# STUDY REGARDING INSTITUTIONAL ENVIRONMENT AND LEGAL REGULATIONS FOR EUROPEAN COOPERATIVES

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***Abstract:*** *In order to foster the competitiveness of the food supply chain, the European Commission is committed to promote and facilitate the restructuring and consolidation of the agricultural sector by encouraging the creation of voluntary agricultural producer organisations. To support the policy making process DG Agriculture and Rural Development has launched a large study, "Support for Farmers' Cooperatives (SFC)", that provides insights on successful cooperatives and producer organisations as well as on effective support measures for these organisations. These insights can be used by farmers themselves, in setting up and strengthening their collective organisation, and by the European Commission in its effort to encourage the creation of agricultural producer organisations in the EU.*

***Key words:*** *cooperatives, measures, institutional environment, mergers*

## INTRODUCTION

An important part of the institutional environment, in addition to the social and cultural characteristics discussed in the previous chapter, is formed by the legal and policy aspects. They merit an extensive discussion, also as policy makers are one of the main audiences of this study. Some legal and policy support issues have already been discussed in previous chapters. In Chapter 5 legal aspects in relation to internal governance were already discussed, a topic we take up again in the next section where we discuss the (basic) legal regulation that governs cooperatives.

These two sections deal with the legal issues that often are not specific to agricultural cooperatives and certainly not the traditional domain of policies in agriculture, food or rural development. Section 9.6 adds those types of policy support measures to the analysis.

Although there is no evidence that Member States actively promote the organisation of agricultural producers into cooperatives nor mandate that they should use the cooperative as the legal business form, the cooperative is commonly used in the EU and appears to be the "natural" legal form for agricultural producers to organise their joint business activities. The cooperative statute is not commonly used in Bulgaria, Estonia, Latvia, Poland, Romania, Slovakia and Slovenia, where the limited liability company is the dominant legal entity in which agricultural producers organised themselves. In Portugal, the division is 50/50. Despite the low numbers of cooperatives in several countries, the cost of setting-up as well as maintaining a cooperative does not seem to hamper the formation of cooperatives.

In terms of internal governance, the data did not identify significant constraints to efficient decision making imposed by problematic legislation. On the contrary, legal frameworks are considered flexible enough to allow the development of proper internal governance structures. In large cooperatives, in particular internationally operating cooperatives with diversified activities, there is some concern about the perceived loss of effective control by members.

## MATERIAL AND METHOD

Only in four Member States members seem to feel an accountability gap. The accountability of the board of directors to members in Greece, Portugal, Spain and the UK is seen as more problematic due to the lack of legal mandates to form a supervisory board or a similar institution – although members could use the bylaws for initiating such a board.

The efficiency of cooperatives could be improved by hiring professional managers, while the monitoring of the board of directors could be enhanced by installing a supervisory board.27 In Bulgaria, Cyprus, the Czech Republic, Greece, Malta, Portugal, and Slovakia, the members of the board of directors can only be members of the cooperative. Sixteen Member States provided the possibility of having non-members elected on the board. In seven Member States, members of the supervisory board need to be members of the cooperative. However, it does not necessarily mean that there is an accountability gap. If cooperatives are small and operating only in the region, leaving members themselves in the position to actively monitor the management board may not pose any problem. On the other hand, in several countries the lack of leadership and relevant competences is seen as problematic for the development of cooperatives.

A recent law made supervisory boards mandatory in Greek agricultural cooperative. Most Member States allow cooperatives to restrict entrance of new members through provisions in their bylaws. The "defined membership" policy is usually intended to protect processing cooperatives from having to handle raw material well in excess of their processing capacity or the quantities they have contracted for with retailers. In countries such as Denmark, France, Hungary, and Ireland, however, the "open membership" principle is legally enforced. In Denmark, for example, a cooperative holding a dominant market position may be legally forced to accept new members.

Directly related to the question of open membership is the question of whether voting rights are allocated according to the principle of "one member, one vote", or whether the cooperative is free to use voting rights proportional to the volume of economic transactions of the individual member. In ten Member States, the principle of "one member, one vote" was the mandatory rule. In eleven Member States, cooperatives were allowed to apply proportional voting; however with an upper limit on the number of votes, while a minority of Member States allowed proportional voting without any upper limits set by law.

Most Member States do not provide cooperatives with effective legal means to control the volume of produce supplied by members. These Member States adhere to the principle of voluntary membership by giving members unrestricted freedom to exit the cooperative (Cyprus, the Czech Republic, Denmark, France, Italy, Latvia, Lithuania and the United Kingdom). In these countries, the free rider problem poses significant challenges to many cooperatives. In the other Member States, cooperatives were allowed to introduce restrictions, showing a large variety of modes over time. Two important findings are: 1) in all members states the restrictions on exit were viewed as reasonable and fair, indicating that setting restrictions on exit is not considered problematic; and 2) the existence of restrictions on exit did not preclude potential members from joining a cooperative.

Overall we conclude that legal structures are not a major hurdle for farmers to cooperate effectively and organize their business according to their strategy. In some countries like Denmark and the Netherlands the legal structure is extremely flexible and has provided cooperatives with room for experimentation and expansion. In other countries legal structures are more restrictive, but this seems often not to be a problem (as cooperatives are smaller or less capital intensive), as restrictions may be overcome through other means. However, this also means that the legal structures do not provide much guidance for good practice, which in some Member States might be beneficial. More legislation is not needed, better legislation is possible but it is not the ultimate solution in promoting cooperatives.

## RESULTS AND DISCUSSIONS

To prevent legal uncertainty due to different legislation in different Member States, it would be helpful to assess which forms of cooperation are as such compatible with national competition laws. If the aim is to promote POs in the agricultural sector, it could be recommended to assess whether general rules are enough or whether specific provisions are required on the national level, from the point of view of different types of cooperatives and different product markets.

In several of our case studies, notably in the F&V sector, representatives of the cooperatives voiced complaints about the behaviour of the National Competition Authorities, both about the grimness with which they scrutinize collaboration among cooperatives and about the legal uncertainty that these authorities maintain by not being clear about their definition of the relevant market.

Several of our case studies, especially but not only those in the New Member States, reveal that cooperatives improve market efficiency in several ways: they challenge markets and powerful international conglomerates in Poland and Hungary, deal with difficult access to the dairy market (including organic) and milk processing in Lithuania, provide market access to smallholders in Slovakia and Bulgaria, enter the farm and energy supply markets in East Germany, establish links to the land and labour markets both in Bulgaria and East Germany, and so on. In such cases the contribution of cooperatives towards efficiently operating markets seems to be much more significant than any risk of upward pricing pressure, but of course this has to be evaluated on a case by case basis.

Tax issues - The way cooperatives are treated by the tax authorities in the majority of Member States seems to facilitate their growth. Cooperatives are treated as an extension of members' farms. Consequently, surpluses (money earned from selling members' products) return to members in cash or held in individual accounts by the cooperative and are taxed only at the farm level (single taxation principle). Profits, that is, money earned from selling non-members' products, are taxed at the cooperative level and, if distributed to the member, also at the farm level. In some countries, cooperatives' profits are not taxed at all at the level of the cooperative, even in case they are kept in special reserves (e.g., for investments in R&D or education). Such provisions are particularly helpful for new and growing cooperatives but not of much relevance for large cooperatives that conduct significant transactions with non-members. In some countries, the taxation of cooperatives is under discussion (e.g., in Spain, where the focus is on clarifying the types of cooperative capital).

Finally, it should be realised that in some cases small farmers are sometimes not willing to join a cooperative as they prefer trading in informal markets with opportunities to evade paying value added tax or income tax. This behaviour has mostly disappeared in other countries where scale and professionalization of farming has increased and where farmers and cooperatives participate in tightly coordinated supply chains which include tracking and tracing systems for food safety, liability and certification reasons.

## CONCLUSIONS

Also, it summaries derived implications for facilitating and supporting farmers to organise themselves in cooperatives as a means of improving their market position and thus generate a solid market income, particularly given the observed imbalances in bargaining power between the contracting parties along the food supply chain. The main conclusions are:

1. Producer organisations, primarily in the form of agricultural cooperatives, are crucially important business organisations for European farmers. Most farmers are members of at least one cooperative, and even non-members trade with them or benefit from the presence of cooperatives in particular markets. However, this fact is not much prevalent in agricultural statistics and research, and only partly addressed in agricultural policy, with the exception of the CMO in fruit and vegetables and the reform of the dairy policy.

2. Cooperatives can be considered as a substitute for the market but they are not fully vertically integrated firms that replace a market where transaction costs are too high. Cooperatives are typically hybrid governance structures (Menard, 2007). This means that cooperatives combine elements of markets (like the price that continues to play its motivational role in the transaction between farmer and cooperative) and hierarchy (like the ownership relationship between members and the cooperative firm).

3. A cooperative is a user-owned, user-controlled and user-benefited organisation. However, joint ownership and joint control of farmers over firms downstream in the food chain is not limited to cooperatives. Other companies with other legal forms may also be owned and controlled by farmers, often through producer organisations or farmer unions. However, in these cases there is not direct user control. Where producer organisations and farmer unions are the shareholders of an IOF, the latter works in the interest of all the farmers. The membership includes farmers supplying to the jointly-owned firm, but may also include many other farmers who do not transact with that firm. A farmer-owned IOF is more likely to pursue the interests of a whole farming community than the interests of a narrowly defined group of users.

4. Whether farmers are better off being members of a cooperative or being contract partners of an IOF is not ideologically or politically determined but depends on the particular characteristics of the product, the farm and the market. Also, farmers have differential preferences as to cooperative membership. The benefits of cooperatives, in terms of improved farmer bargaining position in the food chain, vary with time, place, technology, scale of farming, and human and social capital available.

5. Historically, cooperatives are not replacing markets, but help to create them or make their outcomes more efficient. Primary and federated (or second-tier) cooperatives solve efficiency problems caused by the constraints small-volume farmers face in benefiting from economies of scale and in bargaining. Cooperatives help farmers to access markets and to obtain a better bargaining position. These functions are especially important in remote areas where farmers are faced with thin markets, which are often characterized by asymmetric information between seller and buyer and where farmers depend on only a few (large) traders or processing companies. The European sheep sector is an illustration of this: important sheep cooperatives are found in traditionally remote but specialised production areas like Scotland and Extremadura (Spain); in most other regions more buyers are active or low specialized farmers sell to the local butcher or the informal economy. The strong position of cooperatives in the dairy and fruit & vegetables industries can be explained by the high transaction costs that result from the perishability of the product. Once a product is harvested, it has to be processed and/or sold as soon as possible, which makes the farmer very dependent on the buyer. Farmers have set up (auction) cooperatives in order to reduce the risk that accompanies this dependency.

6. Most large cooperatives have been formed in past decades in order to address one or more of the abovementioned market failures. As the years went by, however, and the competitive yardstick effect of cooperatives resulted in an efficient market, subsequent

generations of farmers have no personal experience of the industry in times of hardship caused by market failures. Therefore, the motives of younger farmers to participate in agricultural cooperatives may be quite different from those of their (grand) parents. However, for cooperatives in the New Member States, the reasons for farmers to set up cooperatives may not be so different from the ones that prevailed fifty or hundred years ago for the members of the now fully established cooperatives.

7. All European Member States have a cooperative tradition that goes back to the Rochdale and Raiffeisen innovations in the 19th century. However, there are important differences between Member States in history, operation and market share of cooperatives. Historically, in some countries the cooperatives are directly linked to large transitions at the end of the 19th century (Denmark, the Netherlands), or a movement for independence (Finland), while others have seen periods were cooperatives were politically not appreciated (Portugal and Spain), or where cooperatives were not based anymore on self-organisation principles but were a socialist planning tool (New Member States). In some countries the labour movement has played a key role in cooperative development, in others it was the Catholic Church. Such diverse evolutionary paths imply that the label “cooperative” has different connotations in different regions.

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