

Economic bases for a cooperative business in Slovenian agriculture

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ABSTRACT

Slovenia's agriculture is essential for the economic livelihood of rural areas as it continues to act in accordance with a market-oriented agriculture, which includes cooperative businesses structures. One solution for improving the marketing and profit margins for so many farm enterprises in Slovenia is the formation of a cooperative business. The cooperative form of business can serve both small and large producers by providing a business structure that can grade, process, sell, and distribute products with the best interests of member-patrons in mind. In other sectors of an economy, the impetus to gain economic efficiencies often leads to a horizontal expansion of the firm. Instead of expanding their business horizontally, farmers are sometimes motivated to form a cooperative in expectations of increased economic efficiencies from vertical expansion. Understanding the economic justifications for starting a cooperative business and the economic strategies that cooperatives can use to compete in the market to remain in business is an important prerequisite for making wise business decisions. Eight economic justifications for cooperative organization are provided for consideration which includes; market failure, economies of size, profits from another level, provide missing services, assure supplies or markets, gain from coordination, risk reduction, market power, the competitive yardstick.

Key words: cooperatives, economic justification, Slovenian agriculture

INTRODUCTION

Slovenian agriculture has and will continue to have a major impact on Slovenia's economic future. Although agriculture only contributes around 2% to the GDP of Slovenia, it plays a more significant role in the rural framework of Slovenia since 50% (CIA Factbook Slovenia 2012) of Slovenians reside in rural regions of the country. According to the OECD criteria for regional subdivision, Slovenia comprises twelve regions, eight of which are mainly rural, and four principally rural. The four principally rural regions account for nearly a third of Slovenia's territory, and are home to 38.5 per cent of the entire population (RDP 2007-2013).

A foundation of a rural economy is small farms which produce of variety of commodities for sale. Slovenia's agriculture is essential for the economic livelihood of rural areas as it continues to act in accordance with a market-oriented agriculture, which includes cooperative businesses structures. Cooperative businesses can play a role in improving the effectiveness of marketing agricultural products and buying agricultural production inputs. In addition, the capacity to increase its agricultural production is grounded in both the agricultural resources of the country and the capability of its people to both work hard and make wise decisions about the use of these resources. Western-style cooperative businesses offer farmers an opportunity to

capture profits from the next market tier through the addition of value to their products. However, in all cases, a prerequisite for establishing a cooperative business is a strong rationale or justification for the cooperative.

There are constraints that limit the ability of Slovenia to realize the full potential of its capacity to increase agricultural production. The average farmer does not have enough capital to reach the optimum level of intensification of his/her farming operations. Other factors that complicate the current situation are the average age of farmers and their average education level. An additional constraint is imposed by Slovenia's agribusiness sector, which the Slovenian government seeks to improve.

One solution for improving the marketing and profit margins for so many small farm enterprises is the formation of a cooperative business. The cooperative form of business can serve producers by providing a business structure that can grade, process, sell, and distribute products with the best interests of member-patrons (producers) in mind. Within producer associations, it is expected that there is some resistance to the term "cooperative" itself, but also to the previous working principles of cooperatives that were promoted during the socialistic period when Slovenia was a part of Yugoslavia. Family farms find it difficult to give up a form of independence, which can be understood as justifiable based on the result of experiences in the past. Presently,

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Slovenian law provides for western-style cooperative formation as a legal business. Now there is support from the European Commission for operating a cooperative with the intention to gain a profit and serve to benefit the member-owners. These circumstances raise questions regarding the legal frameworks, financial obligations (taxes, privileges etc.), business decision-making, and economic justification that are inherent to the cooperative form of business.

At the end of 2005, 497 cooperatives were registered in Slovenia, 145 of which were registered in the field of agriculture (RDP 2007-2013). Although progress has been made, Slovenia's farmers lack access to efficient markets for both the farm inputs they buy and the production they offer for sale. If existing markets do not allow farmers to capture the full market value of the commodities they sell, their incentive to increase production will fall short of the price level needed for the optimum level of Slovenia's agricultural production.

Increased farm production means enhanced food security. It means an increase in Slovenia's national well-being by expanding both the country's GNP and the number of jobs generated by Slovenia's agribusiness sector. It means increased net foreign exchange earnings by either substituting domestic food for more expensive food imports or by expanding agricultural exports. The full range of new wealth generated by farmer-owned cooperatives is a sustainable increase in wealth. It is sustainable not only for farmer members, but also sustainable for rural community development, increased food security, higher GNP, expanded agribusiness employment and more favorable foreign exchange balances. It is clear that promoting farmer-owned cooperatives cannot only increase the well being of Slovenian farmers, their promotion can also assist in the sustainable development of the country. Only through a process of justifying a new cooperative business can the organizers of the cooperative realize success in the form of economic benefits to the owner-members.

WHY START A COOPERATIVE BUSINESS?

Why would farmers be interested in forming a cooperative which involves their management, risk, and investment? What is there about the cooperative form of business that would lead farmers to carry out all of the tasks involved in organizing, using, and financing a cooperative rather than relying on other businesses for marketing, buying products, or providing services? Once established, what strategies can a cooperative employ to stay in business, compete and strengthen its market power? In other sectors of an economy, the impetus to gain economic efficiencies often leads to a horizontal expansion of the firm. Instead of expanding their business horizontally, farmers are sometimes motivated to form a cooperative business in expectations of increased economic efficiencies from vertical expansion. Understanding the economic justifications for starting a cooperative business and the economic strategies that cooperatives can use to compete in the market to remain in business is essential for making wise business decisions.

Early 20th century justifications for cooperatives emanated

from two American leaders, Sapiro and Nourse, who justified a cooperative business from different perspectives. Sapiro was a lawyer from California who justified cooperatives as a means to alter imbalances in grower treatment and improve marketing coordination by using cooperatives to achieve more orderly marketing (Sapiro 1920). Sapiro thought that by organizing a cooperative that had significant market power and emphasized grading and pooling techniques, agricultural products could be sold to buyers in a measured fashion that circumvented the unfavorable results of discarding products at harvest on the market all at one time. Sapiro's vigorous support for cooperative development because of the market power it gave farmers remains a contemporary reason for the economic justification of cooperatives.

The other macro economic justification for cooperatives was developed by Professor E.G. Nourse and has become known as the competitive yardstick school. (Nourse 1922, 1995). Nourse developed his justification as a response to Sapiro's promotion of marketing cooperatives. Nourse believed in the type of cooperative structure that originated from locally organized service cooperatives representative of the farm supply and grain elevator cooperatives in the United States. He argued that cooperatives could be organized to represent a limited share of marketing activity and still serve a 'yardstick' role by which members could measure the performance of other firms dominating the marketing channel. According to Nourse, this function would force other businesses to be more competitive. If markets became more competitive due to the role of cooperatives, Nourse contended from an economic viewpoint, their function was fulfilled and they could cease to exist. In reality, perfectly competitive market conditions were never going to be permanently established. Because he was in opposition to the Sapiro form of cooperatives, which embraced a democratically controlled and dominant commodity associations, Nourse advocated that cooperatives could achieve economies of scale by affiliating through purchasing or marketing federations which preserved a bottom-up structure rather than a more centralized, top down one.

More contemporary cooperative schools of thought have sought to explain the place of cooperatives in the agriculture economy because of reduced transaction costs and the lack of a business hierarchy at the family farm level compared to other types of production enterprises, broadly defined. Staatz (1987) explained the choice of cooperative form of business organization in terms of its ability to economize transaction costs. Hansmann (1996) complemented Staatz's work by explicating the existence of cooperatives to be connected to the high costs of market contracting and low costs of ownership for cooperative members. In addition, Valentinov (2005) argued that agricultural cooperatives are needed because they partially perform the coordination functions ineffectively delivered at the family farm level due to the lack of conventional hierarchical and market types of economic organization. All three authors noted that agricultural production system contains particular elements that make it conducive to the formation of cooperatives for the benefits of member-owners. Finally, Valentinov (2007) traced the origins for cooperative organization back to the lack of a farmer's realization of economies of scale at the farm level and the ability of a cooperative business to develop market

power comparable to that of their up and downstream trading partners.

The economic bases for cooperatives, therefore, is found in the fact that economic efficiencies gained by producing agricultural commodities using a family farm model are difficult to realize at the processing level. One solution to this farm problem is the organization of a cooperative. At the farm level, there are frequent reasons why farmers seek to form a cooperative in order to promote their economic well-being. The fundamental motivation for forming and sustaining a cooperative is to improve the well-being of every member. The cooperative does this by reducing costs or increasing profits at the farm level through marketing commodities or purchasing products for its membership. The following eight economic justifications (adapted from Schrader 1989) describe the more common reasons why farmers may want establish and use a cooperative.

MARKET FAILURE

Market failure is a situation in which markets do not efficiently organize production or allocate goods and services to consumers. Markets work best when there is open competition among businesses and the businesses work with the intention of making a profit. Business practices and market prices react to competition. When a market fails to provide fair prices for buyer or seller, the buyer and seller will become motivated to seek other business arrangements that are more advantageous to them such as the formation of a cooperative. On occasion, this situation does not exist within the agriculture sector of the economy. Farmers may find themselves in a difficult business situation when, for various reasons, they cannot sell or buy a product or service. For example, if individual farmers can only sell a commodity to a few buyers, they must take the price offered. However, when farmers form a cooperative, they can extend their business forward one level or backward one level and thus gain a competitive advantage in the marketplace. When farmers market a perishable product such as fruit or milk, they have few other selling opportunities because of the relatively short shelf-life of their product. In other cases, farmers may have little information about what is a fair price in the market place. A cooperative can benefit farmers by representing them in the marketplace to give them an advantage in negotiating the price and terms of the sale.

ECONOMIES OF SIZE

Economies of size have been achieved when a cooperative business reduces costs and increases production compared to that of each individual farmer. In most cases, this means that when a cooperative grows and production units increase, a cooperative will decrease its costs to a certain point. But for more traditional (small to medium) cooperatives, size does have its limits, so after a point, an increase in size (output) actually causes an increase in production costs. For example, economies of size gives large cooperatives access to a larger market by allowing them to operate with greater geographical

reach, but this reach has its limits. After a certain distance from the cooperative facility, production costs go up due to additional transportation costs and fewer customers. However, a larger economy of size can allow a cooperative business to enter another market level because of the volume of business it represents. By creating an economy of size, fixed costs can be distributed over a larger number of units produced thereby reducing the costs per unit sold. Therefore, a cooperative can be much more efficient when compared to all farmers who try to perform the same functions individually. This is because of the size of the cooperative's facilities, marketing volume, supply, or other services it conducts.

PROFITS FROM ANOTHER LEVEL

A cooperative may perform functions that extend the processing or marketing of a farm commodity to another level. Individual farmers would rarely engage in such extensive marketing or processing activities. Nor would they normally manufacture their supplies. When a cooperative captures economic benefits from these business activities, benefits are realized by farmer members. This benefit typically coincides with economies of size.

PROVIDE MISSING SERVICES

Is there a reason that farmers as a group can provide a service that entrepreneurs cannot? Yes, when profit margins are not high enough for entrepreneurs to invest in the business, a cooperative business may provide a feasible alternative so missing services or products may be available to farmers who need them in order to improve the success of their farm-level business. When farmers are owners and members of the cooperative, the cooperative places needs of the farmer first. In this case, a cooperatives first purpose is to provide a service that is needed by its membership.

ASSURE SUPPLIES OR MARKET'S

The assurance of a service (supply source or market) is just as important as the service itself. Farming requires a dependable supply and a dependable market. Farmers who must rely on undependable supplies or buyers face serious risks of financial failure. For example, a supplier of fertilizer who suddenly discovers it can get a better price in a foreign market, may sell in that market, leaving local farmers without fertilizer to purchase in a timely manner. Similarly, if a buyer temporarily refuses to purchase a perishable farm commodity for some reason, the farmer is at risk and may lose income. In the farming business, such uncertainties are detrimental to planning and reliance on farm income. Farmers benefit from cooperatives whose sole purpose is to serve their needs, and that will take steps necessary to be dependable suppliers and buyers of farm products.

GAIN FROM COORDINATION

The system of agricultural production from the creation of supplies for the farming business through processing and marketing requires coordination. In a properly function market economy, this coordination is performed by the combination of all buyers and sellers working independently to supply business services in response to prices. However, many problems can interfere with this coordination. Cooperatives can potentially provide this system coordination better than individual participants in the supply, production, and marketing chain because of their objectives and close relation to the farming sector. Effective coordination increases the efficiency of the system as a whole, increases returns to farmers, decreases uncertainty and risks of farming, and permits better business planning and investment at all levels.

RISK REDUCTION

A cooperative can combine and lower the market risks of all farmers who are members. This may take place in marketing, for example, where the cooperative pools products it markets for farmer members. A drop in price during a particular period could harm farmers selling during that period. However, the price paid the farmer in a pooling situation would depend upon the prices received throughout the entire marketing period. Cooperatives may also be able to decrease price fluctuations over a longer period by contracting the price of a commodity for delivery at a future date.

MARKET POWER

If a significant number of farmers purchase or market through a cooperative, it is possible that the volume of business done by the cooperative will give it more market power to improve prices. It may be able to bargain for a lower price paid for supplies or bargain for a higher price when it sells members' production. Economic limits exist on the power a cooperative can exercise and unreasonable use of market power may result in public criticism.

THE COMPETITIVE YARDSTICK

Private businesses' major objective is to maximize profit. In part, maximizing profit comes at the expense of the customer. One cooperative objective is to make an adequate profit so the cooperative can remain in business in order to meet the needs of the farmers who own and use the cooperative. Because cooperatives do not try to make a profit for themselves as businesses but only for their members as farmers, they should not try to profit by decreasing prices to farmers as might other buyers or charge more for supplies. Thus, cooperatives afford a measure of regulation when they begin to perform marketing functions in which other businesses have received excess profits. This market regulation

is sometimes called a "competitive yardstick" because it sets a standard of reasonable prices paid or received and makes the entire market work more effectively.

CONCLUSIONS

A culminating reason for starting a cooperative comes down to economics. Will the cooperative increase the profits of the producers at their business level? There are substantial economic advantages to the cooperative form of business. Any one of these advantages may be a reason enough for forming agricultural cooperatives in Slovenia. Understanding the economic benefits of a cooperative is a precondition to making wise business decisions. The ideas presented in this article provide much for Slovenian farmers to consider in regard to the way they may conduct business now and in the future. Fortunately, the entrepreneurial nature of these producers along with the demand for their products gives these business men and women the fundamental ingredients to establish a successful cooperative business venture that has the potential to deliver more profit at the farm level in Slovenia.

Farmers organize and use a cooperative for practical purposes under specific circumstances. Economic theory does not justify cooperative formation unless the benefits to farmers are real. Members who use the cooperative must realize benefits from using it.

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