

# *Untaxing Open Space*

An Evaluation of the Effectiveness  
of Differential Assessment of  
Farms and Open Space

Executive Summary

Coastal Zone  
Information  
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1976

Published for the Council on  
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April 1976

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Executive Summary

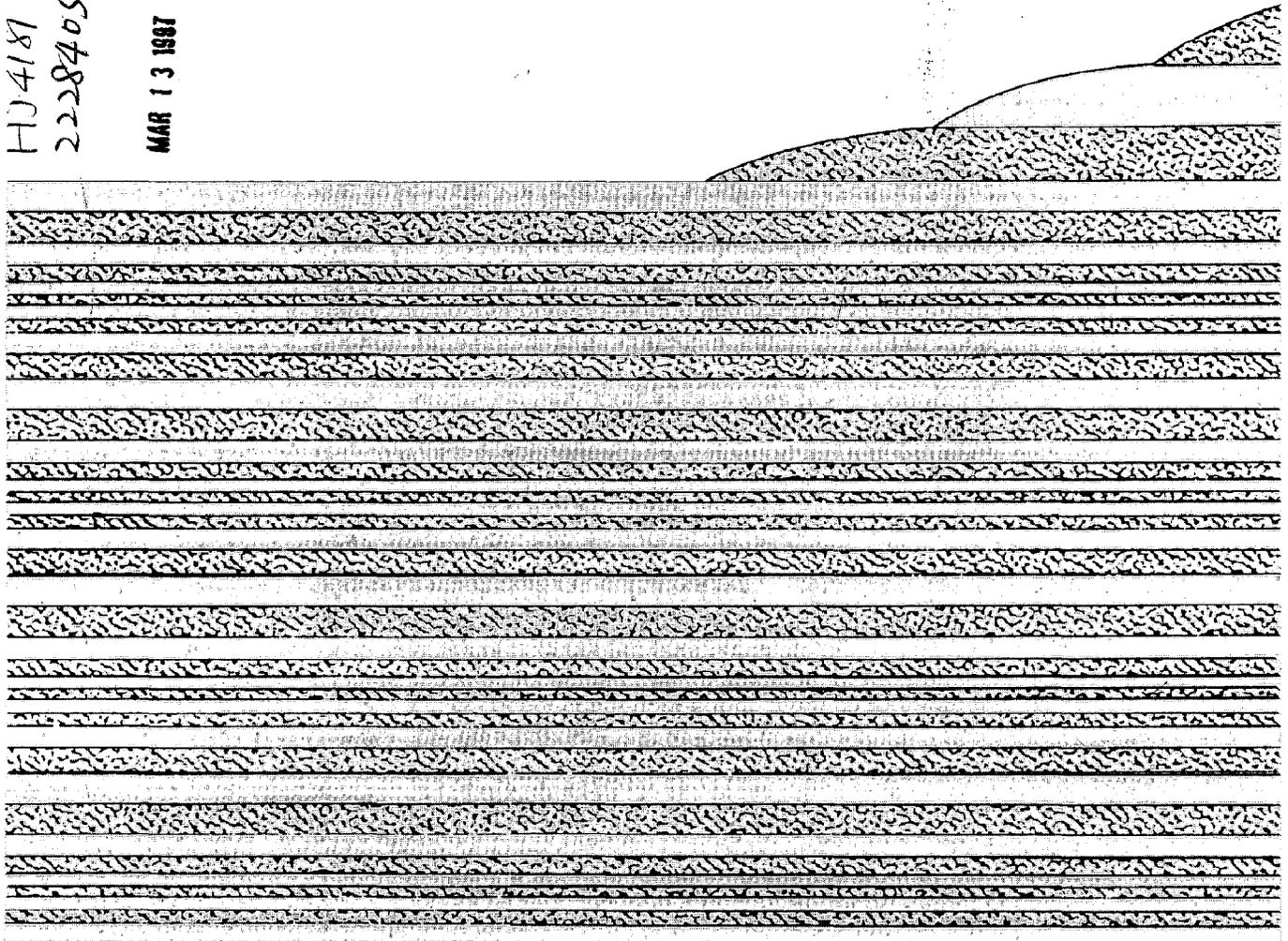
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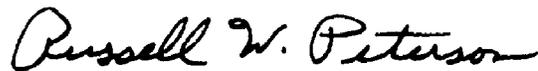
## PREFACE

Rural land values and property taxes paid on farmland and open space have been increasing in many areas of the country. To an alarming degree, these changes are caused by expanding urban areas that increase pressures for development over a wide area at the metropolitan fringe. As this occurs, land increases in value far above its farm or forest value because of its potential for residential, commercial, or industrial use. At the same time tax rates increase because new residents increase the demand for schools, water and sewer systems, roads, police protection, and other public services. Caught in the double crunch of paying taxes at higher rates on land whose market value is rising, farmers and other owners of undeveloped land have sought to have their land assessed for real property tax purposes at its current or farm use value rather than at its fair market value, which often includes a substantial element of development value.

Since 1957, when Maryland enacted the first statute authorizing differential assessment of farmland, 42 state legislatures have passed laws which granted preferential treatment to farm or other types of undeveloped land. Most of the remaining states either have so-called classification laws which allow modest preferential treatment of agricultural land or are currently considering differential assessment legislation. These laws were usually enacted to serve the dual purpose of easing tax burdens for farmers and preserving current farm and other open space uses. Underlying this rationale is the assumption that reducing the tax burden on such lands will reduce the rate at which they are converted to higher intensity uses.

The purpose of this report is to examine the effectiveness of these laws in accomplishing these important environmental goals. As the conclusions of the report point out, differential assessment laws in general work well to reduce the tax burden on farmers. Acting alone, however, they are not very effective in preserving current uses. It is only when such laws are combined with other effective land use mechanisms in rural areas that they contribute to successful long-term preservation of open lands.

We realize that the analyses and conclusions of this report raise questions about some of the claims that have been made in the past about the benefits of differential assessment. Nonetheless, we hope that the report will be seen as a positive contribution to understanding how these tax laws work and how they can be improved to serve both economic and environmental goals.



Russell W. Peterson  
Chairman

## CONTENTS

	<i>Page</i>
I. PURPOSE OF THE REPORT	1
II. STUDY METHODS	1
III. BACKGROUND	2
A. Differential Assessment Laws Seek To Provide Tax Benefits and Defer Conversion of Open Space .....	2
B. There Are Essentially Three Types of Differential Assessment Laws: Preferential Assessment, Deferred Taxation, and Restrictive Agreement .....	3
C. The Characteristics of State Differential Assessment Laws Vary Greatly in Both Eligibility and Attractiveness to Landowners.....	3
IV. FINDINGS	6
A. Differential Assessment Is an Effective Way To Provide Tax Savings to Eligible Owners .....	6
1. The Tax Benefits Depend on Land Market, Property Tax, and Program Factors .....	6
2. Preferential Assessment Provides Tax Savings More Effec- tively than Deferred Taxation or Restrictive Agreements .....	7
B. Differential Assessment Is an Inefficient and Expensive Tool for Achieving Land Use Objectives .....	7
1. The Burden of Property Taxes Is Only One of Many Factors Affecting the Farmer's Decision To Sell .....	7
2. Few Farmers Will Be Deterred from Selling by a Reduction in Property Taxes .....	8
3. Differential Assessment Is Essentially an Estate Planning Device for Farmers and Must be Supplemented by Stronger Development Controls.....	9
C. Differential Assessment Laws Raise Other Important Issues of Tax Equity, Ease of Administration, and Political Feasibility .....	10
1. Differential Assessment Increases the Tax Burden of Owners of Non-Participating Realty .....	10
2. Rollbacks and Subventions in Differential Assessment Laws Can Offset Tax Shifts .....	11
3. Preferential Assessment Is Easier To Administer than Deferred Taxation or Restrictive Agreements.....	12
4. Differential Assessment Programs Are Politically Attractive; Other More Effective Programs Face Political Obstacles.....	12
V. RECOMMENDATIONS	13
A. If differential assessment is to be a useful land use device, existing legislation should be amended .....	13
B. By itself, differential assessment is an inadequate tool for achieving the goal of maintaining current use. It is, however, a useful component of a broader approach .....	13

## I. PURPOSE OF THE REPORT

Over the last twenty years, most states have passed statutes granting tax relief in one form or another to farmers and owners of certain other kinds of land such as forest land. These laws, generically referred to as differential assessment laws, have authorized assessors to assess eligible land for real property tax purposes at its current or farm use value, rather than at its fair market value, which often includes a factor reflecting its potential for development. The legislation has usually been passed under the twin banners of tax relief for farmers and preservation of open space.

The purpose of *Untaxing Open Space* is to evaluate the effectiveness of the various types of differential assessment laws in achieving the expressed goals of tax relief and open space preservation and to explore some of their secondary impacts, especially those concerning tax incidence. As an input to this evaluation, the report presents detailed analyses of the differential assessment programs in nine states and general information about the programs in the rest. It concludes with recommendations for legislative reforms which would enhance the capacity of these programs to achieve their intended goals.

## II. STUDY METHODS

Four basic methods are reflected in the report. First, all differential assessment laws were compiled, analyzed, and classified into one of the following categories: pure preferential assessment, deferred taxation with a short rollback period, deferred taxation with a long rollback period, and restrictive agreement. (These terms will be discussed below.)

Second, case studies were done for nine states selected on the basis of the age of the program, the extent of urbanizing activity within the state, and the availability of data. These were: Indiana in the pure preferential assessment category; New Jersey and Maryland as examples of deferred taxation with short rollback; Hawaii, Oregon, and Washington as examples of deferred taxation with long rollback; California as the best example of a state with a restrictive agreement program; and Connecticut and New York as examples of programs containing unusual approaches of special relevance to the investigation. These case studies appear in Part Two of this report. Members of the research team interviewed government and private officials in each of these states and gathered information from public and private sources on the operations of the programs in each state.

Third, a statistical analysis was conducted to estimate relationships between the loss rate of land in farms and variables representing supply and demand factors bearing on the conversion of land from agricultural to urban uses. Data were collected at the county level for Ohio, New Jersey, and Wisconsin and on commercial farmers in Pennsylvania.

Finally, an extensive search was made of the literature on the real property tax, rural land markets, differential assessment, and related topics. These sources are cited in the bibliography which appears at the end of Part Two.

**B. There Are Essentially Three Types of Differential Assessment Laws: Preferential Assessment, Deferred Taxation, and Restrictive Agreement.**

Differential assessment laws are usually categorized as falling into one of three categories: Preferential assessment, deferred taxation, and restrictive agreement.<sup>1</sup>

*Preferential assessment laws* authorize assessors simply to assess eligible land on the basis of farm use value. They result in an abatement of the taxes which would have been imposed on the difference between assessed value based on fair market value and the assessed value based on farm use value.

*Deferred taxation laws* add an additional feature, by imposing a sanction requiring owners of eligible land who convert land to non-eligible uses to pay some or all the taxes which they were excused from paying for a number of years prior to conversion.

*Restrictive agreement laws* have both preferential assessment and, in all states except Vermont, a sanction in the form of a payment of back taxes and, in addition, require the owner to sign a contract spelling out his rights and duties.

All three types of differential assessment laws reduce the current carrying costs of the land which benefits. Such a reduction would tend to increase the desirability of owning—and thus the market price—of the land. However, this increase in value is most likely to occur under preferential assessment laws. Deferred taxation laws and restrictive agreement laws, because they restrict options and increase the cost of sale or conversion, may even depress land value, depending upon the severity of the restrictive agreements.

**C. The Characteristics of State Differential Assessment Laws Vary Greatly in Both Eligibility and Attractiveness to Landowners.**

Table 1 summarizes the provisions of state laws granting differential assessment to agricultural and open lands which had been enacted as of June 1, 1975. These data were assembled from two excellent earlier studies,<sup>2</sup> from information supplied by tax

officials in the fifty states, and from staff research. The program characteristics are explained in the notes which follow the table.

The varied approaches which states have taken to conferring the tax benefits provided by differential assessment can be analyzed along two principal dimensions. The first is the breadth of the eligibility criteria, and the second, the attractiveness of the program for eligible landowners. The more inclusive the eligibility criteria, the larger the class of owners who potentially may enroll. In a number of states with pure preferential assessment or deferred taxation with weak recapture provisions, it has been argued that the laws may even encourage land speculation and drive up prices by encouraging investment in land. As a state adds restrictions having to do with eligible uses, minimum farm income from the land, duration of ownership, planning and zoning requirements, and other factors, the amount of eligible land decreases. Even a program with broad eligibility, however, may attract only a small portion of the eligible owners, because rollback taxes decrease profitability, application procedures are cumbersome and expensive or, in the case of restrictive agreements, the owner is required to commit his land to current, open use for a period which may extend beyond the development horizon.

While it is possible to determine general information about criteria for eligibility, methods of assessment, rollback taxes, application and withdrawal procedures, contract requirements, and state subventions from the relevant statutes, the actual workings and the fiscal, economic, and land use effects of differential assessment laws are determined by administrative practices and the economic judgments of farmers, timber producers, developers, and other owners of potentially eligible land as they decide whether or not to enroll and later whether or not to develop. Many of the needed data on fiscal, economic, and land use effects are not available. Therefore, it has been necessary to draw on the knowledge and experience of informed government officials and representatives of private interests with a stake in the use and development of open land.

<sup>1</sup>See, e.g., Hady, Thomas F. and Ann Gordon Sibold, *Differential Assessment of Farm and Open Space Land* (Washington, D.C.: Economic Research Service, U.S.D.A., 1974).

<sup>2</sup>Hady, Thomas F. and Ann Gordon Sibold, *State Programs*

*for the Assessment of Farm and Open Space Land*, Economic Research Service (U.S.D.A.) (Washington, D.C.: U.S. Government Printing Office, 1974) and Gloude-mans, Robert J., *Use Value Farmland Assessments: Theory, Practice, Impact* (Chicago: International Association of Assessing Officers, 1974).

## Notes to Table I:

### Program Characteristics

#### i. Eligible Uses

*Agriculture:* The definition of qualifying agricultural uses varies across programs, but is generally quite broad, ranging from pasture to intensive cultivation. Associated waste and wooded land usually is also eligible, but the improvements generally are not.

*Open Space, Environmental Protection:* The definition of these lands is broad, but eligibility is usually contingent on approval by a public body. Critical natural, scenic, and historical resources are usually included in the list of eligible lands.

*Timber or Forest:* While 17 states include this as an eligible use, many also have forest taxation laws which provide greater benefits to landowners. (See the Washington and Oregon case studies, in Part Two).

Within the statutes listed here, there may be different intent in the preferential taxation of forest land from that behind the preferential taxation of "timber" land, with the latter implying benefits to harvesters and the former a reward for resource conservation. However, such distinctions are not apparent on the face of most statutes and the words seem to have been used interchangeably to refer to land with large numbers of trees growing on it. In several cases the eligibility of these lands hinges on the approval of a state official, such as the State Forester.

*Recreation:* These provisions are designed to benefit country clubs, golf courses, ski areas, hunting grounds, and other such recreational facilities.

#### ii. Additional Eligibility Requirements

*Minimum Farm Income Required:* This is typically worded in terms of a minimum required level of gross annual receipts, with an additional amount per acre in some cases. Two states require that the owner earn a minimum percent of his income from the land. In Minnesota, the owner must satisfy one or the other of these provisions, a requirement designed to make speculators ineligible while including low-income subsistence farmers. Two states which merely require that land must be used for profit are not included in this category.

*History of Eligible Use Required:* In these programs, the land must have been in the eligible use for a number of years prior to application, typically two years.

*Minimum Length of Tenure Within Family:* Programs listed here require that the land has been owned by the applicant's family for a period of years. In North Carolina and Minnesota, this is seven years, unless, in the latter, the applicant lives on the property.

*Land Must Be Planned or Zoned for the Eligible Use:* These provisions, which link preferential assessment to the land use planning process, are rarely included. When included, their strictness and effectiveness vary greatly across states. In most of these programs, a use must be allowed under the zoning ordinance to be eligible, but there is no provision that other uses could not be

allowed under the zoning category. Five states terminate eligibility when the owner applies for a zoning change or files a subdivision plan.

Connecticut and Washington have planning requirements for lands in the "open space" category but not for farmland.

#### iii. Sanctions on Conversion

While most penalties are assessed on conversion of the land to a non-qualifying use, a few states assess the penalty either then or at the time of sale. Eleven programs specifically require notification of changes in use, and some provide additional penalties for failing to do so.

*Rollback Taxes Collected:* These are usually calculated as the difference between the taxes that would have been due at market value assessment and the taxes actually paid under the program, summed over the number of specified years. For administrative simplicity, several states have changed this to a multiple of the difference between market and use-value taxes in the year of conversion. In a market with rising property values, this will produce a larger rollback.

*Interest on Deferred Taxes:* The interest rates range from 5% to 10% and are usually not compounded. Michigan has compound interest for early termination.

*Penalty Based on Market Value in Year of Conversion:* This is a specified percentage of sale price or market value at conversion.

*Other Penalty:* For withdrawal before a specified number of years, some states levy an additional penalty, such as a certain percentage of the deferred taxes.

#### iv. Restrictive Agreements

*Minimum Length of Term:* While the term is negotiable in most states, four out of the five states set a minimum length of term.

#### v. Scope of Program

A program is considered statewide if local assessors or governing bodies have no choice in the acceptance of applications from lands that meet the statutory eligibility requirements. In a very few cases, the laws apply only to specified parts of the state.

In the voluntary programs applications are required initially and in some cases annually. In the automatic programs assessment regulations for all specified lands are state mandated.

#### vi. State Subvention Payments

State payments to offset the revenue loss attributable to preferential assessment are provided under only three programs. In California, these are tied either to the estimated tax loss or the acres of land in the program, whichever is the lesser amount. In New York, subventions are provided only when the state initiates an agricultural district, which has not happened to date.

(For notes on selected state programs, see the full report.)

and condition the receipt of tax benefits on the owners signing legally enforceable long-term restrictive agreements which tie up the land for a specified period.

*2. Preferential Assessment Provides Tax Savings More Effectively than Deferred Taxation or Restrictive Agreements.*

The programs adopted by the states differ from one another in many ways, some as a result of the enabling legislation, some as a result of administrative practices and market conditions in the state. They can be arranged in a very rough spectrum with respect to their effectiveness for making tax benefits available and attractive to eligible owners. Pure preferential assessment programs with few eligibility conditions and methods of assessment which produce a low assessed value based on current, agricultural use value are most effective. They are easy for owners to enter and award full abatement of taxes on the development value of land. As eligibility criteria are multiplied and tightened, fewer will enroll and thereby receive tax benefits.

Deferred tax payments reduce the economic attractiveness of the program for farmers and thus deter some from enrolling their land. In existing programs, the rollback ranges anywhere from two years to the entire period during which the property received differential assessment. Interest is sometimes charged on deferred taxes, at rates varying from 5 to 10%. Obviously, the longer the rollback and the higher the interest rate, the less incentive there is for the farmer to enter his land in the program.

The restrictive agreement approach is least effective for achieving the goal of awarding tax benefits to owners of eligible land, because the prospect of being locked in, unable to develop their land, deters many owners from putting their land under contract. Only those in essentially rural areas or wholly committed to agricultural activity, who do not expect to develop their land within the period of the contract, are likely to enroll their land.

**B. Differential Assessment Is an Inefficient and Expensive Tool for Achieving Land Use Objectives.**

The second major objective of most differential assessment laws is to reduce the rate at which farm and other open land is converted to urban uses.

Advocates of the legislation argue, first, that a significant percentage of farmland sales for development occur primarily because of the profit squeeze felt by the farmer, especially in rural-urban fringe areas, and second, that since real property taxes are a significant and rising component of a farmer's costs, differential assessment programs which would lower or set a ceiling on these taxes would relax the squeeze and reduce the number of forced sales.

*1. The Burden of Property Taxes Is Only One of Many Factors Affecting the Farmer's Decision To Sell.*

The decision-making process which a farmer goes through when faced with an opportunity to sell his farm, however, is affected by many factors. On the one hand are the supply factors which are classified as being demographic, economic, secondary (those concerned with intrusions resulting from urban expansion), and transitional (those concerned with the farmer's desire to leave the area or quit farming). On the other are demand factors, such as population growth and construction of highways, sewage treatment facilities, and other elements of urban infrastructure, which are translated into the offer to purchase. The decision-making process is shown schematically in Figure 2 although the process is not, of course, sequential as implied in the chart.

As Figure 2 indicates, the real property tax is only one of many important factors influencing the farmer, and his decision will, in most instances, be determined by a combination of considerations. A review of the few available relevant studies as well as a survey of farmers undertaken for this project revealed the general consensus that demographic factors, such as retirement, death, and the presence of heirs to take over the farm, and the price offered for the land were the most significant in a majority of cases. High property taxes by themselves were cited much less frequently as reasons for sale.

To explore further the relationships between property tax levels and the conversion of rural land in the general context of aggregate supply and demand factors, regression analyses were formulated for county level data relating percent change in farm acreage to agricultural property taxes per acre, gross farm income per acre, increases in population density, and the percent of farmers over 65. Of twelve states where inquiries were made, only Ohio had data available in the form which could be used for

ential taxation may prove critical in enabling him to attain his goal.

But if the owner is indifferent, is influenced in his decision to sell by non-economic factors, or is actively looking for an opportunity to sell to a developer, the tax savings from preferential assessment will not have much effect in deterring him from selling.

Moreover, the farm owner may be forced to sell his land to pay unusual expenses (e.g., hospitalization) or to finance his retirement. Future tax savings will then be of little importance to him. Even if he keeps the land, his heirs may sell it to pay estate taxes or because they have no interest in farming themselves.

Whenever land is sold on the open market, the type of buyer will be determined primarily by the potential of the land for development and for agricultural production (and in more specialized instances its potential for strip or other mining). Except in strongly rural areas, urban uses can almost always outbid agricultural uses, no matter how efficient and productive. Tax savings will not be enough to make a difference. In addition, the ability to continue farming in the face of expanding urbanization could also be hampered by other factors, such as encroachment of urban activity.

Therefore, preferential assessment is likely to make a difference in the rate of conversion to urban use primarily for land that is in the hands of owners who either want to maintain a country home, or those relatively young farmers who want to continue to farm, and are in a location where farming is not impeded by urban neighbors.

For these people the tax savings may be large enough to enable them to maintain their land in an eligible use. Such people in such situations constitute a small portion of all those who are likely to sell their land.

Thus the "target population" for differential assessment laws which seek to deter conversions consists of farmers whose decision to sell or refrain from selling might be influenced by a reduction in property tax burden. But according to several studies, demographic factors are predominant in 55 to 60% of all sales, and correspondingly economic and other motives could be dominant in only 40 to 45%. In 1974, title was transferred to 5.5% of all farms in

the Northeast region. Even in this highly urbanized region, only 12% of these transfers were to sellers who were considered likely to convert the land to non-open space uses in the following five years. Combining these statistics, we find that less than 10% of those selling in any one year (or less than 1% of all farmers) may be potentially deterred by differential assessment from selling their land for development. Of these, those with land in rapidly developing areas may be assisted in continuing farming. However, if there is no significant penalty associated with the land conversion when such land does become available, a farmer considering buying it will have to pay a high, development-oriented price, and will thus be unable to reap a reasonable return on his investment from farming.

Thus, while the cost of differential assessment is measured by millions of dollars of tax expenditure to all participating landowners, its effectiveness with respect to the goal of maintaining current use is measured only in terms of the small number of farmers who are contemplating sale in a given year and who may be deterred from selling by a reduction in their property taxes. Even if differential assessment has marginal effectiveness for achieving this goal, it is an expensive way to do it.

*3. Differential Assessment Is Essentially an Estate Planning Device for Farmers and Must Be Supplemented by Stronger Development Controls.*

It is clear that all forms of differential assessment help to insulate the farmer from market pressures to sell which come to bear on him in the form of higher property taxes based on rising property values. They make it easier for him to schedule the sale of his land for a time, such as retirement, which fits into his estate planning.

One of the central issues raised by differential assessment with respect to the goal of maintaining current use is which of the following systems for timing the sale and conversion is best:

1. a system which keys the conversion of open land to the personal life cycle and estate planning considerations of individual farmers;

2. a system which relies on the push of rising property taxes and the pull of high offers to ease land into development;

3. a system which relies more heavily on governmental resource and development planning to

value) then the tax rate would have to be raised by 33%. All taxpayers would face this increase, but for owners of participating land, it would be offset by the reduction in assessment. The full increase of 33% would be faced by non-participating landowners, typically townspeople, businesses, and industries. Figure 4 indicates how tax rates must be adjusted depending on the average reduction in assessment and the portion of the tax base (before differential assessment) in participating land.

Analyzing actual data on tax shifting indicates that of 39 Florida counties, over half (21) experienced a tax rate increase of less than 4% and all but 3 had an increase of less than 10%. A study of 151 rural New Jersey townships revealed that over

half had tax rate increases of under 20%, while another 40% had increases of 20% to 50%. Analysis of California data showed that of the 46 counties under the Williamson Act, 38 or 82% experienced revenue losses of less than 3%, six, of 3% to 9% and only two, of more than 10%.

2. *Rollbacks and Subventions in Differential Assessment Laws Can Offset Tax Shifts.*

The tax rollback or conveyance tax provisions which thirty-two states have enacted serve to mitigate the tax shifts discussed above, when farmers start selling participating land for conversion to ineligible uses.

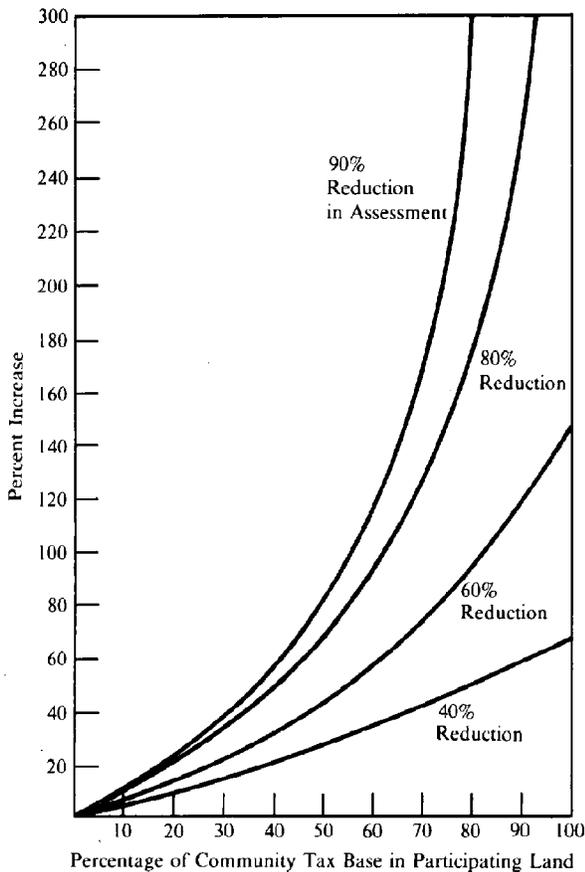
As the real estate market adjusts to the new tax ground rules established by a differential assessment program, values of differentially assessed land will tend to rise (because carrying costs are reduced), and values of other land will tend to fall because taxes attributable to it are somewhat higher. Of course, the rollover and recapture of deferred taxation and the provisions of restrictive agreements can reduce or eliminate this effect. All these effects will counteract to some extent the initial tax shift impact. In states with deferred taxation programs, deferred tax payments by farmers who convert add to revenue and thereby reduce the overall tax rate and the tax shift.

In summary, the tax shift in a small rural township could be quite significant, if land is under development pressure. In a large community with a significant non-farm tax base, it will normally be a much smaller percentage. On a statewide basis, in the four states of those studied which had sufficient data, tax shifts constituted less than 3.5% of total tax revenues. While the percentage of shifts were relatively small, the amount of tax shifts was significant. In Washington (with a relatively new program) it was \$2.7 million, in Oregon, \$24.9 million, in New Jersey, \$40 million and in California, \$60 million. As landowners enroll in the more recently enacted programs around the country, legislature after legislature will be confronted with the decision as to whether tax shifts of this magnitude can be justified either on the basis of tax relief for farmers (which they clearly achieve) or on the basis of the preservation of open land (which the evidence assembled in this report indicates they fail to secure).

Four states have adopted provisions which seek

Figure 4

Increase in Tax Rate Necessary to Compensate for Loss in Revenue Due to Differential Assessment



## V. RECOMMENDATIONS

*A. If differential assessment is to be a useful land use device, existing legislation should be amended (and new legislation should be written) so as to contain the following provisions:*

1. All differential assessment statutes should provide for deferred taxation in order to achieve greater equity among all taxpayers. The rollback period should be at least 10 years, and, preferably, the entire period during which tax savings were enjoyed. Interest should be charged on the deferred tax benefits at rates at least as high as those charged by commercial lending institutions.

2. States which mandate differential assessment by units of local government should provide at least partial compensation for the tax expenditures which result. The reason for this is that the benefits in preserving agriculture and open space which may result from differential assessment are enjoyed far beyond the boundaries of the local taxing jurisdiction in which the differentially assessed land is located. Therefore, the costs should be shared broadly, not borne solely by the non-eligible taxpayers of the local jurisdiction.

This can be done either by a state subvention, as in California, or through the use of a state income tax credit as in Michigan. In any case, uniform assessment procedures should be set up and enforced by the state so that each taxing jurisdiction is treated equally.

3. A statewide data system should be established and made part of the basic legislation. The information collected should allow officials to assess the tax expenditures involved in the differential assessment programs and to determine more accurately the impact of the program on rates of sale and conversion. This information would also be useful for general planning purposes.

*B. By itself, differential assessment is an inadequate tool for achieving the goal of maintaining current use. It is, however, a useful component of a broader approach which should have the following characteristics:*

1. Eligible land should be designated specifically following studies of its capability for agricul-

ture, the need for farmland and land in other open uses, and the projected demand for land for urban development, vacation houses, strip mining, etc. It is especially important that the agricultural districts designated be large enough to be functionally and economically viable and located so that they will be relatively free from intrusion of urban and suburban activity. The designation of these areas will determine large-scale land use patterns. Therefore, designation should be made by state, regional, or possibly county government, rather than by local government.

2. Strict controls should be placed on the development of designated land. If these controls exceed the limits of police power regulation, compensation should be paid to the owners, by such techniques as public purchase of development rights or the transfer of development rights. Funds for the public purchase of rights should be raised by the level of government which designates the eligible land, the major part of the funding coming from special levies on other land when it is developed. A capital gains tax covering at least a 15-year period would be one such levy.

The foregoing measures should prove sufficient to keep specified land out of development, but they will not necessarily be sufficient to keep it in agricultural use. To do that, additional policies would have to be enacted, perhaps including special incentives and subsidies. The detailing of such policies, however, lies far beyond the scope of this report.

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