WHERE WILL THE MONEY COME FROM?

An Address by

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There is an excitement, a sense of promise, about American agriculture these days. No longer the aged poor relation at the Thanksgiving dinner, the farmer is returning to the place he had before the first World War - that of the fondly regarded young son of whom great things are expected. A technological explosion has happily met with a sudden expansion of markets to bring this about. The general feeling of good will, high hopes, and relief this has brought to all of us has obscured some of the implications of the economic limits within which all business growth must occur. Agriculture, like all other American business when stripped to its bare bones, is a stream of cash coming in from product sales, credit advances, loans and equity or owner investments, from which payments must be made for labor, supplies, taxes, debt service, and plant investment - with, the owner hopes, a little something left over for him at the end.

I would like to address my remarks today to two of the limitations of business shared by the farmer with his industrial cousin - management techniques and financing patterns. Both can often be profitably copied by one business sector from other sectors - and competitors, I might add.

As to management - in this context I am referring only to the analytical process by which every businessman tests his operating decisions. The universal requirements of the Internal Revenue Code have forced an awareness of record keeping on most farmers. Gradually this awareness is being enlarged to include an appreciation of their use as an operating tool. To the spur of profit improvement is added the prodding of the more enlightened of the credit suppliers. Increasingly, these people are no longer willing to keep agriculture in a box apart from other business credits, but are asking to see the cash flow projections, and pro forma balance sheets they require from industrial borrowers. They are asking for financial worksheets to answer such questions as: Why is the additional machine necessary? Why is the tiling essential? What will the concentrated fertilizing do? The banker who insists on financial worksheets to support the expenditure of the bank's money is the best friend the farmer has.

If you cry "I will not become a bookkeeper!" then you must realize what you are really saying is that you are not interested in running a profitable operation, for record keeping is now a necessity. Farming is far too complicated today - the margins are too thin - the product sales/capital ratios too close - to permit operation by hunch, intuition, or art. A move to pre-printed forms and standardized cost accounting criteria can make the accounting process much less of a chore and provide a basis for interfarm comparisons. And, of course, the greatest time saver of all, the computer, is coming to the aid of the farmer.

Many of you may think of computer use as a tool of the laboratory or the largest businesses. Not so. I have no idea of the proportion of agricultural producers now using computer services in some degree, but it is increasing rapidly - enough so that IBM has felt justified in conducting four annual agricultural symposiums which apparently have been well attended by an advance guard of educators, producers, suppliers and processors. The computer's contribution to the farmer is twofold: its capacity to store and arrange information for quick retrieval, and to make rapid and complicated calculations of yield and productivity in comparative form on which informed decisions can be made.

Phenomenal gains have been made in farm production economics and farm management techniques. As yet, this advance is most apparent at the research level where highly sophisticated types of farm resource analysis are being developed. But the results of these analyses are making possible an understanding of the economics of farm management never before possible. From this information is coming the basic principles of economic resource allocation, farm management decision rules and other vital information. The importance of this can not be over-emphasized in terms of farm finance because it moves farm management, and, more importantly, the appraisal of farm management decisions, closer to science and away from art or intuition.

The practical application of these farm management techniques to farm operations is still in the formative stage, but here, too, significant progress is being made. Given the current economic environment, I would expect a marked increase in the number of farms employing fairly advanced management methods based primarily on computer technology - farm operation, record keeping, and the analysis of farm records. Again, I base this expectation on what I think are fairly solid grounds. As I have said, most of the essential spadework has been done at the experimental level - the ability to make fast and useful economic analysis of farm business operations exists.

Another essential ingredient to this revolution in farm management is, of course, the availability of computer capacity. Time sharing of machinery is an old story to most farmers. As business firms, particularly the financial institutions, install computers for internal operations, they frequently find that excess machine capacity can be profitably absorbed in providing farm management services for their customers. Thus, we are continually hearing of banks, PCA's, and other institutions that are either actually providing such services or are preparing to provide such services in the near future. For this trend to bring optimum results in terms of the most useful record information, the closest of cooperation among the furnishers of the service, the college researchers, and the farmer who ultimately has to apply the information, must exist. Standardization of terminology and procedures has to come, and now is the time to assure that it does. The essence of management evaluation is comparison. Only as the results being compared are commonly defined, is the comparison useful.

The commercial farmer, being the remarkable innovator that he is, is quick to take hold of these new management techniques as they become available. In looking ahead, one of the results of the revolution in farm management that can be expected is that farmers will turn to off-farm sources for the required management services - much as they have turned to off-farm sources for tax and other advisory services. This is simply part of the trend in specialization. We can expect to see much greater use by farmers of farm record services and outside advice in farm financial matters.

While these changes in farm management will greatly improve the farms' profit potential, a more significant impact will be felt on the supply side of the funds question. As a result of the research and application of management techniques, it will be possible to do more than talk about the favorable rates of return to investment in agriculture - the hard figures and facts will be available for decisions. And, there is no doubt in my mind that such figures will be favorable for agriculture. This has been demonstrated time and time again by farm resource studies published by our universities. Moreover, not only has the return on a total farm capital base been quantified, but it is also possible to pinpoint those alternatives within the farm organization where the greatest financial returns are to be made. Thus, we are breaking through some of the old myths and folklore of farm finance and can accurately show that not only can appropriately placed farm capital pay for itself out of the income it generates, but that the farm income itself can be significantly expanded. At this point in the analysis the researcher often makes the not unreasonable assumption that given these favorable rates of return to capital and credit applied to farm production, funds will flow into the sector. I agree with that assumption but I feel that such an expectation passes over much too lightly some of the adjustments that must be made in the traditional methods of supplying funds for agriculture. Then too, the capital requirements facing agriculture are enormous. Will the flow from traditional sources be sufficient?

In preparing for this talk, I reviewed a few of the many excellent studies pertaining to the financial conditions in agriculture - conditions as they exist today and those that are likely to prevail during the next 5 to 10 years. The expected growth of capital and credit requirements put forth in those studies are impressive - even awesome. I will not take the time here to recite the numbers but I do urge those of you who either doubt that a problem exists or are unaware of the magnitudes of the future requirement to take a close look into the matter. I doubt that existing capital sources and patterns will do the job. Certainly there has been some progress.

New systems have been developed to tap the capital markets as is amply demonstrated by the Farm Credit Administration and the Cooperative Credit system. Country banks are establishing and making greater uses of correspondent lines and are developing other methods of providing credit funds for farmers. To this, must be added the extensive use of supplier credit and the supplemental help of the Farmers Home Administration, all of which have greatly increased the amount of capital available to agriculture. But still, agriculture remains an industry that continues to finance most of its capital requirements through the savings it has been able to generate.

The current interest in the problem stems from the fact that past patterns are clearly inadequate in the face of the known demands for farm financing. New approaches to farm finance are going to be necessary if the flow of funds to agriculture are to be sufficient to finance modern farming.

The current pressures on farm finance reflect a continued shift in various trends in the economic organization of farming. These forces are combining in such a way as to bring the problem of farm finance to a head. While there are many ways to describe these changing forces they include, generally, the following things. First and perhaps most important, the pressures of farm modernization, especially the massive substitution of machinery for labor has created a large demand for credit financing particularly for the intermediate term. Second, is the rapid change occurring in technology of machinery and farm products, which induces a faster rate of obsolescence in both equipment and in more permanent building structures. If the farmer is to keep pace and increase income through greater efficiency as has been the case in the past, he will be required to use even larger amounts of credit. Third, as farmers have specialized in their farm operations, they have tended to purchase more of their production supply requirements from off-farm sources, thus greatly increasing the proportion of operating expenses to gross income and putting additional pressures on cash flows.

As the requirements for production credit and intermediate credit have grown, so have the requirements for long-term capital. The modern commercial farm of today represents a large investment in capital assets - an investment that frequently precludes the efficient transfer of those assets by the means that are now available in the financial markets. Whether the transfer is accomplished by death or by sale, the number of dollars required is increasing rapidly with no end in sight. Perhaps the transfer of farm asset ownership presents one of the toughest problems in modern farm finance.

Whether to meet death tax payments, which represent an involuntary purchase by the heirs of the deceased owner, or payments on a purchase contract, increasing reliance has been placed on borrowed money - <u>dangerous</u>, because it is essential that the proper balance of ownership equity capital be preserved if the farmer is to avoid being caught between debt service burdens on one hand and market fluctuations on the other; but necessary, perhaps, because of the lack of alternatives.

Congress has attempted to ease the burden of death taxes by permitting installment payments under certain narrowly defined circumstances, which is less a solution than a palliative. It is a subject in itself. Sufficient here, perhaps, to remind you of it. Death taxes can be reduced by appropriate planning which is another influence shaping the legal form of the farm operation. That the taxes, like death, are inevitable, must be remembered in determining long-term fund needs.

A partial solution to capital requirements for expansion whether of land or equipment, is through leasing or renting. Patterns for equipment rental are well established in industry, although not generally used yet in agriculture. The catch in land rentals is that our tenure arrangements are not as yet adequate, or, at least not yet developed and understood well enough, to insure the optimum long-run arrangement for both farm operator and land owner.

A second approach to the equity problem, and one filled with more than its share of emotional import, is through some form of incorporation or the selling of equity shares to off-farm investors. Let me hasten to add that I am not necessarily referring to the bugaboo of so many people - "the large corporate farm". I am referring to a common method of financing that must be more thoroughly examined with respect to the farm firm. It is no longer reasonable to expect the farm operators to generate sufficient funds to finance the necessary total capital outlays for a modern farm operation. Unfortunately, it is only in agriculture where this belief exists that the use of outside equity capital is in some sense bad. Use of "OPM", or other people's money, is an accepted, and desirable, pattern of investment. For too long this type of thinking has hampered agricultural growth and imposed an unwarranted burden of debt cost on the individual farmer. The time has come for an objective look at farm incorporation and for the development of acceptable forms of that type of financing.

I believe that another significant change will occur in credit extension patterns during the next few years. To date, farm lending has tended to be compartmented into long, intermediate, and short-term categories, a situation that does not adequately serve the needs of modern agriculture. The result of this is that all too frequently the farm operation is a hodgepodge of unrelated and uncoordinated public and private financing. It is rare for either the farmer or the credit agencies to have a clear view of what and where borrowed funds are being used in the operation, or precisely what is being accomplished by the financing arrangement. The credit needs of a farming operation should be regarded in total rather than in separate pieces supplied by diverse segments of the financial community. What is required is a method whereby a single agency can provide the necessary credit funds. In this way adequate control can be maintained jointly by the farmer and the credit agency. I use the term agency here because it is not all clear to me at this time who will provide this service. I am reasonably certain that such a financing arrangement will be developed, given the existence of this rather obvious gap in financing methods.

Another approach to new funds that appears to have a sound basis is through joint venturing on a limited basis between a farm operator and an outside investor. Examples of these ventures that quickly come to mind are feed lot operations and some poultry enterprises. This system provides advantages to both the farmer who wishes to expand his operation into new areas while minimizing his capital outlay and his risk, and to the off-farm investor who seeks tax advantages and a reasonable expectation of an adequate rate of return, preferably at capital gains rates.

One of our major tasks during the next few years will be the restructuring of the institutional channels through which funds flow into the rural areas. The question is not whether we can justify the use of expanded amounts of credit in farming but how do we reduce the friction on the flow between the capital market and the farm. The nature of farm economics with its large number of relatively small units, in a business sense, and the unique risks agriculture faces in terms of weather and prices, mean that special devices will probably have to be developed by the farm credit institutions. It is becoming apparent that as credit demands of the farm grow, these demands frequently prove to be greater than can be met by the local bank with its statutory loan limits. Small country banks are having a difficult time in keeping up, especially as deposits grow relatively slower than loan demands. Perhaps an even more serious problem facing our present institutional structure with its many small lending agencies is the concentration of risk in a single geographic or economic area. This risk factor or the inability to spread risk needs to be overcome if we are to expect outside investment to be made in agriculture.

There are some encouraging signs that we are starting to make inroads on these problems. Certainly, the pattern of capital acquisition established by the Farm Credit Administration provides an important illustration of what can be done in minimizing risk and providing an attractive investment package for the money market. Access to national money markets for additional lending capital when it is needed through the Intermediate Credit Banks, gives a flexibility to the PCA's that is highly desirable. A similar method for the pooling of agricultural credit risk is needed within the commercial banking system and will become a necessity within a few years if country banks are to provide a reliable source of credit for farms. The private sector has a considerable stake in farm finance, and solutions have to be found by the banking system if they are to retain their share.

I do not wish to give the impression that nothing is being done at present by the financial institutions. The major banks are beginning to pay greater attention to the investment potential in agriculture. I believe we can look forward to some further advances in that direction. One key to this process will be the development of competent agricultural credit staff in the larger banks, whose services will be made available as part of the regular correspondent relationship. This will enable the local banks to more adequately provide for the total credit needs of farm customers. Another development that is still in the embryo stage is the formation of agricultural credit corporations, allied to the private banking sector, designed to provide the farmer with a more direct access to the money market, in a pattern similar to the Farm Credit Administration. Nor can we neglect the impact that improved and expanded farm merchant and equipment dealer credit is having as a source of much needed farm credit.

To brainstorm about the future for a minute, imagine what an advantage one-stop financial and management consulting services would be to a farmer - a company, if you please, that could offer these things - a single source of credit across the whole spectrum of requirements from short-to long-term; the leasing of equipment; equity capital through participations in ownership; computer record keeping with a regular flow of analysis for the farmer on which he could base his operating decisions. Visionary? Not really. The elements already exist and are being used by American industry, if not always in agriculture.

Such companies could pool capital demands with direct access to the money markets in the pattern of the Farm Credit Administration; utilize the widely dispersed commercial banking system for local representations and a partial source of the short-term credit; furnish equity capital in a way similar to the Small Business Investment Corporations created under the Small Business Act; lease equipment to the farmer like the specialized companies now serving American industry do for their business customers; furnish computerized record keeping services and advisory help like major correspondent banks are now doing for country banks; and so on.

Given the financial and management vacuum developing in American agriculture and the extraordinary level of experimentation being successfully conducted by the great land grant colleges, together with some of the farmer leaders, and various of the U.S. industrial corporations interested in the farmer market, a breakthrough will come.

In summary, it is my belief that during the next five years, we will see marked changes in the capital and credit conditions in agriculture. Through the greater application of the known management techniques on operational farms, farmers will come to understand and use capital and credit as an important tool in increasing farm profits. At the same time the money markets will become more accessible to the farm sector and an adequate flow of funds will find its way, in an efficient manner, into agriculture. Hopefully, the day is near when agriculture will no longer take a secondary place in the capital market and the question "Where will the money come from?" will no longer be asked.