

# **AFPC**

**Agricultural & Food Policy Center**  
at Texas A&M University

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Briefing Paper 04-3

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## **The Impact of Senate Bill 2 and Other State Tax Alternatives on Agriculture**

The 78<sup>th</sup> Texas Legislature saw the beginning of the process to change school finance in Texas. A bill was introduced in the Texas Senate (SB2) in 2003 proposing a restructuring of property taxes and school funding. Over the past year, significant effort has been dedicated to developing a new system for financing public schools. Most recently the legislature has wrapped up a special session on the school finance issue with no results. While quality of education and accountability will be at the heart of the debate, the impact of alternative tax plans and the potential shifting of tax burdens will be critical.

Restructuring of state taxes could have a tremendous impact on farmers and ranchers across the state. This briefing paper responds to the issue by analyzing the potential impacts of tax alternatives on the agricultural industry and specific case example farms and ranches. Specifically, the paper provides an analysis of the potential impact of SB2 (78<sup>th</sup> Regular Session). In addition, the paper takes a look at existing agricultural tax exemptions.

### **Background**

At the forefront of the debate is the desire to reduce property taxes. Currently, property owners in Texas pay on average about \$2.54 per one hundred dollars of property value. Just over \$1.00 of that tax bill goes to city and county governments. About \$0.10 is designated for local school district bond payments. The final \$1.43 on average represents the school maintenance & operation funds. It is this portion of the tax bill targeted for a new design.

The pressure for a new tax system comes from several angles. First, many districts are at or near the \$1.50 maximum rate for maintenance & operations, leaving them with no flexibility to generate additional funds. Second, school districts at both extremes of wealth are questioning the equity and adequacy of the state's Robin Hood sharing formula. Finally, there is significant support behind the notion that property taxes are too high.

Reducing property taxes is an easy proposal to support, but the funding will have to be made up in the form of some other tax increase or new tax. Many alternatives have been discussed to replace the funding lost by potentially reducing property taxes. The impact of a new tax or an increase of an existing tax could be tremendous for a farm or ranch. More importantly it could outweigh any relief from reduced property taxes.

## **Analysis**

The impacts of potential tax changes were measured using actual data representing the entire agricultural industry and case examples developed from actual producer data across Texas. Texas Cooperative Extension (TCE) works individually with agricultural producers across Texas in the Financial And Risk Management (FARM) Assistance program to assist them in financial and strategic planning. Case examples were developed from a database of over 200 producers to depict a typical crop operation in the Southern Plains near Lubbock, and a typical livestock ranch in South-Central Texas near San Antonio. The FARM Assistance projection model was used to forecast the financial implications of various tax alternatives relative to the status quo, or baseline.

### **Farm Level Case Studies**

Four case examples based on actual TCE-FARM Assistance farms were developed, and each was analyzed relative to the expected financial performance and position under alternative tax provisions.

Both crop farm examples are created from a 2570 acre crop farm in the Texas Southern Plains. The production on the farm consists of 1500 acres of irrigated cotton, 70 acres of irrigated sorghum, 400 acres of dry land sorghum, and 250 acres of dry land wheat.

Assumptions for the first two case examples are as follows:

#### Case 1, 100% tenant operator

- No Land Assets... (1/4 share rent)
- Home Value... \$115,000 (\$100,000 taxable)
- Taxable Services... \$193,000

#### Case 2, 100% owner operator

- Land Value... \$1.8 million (\$0.8 million taxable)
- Home Value... \$115,000 (\$100,000 taxable)
- Taxable Services... \$237,000

The livestock ranch examples consist of a 225 cow herd located in South/Central Texas on 1500 acres. Like the crop examples, one case represents a owner operator and the other is a tenant rancher. Assumptions for the livestock cases are as follows:

Case 3, 100% tenant operator

- No Land Assets... (cash leases land)
- Home... \$ 115,000 (\$100,000 taxable)
- Taxable Services... \$ 8,650

Case 4, 100% owner operator

- Land... \$ 1.5 million (\$93,750 taxable)
- Home... \$ 115,000 (\$100,000 taxable)
- Taxable Services... \$ 10,150

**Senate Bill 2 (SB2, 78<sup>th</sup> Regular Session)**

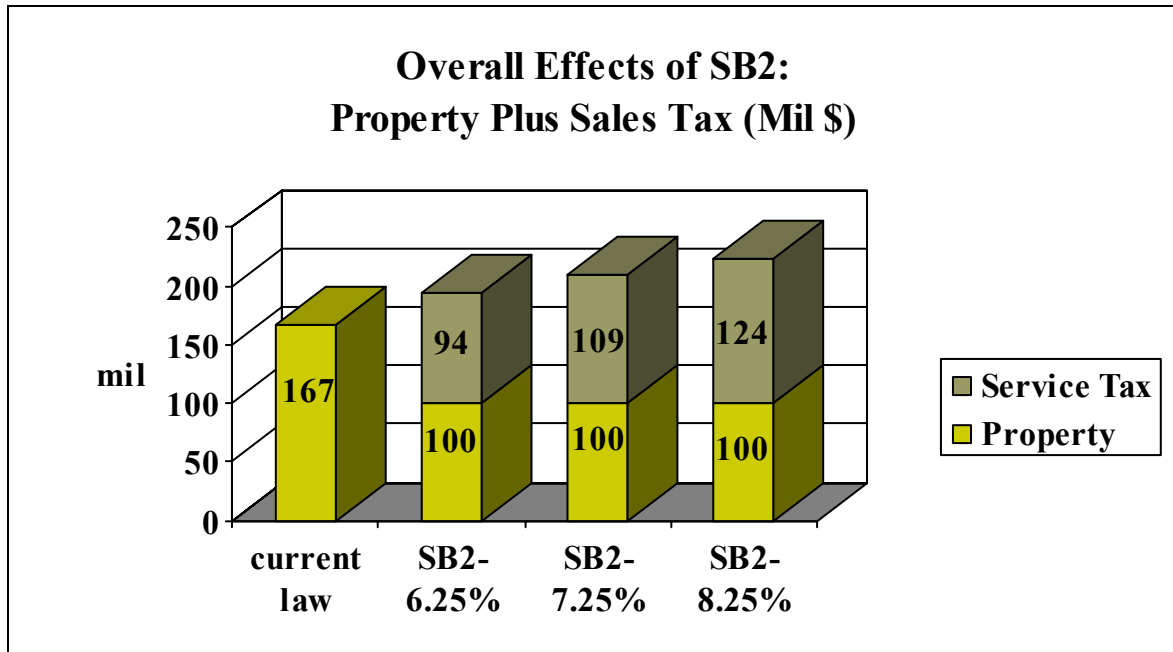
SB2 presented in the 2003 Texas Senate proposed the creation of a sales tax on services along with reducing property taxes. The service industry is one of the fastest growing segments of the nation's economy and Texas is no exception. The service tax idea has support in that it matches an output of the economy and has the potential to grow the tax base as the economy grows.

The significant provisions of SB2 include:

- Eliminating the local school property tax of \$1.43 per \$100 valuation
- Creating a state property tax of \$0.75 per \$100 valuation
- Allowance for up to \$0.10 local enhancement property tax
- Creating a sales tax on services (except health) of 6.25%
- A Potential increase in all sales taxes from 6.25% to 7.25%

The impact of such a plan would vary greatly across agriculture, but the whole industry could expect to pay an additional \$27 million in taxes under such a system. Figure 1 illustrates the total impact of SB2 under various sales tax rates. 2002 data indicates the "ag use" land or, more

specifically, qualified open space land (QOSL) valuation totaled \$11.7 billion dollars. At an average \$1.43 tax rate, agricultural producers paid a total of \$167 million dollars toward local school district maintenance and operations (M&O). Assuming the full \$0.10 enhancement and the \$0.75 state tax, the tax levy on the same QOSL property would amount to \$100 million under SB2. Although agriculture pays no sales tax currently, SB2 made no mention of an exemption for agriculture on the new service tax. In 2002 farmers and ranchers in Texas spent \$1.5 billion on farm services (NASS, USDA). Under SB2, the sales tax on services in agriculture would amount to roughly \$94 million. Each percentage point increase in the sales tax rate would create an additional \$15 million in service tax. The net effect at the lowest sales tax rate would increase the agricultural industry's tax burden by \$27 million.



**Figure 1. Agriculture Taxes under Current Law and Senate Bill 2.**

Assumptions for the case study analysis of Senate Bill 2 include replacing a portion of the local property tax (\$1.43 local I.S.D. M&O) with a state tax of \$0.75 plus a local enhancement of \$0.05 (half of the optional enhancement). A 6.25% sales tax on all services (custom applications, custom harvest, scouting, ginning, insurance, accounting, legal, ½ repair, veterinarian services, and utilities) was assumed. And no change in land values, land rents, or management were calculated.

The direct affects of SB2 on are presented in Table 1 in terms of the total net impact on the 2003 net cash income. The case studies conclude that some livestock ranches might see a small net benefit. Most livestock ranches spend very little on hired services, and could expect the savings in property taxes to be comparable to the additional service tax. The same is not true for most crop production in Texas. Depending on how services are defined, a 2500 acre cotton producer spends as much as \$237,000 each year on services, including custom application, custom harvesting, ginning, grain drying, consulting, accounting, repairs, and insurance. At a 6.25% tax rate, the producer would pay over \$14,800 annually in service tax. The same farmer could only expect a property tax savings of around \$5,600 under the provisions of last year’s senate proposal. The net effect would roughly amount to a 10% lose in cash profits for this example cotton farmer.

**Table 1. Senate Bill 2 Impacts: 2003 Direct Annual Net Cash Impact**

	Tenant Crop	Owner Crop	Tenant Livestock	Owner Livestock
Resident Property Tax	\$630	\$630	\$630	\$630
Ag Land Property Tax		\$5,037		\$591
Service Sales Tax	- \$12,065	- \$14,829	- \$541	- \$634
Net Change	- \$11,435	- \$9,162	\$89	\$586

**Sales Tax Exemptions and Open Space Valuation**

The discussion of property taxes and tax changes prompted the question of the value of certain exemptions currently in place benefiting the agricultural industry in Texas. Specifically the sales tax exemption and the property tax special valuation for open space land, or “ag use” land were also analyzed. For all of Texas agriculture, the sales tax exemption is estimated to

save producers approximately \$317 million annually. The special valuation of agricultural land is worth considerable more, saving producers \$1.4 billion each year. The same four case examples were subjected to the potential scenario of losing these exemptions. Assumptions for these two scenarios include:

#### Eliminate Sales Tax Exemption

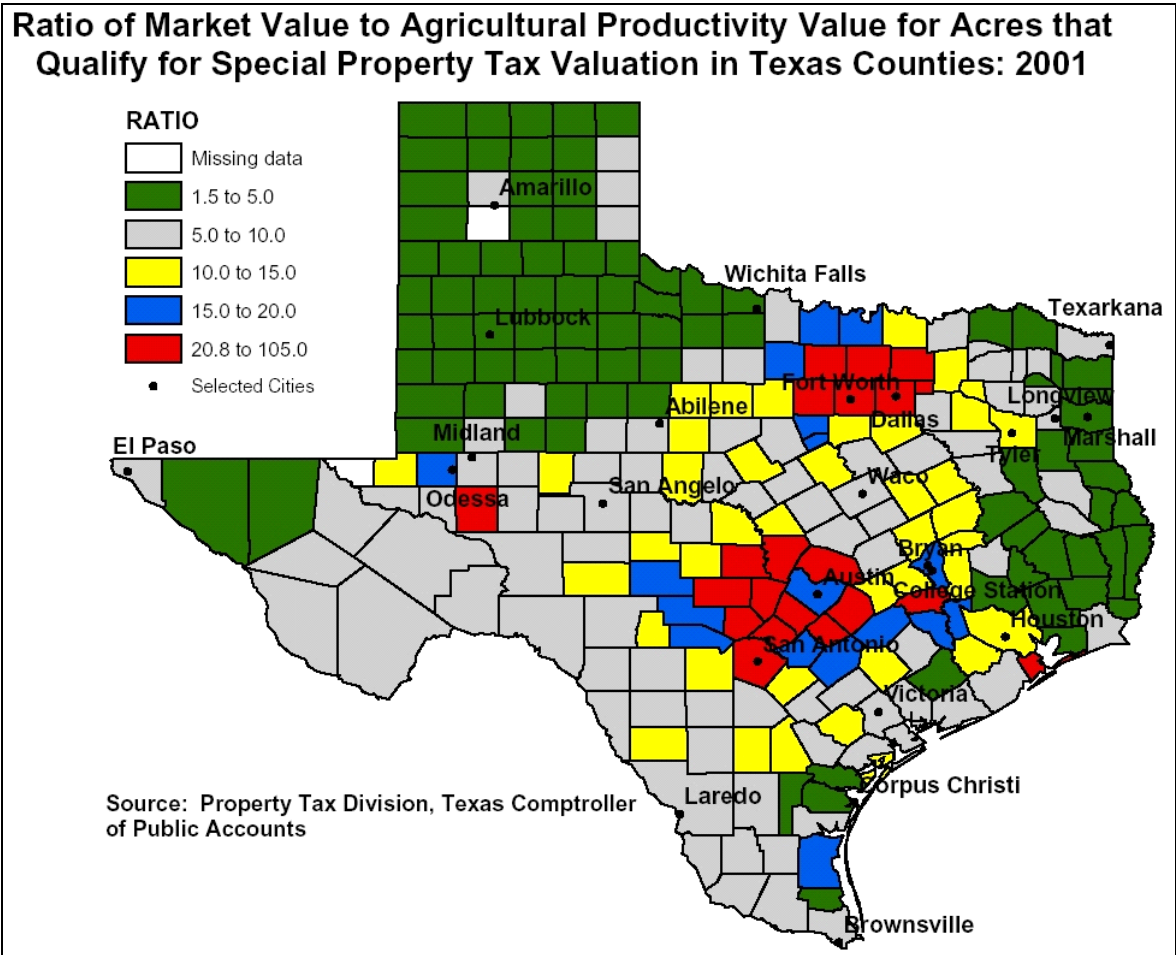
- 8.25% Sales Tax (seed, fertilizer, herbicide, insecticide, fungicide, feed, feed supplements, ½ repairs, and supplies)
- 6.25% Sales Tax on Equipment
- 20% increase in fuel costs (\$0.22 state tax on fuel)
- No Change in land values, land rents, or management

#### Eliminate “Special Valuation” for Property Taxes

- Increase property taxes by 2001 ratio of: Market Value of Ag Use Land divided by Productivity Value of Ag Use land
- No change in property tax rates
- No change in land value
- No change in land rents

The value of the special valuation provision varies by region of the state. Depending on the non-agricultural pressures that drive up land values, the savings resulting from the assigned productivity value can be great. Figure 2 illustrates the ratio of market values to productivity values by county in Texas. As expected, in areas close to urban cities land values are heavily influenced by non-agricultural market forces. In extreme cases, market values may be as much as twenty times greater than productivity values. In such examples, the immediate impact of removing the special valuation would lead to a twenty fold increase in property taxes.





**Figure 2. Ratio of Market Value to Agricultural Productivity Value.**

Summary results for all three scenarios are provided in Table 2 and Figures 3 & 4. The average annual impact over an extended forecast period (2003-2012) indicates that there may be some ranchers in Texas that would benefit from provisions similar to SB2, but for most crop farm the additional service taxes would far surpass the benefits of reduced property taxes. For the two crop farms, the difference in the SB2 impact depends on ownership of the land. The tenant farmer would realize no immediate benefit from the property tax reduction on the farm. Forecasted losses for the tenant farm reach 20% of net cash income, compared to less than a 10% loss for the owner-operator.

The loss of the sales tax exemption would negatively impact all producers. Livestock ranches are typically less intensive than crop farms when it comes to production expenses, making the impact of paying sales taxes smaller for ranchers. The crop cases could expect a loss of 20-25% in net cash income as a result of having to pay sales taxes. The loss in equity after 5 years of no sales tax exemptions is projected from 5-10% for the two crop farms.

Losing the special valuation provision for qualified agricultural land would prove devastating for some producers. No immediate impact is estimated for tenant operators. However overtime, the loss of the provision would put pressure on land rents and share rent agreements between tenants and landlords. Paying property taxes on the full market value of land created an annual 20% loss in net cash income for the owner-operator crop farm. The livestock ranch was located in an area with much larger disparity between market value and productivity value, due to the urban influence on market values of land. If the owner-operator ranch lost the special valuation provision he would realize losses of more than 80% of net cash income.

**Table 2. Annual Impact on Net Cash Income, 2003-2012 Average**

	Tenant Crop	Owner Crop	Tenant Livestock	Owner Livestock
Senate Bill 2	- \$15,240	- \$11,760	\$120	\$720
Eliminate Sales Tax Exemption	- \$20,650	- \$25,150	- \$1,880	- \$2,020
Eliminate Special Valuation		- \$28,100		- \$38,350

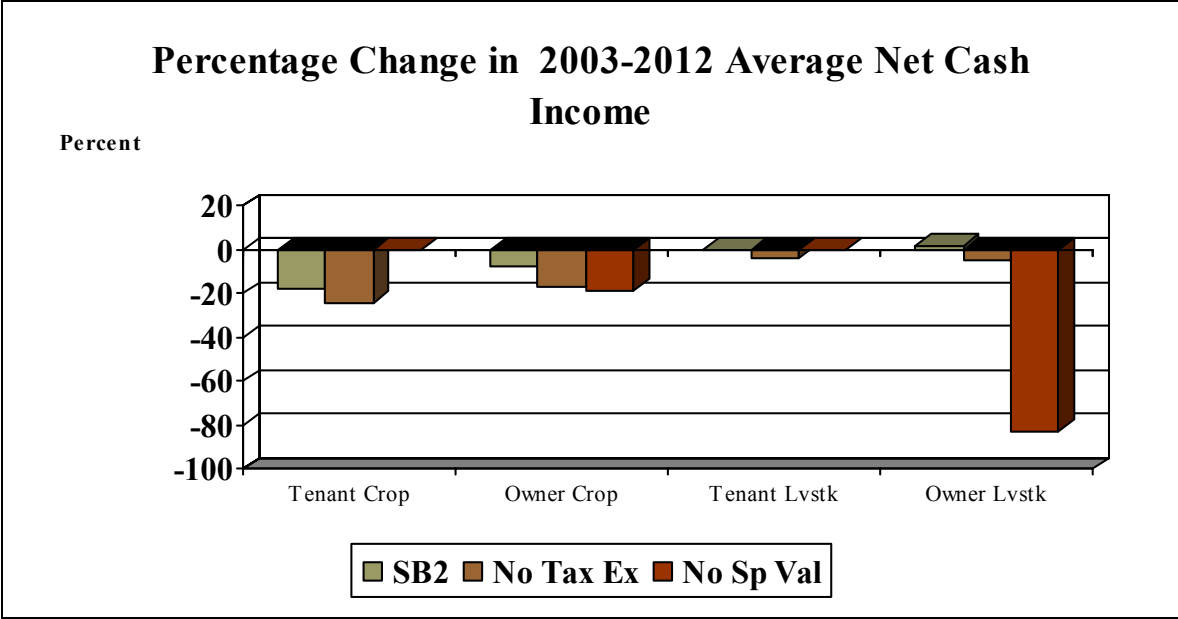


Figure 3. Tax Alternatives, Impact on Net Cash Income

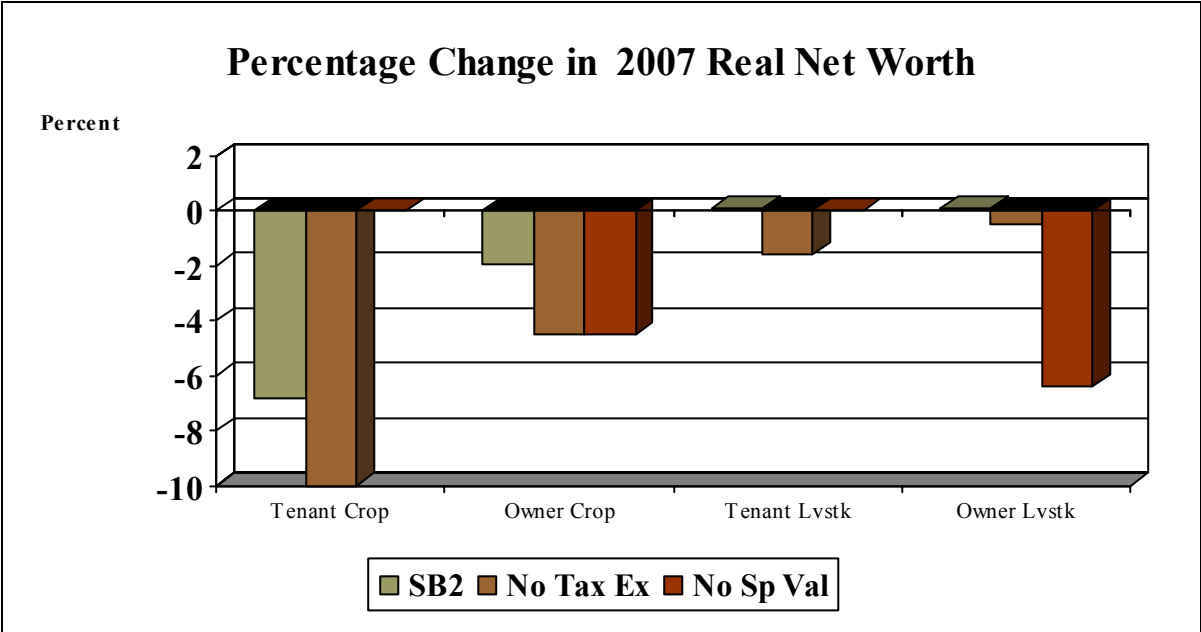


Figure 4. Tax Alternatives, Impact on Real Net Worth

## **Conclusions**

The provisions of SB2 would be expected to have a more severe impact on tenant farms or ranches relative to owner-operators who would receive greater benefits from lower property taxes. The service tax provision would likely outweigh the property tax savings for expense intensive producers, while the net impact for some low intensity ranches may be positive. The intensity of production in terms of product purchases (seed, fertilizer, pesticides, etc) determines the degree to which a farm or ranch would be impacted by having to pay product sales taxes. The impact of losing the property tax special valuation provision depends highly on the proportion of the farm or ranch that is owned and the location that determines the relative difference between the current productivity value and the market of property.