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Invited Presentation

A Perspective on the Financial Situation in Agriculture

John R. Brake

My purpose in this presentation is to give an overview or perspective on the financial situation in U.S. agriculture. Since descriptions of the situation are generally available (Easterbrook, J. Lee, Melichar-1985, ERS-USDA, van Blokland), I'll only briefly review the problem and its roots. The major emphasis of my presentation is devoted to two areas: difficulties in addressing current financial problems of the sector, and issues which deserve consideration for the future.

The Problem and Its Roots

A number of analysts have written on the causes of the agricultural difficulties in the 1980s (Drabenstott, Duncan and Norris; Duncan and Harrington; W. Lee). Each seems to have a favorite set of causes. The recipe for agriculture's financial problems might be described thus:

take 3 cups high real and nominal interest rates,
one tablespoon adjustable interest rate loans,
two cups overuse of debt,
one cup "balance sheet" lending,
one and one half cups changes in international monetary exchange rates,
three tablespoons worldwide recession,
three cups unexpected disinflation,
two shakes drought,
two cups changes in price supports and government programs.
Mix vigorously with incorrect expectations.
Give the mixture time to work.

While there is some agreement on the ingredients, there is still much argument about the relative measures!

Another view is that the present "crisis" is but a continuation of the outmigration from agriculture that has been occurring since the late 1930s, and in fact, is even now occurring at a less dramatic pace than in the 1955—65 period. This view holds that decisions farmers and lenders made in the 1970s were correct given the information at the time. That is, the signals concerning inflation, exchange rates, government programs and other factors were "wrong signals" and convinced resource owners that real estate values were justified. Balance sheet lending based on those signals led to overuse of credit in capitalizing farm units. The lessons of the 1930s were forgotten in the 1970s.

Whatever recipe one favors, an important point, it seems to me, is that a number of reasons played a part in contributing to the 1980s financial problems of agriculture. Consistent with a complex, varied, diverse, wide-ranging farming system, important causes depended on the characteristics of the farm business, the operator and the family, as well as economic and environmental circumstances.

The *symptoms* of the farm level problem, in my estimation, include low sector returns, falling asset values, inability of a relatively large proportion of farmers to service their debt obligations, and higher proportions of farmers than usual being forced out of fanning. Interestingly, size characteristics of those forced out does not seem to be significantly different than the average of all farms, i.e. it is not a problem of small, inefficient producers. The problem seems newsworthy, in part, because of the importance of our food supply, the numbers of people affected, the special feeling the public has toward the family farm, and the not too distant roots most of us have in rural areas and in the soil.

The *problem,* I think, consists of two parts. One is the distribution of debt. Perhaps 10-

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W. I. Myers Professor of Agricultural Finance, Cornell University.
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20% of farm operators have debt that they cannot service. Most of these operators will be forced out of farming or at least into a substantially changed mode of operation. The second part is too many resources in agriculture resulting in excess production. Extra resources came into agriculture, or remained in, during the 70s due to market signals and farm profitability. Further, .continued technological change, encouraged by tax incentives, led to the need for fewer resources to satisfy production demands.

Raup underlines that effective adjustment must address the resource issue. He believes, however, that adjustment should focus on the nonhuman factors—that restriction on land resources, for example, could raise returns for the sector, and fewer human resources would need to exit. The issue of ways to minimize outmigration of people is useful to consider.

Part-time farmers, of which there are many in the Northeast and South, have found an answer consistent with Raup's position. They own land counted as part of agriculture; yet, they generate substantial cash flow from nonfarm sources to supplement their farm income.

Given a problem of excess resources leading to low returns, the economic adjustment is predictable in form (Breimyer), if not in timing: 1) Durable assets will fall in value reflecting decreased earning power. Some resources will leave the sector, others will shift to lower value uses, but nearly all durable resources will be devalued by the market. 2) Devaluation will occur until excess production is corrected by some combination of lower quantity produced and increased quantity taken from the market. Devaluation will cease when a new entrant can buy productive assets and earn a satisfactory (competitive, opportunity, historical have been used as benchmarks) rate of return. 3) A major issue in this ongoing adjustment (Bullock, Melichar-1984), is how the wealth (capital) losses will be distributed among farm real estate owners, farm operators, lenders, and the general public. The first two consequences are already well underway, and the third is being answered by default if not by active decision making.

Another serious concern is the second-order effects of the farm level problem on the financial support system of the agricultural sector. Characteristics of this facet include the large number of agricultural and rural bank failures, the Farm Credit System difficulties that led to request for special government funds to aid the system, the large proportion of the FmHA portfolio in delinquency or default status, the large-scale writedown of, and defaults on, land purchase contract balances, and the increased losses on accounts receivables of farm input suppliers.

Critical, but having received less attention, is the ripple effect on rural communities. There are at least two dimensions: one is the structural change occurring among input suppliers—machinery dealers, elevators, etc.—proportionately more of whom have experienced defaults and business failures than have farmers. The impact may spread to product-buyers as adjustments in output occur. The second dimension includes loss of rural businesses, lowered property values serving as a tax base, higher unemployment, and generally declining absolute employment levels. While we perceive many of these rural community effects, they are as yet poorly documented.

Difficulties in Addressing Current Financial Problems

Data-conceptualization Problems

As the financial problems of agriculture developed, policymakers and professionals desired data describing the extent of the problem. Without a good conceptualization of the problem, data availability tended to dictate the nature of the description. Very quickly, debt asset ratios became *the* description of the financial crisis. In fact, cash flows, ability to service debt, or debt service plus funds available for new capital purchases would have been preferable measures of the extent of financial problems. Profitability analyses also would have been helpful. Early data did not well describe the financial problems, and they tended to focus on but one of several characteristics, some of which were more important than the one presented. As the financial problem developed, it became apparent that the quality of data on agricultural debt, debt service, cash flows, and related items left much to be desired. Further, a discrepancy arose between debt data from the Balance Sheet of the Farming Sector and debt data from the Farm Production Expenditure Survey of USDA. We were unsure how much farm debt was outstanding and who owed it.

Policies inconsistent with market forces

Too often in our policy approaches to farm problems, we have overlooked a criterion of consistency with market forces. Examples are many within the context of the need for capital to move out of agriculture: 1) Increasing support prices beyond levels required to produce needed food; 2) Subsidized interest rates, federal government interest rate buy downs, and principal forgiveness; 3) Tax shelters encouraging investment in agriculture; 4) Tax laws which discourage farmers from exiting the sector because of the substantial tax obligation that might be incurred, even when net worth of the discontinuing farmer is zero or less; 5) State programs to aid beginning farmers at subsidized interest rates; 6) Lack of state and federal programs to help distressed, failing, economically marginal farm families move out of agriculture and into productive employment outside farming.

Beneficiaries of "farm policy"

Typically, the ultimate benefits of farm policy accrue to the consumer. Price supports that reduce risks without adequate production controls virtually insure lower prices. Subsidized, low interest credit at the margin encourages resources into, or to stay in, agricultural production when they can not earn a market rate of return. And even when farm policy does result in higher returns or higher asset values, benefits tend to be capitalized into assets thereby benefiting farm operators only as farm asset owners.

A related point needs emphasis. For decades we have combined and confused policies to assist in the development of agriculture (i.e. agricultural policy) and policies to assist those who are unable to adjust to the current realities of the agricultural situation (social policies). In trying to solve two different objectives with one set of policies, we have usually failed to solve either. Let's recognize that both are important but that each needs its own set of policies. Further, let us also recognize that general economic policy is as important, if not more important, than farm policy, in its effects on agriculture.

Similarly, policies of encouraging innovation, entrepreneurship, and development of new technologies put farmers on a treadmill having to run to keep up. While innovators and excellent managers benefit, sometimes greatly in the short run, ultimate benefits get passed through to consumers through lower prices brought about by expanded production and inelastic demand. The relatively low variable costs of production compared to fixed (sunk) costs then tend to exacerbate and continue the overproduction mode for some period of time. I do not argue that policy benefits should be otherwise; I do suggest it's important to recognize this fact when devising policies and programs to deal with sector financial difficulties.

Short-run versus long-run

Farmer decisions, lender, and federal policies seem to assume that if, somehow, farmers can be helped to hold on for just another year or two, things will return to "normal", and they'll be okay. Economic forces will push toward a norm, but that norm is not likely to be the 1970s mode. The major models of the agricultural sector (Womack, *et.* a/., Penson and Hughes) give little hope for a substantial turnaround in the near future. Overcommitment of resources, large stocks of grains, and relative oversupply of many commodities are consistent with a longer term problem. Moreover, these same features characterize most of the developed countries of the world; and like it or not, we are in a "world class" competition. Barring some major disaster, there is little reason to expect substantial improvement within the next several years. (Chernobyl reminded us that the probability of that *is* greater than 0.)

This underlines the need to emphasize longer term policies (Barry and Boehlje), their consistency with longer term market forces, and specific consideration of objectives of the food and fiber system—all within a worldwide dimension. Unfortunately, it seems that our political decision makers can not address any issue beyond the newest "brush fire", or at best, the next election. In fact, it seems the more critical the problem and the more the public awareness, the shorter run is the emphasis. The three person Board of Governors specified for the Farm Credit Administration in the December 23, 1985, Farm Credit Act, which was to be appointed within 30 days, required over four months for selection. The 15 member commission to consider the future of the Farm Credit System which was also to be appointed within 30 days of that Act, and was to report back to the Congress within the year, has not yet been appointed in the six months that have passed.

Stereotyping of farmers

There are at least two bothersome aspects of this point. One is the tendency to forget the difference between farm operators and farm resource owners, in effect, to view all farmers as being both. There are important differences between them in terms of rewards for function performed.

A second erroneous stereotype, due in part, perhaps, to one-sided media coverage, is that all or most fanners earn low returns. Many farmers, perhaps 10%, do have low returns in spite of excellent efficiency. Others have low returns because of poor efficiency. Many, perhaps 10-15%, were caught suddenly in adverse situations due to circumstances beyond their immediate control. These were often related to farm type. Yet, there are many farm operators making impressive returns. We too often forget this group as well as the tremendous variability within the sector.

Issues Needing Attention **for** the **Future**

A number of issues need attention for the future.

1. Sharpen and change policy focus.

Policies to address the financial problems of agriculture must both promote the transition of economically failing human resources out of agriculture, and simultaneously but separately, implement viable means to help other potentially productive human resources to remain.

A large proportion of past programs has been ineffective to inappropriate in dealing with elements of the current farm financial crisis. For example, policies to provide subsidized, low interest credit whether to help highly indebted farmers stay in farming or new entrants to get started in farming, amount to making marginal capital available to the sector at lower than market rates of interest. These are policies consistent with continuing a low marginal rate of return to investment in farming. They not only won't solve the problem, they contribute to it. It would be preferable to develop state and federal programs to aid people at the financial margin to adjust. Alternatives include part time farming where off farm work is available. Changing of enterprises to more labor intensive, less capital intensive types is another. In other cases we should aid people to get out of fanning by helping them find, and promoting, better opportunities for them outside of farming (Jones). One difficulty with this latter approach is that, in general, the agricultural leadership and the politicians have difficulty in publicly supporting such policies.

Alternatively, if the problem in agriculture is viewed as one of excessive non-human resources in production, then solutions need to address means of increasing returns to human capital, perhaps by restricting, retiring, or decreasing use of nonhuman resources. The means, however, must reward human capital rather than the limited and constrained nonhuman resources which have received the capitalized benefits in past public programs. That is, means must be found to separate rewards from price per unit of production or ownership of real estate.

Related to this point, we need to examine the critical role of economies of size and of small to middle-size, efficient, small businesses in agriculture. This effort would help us focus on policies that could assist the efficient family farm in competing with superfarms without having to save all small farms or inflicting large inefficiencies on the system. Such policies might include restricting the access of superfarms to economic development monies, directing public research and extension dollars toward size-neutral technologies and programs, and developing publicly supported strategies to assist smaller farms in capturing economies of size.

2. Promote an "attitude adjustment" in agriculture.

Agriculture has attitude problems. One example is the feeling that we should not let farmers fail. Is farming so special or so essential that we should guarantee survival for anyone who wants to farm? I think not. This attitude makes transition out of farming especially difficult. Our studies in New York State suggest that transition is substantially less stressful to those who see themselves as managers, businessmen, and decision makers than it is for those who see themselves as farmers with no alternatives.

Another problem is the attitude among farmers and farm leaders against use of social service agencies. This attitude makes it difficult, and in some cases even impossible, for needy farm families to access the social services safety net. The attitude keeps the ag-

ricultural leadership from addressing the problem of farmer eligibility for the social services safety net that should be available to them. We see families forced to exit agriculture whose assets are completely tied up in bankruptcy courts or liquidation proceedings. They have no cash flow or income to live on, often for weeks; yet, they are denied social services because of the asset ownership eligibility criterion. Even with no net worth and little or no income, these farm families can not qualify for needed social services. They get no help from their own agricultural leadership in pleading their cause.

A corollary of the above attitude is that Cooperative Extension's charge is to work only with farmers; i.-e., extension should not work with farmers in transition because they will no longer be farmers. This attitude is commonplace in extension advisory committees who give less than full support to agents working with exiting farmers. The attitude is prevalent also in farm organizations which typically do not support extension efforts to help families leaving the sector.

Attitudes also differ as to whether farming is a way of life or a business. Clearly, farming may be thought of as a way of life, but it can not survive as a way of life if it does not survive as a business. In my opinion, our teaching and extension programs must help students of all ages to become conscious decision-makers. Mistakes are a part of the learning process. When one does not succeed in a business venture, it should not be viewed as a failure of the human being but of that business decision. Successful entre-preneurship whether in the small business area of family farming or in some other small business area can help one attain the "good life" whether it be in farming, rural living, a college community, or some other life style.

A final attitude problem is that of "doom and gloom" which needs to be replaced with the reality of life in a competitive economy: i.e., the need to make major changes from time to time. These include exit from one occupation into another or major business changes to improve chances for success. Further, let's not let media coverage and our discussions of current financial problems sour the attitude of young people toward agriculture. There will be challenges and problems, but these are only the basic ingredients for accomplishment and success.

3. Assess the future role of FmHA.

Farmers Home Administration has received minimal attention in the present crisis except as a means of pumping additional public funds into the agricultural sector. FmHA, as both a direct lender and as a conduit for public funds into the agricultural sector may well be outdated. Implementation of policy varies widely by county and state. Its authorities and mandates are so subject to political winds and whims that new policy barely gets to the grass roots before it is superseded or revised by a new directive. Further, influencing and overriding of individual credit decisions of professional staff by politicians on behalf of their constituents has become altogether too commonplace.

The agency's farm lending authority probably should be terminated. Its programs should move in the direction of loan guarantees with no public funds to lend to agriculture and without use of bonds or Congressional appropriation for farm lending other than to underwrite the guarantees. If the direct lending role of Farmers Home Administration in agriculture is discontinued, we must be sure that any lender that takes over any of FmHA's current purposes or target groups is protected from improper political influence over individual loan decisions.

4. Consider the future role of the Cooperative Farm Credit System (CFCS).

One important issue concerns expanding lending clientele and services. Questions are already being raised with respect to servicing agribusinesses or rural businesses in general. Other possibilities include providing depository services or investment services.

Another focus is structure and decisionmaking. How should decisionmaking in the System be allocated among local, regional, and national levels in a new CFCS? PC As and Federal Land Bank Associations are being consolidated both into larger districts and into joint lending offices. Are district-wide PC As appropriate? Should districts themselves be combined? Is the system responsive as a farmer cooperative? In short, what is the proper balance between size of unit, centralization and decentralization for the system?

Furthermore, are these consolidations addressing the right questions? It might be useful to contemplate the reasons for the present

problems in the CFCS portfolio. While the consolidations now taking place may gain small benefits in efficiency or economy, I question whether they would have prevented the massive problems of nonperforming loans that recently materialized.

The answer to the nonperforming loan problem of the 80s was already in place in the Normal Agricultural Value (NAV) approach the System implemented in the 1930s. That conservative approach allowed lending only two-thirds of "normal agricultural value". In a period of rampant inflation, FLBAs could lend 50% or less of "market value". But, that rule didn't permit expanding the CFCS market share; it didn't allow CFCS to outdo its competitors. So the System asked, and the Congress did away with the NAV. Lending limits were raised to 85% of current market value. Competition then led all lenders to excess. When asset values dropped by 50% or more in some areas within the 5 years from 1981—86, serious lender solvency problems resulted. Restructuring the CFCS into larger units may spread some risks, but it seems questionable whether such restructuring addresses the basic mistakes of the 70s.

Finally, there is a new role to be carved out concerning the relationship between the Farm Credit Administration and the CFCS. The concept of "arm's length regulator" seems appropriate, but the direct appointment of the FCA governing board in a political mode raises serious concerns about its ability to remain arms length. Influence over the distribution of money seems to invite political meddling, e.g. FmHA.

5. *Improve the quality of agricultural finance data.*

Bonnen and others have addressed the issue of data needs in the agricultural sector. Unfortunately, other than addressing these issues in a general way, few specific suggestions or proposals came forward. As David Stockman has said, much policy is made by those doing day-to-day work with the numbers. How, then, do academics and other users of data get input into the data collection system? It seems to me that these users and the USDA professionals collecting the data have a need jointly to explore, on a continuing basis, conceptualization and data collection issues concerning the financial well-being of fanners.

Emphasis on conceptualization and data inelude micro aspects as well. If one were to count the record-keeping systems being offered to farmers for farm business analysis by public and private agencies, my guess is there would be a dozen, more or less, *different* systems. They use different concepts or the same concepts in different and inconsistent ways. Analyses of farm account data are not comparable between states, nor between state and federal systems in general, nor are instructional materials comparable from different sources.

The Coordinated Financial Statements for Agriculture proposed by Frey and Klinefelter were a significant step ahead relative to most of the systems being used before its introduction. It's time that we, in collaboration with private vendors, agree upon a set of coordinated financial statements for agriculture including the concept of value added. The basic importance of farm records to farm operators in financially stressful times cannot be overemphasized. Using and understanding a quality farm records system may be the most important single survival strategy available to a farm family.

Perhaps part of our problem is that we tend to teach "farm records" rather than accounting with reference to small business. Let's initiate a commission with a charge to derive generally accepted farm accounting practices.

6. *Improve modeling of farm firms.*

For many years researchers have modeled farm firm growth, profitability and farm survival. Many of these models have ignored, or have not adequately included, cash flows. In particular, debt service requirements have typically been overlooked. While cash flows need not be a part of the objective function in a model, they should be incorporated into the constraint section of the model. The firm must meet its debt service requirements. There are, of course, ways to get around the debt-service constraints including refinancing and restructuring of debt.

7. *Adjust sector financing to lower financial risks.*

A part of the recent agricultural finance problem has resulted because of the relatively high amount of debt financing in the 1970s and until about 1981. Given the overuse of debt financing in the late 1970s, certainly more con-

servative lending rules will be applied in the near future.

Another approach to financial risks might utilize a higher proportion of equity capital—probably outside equity capital—in sector financing to improve risk bearing ability with respect to volatility in earnings and asset values. If this risk of changes in earnings and asset values is not addressed, the problems of the 1930s and 1980s may well be repeated again in the 2020s or 2030s.

Perhaps a future role for credit agencies will be to provide an investment banking function which brings together both debt and outside equity capital for a business depending upon its characteristics and needs. Also, in the long run, it will be necessary to effectively serve the needs of new entrants.

Summary

Let me quickly summarize several major points.

1) We must understand the underlying economic forces at work.

2) Policies to alleviate problems must truly address the problem and must be consistent with the underlying economic forces.

3) The current financial stresses of the agricultural sector are not likely to be short term; so let's recognize the relative ineffectiveness of short term policy proposals, and emphasize long term policies.

4) Efforts should be increased to help human resources make the transition out of agriculture into useful nonfarming employment.

5) Attention should be devoted to conceptualizing the data and information needs for describing financial characteristics of the agricultural sector. Let's also work toward generally accepted farm accounting practices.

6) The future roles of the Farmers Home Administration and the Cooperative Farm Credit System need consideration now.

7) Finally, let's adjust outmoded and questionable attitudes within the agricultural sector: recognize the reality of, and need to, change, improve decisionmaking skills, and give appropriate support and attention to needs of those families exiting the sector.

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