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STRATEGIES FOR CAPITALIZING FARMER COOPERATIVES: DISCUSSION

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Dr. Royer has provided us with a fine survey of cooperatives' capitalization alternatives and an up-to-date analysis of statistical trends in co-op margins and debt/equity relationships. However, the focus may have been somewhat skewed towards capitalization issues most relevant to large co-ops at the expense of assessing the financing problems of small, recently conceived cooperatives or prospective co-op ventures that have yet to get off the ground.

My experience, based on recent examination of cooperative activity in California, is that, in spite of a strong cooperative presence in the state, there has been almost no new co-op activity during the past several years. Although this fact of itself does not indicate a problem, lack of new co-op activity is a trend we should monitor along with developments endemic to larger, more established associations.

The financing problems faced by new co-op ventures may be quite different from those encountered by their more established counterparts. For example, nascent co-ops probably do not have access to most of the sources of debt financing on Dr. Royer's list, and they need to generate an initial infusion of equity before operations can begin and patronage-related charges can be assessed.

A way of generating an equity base not explicitly discussed by Royer but of prospective importance particularly to new co-ops is through limited partnership offerings. I'm aware of this method currently being employed by a handful of urban cable television cooperatives and at least one major California agricultural marketing co-op.

Partnerships may be sold to general investors, or they may provide a way for some prospective co-op members to augment their support of the association in a financially prudent way. These investments offer potentially attractive tax advantages in the form of ordinary losses and investment tax credits. They are set up to have a finite life, existing only long enough to exploit the available tax advantages and enable the co-op to acquire enough equity through conventional means to buy out the partnerships. During the partnership's life, outside management is probably necessary to guarantee the partners' interests.

Beyond this point, I have little to add to Dr. Royer's presentation and interpretation of the statistical trends and financing alternatives. Therefore, I would like to focus the rest of my discussion on some conceptual issues concerning the economic effects of the alternative capitalization methods. My comments are made in the context of a supply co-op, but they are equally applicable to marketing associations.

Among the three capitalization alternatives, think we should have a clear preference for direct investment. Dr. Royer's observation that only 14.7 percent of new 1980-84 equity came from this source is, therefore, somewhat disconcerting.

The reason for this preference is simple. Retained net margins require the co-op to obtain a "profit" from member business, while issuing per-unit capital retains amounts to setting prices to members above marginal cost (MC). Departures from MC pricing imply that members' input mix will be distorted and output most likely reduced from its optimal level. Although these inefficiencies are well known, they are a necessary by-product of per-unit retains financing and an almost certain consequence of generating "profits" from member business.

The reason I hedge slightly on the latter point is that MC pricing does naturally generate a "profit" when production is set beyond the minimum of average cost (AC). However, I doubt for both theoretical and empirical reasons that many co-ops actually operate at outputs beyond minimum AC. The theoretical reason is related to sustainability (Baumol, Panzar, and Willig). Output levels in excess of minimum AC are naturally unstable because production is costing more per unit than is necessary. The empirical reasons are industry studies which uniformly report that co-ops are smaller than their for-profit counterparts in the same industry (O'Day) and could benefit from expanding output and exploiting scale economies.

Therefore, from the viewpoint of the co-op membership, a Pareto superior result to capitalization based on retained margins or per-unit retains should be attainable by (1) pricing services to members at marginal cost, and (2) acquiring necessary capital through direct investment by members.

The pragmatic problem with this arrangement is that it is apparently more difficult to convince farmers to directly contribute equity than it is to obtain it indirectly through net margins or per-unit retains. I think the key to circumventing this problem is to explicitly recognize that member equity contributions are not intended to be profitable as investments per se. Rather, they should be structured and characterized as membership fees which afford the payee the privilege of utilizing the co-op's services. In this sense, Royer's observation that "direct investment has worked successfully when it has been tied directly to use of the cooperative," hits the nail squarely on the head.

A final observation on this topic concerns the efficacy of patronage-based financing itself. One of the original Rochdale principles, patronage financing is universally regarded as a hallmark of fairness in co-op pricing, e.g., it is the objective behind Royer's base capital plan. Unfortunately, patronage financing need not be fair under what I believe contitutes the most logical definition of fairness, namely, the absence of cross-subsidies between members. Although space precludes setting forth a formal description of cross subsidization in a co-op context, the presence of cross subsidies basically implies that some members are being charged more than the cost of serving them or are receiving fewer benefits than they are earning. It can be shown (Sexton) that pure patronage financing may induce cross subsidies under very general circumstances. Aside from its normative implications, this result also implies in a game theory context that the patronage-based payoff may be unstable, a result of prospective behavioral importance.

The reason for this result is that patronage may not be a very good barometer of the benefits accruing to cooperation. Perhaps not surprising, therefore, is the result that supplementing an MC-pricing plan with capitalization contributions made in proportion to each member's benefits from cooperating will generate a stable, subsidy-free payoff under some fairly general conditions. The practical significance of this result remains to be determined. Money benefits from cooperating are harder to observe than patronage levels, and patronage financing is codified into law in some cases, e.g., as an eligibility requirement for subchapter T tax treatment.

In conclusion, although cooperatives' traditional financing principles have served them well, there is room for improvement in light of conceptual advances in economics and finance. I would particularly suggest that (1) cooperatives be alert to capitalization alternatives which do not require them to depart from optimal (i.e., marginal cost) pricing principles, and (2) they strive to develop financing plans which minimize intermember, intertemporal, or intercommodity cross subsidies.

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