WHY RESEARCH FARM LAND OWNERSHIP AND FARMLAND VALUES, PARTS II AND III

By Dr. Mason Gaffney, Riverside, CA

(Part I was published in the August 2015 GroundSwell of this invited paper presented at the Assessment Workshop of the USDA-ERS-NRED and the International Association of Assessing Officers June 25-26, 1985 in Chicago, IL)

II. Major biases in land assessment

Assessors traditionally enjoy a certain latitude which may be used as de facto "industrial policy" (as the current fashion has it), and has been for decades past, to the degree that assessors must be or are responsive to local political pressures. It is hard to generalize about such biases because the pressures vary according to local attitudes, and the vulnerability to them varies with the local political structure.

Up until 1955 or so the preferential assessment of farmland occurred in many jurisdictions without benefit of law, and the legislative movement kicked off by then-Assemblyman Spiro Agnew of Maryland merely formalized and reinforced, to meet the new pressures of galloping urban sprawl, what had long been the fact. But in other jurisdictions we find assessment that is growth-oriented, where assessors find it difficult to locate new plants until a few years after they are built. In yet others assessment is oriented to "Urban Removal" programs with clear biases against unpopular minorities and/or putative generators of fiscal deficits.

In California, assessors achieved a higher degree of professionalism, and insulation from local politics, by the combination of excellent state supervision, and being elected in extremely large counties containing dozens or hundreds of local mayors and planning commissions. Yet this did not prevent, and probably worsened the bias against owner-occupied homes, as aforementioned.

Hard as it may be, nevertheless we must try to generalize if we are to use assessment data to estimate true values. We must first get an overview of the mosaic of complexity, and then generalize. What follows is my effort to that end.

A. Regressive assessment.

Not every researcher finds regressive assessment everywhere. Herbert D. Simpson, in his now obsolescent Tax Racket and Tax Reform in Chicago, found otherwise, but I have learned to suspect the provenance of this work. I myself have found it, everywhere I looked in the literature and in the field, and I am convinced it is the prevailing bias, even if not universal. It may be a matter of knowing what to look for.

A bias against homes, for example, is clearly regressive because the mean non-residential holding is much larger. In Milwaukee County industrial land is always under assessed relative to residential land across the street because the working rule is that subdivision triggers land reassessment (and our subject here is land assessment). In Oregon and some other timber states large timber holdings are routinely under assessed because the practice is to assume they will be used more slowly. In most of the Appalachian states the underassessment of coal reserves held by multinational giant corporations is a national scandal.

My own experience is that research grants dry up when one invades this area, which may account for why much of the evidence comes from marginal local crusaders and the Ralph Nader organizations. I was drawing beautiful Lorenz Curves and finding high Gini Ratios just before the Social Credit Party drove me out of British Columbia. It is a sensitive area which you enter at your peril, which reinforces my conviction there is something to it.

B. Raw Land

The most consistent and pronounced bias documented in the U.S. Census of Governments is that in favor of raw land. On this point there is, to my knowledge, no dispute, except that some people think it is a good policy so long as the land is "agricultural".

The line between raw land and cooked is a gray area, of course. It has been said that the wheel is the greatest invention because it converts real property into personal, a matter of great value in those jurisdictions that exempt some or all personal property from taxation. This point also bears on our present focus, which is land assessment. Building permanent improvements on land is often the trigger for reassessment of the land under and around the building. Running livestock or tractors, which are mere personal property, needs no building permit and triggers no reassessment. Ergo, certain kinds of farm enterprises receive more favorable assessment than other kinds.

In terms of regressively the U.S. Census of Agriculture makes it very clear that building improvements go with small farms, while breeding stock (the kind that needs fewer buildings than feeder and milking stock) and especially machinery on wheels go with larger farms.

C. Slow-turning classes of property

In many jurisdictions it takes a sale to trigger reassessment, which may therefore be avoided by sitting on lands quietly and avoiding attention. I know a Vermont farmer who will not sell the smallest corner of his now-exurban dairy farm for fear it might trigger a review of the whole, but that is small potatoes next to the steel corporation around Birmingham, timber companies around Seattle, estates in Orange County, and so on. The effects are not as extreme as the dead hand grip of old English entails, but tending the same way.

I have already noted what differential turnover rates do to median home assessments. Proposition 13 has further refined and legalized this now by providing that no upward reassessment (other than a nominal annual factor) can occur without a sale. If this seems to worsen the original problem don't blame me, I am only a camera at The Cabaret. It also ironically reverses the old doctrine of the innocent purchaser whose chastity was supposed to (continued on page 8)

WHY RESEARCH FARM LAND (from page 7)

sanctify all unearned increments. Now it is the ancient possessor, the least innocent purchaser, who is best protected from taxation. O tempora! O mores! But for technicians using assessment data the lesson is clear: restrict your data sources to the recent sales, then extrapolate from them yourself, the assessor isn't doing it for you.

Turnover alone may not generate the right information, either, where parcels traditionally are held in oversized units that resist subdivision. A reverse twist occurred recently when the 80,000 acre Irvine Ranch of Orange County, California changed hands. The county assessor appraised the land at about three times the sales price, using comparable sales and highest use. The new owners won a court case requiring him to use the new sales price instead.

They relied in part on the peculiar language of our own Proposition 13. But this case is a catercousin of the Oregon practice cited earlier of underassessing large timber holdings on the assumption that they will be sold out slower, an assumption tailored to the needs of those who are holding out against negative plottage. In the Irvine case the tradition is never to sell, only to lease. In Hawaii, of course, that tradition is statewide, presumably with parallel effects.

A growing and vexing problem is that of corporate landholdings. Corporations are our largest landholders. Ownership turnover occurs mainly through shares of stock; seldom by direct sale of specific assets. When assets do move it is often in large, complex bundles. This kind of ownership as it grows keeps reducing the reservoir of comparable sales on which to base valuations. Some California assessors under Proposition 13 are claiming that real estate has been sold (and may therefore be reassessed) when some arbitrary percentage of the shares are sold. I wish them all success. The successful assessor must be resourceful and bold!

D. Different assessment methods

It is time for assessors to stifle the refrain that they can use three methods of assessment on one roll at one time and reconcile the results. The plain fact is that comparable sales and capitalized income and historical cost, when applied to different properties, do not provide fair assessments as between the properties. Pick one method for all, and the only justifiable method is comparable sales. If some class of property doesn't generate many comparable sales, that is a good sign that assessments are too low, but meantime do the best you can with what you have and spare us the old saws that seek to square the circle. If you have to fight in court, do it. But stop underassessing industrial and commercial property on the pretext that you must use capitalized income in a time of inflation.

E. Preferential assessment

A lot of assessment bias is now legislated, of course, and assessors are innocent victims along with us all. We know about the institutionalized underassessment of farmland. In Spiro Agnew's Maryland this was supposed to save farms in suburban areas, although a relative in Potomac has removed his four steers, dropped from The Hunt Club, subdivided his 110 acres and retired, while Montgomery County is turning to TDRs (Transferable Development Rights) for salvation. In California, the homologous Williamson Act has been applied less in suburban areas than almost everywhere else. But no matter, the point here is that vast farming areas are underassessed by legislative mandate in more than half the states, so there is little reason to believe that farm assessments now yield any accurate index to farm values.

Fewer people know about preferential assessment for timberland. Second growth timber in California has long been exempt from property taxation, which may be a good thing unless you believe in uniformity, but the timber landholders had another problem. It seems that the land under the trees was valued for homesites and recreation, which was pushing up values and assessments. The late Don Hagman, beloved Professor of Law at UCLA, played Paul Revere on this but in vain as the legislature quietly slipped through its "TPZ" Act which, as Hagman kept warning, affects more acreage in California than the Williamson Act.

The moving force was our largest timber holder, Southern Pacific, a fact not sequestered but bragged on in the standard literature of business administration, where it is treated as a good example of creative business problem-solving; and TPZ means simply Timber Preserve Zone, and not anything about Crown Zed. But the land in the zone must be assessed on its capitalized income from timber culture, and nothing else. Now timber culture yields a return once every 50- 100 years, depending on the site class, and if you cannot imagine what kind of a capitalized income that yields I will tell you: about zero.

Then there are golf courses. Clubbing smooth ivory balls into holes from a green cloth is a sign of misspent youth, so they say in The Music Man, echoing a popular attitude. On the other hand, clubbing smaller dimpled balls into holes from green grass has redeeming social merit, our legislature believes, so California extends preferential assessment to golf course land. An 18-holer takes some 200 acres. The Los Angeles Country Club straddling Wilshire Boulevard near Century City and Rodeo Drive has a value at give or take $100 per square foot. This doublesized course actually has 36 holes, plus 3 for good measure, making perhaps 450 acres. At 43,560 square feet per acre, I leave the total value to your calculators.

But you will find no such calculation on the assessment rolls.

F. Tax exempt land

The extreme form of preferential assessment is complete exemption, about which so much has been written and so little said. To raise this topic is to arouse every latent anti-cleric, but their paranoia is out of proportion to the facts, at least in this country, unless we blame the churches for the cemeteries, which really are vast. Cemeteries in Milwaukee, Wisconsin, with space for the corpses of ages to come, preempt more land than all industry. Otherwise let us leave the dead past to Henry VIII and survey the present.

While serving on a Commission (cont'd on p. 9)

WHY RESEARCH FARM LAND (from page 8)
on Property Tax Reform in British Columbia I compiled extensive data on this matter and learned to look to the Universities -- not to their libraries but to their real estate records, if they keep any. Accordingly in California I find that UC-Riverside holds some 400 acres of urban land splitting up and repelling needed industries from its matrix, the City of Riverside; and another 840 acres blocking the path of the new boom city of Moreno Valley. It has no intention of relinquishing any part of either tract because they are tax free and the annual opportunity cost never appears in the budget.

But that is peanuts. Statewide the UC system holds 58,000 acres in fee. Meanwhile back at the "Leland Stanford Junior Farm" there are 9,000 acres in Palo Alto, less than the UC total but in perhaps the most desired industrial and residential area in the country, whence electronics firms are spinning outwards to find industrial sites. The area of San Francisco, for comparison, is 27,000 acres.

Around older eastern campuses a wry city planner has remarked that "Slums must create great universities, because it couldn't possibly be the other way around."

But as bad as we academicians may be we yield to the Pentagon, concerning which I will merely cite one small item, The Presidio in San Francisco, case closed.

Some assessors keep values on exempt land which often are not current because the incentive is weak to give priority to work with no payoff. On the other hand for someone wanting to estimate the subsidy value of exemption such values are very, very interesting. The social tragedy, however, is that the value of the subsidy to the beneficiary is usually much less than the cost to society.

G. Minerals

Minerals generally enjoy a high degree of preferential assessment. California is said to do an excellent job of valuing them but even here the man in charge, Robert Paschall, writes articles favoring a net proceeds tax instead. Things get worse as you go east, reaching rock bottom in Appalachian coal, noted earlier. The problems must be more institutional than physical: underground coal reserves are easier to measure than oil and gas. One notorious institutional problem is the provision of the Montana State Constitution that lands bearing copper shall never be assessed higher than the original price of $1.25/acre paid to the U.S. Land Office, a modest figure indeed for what was for decades "The Richest Hill on Earth" in "The Treasure State".

The preferential assessment of farmland based solely on farm income is an excellent way to keep mineral values off the tax rolls, at least until there is a mineral lease. The share of U.S. farmland that is prone to commercial minerals is perhaps 15%.

Minerals offshore in the OCS are in no state or local taxing jurisdiction. Upland Federal lands are, and local assessors can get taxes from private "possessory interests" thereon. Not so under the salt, however, and that is where so much of the action is today.

H. Water

Where there is a surplus of dry land, water is imitational, so part of the economic surpluses attaching to land are shifted to the water, and licenses to appropriate water assume great value. Some of those values show up on the tax rolls, mostly where some resented southern intruder is tapping northern waters. Thus San Bernardino County taxes Riverside, and Inyo County taxes Los Angeles. But those are exceptional, and more symbolic than substantive.

Licenses are colloquially called water "rights", and the colloquialism is tendentiously adopted by some lawyers, but such usage is legally presumptuous considering the precarious nature of licenses. The legalisms are complex and shifting, but the upshot is that many licensees have the best of both worlds: an asset with the economic substance of real property but a legal form that exempts it from the property tax.

Acquiescence in this condition is rationalized by presuming that the value of the water is reflected in the market value of the land to which it is applied and is, in some measure, "appurtenant". It is a half truth. The other half is that many licensees hold large surpluses of wasting waters which add little to their land values, and whose opportunity cost simply disappears from any social accounts.

It is widely believed that the removal of "legal obstacles" to free transfers of water will remedy the problem, and that such relief is imminent in this libertarian and deregulatory era. It is a touching faith which I was once guilty of encouraging. It is redolent of the 19th century dogma that "free trade in land" would solve the Irish land problem and reform and uplift English agriculture and modernize Europe and so on. Assemblyman Richard Katz of Sepulveda successfully carried legislation to remove legal obstacles to transfer of water rights in California. That was two years ago, but the first ensuing transfer has yet to occur.

There is plenty of frustrated demand. The problem is that it takes two to tango and the suppliers are in no hurry. Real estate agents abhor the unmotivated seller, and a resource holder free of cash drains and with no moving deadline is the least motivated seller in the world. There is opportunity cost, of course, but keep your eye on California and see how fast that moves the market. Meantime a substantial share of our imitational water resource remains without economic valuation because it is not assessed and it does not move in any market that creates recordable values.

That points up the mutual dependency of markets and assessments, a mutuality that is universal. We all know that assessments presuppose markets, but assessments help to make markets, too. Without assessments and land taxes, land markets turn to glue. Where there is neither one or the other some drastic exogenous force may be needed to start the system going. Was that not the historical mission of the Northwest Ordinance and the Homestead Act?

As valuable as water itself is the aquifer or reservoir site to store the water. Most of those escape assessment almost completely.

I. Radio Spectrum

This is the age of communication. (cont'd on p. 10)

WHY RESEFARM LAND ARCH (from page 9)

Old locational factors are made obsolete, they say, as signals bounce off satellites and video conquers all. Allowing for the hype there is a nub of truth there. But all these signals travel through a limited natural resource that has the essential characteristics of real estate: natural origin; permanence; fixed location; appropriability; police ability; and now salability, and at prices commensurate with the hype of the age of communication.

But little or none of those values appear on assessment rolls, except indirectly by adding something to otherwise ordinary land and capital used to utilize the spectrum. Spectrum is a major omission from any full accounting of national assets.

J. Rights of Way

Rights of way are traditionally valued with the rail or utility possessing them. Whether one uses historical cost or opportunity cost one likely undervalues them in their highest and best use, which is what they are, rights of way, created by delegation of the sovereign's priceless power of eminent domain. There is a large element of a peculiarly valuable form of pottage in the completion of a right of way.

To the extent that the undervaluation is shifted forward to consumers in lower rates it is a self-fulfilling valuation. The lost value is shifted to the consumers' real estate and does not escape the assessment rolls. But misvaluations of inputs do bad things to resource allocation and the incentives of utility executives. The whole tortured question of utility rate structuring and supply planning and system extensions may never be resolved until it is brought to focus on the neglected issue of proper valuation of rights of way. Meantime let us just enter a bold question mark over whether rights of way are being accorded the values they warrant. Those who have them seem loathe to relinquish them, and only grudgingly share their use with municipal utilities such as that of which I am a Commissioner, and whose primary obstacle to acquiring cheap power is getting access to transmission over the long, wide Rights of Way used by high-voltage power lines.

K. Severed Property

Sometimes valuable portions of the real estate bundle of rights are severed, become intangible or invisible, and escape valuation. Here are a few examples.

A Milwaukee department store sold a block of land adjoining itself, encumbered with a covenant not to compete. The assessor accordingly downvalued the encumbered block, but did not assess the beneficiary a corresponding premium.

Some jurisdictions are downzoning land and compensating the holders with TDRs (Transferable Development Rights). The downzoning will cause or sustain low assessments, but will the TDRs be assessed as real property, or will they be called 'intangibles", tax-exempt? (North Carolina is about the only state that tries to tax intangibles.) Even if they were assessed and taxed, how long would it be before a decent market developed for this novel form of property? Judging from Montgomery County, Maryland, it could be a long time.

In some regions, notably the long-suffering Los Angeles Basin airshed, pollution rights are being recognized. Really. I am serious, it is Coase's dream come true. Ancient and honorable polluters are deemed to have established the right to continue, or to sell that right to another. Thus they have established a de facto easement over the lands of their victims, or, excuse me, in Chicago we say "receptors". The receptors' lands lose value, obviously. But the polluter (or emitter in polite society) now possesses an intangible asset that does not appear on the assessment rolls. The same is true of airport landing rights, of course, vis-a-vis the afflicted householders under the end of the runway.

Leaseholds are an effective way to split up the bundle of rights. A mineral lease removes the major value inherent in certain lands from the local jurisdiction to White Plains, Bartlesville, Houston, or other headquarters. Of course a record remains locally, and it is piously to be hoped that appropriate valuations and levies are applied, but are they? How about overrides? Deals can be made as complex as someone wants, and it would be a good guess that something is lost in the shuffle. It is an area involving prodigious values, so the expenditure of some effort might identify large unrecorded sticks in the bundle of rights.

Some leaseholds on public land seem to be "sweetheart" deals, some of long standing. School section lands in certain states have achieved great notoriety. Boat moorings in big cities seldom seem to go to the highest bidder. Are these de facto possessory interests ever assessed and taxed?

The more one observes the more one realizes such examples could be extended indefinitely -- a rich field for researchers in land data who want to go beyond the assessment rolls.

III. Farmland assessment

Where does farmland stand in the bias scale? Somewhere in the middle. We have seen that assessors have trouble valuing "exotic" forms of property, and mobile and intangible and sophisticated and novel and invisible and underground forms. Farmland is the least exotic and most traditional form. Everyone, even the greenest elected assessor knows that farmland is land. Hammurabi taxed farmland in ancient Babylon and the cultural subconscious is inured to it. The mere vastness of land seems to justify a value, even when nothing else does, whereas the notion that a mere acre in downtown Chicago, New York or San Francisco could be worth $40 millions (@$1,000 per square foot) has a reputation for intimidating assessors into lowering the peak values down towards the mean.

But on the other side there is the equally traditional pathos (or bathos, as Hofstadter prefers) or protecting the sturdy yeoman and breeder of infantrymen. More operationally effective, I suspect, is political organized strength, an increasing share of it coming from that vast gray area that separates the city from the country where farmers are speculators and speculators may (continued on page 11)

WHY RESEARCH FARM LAND (from page 10)
be farmers and both are philosophers of the capitalized-income approach to land assessment.

So we cannot say with confidence that farmland overall is under- or over-assessed relative to some mean (which we do not really possess). But we can say that ripening land on the fringe between uses ("the margin of supersession", we were once taught) is under-assessed relative to land in more stable areas, whether rural or urban. Assessments here are something of a laugh, to the extent that we are permitted to laugh about serious matters. Here are some problems with the capitalized income approach to assessing farmland, which seems dominant in this area even where not mandated by law.

A. Amenity values

Capitalized income is based on cash income. But proximity to cities, and/or the good roads that lead to cities, has always been a major element of farmland value, without any reference to anticipated urbanization. Farm people shop in cities, see doctors there, work there part time, bank there, and generally benefit in many ways other than marketing food and fibre.

When Montgomery County MD went to TDRs they assumed that developers would buy them at a good price from the "sending" areas to apply in the "receiving" areas, but so far the prices have not been good at all. This suggests that the severed development rights were not as large an element in the values of the sending areas as assumed; that, rather, the imputed amenity and locational value for living under Hunt Club conditions and within reach of the Kennedy Center and K Street are a large part of the value.

B. Expected rising cash flows

Values capitalized from current income, using current mortgage rates, will be unrealistically low under inflationary conditions, and therefore have been for a long time into the past. When you buy common stock it is no mystery that your income comes in two forms, dividends and appreciation. If you rearrange terms in Equation (1) * in Part I so that the denominator on the right side is i alone, rather than (i-g), you will find the numerator has become (a+gV). But gV is the annual appreciation, which says that value is found by capitalizing the sum of ordinary current income plus appreciation, using the mortgage rate. (* $V = \frac{a}{i-g}$)

But assessors cannot do anything so "speculative". And so in those areas where they have to use the capitalized income approach they have been under-assessing farmland as farmland, using floating urban value as an excuse. They have acted and talked as though speculative expectations were evidence of urban influence, even though some were of rural origin. In addition, of course, many are indeed of urban origin.

Today an assessor might well reply "Aha, you see now, the market was wrong and so I was right." I cannot agree. The assessor is supposed to follow the market, not outguess it, and if a certain madness prevails he is supposed to go along. In so doing he will not worsen the overpricing but cure it quicker than anything or anyone else could. It was the lack of such a quick remedy that let the land bubble of the 70s soar so dangerously high above reality.

C. Tax shelter values

The value of farmland as a tax shelter is not news, but perhaps never so dramatized as in a paper by Finis Welch and Robert Evenson finding that the farm income reported on the 1040s of farmers in certain states was about 2% of the respective state's farm income as estimated by the USDA. California was one of those states; Florida was another. Such advantages can hardly fail to stimulate the demand for farmland, and thus to be capitalized into farm land values. The capitalized income approach, however, generally sifts them out.

D. Mineral rights

As noted earlier mineral rights, before being severed to a lessee, add value to farmland over vast areas, perhaps 15% of the country. Proneness to possible bonanzas raises market values, but adds nothing to the current income that is capitalized. In respect to regressivity it bears noting that in some areas farmland was so cheap that oil companies never bothered taking leases but simply bought titles, surface and all. In some other cases, like the Kern County Land Company, now part of Tenneco, a large rancher became an oil company. Texaco of White Plains, N.Y., now holds 77,000 acres in Kern County. It would be a pity were all that to be assessed purely on its net income, even potential income from farming alone.

E. Entitlement values

Much dry land in Southern California is "entitled" (in some sense) to future water by virtue of membership in a district that has paid some dues down on the California Water Plan to finance its works. Such entitlements are claimed to be "binding contractual obligations". Just how binding may depend on future voters, but there is at least a fighting chance there of future waters.

Of such figments are speculative land values made. But there is no current income to capitalize. This is representative of a whole class of "floating values" to which various landholders feel "entitled", and which they may actually acquire some day. Future events cast their shadows before them in the speculative price of land.

(Why Research Farm Land Ownership and Farmland Values was previously published in Almy, Richard R., and T.A. Majchrowitz (eds.), *Property Tax Assessment* (Chicago: U.S. Department of Agriculture, International Association of Assessing Officers, and The Farm Foundation, 1985), pp. 91-109.)

Part IV will be published in the next GroundSwell.

Economics Professor Dr. Mason Gaffney may be emailed at m.gaffney @dslextreme.com)