COMMENT

THE AD VALOREM PROPERTY TAX AND PRODUCTIVITY VALUES FOR FARM AND RANCH LAND: A LEGAL POLICY IN SEARCH OF JUSTIFICATION*

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In one form or another, virtually every state in the nation has chosen to afford preferential treatment to land employed for agricultural purposes. The underlying notion is that the application of the property tax to the true market value of such property leads to undesirable social, economic, and environmental outcomes. The techniques chosen by the states vary. Some attempt to

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capitalized the actual or some projected income stream in order to arrive at an appropriate valuation of the property. Others provide for a current use valuation, with some form of recapture of past taxes, based on the actual market value of the property, when the agricultural land is converted to some other use. Still other states classify property by uses and provide for a lower assessment ratio or maximum tax rate for farm and ranch property. And then there are a few states experimenting with rebate schemes under which the state rebates a portion of the local property taxes paid by ranchers and farmers—either in the form of direct subsidies or credits against state income taxes.

In the rush to judgment about these matters, creativity in devising relief schemes for farmers and ranchers has been matched by the unwillingness of policy-makers to think through the critical questions: Why should farm and ranch land be treated any differently than property put to other uses? If we know why, does the preferential treatment actually accomplish the objectives of the laws and constitutional amendments? To begin with the obvious, there is much to be said for valuing property at its highest and best use, a catch-phrase for market value, and for not allowing distinctions among classes of property. By taxing all property on the same basis, market forces are allowed to operate. If farm and ranch uses do not yield the same income as other uses—whether highways, recreational areas, rural resi-
dences (gentlemen farmers), high rise apartment houses, or whatever, efficiency would dictate use of the scarce resource of land. Declining industries should decline, and not be preserved at taxpayer expense. This might mean that the amount of land in agricultural production would diminish even more rapidly than over the last 25 years or so, and eventually farm land would become so scarce that its price would begin to rise. This would increase the cost of raising food, and this would be passed on to consumers, assuming stable demand or increased demand for farm and ranch products. Further, the market approach readily allows us to make certain equity comparisons among classes of property owners, and the tax would remain proportional to wealth for all taxpayers within a given taxing jurisdiction.

If special treatment for agricultural land is to be justified, there must be something wrong with this scenario, or extrinsic reasons why we should not accept what appears to be the inevitable result. I can think of a number of such reasons. First, we might wish to treat farming and ranching as akin to domestic production of steel and oil. As a matter of self-preservation in the international sphere, it would be unwise to become too dependent on foreign sources of food supplies. In times of national emergency and foreign political upheavals and boycotts, those sources may dry-up. Given the efficiency of American agriculture, however, this seems like an implausible result, but perhaps this explains the
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national desire to preserve farm and ranch lands. Consider the recent wave of protests concerning foreign ownership of American farm land. And note the high transaction cost (near impossibility) of reconverting land back to an agricultural use once it has been converted to a nonagricultural use. Further, unlike blacksmiths in the age of the Model T, farming and ranching cannot be allowed to decline; for if they decline, we decline. For example, demographers have traced the world population expansion of the last 200 years or so to the planting of potatoes and maze and improved farming techniques.

A second reason is that we believe that it is socially undesirable to compel farmers to sell their land, and convert it to other uses. This is akin to the desire not to force the disabled or elderly to sell their homes because they are living on social security and cannot afford to pay their taxes. The lack of liquidity, whatever the value of the property, is the critical factor. Farmers and ranchers may prefer their work to alternative means of making a livelihood, and indeed, their labor may be more efficiently used in farm and ranch management than in the alternatives open to them. And of course there are costs in relocating to find less expensive farm and ranch land or in retraining for other employment. In short, we respect the desire of farmers and ranchers to continue in their chosen line of endeavor, and we are more concerned with distributive justice than economic efficiency.
A third reason is that we wish to encourage orderly urban growth. Robert Gloudemans says that increasing numbers of Americans like to live near but not in cities. Perhaps cities should grow vertically before they begin sprawling out horizontally—perhaps "economies of scale" in public service delivery, lower transportation costs (save energy), etc., should be sought. There is also the danger that developers will skip over highly taxed, high value agricultural land to less expensive land, thereby creating a crazy quilt of urban development. And urban dwellers may prefer open spaces around the cities on aesthetic and recreational grounds.

Finally, perhaps you never thought I would get there, there may be a concern for the economic plight of farmers and ranchers and the equity of property taxation in relation to them. Here there are two problems. The farmer may be "property rich" and yet not have the income flow to pay the taxes. This is just a variation of the theme that we do not wish to force farmers and ranchers to sell, take their capital gains, and pay their taxes. The other concern is that in practice and law the ad valorem property tax does not apply to all forms of wealth. Perhaps in the mid-1850s a person's wealth could be more or less accurately measured by his real property holdings, but today people invest a great deal of their wealth in personal property and intangibles, e.g., stocks and bonds. Thus, two people in the same jurisdiction who are equally affluent (say that they each have
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$100,000 invested, will pay very different property taxes, depending upon how they have chosen to invest their money. In the extreme case, one person may have invested in stocks and bonds and pay no property taxes, while the other owns only his farm and pays property taxes on his entire investment.

This equity factor is complicated by numerous additional concerns. If the state has other taxes, non-property taxes, on intangibles, this may restore some of the lost equity. For example, there may be a transfer tax on stocks, and the income from intangibles could be taxed—when perhaps the income from the farm would not be taxed by the state. All, of course, would fall victim to federal income taxes. There is also the fact that land may be a better hedge against inflation than stocks and bonds, so in the end the investment of the farmer appreciates more rapidly than the investment of the stockholder. The stockholder has suffered the opportunity cost of not gaining greater appreciation for the short-run benefit of paying lower taxes. And then, of course, the farmer may have a $90,000 mortgage on his property, so that he is truly worth only $10,000, and yet he is taxed on the full amount. The owner of intangibles may not have any indebtedness on his investment. Yet, the farmer gets to deduct his interest payments on the mortgage. And so it goes. These matters of equity are very difficult to determine empirically in the real world.

The basic point of this paper, however, is that legislatures are accustomed to making difficult judgments
about equity and fairness in taxation, and we generally respect those judgments or elect new legislators. Thus, equity may justify the differential treatment of farm and ranch property under the ad valorem property tax system. On the other hand, I am unpersuaded that preferential treatment, in the absence of other measures, actually retains land in agricultural production. If I am right, then the system of differential treatment should be chosen on the basis of what policies are most likely to advance the economic interests of farmers, and should not be premised on the forlorn hope of preventing conversion to other uses. This also implies that the property tax relief be given to those who are thought to need it most, and not to those who are primarily speculators who are seeking a tax shelter. Further, the scheme that is chosen should be relatively easy to administer.

Let me begin with a basic outline of the problem. In rural areas, it is frequently the case that a current agricultural use is the highest and best use of the property, and that a sale will not result in a conversion to non-agricultural uses. This means that the productive value of the land, when capitalized at an appropriate rate, should yield about the same value as market sales figures. It is also true that historically, rural farm and ranch land has not been valued at its true market value. This is because there usually are fewer government services in rural areas, because there is more real property wealth per capita in such areas, because assessment practices
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are generally sloppier in rural areas, and because of the politics of the assessing process. In short, a valid application of use values would either raise or maintain current valuation levels in rural, agricultural areas. Given certain equity assumptions, this would be the worst possible result; for despite the lower tax burden, such farmers pay a higher percentage of their income to property taxes than other classes of landowners—and they do not even get the advantage of cashing in on the speculative value of their investment.

The real problem occurs when the productive value of the land, when capitalized, does not even begin to approach the market value of the property. In these cases, the current yields are not determining the market price; rather extrinsic market forces make this determination. This primarily occurs when the farm and ranch land is within an urban, metropolitan area. The price of the land is determined by speculators, and what developers and others are willing to pay for it—those anticipating yields far beyond what the farmer derives. This explains why, in real dollar terms, market values of farmland nearly doubled between 1950 and 1972, while net farm income declined. It also explains why farmland with nearly identical productive capacities can sell for five or more times the price of such land in rural areas. It explains why the effective tax on farms is greater now than at any time since the Great Depression. And why it is that densely populated, primarily
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urban states, were the first to jump aboard the bandwagon for differential treatment of farm and ranch land. Some of these states, such as Massachusetts, Connecticut, and New Jersey, have lost as much as 50 percent of their farm land to other uses over the last 25 years or so.

If one wishes to thwart this conversion process, I fear that small skirmishes can be won through productive values, but the battles and wars ultimately will be lost. The difficulty is the amount of tax relief is so insignificant in relation to the appreciation of such land that there is little hope of stemming the tide. Assume that the productive value of a farm were zero (a not very good farm or farmer or both), and the tax rate were 2 percent (high) of true market value on a $100,000 farm. A productivity valuation would effectively abolish the property tax on the farm and would save the farmer $2000 per year. But in the mid-1970s, farm and ranch land has appreciated nationally to the tune of 13 percent per year, and even taking into account the current yield of the farm put to an agricultural use, the tax relief is a mere fraction of what it would take to create incentives, meaningful ones, for the farmer to refrain from selling his land. If he does not sell, it is because of his pride, his love for the land, his enthusiasm for the enterprise, and other personal utility factors, and not because of a rational market judgment. The best that one can hope for under such circumstances is that the tax relief will
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slow the progress of conversion. Farmers are reluctant to sign agreements with the states not to convert to non-agricultural uses for specified periods of time (in the California experience). The question is not if, but when it will be converted. Alternatively, if we take a less heroic view of the American farmer or rancher, the farmer will hold on to the land because he too is a speculator. Under such circumstances, the tax relief simply encourages him to engage in the speculation because the cost of holding on to the property has been reduced. Moreover, even if the farmer sells, the purchaser may be another speculator—let us call him a pseudo-farmer, dilettante, hobbyist, or tax evader—who continues the land in agricultural production—perhaps with a lower yield—looking forward to the day when he too can realize a huge capital gain.

What then is the effect of productive values when viewed from the land conversion perspective? The effect is nil, and this is what field research demonstrates. Farms and ranches are converted to other uses no more quickly in states without agricultural values than those with them. Further, the tax base has been diminished. This means a higher tax rate, or a decrease in public services, or—if there are few farms in the area a transfer of the tax burden to non-farm and ranch owners. This is true unless the state government makes up the losses, a way of spreading the tax to non-farm owners. Further, there are the costs of computing the productive values (con-
sider what the average assessor knows about this), the almost inevitable errors in computing the capitalization rate, the inevitable "cover-up" in *de facto* variations in assessment ratios, and the corruption of the whole wealth tax notion. Once the system deviates from the linchpin of market values, it is nearly impossible to make comparisons between different classes of taxpayers. If you think Board of Equalization hearings are a joke now, just wait until board members begin comparing market values and soil samples to insure equal and uniform assessments. And the primary beneficiaries may not be farmers or ranchers at all, but speculators, the incidental beneficiaries of a fruitless policy of seeking to prevent conversion to non-agricultural uses. And note finally, that the rural farmer who really needs tax relief, who is not a speculator, obtains little or no relief, while the urban area farmer obtains a great deal—and he can make good on his investment. A grave inequality is created among farm and ranch owners in rural and in urban areas.

At best, the urban area farmer should be entitled to defer his taxes until his land is converted to a non-agricultural use. We may be sympathetic to his cash-flow problem, but it is hard to be alarmed about his overall economic situation. A preferable, but far from perfect, form of tax relief would be to classify farm, ranch, and timber property, and to require it to be assessed at a lower assessment ratio or taxed at a lower tax rate. If
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properly structured, this would virtually guarantee the rural farmer a fairer shake; for his taxes might actually be reduced—particularly if the state subsidized the local district for the loss of revenues (something the recently passed Texas Constitutional Amendment permits but does not require). There would be no need to make soil-samplers out of assessors, or to determine what a well managed farm with a ravine running through it would yield. The vagaries of the capitalization rate would also be avoided. Further, as under previous law, we might try to isolate the true farmer from the hobbyist—although we may never disentangle the speculator from the non-speculator. This could be accomplished through minimum acreage requirements (e.g., 100 acres in California) and by requiring that some minimum income or some percentage of gross income be derived from the farm. Clearly, the old Texas law was too restrictive in requiring single proprietorships and more than one-half of the income from the farm—only about 1000 farms and ranches in Texas in 1970. But less stringent requirements could be set. I would even prefer direct subsidies, albeit this is politically unrealistic. This approach would eliminate any advantage which the urban area landowner has over the rural area landowner with respect to tax relief for agricultural uses.

In summary, what I am arguing for is a more honest stating of the public purposes for deviating from market standards when administering the property tax to farm
and ranch land. The new Texas Constitutional Amendment could not be more disingenuous in declaring that productive values will "promote the preservation of open-space land." The evidence is all to the contrary. I am also arguing for a more flexible approach, tax relief measures other than resort to productive values, although I admit that it is probably too late in the day for Texas to move in this direction. Further, I am contending that the true purposes of property tax relief for farmers—treating them more equitably, taking into account their economic hardships, and giving them more choices as to whether to remain on their farms—should dictate carefully drawn measures which do not reward those for whom we do not have as much empathy. If our purpose is simply to increase the yields on farm and ranch investments without regard to equity, perhaps this is justifiable. This is not, however, how these property tax relief measures have been justified by proponents or perceived by voters.