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COOPERATIVES, CAPPER-VOLSTEAD AND THE ORGANIZATION AND CONTROL OF AGRICULTURE

Philip M. Raup*
Department of Agricultural and Applied Economics
University of Minnesota

INTRODUCTION—CO-OP NUMBERS

Mergers and consolidations have been the dominant structural trend in the business world over the past quarter century. With differences in form and scale, the same trend has dominated the farming sector. This is no less true of the cooperatives serving farmers.

Over the quarter century from 1950 to 1975, the total number of cooperatives declined from 10,064 to 7,645, with roughly three-fourths of the decline accounted for by marketing cooperatives. The largest percentage decline was in dairy cooperatives, whose numbers were cut approximately in half.[1]

The trend toward fewer and larger cooperatives is associated with similar trends in the size and structure of farms. Between 1950 and 1974 the number of farms in the United States was cut in half (from 5,648,000 to 2,821,000), and the average size of farm increased from 86 hectares to 156 hectares (213 acres to 385 acres).

The change is even more dramatic if measured in terms of the dollar value of gross receipts from sale of farm products per farm. In 1949, approximately half of total U.S. receipts from farm marketings were received by farms with gross sales of over $10,000. In 1969, just under half of all farm receipts went to farms with gross sales of over $40,000 per farm. Four years later, in 1973, farms with sales of over $40,000 were 16 percent of the number of farms but accounted for 70 percent of total cash receipts from farming. Those with sales of over $100,000 per farm were only 3.8 percent of the number of farms but received 46 percent of total cash receipts.[2]

This trend toward fewer and larger farms is associated with an even more significant trend toward specialization. The typical family farm in the past produced grain, hay, milk, meat animals, poultry, and a wide variety of specialty crops. For example, in the state of Minnesota as recently as 1954 cattle were reported on 84 percent of all farms, milk cows on 74 percent, hogs on 59 percent and chickens on 73 percent. In 1974, approximately 40 percent of Minnesota farms had no cattle of any kind, 70 percent no milk cows, 70 percent no hogs, and over 90 percent no chickens. A pattern of specialization has developed in which many grain farms keep no livestock, and livestock farms produce a steadily declining fraction of their feed supplies. Much of the volume of farm marketings is sold directly or indirectly to other farms, especially in the feed-livestock sector.

*I am indebted to my colleagues Dale C. Dahl, Frank J. Smith and W. B. Sundquist for helpful comments on an earlier draft. Responsibility for any errors that remain is mine alone.

CREDIT

Paralleling these structural changes, there have been significant changes in the sources of agricultural credit. Prior to the first World War individuals supplied three-fourths of all credit to agriculture. The remaining one-fourth was divided more or less equally between the banks and the insurance companies. By the end of the Depression years of the 1930's, the share of debt held by individuals had been cut more than in half, the share held by banks was only 8 percent, and the Cooperative Farm Credit System held 43 percent of total debt. By 1976, the shares of total farm debt held by banks and insurance companies was almost the same as their shares in 1910, and together they held one-fourth of the total.

Table 1 shows the dominant change in farm credit sources from 1910 to 1976 was the replacement of debt held by individuals with debt held by the Cooperative Farm Credit System and by the Farmers Home Administration.

Table 1: Sources of Farm Credit 1910, 1940, 1976.[a]

	Outstanding Farm Real Estate Debt (percent of total)		
	1910	*1940*	*1976*
Banks	12.7	8.1	12.3
Life Insurance Companies	12.1	14.9	13.2
Individuals and others	75.3	33.7	36.7
Coop. Farm Credit System	0	42.7	31.2
Farmers Home Administration	0	0.5	6.6

[a] *Agr. Finance Data Book,* Fed. Reserve System, Sept. 1976, pp. 3, 9, 14, 15, 18.

The changes in sources of farm capital, decline in farm numbers, increase in farm size, and growing specialization are producing an agricultural structure that is increasingly segmented. One of the most important consequences is a separation between the sectors of agriculture with political power and those with economic power. The majority of farms are relatively small in size, are operated by farm families, but contribute a small share to the total volume of agricultural production. Farms with sales of less than $10,000 in 1973 were 52.8 percent of all farms but accounted for only 5.46 percent of cash receipts from farming. There were 1,835,000 farms with sales under $20,000 in 1973. These were 65 percent of all farms but received only 11.35 percent of total cash farm receipts.

The lower end of the size distribution of farms thus includes almost two million farm families, with numbers sufficient to exercise political power but without ability to make their power felt in the economic market place. At the other extreme, the 109,000 farms with gross receipts of over $100,000 have economic power, but lack the numbers necessary to exercise political power through conventional political methods. They do not have the votes.

POLITICAL

This explains the appearance of attempts by farm groups to obtain political

power by unconventional means. These have included large cash political contributions, intensified special interest lobbying activities, and alliances among commodity groups or along product lines.

Another measure of the segmentation of American agriculture is provided by the contrast between grain farmers and livestock farmers. Grain farmers are relatively numerous, are not significantly involved in incorporated businesses, and among all types of farms are least involved in vertically integrated or contract production. A major part of their market is foreign. Imports are not a threat. They can compete with the world.

Livestock and poultry producers are rapidly declining in number, are often controlled by large corporations, and are heavily involved in contract production or vertical integration. They have virtually no foreign markets, apart from lard and tallow, hides, offal, and some poultry. Imports are a continuing threat to meat and dairy producers and they easily develop a highly possessive and protectionist attitude toward the U.S. market.

Grain producers are scattered over the landscape and are still politically significant in many regions. Producers of meat, dairy products, and poultry and eggs, on the other hand, are increasingly concentrated in a relatively few geographic areas. Even in major producing areas they are often not numerous enough to carry political weight at the polls. In the political field, they are now a minority group. They must seek power through economic means.

This growing segmentation of the political structure of American agriculture was well under way in the 1960's. It was given a powerful stimulus by the sharp increase in world market grain prices following the grain purchases by the USSR in July and August of 1972.

The short-run effects were increased prices of grains and other field crops relative to the prices of livestock and poultry products. The significance of these trends lies in the fact that the principal benefits were received by the field crop sector, which is most heavily involved in export markets and least involved in corporation farming or (with the exception of cotton) in contract and vertically integrated production. In contrast, the sectors that benefitted least from price trends from 1972 to 1975 were the sectors that have been increasingly dominated by corporation farming and production under contract of poultry, livestock products, fruits, and vegetables, primarily for domestic markets. One consequence has been increasing pressure on livestock, poultry, fruit, and vegetable producers to speed up forward or down-stream integration into processing and retailing activities. With reduced ability to control the prices of feeds and other inputs on the supply side, they have sought greater control over market outlets and prices on the demand side.

A consequent reordering of the power structure in American agriculture is underway. Our existing mix of forms, agribusiness firms and farmer cooperatives is largely a result of growth patterns set in motion in the years from roughly 1910 to 1950. In these formative years, agribusiness firms and cooperatives were a reflection of the size, structure, and distribution of farm types. For cooperatives in particular, firm structure followed farm function.

Since about 1950, the causal relationship has reversed. The farms that have

survived are increasingly a reflection of the size, structure, and function of supply, processing and marketing firms. In many cases, farm structure now tends to follow the function of off-farm agribusiness firms, including cooperatives.

This heightens the significance of the emerging struggle for command over the capital required to finance a farm and agribusiness structure made up of large and segmented units.

CAPITAL

Mobilization of capital is one of the major functions performed by a business firm. Historically, this has been a major rationale for both corporate and cooperative forms of business organization. The functional test is clear: That form of organization is best that can mobilize capital most effectively. In modern capital markets this mobilization task has been heavily influenced by three recent developments:

a) The growing importance of pension funds and other forms of institutionalized investment.
b) Preferential tax treatment of capital gains and related income tax rules.
c) Inflation.

How have these developments affected the relative position of cooperatives in acquiring capital? In the past, retained earnings have been the major source of capital for cooperative expansion. The existing structure of farmer cooperatives has been erected on retained patronage refunds, with minimum attention to the impact of tax policies.

This is now changing. Patronage refunds due members must be taxed as income to the members even if retained by the cooperative. It is not yet clear just how heavy a burden this will create for cooperatives in acquiring capital in the future. The bigger cooperatives may be able to acquire capital on the strength of their size and performance record, in spite of the tax handicap now placed on undistributed patronage refunds. The major burden seems likely to fall on new cooperatives or on smaller ones seeking to expand.

Inflation may have placed conventional corporations in a better relative position to retain earnings, in that investors are often willing to forego distribution of dividends and are satisfied to watch their net worth increase. Their "earnings" can ultimately be received as capital gains, and will thus be taxed at a lower rate, if received by individuals with taxable incomes above about $50,000. If held until the death of the owner, the capital gains tax liability will be erased. Any appreciation in value due to internal reinvestment of funds that might otherwise have been declared as dividends will be passed on to the heirs untouched by the personal income tax.

This advantage is virtually unavailable to cooperatives. It is much more difficult for their patrons to benefit from the preferential taxation of capital gains when earnings or patronage refunds are retained. It is also more difficult for cooperatives to attract capital from pension funds or similar pooled investment sources. The net effect of these recent changes may be to worsen the relative position of cooperatives in the mobilization of capital.

The significance of capital gains for the financial structure of agriculture is

not confined to the off-farm corporate or cooperative agribusiness sector. In the four years 1972-75 real capital gains in farm asset values in 1967 dollars exceeded net farm income in all years except 1974. (The exception in 1974 was due to the massive drop in livestock values in that year.)[3]

These were the only years since 1940 (the initial year for this data series) in which farm capital gains exceeded net farm income. This recent predominance of capital gains over net income is exercising an unmeasured but undoubtedly heavy influence on decision making by agricultural producers and their creditors. The financial well-being of farmers is increasingly dependent upon asset value appreciation instead of net income. The cash-flow problems this is creating have not yet reached their peak. The bank credit that is financing the current large volume of farm-stored grains, for example, has been sustained in recent months by land value appreciation. This structure is highly vulnerable to land market trends, and dependent to a disturbing degree on an inflation psychology. If land values adjust downward to match current levels of farm product prices, we can anticipate a major farm credit crisis.

In the farm cooperative sector, the search for capital to achieve economic power through market control and manipulation has recently been given a new dimension. A major strategy in some cooperatives is to develop consumer loyalty for brand-named products. One implicit goal is to create an alternative source of capital for business expansion. If the strategy succeeds, it seems likely to generate a new control structure for cooperatives.

The larger and more highly integrated cooperatives are now increasingly able to obtain capital "by extracting a profit from the market place."[4] These were the words used by Harvey Ebert, marketing director of Land O'Lakes, Inc., Minneapolis, Minnesota, in explaining the need for large amounts of capital if cooperatives are to develop their own brand-named products.

Ability to use advertising and market power to create customer loyalty for brand-named products makes it possible to look to customers instead of creditors or stockholders to supply needed capital for firm growth. In effect, the firm that succeeds in creating brand loyalty can levy the equivalent of a private-sector sales tax on its customers, who pay a higher price for the product than would otherwise be necessary.

This has been a major characteristic of the business world since the introduction of mass-media advertising. One result has been a decline in the significance of the traditional stockmarket as a source of business capital. The more powerful the business firm, and the greater its ability to exercise market power and to manipulate demand through advertising, the greater also has been its ability to extract capital for operation and expansion from its customers.

Cooperatives in the past have not felt compelled to make investments to create or sustain consumer brand loyalty. To the extent that branded products play an increasing role in cooperative marketing strategy it will be necessary to increase capital input into activities that build brand loyalty. From a national and social point of view this will be justified only if it increases the net capacity of the economy to create productive capital.

If brand loyalty permits increased capital investment from retained earn-

ings, it could lead to a greater (or a cheaper) supply of capital than could be obtained through credit or equity markets. But if brand loyalty simply redistributes market shares, the investment needed to create it is unlikely to yield any net social benefits.

This is not a new problem in the corporate business world but it is new in the cooperative world. It raises fundamental questions about the significance of the Capper-Volstead Act as a cornerstone of the legal basis for cooperatives, their capacity to retain the loyalty of their members, and the ability of cooperatives to command public support as necessary elements in a competitive, free-enterprise economy. If cooperatives succeed in the achievement of market power through the development of brand-named products, they run the risk of becoming just another form of big, quasi-monopolistic business. As spokesmen for cooperatives have been pointing out for many years, the Capper-Volstead Act does not exempt cooperatives from anti-trust laws. It simply reduces enforcement to a case-by-case basis. The trends of recent years have unquestionably weakened cooperative protestations that they should remain free from attack under antitrust legislation.

The historic explanation of the structure of a private enterprise economy is that business firms are controlled by their operating owners or their stockholders. Their right to grow is regulated by the stock market and the banking system, which grant capital and credit to profitable firms and withhold it from unprofitable ones.

The rise of a professional managerial class and the fall in the real cost of influencing public opinion by mass media advertising have combined to make obsolete this traditional explanation of the operation of a market economy. The dominant private business firms are so large and complex today that they are often beyond the control of their conventional owners, the stockholders. The emerging danger is that the management of large regional and federated cooperatives may also become so remote from farmer members that the historic reliance upon farmer control becomes a fiction.

If capital for expansion can be obtained from customers through control of markets, this weakens the equilibrating influence of the stock market, the credit market, and patrons or investors. Some analysts see this occurring in the cooperative sector of the American agricultural economy. They ask: What is the purpose of cooperatives? In the words of one of the sharpest recent critics:

> "Cooperatives . . . are intended to be more than simply another American business group. They are intended to be a unique form of business, owned and controlled by the farmers who are members and patrons of the coop. It is their difference that counts. But the difference is being obscured, and they are becoming just another agribusiness . . ."[5]

Cooperatives were designed in part to provide a remedy for market failure. The danger now is that cooperatives (and other agribusiness firms) are vulnerable to organizational failure, due to prohibitive increases in transaction costs, and the indeterminateness or "incalculability" of inter-unit prices in integrated firms or hierarchies.

It was unequal access to information, and resultant high transaction costs for farmers, that created situations in which cooperatives flourished through mergers, vertical integration and the creation of hierarchies of control.

Presumably the principal reason for substitution of a hierarchical organization structure for a multiplicity of small cooperatives or agribusiness firms was to reduce transactions costs. It will be ironic if these internalized transactions costs become so burdensome within the enlarged firm, and so subject to organizational rigidity, that they now threaten organization failure. If it occurs, this failure will be due to a breakdown in internalized communications and pricing efficiency within the hierarchical firm.[6]

The challenge to cooperatives is to rise to the requirement dictated by the need to mobilize capital and maintain market power, without sacrificing responsiveness to their members, or to the principle of member control.

Their dilemma focuses sharply on the old question: Is democracy reconcilable with efficiency? The cooperative principle has always assumed that no conflict was involved. The current scale of cooperative firms raises anew the question of whether or not cooperatives have invested as much effort in maintaining their political capital represented by the goodwill of their members as they have in acquiring monetary capital and market power. Underlying this question is a more significant one: Have cooperatives brought their membership along with them in their climb to economic power?

There is thus a bittersweet element in the recent growth record of agricultural cooperatives in the United States. Some years ago Edwin G. Nourse, a pioneer in the study of American agricultural cooperatives, observed that "the true place of the cooperative is that of economic architect, not commercial Napoleon".[7] It is this philosophy that is sharply challenged by recent developments in the farmer cooperative movement.

NOTES

1 U.S. Department of Agriculture, *Cooperative Growth, Trends, Comparisons, Strategy,* FCS Information Bulletin No. 87, March 1973, p. 9, and *Statistics of Farmer Cooperatives,* FCS Research Report 39, April, 1977.

2 U.S. Dept. of Agriculture, Farm Income Situation, FIS-224, July 1974, pp. 67-68.

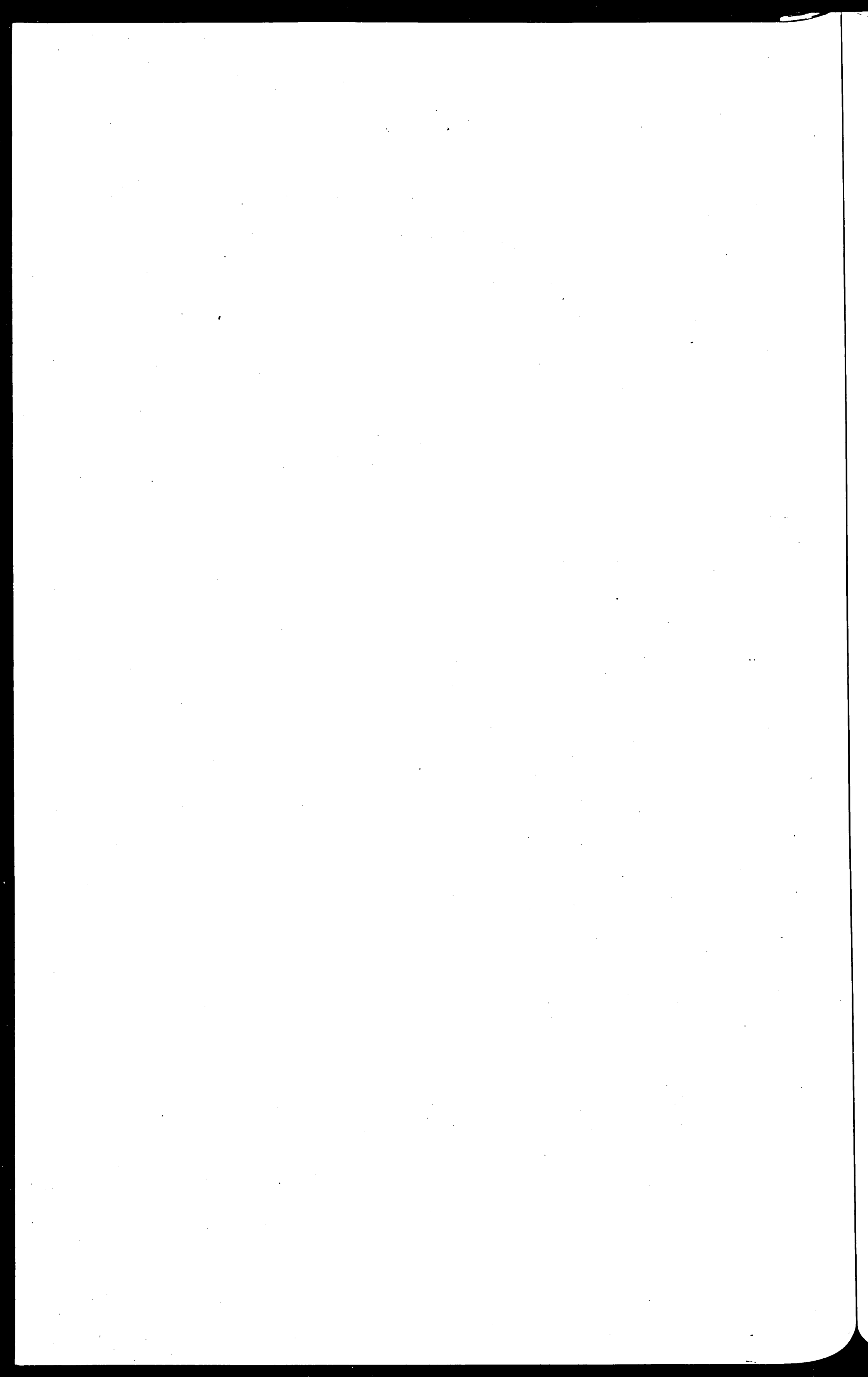
3 *Agricultural Finance Databook,* Federal Reserve System, Sept. 1976, pp. 60-62.

4 "Why Bargaining and Marketing Cooperatives Must Work Closer Together", *News for Farmer Cooperatives,* May 1974, p. 11.

5 Linda Kravits, *Who's Minding the Coop?,* Washington, D.C., Agribusiness Accountability Project, March 1974, p. 110.

6 For a discussion of these issues in a setting of particular significance for cooperatives, see Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications,* New York and London, The Free Press, 1975.

7 Quoted in a commemorative note on the occasion of his death in 1974 in *News for Farmer Cooperatives,* Vol. 41, No. 3, June 1974, p. 20.



CHAPTER II
THEORIES OF THE COMPETITIVE BEHAVIOR AND EFFECTS OF COOPERATIVES