World*; in Worz(ed.), 1983, p17.

<sup>309</sup> A. Hanel, *The development of rural co-operative organisations in Third World countries with reference to economic system-related policies*; in Worz(ed.), 1983, p62.

Many failures of co-operatives around the world, initiated from above and aiming to meet macro or meso-economic objectives are not just the result of some evil powers inherent in the process of initiation and control of the co-operative act by the state but more the result of no effective accountability. It is no accident that such failures mainly occur in less developed, newly independent states with weak democratic systems where effective implementation of accountability systems is probably more difficult.

### 5.9 Conclusion

As already demonstrated in chapter 4, the Turkish invasion of Cyprus in 1974 produced market failures both at the meso-economic but also at the macro-economic level. Failure of the second kind manifested itself mainly in the form of a very large increase in the rate of unemployment. In that chapter, the hypothesis that co-operation can effectively act as an economic recovery mechanism was successfully tested, at least in the case of housing credit which was shown to have been one of the main motors of economic reconstruction after the Turkish invasion of Cyprus in 1974. State involvement in this context was limited to the role of a fall-back agent for existing co-operative structures with no direct government interference at the planning and implementation stages.

In this chapter, empirical evidence from Cyprus has been used to test a similar hypothesis, however, the parameters of state involvement this time were very different. A senior state bureaucrat, apparently acting under the silent consent of elected officials, is seen to force upon the co-operative movement a number of major investment decisions in new industrial projects as part of the government's overall effort for economic reconstruction. The whole attempt proved to be a major disaster.

The bulky volumes of literature on co-operatives have so far concentrated mainly on technical aspects of co-operative failure while taking for granted certain assumptions made by earlier co-operators which were embodied in the so called principles of co-operation. This chapter has brought one of these assumptions, relating to state involvement in co-operative affairs, under the scrutiny of theoretical analysis coupled

with hypothesis testing on empirical evidence from the co-operative movement of Cyprus.

The study of co-operation as a function of the state variable given an ex-colonial institutional and legal environment is extremely important in view of the fact that many governments, especially in the developing part of the world, invest valuable scarce resources in the direct promotion of co-operatives which they consider as an appropriate mechanism for economic development and reconstruction.

The overall results from such state directed initiatives have so far fallen short of expectations and this is partly blamed on state control and involvement. Empirical evidence from Cyprus together with various aspects of institutional theory have been employed in this chapter to explain why too much state control and involvement may lead to such failure.

An attempt has been made to explain this failure in terms of the principal-agent theory. The facts of the Azinas affair as reported by the Commission of Enquiry provide strong evidence in support of the anarcho-capitalist proposition that state bureaucrats act more like principals rather than agents, whose main objective is the maximisation of their own personal utility function.

Maximisation of this utility function has been shown to be directly related to certain elements of the legal environment. It was mainly two of these elements that produced a failure of the system of accountability and also created a dependency relationship between the Registrar and all Secretaries; the double role assigned to the Registrar as both supervisor and auditor of co-operatives, and the powers over the appointment and remuneration of Secretaries. This dependency relationship explains the greater amount of influence and control the Registrar was able to exert over the management of non-primary co-operatives as compared to primary ones.

A number of important issues are raised in relation to this apparent influence and control; the first relates to the idea sectoral and intra-sectoral linkage arising mainly due to psychological inter-relationships. The Registrar and any other central agency like the

central co-operative bank, seen to be mere extensions of his department, are said to create such linkage problems. Any reported misconduct of the linkage agent in any one sector may give rise to a series of reactions in other sectors or other segments of the same sector. The intensity of these reactions has been shown to depend on the transactional characteristics of each sector.

Another important issue relates to the role of the central co-operative bank, a non-primary co-operative, as a national funds redistributing agent. It was through this agent that funds were transferred from primary co-operatives to non-primary ones. This transfer was thought essential by the corrupt state bureaucrat who intended to use these funds for his own dubious purposes and hoped to escape detection. This is explained in terms of dependency relationships and the ability of the Registrar to exercise significant influence and control over the management of co-operatives.

A very important conclusion that is extracted from analysing the events of the Azinas affair using instruments from the fields of institutional theory and the political economy of corruption, is the need to separate the audit and the supervisory functions. Management decisions, whether self-originated or imposed from above, must be audited by an independent authority not taking part in the actual decision-making process. This will not only protect members of the co-operative from the corrupt or incompetent activities of committee members but it will also prevent state bureaucrats from abusing the powers entrusted to them by law.

Another pre-emptive measure would be the break-up of the dependency relationship between agents of the state machinery and employees of the co-operatives. This could be achieved partly by the removal of the Registrar's powers over the appointment and remuneration of Secretaries. However, complete break-up of the dependency relationship would be difficult for as long as there exists a supervisory function. Removing this function completely would entail certain risks with expected costs that might exceed the expected benefits.

Another possible measure to partly deal with the dependency problem may be to offer the majority of the seats on the committees of non-primary co-operatives to people not

employed by any co-operative. The benefits of some expert knowledge may be lost, however, this loss can easily be replaced by hiring professionals with the right qualification on the personnel teams of these co-operatives.

Following the recommendations of the Commission of Enquiry the House of Representatives passed a new law for co-operatives in 1985. Addressing the dependency problem some amendments were made to a number of provisions of the old legislation limiting the powers of approval of the Registrar although unavoidably, some provisions giving rise to dependency still remain unchanged to this date.

But the provision in the new law with the greatest impact was the creation of an independent Audit Service, putting an end to the double role of the Registrar as supervisor and auditor, thus dealing with the very serious problem of lack of accountability. The experience of the last ten years has shown the effects of this innovative measure to be very positive, even in the case of non-primary co-operatives which were originally set up at the instigation of state agents.

The analysis of the empirical findings within the co-operative institutional framework of Cyprus has led to the conclusion that state instigated co-operatives may have an equal chance of success as other co-operatives provided there exists a proper system of accountability in relation to both management and state bureaucracy. The existence of management accountability ensures not only the bona fide nature of decisions by management but also the business sense of these decisions. Regarding the relationship between state bureaucracy and the co-operatives, is an effective control against any possible fraudulent behaviour by the bureaucracy.

A number of non-primary co-operatives like SOPAZ, SEVEGEP and SYNERGKAZ, set up at the instigation of state agents, were turned into success stories once managerial decision-making, under the heavy influence of state agents, came under the scrutiny of a truly independent audit agency. For as long as the audit function was in the hands of the same state agents that were also empowered to supervise these co-operatives under a restrictive legal framework, all three organisations performed poorly.

This proposition about the need for accountability is very much in line with Weberian mechanisms for limiting the scope of systems of authority generally and bureaucracy in particular. Albrow classifies these mechanisms into five major categories; first, collegiality, where decisions at each level are taken by more than one official; second, separation of powers, meaning the division of responsibility for the same function between two or more bodies; third, amateur administration, when a government did not pay its administrators but instead it was dependent upon those who had the resources to permit their spending time in unremunerated activity. Where amateurs were assisted by professionals it was always the latter who made the real decisions; fourth, direct democracy, where there were several devices ensuring that officials were guided directly by, and answerable to, an assembly; short term of office and selection were designed to serve this end. Fifth, representation, where charismatic and traditional leaders claimed to represent their followers. The existence of collegial representative bodies, whose members were selected by vote and were free to make decisions and share in authority over those who had elected them offered, according to Weber, the greatest possibility of a check on bureaucracy.<sup>310</sup>

Co-operatives are seen at local, national and international level as very important mechanisms of economic development. Unfortunately in areas mostly in need of such mechanisms, underdevelopment leads to serious breakdowns in the systems of accountability and this accounts for the large number of state initiated co-operative failures. On this basis it is proposed that where international agencies subscribe to the setting up of co-operatives in developing areas they should also make sure that a proper system of accountability is established. This system should ensure that the audit function is independent both from the state and the co-operatives and should not be limited to the financial aspects only.

Corporate systems of accountability are destined to provide members with the basic information they need to play a meaningful monitoring role in their organisation. They are designed as a break on mismanagement, the argument being that if managers and

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<sup>310</sup> Albrow, 1994, pp 47-48.

directors know their actions are open to scrutiny because of the disclosure requirements, they will not misbehave. It is recognised however that the information provided is rather formal and may not give a flavour of the dynamics of the organisation. The true independence of auditors is also questioned bearing in mind that although under the relevant laws they are supposed to be appointed by the members, it is the management that recommend them to the Board and members.<sup>311</sup>

The current structure of the Co-operative Societies Audit Service in Cyprus overcomes these hurdles since neither co-operatives nor state agents in charge of supervision of co-operatives have a say in either the appointment or the work of the auditors. Also the audit function extends not only to the standard financial audit but also to the very important concept of management audit.

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<sup>311</sup> C. S. Axworthy, *Myth and reality*, in M. E. Fulton(ed.), **Co-operative Organisations and Canadian Society**, Toronto, 1990, p49.

## CHAPTER SIX: PARTISAN POLITICS AND THE CO-OPERATIVE FUNCTION

### 6.1 Introduction

This chapter examines both the advantages and disadvantages of political party involvement in co-operatives and tests the hypothesis that such involvement is inversely related to co-operative success. The approach will be both theoretical and empirical, making use of tools of analysis borrowed from a number of disciplines. Also, the study of co-operation as a function of political party involvement can not be looked at in isolation of two other variables in the equation which can be described as dependent variables. These are member participation and member loyalty.

Political neutrality has long been advocated by co-operators around the world as one of the most important principles of co-operation. This way the possibility of persons being excluded from membership due to their political ideology, or conflict between various political groups inside the movement are said to be avoided and therefore the chances of co-operative success are assumed to be greater.

This analysis however ignores the possibility that political party involvement may also play a positive role as a variable in the co-operative function. For example Coser proposes that far from being always a negative factor that tears apart, social conflict may contribute in many ways to the maintenance of groups and collectivities as well as to the cementing of interpersonal relations. He therefore considers conflict to be independent of co-operation.<sup>312</sup>

Any scant attention paid so far to the relationship between the co-operative function and politicisation relates mainly to the potential of national co-operative movements turning into a separate political force. Researchers appear uninterested in instances of direct party involvement in the affairs of co-operatives. And yet such involvement should not come as a surprise in a western type democracy bearing in mind the amount

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<sup>312</sup> L. A. Coser, Conflict: social aspects, *International Encyclopedia of the social sciences* 3, 1968, pp232-236.

of economic and hence political power at the command of whoever is seen to be in control of the management of these non-capitalist, community based institutions.

There is a limited amount of literature on co-operative member participation too, dealing mainly with the risks of apathy but failing to propose a theoretical framework analysing those forces that give rise to participation in the first place. In the case of member participation as a function of political party involvement, there does not appear to be any record in English of any serious amount of research carried out so far.

Similarly, the relationship between politicisation and power structures in co-operatives seems to have failed to attract the attention of researchers. It is usually taken for granted that these structures are of an identical shape with those found in the corporate world.

There can be a number of reasons why students of co-operation tend to avoid the issue of politicisation. The most obvious one is that based on experience in other fields they are convinced that political party involvement in the affairs of co-operatives can only have adverse effects. Another reason could be the difficulty in collecting empirical evidence, due mainly to the unwillingness of co-operative agents to admit that such involvement does take place contrary to the important principle of political neutrality, so highly espoused by the International Co-operative Alliance (ICA).

Things for the researcher become even worse due to the complete absence of any written records. As with all other cases of political party involvement in Cyprus, transactions between principals and agents take place “under the table” and can not easily be traced. It would therefore be extremely difficult for anyone outside the movement to extract any amount of meaningful information on the subject given the absence of both oral and written evidence.

But apart from the usual technical reasons it is also likely that failure to handle political party involvement may have something to do with the usual misunderstanding over the exact nature of co-operation. Laycock for example appears to assume co-operatives behave like any other business enterprise and therefore avoid forcing decisions on

partisan affiliation which would lead many of their customers/members to choose Hirschman's exit option for influencing organisational behaviour. From the perspective of career bureaucrats and managers increasingly schooled to private sector specifications, he thinks the risk presented to their corporate-like welfare by partisan affiliation is simply too great as the politics of promoting policy through both business associations, co-operative and other, and a political party could easily appear nightmarish. This risk can always be portrayed as outweighing longer-term benefits in the areas of social reform to which co-operatives have been historically committed.<sup>313</sup>

Laycock's proposition appears to be inconsistent with Emelianoff's analysis of a co-operative as an aggregate of the members' enterprises. Using a similar line of reasoning for political behaviour as for economic behaviour, a co-operative can only be politically neutral if its members are also politically neutral or if left and right balance at 50% each. The chances of this happening can not be very high.

Section 6.2 attempts to explain political party behaviour in relation to the co-operative movement as a function of patronage power associated with the workings of co-operatives. Section 6.3 analyses the role of co-operative agents during committee elections and examines the possibility through the facts of a case-study that member ideological preferences may give way to patron-client alliances. Section 6.4 examines the distribution of power within co-operatives as a function of both patronage and partisan politics and how this compares with power structures predicted by traditional management theory. Section 6.5 analyses the characteristics of co-operative involvement of the two main political groups in Cyprus. Section 6.6 examines member participation as a function of partisan politics. Section 6.7 proposes three further possible advantages of partisan political involvement in co-operative affairs and section 6.8 examines a further serious possible disadvantage of such involvement.

## 6.2 The search for patronage power

Political parties in a western type democracy are likely to become interested in the affairs of co-operatives once they realise the patronage potential of these organisations

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<sup>313</sup> D. Laycock, Political Neutrality and the problem of Interest Representation: Co-operatives and Partisan Politics in Canada; in Fulton(ed.), 1990, pp176-178.

among their political clients. Such potential is the result of market imperfections which give rise to monopolistic exchanges and excess profits. In the case of capitalist firms all surpluses tend to go to the owner of capital whereas co-operatives pass some of this surplus over to members-consumers. Due to resource constraints an allocation of this surplus has to be made among members which is not based on any commercial criteria but rather on non-market considerations, thus giving rise to a patron-client type of relationship between the agent of the co-operative seen to be responsible for the allocation and the member benefiting from such allocation.

For example, effective interest rates charged by credit societies in Cyprus do not exceed 9 per cent for any type of loan. In the case of commercial banks effective interest rates, taking also account of various fees charged, vary from 12 to 15 per cent, depending on the nature, purpose and security offered for the loan. Not surprisingly, credit seekers would prefer to borrow from their local co-operative rather than from a commercial bank. As a result, loan applications with the co-operatives far outweigh available funds and therefore an allocation has to be made.

The difference in the effective interest rate between co-operatives and banks is the monopolistic surplus that co-operative agents usually pass on to members on a selective basis. Ideally a fair system of credit allocation should not be too difficult to implement. However it is common knowledge in Cyprus that the chances of obtaining a loan from a co-operative are directly related to having direct or indirect personal access to management. This is not to say that it is impossible to obtain a loan through normal procedures but there will definitely be a longer waiting period, as a result mainly of frequent queue jumping by a high percentage of loan applicants which at times may be as high as 70-80%.<sup>314</sup>

Such queue jumping tactics give rise to a large number of obliged clients. Instances are known where members are provided with the required loan facilities without the need for queue jumping, yet management assure them that many other applications had to be

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<sup>314</sup> Interview with the Secretaries of Strovolos, Pallouriodissa and Egomi credit societies.

pushed back in order to make room for their own. Queue jumping gives rise to a patron-client relationship between the manager and the loan applicant.

In the case of a marketing co-operative a member's income very much depends on the product quality control procedures introduced by management, containing a significant element of subjectivity. Once the member's produce is received at the warehouse it is given a grade for valuation purposes. Before a final valuation is made a certain percentage is deducted for possible damages. Both the grading procedure and the estimate of the percentage for possible damages involve a certain amount of subjective judgement. The person in charge of the final valuation procedure, usually the Secretary of the co-operative, will therefore be seen to carry a significant amount of patronage power especially by those members whose livelihood depends on the income received through the co-operative. His decision on the individual valuations of members' produce will be constrained by the total saleable value of all the produce. Like in the case of credit societies management has to make decisions of an allocation nature which may give rise to patron-client relationships due to the importance of these decisions on the lives of certain people.

Silverman defines patronage as an informal contractual relationship between persons of unequal status and power, which imposes reciprocal obligations of a different kind on each of the parties. As a minimum, what is owed is protection and favour on the one side and loyalty on the other. The relationship is on a personal, face-to-face basis, and it is a continuing one.<sup>315</sup>

In his study of patronage in Spain Kenny defines a patron as someone who is regarded as a protector, a guide, a model to copy, and an intermediary to deal with someone else or something else more powerful than oneself, whether or not such power is imaginary or real in a single context or in all, and whether or not the advantages to be gained from his patronage are material or intangible. Likewise Kenny defines a client as

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<sup>315</sup> S. F. Silverman, *Patronage and community-nation relationships in central Italy*, in S. W. Schmidt, J. C. Scott, C. Lande, L. Guasti(eds.), *Friends, followers and factions*, California, 1977, pp295-296.

someone who avails himself of a patron's services and who maintains a reciprocally beneficial relationship with him.<sup>316</sup>

This kind of behaviour is explained by Lande in terms of dyadic alliances. In a patron-client relationship, the patron by definition has more wealth, status and influence than the client, and gives more of these to the client than the latter can ever give him in return. Thus the tangible benefits received by the client - material help and protection - exceed his tangible costs. What the client gives to the patron in return is in large part intangible. Aside from some small token gifts which the client offers to his patron, in recognition of his indebtedness, the client gives to his patron, in return for favours received or expected, his personal service, his loyalty and his acclaim. Still, according to Lande, these are insufficient to balance what the client has received from his patron. The client therefore, must give something in addition; he accedes to the patron the preponderance of power to decide how the two of them shall interact and collaborate. That is to say, he gives leadership to the patron, and accepts followership for himself. This last gift, concludes the author, is of crucial importance for the structure of clienteles.<sup>317</sup> Staniford is in full agreement with this theoretical analysis, commenting that political action is the art of manipulating dyadic relationships.<sup>318</sup>

In the case of a credit society, a committee member or any other agent of the co-operative that personally assists an applicant to obtain a loan has a personal financial cost of zero. The benefit received by the client however may be of extremely high value, which means that he will remain indebted to the agent for a very large balance and probably for a very long time. For example, an applicant who is desperate for a loan in order to meet the medical costs of a close relative, or a small businessman who is in need of a capital injection in order to keep his business from going down due to cash-flow problems, will feel that the benefit of queue-jumping received from the agent is invaluable.

<sup>316</sup> M. Kenny, *Patrons of patronage in Spain*, in Schmidt, Scott, Lande, Guasti(eds.), 1977, p356.

<sup>317</sup> C. H. Lande, *The dyadic basis of clientelism*, in Schmidt, Scott, Lande, Guasti(eds.), 1977, ppXXVII-XXVIII.

<sup>318</sup> P. Staniford, *Pioneers in the Tropics*, London, 1973, p122-123.

This theoretical framework can be used to explain why there is so much competition among various political parties to win control over the committees of co-operatives, especially the thriving ones. But even among agents of the same party there are usually fierce personal contests as to who will represent the party at committee elections. And yet office tenure is without remuneration and usually requires the sacrifice of long hours of one's personal time.

The only obvious explanation that can be offered for such behaviour is the power of patronage that accompanies the position of committee membership. Individual agents are expected to use this power for the benefit of the party they represent, however, there is nothing to stop them from using this power to their own advantage as well, provided party interests are not seen to be harmed. This is another instance where an agent has the opportunity to act like a principal and thus confirm once more the anarcho-capitalist proposition.<sup>319</sup> The degree of freedom of action of these agents is very much dependent on a number of factors, the most important being the nature of political involvement, analysed later in this chapter.

If a member has secured a place on the committee with the support of a certain political party a dependency situation is created between the member and that party. The committee member becomes the agent of the party and hence the protector of its interests. His relationship with the party as agent of the co-operative depends not only on his ideological commitment but also on the knowledge that his position as agent of the co-operative will in the future depend on his current behaviour.

A similar analysis can be used in the case of professional management appointed by elected committees. If a manager is appointed at the instructions of a party, a dependency situation is created between the manager and that party. For as long as the committee of the co-operative is under the control of that same party it is unlikely that the manager will go against party wishes. This dependency situation is further strengthened by fears of the appointee that a new committee under the influence of another party will be biased against him and even try to dismiss him. During committee

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<sup>319</sup> See above, section 5.1

elections he will therefore do his utmost to see the committee remain under the control of the party that instigated his appointment.

### **6.3 Partisan politics Vs personal patronage power**

At least on the basis of empirical evidence from Cyprus, managers and employees can sometimes influence voters during committee elections to a significant degree. Unlike national and local elections in Cyprus, elections for the local co-operative are not compulsory and turnouts are usually very low.<sup>320</sup> Especially in the case of urban co-operatives with large memberships this means that elections are won by candidates that persuade a sufficient number of their own voters to show up on the day of the elections. Managers and employees of the co-operative can privately urge a number of members to show up on election day, taking advantage of the personal relationship they established with these members during the course of ordinary business.

Experience has shown that voting patterns during committee elections do not always match with those during national elections. This may have something to do with the more personalised nature of co-operative elections as compared to national elections, but this argument weakens in the case of co-operatives with large memberships. Empirical evidence suggests that co-operative election outcomes are usually affected by both party loyalties and by relationships of a patron-client nature. The importance of patronage can only be examined if isolated from party alliance. This can be done where patron and member partisan politics are dissimilar.

What is suggested here is that a member who once benefited from a fast loan urgently needed or from some other service provided by the co-operative may be tempted to ignore party line at the time of committee elections and vote according to the wishes of the agent he sees as his patron. A good example of ideological alliances giving way to

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<sup>320</sup> The elections records of four urban co-operatives reviewed, Egomi Savings Bank, Latsia Co-operative Credit Society, Civil Servants Co-operative Building Society, and Pallouriotissa Co-operative Credit Society, show that on all occasions less than 30% of all members turned up to vote despite the strenuous efforts by the various contestants. A senior official in the department of co-operative development, many times presiding over election procedures, commented that during the last ten years he does not remember more than one or two occasions when this percentage was exceeded in urban areas.

loyalty towards patrons is the committee elections of the Emi Savings Bank during the period 1989-1996.

### **6.3.1 Emi Savings Bank**

Emi is one of the smaller suburbs of Nicosia and has traditionally been a right-wing strong-hold. During the last three national elections the right secured more than 70% of the local vote.

The local co-operative, registered in 1961, is in the business of providing housing loans and other credit facilities to its 4000 members as well as accepting deposits. Since registration the committee of the co-operative was made up of local party activists, the majority of the seats being held by the right. The fact that two of the five places on the committee were held by supporters of the left was the result of a gentlemen's agreement between the two sides aiming to safeguard the interests of the co-operative against possible adverse effects of partisan politics.

Things however changed in 1989. A finance agreement between the co-operative and a motor company put mounting pressure on the liquidity of the society. Allegations were made that both the Secretary and the members of the committee were receiving commission from the motor company owner for each car sale financed by the co-operative. Finally the Registrar, in a very rare move, dismissed all five committee members and placed the Secretary on probation. He then declared elections and simultaneously ordered a special investigation into the affair.

Throughout this period feelings in the community ran high, especially among the friends and relatives of the five dismissed committee members and the Secretary. Members of the co-operative felt confused and disillusioned about the whole affair. During the elections ordered by the Registrar the coalition of the left, three communists and two socialists, won marginally. In 1995 the same committee members won the elections for the third time in a row.

The obvious question that is raised in relation to the facts of the above case-study concerns the electoral victory of the left in a right-wing strong-hold area, where the majority of both members and employees of the co-operative were right-wing supporters.

During the first committee elections in 1989, confusion, disillusionment and the fast pace of events caught the right by surprise, falling victim to the very well organised political machinery of the left.<sup>321</sup>

Once settled in, the new members of the committee started building on the patron-client relationship potential offered by their newly acquired position. Loans were approved to supporters of the left as well as the right, but priority was given to applicants who had personal access with any of the members of the committee, irrespective of ideological preferences. Before the official notification of the approval, committee members contacted personally these successful applicants to brief them of the decision of the committee and thus collect gratitude. A patron-client relationship was therefore established.

But apart from advancing loans to members irrespective of their politics, another measure taken by the new committee in order to prevent any amount of criticism for political bias was the new procedures established in relation to staff recruitment. All candidates for any new vacancies would have to go through an examination procedure controlled by the Ministry of Education, a state agency whose independence could not be questioned. The fact that of the eight new employees recruited during the period 1990-1996 only three were left-wing supporters is clear evidence of the impartiality of the system.

The establishment of a patron-client relationship and successfully avoiding moves that would provoke any feelings of resentment among members with right-wing inclinations brought about the seemingly curious situation of the left being in control of a co-operative committee in a right-wing heartland.

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<sup>321</sup> T. W. Adams, **AKEL: The communist party of Cyprus**, Stanford, 1971, p59.

It should be stressed that the Emi phenomenon is only but an exception to the rule. Usually political parties are always careful not to lose control of what is considered a very important medium of political clientelism. This however can not prevent competitive behaviour among their own numbers to become party agents in this relationship.

As already explained patronage potential may be the single most important reason for the amount of interest shown for securing a place on the committees of local co-operatives. The material and other benefits available to various agents are a function of this relationship. Various agents will compete to acquire as much patronage status as possible in order to maximise their expected returns. This will result in specific modes of distribution of power within the co-operative.

#### **6.4 Power distribution as a function of patronage and partisan politics**

As Axworthy explains, any organisation which is too large or complex for one person to operate must have agents to perform the various functions.<sup>322</sup> On the premise that control over the affairs of an organisation is a direct function of control over the information flow in that organisation, it is often assumed that as the co-operative gets bigger professional managers are likely to have more say in the affairs of the co-operative since they are the ones who control the flow of information. Fairbairn and others warn however that their actions may not reflect the needs and wishes of the members and may therefore jeopardise the co-operative's chances of success or survival.<sup>323</sup>

The corporate legal framework usually contributes towards a power distribution in favour of management at the expense of members. Axworthy points out that the law's refusal to intervene in management decisions, serves to entrench the power of the directors and the managers and to point out how little effective power members really have.<sup>324</sup>

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<sup>322</sup> Axworthy, in Fulton(ed.), 1990, p41.

<sup>323</sup> Fairbairn, Bold, Fulton, Ketilson, Ish, 1991, p77.

<sup>324</sup> C. S. Axworthy, *Myth and reality*, in Fulton(ed.), 1990, p55.

However, once a new variable is introduced in the co-operative function, that of patronage power associated with both the functions of professional management and those of committee members, patterns of distribution of power begin to take a different shape to the ones predicted by traditional management theory.

Once elected, active involvement in the affairs of the co-operative may be a precondition in order to enjoy the fruits of patronage power associated with the position of a committee member. Members of professional management and elected directors will therefore find themselves in a competitive situation, both as a group but also as individuals, as to who appears to have more power, assuming validity of the anarcho-capitalist approach.<sup>325</sup>

Although the provisions of the relevant legislation favour elected directors, it appears from a number of case-studies that the end result very much depends on a combination of factors. A very important factor seems to be the involvement of various political actors. The nature of this involvement will therefore have to be analysed.

#### **6.4.1 Partisan politics and the electoral system**

According to the relevant legislation, the elected committee of a co-operative is effectively its main decision-making body. In Cyprus, committee members are usually local political party activists. The electoral system is based on the majority vote rule, i.e. on a committee of five, the persons elected are those five candidates winning the largest number of votes.

The problem in a multiparty system is that where there are no alliance agreements, all five committee members may be candidates from the same party to the exclusion of all other political groups, even when the winner party has only a marginal lead over the second largest party. This could create feelings of resentment among existing and

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<sup>325</sup> See above, section 6.1.

potential members who may prefer to take their business elsewhere thus harming the interests of the co-operative and its members.<sup>326</sup>

It is not uncommon in Cyprus for all committee members to belong to a single-party. For example, all five elected members on the committee of the largest co-operative on the island, the Limassol Co-operative Savings Bank, belong to the communist party AKEL. In the 1996 Parliamentary elections AKEL came out the largest party in Limassol with 35.4% of the vote as compared to 30% by the Conservative party. In the case of the second largest co-operative, Strovolos Co-operative Credit Society, all five members on the committee belong to the conservative party which in the 1996 Parliamentary elections won 35.9% of the total vote in the Nicosia suburb of Strovolos, as compared to 27.8% by AKEL.

A question that naturally arises in cases similar to the above is why representatives with dissimilar political affiliations do not form alliances to outnumber the ruling group. For example, in the cases of the Limassol and Strovolos societies a non-communist and a non-conservative coalition could muster nearly two thirds of the votes respectively.

This and other aspects of party politics as a variable in the co-operative function seem to have failed completely to attract the attention of researchers. The stories of a number of co-operatives need to be looked at in some detail as they provide useful empirical evidence which can be used in the study of the co-operative function in the context of a western-type electoral system.<sup>327</sup>

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<sup>326</sup> The Secretary of the Geri credit co-operative society has remarked that nearly no left-wing supporter from the village of Geri ever does business with the co-operative due to the fact that there is no left-wing representative on the committee. Geri leftwing inhabitants either do business with local commercial bank branches or they become members of the co-operative in the neighbouring village of Aglandjia which has an all-leftwing committee. Similar remarks have been made by Secretaries of other village co-operatives with single party control. In the case of urban based co-operatives like the Strovolos or the Limassol credit societies the fact that the left or the right are fully excluded from committee representation is not such a big hindrance to membership by supporters of different political affiliations. This may be an indication of how more politically biased people are in rural rather than in urban environments or that the larger the community, the less any personal characteristics (political/religious) matter in commercial affairs.

<sup>327</sup> Empirical evidence on this occasion mainly relates to the writer's own observations through his personal contact with the co-operatives concerned, in his capacity as Principal Auditor of the Co-operative Societies Audit Service in Cyprus.

#### 6.4.1.1 Solos Co-operative Credit Society(SCCS)

Solos is a suburb of Nicosia, the capital of Cyprus, and is one of the most populated localities in Cyprus. The local credit society was registered in the 1940s while Solos was still a village and the main occupation of its inhabitants used to be farming. This meant that SCCS initially operated as a funds redistributing agent as explained in Chapter Two in order to rid the peasants from the exploitative practices of usurers. Of its 25,000 members today not more than a dozen still register farming as their full-time occupation.<sup>328</sup>

As a result of the large influx of refugees following events in 1974, Solos quickly became urbanised and the bulk of the local society's business became the provision of house mortgages. Unlike many other co-operatives, the committee of the society was never firmly rooted in any of the political groups in Cyprus. Members of the committee were usually well-known local figures from various ideological backgrounds, although the right appeared to have a more permanent grip over the composition of the committee. This was to be expected bearing in mind the fact that Solos traditionally has been a right-wing strong-hold. At the 1996 Parliamentary elections the broad Right in Solos secured more than 54% of the vote.<sup>329</sup> This percentage was very similar to ones of the previous two electoral contests.

From experience, whoever is Secretary of SCCS has also been the decisive force during committee elections and on most occasions has succeeded in securing the election of persons of his own choosing from various political backgrounds, although for purely tactical reasons the majority on the committee has usually been of right-wing orientation as the society is located in an area with a right-wing majority.

The ability of a single agent of the co-operative, the Secretary, to exert so much influence at election time can only be explained in terms of the establishment of a patron-client type of relationship between this agent and a large number of members. The establishment of such a relationship in the case of the Solos credit society can be explained by the fact that the Secretary makes sure that all loan applications are seen to

<sup>328</sup> Solos co-operative credit society, Register of members.

<sup>329</sup> Φιλελεύθερος, Λευκωσία, 14/12/1996

be processed directly by him. This is the point where the patron-client relationship is established. Unlike the case of commercial banks where a number of established banking procedures ensure professionalism in their dealings with clients which are based almost exclusively on commercial exchange considerations, in the case of SCCS and many other similar co-operative institutions the Secretary is in visible control of all stages of processing loan applications and members know all too well that whether their loan application gets accepted or rejected depends exclusively on the wishes of the Secretary. They are also aware that the chances of receiving a positive reply are much greater if they establish a good personal relationship with the Secretary or someone close to the Secretary.

Once such a relationship has been established members expect their future requests for more loans to be treated in a similar manner. It is therefore in their interest to assist their patron maintain his position of power even if he belongs to a different political grouping than themselves. This may explain a number of unorthodox ballot results in a system of secret voting.

Clearly therefore the nature of the relationship established between a member and the co-operative is not exactly similar to the one established between commercial establishments and their clients. Although commercial considerations are not totally absent so far as loan security and repayment are concerned, the decisive factor in the decision-making process is the relationship between the member and some agent of the co-operative.

This kind of patron-client type relationship is also found at the Liol Co-operative Savings Bank, however, the distribution of power among the various agents is very different to the one in Solos.

#### **6.4.1.2 The Liol Co-operative Savings Bank(LCSB)**

This co-operative was registered in the 1940s by a group of traders, all members of the Union of small traders of Liol, in order to get rid of the exploitative practices of black marketers and usurers as well as to obtain reasonably priced credit for the

purpose of securing decent accommodation. Fifty years later the LCSB is one of the largest co-operative societies in Cyprus and among the largest financial institutions in Lioi, one of the largest cities of Cyprus. Currently the bulk of its business appears to be the provision of house mortgages and on the basis of research carried out on its behalf at least one in four inhabitants of the city of Lioi does business with the LCSB.<sup>330</sup>

Traditionally, small trading in Cyprus has been an AKEL strong-hold.<sup>331</sup> It was therefore natural to expect that the early committees of the LCSB would be controlled by AKEL. Even years later when its main line of business became the provision of house mortgages and membership was left open to the inhabitants of Lioi from all occupational backgrounds it appears that admittance of new members went through careful political party screening so as to prevent the loss of the majority by the communists.

But it was not only admittance of new members that went through careful party screening. The committee will only recruit staff at the instructions of local party headquarters. Being AKEL supporters is an unwritten entry requirement.<sup>332</sup> This does not only ensure the satisfaction of political clients but also that a very effective mechanism is set up for winning committee elections, as explained earlier in this chapter.

As membership is a pre-requisite for obtaining a loan according to Cyprus co-operative legislation, and as approval of new members has usually passed through party screening, by definition the granting of loans needs the consent of the party. It is privately acknowledged by officers of the co-operative that in practice a large number of loan applications come through the party network and that approval by the committee is a mere formality.

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<sup>330</sup> Συνεργατικό Ταμιευτήριο Λιόλ Λτδ, Έκθεση και Οικονομικές Καταστάσεις 1994 και 1995, Λιόλ, 1996, p 4.

<sup>331</sup> Α. Πανάτος, Συνεργατικό Ταμιευτήριο Αιόλ 1946-1993, Η Ιστορία μιας μακρόχρονης προσφοράς, Λιόλ, 1994, p14.

<sup>332</sup> Such political party screening for members was very common until recent years and it is still very common with respect to the hiring of employees, according to all senior officers of the Co-operative Societies Audit Service interviewed. They do point out however that similar behaviour can be found in co-operatives under right-wing control. The act of political party screening is officially denied by the management of all co-operatives, however confidentially in a number of cases senior officials of some co-operatives have admitted to the writer that it is still in practice.

Of course not every single new loan-membership application passes through party procedures, however, the numbers are closely watched so that the balances are kept in favour of AKEL. This has been known to be happening for a great number of years and has created a certain psychology among the wider public of Liol, that unless an applicant is left-wing his chances of obtaining a loan and become a member are few. As a result the majority of loan applicants are left-wing even if the majority of the population in Liol are not left-wing. A large number of non-left-wing supporters simply don't bother to apply, anticipating a negative response.

#### **6.4.1.3 Co-operative Savings Bank of Pas**

This co-operative was first registered in 1963 to service the savings and credit needs of the citizens of Pas, a right-wing stronghold. Through a gentlemen's agreement both right and left had representatives on the committee, until 1983 when the centre right-wing Democratic Party took over completely. Traditionally the Democratic Party was the largest party in the city of Pas with more than 30% of the vote. The leader of this new move was a Mr. Pitis.

Before 1983 the situation in the case of the Pas Savings Bank was exactly the same as in Solos, with the Secretary vested with all the decision-making powers and patronage status. Once however the committee came completely under the control of the Democratic Party he had to surrender some of this power and prestige to the new president of the committee, Pitis, who was already known locally for his participation in trade union affairs. He was the Secretary of the local branch of a right-wing trade union.

Following his election as president of the Committee Pitis realised that his popularity as a result of his connection with the loan-processing operations of the co-operative increased significantly. He knew it was now the right time to try his luck at the Parliamentary elections. Not only did he get elected at the 1986 elections but he also won the largest number of votes in the Pas area.

His triumph was certainly not unrelated to his position as president of the co-operative in Pas. Realising this he continued to tighten his grip on the affairs of the society taking advantage of provisions in co-operative legislation, until he managed to push the Secretary to the sidelines. Unlike the case of the Solos Credit Society, the president and not the Secretary is now seen in control of matters like committee membership, staff recruitment, allocation of credit facilities to members and all other major issues. Similarly to the Solos case he makes sure that the other four members of the committee are low profile individuals unlikely to disagree with any of his decisions.

It is no secret that the President of the committee of the Pas Savings Bank, contrary to established practice, makes a habit of interviewing a large number of loan applicants himself, away from the offices of the co-operative and outside the administrative procedures of the society. It is also well known that on many occasions positive replies to loan applicants are communicated to them personally by the president of the committee rather than by the co-operative as a body corporate. Such practices by the president of the committee have often produced the reaction of the professional management of the society.<sup>333</sup>

In 1994 this reaction culminated into a head-on collision between the Secretary and a senior member of staff on the one hand and the president of the committee on the other. Things became so bad that the Registrar had to intervene. Fears by the president of the committee about the possible political cost and fears about possible career damage by the professional staff, finally led to a compromise. However the law was on the president's side who has never stopped his patronage activities.<sup>334</sup>

#### **6.4.2 Comparative analysis**

The amount of patronage power acquired by agents of co-operative institutions is clearly demonstrated by the fact that a disproportionately large number of such agents get elected in public offices, both at a national but also at a local level. For example, out of the four members elected in the House of Representatives in 1996 from the Paphos area, one was President of the Committee of the Hellenic Co-operative Savings

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<sup>333</sup> This information has been obtained from high-ranking officers of the Pas Savings Bank.

<sup>334</sup> Interviews with two high-ranking officials in the department of co-operative development.

Bank, the largest co-operative in Paphos and a second one was the son of a member of the Committee of another local credit society.

During local elections for the three municipalities of Paphos in the same year, the Secretary of the Peyia co-operative was elected mayor while in a second municipality the Secretary of the local co-operative finished second, only marginally behind the winner and despite the fact that he did not have the backing of any of the parties like the other three candidates.

Another example of a member of the House of Representatives who owed his election to his association with a co-operative was the Secretary of SODAP, a wine processing and marketing society catering for the needs of over 10000 vine growers in Limassol and Paphos.<sup>335</sup> This number far exceeds the required number of votes in order to get elected into office. His election was considered by many vine growers as their chance to have a voice in the House of Representatives even though it has always been widely acknowledged that the man has been one of the weakest members in the House. His failure to be re-elected in the last Parliamentary elections in 1996 coincided with the time of his retirement as Secretary of SODAP. This may add further evidence to the idea that he owed his previous electoral success to his position as secretary of a co-operative. It is also worth noting that a number of writers including Staniford suggest that gaining control of the marketing organisation is an effective way to enhance one's political power.<sup>336</sup>

There are many other recent examples of the way association with a co-operative has helped certain agents rise to positions of political power, either on a national or a local level. But political advantages gained are not the only incentive for such an association, especially in the case of committee members who receive no remuneration for their services as officers of the society. The fierce competition among candidates during committee elections looks very much like what Graziano calls a struggle that takes

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<sup>335</sup> As per the audited financial statements of SODAP Ltd for the year ended 31 December 1995.

<sup>336</sup> P. Staniford, *Pioneers in the Tropics*, London, 1973, pp122-123.

place between competing clientelistic factions.<sup>337</sup> The analysis of this behaviour would inevitably lead to the theoretical sphere of patron-client relationships.

It is by now obvious that once the Secretary or any other agent of the co-operative succeeds in establishing his patronage status through his position in the co-operative he is also able to exercise considerable control over committee elections. And as long as he refrains from activities which might provoke resentment among any of the main local political groups he can be assured, like in the case of Solos, sustenance of his position. Where such acts of provocation are absent it is not likely that political groups will risk losing an election, like in the case of Emi, even at a co-operative level.

It is in order to avoid feelings of resentment among the left that the right-wing Committee of Solos, under the guidance of the Secretary, abstains from any visible acts of political bias. Looking at Trade Union membership for example it is evident that the percentage of new recruits that join PEO, the left-wing Trade Union, is not very dissimilar to the percentages achieved by the left during Parliamentary elections in the suburb of Solos.<sup>338</sup> Also grants in aid given to left-wing sporting clubs in the Solos area by the local co-operative society are not materially less than those given to sporting clubs controlled by the right.<sup>339</sup>

But the same kind of patron-client theoretical analysis that explains the over-powers of some Secretaries can also be used to explain the over-powers of some committee members. In fact the analysis in the two case-studies of Solos co-operative credit society and the Pas Co-operative Savings bank could run in exactly the same way. In the case of Pas the agent vested with all the power, due to his ability to exploit his patronage status is the president of the Committee where as in the case of Solos it is the Secretary. In both instances patronage power is concentrated in the hands of a specific agent who is able to use it in order to acquire and maintain full control over the activities of the co-operative through his influence over the decisions of the committee. The personality of the agents involved plays an important role. The law

<sup>337</sup> L. Graziano, Patron-client relationships in southern Italy, in Schmidt, Scott, Lande, Guasti(eds.), 1977, p365.

<sup>338</sup> Solos co-operative credit society, Payroll records.

<sup>339</sup> Solos co-operative credit society, List of grants in aid for the years 1990-1995.

favours the president or other members of the committee provided they are in a position to take full advantage of their rights. Where the president and the rest of the committee members are of weaker personality to the Secretary, he may appear to be the real leader and therefore all patronage power is vested in him. This typifies the situation at the Solos Co-operative Credit Society where the Secretary completely overshadows the members of the committee. These members are in fact selected by the Secretary and not surprisingly they are selected exactly because they are persons of weaker personality and lower educational status than him.

The story of the Liol Co-operative Savings Bank is rather different. A certain amount of patronage power is still seen to be vested in the members of the committee and the Secretary, however it is not the main factor during committee election time. Nominations for the committee as well as a number of important strategic decisions of the co-operative are made at party level. One example of the controlling influence of AKEL, the communist party of Cyprus, over the nominations for the committee was the replacement of the president in 1993, a communist ex-member of the House of Representatives, when he fell out with the leadership of the party.

But nowhere is AKEL's powers to interfere in co-operative affairs better illustrated than in the case of Gera co-operative.

#### **6.4.2.1 Gera co-operative credit society**

Until the war of 1974 Gera was still a small village of less than 1000 situated at the outskirts of the city of Limassol and the main occupation of its inhabitants until then was farming. The local co-operative was of the multipurpose type, having to service the needs of a mainly agricultural membership in the supply of agricultural fertilisers and other equipment, in the provision of short-term credit and in the marketing of their products.

During the post-1974 national economic reconstruction effort tourism was the sector most heavily invested in. Gera's location was ideal. The village was only a few kilometres from the sea but its geographical boundaries extended to the coast. Land

prices went up as well as income from tourism. For the majority of the population farming was no longer worth the effort. Instead, easy money could be made by converting farmland into areas for tourists. Citrus growers became hotel and tourist apartment owners. The less fortunate ones with no land near the tourist development area became waiters or small souvenir shop owners on rented premises. Gera was no longer a small village but instead one of the suburbs of Limassol with its economic life now depending mainly on tourism.

By the mid 1980s the number of members of the local co-operative still registering farming as their main occupation was only a handful. Similarly, loans for agricultural purposes became negligible as a percentage of total loans. These were spread evenly between residential housing loans and tourism property development.

The above changes meant a significant increase in the population of Gera. New residents came both from the northern occupied part of Cyprus but also from poorer unoccupied areas seeking jobs in the tourist industry. During the ten years transition period the population more than doubled. As a result the large majority of AKEL was cut down to less than 50%.

Party headquarters could now clearly see that control of the local co-operative in the long-run could only be safeguarded through the usual tactics of political party screening of new members and new employees. Contrary however to what was happening in the majority of cases of co-operatives under left-wing control, the Secretary was in a position of absolute control over the decision-making process of the co-operative taking advantage of both the amount of patronage he had acquired as a result of his capacity as officer of the co-operative but also the trust shown in him by the five members of the committee due to personal relationships, friendship and inability to understand the business of the co-operative.

The first serious challenge to party control came in 1992 when the committee, at the instigation of the Secretary appointed a right-winger as the accountant of the co-operative. The recruitment monopoly of the party was violated for the first time. A few years later a new violation of a similar nature occurred, again at the instigation of the

Secretary and contrary to party guidelines. What is more, the Secretary and the committee failed to exercise party screening on new loan applicants.

At the 1996 committee elections AKEL withdrew its support from the existing members on the pretext that they had allowed the Secretary to mismanage the affairs of the society.<sup>340</sup> The replacements were hard-line party supporters who made it their business to “put things right.” The result was that both the Secretary and the accountant were sent home a few months later on the pretext of serious liquidity problems. Meanwhile at their request the Registrar arranged for a special investigation in the financial affairs of the society.<sup>341</sup> The report prepared by the investigating committee strongly criticised the previous management for allowing the liquidity of the society to fall very low. However, the report does not contain any hints of misappropriation of funds.<sup>342</sup>

But cash flow mismanagement was definitely not unique to the Gera society. And yet no other Secretary or employee were removed on this pretext. A brief look at the Annual Report of the Co-operative Societies Audit Service to the House of Representatives will show that mismanagement of the kind reported by the investigating committee at Gera was a phenomenon common to a number of societies throughout the co-operative movement and not just to Gera.

But the Gera story becomes even more interesting at the stage when a replacement was sought for the dismissed Secretary. From the beginning it was clear that the new Secretary would be an AKEL member. The vacancy was announced in the daily press, although it was common knowledge that the replacement was already found. The new Secretary was not local and what is more, he was tried as Secretary in another co-operative society two years earlier, after having been made redundant by a third co-operative and failed dismally. On that occasion local public outcry together with

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<sup>340</sup> Interview with Mr. K. Nicodes, member of AKEL's Central Committee.

<sup>341</sup> Memo sent by the Assistant Registrar of Co-operative Societies to the Director of the Co-operative Societies Audit Service, Nicosia, 30 October 1996. The investigation started officially on the 2 November 1996.

<sup>342</sup> Interview with the Head of the Investigation Committee, Mr. Serades, 25 November 1996.

dissension among local party activists forced party headquarters to accept his replacement.

### 6.5 The rationale of varying degrees of political party involvement

There is a general tendency to criticise politicians' involvement in the affairs of co-operatives and the facts of the Gera case can explain why. So far this criticism in existing academic literature has mainly concentrated on the role of politicians as agents of the state, ignoring the effects of political party involvement. The analysis that is required in this respect clearly differs to the one that relates to state agents although in both cases the theory of patrons-clients can be used as a very useful analytical tool.

Political neutrality is one of the widely accepted principles of co-operation. Yet there are many examples where this principle is not upheld. Experience shows that co-operatives can fall into any political camp. Fairbairn explains that co-operation in general is not party political in the sense that only one political philosophy fits with it, but according to political and social conditions, circumstances can arise in which it is inevitable that a given group's co-operation acquires political overtones, and the nature of those overtones depends on the group and its role in society.<sup>343</sup>

In the case of Cyprus the vast majority of co-operative committees get elected with the backing of one or more political parties. Party involvement in co-operative committee elections should not come as a surprise bearing in mind the amount of patronage power vested in a few co-operative agents. Politicians realise the importance of a co-operative network that covers nearly every single village and town in Cyprus. Members of the department of co-operative development and the audit department can still remember the days when their boss, Andreas Azinas, used to send them out in the countryside during every pre-election period in order to convince secretaries to work in favour of specific candidates at the national elections, both Presidential and for the House of Representatives.<sup>344</sup> Such actions by a state bureaucrat are in line with

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<sup>343</sup> B. Fairbairn, Co-operation as Politics, in M. E. Fulton(ed.), 1990, pp129-136.

<sup>344</sup> Interviews held with a large number of officials in the two departments.

Walter's observation that politicisation of economic decisions confers even more widespread power of patronage on the bureaucrat than it does on the politician.<sup>345</sup>

Such state agent electoral interference through co-operative agents may partly explain why in the case of co-operatives controlled by the left, the powers of patronage of committee members and Secretaries are usually overshadowed by the powers of the party. AKEL would certainly not be expected to sit back idle while risking the loss of any number of votes due to the electioneering activities of an all-powerful, among Secretaries at least, fanatically anticommunist Commissioner of co-operative development. Smith points out that bureaucrats who influence the determination and implementation of policy cannot isolate themselves from ideological inclinations.<sup>346</sup> This may also explain why in the case of co-operatives controlled by the right, powers of patronage lay clearly with management. Right-wing leaders knew all too well that any state agent political interference would most probably favour some candidates among their own numbers and in fact, depending on the strength of the patron-client relationship, even some left-wing voters might be convinced to vote right. It was therefore not considered necessary to spend any serious amount of time or energy interfering with the affairs of co-operatives controlled by their own supporters. Such a hands-off approach had the added advantage that the risk of displeasing some of their own supporters that failed to secure a seat on the committee was avoided. There were after all only five such seats per co-operative.

The above analysis tries to offer a plausible explanation as to why co-operatives controlled by the left presented such a different power distribution pattern as compared to co-operatives controlled by the right. It is an attempt to escape from the oversimplification of traditional patterns of reasoning which relate to internal organisational structures of the traditional left as compared to the right. But the analysis of the institutional and organisational framework of the co-operative function can not be considered even partially complete unless the subject of membership participation is dealt with.

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<sup>345</sup> A. A. Walters, *The politicisation of economic decisions*, London. 1973, p3.

<sup>346</sup> Smith, 1988, pp33-34.

## 6.6 Member participation

Vyas considers member participation a function of four key elements; first, willingness of members to participate and the free rider problem; second, access to the right information; third, capacity to participate and level of education and fourth, effectiveness of participation. He, like other writers notes that members of co-operatives in both developing and developed countries are increasingly showing signs of general apathy towards their co-operatives' affairs.<sup>347</sup>

Literature on co-operation appears to be in general agreement with Vyas's analysis of the function of member participation as well as with his observations of general member apathy. Laidlaw for example, outlining the state of the world movement at the end of the 1970s, found that commitment by members was declining along with their participation as a result of lack of members' education.<sup>348</sup> Ostegaard and Halsey suggest that members' loss of interest is the result of their realisation that they are powerless to influence the organisation.<sup>349</sup> A number of measures are suggested in order to get rid of the apathy syndrome like for example the dismantling of large co-operatives and their replacement with smaller ones, put forward by the ICA Congress in Moscow in 1981.<sup>350</sup>

However there appears to be an overall defeatist attitude about the possibility of reversing the general trend. Machinek for example explains how the acceleration in the dynamics of the environment and the pressure of innovation it produces, meets with limited capacity to process information among the members. They have to relinquish the innovational and informational function to the management of the co-operative and, with time, are no longer in a position to participate in the decisions of the co-operative. He concludes that the growth of co-operatives make it more difficult for individual members to participate, even in the traditional type of co-operative.<sup>351</sup>

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<sup>347</sup> V. S. Vyas, in Dulfer, Hamm(eds.), 1985, pp235-237.

<sup>348</sup> Craig, 1993, p39.

<sup>349</sup> G. N. Ostegaard and A. H. Halsey, **Power in co-operatives: A study of democratic control in British retail societies**, Oxford, 1965, p100.

<sup>350</sup> P. Verrucoli, **Observations on members rights to information within the framework of a co-operative democracy**, in Dulfer, Hamm(eds.), 1985, p391.

<sup>351</sup> M. Machinek, **Member participation, innovation and information in the rural co-operatives in Bolivia**, in Dulfer, Hamm(eds.), 1985, p385.

Regarding the suggestion to dismantle larger co-operatives into smaller units Laidlaw notes that the road of co-operative history is strewn with the wreckages of innumerable small societies of dubious business viability, with weak management and dominated by local leaders with a selfish interest for keeping them small and ineffective. He supports the idea of large primary societies of the multi-purpose type, with emphasis on efficient management and economic viability coupled with strong regional or national federations.<sup>352</sup>

Discussing problems of member participation at different stages of co-operative development, Furstenberg attempts to explain how the multi-tiered organisational structure of co-operatives created a progressive functional differentiation and distribution of power, that in turn led to an essential change in member roles. He puts forward the theory that because of profitability as a result of the integration of the co-operative into modern economic society, this has only led to partial membership integration, based on calculations of profit and usefulness, as well as to bureaucratised organisations. Furstenberg notes that in most countries with successful co-operative development this phase has, at least partially, already been reached. It is characterised by growing tensions between increasing organisational efficiency and stagnating, if not diminishing, member integration and he refers to poor general meeting attendance and participation to prove his point. He also refers to Patera's observation that the literature on co-operatives has long been occupied with the increasing amount of apathy shown by co-operative members.<sup>353</sup>

Member participation may be thought of as a direct function of expected returns from such participation. This approach is perfectly consistent with Adam Smith's proposition that society consists of discrete, self-interested individuals.<sup>354</sup> These returns need not however be just in the form of monetary gains but may also any other non-monetary form. Expected returns from participation refer to the benefits obtained from being actively involved in the decision-making process and general affairs of the co-

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<sup>352</sup> A. F. Laidlaw, *The mobilisation of human resources for rural development through agricultural co-operatives*, in Andreou(ed.), 1977, p9.

<sup>353</sup> F. Furstenberg, *Problems of member participation at different stages of co-operative development*, in Dulfer, Hamm(eds.), 1985, pp 110-111.

<sup>354</sup> Staley, Oxford, 1991, p42.

operative and not just the benefits from doing business with the co-operative. One indication of member participation is, for example, attendance at general meetings. Where individual returns from participation are expected to be nil, apathy will be preferred to active involvement as personal time spent carries a certain opportunity cost. This may explain why it is generally believed that the larger the organisation the less the participation, at least with respect to general meeting attendance. The ability of each member to influence the decision making process of a co-operative organisation when members carry one vote each, is an inverse function of the size of the organisation. On the other hand, expected returns from participation are supposed to be a direct function of this ability. Therefore member participation may be defined in terms of the perceived ability to influence the decision-making process of a co-operative organisation and also in terms of the size of the organisation.

If it is assumed to be an inverse function of size, as the organisation grows bigger there will come a point when individual members will no longer have a voice of any significance in the affairs of the co-operative. This is the reason why some writers on co-operation, being in favour of active member participation, suggest the dismantling of large co-operative organisations into smaller units. And yet experience has shown that in a fully competitive market environment small co-operative units could not survive and had to merge into much larger organisations, mainly in order to take advantage of economies of scale.

If it is also assumed that success is usually accompanied by an expansion in the scale of activities of the co-operative then member participation has to be an inverse function of success. Such a conclusion would contradict a large volume of co-operative literature but would be consistent with Kleer's view that a large measure of participation tends to limit the rapidness of economic expansion of a co-operative due to the short-term benefit horizon of members as opposed to the long-term benefit horizon more appropriate in the case of the co-operative organisation.<sup>355</sup> Kleer's view contradicts the stand taken by most writers on co-operation that success is a direct function, among other variables, of member participation.

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<sup>355</sup> J. Kleer, The co-operative system - between participation and growth, in Dulfer, Hamm(eds.), 1985, p372.

Assuming that membership participation is an equivalent to general meeting attendance, the expected returns theory can be given some support on the basis of empirical findings from a number of annual general meetings in Cyprus. Many co-operative officials nowadays are well aware that if they want a large turnout they must promise members a small gift on attendance whose value usually does not exceed CYP15. This policy has been followed by the Solos Credit Society with a significant amount of success and later copied by a number of other co-operatives. In the case of Solos for example, with a total of 25000 members, an attendance of 2000 is considered the norm.<sup>356</sup> In contrast, general meetings of neighbouring Laka Credit Society with a similar membership base, but without the promise of a gift, do not usually attract more than a few hundred.

The Solos and Laka examples show that at least one form of member participation can be bought at a price. It should be noted however that in both instances partisan politics take a backstage. Thing begin to change once partisan politics are introduced as another variable in the member participation function.

Assuming general meeting attendance to be a fair measure of member participation empirical evidence from Cyprus would suggest that political party involvement affects positively such attendance. Co-operatives with no real political party affiliations like the Civil Servants Co-operative Savings Bank experience very low turnouts. Complaints are commonly made by the Secretaries of a number of these co-operatives that on some occasions even members of the committee fail to turn up at annual general meetings.

Co-operatives with political party affiliations, either on the left or the right, appear to enjoy higher rates of general meeting attendance than politically neutral co-operatives. Co-operatives controlled by the left generally appear to enjoy higher rates of turnouts than those controlled by the right. In the Famagusta area for example the villages of Frenos and Dynia are well known communist strongholds. Each year at the annual

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<sup>356</sup> Interview with the Secretary of the Solos Co-operative Credit Society in 1995.

general meeting of the local co-operatives well over 50% of the membership are present. In the two neighbouring villages of Sora and Litri, both under the control of right-wing committees, turnouts at the annual general meetings are well below 10%.<sup>357</sup>

Craig's analysis may be used to explain these phenomena; Assuming co-operatives to be part of a social movement Craig explains how membership is generally based on personal identification with the cause and values of a social movement, and how individuals may decide to formalise their commitment for a number of reasons. Joining the movement may be expedient, or it may be the path of least resistance in a pressure situation; or the individual may be convinced of the absolute rightness of the purpose of the movement and may join out of a sense of duty or responsibility. Because of these differences in motivation, Craig believes that in any social movement there will be members who are active and enthusiastic supporters and members who are passive. He proposes that a movement to be successful must reflect values and practices that will satisfy the expectations of both groups. The values of a social movement, according to Craig, influence the structures that link its members and provide a framework for action. For example, social movements that place a high value on equality and participation establish structures that permit and encourage member involvement in decision-making.<sup>358</sup>

Political party affiliation provides the means for personal identification by members in accordance with Craig's analysis. The fact that left-wing controlled co-operatives enjoy a higher level of participation than right-wing controlled co-operatives is also consistent with Craig's proposition on equality and participation as there is a tendency on the left to attach more importance on such values. In his study of patterns of politics and kinship in a Greek Cypriot village Cassia explains how supporters of the left thought they possessed an ideological monopoly over the whole concept of co-operation.<sup>359</sup> Assuming validity of the earlier analysis of AKEL's more active involvement in the affairs of co-operatives and bearing in mind that such involvement

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<sup>357</sup> The facts regarding the specific co-operatives are based on the members' attendance registers. General observations are based on the writer's own experiences from annual general meetings.

<sup>358</sup> Craig, 1993, pp20-21.

<sup>359</sup> P. S. Cassia, **Patterns of politics and kinship in a Greek-Cypriot community: 1920-1980**, Ph.D thesis in Social Anthropology, University of Cambridge, 1981, pp221-222.

takes place through a very well organised system of local groups of party activists, the envy of all other political groups in Cyprus, it is considered natural that a greater number of members will be informed about the affairs of the local co-operative and therefore elect to participate.

Axworthy looks at the problem of participation from a legalistic point of view. He notes that co-operatives and corporations share the same legislated structure, even though they espouse different models of democratic theory. The basic premise on which the law is based is supposed to be that the members surrender virtually all of their management powers to the directors when they elect them. Axworthy finds it disturbing that members of co-operatives are essentially powerless to affect the direction of their co-operative. Axworthy concludes that claims by co-operatives of democratic organisational structures are a great myth.<sup>360</sup>

Political party involvement may offer a solution to Axworthy's reservations about the possibility of member participation. Provided political parties have a strong say in the management of a co-operative, members may try to influence specific management decisions via the party they are affiliated to. Political party involvement may therefore turn the myth into reality.

The last unresolved problem relates to fears that a co-operative with specific political party affiliation may exclude a large number of potential members from joining. It is fears such as this that prompt local party agents to opt for committees on which at least the two biggest parties are represented. In the case of a large number of co-operatives it is no longer considered necessary by the largest local party to elect all five members on the committee. It is realised that effective control can be exercised even if only three of the five are affiliated to the party as decisions can be taken by the majority rule. By giving away the remaining two seats to representatives of other political affiliations the co-operative may further grow in size and this can only be to the benefit of all community members irrespective of political affiliation, provided growth and economic efficiency are positively related.

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<sup>360</sup> Axworthy, *Myth and reality*, in Fulton(ed.), 1990, pp56-59.

Once the important role of partisan politics in the member participation function has been established it is necessary to explore any further advantages of such politics in co-operative affairs.

### **6.7 Further advantages of political party involvement**

There are at least three further positive contributions that political party involvement can make towards co-operative success. The first relates to the theory of co-operative success as a function of accountability, the second relates to member loyalty and the third relates to the ability of the movement to act as a pressure group.

#### **6.7.1 Partisan politics and accountability**

Where a local co-operative is controlled by a specific political group, opposing political groups will be on the look-out for a sign of mismanagement in order to score some political points. This is part of the political game and makes controlling parties watch their footsteps.

The easiest way for the opponents to detect any signs of mismanagement is through active participation and a careful screening of all published information. They are greatly aided in this by the provisions of the relevant legislation that the auditors' report, both regarding the truth and fairness of the financial statements but also regarding sound management practices, must to be read at the Annual General Meeting of the members of the co-operative.

Provided a truly independent audit takes place, members of the existing committee and professional management know all too well that not only deviations from bona fide lines of action will be reported to the members but also any unsound business practices due either to incompetence or political expediencies. A very good example is what happened in the Nicosia suburb of Aglandjia during the last municipal elections.

#### **6.7.1.1 Agla Co-operative Credit Society**

This is another instance of an agricultural village turning into a city suburb following the large population movement of 1974. The local co-operative duly transformed, its main business now being the provision of housing loans instead of agricultural credit.

All five members on the committee are AKEL appointees since traditionally Agla has been an AKEL stronghold area. Following three consecutive terms in office the president of the co-operative managed to get elected as Mayor of Agla for the first time in 1987, despite the fact that the right had a marginal majority in the municipality, taking full advantage of the patronage status associated with his post as president of the co-operative. In the two subsequent elections that followed, in 1992 and 1997 he has retained his office as mayor and each time with an increased majority. Characteristically in the 1997 elections he won 60% of the vote despite the fact that AKEL in the last Parliamentary elections of 1996 won less than 40% of the vote.

The municipal election campaign of 1997 of the right-wing opposition was not based on any specific policy issues but rather concentrated on the activities of the mayor as president of the local co-operative. He was publicly accused of using co-operative funds to finance municipal projects only a short period before the elections so as to win support among the electorate.

The above criticism was based on a report by the Audit Service that during 1996 the co-operative donated the amount of £50,000 towards the cost of construction of a hospital in the municipality which was the property of the municipal authorities. This amount exceeded by far the legal maximum of 7.5% of net profit by £35000. In order to get round this problem the co-operative financial statements were cooked in such a way that the amount of the donation was presented as cost of advertising rather than donation and was spread over two years, 1996 and 1997. This could hardly fool the auditors who disagreed with the treatment and mentioned their disagreement in their annual report.<sup>361</sup>

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<sup>361</sup> Co-operative Societies Audit Service, *Annual Report on the 1996 financial statements of Agla Co-operative Credit Society*, Nicosia, 1997.

Undoubtedly the 60% share of the vote won by the mayor was a big triumph and may play down the effectiveness of the propaganda campaign of the opposition using the co-operative argument as the spearhead of their campaign. However, even members of the mayor's campaign team admit that had there been a better opponent than the one presented by the opposition things would not have been so easy for the mayor. They also admit that since the co-operative donation affair his image suffered and this subsequently made him and the rest of the committee extremely sensitive on co-operative legal compliance issues. He got a first hand experience of the possible repercussions of being held accountable.

Had the president of the co-operative and the rest of the committee not been politically coloured it is doubtful whether the report of the auditors would gain so much publicity and attention. After all, the money was spent for a very good cause. Partisan politics however blew the whole affair out of proportion and for a whole month figured on all TV and radio election programmes.

#### **6.7.2 Partisan politics and member loyalty**

The second contribution relates to loyalty of members and the avoidance of co-operative failures due to free rider problems, especially in the case of large groups. Olson predicts that in a large group in which no single individual's contribution makes a perceptible difference to the group as a whole, or the burden or benefit of any single member of the group, it is certain that a collective good will not be provided unless there is coercion or some outside inducement that will lead the members of the large group to act in their common interest.<sup>362</sup>

Political party involvement provides such outside inducement. Empirical evidence from Cyprus would suggest that a number of large villages retail co-operatives were doomed to failure had it not been for the party loyalty of their members. In these villages there is usually a small number of privately owned grocery shops which are in competition to the local co-operative shop. Economies of scale would not allow more than a few shops to exist at a no loss-making position. It is generally recognised that

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<sup>362</sup> Olson, 1971, p44.

privately owned retail shops are run far more efficiently than co-operative stores due mainly to the fact that they do not employ salaried staff other than members of the owners' family, work longer hours than the co-operative store and do not suffer from malpractice as in the case of a great number of co-operative stores.<sup>363</sup> Due to lower costs the private competitors are usually in a position to charge lower prices in an attempt to attract business away from the co-operative.

In a number of cases the obvious thing happened with co-operative stores being liquidated. Yet in some cases where the co-operative store had strong connections with one of the political parties, members remained loyal due mainly to party allegiances. Closing down the store is seen as party failure.

Empirical evidence suggests that nearly all instances where co-operative stores still manage to survive despite competitive disadvantages members are left-wing supporters. The analysis of such member behaviour in relation to their party allegiances should follow a similar pattern to the one on member participation.

The question that naturally arises in cases such as the above is whether the sustenance of a non-efficient economic institution is warranted even if it means the survival of this institution. Avoiding any ethical issues involved there is a simple logical argument in favour of such survival, especially where the area of operations of the co-operative store is distant from any of the urban centres where the retailing market can safely be described as saturated.

The essence of this argument is that the local co-operative store acts as a preventive measure against the formation of monopolies or oligopolies by the local private retailers. This state of the market would most certainly mean the transfer of economic surplus from the consumer to the supplier. The overall economic surplus may be greater in a situation where the co-operative store vanishes, however the distribution of this surplus is bound to alter in the direction of the private monopolist or oligopolist. Although subjectivity is still present in this line of argument the fact remains that in

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<sup>363</sup> Co-operative Societies Audit Service, *Annual Report for the year 1995*, Nicosia, 1997.

such a state of the market previous members of the co-operative will now see prices rise and therefore feel the effects of the transfer of economic surplus away from them into the pockets of the private traders. The subjectivity element relates to the scale of price rises once the private traders gain their new position. The scale of these rises is assumed to be directly proportional to the distance between the geographical location of the community and the urban centres.

Subjectivity becomes certainty in the case of the village of Oikos, on the northern part of the Troodos mountains. Following a series of fraudulent activities on the part of the Secretary of the co-operative retail store, uncovered during the 1994 annual audit,<sup>364</sup> the committee decided to sell the store to a private trader, who then became a monopolist. Only a few months after the event inhabitants of the village sent angry messages to both the Co-operative Societies Audit Service and to the Department of Co-operative Development demanding the re-opening of the local co-operative store. The general feeling in the community was that they were being robbed by the new owner of the store due mainly to the fact that he was a monopolist, in a distant village, inhabited mainly by old people without easy access to modern means of transport and therefore finding it extremely difficult to do their shopping from anywhere else.

#### **6.7.3 The co-operative movement as a national pressure group**

A third added positive contribution made by partisan politics to the co-operative function relates to the ability of the co-operative movement to act as a powerful pressure group in the context of overall national policy-making. This is made possible through the double role of a large number of members as co-operative officials as well as party activists.

As already noted a number of national and local politicians are themselves active co-operators either as committee members or as members of staff. Similarly a great number of co-operators are local party activists. This means that all political party sub-committees specialising in co-operative affairs are usually made up of these activists. As political party line is usually determined at sub-committee level it is only natural

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<sup>364</sup> Co-operative Societies Audit Service, *Annual Audit Report on the Financial Statements of Oikos Co-operative retail store for the year 1994*, Nicosia, 1995.

that this will coincide with the line best serving the interests of the co-operative movement. This line is usually expressed by the Pancyprian Co-operative Confederation(PCC), the main representative body of the co-operative movement in Cyprus.

The connection of the co-operative movement with all major parties on the island is clearly demonstrated by the make-up of the committee of the PCC. This committee is made up of nine representatives from primary and non-primary societies. Dreading the consequences of a possible split within the co-operative movement it is standard practice that the Registrar together with the three major parties come to a pre-electoral gentleman's agreement on the make-up of the PCC committee so as to avoid an electoral contest which might leave one or two of these parties outside the committee and thus lead to a withdrawal of a significant number of co-operatives from PCC membership. The end result of this agreement is usually an equal representation for each of the three parties.

A political consensus type arrangement is therefore reached not just as a result of generally accepted standard practice in Cypriot politics but also, as already mentioned above, due to fears about the consequences of a possible split on political party lines. In the event of such a split it is feared that it will no longer be possible to maintain a united front facing the outside world and thus the position of the co-operative movement will be weakened, both with respect to its strength as an important pressure group but also in the face of a fast changing economic environment moving towards market liberalisation. No political party in Cyprus would ever risk carrying the blame for such a split and its consequences as it would amount to being seen going against the interests of a very popular institution. Such a consideration becomes extremely important where the power bases of major parties are not differentiated by any specific class system but are instead mainly remnants of a nationalist past similar to that of Cyprus.<sup>365</sup>

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<sup>365</sup> Loizos, 1975, pp124-127.

The most recent example of the co-operative movement acting as a very powerful pressure group relates to the many failed attempts of the Central Bank of Cyprus and the government of the Republic to change the provisions of the interest rate law of 1944 which stipulates a ceiling rate of 9%. In public, co-operative leaders oppose such a change on the pretext that it will mostly hurt the interests of the working and lower middle classes once interest rates start to move upwards. The true reasons for such opposition have already been explained in chapter 3 and do not concern the current discussion. What is definitely relevant for current discussion purposes is the fact that all political parties, large and small, have repeatedly expressed their sympathy and support for the co-operators' public argumentation, themselves voicing concern over the possible loss of welfare by certain income groups of the population, and refusing to endorse in the House of Representatives the proposed interest rate liberalisation law despite the strong support it carries in most economic sectors other than the co-operative movement.

#### **6.8 Further disadvantages of political party involvement: The ESEL case-study**

Besides the risks of losing members and those associated with a possible split of the co-operative movement, as well as the usual concerns about nepotism, a further major disadvantage accompanies political party involvement, as clearly indicated by empirical evidence from Cyprus. This relates to the possibility that partisan politics within a co-operative take priority over economic efficiency. The results, as can be seen from the ESEL case-study, can be catastrophic.

ESEL is the largest consumer co-operative in Cyprus, based in the town of Limassol, and for a number of years has been one of the largest retailers on the island. From the first day of its registration in 1971 ESEL has been under the control of the left and new membership has traditionally passed through careful party screening. During the 1970s and most of the 1980s when it had a near monopoly of supermarket business in the town of Limassol, ESEL was making reasonable profits following a rapidly expanding turnover. However in the face of growing competition during the late 1980s and 1990s the position was reversed with a steady decrease in profitability following stagnating sales, finally arriving at a loss-making position.

Compared to F. W. Woolworths(Cyprus) Ltd, a private public company in the same line of business, of similar scale of operations and similar gross profit margins it is clear that the problem does not lie in the pricing policies of the organisation. Pricing policies in a near perfectly competitive environment are dictated by the forces of the market leaving no room for management to manoeuvre. The only other two controllable variables in the profit equation are overhead expenses and finance costs. Overhead expenses relate to administrative and selling expenses which consist mainly of employee salary costs. Finance costs depend both on the net cash-flow generated by ordinary operations but also on the investment policy of the organisation. The comparison between ESEL's and Woolworth's income statements show clearly that the main difference lies in overhead expenditure.

A recent feasibility study made by the Audit firm KPMG on behalf of ESEL has shown that over-staffing in all departments is a serious problem facing the organisation, not to mention the high rates of remuneration as compared to rates of pay for similar work in the private sector.<sup>366</sup> High rates of remuneration can be explained mainly by the fact that being a co-operative it does not experience high staff turnovers and therefore salaried employees have on the whole a greater number of years of service than their counterparts in the private sector. A co-operative is not expected to behave in a similar manner to other private businesses where high staff turnovers are encouraged by management as a way to keep costs down. The fact that low staff turnovers are experienced by every single co-operative in Cyprus, with or without political affiliations, makes the political party involvement argument fairly irrelevant in explaining these turnovers. Rates of remuneration can therefore be conveniently ignored for the purposes of the current discussion on political party involvement and efficiency as these relate mainly to co-operative attitudes in general. The one remaining variable in the high overhead function therefore is over-staffing.

Recruitment of employees in ESEL has traditionally gone through very careful party screening. Committee members but also appointed managers of the organisation have

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<sup>366</sup> Feasibility Study made by KPMG at the instructions of ESEL LTD, Limassol, 1995.

always been high ranking officials in the communist party AKEL. Especially in the case of the unpaid committee members their allegiances lay first with the party and then with the interests of ESEL, seen to exist merely for the benefit of the party. Such benefit was mainly in the form of providing employment to hundreds of left-wing supporters, some of whom received their education in the former Eastern Block countries, with no hope of proper recognition of their University degrees or other qualifications by other major employers or the government. ESEL therefore became the medium for the satisfaction of AKEL's political clients.

Most recruitment took place in the 1970s and first half of the 1980s when ESEL was still a profitable organisation, in the absence of a very competitive environment in the supermarket business of Limassol. It is an acknowledged fact, even by members of senior management, that on a great number of occasions recruitment was the result of direct instructions by the Central Committee of AKEL without any consideration, either regarding the appropriateness of the qualifications of the new recruits or the need for such recruitment in the first place.<sup>367</sup> The costs of over-staffing could be absorbed for as long as ESEL was in a monopolistic position in the supermarket business of Limassol. However once competition became acute, seriously constraining pricing policies and turnover volumes, rising costs could not be met by rising revenues. The result was the current loss-making position of ESEL. In 1996 these losses amounted to Cy£1.5 million, part of which related to redundancy payments.<sup>368</sup>

In view of the rapidly deteriorating economic situation of ESEL the leadership of AKEL, even at a late stage, some say too late, took the political decision that jobs must be shed if the organisation is to survive.<sup>369</sup> Until the end of 1996 at least 200 of the 700 employees were made redundant. More of these redundancies are expected in the near future.<sup>370</sup>

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<sup>367</sup> Several interviews conducted with the assistant general manager of ESEL during the period 1992-1996.

<sup>368</sup> As per the unaudited financial statements of ESEL for 1996.

<sup>369</sup> Interview with the head of AKEL's economic research division in December 1996.

<sup>370</sup> Interview with the financial controller of ESEL in February 1997.

The thoughtless policy of patronage without paying due respect to the business efficiency side of things led to the backfiring of this policy as clients made redundant have now turned against their earlier patrons. This is where the right, with its complete hold over public and semi-public organisations, financed through the tax system of the state, has never faced the risk of its patronage activities backfiring. Co-operatives on the other hand cannot use patronage in a similar way as there are serious business constraints. Had such constraints been taken into consideration ESEL would have now been in a very different position, especially bearing in mind the high degree of loyalty of its 25000 members and many other non-member customers who will shop from nowhere else due to their political party loyalty.

## 6.9 Conclusion

A serious case has been made in this chapter against the logic of a very important principle of co-operation, that of political neutrality. The co-operative type of association gives rise to patron-client type relationships between co-operative agents and members. Such a relationship can be established whether real power lies with individual co-operative agents or whether it lies with a specific political party. However due to the fact that a greater number of agents are involved in the case of party involvement than otherwise, this is considered far more desirable especially from an accountability point of view. It also appears consistent with Max Weber's first and fourth mechanisms mentioned earlier. Bureaucracy in this case can either be the state or the management of the co-operative.

But other considerations also argue in favour of political party involvement like members' loyalty and the ability of the co-operative movement to act as an important pressure group, on a national level, protecting its own interests. In a pluralistic political system, party involvement is also a fair substitute for membership participation. The loss in the strength of the voice of individual members due to scale of operations can be replaced by political party agents' involvement in the affairs of co-operatives. These agents are seen to be an extension of each and every one of their supporters depending on the degree of their political accountability.

One of the major contributions of political party involvement in co-operative success, as proposed earlier, relates to accountability. The question that naturally then arises is why, if such is the case, the co-operative movement in the late 1970s came so close to economic destruction. The answer lies in the facts of the case itself. As has already been stressed it was the ability of the Registrar to act through non-primary co-operatives, away from political party vigilance and in the absence of a truly independent Audit Service that enabled him to act in the way that he did. The fact that primary societies were also affected by the Azinas affair was a result of the inter-sectoral linkage properties of the co-operative function.

But political party involvement is not always to the benefit of co-operatives. The facts of a specific case-study have been examined to show how the behaviour of a political party with respect to satisfying its political clients can lead a co-operative close to destruction. The natural question that arises relates to the ability of an independent audit and the powers of supervision of the Registrar to put a stop to such thoughtless behaviour. The answer to this question also lies in the facts of the case-study. There was no need for any external agent to put a stop to such behaviour. This role was assumed by market forces.

## CHAPTER SEVEN: THE CO-OPERATIVE FUNCTION IN PERSPECTIVE

### 7.1 Introduction

The analysis of empirical evidence from Cyprus has established the need to reconsider a number of earlier assumptions and propositions about the co-operative function, especially in relation to the behavioural characteristics of some of its variables. Some of these characteristics have either been ignored so far or taken for granted, both from an empirical but also from a theoretical perspective.

During the preliminary stages of writing this thesis a review of existing literature was considered necessary. It did not take long however to realise that masses of volumes were preoccupied with promoting what is considered an ideology rather than attempting a critical evaluation and analysis of the issues involved. A significant number of writings seem no more than a descriptive account of the stories of either individual co-operatives or national co-operative movements. Others attempt to explain the large number of failures recorded in the developing part of the world either through the language of business administration or through associating such failure with state attempts to keep co-operative institutions under control. The approach on most occasions is technical and the recommendations by different writers look more like consultants' reports rather than anything resembling academic research.

Of course there are the exceptions although most academic work seems to have concentrated on business organisational aspects ignoring a number of other very important issues like the potential of co-operation to act as a mechanism for macro-economic development, those forces inherent in government action that may affect positively or negatively the co-operative function, and co-operation as a function of political party involvement.

## 7.2 Valenti and Emelianoff revisited

Valenti's analysis of the co-operative function as a treatment to natural imperfections of the distribution of wealth has led students of co-operation like Mariani to believe that co-operation is capable to a certain degree of softening and abbreviating social conflicts which result from economic differentiation. Valenti's insistence however on recognising the co-operative character of those associations only, which in their actual work compete with the capitalistic or speculative enterprises casts certain doubts on the overall validity underlying his theoretical exposition. And yet nearly all attempts at promoting co-operatives in the developing part of the world during the twentieth century are based on these two men's theoretical analysis.

A serious omission in nearly all writings reviewed is failure to take any account of Emelianoff's economic analysis of a co-operative. Although constrained by the static nature of his model it has been found extremely useful from an analytical point of view for the purposes of this thesis. Emelianoff should be thankful to Davidovic, despite this man's abusive manner of criticising his work, as this was one of the very few instances when anyone bothered to pay any attention to his writings.

The reaction to Emelianoff's work and to the man himself would be consistent with the overall ideological attitudes of a great number of writers on co-operation. It is clear in their writings that they are strong co-operative supporters and usually such attitudes are also consistent with socialist political preferences. Emelianoff's strong anti-socialism was well known in the fifties, blamed by Davidovic on the fact that he had run away from his native Russia after the revolution.

The idea of a co-operative as being the aggregate of economic units and not an enterprise or an economic unit proves to be extremely important in a number of respects, especially if the model is not constrained to economic theory only. Applying this idea in explaining behavioural characteristics of the co-operative function helps to clear a number of misunderstandings regarding the relation between this function and some of its variables.

The first such misunderstanding relates to the definition of a successful co-operative. The traditional method of measurement assumes the co-operative to be an enterprise whose main objective is other than profit, what ever this may be. And yet success is recognised on the basis of parameters like volumes of transactions and numbers of members. Both of these are important variables in the profit equation of any enterprise, co-operative or otherwise. Once the Rochdale principle of sale at market prices is included in the equation no other difference remains between a co-operative organisation and a capitalist organisation except that any profits, instead of being accrued to the providers of capital accrue to the customers on the basis of the amount of their purchases. All that is happening therefore, at least in the case of consumer co-operatives, is a transfer of economic surplus from the capitalist to the consumer. Similarly in the case of an agricultural co-operative there is a transfer of economic surplus from the capitalist to the agriculturist, and in the case of a producer co-operative from the capitalist to the agents of production.

As the overriding criterion underlying the above theoretical framework is the transfer of economic surplus from the capitalist to the members of the co-operative it is no surprise that Valenti only recognised the co-operative character of associations which in their actual work compete with the capitalistic enterprise. In the absence of the capitalistic enterprise there was no possibility of a transfer of economic surplus.

Emelianoff however, admittedly over-exaggerating, suggested that in the majority of cases co-operatives are not operating in the same market as other capitalistic enterprises. He then explained how the main characteristic of a co-operative was the attempt by each individual member household to maximise its own utility. The co-operative itself was not an economic unit and treating it as such would lead to very erroneous conclusions.

### 7.2.1 Redefining the co-operative function

It is proposed that co-operation acts as a counterweight to market imperfections caused by a number of transaction costs, both inherent and exogenous to the market. This proposition is consistent with Valenti's and Mariani's theoretical expositions in as far as the co-operative will act to eliminate any abnormal profits. However it also includes those co-operatives that act as a counterweight to market imperfections that previously prevented any amount of exchange due to market failure. A typical example from the history of co-operation in Cyprus includes the supply of residential housing credit during the construction boom of 1976-1981. For a co-operative function to exist therefore there is no need for a transfer of economic surplus from the capitalist to the member.

Success or failure of co-operative attempts can therefore be measured in terms of preventing the realisation of abnormal profits in a market but also in terms of overcoming market imperfections which earlier produced complete market failure. The new market position should also be a normal profit position.

This proposition seriously questions standard measures of success or failure of a co-operative attempt. Assuming validity of the theory of an aggregate of economic units it does not follow that maximisation of those units' utility function pre-supposes financial success for the co-operative. Each unit will act independently to maximise its own utility function which does not preclude it from transacting with non-co-operative agents as well as with the co-operative. A position may therefore be reached where a co-operative movement faces dissolution due to poor financial results and yet be considered a success.

The most obvious example of this theoretical prediction is what happened to the co-operative retail consumer movement in Cyprus. The movement flourished initially as it entered into a market where abnormal profits were being made due to various transaction costs like poor transport facilities and limited information, as well as

linkage to the unofficial credit market. The success of the consumer movement lay in the fact that abnormal profits were soon to be eliminated and competition facilitated through de-linking the retail market from the unofficial credit market. During the adjustment period of their private competitors, co-operatives in this sector showed good financial results. Once however the adjustment period was over, problems began to appear due to various inherent disadvantages like high overhead expenses, limited hours of work and fraudulent employee activities.

But the financial failure of the co-operatives in the retail sector did not mean that members in general were worse off. On the contrary, many of them could now enjoy a greater amount of utility if they transacted with the private players in the market than with their co-operative due to transition from monopoly to a situation resembling perfect competition. As the co-operative movement in this sector acted as a catalyst of transition, where a tendency towards normal profits was observed, its overall contribution and role can only be described as successful.

### **7.3 Co-operation as a mechanism for macro-economic development**

The apparent lack of attempts so far to measure the possible contribution of co-operation on a macro-economic level may reflect a widely held opinion, voiced by Hanusch, that co-operation is not an appropriate mechanism for economic development other than at the meso-economic level. This relates to welfare losses due to monopoly, partly accepting Valenti's definition of a co-operative. It is therefore generally assumed that the main objective of any co-operative attempt is to transfer economic surplus from the monopolist agent of exploitation to the exploited. In the context of developing countries the exploited usually refer to the poor agricultural masses. Even at this level however writers like Hanel, Khan and many others often refer to co-operatives' repeated failure so far to service the needs of marginal groups and bring about any structural changes.

Pestoff makes an attempt to measure overall contribution by co-operatives in Sweden, however his efforts stop at the point of recording the number of co-operative employees in each different sector of the Swedish economy and does not look at the

contribution of co-operation as an actor in the process of economic change and development.<sup>371</sup>

Empirical evidence from Cyprus appears to tell a rather different story to co-operative experience in the developing part of the world, even during periods when the economy of the island had all the attributes and characteristics of a developing nation. In two distinctly separate and critical phases of economic development co-operation played a very significant part, not only as a mechanism for market transition but also as an important contributor on a macro-economic level.

The first instance relates to the period from the beginning of the twentieth century until independence in 1960 when the economy was still largely dependent upon small scale farming. Co-operation provided the much needed finance capital, first, to free the peasant farmers from the clutches of the usurers and second, to enable investment in capital intensive projects. Both were pre-conditions before the transition of agriculture could take place which in turn facilitated national economic take-off.

The second phase relates to the post-1974 reconstruction effort following the Turkish invasion of Cyprus which left more than a third of the working population unemployed. Assuming the very important role of construction in this effort, co-operation, being the main source of finance for construction through the provision of housing loans, appears to have played a leading role in the overall reconstruction effort.

A list can now be attempted of the main factors that enabled co-operatives in Cyprus to play such a significant economic role as compared to so many reported failures abroad, especially in the developing part of the world, where economic conditions even today are not very dissimilar to the ones of pre-1960 Cyprus.

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<sup>371</sup> V. A. Pestoff, **Between markets and politics: co-operatives in Sweden**, Colorado, 1991, pp6-7.

#### 7.4 The role of the State

Nearly all writings on state involvement so far relate to developing nations and the established practice of promoting co-operatives that are set up, financed and controlled directly by the state. The end-result of such policy in the great majority of cases is failure to achieve any of the defined objectives which mainly concentrate on social and political integration of marginal groups. This study has classified state involvement into five different behavioural categories analysing each separately.

In the first type the role of the initiator and literacy substitute is assumed by private citizens leaving the state completely outside of the whole process. The very successful Lefkonico experiment in 1909 clearly demonstrates the importance of the literacy substitute to act as a catalyst but at the same time proves the fact that such a catalyst does not need to be a state agent and that no specific co-operative legal framework is needed for the success of the co-operative function. The implementation of such a framework in 1914 clearly failed to produce any significant positive developments to co-operative affairs in Cyprus.

The second type of state input resembles very much the first type only this time the role of the initiator and literacy substitute is played by a state agent who merely acts as an indirect instigator with no state funding and no relevant legislation that would give him supervisory or other controlling powers. The Paphos experiment in 1905 proved this type of state involvement successful. As illiteracy levels in the district of Paphos were very high at the time, Bevan, a state agent was there to fill the literacy gap and act as a catalyst, confirming Dobyns's fourth proposition about engineering successful co-operatives which relates to the need for a quantitative measure of success or failure through a system of accounting so as to prevent fraud, but also gain members' trust and confidence. Once this literacy substitute was removed the first Paphos experiment moved from a point of success to a point of failure.

The third type of state input to be examined was the direct instigation and control of co-operative development using state generated funds. The setting up of a large number of co-operatives throughout Cyprus to become distribution agents of funds to

be supplied by the state-funded Agricultural Bank, set up in 1925, in the hope that such a move would act as an incentive for a co-operative take-off failed miserably in the face of large debt arrears. Loans supplied by these co-operatives were seen by members more like state aid rather than a temporary injection until co-operatives could move to a state of self-funding. Political considerations prevented the government from taking any serious measures to deal with the problem of debt arrears. The end-result of this experiment was in fact the opposite of what was originally hoped for; a large number of pseudo-co-operatives facing serious viability problems before any market re-structuring could take place.

The fourth type of state input relates to co-operatives set up at the instigation of the state without state funds but with an active involvement of the state as a consultant, supervisory and audit agent. Following the dismal failure of the Agricultural Bank experiment a separate government department was set up in 1935 which actively promoted co-operative education, resumed the role of a literacy substitute through its functions of supervision and audit and strongly encouraged co-operatives to use the provisions of relevant legislation in order to collect debts in arrears. The study of relevant economic data has shown this phase to be the most important in the history of the co-operative movement in Cyprus when a real take-off can be said to have taken place.

Finally, the fifth type of state involvement relates to the instigation and control of co-operatives without the use of state funds. This new type of state input is associated with the setting up of a number of non-primary co-operatives at the direct instigation of the Registrar of co-operative societies to act as instruments of economic reconstruction following the catastrophic events of the summer of 1974. The experiment proved to be a complete disaster due mainly to the fraudulent activities of the Registrar himself.

Experience of co-operative activity in developing nations falls mainly under the third type of state input and it should be hardly surprising that failure stories far outnumber success stories. Complete independence from the state is not however a pre-requisite for success, as the above analysis clearly indicates. The real co-operative take-off in

Cyprus only began after the setting-up of a separate government department entrusted with the duties of audit and supervision, i.e. type four.

The need for this type of state input to act as motor to co-operative development under the circumstances of mid-twentieth century Cyprus can only be explained in terms of the functions associated in this thesis with the literacy substitute. These included not only the provision of educated advice on the running of a co-operative but also acting as the main agent of the accountability function. As membership is voluntary and as such membership largely depends on the trust and confidence that members have in those running the co-operative, state agents were conveniently positioned to act as an independent check on the actions of co-operative agents due to the powers entrusted in them by law but also due to public perceptions in Cyprus about state agencies.

Once however such perceptions change, any positive effect associated with the role of state agents as agents of accountability immediately become negative. This may be another explanation why in some developing nations even option four will not mean successful co-operative development. In these countries low literacy levels are definitely an important hindrance to any form of co-operative development for reasons already explained. The state may then be asked to play the literacy substitute, however, if by experience state agents are considered to be corrupt then not even under these circumstances can co-operative attempts be successful.

The above analysis explains on the one hand the many failed co-operative attempts recorded in the developing world as a function of low levels of literacy and on the other hand sends a pessimistic message about the chances of success of any co-operative endeavour under any form of government involvement given the continuing high levels of illiteracy and the significant rates of state corruption and consequent absence of any amount of confidence in state agencies.

Type one which relates to successful co-operative development without any state participation, direct or indirect, partly explains successful co-operative development in Western European nations during the second half of the nineteenth and most part of

the twentieth century. The various historical accounts of co-operative development in this part of the world clearly associate success stories with the names of enlightened co-operative leaders who assumed the role of the literacy substitute.

The fact that the success of the Lefkonico experiment could not spark a general co-operative take-off may be explained in terms of the low literacy levels at the beginning of the century in Cyprus and the unavailability of more literacy substitutes. The politician and professional banker John Economides who acted as the literacy substitute in the case of Lefkonico offered his services on a purely voluntary and part-time base. But besides time constraints, his potential to act as a literacy substitute on a national scale was severely limited both by the envy of his Greek Cypriot opponents in the local political arena, most of whom represented interests not unconnected with the money-lending class, but also by an unfriendly foreign administration who would obviously not be very happy to see one of the nationalist leaders gaining excessive power due to his connection with the co-operative movement.

#### **7.4.1 The transition from literacy substitute to control**

The most significant aspect of type five of state input relates to the fact that under a British colonial type legislative environment, so common even today in many parts of the developing world after independence, the powers entrusted by law to state agents may gradually cause a transition from type four to this type. This is made possible through the existence of non-primary co-operatives and their ability to attract funds from primary co-operatives through the redistributing agents, also of a non-primary nature.

State agents therefore find themselves in a position of absolute control over the information flow in a significant sector of co-operative activity. Provided Rose-Ackerman's extra conditions of secrecy and complicated projects of a capital nature are met, there is a high possibility of corrupt practices on the part of state agents.

It was such practices that brought the co-operative movement of Cyprus close to catastrophe in 1980; not only because of the actual amount of funds misappropriated

or wasted in the process but also because of the potential losses that might have been incurred due to loss in members' confidence. This was the result of activating certain mechanisms as explained by the psychological inter-linkage theory put forward in chapter five of this thesis.

Rose-Ackerman proposes that an informed electorate and a comprehensive set of interest groups must be present in order to provide sufficient protection against corrupt activity; in other words accountability. Rose-Ackerman's proposition can now be seen to be applicable both at the level of co-operatives but also at the level of the literacy substitute.

Empirical evidence from Cyprus during the post-Azinas period would suggest that the functions of accountability and audit, which have been established as extremely important variables of co-operative success, should be completely separated from the functions of supervision. In other words, a complete dichotomy should take place in the functions of the literacy substitute and this can only be achieved through a change in the relevant legislation.

## 7.5 The principle of political neutrality

Even before the time of the Rochdale Pioneers political neutrality was an accepted international principle of co-operation aiming at preventing partisan politics from standing in the way of co-operative business and new membership. At the 1831 Co-operative Congress in Birmingham for example, the pre-Rochdale co-operative movement, possibly reacting to the theological stance of Robert Owen, approved a resolution that read "Whereas the co-operative world contains persons of every religious sect and of every political party, it is resolved that co-operators as such, jointly and severally, are not pledged to any political, religious or irreligious tenets whatsoever; neither those of Mr. Owen, nor of any other individual". But more importantly and of far wider international acceptance was the principle of political neutrality contained in the constitution of the Rochdale Society in 1844.<sup>372</sup>

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<sup>372</sup> A. Bonner, **British Co-operation**, Manchester, 1961, p30, 49.

And yet despite this principle the traditional association of the British co-operative movement with the Labour Party is only too well known, not to mention the establishment of the British Co-operative Party. Bonner points out that although the British co-operative movement in 1936 was the only one with a political party of its own, six other national co-operative movements at the time were reported by the ICA to have relations with socialist parties.<sup>373</sup>

This is another instance where Emelianoff's analysis of a co-operative being the aggregate of economic units can be appropriately revised to explain co-operative behaviour in terms of partisan politics. This time however participating units are not only of an acquisitive nature but also assumed to be politically biased. This theoretical analysis would cast doubts on the ability of a co-operative to remain politically neutral, especially in a country like Cyprus where partisan politics play a very significant role in most areas of social, economic and human exchange including sport, food preferences, the job market and parish church administration.

Emelianoff's analysis can be used to explain why consumer co-operation in Britain has traditionally been associated with the labour movement. After all, membership of consumer co-operatives, the most important form of co-operation in Britain, consisted mainly of members of the working classes. It could also explain why rural credit co-operatives in Italy have traditionally been associated with the Christian Democrats and the Catholic movement.<sup>374</sup> Similarly, it does explain the eventual alliance between consumer co-operatives in Germany, the Social Democratic Party and the trade unions during the post-Marxist revisionist era, despite earlier opposition to this form of co-operation by Lassalle.<sup>375</sup>

But nowhere is the violation of this co-operative principle more evident and perhaps more complex than in Cyprus where partisan politics play a very important role at an individual co-operative level. Co-operatives in Cyprus are treated as important instruments of exchange between parties and political clients but also as convenient

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<sup>373</sup> A. Bonner, 1961, pp308-309.

<sup>374</sup> J. Earle, *The Italian Co-operative Movement*, London, 1986, pp51-52.

<sup>375</sup> W. Hesselbach, *Public, Trade Union and Co-operative Enterprise in Germany*, London, 1976, pp34-41.

means for individual party agents' rise to various public offices at both local and national level. This is the result of patronage power associated with office-holding at individual co-operatives and can also explain many cases of fierce competition, both on a party but also on a personal level, during committee elections.

As political party involvement and competition take place at local co-operative level and as grass-root membership is usually community based rather than social class based, such involvement usually mirrors political party support patterns in the respective locality, again in full compliance with the revised version of Emelianoff's analysis. The majority rule electoral system for co-operatives may therefore lead to a single party's representatives winning all seats on the committee despite the fact that significantly less than half of the community electorate may be that party's supporters. To avoid dissension among supporters of other parties a fair number of pre-electoral gentlemen's agreements are struck before elections so as to include representatives from more than one side. However the number of cases of single party control continues to be large although decreasing.

This form of political party involvement in co-operatives at a local community level appears to be different from the European examples cited already. This can be explained by the fact that whereas co-operative movements in Europe, like political parties, were originally built and subsequently based on specific class systems, in the case of Cyprus co-operatives had to be built and subsequently based on community networks, in the absence of a clearly defined class system. As different communities traditionally presented different patterns of political party support it was only natural that co-operatives would also present similar patterns.

#### **7.5.1 Control structures**

On the basis that control is a function of control over the flow of information Axworthy and Fairbairn assume that co-operative management exhibits the same behaviour characteristics as corporate management where professional management are in real control. This however ignores the possibility of political multiparty involvement as an important variable in the co-operative function. Once this variable is

taken into account control structures appear very different to the ones predicted by traditional management theory.

Although internal political party organisational structures and ideological reasons may be of some relevance in Cyprus, it is mainly historical reasons that determine behavioural characteristics of different political sides in relation to the internal distribution of power and control within co-operatives. Empirical evidence suggests that co-operatives under the control of right-wing parties appear more likely to experience control patterns associated with individual agents and their personal acquisition of patronage power. These agents may be elected officials, like in the case of the Pas Co-operative Savings Bank, or may be members of professional management like in the case of the Solos Co-operative Credit Society. In the case of co-operatives under left-wing influence, control patterns are associated more with the central administration of the party rather than with individual co-operative agents even though such agents are usually nominated by central party administration.

Standard political theory may consider this difference in attitudes perfectly consistent with respective ideological perceptions however the main explanation proposed in this study relates to the historical development of the Cypriot Civil Service as an exclusive territory of the right, at least until very recent times.

As historically the left has been excluded from Civil Service positions state agents are of right-wing ideological inclinations and in fact most of them owe their status to right-wing political party connections. It is common knowledge in Cyprus that to this day, before and during national elections such agents are used by the right for party campaigning. The dependency relationship between private and state agents due to specific provisions in the legislation is nowhere more obvious than in the co-operative movement. Accepting the fact that co-operative agents have the capacity to set up patron-client type relationships with a large number of members of the co-operative it is hardly surprising that the left will not risk allowing too much room for manoeuvre even to co-operative agents considered hard-line party supporters. This is indicative of the importance attached to the amount of patronage power inherent in the co-operative function.

But apart from control patterns within co-operatives, partisan politics also appear to influence observed patterns of member loyalty in accordance with Hirschman's analytical framework.<sup>376</sup>

#### 7.5.2 Exit, voice and loyalty

Hirschman explains how the availability to consumers of the exit option, is characteristic of normal non-perfect competition, where the firm has competitors, but enjoys some latitude as both price-maker and quality-maker. Voice on the other hand, is defined by Hirschman as any attempt at all to change, rather than to escape from, an objectionable state of affairs. This may happen either through individual or collective petition to the management directly in charge, through appeal to a higher authority with the intention of forcing a change in management, or through various types of actions and protests, including those that are meant to mobilise public opinion, when the customer makes an attempt at changing the practices, policies, and outputs of the firm from which one buys or of the organisation to which one belongs. Hirschman then analyses the voice option in terms of exit and explains why the presence of this option can sharply reduce the probability that the voice option will be taken up widely and effectively, as the first to exit are usually the most vocal customers.

In the choice between voice and exit, voice will often lose out unless loyalty helps to redress the balance by raising the cost of exit. Hirschman therefore sees loyalty as a key concept in the battle between exit and voice.

Hirschman's theoretical approach may be employed to explain why co-operatives in Cyprus enjoy such high resistance levels to exit, as clearly demonstrated by the fast rate of recovery in deposits with co-operatives following the Azinas affair. The fast recovery in the rate of increase in deposits with co-operatives in Cyprus following those events was a clear sign that resistance levels to "exit" among members, put to the test during this period, were high.

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<sup>376</sup> A. O. Hirschman, **Exit, Voice and Loyalty**, London, 1970.

Money deposits with co-operatives at the time of the crisis could earn approximately the same rate of interest as those with commercial banks. In other words, commercial banks, always thought to be safe from a depositor's point of view, both due to experience but also due to their connection with the Central Bank, acting as a lender of last resort, were a very close substitute to co-operatives except in the case of small and remote villages where no other banking facilities were offered except those of the local co-operative. Long distances from the nearest commercial banking outlet acted as a serious constraint to exit, however the overall effect under such circumstances could only have been negligible as a percentage of total volume of co-operative banking since the bulk of money deposits with co-operatives belonged to people with very easy access to commercial banking services.

Despite the presence of a close substitute and fears among depositors about the safety of their deposits, high resistance levels to exit can only be explained in terms of their loyalty to the co-operative movement. The existence of such loyalty meant that the majority of members selected the indirect voice option rather than exit. This option took the form of members voicing their concern about the deteriorating state of the co-operative movement and demanding action through their intermediaries with the government of the day and the national legislative body. The intermediaries in question were agents of the various political parties. The result of choosing the voice option was for the government to act again, like in 1974, as a fall-back agent for the co-operative movement but also a new legislative framework aiming to prevent repetition of the events that led to the near destruction of the movement. In other words, the inter-mediation by political party agents enables members of co-operatives to act as a powerful pressure group, especially in view of the fact that nearly all political parties are represented to some extent on some co-operative committees.

Similarly the ESEL case-study clearly illustrates how loyalty to a co-operative, linked to loyalty to a party, may extend the life of an ailing organisation. The voice option in this case is addressed to the management of the co-operative, again through the inter-mediation of political party agents. The need for intermediaries both in the case of ESEL but also in the previous example arises as a result of very large memberships.

But ESEL may also be used as an example where member loyalty may prolong the life of an inefficient organisation operating in a very efficient market. Such inefficiency may be overlooked by members simply on loyalty grounds, as they know it was the result of party decision to use the organisation as a means to satisfy political clients. Whereas inefficiencies produced by political clientelism may be absorbed by credit co-operatives which are still making profits as a result of market imperfections, such inefficiencies can be very costly in a market cleared from nearly all imperfections.

But if political party agents can play the role of intermediaries between members and some higher authority, equally they may be used as a substitute for direct member participation.

### **7.5.3 Member participation**

The subjectivity involved in measuring degrees of member participation does not stop various writers like Vyas, Laidlaw, Ostgaard and others from commenting on the greatly diminished propensity observed of members to participate in the affairs of their own co-operatives. As such participation is explained in terms of ability to influence decision-making and therefore size of membership, some writers even propose the dismantling of large co-operatives into smaller units.

Using the same logic Kleer links success with expansion and therefore with less participation which contrary to the general sentiment he does not consider a serious drawback. Inherent in this analysis must be the idea that management must be left to the professionals.

In the absence of any other effective mechanism of ensuring accountability the role of member participation cannot be ignored. Even however where such a mechanism exists, as in the case of the Co-operative Societies Audit Service in Cyprus, unless members are informed of the results of the audit the effectiveness of this system greatly weakens. It is the knowledge by management that any inappropriate decisions and actions of theirs will be communicated to the members, that acts as a serious constraint

on managerial excesses. Audit reports are usually read at the annual general meetings of co-operatives and therefore expected levels of members' attendance at such meetings is very important.

As participation is a function of access to information, and as access to information pre-supposes attendance at general meetings, any subjectivity involved in using levels of attendance as an indication of the degree of member participation can be safely ignored. The idea therefore that accountability is also a function of member participation makes this concept and the study of variables that affect it extremely important.

Empirical evidence from Cyprus would suggest that member participation in the form of general meeting attendance is not only influenced by the expectation of direct tangible returns from such attendance, in the form of small gifts, but is also very much a function of political party involvement. Further more, levels of attendance also appear to be influenced by which specific political side is in control; co-operatives under left-wing influence for example present higher attendance levels than co-operatives under right-wing control. This observation has already been explained in chapter six in terms of Craig's analysis of co-operatives as part of a social movement and how membership is generally based on personal identification with the cause and values of such a movement.

It is also of interest that co-operatives under both left-wing and right-wing control however present significantly higher attendance levels than co-operatives claiming to be politically neutral. These co-operatives are usually savings banks catering for the needs of various professional groups of government employees like teachers, Civil Servants and members of the police and the army.

One possible explanation for the fact that partisan politics appear to be left out of such organisations may be related to the earlier statement made in this chapter about the historical development of the Civil Service and the exclusion of the left. Their apparent political neutrality may therefore be no more than a cover for the near absence of potential competition from members with left-wing inclinations. On at least three

different occasions when committees of all co-operatives in Cyprus were asked to vote at the general meeting of the Pancyprian Confederation of Co-operative Societies on issues that were politically divisive, the representatives of these organisations had no second thoughts as to where their allegiances laid.

But if the political neutrality argument for these saving banks is rejected then other arguments must be sought in order to explain the very low levels of general meeting attendance and evident member apathy. One possible explanation relates to the close involvement of each respective group's trade union in the management of these co-operatives. On a number of occasions the same persons that are members of the committee of the co-operative are also members of the executive council of the respective trade union. As a result of such close connections members cannot be blamed for thinking of the co-operative as a mere branch of their trade union, leaving its affairs to be handled by their representatives on the union.

This theory, if valid, may offer a possible explanation to the observed member apathy, at least in the case of developed countries where the majority of co-operative movements have close connections with the trade union movements. Where such connection is missing the proposition most likely to explain member apathy relates to the recognition by members of their complete incapacity to have any say in the affairs of the co-operative.

## CHAPTER EIGHT: CONCLUSION

Policy makers but also students of co-operation generally appear to believe that co-operatives may be appropriate policy vehicles for income redistribution among various classes of economic agents but have so far ignored their potential as appropriate mechanisms of macro-economic policy.

The main objective of this thesis has been to test the effectiveness of co-operation as an instrument of macro-economic policy in the context of the modern economic history of Cyprus, identifying and analysing the role of the various economic, social and political factors involved in the co-operative function. This analysis has led to a number of interesting conclusions regarding both the primary objective of the thesis but also in relation to the determinants of co-operative success

A very important conclusion which is also the major contribution of this thesis relates to the role of co-operation in Cyprus as an effective mechanism of macro-economic policy without being too much of a burden on either national or international aid funds, at least during two of the most critical stages of the island's socio-economic development.

The first critical stage relates to the period before 1950 when Cyprus was still very much a rural society with its economy largely dependent upon a very backward agricultural sector. Various reports at the time indicate that the main problem facing agriculturists was heavy indebtedness that prevented any serious amount of capital investment which would have led to higher agricultural efficiency and thus resources being made available to enable transition to the next stage of economic development. This heavy peasant indebtedness was shown in the thesis to be mainly the result of a number of exogenous factors which gave rise to a very inelastic demand for credit thus enabling usurers to implement a policy of near perfect discrimination.

The island's macro-economic development at the time was clearly dependent upon solving the agricultural credit problem. Various state-initiated attempts at solving this

problem through the establishment of an Agricultural Bank, either financed by the organised credit market or financed by the state, ended in failure. In an environment of very high transaction costs and given a rate of interest only a few percentage points above the normal rate, agents of the organised credit market found it more profitable to leave rather than stay in this particular sector. Similarly, state funded attempts through a new Agricultural Bank ended in failure, this time mainly due to the nature of such funding. Loans were perceived by the peasant population to be grants in aid rather than repayable loans. Legally enforcing the original terms of the loan agreements was very difficult for a government under constant nationalist pressure.

Even however in the absence of nationalist pressure the political cost of taking its own citizens to court and selling up their property would be prohibitively high for any government. The experience of the Agricultural Bank in Cyprus explains the difficulty of promoting co-operative development through state capital injections as the success of the scheme depends on the rate of loan repayment.

Once state-funded solutions had been rejected as the answer to the serious agricultural credit problem facing Cyprus a truly co-operative solution was put to the test by the British Administration on the basis of the self-help and mutual aid principles. The state assumed the role of a literacy substitute thus ensuring accountability and also put pressure on co-operative management to collect debts. Debt collection was no longer a direct matter for the state and did not involve state funds. Any monetary losses were to be born by all the members of the co-operative since it was their money that free riders were refusing to return and not state money.

This double role of the colonial government as supervisor and auditor proved a great success and by the time of independence in 1960 the agricultural debt problem had come under control, thus enabling capital investment and modernisation of the agricultural sector that eventually led to the overall macro-economic development of the island. This same double role however later proved catastrophic once handed over to the local elite.

But co-operative development during this period was not limited to the mere provision of credit. Consumer, marketing and other forms of societies were set up following the success of credit societies. The fact that credit societies were the first to take root in rural Cyprus was no accident.

Empirical evidence from Cyprus shows that applying co-operation in different agricultural non-credit markets before tackling the credit market problem first may prove totally ineffective, like in the case of the Pedhoulas cherries marketing society. This is due to market inter-linkage, a problem especially common in agricultural economies. It would appear that access to finance capital is the source of most market abnormalities in a backward small-holder agricultural economy, giving rise to an unofficial credit market, which in turn inhibits the normal operation of all other related markets. In the case-study of Pedhoulas local money-lenders, who also controlled the marketing of cherries, succeeded in stopping attempts by local people to set up a marketing society by threatening to call in all outstanding debts. Once however the local credit society was in a position to satisfy local demand for credit, private money-lenders were no longer in a position to prevent the setting up of the marketing society which has since operated successfully for the benefit of its members.

Another important issue brought up in this thesis relates to the practical workings of the self-help and mutual aid principles. Empirical evidence suggests that a co-operative is a unique mechanism in dealing with rural credit requirements through its main function as an agent of redistributing funds, either on an intra-community level, or on an inter-community level, or acting as an intermediary between the official credit market and peasant farmers. The ability of a co-operative to act in this way means that non-government funds can be made available to the agricultural community at reasonable cost due to low transaction costs and the absence of expensive monopolistic intermediaries. Low transaction costs are mainly the result of low information costs.

A co-operative can only successfully engage in its redistributing function once suppliers of funds are convinced of the safety of their investment. On the basis of empirical observations it has been shown in the thesis that in areas of very low literacy

levels like in the case of Cyprus at the turn of this century it is absolutely essential to have a literacy substitute so as to inspire confidence among members about the bona fide nature of the exchange environment. In other words, accountability is of crucial importance. This literacy substitute can either be an enlightened local leader like in the case of Lefkonico or a state agency, as in the case of the department of co-operative development, where these are considered trustworthy.

The theory of the literacy substitute developed in the thesis may offer some explanation for co-operative failures in some developing parts of the world despite the great number of studies, reports, resulting recommendations and efforts. It is possible that no such substitute may be found from local sources, either due to extremely low literacy levels over wide areas or due to corrupt governments not trusted by potential membership. Under these circumstances foreign aid agencies should spend any available funds on training local people on the running of co-operatives. At the same time any international aid towards co-operative promotion and development should be linked to independent systems of accountability. Such systems in certain states may have to be run initially under the control of the international agencies themselves which effectively assume the role of the literacy substitute.

A second critical stage of economic development in Cyprus was the result of war in 1974 when the island's economy suffered a very serious setback, with well over one third of the population remaining unemployed and homeless. The rate of post-war economic recovery has been described by a number of writers as an economic miracle. Undoubtedly favourable exogenous factors contributed significantly towards achieving this miracle. However, a very important role was also played by the construction industry. Authors like Zetter have argued strongly that post-war Cypriot economic recovery was mainly the result of investment in the construction industry. The disproportionately large size of the sector was due mainly to the refugee re-housing projects, both private and state funded. The co-operative movement is estimated to have contributed CYP217mn in loans for housing which amounted to 53% of the total gross output or 89% of all private expenditure on housing. This last percentage is very much in line with current co-operative loan contribution to the housing sector, the remaining percentage covered mainly by state financed credit institutions.

The contribution of co-operatives towards macro-economic reconstruction is therefore more than obvious from the above numbers. However a number of other conclusions are also drawn on the basis of economic historical analysis of co-operation in Cyprus during this same post-war period.

One such conclusion relates to state reaction in case of co-operative failure. Both in 1974 when the co-operative movement suddenly lost a significant percentage of its assets due to war but also in 1980 when the loss of assets was due to the corrupt practices of a senior state agent the government was able to maintain the confidence of members in the co-operative movement through a mere declaration of intent to act as the lender of last resort. In both instances the actual use of state funds was almost completely avoided and the co-operative movement was left on its own to recover its losses.

Another important conclusion during the same period relates to direct state involvement in co-operative decision-making especially in relation to investment policy. On the pretext of the government's overall post-war expansionist economic policy, the Registrar of co-operative societies initiated the setting up of a number of industrial units using co-operative funds. All the projects started in this way ended in miserable failure causing heavy losses to the co-operative movement. Bad planning, bad management and apparent misappropriation of funds were later blamed for this sad state of affairs.

Analysing the above events and circumstances therefore leads to the conclusion that excessive legislation giving the state too many powers over the affairs of co-operatives should be avoided as such powers may be used by state functionaries in their capacity as principals rather than agents. Where such powers are considered essential mechanisms should be implemented to ensure accountability of the relevant agencies.

Existing law at the time, copied from the ex-colonial co-operative legislation, reserved such powers of supervision for the Registrar that he had a say over the career development prospects of all co-operative employees, including Secretaries. In the case

of non-primary societies the committees were usually made up exclusively of primary co-operatives' Secretaries. The Registrar was therefore in a position to have direct control over the affairs of these co-operatives. The industrial units were in fact subsidiaries to some of these non-primary co-operatives. Start-up capital was easily obtained from the Central Co-operative Bank, another non-primary co-operative institution. The use of the Central Co-operative Bank as an agent for redistributing funds meant that any possible reaction to the Registrar's plans from elected officers of primary co-operatives could easily be avoided.

But apart from his supervisory powers the law also made the Registrar head of the audit department. His actions therefore in relation to the non-primary co-operative sector came under no scrutiny. Realising that this was the main reason for the events that led to the Azinas' affair in 1980 the House of Representatives passed a new law setting up a completely independent Audit Service of co-operative societies. The report of the Audit Service at the end of each annual audit has to be read to the members at the Annual General Meeting of each society. This is a report on the outcome of the financial audit but more importantly is about the results of the very elaborate management audit.

A proper system of accountability does not only encourage members to feel secure about the bona fide nature of the transactional environment but it also prevents agents assuming the role of principals, whether such agents are co-operative officers or state functionaries.

Accountability is not unrelated to member participation. Most writers complain that with the passing of time members become less interested in the affairs of their co-operative and this is shown by the falling numbers attending Annual General Meetings. It has been shown in the thesis that both member participation and accountability may be greatly aided by the involvement of partisan politics, an idea dreaded so far by international students of co-operation.

Political neutrality is therefore not an essential ingredient of successful co-operation. Partisan politics may in fact play a useful role as a mechanism of more effective

accountability as well as increasing member loyalty and therefore improve chances of success. These chances are also increased through the intermediary role of party agents between the co-operative movement, the national legislative authorities and the government.

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