



Land Gains and Taxation

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LAND GAINS AND TAXATION

Mason Gaffney

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Movement for Preferential Treatment of "Capital" Gains

President Bush has committed himself to achieving a lower income tax rate (corporate and individual) for realized capital gains. He at first defined "capital assets" more narrowly than they were before 1986, but it seems unlikely he could win passage without reviving old alliances and lowering the rate on real estate in its many forms. So we will probably soon face a proposal to exempt part of real estate gains from taxable income, as they were before 1986. Here we treat the question whether there is a case for this or any other preferential tax treatment of gains to land price. We will then ask if there is a case for higher taxation of gains to land price.

The question is always timely, regardless of the Bush proposal. Such gains continue to receive many forms of preferential treatment other than the lower rate. These include forgiveness (step-up of basis) at death; deferral of recognition until realization; expensing of holding costs; expensing of "rent-seeking" outlays; exemption of gains taken by non-resident aliens; deferral via instalment sales and/or barter; deferral for homeowners; one-time \$125,000 exemption for homeowners; etc. The 1986 reform only touched one of those many preferences.

VAT (in the form commonly advanced) is another route to excluding land gains. An articulate group, prominent in forwarding VAT, has long held there is double taxation when any property income is taxed, and especially capital gains. The group includes Charls Walker, Norman Ture, Paul C. Roberts, Joel Barlow, Arthur Laffer et al. Their rationale runs counter to the Haig-Simons concept of taxable income, to be sure, but there is some wavering as even Brookings veterans like Henry Aaron and Alice Rivlin change their views and endorse Walker's VAT. Joseph Pechman himself seems to accept the view that an expenditure tax is intertemporally neutral, and has endorsed state sales taxes.

Walker's American Council for Capital Formation has secured and circulated signatures from Henry Aaron, Benjamin Friedman, Paul McCracken, Charles McLure, James Schlesinger, Lawrence Summers, and Lester Thurow in support of a VAT which is "consumption-based" (i.e. which excludes capital gains), "or other form of national sales tax".

The President argues downtaxing gains is needed to encourage "venture capital". Other champions stress the same point, and broaden it to imply downtaxing gains will, as its primary effect, raise the rate of return-after-taxes on new investments.

Professor James Poterba, on the other hand, recently estimated "venture capital" accounted for only about 1% of capital gains in 1987¹. Thus the venture capital rationale may strain at a gnat while swallowing a camel. Granted there are other new investments that are not "venture capital", but Poterba's finding is not inconsistent with a belief that much of what qualify for "capital" gains treatment are old assets, notably including land.

The declared goal of abating taxes on productive new investments is worthy on its own merits, and should not have to be approached sideways. There are ways of converting ordinary income into capital gains which have the effect of avoiding taxation on real new investment. But is that the main effect? The proposed detour through excluding capital gains may be indirect and inefficient. It may untax a maximum of pure surplus to achieve a minimum incentive to new investment.

The issue here is not whether interest, and ordinary earnings from capital should be exempt, the issue stressed by VAT champions. The present issue is independent of one's position on that. The issue here is whether and how much land gains should be taxed. The writer is distressed that champions of the Charles Walker School consistently blur the two issues, and so weaken their otherwise arguable case. The fate of Congressman Ullman, and recently Japanese Premier Uno, manifest the unpopularity of consumer taxes unrelieved by equity considerations.

There are however several powerful and popular arguments for excluding gains from taxation. We next review these.

¹Business Week 24 April 89 p. 20

Is There Double Taxation?

Charls Walker et al. ^{maintain} ~~insist~~ it is double taxation to tax a capital gain, as well as the subsequent advanced income whose coming gave rise to the gain. In other words the capital gain is not an income. They ~~almost always~~ meld this view with the more general claim that all taxation of property income is double taxation, because property is acquired from savings. *To sort that out I will consider this point as well.*

In evaluating the claim of double taxation we find some help from accounting, but some equivocation. Capital gains are recognized as business income, when realized by sale. Accounting does not, however, generally recognize unrealized gains, even when these are cashed out by use as collateral for loans.

On the other hand, standard financial shoptalk is a kind of informal accounting which speaks of value increments as income. In buying and selling common stock, market participants see two incomes, the dividend and the expected gain. It is the same with real estate in its many forms, except with greater emphasis on the expected gain. In calculating yield-to-maturity of bonds, again, the expected gain is part of the yield.

Utility accounting is clear and unequivocal on the point, in respect to plants under construction. Here, a plant taking some years to complete is kept out of the rate base until it goes on line; but then it does, and what goes into the base is not just construction cost, but also capitalized interest accrued over time. The sum is called Allowance for Funds During Construction (AFDC).

When a regulated utility spends equity capital on construction the interest is imputed, at the regulated rate, and reported as current income, even though not received in cash. When the plant goes on line this accumulated implicit income goes into the rate base and starts earning cash income. Here it is clear, part of the growth of AFDC is interest income; and later an additional income is allowed the utility, viz. a return on the AFDC which includes capitalized interest. It is a clear case where "money makes money, and the money money makes makes more money" (Ben Franklin). If this is not double-counting then it is not double-taxation to recognize and tax both incomes.

Business accounting on the other hand is not helpful with other unrealized gains. It allows write-downs of overvalued assets, but no write-ups of undervalued assets. The write-downs are deductible from taxable income, explaining an understandable

pressure to sustain this asymmetrical practise. One familiar result is that corporations carry land at historical cost, often ancient and trivial. An exception was Reserve Recognition Accounting, mandated by FASB in 1980 for oil firms (but revoked a year later).

NIPA accounting is even less help: it excludes capital gains entirely, whether realized or not. It also excludes resource discoveries and depletion. Because business and NIPA accounting are less than definitive on our subject, I will give several reasons why taxing the income of property is not double taxation.

1. Deduction of Basis

The original income from which saving occurs is not taxed a second time, because the basis of later investments is not taxed, it is depreciated or expensed. Only the income over the basis is taxed.

That is not necessarily to argue we should tax all income impartially, that is another question. But there must be a real reason, not an ~~indefensible~~ ^{elementary} confusion around the word "income".

If the same original income be invested in raising a child to its majority, plus perhaps sending it through college and professional schools, the child's income is thereafter fully taxed, without depreciation or expensing of cost. In this contrast there is actually discrimination against labor, not capital. (Call it "human capital" if you must; ~~but~~ I consider that usage inhuman.)

It might be objected that if one buys land it is not depreciable, according to law. That is, however, because land does not actually depreciate as a rule. If one does contrive to depreciate land (illegally), that amounts to tax exemption in perpetuity. All the Treasury gets from then on is interest on its own investment. This is simply a corollary of the now-familiar principle that expensing a new capital investment amounts to tax exemption, only with land it is more serious, the exemption is eternal.

If one does it a second time it is a subsidy -- not just a "tax-subsidy", but a pure subsidy. Most buyers of used real estate "income property" do, in fact, succeed in allocating part of the land value to the building. Thus they set themselves up to depreciate part of their land. As this has been going on over

several decades it is fair to infer the net contribution of some land income to the U.S. Treasury is negative, and heavily so.

If one buys land yielding imputed income, that income is not taxed. A substantial and growing part of the value of most land is the "amenity" value. Another part of location value is access to employment, obviating commuting costs. Since the latter are not deductible, access to the job market is also a kind of imputed income. Access to shopping and society are other untaxed service flows from residential and resort land in superior neighborhoods.

2. Tax-caused Gains

Any tax on new capital or its income is partly shiftable and partly not. Insofar as it is shiftable it is not a tax on capital. To the extent it is not shiftable, the tax tends to divert investors into buying up old assets. That of course lowers cap rates, which represent the opportunity cost of investor money. That in turn pushes up the price of old assets, creating new gains for old capital, and especially land.

Some economists of the rational-expectations school miss this point. Robert Barro may be one. "The (stock) market is ... the best predictor of long-run economic activity. And the fact that it has been booming indicates that economic growth should continue to do well."² Besides closing out history, Barro seems to overlook any difference between old and new assets.

Downs and Hendershott come nearer the mark when they attribute a stock market rise to a tax hike: "The rise in stock prices follows from the heavier taxation of new capital and the resulting rise in returns on existing capital." Their choice of words might be improved, but the evident meaning from their article is that given returns are capitalized at a lower rate of interest, so prices of existing capital and land rise.³ Joel Barlow, pleading for faster write-off of new capital, has made the same point.⁴ Hatsopoulos, Krugman and Poterba are also clear

²Robert Barro

³Thomas Downs and Patric Hendershott, NTJ XL 183).

⁴NTJ XXVI (3) 429.

about it⁵. So is Richard Musgrave⁶. So is Alan Auerbach⁷. No analysis is valid that fails to distinguish old from new assets; we shall observe the distinction throughout.

So are many other leading tax experts.
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3. Phantom Income Taxation, and Land's Escape

It is true, there is taxation of phantom income caused by the money illusion during inflation. This is what some people mean by double taxation. Many apparently temperate or moderate economists, like Alan Blinder,⁸ advocate indexing capital gains so as only to tax the real gain.⁹ Joseph Pechman, generally a champion of taxing capital gains, calls this abatement "essential"⁹, and knows that "economists agree".

This seemingly reasonable posture is in fact highly discriminatory because it selects out "capital assets" for special relief, ignoring other assets taxed by inflation.¹⁰ "Capital assets" are simply an arbitrary group whose constituents have political influence to secure preferential treatment. Many "capital assets" are not capital at all, but forms of land. There are several reasons why land yields less taxable phantom income than other assets. Even wages and salaries suffer from inflation, as will be shown.

a. Most real assets, not just "capital" assets, yield phantom income. In some inflationary years over half of reported business earnings have come from inflation-induced marking up

⁵George Hatsopoulos, Paul Krugman and James Poterba, Overconsumption, Waltham, MA, American Business Conference and Thermo Electron Corporation, 1989, p.16.

⁶"Short of Euphoria", J of Economic Perspectives I (1) Summer 1987, p.69.

⁷"The 1986 Tax Reform and the Cost of Capital", J. of Ec. Perspectives I (1) Summer 1987, p. 83.

⁸Business Week, 1 August 1988, p.14.

⁹"Tax Reform: Theory and Practise", J. of Ec. Perspectives, I (1), Summer 1987, p.23.

¹⁰Blinder and Pechman would also tax gains at death. This partially tempers the bias of the position, but they are silent on the other preferences cited on p.1 of this MS.

adds a major bias in favor of deathless corporations, & a minor one in favor of against short-lived people

inventories before sale¹¹. Inventories yield phantom income early and often, compared to land. The more deferred is the tax-recognition of phantom income the less is the real tax burden.

LIFO accounting abates this problem in part, which may lead some to think there is no problem. But very complex rules are involved, and LIFO is not ordinarily used by small business. LIFO gives no relief to additions to inventories: the cost of goods not sold is not deductible.

Depreciable assets also yield phantom income. Many reformers have championed indexing depreciation allowances, but the present proposal simply to index capital gains does not do so (except incidentally in special situations where ownership changes).

b. Monetary assets are constantly taxed by inflation. It is unbalanced to leave this loss unredressed while arranging indexing for land gains. It is regressive as well, because the share of wealth held in monetary form falls steeply with total wealth. How are we to explain the thinking of economists who give priority to indexing land gains while silently tolerating this most direct and obvious confiscation-by-inflation? In theory they are against it, but in practice give priority to relief for land gains.

c. The ordinary cash flow of land, or ground rent, yields no phantom income because there is no depreciation. Phantom income arises when there is a sale of the corpus of an investment at a nominally higher price. Phantom income arises when durable capital yields cash flow and depreciates; depreciation represents sale of the corpus, little by little. Ground rent by contrast is pure income without impairment of substance, i.e. without any sale of the corpus.

That is a basic point that should be elementary, and accounted for in every treatment of this subject. But it has been entirely overlooked, to my knowledge, in the extensive literature and public comment on phantom income. That is not because it is difficult or obscure. To address the point is to see it: the

¹¹The U.S. Department of Commerce reports this "inventory valuation adjustment", or IVA, regularly, and many economists have noted, some with missionary zeal, the malignant tendency to overstate real profits and incur excessive taxation. No modern economist can really be unaware of this phenomenon.