

News Articles Regarding Mason Gaffney

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BONUS PAYMENTS SYSTEM CHALLENGED BY GAFFNEY

ON WHAT basis should private firms be allowed to go prospecting for profits on the public domain?

The question assumes increased importance with President Carter's decision, announced on July 15, to restrain oil imports in favour of exploring for, and exploiting, domestic sources of energy.

The traditional US system has been for the Federal and State governments to invite firms to submit bids for bonus payments: the highest bidder received the right to pump up the oil.

These bonuses, paid in advance of exploration, constitute economic rent: the surplus over and above that income which is necessary to attract labour and capital into the enterprise. But is it the *whole* of the economic rent? This is certainly the orthodox view, which rests on the assumption of a competitive system. For example, Kenneth Dam has defended the established method of auctioning off licences in these terms:

> **"Not only does it capture the economic rent for the government rather than leaving it to a private party, but it also tends to select the licensee that is in fact most efficient in the sense of having the lowest costs. Efficiency in the economy is thus enhanced. The firm that is most efficient can afford to pay more, and it therefore will bid more, capturing the license."**[1]

He admits that the full economic rent could not be captured at any one auction; sometimes the actual economic rent was higher than that bid by the firm, but at other times it was less. "This discrepancy should not be thought to be a weakness of the auction method, because the two possibilities tend to balance each other."

THIS hit-and-miss method has been challenged by Mason Gaffney, Professor of Economics at the University of California, Riverside.

In evidence to the joint hearings of the House Resources and House Finance Committees in Washington last March, he exposed the weaknesses of the "money up front" approach.

- The ability to find the advance money is highly concentrated, placing a premium in favour of firms rich in cash. Acreage is concentrated, leaving less for other firms. Smaller firms were at a competitive disadvantage, and so they were encouraged into joint bidding. "This, of course, damps the competitive edge of bidding by reducing the numbers."

  – *The community, then, received smaller bonuses: part of the economic rent was captured by the private sector.*

- Financial power rather than economic efficiency became the dominating factor. Firms which most resembled large banks had an advantage over those which most resembled oil producers. Efficiency moved down the scale as a factor determining the highest bidder.

  – *The most efficient firm is the one that can pay the most money over time: this is not the firm normally which can pay the money "up front".*

- A policy which favoured "big capital" penalizes local entrepreneurship and ownership. Initially, the inflow of outside capital

Britain plans to hand out billions of pounds to the oil giants

THE AMERICAN system of appropriating economic rent for the community has proved more efficient than the UK's mix of fiscal and bureaucratic policies.

Between 1953 and 1978 the cumulative US receipts from lease sales, royalties and rentals, but not including corporation tax on profits, amounted to 70% of the total value of oil and gas produced on outer continental shelf leases.

UK Government revenue (excluding corporation tax) since the beginning of North Sea oil and gas production has so far amounted to under 10% of the value.

The incomprehensible British situation arises from the discretionary allocation of licences by bureaucrats, the serious deficiencies of which are exposed when we examine public auctions as an alternative method.

In 1971, 15 blocks of North Sea licences were auctioned to the highest bidders. Over £37m. was raised for the exchequer. Simultaneously, 267 blocks were allocated on the discretionary basis – and raised a derisory £2.7m. Auctions have not since been used.

THE CASE for auctioning North Sea licences is documented by stockbroker Peter Lilley in *Oil Commentary.** **He declares:**

"The established British system of discretionary allocation is staunchly supported by the oil industry which, not surprisingly, approves of a system under which it receives in return for a peppercorn rent the rights to oil and gas reserves worth billions of dollars."

may improve the economic base of a community, but the outflow of profits would constitute a permanent leakage.

– *The inflow of capital followed by an outflow of payments leads to swings of boom and bust.*

● Large firms do almost everything in more capital-intensive, labour-saving ways, which may not produce the optimum combination from the viewpoint of the whole economy.

Oligopolistic power exercised by the large firms enables them to sidestep the adjustments in factor inputs which would be forced on them by free competition.

PROF. Gaffney, an expert on economics of resource extraction,[2] has no doubt that medium and small firms would bid much more if they could pay over time.

The high risk of bidding "blind" against firms with larger resources compelled them to require high target rates of return – i.e., reducing the economic surplus (= rent).

Other defects with the "front end bonus" system:

● Cash advances to the community reduces the capital available to develop lands. This hits the smaller firms at the time when they most need to husband their limited capital for exploration.

● Bonuses have to be calculated "blind": the system resembles a game of poker. It is inequitable because it falls indiscriminately on both the lucky and unlucky prospectors. Large



● **Prof. Gaffney**

firms, on the other hand, "can spread the risk around the world and bury it in statistical probabilities [and] set high target rates of return as a device of implicit collusion to lower bids."

Some alternatives to the bonus payments, however, also have their defects. For example, fixed royalty at a uniform rate "would succeed in stifling marginal production while at the same time failing to collect much of the rent from bonanza producers."

THE SOLUTION, in his view, was a system which allowed the producers to pay as production proceeded out of income derived from current production. This encouraged competition, reduced private risks and increased the surplus available for collection by the community.

Firms would have to be allowed to deduct the costs of production, providing these were incurred on-site.

The 1978 Alaska Leasing Act gave the Commissioner of Natural Resources a new flexibility in selecting leasing terms. But Prof. Gaffney expressed concern about the Department of Natural Resources' failure to fully equip itself to use those powers.

"There is always this temptation to say it is all too complicated and go back to the simple old front money system. Yet, a lease for oil and gas is no more complex than the standard deal between a cinema distributor and a theatre owner. Businessmen are used to working with complex contracts, risk sharing arrangements, and joint ventures. It is we, the general public, who are too soon tempted to stop scratching our heads, grab the money and run. That is the worst mistake we can make."

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1. K. W. Dam, *Oil Resources*, University of Chicago Press, 1976, p. 7.
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Nicholas Tomkins

He argues that economic rent – "the excess of the value of the oil revenues over the total of all relevant costs including the appropriate return on capital necessary to attract and compensate risk capital" – would be captured by the auction system.

Using a conservative basis for his calculations, he concludes that remaining licences could raise between £1.5bn. and £2.7bn., in addition to royalties, petroleum revenue taxes and corporation taxes (which are taken into account by bidders at an auction).

That money, under the discretionary allocation system, is to be handed over to the oil companies!

PRIME MINISTER Margaret Thatcher, however, not content with giving away the economic rent of North Sea oil and gas, has ordered the British National Oil Corporation to sell off £400m. of its assets.

Dept. of Energy civil servants, of course, would not admit that their intention was to *give away* the value of the nation's natural resources, although that is the result – or, as Lilley puts it, "In effect recipients are given presents worth in aggregate hundreds of millions of pounds."

Their contention is that their criteria (which have not been endorsed by Parliament) – for example, showing a bias in favour of UK companies – ensures that Britain gets the best overall deal.

But there is ample evidence that bureaucrats do not necessarily know what is best. In the US, for example, the Dept. of the Interior has consistently underestimated the value of its oil leases. Industry has been prepared to pay between two and 10 times the assessed value of the acreage under offer at auctions!

LILLEY argues that, because of the element of subjectivity involved in calculating economic rent in oil exploration, taxes alone cannot be used to extract the full economic rent.

But companies would be willing to pay the full economic rent for the right to explore. "Although taxes cannot be used to capture 100% of the economic rent they can perfectly well be used to capture a significant proportion of it. The remainder of the economic rent can be captured by auctioning the licences subject to a known tax regime for future discoveries."

● Cont. on P. 7

Exposed: missing link in land theory

THE "missing link" in the theory that attributes unemployment to land speculation has been identified by Californian professor Mason Gaffney.

The theory was originally developed by American economist Henry George in *Progress & Poverty.*[1]

In Prof. Gaffney's view, the theoretical gap between land speculation and recessions is filled by the theory of circulating capital.

Speaking at an Engineering Foundation conference at Rindge, New Hampshire, Prof. Gaffney declared that we need new tools to analyse the role of capital in macro-economics, and money in banking.

"Labour as such doesn't create capital, it replaces capital which is advanced to labour as it works," he said.

"To create capital, someone has to save, which is more likely to be the property owner than the worker. It is a long, slow process."

Dr. Gaffney, who is professor of economics at the Graduate School of Administration, University of California at Riverside, said that the "villain" among economic theorists was John Bates Clark, the founder of neo-classical economics.

"Partly for the purposes of under-cutting Henry George, he eliminated the distinction between land and capital, and denied that capital turned over. He succeeded in putting this over as neo-classical economics, which differs from classical economics in eliminating the concept of capital turnover, and we have been wandering in the outer darkness ever since."[2]

By Paula James

ACCORDING to Prof. Gaffney, the nation's capital makes one complete rotation every three years. This circulation, however, is impeded by a wasteful expenditure of capital, which slows down growth and causes unemployment. "This is where land speculation comes in," he said.

"Speculation and sprawl cause massive over-commitment of our limited capital stock to infrastructure. This capital is then immobilised, frozen, sterilized, its rotation is stalled.

"When properly invested and re-invested, capital is a revolving fund that animates activity with each revolution. But when it is frozen it might as well have been pushed off the edge of the world.

"If we eat the seed corn, to subsist while we are building roads to tap new land, how will we plant the new land? That is the strange sort of problem that land speculation leads us to. And initially it gets transformed into a capital shortage, and a sharp fall of land prices then gets the banking system."

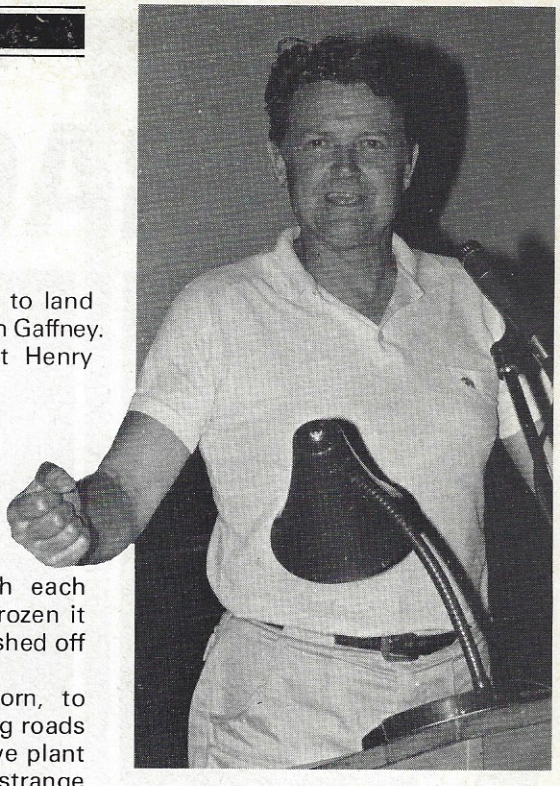
Prof. Gaffney noted three relationships between land speculation and the circulation of capital.

- Scattered settlements increase infrastructural needs.
- Premature abandonment of old buildings – for example schools in old cities – results in the gross under-utilisation of capital.
- New infrastructure is built prematurely to validate speculative values.

"This is what water battles in California are all about. The pattern is one of investing public money, freezing it up for decades, so that landowners can have the option – for their future delectation – of using it some day, if they feel like it. But they are under no pressure, because no-one is taxing them."

A TAX on the value of land was a key solution, said Prof. Gaffney. This would deter speculators from wasting land and forcing people to invest in new urban centres on peripheral locations.

"The result, in addition to an improved use of land, would be a reduction in the enormous waste of capital, which would remain mobile and available for use in the private sector.



● Prof. Mason Gaffney thumps home his message

Henry George's vision, said Prof. Gaffney, was to tax land into use. "This should be supply side economics, but I don't see any sign of it in the policies of the present administration," he said in an attack on the shortcomings of President Reagan's economic strategy.

America, he noted, had plenty of surplus land. Historically, however, people bought it up and went to "sleep" on it. This, in turn, encouraged a wasteful over-commitment of capital.

In agriculture, for example, "we retire land in the east, which is favoured with abundant rainful. So we reclaim land in the west with public money."

The paradox was that "this ultimately leads to a decline in the price of land. The long term result is an artificial abundance of land, caused by massive substitution as a result of the development of marginal lands. Sometimes this leads to a collapse of land values."

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2 Prof. Gaffney's full critique of J. B. Clark appears in a new book, *Land Value Taxation,* editors: R. W. Lindholm and A. D. Lynn, Jr., Madison: The University of Wisconsin Press, 1982, which will be reviewed in the Jan.-Feb. 1983 issue of *Land & Liberty.*

U.S. professor builds on Henry George theory

THE UKROPINA REPORT

Published by William D. Feldman Associates

SPRING 1984

Lower Taxes?

Henry George — the name has the ring of Americana; the sound of a name which might have been a patriot in the American Revolution. Yet, George followed the revolution by 100 years and the impact of his ideas is being widely felt today.

In this special issue of the Ukropina Report we examine Reduced Taxation on Improvements or RTI. This concept of taxation originally distilled by George over a century ago and subsequently supported by businessmen, economists and politicians, conservative and liberal alike, is taking on a strong new appeal.

In the last year, a major article has appeared in *Fortune* Magazine and three editorials in the NEW YORK TIMES reporting on or advocating the virtues of this form of property taxation. Already, various forms of this tax structure have been applied both in the U.S. and abroad with great reports of success. Essentially this taxation method unencumbers improvements by placing greater property tax burden on land value. The claimed results: developers are rewarded, speculators penalized, unimproved or rundown properties gain useful new lives, employment increases and municipal revenues are greatly enhanced.

With increasing media attention, George's legacy may one day come to California. It's possible impact slight or great, should be of concern to all, especially those in the real estate, development and business communities.

–Bill Ukropina
Wm. D. Feldman Assoc.

RTI — A Quiet Revolution

Population in the U.S. is expected to reach 400 million by the year 2020 — Federal deficits are almost uncontrollably high — municipal revenues are tightly squeezed and the funds needed for the rehabilitation of roads and bridges alone are projected to be at least $5 trillion dollars. Last summer, at the American Cities Mayor's Conference, it was agreed that the worst single problem facing U.S. cities is uncontrolled hunger and destitution. Also concluded, however, was that no means exists for the cities to solve the problem from their own resources — the funds must come from the Federal government.

Inspite of such a grim outlook, advocates of Reduced Taxes on Improvements or RTI, claim the future can be brighter for all — cities, landowners and developers combined. Cities here and abroad, which have placed RTI into effect, are discovering unexpected resources with which to finance the future along with self sustained property and economic development. *Fortune* Magazine (8-8-83) quoted a Pittsburgh Councilman describing the new taxation method, ". . . like finding a pot of gold in our own backyard . . ." This method, reducing property taxes on improvements, while it has recently come to the fore as a hope for the future of our cities is not a new idea. In the past, however, resources were such that there was little need to attempt to achieve maximum efficiency in generating revenues from the real property taxes. Cities in Pennsylvania, Alberta, New Zealand, Australia, South Africa and Taiwan have generated strong revenue growth and property development through this taxation method first explained by Henry George almost a century ago.

RTI proponents explain it this way, land has value as defined by its optimal economic usage. A simplified model of the effect works like this:

"Imagine that A and B each hold identical plots of land assessed at $10,000 on which $100 of taxes are paid. However, A's property has been improved by the construction of a building assessed at $100,000 on which taxes of $1,000 are paid. Total revenues for both properties are $1,200. Now let us assume the voters decide to eliminate taxes on improvements and to shift the tax to the land itself. Both plots of land are now assessed at $110,000 the value which A's building has demonstrated them to have. Assume that the rate of taxation (1%) remains the same. In this unlikely event, revenues would rise to $2,200, an increase of 83.3%. But let us assume that the community concludes that a 15% increase in revenues is adequate. They thus desire to produce $1,380 in revenues from these properties. Since both taxpayers are now paying equal amounts, A's taxes drop to $690 while B's rise by $590 or nearly 600%. A has been rewarded by the community for having improved his property, an act which conferred a benefit upon the community in the form of additional jobs and the injection of payroll funds into the stream of local commerce.

"B, on the other hand, must now either find a use for his property which will support the increased tax load or sell it to someone who will. It should be noted however, that if B does decide to improve his property thus conferring a benefit upon society, he is not penalized as under present conditions."

The experiences with RTI throughout the world have been the same — it has worked wherever tried with the same degree of success as the extent to which it is applied. Where taxes on improvements have been totally removed, its success has been greatest and the degree of its success elsewhere has been in direct proportion to the amount taxes on improvements have been reduced when taxes on improvements are not totally removed. In Pittsburgh, the mill rate on land is presently 15.15 and that on improvements 2.75. As a measure of its success the city recently advertised that during the last ten years 167 companies, 85 from abroad, have moved their U.S. headquarters to that city to take advantage of the favorable tax climate. Four other communities in Pennsylvania; McKeesport, Scranton, Harrisburg, New Castle and Hawaii County, as well as over 1000 communities in Australia, New Zealand, Canada, Denmark and Taiwan report experiences similar to those in Pittsburgh.

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A conversation with

MASON GAFFNEY



YOUNGBLOOD

Mason Gaffney, Professor of Economics at UC Riverside, specializes in the economic implications of taxation. A proponent of RTI, he has also written extensively on timber, mineral and agricultural taxation; urban development and the economics of water use. A former economist to the Provincial Government of British Columbia, Gaffney received his Doctorate in Economics from UC Berkeley.

Reduced taxation on improvements offers the possibility of reduced per parcel taxes while promoting economic growth and enhanced municipal revenues — how are such paradoxes possible?

As individuals, we all view taxes negatively because they take money away from us and we don't like that. But, if you think about the effects and incentives what's important is whether the tax appears as a fixed cost or a variable cost to the individual. Tax economists describe the occasion for paying taxes as the taxable event. In the case of a tax on land values, instead of improvements, the only taxable event is, the earth going around the sun, once a year the tax is due. It only depends on the value of the land and the value of the land does not depend primarily on what the land owner does, so the tax is exogenous. It is not controlled by the individual — but maybe we could just stick with the fixed cost idea. The tax is part of the fixed cost and not part of the variable cost. Unless, of course, he buys more land, but as far as the individual parcel of land is concerned, it's a fixed cost. In order to meet that fixed cost he's under the gun to improve the land but when he does improve the land there's no increase in the tax.

If I'm correct in my understanding, the current tax structure functions as a fixed and variable tax both since we are taxed for the land at sale value which would be your fixed tax, plus the value of the improvements which is your variable tax.

That's right. And in California the property tax base is divided about equally between land and improvements.

When a reduced taxation on improvements structure is set up — let's take a model and say that it is taxed 50% to improvements and 50% to the value of the real estate, and you switched over to RTI — what happens in that particular moment to a land owner who has a vacant lot that he is speculating on and his neighbor next door who has a commercial structure he uses for business?

The owner with the vacant lot is put under increased pressure to improve that lot. In addition, the value of his lot in the market would probably not be much affected — although his taxes go up on the land the anticipated taxes on the improvement that hasn't been built yet are reduced to zero. Since the land value is determined by capitalizing individual income left over after penciling out the improvements, the net return from the improvement goes way up and that advantage is capitalizing to the land value. So, those two effects offset each other as far as valuation is concerned. There's no big effect on value but there is very great effect on incentives.

In the model situation we've switched from the situation where the speculator benefits to where the developer benefits.

That's correct. It's a double-barrel effect when you consider the effect on credit rating of the two parties, because at present the developer is in a cash squeeze at the time he builds because he is most vulnerable then. He's put out the most money and at that point the tax collector jumps on him. At the same time the non-developer being favored by the tax system is in a better credit position. But when you change the tax system you also change the credit picture so that

". . . RTI has the same effect as lowering the tax rate for the person who improves."

Interviewed by Bill Youngblood

now the person that doesn't build has poorer credit because he's got the cash drain of losing freezed taxes that forces him to sell or improve. The person who does build is in a better credit position because he doesn't have to pay increased taxes at the time he builds.

What are some more subtle implications of how RTI promotes development?

It's not really so unfamiliar when you look at the reasoning that went into the Williamson Act. There, the thinking was very much that there were some people who wanted to slow down the conversion of farm land to development. They observed that the pressure of property taxes was the thing that made a lot of land owners sell and it was with that in mind that they pushed through the Williamson Act — in order to keep out land speculators. It is not the way they put it of course but that was the effect. So it's not a strange idea, it's saying in effect that you want to encourage speculators to sell.

What are a few examples of the areas where RTI has been applied, what's the extent of application and how has it worked?

RTI is something that can be applied in whole or in part, on a large scale or a small scale. If you look at it in a comprehensive reform it's never been fully applied. If you look at it as a partial reform there are dozens of instances all over. One such instance is here in California starting with the Wright Act of 1887 which set up assessment districts for financing water supply projects mainly in agriculture. Today we call these irrigation districts. They cover about 4 million acres of farm land in California. Under the original act, there was a local option where the district could, if they wanted to, include buildings for taxation. In 1909 it was made mandatory to exempt buildings and farm improvements. So, since 1909 the irrigation districts have levied exclusively on land value. It had two or three objectives which were pretty well carried out. One — when the district issued bonds and put up a lot of front money to develop the water supply system they wanted to make sure that the land owners were under pressure to switch over to irrigation at more or less the same time, so they wouldn't be hanging out to dry paying interest without getting any revenue. So its purpose was to synchronize and accelerate development and it worked very well. The second — to avoid the high cost of running ditches past empty land. They wanted compact service areas and again it succeeded in that. That business of running ditches past empty land is the agricultural equivalent of urban sprawl. You could call it irrigation sprawl. They wanted to avoid irrigation sprawl which would run their costs way up. There are over one-hundred irrigation districts in the state. Some of them are just paper districts, but a lot of them have financed very expensive and impressive projects — they have developed the land in conjunction with the project. It takes both and this financing system has accomplished that. It is a truly remarkable achievement that is very little appreciated by most people. Now, it should be understood that we're just talking about a portion of the large tax structure, these irrigation districts really were superimposed on the existing system of county taxation.

What would happen if you take what we demonstrated with the water district and applied it to California as a whole on residential and commercial property?

It has two effects. One at least. First — it would accelerate the pace of development and the other which is an important adjunct — it would tend to recentralize development. The impact would be felt stronger in the more central areas. And I think that is very important because the major opposition to development today is based on fear of urban sprawl and all that that implies.

So, your downtown areas where you have the greatest urban blight, because currently there's no incentive to improve, would be the areas that would feel the greatest impact of a change.

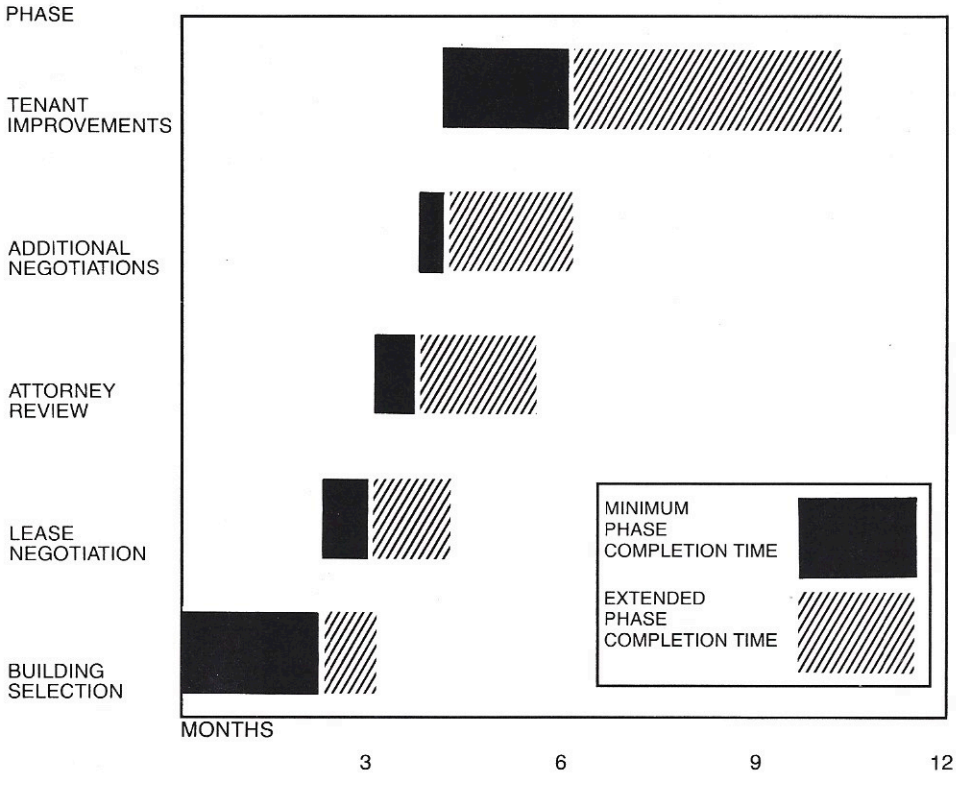
Certainly at first, and then I think it would roll outward over time but you'd end up serving the given population in a smaller area. It gets more compact development. Infilling I guess is a good word they use today. Some years ago I did a study in Milwaukee in considerable detail and discovered that if you switch from the present property tax system to an RTI system, an incredibly high percentage of all the land would be renewed almost immediately. It was something like 25%. Twenty-five percent of that land was hanging right at the edge of a cliff of demolition and renewal.

What about municipalities and the implication to their revenues. I understand there are indications that they can actually generate more revenues.

Yes, you'll find some places that depend heavily on one or a few industries for their property tax revenues. We'll find that the industry has a high ratio of building to land value and then they'll be concerned that this may involve a switch to residential property. There are a few cases where that is true. I've looked at a few of those and my strong impression was that the industrial land was being seriously under valued. I think of one specific example which is not untypical — in West Allis, Wisconsin where Allis Chalmers is located. The factory building happens to be right on the hottest corner in town. Three of the corners are commercial and the fourth corner is the edge of the Allis Chalmers factory but because that land has never been subdivided, it's assessed as raw acreage and the assessment on that land is 10% or less than the land across the street. Now, I just call that bad assessment practice which could be corrected. I think that some review of assessment practices is necessary in order to make this thing work out in a case like that.

As an economist how do you appraise the real applications of RTI?

I think it's a very effective tool for development and urban renewal. It can be applied on a small scale in which case you'll get small, finite, and practical results. It could theoretically be applied on a large scale in which you could get some sensational results. It really does for a property tax what accelerated depreciation does for the income tax. Acce-



Leasing

Making the Move

Looking for office space is often a long and time consuming process. The greatest success comes to those firms starting their search for new locations early. If a company move is planned and your lease expires within nine to twelve months your location hunt should be well along.

Location is the most critical factor in your mix of decisions. This key element can effect business growth, exposure, accessibility, costs and labor pool. Consider items such as: site visibility, freeway system access, airport proximity, public transportation, business neighbors, nearby residential areas, telephone area code and rates and possibly crime statistics. Area selection can run from one to three months.

Searching for that ideal building begins once the general area has been decided. Touring available buildings thoroughly can be expected to take at least a month with considerable time in the field away from the office.

Negotiations should begin with at least two buildings once the choice has been narrowed. This provides leverage and bargaining power as two or more building owners will better each other's offer when competing for the same tenant. Among the overall rental terms consider: rent, tenant improvement allowances, parking, operating expenses, rental escalations, term of the lease, subleasing rights and any special allowances or requirements. Initial negotiations will take a minimum of 30 days to decide on one particular building.

After the lease is negotiated in principal, it is imperative that both parties sign a written letter agreeing on the terms and conditions of the transaction. This will help prevent any disputes before the lease is drawn. Counsel review is the next step to protect against any hidden clauses or ambiguous wording which would prove costly at a later date.

Once the lease is signed, your schedule will revolve around improvement and moving time requirements. Improvement requirements and deadlines should be carefully specified in the lease so that the present lease doesn't expire before the new space is ready for occupancy. Space preparation and moving are big variables in a relocation timetable and should be allowed for according to the level of improvements required and the current condition of the new space. Allowing at least two months after lease signing before move-in is a good rule of thumb.

To expedite the search process most firms choose to work with one particular industrial or commercial real estate broker as their representative. This provides for consistent hunt and negotiation strategy as different buildings are compared. Ultimately this consistency will benefit the firm in time savings and the most favorable leasing agreement.

RTI . . .

Continued from page 1

The great drawback of the present method is that it harnesses the profit motive in reverse, rewarding him who does least, penalizing him who does most to generate economic growth and employment. Speculators win while developers have to carry tax burdens. In New York City this fact is being made clear. Three times in the last year the NEW YORK TIMES has employed its editorial pages to urge the legislature of New York State to enact the legislation necessary to permit New York City to tax improvements at a lower rate than real property. The TIMES had this to say in their most recent comment on the topic: "The best way to encourage useful development is to reduce the tax rate on all improvements, while correspondingly raising the taxes on their locational values — land."

GAFFNEY . . .

Continued from page 3

lerated depreciation encourages investment in new capital. It gives you an advantage when you improve — it doesn't give you an advantage when you don't improve, and since land is not depreciable the benefit of accelerated depreciation goes entirely to the person who improves property. It has the same effect as lowering the tax rate for the person who improves. That's the same idea that RTI has to apply through the property tax instead of through the income tax.

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Tax Report

A Special Summary and Forecast of Federal and State Tax Developments

the TAX BLITZ provokes resistance in many printi[ng]
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CENTER CITY RENAISSANCE is promised, but a tax man is dubious.

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Gaffney relies on findings from his study of 2,200 land sales in Milwaukee. The site tax system would roughly triple taxes on poorly used parcels, like parking lots or slums, he says. But taxes paid by owners of superior buildings, like good homes and offices, might drop by 40% to 75%. On balance, removing the tax threat from new buildings would make 40% of Milwaukee economically ripe for redevelopment, the professor maintains.

But Milwaukee tax commissioner Vincent A. Schmidt has his doubts. Owners of older homes or small stores could neither absorb higher land taxes nor redevelop their sites. They would simply be squeezed out, he declares.

BRIEFS: Idaho bars deposit of public funds in banks that don't pay sales and personal property taxes. The target: National banks, exempt from the levies. . . . IRS examiners scrutinize returns from 12,000 tax-exempt organizations last year, recommend that 182 lose the exempt status.

THE WALL STREET JOURNAL
WED., MARCH 19, 1969

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WHAT DOUBTS ??

...high pressure tactics. production. Turn to Israel, page 7, col. 4

Tax on Land Only Could Start Building Boom

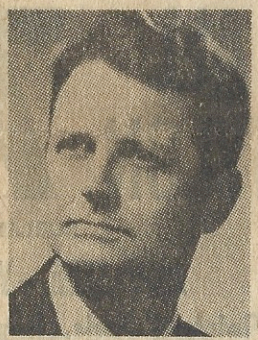
By JAMES W. McCULLA
of The Journal Staff

What would happen if the city of Milwaukee:

Assessed all land as though the owners were using it in keeping with its market value, whether they were or not?

Stopped collecting property tax on buildings and other structures and collected only on land?

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M. Mason Gaffney

revenue lost by removing the tax from buildings?

Such policies could trigger a fantastic building boom in Milwaukee and similar cities, according to a study of property tax policies here just published in the magazine Nation's Cities.

"The old problem has been how to end the construction stagnation that results in slums and decay; the new problem would be how to control a building boom that could wildly overtax the construction labor and construction financing resources of the city as thousands of property owners rush to take advantage of the tax shift," the study said.

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The magazine said the findings applied "specifically for Milwaukee, but by implication for almost any other central city facing problems of blight, obsolescence, slums and decay as all big cities do."

The four year study involved more than 2,500 land parcels in the city and was done with the co-operation of Vincent A. Schmit, city tax commissioner. "It provides the first comprehensive analysis anywhere of just what could be expected" if a city stopped taxing buildings and shifted all the property tax to land, the magazine said.

According to the study, Milwaukee "and any similar city" now collects about two-thirds of its property taxes from improvements and the rest from land values.

A shift "would roughly triple the tax take from idle land, parking lots, gas stations, slums and other decaying, obsolescent or ill advised buildings that add little (and sometimes less than nothing) to the value of the land they preempt," the report stated.

"Actually, it might do much more than triple their tax because Milwaukee assessors, like all other assessors, tend to confuse the property tax with an income tax and therefore grossly underassess underused land that is not bringing in enough income to pay the full tax on its market value," the reported stated.

Thus, a shift would "make it almost prohibitively unprofitable to keep close-in land idle or misused."

Would Add Tax

The study said the shift "would add roughly 50% to the tax take from properties whose improvement value approximates the location value, and it would make no change in the tax take from properties whose improvement to land ratio is close to the city average of two to one.

"But on good homes, good apartments, good office buildings, and good commercial and industrial structures, whose improvement value is likely to run at least four times their location value, the shift would cut the tax take by 40% to 75%," the report said.

The prospect of substantially reduced taxes on good, new buildings would stimulate the market price of close in locations that are ripe for rebuilding. Furthermore, higher land taxes would put heavy pressure on the owners of underused land to use it more productively and profitably.

Subsidies Unneeded

Change should negate the need for subsidies by making it profitable for owners of almost all parking lots and obsolete buildings that "pre-empt nearly three-quarters of the valuable land near the heart of Milwaukee (and most other big cities)" to replace them with new buildings.

This would vary between new offices, stores, low cost housing, parking garages, high rise apartments, garden apartments, single family homes — whatever was the "highest and best" use of the land.

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Turn to Taxes, page 5, col. 1

A Winter's Tale

Pupils Get to Take It Out on Principal

WELLESLEY, Mass. –AP– A winter's dream came true for 150 fifth and sixth grade students at Phillips school during an afternoon recess recently.

They threw snowballs at their principal, Willard Woodruff, and others brave or foolish enough to get within range.

It was Woodruff's idea.

"It was a form of bribery," he said. "I told the students that if they resisted the temptation and didn't throw snowballs all week, they could get it out of their systems all at once."

* * *

Douglas, Isle of Man –UPI– The mourners at James Wilkie's funeral thought it strange that they were asked for their names and addresses before being seated.

A few days later, they learned why. Wilkie, a lifelong bachelor, set aside 30% of his estate to be divided among all who showed up at his funeral.

Nearly 100 persons will share. The value of the estate has not yet been determined.

Milwaukee Journal 3-21-69

Your Dollar



Tax Solution For Cities Told

By Sylvia Porter

Q.: Why has virtually all new private construction come to an abrupt halt in New York City—with the exception of never-mind-the-cost office buildings renting at $8-$12 a square foot, or luxury apartments selling at $10,000 a room?

A.: Because New York City's tax of 4 per cent a year on property improvements actually prevents the improvements.

A.: Why is new private construction in Boston on the rise again after a long interval of devastating stagnation?

A.: Because Boston changed its tax of 6 per cent a year on improvements so that improvements can now be taxed only half as heavily as existing buildings.

'WORST OF TAXES'

The property tax accounts for a whopping 87 per cent of all the revenues of our local governments but "as most cities apply it, this tax may well be the very worst of all taxes," an extraordinarily eminent cross-section of experts agreed at a recent two-day seminar sponsored by Time, Inc., and the National League of Cities. The 54-page statement, released this Sunday, went on with the following indictment:

"It is a weird combination of overtaxation and undertaxation, an incentive tax for what we don't want and a disincentive tax for what we do want. It harnesses the profit motive backwards instead of forward to both urban renewal and urban development. Too often, it makes it more profitable to misuse and underuse land than to use it wisely and fully, more profitable to let buildings decay than to improve them or replace them."

A 3 per cent-a-year tax on improvements sounds small only because it is expressed as a percentage of capital. The following will suggest the enormity of it, though.

In terms of the income tax, a 3 per cent-of-true-value tax on improvements is apt to tax away 75 per cent of the net income a new building would otherwise earn.

In terms of the sales tax, this 3 per cent-a-year tax is the installment plan equivalent of a 5[illegible] per cent sales tax.

[illegible] will add more than 25 per cent to the rent a tenant must pay or more than 25 per cent to the carrying costs an owner must meet.

PROPOSAL ANALYZED

A prime proposal of the round table was that unused, underused and misused land be taxed far more heavily while property improvements be taxed much less heavily. This, the experts agreed, would:

—Help pay the cost of local governments while offsetting the cost of untaxing improvements;

—Slow down the pace of land price inflation, with all this implies to present and future buyers of homes;

—Help force owners of underused and misused land — most specifically, slums — to put it to far better use;

—Let cities expand in an orderly manner instead of disintegrating in suburban sprawl and premature subdivision.

An illustration of what might be the result is the city of Southfield which almost overnight became the boomingest city in Michigan after it boosted its tax on land and slashed its tax on improvements. It has since then recorded more new office building construction than 30-times-as-big nearby Detroit. Meanwhile, land acreage which was assessed at $2,400 in 1961 has zoomed to $100,000.

This is hardly the only solution, but it well may be the most crucial — for there is no disputing that one of the fundamental things wrong with our cities is their tax structure.

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(RE: Perry Prentice's writeup of a roundtable he organized and ran appearing in the March issue of Nation's Cities. Also shortly to get a write-up (by Mase?) in the Wall Street Journal.) WC.

Tax on Land Only Could Start Building Boom

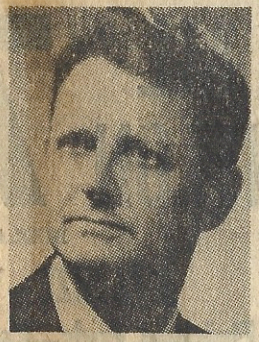
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Effect of Tax on Land Only?

From page 1

the opposite problem," according to the report.

"The shift would, in fact, be such strong medicine for what ails our cities that it would have to be given in small doses spread over a period of perhaps 10 years," the report said.

A change would make good city planning more necessary and effective, the report said. It noted that planning was essentially a negative power that could halt something but not compel owners to do what they ought.

The present property tax system discourages new construction by heavy taxation and encourages obsolescence and decay by undertaxation. Thus, most of Milwaukee "has passively defied effective city planning," the report said. A building boom would give the planners an opportunity to direct the course of city development.

Good for Building

The study claimed that contrary to popular belief, tripling the tax on land would not be bad for landowners if improvements were untaxed.

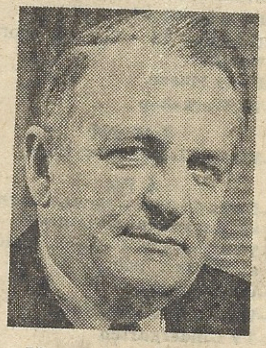
"A three times as heavy tax on land would indeed be almost confiscatory if the owner of unused or underused land persisted in leaving it that way, but untaxing improvements would enable him to triple his profits if he improved his property and put his land to its highest and best use," the report said. "This smaller tax on the improved package would be capitalized into the higher price for the land, so the land owner would find himself better off instead of worse."

The owners of valuable idle land could be the first to benefit because they would be first to take advantage of the tax exemption on improvements. "The only landowners who would stand to lose by the tax shift are owners of fringe land that now derives a fictitious value because the owners of so much closer in land can now afford to hold it off the market waiting for still higher prices."

More intensive use of valuable land near the center of the city would be stimulated. The study said that this, in conjunction with heavier tax pres-

value is assigned to the improvement, then the tax rate on land alone would have to be at least tripled, the Nation's Cities report said.

"Serious doubts as to the correctness and soundness of today's practice of assessing the building first are raised by the Milwaukee sampling, which showed nearly a fifth of the properties on which the assessors assigned a substantial value to the improvement



Vincent A. Schmit

would have sold for as much or more if the land had been bare."

Assessing would be much easier and more accurate, the study said.

A first step could be to reverse the present practice of assessing underused land at a much smaller percentage of market value than fully improved properties, "a practice that is somewhat less notorious in Milwaukee than elsewhere."

Backing Likely

Most Milwaukee voters would greet the shift enthusiastically, the report claimed, because it would lower taxes on their homes. The improvement-land ratio on such structures is well above the city average.

"Taxes on slum property would be doubled or tripled, but this would not affect many voters living in the slums since most slum dwellers are renters and (as any good economist can demonstrate) taxes on land cannot be passed on, but must be paid out of the owner's own pocket — except under rent control," the report said.

"The only voters hit hard by the tax shift would be the land speculators who are now making such a good thing out of today's property tax practice," the report said. It added, however: "Unfortunately, they are by far the most powerful and effective pressure group in local politics."

Helps Government

The shift to land would ease the financial plight of local government, the study contended. "Instead of depending on a tax base subject to accelerating erosion as the older close in buildings deteriorate without replacement and as industry and upper income families move to the suburbs, the city would find its tax base growing and the flight to the suburbs checked by the tax shift induced construction boom close in," the study said.

"The 40% or more property tax saving that the shift would assure new offices and new industrial plants would make the city a more profitable place to do business in, and could, therefore, be expected to attract more business and industry, thereby further strengthening the tax base."

The magazine said that findings of the Milwaukee study were being confirmed in Southfield, Mich.

Outside assessors doubled the assessment — and the tax —on land, allowing a substantial reduction on buildings. Since then, the city has had 30 times more office construction than neighboring Detroit, land values have soared and the mayor who instigated the tax shift has been re-elected three times.

city would be stimulated. The study said that this, in conjunction with heavier tax pressures on the owners of underused outlying land, would have important side effects:

Persons who prefer open space living "should be able to find land they could afford roughly half as far out as now, for more intensive land use downtown would siphon off much of the demand that is now proliferating sprawl."

Inner city and slum unemployment problems should be eased because factories and other blue collar employers would find it economical to locate closer to the residences of poor people.

More intensive use of downtown should reduce downtown traffic congestion because more people would walk to work or use public transportation.

The size of the tax rate increase required would depend on whether the assessors assign to the land or the tax exempt improvements the "big increase in the value of fully improved property that would result from reducing the tax on it by more than 40%," the study said.

If assessors follow their present practice of assessing the building first at cost less depreciation and assign all the big increase in residual value to the land, then the tax rate increase could be small. But if the land is assessed first and all the big increase in residual

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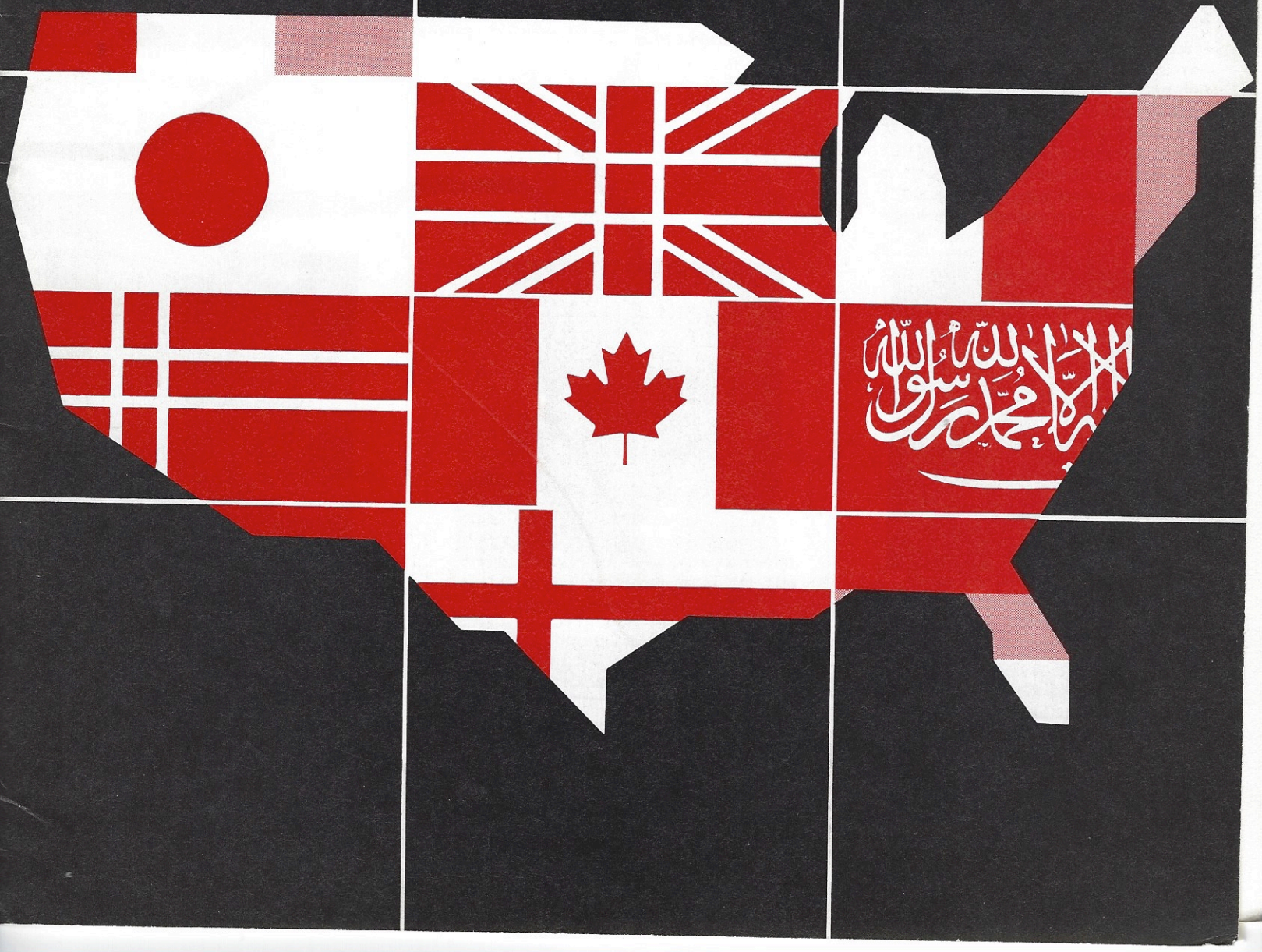
CHICAGO TITLE INSURANCE COMPANY

the GUARANTOR

summer 77

Foreign Investment in U.S. Real Estate

Repercussions of Tax Reform Act on Real Estate

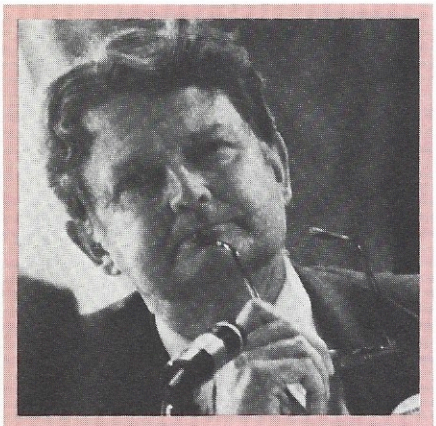


Foreign Investment
GOOD or B

Should we discourage or encourage foreign investment?

First, who's doing it, and where, and why? Does it yield economic benefits to all? Or is there a social/political cost to consider? This controversial issue affects not only those with property interests, but all U.S. citizens.

To air the issue, the St. Louis office of Chicago Title hosted a round table discussion consisting of five experts, moderated by newsman Ted Schafers. The results form the exclusive GUARANTOR feature presented here.



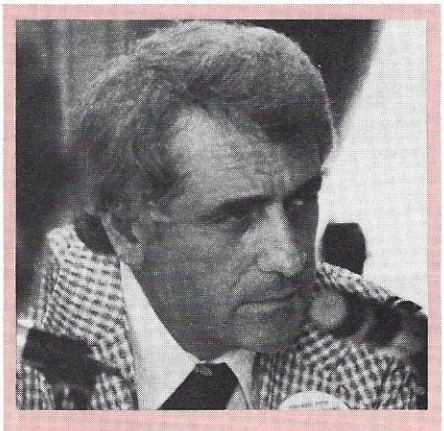
Mason Gaffney
Academician

- professor, Graduate School of Admin., Univ. of California—Riverside. Former faculty (economics) at Univ. of WI, MO, OR, UCLA; N. Carolina St. Univ.
- B.A., Phi Beta Kappa, Reed Coll.; Ph.D. in economics, Univ. of CA.
- consultant, lecturer, author and public speaker on economic theory, urban land economics, finance, etc.



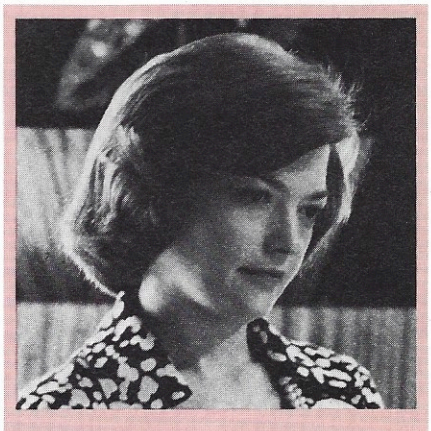
Ted Schafers
Moderator

- business and financial editor of St. Louis *Globe-Democrat.*
- veteran journalist with 35 years of newspaper experience (including *Business Week, Engineering News Record,* and others).
- two-time winner of the National Headliners Award for articles in the field of public service.
- regular guest on KMOX-Radio.



Philip D'Anna
Investor

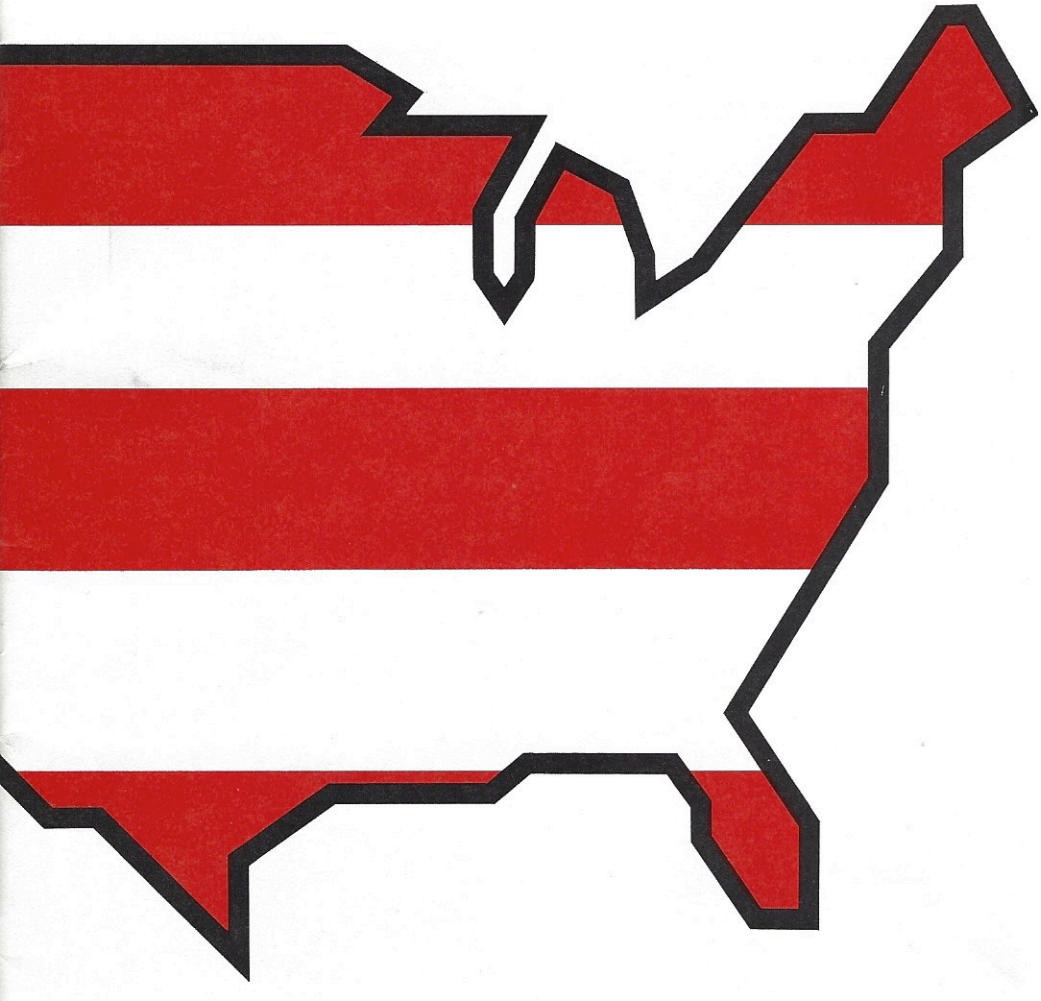
- president of Paramount Development Co. (Chicago-based affiliate of the Werner Otto group of W. Germany), investing $150 million in U.S. real estate last year.
- former gen. mgr. of Oak Brook Dev. Co. (joint venture of Del E. Webb Corp. and Paul Butler Co.).
- frequent speaker on foreign investment and sales management.



Ranne Warner
Research Analyst

- real estate investment analyst for Commercial Union Properties, Boston subsidiary of London-based Commercial Union Assurance Co.
- Harvard MBA (with distinction); Journalism degree, Univ. of MO.
- developer of case studies concerning business and property, and researcher for public interest research firms.

in U.S. Real Estate: **AD** for the U.S.?



Schafers: We are discussing today whether foreign investment in U.S. real estate is good or bad for this country. No one seems to have a firm fix on real estate investments, so first we'll ask each panel member to present a particular aspect of the general subject matter—such as, how is it being done? who are the players? what types of property are in demand? and where are the biggest plays?

Schafers: Mr. D'Anna, why do foreigners invest in real estate in the United States?

D'Anna: To foreign eyes, the U.S. probably represents the last bastion of capitalism in the world. Politically, we have a good track record: 200 years of free enterprise. We respect private capital and political stability. Often times we may feel we are going to hell in a hand basket, but compared to the rest of the world, we are doing quite well.

Many foreign companies and individuals want to put money in the U.S. to shelter it from socialism. The increasing power of the labor movement in some foreign countries is exceedingly threatening.

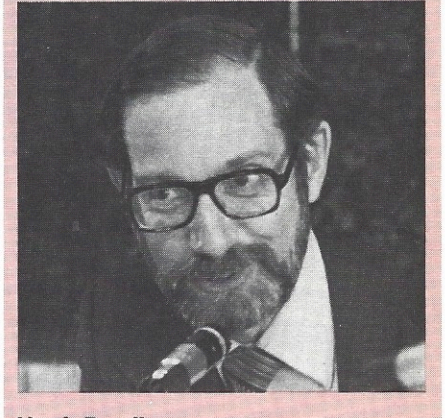
There are financial reasons as well. Overall, the U.S. has controlled inflation much better than the rest of the world. And there is a feeling that our economy will continue to expand at a faster rate than that of the rest of the world.

One other reason is that a number



Albert Burger
Economist

- assistant vice president and senior economist for the Federal Reserve Bank of St. Louis.
- author of *The Money Supply Process.*
- recipient of B.A. and M.S. from Oklahoma State University, and Ph.D. from Purdue University.
- author of numerous articles on monetary policy and banking.



Hugh Brodkey
Consultant

- vice president and associate general counsel for Chicago Title Insurance Company.
- consultant to private and government bodies on title matters concerning alien investment.
- underwriter of title insurance on alien investment in U.S. real estate.
- graduate of University of Chicago (A.B. and J.D.); member, Illinois Bar.



"Who is doing the purchasing and what types of property are being purchased by foreigners?"

—Ted Schafers

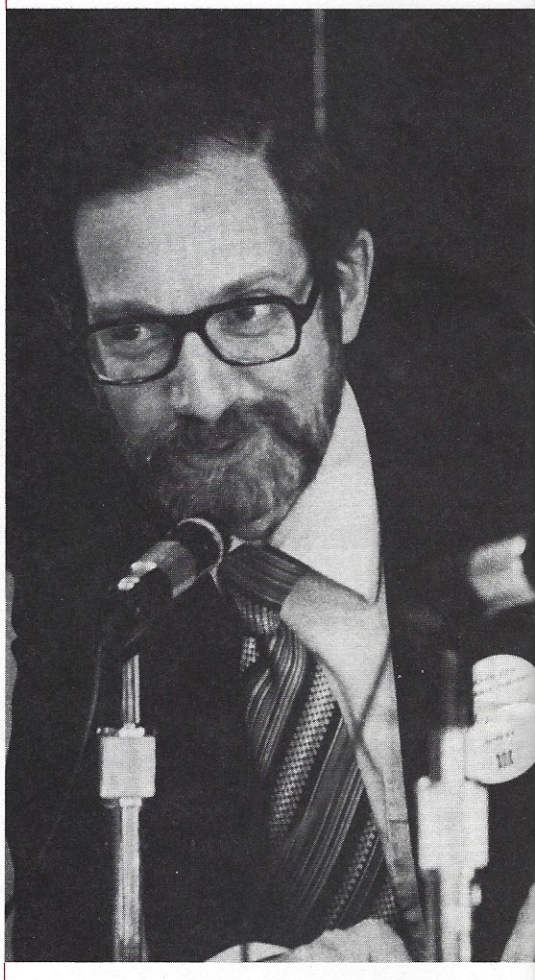
of companies throughout the world have accumulated much wealth. They sense—just as we did right after World War II—that they should be investing in other markets. In other words, diversification is another strong motivation.

Schafers: Mr. Brodkey, who is doing the purchasing and what type of properties are being purchased by foreigners?

Brodkey: The short answer is *everyone* and *everything.* Just about every country is represented to one degree or another in investments in the States. As to what kind of people, it ranges from private individuals and wealthy individual families to institutions. Investments are being made by Swiss Banks, Luxemburg Banks, quasi-governmental institutions like foreign pension funds, and governments themselves. Most notably, the government of Kuwait has money invested in land in the States.

Each foreign investor entity has its own set of goals. French and Italian families who are afraid of a socialist government somehow getting at their funds want to get the money out—so-called "flight capital." Mexicans were afraid of devaluation. Germans are interested in tax benefits. Investment emanates from a lot of different sources for a lot of different reasons. As you've already indicated, facts are hard to come by. The perspective each of us gets is a little distorted by whomever we ask.

And what are they investing in? Again, people try to make up profiles saying "most Germans prefer this kind of investment, most Englishmen prefer this kind," and you get almost contradictory information. At one conference, somebody said "Arabs always insist on liquidity and low risk"—in which case maybe they shouldn't be in real estate at all! But at the same conference, somebody else said, "Oil money seeks high risk and high up-side"—which might explain why you see Kuwaitis buying into a joint venture on Kiwaah



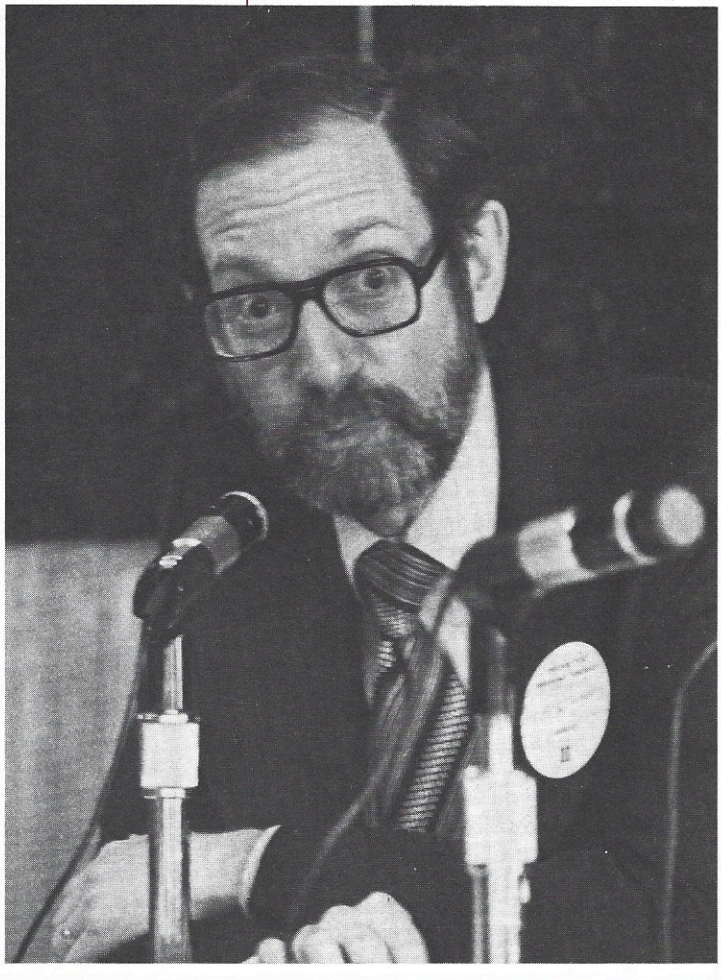
"The short answer is everyone and everything." —Hugh Brodkey

Island, South Carolina, for development of recreational lands.

The most apt generalization I can make is that the investments that look good to American investors also look good to foreign investors. Wide diversity of interest exists for foreigners just as it does for domestic investment.

Schafers: Dr. Burger, how much foreign investment in real estate is





"Facts are hard to come by." —Hugh Brodkey

"The perspective is distorted by whomever we ask." —Hugh Brodkey

there in the United States, and is there any real difficulty in finding out?

Burger: It is extremely difficult to get a good fix on the data. For one thing, land records are kept at local levels, and there is no federal aggregation of records. Currently, it is not feasible to total how much foreign investment there is or how much it increases from one year to the next.

Also, with the exceptions of Iowa and Nebraska, no state requires record keeping that identifies the actual ownership of land by citizenship or by domicile. Furthermore, reporting the name of the person who holds legal title does not necessarily identify the person who holds the beneficial interest in the land.

There's a problem here. If we adopt federal standards requiring registration of all alien investment, how can these reporting requirements apply to foreign investors and not to domestic investors? Domestic real estate investors might not want all of their transactions revealed, just as the foreign investors might not.

According to the most recent data on foreign ownership (a Commerce Department benchmark survey from 1974), about one tenth of one percent

of U.S. farm acreage could be traced to foreign ownership. Foreign control of U.S. timberland—through either ownership or leasing—amounted to approximately two million acres, a magnitude of about one percent of the nation's commercial timberland. So the little aggregate data we do have—and it is very little and very fragmentary—suggests that foreign investment in real estate is still quite small relative to the total.

Schafers: Dr. Gaffney, where do foreigners tend to invest?

Gaffney: As Mr. Brodkey and Mr. Burger pointed out, no one has clear answers. The U.S. Census Bureau collects data in fascinating detail on indoor and outdoor plumbing facilities and the peanut crop value, but as to who owns the basic resources of this country, it is silent. Not since the year 1900 has the Census conducted a comprehensive survey of what foreigners own farmland in the United States.

Standard sources and corporate records don't help us very much. We have to look at the smoke and try to determine how much fire is under it. Particularly in real estate, of course, ownership is disguised.

Another smokescreen is generated by what you mean by "foreigner." To some people, multi-national corporations which own property worldwide and whose common shareholders live around the world are as much foreign as they are domestic, regardless of where they may be chartered. If we look upon some of the multi-nationals as foreigners, then obviously their ownership is omnipresent.

Turning to the more common interpretation of foreign ownership, Canadians own extensive real estate along the border states. Europeans traditionally have concentrated in the mid-Atlantic states with chemical firms, manufacturing firms, machinery, and scientific products. They are now gravitating toward the sun-belt like everyone else.

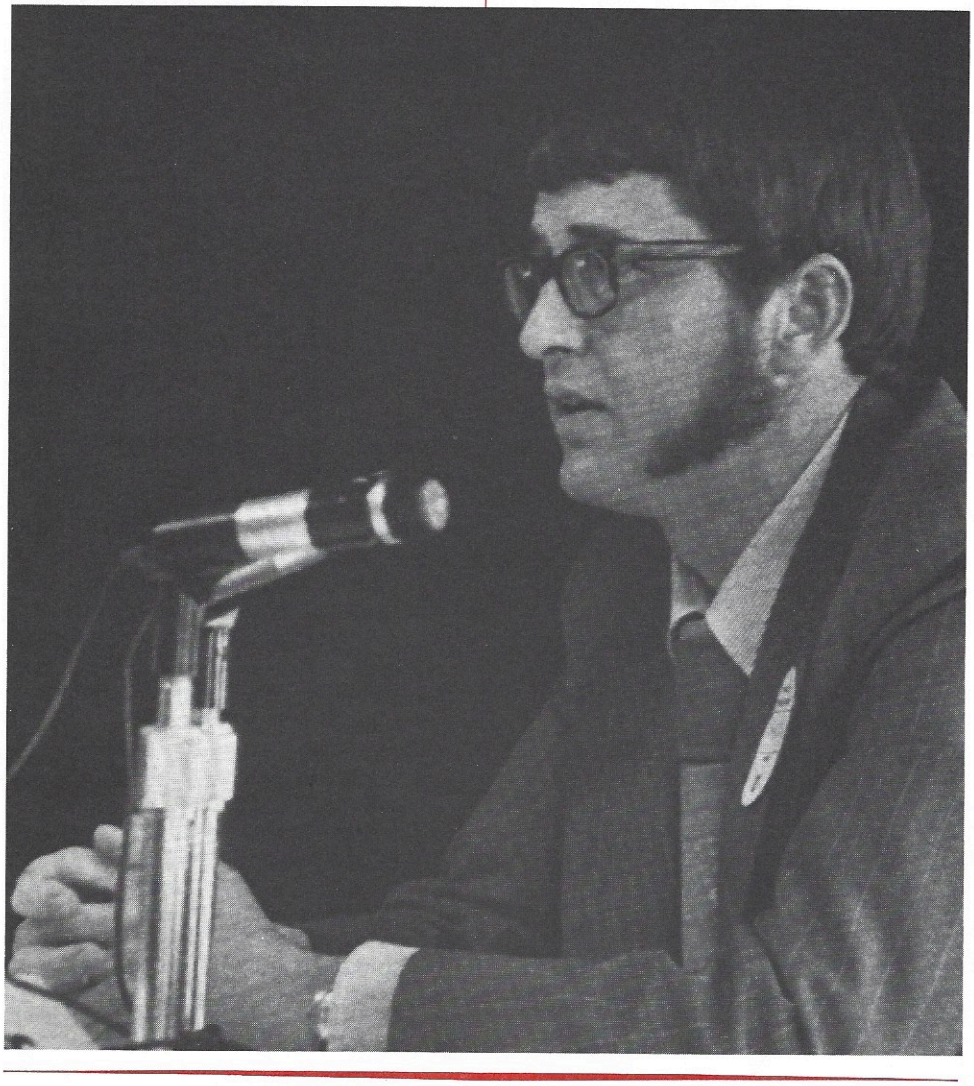
In frontier days, foreign ownership of farmlands was common in the Mid-West. There was an extreme reaction. Populism and isolationism were indigenous, and are reflected in the land laws of many of the middle western states which—unlike most other states—imposed severe restrictions (nominally, at least) on foreign ownership of land. Foreign investors, like other investors, are less likely to go where they're not wanted. So there's probably less tendency for foreigners to buy in the midwest region than others.

The Japanese have traditionally concentrated in Alaska and in Hawaii where their presence is conspicuous and, in some sectors of the economy,



"Absentee ownership does pose certain problems. You suggested one of them—holding land underutilized."

—Mason Gaffney



"I have a hard time seeing why foreign investors in land should behave much differently from domestic investors."

—Al Burger

very large.

And everyone, it seems, is going to California.

Schafers: Can you give us examples of restrictive laws?

Gaffney: In Illinois, if you're a foreigner and you buy land, you have to sell it after six years. Some other states restrict foreign ownership to certain acreage—but the laws aren't worth much because they're specified in terms of *acres* rather than *value.* Foreigners are attracted by the same characteristics of real estate that attract absentee domestic investors, and one of the attractions is downtown urban real estate where, of course, acreage is an irrelevant measure of value.

Schafers: Ms. Warner, how do you make contacts to get this money?

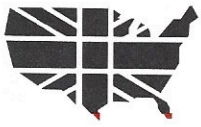
Warner: I can tell you two ends of the spectrum: (1) how to make contacts if you're the institutional investor interested in buying property—which is the position I occupy; and (2) for real estate brokers who would like to make contact with people with money to invest, I can explain how we went about it and make some suggestions on how you might go about it. Mr. D'Anna would be someone with money in the bank, so he would be a good person to meet today!

First we identify ten or twelve major markets in the country, and then we visit primarily with the financial institutions.

Interestingly, Europeans are used to living in a planned society, so they contact city planners in the U.S. thinking they exert a large measure of control over what happens.

We were quite surprised that people in the States were so open and so willing to share information. Europeans are much more closed and reserved, more conservative. If you are a broker trying to make contact with the European market, be aware that Europeans put much emphasis on official introductions and formal affiliations. Credentials and an institutional association are necessities when seeking foreign contacts.

If you are a broker with property to sell to a European, your primary sources of potential investors are large financial institutions and pension funds—plus wealthy individuals, who are usually represented by lawyers or large banks. In both instances, potential foreign investors are likely to be interested in your credentials and will prefer to deal with recognized U.S. financial institutions—particularly the large banks or law firms. Several large U.S. real estate firms have offices overseas, but if



your firm cannot justify that kind of overhead, you will probably want to establish contact overseas through the large U.S. banks which already represent foreign funds.

Schafers: Mr. D'Anna, since you do millions and millions and millions of dollars worth of business, tell us how it's done.

D'Anna: We've set up a domestic corporation with subsidiaries to make each acquisition. Every piece of property that we've purchased has been directly negotiated by us with real estate brokers. Of course, we're probably unique as a foreign investor. We don't go through financial institutions. I think a lot of foreign investors who deal with institutions are making a terrible mistake. For one thing, many bankers and securities' investment people know little about real estate. For another thing, financial institutions and investment houses can't move very quickly.

"Credentials and an institutional association are necessities when seeking foreign contacts."

—Ranne Warner



Schafers: Do you agree with him?

Warner: I'm saying that most of the money is coming through some sort of conduit with a track record, a position of established authority—be it an institution or agency or organization.

Mr. D'Anna's other point about the ability to move is valid. Most European institutional investors can't act fast enough. Usually, they don't give anyone here the authority to transfer the funds. Many times, they must go to a committee and get recommendations. This is one of the major disadvantages if you're a broker trying to sell something: you can't get an answer.

Brodkey: People connected with large Chicago banks tell me that the European investor goes to his banker; his banker refers him to a banker in the States; the banker in the States then gets the authority to find investments for him. I have the definite impression that there is so much money and so many Europeans looking for good investments here that at least one bank has a waiting list. They tell their foreign investors, "We will beat the bushes and try to find some investments for you, following some established guidelines on the kind of investment you prefer. We'll try to make the contacts with brokers, and we expect brokers will come to us because we are a big bank and they know we're in this business. And we'll put you on a waiting list. If we get something good, we'll notify you and give you a limited time to accept. If you don't like the proposal, then we'll offer it to some other investor whom we represent." That's one way of shortening the time frame.

Schafers: Is there any printed material telling a broker some of the holes he can fall into, or a glossary of laws affecting land purchases by foreigners, state by state?

Brodkey: As a title company, we distribute some technical material on state laws affecting ownership. On the question of how to make the

contacts, I don't know of anything specifically that's available.

Warner: It's like the real estate business: word-of-mouth.

Schafers: People just don't know how to start.

D'Anna: If you're interested in attracting foreign investors to your area, you or your Board of Realtors must set a professional public relations firm in motion. Tell the world why it's worth investing in the St. Louis area, for example.

Schafers: People wonder: Foreign investment seems good if it's going into factories, because that produces jobs; but is it wise to let our farmland, apartment properties, office buildings, shopping centers, and what not go into foreign ownership?

D'Anna: I don't see where that's going to hurt us. Rather, it will encourage foreign funds—and they'll invest *their* monies, freeing up *our* capital. Predictions about the next 10-15 years say there'll be a capital shortage. But the influx of foreign funds is going to release much of the capital we normally would have tied up in real estate.

Schafers: Without killing the goose that lays the golden eggs, how can we exercise some kind of effective control? If foreigners gobble up large chunks of land and leave it lie fallow, the country does not benefit.

Gaffney: The points that Mr. D'Anna made, as far as they went, are correct. If we sell some of our assets to foreigners, it creates capital inflow; at the same time, it creates debt which requires servicing. These, in a sense, balance each other, and the net result is an increase in absentee ownership.

Absentee ownership, however, does pose certain problems. You suggested one of them—holding land underutilized. Historical evidence indicates that foreign owners (and absentee owners in general) tend to prefer appreciating real estate as a form of investment. That means they tend to hold it out of use or under-utilize it, relative to domestic owners. And this is probably a disadvantage to the society in which it occurs, although there is a lot of dispute about that.

The social disadvantage doesn't just apply to *vacant* land, by the way, but also to *improved* land. A University of Wisconsin study by John Udell entitled "The Social and Economic Consequences of the Merger Movement in Wisconsin" tracked the history of branch plants (or independent plants that became branch plants) that were merged in Wisconsin over a period of years. The "before" and "after" study showed that after merger, the executives in those plants reduced their contributions to local civic good works. In addition, employment fell. These and other undesirable social and economic consequences were revealed.

Schafers: Does any panel member see any direct evidence of this in

(continued on page 16)

"A lot of foreign investors who deal with financial institutions are making a terrible mistake."

—Phil D'Anna



Repercussions of the Tax Reform Act on real estate:

a little?

a little

Reform has repercussions. A little . . . a little more . . . and a lot.

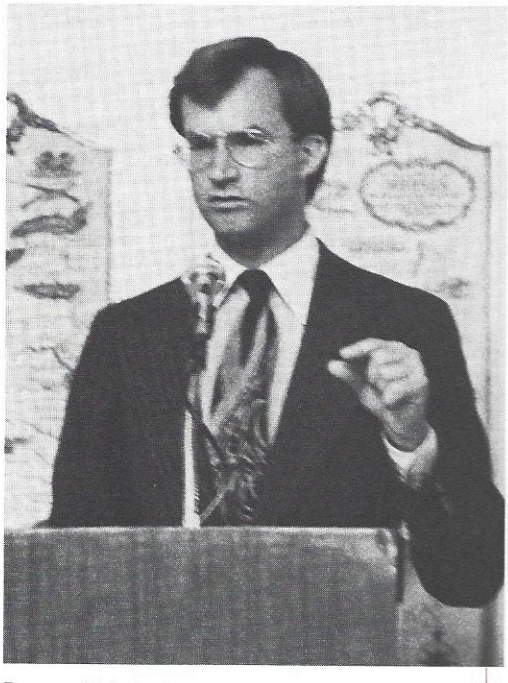
The Tax Reform Act of 1976 has left heads rolling. Sleeplessly sometimes. The Act came down hard. Tax accountants, attorneys, real estate consultants, and investors are doing heavy mental weight-lifting to see what's left underneath it all. Two elements emerge: there *is* something left; what's left requires the most intricate acrobatics and a keen sense of timing to generate spectator applause.

The Tax Reform Act (TRA) was, in the main, detrimental to real estate investment. The tax benefits declined —especially the former up-front benefits. Income flow over time is now more important because benefits occur further down the line. Since risk increases in direct relationship to increased time, the margin for error has become a narrow corridor where bad guesses in the dark leave black eyes . . . and blood-red ink on the balance sheet.

If there was any remaining doubt after the '60's that real estate investment had left the arena of amateurs for good, that doubt was thoroughly dispelled by the Tax Reform Act. Real estate investment is the realm of experts.

Some of the experts are pooling and sharing their knowledge, keeping real estate a viable investment vehicle rather than allowing it to be obscured by reams of regulations. Meeting at a seminar in Seattle sponsored by Property Press of San Francisco, four specialists dissected the Act to explain how the movable parts work.

Their technical and legal advice and best procedural recommendations fill a 500+ page volume, *Real Estate Investment Under the New Tax Reform Act of 1976* (second edition, 1977; Property





Press, 601 California Street, San Francisco, 94108). And their knowledge-based observations fill a room for two days with straightforward commentary on implications and outcomes . . . and on coping with the tax shelter scenario as it now unfolds.

The specialists don't pull any punches. They are clear about what the Act did to change the nature and structure of successful investment; and they are equally clear about what the Act did *not* do: it left real estate investment relatively unscathed compared to some other tax shelter vehicles which were all but wiped out.

The GUARANTOR here extracts insights from that seminar, excerpting chiefly from Stephen E. Roulac's wrap-up, which emphasizes the Tax Reform Act in the larger perspective. Roulac is Chairman of the Board and President of Questor Associates, a financial services firm specializing in real estate valuation and economic analysis.

Evolution

Historically, recent changes in tax law are easy to summarize in the aggregate: continual deterioration of tax benefits for real estate.

- 1968—cutback in prepaid interest.
- 1969 Reform Act—alteration of depreciation recapture provisions.
- 1971 (when syndication and partnership activity was strong)—IRS began applying new standards to partnership status. It was not an official change of law, but IRS rulings instigated net worth tests.
- 1972—the "safe harbor rule" added new qualifications.

Concurrently, the courts have chosen some very bizarre postures. These factors combine (or collide), forming a single conclusion: you can't have confidence in the tax environment. You can't assume long-term favorable tax treatment.

Tax-sensitive as investors are, this translates into a demand for higher return on investment. The investor requires a premium for exposing himself to risk. In analytic terms, the expected value of the property must be weighted by various probabilities of outcomes.

more?

a lot?





The negatively changeable tax environment produces greater range and volatility of values. And the cost of capital rises to cover the risk. Further, the value of certain tax strategies has been materially impaired, and former investment benefits are no longer available. The Tax Reform Act (and its predecessors) thus represents a *taking of value* and is *highly inflationary* in its impact.

Regulatory controls—the rules of the investment game—are pervasive and complex. When the rules are changed in such a way that they affect fundamental relationships, somebody is going to be in a better position, and somebody else will be worse off. Changes such as those introduced by the Tax Reform Act (TRA) influence what kind of players to recruit, what defense to run, and what bases on which to develop strategy.

An example of the complexity is exhibited in how real estate fares under the TRA. The new tax law is going to cause *lower returns* than were originally forecast. The disincentives (such as elimination of prepaid interest, deferral of deductibility of property taxes and interest during the construction period, and higher taxes on preferences) take a toll on new investment activity. The flip side (action/reaction) is that *existing* income property will therefore become more valuable, putting upward pressure on rents because of less new construction. So you get a push/pull effect.

The TRA also forces a recognition that the rules of the game are not stable. They will continue to be a fluctuating dynamic in the business arena. And the better players must keep an ear to the ground, catching daily reverberations, detecting future shock waves—or even retroactive echoes.

To be more precise, the predictability of tax assumptions under which investments were made is being erased. Not only do fewer benefits accrue under the TRA, but also the rejection of the "grandfather concept" (exempting earlier practices from new rules and regulations) introduces changes *after the fact*—affording much less protection for projects already undertaken.

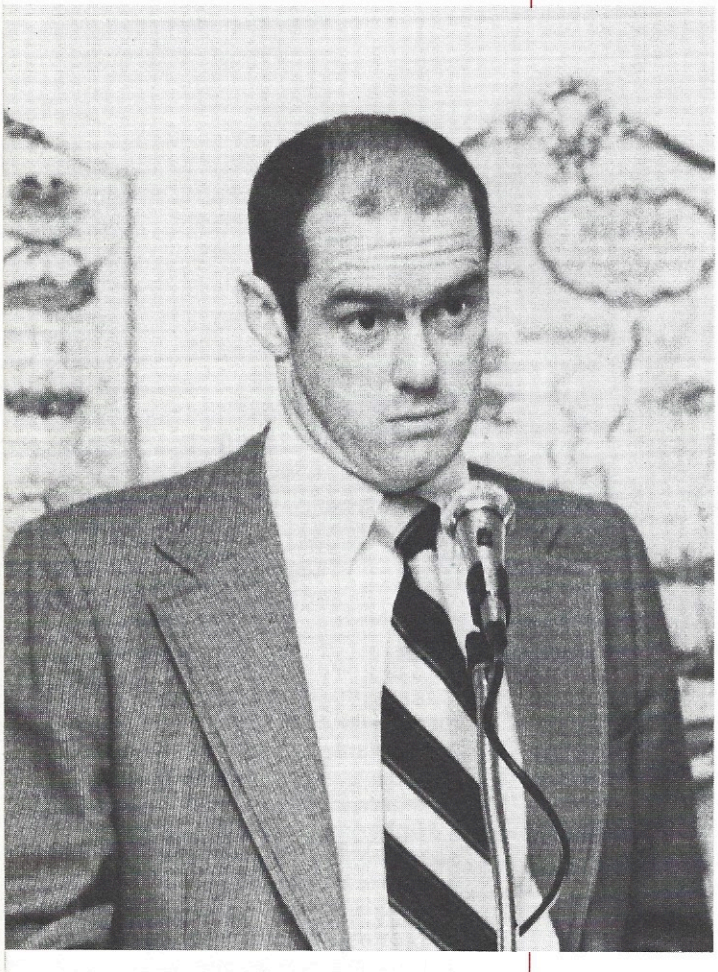
So we come around again to that rascal, UNCERTAINTY. Investor, tax accountant, lawyer and developer are now less comfortable and less confident in the projected outcome.

Higher risk means that the psychological framework of investors is affected. Besides figuring specific investment returns much closer to the mark, the new deal-maker must be aware of alterations in behavior of investors in the marketplace—a multiple variable equation composed of action, reaction, counteraction, confidence levels, etc. Building a game plan requires knowing your players' temperaments and proclivities, and providing some margin for the unknown.

Value Added and Subtracted

Investment strategies hereafter, then, must include much more fine-tuning. The only route to better pay-off is more precision, more expertise, more care. "The time value of money" will be a recurrent phrase, expressing as it does the economic cost of deferred benefits. Near money is dear money.

Depreciation recapture rules were



"The old hue and cry in December, 'Get me a tax write-off,' is now likely futile. Under the Tax Reform Act, participation in a partnership *throughout the year* determines one's loss—not joining in December. Old losses in a single-tier partnership cannot be allocated retroactively to new partners."

C. James Judson
Tax Attorney
Davis, Wright, Todd,
Riese & Jones
Seattle

made more severe, eliminating the preferential treatment for residential property, so now all conventionally financed property—both residential and non-residential—is taxed the same. (Subsidized housing projects, however, still enjoy preferential depreciation recapture treatment).

Occasionally, there is a conferral of value—in low-income housing rehabilitation, for example. The TRA reestablished a former provision and raised the maximum deduction. If a minimum of $3,000 per unit is spent, you've got a deduction—up to $20,000 (formerly $15,000).

Deductibility of moving expenses was liberalized: the required distance was lessened while the deductible cost incurred was increased. In widespread geographic locations like Houston and L.A., it will stimulate moving patterns—conferring a value to those markets.

A change in taxation at the corporate level is beneficial. It provides a $6,000 benefit to corporations earning $50,000 or more (by the extension of a lower tax rate to the second $25,000 of income). That's meaningful to a small business.

In the case of landmark preservation, TRA provides tax incentives—plus powerful *dis*incentives to discourage razing of significant historical structures.

Rental vacation homes are hit by a requirement: there must be sufficient rental activity in comparison to personal use to justify deduction beyond real estate taxes and interest. For recreational condominium rentals, this raises complicated issues such as how to interpret grouping of renters on one floor (which might be done to reduce building overhead during the off-season).

Even traditional estate management theory may be challenged. Reconstituting the composition of portfolios may be necessary because the former "custodial attitude" could be unwise under the current TRA atmospheric conditions. Active economic analysis of the overall portfolio may be called

SAMPLER

The Act granted some tax incentives: preservation and enhancement expenses on certified historical structures can be amortized over five years (rather than capitalized as formerly).

Judson

The first level of impact of the TRA is how it affects investors. The *ultimate* effects, however, impinge on (1) the consumer, in the pricing of the product, and on (2) capital market allocation: am I better off investing in land or in chinchillas? in housing or in commercial property? The incentives implicit in the tax structure determine the latter. Perhaps where we are headed is the achievement of parity, with no substantial benefit in any direction—a single form of taxation for all.

Roulac

Condominium associations are subject to new and beneficial rules. They are exempt from federal tax and are allowed carry-over cash from year to year as long as the condo is used primarily for residential purposes (as opposed to rental).

Judson

The Act substantially curbs allowable deductions for business use of home. Exclusive or regular activities must be conducted on the premises—and for the convenience of the employer, not the employee.

Judson

The "at-risk" provisions of the TRA clobbered the liquidity feature of oil and gas tax shelters, and badly crippled movies and equipment leasing. As for cattle-feeding shelters, they have been steadily declining in popularity, not because of the Act especially, but because the basic economies of the beef industry has been a disaster: it costs more to feed and raise herds than you get back at the marketplace.

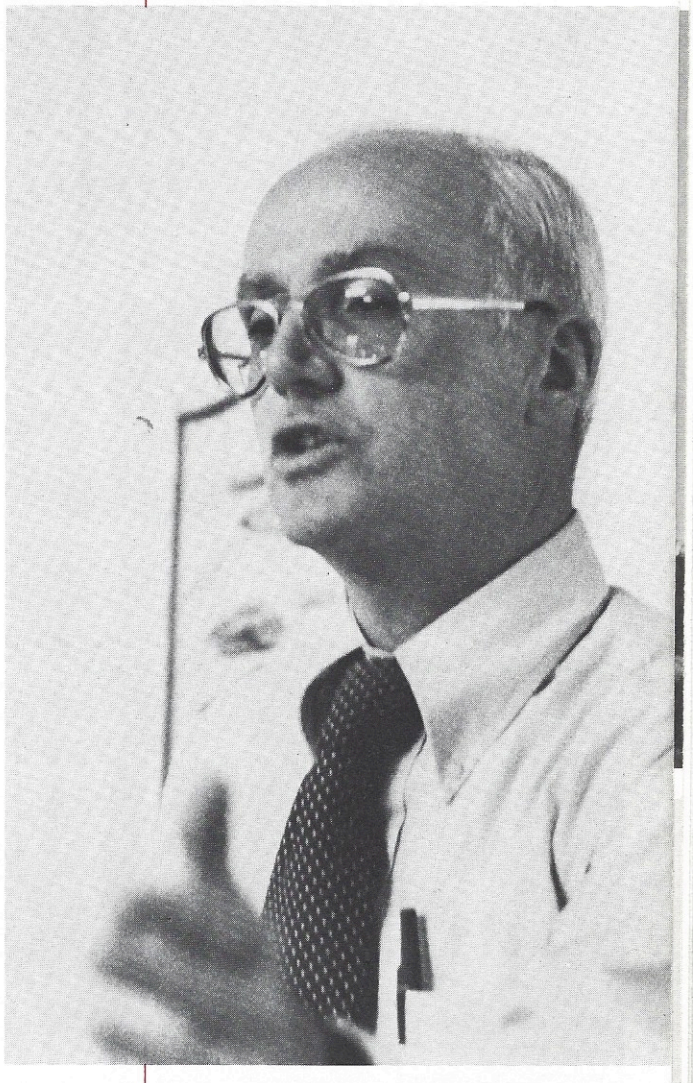
Mosburg

Some say there's no point in claiming accelerated depreciation anymore, since tax preference has negated the advantage. But the answer really depends on what else you're paying in taxes. It may not hurt you at all. The advice is not to jump to a single conclusion, but to look at the relative situation: check out the mix of income and set up suitability standards.

McGuire

"The guiding principle of many sections of the Act is a balance of the benefits and burdens of ownership for tax purposes. Who's at risk in regard to the income? Whose loss will it be? The issue is that the benefits represent a bundle of rights—and the investor assuming greater risk should receive the greater tax benefit. This has enormous impact on structuring the deal."

John McGuire
Tax Partner
Touche Ross & Co.
Houston



for—and those using the passive caretaker approach might get caught in a liability suit for imprudence.

Similarly, traditional appraisal valuation for farms and closely held businesses is altered. The new tax law provides that for estate tax purposes, the value of the asset can be based on "current use" as distinguished from traditional "highest and best use." This feature of the tax law is of special benefit to the small farmer . . . but interpretive problems may well render this provision essentially ineffective.

Use of REITs as investment vehicles has become less burdensome since some of the sources of their previous tax problems have been clarified by the TRA. So some value has been added through the elimination of certain administrative burdens.

Mutual funds were given a break in claiming retroactive losses—a windfall tax gain for those funds that had bad years in '71, '72.

And what impress did the TRA put on tax shelter investments overall? Monies which formerly were immediately deductible now must be capitalized and amortized. Also, with the exception of real estate (which enjoys a special exemption), the "at risk" provision has been amended to make clear that the deduction limit is the amount the investor actually has at risk and does not include any portion of a debt for which there is not direct recourse against the investor. This has complicated the situation to such an extent that major restructuring techniques are evolving.

Non-tax-oriented investors like insurance funds, institutional pension funds, etc. are favored by the TRA, since these sources of funds were not seeking immediate large write-offs and accelerated



"Decisions regarding real estate investment must take into account the full cycle of tax consequences over time. Large tax write-offs in the early years are no longer enough. Nor is an 'individual project view' appropriate; instead, use an overall portfolio approach to diversify and spread risk."

Stephen Roulac
President & Chairman of the Board
Questor Associates
San Francisco

depreciation anyway.

Another indirect outcome of the TRA is to put a premium on unusual expertise. There is an opportunity for creative tax planning, for imaginative interpretation of issues, and for special talent in economic analysis. Investors will rely increasingly on those with good track records, hard experience, and high recommendations.

Seismographic Ripples

Expanding the circle of effects still wider, we sense a subliminal philosophic change asserting itself through tax law. The U.S. capital crisis received much publicity a year and a half ago when a New York Stock Exchange study announced investment capital shortfall of some $650 million between now and 1985. Nothing has been heard lately and, "once an issue is no longer talked about in the press, it's solved!" But the capital crisis is still with us.

Yet the TRA is *anti-investment* and *pro-consumption.* You can at least enjoy whatever you spend . . . but you have no assurance about investments.

Aggravating this attitude is still another negative: the TRA is *anti-individual investor.* The target of legislation is not so much industry—not developers or the corporation—but non-professional investors. The little guy. TRA tends to reject or discourage the concept of joint ownership and, for that matter, of the stock market.

Historically, economic expansion in the U.S. has occurred because of capital investment. It's been a positive theme and there has been

ready access for the individual. But TRA frustrates this—and even penalizes natural resources, housing, food and energy in the process.

Financing is becoming institutionalized rather than entrepreneurial. It is becoming bureaucratic. This is worrisome to those who respect the free enterprise system we think we have.

The Practical Matter of the Future

Before or after the TRA, there are still four ways to make money in real estate:

1) improve the income of the property,
2) sell it for more than you paid,
3) use leverage,
4) use taxes advantageously.

Only the focus has changed: don't focus especially on the tax breaks anymore. They're more difficult to find now and not as valuable as before.

Real estate as a tax shelter still depends on arbitrage—the price differential resulting from three interlocking market relationships:

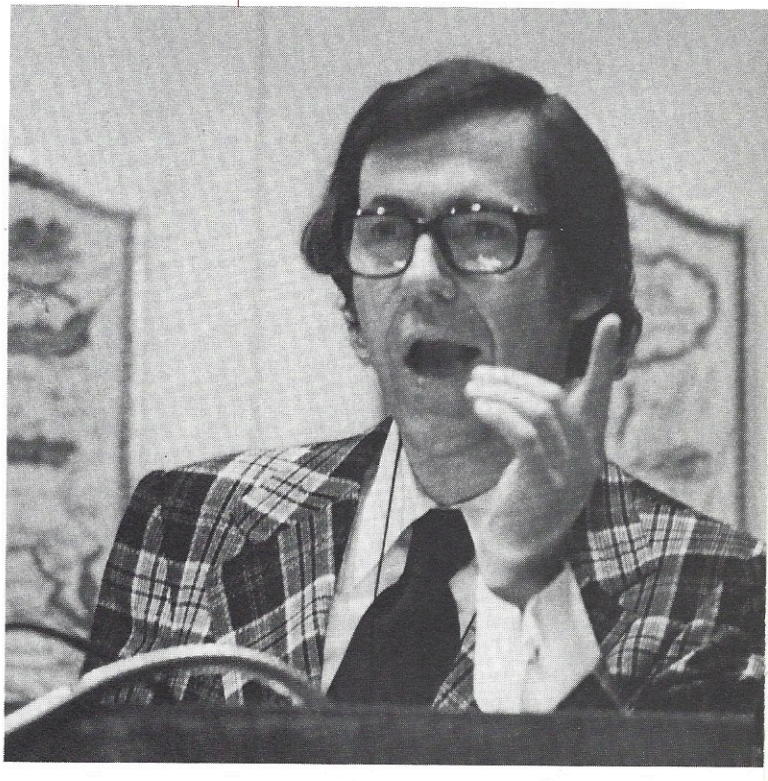
1) Different tax shelter participants have different tax brackets;
2) Different participants operate under different tax rate structures (some operating as individuals, some as corporations, etc.);
3) Different investors have different rate-of-return objectives.

Manipulating these three variables is what keeps the shelter concept viable. However, under TRA, the differentials are merging. The markets are becoming more homogenized. For one thing, it is difficult to find someone with low rate-of-return objectives.

This leads us to the conclusion that more and more emphasis must be placed on economic analysis, not on tax write-offs or tax structure differentials. The hard figures must be harder than ever, to compensate in part for the softnesses introduced by TRA: added future uncertainty and decreased immediate benefits.

"Guide 60—the new tax disclosure guideline for real estate syndication offerings—introduces grey area after grey area, substantively as well as regarding communications. You must warn the investor of consequences and risks, disclose the risk of total audit, and alert him to adverse income tax consequences. The idea is that the 'informed investor is usually a good loser'—he won't sue. Should you warn him, too, of the near-certainty of another major tax change in the next two years?!"

Lewis Mosburg, Jr.
Attorney
Andrews Mosburg Davis
Elam Legg & Bixler
Oklahoma City



"The Tax Reform Act underscores a steady historical trend of Congress and IRS: erosion of tax benefits for the individual (as opposed to corporate) investor. The provisions of the Act impact all of the traditional tax shelters—often with much worse effects than those on real estate—so there is no cause for despair, but certainly a cause and a necessity to change the method of evaluating and structuring investments."

William Ramseyer,
Seminar Moderator
and
General Manager
Property Press
San Francisco



Tax Reform Act (continued)

Economic analysis must be over the full life-cycle of the project, grounded in present value concepts, and calculated on an after-tax basis. Anything else is archaic.

Since analytic results will be only as good as the input data, the generation of accurate information is essential. Research, verification, and creative synapses are called for.

Some of the information you need doesn't exist. It can't be known. But it can be imagined. Analysis must reflect alternative tax scenarios, for example, making a prediction about the range of possible outcomes and dispersion of variance in returns—very probablistic.

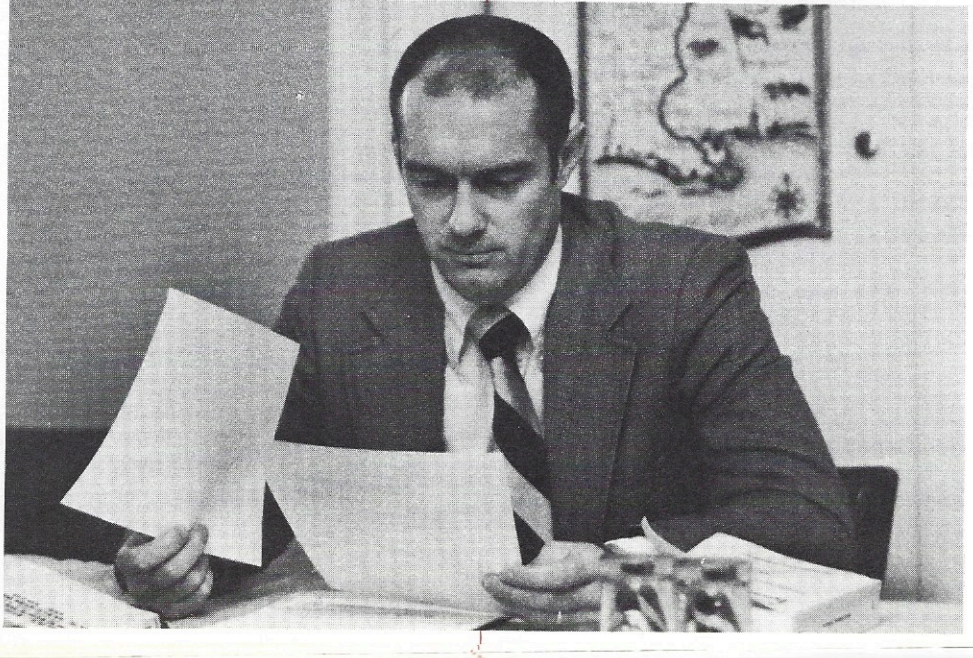
The probability of legal events happening has to be included. Surprisingly, the most accurate "answers" often result from a Monte Carlo system of determining events: random numbers! The chance of Congress or IRS doing something is "impossible to determine *rationally,* so use random odds!" This exotic idea is being used successfully today —not in a clever theoretical business school model, but applied in situations with substantial resources at stake.

Given the foregoing, it is small wonder that legal opinions (especially on investment disclosures) are becoming increasingly irrelevant and unspecific. Attorneys are fencing with all the uncertainty created by the Act and by the tax environment, totally caveating their statements so as to become equivocal . . . and meaningless . . . and "nothing you can hang your hat on."

Lawyers, like investors, "must step up to the line and accept some accountability. Lawyers are going to have to enjoy the game, too! They are going to have to put a number on their opinions." For example, the comfort level of the attorney on a given opinion might be 80% certainty. The investor should know not just the opinion, but also the numerical probability attached to it.

Real estate investment is a very sophisticated playing field demanding unusual teamwork among professionals. Even with the newest analytic economic gameplans and body-building structuring techniques and much mastery of skills, there is every indication that the tax rules will change again. It is a very open-ended field at this point, with no one being sure where the goal line will be placed next year. Moreover, tallying the scores is not purely mathematic, but social and political as well.

We end, then, with the final comment printed on a Touche Ross report on the TRA: "TO BE CONTINUED." ■



Foreign investment (continued)

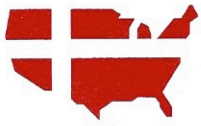
land dealing at the moment?

Burger: I have a hard time seeing why foreign investors should behave much differently from domestic investors. A foreign investor is buying a piece of property for the rate of return on that property. He's not buying it just to hold it idle—unless holding it idle offers the greatest return. Likewise, a domestic investor is not buying a piece of property just for the sake of buying a piece of property. He's buying it for the return. If the greatest return is holding it idle, I assume that he will hold it idle just like the foreign investor.

Yet, spectres are raised as though the foreign investor will come in and gain control of the land and perhaps of our agricultural production. Of course, the problem is of no magnitude at the present. But even more importantly, there are certain federal laws on the books—such as the Trading With The Enemy Act, that provides for seizure and administration of the property of alien enemies. Also, foreign Asset Control Regulations allow the U.S. to block foreign assets if aliens are behaving in a manner detrimental to the welfare of the United States. As I understand the matter, the latter restrictions do not even require legislative action.

Schafers: Under that legislation, you could decide that foreign investment is evil, and simply expropriate the real estate, right?

Burger: Correct. The foreign investor is in a much weaker, more tenuous, position than the domestic investor. This is true in other countries as well. If an American invests in a foreign country, he's at a disadvantage there relative to a domestic investor to the same extent that a foreign investor is at a disadvantage here. So, as I said, I have a hard time seeing this as a grave social problem—as if I'm going to wake up some morning and the Japanese or the Arabs or somebody is going to be controlling my life.



Schafers: You care to comment, Dr. Gaffney?

Gaffney: I would have said, until I heard you, Mr. Burger, that I would yield to no man in my dedication of the principles of the free market. But I must say your principles are purer than mine. I *do* think there is a lot of historical evidence to show that foreign investors are different from domestic investors.

I hate to go back to 1900, but that is the last time that the U.S. Census really studied the question systematically. The 1900 Census did show that the farther away from the land the investor lived, the larger the holding was and the less intensively the land was used. In addition, the Wisconsin study showed quite clearly that the consequence of merger was to reduce the intensity with which the property was utilized.

Schafers: What about the question of reciprocity? Can we buy land in Japan?

Brodkey: The Japanese government would have to screen the purchase, especially if it's agricultural or forest land.

Schafers: Yet, they're grabbing all our timber resources in Alaska, and we do nothing about it.

Burger: The question is, where do the foreigners get the funds to buy our land? The answer is that we bought something from the foreigner.

Brodkey: The idea of foreigners coming in and buying up the land is an emotional issue that does not seem to translate directly into law. Hawaii went through a serious period of Japanese investment, often involving overt discrimination against Americans and Hawaiians. And I would have expected Hawaii to pass a statute somehow restricting foreign investment. There *was* one introduced, but it wasn't enacted.

Schafers: Hawaii is a different country. Their tolerance for other people is very high.

Brodkey: But I've been observing the farm states and others to see if they are absolutely panicking over foreigners buying up land. The few bills that are in legislatures now to tighten regulations aren't all beamed specifically at foreigners; most are aimed at absentee owners. They restrict all corporate ownerships and all trusts, including agriculture trusts.

Schafers: Is it constitutional to restrict ownership—to Iowans only, for example?

Brodkey: Probably not. But restricting *non-resident aliens* is clearly constitutional. Yet, the fear of absentee ownership is more predominant than the fear of foreigners. It's a curious phenomenon.

Warner: I'd like to comment on the absentee issue and Dr. Gaffney's point about "the farther away the owner, the less intensively the land is used." The European institutional investor—which is different from the wealthy individual—is accustomed to owning property and managing it. One critical question that an institution asks a broker is: "Who is going to manage the property, and how well is it going to be managed?" They are very concerned about managing investments to optimize return.

D'Anna: Let's talk more about this question of absentee ownership. Take one of our large life insurance companies which owns a lot of property all over the country. Are we going to consider them absentee owners?

Gaffney: I couldn't agree more with the implication of your rhetorical question. Yes, they are absentee owners; and no, there is no practical way to sift them out. I don't believe that legal strictures against absentee owners are workable. I suffered for three years in British Columbia with a socialist government which was paranoid in its xenophobia and I would hate to see anything like that happen in the United States. I used to ask them, "Would you rather be screwed by a rich Canadian property owner than by a foreigner?" and the implicit answer was, "Well, yes."

To me, the solution lies in adopting institutions that will cause property owners of whatever nationality or whatever place of residence to behave in a more socially acceptable manner. That's what local government is for.

Schafers: How many states are there where corporations cannot own farmland?

Brodkey: Nine states have some sort of prohibition or restriction on corporations owning farmland, and two more have statutes aimed only at corporations controlled by foreigners. But don't forget that over half the 50 states have limitations on ownership of land by non-resident aliens. Some restrict the quantity of land or length of time it can be held; some restrict the type of land.

Schafers: What other unusual difficulties might be encountered?

Warner: Communication becomes a problem—even when the foreign investor speaks English. The same words can have different meanings. This is particularly true of real estate and financial jargon. Few of our internal rate-of-return techniques and terminology are used abroad, and they may mystify foreigners to the point of raising suspicion.

Brodkey: I am reminded that we tried to close a transaction for a French investor through an escrow in Chicago, and I kept explaining that the safest way to close a transaction was to give your money to an escrow—and it wasn't getting through, until somebody explained to me that the word pronounced "escrow" ("escroe") in French means "crook."

Schafers: Mr. Brodkey, we have an audience question from a spokesman for a savings and loan association: **"Will Chicago Title readily insure the enforceability of mortgage documentation in cases where foreign investors are involved in securing mortgage financing or purchasing U.S. property?"**

Brodkey: It depends on the state



in which the land is located and on the nature of the foreign investor. If it's a foreign government signing a mortgage, for example—no, we could not guarantee that you're going to be able to drag them into court to collect or that you could foreclose the mortgage. On the other hand, if it is a foreign national in a state where foreign nationals are entitled to own land—yes, they can sign documents and mortgages as readily as anybody else, and we'll insure the validity and enforceability of the mortgage the same as any other transaction.

Schafers: Another question—directed to Phil D'Anna: "Since the required return on foreign capital seems to be considerably less than U.S. investors expect, what effect do sales to foreign buyers have on recognized market values of real estate?"

D'Anna: In many instances, it's true that the return which foreign investors have looked for is quite a bit lower—for example, in Houston right now, foreign investors are making deals at 5, 6, 6½ per cent. We're not going to take less than a U.S. investor. We don't have to.

Schafers: So not all foreign investors are going to take that short deal.

D'Anna: In certain markets, they're buying potential. In the Houston market, maybe that's so. But they are not going to take a much lower return. You're right though; it does drive up prices when you get a lot of them in one area.

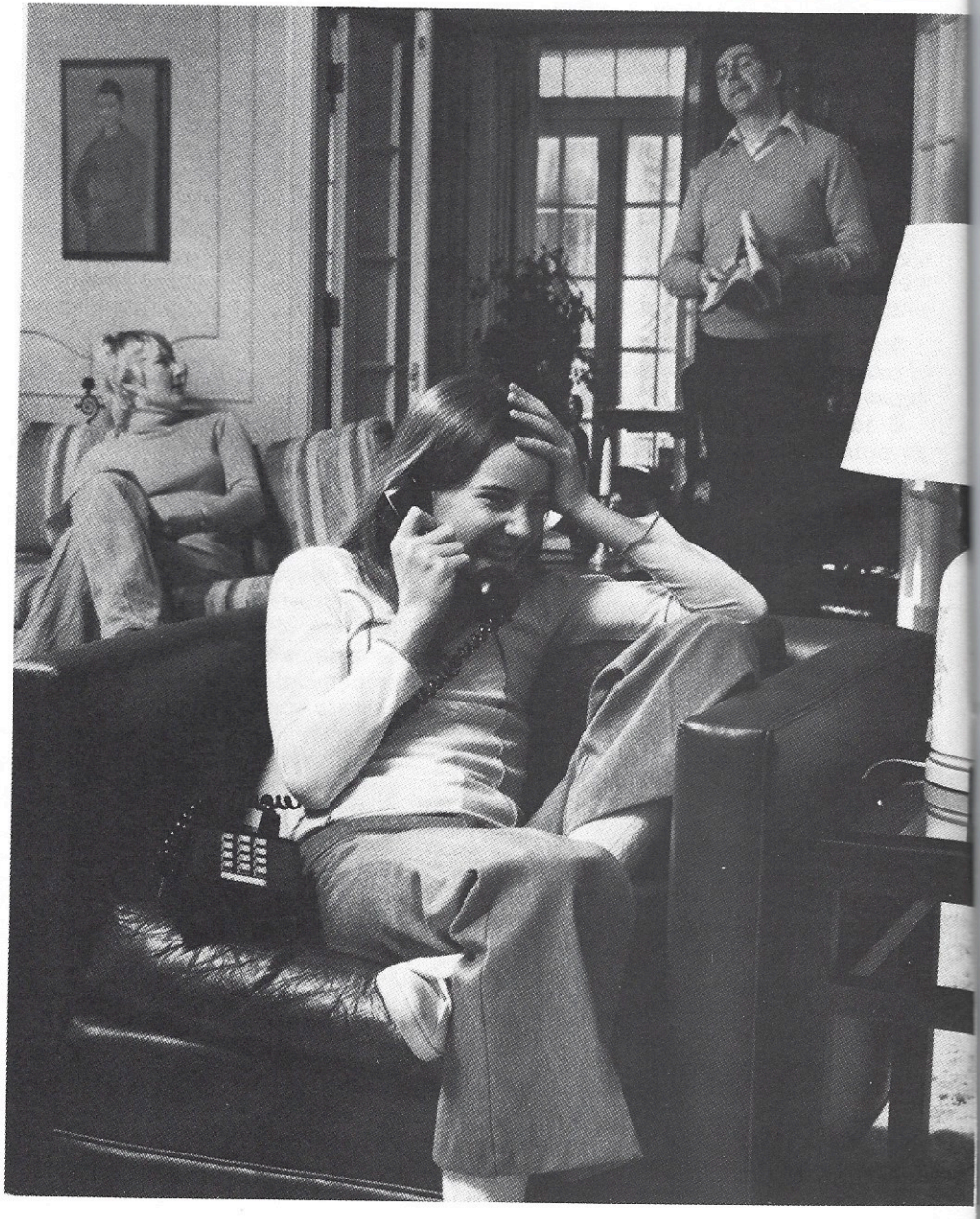
Schafers: Dr. Gaffney, are foreign investors generally subject to the same U.S. tax regulations that U.S. investors are?

Gaffney: In some cases—if it's a foreign government, for instance—the income is not subject to U.S. income tax and, as a result, the foreign purchase causes a net decline in U.S. tax collections. This is a serious problem and I'm glad the question was raised. The solution, it seems to me (and I know this goes against a modern cliché), is to make greater use of the property tax—or at least not to make *less* use of it—because property tax is impossible to avoid by concealing ownership.

Schafers: You've got to pay it in good times and bad, too!

Gaffney: Furthermore, the thing that is forfeited in case of default is the land which is within the taxing jurisdiction. And it doesn't matter where the owner resides.

D'Anna: I'd like to note that very few foreign governments are buying land in the United States. Most of our tax laws prevent that. And if they don't, you'll find the Attorney General of a particular state jumping



in pretty quickly. Most foreign investors, if they buy as individuals or as a domestic corporation, are subject to taxation.

Gaffney: However, it is generally agreed that the machinations of the multi-state tax compact—allocating the income of multi-state or multinational corporations among states or among various countries of the world—offers a fairly substantial loophole.

Warner: There are other substantial tax loopholes, too. If the investment is structured as a foreign corporation "not actively engaged in a U.S. trade or business," then the investment can be liable for only minimal U.S. income tax, and in some instances even capital gains tax can be avoided. Being a tax lawyer, it seems to me, is the best place to be: they're the ones making all the money on elaborate tax structuring.

D'Anna: I'm sure tax treaties—such as we have with the Netherlands and Germany—work both ways. U.S. investors in foreign countries are getting certain tax advantages, too.

Schafers: Mr. Brodkey, can you elaborate on what's operating in the Netherlands Antilles? Can you buy property and register it down there and escape taxes?

Brodkey: Before you run down to the Netherlands Antilles, visit your tax attorney and work with him. Tax advantages *can* be developed, but it gets very technical.

Schafers: To Al Burger: "Will the U.S. inflation rate be lower than that of most industrialized nations over the next ten years?"

Burger: Yes. If the U.S. follows an appropriate monetary policy, the only major industrialized country that might turn in a lower inflationary rate is Germany.

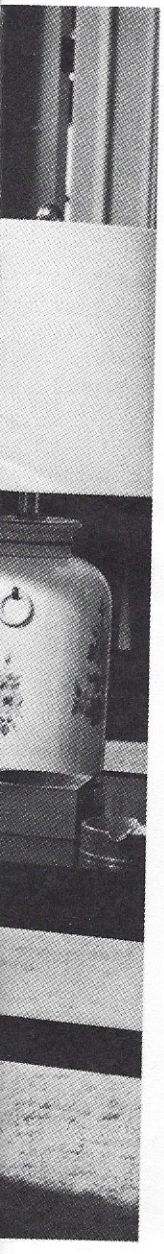
Schafers: Here's one for Phil D'Anna: "In general, how is the management function performed by foreign investors?"

D'Anna: Most so-called absentee owners hire major national management companies or local companies to manage their properties. In short, we've got domestic management.

Schafers: What kind of properties are foreign investors interested in? Is there a pattern? What has No. 1 priority now among properties?—I mean buildings.

D'Anna: There's an old expression: different strokes for different folks.

The small investor looks maybe for apartment complexes. He may have $700,000 or a million or a million and a half dollars of cash to invest.



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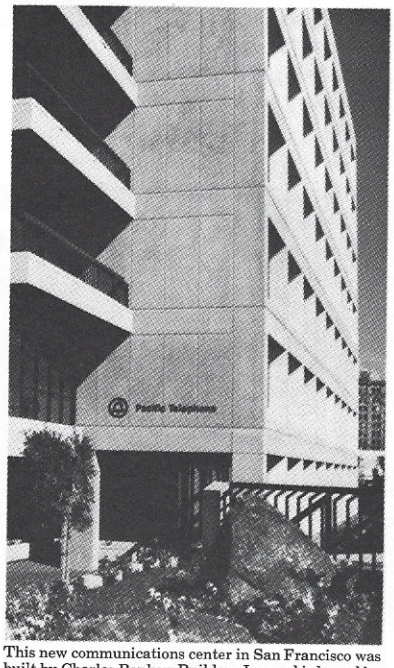
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Schafers: He's *small?*

D'Anna: He's a small investor. You can't pin-point the larger foreign investor and say he buys this type of property and has this many dollars to invest. It depends on what his interests are and what kind of counseling he's getting from his local source.

Schafers: Anybody want to add to that?

Warner: I would add that the queen of investments now is the shopping center, because it can be one of the best hedges against inflation. In most cases, rents are adjusted based on a percentage of sales. As inflation goes up, sales go up, and therefore rents go up. In addition, as a shop owner prospers and sales volume increases, the shopping center owner also shares in the profits. Even in the worst economic times, people still have to buy food and clothes. These percentage rents do *not* exist for office buildings, where tenants can have long-term fixed leases written at historically low levels with little opportunity for escalation. But it's hard to find a good shopping center for sale today.

Schafers: How would you go about making a contact to entice rich Europeans or Asians or whomever to come to you and say, "Look, find me an investment"? Is there a sure-fire way?

D'Anna: First of all, you need to publicize your area—make it sound very desirable, maybe hire a PR firm. You know we're talking about a lot of money and a lot of commissions.

Secondly, make sure you've got property that is a decent investment. Don't think you can pass off rejects. Foreign investors are very sophisticated. They didn't accumulate wealth by being stupid.

Then I would contact large banks, national investment firms, and national real estate firms who are dealing with foreign investors. Or contact me.

Warner: Besides institutions, there are a number of foreign funds already in operation. In several cases, foreign institutions have formed organizations to invest their pooled funds, and contacting their agents may be productive.

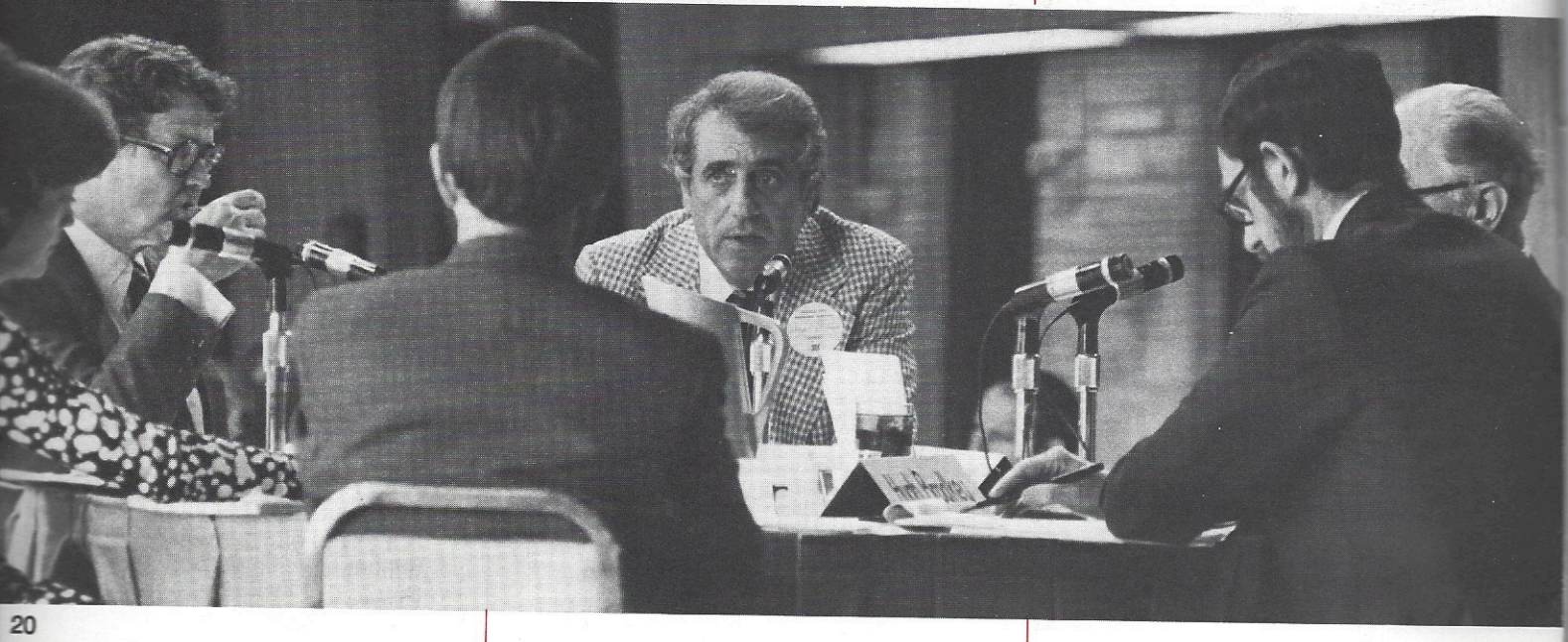
Brodkey: Banks can serve an intermediary function, playing major matchmaker and communication roles.

NOTE:

Secrecy in Foreign Transactions Clouds Title Insurance Coverage

Foreign investors who insist that their U.S. land purchases be kept secret may be jeopardizing their title insurance coverage. All forms of owner's policy used in the U.S. provide that the title insurer is not liable for loss arising from matters known to the insured but not disclosed to the insurer. If the insured is a non-resident alien (or a corporation or trust in which the ownership or beneficial interest is held by a non-resident alien), this should be disclosed in writing to the title insurer so that the legal effect on the title can be properly considered; otherwise the insured is not covered as to problems related to alien status.

Chicago Title Insurance Company staff members will be glad to discuss the question with persons representing foreign investors, in order to anticipate and possibly eliminate title problems related to foreign ownership.



CTI on the move

Appointments and Transfers

CENTRAL REGION

William N. Brainard—to title operations officer, from senior paralegal title examiner, Painesville (OH).

Frederick L. Kramer—to assistant vice president, from divisional construction escrow officer, Kansas City office.

Donald G. McCarthy—assistant vice president, to divisional counsel, Cleveland office.

Miriam M. Schneider—to assistant counsel for the Central Region, from underwriting attorney. Ms. Schneider is located in the Chicago office.

Indrawadan Shah—to title officer, Euclid (OH) office, from assistant manager of escrow department, Cleveland office.

Fred C. Suits—to title officer in divisional underwriting, Cleveland.

J. Milton Wood—to escrow officer, and continues as escrow manager, Kansas City office.

EASTERN REGION

Harry C. Bell—to claims counsel, New York office, from assistant counsel, Chicago office.

Gary R. Cortellessa—to assistant divisional counsel, Capitol Division (Arlington, VA) from title officer, New York office.

Charles G. Iosco—to office counsel, Washington DC office.

A. Claiborne Leigh—to title operations officer, from office manager, Richmond (VA) office.

Lawrence G. Massey—to title operations officer, and continues as manager, Union County office (NJ).

John A. Medinger—to assistant vice president and manager, Cherry Hill (NJ) office, from agency operations officer, Philadelphia.

Gloria J. Pompa—to senior escrow officer, and continues as escrow manager, Washington DC office.

E. Neil Rogers—to title operations officer, from office manager, Tidewater (Norfolk, VA) office.

James N. Wright, Jr.—to title operations officer, and continues as manager, Camp Springs (MD) office.

ILLINOIS REGION

Christopher Abbinante—to manager, production unit I, from attorney examiner, customer unit D.

Dorothy Cammon—to assistant manager, from supervisor, lenders closing department, Chicago office.

John O. Culley—to resident vice president and manager of DuPage County office, from assistant vice president and manager of construction projects, Chicago office.

Gordon T. Davis—to title operations officer, and continues as record maintenance manager, Will County office.

Veronica Davis—to manager examining unit Y, from examiner, unit E.

Carla Eplin—to blanket file specialist, from examiner, unit F.

Arthur W. Fedder—to assistant vice president and manager of construction projects department, Chicago office, from title officer, DuPage County office.

Leslie Henninger—to national marketing officer, Chicago.

Ronald L. Hildebrand—to project counsel, from assistant secretary of construction projects department, Chicago office.

A. Robert Kazlauski—to resident vice president, from assistant vice president, Peoria office.

Claire H. Langguth—to escrow officer, from senior escrow clerk, DuPage County office.

Sandra S. Nerovich—to escrow officer, and continues as manager, Bolingbrook office.

Walter Spreadbury—to consolidated unit manager, customer unit M, from manager, production unit I.

SOUTHERN REGION

Anthony J. Byrne—vice president, to assistant divisional manager, Memphis office, from county manager, Los Angeles office.

Robert L. Cole—to agency operations officer, from agency representative, Tulsa office.

Joseph M. Danese, Jr.—to title operations officer, and continues as manager of Jacksonville (FL) office.

Allen M. Gentry—assistant vice president, transferred to Atlanta from Chicago.

Don P. Lacy—to branch manager, from staff attorney, Jackson (MS) office.

Warren B. Ludeke—to title operations officer, from abstract and examining manager, Houston office.

Winfred L. Myers—to agency operations officer, from agency representative, Dallas office.

Alan N. Prince—vice president, to manager, Dallas division, from manager, DuPage County (IL) office.

Larry D. Rickert—agency operations officer, from agency representative, Houston office.

Guy P. Ridout—agency operations officer, Memphis division, from agency representative, Albuquerque office.

Frank J. Riha—to assistant vice president, from agency operations officer, Houston office.

Horace E. Roberson—to chief escrow officer, from closing department manager, Houston office.

WESTERN REGION

William G. Anderson—assistant vice president, to Southern California operations manager, from manager, San Diego office.

Marx A. Baham—to manager, San Diego County office.

Jimmie O. Brumett—to title operations officer, Los Angeles office.

Charles A. Sanders—assistant vice president, to manager, Los Angeles County operations, from manager, Orange County office.

James R. Thorson—to manager, from sales manager, Orange County office.

William M. Wood—assistant vice president, to manager, San Francisco office, from manager of residential closing operations, Chicago office.

CTI on the move

Special Appointments

Three people have been elected to the Board of Directors of CTI: **John E. Jensen,** senior vice president, Chicago Title and Trust Company; **John E. Krout,** president and member of the Board of Managers of Germantown Savings Bank, Philadelphia; and **Harold R. Spurway,** president of Carson Pirie Scott and Company, Chicago.

Office Openings

A new full-service office has opened in **Bolingbrook, Illinois** at 433 N. Bolingbrook Drive, zip 60439; telephone (312) 759-1001. The manager is Sandra Nerovich.

Also in Illinois, a new office has opened in **Rockford, Illinois** at 4249 East State Street in the Regency Plaza, Suite 202, zip 61108; telephone (815) 398-1496. Manager of the office is Linda Bennehoff.

In **Seattle, Washington** a new office has opened at 1415 5th Avenue, zip 98171; telephone (206) 628-5666. Dan Wentzel is manager of Chicago Title's first office in the state of Washington.

Four closing offices in **Houston, Texas** are located at:

- 6111 F.M. 1960 West, Suite 115, zip 77096; telephone (713) 444-8591, manager of the office is Karen Clark;
- 9525 Katy Freeway, Suite 102, zip 77024; telephone (713) 467-2444, office manager is Gladys Albert;
- 8700 Commerce Park Drive, Suite 150, zip 77036; telephone (713) 776-3303, Leona Salvato manager;
- 10200 East Freeway, zip 77029; telephone (713) 675-8765, manager is Lyn Christopher.

In **Jenkintown, Pennsylvania** a new sales-settlement office has opened at 801 Old York Road, Suite 201, zip 19046; telephone (215) 576-6616. The office is managed by Saul Jacobs and serves Montgomery County.

A new full-service office serving San Joaquin County has opened in **Stockton, California** at 1313 W. Robinhood Drive, zip 95207; telephone (209) 951-9170. County manager is Vincent Balbi.

Also in California, a new escrow office in **Danville, California** has opened at 801 San Ramon Valley Boulevard, Suite D, zip is 94526; telephone (415) 820-5700. Manager is Sheila R. Schultz.

In **Mansfield, Ohio** a full-service office has opened to serve Richland County. The new office, managed by James Aprile, is located in the Stewart Tower Building, Suite 300, zip 44902; telephone (419) 522-5900.

Office Relocations

The **Southfield, Michigan** office has moved to 3000 Town Center, Suite 280, zip 48075; telephone (313) 312-4545.

The **East Brunswick, New Jersey** office has a new location: 197 Highway 18, in the Turnpike Plaza Building, zip 08816; the telephone is the same (201) 828-6277.

Also in New Jersey, the office in **Union, New Jersey** has moved to 2029 Morris Avenue, P.O. Box 2156, zip 07083; telephone (201) 964-4810.

The **Tulsa, Oklahoma** office has moved to 6111 East Skelly Drive, Suite 812, zip 74135; phone number remains the same: (918) 664-0940.

The office in **Speedway, Indiana** has moved to 2822 N. High School Road, zip 46224; telephone (317) 243-7571.

The **Riverside, California** office has moved to 3701 Main Street, zip 92501; telephone is the same: (201) 784-2464.

The office in **Boston, Massachusetts** has moved to 133 Federal Street, on the 9th floor, zip 02110; same phone: (617) 482-0530.

The **Newburgh, New York** office has new quarters: 295 Broadway, zip 12550. The telephone remains the same: (914) 562-4600.

The office in **Skokie, Illinois** has moved to 8707 Skokie Boulevard, zip 60076; same phone: (312) 677-2410.

To The Rescue

When Senator Edward Brooke of Massachusetts asked for special title insurance assistance for his constituents, Chicago Title responded. Portions of Senator Brooke's home state are involved in the Indian land claims now pending in the East. Tribes in Massachusetts, Maine, and several eastern states are seeking restitution regarding lands which they claim were taken from them improperly.

The basis of the claim is that land transfers—some almost 200 years old—were never ratified by Congress, as required by a 1790 law, and are thus invalid, leaving undisturbed the Indians' original rights to the land.

Chicago Title agreed to issue insurance coverage up to a specified limit to land owners in Mashpee, Massachusetts, where real estate transactions have been slowed by the Indian land claims. The insurance will be limited to hardship cases in which property owners might suffer total loss of their investment if they could not sell the property or obtain financing.

Chicago Title was the first title insurance company to indicate its willingness to assume the risk presented by Senator Brooke's appeal on behalf of Mashpee residents.

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Where We Stand

by Albert Shanker President United Federation of Teachers

Land Value Levy Is Progressive 11/7/79

Change, Don't Scuttle the Property Tax

There is widespread fear across the country that Proposition 13 will spread. Wherever I have traveled in recent months the issue has been raised. Public employees are afraid that they will lose their jobs in the near future. College students worry that there will be no jobs for them when they graduate. Citizen groups are concerned about the erosion of public services, about lower-quality schools, police and fire protection, libraries and health services. The same question is asked over and over again: What can we do to stop Proposition 13?

Two recent articles by tax experts point out that one of the reasons for the success of Proposition 13 in California—and the likely success in other places—is that the property tax has been under constant attack from all sides, from left and right. Unless the property tax is explained and defended, especially by those who do not want to lose the money the tax provides for many services, it is doomed to defeat.

Mason Gaffney, professor of economics at the University of California at Riverside, has some suggestions in an article on "Proposition 13: The California Model of the Taxpayers' Revolt," which appeared in the November/December 1978 issue of *The Center Magazine*, published by the Center for the Study of Democratic Institutions. "First," writes Gaffney, "we should stop maligning the property tax." He continues:

> "We have the curious spectacle of George McGovern, Jerry Wurf, State Senator Nicholas Petris of California, the California Tax Reform Association, and others along the Americans for Democratic Action position who tell us the property tax is a bad, regressive tax, and then are dismayed when the voters throw the tax out under right-wing leadership. Their position is so hard to follow, I am tempted to suspect it is they who are confused. Or perhaps they never really meant we should lower property taxes; perhaps they really meant we should raise income taxes. But now that the voters are in a mood to lower any tax whose support slackens, the A.D.A. troopers had better get their act together and look for the good in the property tax if they really want to save it and the social welfare it helps to finance."

Gaffney lists many arguments as to why property should be taxed. "We hear a lot these days about cutting the fat out of the public sector; but there is fat in the private sector too. . . . Howard Jarvis has said that the policeman or fireman who risks his life protecting the property of others has his 'nose in the public trough.' But it has seemed to generations of economists that the owner whose land rises in value because public spending builds an eight-lane freeway . . . is the first to have his nose in the trough."

Many have criticized the property tax as falling mostly on the little man and as inherently regressive. Gaffney retorts that "the ownership of property is highly concentrated, much more so than the receipt of income." Moreover, a high percentage of the property tax is on land. In California, while Proposition 13 was supposed to save renters and small homeowners money, 43% of the property tax base was not buildings or houses, but *land*.

In addition, notes Gaffney, "a high percentage of real property is owned from out of state and even out of the country. . . . Some half of any reduction in California property taxes leaks to out-of-state owners. Nor is this the only leakage. New federal income tax payments will rise by $1.5 billion, until other deductible taxes rise to replace lost property taxes." Gaffney predicts that after the distribution of the state surplus ceases to blunt the effects of Proposition 13, "California will suffer a substantial decline in its economic base which, in a few years, will cause the state either to sink into an Alabama-like desuetude or to repeal Proposition 13." Gaffney's arguments are too numerous and too rich to summarize adequately here. They deserve careful study.

But neither he nor Walter Rybeck, special assistant to Chairman Henry Reuss of the House Banking, Finance and Urban Affairs Committee, believes the property tax should be continued as it is now. Rybeck, who delivered an eloquent speech on the subject at a September conference in Toronto (printed in the Dec. 15 issue of *Vital Speeches*), and Gaffney both propose a major change: that there be no tax on property improvements but a tax on land value only. At present, by taxing the value of buildings and homes, we penalize people for improving their property, we discourage building and renovation which create jobs, we slow down urban renewal.

The land value tax, says Gaffney, would be very progressive, since "the ownership of the base is highly concentrated, much more so than income and even more so than the ownership of machines and improvements. Also, the tax on land values cannot be shifted to the consumer. The tax stimulates effort and investment because it is a fixed charge based merely on the passage of time. It does not rise when people work harder or invest money in improvements."

Similarly, Rybeck notes how Howard Jarvis "struck paydirt with voters by reminding them how the tax, in effect, punished property owners who built or remodeled, even though these activities put people to work and improved city neighborhoods." The trouble with Jarvis, says Rybeck, is that "he tarred and feathered the whole property tax, not just the building tax that has been causing so much individual and social pain."

The rescue of what is good and productive in the property tax has begun. Those who care about the services provided by these revenues—primarily local services that the American public has repeatedly held in high esteem—had better take heed. In responding to the "taxpayer revolt," it wouldn't be wise to throw out the baby with the bath water.

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Spotlighting Undertaxed Land

More economists than not agree with Adam Smith that land value offers an ideal tax base. Their failure to push harder for putting more of the taxload on land, says Dr. Mason Gaffney, stems mainly from the belief that "there's no money in it."

Professor Gaffney takes a penetrating look at the adequacy of land as a tax base in a recent study sponsored by the Committee on Taxation, Resources and Economic Development (TRED) edited by Dr. Daniel M. Holland of the Massachusetts Institute of Technology: *The Assessment of Land Value*, The University of Wisconsin Press, Madison, Wis. 292 pages. $10.

The Wisconsin economics professor now with Resources for the Future, Inc., in Washington, D.C., unreels a raft of perceptive data pointing to an untapped bonanza, particularly in corporate land holdings, that belie the tax planners' notion there's no money in it.

Corporations As Land Speculators

In any jurisdiction the largest property tax payers are usually corporations, says Dr. Gaffney, but few assessors trouble to rank their taxpayers and publish the results. One that does is Lane County, Oregon, where the Southern Pacific Railroad, Weyerhaeuser, Pacific T. & T., Booth-Kelly Lumber, Mountain States Power, Pope & Talbot, Hines Lumber, U.S. Plywood, Rosboro Lumber, and Eugene Fruit Growers Association pay 21 per cent of Lane County's total levy.

As anyone who follows securities knows, the book value at which companies carry land has only a remote relation to its true value, this expert says. "The same is true of governments and institutions. Plant and equipment acquired in 1900 is worthless today, but land acquired then is normally worth many times its historical cost. Many corporations are either dozing on large old holdings or are in the business of holding resources while they appreciate."

Timber Firm Grows Rich in Its Sleep

This land economist finds, for example, that Weyerhaeuser holds more than 3.8 million acres. "For some years," he notes, "these lands were administered by some 'individuals allowed to atrophy in nonproductive positions,' according to President George Weyerhaeuser. But this did not prevent their lands from 'constantly rising in value.' The new president's program of reform is to borrow on his rising land values to – buy 1.8 million acres more land! Land and timber are carried at $117 million; Weyerhaeuser now speaks of its market value at '2 to 3 billion dollars.' "

Other examples from Dr. Gaffney's fine grist:

Castle & Cooke, Inc. (producer of Dole Pineapple, C&H Sugar, Bumble-Bee canned seafood, and Cabana bananas) carries its land at $26 million. *Forbes* suggests $300 million is more current.

Real Sugar Is Land Money

"Land is swiftly replacing sugar and pineapples as Hawaii's most valuable commodity, and Castle & Cooke owns more of it than anyone else." Underusing this land, the author observes, makes Castle & Cooke a prime takeover candidate.

"Railroads: All are major landowners on the basis of their rights-of-way, if nothing else. Hardly a man is now alive who remembers the 20th Century Limited, Hiawatha, Zephyrs and other crack trains, but the same old rights-of-way, and urban yards and terminals remain as the enduring corpus of rail enterprises.

"The New Mexico & Arizona Land Company, subsidiary of the Frisco Railway, is purely a rent collector. Its 750,000 acres yield income from oil, grazing and uranium. In 1959 income was about $500,000 a year, administration $22,000, local taxes $21,000! It carried its land at $540,000, a little more than 1 year's income."

Gas Station Sites Are Mints

Oil and minerals: John D. Rockefeller built up his power by control of lands, wells, transportation routes, and terminals, Dr. Gaffney remarks. "Today we may add chains of retail stations, whose land value exceeds improvement value even now, as elements of the power.

"There are 324,000 gas stations in the United States, mostly in cities on hot corners, owned by oil companies. A new station site in California today runs around $100,000. Improvements are $65,000 when new, after which they depreciate, while hot corners appreciate.

"Taking $50,000 as a cautious low estimate of land value per filling station, 324,000 stations come to $16 billion in land alone."

As for the bankrupt Penn Central, Dr. Gaffney cites the road's recent $88 million flyer in California lands.

He quotes Penn Central Director Howard Butcher III's comment: "These are only a wart on

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the pickle compared with the rest of our realty holdings," and another Penn Central official chimes in with "We are large owners of undeveloped land in the center of big cities." *Forbes* rates Penn's nonrailroad land at over $1 billion. You wonder – just how bankrupt is the poor old Penn Central.

Salt: The Leslie Salt Co. of Alameda County, California, consists mainly of 40,000 acres of concentrating ponds in one of the world's best sites for this purpose, the south shallows of San Francisco Bay. This land is now ripe for urbanization. After the usual fretting and shoving it should be worth $10,000 an acre, or $400 million, for reuse – a nice scrap value for a used asset.

Safeway's Land-based Wealth

Food chains: Retail chains of all kinds are land-based. A principle of urban land economics, says Dr. Gaffney, is that the share of land in real estate value is highest in retailing, with its critical location requirements. What is A.&P., the author asks, but a string of ordinary buildings and managers on 4,600 superior sites completely surrounded by large parking lots? If sites average $200,000 each, A.&P.'s retail sites would come to almost $1 billion, an article in *Forbes* notes, and with Safeway's 2,000 retail outlets, the same pattern can be assumed.

Drawing on a study of land values which he directed in Milwaukee, Professor Gaffney says it is safe to conclude that aggregate national land values range considerably above $640 billion.

California Lands Undertaxed Twenty-fold

The author unravels a long string of biases showing why land is under-assessed, all of which are eye-openers to the average taxpayer. Even in California, which enjoys "a good national reputation in tax administration," Professor Gaffney cites the *California Homeowners* magazine that "every few months publishes cases on the order of sales at 20 times assessed land value." The magazine's devastating studies of Alameda and San Diego county assessment discrimination, are replete with such cases. He mentions Karl Falk, Chancellor of Fresno State College, who sites the state purchase of 3,000 acres of Salt Point Ranch in Sonoma County for 62 times assessed value.

Dr. Gaffney asserts there are cities on the land tax system which seem neither to skimp on public spending nor to have used up their land value tax base. Sydney and Johannesburg are the two largest: both are booming with reported high land values – a bottomless bonanza in a tax base that economists agree is the fairest of all.

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