Economic and Legal Aspects of Vertical Integration

Dale C. Dale

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ECONOMIC AND LEGAL ASPECTS
OF VERTICAL INTEGRATION

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PART I. VERTICAL INTEGRATION

Definition

In economic terminology, integration means the combination of smaller business units into a larger business entity under single management. Integration has two basic forms, horizontal and vertical.

Horizontal integration is the combining of like business units on the same marketing level. Examples of this would be three farms getting together under one management or two processors of a commodity grouping their resources and centralizing their management.

Vertical integration, on the other hand, is the grouping of two or more complementary firms on different levels of the production-marketing process. For example, a processor and a farmer may unite or a supplier, farmer, processor and wholesaler may combine under centralized management. The key idea is the extent of control that can be exercised by the central decision maker or "integrator." It is important to understand that vertical integration is concerned only with single enterprises or single commodities at the present time. A multi-enterprise farmer may integrate only part of his farming operation. A farmer who deals in wheat, corn, hogs, cattle and poultry may only combine his hog operation with a processor or supplier. Vertical integration necessarily involves the transfer of controls. Therefore, standard loaning operations, open credit accounts and non-control-transfer contracts

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that farmers may make cannot be considered forms of vertical integration.

Vertical integration is of three general types.

1. **Ownership.** Complete or partial ownership of land or resources of one marketing unit (such as a turkey farm) can be assumed by another marketing unit (such as a hatchery). Ownership transfer normally indicates transfer of control to a single manager.

2. **Cooperatives.** Through cooperative capital accumulation several farmers may purchase or create a processing unit (such as a seed cleaning plant) or a supply unit (such as a feed company).

   Different forms of integrated cooperatives can include selling coops where farmers agree to mutual standards of product and through cooperative effort are able to improve their market position. Here the farmer usually has to conform to the cooperative's standards thus losing and transferring some of his control. Other forms of coops of this sort could be bargaining associations for farmers, marketing orders established through government action, special commodity groups or present farm groups with authority to act in behalf of the farmer. In each of these groups some decision-making must be transferred to be called an integrated group.

3. **Contracts.** This form of vertical integration, popularly referred to as "contract farming", is most predominant in agriculture today and appears to be of greatest concern to the farmer. In this form, absolute ownership of resources does not necessarily change hands. Instead, some ownership controls are transferred to a contracting party, usually in return for risks assumed. The contracts or agreements are primarily between an agribusiness firm and the farmer.
Although cooperatives and ownership are definite types of vertical integration, this report will be concerned basically with "contract farming." The other types are presented to some extent as alternatives to contract farming in the section entitled "Future" of vertical integration.

**History**

Vertical integration is not new to agriculture. In fact, it is the source of our present outgrowth of specialization and division of labor. In earlier times, farming was integrated both horizontally and vertically. A single farmer produced, processed, and distributed his commodities and held back enough to supply his future production operations. Except for some small items, the farm was a self-sufficient unit. Specialization and the economies attributed to division of labor brought the functions of processing, distribution and supplying into separate, complex agribusiness units.

Contract farming is not new to agriculture either. In the Reconstruction Period following the Civil War it was common in the South for farmers to contract with the military governments for particular commodities. Upon reinstatement of the Southern states' governments, this type of farming lost its foothold.

In non-agricultural businesses, vertical integration had its greatest boom during the corporate growth of the late 1800's. Mergers, consolidations and holding companies were used as a means to draw separate market functions into single units of control. This was done primarily by the ownership method rather than through cooperatives or
contracts. Despite the method, in many industries today several of these marketing functions may be combined under one authority.

Some vertical integration has existed for some time in certain areas of farming, without involving the device of ownership.

1. Contracts have been employed in the canning industry for many years. These contracts stipulated the type, size, and quality of product to be purchased by the canner at a predetermined price guaranteed to the farmer.

2. Integrated cooperatives have existed in the fruit industry for some time. Milk marketing orders have encouraged the formation of integrated cooperatives to assure milk producers a market and to reduce some risks.

Technological changes in agriculture have changed farming from an art to a science. This change has produced a need for large scale operation, high capital requirements and specialized management skills. Vertical integration is a result of this technological advance.

Present Extent

The full extent of vertical integration in agriculture is not known. Research studies are being conducted in some agricultural experiment stations across the nation and the USDA has formed a special section in its organization to investigate this subject. Some information is currently available on vertical integration in the following industries.

Poultry

Broiler production is the first industry to become integrated on a large scale. Estimates are that from 80 to 90 percent of the broilers
produced are now coming from integrated units. This integration has been mainly in the form of contracts between hatcheries, processors or feed dealers and the producer. In most instances, the farmer receives the chicks, feed and some other supplies. For this he allows the integrator to tell him the number and type of birds to produce, directions on how they should be handled, and when he can sell them. In an Ohio study the farmer was paid a flat $10 per bird for his part of the contract. Cooperatives are being used to a limited degree in broiler production as a means of integration. The Cotton Producer's Association of Atlanta, Georgia, is a broiler cooperative offering two plans to the farmer. He can either take 90 percent of the profit his birds bring, or be paid a return on feed performance.

Some contracting is being done in the turkey industry. It is essentially patterned after broiler contract experience and is again being instituted by the agribusiness sector.

In egg production not much information is available, but some experimental contracting is being done.

Livestock

An increase in "hog parlors" and contract feeding arrangements, has brought the hog industry into the integration spotlight today. Estimates of from 5000 to 8000 fifty-unit hog parlors are now in operation. The "hog parlor" arrangement for feeding hogs has been established by a contract between the farmer and the feed company or other integrator. The company provides the pigs, the feed and a set of instructions. The farmer, in return usually receives $3.00 per pig for his work and resources. In Ohio most contracts include specification for quality of
breeding stock used, farrowing periods, weight to be marketed, and in some cases offers of price differentials for meat-type hogs.

Integrated feeding operations in California for feeder cattle have become a prevalent practice. Approximately 275 farmers in contract with feed companies are producing nearly 90% of California's feeder cattle, averaging 14,000 head per farmer. This practice is not as marked in the midwestern states. Some activity was reported by the Ohio study where cattle and feed are offered by the feed company and the farmer's returns amount to 10¢ per head per day for his labor, land and equipment.

Chain stores have become interested in producing milk or contracting for milk to sell in their stores. In some instances the reverse is true. Milk producers have successfully created their own retail outlets. These practices are not significant enough to cause great concern yet.

Fertilizer

Some integrated cooperative efforts have been seen in the fertilizer industry. Local and regional coops have produced and processed fertilizer to supply its member farmers.

Seed

Alfalfa seed has been under contract by processor-wholesaler units with farmers mainly in California. In most cases the processor supplies the seed and pays the farmer for his seed production minus the seed supplied originally. A time limit for selling and a minimum price is established by contract beforehand. Contracting for alfalfa seed has not generally been successful in the midwestern states.
Seeds other than alfalfa are not usually contracted although special demands sometimes make contracting feasible.

**Specialty Crops**

Specialty crops (dependent upon the farming area) have potential for vertical integration because of the "economies of scale" possible with specialization. Either farmer-led cooperatives or agribusiness-led contracting or ownership is possible. Some fruit and vegetable industries fit these possibilities, and, of course, integration has been in these areas for some time.

**Cause**

The integrator is defined by some as the initiator of the vertical integration movement in the marketing chain. But most agree that the integrator is where the ultimate and centralized management is located. In contract farming, the integrator has been predominantly the agribusiness firm. In cases of livestock or poultry integration, it is the feed company that usually starts integrating with the farmer. In crops it is many times the processor who starts the contracting. In both cases, it appears to be started to create and assure continuous supply for the integrator so that he can enhance his profit position.

No one actually knows any single compelling reason why farmers enter into integration contracts or why agribusiness would offer them. Naturally, both must believe they are insuring their profits, if we have any faith in the "economic man" theories.

Farmers enter such contractual agreements for one of the following reasons:

1. They desire a more stable income. Inherent in this
thinking is the desire to transfer risks away from themselves.

a. Farmers may reduce market risks by contract arrangements where processors guarantee a certain price.

b. Production risks may be transferred by the farmer to processors in cases of high risk crops through vertical integration by allowing the processor to assume the debts incurred through crop loss.

2. They want an extension of credit.

a. A farmer may want to expand or create new markets should he decide to change his operations.

b. Young people may have the opportunity to start farming by this means of extending credit.

3. Farmers want to insure their competitive position.

a. Through cooperative action they may be able to assure themselves a market by having greater marketing control over a commodity.

b. Through long term integration contracts they can be in a favorable competitive position relative to other farmers.

4. Farmers can improve resource and labor efficiency through integrated specialization.

a. Farmers may be able to reduce total costs by cooperative action or contract.

b. Utilization of a constant farm labor force may become more efficient.
Agribusiness firms desire to integrate because:

1. They want to standardize the product they handle. Instead of selling whatever quality the farmer decides to produce, firms can command "marketable" products through vertical integration contracts.

2. They want to assure continuous supply. To adequately fulfill their market demands, known supply quantities are as important to the agribusiness firm as quality. Integration contracts provide a means of maintaining his supply needs.

3. They want to improve their competitive position. By having command over a certain quantity and quality of a product, firms can compete favorably with other firms. This could reduce their market risks.

4. They want to create or expand their markets. By contracting for continuous supplies and quality of product, such a venture could be assured to some degree.

5. They want to reduce costs. The firms may desire to make greater use of high cost processing equipment through increased seasonal or extra-seasonal usage.

The consumer may have indirectly caused vertical integration by demand for a standardized product in continuous supply.

Effects

Vertical integration is bound to result in changes in agriculture. These changes, or effects, are, as in most things, both advantageous and disadvantageous. What is considered an advantage to one person may be considered disadvantageous to another.
Advantageous effects of vertical integration may include the following:

1. Production can be adjusted at one stage to meet the needs of the next stage. Marketing times can be scattered to eliminate "rush" and "slack" seasons for producers, processors and other firms.

2. Demand can be better filled through continuous and standardized supply. In agriculture, where supply of certain products has notably outweighed demand, vertical integration offers a possibility for adjustment.

3. Increased specialization through vertical integration could reduce selling, buying and transportation costs because of scale.

4. Demand can be reflected to the producer more rapidly through a closely-knit marketing channel.

5. Management specialization becomes possible. Technological specialists, coordinated by an efficient administrator, allows new knowledge and skills to be practiced that are not as readily accepted by individual operators.

6. Lack of capital or experience can be overcome and could induce more young people into farming.

7. Risks can be transferred to units better able to bear them. Financially stable agribusiness units can acquire capital readily and use it to advantage.

8. Unstable prices in agriculture may become more stabilized through increased bargaining power.

9. May generally improve production efficiency.
Some would perhaps consider the following effects the "price of progress." This assumes of course, that vertical integration is progress. Opinions withheld, the following may be considered disadvantageous effects of vertical integration.

1. Management may become too large, and bureaucratic red tape could develop. This development is exemplified in non-agricultural industry where cumbersome giant corporations have developed.

2. Volume may be of more immediate concern than efficiency. The agribusiness integrator may be concerned primarily in producing in quantities large enough to give him a corner on the market without regard to the optimum size of operation for the farmer.

4. May cause loss of opportunity of the farmer to engage in more profitable ventures or to take advantage of price rises. For example, a farmer devoting half of his farm and three quarters of his time to broiler production, may not be able to produce a new high profit crop.

5. By transferring some risks, a farmer may take on new risks. A farmer may find it necessary to buy additional equipment, land, and buildings to fulfill the contract. Should the contract be cancelled the farmer may stand a considerable loss.

6. Increased specialization may make the farmer too dependent upon the integrator. The entire livelihood of a previously independent operator may rest in the hands of an agribusiness entrepreneur.
7. The integrity of the integrator may be questionable and a farmer may sign away more than he thinks.

There are other effects that arise from vertical integration. Whether they are advantageous or not may be in controversy.

1. Vertical integration should speed up standardization, specialization, and technology.

2. Integration should increase geographical concentration of production. Integrators will most likely choose areas of high production and favorable, market-oriented farming sectors.

3. Farmers who do not integrate may be "squeezed out" of an enterprise by the more competitive, larger units. This may force more of the low income farmers out of farming, but may also encourage more efficient farmers to leave agriculture.

4. The control of decision-making may be shifted away from primary producers. Decisions are made on the basis of controls and some of these controls may have been transferred to the integrator by the contract.

5. Increased scale of operation and specialization may alter the status of family farming generally.

Future

General

Some enterprises are more prone to vertical integration than others. Agricultural enterprises where capital and management are not critical problems and, significantly, where government price supports and controls
have entered the picture, are not readily integrated. Potentials of agricultural enterprises for integration are suggested in Table 1.

Geographically, integration probably will be most apt to start in low income farms on the fringe of specialized farming areas. Integration will probably be most prevalent where large agribusiness firms are located or in their immediate market areas. Potentials also exist for integration to occur in specialty crop areas.

**Future Alternatives**

The future will involve becoming integrated or remaining an independent farmer. Whether or not a farmer would be in a better profit position as an independent operator or through integration is a point of controversy. There is a definite need for economic research in this area.

Some thinkers believe that vertical integration is an oncoming thing, and that the decision will not be between whether the farmer will be integrated or not, but by which method he will integrate.

Integration can be performed by three methods. As stated before, vertical integration can come about by complete or partial ownership, by cooperative effort, or by use of the contract.

Ownership does not appear to be a probable road to future integration. Vast amounts of capital would be required for ownership of various marketing units, and the farmer would probably not want to sell out.  

1/ If we accept T. W. Schultz's "land hunger" theory.
Table 1: Potential of Enterprises Becoming Involved in Vertical Integration

<table>
<thead>
<tr>
<th>ENTERPRISES</th>
<th>Processing Hog Beef</th>
<th>Specialty Broilers</th>
<th>Turkeys</th>
<th>Eggs</th>
<th>Vegetables feeding</th>
<th>crops</th>
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<td>factor not at all exists</td>
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<td>factor either now exists or substantial development appears on the horizon</td>
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<td>factor does not exist in great enough degree to encourage integration attempts (in and of itself)</td>
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- factor drawn directly from "Vertical Integration in Agriculture," Department of Agricultural Economics, Agricultural Extension Service, Purdue University, Mimeograph IJC-154, October, 1957, p. 9.
The Consumer's Cooperative Association has suggested cooperative organizations to accomplish vertical integration (see Figure 1) and some integrated "coops" have been formed in competition with contract farming already. The cooperative is a definite way to compete with contract farming should the need arise.

Some Economic Implications

Dr. Philip M. Raup, in a recent paper, indicated that ownership in farming is becoming more and more complex. He states that ownership is nothing more than a group of controls that the owner has over what he owns. Through use of the contract, ownership can be divided and parcelled out in terms of controls.

Vertical integration by use of the contract is changing the meaning of farm ownership. This has tremendous legal and economic implications. Ownership and control do not necessarily go hand-in-hand in vertical integration. The farmer may own the land but its use may be controlled by a processor. The farmer may own his buildings but a feed company inspector, under the terms of a contract, may force him to repair them.

This change being brought on by vertical integration may involve enormous social and political changes as well as economic. In the words of Dr. Raup,

...we can look forward with confidence to the increasing application of anti-trust policy to business enterprises in agriculture. We can expect with firm assurance the ultimate and perhaps the imminent applications of the body of labor legislation to agricultural labor. We can expect

Figure 1. How Farmers Can Control Integration in Swine Through Their Cooperatives.

1. Demonstration
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   - Farm
   - Cooperative
   - Local
   - Feed
   
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increasingly effective attacks to be made on the separate legal structure of agricultural cooperatives. We are now witnessing concerted attacks on the present advantageous treatment of interstate movement of farm products by truck. We can expect these attacks to emerge in a variety of other instances in which our rural, legal, and economic institutions have been outpaced by structural change.

Considering these predictions it is important for us to consider the contract as Part II of this report.
PART II. THE INTEGRATION CONTRACT

Vertical integration opens a whole new area for economic research and greatly desired is descriptive research in terms of what is being done and how it is being done. What is being done was the subject of the first part of the paper, and how it is being done, through use of the contract, is the subject of this part of the study.

General Characteristics of Contracts

Studies of the contract for vertical integration are limited. Ohio has made perhaps the most popular general study of contracts used in their state. Illinois is currently conducting a contract study, some preliminary conclusions from which will be given here. Some farm magazines have touched on the subject. Capper's Farmer explained some hog contracts they observed. South Dakota State College farm management specialist, Art Anderson, has three representative feed contracts which have been used as source material.

The Illinois study revealed that such integration contracts are difficult to obtain from the integrator for research purposes. One hundred requests were sent to companies known to have issued integration contracts and only twenty-one contracts were received. It was believed by the Illinois researchers that this lack of response was not due to sampling problems normally involved in surveys.

Perhaps the most significant thing about integration contracts in general is that they all do not necessarily include the same or similar provisions. A law student, working part-time for the Economics Department, Illinois Agricultural Experiment Station staff, after carefully reviewing the twenty-one integration contracts obtained from seed, feed,
livestock, and poultry integrators, stated that he was unable to "break-down" these contracts into chart form. This non-uniformity is understandable in light of the fact that such contracts are rather new devices.

In line with this, the Illinois researcher noted that while some contracts were written with apparent legal aid, many have been amateurishly designed, leaving many points vague or undefined. This fact may also account for their dissimilarity.

Although all the contracts are not alike, they do contain something basic to all contracts. One thing is exchanged for another. In integration contracts, the transfers are risk and control. The farmer allows himself or his operation to be controlled by the integrator while the integrator assumes some of the farmer's risk. Some examples of transfer of risks and controls follow.

In Capper's Farmer, a hog contract studied required some rather extensive control features held by the integrating company. The offer to the hog producers was a lease of breeding animals for $3.75 per head. In return, the farmer had to keep the sows until they farrowed two to three litters and had to buy 1000 pounds of feed for each litter. Besides this, one gilt from each litter at market weight (selected by the feed company) had to be given to the integrator, besides returning the sows. Legal title to the pig crop was held only by the feed company until market time by mortgage.

The Illinois researcher told of a broiler contract that offered the farmer the chicks, feed and some supplies. In return, the farmer pro-

vided labor, land, and equipment and signed away his control to:

1. Decide what type chicks and how many will be handled.
2. Decide what kind and what brand of feed, amount and proportions that should be fed to the chickens.
3. Decide the step-for-step manner in which the enterprise would be handled in terms of when and how to do what.
4. Decide when to market the birds.
5. Inspect the enterprise as a manager. Company inspectors were sent out at various intervals to check the operation. Should the company's inspector decide that the enterprise was not being cared for properly by the farmer, they had the right to come onto his farm, take over the operation, and charge the farmer for their services.

For all this the farmer received 10¢ per bird.

The essential questions to be answered by any farmer planning on entering into an integration contract are, (1) What am I giving up? (2) What am I getting in return? and, (3) Is it a fair exchange?

Basically, the answer to the first question will be a reduction of the decisions he now makes over his operations. The answer to the second question will be in terms of reduction in some of the risks that he now is assuming. The third question can only be answered by the farmer considering the contract.

Integration contracts for livestock and poultry have some similarities, while crop contracts are somewhat different. These points should be considered in evaluating each type of contract.
The Livestock or Poultry Contract

1. How will it affect the risk of:
   a. disease and death of animals?
   b. changes in prices of feed and production supplies?
   c. changes in market prices?

2. How will it affect control of:
   a. when to sell?
   b. to whom to sell?
   c. at what weight to sell?
   d. the kind of and amount of birds or animals to keep?
   e. what feed ration to use?
   f. what brand and type of feed to use?
   g. what sanitation practices to use?

3. Who owns the animals or birds and what lien privileges are extended?

4. Who pays for the services of specialists? Who calls specialists in (such as veterinarians)?

5. Who stands the loss of birds or animals by disease, accident, or other cause?

6. Who is responsible for transportation costs if animals must be brought from hatcheries or stockyards to the farm or from the farm to the markets?

7. Who does the manure belong to and who must remove it?

8. Who pays for personal property taxes and insurance on the fowl or livestock? Who determines the amount of insurance?

9. Who is responsible for record keeping and making decisions on production practices?
The Crop Contract

1. How will it affect the risk of:
   a. loss of crops by adverse weather, insects or disease?
   b. market price change?
   c. changes in technology, where equipment can become obsolete?

2. How will it affect the control of:
   a. when to sell?
   b. to whom to sell?
   c. what equipment to use?
   d. the type and amount of fertilizer to use?
   e. what variety and amount of seed to use?
   f. what production practices to use?

3. Who owns the crop and what lien privileges are extended?

4. Who pays the loss of crops damaged by weather changes?

5. Who is responsible for transportation costs involved in getting
   the seed to the farm or the final product to market?

6. Who pays for fertilizer, seed, and sprays?

7. Who pays the taxes and insurance on the crop? Who determines the
   amount of insurance?

8. Who makes the decisions on crop production practices to be used?

General Contract Considerations

1. Is the contract legally binding? Is it for a definite period of time?

2. What is the procedure of determining compensation for both parties?
   Is it clearly understandable?
3. What are all the responsibilities of each party? Is everything fully understood?

4. Who assumes what risk and to what degree?

5. Is the integrator a sound, financially stable, respected business?
   It's a right of both parties to know the "soundness" of the other.

6. What liabilities are incurred in case of default by either party?

7. Who has the right to extend, cancel, or renew the contract? Do both parties have this right?

8. What limitations does the integration contract place on other operations? Does the integrator want the operator's skill full time?

9. What happens on death or incapacity of the operator?

10. Is the contract assignable?

11. Do such contracts involve other security? Are they in conflict with other liens, such as crop liens?

12. What right does the integrator have to come onto the premises.

13. Is there any control over the type or condition of buildings or other facilities?

These are some points that should be covered in each integration contract. Studies have indicated that many of these things are left unsaid or are in fine print in the contract.

Generally, it is wise to hire the services of a lawyer to check a contract before it is signed. He will explain what is "given up" by the farmer and what he will receive in return.

Conclusion

The farmer who is offered an integration contract would do well to first compare his present advantages, economically and legally, with
what integration can offer him. Should he decide integration is most advantageous, he should then compare integrating through cooperatives or by contract. If contract integration is then his decision, he should consult an attorney so he fully understands the legal implications of his contract.
Author's notes from three two-hour workgroup studies conducted at
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the University of Illinois, June 17-20, 1958.

Workgroup membership:
Dr. Howard Diesslin, Farm Foundation
Dr. Donald Kanel, Economist, University of Nebraska
Dr. Joseph Ackerman, Farm Foundation
Dr. Norman Krauzl, Economist-Lawyer, University of Illinois
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Prof. John O'Byrne, College of Law, University of Iowa
Dr. Wilfred Pine, Economist, Kansas State College
Dr. John Timmons, Economist, Iowa State College
Mr. Dale C. Dahl, Economist, South Dakota State College

Special report of University of Illinois study
now in progress of 21 integration contracts in the broiler, feed, livestock, and seed industries was presented.

SPEECHES

"Contract Farming and Vertical Integration", address by Earl F. Crouse, Vice President, Doane Agricultural Service, Inc., to the South Dakota Society of Farm Managers and Rural Appraisers, at Brookings, South Dakota, January 9, 1958.

"Where to in Agriculture-Business Integration?", address by Orlin J. Scoville, Head, Farming Efficiency Section, Farm Economic Research Division, ARS, USDA, to Association of Southern Agricultural Workers, Little Rock, Arkansas, February 3, 1958.


BULLETINS

"Integration-Will it be from the top down or from the bottom up?"

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"Integration in Agriculture", *Nebraska Farm and Ranch Economics*, Nebraska Agricultural Extension Service, Number 123, May, 1958.

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"What's All the Hullabaloo About Vertical Integration?", *Successful Farming*, February, 1958, pp. 47-8, 75-7.
"Will Integration Stick?", *Wallaces Farmer and Iowa Farmstead*, May 3, 1958, p. 36.