

Are Farm Business Profit Margins Enough?

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Since 1999, combined farm and non-farm incomes have been rather good for Kentucky Farm Business Analysis Program (KFBM) sole proprietorships. Although erratic, average farm incomes have ranged from \$28,989 in 2002 to \$76,774 in 2003. Non-farm incomes have been increasing and have ranged from \$27,289 in 2002 to \$36,213 in 2004. Figure 1 graphically illustrates the sources of income from 1998 to 2004.

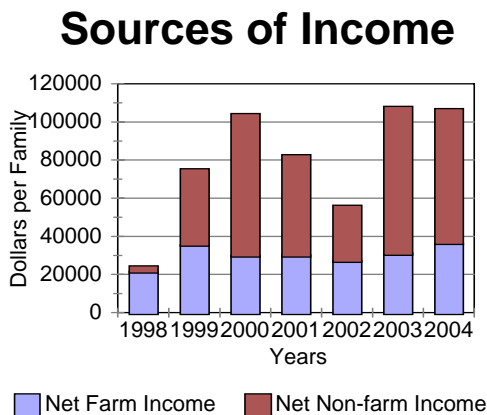


Figure 1.

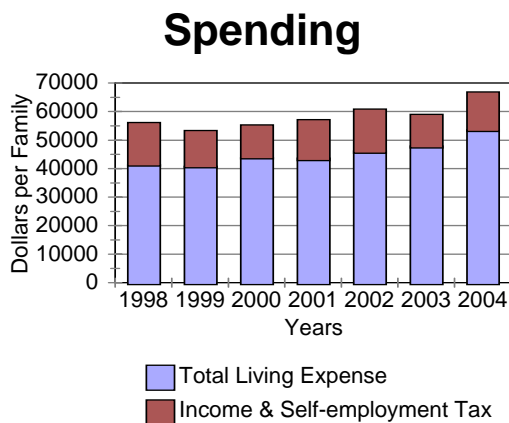


Figure 2.

Where has the income gone? A substantial portion has been spent for family living and income taxes. Family living expenditures have been increasing at a rate of about 3.8% per year. One major contributor to the annual increase is health insurance premiums. For example, from Ohio Valley Farm Analysis Group data, sole proprietorships, where neither spouse has medical insurance provided through off-farm work, paid an average of \$7,555.67 per year for health insurance coverage during 2004. This amount is 16.8% higher than the 2003 level. Sole proprietors with supplemental health insurance coverage paid an average of \$3,438.97 in 2004. The increases came while many individuals changed “plan deductibles” to maintain affordability.

Figure 2 shows family living and income tax expenditures for 1998 to 2004. Total family living expenses ranged from \$40,742 in 1999 to \$53,675 in 2004. Income taxes ranged from \$11,109 in 2003 to \$14,840 in 1998. According to the Economic Policy Institute, in their September 2005 Briefing Paper #165, the U.S. median family budget is now \$39,984. However, there is a wide range in living costs in the U.S., dependent upon size of family and geographic location. KFBM data also has a wide variation in expenditures by family. As expected, there is a fairly high correlation in family living expenditures when compared to the total of farm and non-farm incomes (0.58) - the larger the income, the larger the living expenditures.

The difference between total income sources and family living and income tax expenditures leaves a balance that is available for business capital expenditures, off-farm

investments, retirement contributions, or debt payments. We term this amount “capital available for debt payments” as it seems that debt payments would be a priority. Figure 3 illustrates this amount annually from 1998 to 2004. The amounts range from \$-31,595 to \$49,120 in 2004. Obviously, when the difference is negative, additional borrowing is necessary. When net cash availability is positive, the sole proprietor has choices. However, further analysis of Figure 3 shows the “choice” was not debt payment. Of the seven years shown, 1999 was the only year where debt was reduced, although in 1998, the increase in indebtedness was less than the cash deficiency amount. Total indebtedness increased an average of \$12,271 per year through the seven years.

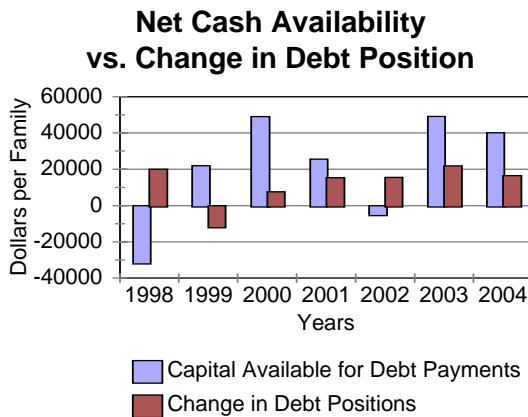


Figure 3.

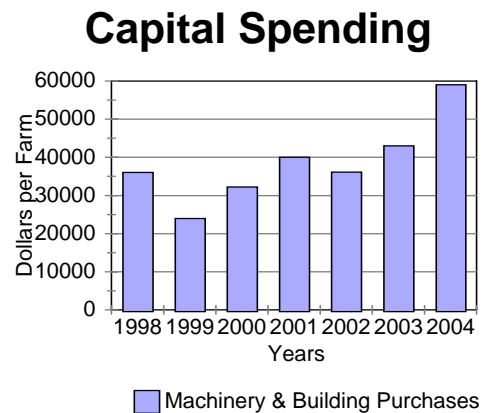


Figure 4.

Now, if the average total indebtedness increased \$12,271 per year and an average net cash amount of \$21,393 per year was available, where did this money go? It went to capital spending for machinery and buildings. Figure 4 represents the average capital purchases made each year from 1998 through 2004. The average capital spending during the seven years is \$38,623 and ranges from \$23,960 in 1999 to \$59,004 in 2004. During 2001 to 2004, capital spending averaged \$17,383 per year above the average depreciation deduction of \$25,633. There were also land purchases during the period, but the dollar amount is not available from the data. Neither is the amount contributed to retirement.

We have used the performance of the past seven years to lay the foundation in expressing concern in looking forward. Without adjustments in spending, projected 2006 expenditures for interest, farm operating expenses, and family living expenditures could increase as much as \$47 per acre or \$30,000 per family farm. Based on recent spending patterns, without more judicious capital spending, we project additional indebtedness of about \$42,000 per sole proprietorship by the end of 2006, unless we realize additional income. This is unlikely, given the current supply situation in crops, although the levels of price available for 2006 crops are very appealing compared to current price levels.

Based on average data, it is doubtful that farm profit margins are sufficient to maintain spending patterns found during 1998 to 2004. It is necessary for sole proprietors to begin serious examination of their individual situations. The intent here is not to be an alarmist. The intent is to stimulate examination of future spending. Certain expenditures are a matter of choice.