3.6: Formation of Cooperatives

Firms such as cooperatives are formed through collective action by individuals to solve a common problem. Cooperatives work best when the solution created by collective action leads to benefits being provided only to members, and when these benefits are unique. In doing so, the cooperative is often formed because the costs of the Make or Buy decision are lowest if the rights of ownership are assigned to those who use the cooperative as a customer. Some cooperatives may be examples of social entrepreneurship in that they help solve social, cultural, or economic issues. Most cooperatives are formed to address an economic objective or purpose. Because cooperatives are composed of members, however, there is often a social purpose many members desire in being a member of a cooperative. This is no different from the reason why people join social clubs such as country clubs or professional trade associations.

A MARKETING AGENCY-IN-COMMON is a cooperative whose members are other cooperatives who have joined to jointly market the products of all members. The rationale for doing so is that the costs of each co-op individually developing and marketing an industrial or consumer product can be significant. Typical marketing agencies-in-common exist for products such as sugar beet co-products or dairy products.

This social and sometimes cultural purpose is often linked with the formation of a cooperative. Examples of these social purposes might be ethnicity, geography, or religion. Rural utility cooperatives were formed based on geography. Credit unions were formed around a common bond such as geography, and fraternal benefit societies often had a common bond of religion or ethnicity. Food cooperatives often include members who want to patronize locally-owned businesses and have a desire to be part of something in their community. All of these are mechanisms to collectively organize for mutual benefit. Cooperatives are a means to an end, which is meeting the needs of users. The social purpose of cooperatives can best be met by ensuring that the cooperative understands and succeeds in its economic purpose.

BARGAINING COOPERATIVES negotiate with processors and other first handlers for a collective price and terms of trade for their members. These cooperatives represent contract growers selling to processors, or growers performing

Cooperatives that quickly understand their commonality of purpose (based on an economic purpose for their members) and position themselves on that purpose are able to create long-lasting value to their members.

Cooperatives are often formed by a desire to improve something. For example, many farm input supply or marketing cooperatives were formed by individuals who wanted to see reform in agrarian economy and were associated with the Populist, Farm Bureau, Farmers Union, Grange, or Equity movements.

Cooperatives that supply products to consumers, farmers, and businesses are often formed to obtain the economic advantages of purchasing supplies or providing services in bulk and passing along the volume discounts to their members. In doing so, the members are vertically integrated “backwards” through the cooperative. For example, farmers may not be able to finance agronomy equipment that is needed to apply crop protectants seasonally or purchase crop nutrients at a favorable price because their individual volumes are too small. Forming a cooperative that can obtain the economic benefits of purchasing size and scale has value to these farmers. Similarly, consumers may wish to purchase certain types of food products such as organic or locally-grown, and do so through a food cooperative. Services such as electricity or credit are more cost effective for a cooperative to provide than for a consumer or producer to obtain on their own.

ELECTRIC UTILITY COOPERATIVES exist in most rural areas as, to a lesser extent, do telephone cooperatives. Electric utility cooperatives were developed in the 1930s to provide electricity. In the 21st century, many are providing internet capability through satellites or broadband. Cooperatives have been formed to provide recordkeeping services and testing of milk through dairy herd improvements associations.

Marketing the output of a consumer, farmer, or business enables a cooperative to obtain premiums associated with volume, and members are integrated “forward” from the cooperative. The same is true for services. In addition to volume premiums, cooperatives can provide services such as constructing storage for a farmer’s feed grain or oilseeds. Members may also integrate forward by forming a corn-ethanol cooperative to market their corn or a soybean crushing plant to process soybeans into oil and meal products.

A HOUSING COOPERATIVE owns the land, facility, and common areas such as indoor or outdoor recreational equipment and common meeting space. Members buy a share in the cooperative, which is an ownership interest in a unit within the housing cooperative. There are many different types of housing cooperatives. Members pay a monthly fee for budgeted expenses such as operating costs and capital investments to maintain the cooperative’s assets.

The same is true for marketing information such as supply variables (including the bearing age of trees and vineyards, rate of tree pull outs and replantings, and varietal selection of fruits and nuts) and adoption rates for mechanization technologies; these are useful for bargaining cooperatives that negotiate a price for a crop such as peaches.

As discussed earlier, this integration decision is called the “Make-or-Buy Decision.” Strictly speaking, members of cooperatives are not vertically integrated through a cooperative because there is no common ownership of the farm or household by the cooperative. Nevertheless, there is collective ownership of the cooperative and alignment of the
cooperative business model with the consumer or farmer.

Many agricultural marketing cooperatives were formed to help pool risk from all producers and manage this risk within the cooperative. In the northern hemisphere, for example, a marketing year generally starts September 1 or October 1 in one year and is finished 12 months later, on August 31 or September 30. The crop is harvested in September or October, and over the course of the year the value of the crop becomes known as the cooperative discovers its value during the marketing year. Because many agricultural products are perishable, the price is always lowest at the beginning of the market year when supplies are greatest and tend to increase over the marketing year as the supply decreases and more information (e.g., quality) is known about the crop. The cooperative bears the price and quality risk by purchasing the farmers output at the beginning of the marketing year, and pays the farmer a competitive price at harvest. The members finance the capital needed by the cooperative to build storage and processing assets to add value to the crop throughout the marketing year.

Most farmers cannot manage this price risk on their own and instead manage it through their membership in a cooperative. In doing so, they also obtain additional marketing margin, and have increased bargaining power to countervail the bargaining power held by buyers who could buy the crop at its lowest price at harvest when supplies are greatest, and to manage the crop inventory throughout the year to obtain more favorable prices. As consumers or farmers integrate backwards or forwards, the cooperative becomes the competitive yardstick in an industry.