Cooperatives in the Food System

1. What’s a Cooperative?

2. How important are co-ops in the US food system?

3. Do Cooperatives perform differently than investor-owned firms?
   a. Theoretical perspectives
   b. Empirical perspectives

4. Dilemmas facing cooperatives and their responses (cooperative conversion and new generation co-ops)
I. Definition and Objectives of Cooperatives

A. Wide variation of definitions around the world lead to confusion about what one means by cooperative.

1. All collective business action involves some cooperation (e.g., a corporation).

2. Based on their diverse experiences, some people love the idea of cooperatives, some hate it. (Cf. views of some in Eastern Africa with those in parts of US). Discuss.

3. Literature on coops until about 10 years ago also largely evangelical (either pro or con.)

B. The aim of this section is to get analytical about:

1. What we mean by cooperatives

2. How their behavior may differ (as a result of their structure and rules governing conduct) from other forms of economic organization, and hence identify the areas they may have certain advantages or disadvantages.

Role of ag. economists in this.

C. **Societal Objectives for Cooperatives.** Definition of co-ops vary because societies differ in what they are trying to achieve via co-ops. Broad philosophic differences [Overhead--quotes by Kravitz and Babcock]
1. Economic--Co-ops as a form of business organization, a mechanism by which small independent firms can band together to gain some of the advantages of scale (horizontal integration) and, at times, vertical integration. In this perspective, the emphasis is on the co-op as a tool of capitalism (Quote from Babcock)

2. Social--Government sanctioned and (at times) organized mechanism whose primary emphasis is on the achievement of other societal purposes (many countries)
   a. A form of decentralizing economic power in society.
   b. An alternative to capitalism. Aim is to achieve various social goals like rural development, income redistribution, and/or state control of rural areas.
   c. In many countries undergoing a transition from a control economy (e.g., the CIS), co-ops are seen as an ideologically acceptable way of trying to address the issue of individual enterprise.

3. In most countries, there is a mix of these objectives for co-ops, and much emotional fervor about them. But in U.S. agriculture, most of the emphasis has focused on cooperatives as an business organization.

D. **Definition:** A patron-owned business, where purchasers of the firm's output or the providers of one or more of its key inputs are the stockholders, and net returns are distributed in proportion to patronage rather than stock ownership. Patrons
rather than stockholders are the residual claimants of the organization.

1. All involve some horizontal integration (cooperation) among otherwise independent firms. But this horizontal integration is different from merger in that the member firms retain a great deal of their managerial autonomy for most production decisions. More like a strategic alliance.

2. Member firms also retain most managerial autonomy when coops involve vertical integration. But the relationship between the co-op and the member is different from just a spot-market relationship. Returns to the member firm from the co-op are contingent on the co-ops performance—cf. market-mediated vertical transactions.

E. Essential Characteristics of Co-ops in the U.S. (derived from Rochdale principles)

1. **Service at Cost**—patronage rebates=>

2. **Return through patronage** rather than through direct return on capital

3. **Democratic control** (often one member/one vote) rather than through stock ownership. Although some allow voting on a stock basis, it is usually tied to some limit or (as in Capper-Volstead Act) to limited return on equity (e.g., 8%).

4. 2 & 3 aimed at preventing the domination of capital in decision-making.

5. One important consequence of limiting stock ownership to patrons and channeling returns through patronage is that there is no secondary market for cooperative stock, which leads to constraints on:
A. Co-ops raising capital

b. Use of the stock price as an indicator of co-op performance. \(\Rightarrow\) greater reliance on board as a disciplinary mechanism for management.

6. Other consequences of structure for performance

a. Theoretically, performance is different from IOFs. Not just motivation that leads to different performance, but structure as well.

b. See reading on co-op theory for details

II. Importance and Forms of Coops in US Agriculture

A. Note that this discussion focuses on coops owned by farmers. But also, as mentioned earlier, other types of coops in US food system, such as retailer coops.

B. Importance by commodity of farmer cooperatives (*Overheads--on total numbers and on market share*)

1. Numbers: - See powerpoint presentation for updated figures.

   (1) Explanation of more coop memberships than farms:

       Multiple memberships in specialized cooperatives.

C. In U.S. agriculture, co-ops have taken several forms [ppt]

D. *Bargaining cooperatives*

1. Horizontal integration, similar to labor unions, to bargain with buyers over price and other terms of trade
2. Most important in dairy and fruits and vegetables

E. **Marketing cooperatives (overhead)**

1. Horizontal integration to achieve forward vertical integration--Market output from farmer members, often with some processing
2. Important in dairy (incl. bargaining), grains and soybeans, processed fruits and vegetables, specialty crops (ppt)

F. **Farm supply cooperatives (ppt)**

1. Horizontal integration to achieve backward vertical integration
2. Important in fertilizers, chemicals, feeds,
3. Not very important in equipment provision.

G. **Specialized Service Cooperatives**--e.g., artificial insemination, various services (e.g., farm management services, custom application of chemicals). Only class where the number of co-ops has increased since 1950.

H. Farm credit system, including the Banks for Cooperatives

I. Rural electrical and telephone cooperatives

J. Structures--centralized vs. federated (**handout**)

III. **What is their effect? Schools of thought regarding roles of cooperatives in economic coordination**

A. Central question when considering whether to try to promote cooperative enterprise is what you aim to achieve with it. This has varied all over the world, and leads to much of the confusion in the discussion about possible roles for
cooperatives. From business aims to political incorporation of rural people, through either farmer-controlled or “captured” rural political organizations. In US, there has been 3 main schools of thought on role of co-ops as business tools.

B. Commodity cartel approach--Concept of countervailing power

1. Championed in U.S. in 1920s by Aaron Sapiro

2. Idea was to organize most of farmers in specific commodity cooperatives and then restrict production to increase price and gain more favorable terms of trade.

   a. Approach generally failed due to free riding; relatively more successful in specialty crops than broad commodities.

   b. Still inspires some of the idea behind bargaining co-ops.

C. Competitive Yardstick approach

1. Promoted, initially in 1920s, by Edwin Nourse

2. Idea is that cooperatives compete with, but don't try necessarily to drive out of business IOFs. Rather, through competition, they provide a measure ("yardstick") against which the competitiveness of other firms can be measured.

3. Much more widely adopted philosophy of most U.S. ag. cooperatives--e.g., in feed, fertilizer supply.

4. Still subject to free-rider problems--if successful, IOFs will price competitively, which leads to little incentive to join or continue to
patronize the cooperative-->problems of cooperative loyalty.

D.  Cooperative-Coordination School (MSU)

1.  Looks at what role cooperatives can play in linking the commodity-oriented production sector of agriculture to the rest of the economy

2.  E.g., can Bank for Co-ops deal with problem of periodic over-investment in grain storage facilities through rationing credit (macro-aggregation of individual firm decisions)

3.  Possible role here for large co-ops in macro-coordination--i.e., balancing overall S and D in a subsector. Alternative to vertical integration or gov't programs?

IV. Historical development and enabling legislation

A.  Cooperative activities among farmers in U.S. began in 19th Century, and grew after Civil War in response to:

1.  Falling agricultural prices due to Westward expansion

2.  Lack of services and poorly integrated markets

3.  Imbalance in market power between atomistically organized farmers and much more concentrated economic actors they faced:

   a.  Buyers of output (e.g., meat packers)

   b.  Providers of inputs and services (e.g., railroads)

4.  Continued to grow through the 1920s due to dissatisfaction with quality of products they received (e.g., closed labeled fertilizer and feed) and high
margins on those items.

B. Attempts to organize cooperatives after 1890 were hindered by charges that farmer cooperatives represented a cartel and restraint of trade, which were illegal under the Sherman Anti-trust Act. Courts ruled that this was the case.

C. Congressional enabling legislation to help support co-ops:

1. Clayton Act (Section 6)--1914--gave anti-trust exemption to organization and operation of non-stock agricultural cooperatives.

2. Capper Volstead Act (1922)
   a. **Section 1** gave anti-trust exemption from Sherman Act to cooperatives that provided common marketing agencies. Allowed this to extend to cooperatives that issued stock, as long as they either:
      
      (1) Had one-member/one vote, or
      
      (2) Paid no more than 8% return on capital.
   
   b. **Section 2** authorizes the Secretary of Agriculture to take action against any cooperative that "monopolizes or restrains trade..to such an extent that the price of any agricultural product is unduly enhanced thereby."
      
      (1) An attempt to prevent ag. marketing cooperatives from using their anti-trust exemption to exploit consumers.
      
      (2) Does not define "undue price enhancement"; by
implication, some price enhancement is deemed legal.

3. Coop Marketing Act of 1926
   a. Created the fore-runner of the Agricultural Cooperative Service in USDA, which provides educational and technical assistance to cooperatives.
   b. Also provided some funding for land-grant university activities in support of cooperatives.

D. Ag. Fair Practices Act of 1967
   1. Aimed at strengthening cooperative bargaining, through making illegal practices like black-listing farmers who try to organize cooperative bargaining.
   2. Does not require good-faith bargaining.

V. Key policy issues
   A. Anti-trust
      1. Declining numbers and growing size and concentration of cooperatives in U.S. (See ppt)
         a. Concentration (ppt)
            (1) Concern raised in Justice Department about market power, particularly wrt dairy pricing.
      2. Secretary of Agriculture has never brought an action against a cooperative under Section 2 of Capper Volstead.
3. To what extent does cooperative monopoly represent a threat?

Theoretically, can a co-op exploit market power?

a. Due vs. Undue price enhancement? What is meant?

(1) Prices above those that would prevail under freer competition? But what was legislative intent in allowing co-ops? Wasn't it in part to increase farmer bargaining power (equalize power in the system)?

(2) What would be a structural criterion? Perfect competition?

b. Why should undue price enhancement clause only apply to co-ops and not IOFs?

c. How would you determine if a co-op had monopoly power? Use of S-C-P?

(1) **Structure:** Does the co-op possess the market power sufficient to unduly enhance prices?

(a) Can the co-op limit supply? Open vs. closed membership?

i) If high profits flow back to members in the form of patronage rebates, this should serve as an incentive to expand supply. Classic defense of cooperative monopoly. (Link to pro-competitive effect of a co-op in
oligopolistic markets.--Argument about whether the co-op bases entry on pre- or post-entry conditions).

a) So how returns are pooled across commodities and whether earnings are retained as unallocated reserves or passed back directly to members is critical in determining supply response.

b) Can co-op limit what members sell to coop or other outlets?

ii) Does the co-op limit membership or erect other barriers to entry?

iii) Does it control supply through surplus disposal, etc.?

(b) If co-op cannot limit supply, then can't unduly enhance prices.

(2) **Conduct**: Has co-op engaged in acts which individually or in total constitute monopolization or restraint of trade (e.g., predatory pricing)?

(3) **Performance**: If co-op can control supply, turn to the
concept of workable competition to look at degree and type of competition, and particularly returns to farm labor and capital compared to other businesses.

d. Classic defense of cooperative monopoly when Minimum Efficient Size of Plant is large relative to market.

e. Pro-competitive effects of co-ops on oligopoly. Farmers gain either way from cooperative entry if returns flow back to them.

B. Bargaining issues

1. Bargaining typically involves perishable commodities, such as fruits, vegetables, and milk. Often linked with marketing orders.

2. Conditions that have influenced farmers to engage in collective bargaining with processors:

   a. Unsatisfactory prices and buying practices

   b. Weak position of individual farmers, especially those without firm forward contracts--e.g., power of processors to withhold commitments to get better prices

   c. Efforts to undercut farmers' attempt to organize for bargaining

      (1) Black-listing of farmers who are leaders of bargaining movement (e.g., origin of Tri-Valley growers in California)

      (2) Sweetheart deals with some farmers

      (3) Refusal of processors to bargain in good faith
   a. Outlawed practices like bribes, coercion, and discrimination (blacklisting) in contracting.
   b. But it did not actually require good-faith bargaining

4. Continuing problems confronting bargaining cooperatives
   a. Voluntary participation-->free-rider problem
   b. Lack of effective supply controls, which hampers price enhancement

5. The Exclusive Agency Bargaining Alternative
   a. Enabling legislation--e.g., Michigan Public Act 344 (for selected fruits and vegetables)
   b. Based on an affirmative vote by farmers
   c. Requires compulsory participation of all growers and non-cooperative processors in the negotiation of transaction (price) terms. Processors must bargain in good faith
   d. The bargaining unit consists of all farmers of a specific commodity in a specific area, following a majority vote in favor of bargaining by a farmer referendum
   e. The bargaining association (bargaining co-op) represents all farmers, both members and non-members (gets around free-rider problem) and is financed by assessment on growers. It is like a
“closed shop” in a union industry.

f. Procedures

(1) Collective bargaining, patterned after labor negotiations

(2) Offers and negotiations

(3) Mediation and fact-finding procedures

(4) In case of deadlock, provision for compulsory arbitration.

This has turned out to be a big item in the law. Experience is that after a few years, binding arbitration is not used as parties have learned what the arbitrator would likely decide, so the two sides patterned their agreement on this.

(5) Once the price is set, all non-coop processors and farmers are bound by the terms. Co-op processors exempted on grounds that farmers can't bargain with themselves.

g. Stormy history of this act

(1) Processors have fought this through the courts. Latest court decision (1990) relaxed the compulsory participation of non-members of the bargaining association.

(2) Still used, especially in apples and asparagus. Trying to develop something on cherries due to the failure of the bargaining order.

(3) But in Michigan, the need for compulsory bargaining has
diminished as grower coops have come to dominate
processing, esp. for apples and cherries.

(4) Has been proposed at the national level but not accepted.

C. What is a coop? When is a co-op not a co-op?

1. Co-ops facing several tough issues (Cook):
   a. Free rider problem
   b. Horizon problem
   c. Portfolio problem
   d. Control problem
   e. Influence problem

2. These have led to joint ventures and other types of financing. Question is
   whether organization should still be called a co-op and be allowed the
   social benefits extended to co-ops--e.g., Capper Volstead exemption;

   Banks for Cooperatives financing.

D. Management and Control of Large Cooperatives

1. Agency issues--farmer vs. management vs. state control
2. Structure in a competitive world--centralized vs. federated
3. Producer commitment
4. Internal financing through retained earnings
5. Equal vs. equitable treatment of members

E. Balance of commitment and external competition for discipline.
F. Emergence of new generation cooperatives as a way of dealing with these problems. Characteristics of new generation cooperatives:

1. Focus on value-added marketing
2. Appreciable and transferable delivery rights
3. Up-front equity capital investment requirement
4. Defined (closed) memberships
5. Pooling and marketing agreements with strong penalties for non-compliance.