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Source: *The American Journal of Economics and Sociology* , Jan., 1988, Vol. 47, No. 1 (Jan., 1988), pp. 29-40

Published by: American Journal of Economics and Sociology, Inc.

Stable URL: https://www.jstor.org/stable/3486813

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Absentee Ownership of Farmland and State and Local Tax Policy:

Income Tax Promotes Absenteeism, But the Property Tax Can Be Used to Strengthen Family Farms

By PETER S. FISHER*

ABSTRACT. The incentive effects of state and local *tax policies* in promoting or inhibiting the *ownership* of *farmland* by non-operators are evaluated. Previous research on the *economic, social* and *environmental effects* of *absentee ownership* is reviewed as well as evidence regarding the impact of tax laws on absentee owners versus *owner-operators.* The Federal tax laws, it is found, work to increase *land prices,* reduce entry into *farming* by young farmers, and increase absentee ownership. State *income tax* policies may reinforce these effects. *Property* tax policies, on the other hand, may counteract income tax laws by giving *tax* relief preferentially to owner-operators. Several modifications of property *tax relief programs* are suggested.

I

Introduction

THE SMALL FAMILY FARM remains the dominant form of agricultural organization in much of the American midwest, despite the severe financial difficulties of the past several years. In Iowa, for example, largely a grain and livestock region, the average farm size remains under 300 acres, and in dairy regions such as Wisconsin, the average size is smaller. Yet despite the trend towards larger farm acreage and rural depopulation going back to the 1920s, the typical size is unchanged.

However, the average farmer is not an owner-operator, popular images notwithstanding. In Iowa, even before the current debt crisis, over half of the farmland was absentee owned; the recent debt crisis and precipitous decline in farm land values have undoubtedly produced an increase both in farm size and in absentee ownership.[1] Nationally, almost 40% of the privately owned farmland was owned by non-farmers in 1974.[2] It is the contention of this paper that absentee ownership of farmland is an important public policy issue, and that tax policies need to be examined in terms of their effects in promoting or inhibiting

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American Journal of Economics and Sociology, Vol. 47, No. 1 (January, 1988).
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the long-term (and recently accelerating) trend towards an agricultural economy of sharecroppers and hired hands.

We begin with an exploration of the concept of absentee ownership. We then briefly review the evidence on the effects of absentee ownership of farmland on soil conservation, land prices, local economic development, rural political and social life, and other issues. The next sections of the paper examine the incentives towards absentee ownership embedded in existing federal, state, and local tax laws. We conclude with an evaluation of state and local tax policies aimed at countering these incentives and promoting the viability of the small, family, owner-operated farm.

II

The Concept of Absentee Ownership

OUR CONCEPT OF ABSENTEE OWNERSHIP is derived from the writings of the American economist Thorstein Veblen. Veblen defined absentee ownership as "ownership of means in excess of what the owner can make use of, personally and without help."[3] To derive income from these excess resources the absentee owner must do one of three things: (1) rent them to others for their use, (2) hire others to make productive, or at least remunerative, use of the resources, or (3) hold the resources in idleness in expectation of selling later at a higher price. Thus the absentee owner derives income from his excess holdings either in the form of rent, profit, or capital gains.

Absentee owners are not identical with "capitalists" as a class, however. The farmer or the craftsman who owns his own land and tools, but owns only so much as he can use productively himself, is a capitalist (albeit a petty capitalist) but not an absentee owner. In some respects (though perhaps not in others) the concept of absentee ownership is more useful than the concept of a capitalist class. This is particularly the case if one does not view absentee ownership as a clearly delineated category, but instead considers absenteeism in ownership as something that proceeds by degrees. The farmer who works his own land may acquire additional land as a speculative investment, a source of retirement income perhaps; the shopkeeper or self-employed craftsman may expand operations and hire a part-time employee. An element of absenteeism (in Veblen's sense of the word—ownership in excess of what the owner can make use of without help) is thereby introduced, but the proprietor is still principally a farmer, a shopkeeper, a craftsman; he or she remains a productive worker; and keeps a close attachment to his or her property.

But absentee ownership can take on very different forms; it can be elevated

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to many higher levels of absenteeism. The farmer may retire, move to town, and rent out all his land. He might later sell out to a wealthy doctor or lawyer with no previous involvement with farming and no intention of becoming involved, or perhaps of even seeing the property. The doctor or lawyer might sell out to a partnership or a real estate investment syndicate, which in turn might sell out to an insurance company looking for a way to invest its cash, or to a multinational conglomerate headquartered in Japan.

In all of this process, the level of absenteeism is increased in two respects: (1) the owners of the property have less and less involvement in, or even knowledge of, the productive uses of the property—the link between the productive and pecuniary attachment is broken and the interest of the owner becomes purely financial; (2) ownership is transferred to parties physically distant from the property as well.

It is the latter form of absenteeism, in the geographic sense, that is implied in common usage of the term "absentee ownership" today. An owner who does not reside or work on the premises, of course, is an absentee owner in both senses—the absentee landlord, the branch plant owned by an out-of-state corporation. But Veblen's definition is much broader than the popular meaning of the term, for he would classify the corporate form of business organization as an absentee ownership structure, even if it were a closely held corporation with the owners residing locally and managing the operations, provided only that the corporation had employees.

Veblen saw in the spread of absentee ownership the ascendancy of the pecuniary interest over the productive interest, of "business" over "industry." Whereas "industry" is guided by the "instinct of workmanship" and enhances the commonwealth, business consists primarily of buying cheap and selling dear, a result obtained primarily through deliberate "sabotage" of the industrial system—the idling of resources and the reduction of commonwealth.[4]

III

The Social Effects of Absentee Ownership

What are the social consequences of increasing absentee ownership? Does it indeed lead to decisions regarding the use of resources that result in the accumulation of private wealth without contributing to the commonwealth? Are these effects more pronounced when structural absenteeism is compounded by geographic absenteeism? Is it only higher orders of absenteeism that are problematic?

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The following effects have been attributed to absentee ownership of farmland, or of "undeveloped" land in general:

(1) The fertility of leased land is less well maintained; one study found that erosion rates are higher for leased land[5] while others report lower investment in soil enhancement and erosion control on leased farms.[6] Since the tenant has no long-term interest in the land he cannot recoup investments in productivity; the absentee landlord may not invest because his interest is purely financial and not long-term, and/or because he is neither a farmer nor a member of the community and thus has not been imbued with the communitarian ethic of land stewardship.

(2) Absentee ownership drives up land prices; non-farm investors in high tax brackets gain more financial advantages from certain features of the tax code than do owner-operators, and thus are able to outbid farmers, making it difficult for beginning farmers in particular to purchase land at a price justified by returns to farming alone.[7] A relatively small number of non-farm investors in a region can significantly affect average farm prices by raising expectations of sellers—and of other buyers who anticipate one day being sellers. Speculation by absentee owners thus contributed to the rapid increase in land prices during the 1970s, an increase that could not be justified solely on the basis of the income-earning potential of the land in agriculture, and to the precipitous decline in values in the 1980s as non-farm purchasers got out of farmland.

(3) Absentee ownership and operation of farms may have detrimental effects on the local economy if absentee owners reduce local purchases and instead patronize non-local shops, banks, law firms, etc. This may be true as well for the corporate farm which is locally owned (*i.e.,* absentee only in the structural sense) if it is in a position to buy in bulk from distant suppliers. At some point, demand could be reduced below the threshold needed to support farm supply and other businesses. The resulting decline in small town businesses can have costly effects on the remaining family farms and small town life in general.[8]

(4) Local political and social structures may be altered as the number of family farms diminishes and a less stable population of tenant farmers and farm laborers expands in numbers. The distribution of income is likely to become more unequal and absentee owners may come to exert undue political influence as a result of their economic status. Support for community institutions—schools, churches, civic clubs, local government—may wither as the area becomes increasingly dominated by those with no long-term commitment to the community as a place to live, to raise a family, and to grow old in, but instead only a pecuniary interest in the community's resources.[9]

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(5) Absentee ownership of land on the outskirts of metropolitan areas may result in premature idling of land and disinvestment in farm structures and soil productivity to the extent that absentee owners are primarily interested in capital gains from resale for development and overestimate the overall demand for developable sites. There is some evidence of this effect.[10]

(6) To the extent that absentee ownership is synonymous with larger landholdings, the family farm's competitive position is weakened. The large farm operation can obtain cost savings (some the result of real resource savings, others merely the effects of large volume discounts, market power, preferential access to credit, or tax advantages) unavailable to the small farmer.[11] This in turn makes it more difficult for beginning farmers, who must purchase land at prices governed by the potential returns available to the large corporate farm.

It is clear from this review of the social consequences of absentee ownership of land that the "lowest order" absenteeism—the family farm owner-operator or locally retired farmer who owns some land rented out to others, or has a hired hand—is not the source of the major problems. It is the higher-order structural absenteeism (the large non-family farming corporation, with a salaried manager and hired farm workers) and the geographic absenteeism (the ownership of farmland by non-local non-farm investors, be they individuals or large insurance companies) that create the problems. It is in these cases that the owner's interest in the land becomes purely pecuniary, and that the family and social interests that develop in a rural community and that become part of the small farmer's attachment to the land as a place, are absent. Neither the owner nor those who work the land for him will sink roots. The owner's interest may be long-term, but it is purely pecuniary; the workers may well follow the instinct of workmanship, but have only a short term commitment to the land as a place, and hence to the community.

IV

Absentee Ownership and U.S. Tax Policy

How is the power of taxation currently being used, at the federal, state, and local levels, to discourage or to promote absentee ownership? Prior to the Tax Reform Act of 1986, the individual income tax exhibited a clear preference for absentee income in general—rent, dividends, and capital gains. The largest single tax preference was the exclusion of 60% of long-term capital gains from income; this was reinforced by the failure to invoke constructive realization upon death of the taxpayer. (Unrealized capital gains passed on to heirs went

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completely untaxed, the heir eventually paying tax only on 40% of the appreciation in value of the asset since the time of inheritance.) Capital gains are absentee income par excellence, for they represent income derived not from the current productive use of absentee-owned resources (as in rent and dividends) but from speculative gains requiring no production at all, no management of the resource beyond protection of the legal claim of the absentee owner.

A number of studies have documented the effects of the pre-1986 Federal tax code on agriculture.[12] In addition to the preferences for investment in general, which applied as well to farm structures and machinery, there were three tax advantages peculiar to agriculture:

(1) cash accounting was permitted, which provided opportunities for shifting purchases and sales in such a way as to produce a pattern of annual net incomes that minimized tax liability;
(2) certain capital expenditures that normally would have to be capitalized, in the case of agriculture could be expensed (deducted 100% in the first year);
(3) additional opportunities existed for the conversion of ordinary income into capital gains, since much of the receipts even from sale of livestock could be treated as a capital gain.

These features of the tax code, along with the investment tax credit, the Accelerated Cost Recovery System (ACRS)—which allowed for very rapid depreciation of buildings and equipment—and the capital gains exclusion, were of benefit to the small family farmer as well as to the wealthy non-farm investor. However, the value of tax preferences increases with the income of the investor. The result is that agriculture had become a fertile area for "tax-shelter" investing by those in the top tax brackets (who saved $.50 in taxes for every deductible expense as opposed to the $.25 or $.30 that would be typical for the small farm operator). For any given level of gross farm income, the net returns on the investment in farming were higher for the high-income high-tax bracket investor who was thus able to outbid the small farmer for land. Furthermore, the incentives for capital investment encouraged highly capital-intensive farming and thereby promoted larger scale farming than could be justified by true economies of scale (which in fact are largely exhausted at a relatively small farm size).[13]

Analysts concluded that the effects of the old federal tax system were to increase land prices, reduce entry into farming by young farmers, increase the proportion of wealthy individuals with interests in farm property, and increase absentee ownership.[14] Recognition of these effects led the National Farmer's Organization and the Nebraska Farmer's Union to urge Congress to reduce or eliminate the

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investment tax credit, ACRS, the capital gains exclusion, and the use of cash accounting by non-farm investors in agriculture.[15]

The Tax Reform Act of 1986 eliminated some, but not all, of the major inducements to investment in agriculture by nonfarmers. The capital gains preference has been completely eliminated, along with the investment tax credit. On the other hand, depreciation provisions continue to provide incentive for investment in such things as "single purpose agricultural structures," such as hog confinement units, by allowing them to be depreciated over a mere seven years and, within that seven year period, to be depreciated in a more accelerated fashion (the 200% declining balance method.) Prior law (ACRS) allowed depreciation over five years but with the less accelerated 150% declining balance method. This kind of incentive for capital investment is of more benefit to wealthy non-farm investors (who will be in the 28% or 33% marginal tax rate bracket) than to small, lower income farmers who may be in the 15% bracket (if taxable income is under about $28,000).

The 1986 tax law eliminates cash accounting for farm investment syndicates and other "passive investors," although a closely held corporation, no matter how large, would still be defined as a family farm and therefore be allowed to continue to use cash accounting. The act also restricts the expensing of certain costs by farm tax shelters, but retains the provision for active farmers. Thus the 1986 act is noteworthy for the distinction it draws between active farmers (owner/operators) and passive investors, *i.e.,* absentee owners.

V

Land Ownership and State-Local Tax Policy

AT THE STATE AND LOCAL LEVEL the potential for use of the power of taxation to reduce the inducements to absentee ownership lies in the property tax. The property tax, as a uniform levy against the value of real estate, taxes all owners, local and absentee, low income and high income, at the same rate with respect to property assets. One of its principal virtues is that it permits the locality to tax quite effectively the absentee owner on his local holdings of property. This, at least, provides no preference to the absentee owner or wealthy investor, relative to the small family farmer (though of course the deductibility of property taxes against state and federal income taxes means that the net impact of the property tax is less the higher the owner's tax bracket).

There are two major ways in which the property tax can be modified to actually penalize absentee ownership. The first is to grant a general tax preference to

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agricultural land but then to exclude absentee owners from eligibility; the second is to make the rate structure progressive with respect to the value of property or size of land holdings.

The first approach has actually been implemented in a few states, though this is not widely recognized. Most states have adopted, during the past 20 years, a system of preferential assessment whereby agricultural land is assessed according to its value in agricultural uses rather than its market value. The principal reason for such assessment policy has not been to penalize absentee owners, but rather to provide tax relief to farmers and to preserve open space by reducing the costs of holding land in agricultural uses where it is under development pressure. While preferential assessment undoubtedly provides a windfall to owners of land at the time of the change in the basis of assessment, it is doubtful that it has provided benefit to new farmers—lower taxes being capitalized into higher land prices—or had a significant effect on preserving land in farming.[16]

The system adopted for calculating agricultural use value is retrospective: it takes an average annual net farm income in recent years, projects that indefinitely into the future, and capitalizes the stream at some interest rate. The result is that in a period of rising expectations (which produce rising market values), use value so calculated will be well below market value even in rural areas where the land has no urban development potential. The effect is to shift the tax burden onto the other classes of property (residential, commercial, and industrial).

Eligibility for such preferential assessment is only mildly limited in most states, by requiring that the land be used for farming, or that it have a recent history of such use, or that it generate some minimum level of gross farm receipts.[17] These restrictions prevent owners of vacant or non-farm land from benefitting, but in no way limit the participation of absentee owners of land that is being farmed.

Alaska, however, explicitly attempts to confine participation to owner-operators by excluding owners not actively farming the land and not deriving at least 25% of their annual gross income from the land.

Kentucky excludes corporations, except those "organized primarily for agricultural purposes," from eligibility for preferential assessment. In Montana, the owner must derive at least 15% of his or her income from farming. In North Carolina, the owner, to be eligible, must reside on the land or the land must have been in the same family ownership for at least four years previous. South Carolina assesses land held by corporations at 6% of use value; land held by individuals or small family corporations at only 4%.

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Minnesota goes the furthest in excluding absentee owners from the benefits of preferential assessment. To be eligible, the land must have been in possession of the current owner or a close relative for at least seven years previous, or it must be the homestead of the owner or of a shareholder of a family farm corporation. In addition, the land must produce at least one-third of family income, or $300 plus $10 per acre in gross farm income.[18]

The tax benefits from preferential assessment can be substantial. In Iowa, for example, use value assessments—until quite recently—were typically only 25% to 40% of market value. In a rural jurisdiction where a large share of the property consists of preferentially assessed farm land, or in an urban jurisdiction where most of the property is non-agricultural, to assess absentee owned land at market value would result in a sizable increase in taxes on that property (probably a tripling of taxes in rural areas, a much higher effect in metropolitan fringe areas where market value is determined by demand for urban uses). Thus the potential for reducing the financial inducements to absentee ownership is substantial, and the result can be obtained with only minor changes in existing preferential assessment statutes.

VI

Some Tax Policy Improvements

THE APPROPRIATE CHANGE, given the above discussion of the effects of absentee ownership, would probably include the following provisions:

(1) Exclude corporations, other than family farm corporations, from eligibility;

(2) Require either (a) that the owner currently resides on the land or resides on one parcel in a set of parcels which he or she is currently farming or farmed at one time, or (b) that the land has been held continuously in ownership by the current owner, or by persons closely related, for the past five years and was at one time the homestead of or was farmed by the owner or a relative;

(3) Require that the owner derive at least one-third of his or her gross income from farming the land.

The first restriction eliminates the corporate form of structural absenteeism. The second eliminates the non-farm investor but permits the farmer who retires to retain the tax benefits indefinitely if the land continues to be his homestead, or for five years if he moves off the land. The third restriction attempts to eliminate the "hobby farmer" without excluding the farm family with a spouse who has non-farm employment or where the farmer has secondary non-farm income.

An acreage restriction might be added, so that preferential assessment is ob-

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tainable only for the first, say 640 acres (or whatever was plainly sufficient to support a family farm and to exhaust most of the true scale economies). This would get at one additional form of absenteeism: the owner-operator who expands his land holdings beyond what he can farm himself. However, this is probably the least objectionable of the varieties of absentee ownership. Furthermore, an acreage limit can be evaded via transfer of title of the excess acreage to a relative. Monitoring and preventing such evasion could prove quite difficult.

The second approach to increasing the tax burden on absentee ownership would be to establish a progressive rate structure. This could be accomplished in several ways:

(1) exempt from property taxation the first, say, 40 acres of land for each owner (an extension of the "homestead exemption" idea); or

(2) devise a progressive rate structure such that, for example, the first 320 acres is taxed at 80% of the nominal rate, the next 320 acres at 100%, the next 320 at 120%, and all land in excess of 960 acres at 150%;

(3) devise a progressive rate structure similar to the above but with brackets defined by the use value of the land rather than acreage. The third version has been proposed in North Dakota and has the virtue of taking into account the productivity of the land, so that a certain minimum value sufficient to support a family farm is taxed at the lowest rate.

The progressive-rate approach effectively penalizes large land holdings, but has the problems of acreage limitations as cited above. Furthermore, it does not reduce the financial attractiveness of small or even medium-sized farm holdings by non-farm individual or corporate investors. This could be accomplished by adding additional eligibility requirements to qualify for the lowest tax bracket. However, the whole approach is more cumbersome than the first, requires enactment of a new tax rate structure, and complicates the work of local assessors. Furthermore, the progressivity of a rate structure that applies to all farmers is unlikely to be steep if it is to stay in the realm of political feasibility. The first approach is simpler and can get at the "problem absentee owner" directly and with more effect.

A final note must be interjected on possible state constitutional problems with the tax schemes described above. Some states have constitutional prohibitions against discriminatory taxation of non-residents, which might be thought to cause problems in the case of "homestead" requirements, but the widespread use of property tax homestead exemptions suggests that this is not the case (at least in most states).

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More importantly, many state constitutions have a "uniformity clause" requiring that all property be taxed "uniformly" or at the same rate.[19] This would appear to be a severe barrier, but in fact preferential assessment laws are pervasive and have not, apparently, run afoul of this provision, no doubt because the nominal tax rate remains uniform. The proposed eligibility restrictions, however, create new distinctions and non-uniformities, even within the class of agricultural property. Whether this would be a problem in some states is a matter for further exploration.

Notes

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2. Ingolf Vogeler, *The Myth of the Family Farm: Agribusiness Dominance of U.S. Agriculture* (Boulder, Colo.: Westview Press, 1981), p. 72.
3. Thorstein Veblen, *Absentee Ownership and Business Enterprise in Recent Times* (New York: B. W. Huebsch, 1923), p. 12.
4. Absentee ownership in its lesser forms need not produce these results unless resources are actually held in idleness, for speculation. However, absentee ownership may be combined with monopoly power, in which case profit maximization leads to the deliberate creation of shortages in order to raise prices.
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10. Lawrence W. Libby, "Land Use Policy: Implications for Commercial Agriculture," *American Journal of Agricultural Economics* 56 (December 1974), p. 1144. See also Peter Wolf, *Land in America* (New York: Pantheon, 1981), pp. 417, 505–06.

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11. Vogeler, *Myth of the Family Farm, op. cit.,* pp. 89–102.

12. The most comprehensive is Charles Davenport, Michael Boehlje, and David Martin, *The Effects of Tax Policy on American Agriculture* (Washington, D.C.: U.S. Dept. of Agriculture, Economic Research Service, AER No. 480, February 1982).

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14. Davenport *et al., Tax Policy & Agriculture, op. cit.,* p. 30.

15. *Center for Rural Affairs Newsletter,* Walthill, Nebraska, January, 1983.

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17. For a survey and discussion of state preferential assessment laws, see National Agricultural Lands Study, *The Protection of Farmland: A Reference Guidebook for State and Local Governments* (Washington, D.C.: U.S. Government Printing Office, 1981), pp. 56–63; or John C. Keene *et al., Untaxing Open Space* (Washington, D.C.: Council on Environmental Quality, 1976), p. 13 and pp. 127–270.

18. For a summary of these laws, see Bob Davies and Joe Belden, *A Survey of State Programs to Preserve Farmland,* prepared for the Council on Environmental Quality by the National Conference of State Legislatures, 1979.

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A New Variant of Market Socialism?

IN DISMANTLING many of its highly centralized structures for economic management, China seems to be headed for a new variant of market socialism, or "socialism with Chinese characteristics," as some observers have suggested.

It has introduced a "household responsibility system" in agriculture that permits peasants to lease plots of land and to keep and sell on the free market a share of the food they produce.

In the industrial sector, more decision-making authority has been given to factory managers and monetary incentives have been adopted to spur greater effort from workers. Price controls have been lifted on such popular items as bicycles, televisions, and sewing machines.

The measures have met with unprecedented success; agricultural output grew at an average annual rate of 8 percent between 1978 and 1985, and industrial output surpassed all expectations, leaping by 17 percent between 1984 and 1985. (Excerpted from the *Ford Foundation Letter,* 18:2, April, 1987, p. 4).

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