How do Farmer's Build Wealth?

by: Joe Parcell, Extension Economist

The goal of the farm business, like most business, is to acquire wealth in the business. Wealth provides some assurance for comfortable living beyond farming, allows for the continued operation of the "family farm" by passing down the farm to the next generation, and is a social status for success. Building wealth in the farm business occurs when a farmer's net income for an operating year is positive after all expenses, taxes, and interest such that the farmer can invest back into the farm business. Additionally, equity can be acquired through assets appreciation. Current assets will not appreciate in value because by definition they are short-term assets that are held for a short time by the farm business. Non-current assets can appreciate in value; however, there are two classifications of non-current assets. The first has historically been referred to as intermediate assets, e.g., buildings and equipment. Buildings and equipment are purchased with the intentions of depreciating the value of the asset in relation to the use of the asset. Because the intensive use of intermediate assets causes wear, the value of the intermediate assets will typically decline over time.

The final non-current assets category is long-term assets. The primary asset in this category is land. Land can be continuously productive if proper management practices are followed. Thus, the productive nature of land seldom decreases over time. Actually, the productive nature of land almost always increases over time as technological changes allow for management practices that increase land productivity. Farmers have needed to increase the acreage in their operation to take advantage of the economies of size associated with cost reduction on large-scale farming.

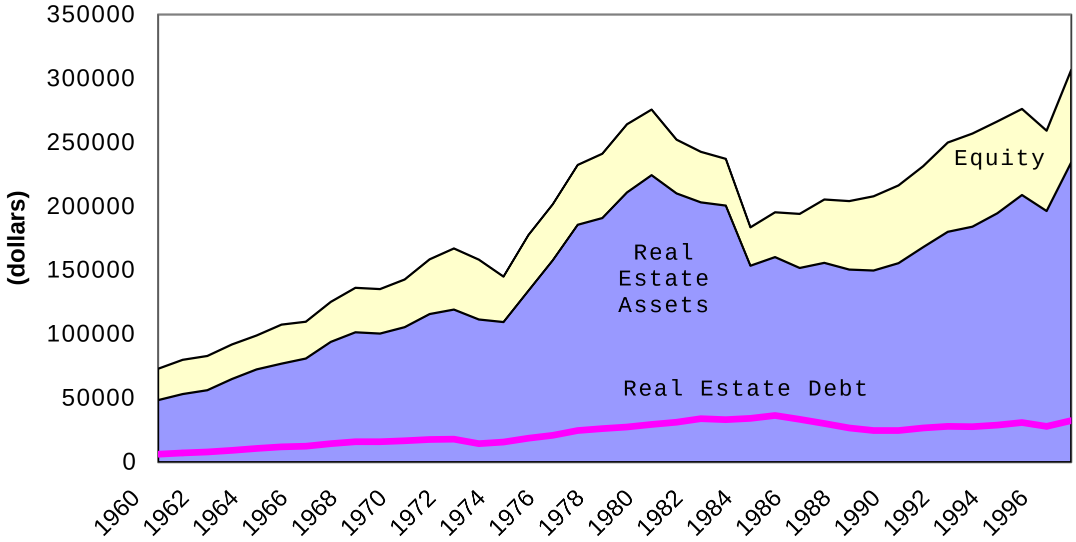
Additionally, inflation, the overall increase in prices, tends to push land prices higher over time. The primary components effecting the level of inflation are macro-level demand and supply shocks. A demand shock might be a change in the employment rate and a supply shock might be a change in oil stocks. Because the demand for agricultural products is determined by the derived demand for the processed goods by consumers, inflation implicitly impacts land prices.

Therefore, it is not surprising that land (real estate) assets are a farmer's major source for increasing wealth in the farm business. Figure1 graphically depicts this relationship for Missouri agricultural producers for the period 1960 to 1997. During this period Missouri owner equity has increased by $233,638, total assets have increased by $277,108, and real estate assets have increased by $212,575. Thus, increased real estate assets have accounted for 77% of the increase in total farm assets. As indicated in the figure, debt on real estate has increased on slightly over this time period. Equity has increased at a rate of 3.8% annually and real estate assets have increased at a rate of 4.3% annually. The annual increase in land values over this time for Missouri has been around 5%. An increase in land values has contributed substantially to the increase in real estate assets and simultaneously to an increase in owner equity.

Over this time period, the change in real estate asset value was 91% of the increase in operator equity. Clearly indicating increasing real estate assets, either through purchase or appreciation, increases farm wealth. And, this suggests that farmers may need to continue to purchase land to continue the realized rate of growth in equity has been seen over the past three decades.

What can be said about the future of land ownership? Agricultural producers will continue to purchase land for equity growth. Renting land can help to increase the rate of return on equity, but for long-term equity growth a farm business will need to purchase land for expansion or to replace land currently being rented. This is not suggesting farms need to grow in size, but reallocate between renting and owning land.

Figure 1. Missouri Average Farmer Total Farm Equity, Real Estate Assets, and Real Estate Debt (real 1997 dollars).



Source: Economic Research Service