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Ag Decision Maker

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Globalization forces rural America to blaze a new trail

by ***Jason R. Henderson, Economist, Center for the Study of Rural America, Federal Reserve Bank of Kansas City***

The rural economy has collided full force with globalization. Many rural communities are struggling as low-cost global competitors challenge rural America's commodity industries. Many are searching for new competitive advantages for a new rural economy. Rural America's new economic frontier may require a new business model, a new policy model, and a new financial model for new opportunities that are being built on technology and developed by entrepreneurs.

This paper discusses the impacts of globalization on the rural economy. It begins by describing the challenges of globalization confronting the rural economy. The paper then discusses a new frontier for the rural economy; a frontier built on technology and developed by entrepreneurs. The paper concludes by examining the need for partnerships, regional competitiveness, and equity capital as rural communities blaze a new trail in search of new competitive advantages in a new rural economy.

Rural commodity industries struggle in a global economy

The traditional rural economy is fueled by commodities. Agricultural commodity production is the tradition cornerstone of most rural communities. Others have been based on the ability to extract minerals and other natural resource commodities. Many rural manufacturers are focused on the production of industrial commodities.

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Handbook Updates

For those of you subscribing to the *Ag Decision Maker Handbook*, the following updates are included.

2004 Iowa Farm Custom Rate Survey – A3-10 (4 pages)

Historic Hog and Lamb Prices – B2-10 (2 pages)

Historic Cattle Prices – B2-12 (2 pages)

Survey of Iowa Farm Leasing Practices – C2-15 (6 pages)

Farmland Value Survey (Realtors Land Institute) – C2-75 (2 pages)

Please add these files to your handbook and remove the out-of-date material.

Inside . . .

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Success in a commodity industry is defined by a single mantra: be the low-cost producer. Increased efficiency and productivity are the economic drivers in a commodity environment. The result has been a consolidating economic map. In agriculture, the necessity to become the low-cost producer has led the drive for economies of scale among farm operations. Over time, farm sizes have become larger while the number of farmers has shrunk.

Competing in commodity based industries was a successful strategy when rural America was competing against its metro counterparts. Rural places have a competitive advantage over metropolitan places when it comes to low-cost production. Rural America is characterized by comparatively abundant natural resources, low-cost land, and low-cost labor. These characteristics are essential in commodity industries where success is defined by being the low-cost producer.

In a global economy, rural America does not necessarily have these competitive advantages. Third-world countries are striving to economic advancement by implementing development strategies based on the availability of undeveloped natural resources and low-cost land and labor. The result has been a decline in rural America's commodity industries. In agriculture, the U.S. accounts for less than 40 percent of world soybean production down from 50 percent in the 1980s. In 2002, U.S. soybean production fell below the combined production of Brazil and Argentina. The U.S. share of world wheat trade has fallen from roughly 42 percent in the 1970s to roughly 20 percent today. Outside of agriculture, many rural factories are closing their doors and moving their operations to other countries. The effect has been a sharp rise in rural mass layoffs due to factory closures. Since 2001, roughly 40 percent of rural mass layoffs were due to factory closures.

New opportunities in a global economy

The challenges in dealing with globalization have left many rural communities in search of a new competitive advantage not based on low-cost land and labor and abundant natural resources. In many cases, the search leads rural places away from traditional commodity production and towards new product-based opportunities build on technology and developed by entrepreneurs.

The new frontier of opportunity for rural America will come from new technologies that diminish distance, create new value, and launch new products. Technology has always made it impression on rural America. But, technology has traditionally focused on increasing the efficiency of commodity production not developing new products. In economic terms, new technologies have been supply-driven, not demand-driven. For example, through improved technologies, the hours required to produce 100 bushels of corn have plummeted from 82 hours in 1850 to less than 2 today.

Increasing the productivity of U.S. agriculture has produced tremendous benefits (lower food costs, opening rural labor pools for industrial production). But, supply-driven technologies may not always lead to total revenue gains. Economic theory tells us that if technology is used to expand supply, a new market equilibrium is established where the quantity sold increases, but at a lower price. Total revenue may rise or fall depending on how demand changes to the new supplies (the elasticity of demand). Economic theory also tells us that if technology is used to create new products and boost demand, prices will rise along with the quantity sold. Total revenue always expands, regardless of the price elasticity of supply or demand.

New demand-driven technologies that create new products are emerging in agriculture. They cover a broad spectrum ranging from new uses for existing commodities to the creation of new high-value products. Ethanol represents a new use for agricultural commodities that is boosting demand. In Blair, Neb, the manufacturing of bio-plastics from corn is another example of a company using new technology to boost demand for agricultural commodities. At the other end of the spectrum, the production of proteins for human drugs in agricultural crops is an example of new technologies creating new high-

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value products. U.S. export activity clearly demonstrates the ability of product agriculture to compete more effectively than commodity agriculture in a global economy. Since 1996, value-added or product agricultural exports have risen 6.3 percent compared to a 32 percent fall in commodity agricultural exports.

The new economic frontier for rural America emerging from these technologies will be developed by entrepreneurs, the pioneers of tomorrow. Entrepreneurs are thinking and acting outside the traditional box. They are creating new products, new markets, and new opportunities in rural places. We know that entrepreneurs can survive in rural America. In the state of Nebraska, 60 percent of the businesses started in 1996 in small Nebraska towns were still in business in 1999, the same percentage as in Lincoln and Omaha. The challenge for rural places is the creation of high-growth entrepreneurs that boost incomes, create jobs, and add wealth to the community. Studies have shown that smaller, more sparsely populated areas have fewer high-growth entrepreneurs.

Blazing a new trail in rural America

Because of the challenges, rural places are blazing a new trail as they seize the new economic frontier. The new trail requires change. It requires adjustments to how we do business, how we organize ourselves and how we finance our firms. Many rural places have found it necessary to use a new business model, a new policy model, and a new financial model to grow a new rural economy.

Many of the new opportunities in the new frontier require a new business model organized around partnerships. The small size of rural firms is a primary challenge. Research indicates that small firms are more competitive when they operate in networks or clusters. Networks or clusters allow these firms to organize formal or informal partnership that foster the sharing of knowledge and leveraging of resources. Partnering is a challenge for rural America because it goes against the idea of independence that is instilled into rural populations. But, many successful rural businesses never did it alone. Many of these business owners had support systems, mentors, or partners that shared knowledge, wisdom and resources that helped their firms grow.

These new opportunities also require a new policy model based on regional competitiveness. Rural firms are not only small, but so are rural communities. Thus, rural communities need to think regionally and work together to leverage scarce resources. Rural economies are already integrated with themselves and metro neighbors. Commuting flows demonstrate the integration of economic activity in rural places. The challenge is to overcome the Friday night football rivalries that separate communities and keep them from working together.

Thinking regionally is also important because rural America is diverse. The High Plains are not the Delta. These regions have a different set of resources, a different culture and a different set of opportunities at hand. As a result, economic opportunities will define region and regions will come in a variety of sizes because economic opportunities do not observe city limits, county lines, or state boundaries.

New regions are forming. In the Four-Corners region of the Southwest, regional cooperation had led to the creation of high-growth entrepreneurs. Between 1991 and 1996, this region ranked third in the U.S. in the creation of high-growth entrepreneurs. Appalachian Ohio is striving to stimulate entrepreneurs. The Prairie States Center for Entrepreneurial Leadership is striving to generate entrepreneurial activity in the Great Plains. This group was initially formed to preserve the lesser prairie chicken but discovered they were in the same economic boat. In Iowa, a six-county region surrounding Waterloo has been formed to create new opportunities in the region. The ability to grow No. 2 yellow corn and produce farm machinery with green paint is not enough to sustain let alone produce new economic opportunities in their communities.

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New technologies and entrepreneurs need a new financial model based on equity capital. Over the past 100 years, rural America has developed an elaborate debt financing network. Yet, many new rural enterprises struggle with financing because their opportunities do not lend themselves to collateral based lending. The U.S. economy is becoming more knowledge-based where success is based on intellectual capabilities that are difficult if not impossible to turn into collateral. Knowledge based activities are more conducive to equity financing instead of debt financing. But, rural America does not have an elaborate equity capital network. Despite possessing 20 percent of the business establishments in the nation, rural America has only claimed 2 percent of the nation's venture capital investment. While new equity capital networks are emerging, they are few and far between.

Conclusion

Globalization presents new challenges to the rural economy. The challenges are especially intense for commodity industries that are no longer the lowest cost producers. Rural America needs new sources of competitive advantage that emerge from demand-driven technologies that produce new products developed by entrepreneurs. Seizing these opportunities may require rural America to blaze a new trial of partnership, regional competitiveness and equity capital in the 21st century.

Internal Revenue Code §179 expensing*

by Gary Hoff, Extension Specialist—Taxation, University of Illinois Income Tax School.

Taxpayers who have a farm or business have been allowed to claim a first year tax deduction up to $24,000 on qualifying purchases, e.g., of machinery and equipment. This deduction reduces the basis in the asset for purposes of regular depreciation. The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased this deduction to $100,000 for tax years 2003 - 2005. The deductions will be reduced to $25,000 in 2006. The rules governing §179 are discussed in this article, using primarily agricultural examples.

The law

Taxpayers who are in a trade or business may elect to expense up to $100,000 of qualifying purchases in 2003 through 2006 if they meet certain conditions.

Deduction limit

The taxpayer may not expense an amount greater than the net income from their business plus any earned income from other sources. The taxpayer is further limited to $100,000 of IRC §179 deduction. If filing separately, one taxpayer may take a disproportionate share of the deduction with written permission of the spouse.

Example 1 In 2003, Tom is an active farmer and has a net farm profit of $70,000 before any §179 depreciation. His wife Mary has a part-time craft business which reports a loss of $5,000 and she also works at the local WalMart where she has a gross income of $15,000. Tom and Mary are limited to a total §179 deduction of $80,000 if they have at least that amount of qualifying purchases.

Farm profit	$70,000
Craft business loss	-5,000
W-2 gross earnings	15,000
Eligible income	$80,000

The deduction becomes limited if the taxpayer has over $400,000 of qualifying purchases during the year and is completely phased-out at $500,000 of purchases.

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Example 2 Assume Tom and Mary had $470,000 of eligible purchases in 2003. Their §179 deduction will be limited to $30,000 calculated as follows:

Maximum amount of 179 deduction		$100,000
Eligible purchases	$470,000	
Threshold cost of eligible purchases	400,000	
Reduction in limitation		$70,000
Dollar limitation for 2003		$30,000

If their total purchases had been $420,000 or less, they could have taken a $80,000 deduction.

Entities are also allowed the §179 deduction. The dollar limit is determined at the entity level. Therefore, a partnership or S corporation is limited to a $100,000 deduction, regardless of the number of partners or shareholders involved. Since these two entities do not pay income tax, the deduction passes through to the partner or shareholder where it is further limited based on their individual income.

Example 3 ABC Partnership has three equal partners, A, B, and C. If the partnership has a $30,000 profit, it is limited to a $30,000 §179 deduction. Each partner will receive $10,000 of the deduction and $10,000 of pass-through profit.

Example 4 Assume the same facts as Example 3 except Partner B has already used $95,000 of §179 deductions from purchases made by his sole proprietor business. Since he is personally limited to a $100,000 deduction, he will only want to elect to expense $90,000 of purchases from his business. If B has excess-pass through §179 deductions, they are lost.

Example 5 Assume the same facts as Example 3 except Partner C has a $6,000 loss from his sole proprietor business. When the $6,000 loss is combined with the $10,000 partnership pass through gain, he has net eligible income of $4,000. Therefore, he is limited to a $4,000 §179 deduction. The remaining §179 deduction of $6,000 will be lost.

Any §179 deduction from eligible purchases in a partner's sole proprietor business can be carried forward.

Qualifying purchase

The following property qualifies for the IRC §179 deduction:

1. Tangible personal property.
2. Other tangible property (except buildings and their structural components) used as:
   a. An integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services.
   b. A research facility used in connection with any of the activities listed previously, or
   c. A facility used in connection with any of those activities for the bulk storage of fungible commodities.
3. Single purpose agricultural (livestock) or horticultural structures.
4. Storage facilities (except buildings and their structural components) used in connection with distributing petroleum or any primary product of petroleum.

Tangible personal property is any tangible property that is not real property. It includes the following property:

1. Machinery and equipment.
2. Property contained in or attached to a building (other than structural components), such as refrigerators, grocery store counters, office equipment, printing presses, testing equipment, and signs.
3. Gasoline storage tanks and pumps at retail service stations.

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Note. Land and land improvements, such as buildings and other permanent structures, and their components, are real property, not personal property. Land improvements include swimming pools, paved parking areas, wharfs, docks, bridges, and fences. However, agricultural fences and drainage tile do qualify for IRC §179, as do single purpose agricultural or horticultural structures.

Internal Revenue Code §179 expensing, continued from page 5

4. Breeding livestock, including horses, cattle, hogs, sheep, goats, mink, and other furbearing animals.

Non-qualifying property

Certain types of property do not qualify for the §179 deduction, such as:

1. Certain property leased to others,
2. Certain property used predominantly to furnish lodging or in connection with the furnishing of lodging
3. Air conditioning or heating units
4. Property used predominantly outside the United States (except property described in IRC §168(g)(4) —commercial airliners, ships, containers, etc.)

These non-qualifying property types are not normally found on farm and ranch tax returns.

Timing of the IRC §179 election

The election must be made on the first tax return filed after the taxable year to which the election applied. It does not matter if the return is timely filed, however, a taxpayer can only amend a return to claim the election if the amended return is filed within the time limit for filing the original return plus extensions.

Example 6 Kevin is a calendar year tax filer. His 2003 tax return is due no later than April 15, 2004, but he may file for up to a six months extension. Therefore, the last date for Kevin to file his 2003 return is October 15, 2004. Assuming Kevin does not file by this time, he can still claim the §179 deduction when he files.

Example 7 Horace timely files his 2003 return on April 15, 2004. He later wishes to claim a §179 deduction. The last date Horace may claim the deduction on an amended return is October 15, 2004. When Horace files his amended return he must write "**Filed pursuant to section 301.9100-2"** on the amended return.

Tax planning using the IRC §179 deduction

From a tax-planning standpoint, many variables have to be taken into account to determine if the election of the IRC §179 deduction is appropriate to a specific taxpayer. Some of the more common planning considerations are:

- Marginal tax bracket of the taxpayer.
- Profitability of the business and availability of other income to satisfy the taxable income limitation.
- Future marginal tax rates of the client.
- Other asset acquisitions during the year.
- Status of estimated tax payments made for the current year.
- Does the client need the asset for the business, or is the acquisition more tax motivated?
- Will the subject asset(s) be **sold** or **traded** in later years?
- Did the taxpayer purchase both shorter use-life and longer use-life assets?
- IRC §179 deduction used as an effective means to reduce possible vulnerability to repair versus capital improvement issues with the IRS.
- Allocation of IRC §179 from other entities.
- Use of IRC §179 and its impact on social security benefits.

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