AgEcon SEARCH
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search
http://ageconsearch.umn.edu
aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

Agriculture's Stake in Federal Income Tax Reform

by Hoy Carman and Michael Boehlje

Proposals to change the structure and provisions of federal income taxes are part of the ongoing congressional debate on promoting or stabilizing economic growth, financing social programs, and reducing the national budget deficit. Major proposed revisions to the tax code currently include partial exclusion of capital gains income and changes in marginal tax rates. There is also a movement afoot to scrap the current complex income tax system and replace it with a flat tax or some form of a value-added tax. What does this mean for agriculture?

Background

While the federal income tax raises revenues to finance operations of the federal government, it also provides economic incentives to achieve a variety of economic and social goals. Income tax incentives have been adopted in the past to assist special interest groups or particular industries, to encourage designated business activities or financial transactions, and to promote nonbusiness activities considered to be socially desirable. Familiar examples include deductions for mortgage interest expenses to promote home ownership, tax-deferred individual retirement accounts (IRAs) to encourage savings, investment tax credits and accelerated depreciation to encourage the purchase of new capital equipment, business energy credits (solar energy, ocean thermal and geothermal equipment) to reduce dependence on fossil fuels, tax credits for the production of ethanol, and deductions to encourage giving to charity. Since income tax incentives (sometimes referred to as tax expenditures) are less visible than direct subsidies, their impacts often have not received the same scrutiny given to other government programs. Because of the "open-ended" nature of tax incentives and interactions between incentives, they sometimes have unintended impacts; in fact, some tax incentives have impacts counter to the goals of other government policy.

Special and general income tax provisions have been an important determinant of agricultural investment and decision-making behavior during the past fifty years. Most have encouraged investment, which over time increased productive capacity and output of farm products. The most publicized impacts were from nonfarm investors' use of large-scale limited partnerships for developments of tree and vine crops, investments in breeding livestock, and cattle feeding. At the height of their popularity in the early 1970s, for example, cattle feeding funds were estimated to have owned 25 percent of the nation's cattle on feed and they owned 50 to 60 percent of the cattle in some of the largest feedlots. Income tax incentives also encouraged land development, machinery and equipment purchases, and production of favored enterprises such as livestock and perennial crops. During the 1970s, agricultural tax incentives averaging over $1 billion annually accounted for almost 25 percent of federal subsidies to agriculture. These tax incentives to increase agricultural production occurred at the same time that other government policies such as set-asides and the dairy herd buyout were implemented to reduce burdensome agricultural supplies.

Tax reforms

The use and abuse of agricultural income tax incentives during the 1960s and 1970s attracted the attention of both the public and their legislators. Farmers disliked the competition from high-income nonfarm investors; promoters were often enriched at the expense of investors and producers; investors who were the most successful in other sectors tended to have the highest losses in agriculture; and tax planning became the most important farm management function. Some analysts saw a threat to the "family farm" as the control of farm assets moved to nonfarm investors, while at the same time producers who tapped into this new source of financing were delighted. Agricultural tax shelters

were targeted by the Tax Acts of 1969, 1976, 1981, and 1986. As the culmination of a series of tax reform efforts, the Tax Reform Act of 1986 focused on both farm and nonfarm investments designed to defer income and/or convert ordinary income into capital gains. The reformed provisions with the most important impact on tax-motivated agricultural investments included *(a)* repeal of the investment tax credit, *(b)* termination of the capital gains exclusion, *(c)* capitalization requirements for preproductive expenditures for plants and animals with a development period of two years or longer, *(d)* limits on deductibility of prepaid expenses, *(e)* changes in depreciation rates and recovery periods, *(f)* passive loss rules to limit nonfarmers' use of farm losses to shelter nonfarm income, and *(g)* reductions in individual and corporate income tax rates. It is worthwhile to note that the 1986 act took a large step in the "flat tax" direction by broadening the income base subject to taxes and reducing rates to two brackets, 15 and 28 percent. Since then, however, brackets of 31, 36, and 39.6 percent have been added.

While the "farm tax problem" was largely solved by the Tax Reform Act of 1986, the importance of income tax provisions to agriculture will continue. If history is a guide, there will be continued attempts by both agricultural and nonagricultural groups to gain income tax concessions and some, which impact agricultural investments, will likely be successful. Recent proposals for new capital gains provisions and changes in tax rates will have implications for agriculture. Based on history, one can also expect proposals to reinstate the investment tax credit and to provide other investment incentives when economic growth slows. The investment tax credit, for example, has been frequently used to stimulate economic activity. The credit was first introduced in 1962, then modified in 1964; it was suspended from October of 1966 through December of 1967, restored in March 1967, repealed in 1969, reintroduced in 1971 and then increased in 1975, liberalized in 1981 with modifications in 1982, and then terminated at the end of calendar 1986. The timing of these changes in the credit correlates with periods of overall economic growth and decline.

New directions

Widespread dissatisfaction with our current income tax system (and the Internal Revenue Service) has led to numerous proposals to scrap the income tax and replace it with a "flat tax." Proponents of tax reform decry the current system as failing all the "good tax system" criteria of fairness, neutrality and promotion of economic growth, and simplicity of administration and compliance. The National Commission on Economic Growth and Tax Reform, chaired by Jack Kemp, has recently recommended development of a new simplified tax code that includes a single low tax rate with a generous personal exemption and reduced biases against work, saving, and investment. The commission did not endorse any of the current flat tax proposals, but advanced a set of principles that any new system should embody and recommendations that any new system should follow.

There are currently three major consumption-based tax reform proposals, with variations. The first, by Congressman Armey and Senator Shelby, is based on the principles advocated by Robert E. Hall and Alvin Rabushka in their book, *The Flat Tax.* Their plan has an individual wage tax of 17 percent and a business tax which allows the deduction of "business inputs," but not taxes, interest, or dividends. The flat tax plan advanced by presidential candidate Steve Forbes appears to follow the outline of the Armey-Shelby plan. The second proposal is the U.S.A. Tax plan (S. 722) introduced by Senators Domenici, Nunn, and Kerrey. It includes a flat value-added tax of 11 percent for businesses, and individuals would pay graduated rates of up to 40 percent on consumed income. Net savings would be deducted from the tax base while withdrawals (dis-saving) would be added. The third major proposal, most often associated with Senator Lugar and Congressman Bill Archer, chairman of the House Ways and Means Committee, is for a National Sales Tax. A tax of 17 percent would be collected on taxable goods and services, which would generally include tangible personal property, services, financial services, and real property. Investment income would not be taxable. Although their provisions differ significantly, each of the proposals move from a tax on income to a tax on consumption. They are also similar in that each plan would expense capital, exempt returns from savings and capital gains from tax unless consumed, eliminate double taxation of corporate income, tax fringe benefits, and change the taxation of imports and exports.

These proposals would involve dramatic changes in the U.S. tax system, with significant transition problems and many "winners and losers." Who wins and who loses from the adoption of a new tax system will depend strongly on the nature of the system's provisions that define its tax base (the definition and calculation of the income, sales, or other measure of economic activity to be taxed) rather than on the particular tax rate selected. One can only speculate on the nature of the provisions defining the tax base that a flat tax might include. Each of the plans, for example, treats the highly visible and popular home mortgage interest deduction differently. The deduction is repealed by the Armey/Shelby plan (and capital gains are not taxed).

Under the National Sales Tax, the sale of homes would be taxable but with a set of tax credits; homeowners would only pay taxes if they moved to a more expensive home and they would receive tax refunds if they moved into a less expensive home. The U.S.A. Tax plan retains the mortgage interest deduction for acquisition indebtedness (but not home equity loans) and taxes capital gains if they are not rolled over in the primary residence or saved.

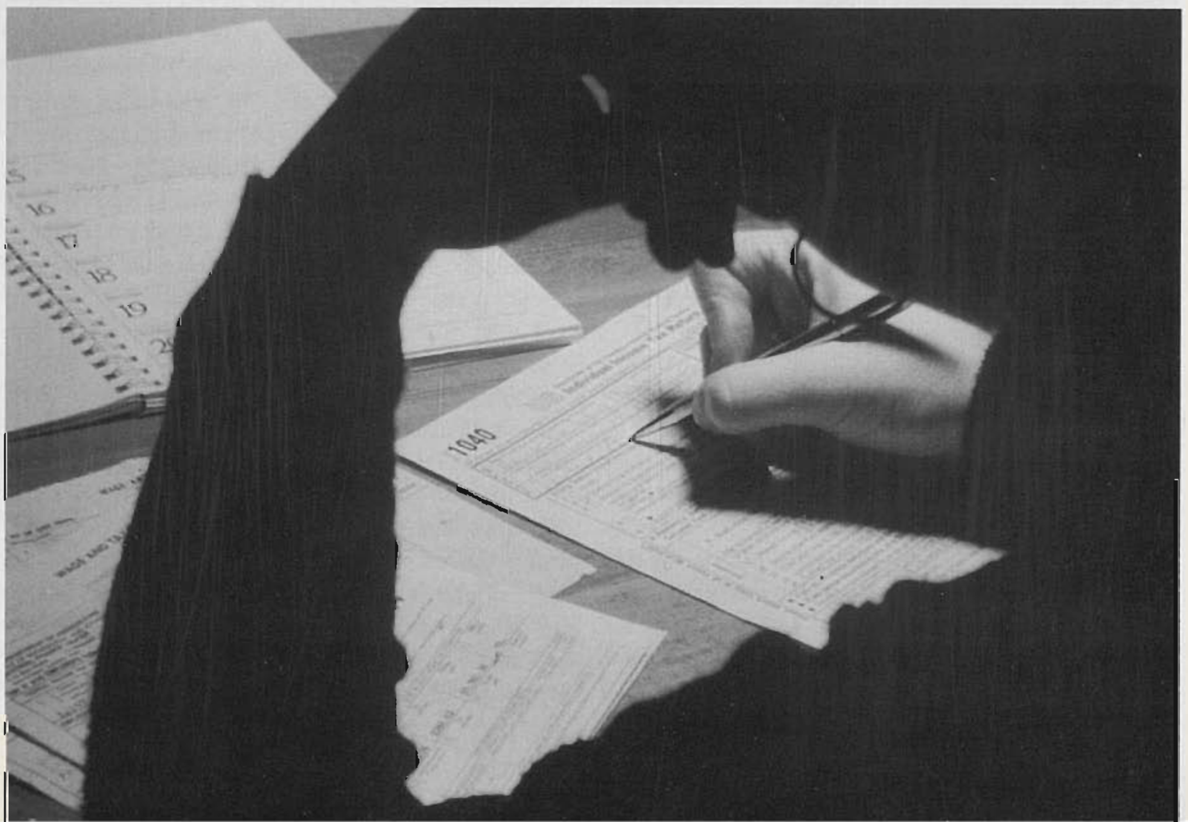
Impacts on agriculture

Farmers and their legislators, who are fond of appeals to "level playing fields," must seriously consider the possible effects of reduced tax rates, new capital gains tax provisions, and proposals for investment incentives. The Tax Reform Act of 1986 significantly reduced the distortionary effects of income taxes on farm investments and operating practices with the result being that the income tax playing field was probably more level immediately following the act than anytime during the past forty to fifty years. Opposition to selected tax law changes may be difficult, however, when it is clear to the individual that such changes will reduce the amount of taxes he or she pays. But the "fallacy of composition" may hold; what appears to benefit individual taxpayers may actually work to their disadvantage when the total response is considered. For example, a capital gains tax exclusion will reduce the income tax liability for the individual cattle producer. As all producers make decisions to take advantage of capital gains provisions, they will tend to increase the total breeding herd, and these changes will eventually lead to higher meat production and lower prices. Thus, the individual producer may end up with lower rather than higher after-tax profits once industry adjustments are complete.

Agriculture competes for funds with other major economic sectors, and the presence of tax incentives influences the flow of funds. Agriculture ranked near the middle of the major industry categories in terms of the effective tax rate on marginal investment prior to 1986. While agriculture was a major recipient of income tax incentives, its share may not have been disproportionate. The impacts of agricultural tax incentives also can extend far beyond the farm gate. Consumers will benefit from increased supplies of food products at lower prices; investors may realize attractive returns; employment opportunities may expand in selected sectors; and some commodities may become more competitive in export markets.

Past studies of changes in income tax laws provide some insight into the expected impacts of some recent proposals. There is a limited research base on the impacts of "flat tax" (consumption-based) proposals, and the final form of provisions that might be included is purely speculative. One can only examine some of the most striking provisions, remembering that "the devil is in the details." Our review of the literature suggests the following consequences.

- Immediate expensing of farmland purchases (Hall and Rabushka) with full taxation of its sale could have several major impacts. The price of farmland would increase, perhaps dramatically; nonfarm investor interest in farmland would increase; and we would expect decreased availability of land for sale if the entire sales price was taxable income.
- Cancellation of the deduction for interest paid under



a flat tax would have differential impacts depending on a farmer's indebtedness, with the impact being especially adverse for those with long-term debt.

- Favorable capital gains tax rates may increase the demand for farmland and other appreciating capital assets. Increasing farmland prices benefit owners, but increased financial requirements make entry more difficult. On the other hand, decreased capital gains taxes may increase the turnover of land.
- Full expensing of capital outlays in the year of purchase would encourage investment in machinery and equipment and other capital purchases because of the reduced after-tax cost of these purchases. This would increase mechanization of agriculture and also of business activities in the machinery and equipment and other capital-goods-supplying industries.
- Increased mechanization due to the opportunity to expense capital outlays reduces farm employment but it can increase the efficiency of production. The nature of employment can change to jobs requiring higher skill levels while mechanization eliminates the most physically demanding and menial jobs.
- Increased tax-sheltering investment behavior (possibly because of the expensing of capital outlays) can result in increased production over time. Increased production induced by tax shelters can have several impacts. Given inelastic farm-level demand, increased production results in decreased total revenue. Producers who expand output will realize the tax advantages and utilize improved technology; others who do not expand or modernize will face lower prices. Other sectors (input suppliers) may benefit from increased demand (i.e., expanded cattle feeding increased the demand for feeders and feed grains in the past; more tree crops increased demand for nursery stock and other inputs). Consumers benefit from increased production at lower prices.
- Management practices followed only to take advantage of tax laws, such as early culling of breeding livestock because of lower capital gains tax rates, may be technically inefficient but also provide increased income to producers. With rapid genetic improvements, increased culling can improve productive efficiency.
- Income tax incentives can contribute to the large-scale establishment of new crops and new production areas. Examples of the past include establishment of kiwifruit and pistachios in California and irrigated crop developments in the Northwest and Plains states. New crop impacts are widespread, extending from increased employment, establishment of new processing and service firms, and increased demand for inputs, to changing international trade relationships.

A final comment

The Tax Reform Act of 1986 reduced investment incentives in agriculture, decreased incentives for debt financing, and will tend to decrease the productive capacity of U.S. agriculture over time. Some producers were concerned about increased taxes in the short run, but one would expect decreased production and inelastic farm-level demand to improve after-tax incomes. For example, a slower-than-expected expansion of beef cattle numbers as a result of several years' favorable returns can be partially explained by tax changes that reduced investment incentives (but with profits there will be a supply response). Reduced tax incentives tend to lead to increased consumer prices for some commodities, but the magnitude of the changes will probably be relatively small. The movement of tax laws in the direction of economic neutrality in decision making is a movement toward improved equity between economic sectors, but impacts on productive efficiency may be mixed.

Agricultural groups and their representatives have been active participants in efforts to acquire and perpetuate special income tax rules and provisions applicable to agricultural enterprises. Some will undoubtedly support current proposed changes in capital gains provisions and revised tax rates, but caution is warranted in pressing for changes in tax laws that would reinstate tax sheltering investment activities. Individual farm taxpayers, in the pursuit of their own self-interests, must weigh the short-run benefits of a reduction in taxes against longer-term levels of total income, asset values, availability of financing, and their ability to compete for resources.

For more information

Boehlje, M., and H.F. Carman. "Tax Policy: Implications for Producers and the Agricultural Sector." *Amer. J. Agr. Econ.* 64(December 1982):1030–38.

Doye, D.G., and M.D. Boehlje. "A Flat Rate Tax: Impacts on Representative Hog and Grain Farms." *W. J. Agr. Econ.* 10(December 1985):147–59.

Hall, R.E., and A. Rabushka. *The Flat Tax*, 2nd ed. Stanford CA: Stanford University, Hoover Institution Press, 1995.

Hardesty, S.D., H.F. Carman, and C.V. Moore. "Dynamic Analysis of Income Taxes on Farm Firms." *Amer. J. Agr. Econ.* 69(May 1987):358–68.

Monke, J.B., M. Boehlje, and G. Pederson. "Efficient Investment Strategies: Impacts of Tax Policies and Risk Preferences." *Agr. Finan. Rev.* 52(1992)72–89.

Hoy Carman and Michael Boehlje are professors of agricultural economics at the University of California, Davis, and Purdue University, respectively.