Understanding the Nature of Cooperatives

Cooperatives are one of four basic types of business organizations which also include single or sole proprietorships, partnerships, and corporations. A cooperative is a business owned and controlled by the people who use its services. They finance and operate the business for their mutual benefit. Working together, they are able to achieve personal economic goals that would otherwise remain beyond their reach. Cooperatives are remarkably flexible and adaptable to a broad range of business and personal needs.

Cooperatives are particularly well-suited for helping people who lack sufficient resources of time, money, and expertise to expand or extend their business enterprises into new markets or for creating reliable sources at reasonable prices for the services and products that people want for their homes and families.

Cooperatives have also been organized to provide electricity or telephone service in remote rural regions, to provide affordable housing in inner-city areas, and to provide personal and business financing at reasonable costs.

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Cooperatives give individuals the power to control their economic destinies through group action. This power flows from the willingness of each member-owner to pool his or her resources with those of all other participants in the venture. When the limited resources of individuals are combined, the economic well-being of each member of the group is improved.

Before organizing a cooperative business, however, the characteristic advantages and disadvantages of all four types of business organizations should be carefully considered. The form that best suits the long-term needs and personalities of the members should be adopted. Keep in mind that one of the strongest characteristics of cooperatives seems to contradict common sense: cooperatives serve individual economic needs through group action.

The significant differences between cooperatives, sole proprietorships, partnerships, and corporations are seen in aspects of finance, distributing of benefits, control, taxation, risk and ownership.

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1. Financing a Business

All businesses require capital to get started, to finance ongoing operations, and to acquire the resources needed to establish, maintain, and expand processing and distribution capabilities and to reach markets in response to the needs of member owner-users.

Long experience suggests that cooperatives are best financed by their member owner-users on an equitable basis. Members usually contribute financing in proportion to the amount of business they do through the cooperative. Such financing may come from direct infusions of cash at the time the cooperative is organized, through additional assessments after operations are under way, or through payment of membership fees as each new participant joins the association. Many cooperatives also require member owner-users to contribute additional financing each year in the form of retained earnings, which are funds withheld from the distribution of benefits to members.

Financing cooperatives with retained earnings is a popular method of "bootstrapping" the growth of a cooperative business when members have few financial resources to invest. Many cooperatives issue certificates of retained earnings (often referred to as common stock) as evidence of members' investments. Some cooperatives "revolve," "retire," or "redeem" investments of retained earnings within a specified period of time or at specified intervals. Others retain such earnings as permanent capital investments.

Usually cooperatives do not pay interest to member owner-users on earnings retained as a source of financing. Under circumstances defined in the Capper-Volstead Act, farmer-owned cooperatives are allowed to pay limited dividends of up to eight percent annually on retained earnings. Consumer cooperatives such as cooperative grocery stores operating under different regulations are free of such restrictions.

The more usual practice of not paying interest on retained earnings grew out of the failures of a number of farmer-owned and consumer cooperatives organized in the second half of the 19th century, all of which tried to borrow their way to prosperity. Repeated analyses of those failures demonstrate that the costs of interest payments on borrowed funds undermined the financial strength of those cooperatives.

All other factors being equal, the cooperative that borrows the least and pays the least amount of interest stands the best chance of long-term survival and of successfully meeting the economic objectives of its member owner-users.

The owners of single proprietorships and partnerships are directly responsible for providing capital to their firms, and corporations acquire their capital through the sale of corporate bonds, common stock, or preferred stock to investors. All are subject to the same constraints of operating on borrowed funds.

2. Distributing the Benefits of Owning a Business

All cooperatives return to their member-owners the difference between the income earned and the cost of doing business. That difference is paid back to member owner-users in proportion to their use of the cooperative's services. Because of this feature, cooperatives hold the legal status of nonprofit organizations. Note that while many cooperatives are organized to provide such direct economic benefits to their members, others are organized to assure access to markets or sources of supply essential to the success of the economic activities of individual members. The value of such cooperatives is realized through reliable access to markets or sources of supplies rather than in the earnings distributed after operating costs are paid.

In corporations, profits may be reinvested in the corporation or distributed to investors in proportion to their investment in the firm. Partners most often divide the profits of their partnership in proportion to their capital investment or other contributions to their firms. Owners of single proprietorships receive all profits (and bear all risks) resulting from their business ventures.

3. Controlling a Business

Cooperatives are democratically controlled by their member owner-users. The form of control involves one of two principles expressed in the "one-member, one-vote" model and/or by voting in proportion to the degree each member-owner uses the services of the cooperative. Control is normally expressed by member owner-users through the election of a board of directors. Directors are elected to represent the general membership in establishing the overall goals and policies of the cooperative, and to select management to develop and implement a business plan designed to achieve their cooperative's overall goals. Directors are also responsible for evaluating management's performance and adjusting the cooperative's goals and policies to meet the needs of member owner-users and in response to changes in the business environment. Representation can be apportioned on a geographic basis and/or in proportion to the volume of business each member owner-user does through the cooperative. The issue of control and representation is an important consideration in every form of business organization, because it is through control and representation that the owners assure that their business is meeting their individual economic needs.

In cooperatives, the central issue of control focuses on determining the nature of services provided to member owner-users. In corporations, control is normally held by owners of common stock who are usually concerned about the returns to their investments in the firm compared to other current investment opportunities. Control and representation issues such as the elimination of "outside interference" very often motivate the formation of single proprietorships and partnerships.

4. How Businesses are Taxed

There are many potential variations on the tax treatment of agricultural cooperatives, but cooperative taxation is a complex subject and individual cases should always be discussed with a tax attorney knowledgeable about cooperative law. However, it is generally true that cooperatives, under provisions of the Internal Revenue Code, enjoy "single-tax treatment." This means that the earnings of a cooperative are not taxed when first earned by the cooperative, but are instead taxed as personal income only after they have been distributed to the co-op members. In some cases, member or co-op earnings are not taxed until distributed in cash; in general, earnings retained by the co-op as permanent capital or earnings from nonmember business are taxed.

Thus, the tax treatment of a cooperative is more like a sole proprietorship or a partnership than it is like an investor owned corporation. Corporate income is taxed when it is first earned by the corporation, and it is taxed again at the personal level when shareholders receive dividends derived from the corporation.

5. Risk

Where liability for financial loss is concerned, the cooperative is more like an investor-owned corporation. While sole proprietors and some partners have unlimited financial liability, the member-owner of a cooperative, like owners of other incorporated firms, has limited financial liability. The owner of the cooperative, like the stockholder in another corporation, can lose no more than the value of the stock he holds in the cooperative.

6. Ownership

Of the four forms of business, only cooperatives are defined in terms of whom the business serves. Only the producers of agricultural commodities are eligible to own and be members of agricultural marketing cooperatives. Only the patrons of a cooperative grocery store are eligible to be member-owners of such a firm.

Anyone with capital to invest may become an investor in a corporation. The laws of the United States and of California are indifferent to the identity of investors as consumers of the services and products manufactured and marketed by corporations. By the same token, anyone may establish a sole proprietorship or participate in partnerships. However, an agricultural producer can become a member of a particular agricultural marketing cooperative *only* if he produces one or more of the particular commodities marketed by that co-op.

The following table compares the major forms of business organization with respect to the issues of financial liability, taxation, and control:

Comparison of Four Forms of Business Organization

Form	Control	Tax	Financial Liability
Proprietorship	Proprietor	Individual rate	Unlimited
Partnership	Partners, based on equity contributions	Individual rate	Unlimited
Corporation	One vote per share	At corporate rate, plus dividends at individual rate	Limited to initial contribution
Cooperative (incorporated)	"One-member, one-vote," and/or in proportion to patronage	Individual rate (patronage business); corporate rate (non-patronage business)	Limited to initial contribution and retained earnings

When Cooperatives are Needed

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As mentioned above, cooperative business structures are highly flexible and can serve many purposes. People form cooperatives for economic reasons, some of which reflect the failure of existing businesses to serve the changing needs of buyers and/or sellers.

Historically, cooperatives have been started to address one or more of the following situations:

1. One or more processors use their market power to depress prices paid to farmers for the commodities they grow. In such cases, the processors retain for their exclusive use important information about current market demand for their products and the value of the commodities they process into those products. Such processors typically negotiate the purchase of commodities from individual growers one by one. Similarly, consumers often question the prices they pay for vital supplies and services such as groceries and electricity. Growers and consumers are motivated to form cooperatives to gather information about the demand for the commodities and to share that information with their members, thereby providing the group with marketing power more comparable to that held by the processors.
2. Often there are so few buyers or sellers in a market area that it is difficult for either side to negotiate satisfactory pricing. A group of buyers may establish a cooperative capable of attracting sellers to a single, central location. In a similar way, sellers may pool their production to establish a cooperative to market members' produce to all buyers.
3. It is often possible to capture large economies of scale in processing and marketing commodities by combining or pooling the production of a number of growers for processing in a single plant for sale through a single marketing group. Such concentration of production and marketing often requires larger capital investments than any one individual can afford, making it advantageous for a number of individual producers to pool their capital resources to build and operate the business cooperatively.
4. Optimum savings can be realized by growers who build processing plants if they are careful to match the volume of their commodity production to the processing capacity of their cooperative plant and to the effective market demand for the products produced. This is the argument for owning and managing processing plants cooperatively, and it works equally well for both marketing and consumer cooperatives. Maximum manufacturing efficiency can be achieved only if the plant's total capacity is constantly utilized, placing added emphasis on maintaining member loyalty and commitment.
5. Vertical integration allows cooperative member owner-users to capture additional profits from engaging in business activities related to the production, processing, and marketing of commodities they grow or consume. For example, a farmer may invest in a fertilizer manufacturing cooperative and, through that cooperative, in natural gas production and rock phosphate mines.

Dairymen often vertically integrate through the formation of breeding cooperatives which make genetically superior cattle available through artificial insemination. They also form milk processing and marketing cooperatives which convert milk into butter, ice cream, and other dairy products for sale under their cooperatives' own brand names.

Land O'Lakes, a dairy marketing cooperative; Sunkist, a citrus marketing cooperative; and Ocean Spray, a cranberry marketing cooperative, have each vertically integrated their member owner-users' production to develop brand names which now earn added royalty income from marketing products unrelated to their members' production. Thus the brand names developed and owned by farmers through their cooperatives provide added income streams to their farming operations.

6. In addition to vertical integration, growers have horizontally integrated their cooperative enterprises by using their combined marketing power and earnings to buy out competitors, thus further increasing their market power.

7. In some situations, cooperatives are formed to coordinate the timing of the delivery of commodities to markets. This coordination function becomes desirable for growers of highly perishable seasonal commodities, who often find their markets unable to absorb all their potential production in the relatively short period of time their produce is marketable.

8. The pricing of many commodities can be highly volatile, varying widely from a low to high level over the course of a year in reaction to changes in supply and demand. Farmers often find that they fare better economically by pooling their production with other farmers and taking the average price earned by selling a small amount every day through a cooperative. The alternative is for each individual to attempt to guess when pricing is most favorable, then find a buyer willing to pay that price, and then arrange delivery in a timely manner to capture that price. Forming a cooperative that is in the market every day, and taking the average price resulting from pooling, minimizes price and market risks. The same principles apply to the operation of consumer cooperatives.

9. Often consumers and producers require certain services or products in regions where the potential sales volume is so small that privately owned companies are reluctant to make their products or services available. Such consumers or producers may join together to form cooperatives to assure the availability of vital products and services on an economically feasible basis. Through such actions, farmers have become owners and operators of petroleum product refining plants, grocery stores, electrical generating and distribution networks, and local telephone exchanges.

Determining the Need for a Cooperative

Because cooperatives are self-help organizations, they are most effectively organized at the grass roots level by those who will directly benefit from the services their cooperative will offer.

To someone starting a cooperative for the first time, the process appears circular—another form of the riddle, "Which came first, the chicken or the egg?" A little further thought on the nature of cooperatives will suggest where one can begin the organizing process.

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Leaders in any community establish and nurture their identities through their ability to identify problems and possible solutions. They are also able to mobilize to action those who would benefit from such solutions. Community leaders who sense that their economic well-being can be improved by organizing a cooperative should first understand how cooperatives might function in improving their situation and then explore that possibility with other members of the community who might also benefit.

This first exploration should be kept informal and open to as many possibilities as feasible. It should focus on establishing a consensus opinion in the community concerning the potential improvement in economic circumstances which could result from owning and operating their own business cooperatively and on their willingness to share personal resources and commit to using the cooperative on a long-term basis.

Above all, leaders of the movement must be aware that they set the example—good or bad—that other potential participants will follow. The success of the cooperative will be a function of the willingness of the leadership group to see the formation of their cooperative through to fruition. They must be willing to share personal resources. They must be willing to commit to using the cooperative on a long-term basis. And they must be willing to honor those commitments by acting for the benefit of all members of the cooperative rather than in their own interests.

Should the leadership conclude that the larger community shares their vision of the role a cooperative business could play in improving the larger group's economic well-being, the time has come for serious, in-depth studies of the economic role the cooperative would serve and how it would achieve those goals.

This stage is a good time for the leaders to write out a simple statement of what they believe the proposed cooperative can accomplish, who its activities would benefit, and in what forms those benefits would be realized. This statement of purpose will serve to focus additional discussion within the community and to provide the key benchmarks in the studies that contribute to the remainder of the process.