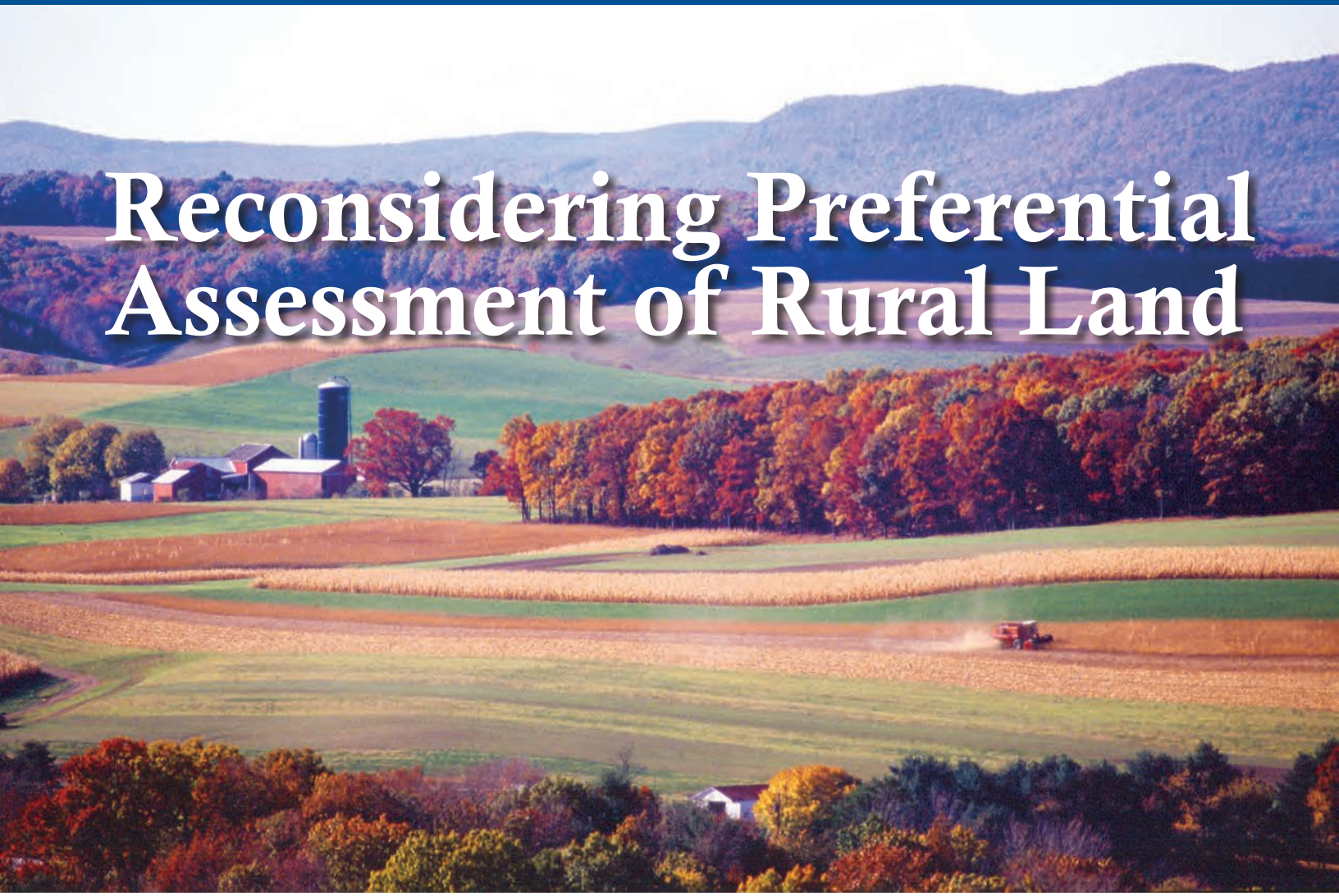
Reconsidering Preferential Assessment of Rural Land



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Working farmland in Klingerstown, Pennsylvania, is assessed for its agricultural use value.

Richard W. England

More than 50 years ago, a slowly unfolding but fundamental process began to transform property taxation in the United States. Because this process took place at the state and local, not federal, levels of government, and because the almost universal adoption of preferential assessment spanned several decades, most citizens are unaware that owners of rural parcels often enjoy such treatment of their properties. As a result, millions of acres of rural land are now assessed far below fair market value for purposes of local property taxation.

These modifications of the property tax began in Maryland in 1957, when the General Assembly enacted an agricultural use assessment law. This statute provides that farm fields and pastures can be assessed below market value as long as they are being "actively used" for agricultural purposes. As evidence of active agricultural use, an owner can document that the property had generated $2,500 or more of annual gross revenue from the sale of agricultural products during recent years.

Several factors prompted dozens of state governments to emulate Maryland and enact use value assessment (UVA) programs during the 1960s and 1970s. First was the massive expansion of U.S. metropolitan regions after World War II, which led to the conversion of tens of millions of acres of farm, ranch, forest, and other rural lands to residential and other nonagricultural uses. Alig et al. (2003) estimate that the nation's developed area more than doubled between 1960 and 1997, from 25.5 to 65.5 million acres. Rapid urbanization of rural land had come earlier to Maryland than other states because its populations in Montgomery and Prince George's Counties, near the fast-growing nation's capital in Washington, DC, quadrupled from 1940 to 1960.

Second, agricultural land on the fringe of metropolitan regions escalated in price during the postwar decades because of its development

potential, causing some farmers to face escalating property tax bills because of higher land value assessments. From 1950 to 1971, for example, there was a 330 percent increase in the ratio of farmland prices to net farm income in Maryland (Gloudemans 1974). A study of the two-state, seven-county Kansas City region in the early 1960s found that the proportion of gross farm income absorbed by the property tax in the most urbanized county was four times greater than in the metropolitan region as a whole (Blase and Staub 1971). Hence, adoption of preferential assessment of rural land was often justified as a policy measure to protect family farmers and ranchers from financial stress or even ruin.

A third and more subtle reason for the adoption of UVA programs reflects how the property tax had been administered in many states before 1957. Until that moment in U.S. history, county and municipal assessors had frequently given de facto tax preferences to farmers despite state constitutional provisions requiring uniformity and equality of taxation. These informal assessment practices were intended to provide property tax relief to "deserving citizens," but often resulted in dramatic differences in assessment ratios among taxable properties within the same community.

The expansion of state aid programs for local governments after World War II exposed some of these discrepancies. Property wealth per resident or pupil often played a major role in determining the formulas used to allocate state grants. Thus, pressure mounted at the state level for uniform local assessment practices to ensure an equitable distribution of state grants. The elimination of de facto tax preferences that had been granted by tax assessors to farmers and ranchers within their communities fueled efforts to gain de jure tax preferences for rural land via state statutes or constitutional amendments.

California was one of the early adopters of use value assessment of rural land. In 1965, its legislature passed the California Land Conservation Act, commonly known as the Williamson Act. The goals of this statute are to preserve agricultural land in order to ensure adequate food supply, to discourage premature conversion of farmland to urban uses, and to preserve agricultural properties for their open-space amenity values.

The Williamson Act enables counties and cities to offer preferential assessment of agricultural land to an owner in return for a contract barring land development for a minimum of ten years. After the first decade of the contract, an automatic extension continues every year unless the owner files a notice of contract nonrenewal. If such a notice is filed, the property's assessment rises annually until it reaches fair market value and the contract finally terminates after nine years.

Diversity and Extent of Use Value Assessment Programs

With little fanfare in the national media, preferential assessment of rural land has become a central feature of local property taxation across the United States. In California, for example, over 16.5 million acres of agricultural land were subject to Williamson Act contracts in 2008–2009. According to the California Department of Conservation, Williamson Act properties comprised nearly one-third of the state's privately owned land at the beginning of 2009.

More than 16 million acres of Ohio farmland had been enrolled in that state's current agricultural use value (CAUV) program by 2007. On average, those acres had been lightly assessed at only 14.2 percent of market value. In December 2011 the Ohio House of Representatives voted unanimously to expand the state's CAUV program to include land used for biomass and biodiesel energy production.

In New Hampshire, 2.95 million acres were enrolled in the state's current use assessment program in 2010. These preferentially assessed parcels comprised over 51 percent of the Granite State's total land area. Since agriculture plays a minor role in the New Hampshire economy, over 90 percent of this undeveloped acreage consisted of forests and wetlands, not farm fields and pastures.

Because economic, political, and legal circumstances vary substantially among the 50 states, it is not surprising that state governments have adopted diverse UVA programs. By 1977, eleven states had implemented programs in which eligible parcels enjoyed automatic enrollment. In another 38 states these programs required owners to file applications for preferential assessment. Nearly all states offered assessments below market value to agricultural land, but only 21 states extended preferential assessment to timberlands and forests.

From a land conservation perspective, the most important difference among the states is that 15 do

not collect a penalty if a landowner converts his property to an unqualified use (figure 1). Another seven states levy a percent payback penalty on development of enrolled land parcels. That is, the owner has to pay the state or town a percentage of the parcel's market value during the year of property development.

Far more common is the rollback penalty, a development deterrent that requires the landowner to pay the difference between property taxes actually paid during recent years of use value assessment and the taxes that would have been paid during those years with market-value assessment (plus accrued interest on that difference in some cases). Twenty-six states utilize this form of development penalty. Economic research has demonstrated that failure to levy a development penalty severely weakens the capacity of a UVA program to delay development of rural land at the edge of metropolitan regions (England and Mohr 2006).

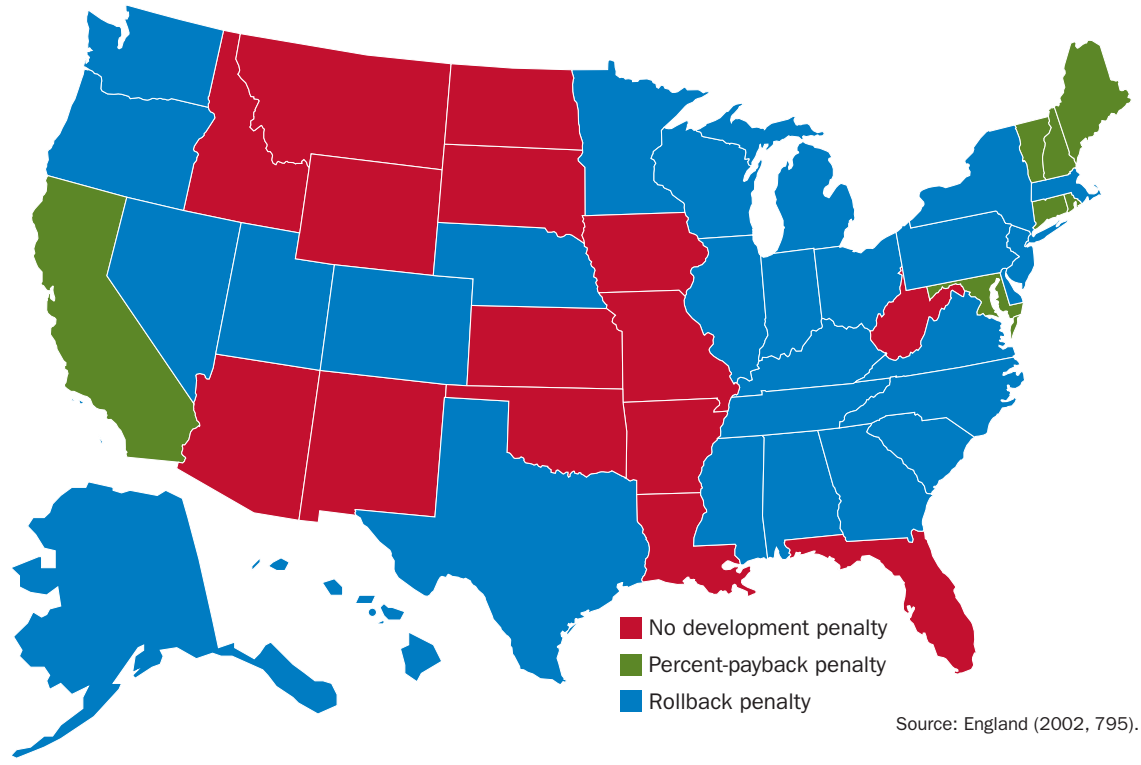
The practice of use value assessment sometimes creates political tension within a community and can even damage the legitimacy of property taxation as a local revenue source. In November 2011, a Wisconsin TV station reported that owners of vacant lots in an upscale residential subdivision had harvested weeds from their parcels and successfully applied for agricultural assessment of their house lots pending construction. This allegation led at least one state representative to call for legislative hearings about abuses of the state's use value assessment program. According to Rep. Louis Molepske, "It should upset every Wisconsinite because they are being duped by those who… [want] to shift their property taxes to everybody else, unfairly" (Polcyn 2011).

Saving Family Farmers and Rural Landscapes

Have UVA programs "saved the family farmer" as some proponents had originally predicted? Not exactly. During the 1980s, the U.S. farm population fell dramatically by 31.2 percent. From 1991 to 2007, the number of small commercial farms continued its decline, from 1.08 million to 802,000. During that same time period, very large farms (with at least $1 million of gross cash income) increased their share of national farm production from nearly 28 percent to almost 47 percent (USDA Economic Research Service n.d.).

If preferential assessment of rural land has not prevented the decline of family farming, has it slowed the rate of land development in rural

FIGURE 1
Development Penalties Levied by Use Value Assessment Programs, 2002



Source: England (2002, 795).

America? The evidence on this question is positive, but modestly so. A study of land use change in New Jersey from its adoption of use value assessment in 1964 to 1990 found that the program had a very modest impact on the rate of conversion of agricultural land to urban uses (Parks and Quimio 1996). After her 1998 study of nearly 3,000 counties across the U.S., Morris (1998) concluded that, on average, UVA programs resulted in roughly 10 percent more of the land in a county being retained in farming after 20 years of program operation. After their detailed study of land use changes in Louisiana, Polyakov and Zhang (2008) concluded that an additional 162,000 acres of farmland would have been developed during the five years after 1992 if there had been no UVA program in the state. It seems, then, that UVA programs have slowed down metropolitan sprawl somewhat during recent decades.

Shifting the Tax Burden to One's Neighbors

Although slowing the rate of land development is an environmental and public benefit of UVA programs, it entails a social cost. When the properties of farmers, ranchers, and forest owners are assessed far below market value, local governments collect fewer property tax receipts unless they raise the tax rate that is levied on all taxable properties. If they raise their property tax rates to maintain public expenditure levels, rural towns and counties increase the tax bills of non-UVA owners, primarily homeowners.

This potentially regressive impact of UVA programs has been known for decades. In its 1976 report on preferential assessment of farms and open space, the President's Council on Environmental Quality (1976, 6–8) stated clearly that these state programs result in tax expenditures of significant magnitude that redistribute income among taxpayers:

> All differential assessment laws . . . [entail] 'tax expenditures,' by means of which the tax bills of some taxpayers are reduced.... In most cases, the cost of this reduction is spread over all the other taxpayers. . . . The effect of a tax expenditure is precisely the same as if the taxpayers who receive the benefit were to pay taxes at the same rate as other, non-preferred taxpayers, and then were to receive a simultaneous grant . . . in the amount of the tax benefit.

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Farms in Maryland benefit from one of the earliest agricultural use assessment laws in the country.

The magnitude of this tax shift among property owners can be quite substantial. Anderson and Griffing (2000) report estimates of the tax expenditures in two Nebraska counties associated with the state's UVA program. The average tax expenditure is approximately 36 percent of revenue in Lancaster County and 75 percent of revenue in Sarpy County.

Dunford and Marousek (1981) have studied the impact of the 1970 Open Space Tax Act (OSTA) in Washington State on the distribution of the property tax burden in Spokane County. Eight years after enactment of the OSTA program, roughly 444,000 acres in Spokane County had been enrolled—about 40 percent of the county's total land area.

The authors calculate that the revenue-neutral increase in property taxes paid by nonparticipating properties to offset the tax cuts enjoyed by owners of enrolled parcels would equal 1.3 percent. Hidden within this countywide average, however, are huge

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Farmland on the edge of suburban neighborhoods, as here in central New Jersey, should be re-evaluated to determine its eligibility for use value assessment.

differences among communities. Although the tax shift to nonparticipating properties would be 1–2 percent in many localities, it would range as high as 21.9 percent in one community. The implication of this and other studies is that granting preferential assessment to rural landowners might help to delay development of their properties, but it might also impose a fiscal burden on homeowners as well as owners of commercial and industrial properties.

Reform of Use Value Assessment Programs

Because many states have had nearly half a century of experience with their UVA programs, this is a good time for state legislatures and tax departments to pause and ask whether this feature of their state and local tax system should be reformed or not. The shift in property tax burden caused by UVA programs in many communities can be justified only if this tax preference serves the broader public interest. The case for reform seems stronger when one realizes that 94 percent of farm households have a net worth greater than the median for all U.S. households.

After the severe downturn in residential and commercial real estate markets in 2008–2010, the rate of conversion of rural land to urban uses slowed in many states, at least for the moment. It might be easier for communities to consider and adopt reforms of UVA programs during this period when many owners of rural land do not expect to sell to real estate developers in the near future. After an extensive review of the research literature on state UVA programs, I recommend the following set of reforms (England 2011).

Those states that do not yet levy a penalty when land is removed from their UVA programs should do so. Unless the owner of rural land faces a penalty at the moment of development, he or she will simply collect the property tax saving offered by the UVA program until the market price of developed land is attractive enough. On the other hand, enactment of a high penalty per acre that declines with years of enrollment in the program could induce the owner of rural land to defer development for years. During those years, land trusts and state agencies have an opportunity to place conservation easements on those rural parcels that deserve permanent protection from development. In an era when few owners of rural land are poor working farmers, UVA programs should help to protect rural landscapes and conserve ecosystem services, not subsidize wealthy landowners.

States should also reconsider three categories of rural land that are eligible for use value assessment. (1) Farm and ranch land should not be enrolled automatically, as is the practice in some states. Rather, landowners should be required to document substantial net income from the sale of agricultural commodities during the previous tax year. This would prevent the owner of idle land that is about to be developed from receiving a property tax

break. (2) Agricultural parcels should not be eligible for use value assessment if subdivision plans have already been filed or if the parcels have been rezoned for residential, commercial, or industrial use. If there is substantial evidence that a landowner will soon develop a parcel, there is no reason to continue the UVA tax preference. (3) Forest, wetland, and other nonagricultural parcels should be eligible for use value assessment if they generate public goods such as flood protection, wildlife habitats, and scenic views. On the other hand, barren land with great development potential on the fringe of a metropolitan region should be assessed at market value if it does not produce ecosystem services that benefit society at large.

States should carefully review the income capitalization methods they employ to estimate the agricultural use value of rural properties. The guidelines for estimating the net income of agricultural land and for selecting the discount rate that capitalizes that income stream should be based on sound economic principles and should be presented to taxpayers in a transparent fashion. Because income capitalization calculations are so sensitive to choice of discount rate, that choice needs to be justified and should not be ad hoc. In principle, the risk-free rate of discount needs to be adjusted for inflation, default risk, maturity risk, and liquidity constraints.

State governments should acknowledge that, although their UVA programs generate environmental benefits for the general public, they also impose fiscal burdens on those localities in which private owners of rural land enjoy preferential assessment. For example, California enacted its Open Space Subvention Act in 1972 to mitigate the impact of the Williamson Act on local government budgets by providing state grants to partially replace foregone local property tax revenues. From 1972 through 2008, those subvention payments from Sacramento to the cities and counties totaled $839 million. (Subvention payments were suspended during 2009, however, because of the state's mammoth budget deficit.)

Since preferential assessment of rural land has become such a central feature of property taxation in the United States, governors and state legislatures need to pause and consider whether these types of reforms would improve the performance of and increase popular support for their UVA programs.

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