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by

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This report summarizes the latest information available on credit and financial conditions in the farm sector. Information has been obtained from USDA surveys, Census, reports of lending agencies, lender surveys, and recent telephone interviews with district Farm Credit System and Federal Reserve Bank personnel.

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Abstract

The agricultural economy is not expected to experience demand related price strength until later this year. Recovery of the world economy offers little immediate hope for expanded U.S. agricultural exports. Farm commodity programs have improved sagging farm prices and the acreage reduction and PIK programs for the 1983/84 crop year will reduce farm production expenditures and credit needs. Farmland values continued to decline during the fourth quarter of 1982, but the rates of decline in many areas were less than those experienced earlier. Interest rates have declined since the middle of 1982, but they remain high in real terms. A relatively large percentage of the customers of farm lenders will continue to have serious cash flow problems. Most lenders believe credit problems will continue through 1983. Funds are available to credit-worthy farm borrowers and most lenders are exercising forebearance with customers experiencing cash flow difficulties.

Key Words: Farm credit, farm loans, finance, debt, lenders, land values, taxation, outlook.

Contents

Highlights

Macroeconomic Outlook: Its Effect on Financial Conditions in Agriculture

- The domestic economy is forecast to grow in real terms by 2.5 and 4.3 percent during 1983 and 1984, respectively. The agricultural economy is not expected to experience demand related price strength until later this year. Meanwhile, declining inflation, lower interest rates, and expanded monetary targets will contribute to the beginning of an economic recovery. Agriculture will gain from declining inflation and lower interest rates.

- Recovery of the world economy offers little immediate hope for expanded U.S. agricultural exports. Most of the recovery in foreign industrial countries will occur in exports and inventory building, not consumption which would benefit U.S. exports. The U.S. dollar is expected to remain relatively strong through 1983 based on the hign return of U.S. assets relative to foreign assets.

- Net farm income for 1983 will range between $18 and $22 billion. Government price support programs, declining inflation forecasts and lower interest rates have improved the farm income forecast from earlier estimates.

- Interest rates have declined since the middle of 1982; however they remain nigh in real terms.

- Federal land bank and production credit association interest rates are expected to continue to fall throughout most of 1983. FLB rates will average about 11.3 percent this year compared to 12.3 percent in 1982. The average PCA interest rate will be 11.9 percent compared to 14.6 percent last year.

Financial Effects of Farm Commodity Programs

- Farm commodity programs have improved some sagging farm prices. The increased grain reserve placements, and the PIK and acreage reduction programs have improved prices for corn, sorghum, wheat, rice, and to a lesser extent, cotton. Some crop prices received a further boost from the recent release of participation rates in government price support programs.

- The acreage reduction and PIK programs for the 1983/84 crop year will reduce farm production expenditures for principal purchased inputs, machine hire, and hired labor by about $6.2 billion, down 12 percent from 1982. However, total farm production expenditures for 1983 will only decline by about $3.7 billion, down 3 percent from 1982.

- Advance deficiency payments, advanced cropland diversion payments, and non-recourse price support loans will reduce credit demand for grain and cotton farmers. This source of cash will improve the farmers' cash flow position during 1983.

- The acreage reduction programs including PIK will reduce short term credit needs from 1982 by an estimated $2.5 to $3.0 billion. Intermediate-term credit demands will decline by $125 to $140 million from 1982. Most of the decline in short-term loan volume will occur at commercial agricultural banks, Farm Credit System banks, and the Commodity Credit Corporation.

- Growth in farm debt is expected to decline due to reduced credit needs and increased debt retirement. Total farm debt as of December 31, 1983 was forecast to be $228.6 billion before the PIK program, a 5-percent increase above 1982. With the PIK program, total debt is forecast to be $221.7 billion, up 2 percent from last year. Most of the reduction in forecasted debt will occur as a result of a drop in loans held by the Commodity Credit Corporation.

- As a result of the acreage reduction and PIK programs, interest expenses paid by farmers will decline by $520 to $570 million, a 2 percent drop from total interest paid during 1982.

- Key personnel at commercial agricultural banks and Federal intermediate credit banks find that, as a result of PIK, some farmers will continue to receive credit that otherwise would have been discontinued. Local interest rates could decline slightly for commercial banks in areas of high program participation. Personnel at Federal intermediate credit banks were less optimistic about a decline in interest rates.

Farm Real Estate Values

- Recent Federal Reserve bank surveys indicate that farmland values continued to decline during the fourth quarter of 1982. The rates of decline in many areas were less than those experienced earlier in 1982.

- When land values stabilize, the borrowing capacity of successful farmers will be improved, and the less efficient farmers will be able to make a more orderly exit from the sector.

Debt Burden

- As many as 45 percent of all farm operators in the $200,000 and over sales class carry debt/asset ratios of over 40 percent. Farmers in this sales class generate about 50 percent of all farm cash receipts.

- The highest concentration of highly leveraged farmers appears to be in the West North Central and Mountain States.

- The types of farms which show the highest percentage of high leverage operators are poultry and egg, corn, cotton, and hog operations.

- Over 60 percent of all farm debt is owed by farmers carrying debt/asset ratios of 40 percent or more. Farmers with debt/asset ratios of 70 percent or higher owe about 30 percent of all farm debt.

- A relatively large percentage of the customers of farm lenders will continue to have serious cash flow problems. Sustained improvement must come through a significant lowering of average interest rates and/or balance sheet restructuring at the farm level to reduce the debt burden.

Lender Responses to Current Financial Conditions in Agriculture

- The PIK program will help some farmers stay in business another year, but most lenders believe credit problems will continue through 1983.

- o Funds are available to credit-worthy farm borrowers. However, qualifying for credit will continue to be difficult for some farmers.

- o Most lenders are exercising forebearance with customers experiencing cash flow difficulties.

- o A moratorium or partial moratorium on FmHA loans is not a solution to the problem of current financial stress in the farm sector. FmHA has exercised considerable forebearance and will continue to do so in working with borrowers who are unable to make their loan payments when due.

Recent Developments in Taxation of Importance to Agriculture

- o The Social Security Act Amendments of 1983 (HR 1900) recently passed by Congress would increase the burden of social security taxes on self-employed farmers substantially. The rate self-employed farmers pay on net farm income would increase 21 percent in 1984.

- o The Payment-In-Kind Tax Treatment Act of 1983 (HR 1296) permits farmers who receive a commodity under the 1983 PIK program to defer the recognition of income until the commodities are sold. The Act also makes it clear that participation in the PIK program will not have an adverse impact on qualification for special use valuation or the installment payment of estate taxes.

Macroeconomic Outlook: Its Effect on Financial Conditions in Agriculture

> "Insofar as agriculture's price problem is ascribed to weak consumer demand, the only real and lasting improvement must await industrial recovery." Professor Harold F. Breimyer, Dept. of Agricultural Economics, University of Missouri-Columbia in Challenge, July-Aug. 1982, p. 40.
>
> "Nonetheless, the role of interest rates in contributing to the financial malaise of the Nation's agricultural sector is substantially less important than depressed commodity prices." Agricultural and Credit Outlook '83, Farm Credit Administration, Dec. 1982, p. 18.
>
> "As is true of other portions of the U.S. economy, Nebraska's agricultural sector has gained wealth and lost financial flexibility from the past 15 years of moderate to rapid inflation." Paul H. Gessaman and Gayle A. Morris, Recent and Projected Financial Conditions in Nebraska's Farming Sector, Dept. Agr. Econ. Report No. 131, University of Nebraska-Lincoln, Jan. 1983, p.27.

Domestic Economy

The domestic economy is currently forecast to grow in real terms during 1983 and 1984 by 2.5 and 4.3 percent, respectively. The agricultural economy is not expected to experience demand related price strength until the later part of this year. The livestock and cotton sectors will be the first within agriculture to experience an increase in demand due to increases in disposable income and employment. Demand will pick up for other crops at a later date. An improved world economy will support a larger export demand but probably not until the mid-1980's. After excess crop stocks are reduced, an improved general economy suggests a healthier agricultural economy during the mid-1980's. Events that could interrupt the expected economic recovery include the following:

1. Reduced monetary growth due to policy changes by the Federal Reserve.
2. International financial crisis caused by defaults on debt obligations by developing nations, both OPEC and non-OPEC.
3. Reduced world trade accompanied by growing protectionism.
4. Inability of the U.S. economy to overcome internal structural adjustments and growing international competition.

The housing and construction sector have begun to improve and most economic indicators suggest that a recovery is in progress. Declining inflation--aided by lower oil prices--and lower interest rates should aid the progress of economic recovery. Also, growth targets for monetary and credit aggregates were recently raised by the Federal Reserve which will delay a sharp increase in interest rates and provide for additional real growth.

Commodity prices--The 1983 outlook for all agricultural commodity prices is about equal to 1982. While crop prices are forecast to be up 2 percent, livestock product prices are expected to be down less than a percent. Generally, prices for most PIK commodities are expected to improve measurably in 1983. However, prices for fruits are expected to decline and offset some of the gains from the PIK commodities. Most crop and livestock prices for 1984 are anticipated to be higher than 1983 as a result of Government programs and world economic recovery. The excessive stock levels of 1982 are expected to be reduced because crop use during crop year 1982/83 will generally exceed production during 1983. While prices for cattle and hogs have been favorable, they are expected to dampen by year-end. Feeders are concerned about production costs and the degree of increase in consumer demand.

Monthly prices received for all farm products as of April 1983 rose more than 6 percent since last October. Grain and cotton prices have generally increased above the normal seasonal rise since January. Although crop price strength was not derived from general demand improvement, a strengthening in demand is expected later this year and throughout 1984. To date, the major reason for crop price strength has been the government price support programs. The PIK and acreage reduction programs or increased entry into the grain reserve have improved prices for corn, sorghum, wheat and rice. Prices for cotton have risen measurably, although pressured by weak demand and abundant supplies. Cattle prices have been strong although indications of expanded hog production will soften hog prices during 1983.

Input prices--Prices paid for major production items during 1983 and 1984 are expected to be up by 3 and 5 percent, respectively. However, unexpected declines in inflation, fuel prices, and interest rates could moderate these price forecasts. Partially offsetting any input price weakness will be the farm origin inputs such as feed or feeder livestock which have been experiencing price gains above a year earlier.

Interest Rates--Interest rates have declined considerably since the middle of last year due to a surge in the growth of the money supply and a drop in business loan demand. However, they remain high in real terms. Farm interest rates have also declined, however, not as quickly as money market rates or those of large banks (table 1). This is because the maturity on the sources of funds at smaller agricultural banks as well as farm credit banks is longer than that of large commercial banks. Hence, most farm interest rates lag other rates as market rates rise and decline.

There is considerable uncertainty regarding the future course of interest rates. Since the middle of 1982, the money supply (M1) has been growing at a compound annual rate of around 15 percent, well above the upper end of the Fed's recently increased target range of 4-8 percent. The question remains how long can the Fed continue to allow this rate of money growth? The answer may be, as long as there remains a serious threat of a deep recession. Clearly, any move that leads to higher interest rates would abort the emerging recovery. The options to the Fed appear to be future inflation or continued recession.

USDA's unofficial interest rate forecasts for production credit associations and Federal land banks indicate that FLB rates will continue to drop throughout 1983 from an average 11.9 percent at the beginning of the year to about 11.3 percent in the fourth quarter. PCA rates will likely drop through the first three quarters of 1983, increasing somewhat at the end of the year (table 2).

Table 1--Agricultural interest rates

	1982				1983	
	Jan.	Apr.	July	Oct.	Jan.	Apr.
Bank prime rate	15.75	16.50	16.50	13.50	11.50	10.50
Feeder cattle loans 1/	16.90	17.30	17.20	15.60	14.40	13.7
Production Credit Assn. 2/	15.30	14.80	14.40	13.80	12.80	11.80
Federal Land Banks 2/	12.10	12.20	12.40	12.40	11.90	11.75
FmHA operating loans	14.50	14.25	14.25	13.25	11.50	10.25
FmHA farm ownership Loans	13.25	13.25	13.25	13.00	11.50	10.75
CCC commodity loans	12.25	13.875	13.50	11.00	9.00	8.875

1/ Seventh Federal Reserve District--average of typical rates at agricultural banks, first day of the quarter. Data are from the Agricultural Finance Databook, Board of Governors of the Federal Reserve System.
2/ Rates exclude some borrowing costs.

Table 2--Unofficial USDA forecast of PCA and FLB interest rates

	Quarter										
	I	II	III	IV	I	II	III	IV	1981	1982	1983
	1982				1983				Average		
PCA 1/	15.3	14.8	14.4	13.8	12.8	11.8	11.5	11.8	14.5	14.6	12.0
FLB 2/	12.2	12.3	12.4	12.3	11.9	11.7	11.4	11.3	11.3	12.3	11.6

1/ Mean PCA interest rate on first day of quarter.
2/ Arithmetic average FLB rate based on first day of each month of the quarter.

Farm income--The outlook for 1983 farm income should compare favorably with 1982's estimated level of $20.4 billion. Net farm income for 1983 is expected to range between $18 and $22 billion. Livestock cash receipts are expected to total about $68-72 billion, up 1 percent from 1982. Livestock receipts have been reduced from earlier estimates based on information from the March Hogs and Pigs Report, which suggests that pork production in 1983 will be larger than expected. Crop receipts are expected to total $[illegible]-$68 billion, down substantially from 1982. Much of the decline is due to a PIK related drop in marketings and changes in loan activity. Due mostly to the large decline anticipated in spring plantings, total farm production expenditures are expected to drop 2 to 4 percent from the 1982 estimate of $144 billion. Lower input prices for some nonfarm inputs and smaller increases in others will also contribute to reduced expenses. Expenses for nonfarm inputs could decline by more than $5 billion with an offsetting $2 billion increase due to farm origin inputs such as feed.

Net farm income for 1984 is expected to improve beyond the level of 1983 due to strengthening farm prices, increased marketings, and recovering domestic and world economies.

International Trade Developments

The world economy is expected to grow during 1983 and 1984 by 2 and 3 percent, respectively. The outlook for world growth through 1984 is particularly sensitive to U.S. growth. Major areas of expected economic growth consist of the United States, Japan and East Asia. Relatively lower growth rates are projected for consumption than for GNP. The value of the U.S. dollar (inflation adjusted, trade weighted basis) is not expected to depreciate much through 1983 but should weaken in 1984.

Given the outlook for low economic growth in the major foreign nations, the demand for U.S. commodity exports is not likely to increase significantly through 1983. For most foreign industrialized nations, excluding the United Kingdom, the recovery is generally forecast to occur in exports and inventory building, rather than in consumption, where it would benefit U.S. agricultural exports the most. Although the U.S. will pursue export programs such as blended credit, markets within developing countries are expected to remain weak because of foreign exchange constraints and weak export earnings.

Although the U.S. dollar is expected to remain relatively strong through 1983, it is expected to depreciate during 1984 by 5-10 percent. However, recently the dollar has exhibited renewed strength. The major factor that has strengthened the dollar over the past two years and that will likely continue to keep the dollar strong through 1983 is the high return on U.S. assets relative to foreign assets. The major factor expected to weaken the the dollar in 1984 is a record negative trade balance which should, theoretically at least, offset the impact of high real interest rate differentials.

Financial Effects of Farm Commodity Programs

* *
* "...the Administration will probably have to employ PIK again *
4* in 1984. But by the end of 1984 government supplies would be *

* sharply reduced, and PIK would no longer be feasible." Business *
* Week, Mar. 21, 1983, p. 108. *
*
* "It's virtually a foregone conclusion that payment-in-kind (PIK) *
* programs will be continued on 1984 crops." Agri Finance, *
* Mar. 1983, p. 8. *
*
* *

The availability of price support loans and direct payments will improve the cash flow situation in the farm sector. The farm commodity programs will remove acres from production which will reduce stocks, provide price strength and reduce farm production expenditures. The combined effects of reduced production expenditures and increased direct payments will reduce farmers' 1983 credit needs, debt outstanding and interest expenses.

The impacts of the 1983/84 farm commodity programs are analyzed with respect to their impact on commodity prices, farm production expenditures, direct producer payments, credit needs, debt outstanding and interest expenses.

Commodity Prices

Government price support programs have strengthened PIK commodity prices, while the livestock industry will experience mixed results. Entry of grains into the reserve and heavy participation in the PIK and acreage reduction programs have strengthened grain and cotton prices.

Crop prices in general have risen since fall but the recent release of participation rates in the acreage reduction and PIK programs have given prices a firm boost. On March 23rd, the day after participation rates were released, commodity futures prices for May delivery closed at $3.09/bu. for corn, up $.08/bu. from the previous day. Soft red wheat prices for May delivery rose $.12/bu. to $3.67/bu. Soybean prices were also strengthened. Moderately higher grain, soybean, and cotton prices are anticipated during 1983 due to a decline of the burdensome stock levels of 1982.

The government price support programs have boosted feeder cattle prices but a decline in fat cattle prices is anticipated later in the summer. Prices of feeder cattle at Oklahoma City, Oklahoma have risen about 15 percent since mid-December, a larger than normal rise. This rise in price is due to an increase in demand most likely caused by the winter wheat graze-out option.

After cattle leave the wheat fields in May or June, they will be sent to the feedlot for about a month. The supply of fat cattle later in summer is expected to be greater than normal, thus driving down slaughter cattle prices. Higher corn prices should also slow the expansion of hog herds currently underway.

Farm Expenditures

Farmers' expenditures for major purchased inputs such as fertilizer, pesticides, machinery repair, seed, fuel, machine hire and hired labor and capital purchases, such as machinery expenditures, are those most influenced by farm commodity programs. Expenditures for major purchased inputs are equal to about one-third of annual total farm production expenses, whereas farm machinery expenditures represent almost half of annual capital purchases. Both types of

expenditures are frequently made with the use of short- and intermediate-term credit. Since crop farmers finance about 30 to 35 percent of their operating expenditures and about 50 to 55 percent of capital expenditures, reduction in operating expenditures will affect farmers' use of credit in a similar directi .

Farm production expenditures for fertilizers, pesticides, machinery repair, seed, fuel, machine hire and hired labor are estimated to decline by about $6.2 billion, down 12 percent from 1982. Heavy participation in the 1983/84 farm programs--idling about 82 million acres--is a major reason for the decline in these expenditures.

Only a minimal impact is expected on farm machinery purchases. Capital purchase of farm machinery is expected to equal $9.9 billion, down $200 million or 2 percent from 1982. Since farm income and liquidity could increase, a slight rise in machinery purchases is also possible.

Direct Producer Payments and Price Support Loans

Farmers' use of direct payments vary greatly and include purchases of production inputs, farm and non-farm investments, household consumption items and retirement of debt. Given the current financial pressure on the farm sector, farmers are most likely to use direct payments and funds from price support loans to retire debt and to purchase input and capital items that otherwise would have been purchased with credit.

Direct cash payments during calendar year 1983 are expected to total $4.2 billion, down $1.2 billion from pre-PIK estimates but still a $.9 billion increase above 1982. The PIK program is expected to reduce deficiency and reserve storage payments from the pre-PIK estimates while diversion payments are expected to rise slightly. Also, PIK entitlements will be received during the normal harvest period and eventually sold in the market.

Credit needs and debt repayment difficulties should ease during the third quarter of 1983 because producer payments will be about $1.0 billion greater than last year. Part of the reason for the surge in these payments was the temporary halt in the January-March disbursements due to the excessive workload in the ASCS county office.

Commodity price support loans provide the farmer with both interim financing and a means of orderly marketing. The reduced acreage and PIK programs are expected to reduce CCC loans made during 1983 to $12.1 billion, down $2 billion from 1982. Crop stocks are expected to decline, strengthening market prices.

Demand for Credit

The demand for short and intermediate-term credit is expected to decline because of reduced production expenditures and advanced payment provisions which provide cash at a time of peak demand for credit. Short-term credit needs are estimated to decline by $2.5 to $3.0 billion from 1982. Intermediate-term credit needs may drop by $125 to $140 million from last year.

Key agricultural bankers and Federal intermediate credit bank personnel report that the PIK program has improved the farmers' 1983 cash flow prospects: prices will likely stabilize or improve, expenses will decline, and a degree

of production risk has been removed. As a result, some farmers will continue to receive credit that otherwise would have been discontinued. The decline in credit will occur mostly with commercial agricultural banks, Farm Credit System banks and the Community Credit Corporation. Agricultural banks will have to seek alternative investments for their funds. The drop in credit demand will be greatest in areas of high program participation.

Agricultural bankers and personnel at the Federal intermediate credit banks (FICB's) indicate that a decline in credit demand at the local level could change interest rates slightly. Agricultural bankers suggested that rates would either remain the same or decline slightly. If equally attractive alternative investments were present, rates would not decline. However, rates could decline slightly due to competition by other banks or due to the lack of alternative investments. Personnel at FICB's indicated that in most cases rates would not change. One person stated that rates could even rise because costs would have to be spread over less volume. The impact of PIK on national interest rates will be insignificant.

Debt Outstanding

The growth in total farm debt outstanding was expected to moderate prior to the PIK program because of poor farm financial conditions. Total debt was expected to be $228.6 billion as of January 1, 1984, up $10.9 billion or 5 percent from a year earlier. This increase compares to an average annual rate of 12 percent since 1970 (table 3).

As a result of the acreage reduction and PIK programs, total farm debt is forecast to total $221.7 billion, an increase of only 2 percent from year-earlier levels. The amount of debt increase is being lowered by $6.5 to $7.5 billion. This decline is due to reduced credit needs, increased debt retirement and PIK entitlements which will reduce CCC debt.

CCC's market share of total farm debt is forecast to decline to 6.8 percent, down from a pre-PIK estimate of 8.7 percent. Market shares for most other lenders are estimated to increase slightly.

Interest Expenses

Interest expenses paid by farmers during 1982 totaled $23 billion, 16 percent of total farm production expenses. As a result of the acreage reduction, lower interest rates, and PIK programs, interest expenses paid by farmers during 1983 are estimated to decline by $520 to $570 million, a 2 percent decline from 1982. The PIK programs will result in reduced credit needs and increased debt retirement.

Farm Real Estate Values

* *
* "No topic commands more interest in rural communities than cur- *
* rent and future land values." Professor Michael Boenlje, *
* Department Economics, Iowa State University, "Land Values, *
* Farm Income and Government Policy," 1980 USDA Agricultural *
* Outlook Conference, p. 1. *
* *

Table 3--Total farm debt, 1970-1984

Farm debt 3/	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983[1]	1984[2]
	Billion Dollars														
Real estate	29.2	30.3	32.2	35.1	39.5	44.6	49.6	55.2	63.3	71.4	85.4	95.5	105.6	109.6	112.4
Non-real estate to:															
CCC	2.7	1.9	2.3	1.8	0.8	0.3	0.4	1.0	4.5	5.7	5.1	5.0	8.0	16.6	15.1
Others	21.1	22.3	25.1	28.0	33.1	36.7	41.6	47.7	54.9	63.7	75.3	81.5	88.1	91.5	94.2
Total[4]	53.0	54.5	59.6	64.9	73.3	81.6	91.5	103.9	122.7	140.8	165.8	182.0	201.7	217.7	221.7

1/ Preliminary.
2/ Forecast.
3/ Debt figures are as of January 1st for each year.
4/ Totals may not add due to rounding.

* "...most analysts are expecting further declines in land values in 1983, but they are hoping to see some stabilization by the year's end....Be careful not to over-generalize from the accounts you hear of the extreme cases....We may well be witnessing a downward adjustment in values from those levels of the late 1970's that simply were ill-founded." Professor Bruce Johnson, Dept. of Agricultural Economics, University of Nebraska in Custer County Chief, Broken Bow, Neb. Feb. 9, 1983, p. 2.

* "All those people who own land but did not buy any after 1973 are hurting psychologically to see their net worth a third less than two years ago, but they should still have good equity positions. Some of those who bought land from 1976 to 1981 at mortgage levels allowed by lenders at that time are now in serious financial trouble if they had no other equities or sources of income. Most lenders who are forced to foreclose on farmland plan to hold the land until land prices work up enough to at least minimize loan losses. They anticipate that the time needed for a rebound might be two or three years." Professor John T. Scott, Jr., "How to Determine the Cost of Land by Observing Rents," p. 25. Paper presented at the "Conference on Rents, Rentals, and Renting," cosponsored by USDA and the Farm Foundation, Mar. 2, 1983, Chicago, Ill.

* "...and while the rate of increase (in land values) may not be quite so dramatic in the 1980's, the value will still go up appreciably." Vice President Vernon Crowder, Security Pacific National Bank (California) in Agri Finance, Mar. 1983, p. 7.

Recent Developments

Recent Federal Reserve bank surveys indicate that the rate of decline in farmland values slowed during the fourth quarter of 1982. As the farm economy recovers, a stronger land market and some stabilization in land values is expected by the end of 1983.

Of the Federal Reserve banks which survey changes in farmland values, none recorded increases over the period December 31, 1981 to December 31, 1982 (table 4). The largest decline was reported by the Chicago Federal Reserve District where land values decline by an average of 16 percent in 1982. However, the rate of decline did begin to moderate in the fourth quarter of 1982 as land values declined by 3.5 percent compared to a 5 percent drop in the third quarter of 1982. The respondents to the latest Chicago District survey remained pessimistic about the outlook for farmland values. Forty-six percent of the bankers surveyed expected land values to decline in the first quarter of 1983 while the remainder expected land values to remain unchanged.

The Kansas City and Richmond Federal Reserve Bank surveys showed, as was the case in the Chicago District, that land value declines in the fourth quarter of 1982 did begin to moderate. The Kansas City survey recorded declines of 1 to 2 percent during the final 3 months of 1982. Results from the Richmond Federal

Table 4--Percent changes in farm real estate values

Federal Reserve District and type of land	1982-Q4	Year ending 12/31/82	From peak value	Date of peak
Richmond, farmland 1/	+1	-9	-14	1981-Q3
Chicago, good farmland 2/	-4	-16	-18	1981-Q3
Kansas City 3/				
Nonirrigated cropland	-2	-11	-17	1981-Q2
Irrigated cropland	-2	-11	-18	1981-Q2
Ranchland	-1	-13	-14	1981-Q2
Dallas 4/				
Dryland	-5	-5	NA	NA
Irrigated cropland	-0	-8	NA	NA
Ranchland	-10	-4	NA	NA

NA = Not applicable because of changes in survey panel.

1/ The Richmond Federal Reserve District includes Maryland, North Carolina, South Carolina, Virginia and West Virginia.
2/ The Chicago Federal Reserve District includes Iowa and parts of Illinois, Indiana, Michigan, and Wisconsin.
3/ The Kansas City Federal Reserve District includes Colorado, Kansas, Nebraska, Wyoming and parts of Missouri, New Mexico, and Oklahoma.
4/ The Dallas Federal Reserve District includes Texas and parts of Louisiana, New Mexico, and Oklahoma.

Source: Table 4 is an updated version of one presented by Emanuel Melichar, "Update Tables for Development in Agricultural Finance," Division of Research and Statistics, Board of Governors of the Federal Reserve System, Washington, D.C., Mar. 21, 1983, Table 3.

Reserve Bank District gave the strongest indication that the largest declines in land values may be over. While survey results showed a 5 percent decline in district land values for 1982, the Richmond District was the only Federal Reserve bank which recorded an increase (+1 percent) during the final quarter of 1982.

Only the Dallas Federal Reserve Bank survey recorded fourth quarter declines in land values which were significantly greater than those experienced earlier in 1982. The values of dryland and ranchland declined by 5 and 10 percent, respectively during the fourth quarter of 1982 compared to 5 and 4 percent declines for those same categories for the entire year. Only irrigated cropland showed a sign of improvement during the final quarter of 1982, declining by less than 1 percent as opposed to an 8 percent decline for the year.

For the most part, the major factors preventing land values from stabilizing are the same as those reflected in the 1-percent decline in farmland values from February 1981 to April 1982 by the USDA land value survey. Uncertainty with respect to commodity prices and farm income prospects, relatively high real interest rates, the high debt servicing costs being experienced by many farmers, and the sluggish growth of the general economy and its impact on off-farm income opportunities for farm families are preventing many farmers from aggressively entering the farmland market.

Land Market Impacts on Financial Conditions

The recent declines in land values have resulted in some large financial losses for those farmers who have been forced to sell land to reduce debts or maintain cash flow. For those who have not been forced to sell, the declines have also created problems because falling equity has reduced their ability to borrow funds for annual operating expenses. Fewer farmers now qualify for credit.

There has been a sharp reversal in the fortunes of those who were using leveraging as a strategy for rapid farm growth. This strategy magnified the large capital gains that accrued to buyers of farmland in the 1970's, but over the last several years it has magnified the capital losses produced by declines in land values. The strategy has now been discredited. Over the next several years farmers can be expected to follow less expansionary strategies and rely less on debt financing.

During the 1970's, farmland values increased in years of both high and low farm income and thus provided farmers with a reliable source of additional equity. The steady growth in equity supported borrowing to solve cash flow problems in years of low income. The rising land values also helped to maintain an active farmland market that gave farmers the option of selling some land to obtain funds during periods of low cash flow. The recent declines in land values have made it much more difficult to sell land to reduce debts or solve cash flow problems. There have been very few bidders for farmland because prospective buyers are waiting for further declines in land values. There has been a large drop in the rate of farmland transfers and a significant increase in the amount of time that it takes to find a buyer for a tract of land.

The sharp reduction in farmland sales has made it more difficult to judge the value of land for loan security, thus making it more difficult for farmers to borrow.

Farmland values are expected to stabilize by the end of this year. If this occurs and activity in the land market increases, lenders will be more willing to accept equity in farmland as security, thus more farmers will qualify for credit. There will also be a more efficient market for land, which will permit a more orderly withdrawal by less successful farmers. Land will be transferred to farmers who have less serious cash flow problems and are less exposed to risk.

Debt Burden

* "Worst off are young farmers who borrowed heavily and paid inflated land costs to get into farming in the boom years of the late 1970's." Business Week, Mar. 21, 1983, p. 115.

* "Farmers' indebtedness has tripled in the last decade. Until recently, the debt load was readily bearable as low-interest borrowing was levered into attractive capital gains. Sharply higher interest rates now imperil debt-financed farmers." Professor Harold F. Breimyer, Dept. of Agricultural Economics, University of Missouri-Columbia in Challenge, July-Aug., 1982, p. 35.

Distribution of Operators by Debt/Asset Ratio

By sales class--In spite of the frequently quoted statistic that almost half of all American farmers are debt-free, significant numbers of commercial-sized farms are carrying a heavy debt load. Farmers reporting over $200 thousand in sales represent only about 4.5 percent of all farmers, however, they generate about 50 percent of farm cash receipts and owe about 40 percent of total farm debt. Given the level of risks associated with agricultural production, debt/asset ratios greater than 40 percent imply considerable net income volatility. In 1980, about 30 percent of these farm operators had debt-to-asset ratios of more than 40 percent (fig. 1). It has been estimated that as many as 45 percent of these large commercial farmers carry debt ratios of over 40 percent today.

By region--Geographically, the regions experiencing the highest concentration of high leverage operators are the West North Central and Mountain States. In fact, these regions are the only ones to display a higher percentage of heavily leveraged operators than the United States as a whole (fig. 2). Over 17 percent of the farmers in the West North Central region and 13 percent of those in the Mountain States had debt/asset ratios of 40 percent or more. The percentage of those in the 70 percent and above debt/asset ratio category was 4.7 percent in both regions.

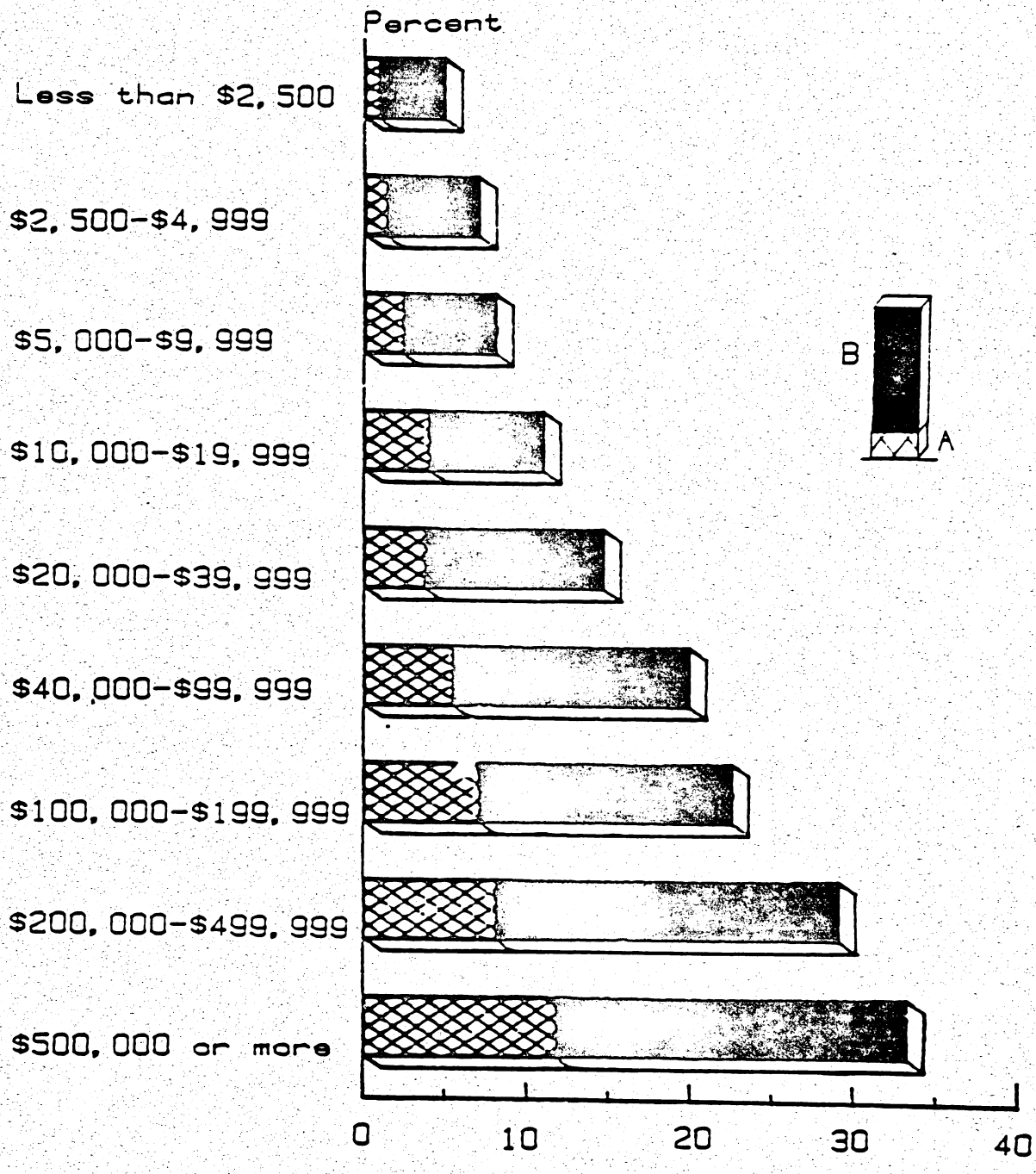
By farm type--The distribution of farm operators by debt/asset ratio varies by type of farm. For example, over 19 percent of all poultry and egg producers had debt/asset ratios of over 40 percent in 1980. This compares with almost 10 percent for livestock farms, 8 percent for fruit and nut farms, and 15.6 percent for cash gains farms (fig. 3).

By type of crop farm--The type of crop farm showing the highest concentration of operators in the high leverage categories was cotton, with about 23 percent carrying debt/asset ratios over 40 percent. Almost 6 percent of the cotton producers carried greater than a 70 percent debt/asset ratio. Corn farmers had a comparable concentration of operators in the very high leverage category (over 70 percent debt/asset) while 18 percent of these farmers had debt/asset ratios of 40 percent or more. Wheat farmers have the smallest percentage of operators in the high leverage categories (fig. 4).

By type of livestock farm--Hog farmers stand out as having the highest concentration of high leverage livestock producers, with 5 percent carrying a debt/asset ratio of 70 percent or more and almost 18 percent showing a debt/asset ratio greater than 40 percent (fig. 5).

FIGURE 1.

Percent of Farm Operators with High Debt/Asset Ratios by Sales Class, 1978



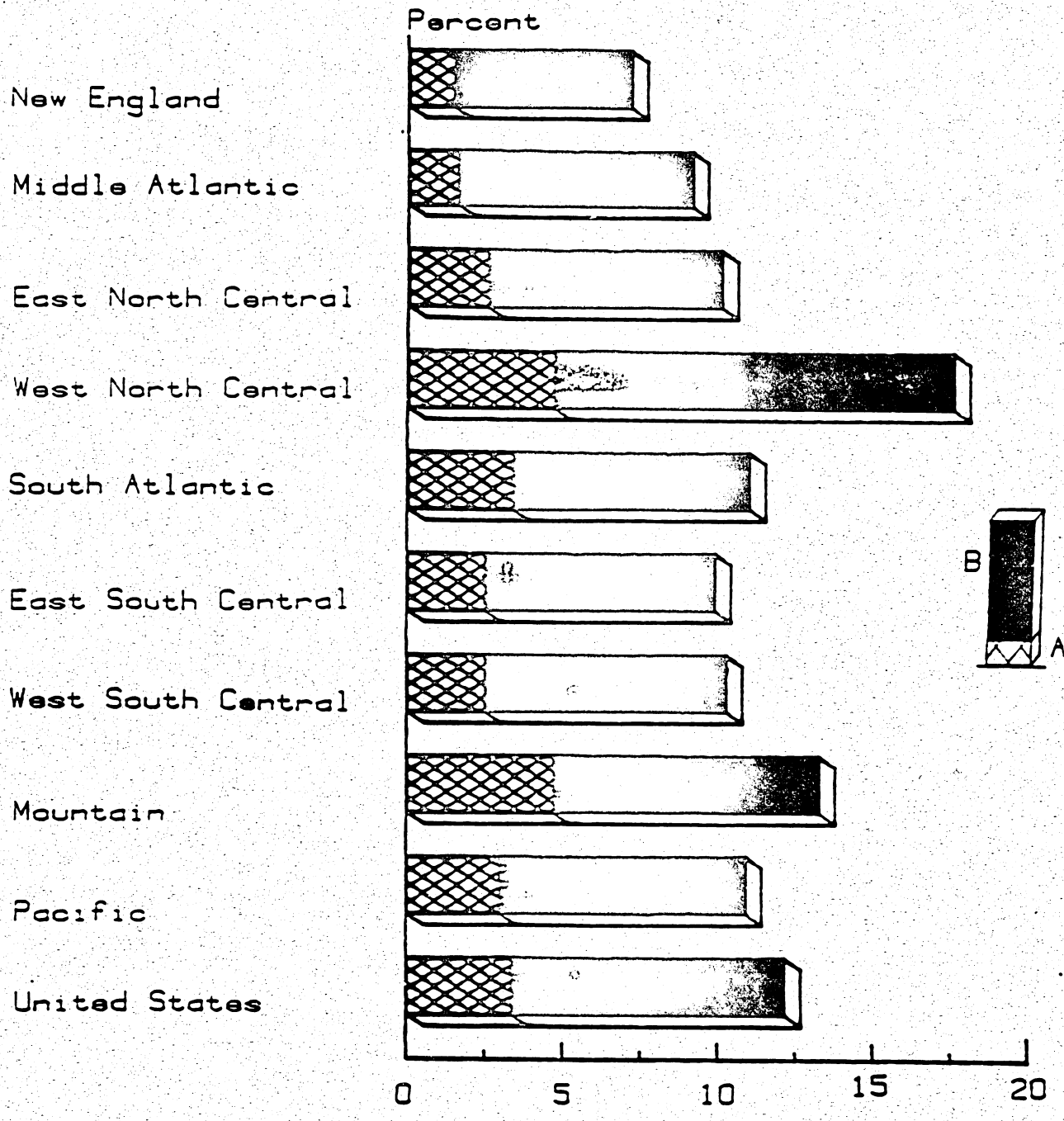
A= Percent of operators with debt/asset ratios over 70 percent.

B= Percent of operators with debt/asset ratios over 40 percent.

Source: 1979 Farm Finance Survey, Census of Agriculture.

FIGURE 2.

Percent of Farm Operators with High Debt/Asset Ratios by Region, 1980



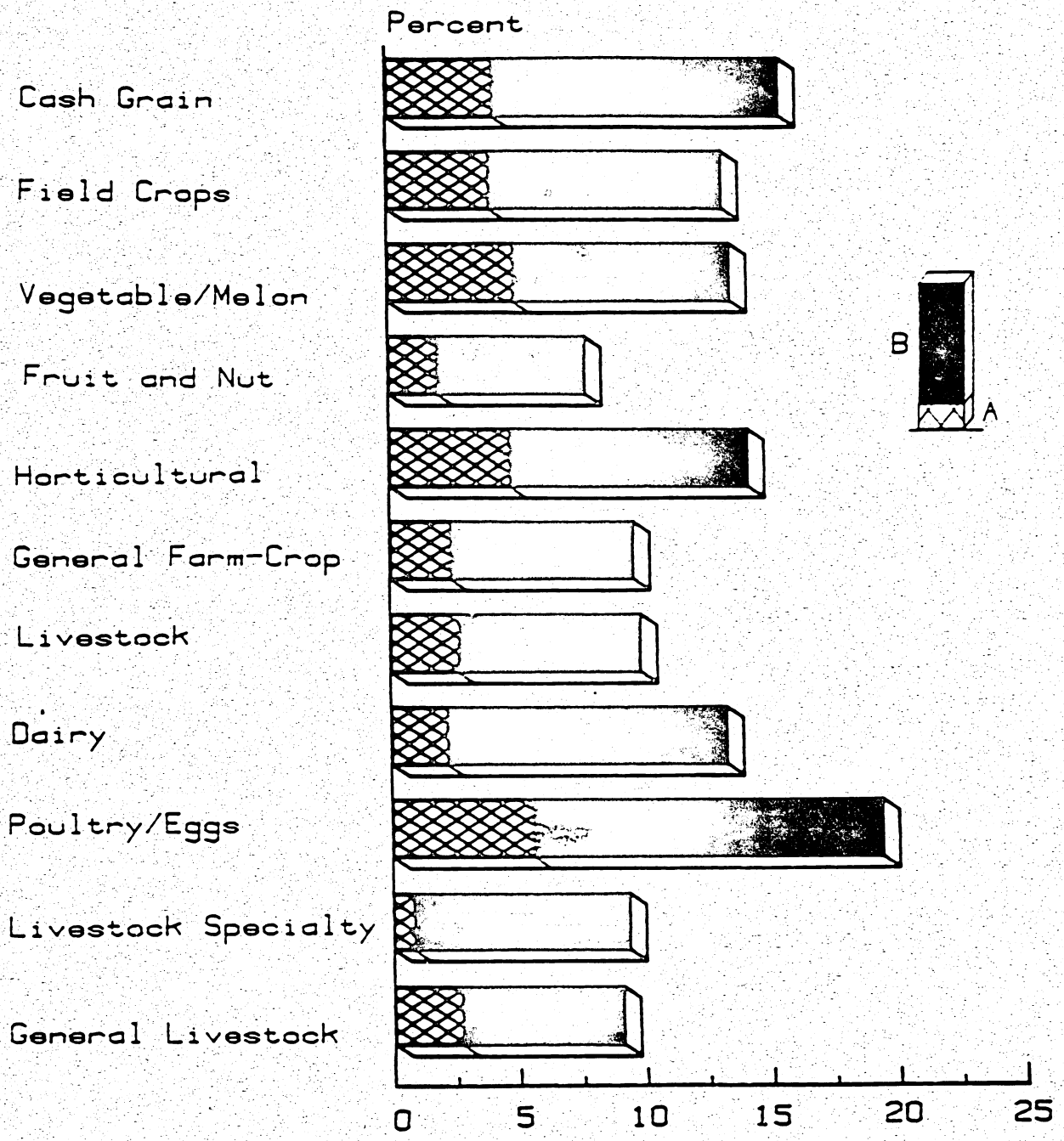
A= Percent of operators with debt/asset ratios over 70 percent.

B= Percent of operators with debt/asset ratios over 40 percent.

Source: 1979 Farm Finance Survey, Census of Agriculture.

FIGURE 3.

Percent of Farm Operators with High Debt/Asset Ratios by Farm Type, 1980



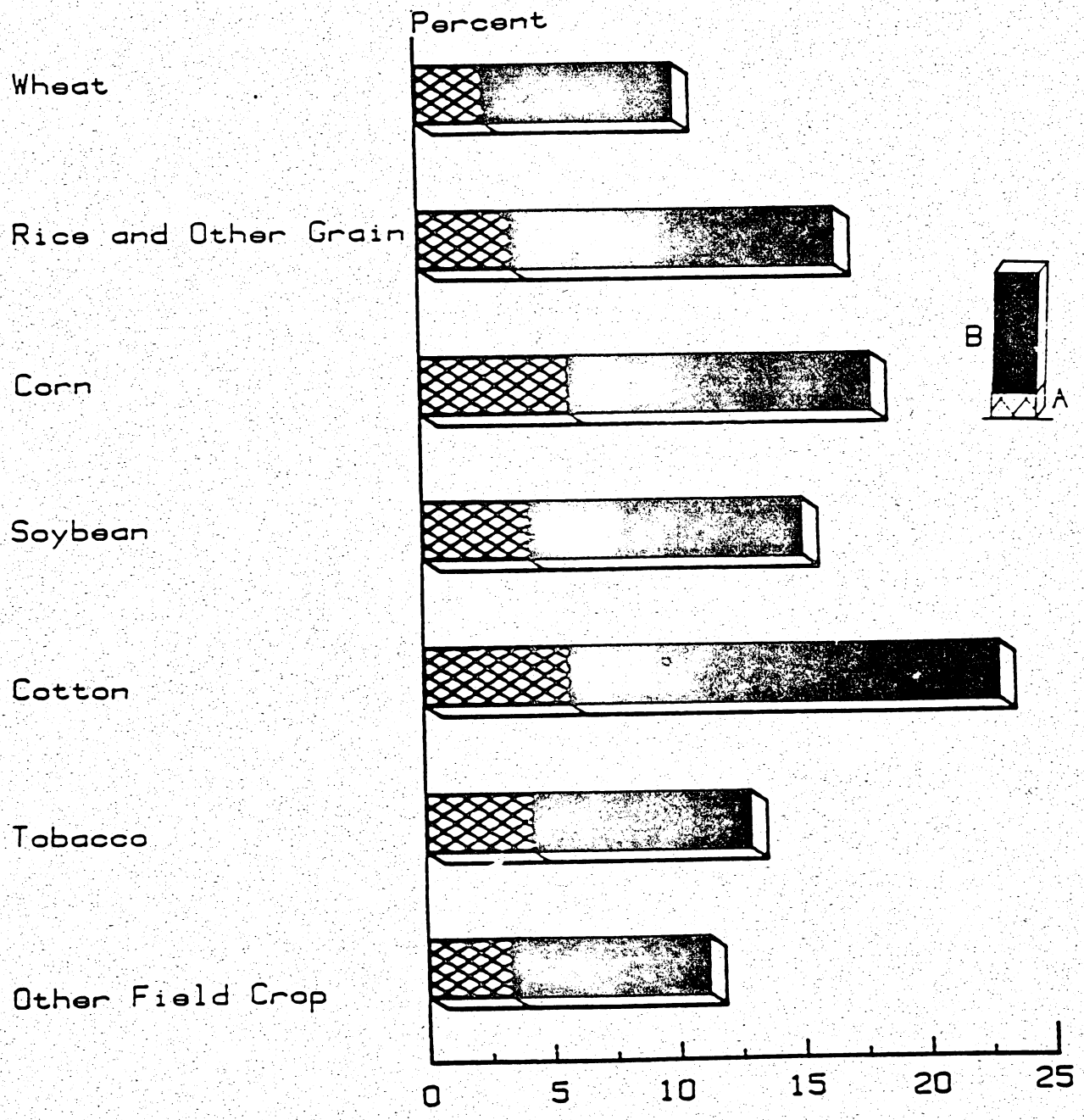
A= Percent of operators with debt/asset ratios over 70 percent.

B= Percent of operators with debt/asset ratios over 40 percent.

Source: 1979 Farm Finance Survey, Census of Agriculture.

FIGURE 4.

Percent of Farm Operators with High Debt/Asset Ratios by Type of Crop Farm, 1980



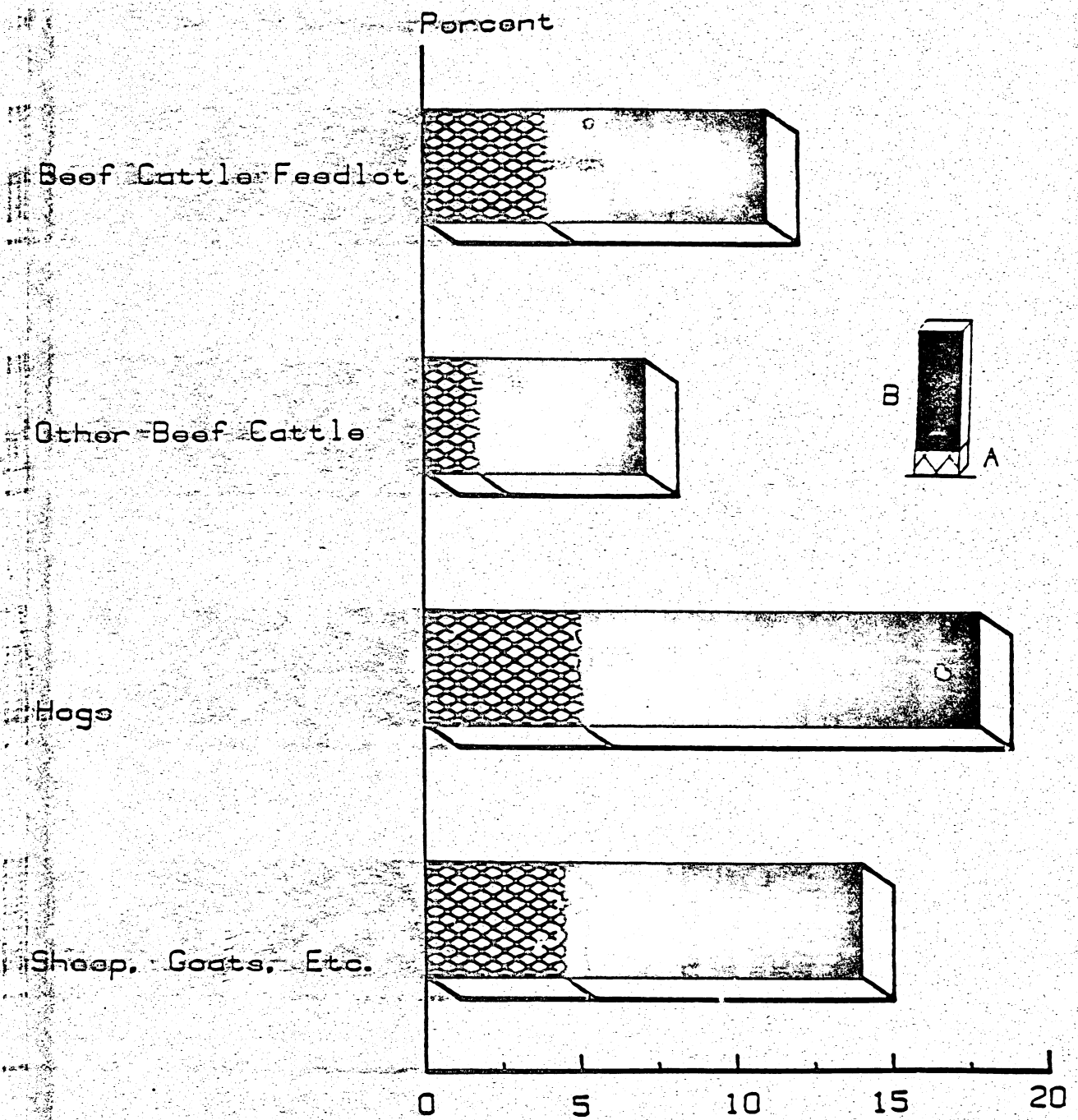
A= Percent of operators with debt/asset ratios over 70 percent.

B= Percent of operators with debt/asset ratios over 40 percent.

Source: 1979 Farm Finance Survey, Census of Agriculture.

FIGURE 5.

Percent of Farm Operators with High Debt/Asset Ratios by Type of Livestock Farm, 1980



A= Percent of operators with debt/asset ratios over 70 percent.

B= Percent of operators with debt/asset ratios over 40 percent.

Source: 1979 Farm Finance Survey, Census of Agriculture.

Distribution of Farm Debt by Debt/Asset Ratio

> "Ag bankers project farm credit conditions will become worse in the year ahead. More bankers expected renewals, refinancing, deliquencies, and losses to increase in the year ending mid-1983 than the number expecting these measures to decline." American Bankers Association, Agricultural Banker, Special Report, Nov. 1982, p. 3.
>
> "Agri-lenders in the state, as well as producers and agri-businessmen, have been severely stung by farm liquidations, bankruptcy proceedings, and problem loan situations. Many lessons have been learned via the financial and economic experiences of the past five years--the key lesson being that 'it's mighty hard to borrow yourself out of debt.'" John C. Gamble, "Farm Credit Situation in Alabama," Alabama Agribusiness, Vol. 21, No. 3, Jan. 1983, p.1.

The distribution of farm debt by debt/asset ratio indicates a dimension of the risk exposure of the agricultural assets of farm lenders. Over 60 percent of all farm debt is owed by farmers carrying debt/asset ratios over 40 percent. Farmers with debt/asset ratios of 70 percent or higher owe about 30 percent of all farm debt. Hence, the majority of all farm debt is held by high- to very highly-leveraged operators--precisely those operators who are most vulnerable to unstable commodity markets.

The effects of financial leverage on the profitability of a farm are illustrated in table 5. In 1982, the average rate of return to farm production assets was 3.3 percent, the sector debt/asset ratio was about 20 percent and the average interest rate on outstanding farm debt was about 11 percent. These factors combined to provide an average rate of return on equity capital of about 1.4 percent, the lowest rate of return in almost 50 years. The rate of return on equity capital measures the farmer's income return on his investment after taking into account his financing costs. It is important to note that financial leverage has a favorable effect on the return on equity only when the rate of return on assets exceeds the rate of interest. Otherwise it has an unfavorable effect. This is illustrated in the table and can be seen by comparing the return on equity as leverage increases under alternative interest rate scenarios. During the 1970's, the capital gains associated with rapidly rising farmland values made the use of financial leverage an effective strategy for magnifying farmers' total return on investment (equity) in spite of its adverse effects on cash flow. However, in a farmland market which provides little, if any, growth in land values, a strategy of balance sheet restructuring to lower the degree of financial leverage will be necessary for farmers with high financial leverage.

Since the farmer's profitability depends on his rate of return of assets, his debt/asset ratio, and his average interest rate, it is impossible to estimate how many farmers are making a negative return on equity. However, some useful insights can be derived. The farm lending industry is primarily concerned with the financial conditions of those farmers who have debt. The Census of Agriculture Farm Finance Survey indicates that in 1980 about 50 percent of all farm debt

Table 5--The effect of alternative debt/asset ratios and average interest rates on farm profitability in 1982

Debt/asset ratio	Interest rate on outstanding debt			
	Percent			
	3	7	11	17
	Return to equity capital in 1982			
	Percent			
0	3.3	3.3	3.3	3.3
20	3.4	2.4	1.4	0.0
30	3.4	1.7	0.0	-2.6
40	3.5	.8	-1.8	-5.8
60	3.6	-2.2	-8.2	-17.2
80	3.7	-11.5	-27.5	-51.5

Source: Table 5 is a modified version of one presented by Emanuel Melichar, "Update Tables for Developments in Agricultural Finance," Division of Research and Statistics, Board of Governors of the Federal Reserve System, March 21, 1983, Addendum Table 1.

was held by operators with debt/asset ratios over 40 percent. It has been estimated that as much as 65 percent of the debt is owed by operators in that category today. If these operators are earning the average return on their assets and pay the average interest rate, they are making a negative rate of return on their investment. In order for those carrying a debt/asset ratio of 40 percent to generate a zero rate of return on equity the return on farm assets must return to about 4.4 percent, slightly under the average for the decade of the seventies, excluding the 1973 abberation of 10 percent. How much can we expect the average rate of return on farm assets to rise during the next few years? Can we expect it to reach a level substantially greater than what had been experienced during the seventies? At best, one could assume, based on historical evidence, that the rate of return on farm production assets will rise only very gradually.

It is estimated that in 1983, up to 18 percent of all farm operators fall in the over-40 percent debt/asset ratio category. Those farmers owe about two-thirds of all farm debt. It is true that some of those farmers earn a rate of return on assets which is greater than the national average. Some pay more and some pay less than the average interest rate on outstanding debt. Also, many have greater than a 40 percent debt/asset ratio. Taking these factors into account, it seems apparent that significant numbers of farmers--mostly large commercial farmers with little off-farm income--will be suffering with severe cash flow difficulties in the foreseeable future. A relatively large percentage of the customers of farm lenders will continue to have serious cash flow problems. It is likely that a rather dramatic farm policy initiative would be required to improve commodity prices enough to provide a sustained rate

of return on assets at a level significantly higher than historical rates of return. Hence, progress must come through a substantial lowering of average interest rates and/or significant balance sheet restructuring at the farm level to reduce the debt burden. Neither of these options will be accomplished easily.

The major concern here is that the integrity of the farm credit delivery system be maintained. Balance sheet restructuring could be difficult to accomplish in a soft farmland market. Lenders have expressed concern over the possibility of a domino effect on farm asset values should there be a large number of forced sales in a region. If the financial market perceives a significant increase in risk to farm lenders, one could expect an increase in interest rates sector-wide.

Lender Responses to Current Financial Conditions in Agriculture

"Inability to repay debt ultimately could result in the borrower voluntarily, or involuntarily, going out of business....it is not the most accurate indicator of financial stress. Far more pervasive is the increasing reluctance of lenders to supply the full amount of operating capital that some farmers and agribusinesses desire." Agricultural and Credit Outlook '83, Farm Credit Administration, Dec. 1982, p. 18.

Delinquencies and Liquidations

"Since the first bankruptcy act in 1898, farmers have had special treatment under bankruptcy law as to being forced into bankruptcy involuntarily....Largely because of Congressional recognition of price and yield uncertainty faced by farmers, the 1978 bankruptcy act continues the exemption of farmers from involuntary bankruptcy." Professor Neil E. Harl, Dept. of Economics, Iowa State University in Agri Finance, Mar. 1983, p. 17.

"There is considerable debate as to the definition of a delinquent loan, and the actual interpretations vary among lending institutions....While indications point to increases in delinquencies, defaults and foreclosures in 1983, agricultural lending statistics do not reflect the serious weakness in the farm income picture. The major exception seems to be at the FmHA where delinquencies on farm loans are up sharply. This is explained in part because FmHA serves as a lender to borrowers who have been unable to get credit elsewhere." Menelaos Athanassiadis, Agri Finance, Dec. 1982, p. 10.

"Clearly, reliance on borrowed capital is presently an economic burden that is growing more difficult to bear. In contrast, most of the 1970's was characterized by conditions that

* rewarded the highly leveraged farm business....Within a relatively short period of time, a highly successful leverage strategy had become a prescription for financial distress." Agricultural and Credit Outlook '83, Farm Credit Administration, Dec. 1982, p. 18.

All farm lenders are experiencing higher than normal delinquency rates and liquidations. However, problem loans as a percent of total loans outstanding remain small. Nevertheless, the trend for delinquencies and other indices of credit problems has been on the rise for the last three years. The Payment-In-Kind program will help some farmers stay in business another year, but most lenders believe credit problems will continue in 1983.

Availability of Funds

* "We certainly have the farm sector in a depression-type state. But the farmer still has the potential of borrowing money and operating....In the 1930's credit was unheard of in the agricultural sector." W.D. Willer, Executive Vice President, Decorah State Bank (Iowa) and Chairman of the Amercian Bankers Association's Agricultural Division in Iowa Farm Bureau Spokesman, Mar. 21, 1983, p. 1.

* "I believe lending institutions are making a real effort to go the extra mile in working with farmers. Loans are being rescheduled and restructured." President Dean Kleckner, Iowa Farm Bureau in Iowa Farm Bureau Spokesman, Mar. 12, 1983, p. 20.

* "Today agriculture is facing a very critical period....the agricultural appetite for credit has been tempered. But knowledgeable agriculturists know this 'diet' will soon be over. Farmers will need to be retooled. Expansion will again be profitable and wise. Innovation both in technology and management will again predominate. It will not happen this year and probably not next. But when it does agricultural lenders of all types and variations will be needed to fill the requirements of America's farmers." Bruce H. Herz, Publications Manager, Agri Finance, Mar. 1983, p. 42.

Funds are available to lend to credit worthy farm borrowers. This is evidenced by low loan-to-deposit ratios at agricultural banks which averaged 55 percent in February 1983. This is down from 61 percent in September and from 58 percent a year ago. This average loan-to-deposit ratio at agricultural banks would be the lowest since March 1976 when it stood at 57 percent.

Qualifying for credit will be difficult for some farmers in spite of PIK, lower interest rates, and the dramatic increase in CCC lending activity in 1982.

Hence, without a considerable recovery in farm income in 1983 and 1984 (something that is not in the forecast), one can expect financially weak farm operations to continue to be "culled" from the farm community during the next couple of years.

Lender Approaches to Aid Financially Distressed Borrowers

> "Although farm failures will probably increase, in most cases they will result in partial liquidations and not a flood of farmers losing their land and livelihood. This is true in part because farm loans are not a big risk for commercial banks. Farm financing as it is now structured puts the burden of long term financing on the FmHA and the Federal Land Banks who don't have the liquidity problems that often plague banks during tight credit markets." Menelaos Athanassiadis, Agri Finance, Dec. 1982, p. 11.
>
> "Federal banking officials will allow banks to carry some borrowers delinquent in repaying farm loans, if at all possible, rather than foreclosing, an American Bankers Association (ABA) agricultural task force learned last week....the task force specifically queried federal banking regulators as to how they plan to handle agricultural loans in today's depressed farm economy." Iowa Farm Bureau Spokesman, Mar. 12, 1983, p.1.
>
> "I hope that lending institutions will stretch as far as possible, and regulatory agencies should be cooperative, in assisting farmers to survive and hold on to any viable farming operations." President Dean Kleckner, Iowa Farm Bureau in Iowa Farm Bureau Spokesman, Mar. 12, 1983, p. 20.
>
> "...bankers have stepped beyond traditional bounds of simply lending money to their agricultural customers, and are counseling and providing non-credit services." Statement by Special Agricultural Credit Task Force of the American Bankers Association, Mar. 1, 1983, p. 1.

In spite of the difficulties and risks faced by most farm lenders, they have been exercising considerable forebearance with their financially distressed farm customers. The most commonly cited characteristics of financially troubled farmers are that they are highly leveraged and/or poor managers. Most are working closely with such borrowers to help them to restructure their balance sheets in order to put them on a more sound financial footing. A survey of agricultural bankers conducted by the American Bankers Association in February indicated that the bankers will "stick with" about 95 percent of their farm customers in 1983. Indeed, farm lenders have an attitude of cautious optimism, primarily due to the PIK program and lower nominal interest rates.

Moratorium Proposal

> "...a moratorium would be disastrous to all farm borrowers. The bank obtains its funds from the sale of bonds to the investing public....Should the public feel that the liquidity of farm credit bonds could be jeopardized because of a moratorium, they could require a higher rate of interest to compensate them. This would cause the cost of money to all borrowers to go up....Also, investors might seek other investments." Jim Besore, Executive Vice President, Federal Intermediate Credit Bank of Omaha in Iowa Farm Bureau Spokesman, Mar. 12, 1983, p. 20.

The continuation of poor financial conditions in the farm sector has prompted some members of Congress to propose a moratorium on FmHA farm foreclosures. One proposal under consideration is S.24, a bill introduced by Senator Huddleston (Ky) that would impose a moratorium on foreclosures of certain farm borrowers. S.24 would compel FmHA to defer the principal and interest on any outstanding FmHA loan at the request of borrowers who own or operate family-size farms. The bill would also impose a moratorium on foreclosures of such loans where the borrower: (1) has followed good management practices, (2) due to circumstances beyond the borrower's control, is temporarily unable to continue making payment on such principal and interest when due, and (3) has a reasonable chance of repayment of the loan after deferral and foregoing of foreclosure. Interest accruing during the deferral period would be waived and, at the end of the deferral period, the borrower would be entitled to have the loan consolidated, rescheduled, or reamortized to provide equitable payment terms consistent with the borrower's farm financial situation. The interest rate would be equal to or lower than the rate prevailing on the original loan.

A moratorium on farm foreclosures is not a proper solution to the problem of economic hardship among highly-leveraged borrowers in the farm sector. Weak to poor conditions have prevailed in the farm sector for over 3 years. The FmHA has exercised considerable forebearance during this period, evaluating borrower situations on a case-by-case basis in determining whether and how to extend loan payback arrangements. FmHA has instituted foreclosure proceedings, only as a last resort, against those borrowers who are deemed unlikely to be able to get back on their feet and eventually repay the loan. The basic underlying problem has been and continues to be the economic conditions in the farm sector.

Support for this legislation has been mixed. Some proponents argue that the bill will put into law the principles on which the decision to foreclose is based--principles currently embraced by FmHA actions. Others argue that the FmHA is not embracing the principles proposed in the bill and that, if enacted, the new law would compel FmHA to adopt the legislative criteria. Some further argue that the law will reduce potential law suits by posting notice of criteria and procedures for foreclosure.

Opponents suggest that enacting such a law is unnecessary since FmHA exercises considerable forebearance with respect to borrower financial stress before initiating foreclosure proceedings. Others argue that FmHA, as a lender, should

not be hampered by a law requiring that agency to defer all loans of qualifying borrowers. Still others suggest that FmHA would not be doing many farmers a favor by extending loans where the farmers would be better off liquidating their assets and withdrawing whatever equity remains rather than falling further into debt.

Appearances constitute a major issue with respect to the legislation on FmHA foreclosures. Proponents claim that the current FmHA case-by-case decision-making appears arbitrary where the decisions and the criteria on which they are based vary. Opponents see the legislation as violative of free-market principles. Many private lenders also fear that if FmHA can not foreclose on even marginal cases, by law, private lenders who do so will appear to be the "big bad wolves." These lenders also fear that this legislation, if enacted, could be a first step toward government intervention in private lending actions.

The language in S.24 providing for loan deferral for borrowers with a "reasonable chance of repayment" prevents the bill from being a blanket moratorium proposal. The language, however, is broad, vague, and could become an open invitation for litigation to define the broad criteria contained within the bill, a result contrary to that suggested by proponents.

In general, if FmHA currently practices substantial forebearance before initiating foreclosure proceedings, then S.24 merely codifies and ensures the continuation of that current practice. If, however, FmHA is currently instituting foreclosure proceedings against borrowers who have a reasonable chance of repayment, a policy question arises as to how far FmHA need go before demanding payment under the terms of the loan agreement. If FmHA is not affording borrowers adequate notice regarding borrower options, pending cases may very well provide the procedural requirements with which the agency must comply before it may institute foreclosure proceedings.

Recent Developments in Taxation of Importance to Agriculture

"Participation in the payment-in-kind program--also known as 'crop swap'--could have some unanticipated tax consequences." Professor Neil E. Harl, Dept. of Economics, Iowa State University in Agri Finance, Mar. 1982, p. 12.

"In addition, the principle of controlling output by means of acreage programs stands as a contradiction to other public measures that are output-expanding. Examples of such measures are the funding of research and the promotion of conservation; but more flagrantly in conflict is the bundle of tax write-offs (shelters) that subsidize expanded output." Professor Harold F. Breimyer, Dept. of Agricultural Economics, University of Missouri-Columbia in Challenge, July-Aug. 1982, pp. 40-41.

Social Security Reform

The Social Security financing legislation recently passed by Congress restores financial soundness to the Social Security system by expanding coverage, taxing retirees' benefits, delaying cost of living adjustments and increasing payroll taxes and taxes on the self-employed. Of these measures, the higher payroll tax rates and the higher taxes on the self-employed would have the greatest impact on the farm sector.

Under the bill, the tax rate self-employed farmers pay on net farm income would increase by 21 percent in 1984. Self-employed farmers currently pay a tax rate of 9.35 percent on net farm income. This is approximately 70 percent of the combined employer-employee rate of 13.4 percent. Beginning in 1984, self-employed farmers will be required to pay the full combined employer-employee rate. This rate will be increased to 14.0 percent in 1984 and to 15.3 percent by 1990. A portion of this increase will be offset by a credit against Social Security tax liability. This credit would result in a net tax of 11.4 percent in 1984. The net tax would reach 13.02 percent by 1988.

The 1984 rate increase alone will increse self-employment tax liability from 250 to 300 million dollars. For most self-employed farmers the additional Social Security tax burden would greatly exceed any reductions in Federal income tax scheduled for 1984.

The effect of higher payroll taxes on the farm sector would be less significant. The current payroll tax for both employers and employees is equal to 6.7 percent (combined 13.4 percent). Under the bill, this rate would increase to 7 percent for a combined payroll tax rate of 14 percent. The combined rate would increse to 15.3 percent by 1990. The 1984 increase would be less than 5 percent. In addition, since employers of farm labor are still able to deduct payroll contributions for Federal income tax purposes, the net increase could be as low as 3 percent.

Payment-In-Kind Tax Treatment Act of 1983

Congress passed the Payment-In-Kind Tax Treatment Act of 1983 on March 10, just one day prior to the sign-up deadline for participation in the PIK program. Enactment of the legislation neutralized the impact of taxation on participation in the PIK program.

Under the Act, for tax purposes farmers are allowed to treat PIK commodities as if they had produced them themselves. Thus, a farmer would not realize income on PIK commodities until the year the commodities are actually sold. In addition, the Act makes it clear that cash basis farmers need not include reimbursements for storage costs in income until the year in which they are actually received.

Treating PIK commodities as if they were produced by the taxpayer would also allow cooperatives to treat as patronage source income the proceeds from the sale of such commodities. Consequently, the tax exempt status of agricultural cooperatives would not be endangered due to the marketing of PIK commodities on behalf of patrons who participate in the PIK program.

Participation in the PIK program raised concerns with regard to eligibility for special estate tax provisions. The Act clarifies the estate tax treatment of land diverted from production under the 1983 PIK program. Under the Act, a farmer who participates in the program will be treated as materially participating in the operation of the land under the program and such land will be treated as used in the active conduct of the trade or business of farming. Hence, participation in the program will not have an adverse impact on the ability to qualify for special use valuation or the installment payment of estate taxes.

The tax treatment under the Act applies only to land acquired by the farmer prior to February 24, 1983, unless the acquisition occurred by reason of gift, death or a family member. This antispeculation provision was included in the Act to prevent investors from purchasing farmland to take advantage of favorable PIK tax consequences.

The tax provisions under this Act apply to the 1983 crop year only. The continuation of the program in 1984 would require additional legislation with regard to the tax aspects of the PIK program.