

Farm Programs, Fuel Mandates, and Agricultural Prosperity

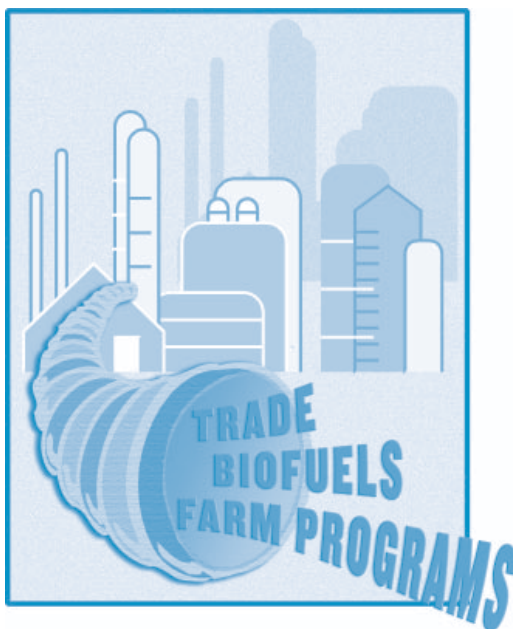
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The future looks bright for corn, soybean, and wheat farmers. Corn farmers can lock in a price on the Chicago Board of Trade of \$4.00 per bushel for their 2008, 2009, and 2010 crops. Soybean farmers can lock in \$9.00 per bushel for 2008 and 2009, and wheat farmers can lock in \$5.50 for the same two years. After adjusting for basis, this corn price is 65 percent greater than the average price received by corn growers for their 2002 to 2005 crops. The soybean price is up 42 percent and the wheat price is up 51 percent over the 2002 to 2005 levels. If futures contracts traded out even further, there is no doubt that these high prices could be locked in for an even longer period.

Three factors help explain why traders in Chicago believe that crop prices seem poised to remain at such high levels. The dollar is down 15 percent on a trade-weighted basis relative to its level during the 2002 to 2005 crop marketing years. A weaker dollar increases demand for U.S. goods, thereby raising their prices. Continuing strong income growth in China, India, and other Asian countries combined with rapid urbanization has led to strong demand for meat and dairy products, which in turn has resulted in strong demand for feed grains and oilseeds. And finally, U.S. ethanol production from corn has doubled in the last three years and is poised to double again in the next two. This has led to sharply higher demand for corn, higher corn acreage, and



relatively smaller soybean and wheat acreage. Wheat prices have also been strengthened by short crops in major producing areas.

The value of the dollar and world income growth are beyond the direct control of U.S. policymakers. But Congress is currently considering what to do with U.S. ethanol policy and U.S. farm policy. The Senate recently passed legislation that would increase the renewable fuels standard from its current level of 7.5 billion gallons (to be achieved by 2012) to 15 billion gallons by 2015. The House seems poised to go along with this increase.

Because 15 billion gallons of biofuels would have a direct effect on U.S. and world agriculture, we might expect the House and Senate to consider how best to modify current farm bill programs so that they work in concert with higher biofuels production. However, there is no

evidence that such coordination is happening. For example, the subcommittee of the House Agriculture Committee with responsibility for farm programs voted 18-0 for a continuation of the current set of farm programs, which were developed to counter the effects of low commodity prices. This vote sent a signal to reformers that changes in farm policy will be difficult to obtain.

Why do many House Agriculture Committee members believe that agriculture needs both traditional farm programs and higher biofuels mandates? What are the needs of agriculture in this new era of expanded biofuels production, and can commodity programs be improved to reflect the new era of expanded biofuels production? Insight into these questions can be obtained by first looking at the number-one driver of the farm bill this year: new congressional budget rules.

Pay-Go and Farm Programs

One of the first actions that the House of Representatives took this year was to restore "pay-go" (pay-as-you-go) budget rules. Under these rules, any new legislation that increases spending above projected levels with existing programs must pay for the spending increase through new tax revenue or spending reductions elsewhere in the budget. House Democrats passed this legislation in an attempt to differentiate themselves from their Republican counterparts who oversaw a large expansion in federal expenditures.

The table provides an estimate of program expenditures under existing legislation for a five-year ➡

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Projected program expenditures under existing commodity programs

Annual Direct Payments		Marketing Loan plus Countercyclical				
		2008	2009	2010	2011	2012
million \$						
Corn	2,116	6	3	2	2	3
Cotton	633	1,409	1,260	1,287	1,308	1,342
Rice	431	107	65	70	80	89
Soybeans	608	288	143	120	151	288
Wheat	1,151	6	3	2	2	3

farm bill beginning in 2008. These estimates are based on Congressional Budget Office projections of crop prices and acreage. For corn, soybeans, and wheat, high crop prices translate into very low projections of program expenditures for the marketing loan and countercyclical payment programs. For these three crops, projected expenditures from the two programs total about \$200 million per year. In contrast, these three crops received a total of about \$14 billion from these two programs under the 2002 farm bill. Looking at the table, it is evident that, with the notable exception of cotton, direct payments are projected to deliver much more agricultural support than would the other programs. Over these five years for these five crops, direct payments are projected to total \$24.7 billion whereas marketing loan and countercyclical payments are projected to total about \$8 billion.

Now consider the problem of writing a new farm bill under pay-go rules. Almost all proposals for changes to commodity programs would involve higher expenditures than are projected for marketing loans and countercyclical payments. Thus, if Congress decides to make changes to commodity programs, it will have to pay for them with decreases in direct payments or find reductions in spending in other parts of the farm bill, such as in the nutrition or conservation titles. However, many farm groups strenuously object to reductions in

direct payments, and there is little appetite in Congress to cut conservation and nutrition programs to increase payments to large and wealthy farmers. Thus, we should expect few changes in commodity programs unless the ag committees can find funds in other programs in their jurisdiction. As pointed out in previous issues of *Iowa Ag Review*, one ready source of funds that some in Congress propose to tap is the crop insurance program. Reductions in the proportion of taxpayer support for the program that flows to companies and agents could contribute to modifications of commodity programs or to additional funds for other program areas.

The pay-go rules thus have reinforced the tyranny of the status quo: after all, by definition, Congress can always extend existing programs under its new budget rules. But a simple extension of current programs may not be possible. There are many groups working to increase funding for farm bill programs that fall outside of the commodity title. Advocates for expanded programs in conservation, research, energy, nutrition, and trade are pushing hard for additional funds for their programs. The only viable agricultural sources of funds for any such expansion is to be found in cuts in direct payments or crop insurance. The big uncertainty with this year's farm bill is whether advocates for reform or advocates for continuing existing farm supports have the votes to pass a farm bill.

Role of Biofuels in Commodity Programs

Congress seems poised to ask agriculture to supply up to 20 percent of the nation's transportation fuel supply. The only way that U.S. agriculture will supply adequate feedstocks to meet this objective while continuing to supply abundant food is through continued high commodity prices. Because the only justification for our current set of farm programs is to protect farmers against low prices, biofuels policy seems to eliminate the need for farm programs.

One reason why this topic has not been ripe for discussion is that it is quite difficult to defend any payments at all when farmers have such a golden opportunity to lock in very profitable price levels. A reasonable person could conclude that the farm bill should focus on areas other than support of commodities because the price and profit problems for program crop farmers have been solved through biofuels policy. For example, high crop prices will pull a significant number of acres out of the Conservation Reserve Program unless USDA dramatically increases per-acre payments. These high crop prices may also induce farmers to apply more fertilizer and, in general, farm their land more intensely. A reasonable argument can be made for increasing funding for environmental programs that keep the most environmentally sensitive land out of production and that reduce the environmental impacts of farmed land rather than to continue payments to profitable farmers. High crop prices brought about by biofuels policy will also have a modest impact on food prices. Again, it is reasonable to conclude that reducing the burden of higher food prices on low-income families by increasing funding for nutrition programs makes more sense than maintaining payments to program crop farmers who already receive the benefits of energy policy.

Because the only justification for our current set of farm programs is to protect farmers against low prices, biofuels policy seems to eliminate the need for farm programs.

One practical argument about why Congress might keep the marketing loan and countercyclical programs is that their elimination would not generate substantial funds that could be used to increase funding for other priority programs. Why give up tried and true programs that would protect farmers against low prices (who really knows what the future holds?) when there are no real funding benefits that could be obtained for other programs? Of course, the same political calculation does not hold for direct payments. Their elimination would generate substantial funds for other priority programs.

High prices, though, mean little to farmers if they do not have a crop to sell. And yield variability remains a big problem for almost all U.S. farmers. If Congress wants to solve a continuing need in agriculture with commodity programs, then it should reorient farm programs to offer protection to farmers against low yields. One step in this direction is the push for permanent disaster legislation, which could easily be paid for through a reduction in direct payments or through savings in the crop insurance program. A more ambitious approach would be to pay for a new risk management program

by transferring the systemic risk from the crop insurance program (systemic risk affects many farmers in a region in the same year) into the farm bill, leaving the nonsystemic risk for the crop insurance industry. This type of program would automatically protect the nation's farmers from the effects of low yields, and its costs could be paid for using savings from crop insurance and a reduction in direct payments.

Which Path for Farm Policy?

Biofuels policy seems poised to keep program crop farmers prosperous for the foreseeable future. Given these circumstances, Congress and farm groups could focus their farm bill writing efforts on problems not previously addressed by farm bills (low yields) or on problems caused by high crop prices (possible environmental degradation and higher food prices). However, most efforts seem focused on either maintaining status quo programs or increasing commodity payments to farmers despite the promise of farm prosperity from high crop prices. Perhaps we should not expect anything else in our representative form of government. After all, if groups do not pursue their own self-interest, who will pursue it for them?

Given tight public funds and knowledge that passage of a status quo farm bill will do little to address the future needs of farmers, consumers, and the environment, momentum could build for a reform bill. However, legislative inertia is a powerful weapon in the hands of those who benefit from the status quo. Given the short period of time that Congress has to work on farm legislation and the natural desire to do no harm through unintended effects caused by adoption of new programs, it is likely that much of what we currently have in the farm bill will be with us in the new farm bill. ♦

Do Biofuels Mean Inexpensive Food Is a Thing of the Past?

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Concern is growing that expanded biofuels production means the end of inexpensive food. After all, the prices of corn, soybeans, and wheat have dramatically increased and are likely to stay high. The line of thinking that expects expensive grains and oilseeds to lead to dramatically higher food costs follows the logic often used by proponents of U.S. farm programs. Many proponents justify subsidies by claiming that farm payments work to keep food plentiful and inexpensive by artificially keeping the price of commodities lower than production costs. For this justification to be valid, farm subsidies would have to expand commodity production, thereby lowering commodity market prices. Lower prices would then, in turn, lead to an expansion in the production of the food that all of us actually eat (pork chops instead of no. 2 yellow corn), which would cause food prices to be lower than they would be otherwise. Thus, according to the argument, we do not need to spend as much of our income on food. By the same logic, high commodity prices caused by subsidized biofuels should result in a reduction in the production of food and higher food prices.

There is enough economics behind this logic to make it plausible, even though it is largely false. In the case of farm programs, it is easy to demonstrate that feed grain and oilseed prices are largely unaffected by U.S. farm subsidies, particularly since 1996 when Congress removed USDA's authority to increase com-

modity prices through acreage set-asides and subsidized storage. It is also easy to demonstrate that the small share of the final consumer food dollar that goes to the farmer means that even a doubling of feed grain and oilseed prices from expanded biofuels production will lead to relatively modest increases in the prices of meat and dairy products. Food prices are largely determined by costs and profits after commodities leave the farm.

How Much for Food?

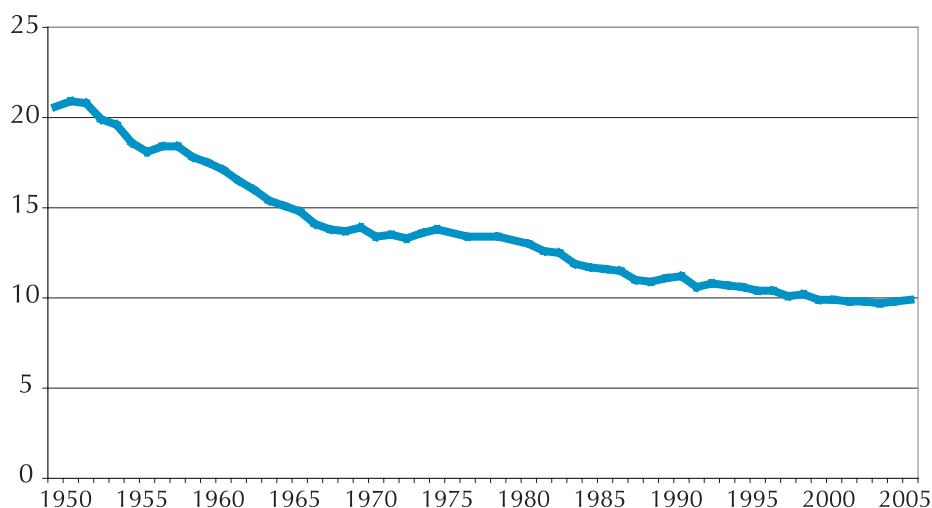
In the United States, consumers spend a relatively small amount of their disposable incomes on food. However, diverting a large share of U.S. feed grain production to biofuels will affect the price of food. Knowing how U.S. consumers spend their food dollars and how higher commodity prices influence food prices will give us a better understanding of whether we'll be spending more or less on food in the future.

One indicator of a nation's standard of living is the proportion of income that its citizens spend on food. Typically, this share is measured using after-tax or disposable income. As shown in Figure 1, this

share in the United States has fallen from 20 percent in the early 1950s to about 10 percent today. In contrast, Canadians today spend an average of about 14 percent of their disposable income on food, and Mexicans spend 26 percent.

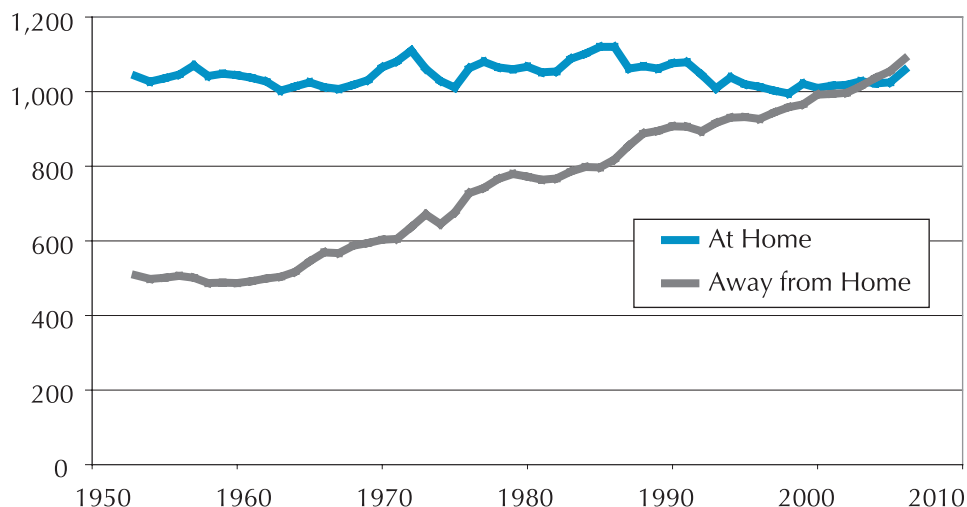
The share of income that Americans spend on food would actually be smaller than 10 percent were it not for the large increase in expenditures away from home. As shown in Figure 2, beginning in the mid-1960s, Americans began to increase the amount of money spent on dining out. Today Americans spend about half of their food dollar on food away from home. Part of this increase in expenditure patterns has been driven by the changing structure of the U.S. family, including more women entering the labor force, and part has been driven by changes in demand for food driven by income growth. USDA reports that expenditures on food total about \$3,600 per person per year in 2006 dollars.

The primary reason why food prices have risen more slowly than incomes and other prices is rapid productivity growth on the farm and all along the food chain. Farmers and



Source: USDA/ERS, Food Expenditure Tables.

Figure 1. Share (%) of disposable income spent on food in the United States



Source: USDA/ERS, Food Expenditure Tables.

Figure 2. Real food expenditures (1988 dollars)

food companies have dramatically increased the efficiency with which they can produce food. There is no reason to believe that we have seen an end to this productivity growth. But expanded biofuels production may counter some of the impacts of this growth on future food prices.

Figuring Feed Costs into Food Expenditures

Increased ethanol production has driven the price of corn, other

feed grains, and oilseeds much higher. Because corn and soybean meal prices largely determine the price of feeding hogs, poultry, and cattle, increased feed costs will eventually result in higher market prices for pork, beef, chicken, and dairy products. Corn is also used widely as an ingredient in many processed foods. Thus, higher corn prices will also affect the cost of soft drinks, snack foods, baked goods, and many other food items.

In general, the percentage by which the price of a particular food item increases because of higher corn prices depends on the value of corn embodied in the product relative to the price of the product. For example, if a \$1.00 can of soda contains 2¢ worth of corn that is contained in high-fructose corn sweetener, then a doubling in the price of corn would increase the cost of producing the soda by at most 2¢. If all this increased cost were passed along to the consumer, then the doubling of corn prices would increase the price of soda by about 2 percent.

Corn makes up a relatively large share of the product prices of eggs, pork, and poultry. Beef and dairy products also contain significant amounts of corn, but the prices of processed foods are largely determined by the cost of other components. Thus, one would expect that the prices of eggs, pork, and poultry would go up by a larger percentage than the prices of beef and dairy products, which would go up by a larger percentage than processed foods.

Continued on page 11

CARD's 50th Anniversary: Taking Stock of Our Past—and Future

In July of 1958, our center was founded as the Center for Agricultural Adjustment, under director Earl O. Heady, and began operation. This fall, the Center for Agricultural and Rural Development will kick off an academic year that not only celebrates our 50-year history but also, in keeping with our founding mission to help improve the condition of the Iowa agricultural economy, sets a course for CARD's commitment to addressing the wide range of challenges in agriculture—in trade, food, renewable fuels, and resource policy—today and for decades to come.

CARD's Founding Years

1956

15 prominent Iowans petition Iowa State President James Hilton and Dean of Agriculture Floyd Andre for assistance from the college in addressing the welfare of Iowa agriculture.

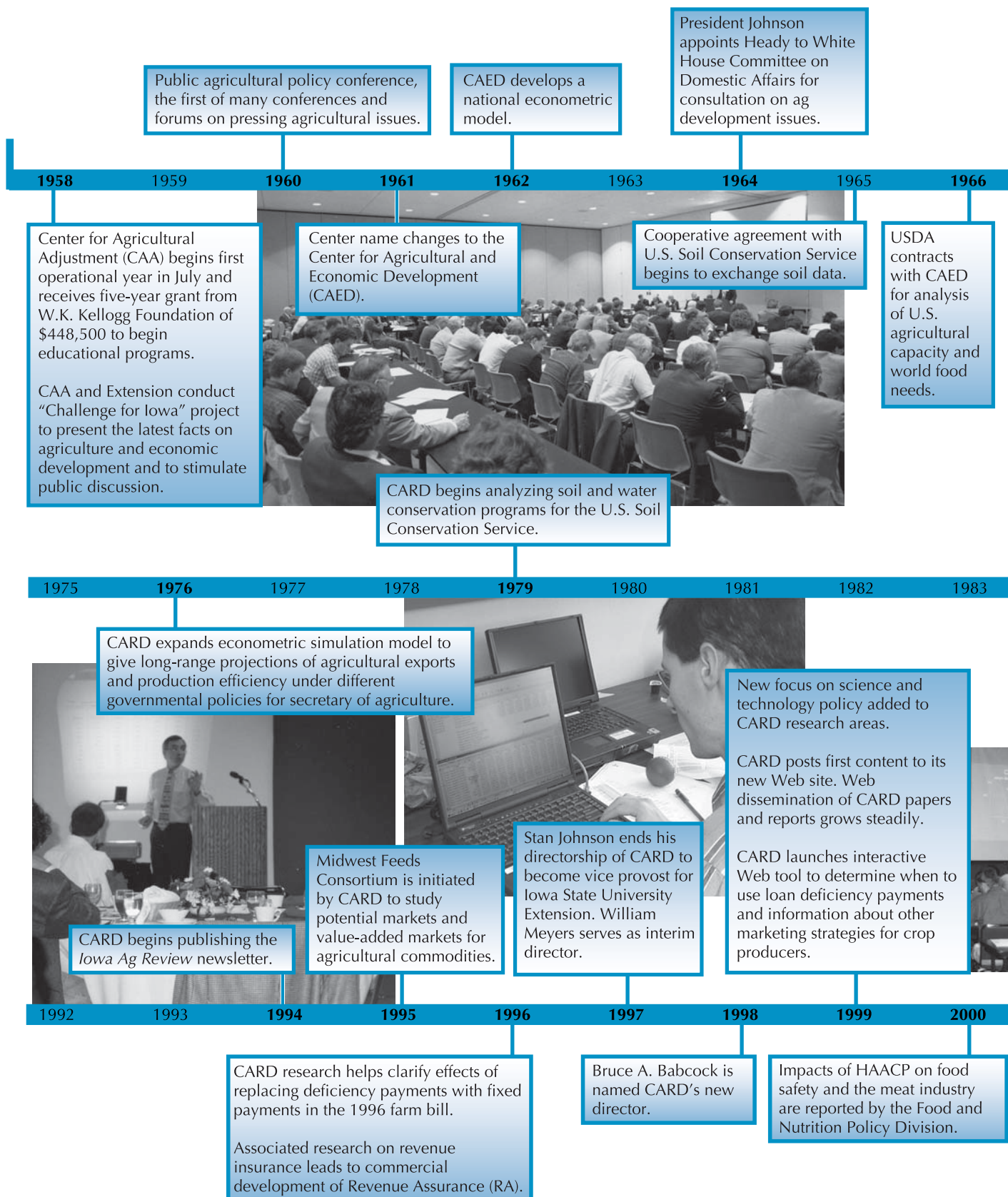
1957

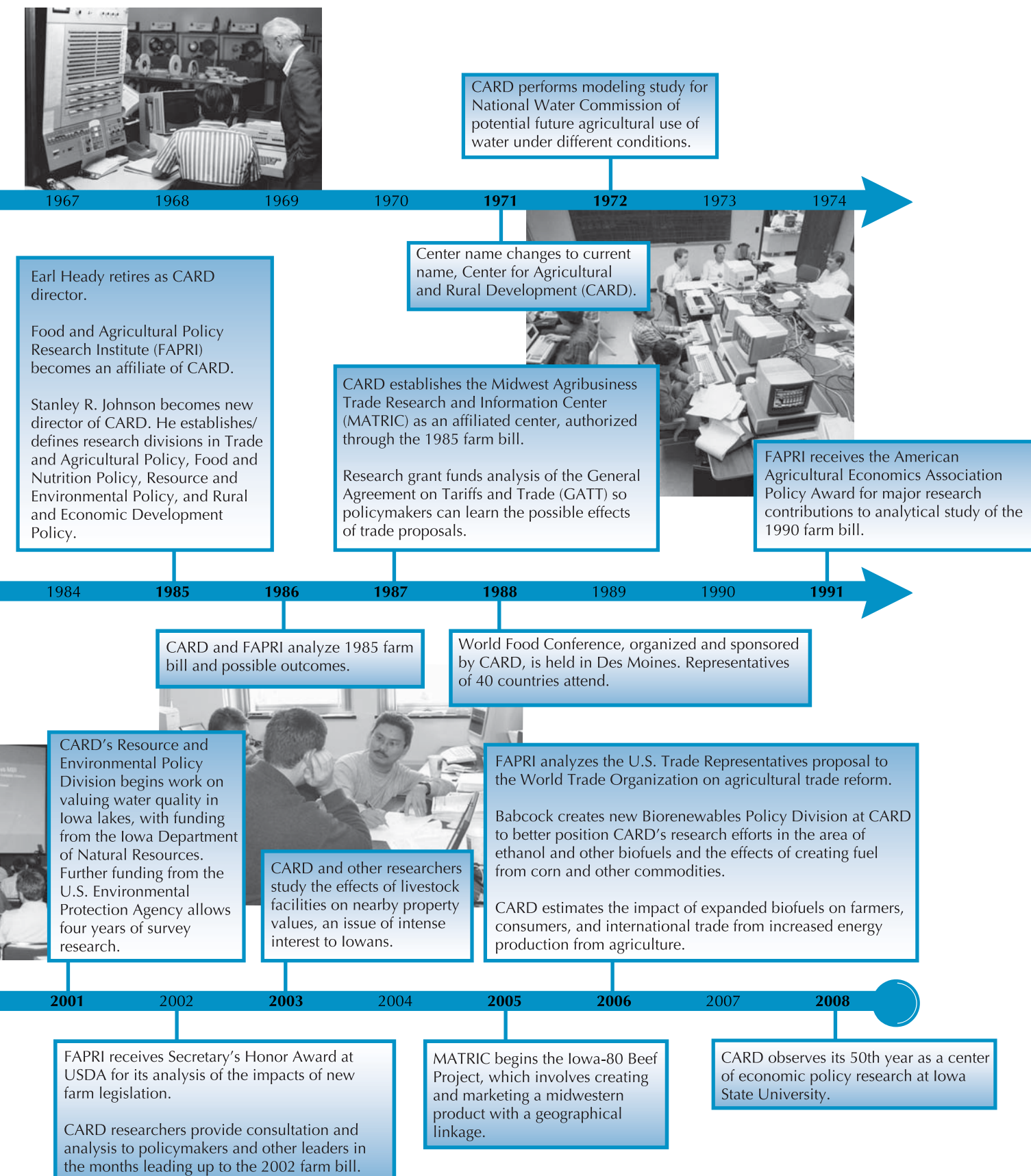
57th Iowa Assembly passes resolution and appropriation of \$100,000 to support research program on agricultural adjustment.

Iowa Board of Regents creates Center for Agricultural Adjustment in the Division of Agriculture at Iowa State College. Earl Heady is named executive director.



Selected Highlights of CARD's 50-Year Timeline





Agricultural Situation Spotlight

Shifting Corn Basis Patterns

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The ethanol industry continues to reshape Iowa's agricultural economy. By the end of this summer, 28 ethanol plants will have spread across the state, capable of producing over 1.9 billion gallons of ethanol per year. Twenty more plants are being constructed in Iowa, with plans for even more. The tremendous growth of the ethanol industry has put pressure on Iowa corn producers to keep up with this growing demand for corn. Producers have responded by planting 14.3 million acres of corn, the second-largest corn area in Iowa on record. (In 1981, Iowa had 14.4 million acres of corn.) The pull on corn from the ethanol industry, combined with the push from Iowa and U.S. corn producers, has resulted in some dramatic price movements for corn over the past year. As Figure 1 shows, since September of last year, the corn market has experienced a strong run-up in prices and an increase in price variability. The growth in ethanol's demand for corn drove prices up through the harvest period last year and maintained corn prices at around \$4 per bushel over the winter. The acreage response hit the market in two waves, around the USDA acreage reports released in March and June of this year. The prospects for increased corn production have reduced corn futures prices to below \$3.30 per bushel.

For Iowa, the supply, demand, and price shifts have also affected the pattern of corn prices across the state. One way to view these impacts is to examine the basis patterns across Iowa. Basis is the difference between the prices listed on the Chicago Board of Trade

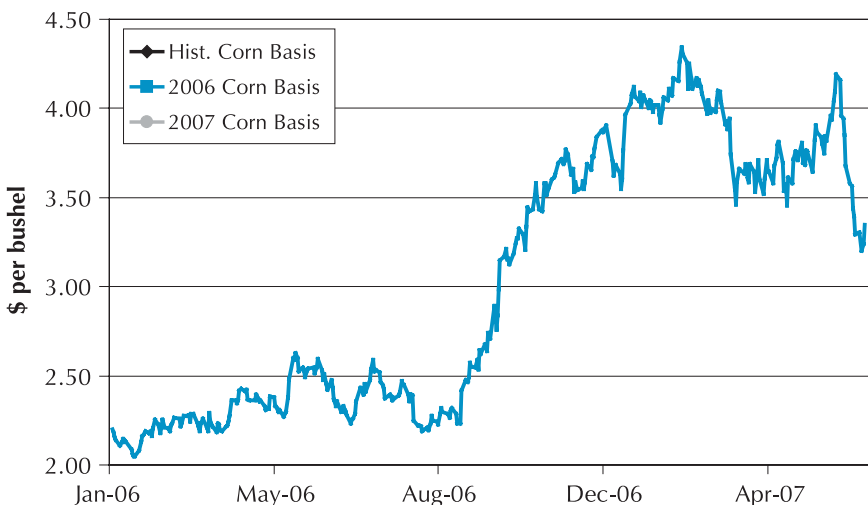


Figure 1. Chicago Board of Trade nearby corn futures prices

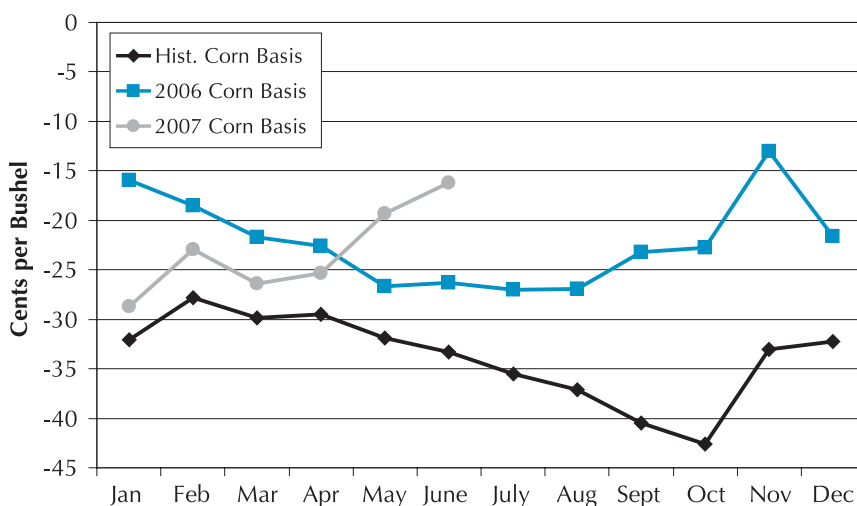


Figure 2. Basis levels for Webster County, Iowa

(CBOT) futures for corn and the prices being paid in Iowa for corn. Since February 2005, CARD has tracked basis levels across Iowa for corn and soybeans (visit our Web site, http://www.card.iastate.edu/ag_risk_tools/basis_maps/, for the latest information). Figures 2 through 5 show historical basis patterns, based on price data from 1998 to 2005, and the basis patterns

over the last year and a half. Figure 2 shows the basis patterns for Webster County, Iowa. Webster County has seen a sizable surge in ethanol production in the county with the opening of new ethanol plants in Fort Dodge and Gowrie. And since January 2006, the basis for Webster County has been above historical levels—sometimes well above. Late last year, Webster County's basis

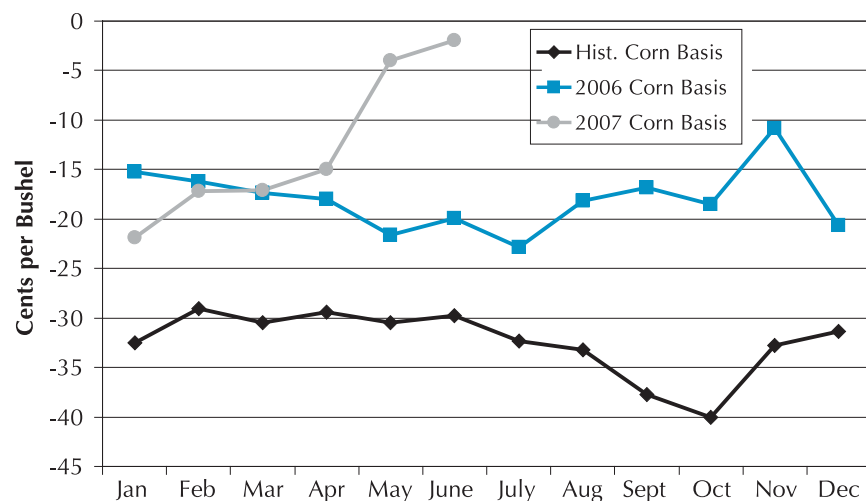


Figure 3. Basis levels for Plymouth County, Iowa

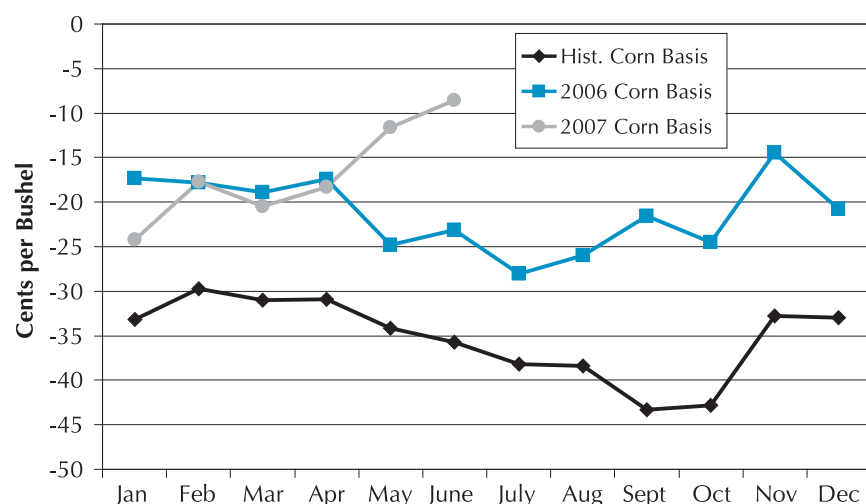


Figure 4. Basis Levels for Kossuth County, Iowa

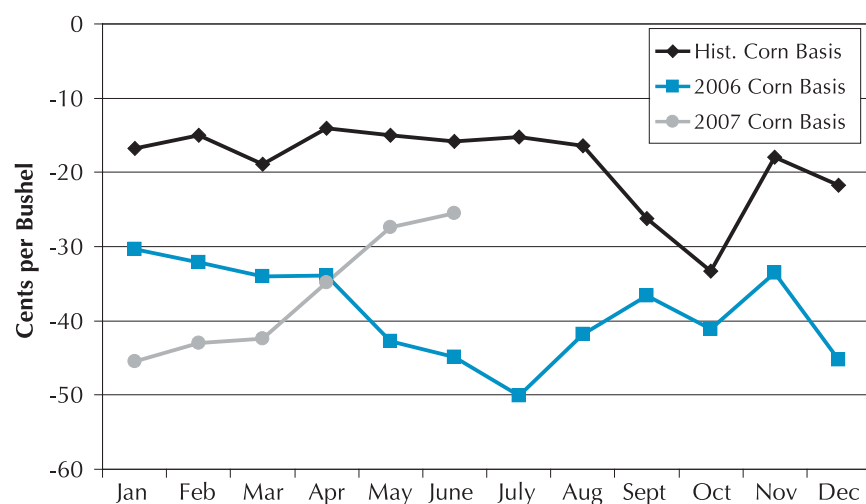


Figure 5. Basis levels for Clayton County, Iowa

ran 20¢ per bushel above historical levels, and it is currently doing so. The ethanol demand for corn in the county has strengthened the basis situation in the county. Historically, corn prices in Webster County run from 28¢ to 43¢ per bushel below the CBOT prices. Currently, they are 16¢ below.

This pattern is not specific to Webster County. For many counties, especially those in north central and northwest Iowa, recent basis patterns have been stronger than the historical averages. Figure 3 shows the basis patterns for Plymouth County in northwest Iowa. Here, local prices for corn have been within 5¢ of the CBOT prices for the last couple of months. Normally, corn prices are 30¢ to 40¢ per bushel below the CBOT prices.

In Kossuth County, recent basis patterns are 10¢ to 25¢ above historical averages, as shown in Figure 4. A tighter stock situation for corn and the ethanol boom have strengthened corn prices across a wide swath in Iowa. However, not all Iowa counties have experienced a stronger corn basis. As Figure 5 shows, Clayton County in northeast Iowa has actually had a weaker basis pattern over the last year and a half. Whereas local corn prices are typically 15¢ to 30¢ per bushel below the CBOT prices, since January 2006, the corn prices have been 30¢ to 50¢ below CBOT in Clayton County.

Figure 6 displays the typical basis pattern for Iowa corn in July, based on prices from 1998 to 2005. Eastern Iowa tends to have the strongest basis, between 0¢ and 15¢ below CBOT. North central and western Iowa tend to have the weakest basis, between 35¢ and 50¢ below CBOT. The current basis pattern is almost the inverse of the historical pattern. Northwest Iowa has a very strong basis currently, while northeast Iowa's

basis is weak, as illustrated in Figure 7. Arguably, the growth of the ethanol industry in Iowa has served to flatten the basis across Iowa, with many of the major corn-producing counties in Iowa seeing an improved basis.

However, the strength in the basis across Iowa is likely to be short lived. With the dramatic shift of acreage to corn, both in Iowa and nationwide, and the relatively good condition of the corn crop (63 percent in good to excellent condition for both Iowa and the United States), possible record corn production will likely soften the basis patterns across Iowa. Iowa would produce a record corn crop if yield is 161 bushels per acre or higher, surpassing the 2004 corn crop when the state-average yield was 181 bushels per acre. Above-average yields would lead to record production and would put a strain on corn handling and marketing systems. This sets up a scenario for weaker basis patterns across Iowa. Figure 8 shows there is already weakness building into basis patterns across Iowa as we look at forward contracting new-crop corn. Where the current basis shows most of the state having corn prices within 35¢ per bushel of the CBOT price, the new-crop basis across Iowa is below 35¢ for almost all of Iowa. Roughly half of the state has a current new-crop basis below 45¢ per bushel.

As the ethanol industry continues to grow and evolve, the corn market will continue to adjust. This is translating into more variable price and basis patterns for Iowa corn producers. We will likely see additional swings in Iowa's basis patterns as more Iowa ethanol plants come online and as Iowa farmers shift acreage to meet various crop demands. Increased volatility looks to be the wave of the future both locally and on the Chicago Board of Trade. ♦

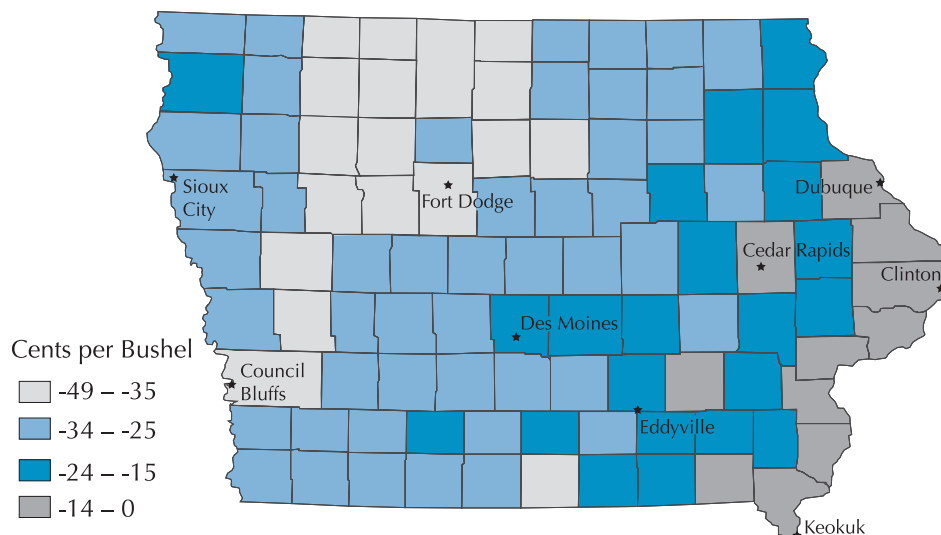


Figure 6. Historical basis, average 1998-2005

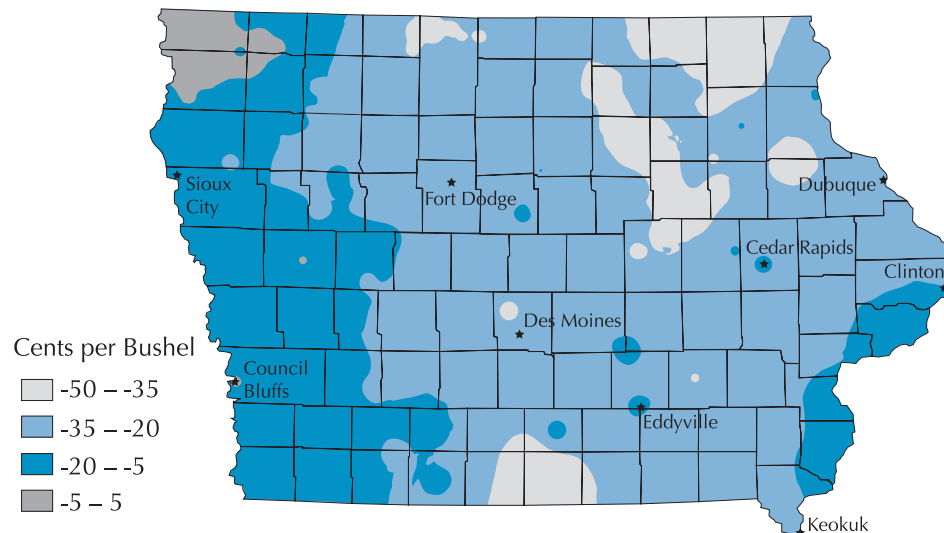


Figure 7. Basis for old-crop corn, July 2, 2007

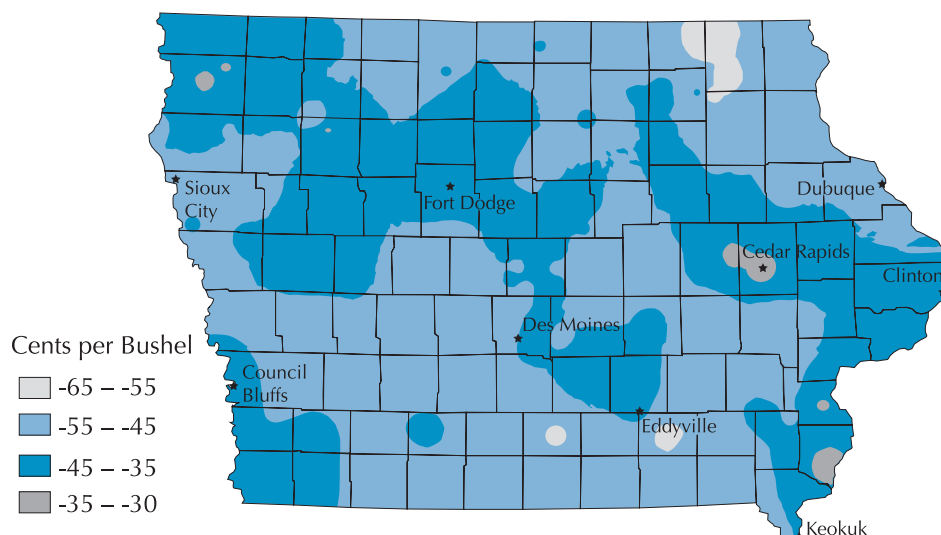


Figure 8. Basis for new-crop corn, July 2, 2007

Inexpensive Food a Thing of the Past?
Continued from page 5

Other things being equal, corn makes up a smaller share of the final price of food consumed away from home than it does for food consumed at home because the consumer must pay for additional costs incurred in preparing food away from home. This lower share acts to decrease the final impact of corn price increases on total food expenditures because half of average food expenditures are made away from home.

In a recent study, CARD researchers estimated that a 30 percent increase in the price of corn, and associated increases in the prices of wheat and soybeans, would increase egg prices by 8.1 percent, poultry prices by 5.1 percent, pork prices by 4.5 percent, beef prices by 4.1 percent, and milk prices by 2.7 percent. For all food consumed at home, average prices would increase by 1.3 percent. For food consumed away from home, average prices were estimated to increase by 0.9 percent. So, across all food consumed, 30 percent higher corn prices increase all average food prices by 1.1 percent, according to our estimates.

The CARD assessment of modest effects on food prices of increased corn prices seems to run counter to what is happening in the supermarket. Milk prices are at an all-time high, while meat and egg prices continue to remain at historically high levels. If high corn prices are not to

*So, across all food
consumed, 30 percent
higher corn prices
increase all average food
prices by 1.1 percent,
according to our
estimates.*

blame, what is? The primary cause of high milk prices is that international demand for dairy products has outstripped international supply. The lack of supply is a result of drought in Australia, a drop in subsidized milk production in the European Union, and a lack of profits in the U.S. dairy industry in recent years. Strong world demand is a result of continued strong income growth in China, India, and other Asian countries, and continued strong U.S. demand for cheese. The excess world demand for dairy products has pulled U.S. products onto world markets, thereby raising U.S. prices. Instead of fighting foreign competition, U.S. milk producers are now benefiting from international markets.

A Bigger Impact for Some Consumers

With agriculture being asked to supply an increasing share of U.S.

fuel, it follows that food prices will trend upward. For most Americans, though, the higher prices caused by ethanol will hardly be noticeable. However, low-income U.S. consumers spend a much greater proportion of their income on food than high-income consumers do. Their large share combined with less flexibility to adjust expenditures in other budget areas means that any increase in food prices will cause hardship.

Low-income consumers in other countries will be hurt even more by more expensive food. For example, the average Mexican consumer spends 12 percent of his or her food budget (about 3 percent of disposable income) directly on corn products, primarily tortillas. This means that any increase in the price of corn will affect the standard of living of many in Mexico.

And finally, food price increases, from whatever source, will directly affect the cost of U.S. nutrition programs. Higher commodity prices combined with shrinking inventories mean that the U.S. government will be forced to pay high market prices for food for school lunch programs. And the automatic food price escalators built into the food stamp program mean rising expenditures there. The silver lining, as far as the federal budget is concerned, is that at least a portion of the higher costs of nutrition programs will be offset by lower support payments for farmers because of high commodity prices. ♦

Recent CARD Publications

Briefing Paper

A Comparative Analysis of the Development of the United States and European Union Biodiesel Industries. Miguel A. Carriquiry. July 2007. 07-BP 51.

Working Papers

Are Standards Always Protectionist? Stéphan Marette and John C. Beghin. June 2007. 07-WP 450.

Crop Yield Skewness under the Law of Minimum Technology. David A. Hennessy. July 2007. 07-WP 451.

The Growth and Direction of the Biodiesel Industry in the United States. Nick D. Paulson and Roger G. Ginder. May 2007. 07-WP 448.

Impact of High Crop Prices on Environmental Quality: A Case of Iowa and the Conservation Reserve Program. Silvia Secchi and Bruce A. Babcock. May 2007. 07-WP 447.

Intellectual Property Rights and Crop-Improving R&D under Adaptive Destruction. Oleg Yerokhin and GianCarlo Moschini. June 2007. 07-WP 449.

Intra-Household Allocation and Consumption of WIC-Approved Foods: A Bayesian Approach. Ariun Ishdorj, Helen H. Jensen, and Justin Tobias. July 2007. 07-WP 452.

Welfare Impacts of Cross-Country Spillovers in Agricultural Research. Sergio H. Lence and Dermot J. Hayes. April 2007. 07-WP 446.

Staff Report

Emerging Biofuels: Outlook of Effects on U.S. Grain, Oilseed, and Livestock Markets. Simla Tokgoz, Amani Elobeid, Jacinto Fabiosa, Dermot J. Hayes, Bruce A. Babcock, Tun-Hsiang (Edward) Yu, Fengxia Dong, Chad E. Hart, and John C. Beghin. May 2007. 07-SR 101.

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