

# **Legislative Reforms for Cooperatives: Guidelines for Armenia**



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## **Objective**

The objective of the study is to contribute to the development of the Law on Agricultural Cooperatives through conducting a background research for the Ministry of Agriculture who committed to develop the Law according to its Action Plan of 2013.

## **Components of the Study**

The first part of the study summarizes the importance of cooperatives through providing new data and information highlighting the main reasons for the success of cooperatives, historical and contemporary evidences of cooperative development, share of income and employment which makes clear that cooperatives play a significant economic role. This part also brings available statistics on the size of cooperative sector worldwide. This section briefly highlights the ways cooperatives contribute to the overall functioning of economic system. Thus, the economic impact of cooperatives is provided. As social actors cooperatives have not been systematically analyzed. In order to highlight the social role of cooperatives a brief paragraph has been provided on the social value of cooperatives. These sections are needed for local policy makers to understand the economic and social impact as well as the importance of cooperatives before developing any policy paper on cooperatives.

The second part of the study explains the cooperative identity and describes public international cooperative law. In particular the emphasis has been made on the ICA Statement on Cooperative Identity, the UN Guidelines and the ILO Recommendation No. 193 which form the core of the public international cooperative law. This was done to make sure that local policy makers or law makers in Armenia understand the cooperative identity, the cooperative principles as well as the aspects covered in the public international cooperative law before developing a national law on cooperatives. We provided an analytic section on comparing the cooperatives and stock companies and highlighted the distinctions between cooperatives and social enterprises.

The third part of the study explains the problems and issues related to the understanding of the cooperative identity in the former Soviet Union countries. As in many former Soviet Union countries as well as in Armenia, the cooperatives are divided into production cooperatives, which are considered to be commercial (profit oriented) organizations and consumer cooperatives which are considered non-commercial (non-profit) organisations. These countries like Armenia also face the challenge of reforming the cooperative legislation based on the internationally recognized cooperative principles and identity. This section reveals the problems, issues and other challenges relevant for such legislative frameworks.

The fourth part of the study describes the current cooperative movement in Armenia and how cooperatives are viewed / understood in Armenia. We separated 3 phases of cooperative development in Armenia starting from 1993 when first autonomous, voluntary farmers' organisations developed in Armenia. Each phase had its own driving force, but similar problems and challenges. This section also describes the donors and international organisations and their programs related to cooperative development. A detailed cooperative statistics is provided (first time in Armenia). As of January 1, 2013 there were 3,737 production cooperatives and 307 consumer cooperatives registered in Armenia according to the State Registrar of Armenia. We concentrated on the statistics of consumer cooperatives as almost all agricultural cooperatives are registered as consumer cooperatives. The report shows

the distribution of consumer cooperatives at marz level as well as by type. The concluding component of this part is the description of current cooperative legislation and its analysis in view of internationally recognized cooperative identity elements. In particular, the Civil Code of the RA, the Law on Consumer Cooperation, the Law on Water Users Associations, the Law on Agricultural Credit Clubs and the Law on Condominiums (these are also registered as non-commercial cooperatives in Armenia) have been assessed and the cooperative elements identified. The accounting, tax and bookkeeping issues and challenges of consumer cooperatives have also been identified and presented in the report.

The fifth part of the report describes the comparative analysis of cooperative legislation of selected countries in view of ICA Cooperative principles and ILO R193. Twenty legislative elements widely used in the cooperative laws have been compared. Some of these elements are directly related to the cooperative identity and some others not but are very important for the sake of well-defined cooperative law. These elements are: *Definition and aim, Economic activity (restrictions), Activity with non-members (admissibility and restrictions), Registration, Minimum number of members, Investor-members (admissibility), Admission of New Members, Capital Variability, Minimum capital requirement, Allocation of the surplus and in particular allocation of the surplus to compulsory legal reserve funds, Distribution of reserves (admissibility and restrictions), Distribution of dividends on paid-up capital (admissibility and restrictions), Distinction dividends/refunds and distribution of refunds on the basis, and in proportion to the activity, Voting rights, Sectorial or section meetings (admissibility), Conversion into another legal form of company or entity (admissibility), Management and administrative boards/organs, Assets devolution in case of dissolution, Specific tax treatment (main measures), Public and/or other forms of supervision (auditing), including precautionary supervision, specific for cooperatives and not merely financial (main objects).*

We selected Bulgaria and Hungary taking into consideration their similar post soviet inheritance, similar agricultural structure, small farms and the level of subsistence agriculture like Armenia. The cases of Germany and Italy have been presented as well, taking into consideration their solid cooperative development history and recent legislative reforms aiming at creating a favourable environment for small farms' inclusion in cooperative structures. Separately we reviewed the recent reforms on cooperative legislation conducted in the Republic of Georgia. The Law on Farmers Groups and Farmers Associations, and the Law on Consumer Cooperation of Georgia have been reviewed. These laws are in line with internationally accepted cooperative principles and cooperative identity and contained the majority of the analyzed legislative elements. These laws can provide some guidance for Armenian policy and law makers.

The sixth part of the report describes the state policies for promotion of cooperatives. Three international documents accepted by member states of respective international organisations were reviewed and the main policy aspects presented. These documents were: ILO R193 (Promoting Cooperatives), UN Guidelines aimed at creating a supportive environment for the development of cooperatives and the European Commission Communication on the Promotion of Cooperative Societies in Europe.

The final part of the report presents the main conclusions and recommendations for the Government of Armenia to draft the law as well as the promotion mechanisms for developing successful cooperatives in Armenia.

**Below main conclusions and recommendations are presented.**

## **Conclusions**

1. Cooperative enterprises are influential institutions. Both in developed and in developing countries, cooperatives contribute to the socio-economic development and employment growth. The role and the importance of cooperatives are increasingly apparent due to the global financial and economic crisis. In most countries cooperatives have faced the crisis more effectively than investor-owned firms. Flexibility of cooperatives has increasingly been acknowledged, and policy makers and public opinion leaders are eager to understand what roles the cooperatives can play in controlling the process of eliminating the negative consequences of the global crisis and reform of the system that has given birth to that crisis.

2. Operating in all sectors of economic activity, cooperatives have greater longevity than investor-oriented firms. The cooperative model has always been adapted to the changing conditions, and innovative forms of cooperation have occurred to find solutions to new economic and social problems.

3. Since their establishment, cooperatives act not only as economic institutions but also as social players undertaking a clear commitment to resolve the problems of the local communities or other needy groups of stakeholders.

4. To develop a law on cooperatives, we should first of all know what a cooperative is. There are diverse opinions about cooperatives, however, even after reaching consensus on the legal definition of a cooperative, the plurality of opinions moves to another plane of discussion, not the legal one. The 1995 “Statement on the Cooperative Identity” of the International Cooperative Alliance (ICA), the 2001 UN Guidelines aimed at creating a supportive environment for the development of cooperatives, and the International Labour Organization's Recommendation 193 on the Promotion of Cooperatives accepted in 2002 make the basis for the public international cooperative law. The content of these documents must be respected during implementation of legal reforms or developing of national legislation.

5. To escape complexities during the development of cooperative legislation, it is necessary to clearly distinguish cooperatives and social enterprises as well as cooperatives and joint-stock enterprises.

6. In the countries of the former Soviet Union, including Armenia, as well as in the countries of Eastern and Central Europe, the issue of the legacy of the socialist past continues to be problematic. In most countries, cooperatives are still forced to combat the negative image of socialist past. The problem for the legislators has been – and in some cases still is – to create the legislative environment for autonomous and self-helping organizations of cooperative nature, which serve the economic and social interests of their members in the new environment of market economy. The legal environment created for cooperatives to date is directly impacted by the ambiguities and contrasts existing in the political arena, for example: existence of the same law based on different concepts; using of the same terms in different senses; poor reforms, without clearly rejecting the old regulations and without creating an equal environment for cooperatives with other types of enterprises.

7. Profit is not the main goal for both the consumer cooperatives and the production cooperatives. To survive in the market, they have to earn more than they spend, meaning to have a surplus upon the end of the financial year. Their incomes are generated partially from

the transactions with their partners in the market and with their customers. This surplus is necessary for covering the expenses of a cooperative, as a service providing organization, to achieve the goal for which the organization has been created. The main activity and the main goal of cooperative organizations is to deliver services to their members under favourable conditions (close to cost price) or – in case of producer cooperatives – offer safe and well-paid jobs to their members. Separation of cooperatives into commercial and non-commercial organizations needs to be revised based on the current conditions. The entrepreneurial activity of cooperative enterprises, due to their being oriented more to service delivery rather than profit seeking, must be recognized as legal, including the distribution of the annual surplus income between the cooperative members in the form of patronage, proportionally with the business transactions made with the cooperative members.

8. Numerous international and national programs have been focused on promoting the development of cooperatives in the Republic of Armenia. In all phases of the cooperative development presented, some progress has been recorded; nonetheless, because of the farmers' mentality, their wrong insight of the cooperative identity and principles, and little or no participation by the members in the management as well as economic activity of cooperatives, most of the established cooperatives stopped existing or they exist only on paper. To date, cooperatives remain underdeveloped and are far from being considered as a full part of the agricultural value chains.

9. The RA Ministry of Agriculture, for the first time, greatly valued the role of farmer organizations and cooperatives in its strategic programs. In the list of measures on ensuring the implementation of the 2010-2020 sustainable rural and agricultural development in the Republic of Armenia, measures focusing promotion of establishment and development of agricultural cooperatives are addressed.

10. Information on cooperatives can be received only from the RA State Register, and that only general one. According to the data of State Register, as of January 1, 2013, 3,737 production and 307 consumer cooperatives are registered in the RA. It is difficult to clarify how many production cooperatives are actually working, how much the share of agricultural production cooperatives is in this number, or how many consumer cooperatives are currently actually working. Here we need assistance from the RA State Revenue Committee.

11. There are diverse reasons preventing cooperatives from success and from being considered a complete part of the value chain system. Among these reasons, special place is given to those in the legal aspect, in particular, the existing laws in Armenia related to the cooperatives. The existing laws do not completely regulate the relations concerning the processes of establishment, operation and dissolution of cooperatives, and there is a need for improvements and amendments. Legal reforms will have essential importance for the sustainable development of cooperatives.

12. Armenia does not have a single comprehensive law on cooperatives, like many countries do. The cooperative sector is mainly regulated by the RA Civil Code, Article 51.3 of which says that “cooperatives, depending on their field of activity, can be profit seeking (commercial) or non-profit (non-commercial) organizations.” The Civil Code provides two separate types of cooperatives: consumer cooperatives and condominiums. The characteristics of these types are regulated by different laws: the RA law on making changes and amendments in the RA law “On consumer cooperation” and the RA law “On Condominium”. Analysis of these laws indicates that, according to the RA Civil Code and the above laws on separate types of cooperatives, cooperatives in Armenia can be commercial, including

production cooperatives, which are, according to Article 51.3, profit seeking organizations, and can be non-commercial, which include consumer cooperatives and condominiums, which in turn are non-profit organizations. Thus, these laws do not meet the provisions of R193 and ICA.

13. Analysis of the RA law “On consumer cooperation” and the RA Civil Code makes it clear that a large number of legislative elements of cooperative activities should be regulated by bylaws of cooperatives, since these laws do not completely regulate the relationships in the processes of cooperative’s formation, activity and dissolution and they need to be improved and completed. Moreover, the provisions of the law on consumer cooperation do not comply with the internationally recognized concepts and principles of consumer cooperatives.

14. Since a bylaw of a cooperative is, as a matter of fact, provisions stipulated by the law on cooperatives in the case of a particular cooperative, therefore, without normal, substantial provisions in cooperative laws, it is impossible to have normal bylaws, which should actually be the internal legislation of cooperatives. In the case of Armenia, the study showed that almost all cooperatives, production and consumer cooperatives alike, have adopted “exemplary” bylaws, without discussing and understanding whether or not the particular sample is necessary for their cooperative at all. Analysis of the bylaws of some of the consumer and producer cooperatives shows that the cooperative bylaws also do not reflect cooperative principles and value system; moreover, in case of production cooperatives, they even contradict with the internationally accepted characteristics of production cooperative.

15. Analysis shows that regulation of most of the studied 20 main elements of cooperative legislation is nonexistent both in the cooperative bylaws and in cooperative laws.

16. The RA law “On agricultural credit clubs” contains elements of cooperative identity and activity. This law could likely pretend to be called a law on cooperatives, because it contains more elements approximated to the cooperative identity and value system, than the RA Civil Code or the RA law “On consumer cooperation”. This law can serve a guideline also for developing a law on agricultural cooperatives.

17. In consumer cooperatives, accounting and taxation are a special problem. According to the existing Armenian legislation, these organizations can act as both profit tax payers and VAT payers, because the operations implemented by consumer cooperatives can be observed as both profit-seeking and non-profit operations. In practice, we can rarely come across accountants who have decent knowledge of accounting and taxation specificities. Given that most of the consumer cooperatives are in marzes and taking onto consideration the low level of the professional preparation of the accountants working in rural areas, steps should be taken to resolve the above problems on a timely basis.

18. The neighbouring country, Georgia, has recently initiated wide-ranging reforms of cooperative legislation. These reforms comply with the norms of international cooperative law. The Republic of Georgia law “On farmers groups and farmers associations” will be adopted soon. The goal of this law is to define the legal bases for formation of farmer groups and farmer associations to support the development of agriculture. The law also aims to create a favourable environment for formation of farmer groups and farmer associations, a relevant tax environment, reduce the administrative constraints, define principles of democracy, volunteerism and autonomy for their activities. Adoption of this law and enforcement of the tax privileges and versatile state support envisaged in the law will apparently improve the

competitive advantages of Georgia's agriculture, which in turn will create challenges for the exported Armenian agricultural products. This fact should be taken into account while implementing reforms in cooperative legislation and developing a state policy of supporting cooperatives.

19. R193, UN Guidelines aimed at creating a supportive environment for the development of cooperatives, and the European Commission's Communication on the promotion of cooperative societies adopted in 2004 suggest a clear framework of formation of state policies for promotion of cooperatives. We can state that all three international documents suggest a package of actions to the governments to take appropriate measures aimed at promotion of cooperatives. All three aforementioned documents explicitly value the roles of the governments in public recognition of cooperatives and in understanding the importance of cooperatives. In the state policies of promotion of cooperatives, issues related to cooperative statistics, research and education are especially considered significant. All three documents address also the other important issue of state policy – create favourable legal, administrative and legislative environment for formation and normal development of cooperatives.

20. Misuse of cooperatives as a development tool and external forcing destroy the core advantage of cooperatives – mobilization of members' own resources for their own profit and activation of the driving forces of organized mutual assistance, thus indirectly promoting the general development. Offering incentives and privileges to cooperatives which are implementing the government's policies results in encouragement of false cooperatives which often act as the government's 'long hand' during implementation of some projects that exist only on paper and only during the time of external support.

## **Recommendations**

1. The best approach to legislative reforms would be developing one universal law on cooperatives. As we could see, the Armenian cooperative legislation does not comply with provisions of ICA and ILO R193, which make component parts of public international cooperative law. Currently, the tendency on the global level too is having a general law on cooperatives, which would regulate activities of all types of cooperatives. This law can address in separate sections also the legal regulation of other types of cooperatives, such as agricultural, worker, credit, etc.

It is widely recognized that a general law on cooperatives will best guarantee the cooperative identity and autonomy of all cooperatives. Normally, general laws are not detailed, and in this sense, in case of a generic law, bureaucratic complexities are decreased considerably. The general law will enable to escape fragmentation of the cooperative movement. In case of separate laws, different types of cooperatives are registered according to different laws and operate mainly in a secluded and detached way. International organizations and other economic entities use the law more often for information and communication purposes. This general law would become an actual landmark and a reference point to have an idea on the cooperative legal environment.

A general law would allow empowering the cooperative movement. If worker, social or financial cooperatives begin to develop in Armenia, it will be necessary to regulate also their activities by separate laws. While having one general law on cooperatives, the activity of a new type, innovative or any type of cooperatives will be easily regulated.

A new, modern single general law advocating the actual identity and principles of cooperatives and complying with international legislative norms would play the role of a “legislative guillotine” in case of Armenia, i.e. would force out from circulation of several laws that pretend to regulate the cooperative activity, however in reality do not regulate it and are about nothing; for example, the RA law “On consumer cooperative” and articles related to cooperatives in the RA Civil Code.

2. As mentioned, the above approach would be the best one. If, for any reason, it won't be possible to achieve adopting one universal law on cooperatives, then the alternative approach should be making changes in the existing cooperative-related laws and developing new laws in compliance with the provisions of ICA, R193 and internationally acceptable legislative elements. We believe, however, that this recommendation will be more labor-intensive and costly, since we will have to revise both the RA Civil Code and the RA law “On consumer cooperatives” in addition to developing a new law of RA “On agricultural cooperatives”.

Thus, the legal elements specifying the cooperative identity, principles, differences between cooperatives and other social economic enterprises and joint stock companies should be included in cooperative laws. To do so, it is necessary to first of all reject the legacy of the socialist past. A production cooperative cannot be commercial and a consumer cooperative – non commercial. The cooperative affiliation into commercial and non-commercial entities should be revised, as, according to international cooperative standards, all types and forms of cooperatives – starting from service providing cooperatives up to producer cooperatives – are defined and regulated by the same standards and are regulated by a single universal law in most of the countries.

The economic activity of cooperatives, being more of a service providing orientation rather than profit-seeking enterprises, should be recognized legal, including distribution of the annual surplus income between cooperative members in the form of patronage, in accordance with the proportion of business transactions with the cooperative members. Cooperatives should ensure positive economic outcome also as economic organizations. However, their goal is not ensuring the said positive outcome but meeting the general economic, social and cultural needs of their members with the help of that outcome. As already mentioned, the positive economic outcome is divided into 2 special parts – profit received from non members and surplus received from members. These very elements and other similar elements should be largely focused while making legislative changes and developing new laws.

The legislative changes should start with the very definition of cooperatives. Definition of a cooperative must reflect the specificities that make cooperatives different from other types of business entities. The matter concerns the cooperative identity and promotion of cooperative members. The principle of cooperative identity is that cooperative members are the cofounders, co-funders, co-owners, co-controllers and finally the co-users and co-beneficiaries of the cooperative. The promotion principle is that improvement of the state of cooperative members is more preferable than ensuring high returns from the capital invested. Coexistence of these two principles confirms the dual nature of cooperatives; i.e. a cooperative is simultaneously an association of people and an economic enterprise. Or, putting more correctly, it is a group of people who have an enterprise. Although this enterprise should work with the profit seeking approach, it is clearly different from capitalistic enterprises. It is necessary to have the right definition of a cooperative in order to reflect the

difference between cooperatives and non-profit organizations, charitable organizations and other types of social economy players.

We suggest to adopt a definition complying with ICA and R193 provisions, which will contain the key elements of the cooperative identity and will be centralized on the goal, the structure and other elements of activity.

3. During cooperative legislation reforms or during developing of any new law on cooperatives, take into account the important elements concerning the cooperative identity and principles explicitly expressed in cooperative legislation, as well as elements that are important from the legal point of view. Based on the example of different countries, this report addresses 20 such elements, which are mainly regulated by cooperative laws as well as are directly or indirectly related to cooperative principles and the provisions of R193.

While regulation of some of the mentioned legal elements can be ascribed to the bylaws of a cooperative, it is more desirable to regulate the following directly by the law:

- Minimum number of members;
- Investor-members;
- Distribution of the surplus and in particular allocation of the surplus to compulsory reserve funds;
- Distribution of reserves;
- Distribution of dividends according to the paid-up capital;
- Differentiation of dividends/compensations/patronage based on the activity and proportion of activity;
- Voting right;
- Meetings of sectoral divisions;
- Conversion into a different form of company or organization or legal entity;
- Asset devolution in case of dissolution;
- Specific tax approach;
- Public and/or other forms of supervision (auditing), including precautionary supervision specific for cooperatives and not merely financial supervision.

We recommend that these legal elements are made a subject for a wide discussion, with involvement of cooperatives, state policy makers, representatives of academia, economic (agricultural) and legal analysts, international organizations and representatives of other stakeholders.

4. It is necessary to study more deeply the tax policy concerning cooperatives, in particular agricultural cooperatives. As we could see, Georgia has exempted the agricultural cooperatives from all kinds of essential taxes and has envisaged a comprehensive state support. To keep the competitive advantage of our farmers on the same plane, it is necessary to ensure similar tax privileges and state support to agricultural cooperatives in Armenia; otherwise, over time, Armenia will lose its competitive advantages which the country currently has in the sector of export of both fresh and processed agricultural products. Nonetheless, before achieving tax privileges, it is necessary to have a new, modern law “On agricultural cooperatives” approximated to ICA and R193 provisions.

5. Simultaneously with the legal reforms of cooperatives, it is necessary to develop a state policy of promotion of cooperatives. R193, UN Guidelines aimed at creating a supportive environment for the development of cooperatives, and the European Commission’s Communication on the promotion of co-operative societies adopted in 2004 suggest a package

of actions to the governments for implementing relevant measures aimed at promotion of cooperatives. The recommendations provided by these documents should be taken into consideration while developing a national promotional policy for cooperatives (or for a particular type of cooperatives, such as agricultural).

In particular, we recommend that the state cooperative promotion policy be centralized on actions focusing public recognition and understanding of the importance of cooperatives; measures aimed to resolve issues related to cooperative statistics, research and education; actions focusing attraction of financial resources on terms favourable for cooperatives; and in general, state measures aimed at creation of favourable administrative and legislative environment for cooperatives.