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What's Missing from the Capital Gains Debate?

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The call for an across-the-board cut in the capital gains tax rate has won growing bipartisan support. Advocates claim that a tax cut would spur new investment, reward productive enterprise, serve as a simple proxy for inflation indexing, [1] and generate additional tax revenue from the consequent increases in asset turnover and productivity. Opponents contend a capital gains tax cut would disproportionately benefit the wealthiest taxpayers, that productive investment is relatively insensitive to capital gains tax rates, [2] and that any boost to asset turnover would be merely temporary.

However, such debate ignores the fact that a large and growing share of capital gains tax revenues, perhaps as large as two-thirds of such receipts, are generated in the real estate sector, a sector that has little discernible impact on productive investment or employment. Moreover, the recent stock market rise has enlarged the number of taxpayers who now stand to gain from a capital gains tax cut--even as it further weakens the rationale that a cut is required to stimulate economic growth. If the goal of the tax cut is to stimulate productive investment, then reductions should be targeted to those sectors most likely to generate them. A cut allowed the real estate sector not only would not stimulate new, productive investment, but would exacerbate existing economic distortions created by the tax.

Some Provisions and Effects of the Current Capital Gains Tax

Much of the current debate about capital gains taxes focuses on the stock market. Business recipients of capital gains are characterized as small, innovative firms earning capital gains by virtue of their wise use of financial capital attracted through initial public offerings (IPOs). Unfortunately, such debate ignores empirical research that finds a large and expanding share of the economy's capital gains--as they are defined, measured, and taxed--has little effect on socially productive investment or employment. Indeed, data collected by the Department of Commerce, the IRS, and the Federal Reserve Board indicate that roughly two-thirds of the economy's capital gains are taken not in the stock market (much less in IPOs) but in real estate (Hudson and Feder 1997).

Measuring the total effect of a capital gains tax cut is difficult because reliable estimates of aggregate capital gains are hard to come by in the official statistics. Moreover, national income accounting methodology frustrates attempts to measure the total return to investors, which includes asset appreciation as well as current income. Statistics based on tax returns conceal and thereby perpetuate real estate tax loopholes. Consider, though, that the Federal Reserve Board estimated land values at some $4.4 trillion and building values at $9.0 trillion for 1994. This $13.4 trillion of real estate value represents two-thirds of the total $20 trillion in overall assets for the United States economy (Board of Governors of the Federal Reserve System 1995, Table Bill). The real property tax is the economy's major wealth tax, although its yield has declined as a proportion of all state and local revenues, from 70 percent in 1930 to about 25 percent today.

Currently, capital gains are taxed at lower rates than ordinary income. Moreover, capital gains taxes are paid only at the time of realization, not as the gains accrue, thereby lowering the effective burden (what economists call the present value of the tax) below the nominal (statutory) rate. Numerous exemptions also shield many capital gains from taxation:

- Major commercial real estate investors, such as pension funds, insurance companies, and other large institutions are exempt from capital gains taxes.[3] Foreign investors are also exempt.
- Substantial exclusions for capital gains on the sale of owner-occupied homes are allowed. (President Clinton's recent proposal would extend these exclusions.)
- No capital gains duties are levied on estates passing to heirs. Assets given as gifts are taxed only at the time they are sold.
- Real estate swaps, transfers via mergers, and certain acquisitions are not taxed on their capital gains.

Fazzari and Herzon (1996) estimate the effective capital gains tax rate by halving the statutory rate to account for the numerous exclusions and exemptions and then halving it again to reflect the benefits of deferral. If this estimate is correct, today's nominal capital gains tax of 28 percent translates into an average effective tax rate of just 7 percent.

Benefits of the Current System to Real Estate

The greatest accounting distortion for the real estate industry occurs in the case of redepreciation of buildings that already have been depreciated at least once, permitting real estate investors to recapture principal again and again on the same structure as a building is resold at rising prices. This provision, which allows buildings to be depreciated by new owners after each sale or swap, is a ruling based on logic that seemingly parallels the justification for homeowners' exemptions in selling a home to move somewhere else. The analogy, however, is specious--homeowners cannot take a depreciation tax credit unless their property generates explicit rental income (although, admittedly, they are not taxed on the imputed rental income of their homes). Most capital gains in real estate today represent repeat gains over unrealistically written-down book values, an accounting fiction that enables real estate investors to continue indefinitely to take their income in the lightly taxed form of capital gains.

Furthermore, the tax deductibility of mortgage interest, which is the real estate industry's major cost, has helped to reduce the industry's tax liability. Mortgage interest now absorbs 7 percent of national income, up from just 1 percent in the late 1940s. The real estate sector generates well over $300 billion in interest payments, more than it contributes in combined income taxes and state and local property taxes. Real estate is the major form of collateral for debt, generating some two-thirds of the interest paid by American businesses. Mortgage debt of $4.3 trillion represented about 46 percent of the economy's $9.3 trillion private nonfinancial debt in 1994.

Real estate accounts for three-fourths of the economy's capital consumption allowances (CCAs, deductions from taxable income intended to allow investors to recover capital as it depreciates). These allowances exempt much of what remains of cash flow after interest costs, so real estate generates little ordinary taxable income. Many investors operate at a nominal loss, leveraging their properties to the hilt. Their hope is to ride the wave of increasing land values and "cash out" by selling their property for more than they paid. In fact, National Income and Product Accounts (NIPA) industrywide statistics show that real estate corporations and partnerships have recently reported net losses year after year. The capital gains tax is thus the only major federal levy paid by the real estate industry.

While it is true that the prospect of earning long-term capital gains is an inducement to new and risky investment (and thereby employment), under present fiscal rules it is not such activity that is rewarded by the capital gains tax structure. A general rate cut would benefit mainly the real estate industry, and even in that industry, it cannot be expected to spur much new construction. Factory owners usually must junk their machinery when it wears out, and depreciation allowances properly ensure that only net income, not gross revenue, is taxable. Thus direct investors suffer less from capital gains taxation than from ordinary income tax, which is applied sooner and at higher rates. Unlike other industrial assets, however, buildings most often are not scrapped. Although they are depreciated when sold, they typically are resold at higher prices than were originally paid. In the aggregate and over the long run, rising land values tend to more than offset the decline in building values; in practice, a significant portion of land appreciation is often imputed erroneously to buildings, expanding capital consumption allowances still further.

Published statistics do not permit reliable estimates, but there can be little doubt that most true "capital" gains in real estate are really land gains. The value of any building tends eventually to decline, until finally it is scrapped and replaced. It is the value of land that tends to rise as population and income grow (over the long run, with cyclical swings), because no more land can be produced. Thus, capital gains in real estate result mainly from land appreciation. Building values fall because of physical deterioration and also because of locational obsolescence as neighborhood land use changes over time, so market prices tend to fall below replacement cost. As the land value rises, a rising share of the property income must be imputed to the land and a falling share remains to be imputed to the improvements. Indeed, where ill-maintained old buildings occupy prime locations, parcels may be more valuable once the buildings are demolished and the lots cleared for reuse. Unfortunately, Federal Reserve Board statistics estimate building values at replacement cost and subtract this estimate from the total real estate value to derive land value as a residual. This method seriously understates the land share of real estate. (Recently, this has led to nonsense results--Fed statistics show the land value component of corporate real estate has declined to near zero over the past five years.)

Clearly, a "capital" gains tax cut cannot cause the production of more land. As for buildings, preferential tax treatment of capital gains, excessive depreciation allowances for real estate, and the income tax deduction for mortgage interest tend to foster not new productive enterprise, but speculation in land and old buildings. One effect of favorable depreciation and capital gains tax treatment is to spur debt pyramiding for the real estate industry. The tax structure provides a distortionary incentive for real estate holders to borrow excessively, thereby converting rental income to a nontaxable mortgage interest cost while waiting for capital gains to accrue. This, along with financial deregulation of the nation's S&Ls, was a major factor in the overbuilding spree of the 1980s following the reduction of capital gains taxes and the extreme shortening of schedules for capital consumption write-offs in 1981.

The Direction of Policy

The central point for tax policy is that taxable gains in real estate consist of more than just the increase in land and building prices; they represent the widening margin of sales price over depreciated book value. CCAs for real estate have historically been excessive relative to true economic depreciation, particularly during the 1980s. True, the fiction of fast write-offs is eventually "caught" as a capital gain when the property is sold or refinanced. The more generous the capital consumption write-offs, the more rapidly a property's book value is written down. Excessive depreciation allowances thus convert ordinary income into capital gains.

Official statistics should provide a sense of proportion as to how the economy works. Especially when it comes to land and real estate, however, national income statistics tend to obfuscate more than they reveal. They are the product of income-tax filings and hence are distorted for both administrative and political reasons; they do not reflect fundamental categories of economic analysis. The present GNP/NIPA format fails to differentiate consistently among land, produced wealth, and financial claims. In the real estate sector most "capital gains," in the colloquial sense of rising market prices, accrue to land, but IRS statistics mainly catch the landlord's fictitious declaration of the loss in building values through overdepreciation.

It can only confuse matters to debate capital gains taxes without separating three major sources: real estate, as the economy's largest recorder of capital gains (separable, in turn, into land and improvements); other direct capital investment; and financial claims on the income generated by this capital (stocks, bonds, and packaged bank loans that are "securitized"). The failure of our national accounting system to distinguish among these makes it easier for the real estate industry to get its own taxes reduced along with industries in which capital gains tax cuts do indeed tend to spur productivity. Wealthy investors have won congressional support for real estate exemptions in large part by mobilizing the economic ambitions of homeowners. The real estate industry and the financial sector, riding on its shoulders, have found that the middle classes are willing to cut taxes on the wealthy heavily, as long as their own taxes are cut even lightly. It is no surprise that President Clinton's first major concession to the pressure for cutting capital gains taxation was directed at homeowners, despite the fact that further preferences for home ownership cannot readily be justified as a boost to industrial enterprise.

Economic policy should distinguish between activities that add to productive capacity and those that merely add to overhead. This distinction elevates the policy debate above a generalized attack by the have-nots on the haves to fundamental and practical issues. What ways of getting income deserve fiscal encouragement, and how may economic surpluses best be tapped to support government needs? Policies that subsidize rentier incomes while penalizing returns to productive effort have grave implications, not only for allocative efficiency and economic development but also for distributive justice.

Given the current U.S. depreciation laws and related institutions, to reduce the capital gains tax rate across the board is to steer capital and entrepreneurial resources to a search for unearned rather than earned income. Far from being a potent stimulus to new investment, such a policy preferentially benefits owners of already depreciated buildings and speculators in already seasoned stocks, leading to further deterioration of economic well-being. It rewards real estate speculators and corporate raiders as it shifts the burden of taxation to people whose primary source of income is their labor. In the real estate industry, for which the capital gains tax is the only significant remaining source of federal revenue, a rate cut would discourage new direct investment and employment while encouraging the purchase and sale of existing buildings.

It is doubtful that a further rate reduction is likely to accelerate real estate turnover (and increase government revenue) by reversing a "lock-in effect." Lock-in results less from high capital gains tax rates than from the step-up of basis at death. Turnover in real estate is strongly affected by depreciation rates. In periods of rapid write-offs-most strikingly during the 1980s, when real estate could be written off faster than in any other period-buildings tend to be sold as soon as they are depreciated. The 1986 reforms reduced the incentives for this rapid turnover, but the principle is clear: When depreciation rates are high, there is a powerful tax-induced incentive to sell a building when it is fully depreciated. Therefore, one must doubt the claim that cutting the capital gains tax would encourage investors to sell their assets.

While it is true that "trillions of dollars are locked up in mature, relatively nonproductive low-cost assets" (Hauser 1995), most of these "mature" assets take the form of depreciated real estate. Although real estate prices have stag-nated, the book value of buildings has been diminished by much more. Now that these buildings are fully depreciated, owners have incentive to sell or swap them once again so as to continue sheltering their income. The effect has been to leave substantial capital gains to be declared in the near future, while the properties can be sold for much more than their depreciated value. This lends renewed urgency to the campaign to cut capital gains tax rates. Even without a rate cut, however, turnover in real estate may surge as investors exploit depreciation rules to maximize their gains from properties acquired under the accelerated depreciation rules of the 1980s. A rate cut at this time would be a mere giveaway, making permanent the income tax deferral from excessive CCAs.

The budget crisis aggravated by such a policy also ends up forcing public resources to be sold off to meet current expenses, sold to the very wealth-holders being freed from taxation. In this way wealth consolidates its economic power relative to the rest of society and translates it into political power so as to shift the tax burden onto the shoulders of others. The first element of this strategy has been to defer revenue into channels that are taxed only later, as capital gains. The second has been to tax these gains at a lower rate than earned income--and it is the struggle over this element that has now broken out in earnest.

Any capital gains tax relief should selectively favor productive enterprise relative to mere trading of nonproduced land or depreciated buildings produced years ago. At minimum, a general capital gains tax cut should be accompanied by both reform of depreciation rules and an increase in the ad valorem taxation of land. Moreover, capital gains policy should be evaluated in comparison to alternative means of effecting similar results. A cut in the payroll tax rate, for example, would be a surer stimulus to employment than an across-the-board capital gains tax cut.

Notes

1. This argument has been rejected by the Treasury Department because it would diminish the "lock-in" effect by which high tax rates at realization deter asset sales. Some argue that eliminating the step-up of basis at death would do more to reduce lock-in than a rate cut (see Joint Committee on Taxation 1990, 21).

2. They argue, for example, that most of the money placed in venture capital funds comes from tax-exempt pension funds, endowments, and foundations (Venture Economics Information Services, cited in Schlesinger 1997, A6).

3. In addition to playing a dominant role in real estate, these institutional investors own nearly half of all U.S. equities (Minarik 1992).

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