Taxing Co-ops: Part II

Current Treatment Doesn't Harm the Economy

by Richard J. Sexton and Terri Erickson Sexton

In the previous issue of CHOICES, the authors examined the co-op income tax controversy. They concluded that the single tax on co-op earnings gives co-ops an advantage over their corporate counterparts whose income is taxed twice. They argued, however, that this treatment is fair and consistent with the rest of the tax code. Their reasoning was that the tax-free income transfer from co-op to patron is no different from the right of vertically integrated corporations to have income from vertical subsidiaries be taxable only to the parent company.

We put the fairness question aside in this article and take up the issue of whether the co-op tax advantage has been or will be harmful to the economy. In particular, do cooperatives use their tax advantage to drive out or acquire competing businesses, thereby stifling competition and causing higher prices and reduced output?

Opponents use the increasing co-op market shares in certain agricultural industries as supporting evidence. For example, since 1950, cooperatives' overall portion of farm products marketed has grown from 20 to 30 percent while their share of products supplied has increased from 12 to 27 percent.

However, the tax advantage is only one of many factors which may have contributed to this growth. Most aspects of tax policy give somebody a relative break; so the policy concern is not the mere existence of a co-op advantage but how the advantage affects the economy.

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Consider two aspects: (1) Has cooperatives' market power shown an alarming rate of increase, as critics suggest? (2) Do co-ops that have a large market share use their size to harm consumers and the economy; could they if they wanted to?

In response to the first aspect, the statistical evidence does not indicate a pattern of market power for cooperatives. Growth in the co-op share in most farm sectors has occurred slowly and has stabilized in recent years at what typically are very modest levels.

Moreover, the relevant indicator of market power is not the cumulative shares held by all co-ops but, rather, only that held by the largest ones. For example, the cumulative farm-gate share held by the four largest co-ops is reported in Table 1 for several commodities.

To compare these co-op "concentration ratios" with those that prevail elsewhere, consider that 28 percent of the 449 U.S. manufacturing industry groups had a four-firm concentration ratio of 50 percent or greater in 1977, and nearly 60 percent had ratios of 30 percent or more. In fact, when the four largest co-ops in an industry are compared with the four largest nonco-ops (Table 2), the co-ops' share is invariably much smaller.

Also worth noting is that co-ops' shares are usually measured where they are their highest, the first-handler level or "farm gate." Co-op activity usually declines rapidly at successive production stages beyond the farm; so farm-level shares vastly overstate co-ops' overall position in the food and fiber marketing system.

Co-Op Membership

As to the second aspect, critics say restricting membership and, hence, controlling output is one way marketing co-ops use market power to hurt consumers and the economy. Because co-op members almost always choose their own production levels, marketing co-ops generally cannot directly restrict output. Some argue, however, that they accomplish the same purpose by restricting membership.

Actually, cooperatives seldom restrict membership. In any event, there are reasons other than market power to justify

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membership limitations. One obvious alternative reason is if output expansion would generate cost-raising inefficiencies; thus, lowering member returns and eventually threatening an association's existence. In 1964 and again in 1977 James Youde and Peter Helmberger conducted surveys of 150 leading regional marketing co-ops. Their studies showed that only about 15 percent of the co-ops restricted membership and just a small fraction of this group did so for market power reasons.

When co-ops do restrict membership, monopolizing effects result only if co-ops also limit entry into the market and restrict total output. For this to happen, those denied membership must have no viable marketing alternative.

Even here, however, a co-op's ability to control market supply is regulated by the potential for entry by new competitors—for example, a cooperative formed by the farmers being denied membership. Alternatively, output may expand as members buy land from the excluded producers.

Price Discrimination

Even though marketing co-ops apparently cannot effectively restrict output, they may still attempt to use market power to control the amounts of product which flow into particular submarkets. This practice, known as classified pricing or price discrimination, is designed to raise producers' average price, often at consumers' expense.

The key to establishing classified pricing is to isolate submarkets and charge a higher price in those markets that can bear it. Common examples are the markets for fluid and manufacturing milk and for fresh and processed fruits.

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However, unless the supply of the product is closely controlled, it is virtually impossible to keep submarkets isolated because the product will flow from the low to the high-priced market, thus eliminating any price differential. This is the so-called "free-rider" problem: Although producers benefit in aggregate from classified pricing, they individually have incentives to cheat (to free ride) by diverting more product into the high-price market.

Co-ops seldom have sufficient market power to control supply and make a price discrimination scheme work. Moreover, a successful scheme may be destabilized by entry of new firms. Critics assert, however, that the free market's resistance to classified pricing has caused co-ops to seek to implement these schemes through federal regulation, particularly the marketing order provisions of the Agricultural Marketing Agreement Act (AMAA)of 1937.

Marketing Orders

Marketing orders provide legal authority to implement classified pricing, and, if voted in by producers, they are binding upon all producers. This provision surmounts the free rider problem,

Table 1—Estimated share of cash farm receipts for the four largest regional cooperatives in selected commodity groups, 1973-74

Commodity group	Percent of cash farm receipts for the four largest co-ops
	Percent
Beans and peas	23.7
Cotton	14.2
Dairy	29.3
Fruit and vegetables	10.8
Grain	13.8
Livestock	4.4
Nuts	38.6
Poultry	4.9
Rice	49.0
Sugar	27.9
Tobacco	13.8
Wool and mohair	13.5

Source: J. Schmelzer and G. Campbell, in B. Marion, ed. Agricultural Cooperatives and the Public Interest, N. Central Regional Research Publ. 256, 1978, 71-104.

Table 2—Sales for the four largest cooperatives as a percentage of sales for the four largest noncooperatives in selected industries for 1980

Industry	Percent
Farm product marketing:	
Grain	24.5
Fruit and vegetable	33.3
Dairy products	62.4
Poultry and poultry products	24.0
Farm product sales:	
Feed	50.0
Fertilizer	72.7
Petroleum products	1.4

Source: U.S. Dept. of Agriculture, Agricultural Cooperative Service, Farmer Cooperatives, Vol. 49, July 1982, 4-6.

and the AMAA often allows co-ops to cast their members' votes as a block on a marketing-order referendum.

We believe the marketing order issue is quite independent of the co-op tax issue. Even though some co-op members may be beneficiaries of marketing orders, it does not follow that co-ops ought to be blamed for these regulations.

Moreover, the isolated instances of anticompetitive behavior attributed to co-op manipulation of marketing orders in the milk, orange, and lemon markets should not cause us to lose sight of the procompetitive effects of cooperatives. For example, farmers may form cooperatives when they face monopoly power in their dealings or when no for-profit enterprise will service a market. In these and similar cases, co-ops act to correct market failure, not to cause it.

We therefore find no basis to the contention that co-ops' tax treatment has been or will be harmful to the economy. Instances of alleged anticompetitive behavior by co-ops are tied to marketing orders which should be debated on their own merits and not used in a backhanded attempt to attack co-op tax rules.

For more information: Agricultural Cooperatives and The Public Interest, *edited by Bruce Marion, is an excellent reference on cooperatives' role in the U.S. economy. It is North Central Regional Research Publication 256, published by the University of Wisconsin, Madison. Of particular interest are articles by John Schmelzer and Gerald Campbell on the size and market share of agricultural co-ops, James Youde on co-op membership policies, and Alison Masson, Robert Masson, and Barry Harris on cooperatives and marketing orders. For single copies write to Bruce Marion at the Ford System Research Group, University of Wisconsin, 427 Lorch, Madison, WI 53706.* C

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A nitrogen fertilizer plant built by a cooperative in the 1960s.