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Cooperative Criteria

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Farmer Cooperative Service
U.S. Department of Agriculture

FARMER COOPERATIVE SERVICE
U.S. DEPARTMENT OF AGRICULTURE
WASHINGTON, D. C. 20250

Joseph G. Knapp, Administrator

The Farmer Cooperative Service conducts research studies and service activities of assistance to farmers in connection with cooperatives engaged in marketing farm products, purchasing farm supplies, and supplying business services. The work of the Service relates to problems of management, organization, policies, financing, merchandising, product quality, costs, efficiency, and membership.

The Service publishes the results of such studies; confers and advises with officials of farmer cooperatives; and works with educational agencies, cooperatives, and others in the dissemination of information relating to cooperative principles and practices.

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PREFACE

Cooperatives are an increasingly important factor in raising living standards. They help stabilize prices, strengthen the bargaining power of their users, reduce costs, improve income and product quality, and benefit consumers in both rural and urban communities. Their importance in carrying out agricultural policy has been recognized by the U.S. Department of Agriculture as evidenced by the increased participation of cooperatives in rural housing, electrification, price support, grain storage, and market order agreement programs.

It has become increasingly apparent, however, that the criteria for determining the distinguishing features of a cooperative now being used by the various agencies in the Department in furtherance of these programs are not uniform. This variation in the criteria used by these agencies is due in part to the difference in wording of the statutes they are implementing or administering. It is also due in part to differences in the interpretations and regulations growing out of them. Thus Department regulations based on these criteria are not uniform in their treatment of cooperatives. This report, therefore, seeks to provide a common framework for agencies of the Department that will enable them to carry out programs through cooperatives on a more uniform basis.

COOPERATIVE CRITERIA

by
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and
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PURPOSE

At the request of John A. Baker, Assistant Secretary of Agriculture, Rural Development and Conservation, Farmer Cooperative Service has undertaken the assignment to develop criteria that define what a cooperative is for use in the U.S. Department of Agriculture.

The purpose, therefore, of this report is to:

1. Describe essential characteristics of cooperatives so that USDA employees charged with the responsibility of administering agricultural policies, and others, can better understand those features that serve to distinguish cooperatives from other forms of enterprise.
2. Develop basic criteria that will serve as a means of determining the qualification of a cooperative as an economic enterprise.
3. Develop guideline criteria that will serve as goals toward which cooperatives should strive in achieving the characteristics that distinguish them from other forms of organization.

Government agencies involved in carrying out agricultural policies through cooperatives will find that the criteria outlined in this report may enable them to develop more sharply defined regulations within the general framework of these criteria. Thus program agencies in the Department should be able to use these criteria as a basis for establishing regulations particularly tailored to their program needs. Where existing laws do not provide specific authority for agencies to establish sharply defined regulations applicable to their use, they may find it necessary to first implement procedures present in their enabling legislation. If authority for promulgating certain regulations is not already provided, they may desire to seek change in the enabling act itself. This report seeks to provide a common framework for agencies of the Department that will enable them to carry out programs through cooperatives on a more uniform basis.

A COOPERATIVE DEFINED

The analysis of criteria used by USDA and other agencies that work with cooperatives has resulted in a definition of a cooperative. This definition follows, supplemented by a section that explains certain terminology included in the definition.

"A cooperative is a voluntary contractual organization of persons having a mutual ownership interest in providing themselves a needed service(s) on a nonprofit basis. It is usually organized as a legal entity to accomplish an economic objective through joint participation of its members. In a cooperative the investment and operational risks, benefits gained, or losses incurred are shared equitably by its members in proportion to their use of the cooperative's services. A cooperative is democratically controlled by its members on the basis of their status as member-users and not as investors in the capital structure of the cooperative."

To better understand what a cooperative is, certain terminology used in the definition needs special interpretation as follows:

1. Persons--includes individuals, partnerships, corporations, and associations.
2. Members--includes persons who hold membership in cooperatives organized without capital stock and holders of capital stock in cooperatives with capital stock. Members have voting rights which give them a voice in management; nonmembers do not have voting rights or a voice in management.
3. Patron--any person who markets to or through, purchases from or through, or obtains a service from a cooperative.
4. Voluntary--refers to the affiliation of members with a cooperative of their own free will. Patrons of some cooperatives--primarily those that process, market, and merchandise farm commodities--may enter into legally enforceable marketing agreements with their cooperatives. Such arrangements do not destroy the voluntary character of members' affiliations with their cooperatives.
5. Contractual--used in the sense that certain requirements (eligibility, patronage, financing, and the like) must be met by members and, in return, the association must provide certain specified services.
6. Joint participation--not only includes active patronage by members of the association's services but includes sharing in the management and financing responsibilities incident to their membership.

7. Legal entity--a cooperative generally organizes and operates under laws that enable it to have the legal authority to function and to do all things necessary to operate a corporate business entity.

CRITERIA USED

Seven criteria emerged on the basis of this study. All are interrelated in character. Thus, they should be considered one with the other notwithstanding the form of presentation which, for convenience, describes each as a separate concept falling within two general groups.

Criteria 1 through 4 in the first group treat with differences that sharply distinguish cooperatives from other forms of business enterprise--that is they are always applicable to cooperatives. They are discussed as follows:

1. Cooperatives render economic benefits to members

Economic benefits come from services that reduce costs, increase members' income, improve quality, provide a nonexistent or improved service, and develop optimum use of members' resources. Specific services range from such consumer services as providing credit, housing, irrigation water, health benefits, rural electric and telephone service, insurance, and recreation to many types of farm production services. These producer services may be generally summarized under the headings of marketing, purchasing, and other related services.

While the purposes of cooperatives are primarily to achieve economic benefits, this form of enterprise also often produces important social, educational, and other secondary benefits.

2. Cooperatives are essentially nonprofit enterprises in the sense that they are not organized to make monetary gains for the cooperatives as legal entities or for their members as investors, but primarily for all patrons as users of their services

Where monetary gains do arise and are distributed to all patrons proportional to their use of its services the nonprofit nature of the cooperative as a legal entity is preserved. Where net savings are realized and these are not vested in all patrons either currently or upon dissolution, to that extent the association operates on a profit basis. For example, if any class of patron, including nonmembers, does not share equitably in the economic benefits derived from their patronage, to that extent the cooperative operates as a profit type organization.

When this criterion is related to the concepts of sharing risks, costs, and benefits on an equitable basis, and to the concept of

democratic control, the idea emerges that there can be no basis for conflict of the financial interest of members in their role as users of the cooperative's services and in their role as investors in its capital structure. By the same token, the role of hired and elected management must be oriented toward providing effective service in accordance with patrons' economic objectives as users of the cooperative's services rather than conducting the affairs of the association for personal gain or power or for taking advantage of "privileged" knowledge acquired by virtue of serving in a managerial or similar position of trust.

3. Cooperatives are democratically controlled

Most cooperatives limit individual members to one vote regardless of the number of shares of capital stock owned. In cooperatives that do not operate on the one-member one-vote basis, members may vote according to the volume of patronage, the number of shares held up to a stated limit, or some other restricted basis.^{1/} However, in those cases where voting is permitted on other than a one-member one-vote basis, State and Federal statutory limitations are placed on the rate of dividends that cooperatives qualifying under such laws may pay on capital shares. Democratic control implies also that the amount and kind of capital or other services provided by some members and nonmembers will not serve to mitigate effective management control by all active members. It means also that management (including the board of directors) will be responsive to membership control, that it will provide effective two-way channels of communication with the membership, and that it will maintain democratic election procedures.

4. Cooperatives are organized around the mutual interest of members

Other factors being equal, the most successful cooperatives are those whose members have a common bond, for example, farmers, rural residents, ethnic groups, and religious sects. An example of individuals with a mutual interest and an increasingly closer bond is: farmers, horticulturists, orchardists, cherry growers, sour cherry growers, sour cherry growers under contract. Although membership is normally open to all who can use the cooperative's services, market requirements, for example, may dictate that more restrictive membership eligibility standards be established.

^{1/} Only one State, because of a constitutional requirement, requires voting on the basis of the number of shares held, but the cooperatives in this State place carefully designed restrictions on voting stock.

There is no unanimous agreement as to what the criteria should be to denote a mutual interest or common bond of sufficient force to hold the cooperative together. For example, one would expect that buyers and sellers of a given product should not expect to jointly operate a cooperative marketing association. Yet experience has shown that farmer cooperatives have successfully combined the marketing and purchasing function with the result that certain products such as grain and seed, for example, have been bought and sold within the same organization to the mutual advantage of all concerned. Most farmer cooperatives in this country now permit only agricultural producers to be members. This matter is discussed in more detail under the seventh criteria headed "A cooperative does business primarily with members."

The remaining three criteria represent desirable policies for cooperatives to follow or goals to attain to achieve success in the cooperative as well as business sense. Their application, however, is not necessarily limited to cooperatives. They are discussed as follows:

5. Risks, costs, and benefits are shared "equitably" among patrons

"Equitably" means that patrons are to be treated fairly with respect to prices paid or received, the allocation of capital reserves, the calculation and payment of patronage refunds, and in all other transactions. A cooperative may distinguish between classes of patrons but it should not discriminate. Usually there would be an economic basis for different treatment of patrons. Some common examples that may justify treating patrons differently are:

A. Sales pools or buying pools made up of a partial list of the cooperative's patrons and operating under a different set of economic circumstances.

B. Persons may patronize their cooperative unequally to an extent sufficient to justify unequal price or cost treatment.

In summary unequal treatment is not inequitable treatment provided it is fair and reasonably justifiable under existing circumstances.

6. Members have an obligation to patronize their cooperative

The nature of this obligation varies from a loosely implied obligation to a legally-binding contract between members and their association to patronize on a specific basis. The type of service that members elect to provide themselves will dictate the nature of the patronage obligation. Generally, these obligations are more binding in those cooperatives that provide marketing services than in others.

7. A cooperative does business primarily with members

While there seems to be agreement on this general statement, there is disagreement over the extent of nonmember business that will disqualify an enterprise from legal recognition as a cooperative.

Member Business.--The percentages of membership business required range from anything above 50 percent up to 100 percent. Three Federal laws, the Capper-Volstead Act, the Cooperative Marketing Act of 1929, as amended, and the Internal Revenue Code, specify that at least 50 percent of the dollar volume (value) of business must be done with members for qualification as a cooperative within the scope of these laws. The Internal Revenue Code further specifies that in order to qualify for exemption from payment of Federal income taxes, no more than 15 percent of the nonmember business of a farm supply cooperative may be done with nonmembers who are not producers of agricultural products. Most agricultural cooperatives operate to conform with the provisions of one or more of these Acts.

The Agricultural Stabilization and Conservation Service shows some differences in its regulations. Those pertaining to cooperatives eligible to store soybeans, dry beans, rice, honey, and cotton on behalf of their members under the Government price support and storage program require that "not less than 80 percent of the eligible commodity marketed by the association shall have been produced by members." For tobacco stored under the ASCS price support regulations, 100 percent must be from member-producers.

Nonmember Business.--In some ways, business done with nonmembers may weaken certain of the more basic aspects of cooperative precepts. Democratic control, mutuality of interest, service on a nonprofit basis, equitable treatment, and obligation to patronize may all be affected in ways adverse to sound cooperative operations. On the other hand, a cooperative may better attain its economic objectives because of the economies of scale derived by doing business with some nonmembers.

A major argument in favor of nonmember business is that in some agricultural cooperatives, for example, only producers are eligible for membership. This precludes many people having the same essential needs as producers from being served. This is particularly true now with respect to the services provided by farm supply cooperatives. Seed, feed, fertilizer, petroleum products, automotive supplies, hardware, and garden supplies are used by many a rural resident who cannot qualify as an agricultural producer.

Farm supply cooperatives believe that nonmember business is necessary if they are to have a sufficient volume to operate efficiently. This is particularly true as increasing numbers of farmers

retire from agriculture, but continue to live in the rural areas, and as city people move into the rural areas.

Rural residents, nonfarmers as well as farmers, are eligible to benefit from REA loans to electric and telephone service cooperatives, and to participate in USDA programs such as housing and rural recreation, and others than can be carried out on a cooperative basis. A cooperative with members whose mutual interest derives primarily from being rural residents and only incidentally as producers of agricultural products, cannot qualify as a cooperative under the Cooperative Marketing Act of 1929, as amended. This automatically makes such cooperatives ineligible for loans from the banks for cooperatives unless substantially (90 percent or more) all voting rights are held by members who are agricultural producers.

In dealing with nonmember business perhaps greater stress should be placed on the "Mutuality of Interest" criterion. This was the intent in the Capper-Volstead Act when it restricted membership to agricultural producers. At the time of the passage of that Act in 1922, most rural residents were agricultural producers. Today this is no longer true. In many rural communities the common bond among the residents, both producers and nonproducers, is sufficiently strong to support certain types of cooperatives.

If both farm and nonfarm rural residents were eligible for membership in those cooperatives that USDA is concerned with, and if effective management control remains vested in those members who are current patrons, the way would be opened for even greater restriction on nonmember business--perhaps to zero, or at most 10 to 15 percent.

Generally, agricultural marketing cooperatives have no problem in maintaining a high volume (90 to 100 percent) of business with members. The exceptions usually occur when a cooperative's members experience a seasonal crop failure and it is necessary to obtain outside volume in order to operate their plant for that season. Such emergencies should receive special consideration. But marketing cooperatives that continually operate on high volumes of nonmember business--over 10 to 15 percent--may be violating many of the basic cooperative criteria.

APPLYING THE CRITERIA

Cooperatives are business institutions that are effective and important to our free enterprise system. The seven cooperative criteria outlined in this report, taken together, distinguish the cooperative from other forms of enterprise. In doing this they outline an interrelated set of cooperative operating guidelines. When one or more of these criteria

are not followed the other criteria are weakened. This is particularly true with respect to such criteria as democratic control, mutuality of interest, equitability, and the nonprofit nature of these organizations.

To strengthen the application of these criteria, many cooperatives provide strict operating procedures by adopting bylaws that define and prohibit conflict of interest; establish democratic procedures for selecting and electing directors to insure control by active members; define membership eligibility criteria; provide for the mandatory distribution of economic gains on the basis of patronage; and otherwise establish rules peculiar to their particular type of operation that insure acceptance by members of these cooperative criteria. The mere establishment of such rules, however, does not guarantee the cooperative character of an organization. Only actual performance in accordance with the spirit as well as the letter of its own rules remains as the ultimate test of its status as a "bona fide" cooperative.

SUMMARY

The cooperative criteria tentatively resulting from this study show that:

1. The basic purpose of cooperatives is to render economic benefits to members.
2. Cooperatives are organized around the mutual interest of members.
3. Risks, costs, and benefits are shared "equitably" among members.
4. Cooperatives are nonprofit enterprises in the sense that they are organized for the economic benefit of members as users of the cooperatives' services and not to make profits for the cooperatives as legal entities or for their members as investors.
5. Cooperatives are democratically controlled.
6. Members of cooperatives have an obligation to patronize their cooperative.
7. Cooperatives do business primarily with members.

Examination of these criteria show they represent actual as well as ideal characteristics of cooperatives that distinguish them from other forms of enterprise. They also serve as workable guidelines that cooperatives should use to successfully achieve economic objectives for their members. Cooperative students and leaders are aware that farmer cooperatives came into being because market middlemen were obtaining excessive margins from marketing products produced by farmers or were rendering inadequate and inefficient services to both farmers and consumers. When individuals got together and organized their cooperatives it was for the purpose of improving their own economic well-being by providing themselves the services needed. The more basic of these needs remain and they are evident in the seven "criteria" listed, particularly in those referring to equitable treatment, democratic control, and business on a nonprofit basis. And emphasis is on cooperation for service and not for returns on investment per se.

APPENDIX

In preparing this report these methods and procedures have been followed:

All USDA agencies, having any dealings or responsibilities involving cooperatives, were asked to submit information to Farmer Cooperative Service concerning the cooperative criteria and regulations, if any, they were then using (see list of agencies at end of appendix).

These memoranda and regulations were examined in detail in order to separate out the criteria included in regulations and administrative interpretations from the mass of material that was based on ideas, opinions, and value judgments.

A working table was prepared in order to make frequency determinations of the criteria. This helped make a logical determination of cooperative criteria being commonly used by various USDA agencies. As was to be expected, agencies often used different words and phrases to express the same criteria. Generally there was more agreement among the agencies on broad principles underlying cooperative criteria than on specific guides for their use. For example, there was general agreement that cooperatives should be permitted to do nonmember business, but there was no general agreement as to the percentage that should be permitted.

This report has not concerned itself with the regulations of the agencies pertaining to cooperatives except to extract from them such cooperative criteria as were deemed to be contained in them. The interpretation accompanying the selected cooperative criteria has been supplied by the Farmer Cooperative Service task force assigned to this study. Their interpretation is based upon the information provided by the agencies and upon their professional knowledge and ~~expe~~ experience in working with cooperatives.

Agencies Submitting Cooperative Criteria Material

Agricultural Marketing Service (now Consumer and Marketing Service)

Agricultural Research Service

Agricultural Stabilization and Conservation Service

Commodity Exchange Authority

Cooperative State Research Service

Economic Research Service

Farm Credit Administration (not a USDA agency)

Farmers Home Administration

Federal Crop Insurance Corporation

Foreign Agricultural Service

Forest Service

Rural Areas Development, Office of (now Rural Community Development Service)

Rural Electrification Administration

Soil Conservation Service

Statistical Reporting Service

