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Are Farmer Bankruptcies A Good Indicator of Rural Financial Stress?

Farmer bankruptcies often are viewed as an important measure of rural economic well-being and of the success or failure of various Federal agricultural and rural policies. But the level of farmer bankruptcies is not a good indicator of rural financial health. Bankruptcies are only a subset of all farm business exits and a lagging indicator of economic stress. They do not reflect overall economic conditions in most rural areas because farming is a relatively small part of rural economic activity.

Farmer bankruptcies are controversial and emotional not only for the parties directly involved but for other observers as well. Whether regarded in a general sense of business closing or in a narrower legal sense, they are thought to signal changes not only in economic and social well-being but in the structure of the rural economy as well. Sometimes they are regarded as a measure of the success or failure of the various public policies (such as price supports, export subsidies, conservation rules, environmental regulations, and public credit funding) directed at improving the economic status of the farm sector.

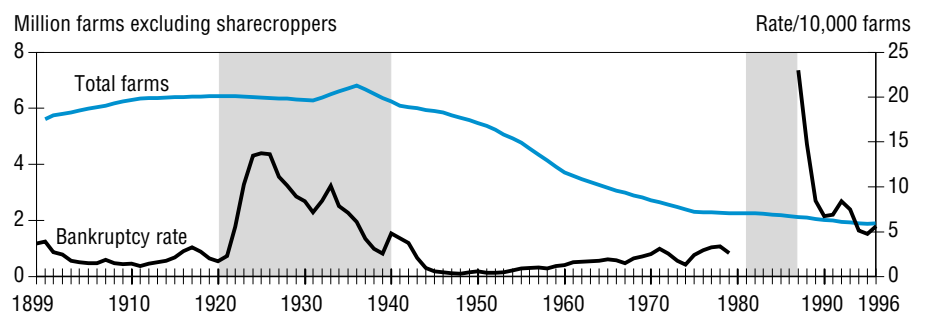
Bankruptcies are important but frequently misunderstood developments in rural areas, particularly during periods of general economic stress. Although farming is no longer the dominant industry in rural America and nonfarm businesses in rural areas also suffer bankruptcies, the historical interest has been on farm failures. The focus has largely been on farmer

bankruptcies because of the economic dominance of agriculture in the majority of rural regions until recent decades. This century has seen rural areas transformed, particularly after World War II. Technological, market, and political forces have changed the entire structure of agriculture. Total farm numbers fell from about 5.4 million (excluding sharecroppers) in 1945 to under 2 million today (fig. 1). With the exception of the Plains and Western Corn Belt, farming is a relatively small component of rural economic activity as manufacturing and service industries have become major economic engines of rural America.

The concern about farmer bankruptcies stems from several factors: (1) the long-held views of the farmer as landowner and patriot; (2) empathy for these rural citizens; (3) concerns that wealthier farmers (and banks and other lending institutions) may end up controlling the majority of farms; and (4) the perception that creditors/lenders have an unfair advantage in the legal system.

Figure 1

Farm-sector financial stress during the 1920's, 1930's, and 1980's led to higher bankruptcy rates but had little effect on farm numbers



Note: Shaded areas indicate general periods of farm financial stress. All applicable bankruptcy chapters were included for 1899-1979 data; data for 1987-96 are for Chapter 12 only. Data for 1980-86 not reported due to changes in bankruptcy law.

Sources: Economic Research Service compiled from Office of the U.S. Courts and U.S. Bureau of the Census data.

The interaction of bankruptcy policy and farm policy is important because the farm sector is dependent upon a lengthy biological production process that generates considerable physical and financial risk. The U.S. farm sector has historically been based on smaller firms that are more vulnerable to these risks. Public concern over farm policy rises when bankruptcy appears to be taking an inordinate toll on smaller farms.

A Blunt Policy Instrument

The longrun effects of bankruptcy statutes depend greatly on the economic performance of the sectors in question. But bankruptcy law is a blunt policy instrument overhanging the workings of credit markets, rather than being fine-tuned to specific subgroups. Bankruptcies occur during both prosperous and troubled economic times, but the effect of the law obviously is much more noticeable when times are hard. Chapter 12 has reduced farmer failure rates, but the shortrun gain to financially stressed farmers comes at the expense of some creditors and, ultimately, other borrowers (see box).

Chapter 12 gives family farmers in financial stress more power to demand concessions from lenders than does Chapter 11. Chapter 12 was not necessarily designed with creditor negotiations in mind, but it has had that effect. Under Chapter 11, where farmers typically filed before Chapter 12 became effective, creditors can more easily block the debtor's plan and force liquidation. The availability of Chapter 12 to certain farmers encourages creditors to negotiate debt-restructuring arrangements outside bankruptcy. But the effect may have been to cause lenders to restrict credit and raise interest rates to some degree.

Farm Financial Stress in the 1920's and 1930's

The U.S. economy generally prospered during the first two decades of this century. The agricultural sector was also generally prosperous, with the

1910-14 period often being regarded as the golden age of American agriculture (with the subsequent parity price formula being based on these years), which was then followed by a boom during World War I.

Concerns about farmer bankruptcy were heightened from 1920 through the Great Depression of the 1930's. Commodity prices collapsed after 1920. Sharply lower incomes left many farmers, who had borrowed to finance land acquisition and improvements

before 1920, unable to repay their loans. Farm-sector problems continued or were intensified by the general economic collapse in 1929, leading to the Great Depression and widespread adverse weather problems affecting agriculture in the 1930's. Nominal farmland prices fell from a post-World War I high of \$69 per acre in 1920 to a Great Depression low of \$30 per acre in 1933. Per acre farmland values then slowly increased in most subsequent years, but it was 1951 before the per acre value exceeded that of 1920.

Bankruptcy Policy and Farmers

Bankruptcy generally describes proceedings undertaken in a Federal court when a debtor is unable to pay or to reach agreement with creditors. The bankruptcy code contains four operative chapters (7, 11, 12, and 13) under which personal or business bankruptcy petitions may be filed. Chapter 7 provides for straight bankruptcy in the form of a liquidation proceeding and involves the collection and distribution of all the debtor's nonexempt assets by a trustee appointed or approved by the court in the manner provided by the code. Chapter 7 accounts for a majority of all bankruptcies, and most cases are personal and not business.

The debtor rehabilitation provisions of the code (Chapters 11, 12, and 13) differ, however, from the Chapter 7 straight bankruptcy because the debtor looks to rehabilitation and reorganization, rather than liquidation, and the creditors look to future earnings of the debtor, rather than property held by the debtor, to satisfy their claims. Chapter 11 involves an individual or business reorganization, with most cases being the latter. Individuals most commonly file under Chapters 7 or 13. A plan under Chapter 11 involves full or partial repayment of debts while assets are shielded from creditor action. Chapter 13 involves reorganization or adjustment of debts of an individual with regular income. Historically, most Chapter 13 cases have involved nonbusiness petitioners.

Chapter 12, the Family Farmer Bankruptcy Act of 1986 (P.L. 99-554), was enacted in response to the farm financial crisis of the early to mid-1980's and became effective on November 26, 1986. It involves the adjustment of debts of a family farm (as defined in the code) with regular income and makes available to farmers the equivalent of a Chapter 13 repayment program. Chapter 12 was originally set to expire under sunset provisions on October 1, 1993, but Congress extended it for 5 years until October 1, 1998 (P.L. 103-65).

Chapter 12 modifies the normal Chapter 11 bankruptcy procedure by permitting farmers to submit a reorganization plan directly to the bankruptcy court, with no review by creditors. Because creditors cannot reject the debt repayment plan developed under Chapter 12, if they are getting at least as much as they would under Chapter 7, farmers can reduce the amount owed, extend the payment period, and lower the interest rate on existing loans to current market levels or less. The writedown or "discharge" of secured debt is limited to fair current market value of the underlying land or other asset, which can be less than its original loan value. In return, the farmer agrees to a repayment plan for the remaining debt. Congress enacted Chapter 12 because of the downturn in the farm economy and the perceived inability of farmers to obtain meaningful relief under the existing provisions of the Bankruptcy Reform Act of 1978.

There were 5.89 million farms as defined by the census in 1910 and 12,001 farmer bankruptcies during 1910-19; but this figure jumped to 51,863 in 1920-29 (see box). The all-time high single-year farmer bankruptcy total was registered in 1925 when 7,872 farmers filed for bankruptcy, a rate of 12.4 per 10,000 farms based on 5.74 million farms. (There were 37,634 farmer bankruptcies during 1930-39 with 28,280 of these occurring during 1930-35.) The repayment schedules of numerous farm mortgages were restructured by lenders under the auspices of several New Deal programs, thus averting an even more severe agricultural situation during the Great Depression.

Farm Financial Stress in the 1980's

The second episode of concern about farmer bankruptcies in this century came during the 1980's, 50 years after the Great Depression, when there were 2.25 million farms and a much differently structured industry. The economic climate of the 1970's encouraged farmers to expand production and benefit from export opportunities and strong commodity prices. High rates of inflation and low real interest rates further encouraged investment in farmland. Per acre farmland values increased more than threefold from \$196 in 1970 to \$823, its 1982 peak. Total farm-sector equity grew 255 percent during 1970-80. Total farm business debt nearly quadrupled from \$48.8 billion in 1970 to \$193.8 billion at its peak in 1984. A considerable number of farmers were financially extended and vulnerable to sudden shifts in economic forces.

Economic conditions reversed in the early 1980's when export markets contracted and input prices and interest rates rose. Monetary policies designed to reduce inflation prompted interest rates to rise to unprecedented levels in the early 1980's. The financial stress turned to crisis when declines in farm commodity prices, income, and land values (farmers' largest asset and used to secure much of the debt) made it difficult for some farmers to service

About the Data

Farmer bankruptcy data were obtained from the Administrative Office of the U.S. Courts. Unfortunately, there are no farmer bankruptcy data for the crucial 1980-86 period that covered the latest farm financial crisis period. Bankruptcy statistics specifying a filer's occupation, including farmer, were recorded until October 1979. Under The Bankruptcy Reform Act of 1978 (P.L. 95-598), these data were no longer reported. The only exception is quarterly data on those who filed for bankruptcy protection under Chapter 12.

Farm numbers were taken from the U.S. Census of Agriculture with straight-line interpolation used to fill in the intercensal years. The data for sharecroppers are subtracted from farm numbers throughout this report to better measure farms subject to bankruptcy. Sharecroppers were restricted to 17 Southern States in the U.S. Census of Agriculture. Their numbers peaked at 783,459 or 12.5 percent of all farms in the 1930 census, but their importance dwindled and they were no longer enumerated after the 1959 census when they accounted for only 3.3 percent of all farms. For the most part, sharecroppers were not independent operators but were merely laborers paid in kind on Southern farms. In each census, the land assigned to each sharecropper was considered a separate farm even though the landlord

or settle their debts. These economic changes, not an overall lack of efficiency, produced the most severe financial stress for the U.S. farm sector since the 1930's. Nominal per acre farmland values fell 27.2 percent from a 1982 peak to a 1987 trough, while total farm-sector equity fell 30.5 percent during 1980-86 (high to low).

Some 18,212 Chapter 12 bankruptcies were filed from the date of its implementation on November 26, 1986, to June 30, 1996. There were 4,812 Chapter 12 bankruptcies filed during the year ending June 30, 1987, for a bankruptcy rate of 23.1 per 10,000 farms based on 2.1 million farms (excluding the Chapter 7, 11, and 13 farmer bankruptcies filed that year for which no data exist). This is the highest annual bankruptcy rate recorded, eclipsing the previous high in 1925. However, the 1987 data include a pent-up demand of farmers who had waited for the new legislation to take effect and the rates in subsequent years are influenced by the generous writedown-of-debt provisions of Chapter 12.

Chapter 12 had an immediate effect on forced farm liquidations, with the greatest number of farms taking advantage of it in the first few months after its introduction; the number of

filings subsequently declined and generally leveled off. During the 13+ months following Chapter 12's implementation (total filings through December 1987), some 6,664 bankruptcies were filed or over a third of the 18,212 total filed through June 30, 1996.

The number of Chapter 12 cases dropped during 1988 and the annual number has been quite stable since. Chapter 12 bankruptcy essentially brought about national farm debt restructuring under fairly uniform rules. In addition, the Agricultural Credit Act of 1987 (P.L. 100-233), signed into law on January 6, 1988, placed a temporary moratorium on foreclosing loans by the Farmers Home Administration (FmHA) and required consideration of principal and interest write-downs on debt restructuring for both FmHA and the Farm Credit System. This produced Chapter 12-type results without the cost and paperwork of bankruptcy filing. Moreover, the overall farm economy improved in the years after 1987. Together, these factors reduced the number of farmer bankruptcies. The overwhelming majority of all farmer bankruptcy reorganizations are now filed under Chapter 12's provisions with the remainder split between Chapter 11 (the large farm bankruptcies) and Chapter 13.

Farm Exits, Entries, and Farm Numbers

Farm bankruptcies contribute little to understanding changes in farm numbers. Longer run changes in farm numbers result from the entry and exit of farm operators, which comprise three components:

(1) The aging and eventual retirement of current farmers is a regular and predictable phenomenon.

The farmer retirement rate is a factor of a complex interplay of forces: age, health, weather, and economic conditions. No longrun data series are available that give the exact farmer retirement rate. Estimates based on census data indicate that little more than half of the 100,000 exits per year are by farmers over age 60. About 7 percent of farmers in this age group exit each year.

(2) The early departure of established farmers, often the subject of public debate, is the most variable element.

The "early departure" category includes farmers leaving because of bankruptcy, foreclosure, weather adversity, low prices, management problems, and numerous other factors.

(3) The entry rate of new farmers is often overlooked in estimates of changing farm numbers. Farm financial crisis periods almost always are discussed in terms of the effect on exits. While no exact long-term numbers exist, adverse economic conditions are significant in slowing entry of new farmers. The decline is especially significant among young farmers. Various Federal and State programs now exist to

help facilitate the entry of young farmers.

A Lagging Indicator of Farm Financial Stress

Farmer bankruptcies are a lagging rather than leading indicator of farm sector financial stress. Bankruptcies are only a subset of all farm business exits. Large numbers of farmer bankruptcies do not necessarily translate into a decline in farm numbers. Farmer bankruptcies did not prevent farm numbers from peaking at 6.1 million in 1935 during the Great Depression. The net outflow of people from farming began in earnest during the post-World War II prosperity rather than during a period of financial stress. By contrast, the bankruptcies of the 1980's occurred in the midst of a long decline in farm numbers, setting off a particularly acute wave of concern.

Conclusions

Increased farmer bankruptcies should not be viewed as a harbinger of financial trouble ahead for the farm sector. Rather, bankruptcies are a subset of the complex phenomenon of farm business exit. No available evidence supports the claim that increased farmer bankruptcies are key leading indicators of farm-sector financial stress. The rate of bankruptcy in the farm sector provides some indication of financial stress, but this is a lagging indicator. The farm sector is internally dynamic, with much shifting among farm size categories and entry and exit to the sector. Bankruptcies are only a subset in this shuffle that constantly changes farm-sector structure.

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Further Readings

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