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Agricultural Land Taxation

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MP-303
17 April 1957

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Taxation on real property has come to the forefront as an attention getter of public officials and leadership of organized groups. The public has begun demanding relief from the persistence of real property tax increases.

The agriculture sector of the economy is probably hit the hardest. Farmers are rapidly being pushed into a position where they can no longer effectively compete for their basic resource—land—for food and fiber production.

While land is our greatest natural resource and the preservation and conservation of it has become one of the major public issues today, the inefficient allocation of the use of land is partly a result of antiquated tax structures.

A tax on real property to the farmer owner-operator cannot readily be shifted. Only a portion of the tax can be indirectly shifted in the long-run so the tax is absorbed as a fixed cost by the farmer. Any increase in real property tax brings more pressure to the severe cost-price squeeze confronting agriculture.

When an increase in property taxes occurs, fixed costs must rise and in most industries this leads to an increase in the selling price of the product. This price rise will offset the increase in taxes. However, due to the nature of agriculture an increase in property taxes does not lead to an increase in price at the farm level. A diagram of this concept is presented in Figure 1.
In time period 1, the farmer is producing the quantity OD with a price at which the product can be sold at P₁ and average total cost designated by ATC₁. Revenue from the product is equal to ODAF which includes a normal profit and total costs incurred in producing the product also equals ODAF. In time period 2, property taxes have increased forcing the average total cost curve to shift to ATC₂. Since the farmer is not able to raise product prices, he must attempt to minimize his losses. In doing this he will still produce quantity OD with revenue equal to ODAF as it was in time period 1. However, total costs have expanded from ODAF to ODBC with the increase in costs being equal to the increase in taxes. The farmer is now operating at a loss equal to ODAF minus ODBC or shown as FABC. While the farmer can incur losses for a few years eventually he must cover all costs or sell out. Unfortunately, many farmers who face this situation are forced to sell since costs cannot be met.

### Property Tax History and Use

The *ad valorem* property tax has long been a part of U.S. history. It was established prior to 1800 to replace the taxation methods brought from Europe and used in America during the Colonial period. During the 1800’s the U.S. was basically an agrarian society with agriculture providing the base for the property tax. The agricultural community initially accepted the property tax for three basic reasons:

1. Tax levies were usually quite low amounting to only a few pennies per acre.

2. Most of the tax revenues were used to finance local government services and improvements.

3. The ownership of land was closely correlated to the wealth of an individual and therefore his tax paying ability.

It is important to evaluate each of these three reasons in order to compare the present day property tax with the initial *ad valorem* tax. Although a tax of only a few cents does not seem exceedingly high, it must be remembered that land was selling for only a few dollars per acre. Therefore the ratio of tax to land value may be relatively the same today. However, the available data suggests that the rate of property tax increase has exceeded the rate of increase for land values. This suggests that taxes make up a greater proportion of land values today than in the 1800’s. But, before condemning the property tax on this point, the differences in services provided must be considered.

In the 1800’s the property tax was used primarily to support the local government. Public improvements were occasionally financed through the use of property taxes but costs were held to a minimum. Local roads were constructed and maintained by citizen labor groups while schools were financed on a private subscription basis.

Today’s property tax still supports the local government and the cost of police protection. However, in addition to these two items it now finances the public school system, hospitals, sewage, and some construction and maintenance of roads. The support of public schools makes up a substantial portion of the tax bill of a community, with some communities refusing to increase their tax obligations to these institutions. Even though farmers benefit from increased services it is questionable that they demand all the services received at an ever increasing cost. In fact, it becomes very difficult to determine the amount of benefits received per dollars spent. A cost-benefit analysis of this is practically impossible.

The last item is the relationship of land ownership and the wealth of an individual with respect to ability to pay. All taxes are essentially taxes on wealth and the property tax is no exception.

In the initial stage of *ad valorem* taxation a good indication of a person’s wealth was the amount of land he owned — the more land he possessed the wealthier he was. Since most of the wealth of the agrarian society was centered around land holdings it was only natural to place a tax on them. However, in this day and age a person’s wealth is measured by more than ownership of land. Today we have such intangible items as stocks, bonds, mortgages, and savings accounts which also have value.
The main difference is that these intangibles can be concealed very easily and not be taxed while land cannot be concealed and is available for taxation.

From an analysis of these three items we may conclude that both the property tax and the services generated from the tax have increased greatly over the past two centuries. Perhaps the most important realization is that as a result of the structural changes in our society the property tax no longer possesses the unique ability to measure wealth as it once did.

In 1970, the U.S. lost approximately 1 million acres of agricultural land to non-agricultural uses. Urban development took the largest amount, 42 per cent. Over the period 1960-70, it is estimated that Missouri alone lost approximately 1.7 million acres. Most of the uses this land is going into is irreversible. In other words, once this land is taken out of agricultural production it becomes very difficult to return it to its initial use.

The question is, how can we expand our cities economically but still preserve our better farmlands and assure adequate open spaces for future uses?

One of the most common methods of controlling an item is through the government power of taxation. Many people feel that land is no exception and that its use can be controlled through property taxation. A few states have attacked the problem of rural land taxation through various legislative acts and maneuvers. The basic idea is to tax agricultural land on its present use value rather than its market value, thus relieving some of the pressure to convert this land into more intensive uses. Farmers will immediately agree with the idea, whether from personal or social motives, that this is what should be done.

During the period 1950-1970, farmers in the U.S. have seen property taxes rise from Av. of $0.69 to $2.48 an acre, or an increase of 259 per cent.\(^1\) During the same period Missouri farmers experienced a rise from $0.52 to $1.87 an acre, or an increase of 260 per cent.\(^2\) It has also been estimated by USDA that during 1964-1968 taxes on agricultural lands located within Standard Metropolitan Statistical Areas (SMSA’s)* averaged more than three times those in adjacent counties and more than seven times those on farms located beyond the SMSA’s and adjacent counties.

At the present time, approximately 24 states have enacted legislation that attempts to alleviate the property tax problem facing farmers and in turn keep land in agricultural use. The goals of these legislators is summed up in a bill passed by the State of Washington. It reads:

The legislature hereby declares that it is in the best interest of the state to maintain, preserve, conserve and otherwise continue in existence adequate open space lands for the production of food, fiber and forest crops, and to assure the use and enjoyment of natural resources and scenic beauty for the economic and social well-being of the state and its citizens.

### Methods of Differential Assessment

The approach through the legislative system has been focused on three general categories of differential assessment or combination of these methods. They are in general referred to as:

1. Preferential assessment.
2. Deferred taxation.
3. Restrictive contracts and agreements.

### Preferential Assessment

This is by far the simplest of the three methods. In this method, land termed as agricultural is assessed at its agricultural value and not its fair market value. In order to qualify, the land must be determined as agricultural, with some states requiring a minimum gross income, others require the land to have been in agricultural use for a minimum number of years, and some states require both. Maryland adopted preferential assessment in 1956, and was one of the first states to evaluate its impact on agriculture. In a study conducted by USDA in Maryland, it was determined that “the preferential assessment of farmland resulted in an average reduction of 46 per cent of assessments based on market value.” It also indicates that since 1930, the total acreage of land in farms in a five county area dropped by 26 per cent, while during the period of 1954-1959 the decrease was 16 per cent.

Currently, nine states besides Maryland have adopted legislation along the lines of preferential assessment. Most of this legislation was adopted in the late 1950’s and early 1960’s; this being the period of initial attempts to alleviate the tax problem.

\*SMSA - a county or a group of contiguous counties which contains at least one city of 50,000 inhabitants or more or “twin cities” with a combined population of at least 50,000.

\(^1\)/Farm Real Estate Taxes, Jan 1972, RET-11, ERS, USDA, p. 11.

Although the preferential method has reduced assessments, its ability to control the amount of land moving into other uses has been limited. Preferential treatment methods have two major weaknesses:

1) This type of law permits benefits to accrue to speculators as much or more than to \textit{bona fide} farmers by subsidizing those individuals who are holding land for expected more intensive use. This stems from the idea that speculators are able to conduct minimal farming operations, thereby qualifying for preferential assessment. Speculators are not always an identifiable group over time. An individual who is a \textit{bona fide} farmer in one time period may well become a speculator another time by some form of public action or investment.

2) Under preferential assessment the general public has no guarantee that land will be kept in agricultural production once urban pressures become evident. The public has simply granted to farmers the opportunity to stay in production and hope that increasing land prices will not entice him to sell his farm for more intensive uses. This weakness alone should discourage the use of preferential assessment since it is a stated objective of the legislators to preserve and conserve these lands.

**Deferred Taxation**

In some respects this method is only an extension of preferential assessment. As under preferential assessment method, land designated as agricultural is taxed on its agricultural value rather than its fair market value. The major difference in the two is in the roll-back technique. That is, when a farm is sold into a use other than agricultural, a roll-back tax is collected. This roll-back is equal to the difference in taxes that would have been paid if the land had been taxed on its fair market value rather than its agricultural value. The time period over which the roll-back tax applies varies between states having this type of system. The time ranges usually from 2 to 7 years with the average approximately 5 years. Thus, a farmer who sells his land for development purposes, or use other than agricultural in a state using the 5 year roll-back pays a maximum of 5 years deferred taxes at the time of sale. If he has been under the system for less than the 5 years he pays for only that number of years.

A few states charge interest on the amount of the roll-back. Oregon is one state that charges 6 per cent interest with a 5 year roll-back.

Using the data listed in Table 1, two examples are given to illustrate how the roll-back method works.

<table>
<thead>
<tr>
<th>Year</th>
<th>Fair Market Value Tax</th>
<th>Agricultural Value Tax</th>
<th>Amount Deferred</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>$1000</td>
<td>$600</td>
<td>$400</td>
</tr>
<tr>
<td>2</td>
<td>1020</td>
<td>610</td>
<td>410</td>
</tr>
<tr>
<td>3</td>
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<td>4</td>
<td>1060</td>
<td>630</td>
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</tr>
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<td>1080</td>
<td>640</td>
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</tr>
<tr>
<td>6</td>
<td>1100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$6,300</td>
<td>$3,100</td>
<td>$2,100</td>
</tr>
</tbody>
</table>

The first situation uses a 3 year roll-back and no interest charged with the landowner selling the property for non-agricultural use during the 6th year. The amount of roll back due at the time of sale is $1,290, ($420 + 430 + 440). Therefore, the landowner was able to save $810, ($2100 - 1290), by participating in this method.

In the second situation a 6 per cent interest charge is added to the first statement. The interest due at the time of sale is equal to $420 \times 0.06 \times 3 + $430 \times 0.06 \times 2 + $440 \times 0.06 \times 1 or $153.60. The landowner must now pay $1290 in roll-back taxes and $153.60 in interest charges for a total bill of $1443.60. His savings by taking part in this method is $656.40, ($2100.00 - 1443.60).

Currently 11 states have adopted the tax deferred method of taxing agricultural land. There are several advantages of deferred taxation over the preferential assessment method:

1) Under the preferential assessment method the revenue lost by the governmental granting body cannot be recovered. However, under the deferred taxation method a partial recovery is made through the roll-back tax. This can be exemplified by the use of Table 1. In using the preferential assessment method, the cost to the governmental body is $2,100; whereas under the deferred taxation method, $1,290 is recovered at the time of sale, leaving a cost of only $810. Thus, by allowing a partial recovery of the cost, some of the problems encountered in finding additional sources of revenue are eliminated.

2) It removes some of the incentives for a speculator to apply for deferred taxation if he plans to develop his land within the period of the roll-back. A USDA article points out the fact that:
“...the extent to which this incentive is removed is a function of the number of years for which deferred taxes are collected when the land use changes, and the expected length of time before the land passes out of agricultural use. A landowner in a state that collects only three years deferred taxes can still save a sizable amount of money if he expects to hold the land for ten years before it becomes a housing development.”

3) During a period of growth and expansion on the rural-urban fringe, a great deal of public services are demanded. Services such as building new schools, streets, laying water lines, etc., require large amounts of revenue. During this period of development, agricultural land is sold for non-agricultural uses and revenue from the roll-back tax will be available for use. The roll-back tax could easily lighten the burden for government agencies in search of additional sources of revenue to finance the services demanded.

4) It is generally felt the tax deferral method offers more equity to the taxpayers as a whole, while easing the pressure of property taxes on agricultural land. Unlike preferential assessment, the tax deferral method enables taxpayers to recover a portion of the costs incurred in preserving our agricultural lands for future enjoyment. Farmers also benefit from the tax deferral method. The main complaint of farmers about property taxes is their farm income cannot bear the pressures of the high taxes. However, through the use of deferred taxation the farmers’ pressures are relieved since his taxes have been reduced. Then, when he sells his farm into a non-agricultural use and his income increases, he is able to repay society for giving him the opportunity to remain in farming.

Restrictive Contracts and Agreements

This method authorizes state or local governments to enter into a contract or agreement with landowners whose land is determined to be in agricultural use. The landowner agrees to restrict his land to agricultural use and in return the state or local government agrees to assess the land on its agricultural value. The contracts normally run from 5 to 10 years, but may vary over different time periods depending on the state. The contracts are automatically renewed each year unless the landowner or governmental authority gives notice of non-renewal. Usually cancellation of the contract can occur only by mutual consent of both parties after a public hearing and if the landowner has initiated the cancellation he must pay a severe penalty for doing so.

California has done extensive work in attempting to evaluate the success of their Land Conservation Act. Missouri differs from California in many respects, however some of the observations and implications of the California plan could be applicable to Missouri. For instance, in a report published by the California Extension Service it mentions that as of 1969 the average decrease in assessed value was $16.83/acre or 39.4 per cent and the average tax on land decreased from $2.75/acre to $1.58/acre or 32 per cent. Missouri could probably not expect as large a decrease since much of its agricultural land has not been faced with the urban pressures experienced in California. Another item is the impact to be expected on non-participants, or tax increases to maintain total tax revenue. California was able to spread the increase of non-participants’ taxes over a relatively large group of taxpayers as a result of population being largely urbanized. In contrast, Missouri is basically a rural state. The increase may be higher than 1.4 to 1 per cent found in California.

In attempting to evaluate the effectiveness of restrictive contracts and agreements in controlling land use, two items should be noted:

- The number of non-renewals submitted and cancellations approved.
- The type of land under contract.

Non-renewals and Cancellations

These two must work hand-in-hand in order to accomplish the objectives. If non-renewals are prevalent and contracts can be canceled easily, the bill is likely to have very little effect on controlling the use of land or maintaining land in agriculture. If this be the case, the restrictive contracts may not be any more effective than the previous methods discussed. However, after four years of operation, California reported only 8 notices of non-renewal by landowners and none by local governments. Also, only 9 petitions for cancellation had been approved, representing slightly more than 9,000 acres or .2 per cent of the acres under contract.

Type of Land Under Contract

Equally important is the type of land under contract. Although the act brought about a decrease in taxes its success in preserving agricultural land appears to be limited. The report states “initial land sign-ups have been concentrated in
The process of zoning in some form needs to be an inseparable part of any plan to alter the present tax system to help direct land use and lessen the tax burden on *bona fide* agricultural units.

Problems involving land use and rising property taxes have become evident and, as mentioned, 24 states have attempted to resolve this problem. Missouri has not adopted such legislation.

Many farmers will undoubtedly reject the idea of land use controls, but they must realize that in order to receive property tax relief they must be willing to give up some rights. The land use controls discussed are attempts to help genuine farmers stay in farming and preserve our agricultural land for future generations.