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J. H. LONGWELL, *Director*

Equity Financing in Agriculture

DON O. ELEFSON AND FRANK MILLER

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THE NEED FOR RISK CAPITAL

Throughout the history of the United States, Congress and state legislatures have sought ways to aid farmers in financing businesses that give their families good incomes. These attempts have led to intermediate credit for working capital and some types of land improvements, and to long-term amortized credit for buying or improving real estate. In the early years of our history, land was sold from the public domain at low prices. Buyers paid one-fourth of the cost at the time of purchase, one-fourth two years later, one-fourth in three years, and the final installment the fourth year. Grants of land were made to individuals for meritorious service, and after 1862 the various homestead laws made land available without direct cash cost. All of these programs had as their major purpose the promotion of owner-operation of family type farms.

Private lenders also have supplied farmers with funds. Individuals are the most important holders of real estate mortgages. Life insurance companies, commercial banks and many other lenders help finance farm businesses, but in no case has risk capital been made available in the way that it is used by other industries.

The various land purchase acts and the homestead laws used in transferring land from the public domain to private ownership divided farm land into operating units many of which have become obsolete under recent technological developments. In 1954, 43 percent of the farms in Missouri and 40 percent of those in the Midwest region were smaller than 100 acres. The need for larger acreages to permit full use of tractor-drawn machinery, higher land prices, and larger investments in livestock and equipment have raised the total amount of money needed to set up a good farm business to a level that makes successful entry into farming as an owner-operator impossible for many young men. A considerable proportion of those who try to get started find that the capital they own is insufficient to provide adequate livestock and equipment on rented land. As a result, their rate of capital accumulation is slow. Many of them find industrial jobs and quit farming. This outward movement keeps American agriculture from becoming as over-crowded as it is in some parts of Europe and Asia, but there are still too many small farm businesses and too many failures that can be traced to inadequate capital.

Data presented in Table 1 show average investments and returns from Missouri farm businesses where records were kept for detailed summary in 1957.

TABLE 1--INVESTMENTS IN AND RETURNS FROM FARM BUSINESSES IN MISSOURI WHERE DETAILED RECORDS WERE KEPT IN 1957

Acres	
Cropland and open pasture	223
Value	
Land and improvements	\$30,577
Working capital	16,898
Total	47,475
Financial Summary	
Total cash receipts	13,602
Total cash expenses	10,998
Cash balance	2,604
Home used produce	362
Net increase in inventory	2,013
Total farm and family earnings	4,979

The operators of these farms had an average of 223 acres of cropland and open pasture, valued at \$30,577. The working capital averaged \$16,898, making a total investment of \$47,475. The families received an average of \$4979 from these businesses, of which \$2604 was cash, \$362 home raised produce and \$2013 net increase in value of inventories. The family income was not large, but it was much above average for the state as a whole.

Records obtained from 152 families who started farming in northern Missouri and southern Iowa in 1953 showed that beginners in that year had average net worths of \$6069¹. Of this amount \$869 was in furniture, clothing and other personal items, leaving \$5200 for business uses. By using several types of tenure arrangements, these men were able to gain control of an average of \$19,377 in business capital. This amount was approximately 41 percent of the sum needed for relatively well-balanced farm businesses. It was little more than enough for livestock, feed and equipment on a good farm, and the equity of the operator was 27 percent. It would have been only 11 percent of the value of a good business. In other words, a great many beginning farmers do not have enough collateral to equip a good rented farm and owner operation is completely beyond their reach. The result is extremely low net incomes from the farm business. The 152 families who started farming in northern Missouri and southern Iowa in 1953 had average net farm incomes of \$1645.

If adequate funds for efficient combinations of land, labor and capital in farm businesses could be made available to good operators, much of the low income problem in agriculture would be solved. The procedures outlined in this publication would made it possible for a well qualified farm operator to set up

¹Ted L. Jones, Progress in Becoming Established in Farming, M.A. Thesis, Department of Agricultural Economics, University of Missouri, 1958.

his business without financial handicaps. With this obstacle removed, he would be able to start with a well-balanced business that would permit him to accumulate capital from the outset. As soon as he had acquired an adequate equity to qualify for a loan from an insurance company, a Federal Land Bank or other lender, he could get credit from one or more of these agencies and finish paying for the business under present financing procedures.

For many years, corporations have attempted to own and operate farm businesses. Some of these ventures have been successful. The most noteworthy are highly specialized undertakings like Wyoming Hereford Ranch and Seabrook Farms, Incorporated. Wyoming Hereford Ranch specializes in purebred cattle that are sold to breeders throughout the world. Seabrook Farms, Inc., produce horticultural crops and market frozen vegetables. Others that use the corporation type of financial organization with apparent success produce broilers, special types of tobacco, and specialty crops such as cranberries.

The number of corporation owned and operated farms has not been increasing. Failure has come to most corporations that have attempted to acquire large land holdings and to grow ordinary crops and livestock products in competition with family owned and operated farms. In 1954, corporations owned 5 percent of the land in farms in the United States. In the west north central states, they owned only 1.2 percent. Data are not available to show the number held by family corporations. It is known, however, that many family farms have been incorporated to take advantage of income tax regulations and to facilitate transfer of the property to heirs when the owner retires or passes away. If the land in these farms were subtracted from the total held by this type of ownership, the proportion that is held by bona fide incorporated commercial ventures would be small indeed.

The plan that is outlined here would expand and intensify the practice of incorporating farms to establish and maintain good businesses for more than one generation. It should be kept in mind that the organization described is far different from the ordinary corporation that holds farm land and operates it with hired workers. It is designed to finance well-balanced farm businesses where the acreage is adequate for efficient use of machinery and labor; the land protected with water control structures including storage facilities for irrigation where this practice is economically feasible; the plant nutrients in the soil maintained at the optimum for low-cost crop production; and the buildings fully adequate for the farm family and for the care of livestock. These units would be made available to competent operators who would lease them and farm them under the guidance of well-trained managers. The operator would not be a hired man. He would be an entrepreneur, just as any other tenant who operates a farm under a crop share, cash and crop share, or livestock share lease. His activities would be somewhat restricted, as are the decision-making activities of any tenant operator, but the risk would be shared with stockholders and the economic advantages would far outweigh the handicaps. The equipment and labor

would be fully employed and working capital would be adequate for the purchase of livestock, feed, fertilizer, and other production materials when needed.

Under these conditions, a young man would begin farming with an adequate business. The findings of farm management research indicate that he would be able to start accumulating capital from the outset, and could become an owner operator, if he so desired, in much less time than is required under present procedures. These facts will be made clear through the analysis that follows.

FARM FINANCING PROBLEMS

Many people who make loans to farmers insist that enough credit is available to meet all the needs of farmers. This observation is correct for men who are already established in efficient businesses; who have 35 percent or more equity to offer as collateral for loans, and have proven themselves to be competent managers. However, there are those who cannot meet these requirements. Many are on inadequate units and are neither able to expand the acreage they are farming, nor to introduce intensive enterprises because of inability to get funds.

Family living and the cash operating expenses of the farm business must be taken from income before interest and principal payments. Under present lending procedures, a deficit in a flood or drouth season is carried over to the following year as an enlarged note or a new loan. The situation of farmers is not at all like that of corporation executives, who look at net returns for the fiscal year and declare dividends that are in harmony with earnings, or pass them if accumulated surpluses do not justify payment.

The consequences of inadequate income to meet operation costs, family living expenses, and debt carrying charges are illustrated in Table 2. The data are taken from a continuous record on a 320 acre farm in southeastern Nebraska for the years 1930 through 1946. On January 1, 1930, the land and buildings in this operating unit were valued at \$44,360. The non-real estate farm property was valued at \$9350. For purposes of analysis, the operator of the farm was assigned a debt of \$65 an acre, secured by a real estate mortgage. The total amount of real estate debt was \$20,800. He was also assigned a debt equal to 50 percent of the value of the non-real estate farm property, or \$4675. Interest was charged on the \$20,800 real estate mortgage at 4 percent. The charge on the \$4675 non-real estate debt was 6 percent. Family living expenses were charged at the average amount spent by farm families in the area where the business was located.

In 1930, the interest on debts and the family living expenses totaled \$2117. In that year, the net farm income was only \$262. The difference between interest and family living expenses and the \$262, or \$1855, was added to the non-real estate debt and carried into the year 1931. This procedure was continued for all of the years through 1946. If the net farm income exceeded the interest charges and family living expenses for the accounting year, the amount of surplus was

TABLE 2--PROGRESS THAT AN OPERATOR OF A 320 ACRE FARM COULD HAVE MADE IN PAYING OFF A DEBT
EQUAL TO \$65.00 AN ACRE AND 50 PERCENT OF THE NON-REAL ESTATE INVESTMENT AS SHOWN BY A
CONTINUOUS FINANCIAL RECORD FROM SOUTHEASTERN NEBRASKA FOR THE YEARS
1930 THROUGH 1946

Year	Assumed Debt		Interest and Family Living Expenses	Net Farm Income	Amount of Debt Change	
	Real Estate	Non-real Estate			Increase	Decrease
1930	\$20,800	\$4,675	\$2,117	\$ 262	\$1,855	
1931	20,800	6,530	2,184	1,349	835	
1932	20,800	7,365	2,316	194	2,122	
1933	20,800	9,487	2,063	3,183		\$1,120
1934	20,800	8,367	2,038	2,986		948
1935	20,800	7,419	1,975	1,061	914	
1936	20,800	8,333	2,142	2,398		256
1937	20,800	8,077	1,922	3,092		1,170
1938	20,800	6,907	1,804	356	1,448	
1939	20,800	8,355	2,028	1,921	107	
1940	20,800	8,462	1,985	3,374		1,389
1941	20,800	7,073	1,987	4,309		2,322
1942	20,800	4,751	2,138	5,549		3,411
1943	20,800	1,340	2,001	7,736		5,735
1944	16,405		1,692	6,904		5,212
1945	11,193		1,533	6,045		4,512
1946	6,681		1,490	7,921		6,430
1947	251					

subtracted from the non-real estate debt until obligations of this type were liquidated. The surpluses after the non-real estate debt had been retired were subtracted from the real estate debt. By the end of 1943, the non-real estate debt was paid. At the close of 1946, the real estate debt had been reduced from the \$20,800 assumed in 1930 to \$251.

The analysis of this continuous record shows clearly that a farm operator who has a considerable load of debt is likely to find interest payments difficult in years of low prices and/or poor crops such as those that were experienced in southeastern Nebraska between 1930 and 1940. Corn was a complete failure in 1934, and yields were low in other years of the 1930-40 11-year period. After 1940, a combination of good crops and rising prices made it possible for the operator to retire all of his non-real estate debt and most of the farm mortgage. The amount owed at the beginning of 1947 was only \$251, which was negligible.

It is doubtful if very many young farmers would continue to operate a business that was carrying them further into debt, as was the case with this farm from 1930 to 1933. In these years, the non-real estate debt more than doubled. The financial progress of the operator was unsatisfactory until 1940. Fourteen years passed before he was able to pay all of the non-real estate debt and begin to reduce the real estate mortgage. Economic and weather conditions like these may never be repeated, but a high percentage of farm businesses are not as large or as well organized as was this farm. Where they are not, returns are likely to be low when prices and weather are more favorable than in the 1930's. In other words, farmers with inefficient businesses would have difficulty in improving them out of income even when conditions were much better than those of the 1930's.

The traditional procedure in agriculture has been to finance the purchase of land with a real estate mortgage. Loans for operating expenses or to purchase livestock and machinery usually are secured by mortgages on personal property or growing crops. These procedures often result in a poor division of assets between the investment in land and in working capital. Many tenants are short of machinery, equipment and productive livestock. Owners sometimes invest their savings in a small farm and do not have enough money left over after making the down payment to buy the livestock that are needed for full employment of the labor force. Financing the farm business as a unit with emphasis on efficient use of land, labor and equipment would help to overcome this handicap.

A brief glance at conditions in agriculture reveals the need for this change in emphasis. Data from the 1955 Census show that 26.8 percent of commercial farm operators in the United States and 43.2 percent of those in Missouri sold less than \$2,500 worth of products from their farms in 1954. In addition to these commercial operators, approximately 30.4 percent of the people classed as farmers, both in Missouri and in the United States, received low incomes. This latter group is made up of non-commercial operators. Some of them have other sources of income, but the farms on which they live do not bring sufficient re-

turns to give them satisfactory levels of living. If the outside income is not substantial, they cannot accumulate capital to retire debts or to enlarge their businesses without extreme sacrifices.

In a great many cases, it would be possible to increase the size of these farm businesses by putting more intensive enterprises on the existing acres. However, this procedure would require material changes in cropping systems and substantial capital expenditures for additional buildings and equipment. Where satisfactory markets are not available for the sale of the products from intensive enterprises, the farm acreage needs to be enlarged so that extensive enterprises like beef cattle and sheep can be developed to the size needed for a larger volume of sales. In either situation, the investment in the farm business needs to be increased. Can money be made available for these capital expenditures out of savings from present levels of income or under existing lending procedures? This is the question that needs to be answered. The fact that these problems have persisted and in many areas have grown more acute while savings of farm operators and present lending agencies have been the principal sources of funds indicates that existing methods of finance have not met the capital needs of a considerable proportion of the farm population.

The data in Table 3 present further proof that all is not well in agriculture. In 1900, more than one-fourth (26.1 percent) of the farmers in the United States were under 35 years of age. In 1950, only 19 percent were under 35. In 1900, almost three-fourths (74.1 percent) were under 55 years of age. In 1950, only 65.4 percent were under 55. In 1900, 2.1 percent of the farmers who owned their land were full owners before they were 25 years of age. Approximately one-sixth of them (17 percent) attained full ownership before they were 35. In 1950, only 1.1 percent of the full owners were under 25 years of age, and 11.2 percent under 35 years. The data show further that the trend has been toward fewer farmers and an increased proportion of operators remaining on the land after they have passed 65 years of age. Data from the 1955 census show that 41.7 percent of the farm operators in Missouri are over 55. This trend toward older people on farms is general throughout the United States. Retirement under Social Security may change the situation, but there will be need for new methods of financing beginning farmers so that young men can take over the businesses relinquished by those who retire.

One of the major purposes of the legislation that created the Federal land banks was to help tenant farmers buy land. The land purchase program of Farmers Home Administration had a similar purpose. A great many renters have become owners, but these institutions have neither eliminated nor greatly reduced farm tenancy. Burkett and Parsons say, "In spite of these efforts, ownership by operating farmers has declined considerably from what it was when the first census of agriculture was taken in 1880. The decline has been irregular, but it has been persistent."² No doubt the practice of renting land will continue. It is

²W. Keith Burkett and Kenneth M. Parsons, "Buying Farms With Hundred Percent Loans: An Analysis of the Farm Security Administration Loan Experience in Wisconsin," *Land Economics*, Volume 17, No. 2, May 1951.

TABLE 3--AGE DISTRIBUTION OF FARM OPERATORS, 1950 AND 1900*

		Total	Under 25	25-34	35-44	45-54	55-64	65 and over
		(000)	(000)	(000)	(000)	(000)	(000)	(000)
Number of operators reporting age	1950	5,044	164	791	1,187	1,157	1,000	745
Percentage	1950	100	3.3	15.7	23.5	22.5	19.8	14.8
Number of operators reporting age	1900	5,635	275	1,194	1,410	1,296	867	595
Percentage	1900	100	4.9	21.2	25	23	15.4	10.5
Number of full owners	1950	2,905	32	292	592	696	669	593
Percentage	1950	100	1.1	10.1	20.4	23.9	24.1	20.4
Number of full owners	1900	3,636	76	541	908	916	683	505
Percentage	1900	100	2.1	14.9	25	25.3	18.8	13.9
Number of tenants	1950	1,323	117	372	363	242		227
Percentage	1950	100	8.8	28.2	27.4	18.4		17.2
Number of tenants	1900	2,044	198	653	425	286	220	222
Percentage	1900	100	9.8	32.6	21.2	14.3	11	11.1

*Lawrence A. Bradford, University of Kentucky, "Critical Problems of Young Families in Getting Established in Farming," Journal of Farm Economics, Vol. 36, page 1012.

a means of gaining control of a more nearly optimum combination of economic factors with smaller equity than is required under owner-operation. In the economic sense, a lease on a farm is a type of 100 percent loan.

The time when a young man could start farming with a team of horses or mules, a few pieces of machinery, a cow and some chickens, and develop a full-time business is past. The amount of capital required and the cash expenditures necessary to operate a farm have increased tremendously, particularly in the last 15 years. These facts are pointed out in a Minnesota bulletin by Beneke and Pond. They summarize the situation as follows: "The beginning farm operator faces many obstacles which prevent him from obtaining the maximum returns from his and his family's efforts. Most of these obstacles grow out of his inability to obtain adequate capital to carry on farming operations."³

Data in Table 4⁴ show the capital invested in farm businesses under different types of ownership and the resource combinations that were required to produce \$1000 worth of output on farms in Minnesota. Beginners who started as owner-operators used a total of \$14,554. They were able to get \$1000 value added with 0.42 of a man year of labor, as compared with established farmers who had \$23,971 of total farm capital and were able to get \$1000 of added value with 0.26 man years of labor. The highest return per man year was obtained on the farm management service farms which were part-owner operated. These men had a total of \$51,225 in farm capital, and added \$1000 of value with only 0.17 of a man year of labor.

In Illinois, men on farm management service farms and those on established farms had large incomes, but they controlled large assets. They probably had superior experience and management ability; but this fact alone did not explain all of the differences in efficiency in use of the resources they controlled. In fact, Allen G. Mueller found capital to be the main factor contributing to differences in income:

"These observations lead us to the conclusion that differences between record keeping farms in a representative sample of all farms are essentially differences in the quantity of basic resources, particularly land and capital utilized by the farm operators. Also that managerial ability as indicated by measures of farm success apparently is positively associated with the amount and quality of land on both survey and record keeping farms; and, given equal basic resources, managerial ability is not greatly different on record keeping farms and survey farms."⁵

In the past, the value of land has been a very high percentage of the total investment in most farm businesses. If a man could get command of this re-

³Raymond R. Beneke and George A. Pond, *Starting Farming in Southeastern Minnesota*, Minnesota Agricultural Experiment Station Bulletin 405, page 13.

⁴Ibid, page 15.

⁵Allen G. Mueller, "Comparison of Farm Management Service Farms and a Random Sample of Farms in Western Illinois," *Journal of Farm Economics*, Volume 36, May 1953, page 292.

TABLE 4--AVERAGE RESOURCE COMBINATIONS REQUIRED TO PRODUCE \$1,000 OUTPUT ON BEGINNING FARMS, ESTABLISHED FARMS, AND FARM MANAGEMENT SERVICE FARMS IN MINNESOTA-1947*

	Number of farms	Working capital employed on farm	Value of land & bldgs. per farm	Total farm capital employ- ed per farm	Man years of labor per farm	Value added per farm	Working capital per \$1000 value added	Land and bldgs. per \$1000 value added	Total farm capital per \$1000 value added	Man years of labor per \$1000 value added
Established farms	56,268	\$ 9,134	\$14,837	\$23,971	1.54	\$ 5,855	\$1,560	\$2,534	\$4,094	.26
Beginning farms										
Owner-operated	23	5,645	8,909	14,554	1.50	3,686	1,531	2,417	3,948	.42
Cash, crop share & cash renter-operated	40	6,275	11,389	17,664	1.46	3,793	1,654	3,003	4,657	.39
Crop & Livestock share & partner-ship renter- operated	53	10,299	14,511	24,810	1.96	6,456	1,595	2,247	3,842	.30
Farm Management Service Farms										
Owner-operated	94	19,431	24,327	43,758	2.06	10,786	1,801	2,255	4,056	.19
Renter-operated	39	18,816	26,014	44,830	2.01	10,594	1,776	2,455	5,231	.19
Part-owner-operated	40	23,117	28,108	51,225	2.13	12,435	1,859	2,260	4,119	.17

*Raymond R. Beneke and George A. Pond, Starting Farming in Southeastern Minnesota, Minnesota Agricultural Experiment Station Bulletin 405, page 15.

source by renting, he was able to get started with little else. Howard G. Diesslin points out, however, that during the last 14 years (1940-1954), "Real estate declined from two-thirds of the total assets to less than 60 percent of the value of all assets. Where machinery made up 6.5 percent of the total in 1940, it was 12.5 percent in 1954."⁶

Edgar T. Sandage states that, "Between 1940 and 1953, the capital investment in agriculture increased from 41 billion dollars to 124 billion dollars. In 1940, the capital investment per worker in agriculture was about five thousand dollars. In 1953, it was over 20 thousand dollars, or a four-fold increase in 13 years."⁷

Recent studies show that minimum capital requirements of an adequate farm business in Missouri vary from \$25,000 to \$60,000 or more, depending upon the type of business and the area where the farm is located. James E. Dillion and Robert C. Suter found the relationships shown in Table 5 between total farm capital, acres in the farm, and labor income in a study of 45 farms in Central Missouri.⁸ Investments in business that returned labor incomes of \$2468 averaged \$60,764. Saving enough capital from a hired man's wages to build a credit base sufficient to start on a unit of this type would take so long that successful accomplishment of the task is almost impossible. Work in industry may offer better opportunities, but this route to farming as an occupation presents other difficulties. Once a man has become established in work off the farm, it is hard to find the way back. He soon loses contact with advancements in agricultural techniques. The task of catching up with the technological change presents a formidable barrier.

TABLE 5--RELATIONSHIP BETWEEN SIZE OF BUSINESS (MEASURED IN TERMS OF TOTAL FARM CAPITAL) AND LABOR INCOME, 45 FARMS, CENTRAL MISSOURI, 1952*

Total Farm Capital		Number of Farms	Total Farm Acres	Acres of Cropland	Labor Income
Range	Average				
\$11,446 - \$ 27,499	\$21,558	15	235	127	\$ 693
27,500 - 38,499	32,666	15	302	142	1,022
38,500 - 126,105	60,764	15	465	227	2,468
All Farms	38,329	45	334	165	1,394

*James E. Dillion and Robert C. Suter, University of Missouri, College of Agriculture, Agricultural Experiment Station Bulletin 603, May 1953.

⁶Howard G. Diesslin, "A Re-Examination of the Credit Needs of Agriculture," *Journal of Farm Economics*, Volume 36, page 1200.

⁷Edgar T. Sandage, "Inter-Bank Relations in Financing Agriculture," *Banking Journal* of the American Bankers Association, July 1954.

⁸James E. Dillion and Robert C. Suter, *Let's Study Your Farm Business*, Missouri Agricultural Experiment Station Bulletin 603, page 8, May, 1953.

CLIMBING THE AGRICULTURAL LADDER

Movement up the agricultural ladder from family worker or hired man to owner operator is becoming more difficult as time passes. The step from the farm laborer or worker in some other industry to owner or tenant is particularly difficult. Spillman noted back in 1919 that it was still possible for a young man starting without capital to become a full owner, but that the time spent in the pre-ownership stages was becoming longer.⁹ This step is more difficult now than it was then. Dr. F. J. Reiss points out this fact in his study of applicants to Farmers Home Administration who did not get loans. His analysis in part reads as follows:

"... the 40 cases among those who were not farming were able to add an average of \$404 to their capital in the year before they applied for the loan. Even at this rate, it would be years before they had an adequate amount to finance a venture into farming. However, this was not a homogeneous group. It was made up of two quite different occupational groups: (1) farm hands and hired men, and (2) non-farm workers, mostly truck drivers or shop workers. Only a few of the latter reported no farm experience. Both groups were interested in farming. Some had farmed on their own at one time.

"The old agricultural ladder appears to have broken down at the first rung, at least for this group of 21 hired men. Off-farm employment appears to be a much more promising route for these men to take in getting the equity capital with which to start farming, but even so, 19 men seeking to enter farming through this route had, at the age of 35, accumulated a net worth amounting to only a little more than two-thirds of their annual labor income. Only two of the hired men and four of the non-farm workers were rated as having less than average managerial ability.

"Ability and wealth are not always found together, especially among young men. Lack of capital not only hampers young men of ability but makes it difficult for them to demonstrate their ability.

"The reasons reported in Table 6 were those which were given a number one ranking by the reporting supervisor. In a number of cases, two or three reasons were cited. For example, of the 111 whose proposed farm units were deemed too small or inadequate, 50 gave that as the only reason for not granting a loan. Thirty others gave that as number one, but added lack of managerial ability, excessive debt, and low equity as the most frequent additional factors contributing to failure to get loans.

"It is evident that the land rental and purchase markets also effect a selection among those who seek establishment in farming. Many, or perhaps most, of the loan applicants who failed to find a farm may have been personally qualified to farm, and might have obtained FHA financing, but they

⁹W. J. Spillman, "The Agricultural Ladder", *American Economic Review Supplement*, March 1919.

TABLE 6--REASONS FARMERS HOME ADMINISTRATION APPLICANTS IN ILLINOIS DID NOT GET OPERATING LOANS IN 1952-53

Reasons for not Granting Loans	Number of Applicants	Per-cent
Proposed farm too small, inadequate or hazardous	111	19
Loan funds exhausted	95	16
Unable to find a farm	90	15
Obtained credit elsewhere	56	10
Lacking in Managerial ability	53	9
Debts too great already	44	7
Not enough equity, net worth too low	26	4
Other reasons*	116	20
TOTAL	591	100

* Among these reasons were the following (in order of frequency): (1) withdrew or failed to appear; (2) proposed refinancing not approved; (3) unsatisfactory lease arrangement; (4) lost his lease or did not get farm he expected; (5) part-time farmer; (6) not eligible, could get credit elsewhere; (7) proposed venture not sound.

found themselves unable to compete successfully in getting possession of or managerial control over enough farm land. Others resorted to such means as purchase contracts to obtain land, only to find themselves in credit difficulties in getting possession of sufficient operating capital. This was true of a number of those who were denied loans because their debts were too high already or their equity was too low."¹⁰

CREDIT PROBLEMS

One of the problems in the present system of financing farm businesses is that of securing additional credit to protect the funds already invested. If an individual who is financed to the limit of the collateral he can offer meets with some unexpected disaster such as drouth, flood, or a rapid decline in commodity prices, he may not be able to borrow additional funds to keep the business running efficiently. For example, a man who has started to develop a farm program according to a Balanced Farming plan may borrow money for waterways and terraces; then have two adverse years such as 1953 and 1954 were in Missouri, which make it impossible for him to meet his payments. If he cannot get additional credit, he is unable to buy needed fertilizer, seed and livestock to take advantage of these previous investments. This situation is illustrated by the experience of a young Missouri farmer. He was able to borrow enough money to start in a dairy business on a livestock share lease. The venture would have been successful except that some of the cows were not good producers. Others had to be

¹⁰F. J. Reiss, *They Did Not Get Loans*, Department of Agricultural Economics, College of Agriculture, University of Illinois, Resources Report Number 4, January 1955.

sold at less than cost because of mastitis. He had borrowed all of the money he could get from the agency that had made the original loan. Had he not been able to get money from another source to buy animals for replacements, he would have been forced to liquidate the business. The fact that he was able to get funds elsewhere permitted him to remain in business and become a successful dairyman.

Farmers Home Administration comes the closest to bridging the gap between the man who must start his business with low equity and the time when he has enough collateral to permit him to borrow from other agencies. But Farmers Home Administration turns down many applications for loans. Most of the reasons for refusal are associated with poor adjustment of people to resources (Table 6). This organization also is handicapped by loan limits that keep it from financing efficient farm businesses. Because of this, the earnings of its borrowers are below those of good operators in the communities where the farms are located.

This shortage of capital results in uneconomic use of agricultural resources. Labor income is lower for farm operators with limited capital than for those with more nearly optimum investments, as shown by Beneke and Pond.¹¹ In many cases, land resources are undeveloped, and erosion goes on at an accelerated rate because of lack of proper water management structures. Since the number of acres that can be added to present cropland in the United States is limited and the cost of developing large areas of additional land is prohibitive at present commodity prices, most of the production necessary to feed a growing population must come from land that is already in cultivation. In many cases the output of food and fiber can be increased at less cost by adding capital in the form of fertilizer, irrigation systems and water control structures to the present cropland than by reclaiming new land. Farm operators who do not have substantial equities in their business find it hard to get the necessary funds for these improvements.

Most tenants are not interested in making land improvements of a durable nature. The man who makes them may not be on the farm long enough to reap the benefits. As a result, resources are inefficiently used. This fact is pointed out by Virgil Hurlburt in the following quotation: "Resources cannot be used efficiently if the quantities available for combination are less than those required for an economic unit. Limited resources and the existence of non-economic units are not necessarily the fault of leasing as a method of operation."¹² They grow out of strict capital rationing on individual farms. The lender may deny the borrower credit because of a low equity to total capital ratio. The man who has very little equity in his business may not ask for credit because of the risks

¹¹Beneke and Pond, *op cit.*

¹²Virgil L. Hurlburt, *Farm Rental Practices and Problems in the Midwest*, Iowa State College, Agricultural Experiment Station Research Bulletin 416, 1954, page 87.

involved and his abhorrence of debt.

Evidence of the progress that can be made when capital is not rationed too strictly is presented in Table 7. The data show the net worth of Farmer H. each year of the first five years after he started farming. He had \$2000 plus his automobile and household furnishings when he started as a tenant in March, 1950. The business was to be operated as a 50-50 livestock-share dairy farm. The first season he had approximately 90 acres of corn. He expected to buy cows in the fall and start the dairy enterprise at that time. Since the landowner had several farms, he bought fertilizer and other items in large quantities and made these supplies available to the tenant at a lower price than Farmer H. would have had to pay on his own account. It was the practice of the landowner to require payment for the fertilizer out of income from the crop on which it was used. Farmer H., at the end of 1950, owed the landowner \$739.30 for his share of fertilizer and other items that were used in operating the business, but was unable to pay this bill because he had used the money from the corn crop to help buy his one-half share of 30 cows, and for feed. At the end of the first year, he owed a total of \$4010. However, his net worth had increased from \$2000 in March to \$3764 in January, 1951.

During 1951, the owner furnished more fertilizer and seed for crops, hoping to get enough production to meet expenses and pay the bill that was not paid at the end of 1950. However, crops were poor, due to excessive rain and the fact that the operator was slow in getting them planted. As a result, he was not able to pay expenses this year. Perhaps the landowner's management suggestions should have been different. Farmer H. was a good dairyman, but was below average in raising crops. Regardless of this, the landowner had insisted upon planting a large acreage of corn each year and fertilizing it heavily. Because of poor weather conditions, returns were below expectations.

During 1951, Farmer H. borrowed money from his brother to buy more cows for additions to the herd and to replace some low producers. His net worth at the end of the year had dropped to \$2835. Total liabilities had increased from \$4010 to \$6091. His debt to the landowner increased from \$739.30 to \$1347.16. Had the owner insisted upon payment of this bill at the end of the year, the operator would have been forced to sell out and give up farming. He had already borrowed all of the money the local credit agency would loan to him, plus a substantial amount from his brother.

Although the next three years were dry, he was able to increase his net worth to \$6140. By the end of 1953 he had decreased his liabilities to \$2668. Today this man is "over the hill" and on his way to becoming an established farmer. He would not have succeeded had credit not been available other than that furnished by the agencies usually making loans to farmers.

TABLE 7--NET WORTH OF FARMER "H"

	1950	1951	1952	1953	1954
Tenant Net Worth (Farm)	\$3,764.00	\$2,835.00	\$4,174.00	\$5,225.00	\$6,140.00
Liabilities					
Due Landlord	739.30	1,347.16	1,972.32	2,349.54	2,604.66
Due Others	<u>3,270.70</u>	<u>4,743.84</u>	<u>3,965.68</u>	<u>318.46</u>	<u>1,076.34</u>
	\$4,010.00	\$6,091.00	\$5,938.00	\$2,668.00	\$3,681.00
Interest at 5 percent on funds supplied by landowner	\$ 39.96	\$ 67.36	\$ 98.61	\$ 127.47	\$ 130.20

SOURCES OF CREDIT

Credit is available to farmers from private, cooperative and public agencies. Farmers who have satisfactory collateral can obtain funds on reasonable terms from individuals, commercial banks, retail stores, insurance companies, the organizations that make up the Farm Credit Administration, and several other sources. In some cases, the terms are not tailored specifically to the needs of the borrower. Land improvement loans, for example, either are secured by real estate mortgages or by liens on chattels. Many are short-term loans. Very few are made for five to ten-year periods. This often is the time required for recovering the cost through increased yield of products. All of the lending agencies except Farmers Home Administration require substantial collateral. Attention is centered upon the normal agricultural value of the real estate or the market value of other property that can be pledged as security; not upon optimum combinations of economic factors and the flow of income made possible by the loan. Reasons for this situation usually rest upon the sources of funds for making the loans, the obligations of lenders to these sources, and their desire to avoid risk.

Farmers Home Administration is the only agency that does not follow the policy of restricting its loans to a percentage of the value of the property pledged as security. However, the amount loaned to a farmer is limited. This means that many farmers who must borrow from Farmers Home Administration operate at a disadvantage until they can increase their equity to a level that makes it possible for them to increase borrowings enough to give them an optimum combination of resources. Usually the net worth is increased by restricting family living expenditures, and the time required to bring it to a desirable level may be so long that a young man becomes discouraged and abandons his plans to farm.

OTHER PLANS FOR FINANCING FARM BUSINESSES

The major problem of a farm operator is to gain control of enough land and capital for full and efficient use of the family labor supply. Where the acreage is small, the cost per acre of owning tractor equipment and specialized machines such as self-propelled combines is high. The operator with a small acreage of corn, wheat, soybeans, hay or other crop that can be planted, cultivated and harvested with a particular set of machinery finds it difficult to compete with a man who has a large acreage and can keep his equipment cost per unit of use low. A skillful manager can offset this handicap to some extent through cooperative ownership of machinery or by hiring work done on a custom basis; however, the timing of operations puts some limitations on these procedures. The need for adjustments in operating units to the new capacity to accomplish work with tractor machinery has long been recognized, but the investment required often makes the needed changes impractical to achieve under present procedures of getting control of capital. Spillman pointed out that attaining the

first rung on the agricultural ladder was becoming difficult back in 1919.¹³ Since then it has become more difficult to enter farming and it takes a higher level of managerial competence to ascend the ladder to full owner-operation. These facts suggest that better opportunities to get started in good farm businesses are essential to continuance of the family farm. Many plans for aiding young men to get started have been discussed. Three recent proposals are outlined here.

*The HOPE Plan*¹⁴

The letters H-O-P-E stand for Home Ownership Purchase Extension. The plan is a form of purchase contract. It provides for the transfer of a farm to an operator under the following conditions:

A. Title to the property remains with the seller until sufficient funds have become available for a cash transfer.

B. The buyer in the meantime guarantees to pay taxes, interest and insurance, to maintain the improvements, to spread lime on the soil when needed, and to keep the farm productive.

C. The depreciation on improvements is paid to the seller during the life of the agreement and is credited to the purchase price unless reinvested in the property.

D. An initial payment of ten percent of the purchase price is required at the time the contract is made.

E. The debt is protected, either by a life insurance policy payable to the seller, or by payments into a fund administered by a trust company as trustee. If the payment into the trust fund amounts to less than 10 percent of the purchase price within each three-year period, the seller has the right to cancel the contract and retain the original 10 percent payment.

F. Interest is paid to the seller each year on the unamortized balance of the purchase price.

This plan decreases the amount of money required to gain possession of a farm, but it has the following major defects:

(1) The fact that it would be necessary for a person first to acquire operating capital (quite often as much as the value of real estate), plus a 10 percent down payment on the farm would eliminate a great many worthy buyers.

(2) The seller also must be satisfied with a 10 percent payment at the outset and only interest payments each year while the interim payments are held in trust.

(3) The low initial payment would tend to increase the price of land if the plan came into general use.

(4) Buyers with small savings would be encouraged to purchase inadequate farm units; thus, in many instances, the adjustments needed for optimum com-

¹³W. J. Spillman, *op. cit.*

¹⁴Columbia University Seminar on Rural Life, *Farmers of the Future*, 1953, pages 34-42.

binations of labor and capital with land would not be made.

(5) Title would remain with the seller, and the buyer would forfeit the 10 percent down payment upon failure to meet any of the conditions of the contract.¹⁵

Veterans Land Board

This procedure was used in Texas to help World War II veterans purchase farms. The general principles were quite similar to those of the purchase contract. A veterans land board was created to purchase farms and make them available to service men with little or no down payment. Title remained with the board until the contract agreement was completed. At the peak of its activities, the Veterans Land Board was a strong factor in the land market. At one time it was reported that "Two out of every five bona fide sales in the state were to the Board."¹⁶

Leases and Special Agreements

Many types of leases and special business agreements have been used. Each has been designed to meet the problems of a particular business situation. Special agreements are most often used in the transfer of rights of property within a family. Under some conditions they enable the user to establish an efficient combination of factors to carry on a farm business. In other cases they retard needed adjustments. Many rented farms do not contain sufficient acreage of cropland for low unit cost of operating equipment, and the improvements are inadequate for the livestock enterprises needed for full employment of family labor. Under these conditions, leases and special business agreements retard the consolidation of holdings into more efficient operating units. It would be possible to set up minimum acreage and improvement requirements for rented farms, but this procedure has never been used in the United States. It would not solve the problem of financing adequate livestock and equipment for use on the land.

Neither the lending methods nor the renting procedures that have been developed have made it possible for farmers to keep pace with economic change. Loans based on ratio of net worth to total assets make it necessary for most beginning farmers to start as tenants. The problem here is to find an adequate farm and to equip it so land and capital equipment are in balance with the labor supply and managerial skill. The plain facts are that most of the farms available

¹⁵A purchase contract is used in many states as a means of transferring control of land to a buyer who makes a small down payment. A common feature of the agreement is forfeiture of the down payment on the principal if any condition of the contract is not met. Usually the buyers make annual payments on the principal to the seller, and the amount forfeited increases with the age of the contract. The HOPE plan is somewhat more favorable to the buyer in its provision for payments to a trustee and limit of forfeiture to the percent paid to the buyer when the sale is made.

¹⁶Progress Report 1956, *Texas Farm and Ranch Land Market*, The Texas Agricultural Experiment Station, Texas A & M College, College Station, Texas, 1953.

to beginning tenants are inadequate. As a result, many young men who make a start in farming are unable to earn sufficient income for the care of their families. The fact that 23 percent of the commercial farmers of the North Central states, the richest agricultural region of the world, received less than \$2500 gross income from the sale of farm products in 1954 shows that the operators of these businesses need to make widespread adjustments in the combinations of land, capital and labor resources that they are using. The material presented in the following section suggests a procedure for making these adjustments.

RISK CAPITAL FOR FARMERS

Risk is an important cost item in farm finance. It is present in the extension of credit of any kind, but usually is thought to be inversely proportional to the equity of the borrower. Most lending agencies are reluctant to make a loan when the equity of the borrower is small. If it is barely large enough to justify the loan, the interest rate usually is high to compensate the lender for the added risk. A beginning farmer is required to pay for this risk at a time when he can least afford it. Thus, he starts farming with a handicap in turning out and marketing a sufficient volume of products for a satisfactory level of income. The nature of this hardship is illustrated in Figure 1.

The established farmer in this illustration who has a good credit base and is able to obtain additional capital at a cost of 6 percent would find his marginal cost at the intersection of the low risk rate and the marginal product lines (Point P). The beginning farmer who is called upon to pay a high rate of interest will find his marginal cost at the intersection of the high risk and marginal product lines (Point P'). The established farmer can turn out OQ units of product, which is a larger quantity than OQ', the output of the beginning farmer who

Figure 1. Influence of contract interest rates on volume of agricultural production.

must pay an additional 1 percent for risk. This fact alone makes it difficult for the young farmer to become established in a good business.

Neither savings when used as a basis for loans from existing credit agencies nor current leasing procedures are making it possible for a great many farm operators to control optimum combinations of economic resources. Capital continues to be scarce on most farms in relationship to needs for funds. The people who control capital will continue to invest or loan it where they can get the highest returns. Agriculture will command only that portion of the total that can be made to earn as high or higher returns when invested in farm enterprises than can be earned if the money is used for some other industry. How can agriculture change its organization so more risk capital than can be supplied by farm operators will flow into the industry? This is the problem that needs to be solved.

The services of present credit institutions will continue to be needed to give farm operators access to funds that accumulate within a community and to transfer savings from areas of surplus to areas of deficit. Profitable farm businesses will attract these funds; subsistence ventures will not. It has already been pointed out that the problem of the individual farmer is to gain control of sufficient resources to set up a near optimum combination of land, capital and labor. Some new method of financing farm businesses is required to help large numbers of beginners make these combinations. The task cannot be accomplished by financing the transfer of existing units. The technological revolution of the last 25 years makes sweeping changes in present farm organization necessary. In many cases, more funds are required than lenders can supply under the rules that govern their operations.

Kristjanson points out that, "...under present conditions, the individual's farming career is dependent to an increasing degree upon his ability to compete in the capital market."¹⁷ The farmer with a substantial equity in a well organized business can compete. The man who is trying to get started with an inefficient business either is left out or is seriously handicapped because of capital shortage. Credit agencies ration funds by determining: (1) the proportion that is to be allocated to the various types of loans, and (2) the types and amount of collateral or security necessary to obtain funds.¹⁸

One of the major problems of the beginning operator is that of acquiring sufficient collateral to qualify for a loan. Many procedures are used to solve this problem. Recent investigations have shown that 80 percent or more of the young men who have started farming have received substantial family assistance.¹⁹ Thus,

¹⁷Baldur N. Kristjanson, "Research Into Equity Considerations in Tenure and Credit," *Journal of Farm Economics*, Volume 35, page 973.

¹⁸Ibid, page 973.

¹⁹Melvin G. Blase, "Procedures for Establishing Adequate Farm Businesses in Missouri," (Unpublished Master's thesis, University of Missouri, 1955) page 55; and Ted L. Jones, "Progres in Becoming Established in Farming," (Unpublished Master's thesis, University of Missouri, 1958), page 44.

the major difficulty has been that this aid has been inadequate. The rate at which they have been able to accumulate capital has been more closely related to the size and organization of the businesses with which they started than to type of farming, educational training, previous experience, and many other factors.

Low equity financing to provide optimum resources for a farm operator increases the risk of the agency that supplies the funds. A financial institution that would meet this need, by the very nature of the operation, must be set up in a manner that will permit it to cope with the risks involved. A credit agency that loans only 50 to 65 percent of the normal agricultural value of a farm and 50 to 75 percent of the market value of chattels is not assuming very much risk, but an organization that provides all of the needed capital is likely to have financial losses and needs to be operated in a manner that will provide for absorbing them.

THE CORPORATION AS A FINANCING AGENCY

The corporate type of business organization appears to be well adapted to the task of supplying risk capital to farmers. A corporation is a body of associated persons authorized by law to act as a single person. Its powers are limited, and its operations must conform to established corporation law. It can hold property, engage in the type of business authorized in its charter, and sue and be sued in the corporate name. It has the following advantages over a partnership or individually owned business: (1) As an organization, it has limited liability. A shareholder can lose only the value of the shares he holds. The other property he owns is not in jeopardy in case the corporation gets into financial difficulty. (2) Individuals who are not acquainted can invest in shares without the need of investigating the other shareholders' integrity. This situation permits a wide distribution of the total investment and also provides opportunity to invest small savings. (3) Provision usually is made to elect a Board of Directors by the shareholders. This board usually is made up of people who are interested in the success of the company, and choose the other officials. (4) The corporate plan of organization provides for continuous existence of the firm for the life of the charter, regardless of whether or not the shareholders change. In partnerships and individual proprietorships, the death of one member dissolves the firm.

There seems to be no good reason why the corporate type of organization should not work as well in agricultural finance as in other kinds of business. One of the principal reasons for not using it is the traditional policy of owner-operation of family-type farms. Timmons of Iowa State University of Science and Technology and O'Byrne of the University of Iowa recently observed that little use has been made of the corporate structure for farm organizations in Iowa, despite its many advantages as a form of business organization. Corporate ownership of farm businesses lends itself readily to settlement of estates, since it converts the nature of the individual holdings from interest in land, ma-

chinery, livestock and other items to readily transferrable ownership certificates which are primarily rights to share in earnings. Furthermore, a corporation may be created to last for a period of years or forever, and therefore continues to exist as a functioning unit, even though the shares are transferred during life or upon the death of the share owners.²⁰

One of the principal difficulties in achieving and maintaining optimum allocation of economic factors in American farm businesses is the fact that our system of treating land as private property requires a farm to be refinanced once each generation. When an owner passes away or decides to liquidate his business, the land usually is sold as a separate asset. Livestock and other working capital are dispersed at a public sale, thus breaking up a good combination of resources. As a financing device, a corporation could correct this difficulty by rendering the following useful services:

(1) It could establish well balanced farm businesses with sufficient acreage of cropland for low-cost use of machinery, equip the land with water control structures, treat the soils for high yields of crops, see that buildings were adequate for the farm family, for crop storage and care of livestock, and provide plenty of livestock and equipment for efficient operation of the farm.

(2) It could supply risk capital for adding enterprises to inadequate farm businesses and for enlarging units that do not bring in satisfactory returns for farm families.

(3) It could make these businesses available to competent operators and aid them in the solution of their managerial problems by having tenants work under the supervision of highly trained farm managers.

(4) This procedure would make it possible for an heir to an estate in farm property to dispose of his equity without forcing liquidation of the business.

An organization of this kind would not own a large acreage of land and operate it with hired men who work under the direction of one or more foremen. It would be a financing and scientific management agency that would strengthen and preserve the family farm by helping young men to set up, operate, and ultimately own efficient businesses. These services could be guaranteed by provisions in the charter that would limit the activities of the corporation to financing and managing family farm businesses.

The first consideration of a corporation of this type would be efficient use of the factors of production. Analysis of farm records shows that no factor can be left inadequate without reducing returns to the business. Ownership of land by the farm operator with very little savings may be undesirable, particularly where leasing arrangements can be made that will give the family reasonable security of tenure. Since the corporation would furnish most of the capital, it would be necessary for it to supervise the management of the businesses it owned.

²⁰John F. Timmons and John C. O'Byrne, *Transferring Farm Property Within Families in Iowa*, Agricultural Experiment Station Research Bulletin 394, Iowa State University of Science and Technology, Ames, Iowa, 1953, page 196.

Specialization in this field would require ownership of several farms. The number would depend upon such factors as types of enterprises included in the individual businesses, location with respect to markets, and amount of rent paid. The manager would need to spend more time with the holder of a livestock share lease than with a cash grain tenant. In the opinion of some professional farm managers, a well-trained man can take care of 25 to 50 farms, if they are in relatively close driving distance of each other. In order to make full use of the services of a manager, the corporation should own as many farms as he could supervise efficiently.

Organizational Structure

The financial structure visualized here would permit the corporation to issue two types of shares, Class A and Class B. The Class A shares would represent equities in the firm. Class B shares would represent equities in individual farms held by the firm. A tenant could purchase Class B shares in the farm he operated if he desired. When he had enough of the shares to own the livestock and equipment free of debt and a sufficient equity in the land to get a mortgage from one of the existing lending agencies such as an insurance company or a land bank, he could buy the farm and have a well-balanced business. If the corporation had 50 farms and it took individual operators an average of 12.5 years to buy all of the Class B shares in the farms they operated or a sufficient number of shares to finance the purchase with another organization, the corporation would average buying four additional farms each year with the cash obtained from the sale of Class B shares. Thus, the assets of the corporation could be used as a revolving fund for consolidating or improving inadequate farm businesses and for making adequate units available to young men who want to farm but do not have the necessary capital for the initial start.

Operating Procedure

The farms owned by the corporation would be made available to tenants under appropriate types of leases or business agreements. Each farm would have a cropping system based upon the use capabilities of the land. The livestock organization would depend upon the feed supply resulting from the cropping system, the type needed to provide continuous employment for a family labor force, and availability of markets. The corporation would finance the entire business, issue Class B shares against the investment in each farm, and let the farmer own as much equity in it as his resources permitted, his equity being determined by the proportion of Class B shares he held. All operating expenses would be paid out of farm receipts. Depreciation on buildings and equipment would be subtracted from receipts and all other inventory changes taken into consideration in determining the net income to be used in calculating dividends on the Class B shares. Out of the corporation's share of the income from all of the

farms it held, reserves would be established and dividends paid to Class A shareholders. Earnings on Class B shares would be figured annually for each farm by taking the returns to that particular business, subtracting a management and reserve charge, then dividing the remainder by the capital value of the unit. For example, if the total investment in a particular farm business were \$40,000 and the net income \$6,400, earnings on the Class B shares would be calculated as follows:

Net farm income	\$6,400
Wages to operator	1,800
Management and reserve charge (20%)	1,280
Net earnings on Class B shares	\$3,320

$$\$3,320 \div \$40,000 = .083 \times \$100 = \$8.30 \text{ per share.}$$

One procedure that could be used in making the annual settlement with a tenant would be to allow him hired man's wages and interest at the rate earned on his investment in Class B shares. In the above example the settlement would be as follows for a tenant who held \$5,000 worth of Class B stock:

Operator's share

Wages	\$1,800
Earnings on 50 shares of Class B stock @ \$8.30	<u>415</u>
Total	\$2,215

Corporation's share

Management and reserve charge (20%)	\$1,280
Earnings on 350 shares of Class B stock @ \$8.30	<u>2,905</u>
Total	\$4,185

Another procedure that could be used in making the annual settlement would be to allow the tenant hired man's wages for his work, interest at a standard rate, say 5 percent, on his investment in Class B shares, and one-half the surplus after similar deductions were made for management service, reserves, and interest on the investment of the corporation. The division of a \$6,400 net farm income would be as follows;

Operator's share

Wages	\$1,800
Earnings on 50 shares of Class B stock @ \$5	250
One-half of net balance	<u>660</u>
Total	\$2,710

Corporation's share

Management and reserve charge (20%)	\$1,280
Earnings on 350 shares of Class B stock @ \$5	1,750
One-half of net balance	<u>660</u>
Total	\$3,690

The second of these procedures is more favorable to the tenant than the first and less favorable to the corporation. From the point of view of economic theory, the second procedure would be preferred. It would reward the tenant for

his labor at the wages he would receive as a hired man. Capital would be rewarded at 5 percent, which was approximately its opportunity return in the year of settlement. Both wage and interest rates could be varied with market conditions. The division of the net balance equally between the contracting parties would reward the tenant for a superior job of farming and encourage him to improve his managerial skills. The second procedure was used in the analysis presented in Tables 8 and 9.

The tenant would receive a dividend equal to the rate paid on the Class A shares of the corporation and one-half of the balance of net income after deducting a similar dividend on the shares held by the corporation and 20 percent of the net farm income for management and reserves. This procedure would give a superior tenant a return on his investment that would be in line with his skill as a farm operator. The provisions in the charter of the corporation with regard to Class B shares could give the holder any or perhaps all of the following privileges:

- (1) To sell his shares to any buyer with the provision that when the transfer was made the shares would become Class A shares. This provision would give the two classes essentially the same market value.

- (2) The corporation would stand ready at any time to buy back the Class B shares from any tenant at the market value of Class A shares.

- (3) In case a tenant decided to move from the farm, he would have the privilege of selling his holdings of Class B shares to the new tenant at a price acceptable to the two parties and to officials of the corporation. In such an exchange, it would be necessary for the corporation to approve the new tenant. If the prospective tenant did not meet the approval of the corporation, Class B shares would become Class A upon the termination of the lease held by the seller of the shares.

- (4) Special provisions could be made for the corporation to purchase the Class B shares from the estate of a tenant who passed away while holding shares of this type.

An issue of Class B shares of necessity could not be for a greater amount than the capital value of the particular farm in which the money was invested. Dividends on the Class A shares would be determined by dividing the net earnings of the corporation by the number of shares outstanding.

Income Records Applied to Plan

The results of operating a business according to this plan were examined by applying the procedures outlined above to some continuous farm income records. The results are shown in Tables 8 and 9. The operator of the farm used in Table 8 purchased the land in 1940 for \$11,225. In 1946 it was worth approximately \$19,419, but the improvements that had been made and the working capital raised the investment to \$28,627. In the analysis it was assumed that the operator had \$5200 to invest in the business. This is the average equity that men

have had when starting farming in recent years. The 160 acres were quite rolling and badly eroded at the time of purchase. The operator was able to make interest payments and save a little money before 1946, but his machinery was inadequate and the buildings, fences and land needed a lot of improvement.

The data presented in Table 8 show how the income from this farm would have been divided and the rate at which the operator would have accumulated capital, if he had started operating it in 1946 with \$5200 equity in the business. The tenant's contribution to the operation was his own labor, which was valued at wages for a hired man who was furnished a place to live and interest on the \$5200 equity. The corporation's contribution was interest on the investment other than the equity of the operator and the part-time services of a skilled manager. Expenses of operating the business were paid out of income. The net farm income was divided so the operator received his wages, 5 percent interest on his equity, and one-half of the net balance after the corporation was paid interest on its equity and 20 percent of the net farm income for managerial services and reserves. If the \$5272 net income for 1947 which included adjustments for inventory changes and depreciation were divided in this manner, the tenant would receive \$2370 and the corporation \$2902. The living expenses of the tenant in 1947 were \$1315. Subtracting this amount from \$2370 leaves \$1055 for investment. With this amount he could purchase 10 shares of Class B stock at \$100 per share.

In 1948 the net income to the farm business was \$5575. The tenant would have received \$2557. His living expenses were \$1707. The difference was \$850, which was sufficient to purchase eight shares of Class B stock. If this plan of plowing earnings back into the business had been followed throughout the 1946-58 thirteen-year period, the tenant could have increased his equity from \$5200 to \$19,400. The corporation would have received an average of \$1026 a year for its management and reserve account and could have invested \$5567 of its share of the net balance in the business. Earnings on the investment after paying wages to the operator and 20 percent of the net farm income to the corporation for management services and reserves varied from 1.2 to 20.1 percent. The corporation would have reduced its investment from \$23,427 to \$14,786 through sale of Class B shares to the operator.

This farm business was too small for optimum use of equipment and full employment of family labor. These deficiencies would be corrected under a program of equity financing of farm businesses and returns to each of the factors would be higher than shown in Table 8. Nevertheless, the income for the years 1946 through 1958 was large enough to pay an average of 7.8 percent dividends on the shares after deducting wages for the operator and 20 percent of the net farm income for management and reserves. At the close of 1958 the tenant would have had an equity of 56.7 percent of the book value of the business. His investment would have been \$19,400—3.7 times the \$5200 with which he started.

In order to determine the results which might occur under a wide variety

TABLE 8--FARM A. LAFAYETTE COUNTY, MISSOURI. INVESTMENT IN AND INCOME FROM A FARM BUSINESS DIVISION
OF INCOME BETWEEN TENANT AND CORPORATION, RATE OF CAPITAL ACCUMULATION BY THE TENANT
AND RETURN ON THE INVESTMENT 1946-1958

(The tenant was assumed to have an equity of \$5200 in the business when he started farming in 1944)

Item	1946	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958
Capital at beginning of year													
Corporation	\$23,427	\$22,871	\$22,575	\$22,549	\$22,414	\$22,064	\$21,679	\$21,115	\$20,443	\$19,566	\$18,613	\$17,610	\$16,553
Farm operator	5,200	5,400	6,400	7,200	7,300	7,600	8,700	9,400	12,200	13,500	14,200	14,800	18,300
Total	28,627	28,271	28,975	29,749	29,614	29,664	30,379	30,515	32,643	33,066	32,813	32,410	34,853
Net Farm Income	2,477	5,272	5,575	3,336	3,793	5,696	4,429	9,492	5,361	3,745	3,457	10,727	3,330
Distribution of Income													
Wages to operator	1,313	1,395	1,464	1,452	1,452	1,644	1,752	1,812	1,812	1,848	1,932	2,076	2,256
Management and Reserves	495	1,054	1,115	667	759	1,139	886	1,898	1,072	749	691	2,145	666
Balance	669	2,823	2,996	1,217	1,582	2,913	1,791	5,782	2,477	1,148	834	6,506	408
Percent return on investment	2.3	10	10.3	4.1	5.3	9.8	5.9	18.9	7.6	3.5	2.5	20.1	1.2
Operator's share													
Wages	1,313	1,395	1,464	1,452	1,452	1,644	1,752	1,812	1,812	1,848	1,932	2,076	2,244
Interest on investment	260	270	320	360	365	380	435	470	610	675	710	740	915
Share of net balance	- 356	705	773	- 135	51	715	136	2,128	422	- 252	- 404	2,442	- 666
Total	1,217	2,370	2,557	1,677	1,868	2,739	2,323	4,410	2,844	2,271	2,238	5,258	2,493
Less living expenses	988	1,315	1,707	1,530	1,498	1,542	1,568	1,555	1,507	1,498	1,583	1,741	1,352
Available for investment	229	1,055	850	147	370	1,197	755	2,855	1,337	773	655	3,517	1,141
Investment	200	1,000	800	100	300	1,100	700	2,800	1,300	700	600	3,500	1,100
Total equity	5,400	6,400	7,200	7,300	7,600	8,700	9,400	12,200	13,500	14,200	14,800	18,300	19,400
Corporation's share													
Management and reserves (20%)	495	1,054	1,115	667	759	1,139	886	1,898	1,072	749	691	2,145	666
Interest on investment	1,171	1,144	1,129	1,127	1,121	1,103	1,084	1,056	1,022	978	931	881	828
Total	1,666	2,198	2,244	1,794	1,880	2,242	1,970	2,954	2,094	1,727	1,622	3,026	1,494
Net balance	- 712	1,409	1,547	- 270	101	1,430	272	4,256	845	- 505	- 807	4,885	- 1,323
Tenant's share	- 356	705	774	- 135	51	715	136	2,128	423	- 252	- 404	2,442	- 666
Corporation's share	- 356	704	773	- 135	50	715	136	2,128	422	- 253	- 403	2,443	- 667

of economic and climatic conditions, the record of a Nemaha County, Nebraska, farm for the years 1934-1947 was analyzed (Table 9). This is a 460-acre beef cattle and hog farm in the river hills section of the county. The farm contains 347 acres of cropland, 70 acres of pasture and 43 acres of farmstead, timber, roads and waste. In the period for which records are available, the operator fattened and sold an average of 215 head of cattle and 130 hogs a year. In 1934, this business represented an investment of \$56,610. If a financing corporation had made it available to an operator with a \$5200 equity, he could have added to his holdings each year of the 14-year period, except in 1936 and 1937. This period was plagued by drouth and low prices. Feed grain crops failed completely in 1936 and yields were low in several additional years including 1945. The index of prices received by farmers varied between 90 and 275 during this 14 years (1910-14 = 100). The low point in the parity ratio was 75 in 1934 and the high point 115 in 1947. From 1934 to 1941 it was below 100. Despite these unfavorable conditions, the operator could have increased his equity from \$5200 to \$8853. The advance came rapidly after 1941 and stood at \$22,953 at the close of 1947 (Table 9).

Analysis of other records shows that a farm operator who starts with a well-balanced business of adequate size for efficient use of capital and labor accumulates savings more rapidly than a man who begins farming with an inadequate unit, hoping to grow into a good business.²¹

Further examination of the data presented in Table 9 shows that the business would have returned an average of 8.2 percent on the investment during the 14-year period after deducting 20 percent of net farm income for management and reserves, and wages for the operator equal to the rate for hired men who were furnished houses. The lowest return to capital was 3.7 percent in 1937 and the highest 19.2 percent in 1942. A financing and managing corporation could have paid 5 percent interest or dividends on all of the capital and increased the investment in the business out of earnings. The 20 percent of net farm income withdrawn for management and reserves would have provided an average of \$1436 per year for these uses. In the lean years (1934-41) the average would have been \$1061. If the corporation had owned 50 farms like this one, the annual income for management and reserves would have been \$71,800 for the 14-year period and \$53,050 for the 8 years 1934 through 1941. These amounts should be enough to pay the costs of the services rendered.

PRICE CHANGES FOR LAND AND CAPITAL EQUIPMENT

One further problem arises in connection with corporation financing of farm businesses. It deals with the effect on the capital position of the corporation, if a farm is purchased and improved at high prices and sold during a period of low prices. Under these conditions, no doubt, the company would receive

²¹Melvin G. Blase, *op. cit.*

less than was paid for the farm. As long as the farms held by the company can be operated at a profit, changes in capital value are not important. If the farm was purchased, improved and equipped during a period of low prices and the business sold at a higher price, there would be a capital gain, but it would cost more money to buy back additional land, livestock and equipment at this time than previously. The net result would be merely an exchange of physical assets. The reverse of this situation would prevail during a period of declining prices. Even though there was a capital loss, it would not cost as much to buy another farm business. Thus, the number of acres, the livestock organization and the volume of products available for sale could be kept about the same, regardless of the economic situation.

If the corporation sold an average of one farm business a year and bought another to replace it so as to maintain a full work load for its staff, the superior efficiency resulting from near optimum combinations of productive factors in each operating unit would maintain its net earnings at a satisfactory level.

Another look at the record for Farm A might be interesting as it relates to the question of whether a piece of land can be purchased, improved and sold for an amount equal to the purchase price plus the cost of improvements. The price the buyer would pay for a farm at a given time is closely related to its productivity and the amenity value it has for that particular person or family. The owner of the farm used in Table 8 paid \$11,225 for it in 1940. By 1956 he had added \$10,309 of improvements, making his total real estate investment \$21,534. After depreciation, his investment in land and buildings at the end of 1954 was \$16,936. A real estate man in the community estimated the value at \$44,000 in the spring of 1955. Comparison of the farm with other places that had been sold recently indicated that this estimate was close to what the farm would have brought on the market. The capitalized value of the net rent income at 5 percent was \$44,200. If the 1955 market price were deflated to 1940 levels, the value of the improved land would be \$18,290. This amount is less than the \$21,200 which represented the 1940 price and cost of improvements. It is more than the \$16,936 value, or original price and value of improvements after depreciation.

SERVICES RENDERED BY THE CORPORATION

The primary purposes of a financing and managing corporation would be to furnish risk capital to farmers and to assist them with their management problems. The two items in which a young man starting to farm is most likely to be deficient are capital and skill in management. The corporation would correct these deficiencies. It would not be wise or practical to take a beginner with no experience and put him in charge of a business representing an investment of more than \$50,000. He would need to spend some time training for the job. This training could be supplied by allowing him to be the second man on one of

the larger, well-established units where his work could be supervised by an experienced operator and the farm manager for a period of one or more years. During this time he would have an opportunity to get acquainted with the organization and its procedures. It would also give the farm manager a chance to observe his attitudes, decision-making abilities and general aptitude for becoming a successful farm operator.

In order to improve efficiency of production, the corporation would buy inadequate farms and equip them for more intensive operation by installing water control structures, treating the soils, remodeling or constructing buildings, and by combining two or more units to get the larger acreages or more intensive enterprises that are needed for more efficient businesses. In some cases, the corporation could take title to an inadequate farm business, pay the operator for his equity in Class B shares, leave him on the place, and enlarge the business to make it an efficient operating unit.

Still another service could be rendered in the transfer of property to the next generation. In many instances, only one member of a family is interested in continuing to operate the home farm. The other heirs want their money when the property is available for transfer to them. This means that either the business must be dispersed completely, or the heir who wants to farm must buy the others out. If the operator does not receive a high percentage of the inheritance, or if the property is already pledged as security for debt, he may find himself unable to pay the other heirs and maintain an efficient business. In such a case, the corporation would purchase the entire unit, give the other heirs either cash or Class A shares for their equities and the operator Class B shares for his interest. He could continue as operator and possibly buy back the unit in later years. By this procedure, the time-worn practice of tearing down farm businesses and rebuilding them each generation would no longer be necessary. By this procedure one of the principal problems in American agriculture would be solved.

In cases where no one in the family wanted to farm or to hold a well-balanced farm business as an investment, the corporation would be in position to purchase the unit just as it exists. If the livestock organization and cropping system were well-balanced, the business adequate for efficient operation, and the conservation needs of the soil were being met, no changes would be needed. If not, the business would be reorganized for efficient use of the resources in it. This procedure would get away from the economic losses involved in building up breeding herds of hogs or beef or dairy cattle and dispersing them each generation. It would also eliminate the practice of depleting the soil with cash crops while beginning operators are trying to grow into efficient businesses.

Still another area in which the corporation would be of value would be the opportunities that it would provide for investment. The farmer who wishes to retire and needs money to buy a house in town may wish to keep a part of the value of his farm in agriculture. At the present time, he can buy Federal Land

Bank bonds, but they bear a low, fixed rate of return. By purchasing shares in the corporation he would have an investment in agriculture that would profit from superior efficiency in production and management. It would be much easier to divide an estate composed of these shares than to divide a piece of land or a single farm business. In case he should die before his wife, the income from dividends would continue without the need of his supervision.

It has been the aim of most legislation concerned with agricultural credit to help farmers become owner-operators. Title to the land he operates has been the ambition of most farmers throughout the entire history of the United States. Many people still think it is necessary for most farmers to sit under their own "vine and fig tree" in order to have a feeling of "belonging" in a community. With fewer than 15 percent of our people on the land and approximately 55 percent of the 4.8 million farms operated by tenants and part-owners, the ideal of 100 percent owner-operation of family type farms as the first requirement of a stable economy appears to be little more than an academic dream. Perhaps the national ideal should be shifted to providing efficient businesses for farm operators, regardless of tenure status. The man who is farming a well-balanced, corporation-financed unit and making a satisfactory income may be better off to continue as a tenant and make his investments either in shares of stock in the corporation or some other type of equity than to attempt owner-operation of an inadequately financed business. Data from northern Missouri and southern Iowa show that farmers who started in business as owner-operators in 1953 with net worths of \$9314 received net farm incomes that averaged \$831, scarcely enough for family subsistence. Off-farm work and gifts brought the total family income to \$1800, which was too low for family needs. Tenants who started the same year with net worths averaging \$5248 received net farm incomes of \$1889 and total family incomes of \$2971.²²

PROBLEMS OF ORGANIZATION

It would be folly to suggest that an organization of the type described in this publication could be put into operation without encountering some difficulties. If this system of farm finance is to become effective, the following types of problems needs to be overcome:

- (1) Legal restrictions on corporate ownership of farm land in some states,
- (2) Investor reluctance to buy the shares of stock so enough can be sold to finance 50 or more well-organized farms, and
- (3) Procedures for meeting, organizing and financing expenses until the company becomes established.

Article XI, Section V, of the Missouri Constitution may be an example of legal difficulties that need to be overcome. It reads as follows;

²²Ted L. Jones, "Progress in Becoming Established in Farming", Unpublished manuscript, Department of Agricultural Economics, University of Missouri, 1958.

"No corporation shall engage in business other than that expressly authorized in its charter or by-laws, nor shall it hold any real estate except such as is necessary and proper for carrying on its legitimate business; provided that any corporation may hold, for ten years or for such longer periods as may be provided by general law, real estate acquired in payment of a debt, by foreclosure or otherwise, and real estate exchanged therefor."

This section does not specifically forbid ownership of farm land by corporations, but the language in it would need interpretation by the courts before investors could safely organize an equity financing corporation. Professor William H. Pitman, of the Missouri School of Law, says he can see nothing in the Constitution and knows of no court rule that would keep the corporation described here from being organized. However, the meaning of the Constitutional provisions dealing with corporation ownership of land in Missouri has not been made clear, and legal restrictions appear to be more rigid in some of the other states. The removal of legal restrictions will require legislative action in many states and court action to clarify the meaning of laws in others.

Removal of investor reluctance to buy shares in an untried organization may require special action on the part of groups who want to improve the use of resources in agriculture. Any new business must have time to become established and to build good will before investors bid strongly for its shares. Approximately 2.5 million dollars would be required to set up an equity financing corporation that could make full use of a minimum staff of well-trained people. It might be difficult to assemble this amount of money quickly through the sale of shares of stock. The following procedures are suggested for financing the initial venture:

- (1) Get one of the large foundations to make capital available for a 15-year period with repayment privileges at any time. Offer the stock to investors and return the money to the foundation as rapidly as sales permit.

- (2) Have life insurance companies and other lenders turn over 50 farms to the financing agency near a central office for use during a 15-year period. As shares in the corporation are sold, return the value of the farms to the companies that make them available.

- (3) Organize an equity financing division in Farm Credit Administration and obtain the funds by reducing cash dividends to National Farm Loan and Production Credit Associations. As operators of the division-owned farms acquire equities that permit standard loans, finance individual farm businesses through the Land Banks and Intermediate Credit Banks. The money that is returned to the equity financing division can be used to bring other farm businesses to a high level of efficiency.

The problem of meeting initial organizational and operational expenses can be met by permitting these items to be paid out of the capital account for a period not to exceed five years. The money can be repaid from earnings as income justifies its return.

Management Problems

The management problems under equity financing of farm businesses might be somewhat different than under individual ownership and standard leasing arrangements. The incentive would be present for the officials of the corporation to make as high a profit as possible. Returns to both operator and owner would be proportional to the net income of the farm business. Net income would be maximized by keeping each major piece of farm equipment in use to its full seasonal capacity. More nearly optimum combinations of factors would reduce or eliminate completely many of the management problems that now exist on inadequate farms. Since all expenses, including repairs to the buildings and fences, must be paid before the net income is divided, the tenant would be interested in keeping these costs as low as possible. The type of joint interest that would be created by the lease or business agreement would require a high degree of mutual trust between the manager and the tenant. For this reason, the farm manager would need to be a person well trained in human engineering as well as farm management.

Transfer of Title

A distinguishing feature of the plan outlined in this analysis is the provision for transfer of the property to a successful operator. The time to consider such a transfer would be when the operator had accumulated sufficient equity to own the working assets completely, and to finance purchase of the land with a credit agency such as the Federal Land Bank or a life insurance company. The business should be sold as a complete unit, not as separate items of land and working assets. Under present lending practices, satisfactory equities would have to be acquired to qualify for both real estate and chattel loans. The price would be determined at the time the sale was made. This procedure is necessary to maintain the assets of the corporation. If land values and prices of working assets such as livestock and machinery have advanced, replacement of the business will cost more than was paid for it. If prices have declined, it can be replaced for less. The operator should not be required to buy the farm where he has acquired his savings, if another business is available at lower cost. Under these conditions, he should have the privilege of selling his Class B shares either to the corporation itself or to another tenant so that he can purchase the other farm.

SUMMARY AND CONCLUSIONS

Families who do not inherit substantial equities in good farm businesses have difficulty in getting established in farming. This fact is causing farm leaders much concern over the possibility of losing the family farm as a basic institution of rural organization.

Numerous programs have been tried to overcome this difficulty. They have

included special credit facilities and many price and income stabilizing measures. Most of these procedures have already proved to be ineffective. They will continue to be impotent if they are not directed toward improving the economic organization of farm businesses so that production costs can be reduced and products sold at supply-demand prices. In order to improve economic efficiency, the farm labor force must be kept fully employed, capital equipment in full seasonal use, and the land at a high level of productivity. Sweeping changes must be made in the organization of most farms, if the economic position of rural people is to be improved.

Present lending practices do not permit most of the credit agencies to finance adjustments needed for farm operators to take advantage of the new farm technology that has been developing in the last half-century. The result is widespread frustration, both among farmers and the leaders of farm organizations.

Successful ascent of the old agricultural ladder from farm laborer to farm owner is practically impossible now without substantial family assistance. This difficulty will be removed, if some provision can be made for supplying risk capital to young farmers at the time they are best able to carry a heavy load of work.

Another problem that confronts many young farm operators is lack of skill in managing a business. A financing corporation designed to bring risk capital to agriculture can overcome this difficulty by providing managerial aid to young men during their early years in farming.

Analysis of farm records shows that this system of finance, when applied to well-balanced operating units, will provide incomes that will permit efficient operators to accumulate capital and become owners much earlier than they can under the procedures now being used. The corporation that supplies the risk capital will be able to pay its operating expenses and return dividends to investors that exceed the usual rate paid on bonds or farm mortgages.

A financing corporation also will make it possible for young operators to begin increasing their net worth almost from the outset of their start in farming. The speed of savings accumulation will depend upon many factors. One of the most important is the spending habits of the family. The records that were examined showed that it would be possible for a farm operator to become an owner in a reasonable number of years while maintaining a level of living equal to or above the average of the community where the farm is located.

The financing corporation that would make this capital available to farmers would present the following major advantages: (1) it would provide for more effective use of resources than under existing financing procedures; (2) it would permit payment of interest on capital, rent on land, wages to labor and profits to management more nearly in line with their contributions to earnings than is possible on a high percentage of farms at this time; (3) it would decrease the economic losses resulting from closing out farm businesses and re-establishing them each generation; (4) it would strengthen rather than jeopardize the family

farm; (5) it would build strong equities in efficient farm businesses for existing credit agencies to finance; and (6) it would help beginning farmers get started in a profitable business without paying the penalty of high interest rates to take care of risk.

Three major obstacles lie in the pathway of organizing this type of financing agency: (1) legal restrictions on corporate ownership of farm land in many states; (2) the problem of selling enough stock to finance 50 or more well-organized farms at a cost of \$50,000 or more per farm; and (3) the expense of operating such a holding corporation until it becomes established and income begins to flow through it.

If these obstacles can be overcome, a financing corporation appears to be the solution to many of the problems confronting farmers and national leaders who frame agricultural policies.