

A Reprint from *Tierra Grande*, the Real Estate Center Journal

# In Defense of Market Value Public Interest Value Bad Idea for Appraisal

By Charles E. Gilliland

The drive to create government-owned environmental preserves has precipitated a controversy in the appraisal industry. Government agencies have acquired properties for which the cost exceeded market values. After such purchases were found to be illegal, some individuals suggested altering the concepts of market value and highest and best use to allow higher prices for environmentally significant real estate.

As defined in the *Appraisal Journal*, "Environmentally significant real estate is . . . a bundle of private real property rights that controls use of a parcel with attributes of geographical, biological, ecological, archaeological, paleontological, cultural, and/or historical significance to society" ("Highest and Best Use: Preservation of Environmentally Significant Real Estate" by Donald C. Wilson, January 1996, p. 76).

This idea has ignited controversy among appraisers because it threatens to alter current appraisal standards and inflate the cost of setting aside environmental preserves. This solution could pave the way to altering appraisal practice in other areas when market value estimates inconveniently obstruct planned projects.

## Eminent Domain

The government generally acquires property for public uses through condemnation or a purchase under the threat of condemnation. For example, private land transactions seldom occur to accommodate highway construction. The eminent domain process assumes that the public purpose constitutes greater value than the exchange value between typical participants in the private market. Furthermore, the process deems market value (value-in-exchange) in a private, competitive market between unrelated buyers and sellers to constitute fair compensation for private assets required to accomplish government objectives for the public good.

The government, however, rarely needs properties chosen at random from a market. Rather, it targets specific tracts because of their unique features. For example, properties located in the path of a planned highway are indispensable and, therefore, targeted for acquisition.

When a private user wants a property for a particular use, the buyer acquires it by offering a sum representing greater value for the current owner than continued ownership. These prices often exceed market value for three reasons.

First, no market for land in the envisioned use currently exists. Second, the buyer believes that profits from the envisioned use will exceed returns to current uses. Third, the owner clearly values continued ownership more than the value-in-exchange. Both the owner and the buyer harbor private property valuations that exceed market value. Clearly, offers at market value will not be accepted.

When current owners have no motivation to sell, government offers on land needed for a public project often meet determined resistance. However, allowing government to increase offers to more than market value would open the door to potential corruption. Condemning authorities could fashion special terms for favored constituents and vastly increase the cost of a public project in the process. Therefore, the courts in eminent domain proceedings have established market value as a fair basis for compensating owners when a public project requires private property. This solution ensures that government pays the opportunity cost of diverting the needed asset from its current use. Meanwhile, the previous owner receives compensation that could replace the property with an equivalent.

Typically, the government extends offers to property owners based on an appraised value at current highest and best use. Frequently, property owners object to initial offers, and the condemnation process focuses on estimates of the market value of the property. Appraisers rely on a commonly accepted set of definitions and principles to estimate these values. Because appraisers apply these principles, most controversies converge to a limited range of possible market values. A fact-finding entity then hears evidence and determines compensation.

## Acquisitions without Eminent Domain

When government undertakes a public project without the power of condemnation, the current owner can safely refuse to accept market value offers. If the agencies pursue these projects while constrained to market value, appraisals based on market values of currently competing private uses can obstruct the project. Agencies may find these appraised values to be a barrier when they fall short of an owner's reserve price. Because appraisers adhere to prescribed concepts when estimating market value, deals fail. An appraisal that could provide a different, higher value could remove those difficulties.

When proponents of both private and public projects that depend on real estate values encounter binding restrictions

linked to market value, they often pressure appraisers for a “more appropriate valuation.” This kind of pressure produced openly scandalous abuses and contributed to the savings and loan debacle in the 1980s. As a result, the appraisal profession came under public scrutiny. In some cases, appraisers even received prison sentences. The situation precipitated reform that culminated with the adoption of a set of Uniform Standards of Professional Appraisal Practice (USPAP) designed to assure the public that every appraisal meets specific requirements.

This 1980s housecleaning should ensure that proposed changes in the appraisal process face healthy skepticism. However, a new controversy centered on appraisals of environmentally significant real estate renews pressures on some appraisers to develop accommodating market-value estimates. Proponents of environmental preservation and politically influential owners of ecologically sensitive land have urged replacing accepted market value procedures, rooted in traditional highest-and-best-use analysis, with a new concept called *public interest value*.

## Public Interest Value

The Appraisal Institute defines public interest value as follows:

Public interest value is the value of a specific property to a public agency or other entity that purchases property based upon the purchaser’s determination that the acquisition is in the public interest. Public interest value presumes a negotiated purchase, as opposed to a condemnation action. (See *Report of the Appraisal Standards Council Subcommittee on Public Interest Value*, p. 2).

**P**roponents see public interest value as a means to circumvent the perceived constraints current standards impose on government acquisitions. They contend that current standards undervalue environmentally significant real estate. Specifically, proponents argue that the concept of market value and the principle of highest and best use can not adequately account for public interest value. Therefore, they believe appraisers reach flawed conclusions when appraisals are based entirely on the private marketplace.

Difficulty arises as government entities attempt to acquire environmentally significant property without condemnation. Most agencies are constrained to pay no more than market value. Appraisers estimate a project’s market value based on a projected highest and best use that identifies the comparable sales to consider. Appraisers ascertain the “reasonably probable” use of the property as that use which a dispassionate participant in the private market would envision at the time of purchase.

Governments are expected to pay only the amount required to divert land from the privately defined highest and best use. In other words, government must match the most likely bid in a private party transaction but not exceed that amount. To bid higher would allow government agencies to set prices in excess of private evaluations. Such a process could lead to government manipulation of markets to benefit specific

constituents at the expense of others. This would substantially distort the market’s efficiency.

**A**scertaining highest and best use sets the stage for the entire appraisal process. Because environmental preservation has not been a prevalent use among competing arms-length private party buyers, appraisers must turn to another use when setting market value. Public interest value proponents argue that appraisers should consider a “noneconomic” highest and best use to estimate market value. Especially on environmentally significant real estate, they argue, the value may substantially exceed the next best use. Appraisers should consider that fact in determining value.

The disagreement over these fine points of appraisal practice actually suggests abandoning market disciplines to achieve the ends of public interest value proponents.

In some transactions, government agencies frequently purchase environmentally significant real estate from land trusts shortly after those trusts acquire the property from a private individual. The trusts negotiate a price with the owner based on market value appraisals and sell to the government at that price plus a markup.

The problem arises when the government must obtain properties at market value. Market value can not differ for the land trust and the government agency on or near the same date. Thus, government transactions that appear to return a markup to the land trust run counter to price restrictions imposed by law.

For example, a May 1992 audit conducted by the inspector general for the Department of the Interior concluded that the department had paid in excess of market value in numerous transactions. Clearly, the market value criterion blocks the government’s purchase of environmentally significant properties. Using public interest value presumably would overcome this barrier.

Appraisers could be instructed to estimate a value based on environmental preservation as the proposed use. This kind of appraisal concentrates on purchases by public entities creating environmental preserves for comparable sales. Furthermore, public interest value appraisals

typically exclude adjustments for remote locations, assuming that the public interest is not sensitive to location. Proponents of public interest value contend that these appraisals reflect highest and best use and produce a market value estimate for the properties in question. Opponents vigorously deny this claim.

## Highest and Best Use and Market Value

The interrelated concepts of market value and highest and best use establish the validity of the appraisal process. These operational concepts, derived from economic theories about the problem of value, seek to derive an objective appraised value that reflects the cost of dedicating real estate to a given use. An estimated value derived via the traditional appraisal process represents the cost to society for diverting real estate from a physically possible, financially feasible, legal and optimum use to another use.

Highest and best use analysis simulates bids from various sources for a particular property at a specified time. The analyst considers each possible land use in turn, examining it in light of market operations. The procedure uses market

# Redefining appraisal to evade market value standard... invites abuse....

data to test the four-fold highest and best use criteria designed to establish the likelihood that a particular use could prevail in a contest to gain control of the property. Potential uses include agricultural production as well as consumer-related activities, such as recreational use. The result summarizes the current prevailing use subject to social values as they are expressed through the legal and moral context of the marketplace.

Properly conducted, a highest and best use analysis indicates the most probable outcome of this hypothetical competition for ownership. The prevailing use should represent value to the most effective user of the property because he or she can and will pay more for the property than anyone else.

Critics argue that highest and best use analysis does not consider the value of other so-called stakeholders in property use decisions. Subjecting appraisal to this limitation biases the process in favor of existing uses and excludes nonmarket values such as the value of environmental preservation, they contend. This line of argument essentially rejects the market as an efficient means of allocating land to various uses.

**I**ncluding highest and best use analysis in appraisal assumes that the market effectively organizes human activities to promote social improvement. The assumption rests on the powerful motivation of profit in return for promoting socially beneficial land development.

A framework of laws and customs governs acceptable enterprise practices. Within this social framework, however, owners can manage property as they see fit and realize the consequences. Generally, individual owners are viewed as being productive members of society who manage their affairs responsibly for their own profit.

In the case of environmentally significant property, highest and best use analysis will fail to provide a satisfactory result when the legal, economic and social context of the market

inadequately represents the true value of environmental preservation. That failure transforms the matter from an appraisal problem to a political and legal problem. Once a political solution has defined a social consensus through a legal or moral solution, the market can incorporate the value of environmental preservation into its price-setting mechanism.

The government's size and power ensure that it can never become just another buyer in the market. Using sales negotiated by the government for their conservation holdings to establish comparable sales creates the incentive to manage today's purchase with tomorrow's valuations in mind.

Rather than create a perverse incentive system when the process involves difficulties in acquiring real estate and necessitates the use of intermediaries, the most efficient solution should require a change in government acquisition rules, not a recasting of appraisal terminology. Either the government should authorize finder fees and pay costs incurred by interim purchasers or such acquisitions should occur under the auspices of condemnation. Either step would solve the problem of paying in excess of market value for properties acquired for environmental preservation. Those solutions would also open the process up to public scrutiny.

Any solution that seeks to change an established, functioning analytical process resembles a redrawing of the 100-year flood plain to accommodate development. Later, when the floodwaters invade a hospital, the recast boundaries drawn on a map provide scant comfort. Similarly, redefining appraisal practice to evade the market value standard leaves little practical constraint and invites abuse with special interests using government to control the market. ☐

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**Tierra Grande** (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115.

**Subscriptions** are free to Texas real estate licensees who provide their name, address, telephone and license numbers to Department JS at the address given. Other subscribers, \$30 per year.

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