

case studies.....



Mondragon Use of Capital – Finance as a tool for development

One of a series of case studies by
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I've written many papers over the years, few of which see the light of day through publication, so I'm putting together a few of them in an informal series, and publishing them on my website.

They cover a range of subjects that I hope will be of interest.

Some are of historical interest, some are topics for discussion.

Some have already been published somewhere, in whole or in part.

Most haven't made it.

Having put in so much thought and effort, seeing them lie in a digital vault somewhere on my laptop seems like a waste – hence this small-scale publication effort.

All are free to download from my website at:-

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Hope you find them of interest.

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Use of Capital – Finance as a tool for development

In the Basque country, following the 1979 referendum, an autonomous Government was established which has many powers, including legislation and tax raising powers. However, although much has changed in the Basque country, the Mondragon version of business start-up, development and growth which they have honed over the years, has not changed a great deal and to a large extent been developed independently of Government policy by the Mondragon Corporation itself.

There are many reasons for this independence, but the strongest is the political situation when Mondragon started in 1956. Spain was still under fascist dictatorship and during the Spanish Civil War, the Basques, a very independent people with their own language and culture, took the side of the Republicans against Franco's coup d'état. When Franco captured the rest of Spain and advanced against the Basque country, the Basques put up a very spirited defence. They suffered greatly as a result, with Franco throwing the weight of his army against them, destroying their towns and imposing a very punitive regime. Many of the Basques ended up in concentration camps; many fled to France but many were summarily executed. The region's industry, which had been highly developed (and which dated back to the days of the Spanish empire) was destroyed.

The first Mondragon Co-op

Serving in the Republican forces was a young priest, Fr. Jose Maria Arizmendi. He was captured by the fascists, put in a concentration camp and narrowly escaped execution. After his release he was sent as a curate to the small town of Mondragon, just 30 miles inland from Guernica. He decided to do something about the high level of unemployment in the town, so in 1943, he started a school for young apprentices where he also preached about the idea of worker co-operatives in which all members share in the ownership, the management and the profits of a concern. When the students qualified they went to work in local industry, and they quickly realised that they would not be able to share in the fruits of their labour, so a group of five established an enterprise of their own in 1956 – an industrial co-operative making gas heaters and cookers. As Spain began to prosper, the demand for their products grew, and FAGOR is now Spain's largest producer of white goods as well as producing a range of automotive and other engineering components.

In 1959, he helped to establish a co-operative bank, the *Caja Laboral Popular*, which played a key role in the expansion of Mondragon by facilitating access to capital and also providing co-operative business management training. In the 1980s, the 150 co-ops then in existence banded together as the Mondragon Co-operative Corporation (MCC) which, in its current legal form established in 1991, is now regarded as the world's largest worker co-operative. Its supermarket arm, Eroski, is the largest Spanish-owned retail food chain. It runs co-operative schools for the children of the workers, a modern technological university, independent research and development organisations and is moving into providing residential and domiciliary social care.

The Mondragon business development system

Firstly, it's important to remember Mondragon was founded by and is still run by engineers. Not only is Mondragon based on industrial production, but the engineer's mind-set runs throughout everything they do. Business development and finance has been approached as an integrated whole, the problem de-constructed, analysed, re-designed and re-assembled. What they have produced is a production line approach, but with immense flexibility built in.

Whilst some elements of their practice can't be simply translated back to other countries as legal, governance and political systems are different, it is important to examine and understand the Mondragon model as an interconnected system if we are to be able to gain from it. If we just try to copy bits we will gain very little.

At the heart of their system is the integration of four main threads;

- Research and Development - the search for new products and services.
- Education and training - to keep a leadership position in production,
- Business incubation – including both product development and business planning
- Finance - linking workers savings and the co-operatives together

Business development to them is not about creating new enterprises as such, but about creating new products, and then raising capital, finding the right people and developing enterprises to supply them. As a result much of their effort goes into research and development.

Research and Development

R&D is big business in the Basque country, and the Basque Government has supported it financially since 1982. The IK4 Alliance consists of 9 research centres, 3 of which are co-ops and 6 are not-for-profit foundations. Mondragon's largest such centre, established in 1974, is IKERLAN, which is a mixed¹ co-operative owned by some of the manufacturing co-ops, Mondragon University and the Caja Laboral. It develops highly sophisticated electro/mechanical applications, and has been so successful that Microsoft has established a development centre just across the valley to further develop the work they have been doing in partnership with them. IKERLAN now works with other Universities and conventional businesses, and is funded roughly 40% by Basque Government research programmes and 60% by the co-operatives and companies it works with.

IKERLAN has established strategic alliances with other institutions and universities throughout the world including Berkeley and MIT, and now has a turnover of €21.8m. It is still based in its original building, although this has been enlarged over the years.

Mondragon University is also active in R&D though a linked co-operative, MIK (Mondragon Innovation and Knowledge). This is a mixed co-op owned by ULMA, MCC and IKERLAN. ULMA is a grouping of 7 worker co-ops specialising in construction and allied products, employs over 4,000 people and turns over €625m

¹ In the UK we would refer to the Mondragon "Mixed Co-operatives" as "Multi-stakeholder Co-operatives"

Education and Training

Mondragon University is the end result of the first project to be established by Fr. Jose Maria Arizmendi. The University started as a technical school in 1941 (teaching 14-18 year olds) and has slowly developed into a modern engineering based university with 3,100 students in Mondragon and a second campus in the next town, Onati. Courses cover engineering, the business school, and teaching. A large proportion of the teaching is in English, as the University recognises the need to compete in the wider world and so knowledge of English is essential.

The university is itself a co-operative, with students and staff as members.

Linked to the University is a student owned co-op, ALECOP, which was formed specifically to provide work for the students to help to pay for their fees and living expenses. Unlike the UK where university education was once free, universities in Spain have always charged fees and working was the only way for poorer students to attend college. ALECOP specialises in 4 hour shift working so that students have enough time to study. It manufactures a range of electrical and electronic equipment as well as office furniture, and is owned and run by its student members.

Within the MCC there are also some local community schools, mostly teaching through the medium of the Basque language. These are independent of the state system, but funded by it, much as church schools, academies and free schools are funded in the UK.

Business Incubation

In 1985 the Mondragon Corporation formed SAIOLAN, a business incubation and development centre. This came about for a number of reasons:

- Mondragon wanted to address the unemployment problems amongst recent graduates from Basque universities, 60% of who went straight from university to unemployment.
- The Bank of Spain had recently ruled that the Caja Laboral should concentrate solely on its financial business and instructed it to close its business advice division with 120 staff ².

It has now taken on Basque Government funding as well as operating just for co-operative development, it now provides services for all types of entrepreneurs.

SAIOLAN operates from a vast modern building in the Mondragon valley and provides product research and business development. Those going through the programme, usually but not always recent graduates, are given access to desk and computer space, laboratory and prototyping facilities, as well as support with business planning, financial modelling, market research, etc.

² At the same time they also had to close their social security operation which transferred to the newly formed Lagun Aro which now operates the pension funds and social security provision of the Mondragon group of co-operatives.

Students of the programmes are able to access some “Enterprise Allowance” type funds as well as some capital grants, although like Government funds everywhere, budgets are limited.

SAIOLAN also works closely with existing co-ops (as well as local companies) to develop and prototype new products and services, and bring them to market.

Finance

Finance was provided until 1982 almost exclusively by the workers, through the Caja Laboral or from other co-ops in the MCC.

The Caja Laboral was founded in 1959, only shortly after the Mondragon project was started, and has been key to its development ever since. It has grown to have assets of over €21bn, 365 branches across Spain and 1,880 worker members. It is sometimes described as a credit union, but it is fundamentally different to our idea of a credit union as it is a multi-stakeholder/worker co-operative, 57% owned by MCC co-ops and 43% by the workforce. To the Mondragon members, co-operation is about the workers owning the business, and the UK model of consumer co-operative, such as the Co-operative shops is not one they are familiar with.

From its foundation, Caja Laboral invested its reserves in Mondragon co-ops. This is part of the reason for the growth of the MCC co-ops as the profits and assets are all recycled into the local economy. However, following the actions of the Bank of Spain in 1982, when it ruled that only 10% of any Spanish bank’s assets could be invested in one place, local lending has had to be reduced, and only 2.8% of its reserves are now invested in the MCC itself. Of its lending, €3.6bn goes to wholesale finance for co-ops and €13.8bn is in local domestic mortgages³. In order to ensure this ruling does not stifle available funds, the Caja Laboral has established joint funding arrangements with the big 5 Spanish banks, and their own lending is used as a lever to bring in outside funds when required.

The bank also funds 2 business development programmes from its own profits. Gaztempresa, originally a young people’s enterprise scheme set up in 1994 receives 10% of all Caja Laboral profits. It provides mentoring and support, which is now available to people of all ages, and since 1994 has established 2,600 businesses, with 80% surviving after 3 years. Many of these are not co-ops, but are often sole trader and small family businesses. They also fund the Mondragon Development Fund with a further 20% of their profits.

The Mondragon Method

As I said at the beginning, the Mondragon group of co-ops is established and run by engineers, and so Business Development follows a clearly established, carefully designed method. The core element of this, which complements the 4 threads of the system, is what in effect is a tithe⁴.

³ Mondragon co-operative members get a special deal on their first house mortgage paying only the EURIBOR (Euro Inter-Bank Offer Rate) currently 1.3%

⁴ This should not be a surprise, as Mondragon grew out of radical Catholicism, and tithes were first officially recognised by Pope Adrian 1st in 767, and co-operation itself was mentioned in the papal encyclicals of Pope Leo XIII, *Rerum Novarum*, Encyclical Letter on Labour and Capital, 15 May 1891, https://en.wikipedia.org/wiki/Rerum_novarum & <http://w2.vatican.va/content/leo->

The business development and support system at MCC is based on new co-ops signing up to give 10% of their profits to the Mondragon Development Fund, which is held at the Caja Laboral, but is owned by the MCC and is used to invest in new co-ops. Basque co-ops operate under a specific Basque law, are based on shares, and therefore this fund is able to invest in any new co-operative formed by buying a proportion of its shares. This in turn means the new co-operative is not over exposed to the problems of borrowed capital. Loans have to be repaid to a schedule and with interest, even if a “holiday” is granted by the lender. Similarly capital raised through Bonds also has a fixed life, whereas invested capital, especially from a friendly source, is a participant and will wait until profits are made.

The Mondragon mind-set is also based strongly around worker co-operatives, rather than consumer co-operatives, and so a plan is always put in place to take the co-operative from its multi-stakeholder formation to 100% worker ownership over time. However, no co-operative is set up without a financial contribution from the workers from the off, and this is based on the average wages paid in that particular area of work. Thus a highly skilled R&D co-op will require an investment from each worker of €15,000, a manufacturing co-operative such as EROSKI will look for €9,000 whilst in the latest social care co-operative, GSR, they are expected to pay €3,000. If required, workers are provided with loans from the Caja Laboral to provide this capital, with a typical payback over 6 years.

Once the co-op has repaid the capital to its initial external investors and comes into profit, a dividend is paid on the workers’ shares. However this is “capitalised”, or in plainer language locked into the co-op. The workers are unable to withdraw their shareholding and its accumulating dividend until they retire, when it provides an attractive lump sum on top of the very generous pension benefits they will also have accrued.

Keeping the faith

The Mondragon Co-operative Corporation is the umbrella organisation for all the co-operatives which are its members. As part of its operation it runs a management school – Otalora – whose purpose is to develop and instil a co-operative model of management, which it uses in its training schemes for the managers in the Corporation and its member co-operatives.

This co-operative management ethos is important to ensure that the decision making processes, and in particular the recommendations from management, are based on a co-operative model of thought and that there is no drift towards a more mainstream business model of shareholder profit maximisation.

Similarly at Mondragon University Business School, students study the co-operative model, and have to start up a co-operative business whilst in University, which must operate at a profit in order to graduate.

[xiii/en/encyclicals/documents/hf_l-xiii_enc_15051891_rerum-novarum.html](http://www.vatican.va/content/pius-xi/en/encyclicals/documents/hf_l-xiii_enc_15051891_rerum-novarum.html) and Pope Pius XI, *Quadragesimo Anno*, Encyclical letter on Reconstruction of the Social Order, 15 May 1931 http://w2.vatican.va/content/pius-xi/en/encyclicals/documents/hf_p-xi_enc_19310515_quadragesimo-anno.html

Distribution of profits

Every Mondragon co-operative, as MCC members, has to give 10% of its profits to the MCC. This is essentially a pay-back for the support given on start-up and the continuing services provided of labour solidarity and financial solidarity which ensure stability when difficulties occur and labour is surplus and cash is insufficient.

Additionally Basque (and Spanish) co-operative law requires 20% of profits to be given to social causes, and in exchange, co-operatives are charged a reduced rate of Corporation Tax. In Mondragon, most of this 20% will be provided to local projects within the MCC such as schools, the University, social care, etc. Additionally some co-operatives may choose to give more than 20%.

As democratic structures, each co-operative decides each year on how to allocate any remaining profits. This will be shared between the (capitalised) share dividend and re-investment in the co-operative.

	2003	2004	2005	2006	2007	2009	2010	2011
SALES	€9,638M	€10,406M	€11,859M	€13,390 M	€16,300 M	€14,780 M	€17,80 0M	€14,832 M
ASSETS	€16,309 M	€18,593 M	€22,977 M	€27,550 M	€32,840 M	€33,499 M	€33,090 M	€32,450 M
PERSONNEL	68,625	70,884	78,455	83,601	103,731	85,066	83,859	83,569
INVESTMENT	€836M	€784M	€1081M	€1,243 M	€2,800 M	€378 M	? ⁵	?
NET PROFITS	€411M	€502M	€545M	€677 M	€792 M	€61 M	€178 M	€125 M

As the table above shows, over recent years the Mondragon co-operatives have chosen to re-invest between 2 and 6 times as much capital as they have allocated to their share dividend. This has ensured their sustainability during the current recession, with only those workers on temporary contracts being laid off and almost no redundancies of permanent staff.

In a nutshell

The role of capital is key to the Mondragon methodology of business development, and is to a large part the reason for their success. They often quote the slogan "*labour hires capital, not capital hires labour*"⁶ as the touchstone of their philosophy.

Mondragon started in a dirt poor area. When I first visited the Basque country in 1962 I was horrified to find donkeys were still used as beasts of burden, many people had no electricity or proper sanitation and there were so few motor-vehicles that petrol was still pumped by hand from roadside garages that were no more than sheds.

⁵ Investment figures for 2010 and 2011 were not available to the author at the time of writing

⁶ This is usually taken to be a reference to Lincoln's First Annual Message to Congress, December 3, 1861. "*Labor is prior to, and independent of, capital. Capital is only the fruit of labor, and could never have existed if labor had not first existed. Labor is the superior of capital, and deserves much the higher consideration.*"

However, at Mondragon they developed a simple but powerful set of actions to change their situation by harnessing what they had, and these have completely transformed their economic condition.

- Capturing and locking in to the area what money people had through the creation of a local co-operative bank. This money was then invested and re-invested, again and again in local people's jobs not some project elsewhere which could make more profit.
- The co-ops they created linked together, investing in each other. Whilst 100% worker ownership is their goal, they are pragmatic about other arrangements, as long as there is a planned exit to worker ownership. In industrial production co-ops the initial investment can now be as high as €300,000 per employee, so the workers initial investment can be as low as 7% of funds required.
- They have established a common development fund from which co-ops can draw finance for start-up or growth. Every co-op commits at least 10% of their profits to this.
- They re-invest most of their profits to ensure future sustainability.
- They share the hard times. To this day there are inter-co-op loans of both cash and surplus workers via a system organised by the MCC centrally to support any co-op that struggles. As a result very few have failed. Even during the recession of the early 1980s when the Basque region lost 150,000 jobs, the MCC created an additional 4,200 jobs. The final result - only 104 of its workers (0.6%) ended up unemployed.
- They share the incomes equitably. The top salary ratio is capped in most of the co-ops at 4 times the lowest paid, although this is stretched in some of the larger co-ops to 6:1 to try to reduce the poaching of top management by other businesses. This compares to the FTSE100 average of 262:1⁷
- They spend their own money on R&D (€140 million in 2009) and business incubation & support in order to secure jobs in the area for future generations. They estimate that in 10 years' time most of what they produce will be different to the products they are manufacturing now.
- They work with others, universities and commercial businesses where necessary, but they are canny about intellectual property ownership and retain it in the Mondragon co-ops whenever they can.

⁷ <http://www.onesociety.org.uk/research/pay-ratios/>