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Forming A Cooperative

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The United States was settled by pioneers who shared a cooperative spirit. Cooperation was essential to the development of pioneer communities. Barn-raising bees, husking bees, bull rings, sharing of labor during planting and harvest, and community socials were common activities. Most of these efforts, however, were informal arrangements that did not involve commercial transactions.

Benjamin Franklin, the famous American statesman, author, scientist and inventor, also helped form the first commercial cooperative in the United States. In 1752 he and others established the Philadelphia Contributorship for the Insurance of Homes from Loss of Fire. It is still operating.

Today cooperatives are a common part of many American communities. Farm supply cooperatives that provide such things as fertilizer, fuel and chemicals have been in many farm communities for decades. Farm marketing cooperatives like county grain growers associations are also common. The Federal Land Bank and the Production Credit Association, recently merged into the Farm Credit Services, have been important agricultural financial institutions in many communities.

We find many other examples of cooperatives in rural America. Many farm and ranch families first got access to electricity and telephones through local utility cooperatives. Many of these utilities still operate as cooperatives. In the western U.S., many irrigation systems operate as cooperatives. Dairy herd improvement associations, breeding associations, grazing associations and wool pools are common among livestock producers.

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Agricultural people are not the only ones who use cooperatives. Many Americans rely on credit unions for their banking needs. Many people also live in condominiums — another form of cooperative. At the local level are cooperatives for retail food, day care and recreation such as swimming pools. On a larger scale, large food processing cooperatives such as Sunkist and Ocean Spray market their grower-member products all over the globe.

Farmers interested in growing alternate crops are showing an increasing interest in cooperatives. This is true especially for horticultural crops, since special marketing expertise is needed for many of these crops. This publication is designed to give a better understanding of cooperatives and how to organize them.

What is a Cooperative?

The cooperative is one of the four forms of business organization that exist in the United States. A fundamental characteristic differentiating a cooperative from the other forms of business organization is that it is owned by, controlled by and intended to benefit the people it serves — its members — rather than outside investors.

Fig. 1 shows how the four types of businesses differ. The first two points emphasize the fundamental characteristic that the users and owners of a cooperative are the members themselves. The next two features show that cooperative member control of their business is shared equally through the one-member, one-vote rule. The fifth point reveals that the members, either directly or through an elected Board of Directors, make the policy decisions for their business.

The next two features deal with the financial aspects of a cooperative. To get tax benefits, a cooperative must limit its return on ownership capital to a maximum of 8 percent. Thus, profit incentives that cause people to invest in corporate stocks are not present in cooperative stocks. If an operating profit is earned by the cooperative, the proceeds can either be reinvested in the business or returned to the members. When profits are returned to members, they are usually based on the share of the cooperative's total business conducted with each member.

Why Are Cooperatives Usually Formed?

Cooperatives are composed of people. The basic reason for forming a cooperative is to fill a need for a group of people — that is, to accomplish something that probably could not be done individually. Commercial cooperatives are usually formed to fill an economic need, correct an inequity or to narrow the margin between the producers and consumers.

To Fill An Economic Need

An example of an economic need that a cooperative could serve is the need to market a product. This might be particularly important to a group that is growing a crop that they have not grown before and whose members are unfamiliar with the markets for the crop. Individually, the growers might not be able to afford to investigate the market potential.

Another economic need that a cooperative could fill is the need to purchase supplies such as seed and fertilizer for its members. This service could achieve economies of size by purchasing in volume not possible by individuals.

Another need might be the need to obtain services, such as the use of spraying equipment, at a reasonable price. Sharing the cost of owning the equipment could reduce the cost to users.

To Correct An Inequity

Many cooperatives have been formed in an attempt to correct what was seen as an

Fig. 1. Methods of doing business under private enterprise.

	Types of business			
			Corporation	
Features compared	Individual	Partnership	Investor-oriented	Cooperative
1. Who uses the services?	Non-owner customers	Generally non-owner customers	Generally non-owner customers	Chiefly the owner patrons
2. Who owns the business?	The individual	The partners	The stockholders	The member-patrons
3. Who votes?	None necessary	The partners	Common stockholders	The member-patrons[1]
4. How is voting done?	None necessary	Usually by partners' share in capital	By shares of common stock	Usually one-member, one-vote
5. Who determines policies?	The individual	The partners	Common stock-holders and directors	The member-patrons and directors
6. Are returns on ownership capital limited?	No	No	No	Yes: 8% or less (usually less if any)[1]
7. Who gets the operating proceeds?	The individual	The partners in proportion to interest in business	The stockholders in proportion to stock held	The patrons on a patronage basis[1]

[1]Basic cooperative principles.

Source: Understand Your Cooperative, Cooperative Information Report 6, USDA.

economic inequity. An example might be a case where many growers of a commodity have had to sell to only a few buyers. The growers might feel that prices they receive have been unfair (too low) or that their crop has been inaccurately graded. Therefore, they might want to pool their crops by forming a marketing cooperative.

This need is often referred to as the need to balance power in the marketplace. It helps members compete with large corporations who have the potential to gain significant market power.

To Narrow Producer-Consumer Margins

The goal of forming some cooperatives has been to narrow the margin between growers and consumers. More narrow margins could increase incomes of producers or reduce costs to consumers. The members might think that they can reduce the middleman costs. Those who attempt to reduce middleman costs, however, must realize that the marketing functions, such as transportation, storage, financing, selling and grading, must still be done. A cooperative might perform a marketing function more efficiently, but costs might be greater if the cooperative does not have the required expertise.

People are interested in forming cooperatives of various types for many different reasons. The focus of the rest of this paper will be on marketing cooperatives. The main principles, however, apply to cooperatives of all types.

Cooperative Marketing Alternatives

A cooperative interested in taking over some marketing functions has several alternatives. The cooperative could simply sell through existing middlemen. The advantages would be that the members could gain market power by pooling their product, and expensive marketing facilities would not be needed by the cooperative.

Another marketing alternative would be to use existing middlemen, but assume some of the middleman functions. An example would be for the cooperative to operate a packing shed and sell the packaged product to wholesale buyers and brokers.

Another option would be to assume the functions of grading, packing, selling and shipping the product all the way to the retailer. Some large food chain stores are increasingly ''sourcing at the grower'' for fresh fruits and vegetables to better control volume, costs and quality.

Qualities of Success

We can find many examples of successful cooperatives and of cooperatives that have failed. In general, the successful cooperatives have a number of attributes in common.

Quality Products

Successful cooperatives handle quality products. If the cooperative has direct contact with the buyers, it can pass quality specifications and preferences directly back to its members. This direct link provides the cooperative's members with the information system needed to produce the quality the market wants. If the cooperative operates a grading and packing facility, it can pay its members based on quality and therefore provide an economic incentive to produce the most valuable grades.

Sufficient Volume

Successful cooperatives have a sufficient number of producers with similar interests and a willingness to work together. Having enough volume to operate the enterprise at a reasonable cost is important. High fixed costs (depreciation, interest, taxes, insurance) of a new facility spread over a low volume could result in a cost per unit which is not competitive. A higher volume would spread fixed costs over more units and lower the cost per unit. The key is to get together a sufficient number of producers with adequate volume so that the operation is economically efficient.

Many successful marketing cooperatives use marketing agreements to ensure sufficient volume. Under a marketing agreement, the members pledge a certain quantity to the cooperative. Having the members pledge all of their production is often best so that the cooperative is not used as a dumping ground for low-quality products. The use of marketing agreements could also enhance the efficiency of the cooperative by allowing it to develop an organized marketing plan.

Some cooperatives have a membership selection policy because it is helpful to select members who have similar intentions, who have the patience to work out problems and who will give necessary support to employees, directors and management. In the beginning, the cooperative may be most successful by specializing in one commodity to ensure that members have like interests.

Good Management

Successful cooperatives are well managed. Members need to recognize that a cooperative is a business operation that needs good employees, managers and directors. Good managers can earn good salaries in other businesses, so cooperatives must pay a salary that is sufficient to attract and keep good management. A well-paid, good manager is much more valuable than a poorly paid, poor manager.

Fortunately, professional improvement opportunities are available for cooperative managers, directors and members. State cooperative organizations, the Cooperative Extension Service and the Bank for Cooperatives are all active in providing educational programs for management of cooperatives.

Good Information System

Good communication between members, management and directors as well as between the cooperative and buyers of its products is vital to the success of a cooperative. For the members to be well informed, an information gathering and dissemination system is needed. In particular, growers need to be informed about grades and prices of their products. They need to know the grades being used and why they are being used. They also need to know why the price they receive may be the same, or different, from the prices received by those who are not members of the cooperative.

Sound Financing

A successful cooperative must be soundly financed, both at start-up and for continued operation. In addition to borrowed capital, member-provided capital can be obtained four ways:

1. Members and investors purchase stock outright.
2. Fees are charged to become a member.
3. Stock is purchased from the proceeds of each unit of business (e.g. 1 cent per pound of butterfat delivered).
4. The cooperative retains some net earnings rather than distributing them back to members as patronage refunds.

A rule of thumb is that at least one-half of the start-up capital should be provided by members. This provides the needed capital, and also puts members in a position of being strong supporters of the cooperative because of the amount of money they have at risk.

Fig. 1 shows that return on ownership capital for a cooperative is limited to 8 percent. The rule has a tax law basis, but allocating small dividends to stockholders has been a commonly accepted cooperative principle. This principle is designed to deemphasize investment for potential returns to the stockholder, but at the same time recognizes that a modest return to members is desirable.

Another cooperative financing principle is that current members should provide for most of the capital needs. A revolving capital plan can be used for current members to provide capital on a patronage basis (as in No. 3 above). At the same time the capital of inactive members can be returned to them. This allows for members who retire or move to get their capital back without disrupting the business.

Another cooperative financing principle is that the operations of the business should generate new capital. About half of the after-tax profits of American businesses is reinvested in the businesses. For cooperatives, this practice limits dividends but lessens the need to borrow money and keeps control of the funds in the organization. It can also provide reserve funds that may be needed during downturns in business or during other emergencies.

Policies regarding the redemption of cooperative stocks should be in place. The cooperative should have the first option to buy stock sold by members. This prevents stock from getting into the hands of people who do not share the members' interests. To reduce speculation stock should also be redeemed only at original face value rather than book value. Finally, a method should be devised for returning capital to those who retire, leave the community or quit the business. This makes investment in a cooperative more attractive.

Federal law requires that at least 20 percent of patronage dividends be returned to the members. Most cooperatives return at least 40 percent to keep members satisfied.

Producer Control

The successful cooperative should remain producer-owned and producer-controlled. This eliminates operating the business for reasons other than what producers want. For example, some nonmembers (stockholders) might want to expand into a seemingly profitable business unrelated to the interests of the producers. The one-member, one-vote rule and the 8 percent dividend limitation pointed out in Fig. 1 help support the producer-control concept.

Service at Cost

A successful cooperative must abide by the principle of "service at cost." The cooperative can either: (1) be price competitive at the time of sale, or (2) give a big patronage dividend at the end of the year. Both options could provide for service at cost. Some members prefer the forced savings aspect of a patronage dividend while others are more concerned about competitive pricing at the time of sale. The motives of the members should dictate which option to follow. If the members choose the first option, costs of operating must be carefully estimated and considered when setting prices.

Method of Payment

Successful cooperatives have carefully designed methods of payment to members. One commonly used method is the pool payment technique. This is where products are pooled and the revenue is divided among the producers according to the volume each provided. The advantage of pooling is that producers can reduce price risk and perhaps achieve better returns by marketing in volumes larger than possible with individual marketing.

If only one pool is used, everyone receives the same price regardless of quality. This means that low-quality producers gain at the expense of high-quality producers.

An alternative is to create a number of pools, sorted by grade and quality. Each producer would be paid based on his or her contribution to each quality pool. The better growers are thus rewarded. This plan, however, requires a good grading system and good communication about the system to members.

A modified pool system can provide for a marketing charge to be deducted from the sales price. This charge could be a percentage of sales price or a flat volume fee. It would cover the cooperative's costs of handling, packaging or processing. If costs are less than the charge, the difference can be returned to the members.

Another alternative is for the cooperative to buy the commodity outright, then sell it and return the profits to the members on the basis of volume. Under this plan, the cooperative would assume the risks of ownership.

Cautious Risk Assumption

Successful cooperatives are cautious about assuming risks. Members of new cooperatives must recognize that they will be taking on the risk previously assumed by middlemen. In volatile market situations, group action may be too cumbersome to make timely decisions.

A successful cooperative can reduce risk for individual members. For example, with a pooling price system, the cooperative can reduce the risk of price inequities caused by seasonality of marketing and varying grades.

Reasons for Failure

Just as successful cooperatives have some general qualities in common, failed cooperatives also have some common reasons for failure.

Inefficient/Ineffective Management

Cooperative members and Boards of Directors sometimes make the mistake of hiring a manager based on the fact that he or she is local, known and liked. Hiring a manager based on his or her management experience and ability is the preferred approach to identify the best qualified person.

Another common mistake is that members do not leave legitimate managerial decision-making to the professional management team. Since they are owners, some members may think that they have the right to interfere with the management of a cooperative. Often, however, they are out of their area of expertise and problems develop.

The Board of Directors has the primary responsibility to evaluate the management performance. Members should communicate concerns about management through the Board.

Another problem could be that managers and Boards of Directors are poorly trained. This need not be an ongoing problem, because many educational opportunities sponsored by public and private organizations are available.

Insufficient Volume

Inadequate volume is a major reason for failure. Members often lack the understanding that efficient operation of a facility depends on a stable, adequate volume of raw product. Without this stable and adequate volume, economies of size are lost and viable markets cannot be established.

Lack of Membership Support

Unsupportive members can lead to the failure of a cooperative. Examples are growers who refuse to stick to policy decisions and those who sell elsewhere if the price appears to be slightly better. Another problem is that some members view their membership as a right to use the cooperative as a dumping ground for inferior commodities they can't sell elsewhere. A cooperative simply cannot function under these conditions.

Financial Difficulties

Financial difficulties can develop from any of the first three problems. Trouble can also develop from poor financial planning, especially in the formation stages of a cooperative. Inadequate accounting systems and operational controls can lead to financial decline as well.

How Should a Group Proceed?

Successful cooperatives have been established by following a four-part procedure. The steps outlined here are for groups that have already held a preliminary meeting and decided that there is a need for a specific type of cooperative.

1. **Form a Survey Committee** — The survey committee should be charged with identifying alternatives, potential membership volume, minimum size facilities, potential markets, required management and marketing skills, capital costs, operating costs and initial membership fees.

2. **Form an Organizational Committee** — The organizational committee should prepare the necessary paperwork for incorporation. This includes drawing up articles of incorporation and bylaws. It would also be appropriate for this committee to investigate marketing agreements between the cooperative and its members.

3. **Form a Finance Committee** — The finance committee would be charged with investigating the potential financial arrangements for capital outlay and facility acquisition. The committee could be expected to make a recommendation regarding the amount of initial capital to be raised by membership fees, stock sales and loans. The committee could also recommend an ongoing financing policy that would adhere to generally accepted cooperative principles.

4. **Form a Membership Committee** — The membership committee for a marketing cooperative should solicit membership by offering a marketing contract. The contracts could be drawn to specify that the prospective member will commit a certain volume of product to the cooperative if it is formed. Typically, the contract is binding only if a fixed number of members or a fixed volume of product has been signed up. Stock or membership fee commitments can also be made at this time.

Summary

The cooperative form of business or- ganization has provided a means for peo- ple to accomplish something that probably could not have been done individually Cooperatives have accomplished this by functioning as member-owned and member-controlled organizations designed to serve the specific needs of its members

Agricultural cooperatives have provid- ed for farmer needs by supplying inputs (fertilizer, chemicals, credit, supplies) and by marketing their products. Farmers have been increasingly interested in diversifica- tion by producing alternative crops, mos of which are new to the farmer. Thus, mar kets for these products as well as methods of marketing these products are mostly un known to the individual farmer. Market ing cooperatives may provide a solution to these problems.

Successful marketing cooperatives have exhibited certain attributes: they marke quality products, have sufficient volume to assure an efficient operation, employ goo management, communicate adequatel with their membership, have sound financ ing principles, remain producer controlled provide service to members at cost, hav methods of payment to members that re flect cost and quality considerations an are cautious about assuming risk. A new ly formed cooperative should keep thes attributes in mind at all times to increas the likelihood of success.

If a group of individuals contemplatin entering the production of a new alterna tive crop thinks that the above attribute can be achieved adequately, a marketin cooperative may be the instrument to pro vide the all-important marketing functio for their operations.

Whether a marketing cooperative is suc cessful depends upon the management em ployed to operate the business. Th cooperative must have competent manage ment to follow through on the functions c planning, organizing, directing, staffin and controlling to ensure a profitable en terprise.

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