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Reasons for and Implications of Declining Farmland Prices

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by

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Farmland prices in South Dakota have declined for three consecutive years. The average per acre price of South Dakota farmland sold from January-July 1985 declined 34% from the 1981-1982 peak.

Long term and recent South Dakota farmland market trends have been discussed in two recent Economics Newsletters (No. 219--March 13, 1985 and No. 229--October 28, 1985). In this newsletter, major reasons for farmland price changes and selected implications of declining farmland prices for South Dakota are discussed.

Fundamental Determinants of Farmland Prices

The level of farmland prices is fundamentally determined by current and expected future net returns earned from using farmland. Net returns are influenced by (1) domestic and export demand for crop and livestock commodities, (2) Federal economic policies concerning international trade and finance, interest rates, taxation and farm programs, and (3) gains in agricultural productivity and farm enlargement pressures. Changes in the first two factors can lead quickly to farmland price changes and are emphasized in this newsletter.

During the 1970's farm operators--the major buyers of farmland--experienced increased returns to land. This took place because of booming export markets for farm products, and related positive demand factors. Many farmers, lenders and investors expected these trends to continue. Because net returns were rising rapidly, it was not unusual for (1) buyers to bid up the price of farmland to the point that rates of return to farmland, in the year of purchase, were less than rates of return on alternative, fixed income long-term investments, and (2) for interest rates to exceed current rates of return on farmland.

Essentially, farmland buyers were competing for the right to obtain expected future increases in land income or net returns. This additional expected income would be used to help make the loan payments. However, when expected increases in net returns to farmland in the early 1980's did not materialize, farmland prices declined sharply.

Factors Explaining Recent Farmland Price Declines

Market prices of farmland are continuing to move downward in response to reduced profits in agriculture and poor prospects for a quick turnaround. Export market demand continues to weaken and reduce domestic demand for some products (beef) has kept farm prices and profits down. The recent reductions in exchange rates could help to stem the decline in exports, but record carryover of coarse grains, wheat and soybeans will likely keep market clearing prices of grain relatively low.

Final provisions of Federal farm commodity and credit programs for the next few years are still uncertain at this time. "Covering losses" on farm loans is likely to prevent major declines in interest rate and other loan charges. Fiscal policies of continued high deficits will likely counter any efforts to substantially reduce interest rates. These and related factors create added uncertainty concerning future earning prospects in agriculture.

Substantial debt loads remain on many established farms--the same farmers who previously were the strongest bidders in the land market. Potential buyers have held back due to already heavy cash flow commitments and/or expectations of further farmland price reductions.

The near term (1986) outlook for stabilization or increases in South Dakota farmland prices is not favorable. Major changes in world agricultural economic conditions and Federal policies (monetary/fiscal, agriculture and credit) could alter the farmland market outlook in succeeding years.

Major Implications of Declining Farmland Prices

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Declining farmland prices are a contributing source of current financial stress in agriculture. Farm real estate accounts for two-thirds of the value of physical assets used in South Dakota agriculture. Buyers purchasing farmland in the late 1970's, with mostly borrowed money, have seen their equity erased and at the same time their debt-servicing commitments increase or remain the same. Many farmers who borrowed against their land equity base for operating capital or purchasing additional land have also endangered their financial position.

Declining farmland prices also reduces the financial wealth base of all farmland owners. The "retirement fund" for many older landowners is reduced when the rental income obtained from continued ownership declines or when farmland sale prices decline. For others, the collateral base for future credit requests is reduced.

The rate and extent of change in farmland ownership may become a major issue in many agricultural states. Many older farmers in a strong financial position may not desire to extend their landholdings. Middle age farmers previously engaged in expanding their farm operations may not have the financial capacity to do so in the next few years. In localities where these factors become important, nonfarm investment capital (debt or equity) could assume a greater role in the farmland market.

At the same time, lower land (and used machinery prices) reduces the entry barriers for beginning farmers who can obtain adequate amounts of equity capital. An important issue determining the future structure of agriculture is the comparative financial strength and risk taking ability of different potential farmland buyer groups.

Declining land prices are not likely to have much impact on the amount of land in agricultural production, in the absence of conservation reserve or production control programs. "Deferred maintenance" of farmland and buildings is likely to increase as producers attempt to minimize cash outlays.

Declining farmland prices affects the security position of many agricultural loans and is highly correlated with reduced repayment ability of many farm loan accounts. This has been a contributing factor to increased failure rates of agricultural banks and to financial problems experienced by the Farm Credit System. Public policies concerning the extent of farmland ownership/leasing by financial institutions may also have some impact on future landownership patterns.

Lower farmland prices and related farm cash flow problems also create financial problems for many businesses, churches and other voluntary organizations in rural communities. Farmland is also the major component of the property tax base in most South Dakota counties and school districts. Current property tax administration procedures delay the impact of declining farmland prices on taxable property values and the amount of property taxes paid by farmland owners. However, at some point, the financing of local public services and schools may be affected.