

Lincoln Institute  
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Frederick D. Stocker  
FARM-USE ASSESSMENT  
REVISITED

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Stocker FARM-USE ASSESSMENT REVISITED

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The Lincoln Institute of Land Policy created the Tax Policy Roundtable, composed of informed persons from the academic, business-industrial, and governmental communities to identify major or emerging issues in tax policy, and programs that impact land use decisions to analyze and evaluate their impact, to generate research, discussion, and publication on these topics, to draw them to the attention of policy makers and government officials, and to prepare materials for instructional use.

Roundtable members are listed on the inside back cover.

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## FARM-USE ASSESSMENT REVISITED

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In 1957 Maryland became the first state to require assessors by law to value farmland, as long as it is actually used in agriculture, on the basis not of market value but of its "value in agriculture." The action was a response to what was perceived as a growing problem. The rising tide of suburban expansion that was engulfing much of the countryside was nowhere more evident than in the suburban counties of Maryland. Farmland values were rising at startling rates, and woods and fields were rapidly giving way to shopping centers and residential developments.

In most other states, and in most of Maryland, the element of inertia ever present in the assessment process had mitigated the effects of the explosion in land values on assessed values and taxes. In a few places, however, where fiscal pressure on growing suburban communities came together with an assessor who takes seriously his legal responsibility to assess property uniformly according to market value, undeveloped land was being reassessed at something like the standard fraction of its market value, and owners faced big increases in taxes.

Even though actual instances of dramatic tax increase in suburban Maryland were relatively few, and the number of genuine farmers who were affected even fewer, the message quickly went out to all farmland owners that under existing law the inflation in land value could bring sharp increase in property taxes.

At the same time assorted conservationists, open space advocates, and planners began to be concerned that rising taxes on undeveloped land might be forcing cash-pinched owners to sell or develop their land prematurely, or piecemeal, with adverse consequences for the long-run orderly development of the area and for preservation of the lovely Maryland countryside.

There were, then, two aspects of the problem as it was perceived. One was the equity problem. To many it did not seem fair to raise taxes on someone whose property has increased sharply in value through forces beyond his control, while his current income has shown no corresponding increase. The other was the problem of economic effects. Many people saw strict application of the *ad valorem* principle as the cause of disappearance of open spaces and of scattered and unplanned development.

To the critical mind, neither of these interpretations seems convincing. Especially in an urban and literate state like Maryland one might have expected general skepticism over the diagnosis of the problem and the appropriateness of the proffered remedy. One might even have expected bona fide farmers and their representatives to question whether the proposed tax relief to urban fringe landowners, many of whom had never had manure on their shoes, was really in the best interest of the agricultural community.

Nevertheless the voters of Maryland approved the necessary constitutional amendment by a wide margin. Seeing the popular acceptance accorded the use-value assessment idea in Maryland, farm groups and their allies in other states moved quickly to secure similar protection from the harsh rigors of uniform assessment. The movement caught on and spread rapidly, with the result that by 1979 all but a few states have adopted legislation generally similar to Maryland's. In the few states that have not, it is more likely that assessments in practice are based on agriculture use-value, whatever the law may say.

Consequently, today it is reasonably accurate, as a generalization, to say that farmland in the U.S. is, in principle and by law, assessed according to standard other than market value, that standard being the agricultural use-value, i.e., the value the property could support if devoted only to agricultural use.

In the two decades since use-value assessment was first adopted in Maryland, the volume of legislative activity on the subject has been nearly matched by the amount of research attention. Among the voluminous output (to which I have made my own modest contribution) several recent studies stand out for their comprehensive and thoughtful treatment of the theory and practice of use-value assessment.<sup>1</sup> In what follows I have drawn heavily on the studies.

It is not my purpose here to discuss in any detail the various state laws providing for use-value assessment. All apply to farmland, though in a few states eligibility is conditioned on the zoning or planning status of the land. Some states allow use-value assessment on other kinds of land such as open space, recreational, scenic or wildlife habitat. A few states require landowners to enter into agreements or contracts assuring that the land will not be developed for a specified number of years into the future. A larger number of states provide a limited recapture provision, under which owners who convert their farmland to development must pay back the amount saved on their taxes by agricultural-use valuation for several preceding years, usually three to five years, in some states with interest. In this form, farm use-value assessment resembles somewhat a tax deferral scheme, and some authors describe them by this term, though in my opinion it is misleading to do so.

My purpose rather is to review the two decades of experience that states have had with use-value assessment and to try to summarize what we can say, on the basis of two decades of experiences, as to their equity effects (that is, who gains and who loses), and their economic effects on land use. After that, I want to consider the significance of the use-value assessment movement to our fundamental notions about the property tax and how it works, and to property tax policy.

#### Equity Aspects

The original impetus to use-value assessment, as I have stated above, was rooted largely in a notion of tax equity which, though quite at variance with that contained in public finance text books, quickly came to supplant it. To most students of the property tax, the principle of horizontal equity has long been interpreted to mean that owners of equally valuable property (at least, real property) should be assessed and taxed equally. Use-value assessment laws in effect assert that owners of equally valuable property are not equal if their incomes differ. They view the property tax not as an unconditional levy based on market value, but as a tax the amount of which should be made conditional on the owner's income. In this sense, use-value assessment is similar to another popular reform of recent years—the circuit breaker—and is subject to some of the same criticisms.

The basic objection to use-value assessment on equity grounds concerns the targeting of its benefits. While owners of urban fringe farmland may be cash-poor (a chronic condition of many family farm operators), they are enviably wealthy in terms of the value of their land. Their problem really is that of being unable, or unwilling, to convert part of their capital gain into cash to meet current consumption needs or to pay taxes. Few conventional lenders are accustomed to advancing funds on the security of an unrealized capital gain in land, especially if the purpose is for consumption, taxes or some such frivolous use and if the borrower presents an operating statement that offers no prospect of repayment short of the time he sells out.

Seen in this way, the urban fringe farmland problem is not a tax problem at all, as I have argued elsewhere,<sup>2</sup> but a credit problem. The solution accordingly should not be sought in some tax exemption or modification, but in some newly designed lending instrument. In the absence of sufficient inventiveness in the private financial community to design such an instrument, to me it seems highly appropriate that government offers itself as lender of last resort, at least up to the amount of the property tax. This of course is the tax deferral idea, found in many states in truncated form, i.e., with limited recaptures, but nowhere in full force.

Use-value assessment confers its benefits on property owners in perverse fashion. The more rapidly an owner's urban fringe property rises in value, the more tax relief he receives. Imagine two landowners, equal in all aspects including income. A's land, lying in the path of urban development, rises rapidly in value and makes its owner a millionaire, while B experiences no such appreciation. What concept of tax equity can possibly justify giving tax reductions to A while B gets none or even possibly helps contribute to A's relief?

After two decades of experience with use-value assessment and many studies of this experience, one might expect that there would be some quantitative evidence of the shift of tax burdens. I have not found any. Some studies have attempted to characterize the owners of farmland covered by use-value assessment. A study of Washington's open space taxation program<sup>3</sup> found that more than half of all applicants were neither farmers nor retired; 62 percent of these has incomes in 1970-71 over \$10,000, compared with only two-fifths of the farmers and retired applicants. A New Jersey study estimated that approximately \$48 million in taxes (about two percent of all property taxes) was shifted from farmers to nonfarmers in 1972, and noted that among the "farmers" benefitting were many large national and multinational corporations, development companies, gentlemen farmers, and speculators.<sup>4</sup> Similar findings were reported in California by the Tax Reform Research Group, which in 1972 identified 10 large landholding corporations as holding over one-fifth of the land affected by the Williamson Act<sup>5</sup>

None of these studies, unfortunately, goes so far as to categorize beneficiaries as to both income and wealth. To attempt to do so would encounter obvious and perhaps insuperable obstacles. Nevertheless the direction of the tax burden shift is clearly away from owners who are lucky enough to own rapidly appreciating property and toward those who own the wrong kind of property or none at all.

#### Economic Effects

The second and probably the dominant objective in farm-use assessment concerns economic effects. Much has been said and written about the land use effect of the property tax. Suffice it to say here that the tax, if applied to land on an *ad valorem* basis, is essentially neutral among the various possible uses of land. The use of land does not determine its value. It is the other way round; the value of land determines its use. The amount of property tax, since it is determined by the value of the property (assuming a given rate), also is unaffected by use. This logic holds as long as the assessment method is not systematically biased among land uses. Economists have generally applauded this neutral characteristic of the property tax.

Farm use assessment is deliberately non-neutral. It is designed to increase the after-tax profitability of one kind of land use—agriculture or other designated low-intensity use. The direction of the effect is thus clear. What is not clear is its strength.

It would be surprising, however, if the effect were very powerful. In the absence of any preferential treatment to farmland, one might expect it to be taxed at an effective rate close to that applied to residential property—a rate that in metropolitan areas averages around two percent. In view of the general pattern of underassessment of farm property and the further tendency to underassess rapidly appreciating property, urban fringe farmland is probably taxed at a somewhat lower average effective rate, perhaps around 1½ percent. The deductibility of state-local taxes for federal income tax purposes further reduces the effective rate, perhaps to the one percent range. More significant, any *change* in property taxes, as for example from preferential assessment, is also partly offset by an opposite change in federal tax liability.

Now, how strong an incentive might it be to a land owner whose annual property taxes (disregarding the federal offset) are in the neighborhood of 1½ percent of true market value to have this tax reduced, or even eliminated. Surely the incentives

created by the market would be a far more powerful consideration, especially if market forces are causing land to appreciate in value at a rate equal to or greater than the annual tax. Moreover, in a world in which interest rates are running above 10 percent, it is surely unrealistic to pick out the 1½ percent per year property tax as the crucial cost element in the decision to hold or sell land.

Again, empirical evidence on land use effects appears scant. For the most part, available data reveal the number of parcels covered by special use-value rules, their location, acreage, sometimes the occupation and income of the owners, and in the case of restrictive agreements, the number of contracts renewed or cancelled. What is missing is evidence indicating how much of this farmland would have been converted to other uses had it not been for use-value assessment.

One suspects that the amount is very small. Gloude-mans notes, for example, that in 1969-70 only 6.4 percent of the land assessed under California's Williamson Act lay within three miles of a city, and only 1.6 percent within one mile. The implication is that most of this land would not be developed in the near future in any event. Gloude-mans goes on to suggest that perhaps one reason for owners of remote farmland to claim use-value assessment is that the capitalization process employed in determining agricultural use value may fail adequately to reflect improvements in farmland productivity, thereby resulting in an underestimate of the farm use value itself.

Two studies of farmland acreage in Ohio give some support to the *a priori* view that use-value assessment has no discernible effect on the rate of conversion of land to nonfarm uses. Plaut and Berry, in studies relating to the periods 1964-69 and 1969-73 respectively, found that in the highly productive farming areas of Ohio, property taxes apparently had no effect on retention of land in agriculture. In urban counties they found that there was a small effect on the rate of loss of farmland, but that it was swamped by the effect of population increase and the demand for land for urban uses<sup>6</sup>.

An interesting question, also unexplored in the research literature as far as I have been able to discover, concerns the effect of recapture provisions on farmland conversion decisions. The farther back such a recapture of deferred taxes goes, the greater is the tax penalty associated with a decision to sell or develop farmland. The effect is similar to the "lock-in" associated with federal tax treatment of realized capital gains (or more accurately, with the nontaxation of unrealized gains). The locking of land into agricultural use is accentuated by application of an interest charge to the deferred taxes, or by other penalties. One would certainly expect land to be more effectively retained in agricultural use, the more severe these penalties. The fact that more than a dozen states have no recapture at all, and most of the others recapture for only five years or less, causes some skepticism over how seriously the state legislatures take the farmland and open space preservation objective of use-value assessment laws.

#### Policy Implications

Both logic and available evidence suggest that there are serious deficiencies in use-value assessment of farmland and open space. From the standpoint of equity, it distributes burdens and benefits in a way that seems difficult to rationalize and defend. From the standpoint of economic effects, it appears to be an ineffective deterrent to development. Especially when it is extended indiscriminately to *all* land used in agriculture or for open spaces, without regard to its location or to any general land use or development plan, it is hard to see how use-value assessment can contribute to a socially more desirable pattern of land use. Surely there are *some* lands on which it is in the public interest for development to occur.

Nevertheless the practice has gained general acceptance and seems now to be just about universal. Among the few states whose laws still call for assessment of farmland under the *ad valorem* principle, it seems probable that use-value assess-

ment is prevalent in *de facto* form. While for the vast majority of farmland parcels, farm-use value is doubtless identical to market value, it is significant that the former rather than the latter is now the accepted target, and that the methods used to estimate farm use value (capitalization of potential income) can easily produce a different result from that obtained by conventional (comparable sales) methods.

This state of affairs presents interesting policy issues. Should those of us who are concerned about rational property tax policy urge the states to turn their backs on use-value assessment, scrap the constitutional amendments their voters have approved, repeal the statutes they have enacted, and embrace again the *ad valorem* standard of assessment, just as some monetary fundamentalists urge the nation back to the gold standard?

Perhaps it is better to accept the idea that use-value assessment is here to stay and to urge policies that might reduce its inequities and perhaps strengthen its effectiveness in achieving its intended land use objectives. Such a posture would emphasize strengthening and extending recapture provisions, imposing realistic interest charges on the amount of any recapture, and/or imposing penalties on owners who after having enjoyed preferential tax treatment, convert land to some nondesignated use. It would also emphasize tying preferential tax treatment into some over-all land use plan that would not shelter all undeveloped land but only that land for which low-intensity use has been recognized as being in the public interest.

A strategy such as this would convert the use-value assessment system into a system of tax deferral. It would retain market value as the basic standard for valuation, but would in effect allow land owners to defer (with interest) payment of part of their current tax liability. Since we would be dealing here with a loan rather than a gift, an accurate determination of the amount that could be deferred would not be of crucial importance; indeed, there would be no serious objection to allowing deferral of the entire amount of the tax, provided of course that an interest bearing lien was placed on the property.

A case can in fact be made for allowing taxpayers fairly generous access to the tax deferral option, so long as the governmental unit itself is able to borrow whatever is necessary to cover the resulting liens. This amounts to a laid back attitude toward tax delinquency but in prosperous times and with reasonably smoothly functioning credit markets, such a policy might be appropriate.

There is another perhaps more fundamental issue that is raised by the general and pervasive acceptance that use-value assessment has gained. The issue is whether it is any longer useful to think of market value as the norm or standard for assessing property, or whether the property tax has by now become a collection of specific levies imposed on bases that, while perhaps clearly and consistently defined, still bear little or no consistent relation to market value. Is it, in other words, still appropriate to think of the property tax as the uniform, *ad valorem* levy of the public finance textbooks?

Clearly, we have come a long way from that kind of tax, if indeed it was ever an accurate description of the property tax. Public utility property, for example, is almost everywhere assessed by capitalization of earnings, in the stock-and-debt method, or reconstruction cost, or some such system bearing only a tenuous relation to the market value concept. Industrial and commercial real estate also is often if not usually assessed by similar crude market value proxies, as is machinery and equipment. Even residential property is here and there (e.g., California) coming to be assessed by methods that explicitly and deliberately depart from the market value standard. Use-value assessment of farmland, rather than a deviation from the norm, may be a step toward conformity with assessment methods applied to other classes. The argument supporters of farm-use value assessment often make is that most other classes of property are already assessed by what are in effect use-value methods, so why not farmland?

Under these circumstances, what is the wisest policy? Should efforts be made to preserve what vestige of neutrality the property tax still possesses by restoring the *ad valorem* principle and adapting assessment practices so that they more nearly reflect market prices? If so, how can this be done? Reconstruction cost schedules, capitalization rates, and depreciation rates have all been made somewhat obsolete by inflation rates experienced of late and doubtless could use more frequent adjustment to tie them more closely to the market. With respect to farmland and open spaces, the conversion of use-value assessment systems into one more nearly resembling a deferral system would help retain the *ad valorem* concept.

A more radical policy would be to recognize that the property tax is not and perhaps never was the neutral, uniform *ad valorem* levy described in the textbooks, and to explore ways to use the tax in deliberately nonneutral ways to achieve specific policy objectives.

The property tax has been or easily could be used for such purposes as to:

- stimulate investment and new commercial construction in older downtown areas
- penalize conversion of farmland and open space to developed uses
- encourage rehabilitation of structures in deteriorating areas
- encourage replacement of older machinery and equipment with new
- encourage installation of pollution control devices
- discourage owners from selling their homes, as a means to stabilize neighborhoods.

It is certainly not clear that all or any of these are necessarily appropriate goals of public policy, or that property tax incentives are the best way to accomplish them, especially when the policy objectives are rather poorly defined and when we know so little about the potency of tax instruments. The fact is that we have gone a long way in using the property tax in exactly these ways. The important thing as I see it is that we acknowledge that the property tax as it actually exists is quite different from the textbook model and that we address pragmatically the question whether the public interest is better served by closer adherence to the textbook principles or further deviation.

The property tax has been around a long time. Like an old friend whom we see every day, it changes so slowly over the years that we hardly notice the difference. We tend to assume it has always existed in essentially its present form and always will. Is it possible that, without our realizing it, the property tax has changed in the past several decades into something bearing very little likeness to the levy we learned about in school, and in the case of some of us, still describe to our classes?

With all its change, however, and regardless of the direction of its future evolution, there is one eternal quality the property tax has that endears it to groups such as ours. It is an inexhaustible source of controversy.

<sup>1</sup>Robert J. Gloude-mans, *Use-Value Farmland Assessments: Theory, Practice, and Impact*, Chicago, International Association of Assessing Officers, 1974; John C. Keene, et al., *Untaxing Open Spaces*, Council on Environmental Quality, Washington, Government Printing Office, April 1976; International Association of Assessing Officers, *Property Tax Incentives for Preservation: Use-Value Assessment and the Preservation of Farmland, Open Space, and Historic Sites*, Chicago, 1975; Robert E. Coughlin, David Berry and Thomas Plaut, "Differential Assessment of Real Property as an Incentive to Open Space Preservation and Farmland Retention," *National Tax Journal*, June 1978, pp. 165-179; Research and Technical Services Department, International Association of Assessing Officers, *Use Value Assessment in the United States*, June 1, 1979.

<sup>2</sup>"The Impact of Ad Valorem Assessment on The Preservation of Open Space and The Pattern of Urban Growth," in IAAO, *Property Tax Incentives*, op. cit., pp. 29-30.

<sup>3</sup>James C. Barron and James W. Thompson, *Impacts of Open Space Taxation in Washington*, Washington Agricultural Experiment Station Bulletin 772, March 1973.

<sup>4</sup>John Kolesar and Jaye Scholl, *Misplaced Hopes, Misspent Millions*, Princeton, The Center for Analysis of Public Issues, 1972.

<sup>5</sup>Cited in Gloude-mans, op. cit., p. 45.

<sup>6</sup>Plaut, Thomas, "The Real Property Tax, Differential Assessment and the Loss of Farmland in the Rural-Urban Fringe," Regional Science Research Institute Discussion Paper Series: No. 97, 1977; Berry, David, "The Effect of the Property Tax on the Loss of Farmland: The Potential Effectiveness of Preferential Assessment," Proceedings of the Meetings of the Middle States Division of the Association of American Geographers, Grand Island, New York, 1975. Both citations, and the summary of their conclusions, are taken from Coughlin, Berry and Plaut, op. cit., pp. 165-179.

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