Basic Cooperative Principles and Their Relationship to Selected Practices

by

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This paper describes a set of basic cooperative principles adopted in a recent Agricultural Cooperative Service study and how these principles relate to various cooperative business practices and issues facing U.S. cooperative organizations. Three principles relating use of a cooperative to ownership, control, and distribution of benefits are outlined. The relationship of these principles to a number of topics, including cooperative membership and control, differential treatment programs, and cooperative finance, is examined.

The basic philosophy underlying all cooperative action is that through joint effort and mutual self-interest individuals may collectively achieve objectives unattainable by acting alone. This philosophy has broad application to the attainment of economic, social, political, and scientific goals. Growing out of this philosophy is a set of fundamental rules or principles that translate the philosophy into a basic design for a cooperative organization. These priniciples are fixed, independent of the goals set for a specific organization. They are transformed from design into application through the practices adopted by the organization.

This paper describes a set of basic cooperative principles adopted in a recent Agricultural Cooperative Service (ACS) study (U.S. Department of Agriculture) and discusses how these principles relate to some practices and issues facing U.S. cooperative organizations. These basic principles were used in the ACS study as one of a set of criteria by which alternative cooperative practices could be evaluated. The focus of this paper is not on what cooperatives should or should not do in pragmatic business response to their overall competitive environment. Rather, it discusses how this set

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This paper draws heavily on material prepared as background for an Agricultural Cooperative Service (ACS) report completed in response to a directive from the U.S. Senate Agricultural Appropriations Subcommittee "to conduct a study on what cooperatives need to do to remain viable businesses and increase returns to producer members." It should not be construed as representing the official view of the agency or individual participants involved in the study. The contribution of several ACS staff members to this paper and the overall study is acknowledged and gratefully appreciated.

of basic principles relates to some of the current points of friction between proponents of differing philosophies of cooperative organization and operation.

Defining Basic Cooperative Principles

Definition of a cooperative and its fundamental principles is essential to distinguishing cooperatives from all other types of business organization. It must clearly and unambiguously characterize the differences between cooperatives and other business forms to ensure full understanding of the rights, responsibilities, and expectations of all parties involved with a cooperative, including the cooperatives' users, directors, employees, and the general public.

During the early period of cooperative development, little distinction was made between principles that defined the unique character of cooperatives and those describing more general rules of sound business management. Although more recent expressions of cooperative principles have by and large clarified this distinction (see Abrahamsen; Roy; Staatz; and Cotterill among others), some confusion remains between the concepts of a true principle and a practice undertaken in support of cooperative principles. Certain cooperative behaviors included in many lists of principles can be shown to be operational manifestations of one or more fundamental principles and therefore should be properly considered practices.

To this end, it was a goal of the ACS study to express cooperative principles in their most general form, capturing the fundamental cooperative concepts free from the burden of specific practical application. The principles expressed herein are derived strictly from those characteristics of a cooperative that, taken as a group, render the cooperative unique among alternative forms of business organization. This list of principles remains consistent with the spirit of earlier expressions but succeeds in eliminating many of the characterizations of cooperatives that may be more accurately described as facilitating or supportive practices.

The starting point in defining cooperative principles was explicit recognition of the four types of interests represented in any business organization: (1) user interests, (2) ownership interests, (3) controlling interests, and (4) employee interests. Any business entity can be described in terms of the relationship among these four interests.

User interests represent, quite simply, the interests of those who use the goods and services produced or provided by the business entity. Ownership interests represent those who commit capital to the organization and will reap the gain or suffer the loss resulting from employment of resources in the chosen set of productive activities. Controlling interests represent those who decide on how resources are allocated among the range of available or alternative productive activities (Condon, pp. 14–18). Employee interests, which could be further segmented into management and labor interests, frequently are viewed as subordinate to other interests, based on their functionary or technical role with respect to the operations of the organization. However, a characterization of management as being strictly technical can be misleading, particularly with respect to the relationship between management and controlling interests (Murray, pp. 82, 87–89).

The unique character of the cooperative organization and the primary difference between cooperatives and other business forms rest in the relationship of user interests to ownership and control interests (Vitaliano, pp. 139–42). In the cooperative, the user is the focal point, with the direct status of user, owner, and control vested in the same individual. From the cooperative's user focus and the relationship between user, ownership, and controlling interests, three basic cooperative principles can be defined:

1. *The User-Owner Principle:* Those who own and finance the cooperative are those who use the cooperative.
2. *The User-Control Principle:* Those who control the cooperative are those who use the cooperative.
3. *The User-Benefits Principle:* The cooperative's sole purpose is to provide and distribute benefits to its users on the basis of their use.

Out of these three basic principles, a simple definition of a cooperative business organization can be stated: *A cooperative is a user-owned and controlled business from which benefits are derived and distributed on the basis of use.*

These principles are interrelated. The user-owner and user-control principles define the status of the interests in the cooperative organization. The user-benefits principle defines the cooperative's purpose. Each principle must be viewed as part of an integrated whole—a design for an enterprise oriented to the user above other interests. Maintenance of a stable cooperative organization with user focus requires adherence to the spirit of these three principles and balance among them. An organization that transforms the three basic principles into an operational reality can be said to be operating on a true cooperative basis.

Several important concepts essential to a successful cooperative enterprise are contained within or implied by the basic principles and the philosophy of cooperation. First, membership in a cooperative is a status knowingly and voluntarily entered with full understanding of the associated rights, responsibilities, and commitments.

Second, the mutuality of members' interests in defining and achieving the cooperative's goals must be fully understood by all parties. Members unite because they have mutual interests and remain united as long as it is mutually beneficial. Mutuality of interests need not translate to same or equal benefits. Rather, each member must believe the benefits of acting together exceed the benefits of acting alone.

Third, implicit in the user focus of a cooperative is the requirement to serve the expressed needs of current users as those needs evolve. This requires continuing reorientation of the cooperative to members' needs rather than perpetuation of the organization as an autonomous and static entity. It demands the cooperative be a tool in the dynamic and evolutionary process of meeting farmers' needs given the changing institutions and practices of the marketplace.

Fourth, the concept of control must be one of effective and active control. The mere existence of control mechanisms is meaningless unless those mechanisms are used. The cooperative's users must have the information, willingness, and tools needed to make informed decisions. Effective control requires a proper combination of involved member-users who are educated in cooperative and business concepts, control-facilitating mechanisms, and a strong orientation and positive attitude toward user control on the part of the cooperative's employees.

This set of basic principles omits many activities or characteristics often included in lists of cooperative principles. Excluded items may be classified more properly as either specific applications of an underlying general principle or necessary for making the basic principles work. For example, education frequently is mentioned as a basic cooperative principle. It is the view of this author that education is a critical element necessary for translating the three basic principles into a successful business organization. However, because it is undertaken in support of the basic principles, especially the user-control principle, education must be properly classified as a practice.

Another example is the frequently cited principle "limited return to equity" (a similar line of reasoning can be applied to "operation at cost"). If the three basic principles are followed completely, ownership and use are precisely aligned. Under these conditions, the limitation of returns to equity as a technique for maintaining user focus becomes a trivial issue. It is only when ownership and use are out of alignment that the limitation of returns to equity warrants consideration. Thus limiting returns to equity capital should be more properly classified as a practice undertaken in support of the user-benefits principle.

Relationship of Principles to Selected Cooperative Practices

The basic cooperative principles described herein represent a plan for a cooperative organization in its ideal or pure form. However, complete achievement of the organizational requirements dictated by these principles may be difficult or impossible as a short-run or practical matter. Deviation from absolute compliance with the basic principles and the corresponding threat to an organization's true "cooperativeness" are matters of degree. The point along the continuum of deviation from the pure cooperative form at which a given principle should be declared violated or an organization should lose its cooperative status is of significant importance but beyond the concern of this paper.

The basic cooperative principles should represent a goal for cooperative organizations, a standard against which practices should be evaluated. It is clear that strict interpretation of these principles can lead directly to real and perceived conflicts with the conditions necessary for operating a contemporary business entity. This does not, however, relieve cooperative organizations from the responsibility to work toward compliance as a goal. Deviation from strict adherence to any of the three principles requires adoption of special arrangements or practices to restore balance and ensure the cooperative's continued focus on use. Perhaps more important than where an organization rests along the continuum is what steps it is taking and the direction in which it is headed with respect to the basic principles.

Cooperative Membership

The user orientation demanded by basic cooperative principles argues by contradiction that nonusers, be they former patrons or persons who have never used the cooperative, should be excluded from the rights and responsibilities associated with ownership and control of the cooperative. The user-owner and user-control principles imply current use. Control must be vested in those who currently use the cooperative if needs are to be accurately represented and translated into operating objectives. The ability of current cooperative users to control the organization must be protected.

The current user focus requires several things of a cooperative. It first must have a clear definition of the requirements for membership based on some threshold of current or recent use. It must keep its membership rolls up-to-date, purging them of inactive or low-use members (see Frederick). It also must place greater emphasis on member recruitment, development, and involvement programs.

Two themes relating to user financing of cooperatives necessarily follow. First, a cooperative's members or users must have a substantial financial stake in the cooperative. Without this financial tie of users to the cooperative, the user-owner principle is violated. To the extent de facto control flows from financial contribution, failure by a cooperative's users to maintain a substantial financial stake in the organization gravely jeopardizes the user-control principle as well. In terms of business strategy, substantial user equity in the cooperative can encourage increased use of and commitment to the cooperative.

The second theme, closely related to the first, is that the cooperative's equity structure should reflect current patterns of use. Farmers currently benefiting from the cooperative should be those financing it. Relatively heavy users of the cooperative should provide a relatively larger share of its equity capital. Farmers no longer using the cooperative should not be expected to have a continued equity stake. Thus programs for revolving equity within a reasonable time frame are an absolute necessity.

Differential Treatment Programs

The increasingly bimodal farm size structure in the United States has highlighted an area of sharp difference in cooperative philosophy: differential treatment of cooperative members in the distribution of voting power and the pricing and provision of goods and services. Debate on differential treatment often is cast in terms of equal versus equitable or fair treatment of members. Proponents of the equal treatment philosophy believe all members of a cooperative should receive the same or equal terms and mix of services regardless of relative volume. Proponents of the equitable treatment philosophy are more oriented to a concept of fairness under which one group of members is not asked to make a relatively greater sacrifice than another for the common good.

That all members should be treated in an equitable manner is almost universally accepted. The question is whether mere fairness is sufficient in a cooperative setting. The egalitarian view of equal treatment is founded on social and political attitudes against concentration of power. The equitable treatment view manifested in differential treatment programs was developed primarily as a pragmatic response to the pressures of the competitive marketplace.

The issues surrounding differential treatment of members relate to all three basic cooperative principles. Resolution of these issues with respect to the principles rests largely on the definitional and philosophical question of whether cooperatives are organized around units of individual users or units of individual use.

The manner in which voting power is distributed not only facilitates effective representative governance but can serve as an incentive for members to patronize the cooperative and participate in decision making. The phrase "democratic control," although intended to convey the concept of user control, often is identified with the practice of one vote per member. The result is widespread acceptance of one-member/one-vote as a fundamental principle of cooperative organization. It actually is only one method of differentiating control on the basis of use rather than investment.

The one-member/one-vote practice reflects a belief in the complete mutuality and equality of members' interests. It also is intended to prevent concentration of control in the hands of a few. Voting on the basis of patronage reflects the belief that, although members have mutual or common interests, their economic needs are not necessarily identical. It aligns control of the cooperative more precisely with use, defining the cooperative in terms of units of use.

Both one-member/one-vote and proportional voting arrangements satisfy the vesting of cooperative control in the user. Thus the choice between patronage-based proportional voting and one-member/one-vote arrangements should be founded on considerations other than adherence to principles. Among these considerations are protection of the rights of different size farmers and responsiveness to their needs, social philosophy of the cooperative's members, appeal of the user control concept to large patrons, and, not the least, compliance with relevant state laws and regulations.

Pricing and provision of services represent the operational, as opposed to governance, aspect of the differential treatment of members. Many cooperatives have adopted formal pricing programs based, at least in part, on cost-related differential treatment of members. They have recognized the competitive necessity of adopting a pragmatic approach for attracting large-volume patrons by adjusting the mix of price and services for individual buyers.

Development of differential treatment programs involves measurement of individual costs of all services and functions that support a product and their separation from the price of the basic product. In most cases, arguments in favor of this type of program have been sufficiently convincing for members. However, a difficult problem exists in the recognition and measurement of differences in overhead or long-run costs. The volume of certain members may be so large as to affect the achievable scale for the cooperative, thereby affecting the cost structure for all patrons. Recognition of these scale effects of large-volume patrons may be an extremely important and conceptually valid component of a cooperative's differential pricing program.

In addition to the pragmatic rationale provided by the cooperative's need to be competitive, differential treatment has a more fundamental justification. The concept of equitable treatment is violated when one group is asked to make a relatively greater sacrifice than others for the good of the organization. Yet this is precisely what a program treating all members of a cooperative in exactly the same manner accomplishes.

Members of the cooperative recognize they have interests that coincide, and, by imposing upon themselves certain constraints or disciplines (i.e., use and support of the cooperative), each may obtain benefits in excess of those that could be obtained by acting alone. This coincidence of interests does not imply equality of needs.

Opportunities and interests of various users can differ greatly. Therefore, asking all cooperative members to accept the same treatment imposes an unequal burden or sacrifice. Differential pricing programs based on accurate assessments of costs and revenues more closely approach the proper alignment of costs and benefits with actual use.

Unallocated Equity Capital

Unallocated equity capital represents earnings of a cooperative not allocated to members but held as unallocated additions to the cooperative's permanent capital base. At the organization level, unallocated equity can be attractive for a variety of reasons relating to taxes, cash flow, and risk or contingency capital accumulation, among others (see Royer 1986, pp. 87–88). Particularly in the development of high-risk value-added product lines, the isolation of a portion of capital as risk capital can prevent members from being directly affected when losses are sustained.

Use of unallocated capital reserves frequently is criticized as having negative implications for member control of the cooperative. Its use has been characterized as a covert method by which a cooperative's management "will work towards accruing the required funds independently of their members' direct sanction" (Murray, p. 82). The argument typically made is that unallocated capital is the cooperative "corporation's" capital, as opposed to member capital, and its use is subject to management discretion.

In actuality, the allocation status of capital has no bearing on its ultimate owner, as the results of a dissolution proceeding would make abundantly clear. A problem with unallocated equity, however, is that users can recover it only through dissolution. Except for this, the rights of the cooperative's member-users, through the board of directors, to control capital are not affected by whether it is allocated.

A potential conflict between user control and use of unallocated capital is indirect and one of degree. This conflict arises from the same feature of unallocated capital that makes it attractive for use as risk capital: the distancing of the members' economic situation from that of the cooperative. Members of a cooperative whose financial structure is dominated by unallocated capital may become complacent about the cooperative's activities or condition because they have little financial stake in the organization. If the level of member interest is reflected in the intensity of the board of directors' concern, such complacency can evolve into loss of effective control. However, abdication of the control of unallocated equity to management is a failure of the board of directors, not a characteristic of the capital.

The more direct conflict between the use of unallocated equity and the basic principles relates to the user-benefits principle. When a portion of the net margins derived from a member's business is assigned to unallocated status, that capital may be returned to the member only in the event of dissolution. If the member allows his or her membership to lapse, the member loses residual claim to the capital as well as a share of the income stream attributable to that capital. Thus users may never receive their rightful use-derived benefits (Ryan, pp. 31–32). Furthermore, benefits flowing to current users result in part from capital provided by former users. Therefore, benefits and use become untied, or at least more loosely bound, by the use of unallocated equity.

Often earnings generated by a cooperative from nonuser business or subsidiary activities is a source of unallocated equity capital. This is increasingly common in many large cooperatives. The role of nonuser business activities within a cooperative business structure presents a number of complex issues that will only be mentioned here. When capital assigned to unallocated status has been generated from sources other than member business, the user-benefits linkage becomes less clear. Proper assignment of benefits or returns from nonuser business activities to users may be difficult, particularly when those activities are only remotely related to serving users' needs.

Investment-Oriented Equity Capital

Investment-oriented equity capital consists of financial instruments held for the purpose of obtaining a financial return on investment. Increasingly, cooperatives have pursued sources of investment-oriented equity capital as traditional patronage-based capital sources have become less accessible or increasingly costly to the cooperative and its users. Typically, investment-oriented capital is held in the form of preferred or common stock.

The rationale for investing in and the expectations for returns from this type of capital are quite different from that for patronage-oriented equity capital. The decision to invest in investment-oriented equity capital is based solely on an assessment of expected returns, capital appreciation, and relative risk. The decision to obtain a patronage-oriented equity position in a cooperative also may include consideration of these factors. However, it more typically is a passive decision coincident to use of the organization or based on a less well-defined use-related return such as obtaining access to a market or decreasing input costs.

Cooperative preferred and common stock has a number of uses and varying characteristics (Matthews, pp. 15–25). However, the only use of these instruments considered in this paper is as evidence of investment-oriented capital in a cooperative. The typical features of preferred stock are a fixed return and no attached voting rights. In addition, the redemption price of cooperative preferred stock generally is limited to par or face value.

Use of investment-oriented capital raises two concerns with respect to the basic principles. First, its use will in all likelihood create a divergence between users and the ownership structure, thus violating the user-owner principle. To the extent rights of governance are attached to investment-oriented capital, the user-control principle also is violated.

Generally speaking, the seriousness of such a violation is a matter of degree. For example, when the amount of investment-oriented capital is small relative to use-oriented capital, the threat to user control is negligible. If persons holding investment-oriented instruments are also cooperative users, the user orientation of the organization is maintained somewhat. However, as nonuser interests gain a significantly larger stake in the cooperative, the objectives and orientation of the organization will most assuredly change.

The second concern, related to the first, arises when the level of return to the equity instrument is tied to the organization's profitability. Under these conditions, the organization's ability to attract investment-oriented equity capital will be tied directly to investor expectations on the return from their investment. This places pressure on the cooperative to maximize short-run profitability and pay out a high proportion of net margins as stock dividends.

Short-run profit maximization behavior remains at least partially consistent with the interests of the cooperative's users in that efficiency will be stressed and generation of high net margins can result in large patronage refunds. However, maximization of profits might not be the appropriate optimization behavior for a user-oriented organization (Cotterill, pp. 182–86; Royer 1978). Output, product line, and service decisions of a profit-maximizing organization may conflict with the profitability of individual users' operations. Division of profits between investor and user interests will be a continuing source of problems for the cooperative.

Most cooperatives with preferred stock pay either a fixed rate or a variable rate tied to a well-publicized interest rate such as the prime lending rate or the rate on U.S. Treasury bills. This fixed or independently determined rate of return, coupled with the normally fixed redemption value of preferred stock, gives the stock some characteristics of a debt instrument. With the rate of return fixed in advance or based on broad financial market measures, the operational focus of the cooperative should remain on serving the needs of its users.

Increasingly, public issuance of common stock with attached voting rights has been explored as a method by which cooperatives can tap public capital markets. The implications of issuing public stock for a cooperative's core business are quite serious. These problems and concerns are not entirely eliminated when a subsidiary or other arm's-length structure is used to isolate public stock capital from the capital structure of the parent organization. In the core business case, public stock dilutes user ownership and control of the organization. It gives nonuser interests a forum in determining the cooperative's direction and policies.

Even if complete user control of the cooperative could be satisfactorily guaranteed, the discipline imposed by the public capital markets would alter the orientation and range of options available to it. The marketability and value of the cooperative's public stock, and therefore its equity base, would depend directly on the near-term profitability of the organization. To protect and enhance the value of its equity base, the cooperative would be forced to adopt a more short-run profit orientation. The dedication of the cooperative to the user-benefits principle and its long-run goals of service to farmers and enhancement of farm income would be seriously eroded. Thus the inherent conflict in goals between a cooperative's users and outside investors becomes apparent both in practice and theory.

When applied to a cooperative subsidiary, a primary issue facing the cooperative involves how the subsidiary is expected to fit into the cooperative's overall strategy. If the objective of investment in the subsidiary is strictly financial return, the degree of control retained in the subsidiary may not be of great concern. If, however, the subsidiary is to perform a function or activity on which other operations of the cooperative depend, the degree of control retained, through ownership or contract, may be of great significance.

As in the core business case, even when a cooperative owns controlling shares in a publicly held subsidiary, the subsidiary's orientation must focus on the marketability of its shares. As a cooperative becomes more dependent on publicly traded subsidiaries (or any subsidiaries held with objectives of financial return), its management will by necessity focus more on the investment, as opposed to use, aspects of the organization. Effective user orientation will be eroded, and control will become diluted.

As farmers' requirements and expectations for their cooperative change, some evolution in the nature of their investment can be expected. However, farmers must recognize and understand that as they allow their organization to evolve along the continuum from a user focus to a focus on returns to financial investment, it will cease at some point to be a cooperative and will approximate more closely an investment club.

Conclusion

As seen from the preceding discussion, basic cooperative principles present a substantial challenge to directors and managers of cooperatives as they steer their organizations through business difficulties in the contemporary economic environment. The issues discussed herein are representative of the nature of the choices facing agricultural cooperatives.

Conflicts will continue to arise between proponents of strict adherence to basic principles and those who favor abandonment of these principles according to business expediency. It is this author's view that for farmers confronted with determining the future course of their cooperative organizations, neither of these approaches is particularly constructive when considered in isolation.

Cooperative principles should be viewed as guideposts or goals, not as absolute acid tests. Flexibility in the application of these principles is necessary. On the other hand, business pragmatists among cooperative directors, managers, and advisors must learn to recognize the values and strengths inherent in the unique features of cooperatives. Their creative and competitive efforts may then be directed toward refinement of the methods and mechanisms that contribute to strong cooperative business performance without compromising the spirit of the basic principles.

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