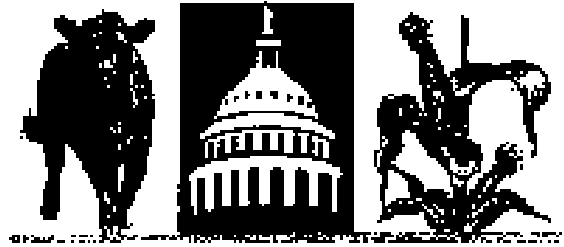


# ECONOMIC AND POLICY UPDATE

Vol. 8 No. 3

March 21, 2008



<http://www.uky.edu/Ag/AgEcon/blueshee.html>

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## In this issue:

- **Farm Bill Update – Will Snell**
- **The Farm Business Side of the Economic Stimulus Act of 2008 – Jerry Pierce**
- **Livestock Risk Protection Insurance – Kenny Burdine**
- **Spring Nitrogen Fertilization of Hayfields – Will it Pay? – Greg Halich**
- **Update on the U.S. Economy and Agriculture – Larry Jones**

### Farm Bill Update

We are now into “triple overtime” with the proposed new farm bill as Congress has agreed to another extension of the 2002 Farm Bill. The last extension expired on March 15<sup>th</sup> and lawmakers are hoping to iron out their differences by April 18<sup>th</sup>, the new extension deadline. The source of additional funding to support expansion of nutrition, specialty crops, conservation, energy, and rural development programs along with the precise amount of appropriated spending above the March 2007 CBO baseline continue to be major sticking points in the debate.

Other issues that have received a lot of attention recently include tightening payment limitations and whether or not to include a permanent disaster provision in the new farm bill. An excellent source to keep up with daily activities surrounding the farm bill and other agricultural policy and economic issues is [www.farmpolicy.com](http://www.farmpolicy.com). (Will Snell)

### The Farm Business Side of the Economic Stimulus Act of 2008.

The Economic Stimulus Act of 2008 (ESA) is best known for the tax rebate checks due later this year. ESA also provides one-time tax incentives to farmers and small businesses. These incentives include an increase in the Section 179 Expense Election and a special 50% Bonus Depreciation allowance for qualified 2008 purchases.

#### Increased Section 179 Expense Election—

Purchases of assets used in a trade or business must be recovered over time through depreciation. Under IRS Code Section 179, taxpayers may elect to expense the cost of qualified assets purchased and placed into service during the year. The maximum Expense Election allowed for 2008 before ESA was \$128,000. The election was phased out dollar-for-dollar for farms that purchased over \$510,000 of qualified assets.

Under the ESA, the maximum Expense Election is increased to \$250,000 for 2008 only. The Phase-out Limit is raised to \$800,000. The new law does not alter the Section 179 Expense Election limitation imposed on certain vehicles. The Expense Election limit for sport utility vehicles is \$25,000. Total Section 179 Expense Election and depreciation is also limited for passenger automobiles placed into service.

**Bonus Depreciation**—The ESA also allows a 50% write-off of qualified 2008 depreciable asset purchases. The asset must be “new” and be placed into service before January 1, 2009, to qualify. This Bonus Depreciation applies to most agricultural

assets, including general purpose barns and buildings. It may be used after any Section 179 Expense Election is applied.

**Analysis**—The \$122,000 increase in the Expense Election limit and \$290,000 increase in the Phase-out Limit are designed to provide an incentive for farmers and small businesses to purchase business assets. If purchasing the assets and taking the Election reduce taxable income, then farmers could defer Federal Income and Self Employment taxes. ESA will not apply to Kentucky state income tax. Actual tax savings will vary by individual situation.

Most Kentucky farmers will have difficulty exceeding the limits in depreciable assets. Livestock and poultry farms with qualifying single-purpose structures best illustrate full use of the increased limits. A farmer who builds four new broiler houses for \$150,000 each and spends \$200,000 on a composter/drystack and other equipment could write off up to the \$250,000 limit under Section 179 against 2008 income. The remaining \$550,000 would be depreciated normally.

Bonus Depreciation applies to the amount of purchase not expensed under Section 179. The same farm could write off half of the remaining cost after using the Expense Election. That would be another \$275,000 of Bonus Depreciation expense.

This would be a great time to build a shop, office, barn, or equipment shed. These assets are subject to 20 year depreciation and Section 179 expensing does not apply. Bonus Depreciation allows farmers to write off one half of the cost against 2008 income.

**A Word of Caution**—Farmers and small businesses should be cautious in using these business tax incentives. Tax liability is best “managed” to reduce extreme ups and downs. Taking advantage of ESA incentives will affect tax returns for many years to come. They may actually increase the total tax burden in the long run. Include your tax preparer in your planning before purchases are made.

Farmers should recognize, too, that while the purchased assets may reduce tax liability, the assets still have to be paid for. Include your lender in the planning, as well. Special attention should be given

to cash flow. Taxes are calculated as percentages of net income. That is, taxes are calculated as cents on the dollar of net income. Special expense elections reduce taxes by cents for every dollar spent, not dollar for dollar. The assets should “earn money” or “save money” for the farm to justify their purchase.

Kentucky farmers may call any Kentucky Farm Business Management specialist for further help in understanding the depreciation incentives and how they apply. Call the County Extension office for the KFBM specialist nearest to you, or you can go online at:

<http://www.uky.edu/Ag/KFBM/fbaspec.php>

(Jerry Pierce, KFBM State Coordinator)

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### **Livestock Risk Protection Insurance**

Since last summer, Kentucky cattle producers have been eligible to purchase Livestock Risk Protection (LRP) Insurance. When you purchase LRP insurance, you are buying a policy that pays an indemnity if the CME feeder cattle index is below a threshold you choose on the ending date of the policy. For example, if you choose a coverage level at \$105 per cwt. and the CME feeder cattle index is at \$100 per cwt. on your end date, then you would receive an indemnity of \$5 per cwt. for each covered animal.

The CME feeder cattle index is the weighted average price of 650 – 850 lb feeder steers in a 12 state area to the west. This is the same index used to cash-settle open CME feeder cattle contracts at expiration. LRP makes adjustments for lighter steers, heifers, and dairy-type calves. Just as basis risk exists in commodity futures, producers run the risk of local prices falling by more than prices in the west and the indemnity not fully compensating them for their loss.

Purchasing LRP insurance is very similar to purchasing a put option on the Chicago Mercantile Exchange in that your coverage level works much like a strike price. But, there are several differences that I believe are more producer-friendly. First, the insurance can be purchased locally through a crop insurance agent and does not require using a commodity broker. Second, the premiums are subsidized 13% by the government. For this reason,

LRP coverage is usually a little cheaper than a put option. Finally, there is no minimum number of pounds for which LRP coverage can be purchased. Feeder cattle futures contracts are 50,000 lbs, which is too large for small-scale backgrounders and the vast majority of Kentucky's cow-calf operators. LRP coverage can be purchased in small quantities.

There is also one major disadvantage of LRP; it is less flexible. Once purchased, LRP insurance is worthless until its ending date. While put options can be sold back or exercised anytime after purchase, the indemnity on LRP is calculated only on that ending date. It is like buying a put option that can only be exercised on the last day.

LRP is also less flexible with respect to the actual sale of the cattle. If the cattle are sold more than 30 days prior to the end date, the insurance is void. This presents a potential problem in years of drought when producers want to move cattle early. Cattle may be sold late, but the indemnity is still figured on that ending date. So, the producer would run the risk of prices dropping after the ending date, but before he or she sells the calves.

As I write this, corn futures are trading well above \$5 per bushel. The volatility that grain prices have added to feeder cattle markets over the last few years has been incredible. This is yet another tool available to livestock producers in a volatile market and is worth some consideration. Feel free to contact me if you would like to learn more about LRP insurance. (Kenny Burdine)

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### **Spring Nitrogen Fertilization of Hayfields in 2008 – Will it Pay?**

We are close to the point where farmers would normally start to apply nitrogen to hayfields to boost spring and early summer production levels. However, with nitrogen currently selling for \$.60 or more per unit, many of these producers are questioning the profitability of this practice in 2008. There are other factors that impact the profitability of spring applied nitrogen, the most important being the price of hay. Unfortunately, the price that hay will sell for this fall and winter is not known with any level of certainty at this point. The profitability of spring applied nitrogen will depend to a large

degree on whether hay prices reach levels seen last year or if they revert back to traditional price levels. The question ultimately comes down to at what hay prices will nitrogen applications prove profitable this year?

To help answer this question, I developed a model that accounts for the major factors that impact spring-applied nitrogen profitability. These include the price of nitrogen, price of hay, response rate of the nitrogen, nitrogen application rate, increased production costs from additional forage, and additional P and K removal.

The price of nitrogen was evaluated on an elemental (unit) basis between \$.50-.70 per pound (\$460-644 per ton urea). The application cost for spreading the nitrogen was set at \$5/acre. Machinery and labor costs of producing the extra hay were set at \$18.50 per 1200-pound bale (including moving to storage) and \$1.65 per 45 lb small square bale (including moving to storage) both sold on the farm. Increased removal of P and K was also accounted for in the analysis.

Response rates were estimated for both tall fescue and orchardgrass at application rates of 40 and 80 pounds per acre. Since the response rate will also vary according to soil moisture conditions and the general fertility level of the soil, multiple response rates were evaluated in this analysis, ranging from 26-65 lbs. of dry matter per unit of nitrogen.

A wide range of hay prices were evaluated to determine which prices, if any, would result in profitable nitrogen applications this year. In general, when hay prices reached \$100/ton for round bales (\$60 per roll) and \$125-150/ton for square bales (\$2.80-3.40 per bale), nitrogen applications proved profitable. When hay prices reached \$125-150/ton for round bales (\$75-90 per roll) and \$175-200/ton for square bales (\$3.95-4.50 per bale), nitrogen applications proved extremely profitable in all the situations evaluated in this analysis. In most situations where the nitrogen was profitable, the 40-pound application rate proved more profitable than the 80-pound rate.

For more detailed and refined results, consult the publication "Profitability of Spring Hayfield Nitrogen Applications - 2008 Guide" (AEC 2008-

02, available online at [http://www.uky.edu/Ag/AgEcon/pubs/ext\\_aec/2008-02.pdf](http://www.uky.edu/Ag/AgEcon/pubs/ext_aec/2008-02.pdf) or through your County Extension office). (Greg Halich)

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## **Update on the U.S. Economy and Agriculture**

The U.S. economy, in my opinion, is at a crossroads. You can look one way and see a full fledged recession setting in, triggered by a host of factors including the well-publicized subprime mortgage issue. But you can also look another direction and note that recent aggressive actions on the part of the Federal Reserve Bank (FED) will not only shorten any economic slowdown, but indeed cause the economy to rejuvenate by the second half of 2008. Which scenario is to be believed?

The FED has taken recent actions to ease the housing mortgage crisis by aggressively adding liquidity to financial markets, lowering the Federal Funds rate (most recently a ¾-point reduction), and arranging for a buyout of Bears Stearns, a major investment bank in New York City. All of these actions are designed to prop up ailing financial markets in the hopes of lessening the economic fallout in other segments of the economy. The legislative and executive branches of government passed a fiscal stimulus package whereby most Americans later this year will receive a \$600 tax rebate. These actions can be characterized as classic monetary (FED) and fiscal (Congress/President) stimulus plans to aid what is obviously an ailing economy with a hope of either avoiding a recession or lessening its severity.

What if the U.S. is not confronting just a liquidity crisis, but perhaps a solvency crisis as well? Have assets, particularly housing become overvalued i.e. a “housing bubble”? Have borrowers (lenders) have been too anxious to take out loans (make loans) for first and second mortgages predicated on the assumption that rapidly rising housing prices would be a fixture in the U.S. economy for years to come? Consumer debt has doubled in the past decade and most of that increase is reflected in housing debt. If the economy is facing a solvency issue, what policy prescriptions are available to ease real estate foreclosures beyond significant government

(taxpayer) infusions of capital to mortgage holders and real estate owners facing foreclosure?

What about agriculture in this economic environment? When investors globally expect higher inflation in the U.S. they tend to move toward commodities such as gold, silver, oil and today increasingly into agricultural commodities as a “hedge against inflation.” According to the U.S. Department of Agriculture, land values and cash rent values have increased at a double digit rate for the past three years. Some agricultural economists suggest that the basic supply/demand fundamentals for agricultural commodities do not support prices at current levels. Are agricultural prices being “bid up” by investors looking for a hedge against inflation? Some economists charge that the FED, by their recent policy actions, appears willing to tolerate higher inflation (at least in the short run) in hopes of stimulating economic growth. All of this leads to the obvious question, “Is U.S. agriculture facing a real estate bubble of its own?” Equally interesting (and troubling) is that if a bubble exists, when will it break? U.S. agriculture went through a similar “bubble” during the late 1970’s only to see a major real estate value re-alignment in the early 1980’s. Could history be repeating itself? (Larry Jones)

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