

# Economics of Consumer Cooperatives

MARIAN RADETZKI

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*Marian Radetzki*

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## ECONOMICS OF CONSUMER COOPERATIVES

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## ROLE AND IMPORTANCE OF CAPITAL

### *1.1 Introduction*

The role and importance of capital has often not been sufficiently stressed when commencing consumer cooperative activities in South-East Asia. It would probably be true to say that in a great number of cases failure can be explained by insufficient capital resources or inability to increase the capital with expanding business. Lack of understanding of the role and functioning of capital would also explain many failures of customers' cooperatives in the Western countries in the beginning stages of cooperative development.

By studying a very simplified case we will try to illustrate in this booklet the needs for capital, and the functions it will have in the running of the society. Conditions in real life will quite naturally prove to be much more complicated than in the examples which we intend to use. We hope, however, that by studying the examples given, some clarifications of the subject will be brought about.

### *1.2 Economic Planning*

Let us assume that we are a group of persons planning to start a consumer cooperative society which will run a shop to attend to our daily needs. Before actually starting to set up the shop, it is essential that we undertake some economic planning. By investigating in our vicinity we will find that about 200 families would be interested in joining as members of the society. By experience we can gather that the average number of persons per family is 5. In other words about 1,000 persons belong to the 200 families.

The next very important point is to determine the total purchase needs of this group of people, which could be satisfied through the shop which our society is going to run. This is important, because this figure will provide the basis on which we must try to establish our turnover, amount of stock on hand and the size of the shop. In the beginning

stages it would hardly be correct to assume that we could carry our assortment of goods broad enough to satisfy all the current consumption needs of our members. Probably we would have to limit ourselves and start on a more modest scale. To begin with, we will only plan for the most common daily consumption necessities such as grains, sugar, fat, tea and some toilet articles. By looking into the spending pattern of some of the families in our group, we conclude that their average monthly spending on such items is around Rs. 50 which amounts to Rs. 600 per year. Thus for 200 families the total should be around Rs. 120,000 per year, sufficient to make our shop economically successful. Would it be correct to base the size of our shop on the assumption of the calculated total consumption needs? At this stage it would certainly be difficult to determine the loyalty of our prospective members and too big a shop could easily become an economic burden.

Let us cautiously assume, therefore, that our members will purchase between 50 and 60% of their established needs from our shop, thus giving it a total yearly turnover of about Rs. 70,000. Perhaps we are underestimating the loyalty of our members? If this is the case, the increasing turnover will prove to be a pleasant surprise. We must, however, be prepared for this eventuality and should arrange the location of our shop so that further expansion is possible.

What is the share value which our member-families could afford? In the initial stages our capital requirements will be heavy and we will not have any reserves to draw on in case of need. Let us suppose that we can induce our 200 families to invest Rs. 20 each for a total of Rs. 4,000. Although it would certainly be more convenient for our members to invest this capital over a period of time, it seems hardly possible to set up the shop without an immediate capital contribution. The share capital must be paid in cash to enable us to establish the shop and start the operations. But will Rs. 4,000 be enough? Let us examine what immediate expenses we will have to incur. For the sake of simplicity we will assume that our society will make all its deals on a cash basis. At a later stage we will also discuss the implications of credit transactions.

First, we will need a stock of merchandise. Our estimated turnover is Rs. 70,000 yearly. We may assume that the goods which we offer for sale will on an average remain in our stock for one month. In other words, our stock will be turned over 12 times a year. Thus, on an average, the value of our stock will be equal to one month's turnover.

One month's sales will amount to about Rs. 5,800 and if our overall margins are 21-22% of the sales prices, then the purchase value of our stock should be around Rs. 4,500. The margins of 21-22% will appear high in South-East Asian conditions. It is possible to work out the capital needed etc., on more realistic margins of about 10% or some other rate. It is, therefore, suggested that the 21-22% margins mentioned above may be taken as only for illustration purposes for the following calculations. The margins will have to cover all our costs including wastage of perishable goods, and depreciation of assets. A stock turnover of 12 times per year is a fairly common figure in grocery shops in this part of the world. We will use it here for the sake of convenience, in order to calculate our capital needs. Later, we will discuss the implications of different speeds of stock turnover. We can thus conclude here that about Rs. 4,500 will have to be invested in stock before we can start our operations.

The premises where we intend to locate our shop, will cost us as rent, Rs. 200 per month or Rs. 2,400 per year. When we start our operation, we will need Rs. 200 for the first month's payment whereas rent for subsequent months could be paid from the current gross surpluses. The premises will have to be fitted with equipment before the shop can start operating. We may need a number of shelves, storage arrangements, scales, etc. and also refrigeration facilities. Later on we may also have to rebuild our premises to a certain extent so as to suit our particular needs. We calculate the total cost for this at about Rs. 4,000.

Now we are ready to estimate our immediate capital needs which appear in Table I.

TABLE I

Purchase of stock	...	...	...	...	Rs. 4,500
Rent—one month	...	..	...	...	„ 200
Equipments and installations	...	...	...	...	„ 4,000
Total initial investment	...	...	...	...	„ 8,700

As previously explained, our expected paid-up share capital would be about Rs. 4,000. We thus need roughly another Rs. 5,000 before we can start our operations. From where can we obtain this money? The best plan would be to acquire it as additional share capital, or as a loan from our members. If this proves impossible, we will have to turn to a Cooperative Bank or to some other lending institution and request financial support.



Before the loan is granted, the bank will probably wish to examine the soundness of our economic venture. We will have to submit statements showing the budgeted income and expenditure and also statements proving our capacity to repay the borrowed money. The first statement will be on the lines of Table I, indicating our initial capital needs plus showing how we plan to cover them, as shown in Table II.

TABLE II

<i>Initial capital needs</i>			
Purchase of stock	...	Rs. 4,500	
Rent—one month	...	„ 200	
Equipment and installation	...	<u>„ 4,000</u>	Rs. 8,700
<i>Proposed supply of capital</i>			
Share capital	...	„ 4,000	
Bank loan	...	<u>„ 5,000</u>	Rs. 9,000

Another statement will have to indicate the yearly sales and gross surplus which we expect to realize in our shop. Here we can also indicate the potential purchasing powers of our members :

TABLE III

Number of member families	...	...	...	200
Number of individuals	...	...	...	1,000
Calculated total purchase needs per year	...	...	...	Rs. 120,000
<i>Turnover and gross surplus yearly :</i>				
Sales Turnover	...	...	..	„ 70,000
Purchase of goods	...	..	...	„ 55,000
Gross surplus	..	...	..	„ 15,000
Gross surplus as % of sales	..	...	...	„ 21.5

In the next statement we have to indicate if we will be able to cover all our costs with the estimated gross surplus of Rs. 15,000. Before we calculate the individual cost items, we must clarify a few other matters. One is that the equipment and installations which have cost us Rs. 4,000 will depreciate in value with the passage of time. Let us assume that on the whole they will last about ten years. Therefore, we will have to put aside an amount from our gross surplus each year, so that after ten years we will have Rs. 4,000 available for new equipment and installations to

replace those which have been worn out during that time. we would call this expenditure depreciation of assets, and it is easy to calculate that Rs. 400 will have to be allotted for this purpose each year.

The bank loan will run with an interest of 6% and will have to be repaid over 10 years. In the first year we will thus repay interest at 6% on Rs. 5,000 or Rs. 300 and also repay 10% of the capital Rs. 500; thus a total sum of Rs. 800. Over the years, as the capital is repaid, the interest charges will decrease. Now we are ready to prepare the fourth statement indicating our costs of operation.

TABLE IV

<i>Operational Costs</i>		(figures in Rupees)		Monthly	Yearly
1. Rent	... ..	...	...	200	2,400
2. Staff	1 Manager	250	...		
	1 Assistant	125	...		
	1 Messenger	<u>75</u>	...	450	5,400
3. Bank loan at 6%, 10 years:		Rs. 5,000			
	Interest	25			
	Annuity	<u>42</u>	...	67	800
4. Depreciation of assets	Rs. 4,000. 10%	...	...	33	400
5. Other costs	... ..	...	...	83	1,000
	<i>Total costs</i>	...	...	833	10,000
Gross surplus	... ..	...	...	1,250	15,000
Less costs	... ..	...	...	<u>-833</u>	<u>-10,000</u>
Net surplus	... ..	...	...	417	5,000

If the above statement has been prepared in a realistic manner, the bank should be willing to grant us the required loan. According to the figures which we have calculated, our repayment capacity is very good indeed, and even after meeting all the costs, there remains a considerable amount of money as net surplus. Naturally, the figures with which we operate in this paper are not taken from any real situation. They have been constructed as a model simplifying the reality so as to enable us to see clearly their inter-relations. Although in reality the conditions will be more complicated and possibly more competitive, it is good to make some exercises in cost and surplus accounting before we involve ourselves in the economic activity itself.

### *1.3 Capital Accumulation*

Our society started with a share capital of Rs. 4,000 consisting of 200 shares valued at Rs. 20 each and a bank loan of Rs. 5,000, which we will be repaying over a 10-year period out of our current gross surplus each year. Although Rs. 9,000 were sufficient to enable us to start our shop, it is necessary for us to increase our capital resources with time. Certainly, we would like to expand our operations. This can be done by increasing the number of customers and by diversifying the merchandise so that further needs can be satisfied from our shop. In both cases our stock value will have to be increased and perhaps we will have to make some improvements in the shop lay-out. This will also require further capital. Our tiny shop will probably not be able to compete effectively in all situations with established private trade. To improve our position, we must gain strength by expanding our activities. In this expansion and competition we may clash with the vested interests in the private trade. A cut-throat competition may develop, and to survive, we must have sufficient capital reserves. Eventually, when our membership increases, perhaps when we admit members from outside our present locality, we will have to consider putting up additional branch shops so as to give equally satisfactory service to all our members. For all this we will need capital. Let us examine the different ways to get additional capital resources.

Allocation to the reserve fund or other funds from the current year's surplus will ensure that a part of the surplus remains with the society. In most countries there is a provision which demands that a certain percentage of the net surplus be transferred to the reserve fund. In India, in case of certain societies this amounts to 25%. In our case we could decide that the entire net surplus of Rs. 5,000 should be retained by the society and kept in the reserve and other funds. The capital accumulation would certainly be quite satisfactory if this practice were adopted. There is, however one serious objection to it. The society is the property of the individual member and it is essential that this fact is reflected in the capital structure. Even if the total surplus goes to the funds, we will, after a couple of years, have a situation where the member capital constitutes only a very small proportion of the total working capital of the society. This is not a very healthy development, considering the democratic aspirations of our cooperative organization. Therefore, some means have to be found to increase the member capital also.

With the expansion of our activities it is likely that more families will apply for membership. Thus our share capital may start to grow

automatically. However, the expansion in membership will also increase the capital needs proportionately, as the new members also will be utilizing the services of the society.

We saw earlier, that each share ought to be valued at Rs. 20. The reason was that most of our members would hardly be in a position to subscribe larger capital amounts immediately. We might, however, look into the possibility of gradually increasing the share capital of individual members. It would probably be difficult to persuade the members to make additional cash payments for further shares. It would certainly be easier to convert part of the surplus created during the year into members' share capital instead of paying it out to the members. Let us see how such an arrangement could be carried out.

We have to keep in mind the following essential facts about our operations during the past year :

TABLE V

Share capital	.	...	...	Rs. 4,000
Sales turnover	...	...	...	,, 70,000
Net surplus	...	...	...	,, 5,000

The share capital must, of course, have its remuneration in the form of interest. To discourage professional investors to join the society and invest large amounts of money for profit-making, we should limit the interest on share capital to somewhere around ordinary savings bank account rates. After all, the members have not contributed the capital to the society to get profit on it. The society was created to provide a satisfactory service. We might decide that 5% should be distributed as interest on share capital. In our case it will be 5% of Rs. 4,000 or Rs. 200. As previously indicated 25% of the surplus i.e. Rs. 1,250 will have to be allotted to the reserve fund. After this there will still remain Rs. 3,550 out of our total net surplus.

In a cooperative organization, where the members are patrons, it can rightly be said that the surplus, which has obviously been created by charging too high prices from the members, ought to be returned to them in accordance with their patronage. In simple words, if I have purchased goods for Rs. 1,000 from the society during the year, I should have twice as large a refund as another member who has purchased for

Rs. 500 only. Through my larger purchase I have contributed more to creating the surplus of the society. Such a dividend is usually called patronage refund. In our case we will see that the surplus remaining with the society after allocating money to the reserve fund and for interest on shares, constitutes about 5% of the turnover. To avoid the risk of over-spending, we may decide to declare a patronage refund of 4% only. Accordingly, I will receive Rs. 40 as patronage refund on my purchases amounting to Rs. 1,000 per year. At the rate of 4% of the turnover we will have to distribute about Rs. 2,800 to our members. In reality we will be lowering our prices by 4% thus making our services still more attractive to members.

The patronage dividend could be a suitable instrument to help us solve the capital problems which have been previously discussed. In our bye-laws we might insert a clause saying that any person joining the society must contribute Rs. 20 in cash. But in addition to that sum, the first 1% of the patronage dividend should not be paid out in cash, but added to the member's share capital. This could be done until his total share capital reaches Rs. 100, or five shares at which time all his patronage dividend could then be paid in cash. In my case, with Rs. 1,000 purchases, and 4% or Rs. 40 patronage dividend the above rule would mean that I would receive in cash 3% or Rs. 30, while one per cent or Rs. 10 would be added to my share capital, which would thus increase from Rs. 20 to Rs. 30. My friend, whose purchases from the society during the year amounted to Rs. 500 would get a cash patronage dividend of 3% or Rs. 15, while Rs. 5 would be added to his share capital with the society.

Let us now examine how the total net surplus of Rs. 5,000 has been used :

TABLE VI : *Division of net surplus*

25% of surplus (Rs. 5,000) to Reserve Fund	...	...	Rs. 1,250
Interest on share capital 5% on Rs. 4,000	...	...	„ 200
Patronage dividend 4% of turnover 70,000			
of which 3% cash	...	...	„ 2,100
1% transferred to members' share capital	...	...	„ 700
Balance for educational purposes	...	...	„ 750
		<i>Total net surplus</i>	Rs. 5,000

As appears from the Table, a certain sum of money has been allotted for educational purposes. This may be both for cooperative education of members and for the training of our employees, so that still better services could be provided by them. After this division, our capital situation will be considerably improved. The share capital of the society will amount to Rs. 4,700 and in addition, there will be an amount of Rs. 1,250 in the reserve fund. Thus the total owned capital will now be Rs. 5,950. By adopting the rule that a part of the patronage refund should be transferred to the share capital, we have ensured that our capital will increase faster, as the turnover increases. This is a very wise arrangement since with increasing turnover figures, our capital needs are also bound to rise.

#### *1.4 Selection of Assortment and Capital Needs*

When we discussed our capital needs for the stock in our shop, we planned that the shop would sell daily necessities only, and that, as a consequence, the turnover rate would be comparatively high. By assuming a turnover speed of once a month we could calculate our stock value at about Rs. 4,500. With the scarce capital resources at our disposal, it would have been difficult to include articles in our stock, which were only seldom in demand. The stock which we keep can be considered as bound capital. And capital may be difficult to obtain. If an article is in our stock for one month, our capital is bound for that period too. If the article remains unsold for six months, then also our capital will be idle and unproductive for that period. When capital is scarce, it must be put into efficient and quick use. This is achieved by fast turnover of our stock. Let us illustrate: Our stock value in purchase prices was Rs. 4,500, or in sale prices about Rs. 5,800. If the stock is turned over once a month, then our yearly turnover will be 12 times Rs. 5,800 or Rs. 70,000. But suppose that the speed of turnover decreases so that on an average it will take us two months to sell the goods we have in stock; then our stock turnover will be only 6 times per year, and with the same stock valued at Rs. 5,800 in sale prices, our turnover will be only about Rs. 35,000. With this slower turnover we would need twice as large a stock with twice as large a capital investment to maintain the same yearly sales. This example clearly indicates how essential it is to keep a fast turnover, when capital is scarce or expensive. To maintain a fast stock turnover, it is necessary to take an inventory at frequent intervals. At these checks we must try to find out whether we keep goods in our stock which are not often in demand and which remain unsold for long periods. If we come across such goods, perhaps the best plan would be

to sell them at reduced prices, as otherwise they may become obsolete or damaged by long storage. In our purchase policy we must be careful to select goods which have a steady day-to-day demand.

In this connection it is also necessary to discuss the purchase quantity. To get a quick stock turnover, the quantities purchased each time should not be too large. But here we must also take into consideration wholesale rebates and other advantages connected with large-scale purchases. These advantages must be measured against our capital scarcity and our desire to put the capital into intensive use.

With the discussion on stock turnover and intensive capital use, it becomes clear that in the beginning stages it is essential that our society concentrates on sales of daily necessities only. Although there may be some demand among our members for other types of goods, such as more luxurious imported food items, or consumer durables, e.g., radios, electric irons, etc., the demand for these will not be steady or easily predictable. We do not want to bind our capital for long period in such goods as our primary aim is to cater to the daily needs of our members. Not until a much later stage, when we have accumulated considerable working capital, we will be prepared for outright business in the field of slow moving articles. For the time being we might consider, whether or not we should provide the seldom demanded articles to our members only on special request. In this way we would avoid binding our own capital in such items for longer periods.

## ADVANTAGES OF CASH TRADE

### *2.1 Introduction*

Should we allow any credit sales for the members in our consumer cooperative shop? This is a question which we will discuss from different angles in the next few pages in the hope that our discussion will lead us to certain conclusions. If we agree with the conclusions reached, we should try to implement them as far as possible, wherever we are involved in consumer cooperative activities.

### *2.2 Social Reasons for Credit Trade*

The private trader usually will extend credit to his regular customers though naturally he cannot give this facility to any stray person who happens to purchase something in his shop. To get credit from a private shop, he has to show his face to the trader rather regularly, the trader must recognize him, know where he is living and what he is doing. If the trader is not aware of these facts, he will probably not be willing to extend any credit facilities as this risk could prove to be too expensive, should the customer run away without paying the dues.

Credit costs money and it would naturally be cheaper for the trader to transact his business on a cash basis. Why does he then extend credit? The first reason is, of course, that his customers are not always in a position to pay cash, and so demand credit from him. But there is a further reason, a more selfish reason shall we say, for his willingness to offer goods on credit. He knows, and I as a customer know, too, that a condition for his extension of credit to me is that I be his regular customer and do most of my purchasing with him. If I do most of my daily purchases with this particular trader, I cannot at the same time purchase regularly from any other shop. Therefore, no other shop-keeper will be prepared to grant me any credit facilities. My shop-keeper is aware of this situation, and knows very well, that by extending credit facilities to me, he can rest assured that most of my purchases will be done through



his shop. By extending credit, the trader is thus neutralizing the competition with other traders in the vicinity, which he would otherwise have to face. Credit costs him money, that is true, but now that he is no longer forced to face competition from neighbouring shops for my loyalty, he can ask me to pay him the extra costs for the extension of credit. In order not to create ill-feeling among his customers, he will perhaps not charge these costs as an additional item. Rather he will make good his outlay by charging higher prices on the goods he sells.

On the other hand, why do I, as a customer, demand credit for my purchase of daily necessities? A large part of the population in South-East Asia, both in the urban and rural areas, lives under an economy almost near the subsistence level. Because earned incomes are low, it is difficult to maintain consumption at or below the income levels. In rural areas, particularly the availability of cash is sometimes irregular and not sufficient to cover the current needs. For those who are paid on a monthly basis, a monthly credit seems to be an easy way to avoid current cash difficulties. Although it might be much more economical to pay on a cash basis, very few customers bother, or know how to calculate the extra costs which they incur through buying on credit. In many cases, the consumer, without ready cash, and with an immediate consumption need for something to eat, has little choice, and will gladly accept any credit conditions that the trader will impose. Consequently, it is usually the customer who requests credit facilities whereas the trader offers consumer credit only as an extra facility to those who shop with him regularly. Credit becomes a weapon in the competition, and the trader who cannot extend credit facilities, is likely to lose customers.

### *2.3 Social Disadvantages of Credit Trade*

We have tried to explain a few of the reasons for credit trade—both from the point of view of the trader and of the individual consumer. Here we will try to examine the social consequences of giving or accepting credit. The purely economic considerations will be dealt with subsequently.

We concluded previously that extension of credit costs money, and that the shop-keeper must compensate himself in one way or another for the service which he is rendering to his customer. We also concluded that by extending credit facilities to his regular customers the trader more or less eliminated competition, and could be confident of their purchase loyalty. This last point is very important to keep in mind. Once the customer is deprived of his full freedom to choose his source of supply,

his bargaining position is weakened, and the trader will immediately cash in on the situation. Usually, the prices of the commodities sold to the customers will rise a little as it no longer matters if the trader's prices are competitive. The customer who buys on credit will in any case have to come to the shop, as the credit binds him, and his choice is no longer free. With the absence of competition, the trader is likely to enter into other malpractices too. Short weights may prove a good income earner to the shopkeeper, as also adulteration of goods. In fact, often the oldest and semi-deteriorated stocks are offered for sale to the customers who must rely on the credit extended by the trader, and who, therefore, cannot protest, because they have no alternative possibilities to satisfy their needs for their daily supplies.

If healthy competition could be maintained between the different retailers, such malpractices would result in a sharply decreased turnover for the trader who adheres to them. But credit trade keeps competition out, and thus indirectly is an important cause for the unhealthy conditions. A consumer cooperative enterprise which wishes to put an end to this situation will find itself in a very difficult position. The customers will hardly be willing to extend their loyalty to the consumer cooperative shop, unless this shop also can give credit to them. This may not be easy, as in most cases the consumer societies operate with a very limited capital supply. But also with regard to price levels, the malpractices of the private trade confuse the real conditions. Naturally, the price per kilo of rice, tea or butter will be much lower if the goods have been adulterated, and contain a high percentage of foreign matter. Thus, the prices charged by the consumer cooperative for the adulterated products which it offers for sale, may appear to be unreasonably high. Here the value of consumer education and information can never be overstressed.

As an interesting remark we might mention that in many cases the retailers also have limited financial resources; and have to rely on credit from the wholesale suppliers. In such instances, it very often happens that the retailer will be completely under the influence of the wholesaler in much the same way as the customer is with the private trader. The malpractices and adulteration may in such cases take place at the wholesale level. When establishing a consumer cooperative society we must keep in mind this possibility while buying our wholesale requirements.

We have already dealt with several of the disadvantages of credit trade for the consumer. One additional point should, however, be

mentioned. Even if it is generally difficult to limit the consumption to the current income, it is easier to spend less if all payments are made on a cash basis. We have all experienced the ease with which one can incur expenses if the purchasing is done on credit. Once I start to use my consumption credit to such an extent that I cannot repay it regularly, it will probably be very difficult for me ever to clear my debt. Overspending easily becomes a habit, and the end result will probably be that I must part with some valuable assets in my possession, be it land, jewellery or other belongings. As consumers we must learn to understand that we cannot spend more than we earn. Such credit does not in any way enable us to increase our consumption. By purchasing on credit we simply postpone the payment for one month or whatever period it might be, and by this postponement we face a number of disadvantages, as explained above. The disadvantages seem to be so serious that every effort should be made to induce the consumer to pay his bill each month and come at par with his spending. This will certainly be difficult in an economy near the subsistence level. If the consequences and economics of credit trade are properly understood, then it will probably be easier to tighten the belt for a temporary period to discharge ourselves from the debts which we have incurred.

Why should not our consumer society extend credit to us, its members? The question has already been answered by the many arguments put forward above. We will now try to analyze the consequences of credit trade on our society from a strictly economic point of view.

#### *2.4 Economics of Credit Trade*

To analyze the consequences of credit trade, we can again construct a simple model, which will facilitate our understanding of the economic inter-relations. As in the chapter on capital, we can assume here, that we have started a society with 200 member-families, and that each member has contributed Rs. 20 to the share capital. Our total share capital will, therefore, be Rs. 4,000 and we estimate our monthly turnover at around Rs. 5,800. The capital of the society is indeed very small as compared to the scale of our business operations. But as we do not wish to strain the financial resources of our members, we have decided to keep the share value at Rs. 20 for the present time. We have discussed in the previous chapter how essential our capital is to enable us to purchase stocks, and to run the shop.

I, as one of the members, have also contributed my Rs. 20 to purchase a share. Suppose now that I and the other members decide that our

society should extend credit to all of us on a monthly basis. My average monthly purchases may amount to about Rs. 50. I get my salary on the last day of every month, and can therefore repay my debt to the society on the first of the following month. In other words, I will owe the society Rs. 50 at the end of the month. Against this I have contributed a share capital of Rs. 20, and my net outstanding debt to the society at that time can be said to be Rs. 30. This means that at the end of the month, instead of supplying capital to my society for its operations, I borrow capital from it. And if all the society members utilise the credit facilities, it will mean that at the end of every month the members will owe the society the whole of the month's turnover, against the capital of the society. But the share capital has been supplied to the society to run the shop and satisfy our requirements. Now, by introducing credit trade, we have not only taken back our capital, which in itself will make the task of running the shop impossible, but have also demanded that the society supplies us with an additional Rs. 1,800. How can the society operate without capital? And how can we expect it to supply us with still more money, which we have never contributed? How can any stocks be maintained if no money is available? And how can we pay out salaries to the employees? From this example it clearly appears that our consumer cooperative society will become bankrupt if we decide to use its meagre capital resources to extend consumption credit to ourselves.

By various devices we can limit the credit facilities given to the members. Even if the results of credit trade will then not be as disastrous as those just described, the granting of credit will deteriorate the financial position of our society. If goods are sold on credit, then the shop manager will be compelled to make the purchases on credit as well. If this is done, it is very likely that our society will soon be tied and confined to one wholesale supplier only, much in the same way as the individual consumer who takes credit from his private shop-keeper. The end results are all too well-known to us. Once competition is eliminated, the wholesaler will offer lower quality goods and charge higher prices. And if this will be the condition, how can we expect our shop to sell to us quality goods at low prices?

Credit costs money. Whereas the social costs are very difficult to calculate, it is easy to calculate that the direct costs, which our society would have to cover in order to obtain credit from the wholesaler, are too high. Let us assume that our society is forced to demand one month's credit from the wholesale supplier. A very common condition, often indicated on the invoice, is that the full invoice price must be paid

within a month, although a 2% rebate is usually given if immediate payment is made on delivery. In clear terms the meaning of the condition is that we get one month's credit at 2% interest rate. Calculated over the year, the cost charged to us for the credit extended in this way is not less than 24%. Even a money-lender would in some cases offer us better terms. And any bank credit would be considerably cheaper than the credit given on such conditions by our suppliers. We easily deceive ourselves by thinking that 2% is not very much, and by not making through calculations. If our society cannot manage with its own capital, then it is much better that a bank or other credit institution is approached and requested to advance a loan. We should always try to avoid trading on credit with the wholesaler.

### *2.5 Conclusion*

We are all agreed on the importance of having sufficient capital resources for running our consumer cooperative efficiently. The more capital we have, the more free we will be to choose and select among our suppliers, to buy when goods are cheap, and to maintain low selling prices also during seasons when the general price trend is upwards. By having capital resources, we can take advantage of opportunities, which we would not be able to utilise if we had to ask for credit. Thus capital adds to our efficiency and to the usefulness of the society towards its members. We have discussed the widespread habit of demanding credit, particularly, where income is earned on a monthly basis. While maintaining the habit of monthly payments we might consider the possibility of introducing to our members the idea of trade deposits. Thereby each member would be requested to deposit a sum of money with the society each month. The sum would be roughly equal to his anticipated monthly purchases. In this way, instead of the society lending the money to its members, it would result in reversing the situation with a very much improved capital position for the society. For some time our members would have to tighten their belts to let their incomes catch up with their consumption, and then let the income earnings get one month ahead of current consumption spending.

The fight against credit trade will not be easy. The general poverty and established customs and habits will have to be tackled. It will be difficult for the poor members to catch up with the payment for past months, for which they at present lag behind. It is here that consumer cooperation has a very important role to play. Introducing and maintaining cash trade, much more healthy conditions as a whole will be created in the retail trade.

By their democratic set-up, the consumer cooperatives have a great advantage over private trading institutions. The role of instruction through participation in the actual operations is very great indeed. When we start our society, we will have to decide with our 200 members a number of policy matters. It is necessary that the members understand the economics of the society. We therefore have to discuss a number of problems with them much in the same manner as has been done in this text. In the course of discussions we will reach certain conclusions. Where the background is understood and a decision is unanimously reached, the adherence and support to what has been decided upon is likely to be much better than if the understanding had not been there.

We have agreed that we want a consumer cooperative society to cater to our needs and we do understand that such a society cannot serve us successfully if credit has to be given to all members. The decision is ours. We must make up our minds, if we really wish to have a successful consumer cooperative society.

## CONSUMER COOPERATIVE PRICING POLICY

### *3.1 Introduction*

In times of rising prices it is sometimes argued that a strong consumer cooperative movement would be in a position to stop the rising prices and restore stability in the price trend. This assumption is obviously based on the belief that the rise in price is caused by increased margins taken by the retail and wholesale trade. If the consumer cooperatives would be active in these fields, they might again lower the margins and restore normal conditions. In certain situations this argument would be correct. Where a temporary shortage arises in the supply of a certain commodity, private retail traders are always eager to exploit the situation to increase their profits. This has been very clearly observed in a hill valley in North India, which during the winter months was disconnected from the rest of the country. As no alternative sources of supply were available during the isolation, the private dealers increased their prices by several hundred per cent. The establishment of a consumer cooperative, which had no primary motive of profit-making, decreased the margins to normal levels. Usually, however, price rising trends have deeper causes, and depend only to a very small degree on conditions in the wholesale or retail trade. The whole economy may be affected by inflationary tendencies, whereby all indices, not only those of consumer prices, will be rising. In such cases it is futile to believe that the establishment of a consumer cooperative movement would in any way affect the general development. In such a case, the role of consumer cooperation is to act as a check to prices charged by private distributive agencies and to contribute to lower distribution costs through rationalization which will eventually benefit the ultimate consumer.

The benefit of the consumer is the ultimate objective of consumer cooperatives. This can be achieved economically in a direct way by offering favourable prices to the members of the society. But in

making decisions for a price policy, several other considerations must be taken into account. We will examine them, point by point, and will try to reach a conclusion as to what type of price policy could, in a broad sense, be most favourable for a consumer cooperative society.

To be able to clarify the issue, let us again use the model of a retail shop, as explained in Chapter I, and try to examine from the administrative point of view the consequences of various pricing policies. For the sake of convenience, the figures will be somewhat modified in this chapter. Naturally we will always keep in mind the interests of our customer-members.

TABLE VIII

Rent	...	...	Rs. 2,400
Manager	...	...	„ 3,000
Stock	...	...	„ 2,400
Bank loan	...	...	„ 800
Depreciation of assets	...	...	„ 400
Other costs	...	...	„ 1,000
	<i>Total</i>		<b>Rs. 10,000</b>

This means that to be able to perform successful business, our gross surplus must exceed Rs. 10,000. If this amount cannot be secured, we will be consuming our capital and will eventually have to liquidate our business. Whatever amount of gross surplus we succeed in acquiring over and above Rs. 10,000 can be regarded as net surplus. The net surplus can be used for at least three purposes: (1) interest on capital supplied by the owners; (2) expansion of business through building up of reserves; and (3) distribution of patronage dividend to the members.

To simplify the matter we may assume that our shop is selling four commodities and that we can estimate our approximate turnover of each of the commodities. From the neighbouring competitor's shops we can collect information regarding prices of identical or similar commodities. These prices will naturally tend to vary from shop to shop, but in spite of this we will be able to get an idea of the average general price level of the goods in the area where our shop is located.



On the basis of the above information we are now ready to prepare Table VIII where the assumption is that we will sell our goods at prevailing market rates.

TABLE VIII

Items		A	B	C	D	Total
Our yearly turnover						
No. of pieces	...	3,000	5,000	20,000	5,000	
Our purchase price						
per piece	...	5	3	1	1	
Market price per piece	..	5.50	5	1.15	0.90	
Our total purchase cost	...	15,000	15,000	20,000	5,000	55,000
Our sales turnover if sold						
at market rates	..	16,500	25,000	23,000	4,500	69,000
Our total gross surplus	...	1,500	10,000	3,000	500	14,000

### 3.2 Market Price Policy

Our total gross surplus is quite sufficient to cover the actual costs, if we choose to sell all our goods at prevailing market rates. There will even be Rs. 4,000 left as a net surplus after all the costs have been met. But if we look at the percentage differences between our purchase prices and prevailing market rates, we will find considerable differences. These differences may partly be explained by higher handling costs for certain goods. Part of the reason for the variation may depend on the selection of source of purchases, imperfection of market conditions and the competitive situation. While we can sell goods A, B, and C profitably we are not very successful with article D. This may depend on the fact that our source of supply is unusually expensive, or else that purchases are made in too small quantities. As there are private dealers offering the article D for Rs. 0.90, it is improbable that we might succeed in maintaining any substantial sales, if we increased our price of this article so as to cover our purchase price and make a contribution towards the operation costs. If it is not possible for us to decrease our purchase price of article D to below Rs. 0.90, there is no business reason to maintain this article in our stock. By discontinuing the sale of D, both our gross and net surplus will be increased.

There may, however, be social reasons for continuing to keep article D in stock.

The net result of our operations according to Table VIII will be Rs. 4,000 (gross surplus Rs. 14,000 minus operational expenses Rs. 10,000). Part of this money has to get the reserve fund, and another will be used as interest on share capital. For the sake of simplicity let us suppose that Rs. 1,000 is allotted to the reserve fund and Rs. 500 paid out as interest on shares. In a cooperative society the main part of the remaining amount ought to be distributed as patronage dividends, as the net surplus is derived from prices over and above costs paid by customer members. We have a large enough amount to allow 3% patronage refund on our sales turnover of Rs. 69,000. This will take care of slightly more than Rs. 2,000 and the remaining net surplus can be transferred to the next year. If we take the patronage dividend into consideration, our prices have been 3% below the market level. This might prove sufficient to attract new members and increase our turnover. If our society is in the build-up stage, and capital is required for expansion, a lesser amount may be distributed as patronage, and a correspondingly larger sum would then be available for the working capital.

### *3.3 Cost Price Policy*

Our total purchase cost is roughly Rs. 55,000 and our operational expenses about Rs. 10,000. Thus, our average costs constitute about 18% of the purchase prices. Being a cooperative society, we might reason that we are not interested in creating a large surplus. We will be satisfied, if we only manage to cover our costs. What would be the price structure emerging out of such a policy? It is difficult to find a clear-cut answer. Should the margin on each of the items sold be 18%, or should the total gross surplus be Rs. 10,000 irrespective of from which items the gross surplus is derived? If 18% is added to our purchase prices, we will easily see that while some of our goods will be priced above market levels, others will be sold at very low rates. This will result in distortion of our turnover. While it will not be possible for us to sell any substantial quantities of goods A and D, sales of goods B will increase substantially, as our price for this product will be much below market rates. It will be difficult for us to maintain a full line of goods with the adherence to such a practice.

TABLE IX

*Comparison between market prices and the prices of our cooperative society if we decide to sell at cost price. Add 18% on purchase prices.*

	A	B	C	D
Market prices per piece	5.50	5.00	1.15	0.90
Our cost prices per piece	5.90	3.55	1.18	1.18

Without a net surplus we will not be in a position to pay any interest on the share capital, nor to pay any patronage dividend. The advantage of patronage dividend as an instrument to build up the share capital of new members thus will not benefit us. We will not be able to build up reserves either to carry through critical periods or to expand our business. Adherence to a cost-price policy may prove very risky. The cost may have been miscalculated, or the prices of commodities already bought may fall. In such a case the result could be disastrous since no reserves have been built up to meet losses of such a nature,

#### 3.4 Active Price Policy

Several reasons lead us to reject the cost price policy. Do we then have any further alternatives to the market price policy as previously described? Instead of passively accepting the prevailing market prices, we might investigate to what extent we could charge lower prices from our customer-members without endangering our cooperative society as we did in the case of the cost price policy. Broadly speaking, the meaning of an active price policy would be that we try to adopt the price level of the goods which we offer for sale to a number of consideration such as :

1. The competitive situation in the market.
2. Our turnover of the respective commodities.
3. Our operational costs in general and for the commodity in particular.
4. The necessity of creating a surplus and building up of reserves.
5. The advantages of patronage dividend distribution in a consumer cooperative society.

How should we now consider the enumerated points in the actual pricing structure which we want to evolve? The first fact which we must keep in mind is that our gross surplus must be so large as to allow us to cover not only our operating costs, but also interest on capital, patronage

dividend and allocation to the reserve fund. Without sufficient funds to cover these items we may easily run into the risks explained under the cost price policy. Thus our gross surplus should at least be of the magnitude of about Rs. 14,000, as indicated under the market price policy. This general statement must be kept in mind when we start to analyse the individual items which our shop offers for sale.

It is necessary to acquire a certain amount of market knowledge, to be able to operate an active price policy. We must be able to estimate how our sales will develop with increased or decreased prices, we must, to some extent, be able to predict how the competitors will react to our price changes, and we must also have a general idea about the purchase price reductions we can benefit from, through bulk buying. For a person without retail business experience these may seem difficult questions but an experienced retail man will certainly have sufficient knowledge to guide him to correct conclusions. In the active price policy it is not possible to determine the prices according to a general rule. Each item or group of items offered for sale must be looked into individually.

Thus we may prepare a number of questions. Keeping the previously mentioned objectives in view the answers will guide us in determining adequate prices for the different items. Among the questions to be asked are :

What will happen if we decrease our prices 5, 10 or 15% under prevailing market prices ?

1. How will our competitors react ?
2. How will our turnover increase ?
3. What purchase prices will we be able to obtain ?
4. What will be the addition to our handling costs as a result of the increased turnover ?
5. How will our gross margin develop ?

In the same way we can investigate the result of price increases on the products offered for sale by us.

After such an analysis we will perhaps find that our optional price and surplus situation will deviate considerably from that shown in Table VII. The result of our adopting the active price policy will perhaps appear as in Table X.

TABLE X

Item	A	B	C	D	Total
Calculated handling costs per piece	—	0.5	0.05		
Our yearly turnover— No. of pieces	3,000	8,000	60,000	1,000	
Our purchase price per piece	5.00	3.00	0.95	1.00	
Market price per piece	5.50	4.75	1.15	0.90	
Our selling price	5.50	4.50	1.05	1.00	
Our total purchase cost	15,000	24,000	57,000	1,000	97,000
Our turnover	16,500	36,000	63,000	1,000	116,500
Gross surplus	1,500	12,000	6,000	—	19,500
Increased handling costs	—	1,500	2,000	—	3,500
Gross surplus minus increased handling costs	1,500	10,500	4,000	—	16,000

The results in this table call for careful explanation and analysis. When analyzing item A we will find that it is not possible for us to get more favourable purchase prices with larger turnover. Also we feel that if we decrease our selling prices on item A, it is likely that the competitors will follow suit. As we are already making a good gross surplus on item A, we can consider the present selling price satisfactory, and will thus continue to maintain it at the market level. Therefore, the situation in regard to item A remains unchanged.

On item B we have a substantial surplus margin. This is partly due to the fact that the handling and selling costs of this item are comparatively high. We have estimated these to be Rs. 0.50 per piece. We decide to lower our selling price on product B from Rs. 5.00 to Rs. 4.50. Our turnover will increase, but as this is a product sensitive to competition, our competitors will make efforts to follow our price-cut. Let us assume that the average price offered by the competitors after the price-cut will be Rs. 4.75. As the difference between our and the competitors' price will not be considerable, our turnover increase will be fairly limited, from 5,000 to 8,000 pieces per year. Our handling costs which form part of the total operating costs, will, as a result, also

increase 0.50 times 3,000, a sum total of Rs. 1,500. The gross surplus minus increased handling costs, Rs. 10,500 has to be compared with the original gross surplus, which was Rs. 10,000. By the price-cut we have succeeded in increasing our surplus to some extent. The sum may not seem very impressive. However, the most important factor arising out of our action is perhaps not the fact that our shop gains Rs. 500 more. As a cooperative enterprise we have succeeded in lowering the price for our customer-members and in this way saved them a total of Rs. 0.50 times 8,000, altogether Rs. 4,000. A further implication of our action is that customer to our competitors' shops also benefit from our action, as prices in their shops have been lowered too.

The changes which occur with regard to item C in connection with our adoption of an active price policy are very interesting and will be considered one by one. It is a fairly small item and is sold in rather large numbers. We have calculated our additional handling charges at Rs. 0.05 per piece with the increasing turnover. In spite of high turnover value the item has been adding only moderately to our gross surplus. As a large number of pieces of this product have to be purchased by each household. it is fairly sensitive to the price. After negotiations with our suppliers we reach an agreement that if we double our purchase orders and if we place these orders well in advance, we will be offered a Rs. 0.05 reduction on the price. To be able to reach the required turnover increase, we calculate that our price-cut must be at least Rs. 0.10. We lower our selling price to Rs. 1.05 and find, to our satisfaction, that the competitors cannot follow in our price-cut. Evidently they have not been able to reach as favourable agreements, as we did, with the suppliers. As a result, our turnover reaches figures higher than our expectations and in spite of increased handling costs, we are able to secure increased gross surplus for our shop. Again our main contribution has been the savings which we have made possible for our member-customers. In this case the savings are Rs. 0.10 times 60,000 or in total Rs. 6,000.

A further implication of our action in connection with the prices of item C is that a number of new customers will be attracted to our shop to purchase this particular item. Even if they usually patronise another outlet for other purchases, it is likely that some of them will find it more convenient and economical to become full-fledged customers with our shop, and eventually members of our society. In this way our total turnover will increase. Consequently, the profitability of our establish-

ment will improve and give us further possibilities for action in the field of prices.

Item D is not a very profitable article in our shop. While we have to purchase it at Rs. 1.00, its market price is only Rs. 0.90. When we followed marked prices, we thus incurred a yearly loss of Rs. 500 on the 5,000 pieces we sold. Besides, this item did not contribute to the coverage of our operating costs. From the business point of view there is no reason for us to offer a product for sale, which will involve us into losses. As we are not able to obtain more favourable purchase prices from the suppliers, we decide despite the prevailing market prices, to increase our selling price to Rs. 1.00 so as at least to cover our purchase costs. Due to this price increase our turnover drops considerably.

In a case like this it is probable that our competitors offer a different quality of produce for sale. For example it may be, that the competitors' products are adulterated at the retail level, therefore their unit cost is lower, hence sale at Rs. 0.90 becomes profitable for them. If this is the case, it would be advisable for us to start an information campaign to make our customers conscious of the difference in quality.

We may now compare our present situation regarding cost turnover and profit with the situation when we adhered to market prices. It appears in Table XI.

TABLE XI

		Market Price Policy	Active Price Policy
Total turnover	...	Rs. 69,990	116,500
Total purchase costs	...	„ 55,000	97,000
Total gross surplus	...	„ 14,000	19,500
Original operation costs	...	„ 10,000	10,000
Addl. operation costs resulting from increased turnover	...	„ 0	3,500
Total operating costs	...	„ 10,000	13,500
Net surplus	...	„ 4,000	6,000

Besides being able to offer, on the whole, more favourable prices to our customers, we have succeeded on increasing our net surplus from which money can be drawn for patronage dividend, interest on share capital and further expansion of the business.

### 3.5 Conclusion

It should be underlined that the example of active price policy, as explained here is only a model of reality where for the sake of clarity, conditions have been over-simplified. In reality it will not be as simple to establish the optimum price level. It will prove very difficult to predict or analyse the competitors' reactions. Thus, the way towards active price policy is not a simple change of the price system, but rather it is a continuous process, whereby our society is always active, considering such matters as purchase prices, handling costs, market prices, turnover trends and a number of other matters in order to get a comprehensive picture of the situation. All this will enable us to decide on our present selling prices. Once a decision is taken, the price should by no means be considered as final. Any new change in market conditions may make it advantageous to reconsider our own prices. An active price policy may naturally be shaped differently in different situations. A well-established cooperative society with sufficient capital resources may so set its prices that a very small surplus will be left for further capital formation. A new society, on the other hand, which needs to expand and develop its financial strength must set its prices so as to allow a considerable surplus, which can be allotted to the reserve or development funds.

From the different approaches to a price policy for a cooperative retail society which we have examined in this chapter, it seems that in the examples given, the active price policy is advantageous. An active price policy, as understood here, would mean an analysis of all aspects of our situation as a cooperative retail organization, and from this analysis, an attempt to manipulate our prices so as to obtain the most profitable results for the society and its member. This, quite certainly, is the most sensible approach to the consumers cooperative pricing problem. □





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