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Cooperatives in the CIS and Georgia: Overview of Legislation

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1. Introduction

Cooperatives in agriculture and in other sectors are usually created by grassroots users to overcome market failures, which are manifested in unwillingness of private business entrepreneurs to provide services in areas that they judge unprofitable or, alternatively, in unfair exploitation of the users by private businesses through monopolistic practices. Best-practice world experience suggests that farmers’ service cooperatives provide the most effective way of improving the access of small farmers to market services in both situations. International Cooperative Alliance (ICA) defines a cooperative as an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise (ICA, 2013). The persons who voluntarily unite to form a cooperative are usually referred to as members or member-owners.

A cooperative is a legal entity and, in a certain sense, it is an analogue of a shareholder corporation. There are, however, some fundamental differences between a cooperative and a corporation, as listed in **Table 1**. Perhaps the main difference concerns the organization’s objective: while business corporations aim to maximize their profit, cooperatives aim to maximize the benefits that members derive from their participation in cooperative activities, including lower prices paid for inputs and services and higher prices received for products (Cobia, 1998). The main areas of activity of agricultural service cooperatives are outlined in **Table 2**

Table 1. Comparative attributes of a cooperative and a shareholder corporation

Attribute	Cooperative	Corporation
Owners	Members	Shareholders–investors
Owners’ objective	Use of services provided by the cooperative	Earning income
Organization’s objective	Maximize members’ benefits from working with the cooperative	Maximize corporate profits
Voting rights	One member–one vote, regardless of share contribution	Number of votes proportional to number of shares (i.e., share contribution)
Income distribution rules	Income distributed to members in proportion to their participation in the activity of the cooperative	Income distributed to shareholders in proportion to the number of shares held

Source: Lerman, 2013.

Smallholders in the Commonwealth of Independent States and Georgia (abbreviated here as CIS)¹ are exposed to both dimensions of market failure mentioned above. After twenty years of transition, there are still not enough private entrepreneurs to satisfy the needs of the huge number of peasant farms and household plots, and smallholders often feel that they suffer from blatantly exploitative practices of private intermediaries due to lack of competition. Market-oriented scholars accordingly expected to see rapid development of agricultural service cooperatives in CIS in response to smallholder needs (see e.g., Gardner and Lerman, 2006). These expectations, however, have not materialized and the development of agricultural service cooperatives in CIS countries lags far behind the status of cooperative development in most of the world (Sedik and Lerman, 2013). Inadequacy of the legislative framework is often cited among the reasons that may be responsible for the unsatisfactory development of cooperatives in CIS (see Sedik and Lerman, 2013). In this

¹ Since August 2009, Georgia is no longer a member of the Commonwealth of Independent States (CIS). The accepted acronym CIS is used in our context in an ad hoc manner to designate the 11 current members of the CIS plus Georgia.

study, we review the cooperative laws in all 12 CIS countries (including Georgia) and examine their compatibility with universal cooperative principles and actual practices in the West.

Table 2. Areas of activity of agricultural service cooperatives

Type	Areas of activity
Marketing cooperatives	Collection, storage, sorting, packing, sale of farm products; provision of marketing information and services
Processing cooperatives	Variety of marketing cooperatives: processing of food commodities (milk, fruits and vegetables, wineries, milling, baking, meat and fish products, cotton gins, oil pressing); sale of processed products
Supply cooperatives	Purchase and stocking of farm inputs, resale to member-producers; animal feed
Technical farm services	Machinery pools, mechanized field works (plowing, harvesting), transport, machinery maintenance; Veterinary services, artificial insemination; Accounting and computer services Agricultural extension and consulting services
Consumer and public services	Development and maintenance of telephone, gas, and electricity networks in rural areas Health-care services Education and training Legal advice

2. The dichotomy of production and service cooperatives in CIS

One of the features of the cooperative legal framework in CIS is the distinction between agricultural service cooperatives (which idiosyncratically are often called in Russian “consumer cooperatives” – *potrebitel’skie kooperativy*) and agricultural production cooperatives (*proizvodstvennye kooperativy*). This dichotomy is hardly ever made explicit in established market economies, where practically no production cooperatives exist and “agricultural cooperative” is automatically understood as “agricultural service cooperative”. In CIS countries, on the other hand, “agricultural cooperative” is automatically understood as an “agricultural production cooperative” and the adjective “service” must be explicitly added in Russian to clarify that an agricultural service cooperative is actually meant (*obsluzhivayushchii kooperativ, servisnyi kooperativ*).

This is a curious situation for a region (former Czarist Russia) that had a developed system of service cooperatives before the 1917 Bolshevik revolution (Epshtein, 1993; Serova, 1991), practically without any production cooperatives (*artel’*, as they became known in Russian in the early part of the 20th century). The paradigm shift dates back to the 1920s, when Lenin proclaimed his socialist vision of the development of cooperatives: gradual and voluntary movement from lower to higher forms of cooperation, from marketing, service, and credit cooperatives to highest forms of production cooperatives (Osipov, 1960; see also Lenin, 1923). This vision, presenting production cooperatives as the highest form of cooperation, was subsequently implemented in Stalin’s collectivization drive (from 1928-1929 through the 1930s), which eventually transformed agriculture in all countries of the Soviet Union (the predecessors of CIS) to agriculture of collective farms, i.e., production cooperatives. Thus, contrary to the situation in developed market economies, tens of thousands of production cooperatives existed in CIS in the form of collective farms (*kolkhozes*) well into the post-1992 transition and many continue to exist in the form of “agricultural cooperatives” after the reforms that eliminated the collective farms (see, e.g., Golovina et al., 2012).

Perhaps the main difference between a service cooperative and a production cooperative is the status of a member vis-à-vis the cooperative. A service cooperative is an association of members-producers who retain their legal and operational independence, with production activities conducted on member-owned farms outside the cooperative (Figure 1). Participation in cooperative activities – marketing, input purchasing, machinery services, etc. – is obligatory, but members are not required to contribute their labor by working in the organization. The service cooperative in turn conducts transactions primarily with its members, not with third persons. It is expected that the service cooperative will be able to achieve, through economies of size, higher prices for the integrated sale of members’ products and lower costs for the bulk purchase of inputs for the members. This price advantage is the benefit that members derive from the service cooperative.

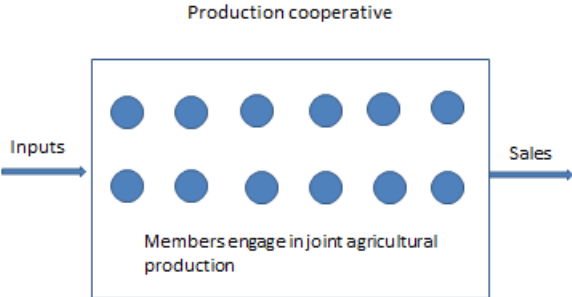
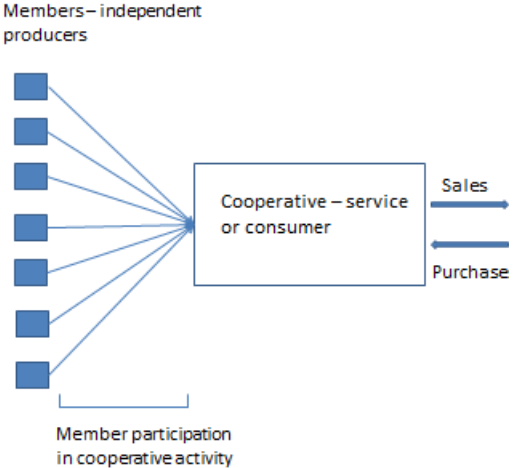


Figure 1. Schema of a service or consumer cooperative. Source for **Figures 1 and 2:** Lerman, 2013.

Figure 2. Schema of a production cooperative.

In a production cooperative, on the other hand, members typically work inside the cooperative, and not as independent entities (Figure 2). They engage in joint production using pooled resources (land or machinery); the cooperative sells the jointly produced output in the market and purchases inputs for the joint production process – not for individual members. The production cooperative conducts business transactions primarily with third persons and remunerates the member-workers from its operating revenues and surpluses. Like a service cooperative, it strives to benefit its members, but in a different way: the benefits to members come through providing them with a secure workplace and a satisfactory salary (income) that could be otherwise difficult to achieve.

The theory behind production cooperatives is that economies of scale work in primary agriculture and that joint production on large tracts of pooled land is more efficient and profitable than individual production on small plots (a claim that has never been proved for primary agriculture). Despite these substantive differences between production and service cooperatives and the frequent promulgation of separate laws for the two types of cooperatives in CIS, the legal definitions of their operating scope are virtually identical: only one function – “production” – distinguishes between the list of activities prescribed for service cooperatives and production cooperatives in the civil codes and cooperative laws of CIS countries. Other than “production”, both service and production cooperatives are legally allowed to engage in the full range of agricultural service and support activities. The 2013 Tajikistan Law of Cooperatives states, without elaboration, that production

cooperatives may engage in production alongside a range of other activities, while the 1999 Tajikistan Civil Code elaborates the “other activities” by listing processing, marketing, contract work, trade, and consumer services – all of which are standard functions of a service cooperative. A recent survey of cooperatives and cooperative members in Kyrgyzstan (Lerman and Sedik, 2013) has actually shown that, in addition to joint production based on member labor inputs, production cooperatives also provide farm services to non-members – independent peasant farmers and household plot operators who are not part of the joint production system. The activities of service cooperatives are thus a subset of the activities envisaged for production cooperatives in CIS legislation; production cooperatives may engage in the same service activities plus primary production. It is therefore understandable how some CIS countries managed to incorporate both production and service cooperatives in one cooperative law (see row 3 of the comparative analysis of cooperative laws in **Table 5**).

It seems that the legal distinction between production and consumer (service) cooperatives in CIS legislation is not based on functional attributes (i.e., what the cooperatives do). Instead, cooperatives are classified based on formal business-related attributes (**Table 3**), such as profit-making behavior (“commercial”, i.e., “for profit” organizations and “non-commercial”, i.e., “not for profit” organizations), clientele orientation (sales to members or non-members), and composition of the labor force (members work or do not work in the cooperative). Unfortunately, these formal attributes are ambiguous and fuzzy for cooperatives and are not suitable for unambiguous classification.

Table 3. Differences in legal classification of cooperatives in CIS legislation

Production cooperative	Consumer (service) cooperative
Legal body	Legal body
Commercial (“for profit”) organization	Non-commercial (“not-for-profit”) organization
Sales to third parties only	Sales mostly to members
Members part of the labor force	Members not necessarily part of the labor force

Source: Lerman, 2013.

In theory, a cooperative – whether a service cooperative or a production cooperative – is a “zero-profit” organization: it may distribute all its operating surpluses to members through adjustment transactions motivated by cooperative principles and end up with zero bottom line in the statement of financial results. Payments to members for their products (or for their work in production cooperatives) and charges for inputs and services are regarded as advances when they are routinely made during the year. In a service cooperative, surpluses may arise if, for instance, the cooperative initially paid the members for their products less than what it eventually received in the market (“underpayment”), or alternatively if the cooperative initially charged for services more than the actual cost (“overcharging”). In a production cooperative, surpluses may arise if the salaries paid to member-workers over the year were too low compared to the final revenues reported at the end of the period. In both situations, the surpluses can be distributed to members (in proportion to their participation in the cooperative activities) so that the cooperative reports zero accounting profit.

Whether or not a cooperative is viewed as a “zero-profit” organization naturally has an impact on its tax liabilities. The prevailing practice in established market economies is to recognize service cooperatives as non-profit entities and to exempt payouts to members from taxation at the level of the cooperative (see, e.g., Autry and Hall, 2009; Dutch Cooperative, undated); thus, only the retained portion of the surplus, if any, is taxed. On the other hand, no clear pattern with respect to tax status can be distinguished in CIS legislation. Many CIS countries treat production cooperatives as “for profit” manufacturing corporations and tax them in full. The treatment of service

cooperatives varies: some countries treat service cooperatives also as “for profit” (“commercial” in Civil Code terminology across CIS) entities and tax their surpluses before distribution to members, while other countries are beginning to allow “not for profit” (“noncommercial”) status to service cooperatives and exempt their surpluses from taxes. It seems that ongoing tax legislation reforms will do nothing with regard to the taxable status of production cooperatives while pushing all service cooperatives toward tax-exempt “not for profit” status.

3. Inventory of cooperative laws in CIS

Legislation on cooperatives in CIS is usually organized on three levels. The general legislative level includes primarily the Civil Code, which is the foundation for the definition of cooperative as a legal form, and the Tax Code, which introduces cooperative-specific taxation provisions (if and when necessary). On the next level, we have cooperative-specific laws, which are devoted in their entirety to treatment of cooperatives as a separate organizational and functional form. These may be separate laws for different types of cooperatives (production, service, consumer), a law on all agricultural cooperatives, or a law on cooperation including both agricultural and non-agricultural cooperatives. In this category, we also have special laws on Water User Associations (especially in Central Asia) and credit unions (credit cooperatives) – recent innovations formulated and adopted during the transition. The cooperative-specific laws are supported by implementation-enabling government resolutions (third-level supporting legislation).² The various cooperative laws in the 12 CIS countries are inventoried in **Table 4**.

4. Content of cooperative laws across CIS

ILO recommendations for cooperative legislation (Henry, 2012) set out the following bullet points for the main contents of a standard cooperative law:

1. Preamble: cooperative principles
2. General provisions: definition of cooperative
3. Formation and registration
4. Membership
5. Organs/bodies and management
6. Capital formation, accounts, surplus distribution and loss coverage
7. Audit
8. Dissolution
9. Simplified cooperative structures
10. Horizontal and vertical integration

² The terminological tangle is exacerbated when we notice that in addition to “laws of cooperatives” the CIS countries also have so-called “laws of consumer cooperation”, which were passed in 1991-1992 based on Soviet concepts of cooperation as enunciated in the 1988 USSR Law on Cooperation. These “laws of consumer cooperation” deal with so-called “rural consumer societies” – part of a centrally imposed state-run system (formerly known as *Tsentrosoyuz* in the Soviet Union) whose function was to supply consumer goods to the rural population and sell the output produced on household plots. The “consumer cooperation system” is dormant today in rural areas, but its administrators in the center remain a powerful lobby. The system, although hardly functioning, is so entrenched in former Soviet countries that Tajikistan, for instance, was forced to retain the 1992 Law of Consumer Cooperation in its statutes in parallel with the new 2013 Law of Cooperatives. The “consumer societies” should be clearly distinguished from the current concept of “consumer cooperatives” confusingly used as a synonym for “service cooperatives”. At the risk of increased terminological confusion, we should mention that, on paper, the “consumer societies” share many characteristics with the Western concept of rural consumer cooperative – i.e., a local “coop store” that supplies consumer goods in the village, thus saving the residents the need to travel to town more than is absolutely necessary.

11. Dispute settlement

Table 4. Inventory of cooperative-related legislation in CIS

Region/country	Civil Code	Cooperative laws
<i>European CIS</i>		
Belarus	Production coops only (Dec1998, Sec. 3, art. 107-112)	<ul style="list-style-type: none"> • Production coops (collective farms): standard kolkhoz statute (Presidential Decree, Feb2001)
Moldova	General non-specific definitions (6Jun2002, Part 3, art. 171-178), anticipating specific coop legislation	<ul style="list-style-type: none"> • Law on cooperation (Jan1992) • Consumer cooperation (Sep2000) • Business (entrepreneurial) coops (Apr2001) • Production coop (Apr2002, upd. 2010) • Draft law on producer groups (2013)
Russia	Production cooperatives (commercial entities) Consumer (=service) cooperatives (non-commercial entities) (Oct1994, Ch. 4, Sec. 3, Art. 107-112; Sec. 5, Art. 116)	<ul style="list-style-type: none"> • Law Ag Cooperation (Dec1995, upd. Dec2011) • Production coops (May1996, upd. Nov2011)
Ukraine	Production coops only (Nov2012 update, Ch. 8, Art. 163-166)	<ul style="list-style-type: none"> • Law on Cooperation (Nov2004, updated Jun2009) • Law on Agricultural Cooperation (Nov2012, eff. Jan2013)
<i>Transcaucasia</i>		
Armenia	General non-specific definition, either commercial or non-commercial entities (28July1998, Ch. 5, Sec. 1, art. 50, 51; Sec. 3, art. 117-121)	<ul style="list-style-type: none"> • Law on Consumer Cooperation (Dec1993, marginal update Oct2011): Soviet heritage inconsistent with Civil Code • Ongoing donor and government initiatives without clear legislative support
Georgia	No mention of cooperatives	<ul style="list-style-type: none"> • Law on Entrepreneurs 2008-2012 (Ch. 5) • Draft Law on Farmers Groups (Mar2013) • Law on Agricultural Cooperatives (Jul2013)
Azerbaijan	Cooperatives are commercial entities (Dec1999, Ch. 2, Art. 109-113)	<ul style="list-style-type: none"> • Law on Cooperation (Feb1996) • Draft law on Agricultural Cooperation, 2010-2013 (2nd reading after Mar2013)
<i>Central Asia</i>		
Kazakhstan	Initially production coops only (Dec1994, art. 96-101), subsequently updated to include consumer (=service) coops (1998, art. 108)	<ul style="list-style-type: none"> • Law of Production Cooperatives (1995) • Law of Agricultural Partnerships and Their Associations (2000) • Law of Consumer (=Service) Cooperatives (2001, updated Dec2012) • Law of Rural Consumer Cooperation (=Rural Service Cooperatives) (1999, updated Dec2012)
Kyrgyzstan	General non-specific definition, either commercial or non-commercial entities (May1996, updated 2010, Ch. 5, Sec. 1, Art. 85; Sec. 3, Art. 152-153)	<ul style="list-style-type: none"> • Law of Cooperation (1991) • Law of Cooperation (1999) • Law of Cooperatives (2005)
Tajikistan	Production cooperative (commercial entity) (Art. 118-123) Consumer cooperative (noncommercial entity) (Art. 128) (Jun1999, upd. 2010 Chapter 4, Sec. 1, 3, 5) <i>Duality of definition as in Uzbekistan</i>	<ul style="list-style-type: none"> • Law of Consumer Cooperation (1992, upd 2008) • Law of Production Cooperatives (2002) • Law of Cooperatives (2013)
Turkmenistan	No mention of cooperatives (Aug2012)	<ul style="list-style-type: none"> • Law of Consumer Cooperation (1991) • Law of Peasant Associations [Production Coops] (1995)

Table 4 (continued)

Region/country	Civil Code	Cooperative laws
Uzbekistan	Production cooperative (commercial entity) (Sec. 2, Art. 69) Consumer cooperative (noncommercial entity) (Sec. 3, Art. 73) <i>Both definitions compatible with notion of service cooperative; see Taj</i> (Mar1997, repeatedly updated to Sep2010)	<ul style="list-style-type: none"> • Law of Consumer Cooperation (1991, revised 1993-98) • Law of Agricultural [Production] Coops (Shirkats) (1998, updated to 2013)

By and large, the cooperative laws in all CIS countries where they exist are formally structured according to these blocks. This applies not only to the relatively recent cooperative laws heavily influenced by donor views (Azerbaijan, Kyrgyzstan, Tajikistan), but also to much of the older legislation based on the traditional Soviet template. While it is useful to keep these bullets as a formal checklist for “clearing” cooperative legislation across countries, we will move from this strictly structural level to more substantive content reflecting the treatment of basic conceptual issues in CIS cooperative laws. In line with the conceptual discussion above, we review the CIS legislation on cooperatives by the following parameters:

- Existence of cooperative laws
- Acceptance of ICA cooperative principles
- Objectives
- Separate laws for service and production cooperatives
- Membership (physical/legal bodies)
- Participation in cooperative activity
- Contribution of member labor to cooperative
- Distributions to members
- Cooperative profits and tax status
- Clientele
- Multilevel structure of the cooperative system
- Ability to invest individual land shares in cooperative equity

The review is presented in **Table 5**, with each row covering one of the issues above. Since most countries have adopted multiple cooperative laws over the years, the information in **Table 5** is based on the latest law currently in force (identified in the notes to the table). Cells marked N.A. in **Table 5** reflect situations when the existing law does not touch at all on the relevant issue. Below we elaborate in more detail the content of the various issues covered by the rows of **Table 5**.

Existence of cooperative laws

Practically all CIS countries have cooperative-specific laws in their statutes (see **Table 4**). Almost the only exceptions are Belarus and Turkmenistan, where agricultural cooperatives are still identified exclusively with collective farms. Uzbekistan, another CIS country that emphasizes collective farms and production cooperatives, has nevertheless elaborated its law of production cooperatives (*shirkats*) to include cooperative attributes ranging beyond the limited scope of collective farms. Curiously, Armenia – originally one of the leading reformers in the CIS – still has not passed a coherent up-to-date law of cooperatives, although various drafts are being debated on donor initiatives. There appears to be a singular lack of political will in Armenia to push in the direction of proper cooperative legislation. Armenia still relies on the 1993 Law of Consumer

Cooperation based on the Soviet *tsentrosoyuz* model of rural consumer societies guided by a national union.

Adherence to cooperative principles

Cooperative legislation in practically all CIS countries (again with the exception of Belarus and Turkmenistan) recognizes the basic principles of cooperation announced by ICA: voluntary participation, freedom of exit, democratic governance, emphasis on member benefits (ICA, 2013). This is not surprising, as similar statements were included already during the Soviet era in the standard statute of a collective farm (*kolkhoz*). In the past, scholars belittled the importance of these statements regarding them as “empty slogans”; they may still be slogans, but no cooperative legislation is conceivable without their explicit inclusion (see the formal ILO-advocated structure above).

Cooperative objective

Supplementing the ICA principles, most laws explicitly recognize that the objective of a cooperative is to increase the benefit of its members. The only exceptions are Belarus, Turkmenistan and Uzbekistan – the countries without full-fledged cooperative law that continue to identify cooperatives with collective-farm structures. In Uzbekistan, the objective of production cooperatives (*shirkats*) is defined as improving “rural social infrastructure”, and in Turkmenistan it is defined (for production-based peasant associations – *daikhan berleshik*) as working for the benefit of the “rural population”. In Belarus, the standard statute of a *kolkhoz* (which has the force of a *kolkhoz* law) describes at length how the *kolkhoz* works to improve the situation of the members and of the rural population at large, without specifically formulating member benefits as the cooperative objective. This is as close as the laws in these three countries come to defining member benefits as the cooperative objectives. Probably nothing should be done about this omission at the present stage: it will need to be taken care of, alongside with other deficiencies, when the three countries are ready promulgating proper cooperative laws, fully recognizing cooperatives of all different types.

As part of the goal of maximizing member benefits, some countries explicitly include a provision that guarantees preferential prices to members. Most countries, however, are silent on this point. The Moldova Law of Production Cooperatives paradoxically includes a provision that prohibits “granting any preferential rights to cooperative members” (art. 14(2), amended May 2008). The only acceptable interpretation of this article is that it excluded granting preferential rights to some members over other members of the same cooperative, not over non-members.

Dichotomy between production and service (“consumer”) cooperatives

The prominent role of production cooperatives in CIS countries (as successors of Soviet-era collective farms) is reflected in the prevailing service/production dichotomy, which is often “canonized” in separate laws for the two types of cooperatives. Six of the twelve CIS countries have separate laws for production and service cooperatives on their statutes (see **Table 5**). This is not the recommended practice in market-oriented economies. The ILO guidelines for cooperative legislation recommend “one law for all types of cooperatives, possibly with specific parts/chapters for specific types of cooperatives” (Henry, 2012, p. 59), and CIS countries indeed seem to be moving in this direction in their recent legislative attempts (Kyrgyzstan, Tajikistan, Azerbaijan, and perhaps most notably Ukraine). According to the ILO guidelines, the one-law approach, among other benefits,

diminishes bureaucracy and prevents fragmentation of the cooperative system that inevitably weakens its self-monitoring and lobbying power. Reduction of bureaucracy is a particularly important benefit in the highly bureaucratized and corruption ridden former Socialist economies.

Cooperative membership

Membership in a cooperative, according to ICA principles, is subject to the “open door” policy, ensuring both freedom of entry and freedom of exit. This is typically reflected in CIS cooperative legislation. Individual members are usually required to be adults (older than 16 or in some countries older than 18) and the prevailing laws generally impose a minimum membership for the creation of a cooperative (**Table 6**). The minimum number of members in CIS laws ranges from 2 to 7, while the ILO recommendations suggest 3 as the minimum: with fewer than 3 members, “the associative or group entrepreneur character of cooperatives becomes doubtful” (Henry, 2012, p. 73). From considerations of freedom of association, the minimum number of members in a cooperative should be kept as low as possible and no maximum should be imposed. Consistently with the ILO conception, CIS cooperative laws do not impose a maximum membership in cooperatives. Cooperatives are allowed to create associations, unions, and other agglomeration, which implies that, in principle, both physical and legal persons may be members of a cooperative. The nature of a production cooperative requires personal participation in cooperative production activities and membership in a production cooperative is typically limited to physical persons. This is not so in service (“consumer”) cooperatives, where members do not work in the cooperative and thus legal persons may join as members.

Although household plots play a crucial role in agricultural production in all CIS countries and due to their smallness are ideal candidates for joining a service cooperative, only the Russian cooperative law mentions them explicitly as a membership category. In all other countries, household plots are relegated to the old Soviet-style law of rural cooperative societies, which was originally designed during the Soviet era to address the specific needs of household plots. This may lead to a legal attitude that focuses only on commercially oriented peasant farms as “agricultural producers” eligible for membership in a service cooperative. On no account should the role of household plots in agricultural production be ignored, and they must always be regarded as legitimate candidates for full membership in service cooperatives.

Member participation in cooperative activity and in labor input

Participation of members in the activity of their cooperative is a basic principle and it is indeed incorporated in the cooperative laws of most CIS countries (see **Table 5**; other countries are silent on this issue). Contribution of member labor to the cooperative, i.e., an obligation to work in the cooperative, is properly limited to production cooperatives, which are totally based on member labor. Service (“consumer”) cooperatives are usually based on hired labor, although members may also work in such cooperatives.

Transactions with members and non-members

Cooperatives are in principle conceived to serve their members’ interests. Transactions with non-members are therefore regarded as an exception. However, it is not always possible to avoid transactions with non-members, as the membership base may be too narrow to allow growth and development. This is the main motive that pushes service cooperatives to engage in transactions

with non-members. In production cooperatives, the situation is somewhat different: production cooperatives employ members' labor to produce for the market, not for the members themselves, and their sales activities are automatically conducted with non-members. The attitude toward transactions with non-members is one of the features that differentiate between service and production cooperatives. The European approach is to treat transactions with members as "cooperative transactions" that do not generate profit and the transactions with non-members as profit-generating "commercial transactions" (Henry, 2012, pp. 23, 38).³ This approach may have influenced (perhaps indirectly) the cooperative law in some CIS countries, where profit earned on transactions with non-members cannot be distributed to members.

Western cooperative literature usually cautions against allowing transactions with non-members to spread too much and emphasizes the primacy of transactions with members, although cooperatives laws in Europe and EU Regulations somewhat paradoxically allow unlimited business with nonmembers (Henry, 2012, p. 12, note 35). The treatment of this issue in CIS cooperative legislation is patchy. Kazakhstan, Tajikistan, and Azerbaijan allow transactions with non-members. Moldova and Russia impose a cap of 50% of sales on transactions with non-members: if this cap is exceeded, the cooperative may lose its status and all associated preferences. Other countries are usually silent on this issue and it is mainly discussed in the context of taxation: tax preferences may be allowed on transactions with members, but not on transactions with non-members.

5. Taxation of cooperatives

Tax inspectors in all CIS countries are bound by the language of the Tax Code. Cooperative law can outline conceptual principles and suggest taxation guidelines, but ultimately any tax ruling is based on the Tax Code. Thus, the 2005 Law of Cooperatives in Kyrgyzstan contains a blanket statement deferring all tax-related decisions for cooperatives to the Tax Code (Article 32). Taxation of cooperatives involves two distinct issues: (a) value added tax (VAT) and (b) tax on profits at the level of the cooperative. In both instances, the Western approach to cooperative taxation is guided by the view that cooperatives are "the mandatories of their members" (Henry, 2012, p. 71), i.e., they "act on behalf of their members as their agents":

Because of the close involvement of the members in the decision-making processes in the cooperative and because of the special nature of the transaction between the members and their cooperative, cooperatives can be seen as the executing agents of the members.

This view suggests that transactions between cooperatives and their members should be exempt from both VAT and profit tax. The burden of taxation should shift from the cooperative ("the agent") to the members as the principal.

³ In Latin American legislation (including the 2008 Ley marco para las cooperativas de America Latina), the transactions between members and their cooperative are qualified as *acto cooperativa* (cooperative acts) as opposed to commercial acts (Henry, 2012, p. 38).

Table 5. Main characteristics of agricultural cooperatives as reflected in CIS legislation

	Bel	Mol	Rus	Ukr	Arm	Geo	Az	Kaz	Kyr	Taj	Tur	Uzb
Acceptance of ICA cooperative principles	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No: created by order	Yes
Objectives: benefit members	Yes (implicitly in kolkhoz statute)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	“Rural pop”	Yes (social infrastr.)
Separate laws for service/production cooperatives	Yes; separate definition in Civil Code	Yes	Combined prod/serv law plus separate law on prod coop	No	No	No; but no distinction in law between two types	No	Yes	No: law covers all forms of coops	No: law covers all forms of coops	Yes	Yes
Membership: physical & legal bodies	Yes (implicitly : right to associate)	Yes (serv.) No (prod.)	Yes; specific mention of hh plots	Yes	N.A. (only physical in rural consumer societies)	Yes (other coops)	Yes (only physical in prod coops)	Yes	Yes	Yes	No	Yes
Participation in cooperative activity	N.A.	Yes	Yes	Yes	N.A.	Yes	Yes	Yes	Yes	Yes	N.A.	N.A.
Contribution of member labor to cooperative	Yes	No (serv.) Yes (prod)	Yes (prod only)	N.A.	N.A.	N.A.	Yes (prod coops only)	No	N.A.	Yes	Yes	Yes
Preferential prices for members	N.A.	Yes		N.A.	N.A.	N.A.	N.A.	Yes	N.A.	Yes	Yes	N.A.
Distribution of income to members	Yes	Yes		Income net of member transactions	N.A.	Yes	Yes	No	Yes	Yes	N.A.	Yes; in propor. to asset share
Cooperative tax status: non-commercial entity, tax exemptions	Prod coop (commer.) Consumer coop (non-commer.)	Commercial entity; no VAT on transactions w. members*	Prod coop (commer.) Consumer coop (non-commer.)	Non-profit entities; transactions with members do not contribute to income	No: either form	Yes	Tax credits for ag producers extended to service coops	Yes	Yes	Noncomm (trans. mainly with members) Comm (trans. mainly with non-members)	N.A.	Prod coop (commer.) Consumer coop (non-commer.), tax-exempt

Table 5 (continued)

	Bel	Mol	Rus	Ukr	Arm	Geo	Az	Kaz	Kyr	Taj	Tur	Uzb
Clientele: members & nonmembers	N.A.	Yes (50%)	Yes (50%)	N.A.	N.A.	N.A.	Yes (service coops)	Yes	N.A.	Yes	N.A.	Yes: hired labor
Multilevel structure	Yes (implicitly : right to associate)	Yes	Yes	Yes	N.A.	N.A.	Yes	Yes	Yes	Yes	N.A.	Yes
Land transferred to coop	Yes	No (serv.) Yes (prod)	Yes for joint use, excl. own plots	Yes (prod coops only)	N.A.	N.A.	Yes	Yes	No (lease only)	No (lease only)	Yes	Yes

Bel: Civil Code (Dec1998), Production coops (collective farms): standard kolkhoz statute (Presidential Decree, Feb2001)

Mol: Law on Business (entrepreneurial) coops (Apr2001); *Tax Code (2013), Part III, Ch. 4, art. 103(1): 22)

Rus: Law on Agricultural Cooperation (Dec1995, upd. Dec2011)

Ukr: Law on Cooperation (Nov2004, upd. Jun2009), Law on Agricultural Cooperation (Nov2012, eff. Jan2013)

Arm: Civil Code (28July1998, Ch. 5); Law of Consumer Cooperation (1993)

Geo: Law on Entrepreneurs (25May2012), Law on Agricultural Cooperatives (12July2013), Law on Cooperation (Feb 1996)

Az: Civil Code (Dec1999, Ch. 2, Art. 109-113), Law on Agricultural Cooperation (draft, 2nd reading, Apr 2012),

Kaz: Law of Rural Consumer Cooperation (1999, updated, Dec 2012), Law of Consumer Cooperatives (2001, updated, Dec 2012)

Kyr: Law of Cooperatives (2005), Tax Code (2009)

Taj: Law of Cooperatives (2013)

Tur: Law of Peasant Associations [Production Coops] (1995)

Uzb: Law of Agricultural [Production] Coops (Shirkats) (1998, updt to 2013), Tax Code (2007-2013)

Table 6. Membership requirements in CIS cooperatives

	Bel*	Mol	Rus	Ukr	Arm**	Geo	Az	Kaz	Kyr	Taj	Tur	Uzb
Minimum age	18	16	16	16	16	18	16	18	18	16	Adults	16
Minimum number	N.A.	5	5	3	30	3-5	3	2	7	3	N.A.	N.A.

For sources, see note to **Table 5**.

* Bel: Age of adulthood from Civil Code (by default)

** Arm: In the absence of a cooperative law, minimum number of members is given according to the Law of Consumer Cooperation (1993) for a rural cooperative society

Value Added Tax (VAT)

Cooperatives as legal bodies charge VAT on all their transactions. This has no major effect on legal bodies doing business with the cooperative – such as registered peasant farms, other cooperatives, or agricultural enterprises. In accordance with universal VAT procedures, these legal bodies simply offset the VAT charged by the cooperative against their own cumulative VAT obligations, while the cooperative offsets the VAT charged by its clients against its own cumulative VAT obligations. In this way, only the last incremental amount of VAT is effectively paid to the VAT authorities. Yet smallholders who are not registered VAT payers find themselves at a disadvantage. On the one hand, they cannot offset the VAT charged by the cooperative on their transactions against anything, and this increases their costs. On the other hand, the cooperative is obliged to calculate the full amount of VAT on any transaction with the smallholders and becomes liable to the VAT authorities for this full amount, instead of just the incremental amount on the last link in a chain of transactions. The cooperative will naturally attempt to charge this extra “cost” back to the smallholder, paying less than the original invoice amount for the product received. The smallholder is thus at a clear disadvantage when selling his products to a cooperative (or actually any legal body) or when buying supplies from a cooperative. A smallholder would be better off by dealing with a small private intermediary (supplier or trader) who does not charge VAT rather than with the cooperative.

Cooperative lobbyists in CIS advocate that all transactions with members should be exempt from VAT. The Moldova Tax Code has maintained exemption of agricultural service cooperatives from VAT on transactions with members for many years (see 2013 version, Part III, Ch. 4, art. 103(1): 22). The 2009 Tax Code of Kyrgyzstan similarly exempts agricultural service cooperatives from VAT on transactions with members (Article 239). This is also the attitude of the developers of the 2013 Law of Cooperatives in Tajikistan, who drafted an appropriate amendment to the Tax Code. In other countries, there are no sweeping exemptions of cooperatives from VAT. Partial solutions have been attempted in Kazakhstan, where service cooperatives enjoy preferential terms paying only 30% of the general VAT rate, and in Ukraine, where the novel concept of Agricultural VAT allows agricultural cooperatives (alongside with all agricultural producers) to accumulate their VAT obligations for internal development purposes instead of transferring them to the state. These solutions are effective for legal bodies, but not for smallholders. The VAT bias against smallholders can be resolved only by unambiguous legislation that exempts from VAT all transactions with members.

Tax on profits

Regardless of the formal status of cooperatives as non-commercial or non-profit organizations, their financial reports may show an accounting profit at the level of revenues and expenses. This accounting profit is taxable in principle. Thus, although the Ukrainian law of cooperatives (2013) explicitly recognizes cooperatives as non-profit entities, this conception has not yet fully penetrated the Tax Code. The accounting profit is called “surplus” in Western cooperative accounting, as the term “profit” is deemed inappropriate for “non-profit” organizations. Surplus is created because the cooperative may have initially underpaid its members for products delivered (expenses too low) or overcharged them for inputs supplied (revenues too high). If the financial report shows an accounting loss (i.e.,

“deficit” or negative “surplus”), this indicates that the cooperative overpaid the members for the products delivered during the reporting period or undercharged for input supplies. In effect, the accounting profit or loss (surplus or deficit) is the result of internal pricing decisions within the cooperative, and not profit in the usual economic sense of the term.

Cooperatives do not know in advance, at the time of the actual transaction, how much to pay to members for product deliveries and how much to charge for input supplies and other services. Financial settlements with members are handled in two waves: the first-wave payments and charges are in the nature of an initial advance, and the final settlement is made at the end of the period, when the financial statements have been prepared on the basis of actual costs and revenues, including all overhead and management costs. As a result, a service cooperative usually presents a financial statement that shows a positive surplus (accounting profit) or a deficit (accounting loss) according to the scheme in **Table 7**.

Table 7. Schematic “profit and loss” statement of a service cooperative

Marketing cooperative	Supply cooperative
Revenues from sale of members’ products to third parties	Revenues: first-wave payments from members
Costs:	Costs:
First-wave payments to members	Paid to suppliers
Operating costs of the cooperative	Operating costs of the cooperative
Gross income (surplus/deficit)	Gross income (surplus/deficit)

Source: Lerman, 2013.

Gross income (доход in Russian) represents the surplus or deficit that is further allocated by three channels:⁴

- 1) Allocation to the cooperative reserve fund or other capital funds (“retention of earnings” in standard accounting terminology).
 - 2) Distribution to members in proportion to their share contribution to the cooperative capital (“dividends” in standard Western terminology; паевые выплаты in Russian).
 - 3) Patronage refunds (кооперативные выплаты) in proportion to the members’ use of cooperative services (i.e., essentially in proportion to first-wave payments to the members).
- The sum of the three amounts distributed to members is equal to gross income. Patronage refunds are determined as the difference between gross income and the first two allocations (**Table 8**).

Table 8. Allocation of profit in a service cooperative

Gross income (surplus/deficit):
Less allocation to reserve fund and other obligatory funds
Less distribution in proportion to share contribution (паевые выплаты, ”dividends”)
Difference available for distribution as patronage refunds (кооперативные выплаты)

Source: Lerman, 2013.

Conventional interpretation of the tax code will require the cooperative to pay tax on the full gross income at applicable rates. Recognition of the special nature of patronage refunds in cooperatives (as second-wave adjustment of initial over- or under-payment to members) suggests that this component of gross income should not be taxable. Furthermore, the U.S. tax code recognizes “dividends” paid to members in agricultural cooperatives (but not other

⁴ This income distribution scheme is outlined in detail in the 2013 Tajik Law of Cooperatives (Article 36) and more concisely in the 2005 Kyrgyz Law of Cooperatives (Article 28) or the 2012 Ukrainian Law of Cooperatives (Article 9(5)).

cooperatives) as non-taxable at the cooperative level, i.e., exempt from withholding taxes (Autry and Hall, 2009). The Dutch principles of the taxation of cooperatives also exempt all distributions to members (“dividends”) from profit tax under the so-called “participation exemption” (Dutch Cooperatives, undated). If these tax principles are adopted, the cooperative will be required to pay tax only on the share of gross income retained in reserve fund and other capital funds. The amount retained in the reserve fund and other capital funds will be shown net after deduction of the appropriate taxes.

Recognizing the need to exempt patronage refunds from taxation, the 2013 Law of Cooperatives in Tajikistan introduced an important provision in Art. 36(3):

Payments to cooperative members in accordance with their participation in cooperative activities ... are treated as expenses.

This essentially implies that patronage refunds are deducted from revenues as part of operating costs in **Table 7** and do not figure as part of taxable Gross Income. We argue that the same treatment should be applied to the “dividend” component (following the U.S. example).

The 2012 Ukrainian Law of Cooperatives classifies service cooperatives as non-profit organizations (Article 9(1)) and similarly to the Tajik law explicitly excludes receipts from sale of members’ products from calculation of accounting profit (Article 9(4)). However, these attitudes have not been fully absorbed into the Ukrainian Tax Code. As of January 2013, the profit tax for service cooperatives is assessed on net income after subtracting all “mandatory and dividend payments,” meaning that the profit tax is assessed on the net income available for distribution as patronage funds – the last component in **Table 8**. This approach still subjects farmers who join cooperatives to double taxation, but the tax base has been reduced considerably.⁵

Tax codes in CIS often allow extensive concessions to the category of agricultural producers. Thus, in Ukraine, agricultural producers have been subject to a so-called special tax regime since 1998, which leaves them virtually untaxed. Agricultural producers are entities that mostly engage in primary agricultural production so that service cooperatives (including processors) are generally not regarded as agricultural producers and do not enjoy the various exemptions allowed to producers. This is often cited as a strong disincentive for farmers to join a cooperative: as independent producers they enjoy a host of tax exemptions, which are lost once they become members of a cooperative. A possible solution to this dilemma is to explicitly recognize service cooperatives as agricultural producers. Thus, in Kazakhstan, the current tax code does not envisage any special tax concessions for cooperatives, but it explicitly puts agricultural service cooperatives in one category with other agricultural producers. As such, service cooperatives in Kazakhstan are entitled to follow a highly simplified tax-return system, with minimum accounting requirements, and furthermore they pay only 30% of the standard tax rate on all basic taxes (primarily VAT and corporate income tax, as well as land tax, land lease payments to the state, property tax, social tax, vehicle tax). In Azerbaijan, the appropriate provision is incorporated directly in the new Law of Agricultural Cooperation. According to Article 9.6, “existing tax preferences ... provided in law for agricultural producers are also applicable to cooperatives created by agricultural producers.”

⁵ A bill to amend the Ukrainian Tax Code so that agricultural service cooperatives are considered non-profit entities in the Tax Code, and not only in the Law of Cooperatives, was introduced into the Ukrainian Rada in March 2012 by the Communist parliamentary faction, but has not been passed.

Although this approach eliminates some of the blatant tax distortions for service cooperatives, possible distortions still arise for operators of household plots. As physical persons, they only pay personal income tax and their agricultural activities are exempt from taxes. If they join a service cooperative, the cooperative – a legal entity – will be obligated to calculate VAT on their transactions and to deduct profit tax from their share of income earned through the cooperative.

6. Registration requirements for cooperatives

Cooperatives are legal bodies and as such require registration, either as part of general registration of legal bodies according to Civil Code or as a special registration procedure specified in the country's law of cooperatives. The ILO guidelines for cooperative legislation state that, "the establishment of a speedy and impartial registration procedure is a first step by the state towards facilitating the development of a genuine cooperative system" (Henry, 2012, p. 69).

The registration requirements in CIS legislation are usually formulated in a muted general language. Thus, the Azerbaijan Law of Cooperation (1996) devotes a single sentence to the registration of cooperatives:

Article 9. State registration of a cooperative

A cooperative undergoes state registration in accordance with the laws of the Republic of Azerbaijan and is granted the status of legal person from the date of registration.

Similar laconic language is used for registration in the cooperative laws of other CIS countries (e.g., Russia, Kazakhstan). The Civil Code of Belarus – a highly authoritarian and centralist country – goes even further and explicitly states that

... refusal to register a legal person from motives of inadequacy is not allowed...
Refusal to register by state registration organs may be appealed through the courts (art. 47.1).

The 2005 cooperative law of Kyrgyzstan similarly states that

State registration of a cooperative may be refused only if the legally prescribed creation procedure has not been followed or its foundation documents are inconsistent with Kyrgyz legislation. Refusal to register ... or avoidance to register [by the state authority] may be appealed to the courts (art. 10.3)

This mild tone adopted in various CIS laws is consistent with the ILO recommendations on registration of cooperatives (Henry, 2012):

- ...a cooperative must be registered once the conditions laid down in the law are fulfilled (p. 68)
- ...if prior approval is necessary, the discretionary power of the approving authority must be strictly and effectively limited by law (p. 68)
- In no case must the registration procedure hinder people from forming entities in the way that suits them best (p.69)

- registration will be concluded within a short time period; a refusal to register must be justified in writing; in the case of refusal, the founders may appeal before a court, which should give a decision within a brief time period (p. 70)
- the fees for the registration and publication must in no case be prohibitive (p. 70)

A different approach is found in the new Law of Agricultural Cooperatives (2013) in Georgia. Uniquely among the CIS countries, Georgia establishes a special state agency, the Agency for the Development of Agricultural Cooperatives within the system of the Ministry of Agriculture. The main purpose of this agency is to develop viable cooperation in agriculture in Georgia. In pursuit of this overall goal, the agency is charged with the following competencies (article 8):

- Administration of government support measures, and provision of a strategy for the development of cooperatives in Georgia.
- Provision of training, advice and information to cooperatives on issues of importance to them.
- Monitoring and evaluation of cooperatives in Georgia.
- Organization of conferences, consultations and seminars on cooperative issues, and cooperation with the International Cooperative Alliance.
- Granting and termination of the status of an agricultural cooperative.

Agricultural cooperatives in Georgia first register in the registry of entrepreneurs and non-profit (non-commercial) legal entities. In order to be granted the additional status of “agricultural cooperative” cooperatives must register with the agency (art. 7.2). The cooperative is then evaluated according to criteria specified by law, and must provide periodic information to the agency for monitoring purposes. In return, the cooperative is eligible for government support measures. According to the Law on Agricultural Cooperatives (art. 15.2), the rules for granting and termination of the status of an agricultural cooperative were to be specified within 2 months after the Law came into force in July 2013. However, to date (March 2014) no regulation on this crucial issue has been made public.

The two-step registration process without clear criteria for the granting and termination of the status of an agricultural cooperative would appear to be inconsistent with the strong recommendations for simplicity and transparency voiced by the ILO (see above). In the absence of clear regulations on the rules for granting and termination of the status of agricultural cooperative, it is not possible to clearly understand the mandate of the Agency for the Development of Agricultural Cooperatives in Georgia. However, sources within Georgia state that the two registrations are of a totally different nature. Registration as a legal entity is the normal record-keeping listing required in Georgia as well as in other countries for legal bodies, including for all cooperatives. Registration with the agency is an optional step to be undertaken if the cooperative would like to participate in government support programs. The authority to grant and terminate the status of “agricultural cooperative” in Georgia represents an effort at quality control, in order to weed out “false cooperatives” which abuse the cooperative name in order to

qualify for state aid.⁶ This is an important function, as the “sleeping cooperative” phenomenon is fairly widespread in the region (Lerman and Sedik, 2014, forthcoming).

7. Conclusion

The CIS countries have established an impressive array of cooperative-oriented laws. Most countries explicitly recognize the ICA principles of cooperation, but difficulties and lacunae remain with regard to practical differentiation between production and service cooperatives as well as taxation of cooperatives.

The specific mix of agricultural cooperatives in CIS requires further work on both the legal level and the public awareness level to clearly differentiate between production and service cooperatives. Education efforts by the country governments and the donor community are needed to explain the advantages of the service cooperative model and its appropriateness for the CIS farming population. Without acceptance by an enlightened rural population, there is little chance for agricultural service cooperatives to take root. As part of the legal efforts, the separate legislation for “rural consumer societies” inherited from the Soviet era should be abolished, as these societies can be easily incorporated in general cooperative legislation. However, this approach will require political will to overcome the lobbying power still retained by old bureaucratic structures.

Attention to taxation legislation is a highly practical area that requires immediate attention. For cooperatives to become sustainable, it is essential to adopt the Western principles and exempt transactions with members and all distributions to members from taxation at the cooperative level. Only the portion of surplus retained in the cooperative equity for growth and expansion may be taxed.

A third issue, which is not related to legislation, concerns access to credit. It is usually recognized that start-up cooperatives may require seed money to launch their operations and establish an infrastructure base. These funds may come from the government in the form of reduced interest rate loans through financial institutions or from donors in the form of direct grants of money or assets. To avoid wasteful distribution of subsidized credit, cooperatives should be required to provide sufficient matching funds before getting cheap loans and entitlement to credit should be strictly linked to performance: only active cooperatives with valid business operations should be entitled to receive subsidized loans or other grants. The approach of the Georgian government (outlined by the FAO Representation Office in Georgia) could represent a novel approach to provide vital investment support to true agricultural service cooperatives, while weeding out false cooperatives which have registered themselves purely to take advantage of occasional government support. As to donor support, it is important to change the donor mindset: the traditional short-term horizons of one or two years are not constructive for development purposes. It is essential to develop programs ensuring sustained long-term support to cooperatives, such as the programs initiated by Heifer Ukraine. It may also be useful to focus on establishing links between agricultural cooperatives, as suppliers of raw materials, and private processors, as users of raw materials. A good example of such an alliance is provided by Danone Ukraine: Danone reaches out to agricultural service cooperatives as sources of supply of quality milk for its dairy operations, while ensuring long-term cash inflows for cooperatives through its milk purchasing commitments.

⁶ Information provided by the FAO Representation office in Tbilisi, Georgia (March 2014).

In summary, development of public awareness, attention to taxation issues, and creation of sustainable forms of financial support are the main issues that need to be considered in the context of cooperative development in CIS.

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