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Some Economic Aspects of Agricultural Zoning and Farmland Taxation*

The previous speakers discussed with you the Oregon statutes relating to assessment of agricultural properties for purposes of taxation. As was brought out, the 1963 legislation allows for two types of exceptions to the general rule that all property in Oregon be taxed according to its true market value. In summary, these are (1) that farm land located in areas designated as "farm use zones" be assessed at its true cash value for farms use and not at the true cash value it would have, if applied to other than farm use, and (2) that any land not within a farm use zone but which has been used for the immediately preceding two years exclusively for farming shall also be assessed at its true cash value for farming and not according to its value in some other use. In this latter case it is necessary that the owner applies for the preferential treatment and that his property qualifies for it in the judgment of the assessor. The previous speakers also treated some specific assessment issues in some detail. I shall attempt to focus on some economic issues. Specifically, we shall try to take a general look at the concept of zoning from an economic viewpoint. Then we shall examine some economic implications of the preferential treatment of farmland for tax purposes. Finally, we shall use some data from a 1964 Benton County study to look at some early accomplishments of the 1963 legislation.

Agricultural Zoning

Zoning has been defined as "the division of land into districts having different regulations."¹ It is not a new concept, the first comprehensive zoning ordinance in this country was adopted 50 years ago in New York City. Barlowe quotes a 1962 law in Massachusetts authorizing certain towns "to assign places in each town, where least offensive, for slaughterhouses, stillhouses, and houses for trying tallow and currying leather."² This old law implies the essential element in the justification of modern zoning ordinances: namely, to prohibit a land use which, if permitted to go unchecked would lead to undesirable neighborhood effects. In many cases the term "neighborhood" may be used literally, in others it must be given a more liberal interpretation. In all cases, however, we are involved with a situation where an action by one party imposes some costs upon some other party. In the economist's jargon this phenomenon is referred to as an "external diseconomy." The term

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1 Edward M. Bassett as quoted in Barlowe, R., *Land Resources Economics*, Prentice-Hall, Inc., Englewood Cliffs, New Jersey, 1958, p. 495.

2 Loc. cit.

“diseconomy” indicates that this is something nonbeneficial; “external” refers to the fact that the cost is imposed upon someone outside of the realm of concern of the person responsible for the action. These “externalities” are widespread and occur both in production and consumption. For example, the possible increase in traffic, noise, and unsightliness of locating a service station in a restricted neighborhood may lead to a decline in residential property values. The construction of a fence by one individual to enhance the privacy of his backyard may impose an external diseconomy upon his neighbor, if it blocks out the latter’s view of his favorite mountain peak.

There are several ways in which society can deal with these externalities. Zoning is one way in which the contact between types of land uses which impose these costs upon each other can be minimized. Even within a given land zone, zoning ordinances may contain additional regulations designed to alleviate or reduce the imposition of external costs among parties practicing the same land use. The prohibition of plantings in certain locations or of television antennas visible to the neighborhood, are examples of these in certain residential zones.

But let us turn now to agricultural zoning. Again, examples of external diseconomies can be cited. Air pollution from industrial establishments has damaged nearby crops and livestock. The immediate vicinity of nonfarm rural residents has meant damage to farm fences, crops and other agricultural properties. On the other hand, the rural suburbanite has been heard to complain about certain air pollution problems stemming from agricultural operations.

While I believe that these problems are important in certain areas and are likely to become more important in others, I do not think that they are currently significant enough to generally justify agricultural zoning.

Some of you have probably become impatient that until now I have said nothing about the need of preserving agricultural land to maintain agricultural production. Many individuals are concerned about the encroachment of municipalities, highways, airports, etc., upon the best agricultural land. Increasing population and income make increases in the demand for agricultural products virtually certain. On the other hand, it has been impossible to foresee any national shortage of agricultural products. Therefore, it may be premature to impose upon ourselves the costs associated with agricultural zoning for the purpose of maintaining land in agricultural production. In any case, it is important to balance carefully the costs of forcing nonagricultural development to higher cost locations against the benefits derived from maintaining certain areas in agricultural production.

We are finally coming back to the topic at which our discussion began, namely, the issue of taxation. As nonagricultural land uses

expand into the countryside, competition for agricultural land puts pressure on land prices. As prices rise, assessments for tax purposes increase accordingly. Higher land prices and higher taxes combine to provide a strong incentive to shift land use out of agriculture. Agricultural zoning would, of course, prevent all this. The non-agricultural land use alternatives would not be available, prices and taxes would remain the same, and there would be no need for farmers to change the location of their present occupational activity. By many this is viewed as a distinct benefit to be derived from agricultural zoning. My contacts with the owners of agricultural land have led me to observe, however, that they are by no means unanimous in their willingness to forego the opportunity to capitalize on a rising land market.

Perhaps we can attempt an explanation now, why zoning in the open country has been less widespread than in the city. As we have seen, the kinds of technical interrelationships which we called external diseconomies were more pronounced in the city than in the country. The market has difficulties in coping with these externalities. Where they are important public intervention may be justified and zoning has been a frequently applied method of intervention in urban areas. Apparently, technical interdependencies of this nature have not yet become important enough in rural areas to marshal the substantial support which zoning ordinances are given in the city.

Supporting agricultural zoning on the basis of the tax issue which we discussed, is not at all an analogous argument. The transfer among land uses which is going on in the absence of zoning is the result of the operation of the market. More specifically, it is the market which transmits information to decision-makers on the basis of which resources allocative decisions are made. To the extent that the transmitted information is complete, reliance on the market can achieve the "highest and best use." Contrast this to the externality case. Here the market did not transmit the relevant information. Public intervention in the form of zoning was necessary to improve resource allocation in a situation where the market itself could not achieve an efficient solution.

Some Implications of Preferential Farmland Taxation

It appears that at the present time the second clause of the Oregon farm land taxation legislation of 1963 may be the most important. As you will recall, his clause relates to the taxation of farmland which is not located in farm use zones. If it is established that property is used for bona fide farm purposes, it may be appraised according to its true cash value for farming and not for some higher value use. However, should the property be sold for non-farm purposes, the additional taxes plus interest thereon become due which would have had to be paid in the absence of the preferential treatment during a period as long as the preceding five years. Let us see if we can derive some hypotheses about the economic implications of this legislation.

First, let us briefly review the fact that the owner of an asset bases his decision whether to hold the asset or to dispose of it on the relationship between three variables: the net income derived from the asset, his time preference rate, and the price he is being offered for the asset. For an asset such as land this means that the owner would capitalize his annual net income and would compare the capitalized value to the price offered for the asset. Presumably, the owner would be indifferent about selling or holding the asset if the two values were the same. He would sell if the offering price would exceed the capitalized value, and would continue holding the asset if the opposite were true. Let us also remember that the relevant net income in this case is "net after property tax payments." How does the 1963 legislation affect these variables?

First of all it is quite clear that a farmer taking advantage of this taxation clause will enjoy a higher annual net income from farming than he would otherwise obtain. The difference stems from the saving in annual property tax payments. We can hypothesize that a farmer who now has a higher net income to capitalize would be willing to sell only if the offering price would be higher than it would have had to be in the absence of the preferential tax allowance. If this is correct, then the market price at which land will move from agricultural to non-agricultural uses will increase.

There is, however, another consideration which is relevant to the farmer in his decision whether to hold or sell his land. This one relates to the payment of taxes which is due subject to the sale. I believe that the appropriate manner for the farmer to take this tax payment into account in his decision making calculus is to subtract it from the offering price. We can see that this aspect of the tax regulation has the same result as the one discussed previously, it will raise the price at which land use is transferred from agriculture to other uses. It is also interesting to note that in the absence of the special provisions for agricultural land taxation rising property taxes have been a catalyst in the transfer of land uses. If the above reasoning is correct, rising property taxes will not be neutral in this respect, but actually will retard the transfer of land from agriculture to non-agricultural uses.

One could continue hypothesizing about the potential roles of farmers as speculators on the land market and about the possible levels of assessment of non-agricultural properties as a result of this legislation. But we have probably carried this game far enough. Some empirical work is needed to substantiate our reasoning.

We did a small study in this area in 1964. In the following final section I will indicate some results on the early phase of the regulation's effects.

Some Early Results³

At the deadline date for application for special assessment, February 1, 1964, 24 applications had been submitted in Benton County. Of these, nine were accepted by the assessor in meeting the requirements for farm use land as set forth by the Oregon Tax Commission. In the nine cases the reduction in assessed value per acre averaged about 30 percent. The range was from 13-67 percent. As one would expect, the highest percentage reduction occurred on a farm adjacent to the Corvallis city limits, while the lowest value occurred in the hill region north of the city. Although we are dealing here with only a very small number of farms, the evidence suggests that the effect upon tax payment on qualified properties are likely to be substantial.

It is also interesting to note that during this early period of implementing the legislation, 15 of the 24 applicants were disqualified for the special assessment on the basis of their failure to meet one or more of the established criteria. In 14 of the 15 cases, gross sales were termed to be "inadequate."

The total number of applications does not appear very high. A likely reason for the small number of applications at that time may have been the short period of duration during which the program had been in effect. Alternatively, this might be explained by the feeling of futility among land owners that they would not be able to qualify under the established criteria in any event, or that the land was already being taxed according to its cash value in farming to a larger extent than is generally thought.

The agricultural tax legislation has now been implemented long enough that one could attempt to answer some of the questions raised in this discussion. These answers might not be entirely irrelevant to other attempts of using the power to tax to influence the use of natural resources. In any case, the legislation under discussion here has added another instrument to the laboratory of the analyst interested in the problem of farm land prices.

³ Based on Robert W. Wales, "Deferred Farmland Taxation on the Rural-Urban Fringe of Corvallis, Oregon," unpublished paper, Department of Agricultural Economics, Oregon State University, Corvallis, Oregon.