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# The Business of an Agricultural “Way of Life”

By Steven C. Blank

In an earlier *Choices* article, Blank (2002) argued that a majority of America's farms and ranches are “hobby farms” that represent a lifestyle choice more than a commercial business. In answering the question “Is agriculture a ‘way of life’ or a business?”, Blank concluded that:

Agriculture is both a way of life and a business. It is a way of life to, possibly, all participants, but it is a business to only some. Large-scale “commercial farms” clearly act like businesses. Many of those farm operators may also view their business as a desirable way of life. On the other hand, “rural residence farms” are hobbies that operators must subsidize with earnings from off-farm sources. (p. 29)

This article takes the analysis a step further by posing a second explanation for why farmers are willing to subsidize their family farm. It abandons the naive view, often expressed by farm advocates, that rural residents are only in it for the lifestyle. That gross underestimate of farm owner-operators' business savvy is replaced with a modern view of the big picture.

## The Never-Ending Debates

In agricultural policy debates, farm advocates have often used the “way of life” argument to support their claim that production agriculture in general and family farms in particular need to be protected in various ways—such as subsidization through direct and indirect government payments. However, many things in agriculture are not what they seem. The net farm income totals reported by the United States Department of Agriculture (USDA) overstate the profitability of agricultural production while they understate the profitability of being a farm owner-operator. The overstatement comes in the form of direct government transfers to agriculture that in some recent

years have been nearly half the total net farm income reported by the USDA (2005). The understatement comes from the income data's focus on only farm/ranch production related activities, ignoring other sources of income. Of these two misrepresentations of American agriculture's big picture, the understatement is far more important. It leads to the perception that an agricultural way of life is one of poverty for most farmers, thus providing a justification for government support.

However, if things down on the farm are so bad, why do farmers stay in agriculture, and why has the number of farms with annual sales of less than \$10,000 increased since 1992, while total farm numbers continue to decline? As Blank noted, the reverse migration from cities to small farms observed over the past decade suggests that more Americans want to pursue a rural lifestyle (Deller, Tsai, Marcouiller, & English, 2001). But is that all there is to it?

The debate over why farmers stay dates back many decades and is typified by Brewster's (1961) hypothesis that farmers willingly accept lower returns than other investors because of the lifestyle benefits derived from farming. This view often leads to a mistaken interpretation of the fact that most farmers are part-timers. The misinterpretation usually made is that farmers seek off-farm income simply to enable them to pursue their lifestyle choice. However, a second possible explanation for why farmers stay is implied by the results of Blank, Erickson, Moss, and Nehring (2004), who found that farmers' wealth comes from capital gains, not production income. This leads to the proposition that many owner-operators may be real estate investors using off-farm income to help them stay on the farm until they choose to capture their capital gains. This implies that farmers, like all investors, have a desire to build wealth, which is consistent with the view that owner-operators see agriculture as a business.

**Table 1.** Average rates of return by region, 1960–2002.

	ROA from current income	ROA from capital gains	Total ROA	SD of total ROA	Total ROE	SD of total ROE
Northeast	-0.03	2.56	2.54	3.65	2.24	4.38
Lake States	1.82	2.13	3.95	6.22	3.53	8.15
Corn Belt	3.13	1.06	4.18	7.83	3.86	9.57
Northern Plains	3.97	0.83	4.80	6.57	4.57	8.37
Appalachia	2.58	1.45	4.04	4.59	3.86	5.52
Southeast	5.50	1.92	7.42	4.48	7.90	5.50
Delta	4.62	-0.02	4.60	6.58	4.34	8.42
Southern Plains	1.87	0.71	2.58	4.92	2.27	5.88
Mountain	2.67	1.24	3.90	5.51	3.78	6.88
Pacific	5.41	0.97	6.39	4.95	6.84	6.57
AK & HI	2.93	1.92	4.85	5.26	4.92	5.80
US total	3.04	1.26	4.30	5.26	4.12	6.60

Note. ROA—return on assets; ROE—return on equity; SD—standard deviation of the time series.

### Wealth is the Key

A business has the objective of increasing the wealth of owners. For most small and mid-sized farms, owners' wealth is reduced by the production losses they incur most years, on average; thus, they are often labeled as "hobby farms" (Mishra, El-Osta, Morehart, Johnson, & Hopkins, 2002). However, if you understand the full definition of wealth, you know that production income is only one source.

Three types of income (or economic gains) contribute to wealth: profits from farm output, off-farm income, and capital gains on assets. Total wealth ( $W$ ) is usually expressed as equity at time  $t$ . Changes in wealth during a time period ending at  $t$  ( $\Delta W_t$ ) equal farm income ( $FInc$ ) plus off-farm income ( $OFInc$ ) plus capital gains ( $\Delta K$ ) minus consumption ( $C$ ), or  $\Delta W_t = FInc_t + OFInc_t + \Delta K_t - C_t$ .

Capital gains are simply the change in value of a farmer's capital from one period to the next:  $K_t - K_{t-1}$ . Capital gains are only realized if the asset is sold. However, lenders will usually loan a farmer up to some

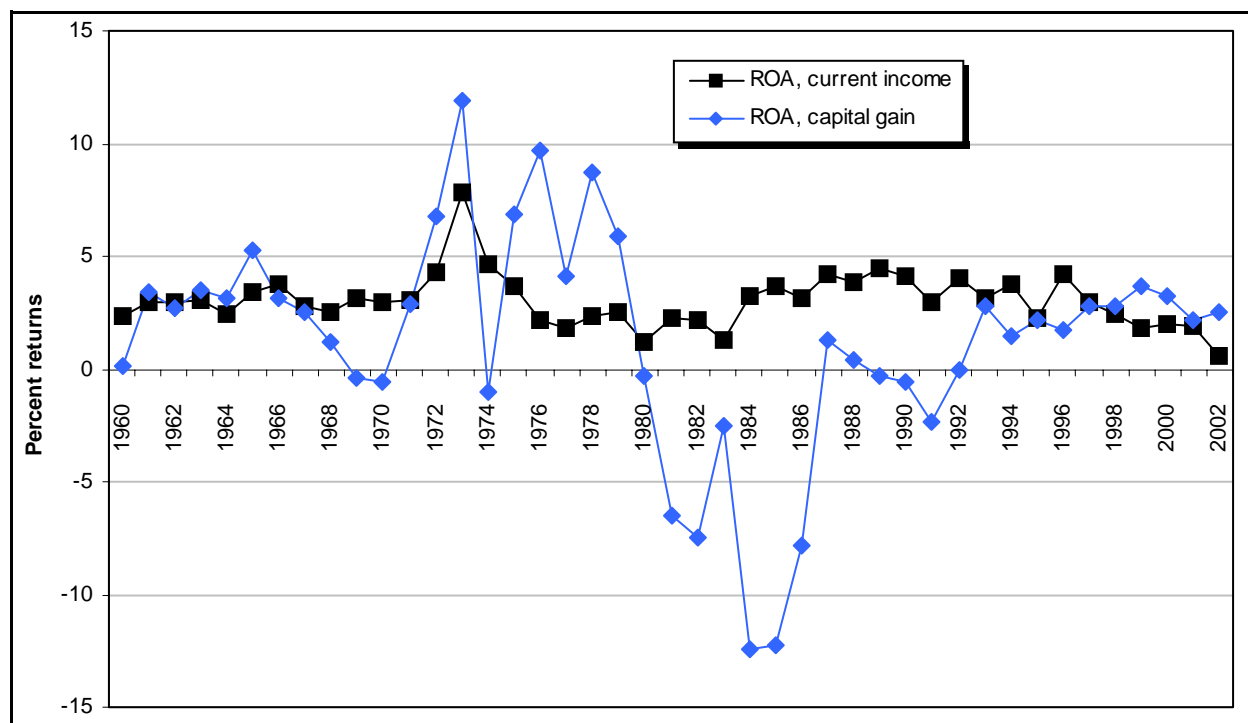
specific portion of the market value of assets, referred to as the *loan-to-value* ratio. Thus, some portion of unrealized capital gains can be immediately converted into cash and used to acquire other assets. In this regard, capital gains—even unrealized gains—immediately improve a farmer's ability to borrow, and thus they aid in financing a larger operation, which presumably will increase the growth in wealth.

So, how are agricultural producers doing in generating income to build wealth? The 2002 Census of Agriculture (USDA, 2004) reports that 53.3% of all farms generated a net *loss* for the year, although the average household earnings from farming activities for that year were \$3,473 (USDA, 2005). Clearly, this amount is not sufficient to support a family—it does not exceed household consumption cost. Thus, relying on this source of income only would result in annual reductions in household wealth.

So, why continue to farm? Although income from farming activities is low, on average, if it is still positive, it helps operators cover

(at least part of) their ownership costs. As an investment, farming has generated a positive return for American farmers. The first column of Table 1 shows the average return on assets (ROA) received by producers in the different regions of the country, plus the average for the United States, over the 1960–2002 period. It shows that over the long run, American agriculture has generated a 3.04% average return on assets used in production activities. That provides some incentive to continue investing in the business.

What about capital gains? Farmland has historically represented about 75% of assets held by farm households (USDA, 2000). Therefore, the ROA from capital gains reported in the second column of Table 1 are primarily from farm real estate. Agricultural land prices are the result of assessments of a parcel's value by both agricultural and nonagricultural markets (Drozdz & Johnson, 2004; Plantinga, Lubowski, & Stavins, 2002), and many of those factors are out of the control of the farm owner. Therefore, farmland values vary much more than do the val-



**Figure 1.** US agriculture's returns on assets, 1960–2002.

ues of other agricultural assets, but they have generated an average return on those assets of 1.26% annually for owners over the 1960–2002 period. The volatility of the two sources of returns is apparent in Figure 1. What is also apparent is that returns from capital gains have been higher than returns from current production income for most of the past decade. What is not apparent is the relative scale of the contributions to owner wealth that are made by capital gains.

As it turns out, capital gains have increased owner-operators' wealth more than have farming profits, on average, in many years. For example, in 2002 the Census of Agriculture found that the estimated market value of farm real estate was \$1.145 trillion dollars. Assuming that the long-run national average rate of return from capital gains of 1.26% (shown in Table 1) was earned on the real estate gives a conservative estimate of \$14.4 billion for capital gains in agriculture for 2002. That total

equals \$6,777 in capital gains earned for the year by each of the 2,128,739 farms reported in the Census. The actual capital gain rate reported for 2002 was 3.18% (USDA, 2005), which gives an estimate for average capital gains of \$17,078 per farm—nearly five times as much as the average amount of farm income per household. Therefore, capital gains are relatively much more important in building farm owner-operator wealth, even though they look relatively minor when reported as in Table 1. In addition, the distribution of capital gains is likely to be weighted more heavily toward small lifestyle farms (that are more often closer to cities) than to large commercial farms (that are usually farther from urban areas). In other words, it is expected that small farms are earning above-average rates of capital gain, thus improving owner-operator wealth faster for lifestyle farms because of the “urban influence” on

land values in their location (USDA, 2000).

Finally, it should be clear that farm income must be augmented by off-farm income to cover the cost of living for most farm households. Even if capital gains could all be realized each year, combining the long-run annual average of \$6,777 in capital gains with the low average earnings from farm activities (\$3,473 in 2002) gives an average farm household income of only \$10,250 per year—far below the poverty line for a family of four. Therefore, off-farm income is a necessity for most farmers. Is this an indicator of poverty?

Apparently not. Farmers are doing better than the rest of us, on average. The average off-farm earnings of farm households in 2002 was \$62,285, with lifestyle farms averaging much more than that and large farms averaging much less (USDA, 2005). Combining this figure with the \$3,473 average earnings from farming activities gives a total income

of \$65,757, which was 13.7% higher than the US average household income of \$57,852 for that year. This means that farm households may be building wealth faster than other Americans, on average.

So, who wants to argue that the agricultural “way of life” needs government subsidies?

## **A Growing Investment**

Agriculture is a way of life to rural residents, but it is a business to all its investors, including absentee owners. Large-scale farms clearly act like profit-maximizing businesses. On the other hand, most smaller farms are lifestyles that provide owners with deductions to write off against their taxable earnings from off-farm sources while gaining wealth in the form of capital gains. In other words, all farmers are pursuing both lifestyle and business goals. This can be more easily understood if we describe farm and ranch owner-operators as investors and wealth builders like all businesses.

A business that builds wealth primarily from capital gains is an investment firm. In many cases, a farm is a passive investment that does not interfere with the owner’s ability to work off-farm. The Census shows that 54.8% of all farmers reported working off-farm at some time during 2002, with the share being higher for small farms and lower for large farms, as expected. Even more telling is that 39.1% of farmers reported working off-farm 200 days or more during the year. That is virtually full-time employment! No wonder farmers earned more money per household off-farm during 2002 than the average American household earned in total. This indicates that farm owners are a talented group and are valued by the labor market, on aver-

age, more highly than average Americans are. Therefore, the business savvy of farmers should no longer be underestimated.

Many farmers are smart investors who have taken “moving to the suburbs” one step further and have found wealth. The direction of causality in the migration from cities to small farms is unclear. Do rising rural real estate values cause the migration, or does migration raise farm real estate values? Or are both explanations working in a circular fashion?

Clearly, the answers vary across the country. For example, the regional results in Table 1 show that farms in the Northeast and Lake States derive a majority of their long-run returns from capital gains, which have outperformed returns from agricultural production as an investment. The reverse has been true in the Delta region. Thus, the relative portions of “farms” in a region that might be called “investment firms” will differ across locations.

## **What is a “Farm”?**

The discussion to this point has raised questions about whether all operations currently defined as “farms” by the American government truly deserve that label and the government support that comes with it. This article offers the proposition that many owner-operators may be real estate investors using off-farm income to help them stay on the farm until they choose to capture their capital gains. If this description fits an operation, it can be argued that the household is more accurately portrayed as an investment firm, even if they are enjoying an agricultural way of life. For these firms, the business motivating their rural way of life has little to do with real agriculture.

“Real” farms and ranches make a real effort to support their household on earnings from agricultural activities. This means making household labor allocations with the primary objective of producing agricultural output, rather than viewing agriculture as the residual market for excess labor in the household. When more household labor is allocated off the farm than is allocated to agricultural activities, the operation is primarily a real estate investment firm, not a farm.

However, care must be taken when trying to distinguish between real farms and investment firms. Sometimes farmers act very much like investors in their business decisions, but they have very different motives. For example, it has often been observed that farmers reinvest most farm income into their operations. This raises the question: Do farmers reinvest out of economic necessity, or are they making investments in expanding their farms to increase their long-run wealth derived from increased capital gains? It might appear that any investment made with capital gains in mind indicates that the person is not a real farmer. However, farm real estate investments play a very important role in the life of real farmers: providing current farmers with a retirement “nest egg.” With no other source of income, most real farmers need to capture their farmland capital gains to be able to retire from the business that has been their life. Ultimately, differences in the nature of investments made in a farm will indicate whether the household is operating like a real farm or an investment firm. A farmer makes investments that raise the value of the operation as a “working farm.” An investment firm makes investments that raise the real estate value of the operation.

Some investments can raise both values.

### Policy Implications

Policies aimed at protecting an agricultural “way of life” are outdated and badly in need of replacement by programs that are based on an understanding of the true business objectives of those living in rural America. The country needs a modern definition of what constitutes a “farm” and an agricultural policy with differential treatment of farms across scale ranges with regard to policy benefits. Also, care must be taken in land-use policies so as not to hurt those people who have served the country as agricultural producers.

At present, at least 53% of farms lose money each year, on average, and focus much of their attention and household labor off-farm. This raises the question of whether those operations should be considered “farms” and receive agricultural policy benefits. It does not make good business sense for the country to have taxpayers subsidize these real estate investors. Yet current subsidies include income tax breaks and direct government payments to farm owners totaling billions of dollars each year. The fact that a lot of money goes to large farms and/or absentee owners adds fuel to the argument that much of agricultural policy is no longer accomplishing its original goals of providing an economic “safety net” for those people producing our country’s food supply.

Land-use policy now holds the future of American agriculture. The lifestyle-driven reverse migration from cities to rural areas has several economic impacts on American agriculture. It creates demand for agricultural parcels that can be developed; thus, it increases the price of farm-

land in at least two ways (Drozd & Johnson, 2004). First, farmland with potential for development serves two markets (rural and urban) and is valued at its “highest and best use,” which is the urban value. Second, each time land leaves agriculture there is a new delineation of the urban fringe, thus causing an outward ripple in land prices reflecting the new pattern of development potential. This can raise the value of current farmers’ retirement “nest egg” but can also make it more difficult for new farmers to enter the profession. On the other hand, if land-use policy tries to keep land in agriculture through zoning (for example), it can hurt real farmers. Without the freedom to capture the development value of their farmland, many farmers will lose most of their expected retirement funds.

Thus, policy-makers need to understand the composition of real farmers’ wealth and the effects of any proposed legislation before undertaking a much-needed overhaul of agricultural programs. The country would be better served by investments in “real” farms, rather than in “lifestyle” operations housing real estate investment firms in rural locations.

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