

312

THE EFFECT OF DIFFERENTIAL APPRAISAL
ON LAND USE CONTROL

by

DAN CARTER

B.S., KANSAS STATE UNIVERSITY, MANHATTAN, KANSAS, 1975.

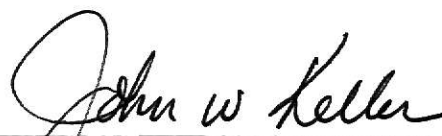
A MASTER'S REPORT

submitted in partial fulfillment of the
requirements for the degree

MASTER OF REGIONAL AND COMMUNITY PLANNING
Department of Regional and Community Planning
Kansas State University

1978

Approved by


Major Professor

Document
LD
2668
.R4
1978
C38
C.2

The author gratefully acknowledges
the assistance and financial support
granted by the Leland R. Edmonds Scholarship
Fund and the high standards of scholarship
and professional practice which this honor
represents.

Daniel Carter
April 17, 1978

TABLE OF CONTENTS

CHAPTER I: Differential Appraisal in the United States

- A. Introduction
- B. Types of Differential Appraisal Laws
 - 1. Preferential Appraisal
 - 2. Deferred Taxation
 - 3. Restrictive Agreements
- C. Variations in Laws

CHAPTER II: Differential Appraisal as a Tax Policy

- A. Introduction
- B. Differential Appraisal Laws as Tax Expenditures
- C. The Purposes of Differential Appraisal Legislation
- D. Criterion of Evaluation
 - 1. Social Justice
 - 2. Consistency with Economic Goals
 - 3. Ease of Administration and Compliance
 - 4. Revenue Adequacy

CHAPTER III: Land Use and Differential Appraisal

- A. Introduction
- B. The Three Approaches
 - 1. Preferential Appraisal
 - 2. Deferred Taxation
 - a. rollback without interest
 - b. rollback with interest
 - 3. Restrictive Agreements
- C. Conclusion

TABLE OF CONTENTS

CHAPTER IV: Conclusion

FOOTNOTES

BIBLIOGRAPHY

CHAPTER I: DIFFERENTIAL APPRAISAL IN THE UNITED STATES

A. INTRODUCTION

Since the early 1950's the United States has experienced a suburbanization movement unparalleled in its earlier history. This phenomena of urban sprawl claims many millions of acres per year and consequently has had a serious impact upon land used for agricultural production around most of our urban areas. Developers, investors and speculators have been active in bidding up the price of rural land. Farmers in turn have had many opportunities to sell their holdings either piecemeal or in total. When they chose to keep the land in agricultural production, they have often found themselves the victims of both higher assessments for property tax purposes and the higher taxes associated with increased local governments to provide new residents with services which the farm population has hitherto regarded as unnecessary.

In order to retain agricultural and other nonurbanized land in their present uses, there has been increased acceptance of use-value methods of property taxation. Three principle motives have prompted this interest: (1) concern over the need for keeping high grade lands in agriculture; (2) a desire to retain existing high grade agricultural and

other developed lands around cities, as open space for greenbelts, scenic, and esthetic reasons; (3) the hope that tax measures can implement the efficient and orderly use and development of rural land around cities for their most socially desirable uses.¹

B. Types of Differential Appraisal Laws

Use value or differential appraisal laws can be defined as legislation which provides that farmland be appraised according to use value for agricultural production rather than market value. Basically there are three types of differential appraisal laws: preferential appraisal, deferred taxation, and restrictive agreements.

1. Preferential Appraisal

States that have preferential appraisal laws value land according to its current use. Under this approach land devoted to agricultural use is appraised on the basis of its value in that use and market value reflecting potential uses such as housing subdivisions are ignored.

Farmland on the rural-urban fringe appraised under this approach would be more consistent with the appraised valuation of similar farmland in rural areas. In both the rural-urban fringe and the strictly rural areas, a relatively accurate relationship would exist between the appraised value of farmland and its earning capacity.

Distinguishing characteristics of the preferential appraisal approach, however, are that the local government has no choice but to grant the appraisal if the landowner meets the requirements of the statute and there is no penalty if the landowner changes land use in future years.

One requirement of a preferential appraisal law is to separate the "bona fide farmer" from the "other user." If the law is successful in this regard it will remove the property tax as a threat to the continued use of land on the rural-urban fringe for agricultural production or open space areas. However, separating the "bona fide farmer" from the other user is difficult and requires an arbitrary definition of farmland or open space written into the statute or an arbitrary decision by the appraisal.

Under preferential appraisal legislation speculators may succeed in obtaining an agricultural classification by performing minimal farming operations. Thus, urbanization is enhanced rather than checked.

Nine states now have preferential appraisal laws: Arkansas, Colorado, Delaware, Florida, Indiana, New Mexico, South Dakota and Wyoming.

2. Deferred Taxation

Deferred taxation also provides for appraisal according to value in current use, but it adds a charge when land is transferred out of farm use. In most cases, the appraiser

also records the value he would have placed on the property if there had been no deferred tax law. In others, he determines market value retroactively when land changes to a noneligible use. It is then easy to multiply by the tax rate and compute the amount of taxes saved under the deferred tax provision. If the owner changes the land to some use which does not qualify under the law, a deferred tax is levied equal to the tax saving he received for several preceding years. Most states use three years. The difference between taxes actually paid and those which would have been paid without differential appraisal is totaled for the last three years. The owner is expected to pay immediately. A few states, however, use longer terms and several also charge interest. A recent trend, particularly where states were modifying an existing preferential appraisal law, has been to base the tax on the price when the land is sold, rather than the taxes foregone. The Connecticut and New Hampshire laws are examples.

A deferred tax provision removes some financial incentive for an individual who is holding land for relatively near-term urban use to apply for differential appraisal. He may save little money. The size of effect depends heavily on the amount of tax recaptured. For example, an individual who expects to hold a tract near a freeway interchange for 10 years and then build a large shopping center on it

probably would not be much deterred by a typical tax deferral of three years. He could still save a substantial part of 7 years' taxes. In the typical state with no interest charges, even a 10-year deferral period would permit him to make money on the interest earnings on his annual tax "savings" from the time the taxes would have been levied until the time when he actually had to pay them because he built the shopping center.

Currently 18 states have deferred tax laws: Alaska, Connecticut, Hawaii, Illinois, Kentucky, Maine, Maryland, Minnesota, Montana, New Hampshire, New Jersey, New York, North Carolina, Oregon, Rhode Island, Texas, Utah and Virginia.

3. Restrictive Agreements

A restrictive agreement is when the landowner and the local government agree to restrict use of the land in return for differential appraisal. Several states have laws permitting local governments to make this type of agreement with landowners. Typically, use of the land is initially restricted for 10 years, and either party must give several years notice if they intend to change land use. After a notice is given, either the land reverts to standard taxation or some type of charge is imposed. If the owner changes land use without following the agreement, more serious penalties result. Usually, the state or the

local government has an option of granting restrictive agreements only in those areas where it wants to preserve open space. The distinction between restrictive agreements and deferred taxes is not always clear. In a few states, the penalty for violating the restrictive agreement is mild and the law might be viewed almost as a deferred tax.

The restrictive agreement approach to land use is compatible with the ad valorem principle, taxation according to its value in the highest legal use. The highest legal use would either be agricultural production or open space and current use-value and market value would be similar. Restrictive agreements in effect could eliminate any non-agricultural value. The landowner under this approach receives the benefits from preferential appraisal but is denied any windfall gains he might receive from selling to non-agricultural uses.

Restrictive agreement laws are in operation in the states of California, Hawaii, Maine, New Hampshire, Pennsylvania, and Vermont. Florida has such a law for park, recreational, and open space land; Maryland has one for country clubs and woodland.

C. Variations in Laws

Currently forty-one states have adopted laws providing for the differential appraisal of farmland, such laws vary

considerably in their provisions. In addition to adopting the different approaches described above, some of the legislative provisions are very brief and leave the interpretation of many points to the tax assessors discretion while others are quite detailed and comprehensive. Some laws such as those of California and Maryland have been subject to considerable legislative revision.

Several of the laws are designed primarily to provide preferential tax treatment for farmers. An increasing number, however, utilize use-value appraisal as a means for directing land use and for preserving agricultural and open space areas around cities. The laws of California, Connecticut (which is supplemented with a separate capital gains tax), Hawaii and Washington provide excellent examples of measures which employ the use value appraisal concept for land use planning purposes.

Some of the leading differences in the individual laws center around their provisions relative to (1) size of eligible tracts, (2) prior use requirements, (3) productivity requirements, (4) permitted uses, (5) systems for determining use-value, (6) voluntary or mandatory participation, (7) rollback provisions, (10) application to partial sales or conversions, (11) application to building and improvements, and (12) treatment of eminent domain and forced conversions.²

All of the laws assume application to agricultural lands. Most of them however, have no provisions as to minimum acreage. Of those that do specify a minimum, most require tracts of five or ten acres, although Pennsylvania requires 50 acres of farmland or 25 acres of forest land with smaller acreages of farmland being acceptable if certain values of production standards are met.

The law generally assumes or requires that eligible lands have prior histories of agricultural use. Three states -- Delaware, New Jersey, and Oregon -- require that the land be used in agriculture during the preceding two years; Texas for the three preceding years and Florida, Kentucky, New Mexico, South Dakota and Utah for the five preceding years prior to special tax treatment. Arkansas requires that the land be designated as farm, agricultural or timberland by the board of county equalization. Maryland requires that it be zoned agricultural or have a current past history of agricultural or timberland use. Pennsylvania requires that it be classified by a local planning commission.

An interesting requirement included in several laws tends to discriminate against property owners who do not operate as commercial farmers. New Mexico requires gross production valued at \$100 or more in the two preceding years; Delaware, New Jersey, and Utah a gross production value of \$500 for each tract in the immediately preceding

two to five years, Kentucky \$1000 of gross returns for both of the two preceding years; Minnesota a gross of \$750 plus a minimum value of production of \$25 per acre, Hawaii a minimum of \$200 per acre except on pastoral grasslands; and Washington a minimum of \$100 per acre on tracts of 5 to 20 acres and \$1000 per acre on smaller tracts of farmland. Alaska goes a step further to require that the owner secure at least a fourth of his income from the land.

All of the laws permit and encourage the continued use of the classified land in agriculture. Many define agriculture as including horticultural and orchard use and use for livestock production. Arkansas, Delaware, Florida, Hawaii, New Jersey, Utah and Virginia specifically include forestry as an authorized use, while California, Connecticut, Pennsylvania, Rhode Island and Washington expand their coverage to include open space land.

Several of the laws make no mention of the procedures or guidelines assessors are to use in the determination of use-values for appraisal purposes. Criteria for appraisal are outlined in several laws, while in others the responsibility for preparing appraisal guidelines is specifically delegated to the state tax commissions. Capitalization of the land or of the gross rental values for the production of farm crops are indicated as the favored valuation technique in Connecticut and Iowa, while analysis of the sales prices of comparable lands for agricultural use is

avored in Kentucky. Provisions are made for the appointment of state farmland evaluation committees to advise assessors on appropriate use value levels in Delaware, New Jersey, Utah and Virginia, while provisions are made for county land advisory committees in Indiana.

Use-value appraisal applies automatically to all qualifying lands in several states. In Arkansas, California, Minnesota, Pennsylvania, and Rhode Island, however, land owners must apply to have their lands classified for use-value appraisal. In Connecticut, Delaware, Kentucky, New Jersey, Texas, Utah and Washington annual applications must be submitted for this purpose.

Eligible lands are classified on a year-to-year basis in most states. The leading exceptions are the classified property states; Maryland, which uses continuing classification; Hawaii, where the State Land Use Board reviews all agricultural district classification every five years; and California, Pennsylvania and Washington, where the classifications involve commitments to keep the lands in their present uses for periods of five or ten years.

Classification for use-value appraisal is automatically terminated in all states if the land in question shifts to or is developed for unauthorized uses. Land can also be declassified at the request of the owner. The laws in

Arkansas, Connecticut, Delaware, and Utah provide for termination of the classification if the owner fails to reapply. Owners who fail to reapply in Arkansas lose their eligibility for use-value appraisal classification for a period of four years.

Rollback provisions are included in the laws of 14 states with deferred tax arrangements. Alaska, Kentucky, and New Jersey levy a rollback tax equivalent to the difference between taxes paid and those that would have been paid under the second appraisal for the preceding two years. Minnesota, Rhode Island, and Texas have a three year rollback period. Maryland has the additional provision that the rollback tax shall not exceed five per cent of the full cash value appraisal of the land at the time the tax is paid. Pennsylvania, Utah and Virginia use a five-year rollback; Oregon, five year plus interest at 6 per cent rollback.

Of the states with rollback penalties, Maryland, New Jersey, Rhode Island, and Utah are the only ones with specific provisions that indicate that the rollback taxes will apply only to the lands that are declassified. The question of what happens with partial conversion or sale of classified holdings for unauthorized use is ignored in most of the laws.

Similar obscurities are involved with the question

of whether the classifications should cover buildings and whether rollback taxes should apply to eminent domain and forced conversions. Alaska, Connecticut, Florida, Hawaii, Minnesota and Utah provide for the inclusion of farm residences under the agricultural classification. California, Delaware, Kentucky, New Mexico, Oregon and Texas specifically exclude farm residences from this classification while the laws of the other states ignore this issue. On the subject of applications of the rollback taxes to land taken by eminent domain, Utah requires the rollback, while Hawaii, Rhode Island and Washington exempt classified lands from the penalty tax, and the other state laws make no mention of this issue.

Kansas is one of nine states which use the market value concept in appraising farmland for tax purposes. The other forty-one states use some form of use-value appraisal. The 1975 session of the Kansas legislature passed House Concurrent Resolution 2005 which was placed before the Kansas electorate in November of 1976. House Concurrent Resolution 2005 is a proposition to amend Article II of the Kansas Constitution. The proposition, which was approved by the Kansas electorate in November of 1976, adds a new section to Article II. This section states that land devoted to agricultural use may be valued upon the basis of its agricultural income or agricultural productivity - - -

actual or potential. The proposition goes on to read that such land will be assessed at the same percent of value and taxed at the same rate as real property subject to Section I of Article II of the Kansas Constitution. The proposition also states that the legislature may provide for a system of recouping lost revenue if use-value appraisal is enacted. However, Proposition 2005 does not direct the legislature to enact use-value appraisal, once approved by the people, the Legislature may or may not enact use-value assessment.

The general problem area of this report is concentrated upon the effects of use-value appraisal or differential appraisal legislation on land-use. As illustrated above, this problem area is relevant because the Kansas legislature is currently considering a differential appraisal bill. From a theoretical viewpoint this problem area is germane because the intent of most use-value appraisal legislation is to prevent the rapid turnover of prime agricultural land to urban use. Numerous studies have been conducted by economists, evaluating the effects of preferential appraisal on agricultural land. However, little research has been done by planners evaluating the effects of such legislation upon land-use.

CHAPTER II: DIFFERENTIAL APPRAISAL AS A TAX POLICY

B. INTRODUCTION

As the public becomes more aware of the limited supply of land relative to present and projected needs, there is an increased concern that society's needs may not be best served by an individual land owner's pursuit of his own personal goals. The regulation of private property for the benefit of society can be traced to the Roman Republic in the form of fire codes. To protect the public against the misuse of privately held land, governments in the United States have regulated private landowners through zoning and other regulatory measures, or in the public taking of privately held land through eminent domain.

Citizens of the United States have a history of freedom and a strong desire for personal liberty; controls, regulations and government ownership of the land is repugnant to their heritage. However, the populace looks to the government for conditions which secure title to land and allow the free market to operate. The public is not aware that much if not most, of the market values attached to the land are the product of society's need for the land and are not the result of their own contribution. Governments spend money in building roads, sewer systems and other

services which add value to privately owned land that is served by them.

Government is not powerless with respect to privately owned land resources. A limited power to regulate the use of land is inherent in the police power, the basis for zoning ordinances, development constraints and nuisance ordinances. The power of eminent domain has allowed the acquisition and use of private property for public purposes if due process and just compensation were employed in the taking. The present concern is with the third major area of governmental power over privately held property, the power of taxation. The assumption is that taxes, appropriately applied can so alter the individuals expected flow of costs and benefits from the options open to him, that he in pursuing his own self interest, will be led to choices more acceptable to the public and at the same time preserve the advantages of the market as an allocative mechanism.

B. Differential Appraisal Laws as Tax Expenditures

The power of taxation was historically conceived as primarily a means for generating revenue for governmental services, instead of a tool for achieving more general social objectives. There have been many instances where non-revenue objectives were important. Oil depletion allowances were designed to encourage exploration and

development of new reserves. The exemption of real property owned by churches, schools, and other charitable organizations from the property tax was designed to encourage private entities to carry on activities which otherwise would have become the responsibility of government or not carried on at all.

Use-value appraisal is a case where the incidence of the real property tax has been manipulated with the intent of achieving non-revenue objectives.³ The rationale is simple. All across the country rural land values and tax rates have been rising as urbanization moves out from the city to undeveloped areas. As this occurs, land acquires an increment in value over and above its farm use value because it can be used for residential, commercial and industrial purposes for such development.⁴ As previously mentioned, tax rates also rise because residents of the rural-urban fringe demand schools, water and sewer systems, roads, police protection and other public services which were previously unnecessary. Caught in the double crunch of paying taxes at higher rates on land whose market value was rising, farmers and other owners of undeveloped land sought to have their land appraised for real property tax purposes at farm use value rather than at its fair market value, which often included a substantial element of development value.

Use-value appraisal is an example of what has come to be known as "tax expenditures" pursuant to which the tax bills of some taxpayers are reduced as a result of special tax treatment. Tax expenditures take a variety of forms such as exclusions from the tax base, exemptions, deductions, tax credits, preferential tax rates and tax deferral. While there are borderline cases in which opinions may differ as to whether a particular item is part of the normal structure of a tax expenditure, there is little question that differential appraisal is the classic example of the latter.

The effect of a tax expenditure is precisely the same as if the taxpayer who receives the benefit were to pay taxes at the same rate as other non-preferred taxpayers, and then were to receive a simultaneous grant from the government in the amount of the tax benefit. Where tax expenditures exist, they have the effect of shifting the tax burden away from the preferred class to all other taxpayers in the amount equal to the benefits conferred
6
on the preferred class.

C. The Purpose of Differential Appraisal Legislation

Objectives in passing differential appraisal laws vary from state to state. But they generally fall into two
7
categories: improving equity and influencing development.

The rationale behind the equity argument is basically

that farmers pay too much property tax. Subscribers to this argument hold that farmer's property holdings are quite large in comparison with their incomes, and that therefore their property tax payments are too large relative to income.

The second group of arguments, which have received a major impetus recently with the upsurge of public interest in ecology and the environment, revolve around the need to influence land use and the pace and direction of development.

The equity argument as well as other criterion in evaluating a tax policy will be discussed in the remainder of the present chapter, while the development argument will be discussed in the subsequent chapter.

D. Criterion for Evaluation

A discussion of differential appraisal must be based on some assumption about the incidence of the property tax. As far as the land itself is concerned Netzer comments:

"It is generally agreed that taxes on the values of base land - the sites themselves exclusive of applications of reproducible capital in the form of grading, fertilizer and the like - rest on the owners of the sites at the time the tax is initially levied or increased. The tax cannot be shifted because shifting is possible under reasonable competitive conditions only if the supply of sites is reduced. But the supply of land is, for all practical purposes, perfectly inelastic." 8

The criterion for evaluating a tax as an instrument of public policy depends on the values of that particular economist. Writing in the eighteenth century, Adam Smith established four canons for evaluating a tax - taxes should be equitable, certain, convenient and economical. These criterion are still widely used, but much of their continuing relevance appears to have come from slowly changing interpretations of just what each term implies. Consequently, many economists use the four criteria suggested by Walter Heller: social justice, consistency with economic goals, ease of administration, and compliance and revenue adequacy.

1. Social Justice

What actually constitutes social justice or equity depends upon a person's values. Planners, public officials, and economists can observe what people consider importance in judging equity and then attempt to provide the relevant data.

One common view is that individuals should pay taxes according to the benefits they receive from the government. This view is often referred to as the benefit principle of taxation. From the standpoint of benefits received a prima facie case can be made for use-value appraisal. It can be argued that while farmers use relatively few of the services provided by local government in an urban fringe

area, such as central water, sewers and residential street maintenance. It is argued that the farmers taxes are entirely out of proportion in relation to the benefits he receives. Preferential assessment or restrictive agree- would help redress this imbalance. Deferred taxation would have the same effect and has the additional advantage, it has been argued, of automatically providing for additional revenue (collection of taxes deferred) when the land changes use and therefore probably needs added services.

The second commonly accepted criterion for social justice is that taxes should be apportioned in accordance with the taxpayers ability to pay. Equity in this sense is subdivided into "horizontal equity" - equal treatment of equals - and "vertical equity" - unequal treatment of unequals. This analysis is concerned principally with horizontal equity.

When dealing with large numbers of people, other factors are assumed to average out and often only income is considered in assessing the ability to pay. Virtually no evidence is available regarding property tax payments as a percentage of income of farmers on the rural-urban fringe vis-a-vis their urban neighbors with equal income. It could be theorized that, if farming is an individual's chief source of income, appraisal of his land on the basis

of its earning power in agriculture would bring his property payments into closer accord with those of a wage earning suburban homeowner with a similar income.

2. Consistency with Economic Goals

The examination of this criterion in the evaluation of differential assessment as a tax policy demands the consideration of the effects of such a tax on economic efficiency. Preferential assessment may reduce economic efficiency if economic efficiency is traditionally defined^{10,11} as equivalent to Pareto Optimality. This will be true because preferential assessment will reduce the costs of using land for one particular use, namely farming, relative to other potential uses and will thus interfere with the operation of the market in allocating resources. Deferred taxation would appear to be neutral if interest is charged on the taxes deferred at a rate equal to that which could be earned on similar investments and if the deferred period is long enough; otherwise, it also would¹² entail some loss in economic efficiency.

The assumptions that are necessary for "invisible hand" to allocate resources in an optimal fashion are highly restrictive. Perhaps the most important assumption for this discussion is the lack of externalities. External economies and diseconomies are legion in urban¹³ development. Large-lot residential development may

entail much higher sewer, water and road costs and the incidence of these costs is not on the landowner. Farms are thought by some to provide scenic and other values to urban dwellers. To the extent that community planning takes account of these "spillovers", the combination of differential appraisal and the planning function and outright purchase of development may contribute to economic efficiency.¹⁴

Concern has arisen among students of public finance about the present tendency to erode the property tax base by granting exemptions to many other types of property. While one might prefer to do away with most of these exemptions, the difficulty of doing so makes it hard to sustain an argument against differential appraisal on grounds of interference with economic efficiency. Restrictive agreements such as those used in Hawaii, California and Pennsylvania, however, provide local governments with another tool, which properly used might help to overcome inefficiencies due to spillovers.¹⁵

3. Ease of Administration and Compliance

The problems in administering differential appraisal are formidable. The assessor must determine which tracts of land qualify for differential appraisal. In most jurisdictions this means determining whether the land is in agricultural (or, perhaps, open space) use. It is

not easy to give the assessor a legal definition of agricultural land that does not leave considerable area for which he must use his own judgement.

The problem of determining agriculture use seems most severe under the preferential appraisal approach. It will perhaps be slightly less under the tax deferral, both because fewer taxpayers may apply for deferral and because some of the additional taxes eventually will be collected. When restrictive agreements are used, it can be argued that in entering into the agreement the local government has decided that land is in agriculture use; the assessor then need only consult the records.

A related and perhaps even more difficult problem is that of determining the value of land in agriculture use. In theory, this is simple; one merely capitalizes the earning power of the land when devoted to the permitted use. In practice, it is not that simple, although it is done. The problem would be simplified if the assessor had comparable sales against which to check his assessments. As the city expands, however, there are likely to be few sales of comparable property for which the sale price reflects only agriculture value. The assessor's problems are somewhat alleviated when restrictive agreements are used; then he may be able to find other properties that are subject to similar restrictions for a

comparable period of time. Even so, other factors may have influenced the sale price.

At a minimum, differential appraisal places an extra record keeping burden on the assessor. In addition, it often creates problems of which land qualifies for the special treatment as well as in putting a value on the land.

4. Revenue Adequacy

The revenue question revolves around the amount of funds the local jurisdictions will have to forgo if differential appraisal is adopted. A Maryland study¹⁶ estimated that preferential appraisal resulted in the reduction of tax revenue (at present rates) which averaged 3.6 percent in eight counties in the Baltimore and Washington, D.C. areas. Revenue loss is less of a problem under deferred taxation. If an adequate interest charge is levied and back taxes are collected for a long period, there is no revenue loss. Revenue is merely deferred. Losses could be substantial under restrictive agreements, but the little evidence available suggests they may have not been.

Dr. Barry L. Flinchbaugh, Public Affairs Economist at Kansas State University, concluded in his most recent study, Yes or No on Use Value Appraisal of Agriculture Land, that differential appraisal in Kansas would,

"Partially shift the county tax base from agricultural investment land to other forms of real and personal property... The shift will be greater in the rural areas than on the rural urban fringe. On the fringe the shift will be negligible if any. In most rural counties the immediate shift will actually be to agricultural investment land from other forms of real and personal property." 17

Because local governments in Kansas rely on the property tax as their main source of income, Flinchbaugh also concluded that use value appraisal of agricultural land will, "Increase general state aid to unified school districts and shift part of the tax burden from property
18
to sales and income."

CHAPTER III: LAND USE AND DIFFERENTIAL APPRAISAL

A. INTRODUCTION

One product of the increased environmental awareness of the sixties is the mounting concern for measures to influence land use towards what many people regard as socially desirable practices. Some advocates of differential appraisal view it as a tool for implementing a community plan for land use and development. The preceding chapter examined use value appraisal as a tax policy. This chapter will discuss differential appraisal as a development policy in connection with preserving agricultural and open space lands on the rural-urban fringe.

The term open space has become a popular maxim, however, it appears to cover a wide variety of concepts. To some, it means recreational areas -- parks, golf courses and similar land uses; to others, it appears to mean any low intensity land use. Still others value open space as a tool for influencing city development by forcing city expansion into particular patterns.

The role of agricultural land in an open space program depends on the type of open space that is desired. If open space is wanted for recreational purposes the role of farmland is sharply restricted. However, the preservation of agricultural land on the rural-urban fringe would be in compliance with the objectives of influencing city expansion

and low intensity land use.

Thomas Hady believes that "Whether differential assessment can actually fulfill its potential role in an open space program depends among other things, on whether it really helps preserve farming." ¹⁹ He feels that if there is a burdening, restrictive agreement farming is ²⁰ likely to remain. ²¹ Hady and others complain about the lack of solid research on the effects of preferential appraisal or deferred taxation as a means for preserving open space. Several articles have been written on this subject that offer opinions as to how use value appraisal preserves open space, but most authors complain that it is too early to obtain conclusive results. These findings will be discussed later in this chapter.

When theorizing about the effects of differential appraisal on land use it should be noted that farmer/landowners are not a monolithic group and own farmland for a variety of reasons. Some reasons make owners sensitive to changes in tax cost; others do not. For example, some farmers view farming as a way of life and are "wedded to their work". These farmer/landowners would not sell their land even if they could make substantial or even phenomenal gains. Some are in the farming business because they enjoy the life but still they would be willing to sell and pursue a different career if it seemed likely to produce more income. Others are speculators who are

carrying on a farm enterprise in order to obtain an income from the land while they wait for it to "ripen" for a higher use that will produce greater returns. Property taxes increase this groups holding costs a little, but are not really important in their decision to sell.

Each of these groups will react differently to a change in property taxes. If the main motivation is speculation, expected changes in land values may completely outweigh any probable change in taxes.²² Correspondingly, taxes are not likely to affect the farmer who is "wedded to his work", at least until they reach the point where he has no income left. The overall effects of differential appraisal depend on how many of each of these types of farmers are in a given area.²³ If there are many farmers who could be induced to change occupations or locations willingly, changes in the property tax level might significantly affect land use trends. Should the owner want to keep his land in its present use, but finds this financially difficult, the savings from some form of use-value appraisal may prove critical in enabling him to attain his desire.

The bid for land sold on the open market is determined by the highest and best use concept. Agricultural lands, no matter how efficient and productive, can hardly compete with urban uses in terms of dollars per acre.

B. The Three Approaches

1. Preferential Appraisal

The Council on Environmental Quality believes that because of the beforementioned reasons, preferential appraisal is only likely to make a difference in the rate of conversion to urban uses primarily for land that is in the hands of relative young owners who are either:

- (1) "farmers who want to continue to farm and are in a location where farming is not impeded by urban neighbors, or

24

- (2) people who want a country home."

The Council felt that the tax savings for these people may be large enough to play a significant role in their decision to sell.

One reason preferential appraisal appears to be ineffective as a means for preserving open space is that there are no disincentives to the owner if he decides to change use. In fact, preferential appraisal might be a boon to speculators in that it lowers the carrying cost of land, making it easier for the speculator to hold the land until it ripens. Preferential appraisal could possibly free additional capital to purchase other land for speculative purposes by this reduction in carrying cost. If this happens, the net result will be that the price of land on the rural-urban fringe is increased thereby eradicating the intended advantage of such a tax.

2. Deferred Taxation

Deferred taxation places responsibilities on the landowner to maintain his land in its current use. Under the deferred taxation approach to differential appraisal the landowner must pay a monetary penalty when he changes land use. The size of the penalty and therefore the amount of deterrant to changing uses will vary from state to state depending on the number of years deferred taxes are collected. The typical period is three years, but some states have longer periods and charge interest.

a. Rollback without Interest

The Council on Environmental Quality concludes that the penalty imposed by the rollback without an²⁵ interest charge is very minor. Deferred taxation without interest simply allows an owner to postpone paying certain taxes until his land is developed. This is equivalent to an interest-free loan to the owners.

Even the total amount of the rollback is not large in proportion to the market value. Tax rates are generally in the range of one to three percent of market value and the rollback taxes are computed only on the difference between farm and market value. Even in states such as Oregon which have a ten-year rollback the tax would amount to no more than thirty percent of the difference²⁶ between appraised value and market value. Tax bills of

such proportions would not seem to constitute a major psychological barrier to selling for development when a landowner is on the threshold of large capital gains.

b. Rollback with Interest Charge

Some state statutes require an interest charge in addition to the rollback penalty. This stipulation could create a real penalty but only to the degree that the interest rate charged is higher than that which a landowner would have to pay were he to borrow from a commercial lending institution. According to this reasoning, interest rate charges in force have not constituted a real penalty for conversion over the past several years in any state, except possibly Washington or Hawaii which specify an interest charge of ten percent.²⁷

Gloudeman has also concluded that the rollback penalty, even with an interest charge, cannot offset the increase capital gains which are usually realized when land is converted to urban uses.²⁸

Not suprisingly, it has been found that the rollback and the rollback plus an interest charge is a smaller percent of total market value in areas with rapidly increasing appreciation rates. In these areas the rollback including interest is less of a deterrent to selling in areas where demand for land is growing rapidly. Ironically then, the rollback is less effective in the areas in which a deterrent to selling for development is desired.

In areas where the demand for development is low the rollback constitutes a relatively important deterrent to sale for development.

An additional drawback to deferred taxation is that such a program will not be effective in influencing the decisions of a landowner who has refrained from entering. Some landowners may be dissuaded from entering this type of program even if it might be in their economic interest to do so. To these landowners the promise of being required to pay a large amount of back taxes, possibly with interest and the time and expense required to enroll their land, more than offsets the advantages of a reduced assessment.

Most authors conclude that deferred taxation, even with an interest charge, is not likely to be an effective deterrent to development. This is particularly true in areas where demand is high and land values are rapidly appreciating. However, many authors argue that the rollback provision is necessary from the standpoint of equity. They argue that without the rollback provision, preferential assessment laws provide a free ride to the speculator, at the cost of others whose taxes are increased to make up the loss in revenue.

3. Restrictive Agreements

The restrictive agreement typically regulates the use

of land and has safeguards to insure that this use is continued for a specified number of years. The Council on Environmental Quality believes that restrictive agreements have "considerable potential as a means of maintaining current use, at least over the term of the contract."²⁹

The Williamson Act in California established restrictive agreements in that state in 1965 and a number of authors have explored its effect on land use. The Act has not been especially capable of maintaining current land use in California largely because they are voluntary and an owner of eligible land may not choose to enroll in the program.

The consensus of the literature is that only owners who are committed to agriculture and have no expectations of developing their land within the next ten or fifteen years will put their land under contract. Those whose land is ripe for development or who expect that it will be within ten years have usually declined to enter the California program. Carman and Polson, studying the California experience found that:

"Land placed in the program was below average value and probably in little immediate danger of being converted to nonagricultural use." ³⁰

Not only was the land of below average value, but it was likely to be more than ten miles from the nearest incorporated area. This is not surprising. Net savings

arising from differential taxation are small relative to other farming costs and to the potential capital gains to be derived from the sale of land on the rural-urban fringe. During the ten year work out period after notice of non-renewal, the owner cannot develop, but must pay roughly sixty-five to one hundred percent of the taxes he would pay if he were not under contract.

The California Land Conservation Act has been criticized for its inadequate performance as a land use management technique. Among those arguing that its existence has not affected the allocation of land use in a socially beneficial way are: the League of California Cities, the Department of Conservation of the State of California, the Sierra Club, the California Legislative Analyst, and a Ralph Nader Task Force. One fear of the critics of the Act is that it might tend to exacerbate urban sprawl by causing leapfrog development patterns.

This concern that restrictive agreements might cause checkerboard development was further augmented by the Council on Environmental Quality. The Council felt that:

One aspect of California's program may have a noticeable effect on conversion rates. The program creates agricultural districts within which contracts may be written. Participants have standing to protest cancellation. By creating a legal structure aimed at preserving agricultural use and vesting owners with an interest in maintaining the integrity of the district, the Act creates a new institution with a certain inertia which operates to retard

change. This effect may be more significant for the preservation of current agricultural use than the simple economic incentive of preferential assessment. 33

Although in many instances this development might be a positive aspect in the preservation of agricultural land, it has one major disadvantage. Checkerboard development could emerge if the county cancelled the landowner's contract and the abolition was denied by the courts.

The Council on Environmental Quality felt that the usefulness of the restrictive agreement approach for the maintenance of current use was effectively limited by the voluntary nature of the agreement.³⁴ They felt that "the potential usefulness of restrictive agreements coupled with differential assessment lies in their use as a mandatory device which is part of an overall conservation and development policy for metropolitan areas."³⁵ Although the Council's diagnosis of the situation might be correct, their solutions are likely to meet vocal opposition in the political arena.

C. CONCLUSION

Data is simply not available on the extent to which differential appraisal will preserve farming. In the view of the price land commands in urban areas, one might speculate that the effect of lower taxes is likely to be small. Similarly, it is difficult to assess the argument that differential appraisal laws have resulted

in large benefits to non-farm speculators, but the general opinion seems to be that speculators benefit greatly in areas where differential appraisal is used - particularly if it is preferential appraisal.

The voluntarism of the deferred taxation and the restrictive agreement approaches have been attacked by many authors, if a development policy is an objective of these programs. A Washington state survey demonstrates this concern is justified.

"Applicants for open space taxation do not appear to be on the brink of massive land use changes. The high percentage of applicants who plan to keep their land in its current use for more than fifteen years raises some doubt about the effectiveness of the program." 36

Figures previously cited concerning the distance from the rural-urban fringe of participants in the California system further substantiate this concern. The concern over the voluntary aspects of these programs is due to the fact that if an objective of the tax policy is to influence development in a socially desirable fashion some compulsory regulation is needed. Growth management cannot be attained if stricture is indiscriminately applied. Haphazard granting of current use appraisal without regard for the future development needs of the region appears to be as wasteful as no development plan, assuming that such a plan is desirable.

Conceding that a development policy is desirable, there is near unanimity among authors that to be an effective tool for achieving land use objectives differential appraisal should be accompanied with other measures that plan and direct growth. Recommended measures to accompany differential appraisal fall in the realm of regulations inherent in the police power and the budget process. Discussion of these recommendations is beyond the scope of this paper.

Presupposing that the retention of agricultural land is the main objective of use-value appraisal, Barry Flinchbaugh has developed a simple explanation of the effects of such a policy on this objective. Dr. Flinchbaugh explains that when land use is changed due to high property taxes the land is pushed out of agriculture. Conversely, when land use changes because of the prospect for large capital gains the land is pulled out of agriculture. He concludes that use value appraisal of agricultural land will "eliminate the property tax as a pusher of land out of agriculture."³⁷ However, differential appraisal will "not prevent the pulling of land out of agriculture when the price is right unless the restricted system is adopted and then only for the length³⁸ of the contract."

CHAPTER IV: CONCLUSION

When evaluating a public policy it is clear that there is no science of public policy in the sense that there is a science of chemistry. By experiment or accident a law of chemistry may be discovered. It will be true and "scientific". If the proof is valid and conclusive the law is established and accepted. No scientist would choose to dispute its existence or validity, much less its propriety. A layman who chooses to deny it is acting in ignorance without reason. Those, for example, who still deny that the earth is round have simply closed their eyes to the facts, but what they say and think on the subject has no effect on the fact and its scientific consequences.

But what people ought to do, or ought not to do; what is proper and what is an improper human or governmental relationship - those are problems which there can be, and usually are, differences of opinion. Even on such an apparently basic matter as murder, there is substantial differences of opinion on the subject as exemplified by laws of other countries (which are equally civilized). The answer to the problem of what constitutes a "good" public policy cannot be reached by any scientific process nor can the validity of the result be proved or disproved.

Differential appraisal is often perceived as a multiobjective policy instrument. Some people believe that such a policy will be an antidote to many variegated problems. Many farmers perceive that use-value appraisal will eliminate "unfair" taxation of their land on the rural-urban fringe. Others see differential appraisal as a tool to preserve open space and agricultural land near urban areas. It is often perceived as a tool or policy in achieving land use control. Some people believe it will achieve all of the beforementioned objectives. Opponents fear it is another tax break for rich landowners and will be a boon to speculators.

Public conceptions of use-value appraisal should be translated into specific goals. These goals should be adopted by the legislature into a workable bill. If differential appraisal is to be adopted, its adoption will be predicated upon the satisfaction of the stated goals, objectives and values of the Kansas legislature at that time.

If use value appraisal is viewed as a substitute for a development policy, the consensus of the literature reviewed is that this objective will not be fully realized under such a policy. Some authors fear that this policy might amplify urban sprawl. A number of writers on this

subject believe that differential appraisal might be effective as a component of a comprehensive land use plan. Persons who support differential appraisal as a means for preserving open space and establishing a process for orderly development are likely to be disappointed.

Use-value appraisal is a means to relieve owners of agricultural and/or open space land near the rural urban fringe of the burden placed upon them by the ad valorem method of property taxation. By itself use-value appraisal should not be expected to do anything more than bring relief to the targeted property owners. The justification of such a policy is found in the values of the public as expressed by their elected representatives.

FOOTNOTES

1. Barlowe, Raleigh, "Use-Value Assessment Legislation in the United States" Land Economics, (May, 1973), p. 207.
2. Ibid, p. 210.
3. Council on Environmental Quality, Untaxing Open Space, Government Printing Office, Washington, D.C. (1976), pp. 6,7,8.
4. Ibid.
5. Ibid, p. 6.
6. Ibid, p. 8.
7. Hady, Thomas F. and Sibold, A. G., State Programs for the Differential Assessment of Farm and Open Space Land. Agricultural Economics Report No. 256, Government Printing Office, Washington, D.C. (April, 1974), p. 6.
8. Netzer, Dick, Economics of the Property Tax, Brookings Institution, Washington, D.C., (1966), p. 33.
9. Heller, Walter W., "Taxation" Encyclopedia Britannica, Vol. 21, (1964), p. 839-841.
10. Hady, Thomas F., "Differential Assessment of Farmland on the Rural-Urban Fringe", American Journal of Agricultural Economics, (Feb., 1970), p. 28.
11. Pareto Optimality is an assumed social welfare norm (by means of a value judgement) whereby social welfare

is increased if one individual moves to a higher satisfaction level (indifference curve) without another man's satisfaction level being lowered.

12. Hady, Thomas F., op cit, p. 29.
13. Ibid, p. 30
14. Whyte, William, The Last Landscape, Doubleday, Garden City, N.J., (1968), pp. 78-101.
15. Hady, Thomas F., op cit, p. 28.
16. House, Peter W., Differential Assessment in Farmland Near Cities, Experience in Maryland Through 1965, USDA ERS-358 (1967).
17. Flinchbaugh, B. L. and Edelman, Mark, Yes or No on Use-Value Appraisal of Agricultural Land, Cooperative Extension Service, Kansas State University, (May, 1976), p. 13.
18. Ibid.
19. Hady, Thomas F., op cit, p. 32.
20. Ibid.
21. Council on Environmental Quality, op cit, p. 66.
22. Hady, Thomas F. and Sibold, A. G., op cit, p. 10.
23. Ibid, p. 11.
24. Council on Environmental Quality, op cit, p. 67.
25. Ibid, p. 67.
26. Ibid, p. 68.
27. Ibid, p. 71.

28. Gouldeman, Robert J., Use-Value Assessment Theory, Practice and Impact, International Association of Assessing Officers, Chicago, (1974), p. 10.
29. Council on Environmental Quality, op cit, p. 76.
30. Carman, Hoy F. and Polson, Jim G., "Tax Shifts Occurring as a Result of Differential Assessment of Farmland: California 1968-69", National Tax Journal, Vol, 24, (Dec., 1971), p. 449.
31. Gustafson, Gregory C. and Wallace, L. T., "Differential Assessment as Land Use Policy: The California Case", Journal American Institute of Planners, Vol, 41, #6, (Nov. 1975), p. 383.
32. Stanford Environmental Law Society, The Property Tax and Open Space Preservation in California: A Study of the Williamson Act, Stanford, Cal. (Feb., 1974), p. 84.
33. Council on Environmental Quality, op cit, p. 76.
34. Ibid, p. 77.
35. Ibid.
36. Barron, James C., and Thompson, James W., Impacts of Open Space Taxation in Washington, Washington Ag. Exp. Stat. Bulletin #772, (March, 1973), p. 73.
37. Flinchbaugh, B. L. and Edelman, Mark, op cit, p. 13.
38. Ibid.

BIBLIOGRAPHY

Barlowe, Raleigh, "Use-Value Assessment Legislation in the United States." Land Economics, (May, 1973).

Barron, James C. and Thompson, James W., Impacts of Open Space Taxation in Washington. Washington Agriculture Experiment Station Bulletin No. 772, (March, 1977).

Carman, Hoy F. and Polson, Jim G., "Tax Shifts Occurring as a Result of Differential Assessment of Farmland: California 1968-69", National Tax Journal. Vol. 24. (Dec., 1971).

Council on Environmental Quality, Untaxing Open Space, Government Printing Office, Washington, D.C. (1976).

Flinchbaugh, B. L. and Armstrong, Jay, Assessment on the Rural-Urban Fringe. Cooperative Extension Service, Kansas State University, Manhattan, Ks., (Feb. 1974).

Flinchbaugh, B. L. and Edelman, Mark, Use-Value Assessment Case Studies. Cooperative Extension Service, Kansas State University, Manhattan, Ks., (1975).

Flinchbaugh, B. L. and Edelman, Mark, Yes or No on Use-Value Appraisal of Agricultural Land. Cooperative Extension Service, Kansas State University, Manhattan, Ks., (May, 1976).

Gouldeman, Robert J., Use-Value Assessment Theory, Practice and Impact. International Association of Assessing Officers, Chicago, (1974).

Gustafson, Gregory C. and Wallace, L. T., "Differential Assessment as Land Use Policy: The California Case", Journal of the American Institute of Planners, Vol. 41, #6, (Nov., 1975).

Hady, Thomas F., "Differential Assessment of Farmland on the Rural Urban Fringe". American Journal of Agricultural Economics, Vol. 52, (Feb., 1970).

Hady, T. F. and Sibold, A. G., State Programs for the Differential Assessment of Farm and Open Space Land. Agricultural Economics Report No. 256, Government Printing Office, Washington, D. C., (April, 1974).

Heller, Walter W., "Taxation", Encyclopedia Britannica, Vol. 21, (1964).

House, Peter W., Differential Assessment in Farmland Near Cities, Experience in Maryland Through 1965. USDA ERS-358, (1967).

Koch, Robert A., Morrill, Harriet H., and Houseman, Arthur, Implementation and Early Effects of the New Jersey Farmland Assessment Act (New Brunswick, Rutgers n.d.) Rutgers Expt. Sta. Bul. 830, (1971).

Netzer, Dick, Economics of the Property Tax, Brookings Institution, Washington, D. C., (1966).

Stanford Environmental Law Society, The Property Tax and Open Space Preservation in California: A Study of the Williamson Act, Stanford, Cal. (Feb., 1974).

Whyte, William H., The Last Landscape, Garden City, n. J., Doubleday (1968).

THE EFFECT OF DIFFERENTIAL APPRAISAL
ON LAND USE CONTROL

by

DAN CARTER

B.S., KANSAS STATE UNIVERSITY, MANHATTAN, KANSAS, 1975.

AN ABSTRACT FOR A MASTER'S REPORT

submitted in partial fulfillment of the
requirements for the degree

MASTER OF REGIONAL AND COMMUNITY PLANNING
Department of Regional and Community Planning
Kansas State University

1978

Differential appraisal is a term used to describe a method of property taxation. Use value or differential appraisal laws can be defined as legislation which provides that farmland be appraised according to use value for agricultural production rather than market value. Basically, there are three types of differential appraisal laws: preferential appraisal, deferred taxation, and restrictive agreements.

Specifics of the three types of differential appraisal vary slightly throughout the forty-one states that have such legislation. Generally, states that have preferential appraisal laws value land according to its current use. Under this approach land devoted to agriculture use is appraised on the basis of its value in that use and market value reflecting potential uses such as housing subdivisions are ignored.

Deferred taxation also provides for appraisal according to value in current use, but it adds a charge when land is transferred out of farm use. In most cases, the appraiser also records the value he would have placed on the property if there had been no deferred tax law. In others, he determines market value retroactively when land changes to a noneligible use.

Several states have restrictive agreements in which the landowner and the local government agree to restrict

use of the land in return for differential appraisal. Typically, use of the land is initially restricted for ten years, and either party must give several years notice if they intend to change land use. After a notice is given, either the land reverts to standard taxation or some type of charge is imposed. If the owner changes use without following the agreement, more serious penalties result.

Differential appraisal laws use the governmental power of taxation in order to achieve general social objectives. The assumption is that use value laws will prevent the property tax from pushing the farmer off his land and preserve agricultural and open space land. Objectives in passing differential appraisal laws vary from state to state. But they generally fall into two categories: improving equity and influencing development.

The rationale behind the equity argument is basically that farmers pay too much property tax. Subscribers to this argument hold that the farmer's property holdings are quite large in comparison with their income and that therefore their property tax payments are too large relative to income.

The second group of arguments, which have received a major impetus recently with the upsurge of public interest in ecology and the environment, revolve around

the need to influence land use and the pace and direction of development.

Data is simply not available as to the extent to which differential appraisal will preserve farming. In the view of the price land commands in urban areas one might speculate that the effect of lower taxes is likely to be small.

Similarly, all three types of differential appraisal appear to have little influence on guiding urban development or retaining open space. Preferential appraisal appears to be ineffective as a means for preserving open space, largely because there are no disincentives to the owner if he decides to change use. Deferential appraisal offers some disincentives to changing use, but these vary from state to state and the capital gains realized from a change in use are likely to be greater than the imposed penalty. The restrictive agreement approach is limited by the voluntary aspect of such a program. Due to their voluntary nature restrictive agreements might tend to exacerbate urban sprawl by causing leapfrog development patterns. This fear is further augmented by the fact that a majority of restrictive agreements tend to be removed from the urban area.

Differential appraisal is a means to relieve owners of agricultural and/or open space land near the rural-urban

fringe of the burden placed upon them by the ad valorem method of property taxation. By itself differential appraisal should not be expected to do anything more than bring relief to the targeted property owners.