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# **De/Reconstruction of Vaguely Defined Property Rights within Neo-Classical Discourse, and Cooperative Finance**

*by*

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## **Abstract**

This article is about the financial structure and capitalization of agricultural cooperatives. It is not an article directly about agricultural cooperatives and industrialization, merger, strategic alliance, concentration and centralization, and globalization. It is a more modest work about the neoclassical economics discourse of cooperative finance, with particular attention given to the construct “vaguely defined property rights”. The purpose of this article is to deconstruct this term by examining the concrete formative structuring of agricultural cooperatives, as cooperatives were formed in the early first half of the 20<sup>th</sup> century in the US. (and how this structuring is carried forth in derivative form to the present day). The construct “vaguely defined property rights” is an expression of the organizing rationale of neo-classical economics itself, as this view reaches the concrete limit of historical financial structures of cooperatives, what it can intellectually specify and appropriate, given its individualizing perspective.

## **Introduction**

This article is about the financial structure and capitalization of agricultural cooperatives, relative to the financial structuring of investment oriented firms.

Most US agricultural cooperatives were formed from the 1920s into the 1940s, or have roots extending back to that time period. There have been other formations since then, but the core of the agricultural cooperative community can be dated within that period. These formations, as legitimated in the Capper Volstead Act of 1922, were not without influence from world events during that period, and were an attempt to provide some workable collectivization of capital in the form of cooperative organization (Guth, 1982).

The two predominant reasons attributable to the formation of agricultural cooperatives are of a defensive, and an offensive character. Defensively, agricultural cooperatives have been formed when there has been exceptionally large production

seasons, that bring low prices, and/or “hold-up” situations such that a single seller of supplies (a monopolist), or a single buyer of production (a monopsonist) can dictate prices to small independent producers. By aggregating, farmers were able to gain some market power, coordinate sales, and improve incomes, thereby sidestepping exploitative relationships. Offensively, cooperatives have been formed to strengthen farmer-member bargaining position and to gain greater economic power in the market place generally (countervailing power). Cooperatives have also been formed when a community of producers needed particular services (broadly defined) that were not available through existing markets. Organization allowed for scale and accessibility.

The internal, relational rationality of the earlier cooperatives have shifted dramatically, from what was at first substantive and *gemeinschaft* to what is presently more formally rational (see Mooney and Majka, 1995, on early cooperative movements). Detailed assessment and comparison of price and service are relatively more important to members of the present day, than was the case when farmer-family members were struggling to achieve minimum basic services, and market access, frequently in a struggle against local monopsonists, and monopolists (Cook and Tong, 1997).

What has remained through time is continuing methods of collectivization of capital (containing both concepts of individual proportionality and equality) to fund cooperative activity. However, these methods of funding have increasingly become suspect, and focus to a re-privatization discourse, predominantly from neo-classical agricultural economics expertise (see Cook, 1995; Royer, 1999; Cook and Tong, 1997; Hackman and Cook, 1997; Cook and Iliopoulos, 2000).

## Cooperative principles

Cooperatives are organized around a set of principles, variously formulated by Laurinkari (1986), Craig (1993), Watkins (1986), Lambert (1963) and others, but first formally codified by the Rochdale weavers of England in the mid-1800s, and Schulze, and Delitzsch of the German credit union movement during the same period. Central to all formulations is an emphasis on member/owner/patron use of the activity of the organization.

This use aspect of cooperatives perhaps has been best captured by Schaars (1980) and later by Dunn (1988) in three cooperative principles as:

- 1) *The User-Owner Principle*. Those who own and finance the cooperative are those who use the cooperative;
- 2) *The User-Control Principle*. Those who control the cooperative are those who use the cooperative;
- 3) *The User-Benefits Principle*. The cooperative’s sole purpose is to provide and distribute benefits to its users on the basis of their use.

There are other versions of these principles, but the set presented above perhaps best captures the use aspects of cooperatives, and highlights their polemic relation to investment firms.

Unlike investor firms, “A cooperative is a user-owned, and controlled business from which benefits are derived and distributed on the basis of use” (Dunn, 1988:85). In linear logic, if somewhat simplistically, investors with money seek to make a return on that money by investing in an activity that will return a profit, thereby (hopefully) ending up with more money. Members (or potential members) of a cooperative need a service or a product. They collectively organize to provide that service and/or product. The organization must achieve some financial margin over costs, to continue to finance, and provide for a flow of services through time. In investment firms, the investor-owners have little connection to the business activity of the firm. If use is made of the activity, it is only on an incidental basis. For cooperative patrons, the activity of the organization (and their use of that activity) is central to their relationship with the organization.

### **Principles and legal structure**

The principles themselves are not passive guidelines, but have been incorporated into various laws and statutes, and strongly encourage, and in certain places mandate and structure operations consistent with the cited principles (Baarda, 1986). The foundational piece of legislation for cooperatives in the US is, as mentioned, the Capper Volstead Act, passed in 1922. It empowers farmer-members to form and operate agricultural marketing cooperatives without being held in violation of antitrust legislation, if “the cooperative members are agricultural producers, non-member business is less than 50 percent, prices of products are not unduly enhanced (in response to the Sherman Anti-trust Act)” and “no member has more than one vote”, or “the association does not pay dividends on stock or membership capital in excess of 8 percent per annum” (Barton, 1989:17; Rasmussen, 1991:282). Cooperative net income is not federally taxed if it is allocated to members in the form of patronage refunds, but only if there is a dispersal to members of at least 20 percent of the total refund. In some sense this 20 percent is a tax on the organization, but paid to members rather than the Internal Revenue Service.

These provisions encourage user/owner financing with member equity, as well as user/benefit flows. The anti-trust provisions seek to keep business with cooperative members (who are producers) rather than non-members, and to discourage use of the cooperative as an investment tool. Various cooperative lenders also require their borrowers to meet similar limits to qualify for loans.

## Cooperative capitalization and the user/owner principle

Pecuniary requirements for member servicing through time – the funding of plant and equipment, and everyday operations – are not different than other firms providing similar activities. These activities must be funded, and if to remain a cooperative, this has to be made in a manner consistent with cooperative principles, *e.g.* the owners of the cooperative are the users of its activities. Cooperatives use several different methods to fund member activities, among them 1) retained patronage refunds, 2) per unit capital retains, and 3) direct investment.

1) *Retained patronage refunds.* Cooperatives typically charge competitive market prices through a given year to help cover operating expenses, taxes, and various other capital needs. Once these deductions are made, some of the balance from the cooperative's total revenue (if there is any) is allocated back to members as patronage refunds. Patronage refunds are the net earnings "allocated to a patron in proportion to the value or quantity of the individual's patronage, whether distributed in cash or left in the cooperative" [the user/benefits principle] (Cobia and Brewer, 1982:185).

The reader will note that these are "patronage" refunds. They are based on the amount of use made of the activity provided by the cooperative. They are not shares of corporate earnings (or dividends) returned to owners of stock investments. Members may receive these payments in cash, as cash refunds, and/or they may be retained in the cooperative in a member account, termed deferred or non-cash patronage refunds. The retained patronage refunds are then available to help capitalize continued cooperative activity, and become part of the collective equity of the cooperative – though retained in individual member accounts;

2) *Per unit capital retains.* Per unit capital retains are assessments made on members per volume of product marketed through a cooperative. For example, a producer might be assessed 10 cents for every bushel of apples, or every hundred weight of milk marketed through the organization. These assessments build up equity in individual member accounts, while providing a collective pool of funds for capitalizing the organization through time. Since per unit retains are not dependent on income, but rather on gross product volume, they provide a more stable flow of funds to the organization. Since they are indexed to a member's volumes, they provide congruency with the user/owner principle;

3) *Direct investment.* Cooperatives also generally have an entry membership fee, sold to members as common stock, and frequently ranging in cost from \$10-\$100. Most cooperatives do not rely on direct investment for capitalization. However, the newly emerging "new generation cooperatives" frequently charge a much higher membership fee, or demand a purchase of stock, that can range into thousands of dollars. The cost of the stock is indexed to the amount of product the producer agrees to provide the cooperative, linking cooperative use to ownership, while providing a collective pool of funds to the organization. However, "new generation

cooperatives” do skew some of the implicit equality issues of cooperatives. These concerns will be discussed more fully later in this article. Of the 3,500 agricultural cooperatives in the US, there are an estimated 100-150 cooperatives of this new generation type – most notably the pasta and sugar beet processing cooperatives of the Northern Plains states.

Cooperatives also have funds that are not allocated to member accounts, termed unallocated equity. This is frequently net-income earned from non-member business, or non-patronage business. This equity is not linked to individual accounts, and is only paid out to members in the event of cooperative dissolution.

Allocated equity, be it sourced from retained patronage refunds, or per-unit capital retains, is revolved out of the organization to members, under various equity redemption programs (see Cobia and Brewer, 1989, and Rathbone and Wissman 1991, for a detailed explanation of systematic, and special equity redemption programs). The intent again, though imperfectly applied, is to keep congruency between ownership and use, with a revolvment out of farmers “over-invested” or out of farming.

### **Differences in financial structure from IOFs (Investor Owned Firms)**

The enactment of cooperative principles results in financing and a financial structure different from IOFs and stock traded firms:

- 1) Only qualifying persons, generally agricultural producers, can become members and own common stock or obtain membership certificates;
- 2) [Voting governance...] of the cooperative is generally democratic, allowing one vote per member, rather than having the number of votes determined by shares owned;
- 3) Net income returned to patrons is in the form of patronage refunds in proportion to the business done through the cooperative – it is not based on the shares of stock owned;
- 4) ...[Equity is provided] in anticipation of benefits arising from patronage rather than in expectation of capital appreciation or dividends;
- 5) Only rarely can holders of cooperative equity sell it for cash. Equity holders of many other businesses can usually sell their equity anytime and to anyone;
- 6) Equity is redeemed by the cooperative (...) par value (...). Therefore, the value of most cooperative equity does not change the way the value of IOF equity does;
- 7) Unlike equity of most corporations, a substantial portion of cooperative equity is temporary because cooperatives have an implied obligation to redeem it (Cobia and Brewer, 1989:245).

The reader may also note that cooperative stock is generally not for sale to the public, and equity stock is not transferable as traded investment stock on an exchange.

In most cooperatives, though not all, membership is open, though generally limited to agricultural producers. Capitalization must occur through some manner of assessment of the user-members of the organization. This collectivizing of capital is organized along both precepts of proportionality (*e.g.* financing based on individual use) and equality (*e.g.* one-member, one-vote; and full availability of the cooperative activity regardless of proportionality of ownership).

### Neo-classical reprivatization discourse

Nancy Fraser (1989) depicts the social as a “terrain of contestation”. “It is a space in which conflicts among rival interpretations of people’s needs are played out” in various forms of discourse (Mooney *et al.*, 1996:567). Fraser identifies three forms of discourse: 1) oppositional – discourse that gives voice to un-met needs in a particular social formation; 2) reprivatization – discourse that seeks to re-entrench, or keep entrenched, value that might shift to oppositional claims; and 3) expertise – discourse that may be either oppositional or reprivatizing and works in the context of “social problem solving, institution building and professional class formation” (Fraser, 1989:171).

Embedded in its history, and in its origin, the cooperative movement has had an “oppositional” character (Mooney and Majka, 1995), particularly in relation to investment forms of organization. Contemporary cooperative economics, in the context of neo-classical agricultural economics expertise, has assumed a reprivatization discourse, in its examination of cooperative finance. At the center of this analysis is a concern that cooperatives are financed without general stock offerings; the equity in a cooperative is not subject to trading; and since not traded, does not appreciate in value, like the common stock of investment firms in a market place. Other troublesome aspects identified in this critique include open memberships, patronage without binding delivery contracts, and in many cooperatives, lack of up front equity investment requirements, *i.e.*, low or non-existent membership and equity entry fees (Cook, 1995; Royer, 1999; Cook and Tong, 1997; Hackman and Cook, 1997).

These cooperative characteristics have come to be bundled within a concept referred to as “vaguely defined property rights”. “Under the assumptions of the neo-classical model, property is privately held and property rights are exclusive and voluntarily transferable” (Royer, 1999:53). When property is not so defined, the results of economic production are held to be less than efficient. Cook and Tong (1997:114, citing Milgrom and Roberts, 1992:294) sum this problematic up stating:

Clearly defined, enforceable, and tradeable property rights produce a socially efficient outcome. In fact, ‘If no one clearly owns a valuable asset, then no one has an incentive to guard its value properly. If property rights are not tradeable, then there is little hope that assets will end up with those people who can make the best use of them and so value them most. If prop-

erty rights are not secure, then owners will not invest great amounts in assets that they may lose with no compensation, or they may sink valuable resources into protecting their claims' (Milgrom and Roberts, 1992:294). Vaguely defined property rights create losses in efficiency because the decision maker no longer bears the full impact of his or her choices.

From this view then, property rights within a cooperative are vaguely defined, and as a result generate a series of "problems." Various authors have characterized these issues as the 1) the free-rider problem; 2) the horizon problem; 3) the portfolio problem; 4) the control problem; and 5) the influence problem (Cook, 1995; Cook and Tong, 1997; Royer, 1999). Nearly all of these "problems" are seen as artifacts of the non-transferable, non-tradeable character of equity ownership in a cooperative. If cooperative ownership equity was tradeable as stock, the price of that stock would presumably reflect present and anticipated future earnings that would flow to that discrete asset. A buyer would be purchasing the present value of stock's earning flows, both present flows, and future flows.

1) *The horizon problem.* "The horizon problem occurs when a member's ...claim on the net income generated by an asset is shorter than the productive life of that asset" (Cook, 1995:1156). Members accrue benefits only as long as they patronize the cooperative. Members with short horizons, older farmers for example, have less incentives to invest in cooperative assets that have long-term pay-offs, particularly "research and development, marketing, and other intangible assets" (Royer, 1999:57). Royer maintains that farmer-members with short horizons are likely to push for large cash patronage refunds and accelerated equity redemption rates, rather than further investment in cooperative assets.

The neo-classical solution is to create tradeable delivery rights to the cooperative, that would capitalize flows in the present, and make that value traceable to a discrete individual.

2) *Free rider problem.* There are two aspects to the free-rider problem, those external to the organization, and those internal to it. Free-rider problems frequently occur outside of an organization "where it is difficult to exclude individuals who do not pay for consuming the benefits arising from a resource" (Royer, 1999:58). A bargaining cooperative may be able to negotiate higher prices for farmers generally. All farmers benefit from the higher prices, even though only cooperative members have paid for those benefits. Internal free-rider problems have been defined as occurring when "new members obtain the same patronage and residual rights as existing members and are entitled to the same payments per unit of patronage" (Cook, 1995:1156), *i.e.*, regardless of the degree of ownership members may have, their use of the organization is not limited differently from any other member. This "problem" according to Royer (1999) and Vitaliano (1983) may be resolved by "restricting membership when "the effects of the decision can be captured fully within the cooperative, expanding membership when this is not the case, or charging new members a substantial entry fee" (or adopting a base capital financial plan)".



3) *Portfolio problem.* The lack of transferability (equity stock can not be sold to others), liquidity (cashing in of equity stock can not be done at individual member discretion) and appreciation mechanisms (present and expected future earnings can not be capitalized into its value), prevents members from diversifying their individual investment portfolios “according to their personal wealth and preferences for risk taking” (Royer, 1999:57). From an investment logic, because investment is tied to patronage, and equity is not tradeable, this results in an over-specialization in asset commitment. The cooperative is dependent on farming and farmer-members for sources of capital. Farmer-members, in turn, frequently will have most of their off-farm assets invested in the cooperative. The cooperative itself is linked to the farming activity. This lack of diversity in assets, and lack of choice in investment, compounds the difficulty of surviving reversals in farming, and/or at the cooperative. The neo-classical solution again is tradeability of assets.

4) *The control problem.* Since no market is generated for cooperative equity, due to it not being tradeable, members lack the information such a market can provide. Market prices for stock are assessments of how well the cooperative is doing financially, and how well it is expected to do in the future. Members lack this information in judging managerial performance. Therefore, managers may be less restrained in exercising their own agendas given their actions are not reflected in stock prices.

Since equity must be owned by members (the owners are the users), it also limits diversity in the make-up of the board, eliminating others who might have other specialties in such areas as finance, law, and accounting, as is typical in investment firms.

Royer (1999:57) also makes the case that non-tradeability of equity can act to prevent concentration of ownership in fewer hands, serving to dilute potential power of individual members and boards of directors. Royer maintains this can serve to create disincentives to discipline and replace management, as well as make other difficult decisions. Members are less invested individually and therefore may be less concerned.

Since managers can not own equity, unless they are also producer-members, this may also serve as a disincentive in the recruiting of expert management.

5) *The influence costs problem.* “Influence activities arise in organizations when organizational decisions affect the distribution of wealth or other benefits among members... and when in pursuit of their selfish interests, the affected individuals or groups attempt to influence the decision to their benefit” (Cook, 1995:1157). In an investment firm, there is a common organizing interest to maximize return on investment. Since a cooperative’s primary objective is to provide an activity, or many activities, particular interests in the organization can seek to influence the flow of benefits (the provision of cooperative activities) in the interests of a few members, rather than all members generally. This competition to privilege some interests over others, can cost the organization time, and resources to resolve.

These five problems make up a good deal of the reprivatization discourse within neo-classical agricultural economics concerning cooperative finance. It also demon-

strates a false dichotomy between subject and object in the epistemology of doing neo-classical economics. Vaguely defined property rights is, in fact, a paradigm generated concept on vaguely defined *INDIVIDUAL* property rights. Neo-classical economics is built up around the ontological assumptions of individualism and individual rationality. Vaguely defined property rights, and the five derived problems, are concepts constructed to understand a reality that is congruent with that individualism. Cooperatives were constructed concretely in an attempt to provide some collectivization of capital, and contain concepts of both equity (*i.e.*, proportionality) as well as equality. It is not so much that cooperatives contain vaguely defined individual property rights (though that is certainly the case in its concepts of proportionality) but rather that cooperatives also contain some property rights that are more collective by design. What seems to be a vague definition, is in fact a product of the neo-classical paradigm itself, as it seeks to see itself (with economist agency) within concrete cooperative reality. From the concrete grounding of cooperatives historically, there is definition of individual property rights, but from within an attempt at the collectivization of capital, generated for cooperative activity. The concept itself, “vaguely defined property rights,” is in fact vaguely defined “individual” property rights, which is then used as a tool from within neo-classical economics, to produce a reprivatization discourse on agricultural cooperatives.

The horizon problem is a neo-classical misunderstanding of cooperative capital. Members contribute equity according to their use of the organization. The more they use the organization, the more their contribution to funding it. However, member use of the cooperative is not limited, or privileged according to degrees of individual member ownership. This in effect embeds cooperative activity through time, providing equal availability to younger and older farmers. The neo-classical solution is to sell delivery rights to members, and make those rights tradeable. This would limit availability of cooperative activities generally to those who could afford to pay. Given tradeability, and cooperative success, this price of entry would increase through time, further limiting availability to the better financially resourced farmer.

The free-rider problems involve similar considerations. Farmers outside of the cooperative benefit from cooperative activities. The cooperative can not assess these farmers for benefits received, even though these farmers may be receiving improved prices due to cooperative efforts. The cooperative may choose to eliminate some of this non-captured benefit by not doing non-member business, or by limiting membership. However, the equality impacts of open membership, and the more general market impacts, embed the cooperative in rural community. Internal free-rider problems are similar to horizon problems. Members with large equity balances in the cooperative are afforded the same benefits as members with little equity, congruent with the collective capital design of cooperative organization.

Royer’s discussion that tradeable cooperative equity prevents the concentration of ownership, perhaps best highlights differences between cooperative and investment orientations (control problem.) Royer sees lack of concentration as a disadvantage for disciplining management. The assumption of course is that the disciplining from a

powerful individual would be in the interest of the general membership, and not the individual. From a cooperative capital perspective, it is precisely the resistance to concentration that is valued. Cooperatives are not designed as investment tools, but rather as organization for providing an activity to its members. It seeks to embed the organization in activity provision, to membership broadly.

Members with little investment elsewhere beyond their farm and their cooperative are at risk. However, member equity keeps the member embedded in the cooperative, rather than opening the organization up to other interests that could be more inclined to direct cooperatives along non-farm related pursuits, ordered by rates of return on investment (portfolio problem).

Influence cost problems are less to do with how a cooperative is financed than the nature of negotiating decisions within it. While cooperatives have been criticized in terms of slowness in decision-making, it is that they allow for more voice, that is definitional to their character. It is not a disadvantage but an advantage that allows for more diverse interests to be served in the long-run.

## Conclusion

What we see is not the ill defined nature of personal property rights, but rather the great difficulty to maintain an alternative logic of capitalization that contains some explicit design for equality and use. The vaguely defined property rights problems are really the resistance points to the transformation of cooperative capital to an investment logic. Investment is the dominant form, and competes with cooperative organization. Investment oriented firms have much greater flexibility in product production, geographic position, and financial structure to compete with and confront a cooperative position. There is a strong homogenizing pull through the market to break these resistance points, *i.e.*, essentially to re-organize as an investment firm, or to access capital along other paths. In consequence, some cooperatives have accommodated in order to survive as organizations, through joint ventures, mergers, and strategic alliances – as documented by Gray *et al.* (2001), Heffernan (1999), Heffernan *et al.* (1999), Rogers and Sexton (1994). Others have pushed towards greater proportionality, *e.g.*, volume discounts and incentives. New generation cooperatives tend to be contemporary organizational accommodations that continue to contain some of the older use and equality aspects of cooperatives, while simultaneously meeting the problematics of a neo-classical view, *i.e.*, 1) transferable equity shares (generally within the membership); 2) appreciable equity shares; 3) defined membership (meaning memberships are sold to a limited number of producers); 4) legally binding delivery contracts (producers agree to deliver certain amounts and a particular quality product); and 5) minimum up front investment requirements (Cook and Tong, 1997:115). These pressures will likely continue with the dynamics of globalization, and agricultural industrialization. Understanding the community embeddedness of agricultural cooperatives may hold greater

efficacy for their continued development in the future.

I offer two additional summary comments of the article, as implicit commentary on the larger socio-economic context:

- 1) It is extremely difficult to maintain a process of capitalization (with even a very formally organized and moderate amount of collectivization of capital) that is at variance with the predominant and hegemonic investment rationale;
- 2) Epistemologically, the article demonstrates a false dichotomy between subject and object in doing science. The concept “vaguely defined property rights” is derived from, and constructed within, the individualist assumptions of neo-classical economics. This construct is then used as a conceptual lens to produce knowledge consistent with its individualist assumptions. Unfortunately, the construct does not allow for an appropriation of knowledge more consistent with the concrete and historical goals of capital collectivization.

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