Current Tax Policy vs. a Flat Tax: Effects on U.S. Agriculture

Federal tax policy has far-reaching effects on the farm economy overall, but regional variations exist partly because state tax policy can offset or intensify the effects of Federal taxation. USDA's Economic Research Service uses an economic model to simulate tax reform and to measure the effects of tax policies on farm markets by comparing current economic conditions in the farm economy with conditions that might exist under a single-rate (flat) income tax. In the analysis, the flat tax rate—one nationwide rate for Federal taxes but different flat rates for each state—applies to *all* income from *any* source.

Current Federal and state tax codes have graduated rate schedules, and provide for numerous exemptions, deductions, deferrals, and other special provisions that shelter certain types of income from taxation. Federal tax policy is favorable to farmers, but states, unlike the Federal government, tax real property, and farmers hold a disproportionate share of such assets.

Provisions incorporated in current Federal tax policies increase average net farm income and average farm household income by lowering the tax burden. According to USDA, the average U.S. farm household in 1997 earned almost $6,000 in net farm income (before income taxes) and around $46,000 from other income sources. After applying tax accounting provisions to farm business income, the average farm household filing a Federal Form 1040, Schedule F (profit or loss from farming) declared around $3,000 in net farm losses, offsetting household income that would otherwise be taxable. Thus, farmers, on average, realize positive net income from farming activities, but adjustments to that income under the current tax code result in lower household tax liability.

Current tax policies generally push up farm-level prices relative to prices under a flat tax. At the current level of farm production, prices of farm products reflect a tax rate on farm income that averages 29 percent (excluding tax rates for publicly-held corporations). This combined average tax rate includes about 21 percent for Federal tax and 8 percent for states (although there is significant regional variation). A flat tax rate that raises the same amount of Federal and state tax revenues would be a combined 20.3 percent. Thus, adding a dollar of farm income to average farm household income lowers the average farm loss by a dollar and adds 29 cents to the household's tax bill under the current system compared with about 20 cents under a flat tax.

For food manufacturers—the primary customer of agricultural producers—product prices reflect an average combined tax rate of 39 percent, compared with an average 34.5 percent for all nonfarm businesses. Under the current tax system, this heavier-than-average tax burden—primarily reflecting high tax rates on corporate profits—causes food manufacturing businesses to scale back production and demand less farm output than under a flat-tax system. In turn, farm prices decline until farmers sell all they produce.

In the longer run, farm and nonfarm producers adjust to the effects of taxation. Over time, some labor and capital displaced by the scaling back of food manufacturing and other highly taxed industries become available for farm production at reduced costs. Overall, the lower pre-tax cost of labor and capital in farm production nearly offsets the higher tax rate under the current tax system, leading to after-tax costs of only 0.2 percent above a flat-tax scenario.

Even though production costs are about the same, lower demand for farm output by food manufacturers leads to lower farm output (less than 1 percent) under the current system than under a flat-tax system. However, in several regions, farm output increases for reasons that involve regional variation in farmers' ability to take advantage of specific tax provisions.

Farm industries in most U.S. regions attract less investment under current tax policies than they would under a flat tax. On average, capital per worker in farming is 3.7 percent lower under current Federal and state tax policy than it would be under a flat tax. This result reverses findings from other USDA analyses of Federal tax policies alone, and reflects the negative effects of state property tax policy on direct farm investment. Regional disparities in changes in farm markets—e.g., in producer prices and farm output—also add potential for shifts in agricultural resources among states.

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Regions Vary in Combined Tax Rates. . .

	U.S.	Northeast	Southeast	Corn Belt	Lake	Delta	Appalachia	N. Plains	S. Plains	Mountain	Pacific
						Percent					
Combined tax rate (Federal plus state)											
Current tax system:											
Farm households	29.0	30.5	25.6	31.3	34.8	25.5	27.4	31.1	27.8	30.3	25.5
Nonfarm business	34.5	35.7	33.9	34.4	37.3	31.6	34.2	33.7	31.0	33.6	33.8
Flat tax	20.3	21.4	19.2	19.5	21.2	18.8	19.0	19.4	18.6	19.9	21.3
...And in Tax System Effects on Farm Markets											
						Percent difference					
Current tax system vs. flat tax:											
Producer price index	0.2	-0.5	0.0	0.3	0.9	-0.5	-0.6	0.5	0.5	0.4	-0.1
Farm output	-0.4	3.4	-1.2	-1.1	-3.0	2.5	3.8	-2.9	-2.3	-0.1	1.0
Capital per worker	-3.7	1.5	-4.1	-2.7	-6.2	2.0	1.2	-6.0	-2.0	-1.9	-7.4
Net farm investment	-1.5	-1.8	-1.8	-2.8	-6.1	5.1	-0.8	-0.7	0.5	0.1	-0.6

Average U.S. and regional combined tax rates reflect variation in state tax rates. The flat tax rate is sufficient to fund current government budgets and applies to all income from all sources. Effect of current tax system versus a flat tax, treating flat tax as the base.

Economic Research Service, USDA