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# Public Policy Brief

## What's Missing from the Capital Gains Debate?

Real Estate and Capital Gains Taxation

*Michael Hudson and Kris Feder*

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# Summary

The call for lower capital gains taxes won bipartisan support last summer. Advocates claim that the reduction will increase output by rewarding productive enterprise. However, Research Associates Michael Hudson and Kris Feder point out that the great irony of the capital gains debate is that most of the benefit of the reduction in capital gains taxes will not go to investors in the stock market or in productive enterprises, but to investors in real estate, a wholly unproductive sector. Because land cannot be created (it is a natural resource that cannot be increased), an investment in real estate cannot produce new wealth, that is, it cannot increase the productivity of the economy; it merely changes the ownership of existing resources. Gains from the appreciation of the value of land are not a reward for productivity, but a windfall for ownership. Given that two-thirds of capital gains are, in fact, real estate gains, a capital gains tax reduction will have the effect of stimulating land speculation rather than productive enterprise.

According to Hudson and Feder, generous depreciation allowances and other provisions of the tax code allow investors in real estate in effect to convert much of ordinary income into capital gains taxes and to shield many capital gains from taxation. Not only are capital gains taxed at a much lower rate than ordinary income, but taxes are deferred until time of sale, making the effective tax still lower. Since these provisions leave the capital gains tax as the only major federal tax that applies to real estate, reduction of that tax leaves this giant industry almost exempt from federal taxation.

Measuring the total effect of a capital gains tax cut is difficult because national income statistics do not provide reliable estimates of sources of capital gains or total returns to investors. For example, Internal Revenue Service and Federal Reserve Board statistics tend to underestimate the role of real estate and to underestimate the role of gains from land values relative to building values. Many statistics on real estate, being based on declarations on tax returns, tend to conceal and thereby perpetuate real estate tax loopholes as well as the overall gains made in that sector as a result of any cut in capital gains taxes.

Hudson and Feder agree that tax policy should be used to stimulate productive investment, but demonstrate that a capital gains tax cut—as

“capital” gains are currently defined—will have the opposite effect and actually reduce productive investment. To improve both the equity and efficiency of the capital gains tax code, they suggest four changes. First, distinguish between gains from land and true capital gains, tax the two sources of gains separately, and increase the tax on land gains. Second, reinstate capital gains taxes on buildings. Third, do not permit buildings to be depreciated more than once. Fourth, reform national income accounting practices. If these changes are implemented, the capital gains tax cut will reward and stimulate productive investment rather than act as a giveaway to land speculation.

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# Preface

Last August Congress reduced the capital gains tax rate from 28 to 20 percent. This move, supporters claim, will spur productive enterprise and create greater wealth for all. Supporters of the rate reduction recognize that the capital gains tax is designed to increase equity by taxing the wealthy, but, they claim, a high rate damages efficiency by taxing the wealthy in their most productive behavior—investing their wealth—thereby discouraging productive enterprise so much that it hurts everyone. If we sacrifice efficiency, they say, even in the name of equity, we will in the end find we have less wealth to divide among us all.

Most of the debate on capital gains taxation centers on how much incentive is needed to encourage productive investment. But, as Research Associates Michael Hudson and Kris Feder point out in this brief, the debate neglects the important point that most capital gains are not made on productive investment. In fact, two-thirds of capital gains are made on real estate, and most gains from real estate represent a change in ownership of existing wealth, not the production of new wealth. Most capital gains—as currently defined, measured, and taxed—are not the fruits of productive investment, but the spoils of land speculation. Moreover, we in no way can assume that these spoils will be funneled into productive investment.

The efficiency-equity trade-off warrants attention when any change in taxes on productive investment is being considered, but the nature of the investment must also be taken into account. The best course of action is not an across-the-board reduction of all taxes on the wealthy. Instead, Hudson and Feder point out, what needs to be done is to

refocus taxes. It is reasonable to reduce the tax rate on capital gains on truly productive investment if land gains are taxed separately at a higher rate. Such a move could improve equity and efficiency simultaneously, but the recent capital gains tax cut will not accomplish that. The effect on the small portion of capital gains that derives from productive investment is likely to be overwhelmed by the effect on the large portion of capital gains that is taken on land speculation.

Hudson and Feder's proposals for refocusing the tax code—separate land gains from true capital gains and tax land gains at a higher rate, reinstate the capital gains tax on buildings, prohibit depreciation of buildings more than once, and improve national income accounting practices so that sources of gains and total returns to investors can be measured more accurately—are good first steps toward encouraging productivity and discouraging speculation. We also hope that their analysis of fundamental issues encourages policymakers to reexamine old assumptions and to examine more closely the effects of any proposed change in the tax code in order to assess more accurately its costs and benefits.

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*Executive Director*
December 1997

# Real Estate and Capital Gains Taxation

The call for lower taxes on capital gains has had bipartisan support. Advocates claim that a tax cut would reward productive enterprise, spur new investment, and serve as a simple proxy for inflation indexing. Some argue that the cut will, paradoxically, increase tax revenues—by encouraging productivity.

Much of the debate focuses on the stock market. Little notice is taken of the fact that a large share of "capital" gains tax revenues are taken not in the stock market or on any capital at all but in real estate. Data collected by the U.S. Department of Commerce, the Internal Revenue Service, and the Federal Reserve Board indicate that perhaps two-thirds of the U.S. economy's capital gains—as they are now defined, measured, and taxed—are generated in the real estate sector. Consider, also, 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 (Federal Reserve Board 1995, Table B.11). The capital gains tax is the major federal levy that applies to real estate, so the recent cut in the capital gains tax rate has virtually exempted this huge industry from federal taxation. Moreover, there is no reason to expect much stimulus to productive investment from such a tax giveaway, especially if revenue losses are compensated for by higher taxes elsewhere.

The principal justification for reducing the capital gains tax rate relies on an efficiency-equity trade-off. The capital gains tax is designed to increase equity by taxing the wealthy, but, advocates of rate reduction

claim, the tax structure errs on the side of equity so much that it has reduced the efficiency of the economy to the point where there is less wealth for everyone; therefore, the capital gains tax cut will stimulate investment. The efficiency-equity trade-off is a valid point that cannot be ignored when discussing taxes on productive investment. But, because land cannot be produced, an investment in real estate merely changes ownership of existing wealth; it does not produce wealth. Any capital gains on the appreciation of land value are not a reward for productivity but a windfall for whoever happens to own land. Yet, the capital gains tax treats a return from the appreciation of land the same way it treats a return from improvements to land or from business investment. Such a tax structure is both inefficient (because it rewards unproductive investment) and inequitable (because it rewards some of the wealthiest individuals at the expense of everyone else). There is an efficiency-equity trade-off on productive investments such as capital but not on fixed assets such as land.

Clearly, a cut in the capital gains tax cannot cause the production of more land. To the extent that capital gains are really land gains, to reduce the tax rate is to transfer surplus from the Treasury to owners of land. The incentive effect is to foster land speculation, not productive enterprise. The current tax system is inefficient because it rewards unproductive investment—allowing it to avoid nearly all taxation by taxing capital gains at a lower rate than other income and by allowing a variety of exemptions and exclusions that further reduce the effective tax rate. It forces productive factors to bear a larger tax burden and thus reduces the incentive for productive investment. The current tax system is inequitable because it rewards landowners (who tend to be at the high end of the income distribution) at the expense of everyone else. Therefore, separating land gains from capital gains and taxing land at a higher rate can increase both efficiency and equity.

The main points of this paper are as follows:[1] First, generous depreciation allowances and other provisions of the tax code allow investors in real estate in effect to convert much of ordinary taxable income into capital gains, which are taxed more lightly. The incentive effect of these tax rules partly explains why the lion's share of taxable capital gains are earned in the real estate sector. So successful are these devices that the real estate industry has paid almost no federal income tax in recent years.

Second, most true appreciation of real estate assets arises from gains in the value of land. Land cannot be depreciated, but buildings can. A share of land gains is routinely imputed to buildings, thereby reducing the tax on the property. The biggest irony of the capital gains debate is that unlike true capital gains, *land* gains represent no labor or investment on the part of the landowner, and therefore the taxation of land gains has no deterrent effect on productivity. Under the current tax code, further reductions in tax rates on capital gains accruing to buildings cannot be expected to have a positive effect on productivity.

Third, 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. National income accounting methodology frustrates attempts to measure total return, which includes asset appreciation as well as current income. Statistics based on tax returns conceal and thereby perpetuate real estate tax loopholes.

Fourth, most of the benefits from the across-the-board reduction in the capital gains tax rate will go to the real estate industry, where little if any positive economic stimulus can be expected. 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.

In discussing faults of the capital gains structure, we are not here arguing in support of income taxation generally. We recognize that some of the theoretical and practical problems in devising an equitable and efficient income tax are insoluble. Our point is that if income is to be taxed at all, the distortions in economic activity caused by the tax will be exacerbated by taxing some types of earnings more than others. An individual's total income is equal to the sum of his or her ordinary income (net of expenses) plus the net increase in the value of assets owned. In general, an income tax system that taxes different forms of income at different rates creates incentives for people to substitute less-taxed for more-taxed ways of earning income. Increases in the value of land and capital are taxed separately, at lower rates, and later than other income. Distortions may be severe when production is taxed much more than asset appreciation or when the earned income of labor and capital is taxed while income from land rent is exempted. Overly generous depreciation schedules result in relative undertaxation of the income from depreciable

property, rewarding speculative second-hand trading and debt pyramiding at the expense of new investment and employment.

## The Effective Tax Burden on Real Estate

Real estate makes up two-thirds of privately owned assets in the United States and accounts for an even larger proportion, about three-fourths, of the economy's capital consumption allowances.[2] CCAs are deductions from taxable income intended to allow investors to recover their investment as capital assets depreciate. In principle, the accumulated CCAs should be sufficient to replace a building or other capital equipment at the end of its useful life. Taxable property income includes only the net revenue after this allowance for depreciation is deducted and not the part of cash flow designated for the recovery of capital.

CCAs in the real estate sector have traditionally been, and continue to be, excessive relative to true economic depreciation. One reason, as we discuss below, is that an excessive share of total real estate value is imputed to buildings, which are depreciable, relative to land, which is not. Another is that depreciation schedules have been unrealistically rapid relative to the rate of depreciation of buildings. The depreciation schedules enacted in the 1981 tax code, which remained in place through 1986, were especially generous. However, the greatest accounting fiction for the real estate industry arises from the provision of the current tax code that allows a property (but not an owner-occupied residence) to be depreciated by each new owner every time it is sold or swapped. This provision permits real estate investors to recapture principal again and again on the same structure as a building is resold at rising prices.

The relative size of the capital consumption allowance affects the way in which the total income from an asset is divided, for tax purposes, between capital gains and ordinary income. This is because the taxable capital gain for, say, a building is computed with reference to its book value, which equals the price at which the building was originally purchased minus the accumulated capital consumption allowance, calculated according to the depreciation schedules of the tax code.

Suppose, for instance, that an investor purchases a building for $100,000 and then resells it when it is fully depreciated and CCAs are due to expire. Suppose there is a straight-line depreciation schedule based on a presumed building life of 20 years, so that each year for 20 years $5,000 is deducted from gross income in the computation of ordinary income tax. The total value of the tax savings depends on the individual's marginal tax rate. If the investor sells the building after 20 years for $130,000 and if there has been no inflation, the investor's real gain is $30,000, but the taxable capital gain is $130,000. This is because taxable gains are computed, not as the difference between the purchase price and the price received at sale, but as the difference between the sale price and the *book* value of the asset. The book value is the depreciated value, which is presumed to be zero after 20 years. Of course, the new buyer can depreciate the building again, using the sale price as the base of the new book value. This is the way in which excessive capital consumption allowances convert ordinary taxable income into taxable capital gains. Most capital gains in real estate today represent repeat gains over unrealistically written-down book values.

If ordinary income and capital gains were taxed at the same effective rate, there would be no loss to the Treasury through CCAs; the income tax revenue shortfall from the excess CCAs would be compensated for later by capital gains revenue of equal present value. The problem is that capital gains are taxed later and at lower rates than ordinary income and the tax is deferred. Because capital gains taxes are paid at the time of realization (sale) and not as the gains accrue, the effective burden is less than the statutory rate, which is already lower than the ordinary income tax rate. The longer an asset is held or the higher the interest rate at which future income is discounted, the smaller is the sum of money that needs to be set aside in an interest-earning savings account in order to cover the future tax payment when it comes due—in other words, the smaller is the present value of the tax burden.

Because the effective tax rate on capital gains is lower than that on ordinary income, one effect of excessive depreciation is to reduce the overall tax burden on real estate. This accounting fiction enables real estate investors to continue indefinitely to take their income in the lightly taxed form of capital gains. Further reductions in the capital gains tax

rate would encourage still more enthusiasm for CCAs as a means of tax avoidance and would virtually exempt real estate from federal taxation.

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 (Federal Reserve Board 1995, Table L.2).

Capital consumption 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, industrywide statistics show that real estate corporations and partnerships have recently reported net losses year after year.[3] The capital gains tax is thus the only major federal levy paid by the real estate industry.

Numerous exemptions further shield many capital gains from taxation. Major commercial real estate investors, such as pension funds, insurance companies, other large institutions, and foreign investors, are exempt from capital gains taxes.[4] Substantial exclusions for capital gains on the sale of owner-occupied homes have long been permitted and have recently been broadened. No capital gains duties are levied on estates passing to heirs. Assets given as gifts are taxed only if and when they are later sold by the recipient. Real estate swaps, transfers of property through mergers, and certain acquisitions are not taxed on their capital gains.

Fazzari and Herzon (1995) 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 deferring taxes until realization. If this estimate is correct, the former nominal capital gains tax rate of 28 percent translates into an average effective

tax rate of just 7 percent. With the recent reduction of the nominal rate to just under 20 percent, the effective rate will be less than 5 percent.

In the aggregate and over the long run, rising land values tend to more than offset the decline in building values so that total property value increases. In practice, a significant portion of land appreciation tends to be imputed erroneously to buildings, expanding capital consumption allowances still further.

Another effect of favorable depreciation, mortgage interest, 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 into 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. Worldwide, episode after episode illustrates the inherent instability of an economy whose banking system relies on land as a principal form of collateral for loans. Currently, for instance, as reported in *The Wall Street Journal*, "Thailand is in a woeful state. . . . There is a massive overhang from the real estate bubble whose burst laid the banks low" (Gonzalez 1997, A22).

One justification for the cut in the capital gains tax rate is that it will reduce the "lock-in effect" whereby high taxes on realized gains (due at the time of property transfer) deter asset sales. It is doubtful, however, that a rate reduction is likely to accelerate real estate turnover. 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. There is evidence that lock-in results less from high capital gains tax rates than from inheritance taxes (Gaffney 1991; Joint Committee on Taxation 1990, 21).

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 stagnated, 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 before the rate cut, however, turnover in real estate may have surged as investors exploited depreciation rules to maximize their gains from properties acquired under the accelerated depreciation rules of the 1980s. The recent rate cut is a 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.

## Measurement Problems in National Income Statistics

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 U.S. 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 1990 these data were analyzed in two studies (Holik, Hostetter,

and Labate 1989, 1990). Subsequent estimates have been published by the IRS in its *Statistics on Income*, but they cover only a portion of the capital gains spectrum (Internal Revenue Service 1994, 1995).

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 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. 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 declared on their tax returns. Table 1 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 totaled $37 billion (reported on Form 2119), 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 19.0 percent to just 1.1 percent of the sample.

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 that would raise the capital gains tax rate from 20 to 28 percent, many investors sold securities they held that had registered the largest advances. Some 40 percent of the capital gains reaped by selling these stocks probably represented real

**Table 1** Estimated Land Gains as a Percentage of Total Reported Capital Gains, 1985

| Source of 1985 Gains | % of Total | x | % Land Gains | = | Land Gains as % of Total | % Capital Improvements | Other as % of Total |
|---|---|---|---|---|---|---|---|
| Land | 7.0 | | 100 | | 7.0 | — | — |
| Farmland | 0.9 | | 100 | | 0.9 | — | — |
| Distribution from partnerships 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 and equipment | 1.5 | | — | | — | — | — |
| Farm livestock | 1.0 | | — | | — | — | — |
| Timber | 0.2 | | — | | — | — | — |
| Other assets | 3.9 | | — | | — | — | — |
| Total[a] | 100.0% | | | | 42.9% | | 28.3% |

[a]Columns don't add up because of rounding.

*Source:* Internal Revenue Service benchmark survey prepared in connection with the Tax Reform Act of 1986. Internal Revenue Service, *Statistics of Income—1991: Individual Income Tax Returns* (Washington, D.C.: U.S. Government Printing Office, 1994); Internal Revenue Service, *Statistics of Income—1992: Corporation Income Tax Returns* (Washington, D.C.: U.S. Government Printing Office, 1995).

estate gains. A major spur to the leveraged buy-out movement driving up the stock market was an awareness that real estate gains were not being reflected in book values and share prices; 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.

Federal Reserve data considerably outstrip the 1985 IRS estimate of $208 billion of taxable capital gains. The Fed's *Balance Sheets for the United States Economy* (Federal Reserve Board 1995) 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, approximately three and a half times the ($108 billion) 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 overdepreciation pay-backs recorded fictitiously as capital gains) in its Z9 release estimating asset values throughout the economy. However, the IRS and the 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 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 (Federal Reserve Board 1995, Tables B.11, B.12, R.11) 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 that 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. 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.[5]

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 (Gaffney 1993). 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 rising, overestimates of building values relative to site values reflect the steady underassessment 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.[6]

Official statistics should provide a sense of 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. Thus 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.

## Policy Implications

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 real estate's shoulders, have found that the middle classes are willing to slash taxes on the wealthy as long as their own taxes are cut even lightly. Thus 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 homeownership or 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 the level of merely carping about inequitable wealth distribution and attacks by have-nots on the haves and moves it closer to fundamental questions: What ways of procuring income deserve fiscal encouragement, and how may economic surpluses best be tapped to support government needs? Policies that subsidize private collection of socially generated value, like the value of a vacant lot near a railway station or in a bustling urban center, while penalizing returns to productive effort have grave implications, not only for distributive justice but also for economic stability, efficiency, and growth.

It can only confuse matters to debate capital gains taxes without separating three major sources of capital gains: 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.

Given the current U.S. depreciation laws and related institutions, the across-the-board cut in the capital gains tax rate will steer capital and entrepreneurial resources to a search for unearned rather than earned income. Far from being a 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.

As for buildings, the preferential tax treatment of capital gains, the income tax deduction for mortgage interest, accelerated depreciation, and above all the repeated redepreciation of old buildings after each transfer are not cost effective means of motivating new investment. 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 a higher rate. 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.

Any capital gains tax relief should selectively favor productive enterprise relative to the mere trading of nonproduced land or depreciated buildings produced years ago. At minimum, a general capital gains tax cut should be

accompanied by 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.

Following are four changes to the tax code that would improve equity and efficiency simultaneously.

Separate taxes on land gains from true capital gains taxes and increase the tax on land gains. 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). Therefore, to the extent that taxable capital gains are really land value gains, cutting the capital gains tax deters rather than encourages 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 (Feder 1994, 146–148). Such a cut also accelerates rent-seeking activities, which consume resources in the service of redistribution, not production (Gaffney 1989, 1993).

Reinstate capital gains taxes on buildings. We agree with the premise that to reduce taxation on 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 are not subject to capital gains taxes, the tax cut will not affect their real estate operations. For these reasons the capital gains tax on buildings can be reinstated without an adverse effect on real estate improvements.

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 a building is sold. To let the building be depreciated 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 owners to avoid paying their 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 particularly 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. 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.

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, U.S. 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 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. 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. IRS statistics now reflect

fictitious declarations of losses in building values through overdepreciation. The GNP/NIPA format does not differentiate among land, produced wealth, and financial claims.

Not only will the cut in the capital gains tax rate make the distribution of income more unequal, but just as importantly it will not have the stimulating effect its supporters claim. Without some reform the capital gains tax cut is primarily a giveaway to landowners that rewards speculation not productivity.

## Notes

1. This brief is based on Hudson and Feder (1997).

2. CCAs for various sectors are recorded in National Income and Product Accounts (NIPA); see Hudson and Feder 1997, Tables 1a, 1b.

3. Real estate corporations paid some $1.3 billion in income taxes in 1988, a mere 1 percent of the $137 billion paid by corporate America as a whole (U.S. Bureau of Economic Analysis 1992, Table 6.18). Comparable figures are not available on noncorporate real estate income tax liability, but the finance, insurance, and real estate (FIRE) sector as a whole reported negative income of $3.4 billion in 1988, out of a total $267 billion of nonfarm proprietor's income (U.S. Bureau of Economic Analysis 1992, Table 6.12).

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

5. Indeed, where ill-maintained old buildings occupy prime locations, a parcel may be more valuable once the building is demolished and the lot cleared for reuse (Gaffney 1971, 1993). 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.

6. 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.

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