

# TYPES OF COOPERATIVES, BENEFITS, AND CONSTRAINTS

## Cooperatives in the Local Food Supply Chain

As the local foods movement has gained momentum, local food cooperatives have become increasingly vital to linking farmers to the local supply chain. The value chain for a cooperative consists of many layers between the producer and final consumer.

- **Producer-** creates the needed product
- **Customers/Market-** people/entities with needs
- **Products/Services-** meets a need
- **Transportation-** moves the product to those who need it
- **Sales-** exchange of value

A cooperative must work to stabilize fair pricing for farmers and farm worker wages, foster sustainable farming, make healthy food more broadly available and affordable, operate a cooperative with a small margin, and cover all of the business's costs.

## Cooperative Benefits

A cooperative's benefits to producers are the ability to maintain or increase market access, reduce risk, and generate more sales. Its strategies would allow producers to have access to pricing and marketing opportunities that otherwise may not have been available. Producers may not be aware of various marketing opportunities and, even if they are aware, they may not have been able to access them because of size requirements or high costs associated with these opportunities.

Cooperatives provide an opportunity for effective coordination that improves marketing system performance by unifying and exerting power to raise total returns to agricultural producers. System rewards from improved coordination have been most visible through efforts of farm input cooperatives at the regional and inter-regional levels in the plant food, crop protectant, petroleum, farm credit, and energy sectors.

## Types of Cooperatives

Many different types of cooperatives exist. Structurally, cooperatives may vary as much as the products or services they provide. Because of the variety of possible structures and functions, classification is not standardized across all cooperative ventures. Below are several short descriptions of selected cooperative structures.

*Marketing Cooperatives:* Marketing cooperatives handle most types of farm products. These cooperatives enable producers to 1) correct market failure where prices are too low or buyers have left the market, 2) provide a service not available otherwise, 3) gain market power (negotiating power) against much larger buyers, 4) spread risks and costs, and 5) have adequate volume to operate on a large enough level to meet the

demands of buyers or a greater level of efficiency<sup>1</sup>. This classification of agricultural cooperatives is the largest segment by sales value.

*Niche-Market Cooperatives:* As a subset of Marketing Cooperatives, some local cooperatives seek to serve a specialized clientele. These cooperatives do not strive to become large because their smaller customer base wants specialized products and/or services. Others are small by nature of the products they handle and the territory where the items can be produced. While some of these cooperatives may be very successful, the opportunities they represent and their overall impact are both limited.

*Marketing Agencies-in-Common (MACs):* MACs are a strategic alliance among marketing cooperatives that join to market under a common agreement. MACs serve as marketing agents for their members to achieve economies of size in marketing their like or complementary products. These cooperatives also share the large costs associated with developing brand names and provide a way to acquire and sell nonmember products when expanding product lines. The agency will usually have exclusive rights to sell members' products in some or all markets.

*Supply Cooperatives:* Supply Cooperatives, the largest number of agricultural cooperatives by type, derive most of their business volume from the sale of production supplies, machinery and equipment, and building materials. Many also handle farm, ranch, and home items, such as heating oil, lawn and garden supplies and equipment, and food.

*Service Cooperatives:* The smallest of all agricultural cooperative types by number, Service Cooperatives provide specialized services related to the business operations of farmers, ranchers, or cooperatives, such as trucking, storing, and drying. Cooperatives that provide these services to their members offer a way for producers to become more productive by lowering their costs.

*Joint Ventures:* Joint Ventures exist across all classification types, and offer another alternative coordination among cooperatives. As shown in a USDA Agricultural Cooperative Service Research Report<sup>2</sup> "A joint venture is a business entity, created and supported by other businesses, that has a limited objective related to solving a problem facing each of its owners." Cooperatives are, in this sense, joint ventures. Formed by members to provide quality goods and services the members need at the lowest possible cost, joint ventures may be organized as Limited Liability Companies (LLC), partnerships, corporations, cooperatives, unincorporated associations, or merely

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<sup>1</sup> United States Department of Agriculture Rural Business–Cooperative Service Cooperative Understanding Cooperatives: Agricultural Marketing Cooperatives *Cooperative Information Report 45, Section 15*

<sup>2</sup> Frederick, Donald A., *Successful Joint Ventures Among Farmer Cooperatives*, USDA, ACS Research Report No. 62, 1987

contractual arrangements.<sup>3</sup> A joint venture that does not meet its objectives may be disbanded without becoming a major disruption to the participants. Joint ventures can be either be short-lived or continue for decades.

*New Generation Cooperative:* A New Generation Cooperative, a complex legal structure rather than a type, is often formed by producers who perceive the best opportunity for continued economic success hinges on their ability to retain more of the value-added dollars generated from their production. This type of cooperative is not legal in all states. Distinguishing features include:

- Limited and defined membership
- Delivery rights and obligations with specified quantity and quality
- Substantial up-front producer equity
- Tradable equity shares that can fluctuate in value
- The right to deliver product to the cooperative is linked to legal responsibility of the producer to provide that product, accomplished through a stock purchase and legally binding marketing agreements.

New Generation Cooperatives are based on significant up-front investment of producer equity as opposed to equity retained over time in traditional cooperatives. Producers provide up-front investment to capitalize the business through the purchase of delivery rights, which would also ensure the cooperative's supply. In return, producers receive compensation based on contracts entered into by the cooperative on their behalf.

This particular form of operation requires complex legal decisions in the organizational phase. Satisfactorily resolving these issues can be time consuming and the legal counsel required can be costly. Because the new generation cooperative requires stock, businesses formed under this structure require oversight by state regulatory boards at a minimum, and in some cases by the Federal Security and Exchange Commission. However, some New Generation Cooperatives have organized under the Internal Revenue Service 521 code, which allows limited exemption from Federal SEC regulations.<sup>4</sup> In many cases, more than one class of stock is issued for reasons of functionality.

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<sup>3</sup> United States Department of Agriculture Rural Business–Cooperative Service Cooperative Information Report 60

<sup>4</sup> Income Tax Treatment of Cooperatives: Internal Revenue Code Section 521, Cooperative Information Report 44, Part 4, 2005 Edition, Donald A. Frederick

## Principles

In addition to state and federal statutes and regulations that must be complied with for a business to qualify as a cooperative, the USDA lists three principles and their accompanying descriptions as being widely recognized and practiced for cooperatives:

- **The User-Benefits Principle** - Members unite in a cooperative to get services otherwise not available - to get quality supplies at the right time, to have access to markets, or for other mutually beneficial reasons.
- **The User-Owner Principle** - The people who use a cooperative own it. As they own the assets, the members have the obligation to provide financing in accordance with use to keep the cooperative in business and permit it to grow.
- **The User-Control Principle** - As owners, a cooperative's members control its activities. This control is exercised through voting at annual and other membership meetings, and indirectly through those members elected to the board of directors. Members, in most instances, have one vote regardless of the amount of equity they own or how much they patronize the organization.

## Advantages and Disadvantages of Cooperatives

- Earnings from business with members are taxed once, either as income of the corporation when earned or as income of the members when allocated to them.
- A cooperative usually has a perpetual existence.
- Members can routinely join or resign without disrupting ongoing operations.
- Rules governing its establishment can be complex.

## Challenges

Although many cooperatives experience success with their business model, they may still face some challenges as they continue to grow. Past and recent growth of the industry demonstrates a strong unmet demand for local food, while also presenting obstacles in growing sales to meet that demand. Two main barriers can affect a business' ability to increase sales: producer growth and increasing the customer base.

### Producer Growth

A large factor that plays into a cooperative's ability to increase sales is its ability to increase the product supply available. Many times, cooperatives face the challenge of building a network of producers that are able to supply the quality produce consumers demand. One of the drawbacks to a cooperative's supply is that it is limited to only what is grown and produced locally. Growing the amount of producers in this network may become problematic because, in order to remain local, the cooperative is limited to farmers and producers within a 400 mile radius. As more

producers are added, the issue of competition within the cooperative among this group also rises.

Season Extension is another barrier that many cooperatives face. No matter the location of the cooperative, producers are subject to seasonality and the possibility of damaging weather resulting in crop losses.

### **Customer Growth**

Along with an increase in a cooperative's network of producers, it will also need to increase its customer base to facilitate growth. To gain a larger customer base and in turn increase sales, a cooperative will need to continue revising and utilizing a business and marketing plan to further explore how they intend to capture a larger audience.

The cooperative's strategy for expanding its customer base should involve making changes and/or additions that better meet consumer needs. This may involve making infrastructure and procedure changes in order to give consumers more control, more variety, and more choice.

### **Incentive Structures**

Cooperatives can also offer incentive programs to benefit all of its member classes. These incentive structures are an important part of maintaining interest and involvement with the cooperative.

Cooperatives can have a tremendous impact on their producer-members by returning a percentage of food dollars spent. The cooperative would be able to continue increasing return to producers through increased sales. The cooperative can also allow producer members to receive prices for their products that are well above the prices they would otherwise receive in a wholesale market. By selling through a cooperative, farmers also do not have to worry about the cost of staffing employees to sell their products, which helps lower their overall costs and increase revenue. With these benefits, farmers and producers can continue to grow their businesses and promote the agricultural industry in their area.

Consumer members benefit from a cooperative's ability to bring together multiple producers and consistently deliver high quality, fresh local products. Consumers also have the opportunity to interact with producers as they are able to learn more about how and where their food is produced.

The final stakeholder class, cooperative workers, benefits from the cooperative by receiving an income and, at times, employment benefit.

### **Information Flow and Sharing**

Enabling information flow and sharing to the different stakeholder classes is an important factor in keeping each class happy. This result can be accomplished with many different methods; a cooperative should find the best channels to fit its needs. One example of an information outlet

is an annual meeting between members, including consumers, producers, and workers. This event can give consumers the opportunity to meet farmers and producers and continue developing working relationships.

A newsletter or other periodic correspondence is another way the cooperative can maintain open communication channels with members. It can provide general information about happenings within the cooperative, as well as updates on products and farmers.