Future U.S. Agricultural Production at Stake: The Challenge of Agricultural Producer Transition

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Introduction

The average age of U.S. farmers and ranchers has continued to advance for many years. The 2007 Census of Ag reports that the average age of farmers is 57 years and that the fastest growing segment of farmers are those 65 years of age and older. In some regions of the country and in some types of agricultural production, these demographic trends are much more pronounced. For example, the proportion of older producers is higher in the South and West and among beef cattle producers.

The question of transition from older producers to a new generation is reaching a critical point. As of 2007, over 655,000 farms, 30 percent of all farms, were operated by producers over 65 years of age. These farmers represent over 267 million acres of agricultural land, 29 percent of all agricultural land, which is facing transition in the near future. The situation does not improve in the coming years. Another 596, 000 farms (27 percent of all farms) and 260 million acres (28 percent of agricultural land) is operated by farmers aged 55 to 64 years. In contrast, less than 119, 000 farms (5.4 percent of all farms) and 36.4 million acres (4 percent of all agricultural land) is operated by farmers less than 34 years of age.

While older producers own a great deal of agricultural land (77 percent of producers over 65 own all the land they farm), they often decrease production or switch to easier enterprises as they age. The average value of sales per farm for producers over 65 years of age is 42 percent lower compared to farmers 45-64 years old, despite the fact that their farm size is only 7 percent smaller. Older producers have greater equity and are more financially secure and thus can afford to decrease production as labor and other issues become a bigger challenge for them. However, this has implications for total agricultural production.

Changing U.S. and Global Agricultural Markets Provide Challenges and Opportunities

U.S. and global agricultural markets have changed dramatically in recent years. The combination of increased industrial demand for grain along with growing global food demand represents increased demand for agricultural resources; higher crop and livestock prices; and increased demand and prices for agricultural inputs. Beginning in late 2006, rapid growth in U.S. biofuel production resulted in sharply higher and more volatile crop prices. This new demand for corn, combined with a backdrop of accelerating global food demand has resulted in dramatic price increases from the 2005 crop year to the 2011 crop year for all major crops including corn (up 210 percent) and grain sorghum (up 228 percent); to wheat (up 111 percent), soybeans (up 119 percent), barley (up 111 percent), and oats (up 114 percent); to rice (up 84 percent), cotton (up 91 percent) and alfalfa hay (up 88 percent) Many crop producers have enjoyed good profitability despite the fact that input prices have also jumped sharply with big increases in fuel, fertilizer and other input prices.

Livestock industries have endured enormous shocks to adjust to feed prices that are double to triple historical levels. These shocks spawned adjustments in the beef, pork, dairy and poultry industries that continue to this day and have precipitated long term structural change in the beef and perhaps other livestock sectors that will take many years to complete. The increased competition for crop production not only results in reallocation of land among crops (corn acreage has increased over 20 percent since 2006, while all other crops are down in acreage), but is also inducing regional shifts of pasture and hay production out of major cropping areas of the Midwest and surrounding regions. The result is a measurable shift of beef cattle production out of the Midwest to the Great Plains and West into areas of rangeland and more marginal cropland.

The dramatic increase in crop prices is being reflected in increased cropland rental rates and land values. The jump in land values is most pronounced and widespread in the Midwest, which is the epicenter of increased crop production, but is spreading to other regions of the country and will eventually affect all agricultural land, including rangeland in the western U.S. High grain prices result in increased forage value and have implications for how and where cattle production will take place.

There are several factors from the previous discussion that are important to the question of agricultural producer transition. First, the new higher plateau for agricultural product values appears to be permanent. While drought and a number of other short term factors are part of the current agricultural market situation, the increased food and industrial demand for agricultural products is fundamental and permanent. U.S. agriculture evolved over the last 50 years in an environment of cheap energy that deeply affected the structure and function of agriculture. Agriculture in the future will adjust to operate in a higher energy cost climate that is significantly different than the past. While biofuel demand has been the catalyst of change in the past few years and will continue to be part of the agricultural market landscape, it is likely that growing global food demand will be more important in the long run. Emerging economic power in several developing countries, but especially China and India, will likely ensure that agricultural product values will remain elevated.

Resource demands from emerging economies will not only keep agricultural product values high but will also continually push up input values. Energy, fertilizer, feed and other agricultural inputs will be increasingly demanded in global markets. Increased volatility of product and input prices and the associated risk is the second major factor that makes future agricultural markets fundamentally different than the past. While expanding global agricultural markets and high product values represent new opportunities, the associated risk implies new approaches to business and new challenges for agricultural producers. Agricultural markets are increasingly subject to more impact and shocks from external macroeconomic and global market factors compared to the past where internal market fundamentals were the biggest drivers of product prices. Many older agricultural producers, recognizing both the opportunities and challenges of this changing global market environment, may be unable or unwilling to make the managerial and business changes necessary to continue production.

<u>The Impact of Drought</u>

In 2011, the Southern Plains experienced a severe drought that forced significant liquidation of beef cattle. A more widespread drought occurred in 2012, somewhat less severe in the Southern Plains, but causing significant crops losses and some livestock liquidation over a much larger proportion of the country. The severely reduced corn crop, along with other crop impacts, has pushed feed prices to record levels and adding to the economic distress in the livestock industry and other grain users.

In the big picture, drought, even two years of drought back to back, is not critically important to the question of farmer transition. However, the drought of 2011, in particular, caused many of those older beef cattle producers in the Southern Plains to sell their herds, thus forcing a decision that was looming large for many in the near future even in the absence of a drought. The questions of transition and succession planning are now heightened for many producers in this region as a result of drought impacts.

The Business and Social Culture of Agriculture is Part of the Problem

Agriculture encompasses a wide array of production sectors, a wide diversity of producers that vary widely in different regions of the country. Though characteristics such as independence and perseverance can be applied to a majority of agricultural producers, the social and business culture of agriculture varies widely around the country and across agricultural industries. Across this variability, the social and business culture of agriculture contributes, in many cases to the challenges of farmer transition.

Agriculture is a way of life for many producers and, very often, the thought of exiting the business for retirement is not even a consideration. Add to that the fact that the farm is also the primary residence for many producers and the predicament is even worse. Farmers often abhor the thought of having neighbors right next door but are nevertheless strongly attached to close knit, if widely spaced, rural communities. Living anywhere else and doing anything else is unthinkable for many farmers. For many farmers, the challenge of separating the home and lifestyle from the business is very great indeed.

Agriculture is often characterized by a somewhat unique business culture as well. About 87 percent of all farms are operated as sole proprietorships. Less than 8 percent are partnerships, with only about half of those registered under state law. Just over 4 percent are corporations, with almost 90 percent of those family corporations, mostly with 10 or less stockholders. Most agricultural producers place a very high value on owning the assets they use for production. Indeed, asset ownership is very often viewed as a principal measure of success for farmers and their peers. For many producers, the idea of “being your own boss” equates to ownership of most, if not all, production assets. For this reason, farmers are willing to incur large amounts of debt, accept the financial risk that implies, and spend many years accumulating wealth in the form of assets, principally land.

The notion of leasing or using non-ownership means of controlling assets is unpalatable for many producers. Leasing is sometimes accepted as a necessary evil on the way to ownership but rarely as a primary business strategy. However, there are some notable exceptions to this and significant regional variation regarding attitudes towards leasing. Even less common is the use of outside investors or partners to help finance agricultural operations. Other alternatives such as

machinery leasing or using custom services in lieu of machinery ownership is often not considered or not preferred. In some instances and perhaps more so in some regions, agricultural lenders may share or encourage this business culture by encouraging ownership over other alternatives to control assets. Similarly, the use of contracts for production or marketing or other alliances or strategic partnerships that may increase access to product value relative to commodity markets are very often viewed as an unacceptable loss of independence for the producer. Nevertheless, the magnitude of capital requirements for agricultural production and the ever more stringent lending requirements are likely to be increasingly at odds with this traditional agricultural business culture.

Retirement Challenges of Older Producers

Many of the issues related to older producers' ability to retire and exit farming are related to tax issues and policies, specifically capital gains and inheritance tax. Farmer often find that, having spent a lifetime accumulating wealth in agricultural assets, it is difficult and costly to withdraw equity if they desire to or to provide for succession to heirs. Estate planning done early and implemented in a timely fashion can significantly reduce these challenges. However, producers who are often not inclined to think about retirement at all are unlikely to think about estate planning in mid-career.

In the current policy environment, producers have little incentive to divest assets and control; and may instead simply decrease production and underutilize assets until death or poor health force a change in management and/or ownership. A lack of heirs or a lack of heirs interested in continuing the agricultural operation is another challenge. Producers who cannot identify successors may simply hold the assets until they are sold through estate liquidation.

The Challenges for Beginning Farmers are Greater Than Ever

The challenges for beginning farmers have been significant for many years. The economies of size and the trend for larger farms and high volume-low margin commodity production systems is a significant barrier for beginning farmers. The recent escalation in asset values has magnified this situation and increased the capital requirements enormously. Increased capital requirements, combined with increasingly stringent lending requirements have made the traditional model of asset ownership virtually infeasible for many, or most, beginning farmers. Even when access to financing is possible, the enhanced risk due to higher product and input volatility make the business far more vulnerable in the early, highly leveraged years. In many cases, beginning farmers cannot get financing and even if they can, the risk may make it a bad idea. It seems increasingly apparent that beginning farmers must be encouraged to focus on asset control rather than asset ownership, at least to the extent of an extended entry strategy.

There are some parts of agriculture that do offer growing opportunities for new and beginning farmers. There is growing demand for specialized, niche products in a low volume-high margin business environment. This segment includes mostly vegetable and fruit production and possibly specialized livestock, dairy and egg markets. Markets may be targeted to any of several market demands including locally produced and organic or natural and may include a range of marketing models ranging from direct marketing from the farm or in farmers markets to u-pick farms to community supported agriculture formats. Increasingly, there are opportunities

to market through major retailers that include sections devoted to specialty or local food production.

A History of Piecemeal Policy, Research and Education

A wide variety of federal and state policies and programs have affected or do affect some dimensions of the farm transition issue. Certainly tax policy, whether intentionally or unintentionally, has a great impact on producer incentives to sell or release control of assets. In some cases programs with an entirely different objective, such as the Conservation Reserve Program, have had an inadvertent impact on farm transition by encouraging older producers to exit production. Other examples might include the dairy buyout and tobacco programs. In general, there have been relatively few programs or policies directly and intentionally focused on the transition of agricultural assets from older producers to younger producers. State level programs vary widely with a few states including significant transition programs but many with little or nothing.

In contrast, there have been a variety of programs targeted specifically to encourage new and beginning farmers. These are often financially focused including low-interest loans and loan guarantees. Additionally, there are growing opportunities for new and beginning farmers to utilizes various entry strategies, including contracting, apprenticeships, and franchising.

Educational programs in Cooperative Extension have regularly included financial management, estate planning, generational transfer of management, and new farmer training but rarely have included both exit and entry considerations in the same programs in the context of agricultural production continuity. Estate planning education, for example, is usually conducted solely from the perspective of the exiting owner with no consideration of the potential role of those decisions on the new owner, except when the transfer is intergenerational in the family. Even then, the focus is mostly on avoiding tax consequences more than on the operational feasibility of the new operation.

Research is limited in the area of transition and mostly focused on economic and policy analysis at a macro level (e.g., exit and entry analysis), without adequate consideration of the micro incentives faced by farmland owners and others interested in acquiring more control of farm assets.

A Comprehensive, Integrated Approach is Needed

The age demographics of U.S. agricultural producers make it clear that farm transition is an increasingly critical factor in the coming years. The traditional transition model assumes that asset transfer occurs completely, immediately and indirectly between exiting producers and entering producers via commercial financial intermediaries. This approach is preferred by many producers whose social and business culture favors asset ownership and the relatively simple business model of sole proprietorship.

However, this model of agricultural asset transfer is increasingly untenable given the growing magnitude of capital requirements, the increasingly stringent lending requirements and

the enhanced risk of globally influenced agricultural markets. It is ever more apparent that current, older producers, who hold large amounts of equity in agricultural resources, must become active participants in the transition of assets to new producers. This is likely to involve a wider array of business approaches than has been traditionally utilized in agriculture. An integrated approach is needed that incorporates the entry decisions of new producers and the exit decision of older producers in a single framework. Such a comprehensive approach must necessarily consider many dimensions related to the transition question including; tax, legal, social, business, financial, production, management, and likely others as well.

The challenge is to develop policy and educational programs that bring older and new producers together to facilitate and encourage agricultural asset transition. From a policy perspective, the first challenge is to evaluate policies and reduce or eliminate disincentives or barriers to transition and hopefully identify and implement policies that strengthen incentives for transition. Certainly there is a need for research to help evaluate financial and risk implications of policy; and social and structural considerations that affect transition.

Future U.S. agricultural production depends, to a significant extent, on the transition from the current older age profile of producers to new, younger producers. Traditional approaches to agricultural transition are inadequate given changing markets, capital needs and financial requirements. Policy, research and education all play an important role in identifying and implementing a broader array of transitions tools to support U.S. agriculture.

References:

USDA-NASS, 2007 Census of Agriculture. http://www.agcensus.usda.gov/index.php