Real Estate and the Capital Gains Debate

by

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Table of Contents

Charts and Tables

1. Introduction

• THE CAPITAL GAINS CONTROVERSY

Capital gains taxation has been a divisive issue in Congress at least since the debates surrounding the Tax Reform Act of 1986, which, aiming to eliminate tax loopholes and shelters and preferences, repealed preferentially low tax rates for long-term gains.[1] To bring effective capital gains tax rates back down again was President Bush's "top priority in tax policy."[2] In 1989, Senate Democrats blocked a determined drive to reduce effective tax rates on the part of Bush, Republican Senators Packwood, Dole and others, and a few Democratic allies.[3] The administration argued that the tax cuts would stimulate economic growth and induce asset sales, thereby actually increasing federal tax revenues; Congressional Democrats countered that the plan benefited mainly the wealthy, and that tax revenues would in fact decline.[4] The Joint Committee on Taxation projected that budget shortfalls beginning in 1991 would sum to about $24 billion by 1994—and that most of the direct benefits would go to individuals with over $200,000 in taxable income. House Speaker Thomas S. Foley said that a third of the savings would be enjoyed by those with gross incomes over one million dollars.[5]

An October, 1990 congressional budget agreement cut the maximum capital gains tax rate from 33 to 28 percent. The cut was less than the administration had sought, and

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[1] Capital gains received preferential income tax treatment from 1921 through 1987. The Revenue Act of 1942 provided for a fifty percent exclusion for noncorporate capital gains or losses on assets held over six months; the Revenue Act of 1978 raised the exclusion to sixty percent. These exclusions reduced the effective rate from approximately 49 to 28 percent. The Economic Recovery Act of 1981 reduced the effective rate still further, to 20 percent, as a result of the reduction in the top marginal tax rate from 70 to 50 percent. However, the Tax Reform Act of 1986 eliminated exclusions for capital gains after 1988. Corporate capital gains were taxed at an alternative rate of 25 percent with the Internal Revenue Code of 1954, then at 30 percent with the Tax Reform Act of 1969. The alternative rate was reduced to 28 percent by the Revenue Act of 1978, and repealed by the Tax Reform Act of 1986, which provided for taxation of (taxable) realized capital gains as ordinary income. Joint Committee on Taxation (1990), p. 11.

[2] Elving (1989), p. 2299.

[3] Elving (1990), p. 1183.

[4] "Capital Gains Study at a Standstill" (1991, anonymous), p. 594; Elving (1989), pp. 2299-2302.

[5] Elving (1989), pp. 2299-2300.

Bush continued to press for further rate reductions; but significantly, it reestablished preferential taxation, as the maximum rate on ordinary income was now 31 percent.[6]

Bush's January1991 budget proposal included provisions to reduce the tax rate on certain capital gains. Individuals would be allowed to exclude a percentage of the gain from qualified assets, the percentage increasing with the length of the holding period. The effective tax rate for an asset held three years or more, for example, would have been 19.6 percent for an individual in the 28-percent tax bracket.[7]

A year later, Congressional Democrats put forth their own plan to index capital gains for inflation, which, they argued, was a more equitable way to reduce effective tax rates. Opponents countered that the wealthy would benefit even more from indexing than from Bush's plan—or that "indexing would not provide the quick stimulus that Bush claims would come from his proposal" to slash capital gains tax rates.[8] While the proposal to index gains has continued support today, it is adamantly opposed by the Treasury on grounds of administrative unfeasibility.[9]

Last year, the tax cut plan of Presidential candidate Bob Dole would have halved capital gains tax rates, from 28 to 14 percent.

Concern that a capital gains tax cut would eventually, after an initial sell-off, necessitate higher ordinary income tax rates to meet budget shortfalls "has kept the nation's business community from monolithic endorsement of the proposals."[10] However, proposals to cut capital gains taxes have increasingly enjoyed bipartisan support in recent months, fueled partly by the run-up of stock prices which has created huge paper gains. President Clinton's budget proposals of January 1997 called for a tax exemption for up to $500,000 in capital gains from the sale of personal residences, and it is reported that he has signaled his willingness to contemplate a broad-based cut in future

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[6]Pollack (1991), p. 56.

[7] "In addition, all depreciation would be recaptured in full as ordinary income." Joint Committee on Taxation (1990), p. 15. "The proposal was introduced by Senators Packwood, Dole and Roth as S. 2071 … March 15, 1990."

[8] Cloud and Cranford (1992), p. 393.

[9] Schlesinger (1997), p. A6.

[10] Elving (1989), p. 2300.

negotiations, perhaps to a 20 percent maximum rate.[11] A bill introduced in January by Senate Republicans would reduce the effective rate from 28 percent to 19.8 percent for individuals and from 35 percent to 28 percent for corporations, and would also index gains for inflation. In February, Senate Democratic Majority Whip Wendell Ford announced his support for a broad-based capital gains tax cut.[12] As *The Wall Street Journal* reports, "Prospects for a big cut in the capital-gains tax seem better this year than at any time since the federal government increased tax rates a decade ago on profits from selling investments."[13]

• WHAT IS MISSING FROM THE CAPITAL GAINS DEBATE?

The most frequently heard arguments for reducing capital gains taxes are: (1) to reduce the "lock-in" effect, by which high tax rates at realization deter asset sales;[14] (2) to relieve a disproportionate burden on homeowners; (3) to compensate for the erosion of capital gains by inflation, as an alternative to indexing;[15] (4) to end alleged double taxation of both capital stocks and income flows; (5) to spur productive enterprise and investment; and (6) to generate more tax revenue from the consequent growth in asset sales and productivity.

This report calls attention to a neglected aspect of the capital gains issue—one which bears importantly on the fifth- and sixth-named consequences.

Much of the capital gains debate today focuses on the stock market. Business recipients of capital gains are characterized as small innovative firms making initial public offerings (IPOs). In recent years such firms have been responsible for a disproportionate share of new hiring. It is hoped that corporations will be able to raise money to employ more labor and invest in more plant and equipment if buyers of their stocks can sell these

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[11] McTague (1997), *Barrons*, Feb 2, 1997. URL: <http://www.barrons.com/bie/articles/19970207/budget.htm>
[12] Hitt (1997), p. A2.
[13] Schlesinger (1997), p. A1.
[14] Some argue that eliminating step-up of basis at death would do more to reduce lock-in than a rate cut. See Joint Committee on Taxation (1990), p. 21; Gaffney (1991).
[15] For an analysis of the case for inflation indexing, see Gaffney (1991).

securities with less of a tax bite. Stock market gains thus are held to stimulate new direct investment, employment, and output.

Typical of the campaign to reduce capital gains taxes is a *Wall Street Journal* editorial, "Capital Gains: Lift the Burden." Author W. Kurt Hauser argues that when the capital gains tax rate was increased from 20 percent to 28 percent in 1989, the effect was to deter asset sales, causing a decline in the capital gains to be reaped and taxed. He refers, however, only to stock market gains, and specifically, to equity in small businesses. Citing the example of yacht producers, he suggests that taxing capital gains on stocks issued by these businesses "locks in" capital asset sales, thereby deterring new investment and hiring, and reducing the supply of yachts.[16]

Others contend that new productive investment is relatively insensitive to capital gains tax rates, arguing, for example, that most of the money placed in venture-capital funds come from tax-exempt pension funds, endowments, and foundations.[17]

What is missing from the discussion is a sense of proportion as to how capital gains are made. Data that is available from 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 new offerings—but in real estate.***[18]

The Federal Reserve Board estimates land values at some $4.4 trillion for 1994. Residential structures add $5.9 trillion, and other buildings another $3.1 trillion. This $13.4 trillion of real estate value represents two thirds of the total $20 trillion in overall assets for the United States economy.[19] Real estate accounts for three-fourths of the economy's capital consumption allowances. It also is the major collateral for debt, and generates some two-thirds of the interest paid by American businesses. Real estate taxes are the economy's major wealth tax, although their yield has declined as a proportion of

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[16] Hauser (1995).

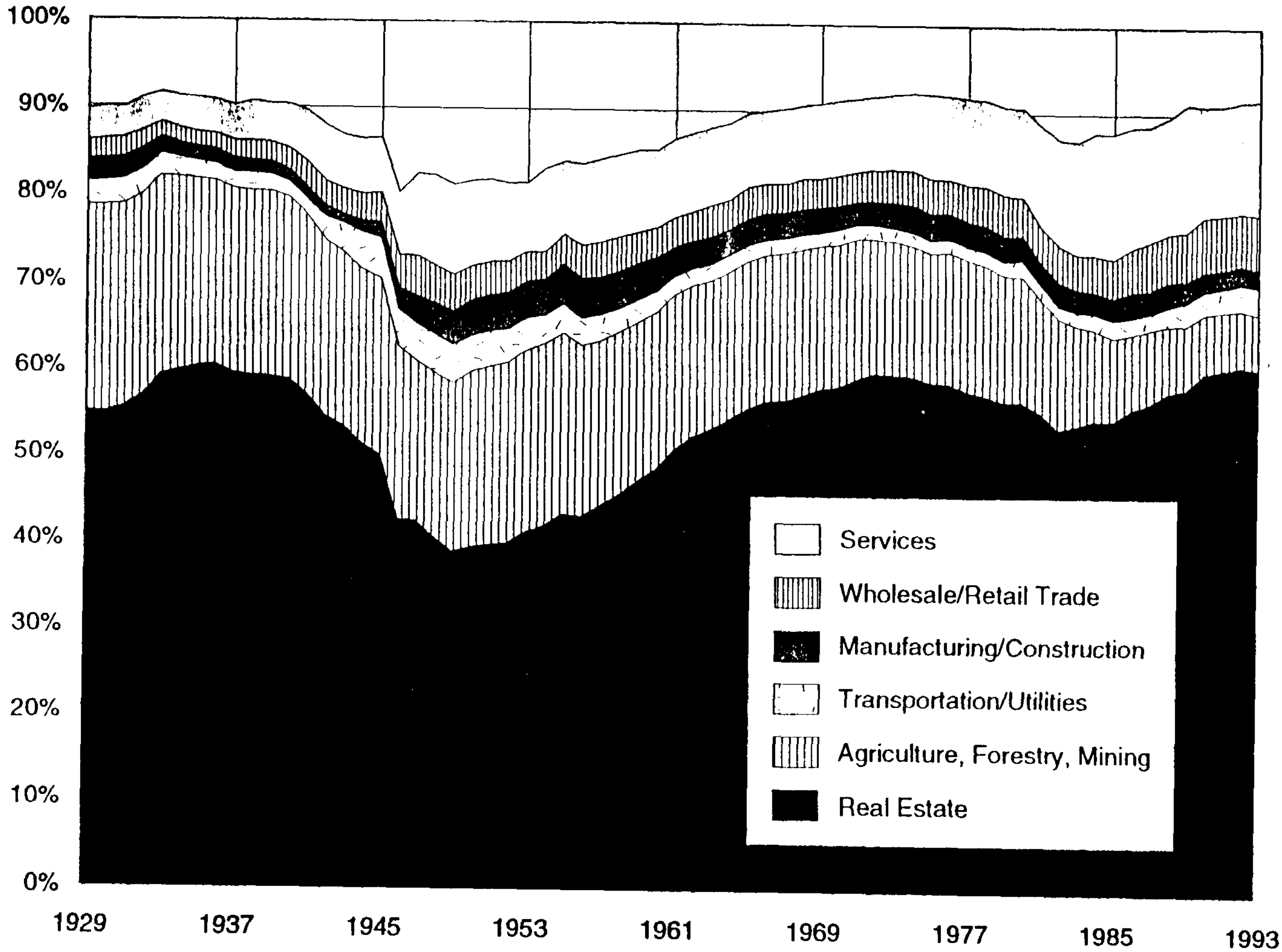
[17] Venture Economics Information Services, cited in Schlesinger (1997), p. A6.

[18] ***Federal Reserve Board, Flow-of-Funds Statistics, Balance Sheets for the US Economy.*** **See section 5 regarding capital gains on land and buildings.**

[19] *Balance Sheets for the U.S. Economy: 1945-94*, Table B.11.

1a. Non-Corporate Capital Consumption (Depreciation)

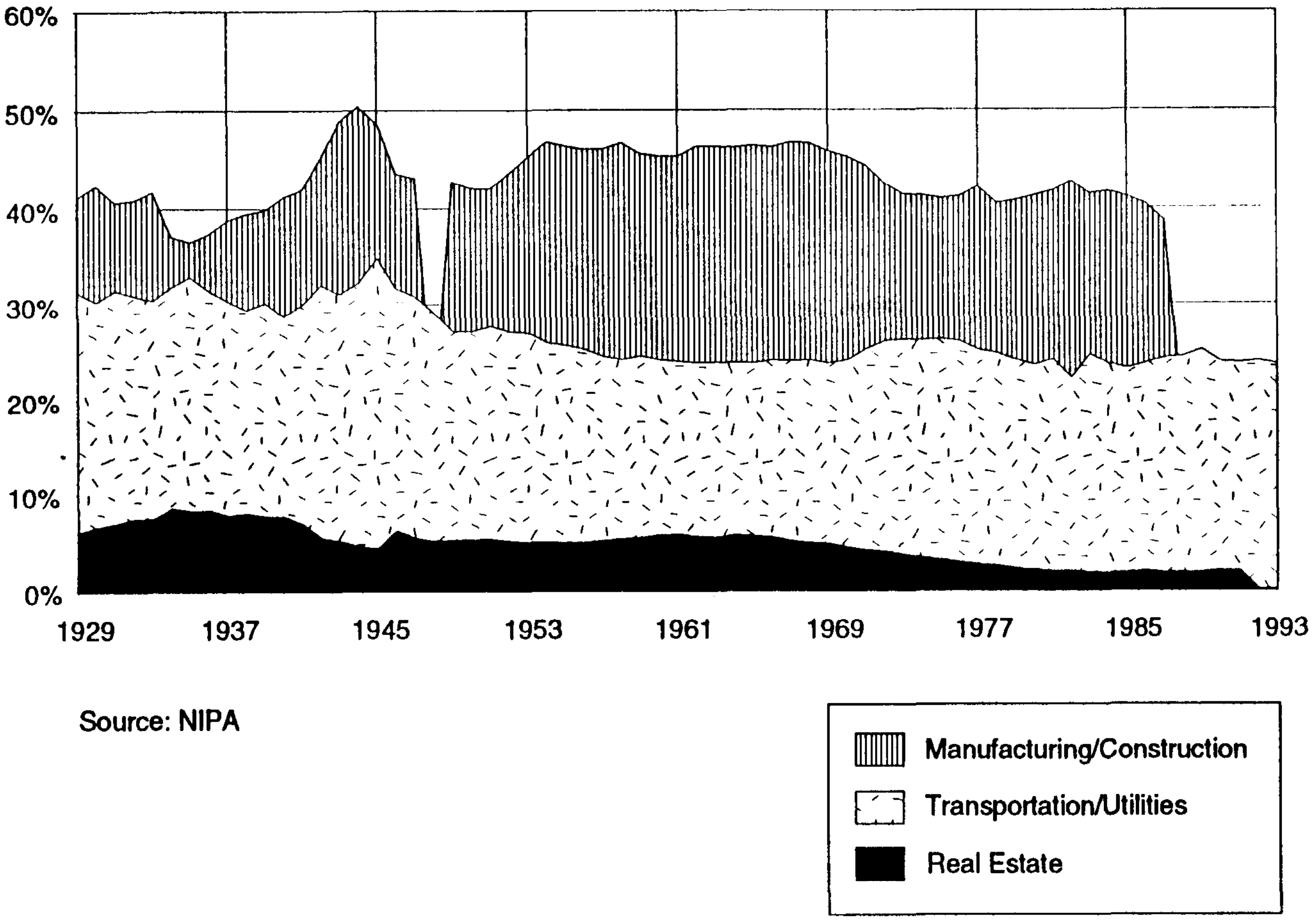
As Percentage of Non-Corporate Capital Consumption Allowances



Source: NIPA

1b. Corporate Capital Consumption

As Percentage of Economy-wide Corporate Capital Consumption Allowances



Source: NIPA

all state and local revenues, from 70 percent in 1930 to about one-fourth today.

Capital gains statistics are much harder to come by. One cannot simply measure the increased value of the capital stock, for part of the rise represents investment—production of new capital—rather than appreciation of existing capital and land. The IRS conducts periodic sampling of capital gains based on tax returns, and its *Statistics on Income* presents various analyses of the shares of total capital gains reported by the economy's income cohorts, from the richest five percent down. The samples are admittedly asymmetrical, however, and some of the categories overlap. Significantly, for instance, stock market gains include a large component of land and other real estate gains.

This policy brief seeks to elucidate the role of real estate in the capital gains issue, indicating the quantitative orders of magnitude involved. We offer two main observations. First, generous capital consumption allowances (CCAs) greatly magnify the proportion of real estate income taken as taxable capital gains. Capital gains accrue not only on newly constructed buildings, of course, but also on land and old buildings being sold and resold. Our tax code allows for properties to be re-depreciated by their new owners after a sale or swap, permitting real estate investors to recapture principal again and again on the same structure. When CCAs have been excessive relative to true economic depreciation, as they were during the 1980s, capital gains have been commensurately larger than the actual increase in property prices. As **Charts 1a** and **1b** illustrate, capital consumption allowances in real estate dwarf those in other industries.

Second, very little of real estate cash flow is taxable as ordinary income, so the capital gains tax is currently the only major federal levy paid by the real estate industry. CCAs and tax-deductible mortgage interest payments combine to exempt most of real estate cash flow from the income tax. This encourages debt pyramiding as it throws the burden of public finance onto other taxpayers.

A central conclusion of our study is that better statistics on asset values and capital gains are needed—or, more to the point, a better accounting format. The economic effects of a capital gains tax depend upon how the gains are made. The present GNP/NIPA format fails to differentiate between wealth and overhead; between value from production and value from obligation. In particular, theory and measurement should distinguish real estate from other sources of capital gains—and, within the category of real estate, distinguish land from built improvements. Markets for immovable structures and for land have distinctive inherent features[20] and are shaped by distinctive institutional constraints.

Our second major conclusion is that, at least until re-depreciation of second-hand buildings is disallowed, a capital gains tax cut would be unlikely to stimulate much new investment and employment from its largest beneficiary, the real estate industry.

Depreciation allowances and mortgage interest absorb so much of the ongoing cash flow as to leave little taxable income. Mortgage interest payments, which now consume the lion's share of cash flow, are tax-deductible, while CCAs offset much of what remains of rental income. On an industry-wide basis, in fact, NIPA statistics reveal that depreciation offsets *more* than the total reported income. As **Charts 2a**, **2b**, and **2c** illustrate, real estate corporations and partnerships have recently reported net losses year after year.

The result is that real estate corporations pay minimal income taxes—some $1.3 billion in 1988, just one percent of the $137 billion paid by corporate America as a whole.[21] Comparable figures are not available on non-corporate income tax liability, but the FIRE sector (finance, insurance, and real estate) reported negative income of $3.4 billion in 1988, out of a total $267 billion of non-farm proprietors' income.[22] These three symbiotically linked sectors thus were left with only capital gains taxes to pay on their cash flow.

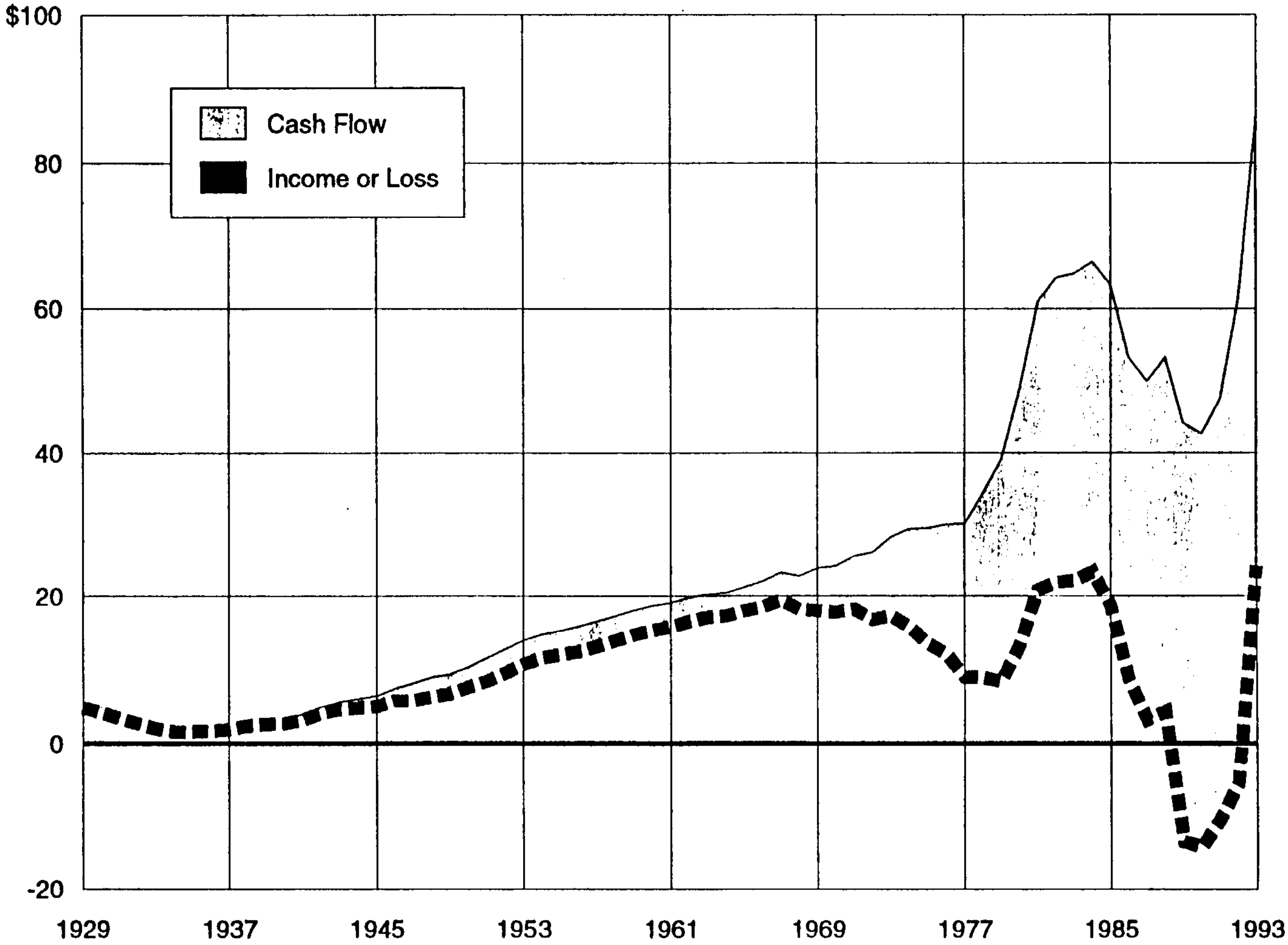
The central point for capital gains tax policy is that taxable capital gains in real estate consist of more than just the increase in land and building prices. They represent the widening margin of sales price over the property's depreciated value. The tax

[20] Gaffney (1994a).
[21] US Bureau of Economic Analysis, NIPA Table 6.18.
[22] NIPA Table 6.12.

2a. Real Estate Cash Flow of Individuals

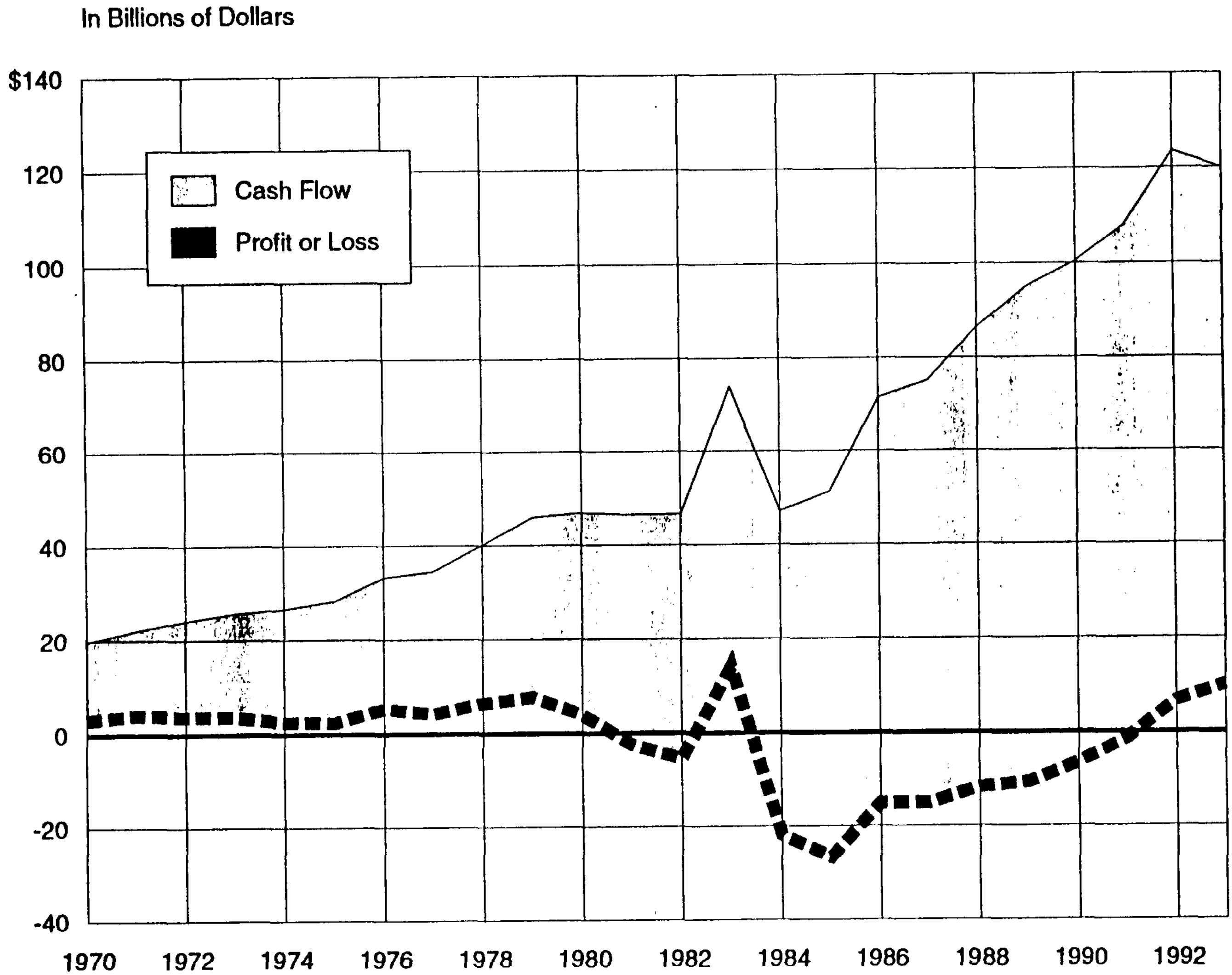
(Whose Major Business Is Not Real Estate)

In Billions of Dollars



Source: NIPA

2b. Real Estate Cash Flow of Partnerships



Source: NIPA

accountant's book-value gains result from charging off capital consumption allowances as a tax credit against cash flow. The more generous are the capital consumption write-offs for real estate, the more rapidly a property's book value is written down. The fiction of fast write-off is eventually "caught" as a capital gain when the real estate is either sold or refinanced.

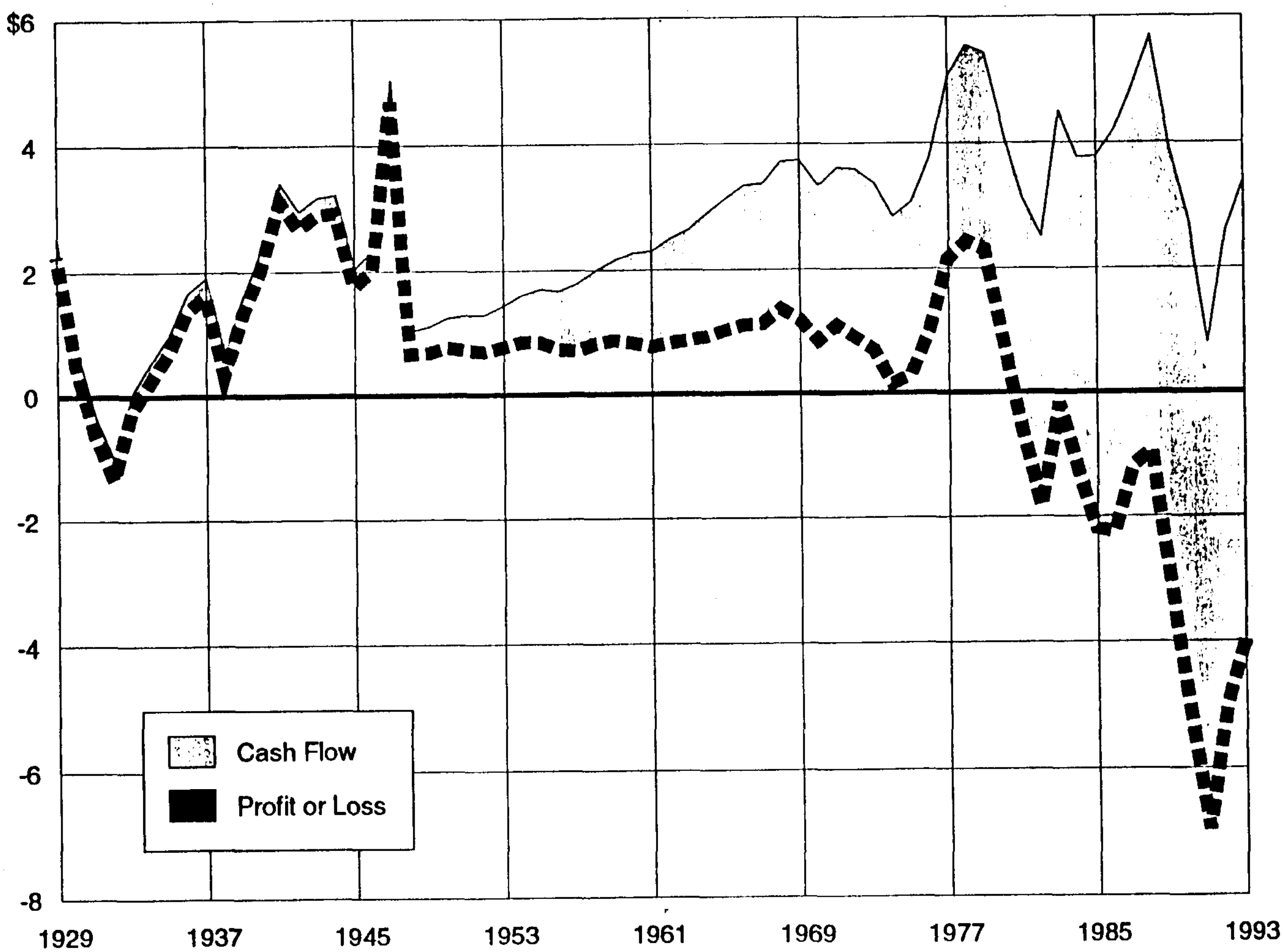
Excessive depreciation allowances thus convert ordinary income into capital gains. Moreover, capital gains are the only point at which most real estate income is taxed. To abolish the capital gains tax would annul the entire accumulated income tax liability which real estate owners have converted into a capital gains obligation. The income written off over the years as over-depreciation would not be caught at all. The economy's largest industry would have its income rendered tax-free.

Capital gains already are being taxed much more lightly than ordinary income, especially when deferrals and exemptions are taken into account. Even if exemptions were eliminated and the capital gains tax rate were set as high as the ordinary income tax rate, the effective burden (what economists call the *present value* of the tax) would be substantially lower to the extent that the capital gains tax is paid only retroactively, upon realization (sale) rather than as the gains actually accrue.

One therefore must doubt the claim that cutting the capital gains tax would increase government revenue by encouraging investors to sell their assets. Kurt Hauser's editorial asserts that "trillions of dollars are locked up in mature, relatively non-productive low-cost assets," but does not explain that most of these "mature" assets take the form of depreciated real estate. Although real estate prices have stagnated, the book value of buildings has been diminished by much more. Now that these buildings are fully depreciated, owners have an 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

2c. Real Estate Cash Flow of Corporations

In Billions of Dollars



Source: NIPA

depreciated value.[23]

While it is often true that the prospect of earning capital gains is what induces new investment to be made, applying further rate cuts to real estate gains cannot be expected to spur much new construction activity under present fiscal institutions. Clearly a "capital" gains tax cut cannot cause the production of more land; land (as distinct from capital improvements) is made by nature, not by the landowner. As to buildings, more of the tax benefit would go to speculators in existing capital than to investors in construction and renewal. We also doubt that a further rate reduction is likely to accelerate real estate turnover by reversing a "lock-in effect." Turnover 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.[24] The basic motivation at work, of course, is to avoid taking investment returns as taxable income. Investors prefer to declare as much of their income as possible in the form of capital gains, which are taxed later and at a lower rate.

Sound tax policy requires an understanding of the fiscal assumptions which underlie our tax code and the mythical world of national income accounting. Far from being a potent stimulus to new investment, a general capital gains tax cut would preferentially benefit owners of already depreciated buildings speculators in already seasoned stocks, leading to further deterioration of economic health. It cannot be expected to raise the volume of capital gains declared by enough to increase the total tax revenue generated.

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[23] In these statistics we find the explanation for the fact that reported capital gains have fallen off since 1989. The reason is not, as Hauser (1995) claims, because the capital gains tax hike has induced fewer sales of stocks or direct business assets that have increased in value, but because the collapsing real estate bubble has left in its wake fewer land-value gains to be taken. Even assuming that investors were sensitive to the increased capital gains tax rate, there have been fewer gains to reap since prices peaked in 1989.

[24] For an analysis of lock-in and capital gains taxation, see Gaffney (1990).

2. Depreciation and Capital Gains

Much of the statistical measurement problem derives from the fact that capital gains in real estate differ from those in other industries. While all investors presumably would prefer to take their income in non-taxable forms and to defer whatever tax obligation is due, the tax benefits to the real estate industry have no analog in manufacturing, agriculture, power generation, transportation, wholesale and retail trade, or other services. Corporations in these sectors pay taxes on their net incomes. Out of their after-tax earnings they then pay dividends, on which stockholders in turn must pay income tax. By contrast, little or none of the rental cash flow received by real estate investors is taxable, because generous capital consumption allowances are treated as costs and deducted from the net income reported to the IRS.

The effect of calculating capital gains for real estate on the basis of depreciated book values may be illustrated by the following example. A building bought in 1985 has probably been fully written off today, thanks to the generous CCAs enacted by the 1981 tax code that remained in place through 1986. For a parcel bought in 1985 for $100 million and sold today for $110 million, the recorded gain is not merely the 10 percent increase in market price, but *the entire value of the building*, perhaps $65 million based on the real estate industry's average land-to-building assessment ratios.

Industrial investors must pay tax on their accruals of unsold inventories as they mount up, *as if* they were sold for cash. Publishing companies, for instance, owe taxes on books that remain unsold at the end of the year, which leads to fast liquidation of such inventories and often to the pulping of unsold books. A shift in publishing policy has taken place toward faster sellers and smaller print runs.

Factory owners usually must junk their machinery when it wears out. At the very least, it is sold off at a nominal price and replaced with higher-productivity equipment, enabling producers to remain competitive in the face of technological progress. Industrial depreciation allowances are thus well justified, and rarely need to be offset by subsequent capital gains declarations. Real estate, however, is depreciated more than once, as a matter of course. Unlike other industrial assets, buildings that have been depreciated just once long run. Nevertheless, it is principally the location that becomes more valuable. Rising land values tend to more than offset any decline in building values. In practice, a significant portion of land appreciation tends often to be imputed to buildings, further expanding CCAs by allowing even land to be partly depreciated.[25]

Thus the putative beneficiaries of cutting capital gains taxes—direct investors—suffer less from high capital gains tax rates than from the treatment of much of their capital gain as ordinary income, which is taxed at higher rates. In real estate, on the other hand, depreciation effectively converts much of ordinary income to capital gains. Whereas industrial investors pay tax on rising investment in unsold inventories, even when no sales revenue is received, real estate investors pay tax neither on rental income nor on increases in property values as they accrue. The industry actually receives cash income, but for tax purposes reports a cash loss. Because real estate and manufacturing face such different cash flow tax treatment, it is misleading to take the manufacturing industry as a proxy for real estate in discussing the effect of cutting capital gains tax rates.

The greatest accounting distortion for the real estate industry occurs in the case of re-depreciation of buildings that already have been depreciated at least once. This re-depreciation occurs following ownership transfers; the CCA is attached not to the physical asset, but to the change of ownership. As the building is resold at rising prices, investors are allowed to re-depreciate them again and again—and to write off these CCAs against their income, as if they were suffering an erosion of wealth. Thus, most capital gains in real estate represent "repeat gains" over unrealistically written-down book values. This accounting fiction enables real estate investors to continue indefinitely to take their income in the lightly taxed form of capital gains.[26]

Landlords already deduct from earnings as normal business expenses their maintenance and repair expenditures, undertaken to counteract the wear and tear of buildings. A rule of thumb in the real estate industry is that such expenditures typically consume about ten percent of rental revenue. More importantly, although nearly all

[25] Gaffney (1993).

[26] Another kind of subsidy occurs in the sphere of farm real estate. Speculation in farmland is reflected in the high ratio of farm prices to gross receipts. This suggests that, on the one hand, "gentleman farming" occurs in near-suburban areas as a means of minimizing property taxes (thanks to the lower appraisals of land zoned for agricultural use), and on the other hand, speculation in anticipation that the land subsequently will be rezoned for commercial and residential development.

land gains are made fully taxable, there is little reason to assume that physical deterioration should be compensated by a special allowance to enable the landlord to recover his capital investment within a given number of years.

Even when *overall* real estate values fell in the early 1990s, the IRS nonetheless recorded capital gains taken on properties built before the frantic price run-up of the late 1980s. Over a fifteen year period, the value of the building in our example might have been written down to near zero. If it were sold for just its original purchase price, the *entire* sales price of the building would be reported as a capital gain.

Although the 1981 depreciation giveaway was replaced by the 1986 revision of the tax code, buildings already under construction and about to come onto the rental market were grandfathered into the old code. Significantly, today these buildings have been fully depreciated and therefore are probably about to be sold, at least for book-keeping purposes—owners may buy their own buildings under different partnerships, or swap them for similar buildings with other owners. Their new owners can begin to depreciate them all over again, after duly paying capital gains taxes on the buildings' increase over their near-zero book value. ***If they do not sell and re-depreciate their buildings, the owners will have to begin paying income taxes on their operating cash flow that hitherto was sheltered by depreciation allowances that have now run out. This lends a renewed note of urgency to the persistent campaign to cut capital gains tax rates.***

Because excessive depreciation allowances favor real estate speculation relative to industrial production, they discourage new direct investment and employment. To reduce the capital gains tax—the only significant remaining source of federal revenue from real estate—would divert even more savings into the purchase and sale of existing buildings.

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subsequently will be rezoned for commercial and residential development.

3. How Mortgage Debt Converts Rent into Interest

Depreciation rules are not the only reason why the real estate sector declares little taxable income. Out of their gross rental income, landlords pay state and local property taxes, a tiny modicum of income tax, and interest on their mortgage debt. A large proportion of cash flow is turned over to lenders as mortgage payments. Since the early 1970s, interest paid by the real estate industry has been much larger than the figures reported for net rental income. As **Charts 3a**, **3b**, **3c**, and **3d** illustrate, real estate investors and homeowners have become the financial sector's prime customers. According to the Federal Reserve Board, 1994 mortgage debt of $4.3 trillion represented some 46 percent of the economy's $9.3 trillion private nonfinancial debt, and a third of the total $12.8 trillion U.S. debt.[27] NIPA statistics indicate that about 70 percent of loans to business borrowers currently are made to the real estate sector, making it the major absorber of savings and payer of interest.[28]

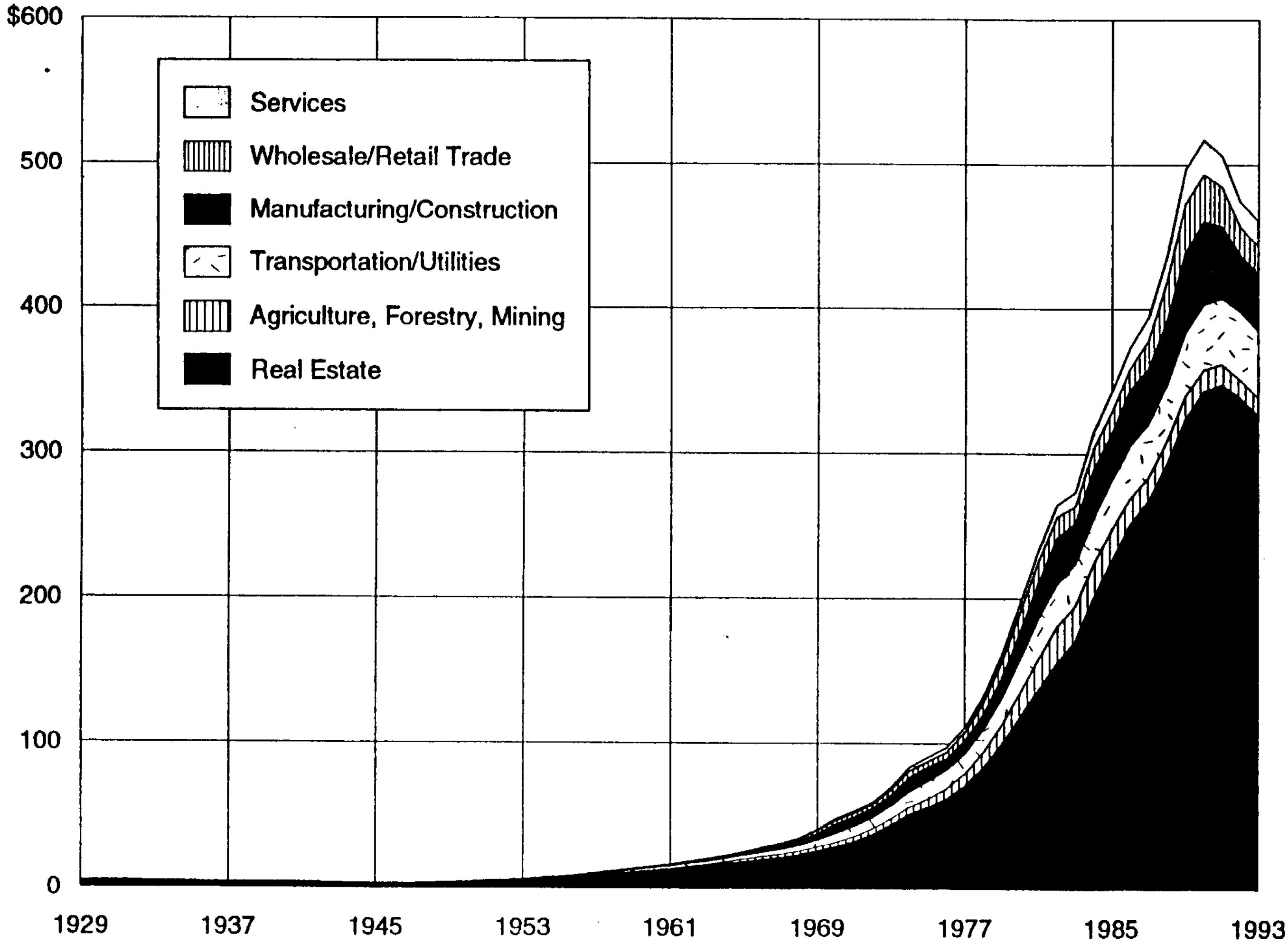
Most cash flow now ends up neither with developers nor with the tax authorities, but as interest paid to banks, insurance companies and other mortgage lenders. In fact, mortgage interest now absorbs seven percent of national income, up from just one percent in the late 1940s. In 1993 (the most recent year for which NIPA statistics are available) the real estate sector generated some $326 billion in interest payments, more than it contributed in income taxes and state and local property taxes together. Meanwhile, over the past half century, net declarable income plus capital consumption allowances and property taxes have been cut in half as a proportion of national income, from over ten percent to less than five percent. Thus interest is the real estate industry's major cost, and as such, has helped to minimize the real estate industry's income tax liability.

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, converting rental income into a nontaxable mortgage interest cost while waiting for capital gains to accrue. This, alongside financial deregulation of the nation's S&Ls, was a major factor in the over-building spree of the

[27] *Balance Sheets for the US Economy*, Table L2, line 8.
[28] "Business borrowers" do not include homeowners, but only non-corporate real estate partnerships and real estate corporations. Mortgage interest paid by homeowners is treated as a "consumer expense."

3a. Domestic Net Interest Paid by Business

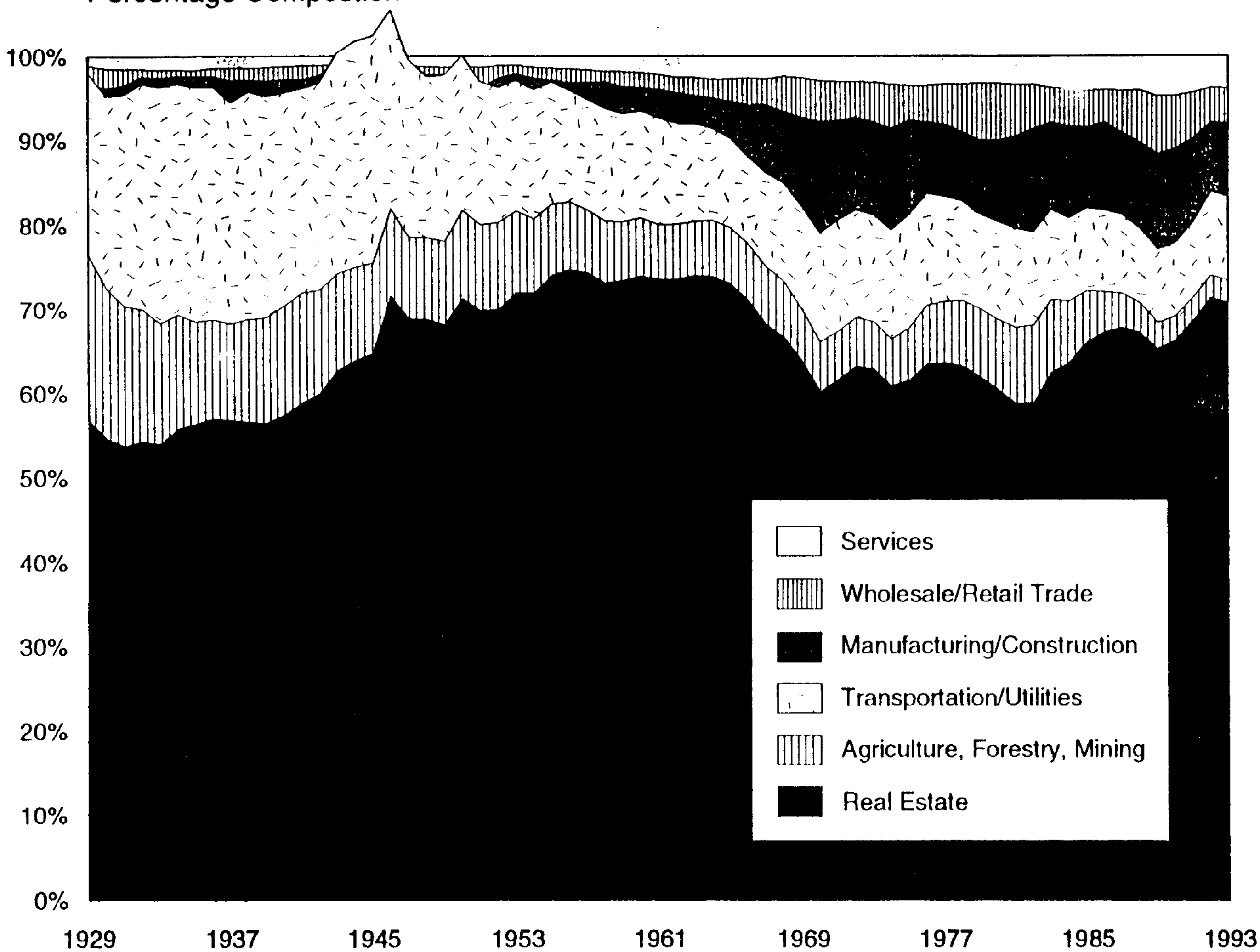
In Billions of Dollars



Source: NIPA

3b. Domestic Net Business Interest

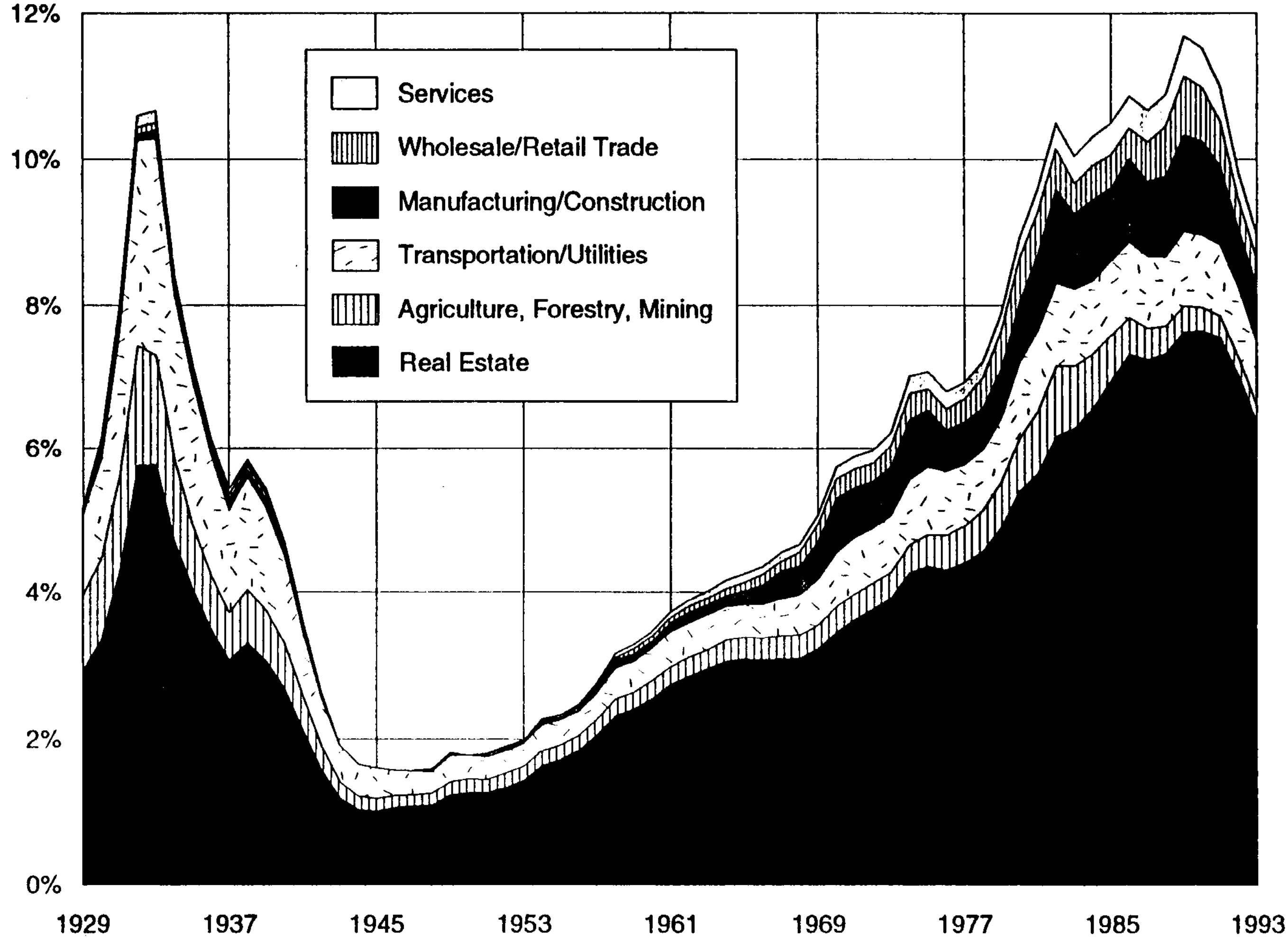
Percentage Compostion



Source: NIPA

3c. Net Business Interest

As Percentage of National Income



Source: NIPA

In addition to paying interest to their bankers, real estate investors turn over the capital consumption portion of their cash flow as loan amortization payments. A major lesson from examining the NIPA accounts is that creditors have ended up with both the mortgage interest and the CCAs. Many investors operate at a nominal loss, and even on the margin of solvency, 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 pursuit of this opportunity to earn capital gains, they seek to control as much property as they can, and are willing to forego current income in return.

Sometimes, of course, no capital gains accrue. In some highly conspicuous cases, landlords have walked away from their properties, leaving their mortgage lenders holding the bag. This is what led to the $500 billion FSLIC bailout by the Reconstruction Finance Corporation. Many smaller real estate parcels likewise were abandoned in central city areas from New York to Los Angeles. Indeed, this process was part of an international phenomenon, extending from Canary Wharf in London to Tokyo's Bubble Economy of 1985-1980. Nevertheless, holding onto properties by paying off their mortgage loans is made easier by favorable tax treatment. Indeed, nominal tax losses during 1984-91 enabled building investors not only to earn a rising cash flow, but to gain tax credits to shelter their otherwise taxable income earned in other sectors.

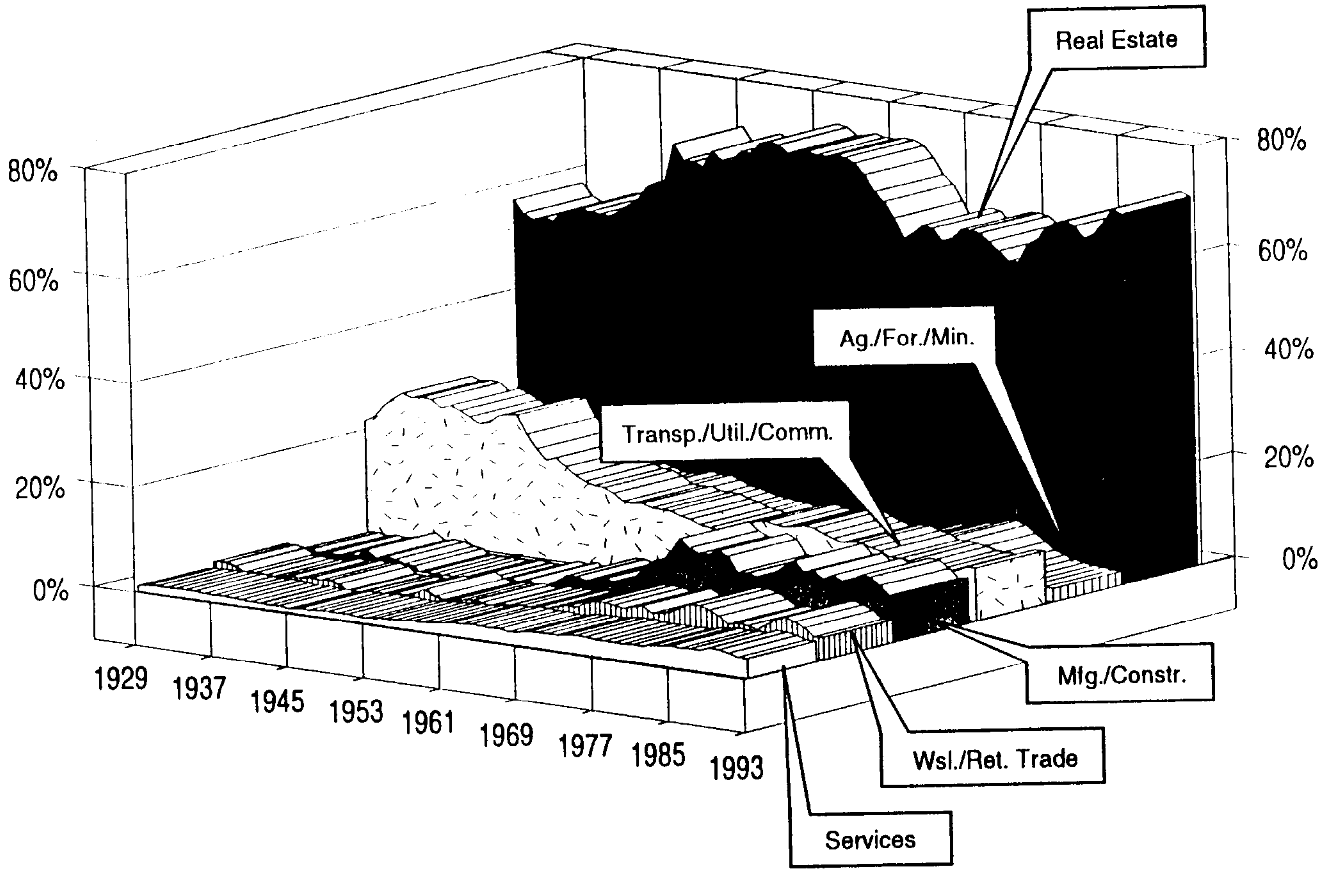
Real estate is pledged to mortgage lenders as collateral in case the promised interest payments fail to materialize. ***Capital gains have been collateralized into new and larger loans decade after decade, increasing the mortgage burden that transforms rental income and depreciation allowances into interest payments. Ultimately, the financial*** **rentiers** ***end up with most of the cash flow which landlords—and government tax collectors—relinquish.***

Tax-deductibility of mortgage costs does not impair government revenues if mortgage lenders pay taxes on their interest income. Moreover, lenders may be able to shift part of the tax burden to borrowers by charging higher interest rates.[29] Actually, however, much interest income manages to avoid taxation, such as that of banks adding to their loss coverage funds (or otherwise offsetting their income) or individuals with tax shelters. The insurance and financial industries have long obtained virtual tax exemption for their income.

[29] Also, insofar as mortgage interest is treated preferentially relative to other forms of interest, there will be

3d. Components of Domestic Net Business Interest

As Percentage of Total



Source: NIPA

immediately. Many take years of negotiation and litigation before they are paid out. In fact, the courts in many states are notoriously backed up by such litigation. Insurance company critics point out that by the time many companies actually pay out on their claims, the delays have saved them enough by deferment of income taxes to meet the entire cost. Also, pension funds and non-profits do not have to pay income taxes or capital gains taxes. (Non-profits include universities, which are major real estate investors.) Mutual funds have fewer tax breaks, but mutual funds for real estate typically are organized as real estate investment trusts (REITs), which often generate tax losses for their investors to charge against other income.

The result is that the FIRE sector as a whole has been subsidized at the expense of direct industrial investors and consumers. As **Charts 4a**, **4b**, and **4c** illustrate, compared to interest charges and property taxes, the reported $150 billion in rental cash flow is relatively small. Net taxable income is smaller yet. Just $24 billion in rental income (and an $86 billion cash flow) was reported by small building owners, that is, owners whose primary source of income was not real estate. $130 billion was earned by partnerships (the most common form of business organization in the real estate industry), while real estate corporations reported a $4 billion net loss (but a $3 billion net cash flow) in 1993.

Chart 5 tracks the relative growth of the finance, insurance, and real estate sector using Labor Department employment figures. It shows that what the classical economists called "productive" labor has remained constant since 1929, while virtually all growth has been in government (mainly state and local) and private sector services—mainly in the FIRE sector. Tax subsidies may largely explain why the FIRE sector has been the most rapidly growing part of the economy over the past half century. This is the conceptual context in which we should view the NIPA statistics.

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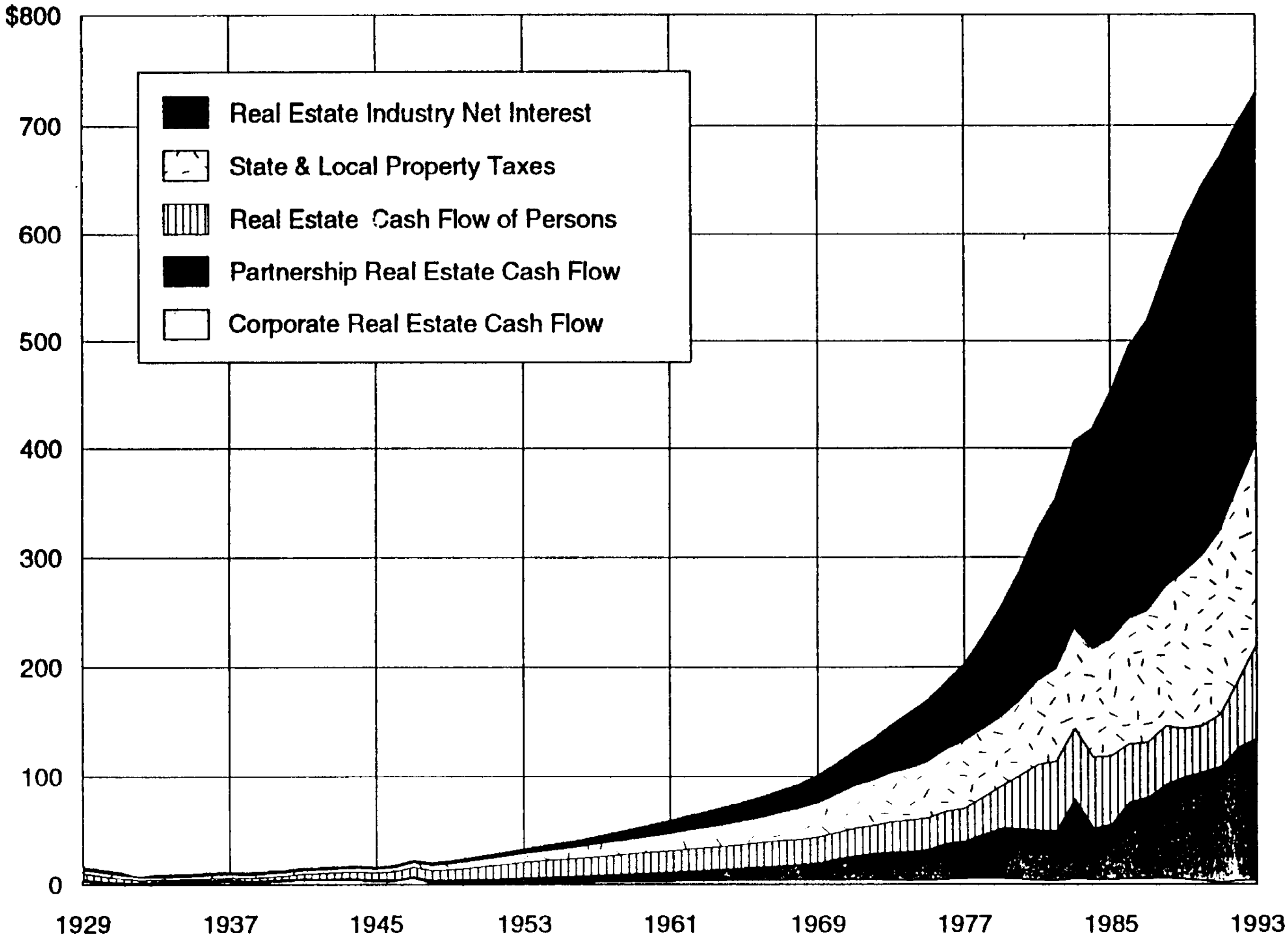
4a. U.S. Gross Real Estate Revenue

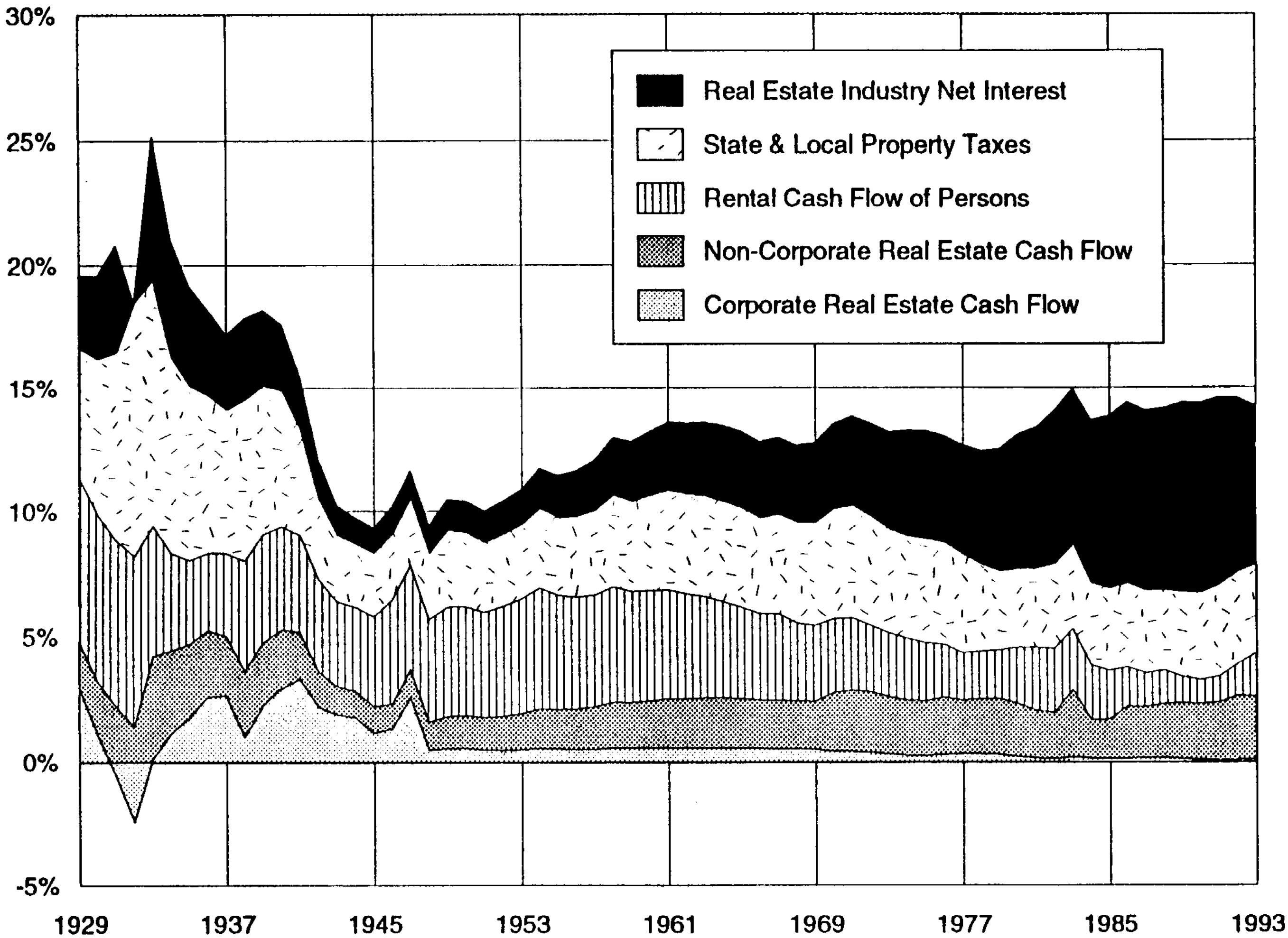
In Billions of Dollars



Source: NIPA

4b. U.S. Gross Rental Revenue

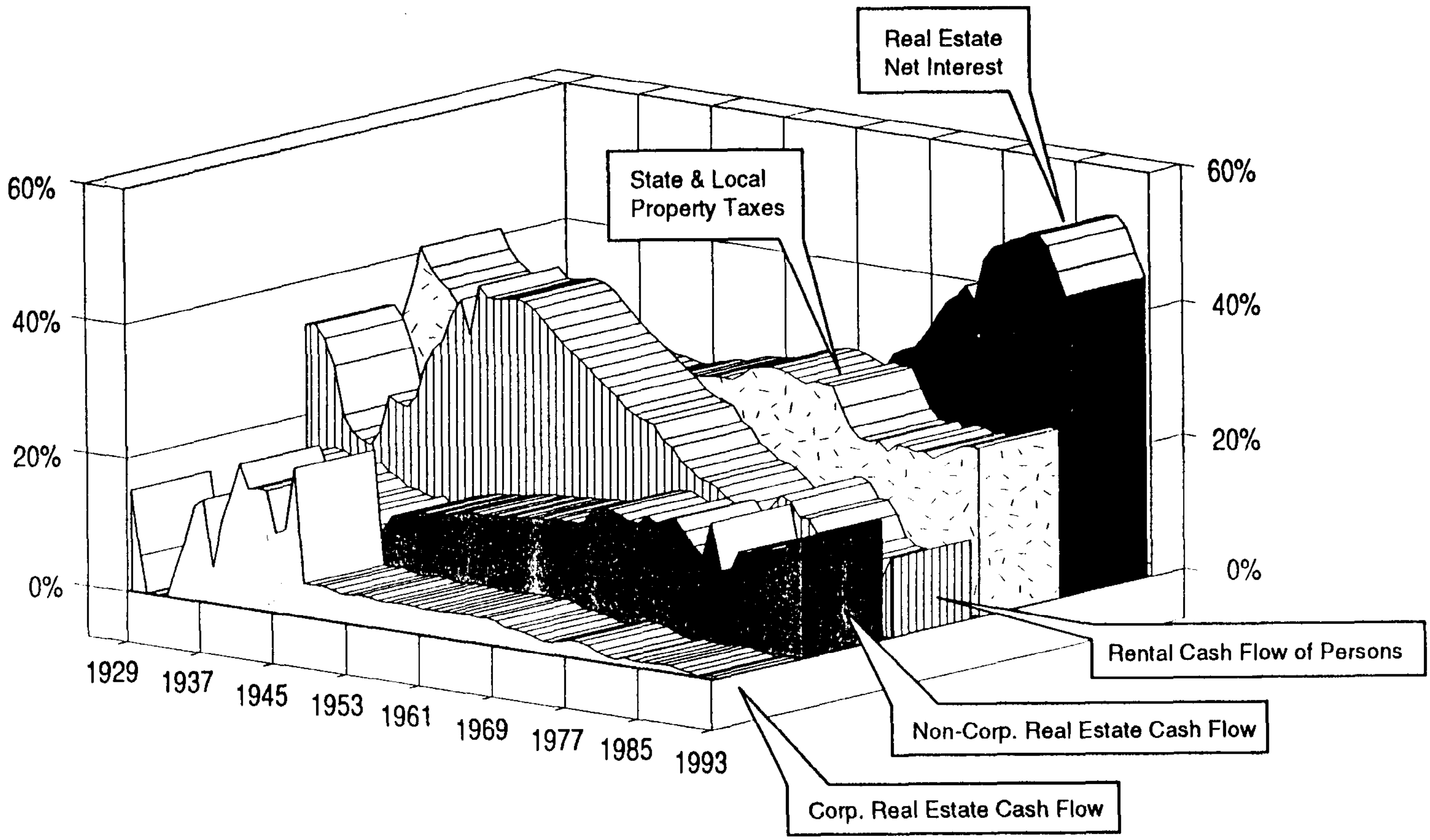
As Percentage of National Income



Source: NIPA

4c. Components of Gross Rental Revenue

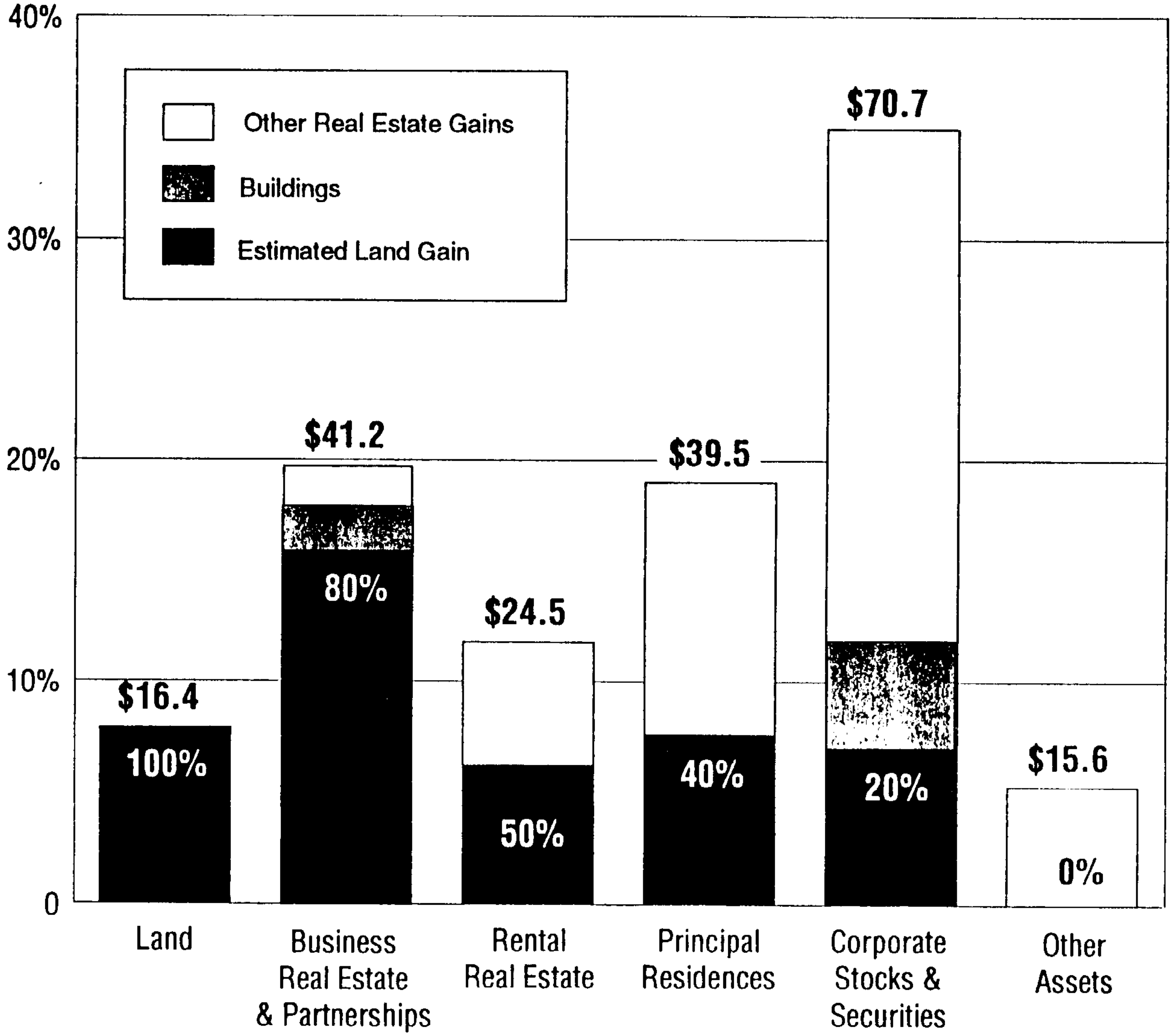
as Percentage of Total Gross Rental Revenue



Source: NIPA

5. Capital Gains As Reported to IRS – 1985

As Percentage of Total Capital Gains (Billions of Dollars)



Source: IRS

4. Capital Gains Taxation in Real Estate

Tax rates on capital gains historically have been low compared to income tax rates (**Table 1**). Even more important is the fact that capital gains taxes are paid only at the time of realization, that is, when the asset is sold, not as the gains actually accrue. The longer a tax is deferred (and the higher is the imputed rate of interest), the lower is its discounted present value.

The effective rate is further reduced by numerous exclusions and exemptions. With regard to real estate, for example, homeowners enjoy a $125,000 exclusion for capital gains on sales of their primary homes, as long as they recycle the proceeds into buying a new residence within a year. Homeowners over 55 are permitted to sell their houses without having to pay any tax on their capital gain, as long as they buy a new residence of equal or higher value. The stated rationale for these concessions is that to tax residential capital gains would make homeowners pay taxes just to stay in the same economic position when they move to take new jobs in other cities or to retire. President Clinton's recent proposal would further extend homeowners' tax exclusions.

No capital gains duties are levied on estates passing to heirs. Indeed, inheritors of real estate may begin re-depreciating their income-yielding buildings afresh at the new (typically higher) transfer price. The estates bequeathed by the richest one percent of the population (over $600,000 in value) are now taxed at a 55 percent rate if not sheltered, but of course these are the estates most likely to shelter inheritance and gift bequests. For instance, assets given as gifts are taxed only at the time they come to be sold.[30] If the capital gains tax were reduced or abolished, the deferral would become permanent.

Most capital gains reaped by business partnerships accrue to real estate firms, which shelter personal income by avoiding incorporation. IRS statistics ranking capital gains in terms of how long the assets were held show that many of these gains represent quick "flips." Often these are land that has been rezoned from a low-value to a high-value use. Retaining the capital gains tax would have little effect on deterring such speculation.

Properties held for longer periods of time by these partnerships typically are sold or swapped after having been fully depreciated. Swaps have long been permitted to the real

Table 1. The Evolution of Capital Gains Tax Rates

	Maximum Capital Gains Tax Rate (%)		Top Marginal Income Tax Rate	
	Individuals	Corporations	Individuals	Corporations
1942-43	25%	25%	88%	40%
1944-45	25	25	94	40
1946-50	25	25	91	38
1951	25	25	87.2	50.8
1952-53	26	26	88	52
1954	26	26	87	52
1955-63	25	25	87	52
1964	25	25	77	50
1965-67	25	25	70	48
1968-69	25	27.5	70	48
1970	29.5	28	70	48
1971	32.5	30	70	48
1972-78 (Oct)	35	30	70	48
1978 (Nov)-June '81	28	28	70	46
June '81-86	20	28	50	46
1987	28	34	38.5	40
1988-89	33	34	33	34
1990-92	8	34	31	34
1993-95	28	35	39.6	35

Source: American Council for Capital Formation, Center for Policy Research, "Update: Questions and Answers on Capital Gains," Sept. 1995, based on Joint Committee on Taxation (1995), "Tax Treatment of Capital Gains and Losses," JCS-4-95, February 13, 1995, and Office of the Secretary of the Treasury, Office of Tax Analysis (1985), "Report to Congress on the Capital Gains Tax Reductions of 1978."

many almost perpetually free of income taxation. The logic for this loophole seems at first glance to be much like that for personal homeowners' exemptions in selling a home to move somewhere else, without having to pay a capital gain tax in the process; but the analogy is specious. Homeowners cannot take a depreciation tax credit unless their property generates rental income, and most do not generate any income against which to claim CCAs.[31] In contrast, the capital gains which commercial real estate investors record for income-tax purposes are calculated, not merely on the gain in the property's market price (as with owner-occupied homes), but on the excess of selling price over depreciated book value.

Major commercial real estate investors such as pension funds, insurance companies and other large institutions are exempt from capital gains taxes, as are foreign investors. In addition to playing a dominant role in real estate, these institutional investors own nearly half of all U.S. equities.[32]

For similar reasons, Fazzari and Herzon note in a Levy Economics Institute brief that "the 'effective' year-to-year tax rate on capital gains (sometimes called the 'accrual-equivalent' tax rate) is actually lower than the statutory rate."[33] They estimate the effective rate by halving the statutory rate to account for the numerous exclusions and exemptions—and then halving it again to reflect the benefits of deferring taxes to the time capital gains are realized rather than paying upon accrual. If this is correct, then for today's 28 percent capital gains tax, the first halving produces an effective tax rate of 14 percent; the second reduces it to just 7 percent. To cut the (statutory) rate to 14 percent, as Senator Dole proposed, would reduce the effective capital gains tax rate to roughly 3.5 percent.

[31] Homeowners do receive imputed rental income, which is not subject to the income tax.
[32] Minarik (1992), p. 20.
[33] Fazzari and Herzon (1995).

5. Government Statistics on Real Estate Gains

• THE 1985 IRS SURVEY

In view of the fact that real estate is the economy's largest asset category—and land its major component—it is desirable to put the capital gains debate in perspective by compiling adequate statistics to trace land and building values. ***Unfortunately, published statistics do not permit reliable estimates of capital gains in real estate. The most recent benchmark for capital gains in the US economy is an IRS sampling of capital gains declarations on 1985 income tax returns,*** prepared in connection with the Tax Reform Act of 1986. By 1989-90 these data were analyzed in two studies.[34] Subsequent estimates have been published by the IRS in its *Statistics on Income*, but cover only a portion of the capital gains spectrum.

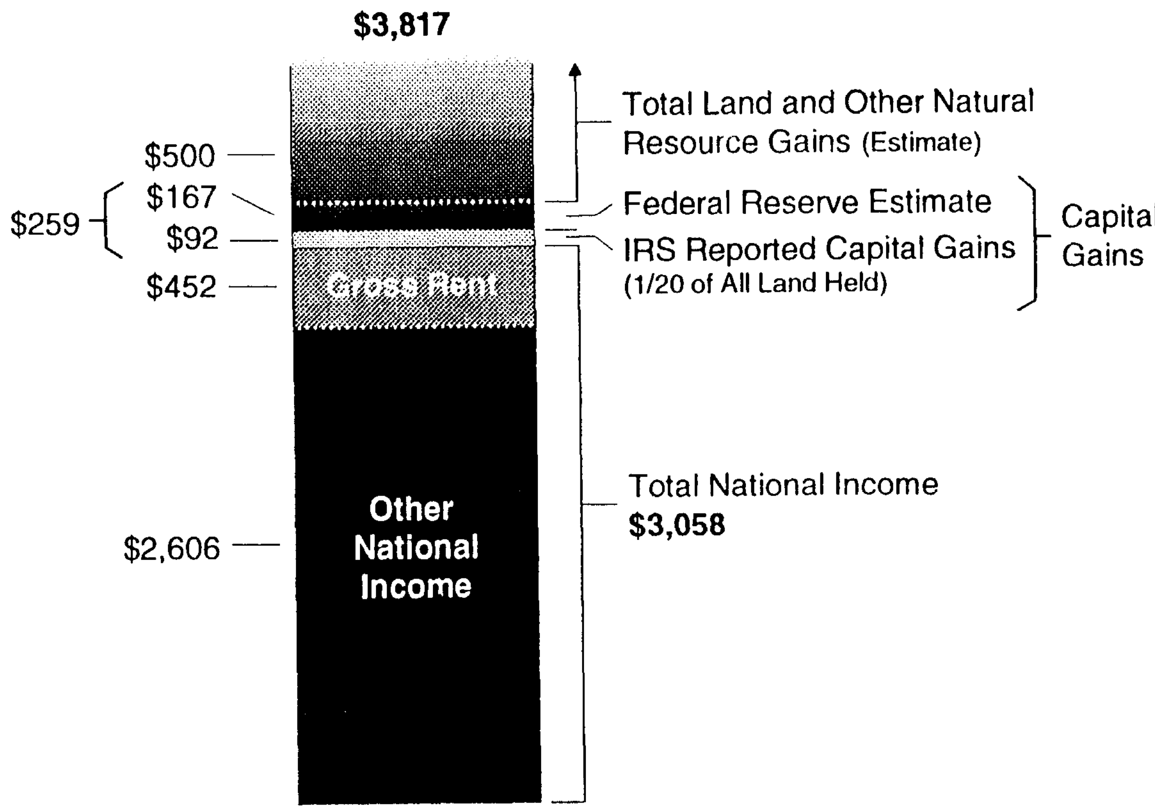
The IRS benchmark survey estimated 1985 capital gains at $208 billion, an amount equal to only 6.4 percent of that year's $3.3 trillion national income. An analysis of how these capital gains were distributed as between land and buildings, plant and equipment, other direct investment, and the stock market indicates that the economy's capital gains are mostly in real estate, and in greater proportion than the IRS benchmark study suggests. For properties sold during the year, including the values embodied in stock-market equities, we interpret the IRS survey as suggesting land value gains of about $97 billion (**Chart 6**). This does not include institutional or foreign real estate holdings, for these are not subject to taxation and thus were excluded from the IRS sample. The IRS statistics show only what individual persons who sold assets in 1985 were declaring on their tax returns. **Table 2** tracks land gains as a percentage of total reported capital gains for the 1985 IRS data.

Within these limitations of scope, sales of principal residences[35] totaled $37 billion, accounting for 19 percent of the capital gains sample. However, the statistics were swamped by the $125,000 exclusion for capital gains on sales of owner-occupied homes. This exclusion was so large, coming as it did just as the real estate bubble was peaking, that it reduced the proportion of *taxable* capital gains accounted for by residential sales from 19 percent to just 1.1 percent of the sample.

[34] Holik, Hostetter and Labate (1989 and also 1990).
[35] Reported on Form 2119.

6. National Income Plus Capital Gains In Land - 1985

In Billions of Dollars



Source: NIPA, IRS

Table 2. Estimated Land Gains as a Percentage of Total Reported Capital Gains, 1985

Source of 1985 Gains	Percent of Total	x % Land Gains	= Land Gains as % Total	% Capital Imprvmts	Other as % of Total
Land	7.0	100%	7.0	-	-
Farmland	0.9	100%	0.9	-	-
Distribution from partnerships, fiduciaries and S-corporations	9.5	80%	7.6	10%	0.9
Business real estate	10.3	80%	8.2	20%	2.1
Rental real estate	11.8	40%	4.7	60%	7.1
Principal residences	19.0	40%	7.6	60%	11.4
Corporate stock	33.0	20%	6.6	20%	6.6
Mutual funds	1.0	20%	0.2	20%	0.2
Bonds and other securities	0.8	-	-	-	-
Commodities and futures	0.2	-	-	-	-
Business machinery/equipment	1.5	-	-	-	-
Farm livestock	1.0	-	-	-	-
Timber	0.2	-	-	-	-
Other assets	3.9	-	-	-	-
TOTAL	**100.0%**		**42.9%**		**28.3%**

Source: US Treasury

Reported capital gains in real estate were understated as a result of exclusions. On the other hand, much direct investment included the cost of land, commercial buildings, and plant and equipment. Taking this into account, we estimate that roughly 70 percent of the capital gains calculated by the IRS for 1985 probably represent real estate. Even this estimate may understate the role of land and real estate. In 1985, anticipating the planned 1986 tax reform which would raise the capital gains tax rate from 20 to 28 percent, many investors sold their securities that had registered the largest advances. Some 40 percent of the capital gains reaped by selling these stocks probably represented real estate gains. A major spur to the LBO movement driving up the stock market was an awareness that real estate gains were not being reflected in book values and share prices;[36] as land prices leapt upward—funded in part by looser regulatory restrictions on S&L lending against land—raiders bought publicly traded companies and sold off their assets, including real estate, to pay off their junk-bond backers. In effect, not only were rental income and profits being converted into a flow of interest payments; so also were capital gains.

• The Federal Reserve Data

Federal Reserve Board statistics considerably outstrip the 1985 IRS estimate of $208 billion of taxable capital gains. The Fed's *Balance Sheets for the U.S. Economy* lists the total value of land, buildings and other real assets. For produced capital, the annual increase in aggregate asset values does not distinguish capital gains on existing assets from the value of new production. For land, however, the value of new production must be zero, so the entire annual increase constitutes capital gains—accurately, land gains. According to the Fed, aggregate building values increased by $204 billion in 1985, while land prices rose by $356 billion, more than three and a half times the value implied by the IRS statistics.

The Federal Reserve Board provides an implied estimate of land gains (and a measure of building gains that does not include over-depreciation pay-backs recorded fictitiously as capital gains) in its Z9 release estimating asset values throughout the economy. However, the IRS and Fed are not measuring capital gains in the same way. The Fed measures the overall nationwide market value of land and buildings, while the IRS

[36] See **Chart 6** for the assumptions made as to the IRS breakdown of capital gains, by industry. This estimate closely approximates the Federal Reserve's statistics for land and real estate improvements as a

sample includes only properties sold during the year. Furthermore, the IRS statistics do not include capital gains on which no taxes are due because of exclusions.

On the other hand, the Fed statistics[37] understate land values for methodological reasons. Starting with estimates for overall real estate market prices, Fed statisticians subtract estimated replacement prices for existing buildings and capital improvements to derive land values as a residual. These replacement prices are based on the Commerce Department's index of construction costs. Thus, building values are estimated to increase steadily over time, on the implicit assumption that all such property is worth reproducing at today's rising costs.

However, the value of any building tends eventually to decline, until finally it is scrapped and replaced. It is the value of land which tends to rise as population and income grow (over the long run, with cyclical swings), precisely 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, but also because buildings undergo locational obsolescence as neighborhood land uses change over time, so market prices tend to fall below replacement costs. It would not be economical to rebuild many types of structures on the same site if they were suddenly destroyed.[38] In particular, where land use is intensifying over the long run, rising land values effectively drain the capital value out of old buildings. This is because the salvage value of land (its worth upon renewal) tends to rise, while the scrap or salvage value of most immovable improvements is negligible. Where land has alternative uses, rent is not its current net income but its opportunity cost—the minimum yield required by the market to warrant keeping the land in its present use instead of converting it to the best alternative use. 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.[39]

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proportion of the US economy's net assets.

[37] *Balance Sheets for the U.S. Economy, 1945-94*, Tables B.11, B.12 and R.11.

[38] Sometimes, to be sure, there is a renaissance, as when gentrification occurs. Land use is currently being shifted away from industry to residential development in the center of cities much the same way that it is being shifted away from agricultural uses to residential development at the outer margins of cities. However, gentrification comes because entire industrial areas have lost their value. In New York, it occurred in the Tribeca and Soho neighborhoods in southern Manhattan, resulting in more than 10,000 residential loft conversions during the city's economic downturn in the 1970s. In Chicago, it occurring west of the Loop, and on the Near North Side.

[39] Indeed, where ill-maintained old buildings occupy prime locations, a parcel may be more valuable once

Thus, the correct way to separate land values from building values is to appraise land values directly in terms of opportunity cost—how much would a vacant lot at that site fetch in the market? If the observed market value of the improved property exceeds the land value, the residual is the implied value of the standing improvements. The Fed's land-residual method theoretically understates the land share of real estate values.[40] The pitfall of this methodology is demonstrated to an almost comical degree by the fact that according to Fed statistics, the land component of corporately owned real estate has been reduced to near zero over the past five years (while the nominal reproduction costs of factories and other corporately held buildings are inflating).

The measurement problem is exacerbated by assessment bias in many states and localities. Particularly where land values are trending upward, overestimates of building values relative to site values reflect the steady under-assessment of land. Note that as a larger share of real estate value is imputed to buildings, a larger share of cash flow can be claimed as depreciation. In effect, assessment bias allows investors to partly depreciate land, at no cost to local government budgets.[41]

Official statistics should provide a sense of proportion as to how the economy works. Especially when it comes to 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. One searches in vain, for example, for an estimate of the distribution of total income among land, labor, and capital, or for an accounting of how *rentier* claims on revenue and output are layered upon directly productive enterprise.

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the building is demolished and the lot cleared for reuse See Gaffney (1993 and also 1971). Some improvements, such as gas stations and refineries, are accompanied by ecological pollution, which can be analyzed as a negative improvement—the property would be worth more without it. Pollution may greatly increase the salvage cost of land, making it uneconomical to salvage some lands despite the value they would have if clean. This "brownfields" problem has received considerable public notice in recent months.

[40] Gaffney (1993).

[41] Studies cited by Gaffney (1993) of assessed building values at demolition indicate a tendency of assessors, too, to overvalue depreciable improvements. At the moment of demolition, for example, a building's value equals its scrap value (if any) minus the cost of demolition. The result can easily be negative. That is, the cleared land may be worth more than the parcel is worth with the old building standing and its cleanup costs yet to be borne. The IRS may question specific building appraisals, but the general practice is to accept the local city assessment, which tends to favor buildings over land. It is well known that Fed statistics on the value of corporate land and buildings show an unrealistic low valuation of land.

6. The Political Context of Real Estate Taxation

Much of the public discussion of capital gains policy has been conducted with little reference to empirical research as to their actual character and composition in the US economy. Capital gains, and savings in general, are defended on the assumption that they are automatically transformed into new direct investment. Yet the more layers has the debt pyramid, the smaller is the proportion of savings used to finance direct investment. Moreover, our investigation suggests that a large and expanding share of the economy's capital gains—as they are defined, measured and taxed—has little discernible impact on net investment or employment.

IRS estimates of capital gains measure only the small proportion that individuals are obliged to declare after all the exemptions and exclusions have been utilized. There is no estimate of the volume of capital gains generated each year, and no adequate breakdown as to where these gains occur. This statistical lacuna means that the economic cost of assorted tax loopholes is not being calculated. ***There is no sound statistical basis for calculating the* total *returns being taken by investors, or the proportion of those returns paid in taxes.***

When statistics are lacking, it often is because some interest groups are benefiting in ways they prefer not to see quantified and publicized. If land assessments lag behind actual increases in market value, for instance, land speculators, as well as homeowners, will pay less than their legislated tax share. Also—and of direct relevance to our thesis—the failure to distinguish statistics on land values and other real estate gains from non-real-estate capital gains in industry and finance 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.

Academic economists likewise have been remarkably slow to address this shift away from earned income to capital gains. It is true that nineteenth-century land reformers such as John Stuart Mill and Leon Walras defined land-value gains as an "unearned increment," and urged that they be collected by the community at large, whose economic activity was, after all, responsible for creating these gains. Ever since Henry George brought matters to a head in *Progress and Poverty* (1879), however, economics has largely dropped the analysis of land-value gains, and indeed, of land itself.[42]

Wealthy investors have won congressional support for real estate exemptions in large part by mobilizing the economic ambitions of homeowners. Most families' major asset, after all, is their home. Two Federal Reserve studies trace the rise in gross house value from 26 percent of household wealth in 1962 to 30.1 percent in 1983 (falling back to 28.5 percent in 1989).[43] Household real estate assets substantially exceeded holdings of stocks, bonds and trust funds (20.5 percent in 1989), liquid assets (17 percent) and total debt (14 percent).[44] The giveaway to real estate interests is thus presented ostensibly as a popular middle class measure. 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 considerably, 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 is directed at homeowners, despite the fact that preferences for home ownership cannot be justified as a boost to entrepreneurial investment. Such is the foreshortened economic perspective of our times.

The LBO movement epitomizes the real estate industry's strategy, applying the developer's traditional debt-pyramiding techniques to the buying and selling of manufacturing companies. Raiders emulated developers who borrowed money to buy or construct buildings and make related capital improvements, agreeing to pay interest to their mortgage bankers or other lenders, putting down as little equity of their own as possible. Having set things in motion, the landlord uses the rental income to carry the interest, principal, taxes and maintenance charges while he waits for a capital gain to accrue. The idea is to amortize the loan as slowly as possible so as to minimize annual carrying charges, while paying them out of the CCA.

For many decades securities analysts have pored over corporate balance sheets in search of undervalued real estate whose book value does not reflect gains in market value. From the merger and acquisition movement of the 1960s through the takeover wave of the

[42] Gaffney and Harrison (1994).
[43] 1962 *Survey of Financial Characteristics of Consumers*, and its subsequent *Survey of Consumer Finances* for 1983, 1986, 1989, and 1992.
[44] Details are reported in Bureau of the Census (1988).

1980s, the raider's strategy has been to borrow money to buy the target company's stock, and then sell off its real estate and other assets to repay the creditors, hoping that something will be left for himself after settling the debts incurred in the process. For the bankers and other creditors, LBOs were a way to put savings to work earning higher rates of interest. The ensuing junk bond commotion pushed interest rates over 15 percent for high-risk securities, whose major risk was that quick capital gains and the cash flow available from re-depreciating properties would not cover the interest payments to the institutional investors rounded up by Drexel Burnham and the other investment bankers who underwrote the takeovers.

The object of building, like buying and selling companies, is thus by no means only to earn rental income. Most cash flow is pledged to lenders as debt service in any case. In a world of income taxation subject to loopholes, sophisticated investors aim not so much to make profits as to reap capital gains—not only in the stock and bond markets, but also in real estate, other natural resources, and the monopoly privileges that have come to underlie much of the pricing of securities today.

As developers borrow money to finance real estate purchases, lenders, for their part, use the real estate sector as a market to absorb and service the economy's mounting stock of savings, applying most of the rental cash flow to pay interest to savers. The end result is that most total returns are taken by the wealthiest ten percent responsible for nearly all the economy's net saving. Viewing US economic statistics from this perspective shows that not to calculate capital gains in the national income accounts alongside directly "earned" income helps foster the illusion that more equality exists among Americans than actually is the case. The fact is that earned income is more equally distributed than unearned gains.

This distinction between real estate (and by extension, other natural resource industries and monopolies) and the rest of the economy helps explain the familiar economic rule that inequalities of wealth tend historically to exceed inequalities of income. The reason is that the wealthiest layers of society control even more of the economy's assets—and the capital gains on these assets—than they do its income. They also obtain a larger proportion of cash flow and other non-taxable income than they do of taxable "earned" income.

This phenomenon has long been known, but not well explained. Edward Wolff has shown that wealth is more unequally distributed than income, but he leaves capital gains out of account in explaining how the American economy has grown more top-heavy.[45] It is unequal wealth that is primarily responsible for generating inequality of incomes. The more the returns to wealth can avoid taxation by being categorized as capital gains, the faster this inequality will polarize society.

Given the current US depreciation laws and related institutions, to lower the capital gains tax rate across the board is to steer capital and entrepreneurial resources into a search for unearned rather than earned income. 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. 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—a fight that has broken out in earnest following the 1996 presidential elections.

[45] Wolff (1995), p. 27. "The top one percent of wealth holders has typically held in excess of one-quarter of total household wealth, in comparison to the 8 or 9 percent share of income received by the top percentile of the income distribution."

7. Policy Conclusions

Because real estate investors make much of their money by buying and reselling existing properties, much as financial investors buy already seasoned stocks and bonds, many real estate and stock transactions have no new employment or direct investment effects regardless of the capital gains incentives being offered. Yet the tax code permits real estate investors to take their returns mainly in the form of capital gains and declare little taxable ordinary income. FIRE sector investors in the finance and insurance industries also have taken their income in ever more lightly taxed forms. These tax subsidies divert effort and ingenuity out of productive channels and into speculation on already existing buildings and land, or already issued stocks and bonds. An across-the-board cut in capital gains taxes would favor the FIRE sector rather than manufacturing, steering investment money further from active to passive investment. Far greater stimulus to productivity is to be expected from, instead, eliminating special privileges and closing loopholes—while reducing taxes on payrolls, sales, and enterprise.

Adam Smith and subsequent classical economists defined some forms of investment and income as being more productive than others, suggesting a normative basis for evaluating legislation on the basis of economic efficiency and productivity. Although there was disagreement as to details, ***it was the essence of classical political economy to distinguish productive from unproductive investment.*** Productive investment added to revenue, employment and wealth. Unproductive investment, what today would be called zero-sum transactions, merely redistributed income.

The classical economists distinguished the earned income of capital and labor from what they deemed *unearned* income, mainly in the form of land rent and, by extension, the rent of public monopolies as well as mines and other natural resources. They applauded industrial profits and other returns to the factors of production; they frowned on the *rentier* takings that burdened productive effort. Profits, they believed, tended to be recycled into new investment, employing yet more labor to increase output, while *rentier* income was a kind of economic overhead. A fundamental problem was the tendency of rent to be dissipated on consumption expenditures to maintain the *rentier* lifestyle, for example, to support a retinue of servants who *absorbed* income rather than generating new growth in revenue. The industrialists, by contrast, tended to recycle their revenue back into new capital formation. By the time of John Stuart Mill, the mainstream of British political economy defined "capital gains" in land and real estate as economically sterile.

Thus the classical view of economics was no law of the jungle. It endorsed an institutional shaping of the market place so that economic self-interest would serve society's long-term objectives. Self-interest was the mainspring, but just as every watch needs controls and release ratchets, self-interest had to be harnessed in service to the general welfare and steered away from unproductive or corrosive activities.

The after-tax earnings of labor and enterprise constitute incentives for markets to expand economic horizons. They generate more taxes in the process, as well as more wealth. Such is not the case with forms of wealth appropriation that constitute zero- or negative-sum transfers from consumers, workers and other taxpayers to corporate raiders, privatizers, real estate speculators or outright crooks.

Two Republican presidential hopefuls, Steve Forbes and Lamar Alexander, sought unsuccessfully to win voter support in the primaries by advocating a flat-rate tax with just a few exceptions. The exceptions were mortgage interest—on the ground that taxing it would reduce the value of much of the nation's real estate, by forcing some strapped homeowners to sell—and capital gains. Yet these are two of the most parasitic ways of getting rich. Bank credit was distorted throughout the 1980s, away from financing real estate trades in preference to direct industrial investment and employment. Speculators borrowed money to buy buildings, agreeing to pay their rental income to the banker (or S&L, insurance company or other mortgage lender) at the taxpayer's expense.

Taxation of capital gains is widely attacked as a "soak the rich" scheme, a program of wealth redistribution that will adversely affect growth in productivity and efficiency. Kurt Hauser's *Wall Street Journal* editorial counters this with the observation that *over half of all taxpayers* reporting capital gains have adjusted gross incomes of under $50,000, implying that a tax cut would not preferentially benefit the wealthy. He neglects to observe, however, that the poorer half of taxpayers account for less than ten percent of the total *dollar value* of capital gains[46]—or that the capital gains tax is virtually the only remaining

[46] Hauser (1995); Wolff (1995).

federal levy on real estate income. Low capital gains tax rates and the tax deductibility of mortgage interest have contributed to the polarization of wealth distribution. A further reduction in the capital gains rate would worsen this maldistribution by making real estate virtually tax-free except for local property taxes, which fell from 10 percent to just 7.4 percent of all taxes at all levels of government between 1955 and 1989.[47]

Time columnist John Rothschild recently accused opponents of a capital gains tax cut of resisting "any reform, no matter how it may benefit society in general," simply "so that the rich cannot benefit."[48] The implication is that any resulting growth in income inequality is the price a free society must pay for an efficient system of economic incentives. Indeed, it would be difficult to oppose widely shared progress simply because the rich are gaining faster than the rest of society. The point, however, is that the tax code encourages the wealthy to enrich themselves in ways that are detrimental to the economy at large. The presumed trade-off between equity and efficiency is mythical, at least with respect to real estate under the current federal tax code.

An inordinate focus on stock market gains—especially the selection of small industrial companies such as a yacht producer just making his first stock offering—diverts attention from the extent to which a low capital gains tax benefits real estate investors preferentially. The irony of casting the issue in terms of the stock market rather than real estate investment is that financial investors have already devised an array of strategies to evade taxation on stock gains. Institutional investors already are exempt from capital gains taxes on securities, as they are on their real estate holdings. Wealthy individual investors can arrange fictitious "short" sales ("sales against the box"), obtaining the proceeds of their stocks without having to actually sell them, by collateralizing them with a bank and borrowing an amount of money equal to the value of the stocks. This is the equivalent of a sale, for it provides immediate proceeds—but without incurring taxes on the securities' rise in value. Bankers find this a lucrative business, while the Treasury foregoes revenue at the expense of less affluent taxpayers. To abolish capital gains taxes would enable these fictitious "against the box" maneuverings finally to be liquidated without having paid any taxes. Also freed would be the accumulated over-depreciation of buildings that has sheltered past real estate income.

[47] Rosen (1992), p. 22.

If the intention is to provide an incentive for new direct investment, employment, and industrial modernization, then an across-the-board capital gains tax cut is at best a blunt policy instrument. We have examined several reasons to doubt that further cuts in capital gains taxes will have a pronounced incentive effect on new direct investment.[49] Capital gains tend to reward accumulation of old assets more than production of new wealth. The stock market is mostly a second-hand market, but we do not lean too hard on this point because the (discounted) anticipation of future capital gains may boost the demand for new stock issues, making it somewhat easier for corporations to finance new investment. The main point is that most taxable capital gains represent appreciation of non-produced land and of structures built years ago. In the current institutional setting, real estate gains are artificially inflated by generous depreciation rules, which apply not only to newly constructed buildings but also to second-hand buildings and even, effectively, to land, which neither depreciates nor is replaced. As long as these and other rules are in place, an across-the-board capital gains tax cut will preferentially benefit real estate and financial speculation at the expense of industrial production. It will also increase the federal budget deficit, ultimately at the expense of lower- and middle-income taxpayers.

One reason often cited for taxing capital gains at lower rates than ordinary income is to exempt "phantom income" arising from inflation. The logic of indexing is that if prices rise by, say, 50 percent between the time of purchase and the time of sale, then this amount should not be taxed; to do so would be to tax investors just for "staying in place." However, inflation erodes all monetary assets, not just capital gains,[50] and may erode the purchasing power of labor income, as has occurred for most wage-earners in recent years. Equity in the face of inflation is thus a poor argument for preferential capital gains tax rates.

Four conclusions for federal tax policy are summarized below, ranked in ascending order as to the confidence with which we offer them.

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[48] Rothschild (1995).

[49] A capital gains tax cut may relieve a lock-in effect caused by taxing capital gains upon realization instead of accrual. However, Gaffney (1991), p. 50, writes that "the locked-in effect results mainly from step-up at death, rather than from a high rate per se."

[50] Gaffney (1991), pp. 49-53. Inflation amounts to a general wealth tax.

- **DO NOT REDUCE CAPITAL GAINS TAXES ON BUILDINGS.**

We agree with the major premise that to reduce taxation the earnings of productive enterprise has beneficial incentive effects. However, given fiscal rules permitting excess depreciation of buildings to be recovered by deferred capital gains taxation at preferential rates, the tax code subsidizes speculation in existing properties more than it stimulates new production. As real estate developers know, construction responds more to shifts in interest rates than to adjustments in the capital gains tax rate. Capital consumption allowances absorb nearly all the rental cash flow left after paying mortgage interest, making cash flow virtually exempt from income taxes. Because foreign investors and institutional investors such as pension funds and insurance companies are not subject to capital gains taxes, a tax cut would not affect their real estate operations in any event.

- **DO NOT PERMIT BUILDINGS TO BE DEPRECIATED MORE THAN ONCE.**

The only point at which much of the real estate industry now pays taxes on its accumulated cash flow after taking capital consumption write-offs is when the building is sold. To let the building be depreciated all over again is to transform what should be a current income tax liability into a deferred capital gains tax. This gives the real estate industry a unique gift. Deferral of tax liability from the time when rental income actually is earned until the time when the building is sold enables the property to avoid paying its fair share of income taxes, transmuting ordinary income into a capital gain that is taxed at a far lower effective rate than ordinary income. This deferral nearly doubles the private rate of return on investment.

As long as capital consumption allowances give the real estate industry a peculiarly generous income tax status, real estate investors will do what they can to impute an excessive proportion of total real estate value to depreciable improvements.[51] Moreover, as long as real estate income is effectively exempted from the income tax, a powerful lobby will continue the drive to substitute income taxes for state and local property taxes.[52]

[51] Local assessors frequently appear to act in collusion with landowners: Gaffney (1993).
[52] An *ad valorem* tax on land values would recapture that part of the real estate value which is created by the surrounding community. While taxes on produced wealth tend to discourage the reproduction of such wealth, well-administered taxes on the market value or annual rent of land are among the least intrusive forms of taxation. They generate no "excess burden of taxation" and discourage neither the production nor

- **DO NOT REDUCE CAPITAL GAINS TAXES ON LAND.**

Land is created by nature, not by human investors. Much of the value of land, especially urban land, is determined by its location with respect to surrounding public and private infrastructure, other capital, and activities of all kinds. Land value is not produced by the investment of individual landowners and users (they contribute the improvements).[53] Therefore, to the extent that taxable capital gains are really land value gains, cutting the "capital" gains tax deters no new capital formation. On the contrary, to cut taxes on land gains is to encourage land speculation, inducing less intensive use of central lands and thereby raising the public, private, and environmental costs associated with a sprawling, inefficient pattern of land use.[54] It is also to accelerate rent-seeking activities, which consume resources in the service of redistribution, not production.[55]

- **IMPROVE THE QUALITY OF STATISTICS AND REFORM NIPA ACCOUNTING PRACTICES.**

Estimates of capital gains from various sources are not easily found. The 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.

Presently, US statistics appear to undervalue land by at least a trillion dollars (at about $4 trillion, down from the $5 trillion estimated in 1990). The Federal Reserve method of calculating land and improvement values by estimating a building's reproduction cost is inappropriate. The market value of land should be evaluated independently, rather than

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the economic use of land (Tideman, 1994, p. 135). They reduce the incentive to speculate, and induce more intensive use of valuable lands. They cannot be shifted to tenants or consumers, and they do not erode their own tax bases. Both efficiency and equity are therefore well served by focusing taxes on land values. High land taxes would also help counter the widespread tendency to over-assess buildings (and hence, to increase their permitted CCA) relative to land.

[53] Macro-developments where developers build entire towns or neighborhood enclaves are sometimes understood to increase land rent in the sense that they internalize location externalities; this may reflect inconsistency in the definition of a land parcel for assessment purposes (Feder, 1993, pp. 83-105). Most such cases are urban or suburban re-developments that involve large public subsidies, with public land turned over at concessionary prices and with generous tax abatements (often to large institutional investors who are politically well-connected).

[54] Feder (1994), p. 146-148.

derived by subtracting the hypothetical replacement cost of buildings from market real estate values. The theoretically correct approach is the building-residual method of real estate assessment, as we noted in Section 5. One result of consistently applying the building-residual method would be to raise the land share and lower the building share of assessed property value, and thus narrow the depreciation loophole.[56]

It can only confuse matters to debate capital gains taxes without separately considering 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"). 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 over-depreciation. The present GNP/NIPA format fails to differentiate carefully among land, produced wealth, and financial claims.

Economic policy should distinguish between activities which add to productive capacity and those which merely add to overhead. This distinction elevates the policy debate above the level of merely carping about inequitable wealth distribution, an attack by have-nots on the haves, to the fundamental 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 productive effort have grave implications, not only for distributive justice and social harmony, but also for economic efficiency and growth.

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[55] Gaffney (1989); see also Gaffney (1993).

[56] Gaffney (1993). Also, land and buildings are frequently assessed in a scattershot pattern, with land for contiguous parcels showing abrupt drop-offs or jumps. An entire profession of appraisal litigators has arisen; lawyers can get their clients' property taxes reduced simply by finding some seemingly similar low-valued properties. Such practices contribute to sharply under-valuing land in many areas. To overcome this administrative problem, smooth, continuous land value maps should be created using geographic information systems computer technology, and should be continuously updated using land sales data. More frequent reassessment, especially in areas with rapidly appreciating land values, would tend to increase property tax revenues and probably also to increase the land share of the total assessment.

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Table 1. The Evolution of Capital Gains Tax Rates

	Maximum Capital Gains Tax Rate (%)		Top Marginal Income Tax Rate	
	Individuals	Corporations	Individuals	Corporations
1942-43	25%	25%	88%	40%
1944-45	25	25	94	40
1946-50	25	25	91	38
1951	25	25	87.2	50.8
1952-53	26	26	88	52
1954	26	26	87	52
1955-63	25	25	87	52
1964	25	25	77	50
1965-67	25	25	70	48
1968-69	25	27.5	70	48
1970	29.5	28	70	48
1971	32.5	30	70	48
1972-78 (Oct)	35	30	70	48
1978 (Nov)-June '81	28	28	70	46
June '81-86	20	28	50	46
1987	28	34	38.5	40
1988-89	33	34	33	34
1990-92	8	34	31	34
1993-95	28	35	39.6	35

Source: American Council for Capital Formation, Center for Policy Research, "Update: Questions and Answers on Capital Gains," Sept. 1995, based on Joint Committee on Taxation (1995), "Tax Treatment of Capital Gains and Losses," JCS-4-95, February 13, 1995, and Office of the Secretary of the Treasury, Office of Tax Analysis (1985), "Report to Congress on the Capital Gains Tax Reductions of 1978."

Table 2. Estimated Land Gains as a Percentage of Total Reported Capital Gains, 1985

Source of 1985 Gains	Percent of Total	x	% Land Gains	=	**Land Gains as % Total**	% Capital Imprvmts	**Other as % of Total**
Land	7.0		100%		7.0	-	-
Farmland	0.9		100%		0.9	-	-
Distribution from partnerships, fiduciaries and S-corporations	9.5		80%		7.6	10%	0.9
Business real estate	10.3		80%		8.2	20%	2.1
Rental real estate	11.8		40%		4.7	60%	7.1
Principal residences	19.0		40%		7.6	60%	11.4
Corporate stock	33.0		20%		6.6	20%	6.6
Mutual funds	1.0		20%		0.2	20%	0.2
Bonds and other securities	0.8		-		-	-	-
Commodities and futures	0.2		-		-	-	-
Business machinery/equipment	1.5		-		-	-	-
Farm livestock	1.0		-		-	-	-
Timber	0.2		-		-	-	-
Other assets	3.9		-		-	-	-
TOTAL	**1 00.0%**		**42.9%**			**28.3%**	

Source: US Treasury