

New strategies for
mobilizing capital

in
**agricultural
cooperatives**



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by J.D. Von Pischke &
John G. Rouse

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Preface

Capital accumulation in cooperatives is often difficult. It is shaped, and to some extent constrained, by a unique set of principles that define the cooperative identity and set it apart from other businesses. While its egalitarian rule of “one member, one vote” and its anti-profiteering precept of “limited return on capital” make the cooperative form of business appealing to a broad audience, these features can create genuine problems in mobilizing capital for growth.

Despite this, cooperatives in many developed countries have found innovative ways to mobilize capital from their members, while retaining important elements of their cooperative identity. Unfortunately, efforts to mobilize member capital have been less successful in developing countries where conditions are less favourable. This is particularly true for agricultural service cooperatives, which were often established by newly independent governments to meet nation-building goals and therefore relied on government support and subsidies.

New donor and government priorities, plus changed global conditions have led to “downsized” government budgets and to liberalized markets. Subsidies for agricultural cooperatives are fast disappearing. To survive and grow in an increasingly competitive business climate, cooperatives must raise more capital from their members and also possibly from commercial sources.

The aim of this booklet is to highlight some of the issues that cooperative leaders must confront in meeting this challenge and to provide suggestions about how capital, especially member capital, can be mobilized in more effective ways.

**Maximiliano Cox
Director
Rural Development Division
Food and Agriculture Organization**

Acknowledgements

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The activity was based on a research design developed by John Rouse, FAO Senior Cooperatives Officer, in collaboration with J.D. Von Pischke, at the time a World Bank financial analyst, and on field research conducted in Guatemala, Hungary, India, Kenya, Poland and Slovakia. All members of COPAC participated in these studies, along with other institutions including the Institute of Rural Management in Anand, India (IRMA), the Kenya National Federation of Cooperatives (KNFC), the Finnish Cooperative Centre (FCC) and the University of Missouri, USA. COPAC Open Forums were also held on the topic in Rome (March 1993) and in Geneva (October, 1993). A final International Technical Meeting on Capital Formation in Agricultural Cooperatives was held at FAO Headquarters in 1995 to discuss the findings and draw conclusions from the global research effort.

Preparation of a simply written booklet was one of the main recommendations of this meeting. The original edition of this booklet represented, to a large extent, the collective thinking on this topic of the members of that group, to whom we are extremely grateful.

Since the 1995 meeting, the cooperative landscape has changed greatly, partly because of dynamic responses to competitive conditions and partly because of failures to respond. A central element of both successes and failures has been the quantity and quality of cooperative capital. As cooperatives struggle to compete under these changing market conditions, innovation is taking place. New approaches to obtaining funds have become commonplace in many countries with competitive cooperative structures; nevertheless, controversy has also occurred as cooperative leaders attempt to harmonize new approaches to capitalization with the unique cooperative identity.

In response to member country and cooperative movement demands for more guidance in this area, FAO asked the authors of the 1997 booklet to revise and update their work. This revision provides: a) guidelines or rules of thumb that agricultural service cooperatives in developing countries should consider in formulating strategies aimed at mobilizing additional capital in different institutional and policy settings; and b) examples that illustrate how this can be done.

All illustrations are by Rustam Vania and the layout is by *bc* consultants.

Introduction

The basic functions of agricultural service cooperatives include input supply, storage, processing, bulking up or aggregating, and selling produce provided by their members. Other functions may involve provision of credit, training and member education, and political action.

Agricultural cooperatives in many developing countries have colonial origins. They were commonly formed by governments to pursue objectives related to agricultural policy. Emphasis was often placed on export crops that were a source of tax revenue, or on achievement of self-sufficiency in certain food products, such as basic grains, sugar and dairy products. Control of marketing and processing by a single buyer was part of this tradition. Cooperatives also became centres of political power as independence approached, and afterwards with the end of colonial rule, popular targets of foreign assistance for nation-building. Top-down government or donor funding financed many of their activities in the first three decades following independence.

The culture of dependency that accompanied this reliance on external capital is fortunately in decline. Government and donor funding is shrinking because these agencies now face budget constraints and new priorities, and because some former supporters have become discouraged with cooperative performance. At the same time, economic reforms have removed restrictions on markets and challenged the monopoly that some cooperatives enjoyed. This has led to increased competition from other businesses and a consequent loss of income that has left many agricultural cooperatives with insufficient funds to finance their operations and invest in growth.

As with any business, agricultural cooperatives require capital to be successful. (A very broad definition of “capital” is used here, referring to the funds used by the cooperative in its business.) Funds are needed to pay wages and other operating costs, to purchase equipment and for expansion. As a generalization, capital is required to provide better services to members and to grow and develop in modern market economies. The search for capital leads cooperatives to explore various sources in order to maintain and strengthen their position in the market. Greater member financing is usually essential.

The subject of this booklet – cooperative capital – would be of only passing interest to members of traditional cooperatives who are content with the status quo. However, once members are no longer content with the current situation or prospects for their cooperative and want to transform it into a genuine member-run business, their cooperative is no longer traditional, and may need to adopt new approaches to mobilizing member investment funds.

To summarize, farmer cooperatives in developing countries increasingly find themselves with lower levels of financial support and are obliged to compete in the open market. Cooperatives that do not adapt and that fail to mobilize more

member capital will be increasingly unable to compete with other more efficient types of business. A traditional interpretation of the principles of cooperative capital does not create strong financial incentives for members to invest in their cooperative. However, a more flexible and pragmatic application of these principles can create new opportunities for growth and prosperity, offering new ways of achieving the cooperative promise and potential.

Part 1 of this booklet discusses the current state of agricultural cooperatives in developing and transition economies, their environment, and their business practices.

Part 2 covers various forms of cooperative capital and ways that proactive cooperatives have found to mobilize such funds.

Part 3 outlines how cooperatives have mobilized funds from external commercial sources.

Part 4 deals with several financial management issues that face cooperatives.



Part 1

Cooperatives and their environment



Agricultural service cooperatives have generally been set up for either defensive or proactive purposes. Defensive strategies have focused on protecting small producers from unfair competition and otherwise helping to keep them on the land. This is often difficult because agriculture is a highly competitive industry, which is occupying less and less of the global workforce over the long run. In contrast, proactive cooperatives have been formed either to respond to new business opportunities as new markets open, or when government-sponsored activities are discontinued or privatized.

In all cases, the goal of agricultural service cooperatives has been to enable rural people to improve their economic condition by working together in ways that are more productive than working individually. This tradition, still very much alive, has promoted the spread of democratic values, local economic and social development, and entrepreneurship, creating important social capital at the community level.

1 The changing cooperative environment

Currently, there are a number of changes in global economic conditions that confront and challenge the viability of agricultural cooperatives in the developed and developing world. These include:

- **Decreasing flows of development assistance**

From the 1960s through to the early 1980s, the promise of cooperatives attracted many supporters: government departments and international

organizations like FAO and the World Bank, as well as development assistance agencies of industrialized countries.

Most donor agencies now, however, face budgetary constraints and changing priorities that have led to a decline in aid to the agricultural sector and to agricultural cooperatives.

- **Privatization of state agencies and businesses**

As state-owned marketing boards and banks are privatized, their new owners are usually interested in dealing with cooperatives only as business enterprises. As such, they are not concerned with the role of cooperatives as government-led sources of supply of agricultural commodities, or vehicles of social change. To work with these boards and agencies, cooperatives need to be efficient, well run competitors in the open market.

- **Globalization of trade and deregulation of domestic markets**

Governments are removing barriers, promoting freer trade domestically and internationally. As a consequence, consumers often obtain cheaper goods and services from more efficient private providers and from more powerful subsidized producers abroad. Under these conditions, governments find it more and more difficult to reserve special privileges or offer special price benefits to cooperatives.

- **Industrialization and vertical integration of agricultural product and food systems**

The growing trend toward larger and larger agro-industrial and retail food chains is driven by competition to reduce costs at all stages between farmer and consumer. This means that less efficient producers will be squeezed: bought by more powerful competitors, merged or driven out of business.

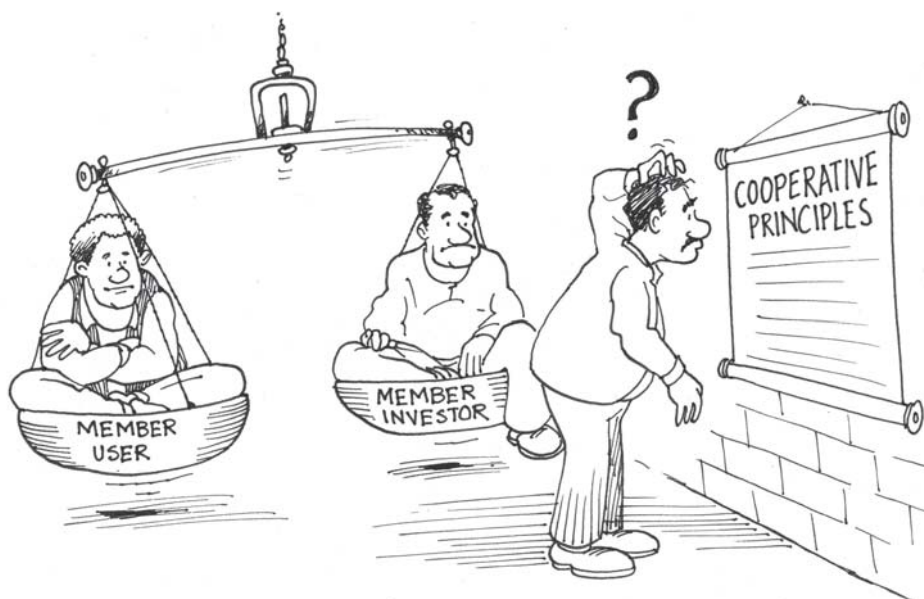
In developed countries, these market forces have led to several responses from the cooperative sector:

- Mergers have helped to realize economies-of-scale and greater market power. The consolidation of the Australian dairy sector between the late 1980s and the late 1990s reduced the number of major processors in the entire industry (including cooperatives and other types of enterprises) from about 50 to about 10.
- Demutualization (abandoning the cooperative form of enterprise) occurred in a few cases, such as the Dakota Pasta Growers in the USA, which became a limited company.
- Some cooperatives that were unable to compete have failed. Two recent American examples are Farmland Industries and Agway.

- Agricultural cooperatives in developed countries – with some notable exceptions noted above – have managed to adapt. However, adaptation has been more difficult in transition and less developed economies.
- In developing countries responses to competitive forces include the growing trend of members leaving their cooperative to join outgrower (contract farming) schemes in high-value cash crops and the threat of agribusiness takeovers of cooperatives as the latter struggle to survive. On the other hand the decrease in government support to cooperatives has led to a reawakening amongst cooperative leaders of the importance of promoting member-financed and controlled rather than government financed and driven cooperatives.
- By contrast, in transition economies there has been a mass movement of demutualization as state-led cooperatives collapsed and joint-stock and other non-cooperative arrangements have emerged; nevertheless, even though the term “cooperative” has fallen in disrepute in many regions, other forms of cooperative-like self-help are beginning to emerge as small producers realize the advantages of larger group approaches in mobilizing investment capital, accessing markets and agricultural services.

2 Cooperative principles and business practices in the early years

Cooperative principles have inspired cooperative leaders and members throughout the world for more than a century. These principles are also the starting point for an exploration of cooperative capital because they define the unique identity that distinguishes cooperatives. They answer the question, “what is a cooperative?”



The main principles on which cooperatives are based are:

- *One member, one vote.* This means that all members of a cooperative have equal voting power.
- *Benefits are based on member's use.* The benefits a member receives are according to that members' use of the services of the cooperative, not according to the amount of funds the member has invested in his/her cooperative.
- *Limited return on capital.* The purpose of investing funds in the cooperative is not just to gain interest, hence the interest or 'return' on the capital is limited.

Cooperative principles were first devised and successfully implemented in the 1800s in Europe and in the early 1900s in North America, in situations where markets were much less efficient. Inefficiency occurs when at any given time the prices of identical goods (adjusted for transport costs) vary widely, as they often do in poor countries today. Lack of information and high transport costs imposed high transaction costs, and low levels of competition further placed small individual producers or sellers of "commodity" products at a disadvantage.¹

Even though small producers of commodity products cannot easily differentiate their product, collective action partially overcomes this limitation. Product differentiation and higher returns to producers become possible when more value is added to the commodity, e.g. when milk is turned into cheese, or when coffee can be branded by origin, or when organic produce creates a new consumer clientele. To add value, capital is usually required.

Collective action enabled early cooperatives to exert more market power by combining their members' produce in bulk thus reducing per unit costs, and also by adding value through processing operations. While the effort to form and manage cooperatives increased their transaction costs, it also increased their net returns. Cooperative retail shops likewise commanded loyalty by fair pricing and good service. Members were typically poor in the early years of cooperation, and the capital of their cooperatives was typically small.

The principles of cooperatives are different from those of private businesses such as corporations (see Box 1) and they create particular problems for cooperatives in raising capital.

The situation now though, is rather different. Proactive cooperatives have learned to adapt in order to survive, which means continued benefits to members through the patronage and investment of all members. These innovative and successful cooperatives have found new ways of interpreting or applying cooperative principles that make it worthwhile for their members both to use and to invest.

¹ Unbranded and unprocessed agricultural commodities of similar quality are identical, such as grain of a certain grade and moisture content, or raw milk with a certain fat content, and therefore cannot be differentiated. In contrast, tractors are differentiated by maker and by special features.

Box 1 Comparison of cooperatives and private businesses

Features	Cooperative*	Limited Company*
Objectives	Service to members; Collective action; Member participation in democratic processes	Profit; Competitive power; Survival
Ownership	By members who join to use services; Emphasis on member patronage (usage) rather than investment	By investors who may or may not be involved in the operation of the enterprise
Control	One member, one vote, regardless of shares held; Elected members constitute the board; Government oversight and intervention in many countries	One share, one vote; Board members and managers are not necessarily shareholders
Nature of Subscribed Capital	Shares purchased and redeemed at par; Redemption is time-consuming; Capital revolves as new members join and old members leave; Member shares may be issued for patronage; A low cost source of finance	Shares are bought and sold freely, unless otherwise agreed by shareholders; Redeemable only in liquidation, or through merger or buy-out; Price determined by negotiations between buyers and sellers or bid/offer; The most expensive source of finance because it bears the most risk
Financial Structure	Shares often dominate where debt is difficult to obtain; Dominated by debt when foreign or government loans are readily available; Institutional capital from retained surpluses is costless	Varies by industry and by firm; Influenced by financial markets' expectations of risks and returns or profits
Value of Investment to Owners	Shares issued and redeemed at par value; No appreciation of share value is possible; Return on shares limited by laws, tax considerations or custom; Benefits from use of services that provide savings, i.e. favourable prices offered by the coop on services used by members	Market value of shares (with an expectation of increasing value over time); Dividends decided by the board of directors
Distribution of Net Income	In proportion to member patronage or use of coop services measured in financial terms	In proportion to shareholding

* This comparison is based on classic cooperative models and on medium and large corporations in the private sector.

3 The diversity of modern agricultural cooperatives

Successful agricultural cooperatives have come up with a variety of innovative ways to address the dual roles of the cooperative member as user and as investor.

These new strategies for raising capital and remaining viable differ according to the orientation of different cooperatives and their opportunities. In discussing capital, it is useful to distinguish between different types of agricultural service cooperatives and how they deal with the challenge of raising funds. As a broad generalization, member funding opens the way to progress, and two varieties of cooperatives may be identified for this purpose: traditional or colonial cooperatives, and commercial cooperatives. (This typology is expanded later in this booklet.)

- *Traditional agricultural service cooperatives*, including those with colonial roots, are found mostly in poor countries and in markets that are not dynamic.

These cooperatives are distinguished by low levels of member investment. Purchase of a share of minor value may be all that is required for membership. The cooperative deducts its operating expenses and statutory allocations from its annual income and returns the difference to members in cash through “patronage refunds.” These cooperatives accumulate little capital, except possibly through donor assistance, giving them little hope and little future as dynamic or permanent enterprises in a competitive business environment. They resemble clubs more closely than enterprises - clubs require no investment by their members.

- *Commercial agricultural service cooperatives* recognize their members not only as users of member services, but also as investors in the cooperative enterprise. They develop financing strategies that link and balance members’ patronage with members’ investment.

These cooperatives are distinguished by their efforts to accumulate member capital, through deferred payments (“retentions”), by offering modest dividends on shares, and by developing other instruments with roots in cooperative principles. The members of these cooperatives tend, by varying degrees, to be commercially oriented and to operate in competitive markets. They have choices, and they affirm their commitment to the cooperative by patronizing it.

Advanced commercial agricultural service cooperatives participate in larger cooperative networks that provide additional services, and some go beyond cooperative bounds by establishing or participating in ventures organized as limited liability companies or other non-cooperative forms of enterprise (see below). Their motivations include efforts to raise capital, manage risk, or create decision-making structures that can respond quickly and effectively in dynamic markets.

4 New challenges and insights

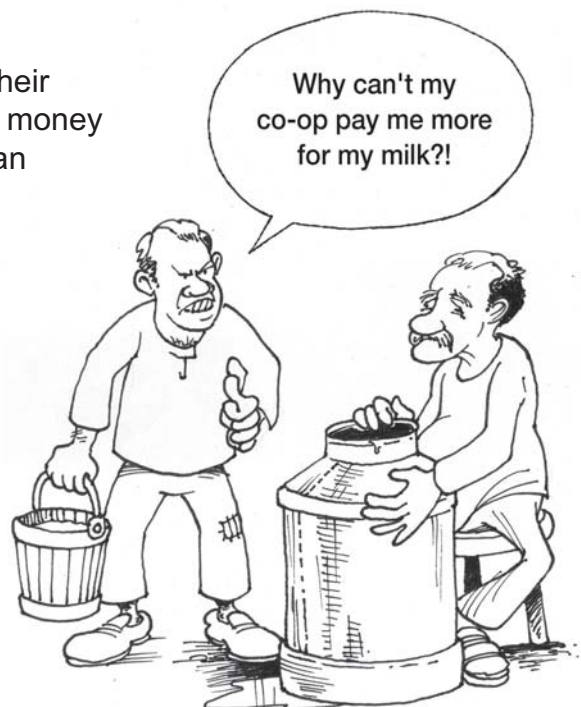
Cooperatives become more complex as they grow and respond to competition. At the same time, members become more demanding, as freer and more efficient markets increase their opportunities. These changes challenge traditional mechanisms of solidarity, and require the adoption of new financial strategies that encourage members to patronize the cooperative and become involved in democratic decision-making in its business operations.

Today, information is increasingly available cheaply and rapidly, transport is faster and competition more intense. Insights from the New Institutional Economics help explain why the current environment produces conflicts arising from cooperative principles.² These economic insights also provide strategic tools for cooperative enterprise and its governance. They suggest that members' interests and the interest of the cooperative as a commercial entity may diverge, while in former times it was believed that cooperative practices were to a very high degree in harmony with members' interests.

Harmonizing members' interests and the cooperative's interests is the key to effective capitalization. The core problem of capital formation in cooperatives is the inherent conflict between: a) members' interests as users or suppliers and b) their interests as investors. This conflict creates at least three important problems: the Horizon Problem, the Portfolio Problem and the Internal Free Rider Problem:

- **The Horizon Problem** consists of pressure by members to increase current payments based on patronage (member usage of services) rather than to make investments in the cooperative that would create greater future benefits, thus leaving the cooperative uncompetitive over time.

Members may be reluctant to invest in their cooperative for several reasons: getting money *now* is much more important to them than getting more money *later* as a result of investment made now; they may not invest because they do not trust the cooperative, or do not view it as a sustainable venture that will help them increase their wealth over the long run; they may simply see themselves as cooperative users or customers, regarding the cooperative's management (or the government) as the real owners.



² See Cook, n.d.


- **The Portfolio Problem** arises when members are not able to construct their investments in the cooperative in ways that they believe are best for them personally. It diminishes members' incentives to invest in their cooperative.

All members hold a variety of assets (a "portfolio") in different forms - land, cattle, implements, savings, investments in the cooperative - and they have choices over how they can manage and increase the value of their assets. Will their investment in the cooperative yield returns that are competitive with returns from investments outside the cooperative? Does their investment in the cooperative fit conveniently into their overall portfolio?

Common questions include: Will these assets grow at an attractive rate? What other benefits will they receive from keeping their funds at work in the cooperative? How much money can they take out, and under what conditions? What control do they have over the funds they invest?

Complications may arise and disincentives may appear because shares in the cooperative may receive low dividends or no dividends at all, and do not appreciate in value. With inflation, their value in terms of purchasing power is likely to decline. Shares may also be difficult to redeem when money is most needed, such as in an emergency or when a special opportunity appears.

Portfolio concerns are often related to lifecycles. As members age, they seek ways of saving that will help them when they are old. Unfortunately, the ways in which they may invest in their cooperative are often not very effective ways to accumulate redeemable savings.



TYPE OF ASSET	POSITIVE	NEGATIVE	NET BENEFIT
In the Co-op:			
Member shares:	Good output prices	Non-appreciable	Holds value
Outside Co-op:			
Land	Holds value	Difficult to sell	Fair
Animals	Increase in value, Easy to sell	Can be stolen Maintenance cost	Good
Savings Account	Secure	Low interest rates	Fair

- **The Internal Free Rider Problem** arises when: a) new members who provide very little capital enjoy the same benefits as long-standing or founding members who have major investments in the cooperative in fixed assets (plant, machinery, equipment) and working capital; or b) when the patronage of new members does not make the cooperative much more efficient or competitive by producing significant economies of scale.

New members get a “free ride” on the investments and other efforts of existing members, thereby diluting the returns to existing members. In this situation, new members do not have much incentive to provide capital because it will not appreciate in value and existing members have little incentive to provide capital that will disproportionately benefit new members.

5 Improved strategies that help cooperatives to compete

Cooperatives need to adapt, finding new ways to finance their operations and compete, while maintaining their cooperative “identity”. As new approaches to generate more member capital increasingly resemble mechanisms used by limited companies, they may become increasingly controversial. Do these mechanisms constitute a useful road map to stronger cooperation, or is it a question of destroying solidarity and joining the competitor?

The answer depends on market conditions and the responses selected by cooperatives. The great majority of modern cooperatives that succeed in addressing competitive situations choose to adapt and innovate, moving away from a strict interpretation of traditional cooperative principles towards definition of a more modern cooperative identity. This identity is based on recognition of the equal importance of the member both as user and as investor, and driven by a new emphasis on independence and autonomy.³

Many changes in cooperative financing are under way and others (covered below) have been under way for decades in Europe, North America and Australia and New Zealand. Familiar features reappear: democratic control remains important, and open membership is preserved in most new forms. Members are very likely to be users, but their role as investors is usually more prominent. For this to be effective, members as shareholders have to receive returns that give them incentives to invest. A more even balance between these roles reduces or eliminates the Horizon, Portfolio and Free Rider Problems that so often arise when traditional cooperatives face capital shortages.

One reason for this tremendous social and economic progress achieved in rich countries is the historic effort of cooperatives to create markets in which more people can participate. On a broad scale, cooperatives have historically created more efficient markets by competing with other forms of enterprise, and have done so largely by empowering common people as producers. Agricultural service cooperatives control significant market shares in the food economy of many countries, and this is likely to continue. However, maintaining or improving upon these achievements in the future will require even more capital to reap the potential gains.

³ In 1995 the International Cooperative Alliance adopted a statement of cooperative identity based on seven points: voluntary and open membership; democratic member control; member economic participation; autonomy and independence; education, training and information; cooperation among cooperatives; and concern for community. (see www.coop.org)

New developments in cooperative financing include the issue of new classes of shares in addition to member shares. These may be weighted on the basis of one share, one vote. This may attract additional members and capital from those who would otherwise not be willing to contribute. Their unwillingness reflects their relative lack of control when control is based on one member, one vote, regardless of the amount of members' investment in the cooperative. Other changes involve the use of deferred payment revolving funds, base capital plans and limited company forms of organization for certain activities undertaken for the benefit of cooperatives and their members. The variety of methods used by modern commercial cooperatives in developed economies to mobilize member capital may surprise many who work with cooperatives. (For more details, see Part 2 Section 2.2 "Innovative forms of member capitalization.")

6 Legal framework and support

Many regulations governing the operation of cooperatives were established long before the emergence of current trends in the world economy. Laws providing legal protection were enacted to justify and control cooperatives' special business status and tax privileges. Control follows privilege, and whether some of these laws have done more harm than good is debatable. Some cooperative regulations from the past are still appropriate, others less so.

Examples of laws and regulations that restrict cooperatives in their business activities and discourage capital accumulation include those that require:

- A percentage of the sales revenue or turnover of the cooperative to be returned to members within a short period of time, regardless of the financial condition of the cooperative;
- Payouts of patronage refunds equal to a specified minimum percentage of the surplus, regardless of members' wishes;
- A certain portion of the surplus to be placed in reserve, or dedicated to community improvement, regardless of alternatives that would possibly be of greater use to members;
- Cooperatives to deliver their produce to government agencies at unattractive prices, or to sell government-rationed goods at mark-ups that are not remunerative;
- Routine business decisions to be approved by a general meeting of members, rather than through delegation to a management committee, making decision-making slow and cumbersome.

On the other hand, many other current business laws and regulations are appropriate and benefit cooperatives. These include those that:

- guarantee that business contracts will be enforced;

- permit land and property to be confiscated on non-repayment of loans and hence allow them to be used as collateral
- promote greater transparency in business transactions; and
- require accounts to be periodically audited.

However, evidence also shows that in developing countries financial support and privileges for cooperatives are decreasing, and cooperatives are increasingly obliged to compete with conventional businesses. Without their former privileges, many of the above regulations put cooperatives at a competitive disadvantage in the marketplace.

A review of existing laws and regulations governing agricultural cooperative businesses is therefore urgently needed in many countries to enable farmer cooperatives to participate successfully in increasingly competitive markets. Support organizations such as the Plunkett Foundation in the United Kingdom and international bodies such as the International Labour Office and the International Cooperative Alliance in Geneva, and the Food and Agriculture Organization in Rome, can provide guidance to movements and governments willing to encourage cooperatives through regulatory reform.