

# Iowa Ag Review

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## Agricultural Payments to Iowa under Alternative Programs

—By Chad Barrett

President Clinton's signing of the Federal Agriculture Improvement and Reform Act (FAIRA) into law in April 1996 marked a major transition in U.S. agricultural policy. FAIRA replaced production constraints, set-aside acres, target prices, and counter-cyclical payments with planting flexibility and decoupled cash payments.

Federal budget constraints were a driving force behind this dramatic change in farm policy. Previous farm programs had primarily targeted farm prices, and this ignored the cost-saving benefits which can be obtained from the negative correlation between production and prices. When yields were high, prices were depressed, causing commodity prices to fall well below their target levels.

Since payments were based primarily on the target price under the 1990 agricultural legislation, a large payment would be given, even though a portion of the producer's loss of revenue from the low price was recovered through greater yields. Focusing on prices and ignoring total revenue (price • quantity) inflated government payments.

FAIRA limited total government outlays to \$5.57 billion in 1996, with payments decreasing to \$4.008 billion in

2002, the final year of the program. Of these total payments, 46 percent were allocated toward corn contract acreage. Besides lowering government costs, FAIRA promoted market efficiency through decoupled production flexibility contract (PFC) payments. This provided for payment rates based on past base acres without restricting the planting of specific crops. Instead, farmers were allowed to respond to market signals and relative prices, resulting in less market distortion and greater economic efficiency.

During the first two years of the program, large PFC payments and high

implementing this new farm policy. Specifically, many question whether Iowa farmers would have been better off under a continuation of the Food, Agriculture, Conservation, and Trade Act of 1990 (FACTA). However, this is not a relevant comparison because federal budget cuts dictated that a change in agricultural policy would occur. Nevertheless, this article compares the payments under FAIRA, FACTA, and a likely alternative to FAIRA.

Table 1 shows the payments to Iowa corn producers (\$1.6 billion) under the FAIRA provisions for the first three years of

Table 1. 1996/97-1998/99 Payments to Iowa under FAIRA Provisions

	1996/97	1997/98	1998/99
Contract Area (Acres)	14,182,000	14,270,000	14,319,000
Participation Rate	99%	99%	99%
Program Yield (Bu/Acre)	117	117	117
Contract Payment (\$/Bu)	0.25	0.49	0.37
	85%	85%	85%
Total Iowa Payment	\$349,073,975	\$688,430,393	\$521,620,193

commodity prices boosted farm revenues and support for the new program. However, projected bumper crops, weak export demand, low commodity prices, and the end in sight of the PFC payments has sparked discussions questioning the validity of

the program.

FACTA provided a 15 percent normal flex policy for corn base acreage. Under this program, participating farmers were required to plant corn on 85 percent of their base acreage and were allowed to plant corn or any other crop on the remainder. However, participants could not receive deficiency payments on the normal flex acreage, but they could qualify for price support loans. Payments were calculated using the following formula: [target price – max (market price, loan rate)] • (base acreage) • (program yield) • (85 percent). Tables 2 and 3 calculate the total payments to Iowa farmers for the 1996/97-1998/99 crop years using FACTA payment rates. The participation rate and base acres were kept at their 1995/96 levels since actual data does not

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Table 2. 1996/97-1998/99 Government Payments to Iowa under FACTA (1990) Provisions (\$2.36/Bu 1998/99 Corn Price)

	1996/97	1997/98	1998/99
Base Area (Acres)	14,035,000	14,035,000	14,035,000
Participation Rate	87%	87%	87%
Season Average Price (\$/Bu)	2.66	2.47	2.36
Target Price (\$/Bu)	2.75	2.75	2.75
Program Yield (Bu/Acre)	117	117	117
15 Percent Flex Discount	85%	85%	85%
Total Iowa Payment	\$109,289,633	\$340,012,191	\$473,588,408

Table 3. 1996/97-1998/99 Government Payments to Iowa under FACTA (1990) Provisions (\$2.00/Bu 1998/99 Corn Price)

	1996/97	1997/98	1998/99
Base Area (Acres)	14,035,000	14,035,000	14,035,000
Participation Rate	87%	87%	87%
Season Average Price (\$/Bu)	2.66	2.47	2.00
Target Price (\$/Bu)	2.75	2.75	2.75
Program Yield (Bu/Acre)	117	117	117
15 Percent Flex Discount	85%	85%	85%
Total Iowa Payment	\$109,289,633	\$340,012,191	\$910,746,939

average corn price would have to drop to \$2.31 per bushel before government payments to Iowa producers under the previous program would equal the PFC payments to Iowa producers under FAIRA. The 1998/99 season average corn price would have to drop further, to \$2.21 per bushel before payments to Iowa corn producers under the 30 percent flex alternative would equal the PFC payments made under FAIRA.

Table 6 shows total government payments to Iowa for the first three years of the program under alternative policies and outcomes for the 1998/99 season average corn price. This table shows that Iowa producers have received higher payments under both price scenarios during the first three years of FAIRA than they would have likely received under FACTA or a 30 percent flex program.

Presented in tables 7, 8, and 9 are projected payments for the next three years for Iowa producers under FAIRA, FACTA, and a 30 percent flex program. These figures are based on the Food and Agricultural Policy Research Institute's (FAPRI) Iowa season average price projections.

Table 10 shows that the projected payments to Iowa producers under FAIRA provisions during the next three years fall below the projected payments under FACTA

exist. Also, evaluation of the program is conditioned on the outcome of the Iowa season average corn price 1998/99 crop year.

This article presents two scenarios. An optimistic scenario is based on an Iowa season average corn price of \$2.36 per bushel for 1998/99. A more pessimistic scenario is based on a season average corn price of \$2.00 per bushel for 1998/99.

As mentioned earlier, federal budget constraints motivated the implementation of the current farm bill policy. If FAIRA had not been enacted in 1996, a policy different than the 1990 farm bill would be in effect today. During the discussions leading to the passage of FAIRA, a proposed alternative would have allowed participating farmers greater planting flexibility and, in turn, would have reduced government payments. A frequently discussed scenario was a 30 percent flex program. Estimates of the payments made to Iowa under this program using the two price scenarios for the 1998/99 season average corn price are presented in tables 4 and 5.

When comparing the projected payments to Iowa corn producers, it is evident that during the first two years of the program, payments to Iowa producers were highest under FAIRA in all cases. The outcome for 1998/99 is yet to be determined and depends on the outcome of the season average price. With an Iowa season average

corn price of \$2.36 per bushel for the 1998/99 crop year, payments to Iowa producers were higher under FAIRA provisions than they would have been under the previous policy or its likely successor. However, the more pessimistic season average price of \$2.00 per bushel shows that government payments to Iowa producers are higher under the previous farm bill provisions or under a 30 percent flex program.

For the 1998/99 crop year, the season

Table 4. 1996/97-1998/99 Government Payments to Iowa under a 30 Percent Flex Program (\$2.36/Bu 1998/99 Corn Price)

	1996/97	1997/98	1998/99
Base Area (Acres)	14,035,000	14,035,000	14,035,000
Participation Rate	87%	87%	87%
Season Average Price (\$/Bu)	2.66	2.47	2.36
Target Price (\$/Bu)	2.75	2.75	2.75
Program Yield (Bu/Acre)	117	117	117
15 Percent Flex Discount	70%	70%	70%
Total Iowa Payment	\$90,003,227	\$280,010,039	\$390,013,983

Table 5. 1996/97-1998/99 Government Payments to Iowa under a 30 Percent Flex Program (\$2.00/Bu 1998/99 Corn Price)

	1996/97	1997/98	1998/99
Base Area (Acres)	14,035,000	14,035,000	14,035,000
Participation Rate	87%	87%	87%
Season Average Price (\$/Bu)	2.66	2.47	2.00
Target Price (\$/Bu)	2.75	2.75	2.75
Program Yield (Bu/Acre)	117	117	117
15 Percent Flex Discount	70%	70%	70%
Total Iowa Payment	\$90,003,227	\$280,010,039	\$750,026,891

Table 6. Total Payments (\$1000s) to Iowa under Alternative Programs and Price Scenarios (1998/99 Corn Price)

Assumed Policy	1998/99 Corn Price	
	2.36	2.00
FAIRA	1,559,125	1,559,125
FACTA	922,890	1,360,049
30% Flex	760,027	1,120,140

Table 7. 1999/00-2001/02 Projected Government Payments to Iowa Producers under FAIRA

	1999/00	2000/01	2001/02
Contract Area (Acres)	14,182,000	14,270,000	14,319,000
Participation Rate	99%	99%	99%
Program Yield (Bu/Acre)	117	117	117
Contract Payment (\$/Bu)	0.36	0.33	0.26
	85%	85%	85%
Total Iowa Payment	\$502,666,534	\$463,636,795	\$366,543,919

Table 8. 1999/00-2001/02 Projected Government Payments to Iowa Producers under FACTA

	1999/00	2000/01	2001/02
Bare Area (Acres)	14,035,000	14,035,000	14,035,000
Participation Rate	87%	87%	87%
Season Average Price (\$/Bu)	2.21	2.26	2.43
Target Price (\$/Bu)	2.75	2.75	2.75
Program Yield (Bu/Acre)	117	117	117
15 Percent Flex Discount	85%	85%	85%
Total Iowa Payment	\$355,737,796	\$595,021,334	\$388,585,361

Table 9. 1999/00-2001/02 Projected Government Payments to Iowa Producers under 30 Percent Flex

	1999/00	2000/01	2001/02
Bare Area (Acres)	14,035,000	14,035,000	14,035,000
Participation Rate	87%	87%	87%
Season Average Price (\$/Bu)	2.21	2.26	2.43
Target Price (\$/Bu)	2.75	2.75	2.75
Program Yield (Bu/Acre)	117	117	117
15 Percent Flex Discount	70%	70%	70%
Total Iowa Payment	\$540,019,362	\$490,017,569	\$320,011,474

provisions or a 30 percent flex alternative. From Table 11, it is evident that the comparison of the projected payments during the first six years of FAIRA depends largely on the outcome of the current and future season average prices. However, using FAPRI price projections for the next three years shows that payments to Iowa producers during the first six years of FAIRA are slightly lower than the payments under FACTA with a \$2.00 per bushel 1998/99 corn price.

Furthermore, the payments under FAIRA are substantially higher when considering the 30 percent flex alterna-

tive or a \$2.36 per bushel 1998/99 corn price. Comparing the total payments to Iowa producers under an alternative program and considering the added benefits of planting flexibility, it seems that Iowa producers have benefited from the implementation of FAIRA compared to the previous farm policy or a likely alternative. ♦

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Table 10. 1999/00-2001/02 Projected Total Payments (\$1000s) to Iowa under Alternative Programs

Assumed Policy	
FAIRA	1,332,847
FACTA	1,639,344
30% Flex	1,350,048

Table 11. 1996/97-2001/02 Projected Total Payments (\$1000s) to Iowa under Alternative Programs

Assumed Policy	1998/99 Corn Price	
	2.36	2.00
FAIRA	2,891,972	
	2,891,972	
FACTA	2,562,235	

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# Iowa's Agricultural Situation

—By Phillip J. Kaus and Darnell B. Smith

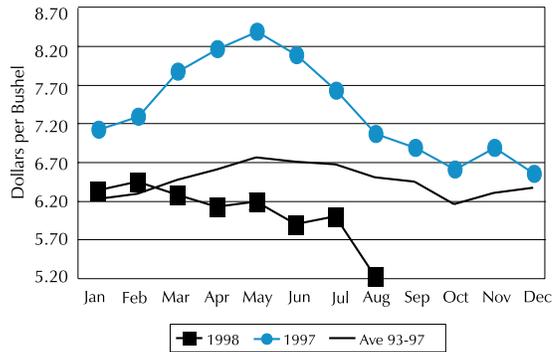
According to the National Agricultural Statistical Service, January to May 1998 Iowa farm cash receipts are down 12 percent from January to May 1997 cash receipts. In fact, early indications are that net income may be down by as much as 35 to 40 percent in 1998 compared to 1997. The cash receipts table (page 5) shows that both crop and livestock producers have been hit this year by lower prices. As shown by the graphs, prices received by Iowa producers for all eight commodities are below last year's levels and well below the five-year average. In addition, this year's above-normal summer decline in prices will result in cash receipts falling even more by the end of the year.

As of August 1998, world crop stock holdings were high. Further projected increases in the stocks-to-use ratios for this year, as shown in the table (page 5), indicate that it may take time to reduce the large supplies, especially on the crop side, because of the large U.S. crop yields expected this year.

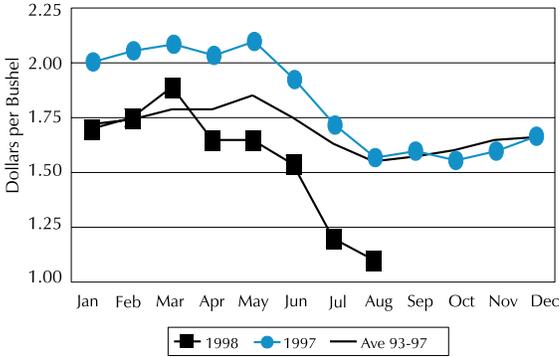
With the low grain prices and a large breeding herd, pork supplies should remain high for the rest of 1998. The unexpected summer sell-off in the southern U.S. cattle herd added to the beef supply woes. Hopefully, those large beef and cattle supplies will be reduced by the fourth quarter. There should then be some recovery in cattle prices. However, the overall market recovery will take time.

Speculation has focused on government assistance to help increase farm income as the U.S. Congress enters the fall session. With low prices, Iowa producers should be eligible for Loan Deficiency Payments (LDP) as they begin the fall harvest. The LDP is a provision of the 1996 Farm Bill and will help stabilize farm income to a certain extent. Producers should check with their local Farm Service Agency representative for eligibility requirements before making any marketing decisions. ♦

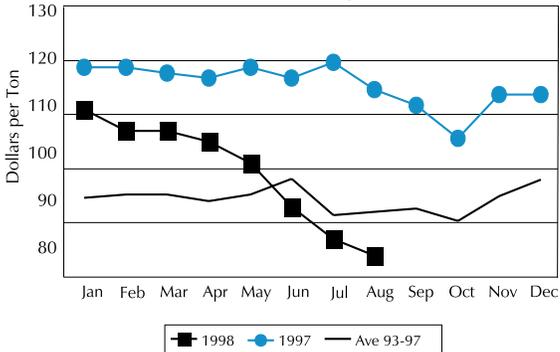
Iowa Soybean Price



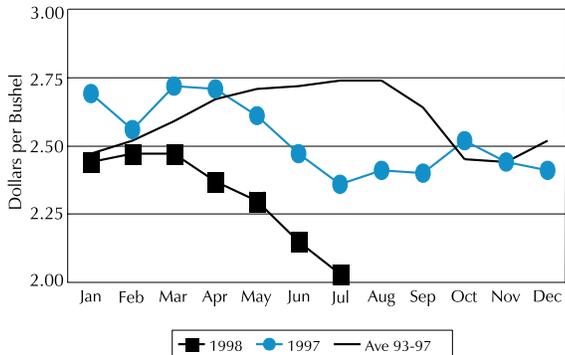
Iowa Oat Price



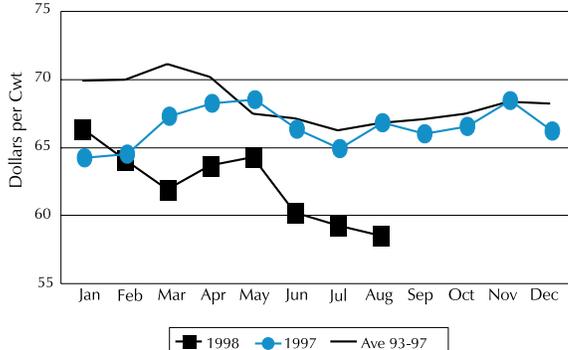
Iowa Alfalfa Hay Price



Iowa Corn Price



Iowa Steer and Heifer Price



## Iowa Cash Receipts Jan. – May

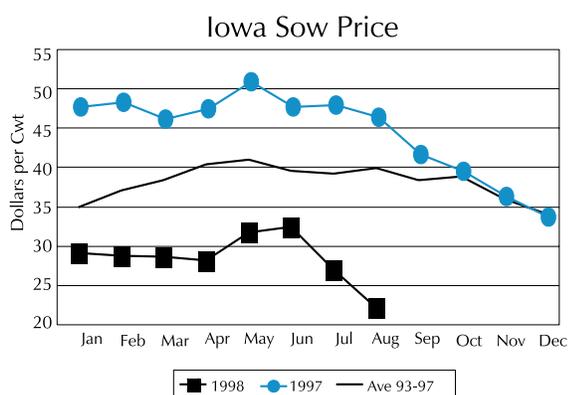
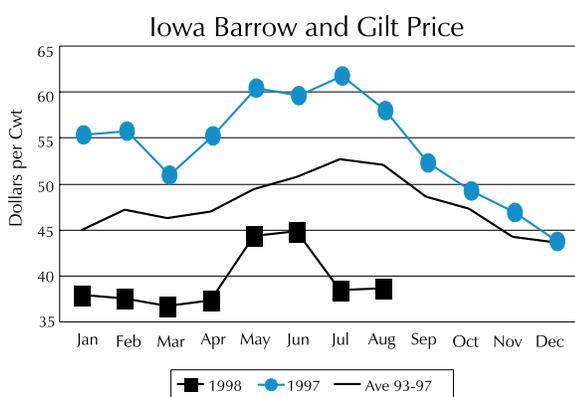
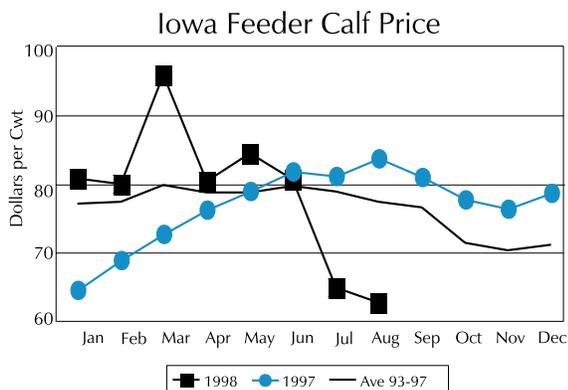
	1998	1997	1996
	(Million Dollars)		
Crops	2,376	3,206	3,089
Livestock	2,011	2,199	2,218
Total	4,803	5,406	5,307

## World Stocks-to-Use Ratios

	Crop Year		1996/97
	1998/99	1997/98	
	July	July	(Percent)
	Projection	Estimate	
Corn	15.17	14.85	16.00
Soybeans	15.96	12.87	9.47
Wheat	21.98	22.59	19.14

## Average Farm Prices Received By Iowa Farmers

	July 1998	June 1998	July 1997
	(\$/Bushel)		
Corn	2.03	2.15	2.36
Soybeans	6.09	5.91	7.64
Oats	1.30	1.54	1.72
	(\$/Ton)		
Alfalfa	87.00	93.00	120.00
All Hay	85.00	92.00	116.00
	(\$/Cwt.)		
Steers & Heifers	59.30	60.20	65.10
Feeder Calves	65.00	80.80	81.30
Cows	37.00	37.00	40.30
Barrows & Gilts	38.50	44.90	61.80
Sows	27.00	32.40	48.20
Sheep	24.70	24.70	34.50
Lambs	88.00	88.00	91.00
	(\$/Lb.)		
Turkeys	0.37	0.37	0.43
	(\$/Dozen)		
Eggs	0.34	0.34	0.44
	(\$/Cwt.)		
All Milk	13.60	13.60	11.60



### FALL POLICY CONFERENCE

The 1998 Fall Policy Conference was on September 4, 1998, at Iowa State University in Ames, Iowa. The conference's theme was "Agricultural Contracts: Freedom Or Restraint?" More information and proceedings from the conference can be found at the Center for Agricultural and Rural Development's Web site at <http://www.card.iastate.edu>.

## Loan Deficiency Payments or the Loan Program?

—By Dermot J. Hayes and Bruce A. Babcock

Low market prices for corn and soybeans have triggered two federal price support programs.

- One program is a Loan Deficiency Payment (LDP) that pays producers the difference between county level prices (posted county prices) and that county's loan rate on a date chosen by the producer (so long as the producer still owns the grain).
- The second program is the traditional loan program whereby the producer puts grain in storage and uses the grain as collateral on a loan. The producer receives the county-specific loan rate for all bushels he or she puts into storage under this program. If market prices exceed the loan rate plus accrued interest within nine months, the producer can repay the loan and sell the crop. If this price increase does not occur, the producer can keep the difference between the loan rate and the posted county price on the day of sale. That is, the producer repays the loan at a price that is lower than the loan rate.

What should you, as a producer, do? You can enroll in the loan program, or you can take a LDP, but you cannot do both. If you take the LDP you can sell the grain at harvest, store it at your own risk, or store it and contract for future delivery. If we knew for sure what the markets were going to do in the coming months, then there would be a single best answer. Without the benefit of perfect foresight, we must deal with probabilities. We can use existing information to say what is most likely to be the correct response.

Consider a producer in Union County, Iowa, who has 10,000 bushels of corn. The loan rate in Union County is \$1.77 per bushel. Suppose at harvest, the cash price is \$1.69, the December futures price is at \$1.99, and the July futures price is at \$2.25. (All of these prices were accurate representations of expected conditions at harvest in Union

County as of Sept. 1, 1998.) For the sake of simplicity, assume that the local price is measured accurately by the posted county price and that this price is always \$.30 below the nearby futures price. At these prices, storage is encouraged. There is a return of \$.26 from storing grain from harvest to July. Typical storage costs of \$.01 per bushel per month implies a net return to storage of \$.17 per bushel.

### CHOICE ONE

*Sell at harvest and take the LDP or use the loan program.*

If you sell at harvest, you get the county price plus the LDP. Together this will equal the loan rate. Alternatively you can guarantee yourself this same amount by putting the grain under loan in the loan program. The difference between these options is that selling at harvest means that you will be out of the market, whereas putting the grain under loan allows you to benefit if market prices increase to a level above the loan rate, plus interest. This option of selling at a higher price, combined with the price guarantee of the loan rate, means that you will always be better off storing the grain under loan than taking the LDP and selling cash grain. In other words, being in a position to benefit from upside price movements without having to worry about downside movements is better than not being in the market.

We can go further and actually place values on these two outcomes. If you take the LDP and sell at \$1.69, you get \$1.77 per bushel or \$17,700 for the 10,000 bushels. If you put the grain in the loan program, you will also get \$17,700; however, you also will have some possibility of making more if market prices strengthen. Using option pricing theory (the loan program is equivalent to a free put option) and current option quotes, we have calculated this additional value to be \$2,229. In other words, the total expected payout from the loan program is \$19,929 versus a value of \$17,700 from selling today and taking the LDP.

### CHOICE TWO

*Use the loan program or take the LDP and store at your own risk.*

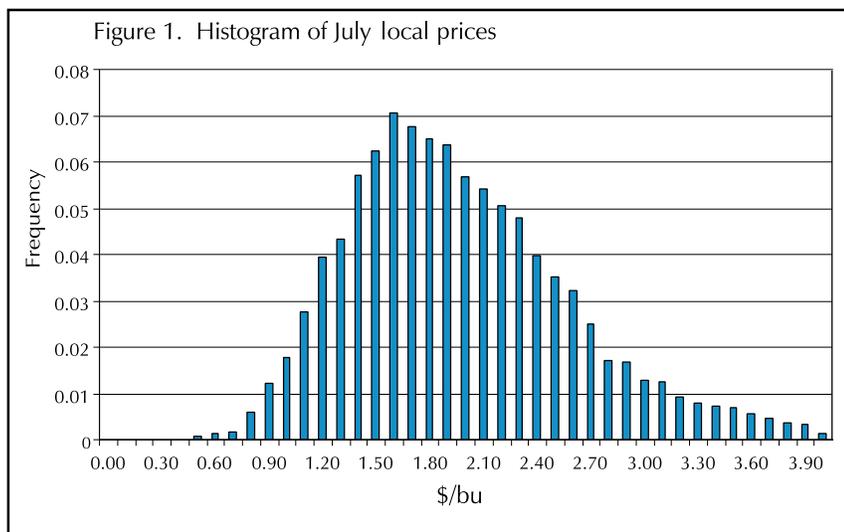
The loan program clearly dominates the cash sale option. But the producer could choose to take the LDP and store the grain outside of the loan program. The comparative advantage and disadvantage of the loan program versus this private storage option is less straightforward.

The private storage option allows the producer to take full benefit of the LDP and to take full advantage of any market price increase. In fact, if the producer knew that prices were going to strengthen, then private storage works better than the loan program. However, if prices fall, then the opposite will be true. While we cannot say for sure which decision is best, it is possible to assign probabilities to various price outcomes and compare the expected values of each of the two alternatives.

Figure 1 illustrates what the futures and options markets are telling us about local prices in July. The horizontal axis reports the prices that are possible. The height of the bar shows us the chances that a certain price will materialize. As can be seen, the futures market is telling us that local prices around \$1.95 are most likely, with low chances of prices above \$2.70 or below \$1.20.

Using the price distributions in figure 1 and accounting for storage costs, the expected value of the private storage option is \$19,400 compared to \$19,929 under the loan program. This comparison would favor the loan program by an even greater amount if we adjusted these outcomes for the additional risk associated with the private storage option. That is, under the private storage option, you would be exposed to the full effect of a price drop to \$1.20 per bushel, whereas under the loan program, you would receive the loan rate of \$1.77.

Note that many producers plan to utilize the private storage option because they believe that the government will not allow market prices to fall much further or



because they believe that the July futures price is going to rise. This decision turns the farmer into a speculator. Many who plan to follow the private storage route would be uncomfortable selling put options or going long on the Chicago Board of Trade July futures, yet they will expose themselves to exactly as much risk under private storage. This does not mean that speculation is wrong; indeed market outcomes may show that the private storage option was the correct course to follow. It does, however, argue that farmers should not confuse speculation with risk management.

### CHOICE 3

*Use the loan program or take the LDP, store, and lock in a futures price.*

An alternative to private storage is to take the LDP and store the grain, but then use the futures market to lock in a July

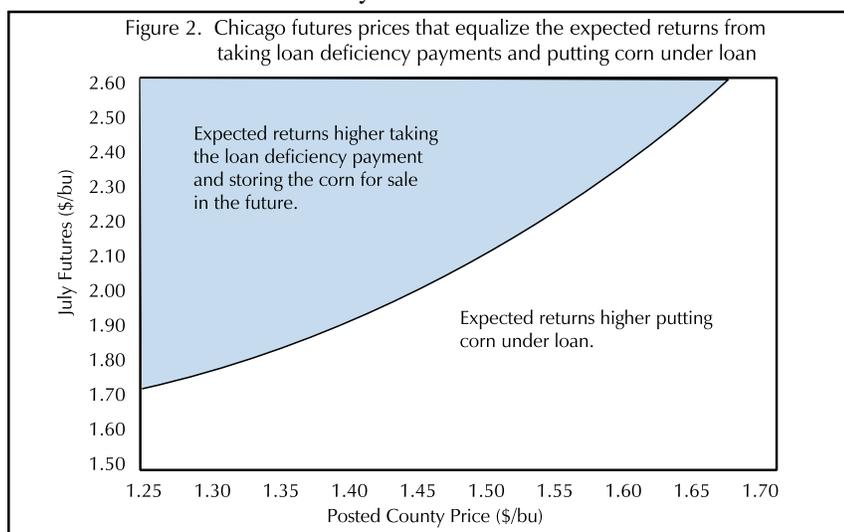
price. If the futures market allows you to “sell” the privately stored grain at a July price that is greater than the loan rate, then you could take the LDP and secure an advantage of the relatively high futures price.

Whether or not this option returns more than the expected value of putting the grain under loan depends on the July futures quote in comparison with current cash prices. When the July futures price is close to the current price, it will not be possible to lock in a premium, and the loan program will dominate. When the July futures price is much higher than current cash markets, then taking the LDP and locking in a July price may return more than using the loan program. Figure 2 makes this comparison for a wide range of July futures and local prices.

The comparison shown in Figure 2 is relevant to situations outside of Union

County and for a much wider range of prices than those used in the introduction. For example, the extreme left-hand value shows a local price of \$1.25 (this corresponds to a nearby futures price of \$1.55). At this price, then, a July futures price above \$1.70 will make it worthwhile to stay out of the loan program. At any July price below this value, the loan program will dominate. If the local price is \$1.65 (corresponding to a nearby futures price of \$1.95), then the break-even July futures price is \$2.60. Although this seems like a large differential, we must add to the posted county price the cost of storage, the expected basis, and the market value of the implicit put option that comes with the loan program.

It is unusual for the futures market to show a large enough storage premium to make it worthwhile to take the LDP and lock in a futures price. However, the federal government may decide to artificially force down posted county prices in order to make the LDP a more attractive option. Figure 2 shows what the differential needs to be in order to make the posted county price a more attractive option than the loan rate. ♦



## Changes in Iowa's Capital Gains Tax

—By Dermot J. Hayes

Late in the 1998 Legislative session, the Iowa legislature passed and Governor Branstad signed into law a provision that eliminates state capital gains tax when a business is sold to a lineal descendant. Why did this happen, and what are the likely effects?

### WHY IT HAPPENED

The principal reason given for the cut in capital gains tax was to stimulate value-added agriculture in Iowa. At first glance it seems like a stretch to link capital gains taxes with value-added agriculture, but the link is there. Iowa AgSTATE (Agricultural Strategic Thinkers Acting Together Effectively), a group of farm leaders and commodity organizations that worked together on a strategic plan for Iowa agriculture, discovered some of these connections in a study completed in the summer of 1997.

During their study, the AgSTATE group found that Iowa family farms could minimize taxes on intra-family transfers simply by waiting until the property-owning parents die before passing the farm on to the children. This incentive exists because land that is transferred at death is assigned a new base value for capital gains purposes. For example, suppose the parents bought the land for \$100 per acre, and the land is now worth \$1,100. If the land is inherited, the children establish a new base of \$1,100 and pay no taxes. If the land is sold to the children before the parents die, then capital gains taxes must be paid on the \$1,000 by which the land appreciated. This unusual situation has caused a distortion in the tax code because this re-basing can only occur at the death of the owners. The importance of this distortion has grown as land has appreciated and inheritance taxes have been minimized.

It also became clear in the study that Iowans had responded to this distortion by ensuring that the oldest family member owned the land. For example, the average age of both landowners and land buyers had increased substantially in recent years.

A third factor was the argument that older Iowans have less incentive to farm

the land or participate in value-added agricultural activities such as building modern hog confinement buildings. In many cases the children were not interested in farming, and the crop ground was rented out while awaiting the death that would allow the land to be sold without capital gains taxes. (As much as 50 percent of the farm ground is now being farmed by someone other than the owner.) In cases where the parents remained involved in agriculture, the evidence suggested that farmers above 55 years of age were more likely to quit hog production than to modernize.

Given that modern livestock production is financially risky, socially controversial, and requires long-term access to land, this aging of land owners probably reduced livestock production among Iowa's family farmers. Note that this ownership issue is not as relevant to corporations because the firm can live forever while shares are gifted on a year-by-year basis.

This thought process helps solve the mystery of why Iowa's family farmers appeared to quit hog production even in years when it was very profitable. (Or more accurately, the mystery of why those producers who quit for age-related reasons were not replaced by younger family producers.) To the extent politicians were convinced by this line of argument, the solution seemed obvious. Those that were interested in economic development and lower taxes could push capital gains cuts as a way of stimulating value-added agriculture. In fact the data showed that a 3 percent growth in value-added livestock production would cause total tax revenues to increase as the extra economic activity offset the lost capital gains taxes. Those that were more interested in social issues saw the tax cut as a way of increasing the family owned share of livestock production at the expense of corporate agriculture.

### WILL IT WORK?

The tax change is limited to lineal descendants and changes only the state tax burden. The lineal descendant

limitation means that the change will have little effect on families where the children have no interest in returning to the farm. In families where one or more of the children plan to remain involved, it will become somewhat easier to justify the sale of land to the interested offspring.

However, the fact that the Federal tax remains in place means that this incentive will be very small. Families who sell to offspring will still be penalized by federal capital gains taxes in comparison with those who wait until a death occurs. The fact that this change occurred in Iowa and not in the competing states, may give some boost to family farm based livestock production in Iowa. Yet, this effect will be muted because some of these states did not charge any income or capital gains taxes in the first place. Also, because so many people were taking advantage of the loophole, Iowa was collecting very little tax under the old system. (Total Iowa capital gains taxes on all land sales in the state amounted to only \$10 million dollars.) And so a very minor increase in value-added agriculture would increase total tax revenues. If Iowa's leadership can someday convince the Federal Tax authorities to remove the distortion, then the state should easily recoup its dollars as U.S. value-added exports increase. ♦

## Grain Market Glut: Asia a Minor Player

—By William H. Meyers and Darnell B. Smith

There is no doubt that we are in a grain market glut of global proportions, and it is fair to ask how we got here. It seems only a short time ago the big concern was low stocks and the possibility of market disruptions arising from yet another shortfall somewhere in the world. Since this market glut coincides with the Asian financial crisis, it has been easy to blame low prices on the collapse of Asian economic growth. However, Asia is a relatively small part of the story.

### GLOBAL PRODUCTION RESPONSE

In fact, the high prices and low stocks of the 1995/96 crop year are the main explanation for the current glut. Growers in the United States and around the world responded to those attractive incentives, and expanded their plantings. Governments responded by reducing set-asides (European Union) or eliminating them

altogether (United States). From 1995 to 1997 world wheat production increased by 13 percent, corn production by 13 percent, and soybean production by 25 percent. Clearly, these increases in supply exceeded the increases in demand, so prices naturally had to fall.

These production increases and consequent price declines were mostly anticipated by market projections, including those of the Food and Agricultural Policy Research Institute (Figures 1-3). These comparisons show the FAPRI price projections of January 1996, January 1997, and January 1998 compared with a September 1998 FAPRI baseline update.

The actual price declines from 1995/96 to 1997/98 were very similar to what FAPRI baselines have projected since January 1996. Although no one knows what the final outcomes will be for the current crop year, it is already apparent that prices will decline more than projected in the January 1998 FAPRI baseline.

The global economic slowdown, while not a major cause of low prices, is a major factor that has caused the grain market glut to be more severe this year than was previously expected. This situation began developing in mid 1997 with the Asian financial crisis and continues with the

Russian collapse, and the secondary impacts on Latin American and other economies. A secondary surprise, especially for corn, is that carryover stocks in 1997/98 were larger than anticipated.

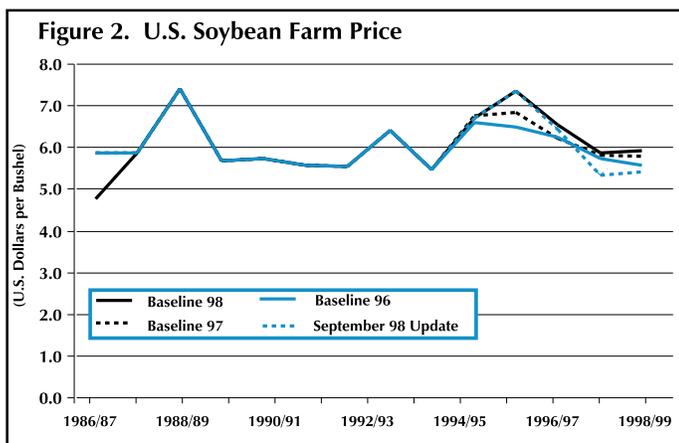
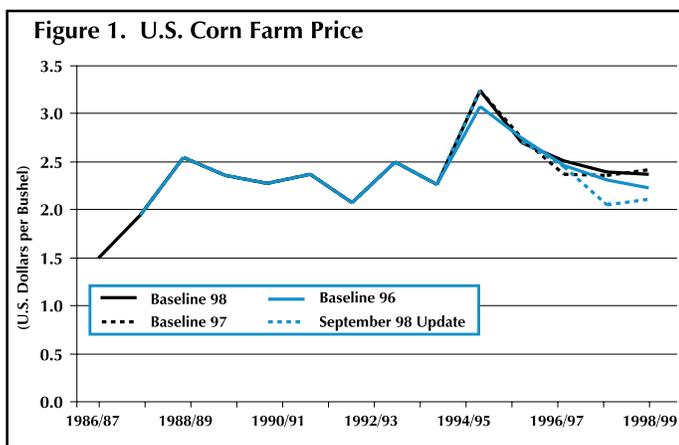
A similar development in hog markets is that production in 1998 increased more than anticipated, so hog prices are also declining more than was projected (figure 4). This, too, was exacerbated by the global financial troubles that reduced demand for meat. Weak demand for meat, of course, translates into weaker feed demand, as animal numbers are reduced. This factor will slow the recovery of grain markets.

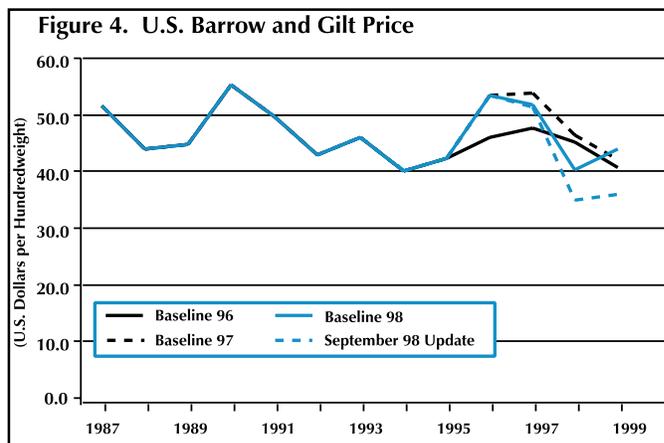
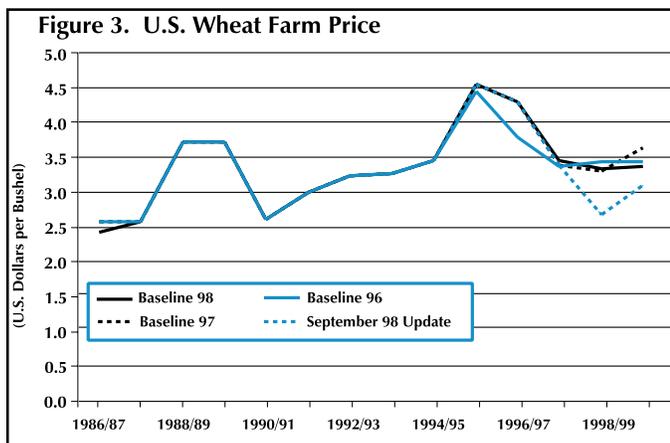
*“The global economic slowdown . . . is a major factor that has caused the grain market glut to be more severe this year than previously expected.”*

### TRADE CONFLICT DANGERS

Low prices tend to stimulate policy reactions. There is a danger that short-term responses to this market glut could create longer-term problems in trade relations. A prime example is what has happened in the Central and Eastern Europe Free Trade Area (CEFTA) that was moving toward freer trade among its members. First Poland raised the import tariff on Hungarian maize from zero to 20 percent and put a minimum import price on wheat imports. Hungary then retaliated with a doubling of tariffs on Polish starch. Slovenia increased tariffs on wheat imports from 15 to 22.5 percent, Romania increased tariffs from about 15 percent to 25 percent (45 percent for flour), and Croatia banned wheat imports altogether. All of these countries, except Croatia, are members of CEFTA and have been in a process of reducing tariffs and promoting interregional trade. Thus, the efforts to protect domestic markets may sacrifice future trade growth.

Some may suggest that the answer





to our domestic price slump is to export more or to be more protectionist. Actually, since this is a global rather than a domestic market problem, there is no export solution. Starting trade conflicts by dumping surpluses or further restricting imports would only slow or setback the progress in opening markets for U. S. farm and food products. Any short-run benefits would reap larger long-term costs in terms of lost market access.

While the Asian economic troubles and the spread of these financial woes to Russia and Latin America were a minor factor in the price decline we have seen, they will certainly prolong the recovery of grain and meat prices. Therefore, measures that speed the recovery of these troubled economies will also contribute to the recovery of commodity market prices.



## FUTURE PROSPECTS

## Meet the Staff

Chad Barrett is a research assistant at the Food and Agricultural Policy Research Institute (FAPRI), working specifically with international livestock modeling. “I like being involved in agriculture, and I find the modeling to be challenging. Developing econometric livestock models for FAPRI has shown me useful applications of economic theory and econometrics,” he says.

Chad has also worked with Iowa AgSTATE (Agricultural Strategic Thinkers Acting Together Effectively). AgSTATE is a group of people representing farm and commodity organizations, agribusinesses, state government and Iowa State University who came together to develop a proactive, futuristic vision for Iowa agriculture and an action plan to help make that vision a reality. “Involvement in AgSTATE gave me the opportunity to observe the policy making process and learn more about the opportunities

and challenges affecting Iowa’s agricultural industry,” he says.

Chad has been able to acquire a diverse range of career skills while working at FAPRI. “The quantitative skills that I have learned are applicable to many subjects other than just livestock modeling,” he says.

Originally from a Dallas Center, Iowa, farm producing corn, soybeans, and cattle, Chad received his undergraduate degree from ISU in ag business/ag economics. He is currently working on his Ph.D. in agricultural marketing. In his free time, Chad enjoys participating in sports and other activities including river rafting, hiking, and motorcycling. ♦



Chad Barrett, Research Assistant FAPRI

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