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## Financing Smaller Farms

by

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Preserving the small or “family farm” has been a long standing concern of policy makers. Agricultural production experienced rapid concentration during the twentieth century and there is little reason to expect this trend to slow or reverse anytime soon. Vertical integration and horizontal consolidation will continue as farms adopt new technologies and thus enable farm operators to exploit economies of size, scale, and scope.

In this environment, family-sized farm operations face greater competition for productive resources from larger and often integrated *industrialized* farms, particularly in some commodity groups.<sup>1</sup> Yet, family farms, which are defined as those farms where most of the day-to-day labor and management are provided by the farm family, continue to be a mainstay of the farm economy. Their future and hence the structure of agricultural production will be affected by the ability of these operators to access capital at affordable rates.

There are benefits to an increasing farm size and industrialization of agriculture. If large farms are more efficient, the cost of food to consumers declines and resources within society are reallocated to the most productive use. On the other hand, the concentration and control of farm production creates concerns about possible impacts on rural communities as expressed by the *Small Farm Commission*:

*...but they (small farms) will fuel local economies and energize rural communities across America. ....small farms will contribute to the strengthening of society, providing communities and the Nation with opportunities for self-employment and providing a cultural and traditional way of life as well as nurturing places to raise families. (A Time to Act, Page 10)*

The Small Farm Commission further contends that:

*...small farms will be stronger and thrive using farming systems that emphasize management, skill, and ingenuity of the individual farmer. (A Time to Act, Page 9)*

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<sup>1</sup>See box for definition of italicized terms.

But even the most skillful managers may be unable to compete unless they have access to sources of affordable capital. In earlier times, operators of smaller farms could more easily lower their capital investment by spending more hours in the field. For modern farms, however, high amounts of capital investment are essential to attaining the scale necessary to maintain economic viability. A modern commercial farm has an average capital investment of over \$500,000, including owner supplied capital and capital from outside sources such as landlords or lenders.

There is a perception that smaller farms may have greater difficulty accessing outside capital than larger farms. Small business loans often represent greater credit risks because the owners have limited financial resources and business experience. The higher cost of evaluating and monitoring credit risks of small businesses, such as small farms, can raise their cost of borrowed capital relative to larger firms. Here, we examine methods used by smaller family farms to obtain capital. We also discuss structural changes occurring among financial institutions and how these changes could affect the availability of capital to small family farms. First, we start by identifying groups most likely to experience problems obtaining access to outside capital.

### *Defining Groups of Farms*

*Noncommercial-sized farm* - Under \$50,000 in annual farm sales which was further disaggregated into the following 6 mutually exclusive groups. The order in which they are listed represents the priority used in classification.

1. *Limited resource*- Household income less than 125 % of the poverty level and less than \$100,000 of farm net worth.
2. *Limited income* - Household income less than 125% of the poverty level and farm net worth \$100,000 or more.
3. *Retired farmer*- Farmers who identify their primary occupation as being retired.
4. *Country home farmer*---Non-retired farmers with operator dwelling valued at over \$80,000 and meeting one of following conditions: one-third total farm assets in the home dwelling; off-farm income of over \$40,000; or household net worth of over \$500,000.
5. *Hobby or lifestyle farmer*--Operators who consider their occupation to be something other than farming or who contribute less than 1,000 hours of labor to the farm.
6. *Part-time farmer*-Operators who consider themselves as farmers or contribute more 1,000 hours of labor to the farm.

*Small commercial farms*- Farms with between \$50,000 and \$250,000 in annual sales and where the farm family contributes 1,000 hours or more annual labor.

*Large Commercial farms* - Farms with over \$250,000 in annual sales, and where the family contributes substantial amount of annual labor.

*Industrialized farms*- Large farms with sales of \$1 million or more and where most of labor and day-to-day management is provided by hired employees rather than family members

## Defining Smaller Farmers

The National Commission on Small Farms was appointed by in July of 1997 to examine the status of small farms in the US and to determine the course of action for USDA to recognize, respect, and respond to their needs. The Commission issued their report *A Time to Act* to Secretary Glickman in January 1998. Following the recommendations of the Commission, we define small farms as those farms with less than \$250,000 in annual sales and for which the day-to-day labor and management are provided by the farm family. The Commission recognized that while \$250,000 in sales may be high for some commodities, in other areas, it is barely sufficient to provide a net farm income comparable to that of an average non-farmer. The Commission chose the \$250,000 definition because it believed that *farms up to that size are among those whose survival is most endangered*, *A Time to Act* (pg. 28).

The Small Farm Commission's definition includes 94 percent of all US farms. This is a broad definition, that encompasses many groups who are likely to have limited needs for capital or for whom accessibility of capital is not likely to be an issue. For example, farm operators who consider themselves retired would have little need for outside capital. Others, such as those with substantial net worths or off-farm incomes, should have less problem accessing outside capital sources. Hence, if one is to understand the nature and magnitude of the role outside capital plays for smaller farms, one needs to take a detailed look at their structural and financial characteristics. Specifically, what groups of small farms are more reliant on outside capital? What groups are more likely to have problems in obtaining outside capital?

### Noncommercial small farms

Though not an official USDA definition, farms with less than \$50,000 in annual sales are generally considered noncommercial since they do not generate enough sales to be a viable business on their own. These farms produce just 10 percent of the value of nation's food and fiber, but number 1.5 million (75 percent of all farms). Despite their low output, they can not easily be dismissed because they own nearly one-half of all farm assets and owe one-third of all farm debt.

Many noncommercial sized farms have limited needs for outside capital. Included in this group are 250,000 farms operated by farmers who consider themselves *retired* (table 1). Given their stage in life, these farmers have limited credit needs as indicated by less than 13 percent reporting any outstanding debt. Another 175,000 farms could more easily be classified as *country homes* than farms. These were characterized by high household incomes, higher valued homes, and higher net worths than other noncommercial farms. With average household incomes of \$76,000 and a average farm net worth of \$445,000, they should have little problem accessing outside capital sources. With 90 percent of their debt for real estate purposes and investment in the operator dwelling, these credits are more characteristic of home mortgages than of farm loans.

There are also 370,000 noncommercial sized farms where the primary operator contributes an average of 490 hours a year to the farm and does not consider their occupation to be farming. Many of the operators within this group could be considered *hobby farmers*. They also have high household incomes, averaging over \$50,000, and rely on commercial banks for much of their financing needs.

This leaves over 700,000 noncommercial farms for whom capital accessibility may be more of an issue. About 340,000 were *limited incomes* or *limited resource* farms with reported household incomes less than 125 percent of the poverty level (table 1). This group is likely to have problems accessing credit because of their low income. Since debt should not be considered a substitute for income, policy options designed to assist this group should include non-credit alternatives.

Another 390,000 farms are defined as *part-time* farmers who consider their primary occupation to be farming and contribute 1000 or more hour of labor to the farm. Included in this group would be those for whom *off-farm jobs are not a choice, but a necessity due to the inability to obtain an adequate return from farming* (A Time to Act, pg 18). While over 40 percent owe some debt, most of the debts outstanding are small. Nearly 80 percent of those with nonreal estate debt owed less than \$25,000 and 66 percent of those with real estate debt owed less than \$50,000. Compared to other noncommercial groups, FCS was a more important credit source supplying 28 percent of their credit. With an average age of 55 years and only 15 percent under 40 years of age, few young people within this group appear to be using off-farm jobs as a method to enter full-time farming.

### **Small Commercial Farms**

There are 400,000 farms with annual sales between \$50,000 and \$250,000, which owe over one-third of all farm debt and account for nearly a third of farm production. But, many of these have high net worths and, therefore, are not as concerned about accessing outside capital. Omitting farms with net worths of over \$500,000 leaves 240,000 smaller commercial-sized family farms for which accessibility of outside capital could be an issue. These farms are much greater users of outside capital than small noncommercial farms, with 78 percent reporting some term debt.

Farms with less than \$250,000 of net worth are of particular concern. Many of these farms require substantial outside capital to obtain a scale necessary to achieve a profitable farm business unit with sufficient income to support a family. Many are highly indebted with about half of the farmers under 50 years of age reporting debt-asset ratios greater than 0.50. Still, some of these low equity farms had limited indebtedness and would probably easily qualify for additional credit. Even for the farms with less than \$250,000 of net worth, about one-fourth of the indebted farms had relatively low debt burdens, with debt-to-asset ratios of less than 0.25.

Commercial banks are the primary supplier of debt to all small commercial farms. This is especially true for farmers under 36 of age with less than \$250,000 of net worth. Banks supplied 60 percent of all credit to this group, much of which was guaranteed by FSA (table 2). The Farm

Credit System's (FCS) market share was less than 15 percent. The Farm Service Agency (FSA) direct loans are an important source of credit for farmers with less than \$250,000 of equity.

Providing access to capital for young or beginning farmers has received greater attention from policymakers in recent years. Legislation has geared much of FSA credit programs to better serve beginning farmers. But, young farmers with limited equity rely much more heavily on renting land rather than purchasing land using credit. In 1995, commercial-sized farmers under 36 with under \$250,000 of net worth owned only 17 of the acres they farmed (table 2).

### **Trends Affecting Small Farm Financing**

Rural financial markets are changing rapidly. Change is coming from advances in technology, financial innovations, and deregulation. Many past barriers to more efficient credit delivery, such as geographic limitations on banking activities have been removed or are being liberalized. Such changes in the financial industry increase local competition and the integration of rural credit markets with national credit markets. Loan funding or the liquidity of rural credit markets, while a traditional concern, remains sufficient in the 1990s to meet the capital needs of most agricultural producers. But, some groups may be affected by the ongoing changes in financial markets. The increased usage of credit scoring and bank consolidation could have adverse impacts on the supply of credit to small farms.

### **Credit Scoring and Low Documentation Procedures**

Small credits are often charged higher interest rates because of the fixed cost of making and monitoring small loans. Agricultural lenders are turning to credit scoring and low documentation techniques to reduce the cost of credit decisions on smaller credits. Credit scoring, where the financial strength of a borrower is rated by a set procedure, has been used extensively in the delivery of trade credit by captive finance companies. Trade credit providers offer farmers one-stop competitively priced credit with credit decisions made within hours. Such credit is particularly appealing to small farms because it is convenient and is suited for their simpler credit needs. Unlike larger farms, smaller farms are less likely to have complicated credit needs. Also, trade credit providers are sometimes willing to take on less creditworthy customers with the prospect of profiting from sales.

Recent USDA studies have shown that providers of trade credit now supply about one-fourth of all nonreal estate credit to commercial-sized crop farms. Further, these nontraditional lenders are becoming increasingly dominant in the financing of smaller loans at the expense of FCS and commercial banks. These gains are a consequence of the cost advantages captive finance companies have had over banks and the FCS, who have used traditional loan making procedures. In order to become more competitive in these markets, traditional lenders are likely to make greater use of credit scoring and low documentation procedures. For example, the FCS has recently undertaken a trade credit financing program called AgSmart which employs credit scoring techniques. AgSmart is a nationwide point-of-sale credit product which will be marketed

by the FCS to retailers of agricultural inputs. AgSmart will fund operating loans, leases, as well as farm machinery and equipment loans.

Since financial institutions can not profit from product sales, they are likely to implement more strict credit standards. This would have both a positive and negative dimension for financing smaller farms depending on the creditworthiness of the borrower. For creditworthy farm businesses, credit scoring is expected to lower the costs of reviewing and monitoring farm loans, making it attractive for more lenders to enter this market. For less creditworthy farm businesses, the standardized rating techniques may increase the probably of loan denial.

Increased use of credit scoring could reduce costs and increase the attractiveness of farm loans of \$50,000 and under. This could result in greater availability and cheaper credit to noncommercial-sized farms and small commercial farms. Many of these farms appear creditworthy and have limited debt needs, making them strong credit scoring candidates. For noncommercial-sized farms, the credit history of the owner may be a more powerful predictors of loan performance than the farm business. The ready availability of this data from credit bureaus and other sources further suggests that lending to part-time farmers may no longer be the domain of community banks. Also, the expanded use of credit scoring will lead to standardization of loans and provide a basis for evaluating pools of similar loans. This ability to securitize a wide range of farm loans may encourage other nonfinancial institutions, such as farm supply cooperatives, to increase their small farm lending.

Low-equity small commercial farms and younger farmers, who are denied credit using credit scoring will continue to rely on traditional financing provided by community banks and FSA. FSA guaranteed loan programs will be important in providing these credits. But, increased use of low documentation procedures by banks and the FCS could deter loan guarantee usage because of the greater documentation requirements. To address this issue, FSA is in the process of examining its documentation requirements for small loans.

## **Banking Structure**

Commercial banks are still the largest suppliers of debt capital to U.S. farms, including small farms. Banks hold nearly 40 percent of all farm debt but supply a greater share of the debt owed by smaller farms. Changes in the structure of the banking industry raises concerns that bank lending to smaller farms may suffer. Mergers and consolidations within the banking industry are yielding larger banking organizations while reducing the number of small banks that are important lenders to small businesses. Since 1986 the number of commercial banks in the US has declined by nearly a third. Further, since 1990 the share of agricultural loans made by banks with under \$100 million in assets has declined while the share made by banks with over \$300 million in assets has increased.

Community banks are believed to have a competitive advantage in lending to small businesses because of their ability to access and monitor the operations of enterprises in their local

communities with which they may have multiple business relationships. Relationships are important for accessing credit, but it is less obvious how terms may be affected.

Empirical investigations of the effect of bank consolidation on lending to small businesses have produced a mixed picture. Small business loans constitute a small percentage of total loans for large banks and a large percentage of loans for small banks. This suggests greater concentration may threaten the flow of credit to small farms. However, when small banks merge or small banks merge with mid-size banks, there appears to be little change in small business lending. In markets where mergers have reduced small business lending, other lenders have increased their share of small business lending. Also, farm lending in regions with high concentrations of commercial farms have not been adversely affected by bank consolidation. But, small farmers in nonfarming regions, such as the Northeast, may have to rely more on non-bank lenders as a source of credit.

### **Leasing and Contracts**

Leasing has always been one of the more common methods of “financing” the control of farm real estate. Studies indicate that for all commercial farms, 40 percent of total capital utilized by the farm firm is leased. This percentage rises sharply for less established younger farmer and low-equity farms. While over half of all farm real estate capital is leased, for young operators with less than \$100,000 of equity, this share approaches 90 percent.

In addition to the leasing of farm and ranchland dominates, the leasing of farm machinery and equipment is also an important financing option for small commercial farms. Leasing is often attractive because access to new technologies can be obtained with lower down payments and lower cashflow demand. As such, there is a greater tendency for less established operators to use equipment and farm structure leasing.

While machinery and equipment leasing remains small in volume relative to debt financing, leasing is growing. Leasing is now widely available and often offers a competitive alternative to borrowed capital. The FCS’s leasing arm, the Farm Credit System Leasing Corporation, has experienced a steady growth in leasing volume during the 1990s.

A rise in contract production in the 1990s is also affecting the way small farms obtain capital. An estimated 30 percent of crop production is now under some type of contracting arrangement. Pork production is currently following the path that broiler production undertook in previous decades. With contractual business relationships, the creditworthiness of a farmer is affected by the strength of contracts with integrators. Also, the integrator provides much of the operating capital, such as feed or livestock. These relationships have enabled small farms with limited equity and less collateral to enter into certain farm business enterprises. USDA studies have shown, for example, that contract hog producers have significantly less net worth than non-contract producers.

### **Attracting Equity Capital**



Nonfarm equity capital has been discussed as a method of capitalizing certain farm businesses. In some instances, farmers have made use of limited partnerships and limited liability corporations to attract investors. But these types of instruments are more attractive to firms with higher earnings potential. In most cases, the low returns in farming discourages outside equity investments. Granted, a few small commercial farms businesses do provide returns sufficient to attract equity capital. For example, about 15 percent of all smaller commercial-sized farms reported net farm incomes of \$40,000 or more and profit margins of 20 percent or more. But, these farms could easily qualify for credit. The main advantage of equity investments would be in lowering the risk profile of these farms.

One alternative for providing equity financing for farm businesses would be the creation of specialized Small Business Investment Corporations (SBICs) for lending to agriculture. SBIC's which are licensed and regulated by the Small Business Administration (SBA), are privately owned and managed companies that provide start-up financing to small businesses. Return expectations for SBICs are fairly modest, averaging just over 11% for the 1977-96 period. With nearly 40,000 smaller commercial-sized farms providing returns of at least this in 1995, many would be viable investments. But, SBICs have fairly significant limitations as to their investments. Investments for working capital, such as vehicles and machinery, are restricted. Also, investments are short-term (typically less than 10 years), limiting their use for financing real estate. While there is limited market potential, this concept may be useful in funding value-added processing or marketing ventures of small farms.

In 1995, farms with less than \$250,000 of equity and operated by farmers 35 and under reported an average return on assets of -2.8%. Thus, beginning farmers, especially those with limited equity, are less likely to have returns sufficient to attract outside equity capital. Many of those in this group will rely on gifts or inheritances received from family members or on the benevolence of the rural community. An example of this benevolence are programs linking retiring with beginning farmers. Typically, the beginning farmers receive use of the land and equipment at a reduced rate.

### **Government Loan Assistance**

While funding for farm lending has generally not been a problem, creditworthiness remains a problem for some small farms. To assist these borrowers, FSA provides credit assistance through two mechanisms: direct and guaranteed loans. Direct loans are originated and serviced by FSA, whereas guaranteed loans are originated and serviced by qualified commercial, cooperative, or nonprofit participating lenders.

Previous USDA research indicates that FSA programs serve borrowers with less wealth, higher indebtedness, less capacity for further debt, and lower incomes. The programs appear to be well targeted to small farms, with 85 percent of outstanding direct program debt and 70 percent of guaranteed program debt incurred since 1984 being owed by small farms. During the 1990s legislation directed FSA's programs to better serve beginning farmers, particularly in the direct loan programs. In fiscal 1997, nearly 90 percent of the loans made directly by FSA to farmers

for the purchase, improvement or refinance of farm real estate were made to beginning farmers.

With nearly 70 percent of USDA credit assistance now coming through guaranteed lending, these programs represent one of the primary safety nets for farmers. Although, guaranteed lending goes primarily to small farms, there is some evidence to suggest that participating lenders are reluctant to seek guarantees on short-term loan requests because of the additional origination and servicing costs. FSA is examining its program rules regarding smaller loan requests, simpler lending requirements could spur participating lenders to increase lending to small farms. Guaranteed loans are made primarily by commercial banks, which account for about 80 percent of outstanding guaranteed loan volume. The FCS is a minor participant in FSA programs. But, the FCS is required by law to operate programs for furnishing sound and constructive credit and related services to young, beginning, and small farmers and ranchers. USDA analysis indicates that some FCS institutions take these requirements more seriously than others. USDA analysis also indicates that FCS lenders underserve young, beginning, and small farms relative to their overall market share of farm debt. The Secretary's Small Farm Commission has recommended that FCS's commitment to serving these borrowers be strengthened by requiring that it devote at least 15 percent of its total lending to farmers under 36 years of age.

### **Summary**

Most of the 1.9 million small farms, as defined by the Small Farms Commission, should have little problem accessing outside capital sources. Most of these small farms would be considered noncommercial since they have less than \$50,000 in annual sales. A majority of these noncommercial-sized farms do not carry any debt. Further, many have household incomes which are above the national average. They tend to rely heavily on banks for their farm credit needs. The ongoing consolidation of the banking industry may mean that these farms have fewer conventional sources of credit. But, because of their creditworthiness and limited credit needs, these borrowers should have ample access to credit.

Smaller commercial-sized farms with less than \$250,000 of equity represent the group most likely to face capital constraints. Most of these farms would require substantial outside capital to obtain a scale necessary to provide a sufficient income to support a family. Further these farmers rely quite heavily on banks for their farm credit needs. Since many lack the financial soundness to qualify for loans using credit scoring or low documentation procedures, greater use of these procedures could adversely affect their credit sources. Also, the consolidation of the banking industry could result in fewer sources of credit available to them. Thus, farmers with limited equity may have to rely more heavily on non-bank lenders. FCS institutions could become a much more important source of credit to small farms with limited equity. But, for FCS to accomplish this task they will need to increase their usage of guaranteed loan programs.

Implementation of the initiative proposed by the Small Farms Commission would obviously

help the economic viability of small commercial-sized farms with limited equity, but at a cost to taxpayers. Policymakers need to recognize that neither subsidized credit programs, nor tax incentives will completely make up for the disadvantages of being under-capitalized. In addition to *utilizing farming systems that emphasize management, skill, and ingenuity of the individual farmer*, the long run economic viability of these farms will require an integrated effort on the part of public and private entities. One possibility would be private sector foundations set up to provide grants to outstanding young beginning farmers. These grants could be combined with existing programs such as the FSA or State loan programs. Organizations which serve agriculture could be encouraged to set-aside a portion of their profits to help fund a foundation which provides grants or awards to outstanding young farmers who otherwise have limited capital.

**Table 1. Financial and structural characteristics of non commercial sized farms.**

	Limited Resource	Limited Income	Part-time	Retiree	Country Home	Hobby- type	All
	-----percent of total for US-----						
Total farms	6	11	19	12	8	18	74
Farm production	1	2	4	1	1	1	9
Farm assets	1	10	12	8	10	8	48
Farm debt	3	5	7	1	6	7	28
	-----percent-----						
Acres owned/ acres operated 80	53	83	77	90	87	83	
Farming as primary occupation	43	59	60	0	25	0	29
Farms with term debt	41	45	43	13	40	49	39
Indebted farms with:							
Mortgage debt < \$50,000	77	56	66	66	45	75	68
Nonreal estate debt < \$25,000	66	84	78	88	73	73	81
Debt market shares							
FCS	12	15	28	40	9	8	18
Commercial bank	50	56	49	41	85	70	64
	-----dollars per farm-----						
Farm assets	69,666	377,032	270,046	268,806	474,174	168,867	267,273
Farm operator dwelling	29,000	61,000	54,000	68,400	135,000	49,000	66,000
Farm debt	21,948	24,528	20,411	4,696	34,608	19,623	20,022
Farm net worth	47,718	352,504	249,635	264,110	439,566	149,244	247,251
Net farm income	(2,023)	(5,666)	144	6,927	644	(173)	(546)
	-----dollars per household-----						
Household income	5,200	2,100	43,760	41,670	75,700	52,900	40,150
	-----years-----						
Operator age	53	59	55	69	52	48	55
	-----hours per year-----						

Operator labor hours                    1,300                    1,700                    1,650                    800                    1,100                    490                    1,134

Source : Farm Costs & Returns Survey, 1995.

**Table 2. Financial and structural characteristics of smaller commercial-sized family farm with less than \$500,000 net worth.**

	Operator age						All Farms
	35 and under		36 - 49		Over 49		
	Net worth < \$250,000	\$250,000 ≤ Net worth < \$500,000	Net worth < \$250,000	\$250,000 ≤ Net worth < \$500,000	Net worth < \$250,000	\$250,000 ≤ Net worth < \$500,000	
	-----percent of total for US-----						
Total farms	2	1	3	3	2	3	12
Farm production	2	1	3	4	2	4	17
Farm assets	1	1	1	3	1	3	10
Farm debt	2	1	5	6	3	4	21
	-----percent-----						
Aces owned/ acres operated	17	43	30	52	53	66	46
Farms with term debt	75	75	82	88	65	77	78
Indebted farms with:							
Mortgage debt < \$100,000	83	39	62	59	64	66	65
Nonreal estate debt < \$50,000	66	66	58	62	69	78	65
Debt market shares							
FCS	13	*	12	18	22	28	19
Commercial bank	60	42	40	47	40	50	45
FSA direct loans	13	*	25	*	30	8	17
Farms with FSA guarantees	28	4	6	6	4	4	8
	-----dollars per farm-----						
Farm assets	176,357	437,634	239,915	482,061	212,543	458,275	334,524
Farm debt	66,933	100,321	106,776	128,113	73,163	86,642	94,937
Farm net worth	109,424	337,313	133,139	353,948	139,380	371,633	239,587
Net farm income	17,613	30,552	9,863	11,296	15,034	13,170	13,743

	-----dollars per household-----						
Household income	28,381	36,700	29,640	26,402	36,071	36,875	31,830
	-----years-----						
Operator age	31	31	42	42	61	60	47

Source : Farm Costs & Returns Survey, 1995.