

The New Noneconomics: Public Interest Value, Market Value, and Economic Use

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Some appraisers apply the term “public interest value” to what they call “noneconomic uses” of real estate. In particular, they have identified conservation use and preservation use (e.g., historical, geological, cultural, and open space) as “noneconomic uses,” uses that do not produce money income. This article examines the history and development of the concept of highest and best use as it is presented in trade and academic publications, and addresses the traditional underlying meaning of “economic” and “economics” to evaluate the implications of “noneconomics” to real estate valuation.

A major debate has developed within the real property valuation profession over the appropriate definitions and applications of the concept of highest and best use and market value. This debate has focused on the valuation of land, principally when it is underdeveloped and might be used for preservation or conservation purposes. Also included are sites on which significant archaeology, paleontology, wildlife habitats, and vulnerable ecosystems are found.

The term “public interest value” derives from federal legislation written in the 1970s, relating to federal land acquisitions and federal income taxes. Although “public interest value” is not specifically defined in either *The Appraisal of Real Estate* or *The Dictionary of Real Estate Appraisal*, the textbook does note “the issue of public interest value has come up in determining the just compensation required in land acquisitions by federal agencies.” [1] This is its first mention in either of the principal publications of The Appraisal Institute. Woodward Hanson, the 1996 chair of The Appraisal Institute’s Appraisal Standards Council, wrote:

As a result of considerable discussion and debate, The Appraisal Institute’s position on PIV (public interest value) and the related family of concepts is summarized as follows:

- If the purpose of an appraisal assignment is to estimate market value, then highest and best use of the property to be appraised must be an economic use.
- Preservation and conservation are not recognized as economic alternatives to be considered in the highest and best use analysis.
- Transactions involving purchasers whose intent is to preserve/conservate privately owned natural land should not be considered as reliable evidence in support of the market value estimate.

Until such time as the definitions of market value and highest and best use are changed, and until new systems are introduced to replace the current legal and market systems of

our country, the above policy will clearly govern the members of The Appraisal Institute. It should also serve as a guide to the profession, governments, and other users of appraisal services, and the public at large. [2]

These same points are made in *The Appraisal of Real Estate*, which states:

Huge amounts of public funds are at stake over what has become a highly controversial issue. Proponents of the public interest value concept recommend a redefinition of highest and best use and market value (*to recognize preservation or conservation as a highest and best use*), extension of the market concept to include public agencies and *conservation groups*, and adoption of alternative valuation methods. (emphasis added) [3]

NATURE OF THE DEBATE

The new nontraditional position is, therefore, that market value and highest and best use must reflect an economic use. Moreover, preservation/conservation is *not* an economic alternative to be used in a highest and best use analysis. However, “economic use” remains undefined and undelineated. Samuelson defines an *economic good* as “a good that is scarce relative to the total amount of it that is desired. It must therefore be rationed, usually by charging a positive price.” [4] If such a good can have alternate uses, are any of these alternate uses noneconomic? Land uses, such as residential, grazing, religious, forestry, archaeological, and wildlife habitat, all represent goods that are scarce, rationed, and priced. However, because some of these uses have been identified as “noneconomic,” some appraisers assert that their sale does not reflect market behavior or market values.

Real estate appraisal activity is governed, at least for those appraisers who are licensed (in most states) or are members of most professional appraisal associations, by The Appraisal Foundation in Washington, D.C. Its *Uniform Standards of Appraisal Practice* (USPAP) does not differentiate between economic and noneconomic uses, nor does it indicate how some types of property can be valued under the definition of market value, while others are valued under the definition of public interest value (which is not included in the USPAP glossary).

Land use for preservation/conservation has generated the greatest disagreement. It has attributes that allow it to be precisely defined. Some of those attributes are:

1. Presence or absence of cultural resources
2. Forested nature of the tract
3. Presence or absence of merchantable timber
4. Whether the property is a desert, wetland, or coastal property
5. Existence or diversity of geomorphic features
6. Size of the property
7. Size of the proximate population centers

These features can be used to differentiate nonurban lands from one another. Once differentiated, the categories exhibit unique patterns of prices within separate submarkets. Therefore, price becomes another differentiating variable. [\[5\]](#)

One part of the controversy revolves around whether sales of preservation/conservation property to various federal and state agencies represent arm's-length transactions. Sales of such property also occur between private entities, however. Other than *The Appraisal of Real Estate*, no authority has officially questioned the propriety of using private transactions, as have federal and state transactions. Therefore, a part of the "noneconomic" debate centers on whether sales to public agencies represent legitimate evidence of market value.

Market value is inferred from market prices. Price is derived from transactional evidence. As long as a purchase or sale is an arm's-length transaction, regardless of who the buyer or seller is or the purpose for which the property is acquired, that transactional evidence is a legitimate market indicator of price and, hence, of value. Based on our research, there is no sound theoretical basis or justification for introducing the disruptive concepts of public interest value and noneconomic land use. [\[6\]](#)

ECONOMIC VERSUS NONECONOMIC HIGHEST AND BEST USE DILEMMA

It is unclear what is meant by the dictum that "highest and best use...must be an economic use." If it refers to the use to which a particular site is being used, is the test whether the site generates monetary income (as opposed to amenity income)?

For example, assume a tract of nonurban land located in an area that is agricultural (alfalfa and pasture land that generates low income per acre) but can be used to grow nursery stock. Nursery stock generates greater cash flow per acre. Adjacent to it is a parcel of land that lies fallow. It is owned by an urban developer waiting for market support to change from agriculture to urban development. This land is held for investment purposes. An analysis of transactional evidence in the marketplace indicates that other land in the vicinity is selling at a price greater than that for agricultural land, the value of which must be supported by the income it generates. Is nursery use the only "economic use?" Is alfalfa-pasture use "economic?" Is the land held for investment currently in an "economic use?" Suppose nursery sites sell for \$5,000 per acre, agricultural land at \$2,500 per acre, and investment/speculative land at \$7,000 per acre. Can one estimate market value for only the nursery and agricultural uses? What kind of value does the investment land represent? If a property can be put to any of these three uses, what is its highest and best use? To complicate things further, assume that the parcel has a wetland area that is a popular waterfowl habitat and that a conservation entity (public or private) interested in preserving the whole site will pay \$8,000 per acre. What then?

Highest and best use as an economic use can be interpreted another (and in a preferable) way. A use generates a certain level of utility, which allows property to command a certain price in the marketplace. Here, “economic use” is used in the context of a market transaction, market pricing, and relative utility. The level of economic benefit (price) derived from the sale of any particular property is a function of the utility that the property can generate. In other words, there is a relationship between the use intensity of a property and its utility, so that as the use intensity increases, so would its utility. As the utility increase, so would its value, or the price at which it would be transferred on the market. [7]

In the wetland and investment scenarios, economic use is based on the transaction/price/utility framework. In the nursery and agricultural transactions, economic use is derived from the monetary productivity of the property. Monetary productivity is viewed in a very short-term context. In the longer-term preservation context, real estate (or any commodity or service having utility and scarcity) that has a market has an economic use that can be measured by transaction prices, which in turn can be used to establish value.

In the marketplace, the process of bidding sets prices and values. Frequently, the bids come from prospective purchasers (users) who intend to use the real estate for different purposes. This is especially true with vacant, undeveloped land. In dealing with environmentally sensitive properties, two bidders might be (a) someone who wishes to mine fossils from a property and (b) an environment/conservation entity, which intends to preserve the fossils. Both parties have equal knowledge regarding the nature and extent of the fossils on the property. Bidding will take place until one of them reaches a price threshold. For the fossil prospector, this would be a function of the rate and nature of the net income stream expected to be generated, as well as the prospector’s rate of return expectations, from the mining operation. For the other bidder, the price threshold would be the resource available for this purchase.

Depending on the utility to be obtained and resources available, one of the bidders will prevail. The proposed nontraditional position suggests that the miner proposes an economic use, while the conservationist proposes a noneconomic use. Moreover, the price paid by the miner would purportedly be used to estimate market value, while the price paid by the conservationist could be used to estimate market value.

Assume that the conservationist prevails and several other similar types of properties in this vicinity are also acquired by conservationists. In all cases, the conservationists outbid alternative users (miners) of the property. If the owner of a property with similar fossil resources located on it asks a real estate appraiser to identify what the market value of the property is, the stated new position is that the appraiser cannot estimate the *market value* of the prospective owner’s property for conservation purposes. Rather, the appraiser must estimate the value based on miners’ bids for the property or on some less intensive or productive use, such as grazing. The new position also indicates that estimating the value of the property, using as market evidence the conservation acquisitions, requires that

some label other than market value (i.e., public interest value) be applied to the value estimate.

It is important to understand the distinction between market value and public interest value. In nearly all litigation contexts, the appraiser is *required* to estimate market value. When an appraiser is requested to provide a lender with an estimate of the property value for underwriting purposes, that value estimate must be market value. The essence of the new position of *The Appraisal of Real Estate* is that any transactional evidence of sales between government entities, conservation organizations, and private individuals cannot be used for market value estimates when the intended use is for preservation or conservation.

The Appraisal Institute's textbook makes it very clear that highest and best use is:

An economic study of market forces...Highest and best use is shaped by the competitive forces within the market where the property is located. Therefore, the analysis and interpretation of highest and best use is an *economic study* of market forces. (emphasis added) [8]

This statement does not refer to *financial* use of the land, such as grazing, which might generate income. The text states that highest and best use is a market-driven concept in which transactional evidence is used to determine the most profitable use of the land being appraised:

An understanding of market behavior is essential to the concept of highest and best use. Market forces create market value, so the interaction between market forces and highest and best use is of crucial importance. When the purpose of an appraisal is to estimate market value, highest and best use analysis identifies the most profitable competitive use to which the property can be put. Therefore, highest and best use is a market-driven concept. [9]

Most profitable use is necessarily based on transactional (price) evidence.

CLASSICAL ECONOMICS

The Appraisal of Real Estate establishes a summary theoretical basis for value. The chapter titled "The History of Value Theory" includes a discussion of the classical school of economics. It notes that Adam Smith, one of the original contributors, developed the notions of utility, scarcity, and value in exchange.

The Scottish economic thinker, Adam Smith (1721-1790), suggested that capital, in addition to land and labor or productivity, constituted a prime agent of production. Smith acknowledged the role of coordination and production, but did not study its function as a primary agent. He believed that value was created when the agents of production were brought together to produce a useful item.

In *Wealth of Nations* (1776), the first systematic treatment of economics, Adam Smith considered value as an objective phenomenon. By virtue of its existence, an item was assumed to possess utility. Scarcity also imparted exchange value to goods. [\[10\]](#)

Smith's work was further developed by Thomas Robert Malthus and Jean Baptiste Say. Their thoughts and writings were parallel to Smith's in regard to utility and price as a measure of value in exchange:

Thomas Malthus (1776-1834) elaborated on Ricardo's theory of rent and, in the process, identified value in use, value in exchange (price), and intrinsic value...John Baptiste Say (1767-1832) rejected the relationship between labor and value, concentrating instead on utility as the determinant of value. [\[11\]](#)

The Appraisal of Real Estate goes on to discuss various challenges to the classical theory. However, the concepts of utility, demand, and value were economic principles that remained steadfast in economists' thinking. For example:

The other challenge was presented by the marginal utility or Austrian school...(V)alue is regarded as a function of demand, with utility as its fundamental precept...Eugen von Boehm-Bawerk (1835-1882) (another member of the Austrian school) defined value as "the significance a good acquires in the contribution of utility toward the well-being of an individual. [\[12\]](#)

The textbook then states that "four interdependent factors create value: utility, scarcity, desire and effective purchasing powers." [\[13\]](#) Therefore, The Appraisal Institute seems to have adopted the theoretical principles formulated by classical (and neoclassical) microeconomics that there is a relationship between utility, scarcity, and value (price) expressed through a market exchange system.

A significant amount has been written about utility, scarcity, markets, and price in economics literature that is not included in *The Appraisal of Real Estate*, The Appraisal Institute's educational curriculum, nor many other college-level real estate courses. Although Adam Smith is cited briefly, some of his more significant writings in the area of market price are not discussed. Smith reasoned, "At each level of economic development the price of commodities reflected the average cost of labor, the average level of profit, and the average rent of land." [\[14\]](#) He called this the "natural" price, the lowest price at which a given commodity could be produced without loss and, hence, the lowest price at which it could be made available over an extended period of time. According to Smith, the actual price at which a commodity or good is sold is market price. He stated, "That price is determined by the relationship between the quantity offered by producers and the amount desired by those with the ability to pay for it." [\[15\]](#)

Smith recognized the difference between natural price (what economists call price and appraisers call value based on the cost "new" to produce a commodity or spatial product) and market price (what a consumer is willing to pay for that product based on market

sales comparisons). In the case of market price, Smith emphasizes the importance of transactions.

NEOCLASSICAL ECONOMICS

In a more contemporary environment, Nobel laureate Paul A. Samuelson still quotes Smith's *paradox of value*:

Nothing is more useful than water, but it will scarce purchase anything. A diamond, on the contrary, has scarce any value in use, but a very great quantity of other goods may frequently be had in exchange for it...Economics relies on the fundamental premise that people tend to choose those goods and services they value most highly. [16]

This choosing of goods and services is what establishes price. For the producer, to maximize price and, therefore, profit means that the benefit to the consumer must be maximized. Nothing in the literature of economics suggests that goods and service consumers demand are separated into "economic" or "noneconomic" categories, for *all* are "economic."

Applications to Land Use Analysis

Land use capacity is "the relative ability of a given unit of land resource to produce a surplus of returns and/or satisfactions above the cost of utilization, according to Harvey Barlowe. [17] "Use capacity has two major components: accessibility and resource quality." [18] Resource quality involves the "relative ability of land resources to produce desired products, returns or satisfactions...It also involves aesthetic considerations such as scenery, trees, water attractions, nearness to parks or open space, access to schools, and cultural opportunities." [19] Land uses reflect various resource qualities, one of the two components of use capacity. "The concept of use capacity is often used in land economics to distinguish between the comparative abilities of different units of land resources to provide their operators with net returns *and other satisfactions*." (emphasis added) [20] Therefore, different types of land have different types of use capacities. These various use capacities provide differential returns in owner/user satisfactions (utility). Because they have different returns, they have different price structures.

There is a relationship between the use capacity of land and its intensity of use. For example, land that has superior locational attributes (use capacity) is likely to be used more intensely. Zoning affects the use capacity of land. Land that is zoned for residential use usually has a lower intensity of use than land zoned for commercial use.

The highest and best use of land is a function of the use capacity of alternative land uses. It is correlated to resource (land) quality and access. When used in the context of the rent-generating ability of land (for example, commercial, residential, farm, and forestry), rent is used as an indicator of land use intensity. Land use intensity, in turn, is a function of the supply of and demand for a resource. The greater the demand and the less the supply,

the greater the land use intensity. The greater the intensity, the greater the land rent or value.

Applications to Highest and Best Use

According to Barlowe, “The concepts of land rent and highest and best use can be used to explain both the competition between land uses and the resulting allocation of land resources between uses.” [21] Therefore, economic highest and best use is directly related to the utility and scarcity of land and the intensity to which it is used. This intensity of use can be measured by price (capitalized land rent) and has nothing to do with whether land can actually generate rent in the form of cash return. Intensity of use cannot be used to differentiate between economic and noneconomic uses.

Highest and best use can have both an economic and social context:

In facing up to the conflicts that occasionally develop between private and social priorities in land resource development, it is important to note the reason for the differences. The succession that takes place in private land resource use often reflects the bidding and counter bidding that takes place in a relatively free, competitive market. No problems arise as long as the owner or top bidder puts the property to some socially acceptable use. Real conflicts may develop, however, if the operator decides to maximize profit or other ownership satisfactions by shifting to a use that damages or exploits the interests of neighbors or of the community at large. [22]

Barlowe means that an economic highest and best use may have a value (price) that includes certain social costs (externalities), such as view blockage or the destruction of an endangered species habitat. Taking these social costs into account, therefore, decreases the margin of total utility associated with particular property. This results in a lower use capacity, less use intensity, and therefore, a lower price. Zoning, especially height restrictions, such as in Washington D.C., and the *National Environmental Policy Act of 1969* are example of societal limitations placed on untrammled economic use of land. [23]

For example, assume that an industrial site with a substantial part of the property affected by a wetland is deemed a significant wildlife habitat. For the industrial park developer, the value of this parcel, or the price that can be paid, may be \$1 million. However, the value may be \$1.25 million to a conservationist who can use the property for industrial purposes and still maintain the wildlife habitat, or use the entire property as a wildlife habitat. Conservation, therefore, represents both the economic and the social highest and best use. It represents a different use capacity and different intensity of use, plus a price premium of \$250,000. This is the social component that the *market* is willing to pay. In summary, it represents a different use capacity, different intensity of use, and different market price. It has nothing to do with “economic” or “noneconomic” highest and best use.

ECONOMIC OR NONECONOMIC NATURE OF A GOOD OR SERVICE

According to *The Appraisal of Real Estate*, “Value is regarded as a function of demand, with utility as its fundamental precept ~ a concept borrowed from the theory of marginal utility.” [24] If a good (art of real estate) or service (laborer or professional) has utility and is scarce (limited supply), then demand for that good or service will result in a certain price at which the good or service will trade (clear the market). Cumulative price levels are appropriate value indicators. A good or service does not have to be “economic” (i.e., generate money income) to have utility. It must satisfy human needs, desires, or wants. The level of usefulness and level of scarcity can be quantified and measured. The indicator of utility of scarcity is price. The prices at which a good or service sells has nothing to do with whether it is “economic” or “noneconomic” (i.e., whether it produces monetary income).

Different goods and services sell at market-determined prices regardless of whether they produce money income. For example, a 15-unit apartment building in Seattle recently sold for \$1 million. This is an income-producing good. On the other hand, the items that, in total, were sold for \$1.282 million from the Jacqueline Kennedy Onassis estate (such as an oak rocking chair, portraits of the former first lady, and a 1992 BMW 325i, four-door sedan, among others) do not produce income. The possible exception is the BMW, which might be leased. These “noneconomic” goods were clearly more valuable on the market than the “economic” good, the 15-unit apartment building. Yet, the “economic use” advocates would have us believe that there is market value associated with one set of goods (the apartment building), but *no* market value associated with the others (the Jacqueline Onassis memorabilia).

LEGAL FOUNDATION

The U.S. Internal Revenue Service recognizes conservation easements as a land use, recognizes the rights associated with that use, and accords them full market value. In fact, a conservation easement qualifies as “like kind property” for a Section 1031 exchange of other real estate. In this case, a waterfowl habitat could be exchanged for farmland, ranch land, or commercial property. [25]

In November 1996, voters in Colorado approved legislation to protect 300,000 acres of state land and establish preservation as a legitimate use of land. [26]

A position paper formulated by the Interagency Land Acquisition Conference, and adopted on April 14, 1995, on the issue provides significant insight into whether a noneconomic highest and best use can be a property basis for the estimate of market value:

Fair market value is to be determined with reference to the property's "*highest and best use*" - that is, *the highest and most profitable use for which the property is adaptable and needed or likely to be needed in the near future.* [27]

Appraisers use several methods to estimate value. Typically, these are the cost, income, and sales comparison approaches. The purpose of each approach is to estimate market value or the price a seller is willing to accept and a buyer is willing to pay for a particular good (e.g., real estate). According to James Eaton, "The courts appear to prefer the sales comparison approach to value overwhelmingly." [28] This is equivalent to saying that *transactions* are the best measure of value. In the suggested new lexicon, are some transactions "economic" and others "noneconomic," based on whether the properties involved are expected to produce money income?

CONCLUSION

Market sales transactions are based on the relative utility and scarcity of various goods and services. When goods and services are exchanged, typically for money, a transaction occurs, and the transaction – price is easily quantifiable.

Real estate can be put to various uses. Because of the variable characteristics of real estate, it can be used at varying levels of intensity. These various use intensities are reflected in the marketplace through transaction prices. The maximum use intensity for different land use categories represents their highest and best use.

Therefore, whether real estate is put to an economic use has absolutely nothing to do with its utility, scarcity, exchange price, most productive use, or market value. Because market value is based on transactional evidence, preservation/conservation as a land use category is consistent with the definition of highest and best use, when it represents the highest price that a property will command in an arm's length, open-market transaction. The prices for transactions that anticipate preservation/conservation as the highest and best use are therefore market-based indicators of market value.

* **Announcement in** The Appraisal Journal, April 1999, *honoring the two most outstanding articles of 1998.*

[1] The Appraisal Institute, *The Appraisal of Real Estate*, 11th Edition, (Chicago: The Appraisal Institute, 1996), 27.

[2] Woodward S. Hanson, "Public Interest Value and noneconomic Highest and Best Use: The Appraisal Institute's Position," *Valuation Insights and Perspectives* (Spring 1996), 48.

[3] *The Appraisal of Real Estate*, 11th Edition, 27.

[4] Paul A. Samuelson and William D. Nordhaus, *Economics*, 15th Edition (New York: McGraw-Hill, Inc., 1995), 4-5, 750.

[5] See, for example, Victoria Adams and Bill Mundy, "The Valuation of High-Amenity Natural land," *The Appraisal Journal* (January 1991), 48-53.

[6] According to Fred N. Kerlinger, *Foundation of Behavior Research* (New York: Holt, Rinehart & Winston, 1986), 9: A theory is "a set of interrelated constructs (concepts), definition, and propositions that present a systematic view of phenomena by specifying relations among variables, with the purpose of explaining and predicting the phenomena."

[7] For an in-depth discussion of use intensity and price, see Harvey Barlowe, *Land Resource Economics* (Englewood Cliffs, New Jersey: Prentice Hall, 1986), 154.

[8] *The Appraisal of Real Estate*, 11th Edition, 48, 50, 298.

[9] *Ibid.*, 298.

[10] *Ibid.*, 30.

[11] The Appraisal Institute, *The Appraisal of Real Estate*, 10th Edition, (Chicago: The Appraisal Institute, 1992), 27.

[12] *The Appraisal of Real Estate*, 11th Edition, 30-31.

[13] *Ibid.*, 32.

[14] Jerry Z. Mueller, *Adam Smith in His Time and Ours: Designing the Decent Society* (Princeton, New Jersey: Princeton University Press, 1993), 74.

[15] *Ibid.*, 74.

[16] Samuelson, 73, 82.

[17] Barlowe, 12.

[18] *Ibid.*, 15.

[19] *Ibid.*

[20] *Ibid.*

[21] *Ibid.*, 187.

[22] Ibid., 203.

[23] PL 91-190. This law was the catalyst for much of the environmental legislation we have today, including the *Clean Air Act 1970*).

[24] *The Appraisal of Real Estate*, 11th Edition, 30-31, and Samuelson, 74-76.

[25] Department of Internal Revenue Service, letter ruling 9601046., Washington D.C., 1996.

[26] Conservation Fund, *Common Ground*, (July/August 1996), 3.

[27] Interagency Land Acquisition Conference, position paper, Washington D.C., 1995, cites the following source for this definition: *Olson v United States*, 292U.S.246, 266 (1934), A3, 8.

[28] J. D. Eaton, *Real Estate Valuation in Litigation*, 2nd Edition, (Chicago: The Appraisal Institute, 1995), 198.