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SIDNEY L. CARROLL

American Family Fortunes as Economic Deadweight

Five percent of American families own nearly all of the economy's nonresidential productive assets. A modernized inheritance-based tax system would productively release enormous amounts of now-idled financial and human resources.

Much has been written over the years about the framework of wealth—how it is distributed, the mechanics that drive concentration, the institutional structures that channel wealth into current uses and, very occasionally, a suggestion that there are alternatives to the current system. I add to this discussion my contention that a massive portion of our nation's wealth is locked away unproductively, and that by substituting inheritance for estate transmission of wealth, this country could, over time, free this wealth and reap profound national and individual rewards.

The existing laws governing the transmission of wealth in the United States were established under Teddy Roosevelt in 1912, after intense public debate. Those laws have produced and fostered our current wealth distribution. The U.S. economy and the world as a whole are substantially changed now, and there is good reason to rekindle the estate versus inheritance debate. We need to explore alternative structures that have the potential for creating a more vibrant economy.

The wealth involved is more than a trillion dollars. It is frozen during the estate transmission process. The Du Pont fortune has been handed in this way from generation to generation since 1802. Massive inherited wealth typically is locked away from individual control in the hands of banks, attorneys, financial advisors, and accountants who manage trusts. Inheritance transmission could put control of these assets in the hands of people—not hidebound

institutions. Significant national wealth transferred in an orderly fashion to a broad-based, yeasty crew of energetic, inventive, and educated young people could produce a profoundly different effect than the many millions locked away to support the idle rich. Some funds would be put to uses we cannot imagine—both good and bad—but there would be churning of this wealth through the economy. Prognosticators, from Nostradamus to macroeconomic forecasters to earthquake predictors, don't have a very good record. But it is hard to imagine that beneficial changes for the country would not occur.

No theory or body of economic literature argues that either excessive wealth concentration or control of significant elements of our national wealth by dead people's wishes is beneficial for the nation. Substituting inheritance taxation for the current estate tax system could profoundly improve the structure of wealth transmission and distribution in America.

Estate vs. inheritance wealth transfers

To provide common ground for the coming discussion, a brief comparison of estate *versus* inheritance taxation systems is useful. The two approaches have three characteristics in common. They each allow tax-free annual gifts up to a limit to anyone during the life of the wealth owner, amounts that do not enter the death levies. Both require at death a tabulation of all wealth. And each

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allows some assets to pass tax-free at death.

The plans differ in four ways. First, estate transmission taxes and then divides; inheritance divides and then taxes. Under estate rules, one person or a thousand may inherit. The tax is the same. Under inheritance guidelines, through division, all taxes can be avoided if the wealth is widely dispersed. There is therefore an incentive to spread the assets. Second, the exemption is applied differently. Under estate transmission, the exemption is applied to the estate before division; as inheritance, the exemption is applied to the heirs individually. Third, under the estate system the decedent may control distribution of the wealth for years after his death. Inheritance transmission transfers unfettered control of assets to the heir. Finally, one person may receive multiple bequests of unlimited amounts under an estate system. In contrast, inheritance transmission imposes a cumulative lifetime limit on what any one person can receive. This feature gives the inheritance system its discipline.

Wealth and income

To clarify such terms as wealth and affluence, some definitions are required. First, the subject is confined exclusively to money. Enhancement of social position, religious insight, libidinous experience, or other forms of psychic income are not the subject. Solid accretions of cash or assets convertible to cash are the only topic.

Money incomes include four subtypes. The most elemental type of income is that received currently for the provision of labor or service. Included are wages, salaries, fees, and commissions, among others, paid in the current period for work done by the person receiving the money. This is *earned* income.

One step away is *unearned* income. This has two aspects. The first is that derived from savings out of past earned income. The second arises from assets that were *not earned*—inheritances, gifts, or other windfall gains such as lotteries. This income can be considered doubly unearned; no personal effort was needed to obtain either the assets or the income. Assets such as common stocks, bonds, saving accounts, annuities, or certificates of deposit that provide income without personal effort fall into this double category.

Total income in a period, then, is the sum of the above classes. It is earned income garnered through personal effort, plus the unearned income received as a return on assets, whatever the asset source.

There is a fourth type of income: *stored* income.

This includes the Picasso on the wall, the Chippendale furniture in the guest house, the diamond rings on the finger. While this kind of income is not apparent when counting current income, it is real nevertheless. It doesn't produce a steady cash flow like a bank deposit, but in many cases its worth can grow faster. If the need arises, it can be converted into current income. Until that time, it can be enjoyed without being consumed.

The most important mechanism for converting income into wealth is compound interest. As income is saved rather than consumed, it earns more money that again can be saved. As the process feeds upon itself, ever increasing wealth can result. Other mechanisms accentuate the tendency for substantial wealth, once solidified, to increase at an accelerating pace. The 5 percent of American families who own nearly all of the economy's nonresidential productive assets—with, not surprisingly, the most ownership concentrated in the top 2 percent—have significant advantages over the rest of us. One is the financial ability to participate in projects with high capital requirements that also yield higher than normal returns. In addition to direct investment, access to credit, as a result of massive wealth, opens bright opportunities for those rich enough to enjoy them. For instance, a borrower with financial clout can buy a company with a loan and then pay off the loan with the earnings of the company. Finally, patience is possible when all one's cash is not required for current needs. One is able to play the economic cycles to buy low and sell high.

Income is to wealth as a river is to the lake behind a dam. The flow of a river can be great in some rivers and very slow in others. The lake behind the dam, representing wealth (created by the flow of the river) can build to immense proportions if the river flow is not diverted along the way to water crops or if it isn't spent for daily needs. Unneeded income can be held by the dam; hydroelectricity (interest) can be generated, if desired. The volume of water in the lake can grow if the flow is slow, but only great rivers create mammoth lakes.

Income and wealth differ in important respects. Wealth can be congealed and passed at death from one individual to another. Earned income attaches to the individual. The position of chairman of the board or president of a Fortune 500 company is not normally a hereditary job. This is also true of athletic, artistic, or musical talent. Picasso and Elvis made millions from their talents. Their children have not.

Thus, income, from whatever source, if not consumed can become wealth. This is a never-ending

Topic: can tax. be progressive w/o impairing cap. funts.

process that accelerates as wealth increases until some ultimate barrier is imposed.

The current wealth distribution

For 1986 the Federal Reserve Board reported an extraordinary wealth distribution for this land of equal opportunity. Our national wealth can be divided into rough thirds: The bottom 90 percent of Americans have 33.4 percent of the wealth; those in the 90-99th percentiles control 35.1 percent; and the top 1 percent control the remaining 31.5 percent. Even within that upper 1 percent, the distribution is not even. In 1986 the lower half held 23 percent while the top half held the remaining 77 percent or \$2.85 trillion dollars.

Conventional economic wisdom is that approximately half the fortunes of that level are new (still in the hands of the originator). The other half are inherited. The 1990 *Forbes* 400 confirms this tally: 217 are current generation fortunes, 182 are primarily inherited, and the remainder are some combination. The gap between the wealth of that top 1 percent and the wealth of the rest of us is so enormous, it beggars the imagination.

Economists, quite naturally, have been fascinated by the study of wealth. A mathematical relationship was discovered by Vilfredo Pareto in 1873 that predicts accurately the distribution of the top wealth sliver. Later, Robert Gibrat, found that the wealth of most of

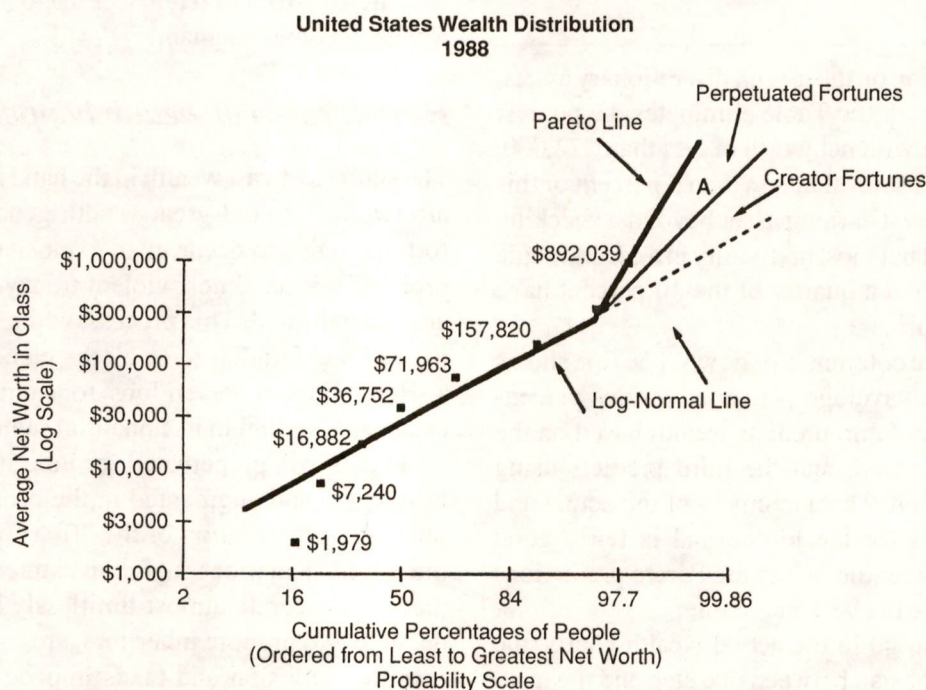
the population except the top few percent of a population also could be represented mathematically. A startling fact emerged: the pattern Gibrat found for wealth is the one that describes the physical attributes of height and weight for a population. These tools allow an objective study of wealth distribution.

A graph relating height to the number of people at each height, will form a normal (or bell-shaped) curve. Height, then, is said to be normally distributed. Weight, however, is distributed somewhat differently. There are more very heavy people than very slim ones. However, if the logarithm of weight is plotted, a familiar bell shape appears. Weight, then, is distributed log-normally.

Wealth, like weight, is log-normally distributed for most of us. Another log-normal scale is the Richter scale for describing the force of an earthquake. An increase of 1 in the index describes a tenfold increase in the power of the earthquake. There is a massive difference between an earthquake of intensity 5 and one of intensity 8. The wealth distribution is similar to the earthquake scale. A person one rung up from you on the wealth distribution ladder has many times as much wealth as you do.

Figure 1 illustrates a Census study of household wealth in 1988. The solid line graphs the logarithm of wealth against the cumulative percentage of people on probability paper. Weight or earthquake strength on the same chart would be a straight line. Wealth is too, up to a point. Abruptly, the slope of the line sharply increases

Figure 1



Source: Judith Eargle, Census Bureau, Household Wealth and Asset Ownership, 1988.

forming a "kink." This is the point where the Pareto distribution replaces the log-normal. The Census data graphically confirms the Federal Reserve's startling results reported earlier. The area beyond the kink is the territory of the 1 percent who hold one-third of the wealth of the United States.

The Table presents typical height, weight, and wealth distributions. At the 95th percentile the height of middle-aged men is 6 feet 3 inches, and weight is 232 pounds. Moving up to the 99th percentile, the Table shows men 6 feet 5 inches or 255 pounds. These figures comport with observation. As noted earlier, height is distributed normally and weight, log-normally.

Table
**The Distributions of
Height, Weight, and Wealth**

% (cumulative no. of people)	Height* (ft. in)	Weight* (lbs.)	Wealth (\$)		
	Normal	Log- Normal	Actual	Log- Normal	Pareto
10.00	5'5"	138	30,952	30,736	94,497
25.00	5'7"	155	45,112	45,821	106,885
50.00	5'9"	176	79,214	82,436	140,572
75.00	6'0"	200	153,741	160,422	224,542
90.00	6'2"	225	354,060	301,289	417,039
95.00	6'3"	241	608,944	442,557	666,155
98.00	6'4"	260	1,259,690	684,951	1,237,240
99.00	6'5"	274	1,998,209	918,035	1,976,299
99.50	6'6"	287	3,050,773	1,201,341	3,156,831
99.75	6'7"	300	5,056,728	1,542,370	5,042,547

*Heights and weights of 45 year old men.

Note: The wealth sample begins at net worth of \$22,000.

Sources: Height: National Health Survey, Series 11, No. 224; Weight: Statistical Abstract, 1987, Table 176; Wealth: Federal Reserve Board Survey of Consumer Finances.

To focus attention on those with discretionary assets, the wealth sample for the Table eliminates the poorest 40 percent—those with net worth of less than \$22,000. Census tabulations show that less than 5 percent of this group held an interest earning asset beyond a checking or savings account but most had equity in a car and some in homes. More than a quarter of the 40 percent have negative net worth.

For wealth three columns are shown. The first shows the net worth of an average person at various percentiles. The second column predicts wealth based on the log-normal distribution, and the third predicts using Pareto's formulation. The agreement of the actual and predicted numbers for the log-normal is fairly good below the 90th percentile, while the Pareto predictions do very well above the 98th percentile.

The higher you go in the actual wealth charts, the more gigantic is the gap between one step and the next. For the top few levels the percentiles increase very

slowly, while the wealth increases enormously. In the one-quarter-of-1 percent increase between the 99.50th and the 99.75th percentile, actual net worth grows from \$3 million to \$5 million. Were it still governed by the log-normal distribution, it would have grown from \$1.2 million to \$1.54 million.

At the highest percentiles the amounts, if anything, are too small. Census and the Federal Reserve researchers note that none of the *Forbes* fortunes were captured in some of their major surveys, and so the true graphs are probably even more skewed than shown. Any errors are of undercalculation of wealth concentration.

One further attempt will be made to put the size of these numbers in perspective. The 1986 Survey of Consumer Finances indicated the total net worth of the top one percent was \$3,720 billion. Personal consumption expenditures for the entire nation for that year were \$2,797 billion. Total estimated net worth of the 1990 *Forbes* 400 was \$272 billion. Contemporaneous statistics for the nation: Checkable deposits and currency: \$587 billion. Total currency and coin in circulation: \$257 billion.

These three descriptions confirm that there is a kink in United States wealth distribution. Federal Reserve Board and Census data, independently gathered, confirm grossly disproportional riches in the hands of about 250,000 Americans. Figure 1 and the Table document the phenomenon. Here is the realm of the fantasy mega-fortunes nearly beyond comprehension. The kink where the Pareto distribution replaces the log-normal is where wealth becomes stagnant.

How does great wealth happen?

The sources of vast wealth in the hands of an individual are twofold. Initial great wealth generation (the first fortune) tends to occur in an explosive, discontinuous process. It is an almost violent frenzy where wealth is created pell-mell. This process, while quite well documented and familiar to us by the names of its creators—Henry Ford or Steven Jobs, for example—is complicated and unusual in its unnatural rapidity.

In contrast, perpetuated (or inherited) fortunes are husbanded and augmented in the orderly, tame, even mundane preservation of the "first fortunes" through the mechanical process of reinvestment. First fortunes that could accrete almost limitlessly if not divided at death to two or more inheritors, are subjected to estate taxation. Division and taxes impede the progressive growth and diminish size, but do not now threaten

the immortal nature of preservation of perpetuated fortune.

Research has identified at least five paths to vast wealth: (1) the invention of a new technique or product; (2) the commercial exploitation of an idea or athletic, artistic or musical genius; (3) the ownership of natural resources; (4) the recognition of the impact of government restrictions and the gains that can be made by those able to circumvent the restrictions; and (5) pure luck.

Perpetuated or "dead" fortunes are qualitatively different in many ways. For these, the link between personal effort and personal reward has been broken. There are two major groups of inheritors—those with essentially unlimited funds from birth, and those who inherit significant funds on the death of a parent, frequently when the heir is into middle or even old age themselves. In neither case does the heir have the expectation of absolute control over a significant but limited amount of wealth that will become available upon entry into adulthood. For those who know from birth they will always have sufficient "trust" income, negating any need for life preparation, two characteristics occur:

(1) Inheritors regard this money as their birthright. The impact of this attitude upon a child can be similar to someone whose family has been on welfare for generations. There is no incentive to become an economically productive person. Life can lose both purpose and structure. Notorious examples are amply recorded in the newspapers. The Hunt Brothers and their attempt to corner the silver market several years ago illustrate one version of this. Doris Duke, who has applied her fortune to many frivolous causes over the years—most recently the defense of Imelda Marcos—demonstrates another.

(2) While the wealth is almost limitless, it is not controlled in many instances by the heir but by terms of a trust. The trusts frequently have complicated rules, are administered by financial agents, and can put a group of inheritors (descendants of a "creator" fortune) on unending dole. Such a dole can last, as the Rockefeller trust has, for generations. The inheritor remains a recipient, not a controller for a lifetime. For those who inherit upon the death of both parents, the timing normally is in middle or late life. By then life patterns are firmly established and the inheritance is mundanely invested and husbanded for old age and the next generation. Inventive uses for these inheritances are rarely found.

What is the alternative?

The world of 1991 is a much different place than the world of 1912 when President Teddy Roosevelt presided over the passage of the estate tax law. The forces that have impelled us through the turbulent intervening years have barely brushed the laws controlling passage of wealth from one generation to the next.

The provisions of the current estate law are these: (1) Estates are taxed. (2) Taxation begins at \$600,000. Until the early Reagan years, this limit had been \$60,000 for many years. (3) Annual tax-free gifts of \$10,000 may be donated by one person to any other. (4) Trusts are legal.

In a typical scenario, a person, contemplating his eventual death, writes a will. Federal law makes only one requirement: If the estate is over \$600,000, taxes must be paid. In this country most people divide their money equally among their children after providing income for the surviving spouse. This frequently is done in trusts so that assets are invested by a financial organization. Income is provided to the spouse for life and the children split the proceeds after the death of the spouse. Provision is frequently made that the children must be of a certain age or have met certain other tests before the money is distributed to them. Unless the estate is greater than \$600,000 no information needs to be filed with any federal agency.

In contrast to estate taxation, the elements of an inheritance tax system are: (1) Estates would no longer be taxed, only inheritors. (2) Inheritances and gifts to the individual would be cumulative. (3) The first million could be received tax-free; on the second million a tax of 25 percent would be due; on the third a 50 percent tax, on the fourth million, a 75 percent tax. Everything over \$4 million would be taxed away. There would be no limit on the number of people among whom an estate could be spread. This means an estate of any size could be distributed totally tax-free as long as no bequest was more than \$1 million. (4) Tax-free annual gifts of \$20,000 per person could be given. These gifts would be included in the cumulative lifetime limit of recipients. (5) At death, *control* of the assets would pass from one individual to another—not to a trust, not to a bank, but to a person. No wealth could be controlled by dead people. Massive estates could no longer be clotted and passed as a whole from one person to another.

Since the substitution of an inheritance for an estate system affects transfers of assets at death, current wealth owners and future creators would be free to

enjoy their riches during their lifetimes without restrictions. While the impact of the change would be gradual, the long-term effect could be profound.

The simulation represented in Figure 2 (a-c) contrasts the societal impact on wealth distribution of estate and inheritance systems after a period of thirty years. It starts with a wealth distribution modeled on Census data. Assumptions were: (1) Each estate was divided equally between two heirs so that each heir received the maximum possible amount under that system. (2) The only money considered was that transferred to the heirs at the death of a wealth holder. If an heir worked or had additional income from any other source, this was considered *lagniappe* (nonSoutherners: see Webster's Ninth Collegiate Dictionary, p. 670) and not included in the model. (3) A generous allowance was made for expenses from these funds, and any excess was then invested at an after-tax rate of 5 percent. (4) After thirty years each heir has a fortune that mirrors the one he inherited. This results from the strictly mechanical effect of compound interest.

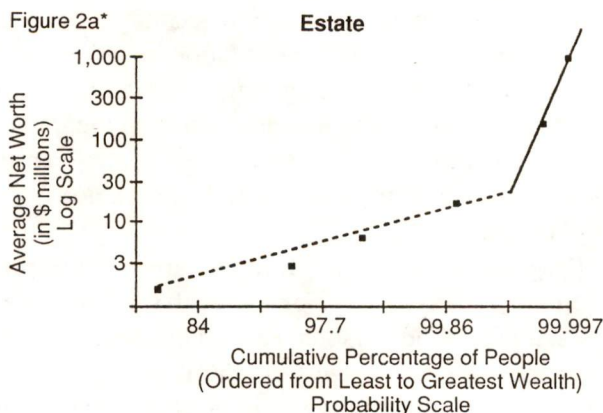
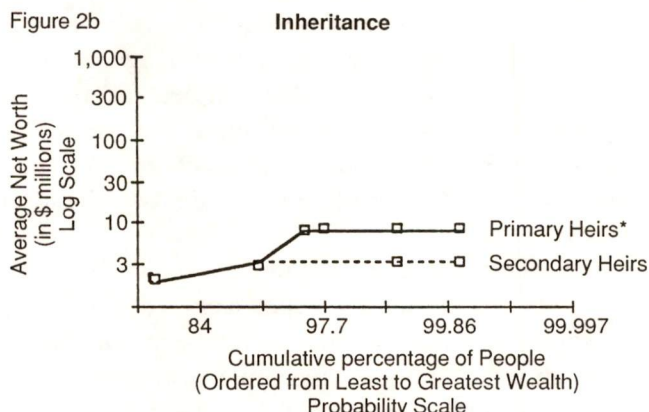
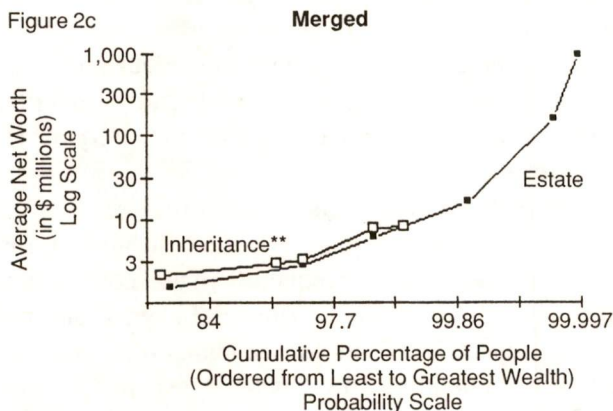
For estate taxation, the two primary heirs split everything. For inheritance, the two primary heirs were left the full \$4 million allowed by law (\$2.5 million to the heir and \$1.5 million to the government in taxes) and then the rest was distributed to others in \$1 million lumps. The wealth distributions after thirty years are shown as Figures 2a and 2b.

Remember that since these regulations do not begin to take effect until \$600,000 for estate heirs and \$1 million for inheritance heirs, neither plan would affect the vast majority of Americans. Estate taxes have never been a major revenue source for the government and the change to an inheritance plan is not designed to alter that.

Thirty years after transmission, inheritance and estate systems produce startlingly different results. The estate graph (Figure 2a) mimics the actual 1988 distribution shown in Figure 1. The inheritance graph (Figure 2b) shows much less of a "kink" for the primary heirs and almost none for the secondary heirs. What happened? There are many more heirs under the inheritance plan and supplementary heirs have absorbed some of the "excess" from the estate system. The merged graph (Figure 2c) shows that some individuals under the inheritance system have more assets than their counterparts in the estate system until the two lines intersect. In addition, under the inheritance system many more people receive assets.

The wealth distribution would continue to show a kink under an inheritance system due to the generation

Figures 2a-c
Estate versus Inheritance
A Simulation of Wealth Distribution
30 Years after Transmission



Notes: Since the number of people is represented as a percentage, relative numbers of inheritance and estate heirs cannot be discerned.

* Figure 2a, and the primary heirs in Figure 2b, represent the same number of people.

** Although the inheritance line in Figure 2c is shorter than the estate line, it represents the sum of the primary and supplementary heirs of Figure 2b.

Source: Author's calculations.

of new fortunes, but the concentration would become less severe as the possibility of inheriting became less of a purely genetic lottery.

What are the forces for change?

The greatest force for change should be a broad understanding among voters of how 1 percent of the population holding one third of the national wealth affects the rest of us. From this should come the concomitant pressure for correcting the perceived problem. Figure 1 reflects the Census wealth distribution. Inheritance transmission eliminates the passage of massed fortunes from one generation to the next. Thus, as current wealth owners die, area A is eliminated moving the Pareto line toward the log-normal. This would mean that although there was tremendous variation in the size of wealth, it would form some predictable pattern for the whole population, like height and weight. Although a kink still occurs because of "creator" fortunes, its size is not magnified by the "perpetuated fortunes."

Attitudes of founders toward passing on their wealth are frequently much different from those with perpetuated fortunes. Andrew Carnegie said he would die a failure if he did not succeed in disposing of his money before his death. He was 99 percent successful. He built libraries in cities and small towns all over this country. Who can tell what impact these institutions have had upon the generations of Americans who have used them or their successors since 1919? A lengthy compendium could be compiled of "creators" expressing worry and doubt about the wisdom of passing large wealth to their progeny. An equally lengthy tome could be produced detailing the exploits of those left with "dead" fortunes. Success stories exist, but the litany of failures and dissipation predominate.

Fortunes are created by risk takers. Young people funded by inheritance transmission are more likely to be creative risk takers than are their elders. The perpetuated fortunes, frequently institutionally controlled or received by older generations, are placed with those whose investment strategy is the antithesis of risk.

Institutional obstacles to revising these laws are formidable. First, one of the highest barriers is the very composition of Congress—quite a few Congresspeople are owners of perpetuated fortunes. Second, the group of constituents most likely to make their wishes known about changing the laws of estate transmission are owners of perpetuated fortunes. These are the people most highly skilled in moving the levers of Congress to their will.

Economic forces argue for change. The transmission of huge estates becomes a public affair, and so we know some strange things that have happened. In 1977 heiress to the Brach candy fortune, Helen Brach, disappeared. Recent newspaper reports document that her estate, passed to the Helen Brach Foundation in 1984 when she was declared dead, has grown from \$17 million to \$50 million during that period. But why should her estate be intact and growing this long after her disappearance? Her hands are still clearly directing the disposition of those assets. Is this the most productive way for our national wealth to be managed and utilized?

Howard Hughes died without a will in 1976, and the courts are still administering his estate. The assets represented have been managed (most conservatively, no doubt) by legions of financial advisors, lawyers, and accountants. The story of the search for heirs is a fascinating one, but are there not alternative uses for this fortune that would have produced superior results for the nation?

Horace Dodge (of car fame) left an estate managed so conservatively after his death, but before the death of his spouse fifty years later, that it suffered an annual compounded shrinkage of 1 percent in value during a half century of "financial management." During that period, these assets were denied to the next generation of Horace Dodges to make their fortunes.

Contrast the lump sum transmissions that now occur under the current system with what might happen under inheritance transmission which would divide massive estates: (1) Knowledge that control of assets would accompany significant resources would reinsert the now missing link between personal effort and personal reward for perpetuated fortunes. (2) The discipline of an inheritance system derives from the lifetime limit. The study of economics is the study of how to use limited resources. Children growing up would know that the \$2.5 million is an economic commodity. If a child squanders an inheritance, a loving parent cannot simply replace the assets. The limit is enforced by federal law. (3) The benefits of giving a child control in life has been demonstrated with poor children. Fifth graders from an inner city school, when guaranteed a college education if they graduated from high school, exhibited dramatic differences from their classmates not so endowed for their educational achievements. Why not offer the same incentives to a rich child? (4) A time distribution of inheritance to youth from middle to old age would change how the assets are perceived and used.

Benefits to accrue

Kevin Murphy and Robert Vishny, in a recent National Bureau of Economic Research working paper, clearly describe one mechanism that contributes to the pernicious structural effects in the economy from long-term concentrated wealth. They argue that those coming out of the nation's colleges and universities can be split into two groups: the rent seekers; and the entrepreneurs. Rent seekers (law and financial services are the two areas the authors specifically mention) get most of their income from redistributing the wealth of others. Entrepreneurs seek to create wealth by introducing new production techniques or organizing the old ones more efficiently. Their income is a share of the wealth they create. The authors proceed from there to assess impact of a system that channels our brightest young people into rent-seeking rather than entrepreneurial careers. At stake is United States' productivity.

The shift from estate taxation to inheritance taxation would replace an incentive system loaded toward rent seekers with one geared to entrepreneurs. No longer would swarms of legal and financial managers be drawn to the massive clots of wealth passed by estate transmission.

✓ Make a rule, and the system will adjust to it. The U.S. rule of estate taxation was made in 1912. Since then the structure of U.S. economic activity has been profoundly influenced by these laws governing the transfer of wealth from one generation to the next. Today's wealth distribution is indistinguishable from

one predicted by applying estate tax laws to the wealth distribution of 1963. We will spin out the current distribution forever unless we change what happens to wealth at death. An inheritance tax system offers an alternative that would drastically change the incentives underlying individual economic effort, freeing for productive use massive resources currently frozen.

My plan is objective. The graphs provide a standard to evaluate how well the plan is working. The wealth distribution for most follows the same type of mathematical patterns as height and weight distributions. The exception occurs for the richest people in the country, the top 1 percent or so. An inheritance system could bend the line of the very richest toward the line of the rest of us. The shift would occur slowly—as current wealth owners die.

The change from estate to inheritance taxation is a story of improved incentives. The phenomenally successful entrepreneur (or lottery winner), having enjoyed his riches during his lifetime, now has an incentive for inventive estate dismemberment. Incentives for the next generation derive from wider distribution of assets, greater average inheritances, and from an individual's desire to be economically productive. No longer will there be a never-ending stream of massive perpetuated fortunes to lure lawyers and financial managers. Those with vast fortunes will be the creators, still managing their own assets. Those clever, lucky, or talented enough to build wealth would invent dispersion systems of which we have not dreamed.

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ORGANIZATION, OUTLINE

World Capital Shortage

Alt titles:

Jobs, cap shortage, and taxation
The black hole of capital
Misdirected investing, cap shortage, and unemployment
Unrecoverable capital

What could cause a shortage: the theoretical possibilities

1. Undersaving
2. Disinvestment: eating the seed corn
(overlaps dissaving)
3. Rising demand
 - a. New outlets
 - b. Higher capital-intensity
 - i. Substitution for labor
 - ii. " " " land
4. Slow recovery
(overlaps high intensity)

Causes of shortage:

1. S&L collapse -- \$500b stolen and consumed!
2. Capped i.r.
 - a. Central bank policy: overworked Austrian view.
 - b. Low int. loans
 - c. State and local tax exemption
 - d. "Free-riding" extensions, of "low quality."
 - i. Vertical, or intensive margin
 - ii. Horizontal, or extensive margin
 - e. Mortgaging the tax power
 - f.
3. Substituting capital for artificially scarce land
 - a. Intensify
 - b. Land-enhancing (convert use)
 - c. Land-linking
 - d. Land-capturing (including military spending)
 - e.
4. Less saving
 - a. Equity withdrawal
 - b. Subtle equity withdrawal: subbing dLV for CCA.
 - c. dLV as perceived income (flow approach)
 - d. Static or achieved high LV as portfolio subst (fund approach)
 - e. Emulation and exclusion: high consumption and "belonging" standards set by rent-receivers.
 - f. Less income means less saving

5. Tax bias

a. Federal taxation

- i. Adds to price of labor
- ii. Lowers effective price of capital
- iii. Lowers effective price of land.

(Anomaly: lower price of capital force-feeds capital; but lower taxes on land, raising market price, also force-feeds capital.)

6. Public works bias

7. Utility rate regulation: guaranteed returns on capital (Averch-Johnson)

(The bias to overuse labor is weaker. True, labor cost is automatically passed through. However, allowable profit is not in proportion to labor force, but to invested capital.)

8. Dissipation of rent

OUTLINE

There seem to be four major topics:

1. Valuation on a rising land market, and stabilizing effect of land taxes.

Sources:

- a. Notes on capitalization of rising rents.
- b. Article presented in London

2. Rate of Return on investments in land-cum-building, as affected by changes in land price.

Sources:

- a. TRED paper, 1985 or so.
- b. ?

3. Positive feedback of liquidity crisis: case of the unfinished bridge that can neither be finished nor liquidated. (For labelling, by the way, this is "Austrian" theory, and may be found in Ricardo, Chap. 1, "On Value.")

Sources:

- a. TMJAW, etc.

4. Rising land price, and overpriced land, both lead to excessive substitution of capital for land: the "stymied bridge syndrome" for the whole economy, or macro-economic gridlock.

Sources:

- a. My notes on Homer Hoyt
- b. Land as distinctive

"Land as a Distinctive Factor of Production," pp. 1-23. This ms. served as pilot paper for the 1987 Annual Conference of The Committee on Taxation, Resources and Economic Development (TRED), which Daniel Holland and I co-chaired, on "Efficiency of the Land Market." Now to be revised for separate publication, and in part folded into a book, World Capital Shortage, q.v.

"Land Gains, Fast Write-off, and Incentives to Build." Paper presented to 23d Annual Conference, Committee on Taxation, Resources and Economic Development (TRED), Cambridge, Sept. 1985. Pp. 1-22. Paper being updated to take account of 1986 tax reform, and current proposals to revise capital gains tax. Much is to be folded into a book, World Capital Shortage, q.v.

"Capital Gains and the Future of Free Enterprise." A chapter originally accepted for publication in Richard Noyes (ed.), Now the Synthesis. London: Shephard-Walwyn, 1991. Pp. 1-49. The series editor, Fred Harrison, pulled it out for expanding into a book, World Capital Shortage. Publication arrangements are firm with Shephard-Walwyn in the U.K., and University Press of America in the U.S.

"Rent, Interest, Tax Rates, and Land Prices." Pp. 1-16. A paper delivered and discussed at The 19th International Conference, International Union for Land Value Taxation and Free Trade, Session on "Fiscal Policy and the Theory of Rent," London, 23 March 91. Being folded into book World Capital Shortage, q.v.

"Taxes, Capital and Jobs." Invited Paper delivered to The National Tax Association -- Tax Institute of America (NTA-TIA), special meeting, Chicago, August 1978. Accepted for publication, AJES, but through inadvertence and distraction I never returned it with minor revisions suggested.

Mason Gaffney
P.O. Box 7998
Riverside CA 92513-7998

19 June 91

Lowell Harriss
14 Plateau Circle
Bronxville, N.Y. 10708

Dear Lowell:

Enclosed sheet shows where HG stretched it a little and came on like Karel Kapek. In other passages he is much less extreme; this may be an aberration.

Thanks for your excellent comments on the AIER conference.

1. Human capital, you are right, a major omission. Ultimately, there will be omissions due to lack of time and space, but at this stage we should cover as much as we can think of that is germane.
2. Pension plans, Alicia Munnell: I will check out her work, which I do not know. Any references?
3. "The productivity of capital," a good kickoff. To keep it interesting, one could face some challenges from critics of oversaving (if we can still find Keynesians!), critics of capital displacing labor, critics of alien control, etc.
4. Embodiment of new technology in capital - surely that is important. I see it as related to turnover of capital stock, as well as net new capital formation.
5. Interstate competition for capital, is it zero-sum for the nation? It seems to me that its possibly regressive distributive effects can be totally offset by matching it with an equal degree of interstate competition for labor, thus meeting legitimate claims of both labor and capital, and benefiting all around by sharpening competition.
6. Effect of death duties on capital formation, an excellent topic that I overlooked. Some have suggested limiting death duties to land values, inducing sale of land assets in anticipation of death, driving funds into formation of real capital (analogous to Taiwanese tax on land gains, forgiven when funds are invested in new capital).
7. Cultural attitudes toward saving, how formed: another excellent topic. Surely sociologists/anthropologists have raised the question; probably a few economists, too. I will scan. I thank goodness for my penny-pinching mother, life has seemed so easy ever since! On the other hand, her imprint on my elder

brother was so strong he has become something of a recluse from normal American society, living on half his income or less while denying himself normal comforts and amenities.

All married couples, I am sure, discover they have different saving patterns, generating infinite data about the effect of different backgrounds. Surely this has been studied?

8. Re risk, perhaps all we can ask from taxation is to be risk-neutral, as among productive risks, and hostile to unproductive and counterproductive ones. Neither Keynes nor Knight would let it go at that, however, and it would make a good topic if someone wants to go at it.

9. Capital formation and the growth of small companies - here is the Dick Noyes case for preferential treatment of capital gains, one featured prominently in Bush's campaign on the subject. Another good topic! While we cannot cover all good topics, each one is a point of entry for drawing important general principles, and gives us another hook for drawing in scholars to join us.

10. Measuring productivity of capital: you raise good points (your #11). They fit under your #4 (my #3, supra). No question in my mind, the preferential tax treatment of owner-occupied housing causes overhousing in America (not a tactful way to put it!)

11. Changes in govt. accounting needed: Yes!
Exempting state and local bonds: profound effects.

12. Pension plans, public and private.

a. As sources of investable funds.

b. As sinks of savings then they are raided and/or malinvested.

c. Unrecognized accrued liabilities as negative capital formation: frightening.

13. New Papal Encyclical? Does it discuss capital formation?

✓ 14. Retiring govt. debt as source of capital? Yes, I would say, agreeing (for once) with Henry Aaron. Who would be good to treat this for us?

Whew! I had thought I had covered most bases, but now you have given me a raft of new ideas for the conference. Perhaps what we have here is a series of conferences on capital formation. We can get quality participation, with a lot of effort, and then build up a center of excellence in a field that all brands of economists recognize as central to the most important concerns of this and any other year.

One key issue I already see coming is, if we untax capital to foster capital formation, what other tax base will we tap? Bob Aten is thinking only VAT, and so, probably, is much of Washington (until they check back with the voters).

✓ A pro-lvt position would be that lvt fosters more saving by lowering the portfolio value of land. I believe that is also the avenue via which higher interest rates foster saving. My plot is, by developing this theme we can show clearly that downtaxing capital tends to increase saving and capital formation.

Meantime, many, many thanks for your help, which is truly major. This gives me a big boost. I trust you will be giving the keynote talk, as Bob Gilmour invited you to do this year, and it will be a publishable paper covering one or more of the topics you have broached.

Sincerely,

at home June 6 et. seq. 1991

from
Samuel Harris

Random thoughts about Mason G's prospectus on capital conference

1 Human capital? Explicit indication that not being considered. Or selected aspects. It's a big and important subject. Inevitable overlap with other topics. But so large^d and probably so differentiated from other topics that ^{probably} wise to exclude.

One aspect that impresses me is the wastage from forced retirements. And unemployment.

2. Pension plans. Govt. role. In itself has elements subject to governmental (political) influence (control). Large, complex. Examples of results of (well-intentioned?) governmental actions that have had quite unintentioned ^{and} and unfortunate results. Effects on allocation and totals.. Alicia Munnell. Others working on aspects of the subject.

3. Explicit discussion of capital consumption, as in annuities and retirement. Part of life-cycle thesis.

4. I once did a piece "Capital formation as the Epitome of Doing Good for Others"—the role and uses of capital. We take for granted so much, e.g., availability of someone's saving to get us places to live, electricity, etc. Any implications? Good thing to do (and to have done for us). Perhaps help to set some tone and give orientation. Can a price system adequately reflect desires, etc. 10 or 20 years from now when today's decisions will still have effects?

It would probably be desirable to give some attention to the various ways in which capital serves human welfare.

5. One of many aspects of allocation is the relation of new capital and technological advance. I was less enthusiastic than some over the investment tax credit—except that it seemed certain to speed (somewhat) the exploitation of scientific advance. New equipment embodies new technology, etc. My impression is that there are skeptics. But worth attention?

6. One of many aspects of allocation is the competition of states and localities for capital, e.g., manufacturing plants. Costs in revenue for the economy as a whole but very different for the successful locality (state). In a sense a conflict of interest between the specific and the totality.

7. Per dollar of revenue, I expect that estate, gift, and inheritance taxes do the most to convert private wealth into funds for governmental consumption. In the 1930s one argument for death taxes was to offset excess saving. Today? Worth attention now? Something that govt. does rather directly.

8. How are ideas, concepts, values, etc. formed? What are the influences on human behavior? Advertising? Religion? Example? Any evidence?

9. One aspect of allocation is risk. I have tended to believe that the payoffs from risk-taking have been so high as to warrant deliberate encouragement by public policy. I am not sure that this is a responsible position. Lots of waste through failures. I do not have any ideas about how to explore the issues or if there is any usable evidence—in the nature of things failures are poorly

recorded.

10. One should not wax romantic over small business. Yet one should not ignore special opportunities and problems. There is a significant amount of saving and capital formation in small firms (however defined). What is their role? Govtl policy. Regulation. There seems to me validity in the argument that the expansion of Federal-state-local regulation can bear very heavily on small and growing companies. Here is partly an allocation issue. But a general question of the growth of capital.

11. I would like to see thoughtful discussion of the measurement of the productivity of capital. I do not know what exists. But when I see figures of 3 % or so as ^{literature} ~~ten~~ long-term real interest rate in the past, etc., etc., and think that the determinant must be (largely) the productivity of capital, and then see that many firms succeed, year after year, in earning very much more, I wonder. What is the productivity of capital in single-family housing? Would we somehow be better off in the next generation if less capital went into such housing and more into manufacturing? or hospitals? or parks? With hurdle rates, payback periods, etc. indicative of real returns very much greater than 3 or 4%, what should one conclude?

12. Changes in govt. accounting as means of possible improvement in allocation and preservation of govt. capital. There has been progress in accounting, but are there opportunities for more? And explicit recognition of accruing liabilities in Social Security and govt. employee retirement plans.

13 New papal encyclical

14. Govt. deficits and surpluses. Deficits are pointed to as major users of savings and deficit reduction as a means of altering net saving. How would different tax (and spending) patterns alter net saving? Complex and controversial but important for (practical) political policy actions.

15. Demographics. Related closely to life-cycle considerations.

Topics currently "in play", with Georgist angles

Mason Gaffney, 3 April 89

1. Capital gains tax. Ref: my letter to Business Week, 28 March 89.
2. Replacing Income Tax with VAT or other national sales tax, for alleged goal of exempting capital income from taxation.

Georgist response: a) Need to exempt labor from taxation, as well as capital.

b) Granting goal of exempting capital, begin with property tax. Also, keep income tax and allow expensing and/or fast write-off on new capital (but not old, which includes land).

c) Granting goal of abating consumption, begin by taxing consumption of land, defined as holding tenure. Ref: my article on "Tapping Land Rents after Prop 13", Western Tax Jnl., Winter, 1989.
3. Modifying tax system to foster capital formation.

Cognate issue: the trade deficit. After clearing the smoke away, this deficit basically represents and results from a net import of capital. Capital import manifests two things: investment opportunities here, a sign of strength; and low domestic savings, a sign of weakness.
4. Conversion (we used to call it "reconversion") to a post-cold-war economy with full employment.
5. Supply-side economics. Georgist land taxation is the quintessential supply-side economics, and support of it is a litmus test of the sincerity of advocates (most flunk).
6. Limits of the earth as limits to growth of population and real income. Can land be created, or is it distinctive? Can capital and labor substitute for land and, if so, what policies promote this? How can we foster most efficient, intensive use of limited land supply? How to accommodate growing populations with fewer drafts on limited natural resources and fewer insults to the environment.

Is population control the answer to world hunger, homelessness, and unemployment? Is immigration control the answer for the U.S?

We should be glad neo-Malthusians keep these issues hot because they focus attention on the key point that land is different, it is limited. Standard-brand economists paper over any differences

and generally treat land as just another kind of capital. George sagely used Malthus as a springboard to focus attention on land.

7. Does urban sprawl with gridlock manifest an inefficient land market? What is "land speculation", and what is wrong with it? How would efficient land markets work to consolidate land settlement patterns and improve urban circulation?

8. How to revive dead and dying cities and neighborhoods.

9. Growing concentration of wealth; key role of land ownership and unearned gains. Growing barriers to entry into land ownership for business and residential purposes. Increase of homelessness and hopelessness at the bottom; tenancy and dependency and heavy indebtedness among the aspiring, young and enterprising; wasteful spending and acquisitiveness at the top.

One can amass capital by forming it, without depriving anyone else. But the only way to amass land is to take from others. Tight control of land is therefore the obvious basis for market control and monopoly.

10. Fiscal federalism: what level of government should collect rents, and how redistribute them? George never tackled this issue, and it is a vulnerable spot in our program.

If this seems a dry topic, we can lead into it via the modern growth-control movement which in large part is a reaction to perverse fiscal federalism (which grants localities money for capital improvements, but levies personal taxes on the persons who might move in and use the lands so improved).

11. Lending on land-value as collateral, how it has made our financial system vulnerable. This calls for lots of fresh thinking that neo-Georgists have not, alas, yet done. The opening wedge, however, is the S&L collapse which resulted from lending not on the basis of use of funds, but collateral security represented by speculative land prices.

12. Land-grabbing (in various shades and aspects) as basis of global conflict. Current meaning of landholding based on force and fraud.

13. Reconciliation and synthesis of communism and capitalism through Georgist tax policy.

14. Tax policies in the "Four Tiger" nations of east Asia, plus Japan, and how they stimulated astonishing rise of production and living levels.

Role of Sun Yat-sen and his land tax philosophy in Taiwan;

Raffles and his counterpart ideas in Singapore; the Crown leasehold system in Hong Kong; etc.

15. Anti-Georgist policies as basis of distress in backward nations: small class holding most land; most taxes raised by excises on expenditures.

16. Mindless deregulation and its alternatives. Example: deregulating the airlines has led to unresolved queueing for time-slots. Needed solution: charging rent for the slots. Entering wedge: Alfred Kahn keeps harping on this theme, which is our theme. Let's work with him.

Decline of required public-service broadcasting as an assertion of public domain over radio spectrum. Rent-collection as an alternative. Professor Harvey Levin of Hofstra writes extensively on the point: let's sign him on.

Movement towards free market in scarce western waters. Need for public charges on water withdrawals and preemptions. Prof. Bruce Billings at U of Arizona is an advocate: let's get with him.

17. Georgist solution to air and water pollution: charge effluent fees. Anti-Georgist solution: create private property rights in pollution, based on histories of discharge.

Georgist solution to non-point pollution, intractable to effluent fees: a complex of Georgist policies, outlined in my paper "Nonpoint pollution: tractable solutions to intractable problems".

18. The environment is common property -- a very Georgist notion. Let's work with the Greens and others who see this cat, and certainly not make sport of the Rachel Carsons et al. who, with all their faults, have carried the Georgist message on this theme.

19. Etc. A few people thinking a while could double this list.

Topics

1. Portfolio effect of LVT
 2. Is saving or inv. stifled by any tax —
i.e., does exempting K from tax do any good?
 3. How to allocate K better.
 4. How to plug leaks
 Wd. higher prop. tax on land stop its role in
 s&h leaks?
 sub. land loans be outlabeled
-

Cleveland
Tom Bier,

Mason Gaffney
Department of Economics
University of California
Riverside, CA 92521

28 March 89

The Editors
BUSINESS WEEK Magazine
1221 Avenue of the Americas
New York, N.Y. 10020

Dear Editors:

Paul C. Roberts denounces the capital gains tax as a means for "pandering to envy" with reckless disregard for capital formation. That is too facile, fearful and fervid. It would be more useful to open up the "capital gains" box and see what's inside.

Capital proper usually depreciates and obsolesces over time, yielding no resale gain of itself. It is rather land which normally appreciates over a period of ownership. "Capital gains" is a misnomer. "Land gains" is more like it.

Land appreciates because it is not reproducible; but since it is not, taxing it or its price increments will not reduce capital formation.

It may even increase capital formation. More economists are now recognizing the prodigal increase in consumption during the 1980s was caused by the rise of real estate prices -- "living high on the old homestead". Hatsopoulos, Krugman and Poterba reported as much to the American Business Conference earlier this month. They also cite common stock prices; but these often rise because they are claims on real estate.

Taiwan has been taxing both land gains and land values at high rates during its period of astonishing growth. Roberts' program would leave us with a tax system more like that of The Philippines, Honduras, Colombia, or other such distressful nation where taxing consumer spending has conspicuously failed to foster capital formation.

Sincerely,

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

DEPARTMENT OF ECONOMICS

CAMBRIDGE, MASSACHUSETTS 02139

13 January 1990

Professor Mason Gaffney
Department of Economics
University of California
Riverside, CA 92521

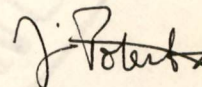
Dear Mason,

Thanks for your note and for sending along two interesting papers. I have only had the opportunity to glance at your paper on "Land Value Gains and the Capital Gains Tax," but I certainly agree with your view that granting capital gains tax relief to the holders of old capital is inappropriate. I am less convinced regarding the benefits of tax reduction for future gains. Although many such gains might accrue to land holders, the lower rate on prospective gains might also encourage the formation of new capital. Pursuing your points regarding "tax-exempt" institutions, there seems to be new fervor in Washington for taxing at least some of the income of these institutions, at least that part from corporate capital.

*if land
does
not
qualify*

I am grateful for your invitation to attend the Great Barrington conference on capital formation. Unfortunately, I must regretfully decline. August is the traditional time for the NBER Tax Program's Summer Research Institute, and as the associate director of that program, I need to stay in Cambridge to monitor the proceedings. I nevertheless wish you the best of luck for what will surely be an interesting conference.

Sincerely,



James M. Poterba
Professor of Economics

Foreign ownership a recipe for disaster

BY MEL HURTIG

Mr. Hurtig is the honorary chairman of the Council of Canadians.

EDMONTON

CANADA IS rapidly heading for a balance of payments and exchange rate crisis. The result will be a decrease in our standard of living, an increase in unemployment, a jump in federal and provincial government deficits, a flight of capital from Canada, even higher interest rates and substantially reduced domestic investment.

The effect on the Canadian economy will go well beyond the impact of the proposed 9 per cent goods and services tax, yet almost no one is paying attention to our looming external debt crisis. On the contrary, the Department of Finance, the Bank of Canada, Investment Canada, the financial press, the Business Council on National Issues and the C. D. Howe Institute, among others, have all been strongly advocating the precise policies which so imminently endanger the welfare of all Canadians.

The bottom line of trade is not our perennial merchandise trade surplus, which we have always heard so much about, but rather the current account balance. It includes merchandise trade, but also the cost of paying for our foreign debt and other so-called "invisibles." The current account balance is the true measure of our two-way trading relationship with the rest of the world.

Despite huge merchandise trade surpluses in recent years (\$122.8-billion during the decade from 1979 to 1988), during the same period Canada had a cumulative current account deficit of \$37.8-billion. During this period, our merchandise trade surpluses far exceeded our wildest dreams (averaging \$17.8-billion a year between 1982 and 1985). But, at the same time, our investment income deficit (the amount Canadians pay foreigners for using their money over and above what is received from Canadian foreign lending and other investment outside Canada) has skyrocketed.

While the cost of servicing our rapidly increasing foreign debt is racing out of control (an average of \$3,558,330 an hour during the past twelve months) our merchandise trade surplus is plummeting. The result has been three consecutive years of huge, record-breaking current account deficits with this year's deficit breaking all records.

At the same time, our current account position with our principal trading partner, the United States, has deteriorated dramatically from a \$2.3-billion surplus in the first half of 1987 to a \$3.4-billion deficit in the first half of 1989.

Our merchandise trade surplus has also been shrinking. From the heady trade surpluses of the mid-eighties, we have now dropped to a sur-

plus of only \$8-billion for the past 12 months. Based on first-half statistics, the 1989 surplus may be in the range of \$6.5-billion.

Meanwhile, payments on our foreign debt are increasing rapidly. Last year, Canada's net investment income deficit was a record \$18.4-billion. The rate for the first half of 1989 points to another record deficit of \$22.5-billion.

These dismal figures fail to include foreign retained earnings in Canada (which annually account for most of the growth of foreign ownership in this country). Were Canada to show retained earnings as part of our current account, a much truer and even bleaker picture would emerge.

In 1965, our foreign indebtedness stood at 17.9 per cent of our gross domestic product. At the

In Canada, more than 30 per cent of non-financial industries are foreign-owned

end of 1988 it was more than 38 per cent and is now approaching 40 per cent.

While there is concern among economists that the U.S. debt burden will ultimately lower American standards of living as more and more wealth is transferred into the hands of foreigners to service the debt, Canada's international indebtedness, both on a per capita basis and as a percentage of GDP, is more than four times that of the United States.

Canada has encouraged unlimited portfolio capital inflows while at the same time allowing large amounts of foreign ownership without considering the costs. When combined with punishingly high interest rates and the resulting upward movement in the value of the Canadian dollar to artificially high levels, the result is a deadly combination for the Canadian economy.

Our deteriorating current account balance is now beginning to signal non-residents that it's time to withdraw capital invested in Canada. The loss of confidence and the resulting flight of capital will encourage the Bank of Canada to raise interest rates even higher to stem the investment exodus. Meanwhile Canada will begin to run down its substantial reserves of foreign exchange and then resort to bolstering standby borrowing agreements with other countries. Soon we will once again be down to Washington on bended knee, ironically as we are involved in free-trade subsidy negotiations with the United States.

Canada is the developed world's premier example of excessive foreign investment and foreign borrowing. The threat to the Canadian economy is as clear as the inevitable accompanying threat to Canadian sovereignty.

The Bank of Canada's response to the coming

crisis will rapidly worsen the whirlpool of debt with potentially disastrous consequences for the nation. Meanwhile, Finance Minister Michael Wilson, Trade Minister John Crosbie, provincial premiers and Investment Canada officials continue to tour the world encouraging more investment.

A graph of foreign ownership in Canada features a line headed straight up — back to the horrendous levels of the early seventies. Today, more than 30 per cent of all non-financial industries in Canada are foreign-owned. By comparison, despite the enormous influxes of foreign direct investment into the United States in recent years, only some 3 per cent of that country is foreign-owned, and only on average about 6 per cent of the European Community.

While portfolio investment will flee Canada, foreign (especially U.S.) ownership will continue to grow as Canadian business is crushed on "the level playing field" by our high interest rate policy and as non-Canadians take over more of the resource and service sectors of the country's economy. This will be largely accomplished with the retained earnings of foreign corporations operating in Canada.

Investment Canada's recently published report on its first four years shows that of \$68.6-billion in new "foreign investment" to June 30, 1989, 96 per cent represented takeovers of Canadian businesses. Only 4 per cent was devoted to new business investment.

FOR CANADA to escape the deadly cycle of more and more high-cost foreign borrowing to finance large foreign and domestic debts, a whole range of new policies are needed. Obviously, government deficits, interest rates and government grants and loans to foreign corporations must all be reduced. Alternate policies for fighting inflation, curtailing excessive corporate concentration, along with more effective investment incentive for Canadians will be necessary. But, most of all, we need a much better understanding of the utilization of domestic capital and the net impact of foreign investment on the Canadian economy.

For decades Canadians have been convinced by business and political leaders that we need foreign capital to thrive; it's ironic in the extreme that not a single soul in the Bank of Canada, the Department of Finance, the Economic Council of Canada or Statistics Canada can tell us how much of Canadian savings are being lent by our banks to non-residents to help them buy up Canada or expand their ownership of this country. I believe the answer would shock the Mulroney government.

No doubt some will inevitably argue that such policies would be interventionist. But, if carefully thought out, they can produce more competition and more true free market conditions, and be infinitely better than our current, accelerating tailspin to disaster.

s of a licence to kill

fied Gen. Noriega's assassination?

An honorable, credible view says that saving 70 lives is not enough to justify a killing. But an equally honorable view says it is — that if not one, two, or a dozen but 70 lives are at stake, the rule against killing is outweighed.

So should we want the CIA to be allowed to engage in foreign assassinations? Not for a minute. The reason isn't that assassinating foreign leaders is always wrong; it's that the CIA would assassinate the wrong leaders.

The rules against CIA killing were introduced in the 1970s, after revelations of past plots against Patrice Lumumba, first prime minister of the Congo, Cuban leader Fidel Castro and former Chilean leader Salvador Allende. These plots were motivated by concern, not for lives or rights in those leaders' countries, but for the U.S. national interest or the interests of U.S. corporations.

This is the worry. An American or any government that thinks it can be right to assassinate foreign leaders will too often assassinate when it is wrong. Its thinking about consequences may have worse consequences than if it just believed assassination was immoral. We may be safer with some squeamishness than with self-awarded licences to kill.

The same is true elsewhere in international relations. The United Nations Charter and later declarations forbid all aggressive

wars — all wars not fought to defend one's territory against invasion. This doctrine has been used to condemn the Tanzanian invasion of Uganda, which led to the overthrow of Idi Amin, and the Vietnamese ouster of the Khmer Rouge in Cambodia.

In themselves, these condemnations are insupportable. Should Vietnam have stood by and let another million Cambodians be killed? But it may be for the best that international opinion issues them. If the world's countries rejected the United Nations doctrine and believed aggressive wars could be right, they would start far more aggressive wars than were right, with awful consequences for us all.

The argument sounds paradoxical: there are moral truths our leaders shouldn't try to act on. But it's based on a realistic assessment of human capacities. The truths (assuming they are such) grant exceptions to familiar moral rules. If our leaders believed the truths they would abuse the exceptions, doing new wrongs more often than rights.

With this in mind, we can applaud the moral acuity of the Bush administration's requests about the CIA, but wish them every failure. Although it's nice if governments have true moral principles, it's far more important that they be good moral actors. If truth threatens goodness, let falsehood prevail.

Prof. Hurka teaches philosophy at the University of Calgary.

fronts taboo subject of gay rights

ANALYSIS

of sexual preference.

Homosexual law reform is a highly sensitive subject in Hong Kong, where there is widespread ignorance about homosexuality and a traditional Chinese reluctance to even discuss sexual matters.

mitted suicide when he was about to be arrested for acts of gross indecency with male prostitutes. It led to the commissioning of the report on law reform in 1983 but the government did nothing.

However, last year it embarked on another public consultation exercise. It is believed that there was a small response and that opinion was fairly evenly divided on the key question of bringing Hong Kong law into line with Brit-

A fascinating array of 'unrelated facts'

IN THE Ontario Legislature yesterday, Premier David Peterson looked like a deer with his eyes caught in the headlights. The muck surrounding the province's land development industry is getting closer to him.

According to information unearthed by The Globe and Mail's Jock Ferguson, the Premier's chief political adviser was primarily responsible for vetoing a public inquiry into alleged corruption among politicians and developers in Southern Ontario's booming York Region.

The inquiry had been recommended by senior staff in the Ministry of Municipal Affairs. It appeared to have the support of the then-minister, John Eakins. But after Mr. Eakins and his officials met in February with the Premier's aide — Gordon Ashworth — the inquiry idea was dead.

Those at the meeting quoted Mr. Ashworth as saying the provincial government would have no control over the inquiry's findings — which, he is reported to have said, would be embarrassing to some municipal politicians (several of them prominent Liberals) and to real estate developers who financially backed the Liberal Party.

Mr. Ashworth later quit his job after it was revealed he had accepted a free refrigerator arranged by Patricia Starr, the central figure in an existing public inquiry into relationships between Mr. Peterson's government and the development industry.

Mr. Ashworth, through his lawyer, has denied that he was responsible for vetoing the York Region inquiry. However, his very presence at the discussions charges the air with sinister intentions.

The major developer in York Region is Marco Muzzo. Companies controlled by Mr. Muzzo and his partners, Alfredo DeGasperi and Rudolph Bratty, contributed \$112,650 to Mr. Peterson's Liber-

MICHAEL VALPY



(and Mr. Muzzo's involvement) were reported in The Globe last October. The meeting in Mr. Ashworth's office to discuss the York Region inquiry was in February — five months later.

In other words, the Muzzo connection with Mr. Peterson was known. Yet here we had the Premier's chief aide being instrumental (at the very least) in burying a public inquiry into affairs that might have touched on Mr. Muzzo's business practices.

Moreover, Mr. Ashworth's activities suggest that the Cabinet system had become rather useless. Instead of ministers of the Crown making decisions on what should be in the public interest, the decisions were being taken by one unelected official in whom the Premier placed boundless trust.

In the Legislature yesterday, Ontario Opposition Leader Robert Rae said:

"You have here a situation where an individual (Mr. Muzzo) and his associates made 71 per cent of the contributions to the Liberal Party coming out of York Region. The same individual was also the main financial interest behind the purchase of the Premier's family firm.

"The activities of that individual and his associates become the subject of public concern . . . raised with the Ministry of Municipal Affairs to the point of having a detailed proposal for a royal commission . . . set out. This royal commission does not

14

LETTERS.

LIBRARIANS UNITE!

Middletown, Conn.

Regardless of one's opinion of Martin Sherwin's editorial "Gorby and Z" [Feb. 12] about "To the Stalin Mausoleum" by "Z," one must agree that his last sentence perpetuates an invidious stereotype about librarians. He hopes that Z "works in a library," implying that librarians lack power, influence or thoughtful opinions worth stating.

Academics and government officials rely heavily on skilled information professionals to select and evaluate materials appropriate for the research process. Professor Sherwin's parochial view of the library profession reveals an intellectual arrogance that vitiates his primary thesis. Would he devalue any other profession this blatantly?

Erhard F. Konerding

Alan J. Nathanson

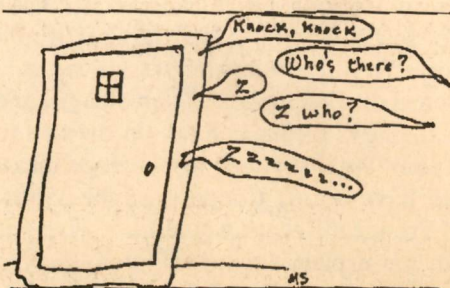
Penny Russman

Wesleyan University Library

SHERWIN REPLIES

Belmont, Mass.

I am pleased to have this opportunity to apologize sincerely to all librarians offended by the concluding sentence of my editorial about the *Daedalus* article by "Z." It certainly was not my intention to demean the value or status of librarians, whose professionalism and influence I, and all historians, respect and appreciate. My statement, "If Z is a government official, we can only hope that he (a copy editor at *The Nation* added "or she") works in a library," referred to James Billington, who is the Librarian of Congress. At the time of writing, Billington, along with Robert Gates, Deputy National Security Adviser, and Dennis Ross, the director of the State Department's Policy Planning Staff, was one of the three leading Z suspects mentioned prominently in the press. In that company I stand by my stated preference.



Anticipating other letters to the editor, I apologize.

Martin J. Sherwin

MYTH MEETS MYTH

New York City

Antonio Stevens-Arroyo's recent article on Puerto Rico's future political status, "Prisoners of Many Myths" [Jan. 22], is itself a

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Geezer

(Continued From Front Cover)

creases [in benefits] that Congress had been adopting, on an *ad hoc* basis, usually in election years." No one expected, it said, that inflation would take off and Social Security benefits would nearly keep up with it, while wages would fall behind.

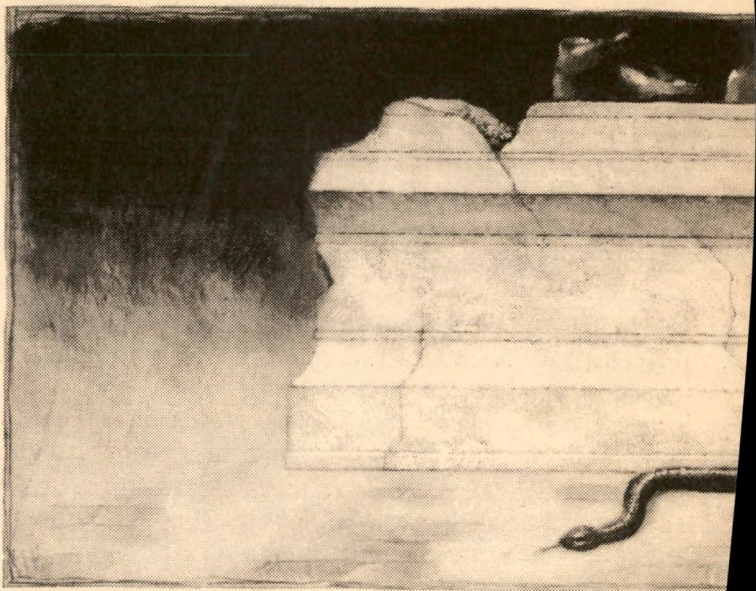
By 1977 alarm bells were ringing. So Congress sharply raised payroll taxes and sharply reduced the formula for benefits to be paid to future retirees. On a chart, this showed a sharp decrease for those born from 1917 to 1921—hence called the Notch. Congress swore that those reforms would keep Social Security in the black into the twenty-first century. The public was, as ever, little aware of all this, but when Notch Babies began to retire in the 1980s, they noticed that their checks were smaller than those of their elder brothers and sisters. (Figured as a proportion of taxed wages, Social Security pensions declined from 54 percent to 42 percent during the decade. The average monthly check in 1990 is \$566.) Some Notch Babies complained. This brought us a lot of unfavorable attention but no relief.

It must have been the act of qualifying for pensions that transformed us into Greedy Geezers, for nothing in our past hinted at such a metamorphosis. We all grew up in the Great Depression, when the country was desperately hard up and

This is the first of two articles. John L. Hess is a veteran journalist who writes a weekly column for The New York Observer.

Byelorussia. He recruited racists, neofascists and anti-Semites — even a former Waffen S.S. officer. Pasztor's political career flourished, and by 1987 he was boasting of his frequent visits to the White House, State Department and Helsinki Commission.

Charges of Republican anti-Semitic and fascist ties, circulating since the 1960s, resurfaced during the 1988 presidential campaign in *Washington Jewish Week*, *The Philadelphia Inquirer* and in a detailed Political Research Associates report by Russ Bellant [see David Corn, "G.O.P. Anti-Semites," October 24, 1988]. The potentially explosive campaign scandal was quickly short-circuited by the supposed removal of a



yet adopted a slew of warm-hearted legislation—just the opposite of the climate of the rich and mean 1980s. The crown jewel of our New Deal was the Social Security Act of 1935, which promised to liberate our elders from welfare and the poorhouse. The House Ways and Means Committee report on the bill declared old-age security to be a right, not a charity, and it promised something better than mere subsistence. There was to be no question of a means test to taint this entitlement (the word was not yet an epithet).

Now, we Notchers were only youngsters then, and like all youngsters we could scarcely imagine being old ourselves someday. Yet I can't remember hearing any of my generation complain about supporting the geezers. Rather, the general feeling was one of pride and relief, except perhaps for a few rich Republicans, who grumbled mainly among themselves. Any spitefulness surely didn't show up in elections.

Our Social Security was patterned after systems long developed in Europe. To finance better-than-subsistence pensions, it was assumed that payroll taxes would be supplemented with funds from general revenues, as was done over there. But by 1940, when the first Social Security pensions were paid, the Depression had ended and the accumulated income from four years of withholding exceeded expectations. To this day the Treasury has not contributed a penny to Social Security—indeed, it has borrowed heavily from Social Security reserve funds, generally at moderate interest and sometimes at no interest. In its first fifty years, Social Security took in \$55 billion more than it paid out.

And it was a smashing success at what it had set out to do. When it began, old people were the poorest of the poor. Thanks to Social Security, the proportion of the elderly classified as poor declined steadily to about one out of eight today, a shade less than the figure for all groups. It is this insignificant margin to which our critics refer in complaining that we are hogging more than our share.

Take Social Security away and not one-eighth but *one-half* of the elderly would qualify as poor. According to a major study by the Social Security Administration, by 1984 it was providing 38 percent of all income received by the elderly. The Social Security check was the only income received by 14 percent and represented at least half the income for 62 percent.

Most significant, perhaps, in light of how the media portray us, the study found that 77 percent of the elderly in 1984 had incomes below \$20,000, and only 3 percent (only 1 percent of elderly singles) enjoyed incomes above \$50,000—that class of welfare parasites that the gentle Ellen Goodman would represent as a Palm Beach matron with pearls, and Henry Fairlie would vituperate in *The New Republic* as “the pampered ones . . . some riding around in golf carts even on the streets, instead of taking an invigorating walk.”

By the time we Notch Babies were old enough to qualify for this pampering, Tender Loving Care was gone. Our New Deal and Fair Deal and Great Society had given way to benign neglect (a phrase promulgated by Senator Daniel Patrick Moynihan, of whom more later) and then to austerity, deregulation and give-backs. Incentives to investment were in, social welfare was out. And since Social Security

was by far the largest element of the welfare state, it became the largest target for demolition.

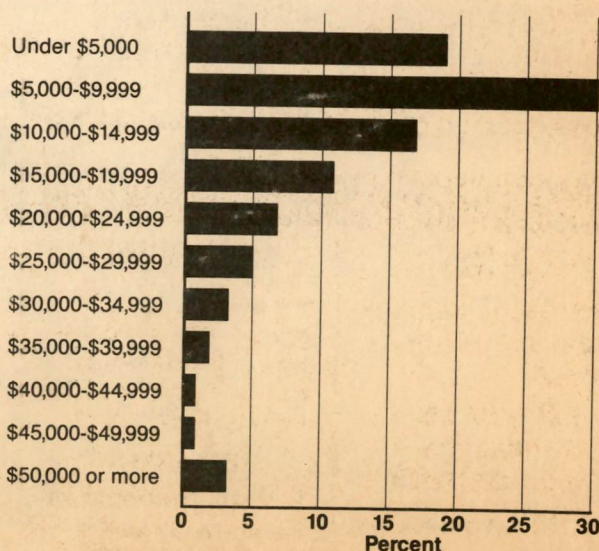
Despite the “rescue” legislation of 1977, which was supposed to have guaranteed the solvency of Social Security to the horizon and beyond, essays foretelling its doom appeared in 1980 in *Time*, *Newsweek*, *U.S. News*, *Fortune* and many leading newspapers. Social Security, the one big program that paid for itself, began to get the blame for inflation. A reporter in *The New York Times* dared to say that “Gray Panthers cheer [inflation] because they know Social Security payments are linked tight as mating dragonflies to the Consumer Price Index.” Remarkable dragonflies, since the cost-of-living adjustment is always three to fifteen months behind the index. The reporter had another grievance: “Most retirees, of course, took care of their housing needs while they were salting away their World War II overtime.”

With this chorus of barking from the media, the Reagan crowd, foes of Social Security from way back, must have thought they had a mandate. Soon after the inauguration, they took a serious whack at it. A supine Congress let them cut out benefits for dependent student survivors and round off all pension checks to the next lowest dollar, but when they sought to slash the basic pension for early retirees, the Senate rebuffed them 96 to 0. The attempt was widely blamed for Republican defeats in 1982.

Nevertheless, the war continued. This time it would be presented as a campaign to *save* Social Security, and would win the complicity of the Democrats. As a first step Reagan named a blue-ribbon, bipartisan National Commission on Social Security Reform. Its task was to resurrect the specter of bankruptcy that had been exorcised by the tax increases and benefit cuts enacted in 1977.

A major contribution was a series of articles in *The New*

Those Rich Geezers 1984 Income of U.S. Households Of Persons 65 or Older



Source: Social Security Administration

York Review of Books in 1982 by the Republican banker-politician Peter Peterson, who purported to prove by computer that the country would eventually be bled to death by Social Security. His cry from the right for social justice for the unborn persuaded such liberal columnists as Tom Wicker, Anthony Lewis and Jody Powell, who reproached Democrats in Congress for their cowardice in the face of us greedy, affluent, inflation-immune elderly voters.

Their conviction was reinforced by the neoliberal *Washington Monthly* of November 1982, whose cover showed an old cardsharp holding most of the chips, facing a young sucker across the table. (Cartoonists in other publications have depicted us as swine at the trough or as stout old men riding the backs of bent young proles.) In the cover article, "Taking America to the Cleaners," a fellow from Princeton named Phillip Longman declared, "Put bluntly, the old have come to insist that the young not only hold them harmless for their past profligacy, but sacrifice their own prosperity to pay for it." Where *his* prosperity came from he did not say. He was 26 years old.

Longman's clincher was his unsupported assertion that the average geezer going on Social Security would get back "in only 19 months what he or she contributed in a lifetime." The suggestion that pensioners soon become parasites has been widely used against Medicare as well, although the line of shame seems to vary according to the whim of the finger pointer. Longman's own editor, Charles Peters, has put it at two years; Cokie Roberts on *ABC News* gave us only twelve months; George Will in *Newsweek* vaguely allowed two years or so; and Lee Smith of *Fortune* generously accorded us four honorable years, presumably taking into account the employer's matching share of the payroll tax.

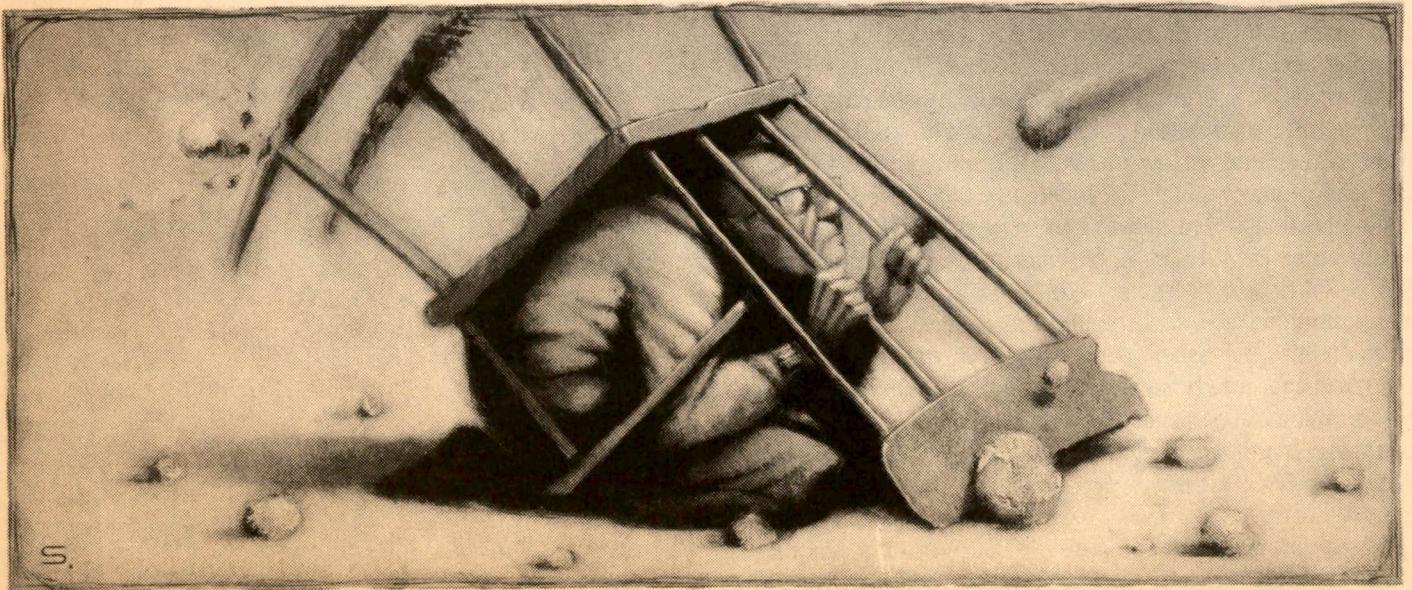
Hey, we can stretch that out some. Take an average Notch Baby. Say he or she has paid in enough dollars, over fifty years, to pay a pension for two years, and his or her employers have matched that. That makes four. Now, if those dollars have been regularly deposited in a savings bank at compound interest, we'd have enough for eight years. Add in the dollars contributed by classmates who have died in

war and peace and will never claim their pensions. Then adjust the whole sum for inflation. By now, your Notch Baby has an honorable claim good until the sweet by-and-by.

But all that is a silly and mean parlor game that has nothing to do with reality. Social Security is a contract the country made with itself, guaranteeing all workers and their dependents and survivors a decent pension. Nothing in the contract bars the government from paying the pensions out of general revenues, but it has in fact paid them all out of Social Security payroll taxes. We have actually paid more than enough; the surplus is deposited in trust funds, or reserves, which are invested in Treasury bonds. Under this contract, we Notchers have for fifty years financed the pensions of our elders without missing a month. Now that our time has come, we are denigrated as freeloaders.

If Social Security is seen as a government contract, it is clear that it could never go broke. To create a crisis it was necessary to pretend that the checks had to come out of the trust funds (actually, the Treasury Department writes the checks) and that the trust funds were going into a black hole. Alan Greenspan, chairman of the bipartisan commission, whipped up a worst-case scenario that stands as a wonder of its kind. For example, he assumed that the Consumer Price Index would rise 9.2 percent in 1985; at this time the White House was predicting 4.6 percent and Wall Street forecasting firms, including Greenspan's, were guessing about 3 percent (the actual figure for 1985 turned out to be 3.6 percent). With similar guesses regarding unemployment and so on, Greenspan predicted a Social Security deficit of \$150 billion to \$200 billion by 1990.

NBC's economic correspondent said it on the evening news: "A time bomb is ticking in Social Security." That's what made the headlines, panicked the elderly and permitted Congress to approve a savage whack at Social Security and see it universally headlined as a rescue. It is curious that Greenspan's phony estimate of the Social Security deficit was about the same as one recently given for the savings-and-loan losses (\$200 billion), but whereas it has been taken for granted that the Treasury must bail out the savings and



loans, there was never any suggestion that it might bail out Social Security.

In fact, there had been no Social Security crisis. Although Reagan later said Social Security would have gone bankrupt by August 1983, its income roughly balanced expenditures that year. It is true that old age and disability reserves had run down as a result of unusually high inflation and unemployment for several years, but there was a cushion that the public was never told about.

Under the law, the millions of Americans who had served in the armed forces were credited for Social Security benefits as if they were otherwise employed, which is only fair. Congress was supposed to pay the equivalent of withholding tax to cover them but put it off for more than forty years—until 1983, at which time the delinquencies came to well over \$20 billion. There was also a bagatelle of \$1.3 billion in benefit checks issued by the Treasury and billed to Social Security but never cashed. So there was no emergency, no cause for panic. But the public didn't know that.

Passage of the "rescue" was nonetheless a remarkable exploit. Until recently, Senator Moynihan was fond of recounting it. In newsletters mailed to voters at taxpayer expense during his 1988 re-election campaign, he called the act his proudest achievement. He quoted Senator Robert Dole, the minority leader, as relating in *his* campaign speeches how "in twelve days in January 1983, a small group of us reached agreement on changes in the Social Security system that left it solid, solvent, secure for half a century to come."

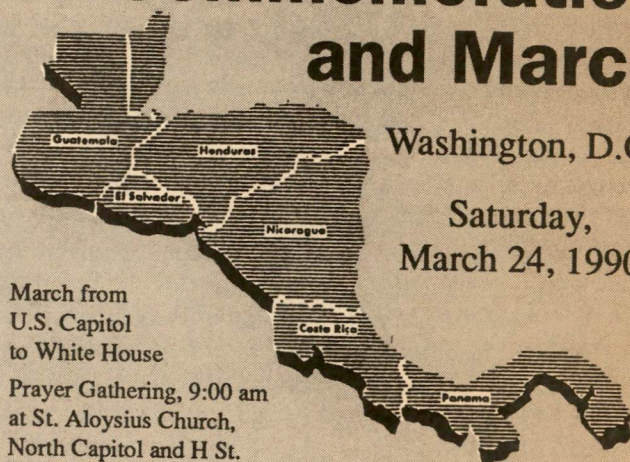
Moynihan could not resist a chuckle at the deception that was going on. He recalled in his newsletter that Reagan "on his own wrote a speech (never given: the man is lucky!) proposing that Social Security be made voluntary," and that David Stockman (a Moynihan protégé who was then White House budget chief) had earlier announced that in October 1982 the Social Security system would suffer "The World's Biggest Bankruptcy." Moynihan wrote, "Americans were, understandably, concerned that the hard-earned money they had paid into the Social Security system would not be there when they retired *even though there was no real danger of this occurring.*" (Emphasis added.) He explained that withholding taxes were coming in faster than had been expected because more people in the typical household were working. Further, he added with a wink, "The Federal government . . . is supposed to pay Social Security contributions for men and women in the armed services. But for near to half a century it had, well, forgotten to do so."

None of this, I repeat, was known to the public when the "rescue" plan came to a vote in January 1983. On the House side, Speaker Tip O'Neill stalled, taking considerable abuse from editors and columnists, apparently because he expected a popular backlash. It never came. Organized labor and the organized elderly almost certainly could have blocked the bill, but their bemused representatives on the Greenspan commission, Lane Kirkland of the A.F.L.-C.I.O. and Representative Claude Pepper, were somehow persuaded to go along with it.

The package called for stepping up payroll taxes, omitting a cost-of-living adjustment for six months (effectively, a

End the U.S. War in Central America

Archbishop Romero Commemoration and March



Washington, D.C.

Saturday,
March 24, 1990

March from
U.S. Capitol
to White House

Prayer Gathering, 9:00 am
at St. Aloysius Church,
North Capitol and H St.

Assemble 10:00 am at the Capitol

Rally at White House

Speakers include Jesse Jackson,
Raul Julia and Ron Kovic

Nonviolent Civil Disobedience After Rally

March 26: Lobby Day



Assassinated
March 24, 1980

- End all U.S. aid to El Salvador
- End U.S. intervention in Nicaragua
- No Invasions;
End the occupation of Panama;
End military aid to Guatemala
- Cut military spending;
Fund human needs

Philip Agee • Susan Anspach • Edward Asner • Jackson Browne • Noam Chomsky • Rev. William Sloane Coffin • Daniel Ellsberg • Bishop Thomas Gumbleton • Rev. Jesse Jackson • Raul Julia • Ron Kovic • Bill Means • Ruth Messinger • Jessica Mitford • Mario Obledo • Claes Oldenberg • Grace Paley • Sting • Coosje Van Bruggen • Little Steven Van Zandt • Robert White invite you to join us in commemorating the life and work of Archbishop Oscar Romero and to call for a new U.S. foreign policy towards Central America.

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MARCH 24, 1990

permanent reduction in benefits) and making half of benefits taxable for recipients with medium or better income. The only votes in the Greenspan commission against the package came from three right-wingers who thought it wasn't mean enough. On the floor a majority double-crossed Kirkland and Pepper with an amendment delaying the retirement age from 65 to 67 by phases, beginning in the year 2003.

Note that all these "reforms" weighed far more heavily on the young than on us geezers, which is ironic, considering that all the propaganda had been aimed at getting us off their backs. Indeed, the columnist Bill Buckley would argue later that Social Security ought to be junked precisely because, as a result of the legislation that his friends had devised, young people were now paying more and would be receiving less than their elders.

With payroll taxes going up every year, the Social Security surplus or "trust fund" really took off. Exceeding estimates in every year to date, it is expected to total \$223 billion by the end of fiscal 1990, \$1.4 trillion by the end of the century, \$4.8 trillion by 2010. (After that we get into real money.) All this is invested in gilt-edged U.S. bonds deposited in trust funds. That has reduced the need for the Treasury to peddle bonds in the market to meet its deficits. Last December Moynihan said the trust funds should be able to buy out the whole national debt by 1995, and that would be just dandy.

Then, as he was leaving for a year-end junket abroad, the mischievous Senator tossed a verbal hand grenade. He observed, rather casually, that the government was not really putting all that surplus Social Security tax money aside for future pensions but was spending it as fast as it came in to reduce the deficit; that the trust funds thus contained not real money but only I.O.U.s; and that if current Social Security revenues some day failed to cover current pensions, the Treasury would have to sell bonds in the market to pay those I.O.U.s. Moynihan also observed that while the affluent were now paying less taxes than they did a decade ago, thanks to the cuts in income tax, most Americans were paying more because of the increases in payroll tax (although he did not stress his own support of both those deeds). So he proposed that, in all fairness, the 1990 increase in the Social Security tax be repealed.

This threw politicians and pundits into confusion. They had been discussing how to fashion a cut in the tax on capital gains; now they would have to talk about a fair distribution of the tax burden. Even the Democrats found

this a hard one to answer. *The New York Times* made a desperate effort. In a stunning editorial it cast aside the hoax about saving Social Security that had won acceptance of the 1983 act. Ignoring the role of the media, including itself, in perpetrating that hoax, the *Times* now declared that the Greenspan commission had "misled the public into a false sense of security." The commission's real aim, the paper said, was "to raise national savings—and thereby provide for economic growth—the only way that is known to work: lower the deficit. And it planned to do so by raising the only tax Congress would touch"—i.e., the Social Security withholding tax.

The underlying philosophy was plain: Prosperity depends on investment, which has to come out of savings. Only the affluent save, so wise fiscal policy calls for giving more to the rich and less to those who only work and consume. That's why the Reagan Administration cut the top income tax brackets by more than 50 percent: It was for the country's own good. That's also why it raised the Social Security tax and trimmed benefits. But that was not enough to avoid a horrendous deficit, nor even to visibly increase savings, so they are pushing for more of the same and using the same tactic: a scare about the future solvency of Social Security and an assault on the Greedy Geezers as the villains of the piece.

The campaign has a full-time booster, financed by major corporations. It is called Americans for Generational Equity (AGE) and was headed by Senator David Durenberger until his recent ethics problems. He remains a director along with such other defenders of the young as Richard Lamm, who when Governor of Colorado once told us ailing geezers we had "a duty to die and get out of the way." Young Phillip Longman, who wrote that geezer-bashing piece for the *Washington Monthly*, joined the staff of AGE. He had found a career.

Lee Smith of *Fortune* magazine drew on the wisdom of AGE in preparing an article in 1987 titled "The War Between the Generations." He described a cartoon on a wall of AGE's offices: "An old woman presses a gun to the head of a child who holds a lollipop. 'OK,' grandma growls, 'just drop it in the bag and no one will get hurt.'" Smith predicted that war—literal, bloody war—would break out a generation from now if today's mainly white baby boomers try to collect their Social Security boodle from a working class that by then will be largely black and Latino. Bloody war, Smith said—unless we prudently advance the retirement age to 70 and replace Social Security with voluntary personal investment programs like I.R.A.s (which are attractive and affordable only to the affluent). If, however, those baby boomers become Greedy Geezers and balk at these sensible proposals, one Ken Dychtwald, a 37-year-old gerontologist, suggested to Smith that they "could be sent on a five-day camping trip with two days' worth of food."

This image of the Greedy Geezer as a parasite who is threatening the survival of the community came to dominate another crisis in social policy—the runaway cost of health care and the catastrophic Medicare fiasco, which will be the subject of a future article. □

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File, Lincoln Fdtn.

Idea: E. C. Harwood, farm out study to him on land spec'n. & banking cycles. But note p. 13, misses factor of mortgage expansion.

December 1960 No. 1

AMERICAN INSTITUTE
for ECONOMIC RESEARCH
Great Barrington, Massachusetts

ECONOMIC EDUCATION BULLETIN

THE GOLD CRISIS

THE EVOLUTION OF COMMERCIAL BANKING

AT FIRST thought, one might believe that commercial banking and money-credit matters generally are too complicated for all but a few exceptional individuals to understand. However, knowing that only simple relationships are involved we are convinced that the difficulty lies elsewhere.

Our conclusion is that the difficulty is traceable to two factors. First, commercial banking is the outcome of an evolutionary process that is simplicity itself when viewed one step at a time as it must have occurred but that is not so readily understood when one looks only at the result to date. Second, many of the technical words have been in common use so long that those attempting to understand are confronted by the difficulty of remembering the technical uses of words that have become familiar in somewhat different uses.

In the following paragraphs, the evolution of commercial banking is described step by step. No attempt is made to date each successive step in the evolutionary process, although some dates are given. Many of the original dates for successive steps are lost in the haze of man's unwritten history; and some of the successive steps have recurred in recent decades and may be expected to recur again wherever formerly well-developed money-credit processes are destroyed, as in Germany after World War II for example, and in primitive societies beginning the long climb upward to a more advanced civilization.

Primitive Markets

We begin with a primitive society where exchanges were simple barter. The grower of wheat exchanged it directly for skins obtained by the tribal hunters, for meat obtained both by the hunters and by those who had cattle, and for gold obtained in crude form by some members of the tribe from alluvial deposits. Why gold was generally desired, other than for the fact that it was used for ornaments and because it

You can help to promote correct understanding and wise decisions in the present crisis by distributing this bulletin; extra copies, 5 for one dollar (\$1).

could be exchanged again for other things desired, need not concern us. We simply observe a fact and report it.

As the tribe increased in number and the exchanges to be made increased greatly, a time came when the bartering was concentrated, for the most part, at a convenient meeting place. Today we should call that meeting place a market or shopping center.

Of course, many other things than those already mentioned were exchanged in the markets. However, the principles we are seeking to understand can be illustrated by discussing initially only a few of the many. We choose to focus attention on wheat, beaver skins, and gold.

As market activity increased, the time came when some individuals became specialists in marketing. One chose to deal in wheat, another in beaver skins, and another in gold. Once these specialists had established themselves, many of those bringing in things to barter discovered a process more convenient than carrying on their backs the things they wished to offer in exchange. The processor of wheat delivered wheat to the warehouse and took in exchange a claim check or warehouse receipt for his wheat. Similarly the processors of skins and gold took warehouse receipts from the merchants specializing in skins and gold respectively.

Claim Checks

Those who thus had obtained claim checks on wheat, skins, and gold then exchanged the claim checks among themselves until they had claims on the things they wanted. When each had claim checks for whatever he wanted, he went to the appropriate merchant warehouses and obtained wheat, or skins, or gold in exchange for the respective claim checks.

At this point, brief consideration of the wording on the claim checks is advisable. The earlier ones for wheat read as follows:

This certifies that John Doe has placed in my warehouse
35 bushels of wheat, which I promise to deliver to the
bearer of this claim check on demand.

Arthur Smith, Wheat Merchant.

Similar warehouse receipts or claim checks were written by the merchants handling skins and gold. In some instances the claim checks were not redeemable by the bearer unless the claim check had been endorsed or signed over to him by the original depositor of the wheat, but these details need not concern us at this point.

Gold as the Medium of Exchange

As the market increased in size and activity the individuals concerned found, to an increasing extent, that gold or claim checks on gold were a convenient medium of exchange. On more and more occasions the men who had gold or claim checks on gold found that they could obtain what

they wanted with the least difficulty in persuading others to accept what they had to offer. Soon, anyone who had gold or claim checks on gold found all others willing to accept gold in exchange, because each seller saw for himself how readily he could buy other things he might want with the gold and how conveniently he could hold gold until he might wish to buy other things.

As a result of the increasing use of gold and claims on gold in effecting exchanges, men developed the habit of estimating the exchange value of other things in amounts of gold. Thus prices, instead of being thought of and talked about in such ways as, "two bushels of wheat equals in exchange value one beaver skin," came to be thought of and talked about in such ways as, "one bushel of wheat equals one thirty-fifth of an ounce of gold, and one beaver skin equals two thirty-fifths of an ounce of gold (also the exchange value of two bushels of wheat)."

The Goldsmiths

At about this stage of development, the gold merchants, or goldsmiths as they were called, saw the possibility of greatly simplifying the marketing and exchange processes. A goldsmith suggested to a wheat merchant that more growers of wheat would bring their wheat to his warehouse if he would give them in exchange claim checks on gold instead of claim checks on wheat. When the merchant replied that he had neither gold nor claim checks on gold to offer, the goldsmith explained that claim checks on gold could be borrowed until such time as the merchant might sell the wheat.

The wheat merchant decided to experiment as suggested. When the next wheat grower arrived with a load of wheat, the merchant offered him a choice between claim checks on wheat and claim checks on gold. When the wheat grower said he preferred the claim checks on gold, the merchant stepped next door and gave to the goldsmith the claim checks on wheat accompanied by a promissory note for gold. Whereupon the goldsmith gave the merchant claim checks on gold, which were delivered to the wheat grower in exchange for the wheat he had delivered. The wheat merchant's promissory note read like this:

This is to certify that I have received and now offer for sale in my warehouse 100 bushels of wheat for which this note is a claim check. Received this date from the goldsmith 100 claim checks for $1/35$ ounce of gold each. As the wheat is sold I promise to return to the goldsmith corresponding claim checks on gold with interest at 6 percent, and if I fail to return all the claim checks within 30 days the goldsmith may claim the wheat not yet sold.

And each of the 100 claim checks on gold issued by the goldsmith read like this:

I promise to pay to the bearer on demand one thirty-fifth of an ounce of gold.

William James, Goldsmith.

Shortly thereafter, the goldsmith made an interesting discovery. At first he had issued claim checks on gold totaling no more than the gold in his possession. His discovery was that few people who obtained his claim checks ever demanded gold. Most of them used the claim checks on gold as purchasing media to buy other things, and the sellers returned the claim checks thus obtained to the goldsmith as agreed in order to repay their borrowings. Occasionally, some individual demanded gold, but even that gold usually returned to the goldsmith, for safekeeping if for no other reason, within a short time.

Commercial Banking

The much greater convenience to all concerned provided by the claim checks, especially those on gold, facilitated great increases in trade. Soon the goldsmith was being urged to issue claim checks on gold for greater amounts than the gold he had. But by that time, he knew from experience that few who had claim checks would want gold if other things were available for purchase in the markets. Consequently, the goldsmith reasoned thus:

a. If I am prudent in judging the gold exchange value of the things the merchants have to sell, and if I am sure that they are offering those things on the markets, I can issue more claim checks on gold than the amount of gold in my possession. Few of the people who get my claim checks will want gold; most of them will use the claim checks to buy other things.

b. If I make sure that the merchants repay their loans promptly by returning to me the claim checks on gold that they receive when they sell wheat, skins, etc., I shall be sure that there are no more claim checks outstanding than the total value of things left in the market place plus my gold. Obviously, I must lend my claim checks only for short periods and must insist that a merchant promptly repay me whenever he sells the wheat or other thing that serves as security for his promissory note.

c. If, for any reason I cannot foresee, many individuals suddenly decide to demand gold for their claim checks on gold, I can refuse to lend any more and insist that the merchants repay past loans. This will force the merchants to reduce prices on what they have for sale; the lower prices will attract purchasers who have claim checks on gold; thus people who have such claims no longer will demand gold from me but will exchange their claim checks for other things such as wheat. Then the wheat merchants, in order to repay their borrowings, will return to me

the claim checks on gold they had borrowed. In a short time, there will be no claim checks on gold outstanding, or at least no more than I can readily redeem with gold if necessary.

Once the goldsmith initiated operations as just described, sound commercial banking was under way. Soon, more of the goldsmiths in the first market and then in other markets undertook the new business of commercial banking. However, for a long time they were known as goldsmiths.

Intermarket Trading

Shortly thereafter some interesting relationships were discovered. In a market area not far from the first, the cost of producing wheat was less because the alluvial valley land was richer. On the other hand, beaver skins were available in larger quantity with less effort in the first market area because of the many hillside waterways where beaver could be trapped. In the second market area the exchange value of wheat for gold decreased (the price of wheat declined), and in the first market area the price of beaver skins was lower than it was in the second market.

Even in the days of simple barter, there had been differences in the exchange values of wheat and skins in the two markets. But with the regular use of gold or claims on gold as purchasing media, the price differences became more apparent and the advantages of regular trade between the two areas became obvious. Thus inter-area commerce increased to the mutual advantage of all concerned.

At first the goldsmiths wondered whether or not the supply of gold would be adequate for the increasing number of exchanges and growing volume of commercial banking for which many more claim checks on gold were needed. However, as the goldsmiths became better known, more gold was brought to them for safekeeping. In addition, the gold producers took advantage of the new inventions stimulated by the general advance of a trading civilization to increase the effectiveness of their operations. Crude pumps were developed to provide water for hydraulic washing of gravel, and the new wheeled carts lessened costs of hauling supplies, etc., as the costs of other industries were similarly lessened. Thus gold production was stimulated.

In addition to the lending to merchants originally undertaken and still continued, the goldsmiths finally were creating and lending claim checks on gold to traders shipping from one market to another and to processors of wheat and skins such as the millers and furriers. In each instance the goldsmiths were at first careful to apply the basic principle of commercial banking, i.e., that each new issue of claim checks on gold created for a borrower should, in effect, represent either additional gold received or other things being offered in the markets.

Savings Deposits

Soon the goldsmiths developed a new aspect of their business. Some of the individuals employed by manufacturers, merchants, and traders found that their wages and salaries would buy more than their immediate needs for consumption. Consequently, they began to save and invest part of their incomes. At first, these individuals invested the claim checks on gold they had saved directly in new houses to rent and other things, but some of them realized that the goldsmiths were in a position to make such investments, safeguard the documents concerned in their vaults, and exercise continuing supervision. By mutual arrangement the goldsmiths then undertook to receive such savings and invest them. For example, a salaried executive would bring part of his salary each month in the form of claim checks on gold to the goldsmith. A record of this deposit was made by the latter; this record was known as a savings account or time deposit.

Of course, the purchasing media in the form of claim checks received by the goldsmiths from savers were already in existence; those claim checks had been created and issued originally by the goldsmiths as commercial loans were made; some individuals who had received the claim checks from the merchants and other borrowers chose not to buy some of the things in the market but to deposit some of their claim checks at the goldsmiths; consequently, things that those claim checks represented still were for sale in the markets, and those claim checks, although the same in all outward appearance as other claim checks, could be loaned or invested by the goldsmiths in other than commercial loans. As far as those claim checks were concerned, the goldsmiths could safely disregard the commercial-loan principle, because those claim checks had been issued in the first place to represent things being offered and still available in the markets. Of course the goldsmiths promptly invested or loaned those claim checks, and anyone who borrowed those claim checks from the goldsmiths would find things of equivalent value already in the markets for him to buy.

At first thought, readers may wonder whether the goldsmiths might not become confused by making two types of loans with similar claim checks. However, the goldsmiths had an exact record of the savings deposited with them. Consequently, they always knew precisely how much they could invest in bonds, mortgages, or other loans that did *not* involve simultaneous offerings of things in the markets.

Inflation

Then, during a period of peace and general prosperity when markets were functioning well and the goldsmiths were actively conducting their

usual businesses of both commercial and noncommercial lending, an unusual event occurred. A would-be borrower who had nothing to offer on the market desired one of the new chariots then becoming fashionable. He asked his goldsmith friend for a loan, but was at first told, "I am sorry to disappoint you, but my records show that all the savings deposited with me already have been invested. As you can understand, a loan to you for the purpose you have indicated would not be a commercial loan because you would not be simultaneously offering anything on the market from which the proceeds of sale would repay the loan. Therefore, I should not create and issue new claim checks on gold in order to lend them to you."

The would-be borrower, a long-established customer of the goldsmith's, had his reply ready. "I realize that what I am asking is unusual, but what harm can result? If you fear for the safety of the loan, I can give you a chattel mortgage on the chariot I buy; it will serve as security for the loan. If I fail to repay when the note falls due, you can repossess the chariot and reoffer it on the market yourself. Moreover, I am willing to pay an unusually high rate of interest. You will be well protected and can profit by the arrangement."

Now the goldsmith in this instance, although by no means stupid, was not well informed on the principles of sound commercial banking. He had fallen into the habit of thinking more about the security for his loans than of their purpose. Finally, he had had no experience with and could not foresee the consequences of departing from the basic principle of sound commercial banking. He therefore created some additional claim checks on gold and loaned them to the persistent borrower. Thus was inflation begun.

As soon as the borrower had the claim checks in his hands he rushed to the market and bought one of the few chariots then available. Within the next several days, other individuals who in the usual course of events would have purchased chariots likewise sought to buy. The chariot merchant realized that demand for his product was exceeding the supply; his haggling over prices altered in tone with the result that chariots soon commanded higher prices.

The chariot merchant then dispatched a letter by mounted messenger to the manufacturer of chariots ordering an additional number for early delivery. The manufacturer was so pleased with the increasing evidence that his products were finding favor in the seemingly more affluent society that he decided to push ahead with plans long under consideration for expansion of his manufacturing facilities. He went to the goldsmith and proposed to borrow on a large scale either by giving his note or bond (another form of promissory note) in which the goldsmith could invest savings at his disposal.

More Inflation

The goldsmith's reply was, "I can see how advantageous your early expansion seems to be; but, unfortunately, I have already invested all the savings at my disposal. In fact, my noncommercial, investment-type assets (holdings of bonds, mortgage notes, etc.) already exceed the savings heretofore deposited with me plus my capital funds. You will have to wait until additional savings are brought to me for investment."

But the chariot manufacturer was eager to proceed; consequently he urged, "Your loan will be well secured. Within a year at most, I shall be producing additional chariots from the new plant, and in 8 or 10 years your loan can be repaid in full. Surely, what I am proposing is a sound loan."

Thus the goldsmith was finally persuaded to create more claim checks on gold and lend them to the chariot manufacturer. The latter then started bidding for labor and construction materials in order to construct his new plant. Of course, the new purchasing media thus made available for purchases of things in the markets were in excess of the value of things then being offered in the markets for sale. Inevitably, competitive bidding forced prices and wages up. In this community a period of boom prosperity began. All makers of things found demand in the market place suddenly increased; all tried to increase their plants, all bid for scarce materials and labor at higher and higher prices. The goldsmiths were urged to make more and more noncommercial loans at higher and higher rates of interest, and the more they disregarded the "old-fogey" principles of sound commercial banking the more their new-found "wisdom" seemed justified by the turn of events.

At least, such were the effects at first. Then subtle changes in past procedures began to appear. Merchants in this market area discovered that they could buy at lower prices in other market areas. First wheat, then skins, and finally even chariots were being brought in from adjacent market areas in large quantities. The local merchants of course had to pay for the things thus brought in, and they gave the claim checks on gold issued by the local goldsmiths.

Then the goldsmiths made an important discovery. Formerly, few of the claim checks they issued were presented as demands for gold. Most claim checks had returned to the goldsmiths as merchants repaid loans and then were reissued for new commercial loans. Almost no one in the local market had seemed to want gold. However, the goldsmiths in other markets (communities B, C, etc.) had no use for the claim checks issued by goldsmiths in the market where prices (exchange values of other things for gold) had increased so greatly; consequently, the claim checks were presented as demand claims for the gold held by goldsmiths in community A.

At first, the goldsmiths in community A were not concerned about the outflow of gold from their vaults. Occasionally in the past, claim checks had been presented for their gold, and they had encountered no difficulty in satisfying the desires of those who, for one reason or another, wished to hold gold. In this instance however, the demand for the goldsmiths' gold persisted. Soon the gold left in their vaults was far below the amounts that they formerly had considered reasonable in relation to claim checks outstanding.

Deflation

At this stage, the goldsmiths in community A became alarmed. Unless some way could be found to alleviate their situation, they soon would be bankrupt. First, they turned to the borrowers who were building new factories or who had bought new chariots and urged them to repay their borrowings. But the manufacturers told the goldsmiths, "Surely, you remember that we have bought bricks and mortar with the claim checks you loaned to us. Someone else has those claim checks now, and we shall not be able to repay for a few more years." And those who had borrowed to buy chariots said, "We simply cannot repay the claim checks we borrowed until our future earnings are received in the months ahead."

Finally, in desperation, the goldsmiths turned to the merchants and said, "We cannot loan you more claim checks to buy more goods; we must have repayment of your outstanding loans. Then the rush to liquidate began. Merchants marked down prices in order to persuade more shoppers to buy with claim checks that could be used to repay loans. Merchants canceled orders for things from manufacturers in order to avoid becoming obligated for incoming goods. Manufacturers reduced production, and the number of unemployed in community A greatly increased.

As prices generally fell, prices of secondhand chariots declined rapidly. Soon some of the goldsmiths in community A realized that their loans secured by chariots were "frozen" because the borrowers were unemployed and the chariots involved were worth much less than the unpaid loans. These goldsmiths repossessed chariots and sold them at auction, but the proceeds of such sales were insufficient to cover the unpaid loans. Some of the goldsmiths then realized that their own capital, and more, had been lost; they too were bankrupt and were forced to close their doors to the dismay of many savings depositors and of others who still held the claim checks on gold issued by those particular goldsmiths.

Gold Production

One of the interesting developments during the days of boom prosperity and afterward was the trend of gold production. When businessmen generally were frantically bidding for raw materials and labor at

rising prices and wages, gold production markedly decreased. The reason was not difficult to ascertain. From the viewpoint of the gold producers, the prices of everything they had to buy and the wages they had to offer in order to attract labor rose rapidly. The gold producers thus were forced to discontinue producing in all but the richer gravel deposits and mines. Labor and new machinery that might ordinarily have been used in producing gold were diverted to other activities.

Later, after prices generally and wages had fallen extensively and many were unemployed, gold miners found that old abandoned mine shafts and gravel deposits could be worked again. Even placer mining by individuals became popular.

Some of the economic theorists in this society had become concerned during the early days of the depression and developed learned theories about the "shortage" of gold, blaming that for the depression difficulties. However, their books hardly were published before gold production was stimulated again as described above and increased to levels never before reached.

With our understanding of the entire situation in community A, we can see that the decrease in gold production was desirable. It tended to discourage continued issuance of claim checks by the goldsmiths when they already had issued too many. Moreover, the subsequent increase in gold production during the depression had a reverse effect in that it made more gold available to the goldsmiths and encouraged them to create more claim checks on gold. For all new gold delivered to the goldsmiths they gave claim checks that were purchasing media, which made possible increased demand for other things. In addition, as their gold holdings increased once more, the goldsmiths were in a better position to resume commercial lending.

England's Experience

As it happened, one national economy where the goldsmiths functioned most effectively was England of the 19th century. In the early 1800's the English goldsmiths, who by then were called bankers, developed a modification of the claim-check procedures described above. English merchants found that handling claim checks was awkward and that a simpler procedure would be to have the banker hold the claim checks and permit the borrowing merchant to transfer them from his account to others in whatever amount he wished by written order directing such transfers.

When merchants or others brought gold or claim checks on gold to the bank, the English bankers wrote a credit on their books, which they called the depositor's "checking account." A depositor who held title to such a demand deposit or checking account then could write checks (written instructions to the bankers) transferring any portion or all of the gold thus represented to others.

In applying the commercial banking principle, the bankers accepted borrowers' promissory notes, but instead of creating claim checks on gold for the borrowers to use, the banks authorized the borrowers to write checks not only for the amounts already in their checking accounts but also for the additional amount of the loan. The excess checking account purchasing media thus authorized were called "overdrafts." An English commercial banker thus had a record showing him continuously the total of overdrafts on accounts in his bank. As the total of overdrafts increased, an English banker tended to be more cautious about making loans. Moreover, the bookkeeping record of overdrafts was a continuous reminder to him that his loans resulting in overdrafts should be short-term strictly commercial loans based on goods being offered in the markets.

Somewhat complicating the situation was the fact that many exchanges in the markets still involved the use of claim checks on gold instead of checks drawn on checking accounts. The claim checks on gold issued by a bank finally were given the name "banknotes," because they were the bank's promises to pay gold on demand.

Experience in the United States

Although the basic principles of sound commercial banking were being applied with increasing success in England during the 1800's, these principles were not so widely understood in the United States. Hundreds of banks were started in the several States of the Union by individuals who knew nothing of banking beyond the fact that they wanted to participate in that mysteriously profitable business. These amateur goldsmiths were easily induced to provide claim checks on gold (their banknotes) to borrowers who wished to speculate in land, then in the railroads, sometimes in almost anything. Moreover, unlike the English bankers who differentiated between overdrafts and the original deposits of gold and claim checks on gold by their customers, the American bankers used the same name, "demand deposits," for both. When they accepted a borrower's promissory note and created claims on gold for him, they either issued new claim checks called banknotes, or added the amount to his previously existing checking account as the borrower desired. Except for technical legal requirements as to banknotes, which need not concern us although important to students of money and banking, the American bankers lacked the constant reminder to be cautious and adhere to sound commercial banking that the English bankers had in their records of overdrafts.

The inevitable result of such banking was a long series of minor booms and recessions, with occasional great booms (whenever all or most of the goldsmiths became especially optimistic) followed by severe depressions. Efforts were made by the State governments and by the Federal Government to remedy the situation. Almost every conceivable

remedy apparently was tried, even the adoption of sound commercial banking for a brief period. A review of the principal remedies adopted is enlightening.

One of the first methods chosen for improving the functioning of the goldsmiths (or commercial bankers as we shall call them from this point on) was to limit the amount of claim checks on gold that they could legally issue in relation to their actual holdings of gold. Thus were initiated the legal reserve requirements that have become characteristic of American banking.

The reason for adopting such a crude, rule-of-thumb procedure is not difficult to understand. Evidently, the hundreds of banks that failed (many thousands as the decades passed) had overexpanded; therefore, why not limit the creation of claim checks (whether banknotes or checking accounts) to a smaller multiple of a bank's gold? This procedure did work, in a manner of speaking; at least, it tended to prevent every major boom from getting as completely out of control as had the tulip speculation in Holland, or John Law's Mississippi Bubble inflation in France, or the French inflation of the assignats, or the Rhode Island paper-money inflation, or the Continental currency "shinplaster" inflation of the late 1700's.

Another means by which better banking was sought was the organization of the National banks in 1861. By establishing certain safeguards, such as requiring deposits of Government bonds in relation to note issues, the credit "rope" with which the Nation's bankers periodically "hanged" themselves and nearly everyone else was somewhat shortened.

At long last, after a particularly disastrous experience with an inflationary boom and bust resulting from ignoring the principles of sound commercial banking, a Monetary Commission was formed. In the course of an investigation extending over 5 years early in the 1900's, the Commission rediscovered the principles of commercial banking that had been applied in England for nearly a century.

✓ Following the recommendations of the Monetary Commission, the United States established in 1914 a Federal Reserve System including 12 Federal Reserve banks and thousands of member banks. Although the resulting money-credit arrangements included many "hangovers" from earlier procedures, the new system at least recognized and attempted to apply the principles of sound commercial banking. In the 3 years from 1914 until the United States entered World War I, the banks of the Nation came as near as they ever have to an understanding and application of sound commercial banking.

Wartime Inflation

During World War I, the governments of the warring nations including England chose inflation as the expedient means of financing

their war efforts. In England, the long-established principles of commercial banking were put aside as the goldsmiths or commercial banks were persuaded to create claims on gold for the national Treasury in the forms of both banknotes and checking accounts in exchange for Government bonds. The resulting great increase in the purchasing media had the usual effects on prices, wages, and business activity.

In the United States during the years of World War I after 1916 similar procedures were followed. The new Federal Reserve System was used as an "engine of inflation" by inducing the commercial banks including the 12 Reserve banks to accept Government bonds in exchange for additions to the Treasury's checking accounts.

Shortly after the war, the Federal Reserve Board sold Government bonds from the Federal Reserve banks and forced deflation. Thus most of the inflationary purchasing media were removed from circulation, and sound commercial banking might have been resumed.

The "New Era" and 1929 Panic

Unfortunately, the wartime practice of having the 12 Federal Reserve banks create new purchasing media (additions to Treasury checking accounts) in exchange for Government bonds soon was resumed. The reasons were complex. They included a misguided and in the end unsuccessful effort to help England restore the gold standard as well as efforts to stimulate business in the United States by means of an "easy-money" policy. The results was another great inflation, the effects of which, and in part the means, were found in unbridled stock market speculation. The speculators who borrowed to buy more stocks obtained newly created purchasing media that became the profits of those who sold at higher prices; and when successful speculators bought new cars, new homes, etc., with their gains, the boom in business was augmented until, for a time, increasing business profits seemed to justify the rise in stock prices.

The outcome, when the great speculative bubble burst, was drastic deflation and accompanying depression. By mid-1932 the process of liquidating prior inflationary borrowings was completed. Hundreds of banks had failed as had thousands of others during the earlier similar periods, but the remaining banks had liquidated inflationary loans and were back to a sound basis. Also as on past occasions, a recovery of business began as soon as the necessary deflation with accompanying reductions in prices and wages was accomplished. By the fall of 1932, the recovery was well under way.

As it happened, however, a presidential election was held in that year. Although the President-elect had espoused sound money and had ridiculed assertions concerning threats to the gold standard, he permitted some close advisers to learn in December 1932 that he favored managed-

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money panaceas and that he intended to do something about the seeming shortage of gold.

The Banks Close

Soon rumors spread, and a run on the banks was begun by many depositors who feared that claims on gold would not be honored after the new Administration came into office. The run reached startling proportions during February 1933 as the President-elect declined to join with his predecessor in reassuring the public as to the new Administration's intentions. By early March every bank in the Nation was forced to close its doors, although nearly all were soon found to be in excellent condition and were reopened. (Most of the few that failed at that time subsequently paid depositors every dollar owed to them.)

In 1934 by newly-enacted laws all existing claim checks on gold were, in effect, reworded so that they became claims for about 40 percent less gold (i.e., only 60 percent of the original amount).

But the devaluation of the dollar failed to raise prices immediately and restore prosperity as some naive advisers had predicted. Another experiment, planned inflation as specifically recommended in detail by Lord Keynes, was undertaken. By again persuading the commercial banks to accept Government bonds in exchange for newly created additions to Treasury checking accounts, the Government's deficits were "monetized" in substantial part. The initial result was a short-lived boom that still left 7,500,000 unemployed; and the aftermath was one of the most extensive and most rapid business contractions in the Nation's history. By 1939 nearly 10,000,000 were unemployed.

World War II

Then came World War II with the repetition on a larger scale of the inflationary wartime financing of World War I. In fact, so great an amount of inflationary purchasing media was created and issued in monetizing Treasury deficits that the early recipients could not find the things they wanted to buy. New cars and new homes desired by individuals simply were not available, and businesses could not obtain new plant and equipment except for wartime needs. Consequently, a large portion of the inflationary purchasing media in the forms of both currency and checking accounts was hoarded or held idle until the postwar years.

Postwar Inflation

Instead of forcing deflation, as was done shortly after World War I, the Federal Reserve Board (the money-credit policy agency in the United States) continued its easy-money program, apparently influenced greatly by an Administration fearful of a great depression. (Many

Keynesian economists then were predicting a relapse into depression with millions of unemployed.) Without describing the postwar experience in detail, we simply note that inflation continued with only minor cyclical interruptions, each of which was cut short primarily by the continuing flow of hoarded inflationary purchasing media into circulation and secondarily by further monetizing of public and private debt.

By 1958 the economy of the United States, in relation to other leading industrial nations, had become like economy A in relation to economies B, C, etc., as described earlier in this discussion. Foreign claims on U. S. gold and foreign withdrawals of gold from the Nation's monetary system increased rapidly. Although some understanding of the situation was evidenced by the Federal Reserve Board when it pursued its tighter money policy throughout 1959, this policy was abandoned by mid-1960, apparently because a business recession was developing.

The Situation, November 1960

At this writing, we do not know whether the recession will become a depression or whether renewed inflation will be undertaken in an attempt to revive the business boom. That the latter action obviously would make an already bad situation worse may, or it may not, have a decisive influence on Federal Reserve Board policy and fiscal policies of the Federal Government.

In any event, another Monetary Commission now is at work attempting to analyze the Nation's money-credit problem and propose solutions. It seems safe to predict that, unless the basic principles of sound commercial banking are rediscovered and suitable measures for the transition to sound money and sound banking are adopted, satisfactory solutions of the Nation's money-credit problems will be indefinitely postponed. In the meantime the question whether the United States will become one more victim of money-credit follies, whether it may even be destroyed as inflation has destroyed many other nations, hangs in the balance.

Correct understanding is a prerequisite to wise action. You can help to promote correct understanding in the present crisis by distributing this bulletin.
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NTA Forum

Perspectives, Ideas and News from the National Tax Association

Winter, 1991

From the Editor

Most economists, it seems, agree that capital investment in the United States is smaller than it ought to be, maybe far smaller. Most seem also to agree that the immediate cause is that the cost of capital is too high. Somewhat fewer, though probably still a majority, feel that U.S. tax policy contributes significantly to the excessive cost of capital.

But how to change tax policy to stimulate investment? Beyond the consensus that reducing the budget deficit would help a lot, there is much disagreement among tax professionals. The Administration has emphasized reducing the tax on capital gains. Others prefer repeal of the corporation income tax or some form of corporate/personal tax integration. Some favor shifting reliance from income taxes, personal as well as corporate, to some form of consumption tax such as a VAT. Some like the idea of a corporate cash flow tax. And some emphasize saving incentives such as IRA's. All these policy options have been debated in recent NTA conferences.

In this issue Robert Aten, Vice President and Chief Economist for the Manufacturers' Alliance for Productivity and Innovation (MAPI), makes the case for reinstating a large investment tax credit. In light of the present economic slowdown, he argues that an ITC would be especially timely. One advantage is that it could be put in place more quickly than most of the other reform proposals.

For eighty-three years NTA has provided a forum for discussion of important tax policy issues of the day. The Association's membership includes representatives of many divergent tax viewpoints. The *NTA Forum* welcomes comments on Dr. Aten's proposal, as well as submissions of other material that will be of interest and value to a wide range of tax professionals.

An Investment Tax Credit: A Contribution to Efficiency



Robert H. Aten

This paper explains why high costs of capital in the United States have helped generate reduced equipment stocks available to U.S. manufacturing. Government itself has generated problems afflicting manufacturing in the form of budget deficits, regulation of the financial community, and tax policies that hinder equipment investment, productivity growth, and competitiveness.

To ease the burden of government-induced problems, it is proposed partially to compensate manufacturing by adopting a large investment tax credit (ITC). Although adoption of an ITC would generate non-neutralities within the U.S. tax system, larger non-neutralities would be eliminated. Apparently

(continued on page 2)

Hickman Presidential Address Stirs San Francisco Conference

It is not usual for the Presidential Address to attract much comment at NTA Conferences. This year was an exception, as is indicated in the following excerpt from Ralph Bristol's report in *Tax Notes* of November 26.

In addressing the opening session, Bristol reports,

"NTA president Frederic W. Hickman of Hopkins & Sutter, Chicago, delivered a scolding both to the field of economics and to the association's quarterly journal . . . and expressed concern for the organization. While praising the NTA for its broad approach and its efforts to bring together economists, lawyers, accountants, tax administrators and other tax practitioners, he fears that NTA may be losing

relevance just because of its strengths.

"The former Treasury assistant secretary for tax policy remarked that we live, unfortunately, in an age of specialization. Hickman underscored, however, that what we need are 'big picture' explanations, developing connections between events and people in the real world and drawing broad inferences from experience. What is happening is that people willing and capable of performing these tasks are losing out to the narrow specialists—the 'niche-niks.'

"Economics began as a moral science. Both Adam Smith and Alfred Marshall considered themselves to be moral philosophers, concerned with the ethical aspects of the subjects they

(continued on page 7)

NTA Forum

Number 6, Winter, 1991

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paradoxically, efficiency gains would be obtained from decreasing equipment taxation, which would increase differentials among related U.S. tax rates, and by reducing such differentials between the U.S. and key foreign tax systems.

A recent OECD report suggests that in the longer term, tax policy is subject to fashions. The reason is that:

"taxation is one of the most political of the instruments available to governments . . . Over the past ten years, there has been a move from an uncritical acceptance of tax incentives to their uncritical rejection. Perhaps the next stage in this cycle is an awareness that tax incentives, if used selectively, can be an effective instrument . . ." ¹

This paper explores the potential utility of the ITC in the light of the OECD staff comments.

The U.S. Cost of Capital and Its Consequences

The cost of capital or the expected pre-tax rate of return on investments is a key policy-influenced factor that helps determine business investment. The cost of capital is known to business as the "hurdle rate" that investment projects must meet or exceed to be selected. Higher U.S. costs of capital mean reduced private investment, as American manufacturers reject potential projects that are not warranted by expected profitability.

Over the long term, net stocks of capital equipment have grown far less rapidly in manufacturing than in other sectors of the economy (Figure 1.) Net stocks of equipment are a key capital input into U.S. productivity, and reflect the availability of equipment stocks after adjusting both for depreciation and for retirements from service. Part of the more rapid growth in non-manufacturing stocks reflects the natural evolution of an economy becoming more reliant on its service sector. Real gains in the 1980's in equipment stocks in finance, insurance and real estate (FIRE) and wholesale and retail trade (WART) contrast with the flat performance of manufacturing equipment (Figure 2.)

A higher cost of capital in the United States has contributed significantly to the decade-old acceleration of the relative decline of the U.S. net stock of equipment in manufacturing as a share of the GNP. These declines have ominous implications for the continued inter-

national competitiveness of U.S. companies, particularly given the large investments being carried out by foreign competitors abroad.

Recent adverse trends in the magnitudes of equipment capital stocks could have many possible causes. These include the rapid inflation of the late 1970s and early 1980s, the massive rise in the value of the dollar in the early 1980s, and two back-to-back recessions in the early 1980s. Some measurement issues may also be influencing the trends.

Resurgent efforts in manufacturing in the 1980s led to significant productivity increases and substantial management improvements. These productivity increases, real wage rises abroad, and declines in the U.S. exchange rate reduced the relative burden of high U.S. manufacturing wages. However, many tax policy changes have also been relevant. For example, depreciation is less generous now than in the 1970s, and the ITC was eliminated in 1986. The corporate tax rate fell significantly in 1986.

One cannot be sure how all these factors sort themselves out. However, federal tax incentives intended to create additional capital investment in the 1960s-1970s were successful over the longer term. The mix of factors influencing investment in the 1980s is clearly more complex, but there appears to be little reason to assume responsiveness to tax incentives is much different.

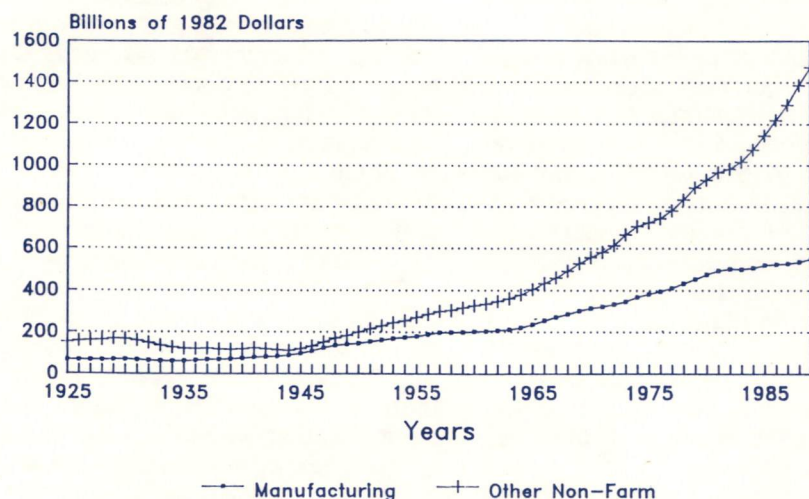
The Three Problems

The main thesis of this paper is that U.S. government inefficiencies directly increase the costs of capital to American manufacturing through (1) continuing massive structural deficits in the federal and state-local budgets when the economy is at or near full employment; (2) regulating the U.S. financial sector, including commercial banks, to require arms' length relationships with business in contrast to the much more intimate relationships permitted abroad; and (3) taxing American business in the United States in ways that have differentially more adverse consequences than arise from taxes imposed abroad.

Budget Deficits

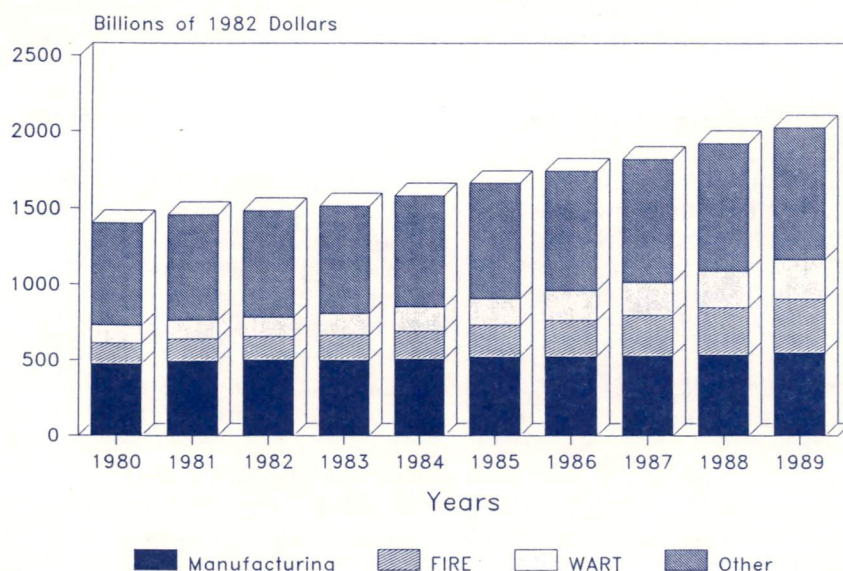
Larger business capital costs are generated by the higher real interest rates caused by the now apparently perpetual inability of the federal government to balance its budget. Recently, state-lo-

FIG. 1
NET EQUIPMENT STOCKS
BY MAJOR INDUSTRY GROUPS, 1925-89



Source: Bureau of Economic Analysis

FIG. 2
NON-FARM NET STOCKS OF EQUIPMENT



Source: Bureau of Economic Analysis

cal governments have also contributed to financial market pressures as their aggregate spending for operating and capital purposes has substantially exceeded their total receipts. To help reduce the cost of capital to business, the U.S. government should increase national saving and eliminate federal government dissaving by eradicating its deficit.

Conventionally, larger federal defi-

cits increase the demand by government for funds in the credit markets. Unless private consumption declines, this directly causes higher real interest rates. Rates also rise indirectly because holders of government bonds issued to finance deficits cause purchasers to feel wealthier and hence to spend more.

The last decade has seen a resurgence of interest in a reformulated Ricardian equivalence proposition (RE) which

challenges conventional views. Challengers believe that larger federal budget deficits do not generate higher real interest rates. Purchasers of bonds issued to finance such deficits do not feel wealthier because they know that a larger current deficit implies higher future taxes to repay the bonds. Bondholders therefore consume less and save more when a deficit is financed with debt so they will be able to pay expected higher future taxes required to repay the bonds. Thus, consumption does not change whether a deficit increase is financed with taxes or with debt. Therefore, real interest rates are not affected by increases in government debt.

As the United States does not pay down its federal debt, RE seems false on its face. Although RE may be partially true, it must be completely true before there would be no deficit-caused effects on real interest rates.

The failure of the federal government to eliminate its structural deficit remains economically indefensible. The FY 1991 budget deal, obtained with such effort, still implies a massive federal deficit through fiscal year 1995. Thus, the federal deficit will continue to increase real interest rates, which will raise the cost of capital and reduce investment. This problem is exacerbated by declining inflows of foreign capital.

Financial Market Structure

One example of problems with financial market structures that adversely affect capital costs arises in commercial banking. Treasury recently announced that it would soon recommend legislation that could eventually have the desirable side effect of permitting closer working relationships between U.S. banks and American manufacturing.

Foreign experience suggests substantial reductions in the cost of capital are potentially available from closer relationships between commercial banks and manufacturing. However, government policymakers are anxious about providing additional flexibility to banks. The federal guarantee of \$100,000 per account in checking accounts and comparable deposits provides a substantial and continuing incentive for risky behavior by commercial banks, partially mitigated by higher capital requirements than were historically available in the troubled savings and loan (S&L) industry. The dilemma is that few really want to elimi-

nate or much modify the deposit guarantee. However, policymakers will be reluctant to take steps that would encourage closer relationships that could be seen as a possible repeat of the S&L crisis in commercial banking.

As a result, policymakers will not soon be willing to encourage commercial banks to provide U.S. manufacturing with the kind of financial support and advice readily available to German and Japanese firms. Instead, the relative interest-rate contributions to the U.S. cost of capital from differing financial structures will remain unacceptably high.

There are other examples of problems of financial market structure that also add to the cost of capital. For example, state "blue sky" securities laws adversely affect the costs of raising equity funds in U.S. markets compared with costs overseas.

Tax Policy Affecting Investment

Current U.S. tax policy adversely affects investment. Examples include U.S. continuation as the only developed nation that utilizes full double taxation of corporate dividends, and the retention and expansion of relatively high U.S. tax rates imposed in the name of equity on sources of funds for investment and on investment returns. These U.S. policies lead to tax-induced behavior that encourages shifting manufacturing jobs outside the United States. These decisions, while efficient for the firms involved, are inefficient for the U.S. economy as a whole.

In a market economy, economic efficiency is not well served by a government industrial policy that targets specific industries or sectors of the economy for subsidy. However, such subsidies may be justified economically if there are government-generated non-neutralities that adversely affect particular industries. Were U.S. manufacturing able to compete on an equal footing, particularly with comparable firms from foreign nations, appropriate U.S. tax policy would be to deny requests for special tax treatment. However, government-generated non-neutralities have become a major source of manufacturing problems, helping to lead to the 1980s declines in equipment stocks as a share of the GNP. In these circumstances, there is a powerful case for intervention to remedy problems government itself has caused.

Two government-induced problems

will not be resolved in the short or medium run--the federal government's structural budget deficits and the continuation of unnecessary arms' length relationships between U.S. manufacturing and U.S. commercial banks.

These problems have adverse consequences for equipment investment too critical to permit adoption of a policy of waiting for potential long-term solutions to be achieved, solutions that may not occur. Instead, manufacturing should be compensated for its additional cost of capital arising from government-induced hindrances to investment. Compensation should be temporary, subject to reversal when the federal government eliminates its budget deficit and permits substantially closer relationships between manufacturing firms and commercial banks.

The adoption of a carefully organized, fiscally balanced package including an ITC to reduce equipment investment costs for American manufacturing by about \$40 billion, financed by offsetting tax increases on consumption, would be a reasonable and promising response to the government failures discussed here.

Tax Rate Differentials and Economic Efficiency

The main tax policy problem now facing the United States involves extending and enhancing the Tax Reform Act of 1986 (TRA) to design and implement globally efficient tax policies for the United States that would permit American firms to compete effectively on a worldwide basis.

TRA was the culmination of long efforts to focus tax policy on economic efficiency. The deal that produced TRA included elimination of the ITC. Proponents of TRA fear that adopting an ITC would lead to questioning of other desirable changes enacted in 1986, such as lower tax rates. Many tax analysts also believe that the U.S. tax system should be structured only to raise revenues to finance government and not to direct resources to specific sectors of the economy through "tax incentives." For them, proposals to adapt the U.S. tax system to compensate for other government "failures" are automatically rejected. These perspectives by themselves should not prevent the enactment of improvements in tax policy.

In TRA, considerations of economic efficiency were raised to a high level of

concern. Because of the perspectives underlying TRA, many tax analysts now believe that economic efficiency requires that every dollar of income be taxed at the same tax rate. They believe that while enacting an ITC might help solve government-induced problems, such a tax would be inefficient nonetheless because it would induce inter-industry differentials in tax rates. However, on theoretical grounds, differential tax rates successfully targeted to improve efficiency will, properly structured, normally be more efficient than equal rates.

The key factor in measuring the efficiency of a tax is the excess burden it generates, or the additional costs it imposes on the economy in addition to the tax collections obtained by government. Another way to say this is that efficient tax policy searches for neutrality. Non-neutral taxes induce behavioral changes as taxpayers seek to minimize taxes. In addition to the pre-tax price and quantity of the taxed item, three main factors affect the excess burden of a tax change. These are the sensitivity of product demand to changes in market price, the comparable sensitivity of product supply, and the tax rate. The more sensitive either demand or supply is to price, or the higher the tax rate, the larger the excess burden. Approximately, these various factors are related multiplicatively to produce a measure of excess burden.

Keeping tax rates low generally reduces excess burden. Moreover, the nearer any pair of tax rates are to each other, all else equal, the smaller the incentives to change economic behavior to avoid taxation from those rates, and the smaller the excess burden. These are the key implications of excess burden analysis that led to the tax changes intended to enhance economic efficiency that were enacted in TRA.

All other factors are not equal. Every taxed product offered by every firm probably has a different sensitivity to market prices. As a result, if minimizing excess burden from taxation, or true neutrality, is a major goal for determining the appropriate level of business taxation, more equal tax rates, while reducing excess burden derived from the tax rate, will not necessarily be successful. In 1927 Frank Ramsey showed that to minimize excess burden or to achieve true neutrality when rates are not exactly equal, the correct tax rate must decline as price sensitivities

rise. Excess burden may also be reduced and true neutrality approached by less than perfect tax rates, so long as they respond approximately to the appropriate price sensitivities.

Manufacturing faces more fierce international competition than many other sectors of the economy. Most U.S. exports (about 85 percent) are of manufactured products. This puts manufacturing in a separate category from many financial market activities, nearly all real estate and wholesale trade businesses, and most retail trade businesses. Equipment stocks expanded most in these other sectors in the 1980s. More competitive international markets for manufacturing products have led to higher price sensitivities there than in most other sectors.

All tax policy is compromise. Because price sensitivities probably are higher in manufacturing, excess burden would be reduced and true neutrality enhanced by lower tax rates for the manufacturing sector. One way to do this would be to adopt an ITC benefiting manufacturing equipment.

In addition, to minimize excess burden and increase true neutrality, U.S. tax policy should take the tax policies

followed by major competitor countries into account. Large government-induced non-neutralities are created in U.S. manufacturing by such international tax differentials. These probably outweigh any non-neutralities within the U.S. between manufacturing and other sectors generated by differences in tax rates. Thus, if other U.S. government policies generating non-neutralities with the Japanese continue, then tax subsidies would need to be correspondingly higher in the United States to permit U.S. manufacturing to remain competitive. For example, if U.S. manufacturers are to be able to compete successfully with Japanese firms without being unduly harmed by government-induced burdens, an ITC adopted here should more than match any Japanese ITC.

To reduce excess burden generated within the U.S. tax system, the ITC adopted should probably be calculated as a percentage of the present value of depreciation permitted on equipment.

Macroeconomic Balance

Intense efforts would be required in the current U.S. policy environment to enact an ITC, as additional revenues to finance it would have to be found.

Expenditure reductions to finance needed tax reductions must also occur, or else necessary declines in government deficits will not be achieved, and a large share of needed reductions in the cost of capital will not occur. Financing an ITC with increased corporate taxes would be counterproductive, as, for example, higher corporate rates or reduction in the corporate interest deduction would also discourage needed investment. Thus, to offset the revenue loss from an ITC and attain additional needed deficit reductions probably also requires adoption of a major tax increase on consumption.

The objection that consumption would be damaged by the adoption of such a tax has little merit. U.S. consumption, consisting of the sum of government and private consumption, is at its highest level ever as a share of net national product. U.S. Consumption has been higher in the last several years than in the early 1980s and much higher than in past decades, largely because of major increases in such factors as debt-financed government transfer payments that aid private consumption. Moreover, consumption will have to decline anyway to shift production to exports, as will happen to finance the additional debt service the United States will have to pay in coming decades to fund the effects of past and continuing trade deficits. However, a choice remains as to whether the necessary reduction in U.S. consumption will occur through that portion financed by government transfers or from the pockets of the U.S. working population. The former approach would imply a policy of reducing increases in government spending.

The working population would be adversely affected by the other possible policies--doing nothing about the federal deficit or increasing taxes. Doing nothing implies a cheaper dollar, increased exports, and, necessarily, concurrent reductions in private consumption, probably not greatly different from the reductions from increased taxes. The bottom line is that consumption will decline as a share of GNP no matter what government does.

The U.S. economy will experience at least one quarter of decline in the fourth quarter of 1990. Adoption of an ITC now would provide American manufacturing with the tax incentives it needs to compete successfully with foreign firms. For those with a Keyne-

How Should States Tax Business?

If you are concerned over issues of how, or even whether, states should tax business, you should plan to attend the NTA Seminar on State Business Taxation to be held in San Antonio March 7-8, at the La Mansion del Rio Hotel.

Present day state business tax systems are a hodge-podge, a product of incremental changes over the decades. Many tax laws have been rendered obsolete by technological and economic change. Revenue pressures, along with uncertainty about just what to do, have delayed reform. Concern over international competitiveness gives new urgency to the problems.

The Seminar "How Should States Tax Business?" will address fundamental issues of business tax policy, as well as current issues affecting many industries. Among the topics are:

- The Economics and Politics of State Taxes on Business
- State Taxation of Corporate Income in a Global Setting
- Reducing Corporate Tax Administration and Compliance Costs
- The Business Activities Tax -- A Viable Alternative?
- Taxation of Multistate Financial Institutions
- Telecommunications Taxation in an Era of Deregulation
- How Should States Tax Insurance Companies?
- Environmental Taxes and Fees on Business Activities

The Seminar has been organized by a committee chaired by Prof. Tom Pogue of The University of Iowa.

The detailed program and registration materials will be mailed in early January.

sian bent, an ITC would also add to investment spending at a highly desirable time in the business cycle. The case for an immediate ITC merely to increase investment spending to help bail out the U.S. economy is quite strong, regardless of other considerations.

In an environment in which world markets are expanding, U.S.-based multinational manufacturing firms, with plants both here and abroad, will have to decide where to make additional investments. The weak dollar now suggests making the investments in the United States. However, the growing markets are now abroad, and the need to be close to markets suggests making investments abroad. Without federal government action now to reduce significantly the extra burdens government imposes on U.S. manufacturing firms, businesses are more likely to invest and create more jobs abroad. An opportunity will be lost to create more jobs in the United States.

Conclusion

An ITC targets benefits directly to investment, encourages rapid writeoffs on equipment, limits benefits to productive activities likely to help increase exports, and builds on the capacities of those who already know best how to increase productivity -- American manufacturers. In addition, adoption would take advantage of the cheap dollar to help reduce the trade deficit and increase the momentum of U.S. manufacturing exports.

U.S. policymakers should understand the bottom line -- American manufacturing will be disadvantaged by the continued high cost of capital in the United States. Without partial removal of the undue burdens imposed by government on business, and exacerbated during the 1980s, there will be much less manufacturing growth in the United States by American firms. It is time to adopt an ITC on the grounds that it will efficiently help speed economic recovery, and help stimulate capital investment.

¹ J. Owens, OECD, "Tax Reforms in OECD Countries: Objectives and Achievements," in *Taxation and International Capital Flows* (OECD, June 1990).

Robert H. Aten is Vice President and Chief Economist, Manufacturers' Alliance for Productivity and Innovation

Survey of Research in Progress

January 1 is the deadline for researchers to report to the NTA office on their current ongoing research. The reports will be summarized in the Association's third annual *Research in Progress on Taxation and Public Finance Topics*, to be published in February.

The first two issues of this report have proven its value to both producers and consumers of research:

- Researchers have been able to learn who is working on related topics.
- Those needing current information or expert advice or testimony have been able to identify and contact persons with active research programs in the area.
- Planners of NTA conferences have made use of the survey in designing their programs.

If you have an ongoing research project or interest, please send in your report *immediately* to the NTA office, using either the report form sent last October to all NTA members or the similar one in the back of the June 1990 issue of the *National Tax Journal*.

Last Call: Seminar on "Critical Issues in Sales Taxation"

There is still time to make plans to attend the NTA Seminar on "Critical Issues in Sales Taxation", to be held January 10-11 at the Omni Royal Orleans Hotel in New Orleans.

State Budget and Tax News, in its October 17 issue, comments on this seminar that . . .

"Scheduled panelists are the heavy hitters from all teams on issues like taxing services, goods shipped across state lines, newspapers and magazines and non-profits. Speakers are a who's who of the top lawyers, corporate tax administrators, state tax administrators, and researchers on these issues. The same issues and many of the same players will be appearing at a state near you in the spring."

We could not have said it better ourselves.

Full details and registration information were mailed to all members in early October but if you need another set, call the NTA office.

Twenty-five Years Ago with the NTA

The Economic Role of Federal Deficits

"In the future, the level of taxation will be related not only to the level of expenditure, but to the desired level of deficit or surplus in the budget. In the past, the two elements, tax revenues and expenditures, have been mutually interrelated in such an intricate manner that even the participants in the formulation of the budget would find it hard to say which was the independent and which the dependent variable. A possible deficit has been a constraint on expenditures and a surplus has been generally desired but seldom realized. We now have embarked on an experiment in fiscal policy in which the deficit or surplus is made a third element for separate consideration. Some of us

are fearful that the new policy will lead to excessive deficits and consequent inflationary pressures. But we must recognize that a deficit is now not necessarily regarded as a limiting factor holding expenditures down and taxes up. It is an end in itself which may permit increases in expenditures or reduction in taxes even when a deficit already exists."

Dan Throop Smith, Professor of Finance at the Harvard Graduate School of Business, speaking on "Changes in the Nation's Tax Structure" at the Fifty-Eighth Annual Conference, New Orleans, November 9, 1965. Prof. Smith was formerly Deputy Secretary of the Treasury and a former President of the Tax Institute of America.

Survey of Emerging Research Needs in Federal Taxation and Finance

The NTA Committee on Federal Taxation and Finance, chaired by Pamela J. Pecarich, has just completed a survey of research needs as perceived by key people involved in federal tax policy making. The survey covered the tax writing committees of the Congress, the Congressional Budget Office, Office of Tax Analysis, and the Office of Management and Budget, among other organizations.

The first ever of its kind, the survey is designed to forge a closer link between the tax research being done and the tax policy process. Respondents were asked to think at least a year into the future to identify issues on which policy decisions are likely to be required but where present knowledge and understanding are deficient.

For example, in the *international* area a need was identified for more research on:

- tax-transfer systems in emerging democracies;
- reform of Subpart F of the IRC as related to tax treatment of earnings generated in Eastern Europe, the USSR, China and Third World countries;
- taxation of income from US financial assets held by residents and non-residents;
- effects of capital gains taxes on foreign investors; and
- the impact of various proposals for modifying foreign tax credits, trans-

fer pricing rules, cost allocation rules, and for extension of US capital gains tax to shares held by non-resident aliens.

Other areas in which specific research needs were identified include federal budgetary reform; taxation of capital; effects of disparate tax treatment of investments for retirement; estate and gift taxes; evasion of federal motor fuels taxes; and harmonization of federal and state taxes.

Members may obtain a copy of the survey summary from the NTA office.

Hickman, continued from page 1

studied. While Marshall felt mathematics could be used to illuminate many aspects of economics, the math was never an end in itself, but rather a scaffolding, to be discarded once the edifice was constructed and explained. Economics today has descended from its earlier state.

"As evidence, Hickman reported on a critical survey he had conducted of the 32 articles published in the National Tax Journal over the last 12 months. Only 5 of these articles could be considered 'big picture' efforts, and half of the total were econometric exercises which, as he put it, were not meant to be read but to be solved. Too many of the articles succumbed to the Pooh-

Bah effect, being mere 'corroborative evidence, to lend artistic verisimilitude to an otherwise bald and unconvincing narrative.'

"Only a few of the articles focused on the expenditure aspects of public finance, and no attention was devoted to current problems such as the impact of deficits or the description of appropriate tax bases in the presence of factors that are mobile, both nationally and internationally. There was no discussion as to the validity of the argument that starving revenues will restrain spending, as the Reagan Administration argued for 8 years. (Later in the program, University of California political scientist Aaron Wildavsky characterized this as the Childrens' Allowance theory: 'If they ain't got it, they can't spend it!'.) Hickman concluded with a plea for increased relevance by/ of the Association."

Bristol ends by commenting that "Hickman was unduly harsh on the National Tax Journal. Of all the professional journals devoted to economics in its many branches, one would be hard pressed to find a publication providing greater relevance or containing more articles devoted to practical, real-life policy problems. While it is not entirely free of 'corroborative detail' or mathematical esoterica, the NTJ is practically a 'How To' manual, next to most economics journals."

Hickman's Presidential Address, which was much discussed throughout the three-day conference, will be published in full in the Annual Conference Proceedings.

We invite you to join us in our work

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My check for \$_____ is enclosed for the payment of annual dues. I understand that \$40.00 of my dues (\$45.00 for foreign members) covers the subscription cost of the *National Tax Journal*, and that I will receive the *Proceedings of the Annual Conference* and all other publications of the Association at no additional cost.

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New Members

The Association is pleased to welcome the following new members who have joined between August 1 and November 30, 1990

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FISCAL POLICIES AND THE WORLD ECONOMY

An Intertemporal Approach
Jacob A. Frenkel and Assaf Razin

"This fine book is the first attempt, and a very successful one, to develop the new classical economies in the context of an open economy. No serious student (or teacher) of international economics can afford to do without this work." — Rudiger Dornbusch, MIT

1989 — 504 pp. — \$15.95 paper
0-262- 56049-6 FREFF

REAL EXCHANGE RATES, DEVALUATION, AND ADJUSTMENT

Exchange Rate Policy in Developing Countries
Sebastian Edwards

Sebastian Edwards provides a unified theoretical and empirical investigation of exchange rate policy and performance in scores of developing countries. He develops a theory of equilibrium and disequilibrium real exchange rates, takes up the question of why devaluations are the most controversial policy measures in poorer nations, and discusses what determines their success or failure.

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1989 — 371 pp. — \$35.00
0-262- 05039-0 EDWRH

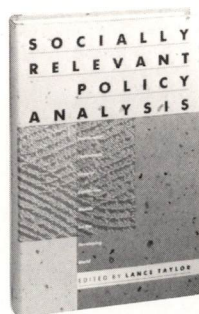
SOCIALLY RELEVANT POLICY ANALYSIS

Structuralist Computable General Equilibrium Models for the Developing World
edited by Lance Taylor

"Taylor is very original, and his attempt at going beyond the straightjacket of most neoclassical CGEs is most welcome and useful." — Jaime de Melo, Senior Economist, The World Bank

Economist Lance Taylor is an advocate of aggressive government management of developing economies. This collection of work reviews the results of using CGE models since the early 1970s, with an emphasis on models that encompass broad structural factors such as distribution of income and wealth, land tenancy relationships, foreign trade, production, markets, and control of the means of production that are fundamental to the behavior of developing economies. Taylor's detailed discussion of structuralist CGE models is followed by contributions that take up their application in specific countries.

1990 — 379 pp. — \$37.50
0-262-20075-9 TAYSH



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"Buy Shiller's book and think on its contents. Learn what the October 1987 crash was really about." —Paul A. Samuelson, MIT

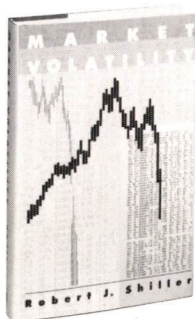
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Robert J. Shiller

Backed by substantial statistical evidence, Shiller proposes an innovative theory on the causes of price fluctuations in speculative markets. He challenges the standard efficient markets model for explaining asset prices by emphasizing the significant role that popular opinion or psychology can play in price volatility.

"It is no exaggeration to say that some of the essays in this book have dramatically altered the way academics think about the efficiency and volatility of speculative markets . . . It should be read by anyone with a serious interest in the functioning of markets." —Richard A. Grasso, President and Chief Operating Officer, New York Stock Exchange, Inc.

1990 —464 pp. —\$35.00
0-262-19290-X SHIMH



THE EVOLUTION OF CENTRAL BANKS

Charles Goodhart

Goodhart employs a wide range of historical evidence and reassesses current monetary analysis to argue that the development of non-profit-maximizing and noncompetitive central banks to supervise and regulate the commercial banking system fulfills a necessary and natural function.

1988 — 224 pp. — \$13.50 paper
0-262-57073-4 GOOEP

NUMERICAL TECHNIQUES IN FINANCE

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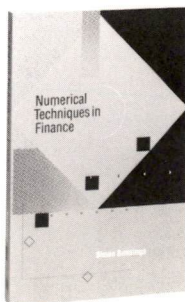
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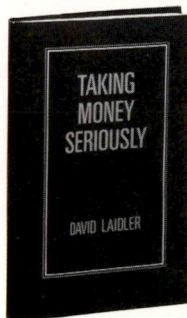
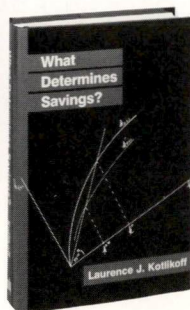
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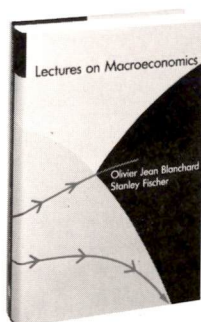
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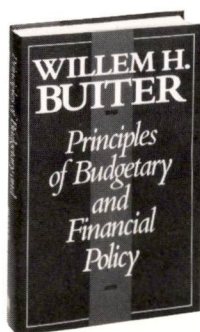
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PRICE MOVEMENTS OF BUILDING SITES IN THE UNITED STATES — A COMPARISON AMONG METROPOLITAN AREAS

by Sherman J. Maisel*

1. INTRODUCTION

Cost of building sites for urban development in the United States have experienced extremely sharp increases since 1950. An advance of over 160 percent between 1950 and 1962 (see Table 1) was recorded in the only available general index—that of the average price of developed lots used for the building of new single-family houses with mortgages insured by the U.S. Federal Housing Administration (FHA). This contrasts with a rise of less than thirty

TABLE 1: Price of Building Lots for New Houses
with Mortgages Insured by FHA,
U. S. Average, 1946-1962

Year	Market price of site, dollars	Site as percent of total price of house and lot
1946	761	11.5
1947	893	11.8
1948	1,049	11.7
1949	1,018	12.0
1950	1,035	12.0
1951	1,092	12.1
1952	1,227	12.0
1953	1,291	12.7
1954	1,456	13.1
1955	1,626	13.4
1956	1,887	14.1
1957	2,148	14.9
1958	2,223	15.4
1959	2,380	16.7
1960	2,492	16.6
1961	2,594	17.1
1962	2,715	17.5

Source: FHA Annual Reports

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*Newly appointed to Fed. Res. Bd. of Govs.,
4-65.*

percent for the general price level. In states of rapid growth, such as California, the increase has been still sharper. Thus, in San Diego, average developed site values rose from \$1,344 in 1950 to \$4,813 in 1961.

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Whereas at the start of the post World War II housing boom it was possible in many cities to buy developed lots in tax sales at less than the cost of their improvements (i. e., with a negative raw land value), by 1962 prices for raw land of over \$10,000 per acre were common in high land price areas even at the fringe of urban development. While the rise in land prices has been general, it has also been highly diverse. The amount paid for land varies tremendously among Standard Metropolitan Statistical Areas (SMSA). Thus, in 1960, the value of "suburban" developed sites clustered about \$1,400 for such cities as Providence, Rhode Island; Chattanooga, Tennessee; and Tacoma, Washington. In Honolulu the value was over \$6,500, and it was more than \$4,000 in Los Angeles and San Diego.

This article offers an insight into some of the forces which have brought about these rapid price increases and their continuing diversity. It accomplishes this through the use of a cross-sectional analysis based upon a comparison of both the level and changes in lot prices among 86 Standard Metropolitan Statistical Areas.

2. THE MODEL

In a previous report, I discussed a general theory of prices for suburban building sites and illustrated the major concepts with data from California and the San Francisco Bay Area.¹

Most theories of urban rent show land prices dependent on the size of cities, the population density, income, terrain, and transportation cost. Rents or land prices are explained by a model which assumes that employment and other desired transportation objectives lie in the center of the city. People who do not dwell in the downtown area must pay transportation cost—both real and imputed—to reach the center. Total costs depend upon the distance and terrain to be covered, the income lost in travel time, and actual transportation charges. People who live in the center can avoid these costs, but to do so they must pay equivalent rents to the owners of the land. Moreover, land will not be free even at the fringes of the city. At the margin of development, builders must pay land owners sufficient sums to make it worthwhile to withdraw the land from agricultural or other uses.

As a result, the idealized theory of rent shows a rent surface with values at the margin dependent on alternative uses and which then rise steadily to the center. The gradient, or rate and amount of increase as one approaches the center, depends on distance, density, income, and transportation costs. It is recognized that topography, public facilities, status, and costs will not exist in the idealized manner. Consequently land uses and prices will vary from the model, but the basic analytical concepts are still deemed applicable.²

¹ Sherman J. Maisel, "Appendix" in: State of California, Governor's Advisory Commission on Housing Problems, *Report on Housing in California*, Sacramento, State Printing Office, 1963, pp. 221-281.

² See, for example: Herbert D. Mohring and Mitchell Harwitz, *Highway Benefits*, Evanston, Ill., Northwestern University Press, 1962, ch. v.

Rent theory of this form is primarily static. In a more dynamic model, we must consider the possible impacts of expectations and of normal or artificially induced lags in the adjustment of supply to new demand. As was well recognized by Ricardo and Malthus, and particularly stressed by Henry George, land subject to development will gain value simply as a result of the passage of time if population density and income increase. This causes the selling price of land to depend not only on its alternative present uses but also on the discounted value of future returns. While all agricultural land may gain value as a result of future expectations, land with prospects of future urban use will have still higher present values. The amount by which suburban land prices will exceed their values as farms will vary among localities depending upon the rate of growth in density and income of each particular urban area. ✓

A further dynamic factor arises through normal lags in the rate at which agricultural land can be brought into urban use. Public utilities and facilities must be extended. Transportation and highways must be built. The actual process of subdividing takes time. Artificial lags may be introduced if land-owners believe it worthwhile to hold on to land until still higher prices are gained. Such supply lags are additional reasons for the prices of land actually going into development to exceed by considerable amounts their simple agricultural values.

It is this dynamic model of suburban land values that we desired to test. Because of their importance we would have liked to say something about the static theory and the rent gradients within localities, but we had no prices reflecting these forces. Our basic information refers primarily to suburban land in the process of development.

According to our model, prices of land for development should depend in the first instance on the prices of agricultural land. Variations from this level should depend upon rates of urbanization, cost and income levels, population density, and perhaps on the distributions of population and jobs. The hypothesis that suburban land values will vary with these factors is tested by correlation and regression.

3. THE DATA

Our basic dependent variable is the estimated market price of sites used for new one-family houses purchased with mortgages insured by the FHA. A national average (mean) for this value has been published regularly by that agency. In addition, an average value for particular Standard Metropolitan Statistical Areas was published for 1950 and annually since 1955. For a specific SMSA to be included there must be a minimum number of insured new houses. Because some SMSA's are not included in all years, our work was based on 86 areas for which data appeared in each of the years 1950, 1956, 1960, and 1961.³

Because of the nature of FHA operations, these data cover primarily houses built in newly developed tracts lying in the suburban parts of each SMSA. The houses insured by FHA tend to lie near the margin of development. These prices suffer in comparability because the average lots vary in size from one part of the country to another. Also the costs of street improvements and ✓

³ For specific source references see APPENDIX to this Paper.

rough grading are included, and these will differ somewhat among localities. As noted previously the range of site values among the SMSA's in 1960 was over \$2,600 on the continent and over \$5,000 if Honolulu were included. The average cost of a suburban building site in the most expensive continental city was nearly 300 percent that of the cheapest.

The independent variables shown in Table 2 cover various measures of population, income, growth, and farm land values. The values of agricultural land per acre for each SMSA are collected at the times of the Agricultural Census. We utilized the reports for 1954 and 1959. The average values of farm land per acre are published by states for each year. These prices, both in absolute and in index numbers, are issued by the U. S. Department of Agriculture Economic Research Service in *Farm Real Estate Market Developments*.

Other variables were taken from the decennial census. These included population, area size, and income for both 1950 and 1960. Data are available for entire SMSA's and for the divisions of each into the central city or cities and the surrounding ring. From the 1960 Census alone, data are available on work places and the relation of jobs and housing again by divisions into the central city and ring.

Finally, from the FHA we obtained the average cost of new houses in each SMSA for each period. We also utilized information on the average size of lots for each of 72 insuring offices in 1962.

Clearly the data are far from ideal. They differ from the exact concepts which one would attempt to measure if he were starting a survey *de novo* and were not dependent on administrative data. Most serious of the flaws are those concerned with the dependent variable. The location of the land built on in each year will not be at the exact margin of development. It may contain differing degrees of amenities. The size of lots and the cost of their improvements may also change over time and from one location to the next. The share of the FHA in each market varies both over time and compared to other cities at any particular time. On the other hand, the use of FHA data as a basic source has the great advantage that the information is gathered by trained appraisers interested in accuracy and paid to analyze the cost carefully in order to make an important economic decision.

Finally, of course, one must state the traditional qualification for any tests based on multiple correlation, and particularly for those which correlate observations for areas rather than for households or other more basic decision units. We have tried to avoid some of the more obvious weaknesses of the correlation technique by fitting our model to one period and then both "forecasting and backcasting" in order to see whether or not the same relationships held in other periods. Also we were not satisfied with simply testing the status of the variables in each period, but attempted the more difficult task of relating the values at each time to the changes from one period to the next.

One can also argue that the standard metropolitan areas are the true observation points one should be concerned with in attempting to explain divergent land prices. The land value model is not based primarily on theories of action by individuals or firms. It attempts to explain why prices in each area vary and why diverging rates of change occur among the cities. For this purpose observations on such factors as the area's density, average income,

etc., are pertinent. The decision unit is actually the area rather than the individuals within it.

4. THE TESTS

Simple Correlations. For the purpose of testing the significance of the variables in our model, we utilized a step-wise multiple regression program. Table 2 shows the relationships of the simple correlation coefficients for the final model. We might point out that prior to this stage we utilized various alternative definitions of the density, growth, and distribution variables. These included such factors as absolute population, rank size, household change, new dwellings, and central city and ring densities. In each case there was a high correlation among the different observations of the same basic variable. The particular observation employed seemed to make but slight difference in the final tests.

We note from Table 2 that the highest simple correlation exists between the agricultural value of land within an SMSA (2) and the value of building sites (1). Clearly, however, these are not independent variables. According to our model we would expect that the amount paid for building lots would depend on the value of the land for alternative uses, particularly agriculture. At the same time, the value of agricultural lands in SMSA's should be influenced by prospective prices as building lots. ✓

It is clear from the respective means that while the variances of lot prices and the average value of agricultural land in SMSA's are related, the actual values differ greatly. The average value per acre of developed sites is nearly fifteen times as high as the value of agricultural land in the same SMSA. Part of this difference reflects the cost of development. However, the differences in the means primarily reflect the sizeable acceleration of land values which occurs as land previously used as farms is encroached upon, and as it becomes eligible for urban development. While differences in agricultural land values are significantly related to variances in prices of urban lots, we note from the final regression that their share of the total variance is less than a third. ✓ ✓

Table 2 shows that the correlation between the values of agricultural land inside SMSA's and building lots is considerably higher than that of agricultural lands elsewhere in the same state (3). This higher relationship we assume reflects the impact on farms within the SMSA's of future expected urban values. One notes that the level and change in state land costs during this period were highly related to growth in population and income. This reflects among other forces the high growth rate of California and Florida, where land for the state as a whole is both expensive and has grown rapidly in value. The relationship is considerable between increased prices of agricultural land and growth of SMSA's and their own farm values. The absolute value of agricultural land prices within SMSA's remains, however, a third higher than in the remainder of their states. ✓ ✓

Significant relationships also exist between lot prices and the amount spent on houses (4) and income (5). Again this follows the hypothesis of the model. The house prices reflect the amount families will spend. It is highly determined by their incomes but also by their tastes with respect to housing standards (higher prices reflect demands for more space and comfort) and by building

TABLE 2: Matrix of Simple Correlation Coefficients* for Status Variables
for 86 Standard Metropolitan Statistical Areas; 1960

Variable	Number	Symbol	Mean	Variable number										
				1	2	3	4	5	6	7	8	9	10	11
FHA value of building site	1	(V)	\$ 2,434	1.000	.594	.395	.452	.403	.330	.240	.214	.020	-.163	-.268
Value of farm land in SMA	2	(FSMA)	\$ 433		1.000	.494	.314	.363	.353	.225	.230	-.114	-.231	-.197
Value of farm land in state	3	(FST)	\$ 338			1.000	.120	.163	-.198	.635	.339	-.161	-.336	-.299
FHA price of new house	4	(PR)	\$12,721				1.000	.434	.184	-.088	.182	-.020	-.137	-.159
Average census income in 1959	5	(Y)	\$ 6,020					1.000	.396	-.089	.346	-.003	-.312	-.277
Log population density	6	(LPOP)	2.647						1.000	-.337	.151	.030	-.134	.060
△ population 1950-60	7	(△POP)	35.7%							1.000	-.002	-.121	-.020	-.280
Percent population in ring	8	(RIN)	43.7%								1.000	-.088	-.951	.116
Percent in ring who commute to central city	9	(RCO)	40.3%									1.000	.162	.091
Percent employed in central city	10	(CC)	57.5%										1.000	-.089
Average size of lot (in acres)	11	(Lot)	.343											1.000

Source: see APPENDIX.

$$* r_{ij} = \frac{\sum (x_i - \bar{x}_i) (x_j - \bar{x}_j)}{\sqrt{\sum (x_i - \bar{x}_i)^2} \sqrt{\sum (x_j - \bar{x}_j)^2}}$$

costs. Positive forces among any one of these factors should lead to higher prices for developed land. The level of income is expected to raise land values directly. It also, however, is reflected in higher expenditures for housing in general.

The log of the population density (6) has a simple correlation of .33 with the prices of building sites. This is virtually the same relationship as the log of population density has to the value of farm land in the SMSA's. Interestingly enough, however, there is a negative correlation between the density of metropolitan areas and the average value of farms in the states in which they are located. We employ the log of population rather than its absolute value in order to increase the homoscedasticity of the variable. Because the range in population from 150,000 in Lubbock, Texas to over 10 million in New York is much more extreme than for other variables, the log of density appears to be a more logical variable, but the use of absolute values would give nearly the same effect in the final results.

✓✓
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farms

The percentage growth in population (7) in an area from 1950 to 1960 has a correlation of .24 with the average value of building sites. Here a variable measuring change and one measuring absolute levels are being related. While the model says growth rates should affect values, there is no indication of how long a period must be considered. The present values of land are a reflection of many past periods of growth. On the other hand, we noted already a very high correlation between population growth and land values in states. This may simply reflect the fact that the population migration during this period was to areas which have very specialized farming and high land values.

Variables (8), (9), and (10) are measures of the distribution of the population and jobs within an area. Variables (8) and (10) are almost reciprocals of each other. The first measures the percent of the population living in the ring in 1960, while the second measures the percentage of the total SMSA employed whose jobs are in the central city or cities. Clearly the higher the percentage who live in the ring, the higher the percentage who work there. This is further reflected in the fact that viturally no correlation exists between the percent of ring dwellers who commute and these other variables. All of these distribution variables also have low correlation with the values of building sites.

psf?

The final variable, size of lot, (11), has a negative correlation with the value of lots. This is almost certainly explained by traditional economic theory which points out that we will economize on scarce goods; or that the higher the price per foot of land the less we will use for our house. This means in effect that the size of lot tends to be a dependent variable when related at one point in time to prices. It is unfortunate that we do not have measures of the changes in lot size over time. Our previous study showed that about 20 percent of the increased costs of lots in California in the past decade arose from the fact that people increased the amount of space they purchased as incomes rose. The positive income demand for space exceeded the negative price impacts.

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Table 3 reports the matrix of simple correlation for a set of change variable. They are listed in the same basic order as in Table 2. Unfortunately we do not have measures for all of the changes over identical time periods. We

TABLE 3: Matrix of Simple Correlation Coefficients for Change Variables for 86 Standard Metropolitan Statistical Areas; 1956-60

Variable	Number	Mean	Variable number					
			1	2	3	4	5	6
Percent FHA value of building site 1960*/1956 (ΔV)	1	134.0%	1.000	.207	.296	.498	.241	.140
Change in SMA farm land costs 1954-59 ($\Delta FSMA$)	2	\$ 160.1		1.000	.461	-.059	.326	.311
Change in state farm land costs 1956-60 (ΔFST)	3	\$ 155.4			1.000	.054	.117	.607
Change in price FHA house cost 1956-60 (ΔPR)	4	\$ 941.0				1.000	-.060	.051
Change in median family income 1949-59 (ΔY)	5	\$2672.0					1.000	.070
Change in population 1950-60 (ΔPOP)	6	35.7%						1.000

Source: see Table 2.

* Δ 1956-60: \$600.00

chose a middle period, that of 1956-60, for our initial tests so as to be able to "forecast and backcast." This period differs from that of the agricultural and population censuses. One must therefore assume that the rates of change reported by the census for the entire period prevailed during the period of the tests.

✓✓ The highest simple correlation exists between changes in the prices of the house and its land. This may reflect the influence of the builders' rule of thumb which states that a constant relationship should be maintained between value of house and lot. People desiring to spend more for housing logically should increase the amounts paid for both their house and its site. Greater utility can be obtained by increasing expenditures along both paths rather than one alone. No constant relationship was maintained, however. As amounts spent for housing increased, expenditures on sites rose nearly twice as fast as those on building (see Table 1). Furthermore, the average percentage of the total price of house and lot allocated to the lot varied from 10.7 percent to 23.1 percent among the various continental SMSA's in 1960.

All of the other change variables also have some positive correlation with site value changes. The simple correlations which fall between .2 and .3 may be considered significant for cross-section data, but they are far from large. The still smaller correlation which appears for population changes seems to be comparatively unimportant. In the matrix of Table 3, population density is not listed separately since changes in its values are directly related to the previously stated percentage movements of the total population.

Multiple Regression. In order to test more completely the possible relationships, to take into account their inter-relationships, and to get some idea of orders of magnitude, we used regression analysis for the variables listed in Tables 2 and 3. Our procedure took the FHA site values and ratio changes in these variables as the dependent variables and related them to all of the other variables through a step-wise multiple regression program. Since the

two variables for farm land values whether for the State or SMSA, variables (2) and (3), serve the same purpose in the model, it was necessary to run the tests using each separately.

We initially selected state farm values to represent agricultural land in our model on the assumption that the prices of farms within the SMSA's already partially reflected future urban values. We established our F value at 1.90. The first results are shown in Equation I of Table 4. (The equation's symbols follow those of Table 2.) Following this, we ran the regression containing all nine independent variables. The next two equations are special cases of this same test. Equation III contains the same variables as Equation I

TABLE 4: Regression Functions

I. 1960							
$V = -2236 + .5194 \text{ FST} + .2154 \text{ PR} + 593.3 \text{ LPOP} + 5.184 \Delta \text{POP}$							
T-values	(2.67)	(4.27)	(4.51)	(1.98)			
Beta Coefficients	.289	.364	.396	.221			
$R^2 = .46$	$\text{SE} = 427$	$\bar{v} = 2434$					
II. 1960							
$V = -3001 + .4819 \text{ FST} + .1881 \text{ PR} + 562.5 \text{ LPOP} + 5.080 \Delta \text{POP}$							
T-values	(2.17)	(3.43)	(3.93)	(1.86)			
Beta Coefficients	.269	.318	.375	.217			
$+ 1076 \text{ CC} + 1032 \text{ RIN} - 662.6 \text{ Lot} + 1.939 \text{ RCO} + .0480 \text{ Y}$							
	(1.13)	(1.07)	(1.01)	(.799)	(.538)		
	.314	.305	-.097	.069	.058		
$R^2 = .49$	$\text{SE} = 429$						
III. 1960							
$V = -2330 + .476 \text{ FST} + .1975 \text{ PR} + 544.9 \text{ LPOP} + 5.416 \Delta \text{POP} + 0.757 \text{ Y}$							
T-values	(2.38)	(3.65)	(3.84)	(2.06)	(.919)		
Beta Coefficients	.265	.334	.363	.231	.092		
$R^2 = .47$	$\text{SE} = 427$						
IV. 1960							
$V = -1396 + .5136 \text{ FSMA} + .1909 \text{ PR} + 360.1 \text{ LPOP} + 6.353 \Delta \text{POP}$							
T-values	(3.60)	(3.82)	(2.53)	(2.94)			
Beta Coefficients	.347	.322	.240	.271			
$R^2 = .50$	$\text{SE} = 413$						
V. 1956-60							
$\Delta V = 91.25 + .0115 \Delta Y + .00831 \Delta \text{PR} + .0208 \Delta \text{FST}$							
T-values	(2.77)	(5.71)	(2.74)				
Beta Coefficients	.243	.499	.241				
$R^2 = .38$	$\text{SE} = 14.6$	$\bar{v} = 134.0$					
VI. 1956-60							
$\Delta V = 95.87 + .0103 \Delta Y + .00866 \Delta \text{PR} + .0150 \Delta \text{FSMA}$							
T-values	(2.31)	(5.81)	(1.76)				
Beta Coefficients	.218	.520	.166				
$R^2 = .35$	$\text{SE} = 15.0$						
VII. 1956							
$V = -1123 + .1864 \text{ FST} + .1700 \text{ PR} + 294.0 \text{ LPOP} + 3.637 \Delta \text{POP}$							
T-values	(.879)	(5.37)	(2.60)	(1.79)			
Beta Coefficients	.095	.497	.252	.199			
$R^2 = .41$	$\text{SE} = 347$	$\bar{v} = 1835$					

TABLE 4: (Continued)

VIII. 1956	$V = -897 + .2556 \text{ FSMA}(1954) + .1655 \text{ PR} + 215.3 \text{ LPOP} + 4.005 \Delta \text{POP}$			
T-values	(1.15)	(5.16)	(1.67)	(2.30)
Beta Coefficients	.121	.484	.184	.220
$R^2 = .42$	SE = 345			
IX. 1961	$V = -2063 + .6412 \text{ FST} + .2273 \text{ PR} + 510.0 \text{ LPOP} + 3.425 \Delta \text{POP}$			
T-values	(3.40)	(5.04)	(3.71)	(1.25)
Beta Coefficients	.360	.413	.313	.134
$R^2 = .51$	SE = 445	$\bar{v} = 2551$		
X. 1961	$V = -1146 + .644 \text{ FSMA} + .2056 \text{ PR} + 221.0 \text{ LPOP} + 5.524 \Delta \text{POP}$			
T-values	(4.35)	(4.65)	(1.50)	(2.49)
Beta Coefficients	.400	.374	.136	.217
$R^2 = .54$	SE = 428			
XI. 1950-60	$\Delta V = 81.50 + .0410 \Delta Y + .0126 \Delta \text{PR} + .0010 \Delta \text{FST}$			
T-values	(3.13)	(2.40)	(.071)	
Beta Coefficients	.319	.245	-.007	
$R^2 = .17$	SE = 45.9	$\bar{v} = 256.5$		
XII. 1950-60	$\Delta V = 76.93 + .0425 \Delta Y + .0130 \Delta \text{PR} - .0010 \Delta \text{FSMA}$			
T-values	(3.11)	(2.44)	(.373)	
Beta Coefficients	.331	.252	-.041	
$R^2 = .17$	SE = 45.8			
XIII. 1956-61	$\Delta V = 93.05 + .0127 \Delta Y + .0103 \Delta \text{PR} + .0163 \Delta \text{FST}$			
T-values	(2.44)	(6.05)	(2.29)	
Beta Coefficients	.210	.520	.196	
$R^2 = .41$	SE = 18.3	$\bar{v} = 140.9$		
XIV. 1956-61	$\Delta V = 98.60 + .0152 \Delta Y + .0107 \Delta \text{PR} + .0188 \Delta \text{FSMA}$			
T-values	(1.90)	(6.22)	(1.80)	
Beta Coefficients	.173	.539	.163	
$R^2 = .39$	SE = 18.7			
Where: T-Value = $\frac{\text{regression coefficient}}{\text{standard deviation dependent variable}} = t_j = \frac{b_j}{s_{bj}}$				
Beta Coefficient = $B_{ij} = b_j \left(\frac{s_j}{s_i} \right)$				

except that income is added. The level of incomes has a non-significant coefficient because of multi-colinearity, but it turns out to have a significant coefficient in first difference equations. Equation IV substitutes farm land values in the SMSA's for the average based on the entire state within which a city falls. We note by a comparison with Equation I that some improvement in the fit occurs.

The regression results are clear. State land values (FST), the price of new houses (PR), population density (LPOP), and growth in population (ΔPOP) all appear significant at the .95 confidence level. The R^2 of .46 is rather high

for correlations based on cross-section data. The prices of new houses and population density contribute the most to the relationship, but farm land values and change in population are not far behind.

On the other hand, none of the other variables such as lot size, income, or those having to do with the distribution of houses or jobs adds anything to the explanation. Their individual coefficients are not significant. The addition of these variables, either separately or as a group, lowers the standard error corrected for the loss of degrees of freedom.

A comparison of equations I and IV shows that a slightly better relationship is obtained when the value of farm land for SMSA's is substituted for that for the state. It is clear from the change in the other coefficients that the divergent results stem from higher order inter-correlations in state land prices with population density and population growth.

When these equations are put into the form of first difference for the period 1956-60 (see Table 3), the change in population or its density for the period 1950-60 appears to have no significant relationship. The other variables of house price, farm land price, and income are significant. Equation V shows one result of this type of multiple regression. We note that, using the value of farm land within the states the highest relationship is shown by the change in house prices, while the change in income and change in land prices each carry roughly similar weights. Considering the fact that first differences of cross-sectional data are being employed, the correlation is rather good. The standard error indicates that if we had wanted to predict 1960 site costs from 1956 information we would have done better by using the first difference equation than by the direct use of status variables in 1960.

Equation VI covers the same period using the change in SMSA land costs in place of those for the states. The fit is not quite as good, and the new land costs are on the border normally considered as significant. Thus for the two variables of land values, one gives a better fit in absolute terms while the other is better in the equation of differences.

We have examined the tables of residuals from these regressions rather carefully and find no indications of other variables such as area of the county, size, or age of city which appear to play any role in explaining the remaining differences in land values. A few wide discrepancies remain unexplained and these cause much of the loss in correlations. However, a comparison of these extremes provides no insight into other explanatory variables either. It also appears that for any SMSA the relationship between the residuals for the status and change variables is almost random.

"Forecasts and Backcasts." Because of the well recognized danger of attempting to use correlation and regression coefficients alone as tests of hypothesis, at the start of our work we decided that when we had tested our model based on the data for 1960 and 1956-60, we would use the variables which appeared to be successful to see what results they give for earlier and later periods. The equations showing these tests for other periods are contained in Equations VII-XIV of Table 4.

The results are not surprising but do increase our belief in the validity of the initial tests. As we move from one equation to the next, we note that the correlations remain significant. The order of magnitude of the regression

coefficients remains approximately the same. Only one change of sign occurs, and it is not significant. We do note, however, that if we had selected other years for our initial test, we might not have ended with the same variables. Thus land values are not significant variables in 1956 or for the change from 1950 to 1960. Also the change in population is not significant for one equation (IX) in 1961 while population density is not significant in the other (X). This confirms our impression that significant multi-colinearity exists among values of farm land, population changes, and urban land values. Thus one must be careful in imputing exact values to the coefficients, but the validity of assumptions dealing with constellations of the influences appears confirmed.

5. CONCLUSIONS

The many tests discussed in the previous section appear to support the conclusion that a dynamic model can be constructed to explain the varying urban land values which prevail among United States cities. This same model also serves as a partial explanation for the rapid postwar rise in the prices of building sites.

The model starts with the hypothesis that land has values in many possible uses, particularly for farming. However, while differences in agricultural values play a role in explaining both the growth and variances in urban values, they are far from the determining factor. We noted that even at the fringes of suburban development, land for building will sell at ten times or more its purely agricultural value. (This, of course, is a basic explanation of why agricultural zoning in urban areas is so difficult and probably illogical except as a method of aiding the owners speculate on future land values.)

The traditional model of a rent surface with urban values rising from the fringe to the center does not suffice to explain the high prices at the fringes. It does serve a function, however, since it offers an explanation of why rents come into existence. If the form of the city remained oriented towards the center, rents and therefore land values will rise as the city grows and as incomes go higher. These future increases in rents will be discounted back to the present to affect present values. The amount spent for urban sites will be a function of their expected future returns. In addition, land around a city may gain a scarcity value if the rate at which it is brought into urban use lags behind its demand. Builders and developers will be forced to pay scarcity prices to move suitable building sites out of the hands of those who can afford to hold them for future increments in value.

These dynamic forces were assumed in our model to be represented by growth of income and population, changes in housing tastes and costs, and finally by the existing population density. All of these variables appear to be significantly related to urban site values. They aid in explaining both the variances among cities and the increases in prices which have occurred over the past decade. On the other hand, variables reflecting the differential distribution of jobs and houses appeared to have no relationship to variances or growth in the dependent variable.

As our original article pointed out, however, the significant variables should not be expected to be sufficient to explain all differences. The rate at which land will be made available to the market depends not only on actual increases

in demand, but also on the expectations of land owners as to future demand and on the future costs of holding land compared to present offers. Our case studies indicated that in recent years these expectations seem to have risen rapidly. In addition, land in suburban areas appears to have been gravitating into the hands of those interested primarily in holding it for future gains which they expect will result from population growth and urban development. ✓

The present study indicates that in a dynamic situation such as has existed for the past decade, the prices of urban sites should logically have increased. The model does not, however, show whether the rapid rises which occurred were of an order of magnitude which could be maintained or whether even more rapid increases would have been possible. ✓

APPENDIX

Variable
Number

Source References for Variables

- 1 U. S. Federal Housing Administration, Division of Research and Statistics, Statistics Section, *F. H. A. Homes 1960, Data for States and Selected Areas*, Washington, F. H. A., 1960.
Table 43 M-Property Characteristics, Selected Housing Areas, 1-Family Homes, Sec. 203, 1960; New Homes, Column 4: Average Market Price of Site.
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- 3 U. S. Department of Agriculture, Economic Research Service, *Farm Real Estate Market Developments, Market Value of Farm Real Estate 1960*, Washington, G. P. O., June 1962. ✓
Table-Farm real estate: Estimated market value of land per acre. Column 1: Value per acre land only 1960, Cropland, pp. 30-31; Table 13-Farm real estate...selected Western States, Column 1: Value...Cropland, Irrigated, p. 32.
- 4 ...*F. H. A. Homes 1960*...
Table 61 M-Purchase Transaction Characteristics, Selected Housing Areas, 1-Family Homes, Sec. 203, 1960; New Homes, Column 2: Average Total Acquisition Cost less market price of site.
- 5 U. S. Bureau of the Census, *County and City Data Book, 1962*, Washington, G. P. O., 1962.
Table 3: Standard Metropolitan Statistical Areas, Column 22: Median income in 1959 of families, 1960, pp. 433, 441, 449.
- 6 *ibid.*
Table 3: Column 4, Population per square mile, 1960, pp. 432, 440, 448.
- 7 *ibid.*
Table 3: Column 5, Population decrease or increase, 1950 to 1960, pp. 432, 440, 448.
- 8 U. S. Bureau of the Census, *U. S. Census of Population, U. S. Summary*, Washington, G. P. O., 1963, vol. 1 (Number of Inhabitants).
Table 33: Population Inside and Outside Central City, Column 1: 1960, pp. 106-111.
- 9 *ibid.*, vol. PC (1)-ID, (Detailed Characteristics).
Table 302: Place of Work...1960, Column 11: Percent living in SMSA ring, working in central city, pp. 1-798-1-800.

- 10 *ibid.*
Table 302: place of Work...1960, Column 4: number living in Central City, working in central city, plus number living in ring working in central city over total working in SMA.
- 11 Letter from Division of Research and Statistics, Federal Housing Administration (Washington: February 8, 1963, giving average number of lots per acre by insuring office, 1962).

NTA Forum

Perspectives, Ideas and News from the National Tax Association

Spring, 1991

From the Editor

A time honored tax reform calls for reduction or elimination of the *ad valorem* property tax on improvements accompanied by a sharp increase in the rate on land.

While other nations have dabbled with various forms of "site value" property taxation, it has never caught on in the United States, notwithstanding decades of energetic effort by its proponents. Its probable economic and fiscal effects are much debated.

Now some movement seems evident. As Walter Rybeck reports in this issue, recent years have seen adoption by more than a dozen Pennsylvania cities of the "two-rate" property tax, with land taxed (for municipal purposes, not school or county) at rates up to 16 times that on improvements. This reform, he argues, is especially well suited to economic circumstances such as those found in Pennsylvania's depressed smokestack cities.

A long-time NTA member, Rybeck is Director of the Center for Public Dialogue and a researcher and consultant on local government finance, housing, infrastructure funding and related metropolitan issues.

The editor invites comments on Rybeck's article, in the spirit of open discussion and debate to which NTA is committed.

This issue also contains a critique by Prof. Kevin McGee of Robert Aten's proposal in the Winter *NTA Forum* calling for revival of an investment tax credit for manufacturing equipment, followed by Aten's response. Together these contributions exemplify the kind of thoughtful debate on important tax issues that the *NTA Forum* seeks to encourage.

The editor welcomes further comments, as well as submissions of other material that will be of interest and value to a wide range of tax professionals. ♦

Pennsylvania's Experiments in Property Tax Modernization



Walter Rybeck

by Walter Rybeck
Director, Center for Public Dialogue

Over a dozen cities are reducing homeowner taxes while generating more property tax revenues . . . Investors are launching a 95- million-dollar mall in the center of Scranton . . . Harrisburg is steadily putting boarded-up homes back into use . . . Pittsburgh skyscrapers sprout downtown instead of in outlying cornfields . . . After years of deficits, Aliquippa enjoys a revenue surplus.

These items relate to a unique property tax reform. A *two-rate tax* with much lower tax rates on buildings than on land values is being used by 15 Pennsylvania cities.

(continued on page 2)

An Investment Tax Credit: A Comment

M. Kevin McGee
University of Wisconsin - Oshkosh

In the Winter 1991 issue of the *NTA Forum* Robert Aten argues that American investment has been hindered by high U.S. structural budget deficits, by regulations requiring arms's length business-bank relationships, and by corporate taxation. While reluctant to comment on the second of his trilogy (and uncomfortable, given the state of banking in New England these days, with anything remotely resembling a reduction in bank regulations!), I view the other two as problems that need to be addressed.

Aten proposes to partially offset these three hindrances through a temporary

investment tax credit (ITC) for manufacturing equipment. I have three basic objections to his proposed cure. The first is, why temporary? Concerns about inadequate American rates of savings and investment well preceded our mammoth deficits (and paradoxically contributed to them, since the supporters of the 1981 Economic Recovery Tax Act predicted that the tax cuts would in fact encourage more savings and investment); undoubtedly they will persist even if the deficit is ever eliminated and banking regulations reduced. Any measure appropriate for encouraging investment now will presumably continue to be appropriate then as well.

Secondly and more seriously, why only for manufacturing equipment? The

(continued on page 5)

NTA Forum

Number 7, Spring, 1991

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This reform helped communities weather Pennsylvania's recession in the 1980s, when the steel industry collapsed. Their experiences may be instructive to cities facing the current real estate crunch, shaky banks and reduced revenues with little prospect of outside help.

Background

Pittsburgh and Scranton pioneered the reform in 1913, gradually lowering tax rates on improvements and raising rates on land. By the 1920s, their building rates were half the rates on site values. The legislature allowed more cities to levy this tax of many names: graded tax, split-rate tax, two-tier tax, land tax. Harrisburg, suffering blight and decline, was next to give it a try (1975).

After 1978, while California's property tax revolt was grabbing national headlines, Pittsburgh and Scranton quietly shifted more taxes from buildings to land. McKeesport went that route in 1980, and New Castle in 1982. Washington and Duquesne followed suit in 1985, followed by Aliquippa (1988), Clairton and Oil City (1989), Titusville (1990), and Coatesville, DuBois, Hazleton and Lock Haven (January of 1991).

What accounts for the rapid spread of the two-rate approach? Steven Cord, editor of *Incentive Taxation* newsletter, plays a central role. Cities credit him with generating interest and providing technical back-up. Officials in the two-rate cities sell the idea to neighbor communities and a Pittsburgh research group, the Pennsylvania Economy League, also promotes it.

Not all reform efforts have succeeded. Allentown's council voted three times for the two-rate tax in the 1980's but was unable to override the mayor's veto. Philadelphia Councilman James Tayoun, undaunted by four prior defeats, says his city's current budget crisis is bringing former opponents to his side. Erie last year rebuffed a two-rate proposal.

Who opposes shifting taxes from buildings to land? Land speculators and slum owners, of course. Their taxes go up. Intellectuals, perhaps influenced by the derision of many politicians and economists for any form of property tax, are often unsupportive.

Among other states, only Missouri may be close to introducing the system. Congress in 1974 permitted the District of Columbia to tax land at a higher rate

than buildings; in 1990 Council designated vacant land as a separate class and imposed a tax rate on it higher than on the other four classes. Some California irrigation districts, Peoria's enterprize zone, Fairhope, Alabama, and Arden, Delaware, downtown or untax buildings in other ways.

The two-rate tax, however, is mainly a Pennsylvania story. The cities employing it vary from five towns under 10,000 to Pittsburgh, a bustling metropolis of 364,000. Their proportions of non-whites—blacks, hispanics and orientals—range from near zero in six cities to nearly half the local population in Harrisburg. Some are one-industry towns, others are more diversified.

How does this tax affect a \$160,000 Scranton home on a \$30,000 lot? The tax on the structure, at 12 mills, or .12 percent (see table), is \$192, and the land tax, at 66 mills, is \$198, for a total of \$390. The conventional property tax, at 26.1 mills, would have resulted in a tax of \$496, or 27 percent higher.

Land tax rates are 16 times higher than building rates in Aliquippa, 6 times higher in Pittsburgh, but only 2 or 3 times higher in several cities (Column 3). In the abstract, there is no "right" set of rates. Small differentials and gradual yearly changes reflect political decisions to make few waves. Larger differentials reflect a greater urgency to generate better land use and give relief to certain taxpayers.

Regional Crisis

Many giant mills went belly up in the 1980s, but steel's demise was not sudden. The region reached its peak population in the 1930-50 era. Since then these 15 smokestack cities have dwindled to 45 percent of their former size. Population loss in the '80s—14 percent in Pittsburgh, 3 percent in Harrisburg, over 20 percent in Aliquippa and Clairton—was no more dramatic than in the '60s and '70s.

High unemployment touched off this virtual hemorrhage of outmigration. Jobless rates in cities now using the two-rate tax ranged from 6.6 percent to 13.4 percent in 1980. Local leaders say unemployment was nearly double the official rates because workers idled for years are no longer counted in the labor force. Under the circumstances, high poverty rates, 13 percent in many of the cities, are not surprising.

Positive Growth Impacts

Washington Mayor Anthony Sposey, who operates a barbershop, says, "After adopting the two-rate tax, we saw a noticeable increase in construction and renovations, a lot of it downtown. A big manufacturing place converted to a major office-retail building. It's doing well. Was this a coincidence?" A 1989 study showed 78 percent more building permits during the three years after adoption than in the three prior years. And 85 percent of homeowners pay less.

In Clairton building also increased. In the two years after reform, the dollar value of building permits was nearly three times greater than in the previous two years. "It's hard to know which of a number of things, such as a big push on code enforcement, also contributed to this," says Finance Director-Tax Collector Mary Louise Bittner.

New Castle Business Manager John DiMuccio echoes this thought: "We've had downtown development but don't know how much to attribute to our tax. We adopted it at the start of a major recession. An unstable economy skews the data. We found that 75 percent of homeowners save money under this system, and I'm confident it helps senior citizens remain in their homes."

Councilman Michael Melnick of Scranton, who teaches accounting, says, "There's definitely been more construction. You buy a home and always dream of improving it. Here you're not penalized for this. In my case, it encouraged me to do things. This had a domino effect in the neighborhood. A very good sign—a \$95 million downtown mall is just starting." After another tax hike in 1990 the *Scranton Times* editorialized:

By keeping the tax increase on land and holding the line on improvements, council is adhering to the theory that higher taxes on land encourage development of vacant parcels.

Vacant housing in Harrisburg dropped from 1,800 to 700 units in the past seven years and a special commission endorsed the two-rate tax. Says Finance Officer Robert Kroboth, "It did not identify this as the only reason for increased construction and good development—yet it urged a greater shift to land taxes." Jeffrey Schaffer, Director of the Mayor's Office of Economic Development, emphasizes the wide array of tools the city uses to attack urban problems. "Though it's hard to prove the effect of any one

device, the two-rate tax certainly hasn't hurt," he says.

The Club Analogy

Joseph Bendel, Jr., a local government consultant when not on duty as McKeesport councilman, shares his perspective: "A residential street is like a club. Identical lots all pay the same land tax or 'dues' to support police and streets because they share equal access to these services. Why charge anyone extra for building better homes and putting more jobs in the city? Under the old system, a vacant lot paid less for not using the 'club' but there are no free riders anymore."

Building taxes formerly produced 85 percent of the City's property tax revenues, now 47 percent. Bendel thinks the change sparked McKeesport's sizable increase in construction while permits plummeted in nearby Duquesne and Clairton—cities that later adopted the two-rate tax.

McKeesport after a decade of tax reform is no paradise. Its pleasant hill neighborhoods overlook a drab downtown hurt by out-of-town malls. On 300 riverfront acres rusts a ghostly mill that began shutting down in 1983; 4,000 jobs were cut; only skeleton operations continue. "Despite our problems," says Bendel, "city finances are in good enough shape that we reduced our taxes for

1991. Not many cities can say that. We kept the same rate on land but dropped it on buildings."

Managing Two Rates

In cities that made the transition, officials uniformly report no trouble administering a two-rate tax. A typical response: "The county assesses all parcels. They give us two columns, building values and land values. We multiply the first by our building rate, the second by our land rate. We add the two together for the tax bills. That's all there is to it."

However, Dr. Charles Blocksidge, director of Allegheny County assessments, says: "The graded tax is an added dimension. In other municipalities we look at the market value of the entire property. In Pittsburgh, McKeesport, Duquesne and Clairton, we have two components. It's easier dealing with one element than two. Appraisers for these four cities require more training in land valuation than for the county's other 126 jurisdictions. You have to think not only about existing buildings but what else can be done with the sites. People say a higher tax on land is an incentive to do more with it. We come under greater scrutiny in those places."

Surviving Falling Real Estate Markets

Oil City kept seeing appeals for lower

Cities Using Two-rate Taxes: Their 1991 Tax Rates, Assessed Values and Revenues

	Tax Rates on:		Equivalent Rate (mills) [2]	Land Ratio [3]	Assess. Ratio (%) [4]	Assessed Values		1991 Revenue (\$Ms) [5]	Anl. Tax Saving on Bldgs (\$Ms) [6]
	Bldgs (in mills) [1]	Land				Bldgs (in \$Ms)	Land		
Aliquippa	5.0	81.0	25.0	16.2	50	63.185	22.585	2.145	-1.264
Clairton	21.1	100.0	37.2	4.8	25	20.475	5.247	0.956	-0.331
Coatesville	25.0	40.6	28.0	1.6	100	14.221	3.417	0.494	-0.043
Du Bois	14.0	32.0	18.0	2.3	25	33.272	9.604	0.773	-0.133
Duquesne	34.8	73.5	41.6	2.1	25	18.233	3.856	0.918	-0.124
Harrisburg	10.8	32.3	14.6	3.0	100	610.803	131.489	10.807	-2.352
Hazleton	25.0	79.0	33.0	3.2	11	34.827	6.098	1.352	-0.279
Lock Haven	12.0	24.8	14.0	2.1	60	47.626	8.776	0.789	-0.095
McKeesport	20.5	100.0	37.4	4.9	25	54.964	14.795	2.606	-0.929
New Castle	23.0	70.1	31.7	3.0	100	106.274	24.014	4.131	-0.922
Oil City	27.4	55.5	32.8	2.0	100	47.275	11.213	1.918	-0.255
Pittsburgh	32.0	184.5	59.3	5.8	25	1695.572	350.111	118.854	-46.289
Scranton	12.0	66.0	26.1	5.5	100	286.059	101.237	10.114	-4.033
Titusville	15.0	61.3	21.1	4.1	80	54.458	8.320	1.327	-0.332
Washington	16.8	83.1	29.9	4.9	25	46.525	11.420	1.731	-0.609

Sources: Center for Study of Economics; county assessors.

1. A mill rate is 0.1%, expressed also as \$1 per \$1,000 of assessed value.

2. Equivalent rate: conventional single rate to produce same revenue as two rates.

3. Land rate/building rate. Scranton, e.g., taxes land at a rate 5.5 times building rate.

4. Assessment ratio is the official assessed value as a percent of full market value.

5. Expected revenue=(land rate X land value) plus (bldg. rate X bldg. value).

6. Annual tax savings to buildings under two-rate system vs. conventional property tax.

assessments—a manifestation of depressed times. “We lost several million dollars in assessed values,” explains City Manager Thomas Rockovich. “It was a lose-lose situation. We needed a tax increase of 1.4 mills, but higher building taxes would bring more appeals and more losses. So council put all the increase on land. No radical change—a little at a time [over the years 1988-1991.] It’s maintaining our tax base.” Between 1989 and 1991, building rates were dropped from 31 to 27 mills while land rates were raised from 38 to 56 mills.

Erie Planner Daniel Borgia, a former developer, discusses a narrow defeat: “Large owners got their taxes reduced. It left everybody else holding the bag. To overcome a revenue crunch, Erie even leased its water system. Last fall council voted 4-3 for a two-rate plan. A print-out of every property showed 66 percent would see taxes go down, and 75 percent of single family homes would enjoy a decrease. Yet opponents persuaded the mayor to veto the plan.”

John Baldwin, partner in an Erie realty-development firm, explains why business united against the change: “Assessments have not been updated since 1969 despite our law suit to force the county to reassess and correct gross inequities. Downtown has decayed over the years. New buildings in outlying areas are underassessed. To avoid unfair burdens, downtown landlords appealed for lower assessments. All the reductions were taken off buildings. Now many show 85 percent of the value in the land, only 15 percent on the building. If the tax was mostly on the land, owners would appeal again. The county would have a tough time denying the land portion is too high. A flood of successful appeals could bankrupt the community.”

A court-ordered re-assessment spurred Washington to modernize its property tax in 1985. Mayor Sposey says new assessments spelled tax increases for many older residents. Council studied the two-rate tax and was impressed it could be designed to avoid these increases. “Once we put it in,” he says, “many older people actually paid less. We saw widespread appeals and reduced building assessments. But with land taxed at five times the rate on buildings, our revenue loss is minimal.”

Clairton anticipated that it would reap big revenue gains when it shifted to the two-rate tax because of its large expanse

of steel mill land. But land values collapsed along with the industry’s collapse and these expectations did not materialize. “We broke about even,” reports Finance Director Bittner.

Duquesne did worse. “The nation is just going into recession, but we’ve had a depression for seven years,” says City Manager David Poljak. “We got no help from anybody. We went to a land tax in 1985 to benefit more from our large steel plant.” That year USX, the major employer, shut down the plant that represented 45 percent of Duquesne’s tax base. USX fought the new tax for years, then persuaded the city to lock in its previous low tax to help it attract a buyer. However, another prerequisite—demolishing the plant—has only just begun and may take years.

“There’s no way to get a reading on effects of the two-rate tax here with our extremely distressed finances,” Poljak says. Revenues went down, not up. The city cut its work force. It began charging for garbage pickup. When it had to raise taxes again, it put some burden back on buildings. The building-rate-to-land-rate ratio thus dropped from 1:2.5 to 1:2.1.

New Castle, facing similar problems but not a one-mill city, fares better. “We had tremendous losses—about \$15 million in assessed values—as closed plants got great reductions,” DiMuccio says. “With our land rates four times building rates, revenue loss has been held to 10 to 15 percent. Compare this to the school district which taxes property the old way—it suffered a 30 to 40 percent loss. In these hard times, the revenue savings may be the biggest single benefit to us from the two-rate tax.”

Scranton watched revenue sharing and urban programs dwindle. “To replace federal aid,” Councilman Michael Melnick recalls, “some called for wage taxes, but we kept raising land taxes. If you tax wages, jobs leave town. If you tax land, it won’t leave. It will be used more efficiently. Before, people bought vacant land just to hold. The higher tax encouraged them to develop or sell to somebody who wanted to use the land.”

“The biggest reason for adopting the two-rate tax in Aliquippa was that our main employer, LTV, was in the process of shutting down its steel mill,” says Mayor Daniel Britza. An accountant for the state auditor general, he is one of LTV’s 15,000 ex-employees. He tells a familiar story: “LTV kept going to court for lower assessments. Their taxes went

from \$1 million down to \$200,000. Most of this reduction was on the structures. Shifting to a higher land tax renewed a good bit of our tax base. They now pay about \$450,000 a year. They’re even getting other uses out of the plant.”

After 1988 rates were set at 81 mills on land, 5 mills on improvements, construction on vacant lots started right away, Britza says. Building permits increased almost 200 percent. Revenues increased 10 percent. Four-fifths of homeowners got tax reductions. “We had years of deficits—half a million dollars one year,” he recalls. “With a budget around \$3 million, you get an idea how bad that is. We ended 1990 with a budget surplus between \$50 and \$60 thousand. We’re recovering.”

Open Space Implications

Harrisburg Mayor Stephen R. Reed calls property tax modernization “an important economic development incentive, especially for larger projects.” He is even more enthusiastic about its land use impacts: “Many states try to save farmland by buying development rights. That’s expensive. Without spending a dime, we can achieve the same goal with a two-tier tax. Unused urban land is what pushes development into open spaces. This tax, by assuring better use of unused land in cities and suburbs, will discourage the gobbling up of farms. It’s an old idea whose time has come.”

Pittsburgh’s Tax Swap

Pittsburgh’s dramatic post-World War II rebirth inspired the nation’s urban renewal program. Ironically, federal designers ignored the graded tax that undergirded the Golden Triangle transformation. Mayor David Lawrence described the *stick* of this tax, saying it discouraged “hoarding of vacant land for speculation.” His successor, Mayor Joseph Barr, emphasized the *carrot*: “Most of the fine structures erected through private investment as part of the renewal program benefitted by the lower tax rate on buildings.”

While the federal program stumbled from trying to remove blight with hand-some subsidies to owners of derelict properties, Pittsburgh council remembered the importance of using tax penalties and rewards. To continue promoting good land use, they persisted in raising tax rates on land.

Council President Jack Wagner says, “I’m not going to say the land tax is the

only reason a second renaissance occurred, but it's been a big help. We rebounded from a big depression in 1981 to 1983.

After years of shifting taxes from buildings to land, Pittsburgh shifted them in 1990 from wages to land. Its high wage tax was four times higher than in the suburbs. Council lopped off a quarter of this tax and swapped it for a 33-mill land tax plus 5 mills on buildings. This led some to ask whether other onerous taxes might be swapped for the reformed property tax. Pittsburgh's two-rate tax is its largest revenue source, producing \$115 million of the \$325 million annual budget.

Conclusion

As noted, rate differentials are reduced because overlapping school and county property taxes are levied on the old flat-rate basis. Some observers question that such modest reforms really make a difference. A growing number, however, find the pattern too uniform to be mere chance. If positive results stem from rather tiny doses of the two-rate tax, this suggests how potent it may be. Or perhaps tax relief of \$57 million a year to buildings is not a tiny dose after all.

Here is a real-life lab for testing systems of taxing land more and buildings less. Do they reduce sprawl? Foster better land use? Generate affordable housing? Offer a way to halt the troubling and growing anti-property tax movement?

Given the desperate search by communities for solutions, surprising little research has focused on these issues. Cities should be able to look to tax advisors and others for more guidance than they have had to date on the lessons from this Pennsylvania story. ♦

Future NTA Annual Conferences

November 10-13, 1991
Williamsburg, VA
The Williamsburg Inn

October 11-14, 1992
Salt Lake City, UT
Little America Hotel

November 7-10, 1993
St. Paul, MN
Radisson St. Paul

November 13-16, 1994
Charleston, SC
Omni Hotel Charleston

(Comment, continued from page 1)

cynical response is that Aten, as Chief Economist for the Manufacturers' Alliance for Productivity and Innovation, represents the interests of manufacturers only. Admittedly, Aten presents a somewhat plausible optimal second-best taxation argument for special treatment of manufacturing: since it faces fierce foreign competition, its various elasticities are higher than in other sectors of the economy, so its optimal tax rates should be lower. But to carry that logic further, are all manufacturing industries equally impacted by foreign competition? Should we not offer different tax breaks for different types of equipment? And even if, *in general*, manufacturing should be taxed less than other sectors, *in specific*, aren't there any other special cases that deserve special treatment as well?

These questions bring out the problem with Aten's approach: as soon as we admit that differential taxation is theoretically superior to the neutrality aimed for in the Tax Reform Act of 1986 (TRA86), we open a political Pandora's box of uncertain outcome. Yes, uniform taxation is economically non-optimal, but as Alan Auerbach has recently demonstrated ["The Deadweight Loss from 'Non-neutral' Capital Income Taxation", *J. Public Econ* 40(1), October 1989, pp. 1-36], the gains from optimal differential taxation are likely to be "empirically inconsequential".

Achieving those small gains would require both precise estimates of a large number of demand and production elasticities and a political process that focused on those elasticities and those elasticities only. We have neither. As Henry Aaron has eloquently argued ["Politics and the Professors Revisited," *Am Econ Rev* 79(2), May 1989, pp. 1-15], the traditional principle of uniform taxation is "a kind of second-best rule that may lead not to the highest, but (in our rough and tumble political system) the most sustainable increase in welfare."

Third, if we wish to reduce the tax rate on new investment, why the Investment Tax Credit? If non-neutrality in the tax code is the goal, the ITC is an excellent choice, because it's guaranteed to deliver non-neutrality with a vengeance. [David Bradford, "Tax Neutrality and the Investment Tax Credit," in Aaron and Boskin, eds., *The Economics of Taxation*, Brookings: Washington, 1980.] On the other hand, if tax neutrality is preferred, the ITC has a clearly superior

alternative: partial expensing. [Arnold C. Harberger, "Tax Neutrality in Investment Incentives," in Aaron and Boskin, eds., *The Economics of Taxation*.]

Like the ITC, partial expensing—that is, immediate depreciation of some fraction of the asset's purchase price, with the remainder depreciated as under current tax law—reduces the cost of new capital investment. Unlike the ITC, it does so in a way that reduces the differences in effective tax rates that our imperfect system of tax depreciation creates. Hence it would be an option favored both by those who seek greater investment incentives and by those who advocate increased tax neutrality.

Like the ITC, partial expensing results in an immediate decrease in tax payments when investment occurs. The difference is that with expensing, this tax benefit is partially offset by reduced tax deductions in the future. Hence to achieve the same increase in investment incentives, the partial expensing "rate" would need to be greater than the tax credit rate: e.g., allowing 30% of an investment to be expensed might have the same impact as a 10% tax credit. While the ITC would have to apply different tax credit rates to different assets to be optimal, a uniform fraction expensed would be appropriate.

Unlike resurrecting the ITC, implementing partial expensing would not be counter to the spirit of TRA86. Indeed, if expensing were partially paid for by reducing interest deductibility, it would clearly continue that spirit: cutting the overall (effective) tax rate (on investment) while reducing the special tax breaks provided to a special activity (debt financing).

I assume Aten, in writing his article, hopes to develop some political momentum for an investment-favoring change in our tax code. While I'm not sure if the time is right, I sympathize with his objective. Nevertheless, I'm forced to conclude that his proposed solution is fatally flawed. Uniform partial expensing would attract a broader political constituency than a manufacturing equipment ITC, with greater support within the economic community as well. On all counts, expensing would be the preferred way to go. ♦

Reply to McGee

by Robert H. Aten

Kevin McGee and I are in substantial agreement on the main point: there are serious concerns regarding the scale of U.S. investment that policymakers should address expeditiously. While I continue to believe in the merits of the second-best case for an investment tax credit (ITC), partial expensing also has merit.

McGee asks three questions. Why: (1) adopt a temporary solution to the factors increasing the cost of capital? (2) enact differential tax rates? and (3) enact an ITC and not uniform partial expensing.

(1) The federal budget deficit has existed continuously since 1969. Deficit elimination will require, on an optimist's perspective, at least another half decade. Our investment shortfall should not wait that long for a permanent solution. Hence an interim fix is appropriate. An ITC could be enacted very quickly. A good solution enacted soon is superior to a better or perfect solution adopted too late.

(2) McGee believes that the efficiency gains that would be achieved from the enactment of differential tax rates are *de minimis*, citing Auerbach's findings based on an isolated tax system encompassing commodities with differing supply and demand elasticities, e.g., the U.S. tax system in isolation without production abroad or world trade. In such circumstances he is correct, but ours is not an isolated tax system. The welfare gains from uniformity (equalizing rates) within even a large component of the world tax system (the U.S. tax system) could readily be more than offset by the welfare losses arising from the differences between the tax rates of that tax system and of other large tax systems (Japan and the EC). That is, the proper framework for efficiency analysis of the U.S. tax system is the global system, including both significant tax and non-tax factors. Moreover, the anti-tax-differential arguments made by McGee do not address the differential increases in the costs of capital and the resulting need for compensation arising from the continuing federal budget deficit and failure to achieve U.S. banking reform.

From an administrative standpoint, McGee is correct that adoption of one

uniform tax rate would certainly be better than enactment of hundreds of differential rates. It is also better for tax policy to be approximately right (two tax rates) than consistent but wrong (one tax rate for everyone in the United States but with no tax-policy solution to competitive pressures.)

McGee's allegation of ITC non-neutrality begs the main question. In an imperfect world, adoption of an ITC would help to achieve neutrality in overall tax policy, perhaps even more than partial expensing. I continue to concede there would be relatively small nonneutralities (compared with the nonneutralities I consider) between domestic activities assisted by an ITC and those not assisted.

(3) McGee believes uniform expensing might attract a broader political constituency. However, let's get the merits straight first. I believe the economic gains from current tax policies to encourage increased equipment investment outweigh any economic distortions that might result.

Robert H. Aten is Vice President and Chief Economist, Manufacturers' Alliance for Productivity and Innovation. ♦

Symposium to Focus on New Perspectives in Tax Policy

The annual NTA Spring Symposium will be held May 9-10 at the Crystal City Marriott Hotel in Arlington, VA.

The Symposium Program Committee, under chairman Tom Neubig, has adopted the theme "Tax Policy: New Perspectives". Topics on which new work and new perspectives will be presented include:

- the new budget process and the role of taxes in macroeconomic policy
- progressivity in tax and expenditures
- state tax policy and the federal government
- various emerging business tax issues
- tax policy and tax exempt organizations
- pension tax policy

The luncheon speaker on Thursday, May 9, will be Lawrence H. Summers, on leave from Harvard University to serve as Vice President and Chief Economist at the World Bank.

The program and registration information have been mailed to all members. For additional information or registration material please contact the NTA office. ♦

Sixty Years Ago with the NTA

Some Problems Never Go Away

"... long experience with the question of allocation and apportionment leaves me with the definite conviction that it is an infinitely difficult problem, comparable in its complexity and difficulty to the problem of finding a remedy for cancer. In all probability we are going to find a simple answer to neither problem. We shall require on the part of economic thinkers and tax men all the powers of analysis which they can summon up. The problem will probably be solved largely in or under the auspices of this Association and the Fiscal Committee of the League of Nations. But to solve the

problem we must keep everlastingly at it; approach it from many directions, and above all things approach it with completely disinterested and open minds. It is an extraordinary problem and may require an extraordinary remedy."

Prof. T.S. Adams, of Yale University, in discussing "Allocation Versus Apportionment" at the 24th Annual Conference on Taxation, Atlanta, GA, October 12-16, 1931. Adams was one of the foremost taxation scholars of his day and served as President of the National Tax Association in 1922-23.

New Members

The Association is pleased to welcome the following new members who have joined between December 1, 1990 and February 28, 1991

NAME	STATE OR COUNTRY	NAME	STATE OR COUNTRY
Jeffrey L. Abbas	DC	James B. Mackie, III	VA
Arthur Andersen & Co.	NY	Fannie L. Malone	TX
Susan Anderson	TX	Thomas Moncada	IL
Deborah Bailey	CA	Mark J. Nigrini	OH
Peter Barton	WI	Robert R. Oliva	FL
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Jane O. Burns	TX	Philip Morris Management Corp.	NY
Debra S. Callahan	SC	Thomas J. Purcell	NE
Chris Clotworthy	DC	Rati Ram	IL
Karen S. Cravens	TX	Frank Sammartino	DC
Comptroller Of Public Accounts	TX	Debra Sanders	WA
Cynthia Eakin	FL	Dennis R. Schmidt	WY
Richard A. Forschler	MN	James R. Scott	MT
Micah Frankel	AZ	William M. Shobe	NC
French Embassy	DC	Mike Sobul	OH
Sheryll A. Goedert	FL	State Advertising Coalition	DC
Harry B. Greene	GA	Robert G. Strong	OR
David B. Grishman	MS	Tera N. Sudderth	AL
Stan Hansen	IA	Judyth A. Swingen	NY
Thomas A. Hendrickson	IN	Univ. Politecnica de Madrid	Spain
Robert C. Hentges	MN	University Of Malaya	Malasia
Steven J. Huddard	CA	Richard J. Wall	NY
Susan B. Kattelus	MI	Robert W. Wood	CA
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GRASS-ROOTS GRUMBLING: PENNSYLVANIA DEMOCRAT McHALE TRIES TO EXPLAIN HIS VOTE

FEAR AND LOATHING ON THE HUSTINGS

Voters are after the scalps of lawmakers who switched on the budget

You're a spineless coward, and you are a disgrace to your country," ranted Eric from Allentown before he hung up on Representative Paul McHale. A freshman Democrat congressman from Pennsylvania's Lehigh Valley, McHale thought his Aug. 9 appearance on a popular call-in show on WAEB-AM radio would let him explain his vote for President Clinton's budget. But he also wound up getting an earful from irate constituents. "Thank you for successfully guaranteeing the end of small business in this district," snarled another caller, Jacob from Emmaus.

President Clinton knew that many supporters of his recently passed deficit-reduction package would be roundly criticized by constituents after voting to raise taxes by \$241 billion over the next five years. But none is getting more heat than McHale and seven other House Democrats who voted against the President's plan on May 27, only to change sides to support the House-Senate compromise on Aug. 5.

After giving Clinton the narrowest of victories, the switchers face charges of

hypocrisy, of caving in to pressure from the White House, and of engaging in unseemly horse-trading. The about-face "is a question of their integrity as officeholders," says Representative Bill Paxon (R-N. Y.), chairman of the National Republican Congressional Committee.

NO APOLOGIES. So while many in Congress head for the sun, most of the Endangered Eight are hustling to explain themselves. It hasn't been easy going. Right after the showdown vote, McHale, a 43-year-old Marine veteran of the Persian Gulf war who unseated longtime GOP Representative Don Ritter last year, learned that Paxon's NRCC had called every major media outlet in his district to attack the vote. Then the GOP announced plans to denounce the vote switch on billboards around the district. But the deepest wound came when McHale, marching with his family in an Aug. 7 centennial parade in Wind Gap, Pa., encountered scattered obscenities from some disgruntled constituents.

What's really disconcerting to McHale and others is the breadth of confusion over what exactly is in the legislation

they passed (table). Above all, individuals and business owners are convinced they face massive tax increases. But the Clinton Administration claims the rate hikes will affect only 1.2% of filers and 4% of small businesses. As for the widespread disgust at the law's retroactivity? Democrats note that only high-income taxpayers are affected.

McHale knows he has lots of explaining to do, but he blames Republican half-truths rather than his party's taxes. "It is critical that a truthful presentation of the bill be made immediately—and preferably sooner," he says.

McHale insists that his flip-flop was motivated by deeply held principles. His district is home to energy-intensive companies such as Bethlehem Steel Corp. and Mack Trucks Inc., and he opposed the original House bill because its BTU tax would hit such companies, he says. But once the energy levy was stripped down to a less onerous gas tax, McHale endorsed the legislation.

TOUGH SELL. The congressman has won praise from Bethlehem Steel Chief Executive Curtis H. Barnette for publicizing the dangers of the BTU tax. Barnette calls McHale "a very effective congressman" and says the tax bill is "a very important step" in reviving the economy.

And McHale is winning over some small-business owners and senior citizens who learn that their tax hike is negligible. "Like everyone else, I don't like to pay taxes," says Mayor James E. Mullen of Pennsburg, who will pay taxes on more of his Social Security benefits. "Deep down inside, while I'm not anxious to pay more, I think it's the fair thing to do."

For now, McHale is plugging away, one voter at a time. He and the 217 other House Democrats who backed the plan are optimistic they can placate voters by next Election Day. After hearing his congressman's windy description of the bill's details, Dennis Krause, owner of the Shady Nook Restaurant in Pennsburg, says: "I guess it's not going to be real bad. I don't mind paying the taxes if I'm making money." A backhanded endorsement at best—and an indication of how big a selling job Clinton and supporters such as McHale have ahead of them to convince voters the pain of deficit-cutting will ever equal the gain.

By Richard S. Dunham in Pennsburg, Pa.

HOW McHALE IS PITCHING CLINTON'S PLAN

COMMON COMPLAINTS

Higher taxes will hurt small business

The plan's \$241 billion tax hike socks the middle class

Most Americans will be forced to pay retroactive taxes

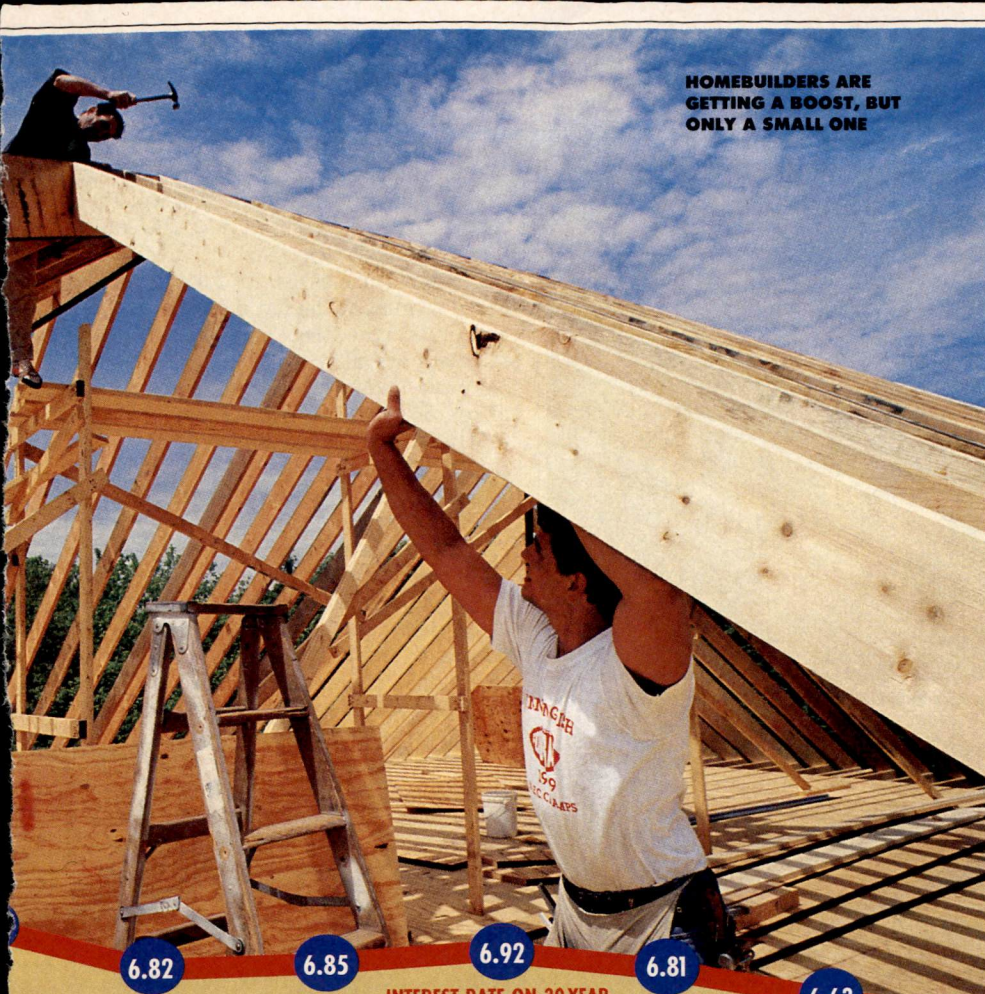
SALES PITCH

The plan will only affect about 4% of small businesses

Wealthy taxpayers bear the burden of the new income taxes, and 98.8% of Americans will see no increase

Retroactive taxes are unfair, but only the wealthiest 1.2% of households will pay them

HOMEBUILDERS ARE GETTING A BOOST, BUT ONLY A SMALL ONE



6.82

6.85

6.92

6.81

6.63

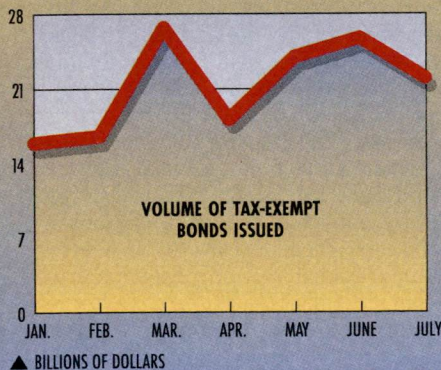
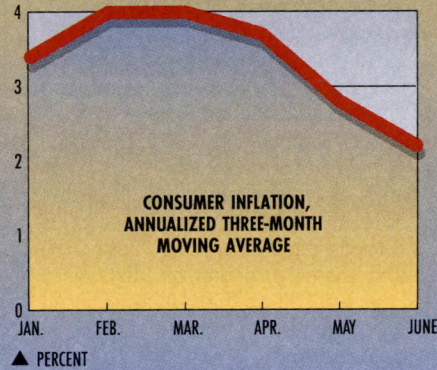
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INTEREST RATE ON 30-YEAR TREASURY BONDS

...MUNI BOND ISSUES ARE UP...

...AND INFLATION HAS DIPPED

AUG. 10, '93



um- and long-term interest rates still range from 3¼% to 4% in real terms. That may explain why the economy's response to falling rates so far this year, while positive, hasn't been dramatic.

LIGHTER BURDENS. This suggests that housing, auto sales, and investment, which typically thrive with declining rates, will do so once more—but not spectacularly, unless real rates start to fall as well. These three interest-sensitive sectors, which generally propel economic recovery, indeed have been doing better in recent months. But the gains have been steady and gradual and are

likely to remain so. No fireworks here.

Mortgage refinancings, for instance, now account for a hefty 55% of all mortgage application volume after a second spurt this year (chart). If rates keep falling, another round of refinancing is bound to occur. Household debt burdens will get lighter, and cash flow will be freed up. Ideally, then, there will be more spending on home improvement, appliances, furniture, and other goods. "People will feel more comfortable spending on their homes," says Roger Kubarych, economist at Henry Kaufman & Co. And an improving housing resale

market will mean that "they feel they're investing in an appreciating rather than a depreciating asset."

Likewise, the homebuilding market is getting a boost, but so far only a small one. Housing starts are up an annualized 3%, to 1.25 million units, so far this year. But that remains well short of the 1.5 million annual units of the 1980s and 1.8 million units of the 1970s. Part of that has to do with demographics—household formation has slowed down. But economists also believe that it will take a bigger break in rates to really rev up the housing construction market.

GRADUALIST GAME. Auto sales, too, are improving, thanks in part to lower rates. Car and light truck sales are running at a 13.6 million annual rate so far this year, up 6% from last year. But that's below 1990's 13.9 million pace and 1989's 14.6 million units sold. Business investment has been concentrated in equipment, and here, lower rates have clearly made spending more attractive—pushing expenditures up at a 14.7% rate in real terms over the past year. But unless U.S. manufacturers enjoy the follow-through of rising and healthy demand for their products, capital spending gains will slow.

Much of what happens next depends on the rest of the world. Following the near breakup of the European Monetary System, rates should begin to fall across the Continent as government officials, freed from following Germany's tough money policy, pursue domestic economic objectives and try to revive growth. European currencies may weaken against the dollar as a result, a development that would give Europe a trade advantage. But the effect of cheaper money in boosting demand for goods could overwhelm that advantage and allow the U.S. to export more to Europe. And sliding European rates could, in turn, permit U.S. rates to fall further.

How much good will lower rates do the economy in the end? There's no doubt the effect will be positive. But after 12 years of steadily falling rates, it's not clear that a few more turns of the screw will make a huge difference for growth. And if lower rates only ensure growth of 2½% for the foreseeable future, it could take a long time to bring the unemployment rate down markedly from its current 6.8%. These days, gradualism is the name of the game. It yields a steady but halting improvement in the economy—hardly the one Americans are accustomed to, but far from the worst possible outcome.

By Karen Pennar in New York, with Christopher Farrell, and Owen Ullman in Washington

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HOW LOW CAN RATES GO?

PROBABLY LOW ENOUGH TO OFFSET THE TAX HIKES

It shouldn't have come as a surprise—though it did to many. No sooner had the vote been cast in Washington in favor of a historic budget-cutting agreement than the bond market opened with a rally, pushing the yield on the 30-year Treasury bond to a 16-year low of 6.44% by Aug. 10.

The market will give up some of its gains, but the trend is clear: Interest rates will ratchet downward for some months to come. In the 1980s, easy fiscal policy was offset by tight monetary policy. In the 1990s, the relationship may be reversed—fiscal drag could well be offset by lower rates.

The Clinton Administration bet that rates would fall when it pushed for the deficit reduction package, and it continues to hope for still lower rates as it tries to convince the public of the rightness of the new fiscal discipline. "I don't think there's any question that the fall in [long-term] rates in the last few days is due to passage of the deficit reduction package," says Robert E. Rubin, director of the White House National Economic Council.

The Clintonites seem likely to get their wish. Lower rates will prevail, not because the Federal Reserve Board ordains them or because the financial markets like them. Indeed, members of the Fed have recently sounded warnings about inflation, and the financial markets remain sensitized to the smallest hint of rising prices. If anything, the Fed and the markets have been slightly biased toward higher rates, not lower ones.

INFLATION MIRAGE. But the budget agreement ensures that what was sluggish growth is likely to remain so, even with the help of lower rates. Thus the mirage that held sway over the financial markets—the prospect of healthy eco-

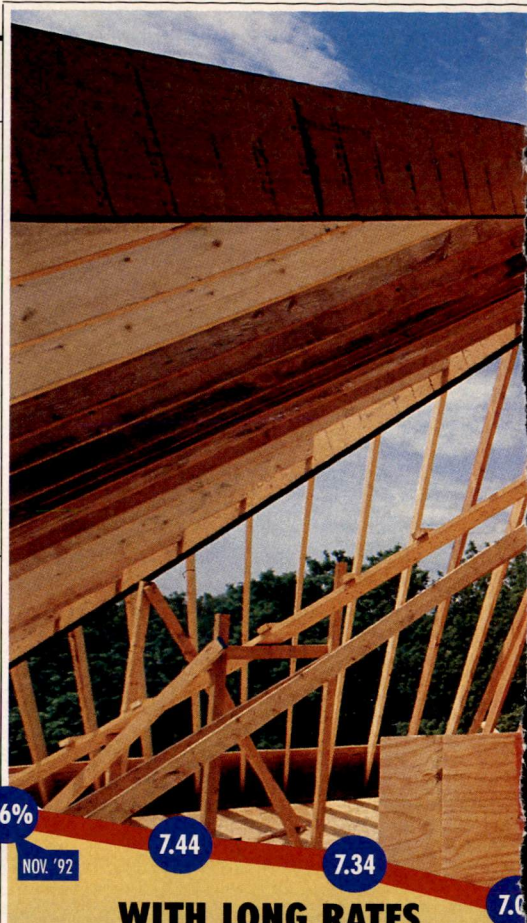
nomic recovery that might ignite inflation—has now truly vaporized. Throw in the harsh reality of recession or near-recession in all the major industrial nations, and the stage is set for still further declines in interest rates. "These lower rates have a lot of staying power," says economist David Resler of Nomura Securities International Inc. "There's no economic activity out there that would cause them to reverse course, and there should be continued downward pressure." Indeed, if the inflation rate keeps decelerating as it recently has (chart), there's room for the long bond to fall below 6% and even dip to 5½% in coming months.

**If Clinton
lucks out,
lower rates
will keep
the economy
growing at a
2½% pace—
and the budget
deficit will
go down**

Lower rates may not be able to lift the U.S. economy above a growth path of 2½% to 3%, but they will certainly be the tonic that prevents rising taxes and defense and Medicare spending cuts from pushing growth below that range. Expectations are that the budget agreement could shave a half-percentage point off gross domestic product growth next year. Cheaper money—especially the delayed impact of the rate decline that began in February—should work to offset a good part of that fiscal drag. On balance,

though, it will be a considerable achievement to obtain growth of 2½% just as serious deficit reduction begins.

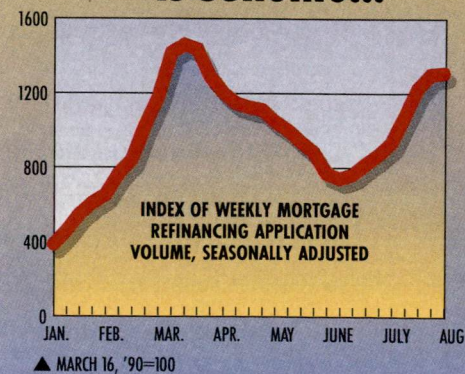
There may be other benefits that kick in only later, enhancing growth after this year. One is that companies have been able to refinance their debt at lower rates, and that has put them in a better position to ramp up spending and production if demand picks up steam. Then, too, lower rates have restored a measure of financial health to the banking system, which was flirting with a 1930s-style collapse only a few years ago. So when growth revives, banks will



**WITH LONG RATES
GOING DOWN...**

DATA: FEDERAL RESERVE

**...MORTGAGE REFINANCING
IS SURGING...**



▲ MARCH 16, '90=100

DATA: MORTGAGE BANKERS ASSN.

be in a better position to meet rising loan demand. Finally, higher marginal tax rates and falling yields may make state and local securities more attractive, providing the public sector with new opportunities to finance infrastructure spending. Such spending could give oomph to the economy, perhaps next year and into 1995.

The boost only goes so far, though. Despite the hoopla that would have us celebrating the lowest rates in years, rates in real or inflation-adjusted terms are not so low as they seem. After subtracting inflation of about 2½%, medi-

CIT

US output 'hit by fall in savings'

Financial Times

By Peter Riddell, US
Editor, in Washington

US OUTPUT may have been reduced by between 5 and 7 per cent as a result of the fall in the nation's savings rate during the 1980s, according to a study by the Federal Reserve Bank of New York.

Writing in the winter 1990-91 issue of the New York Fed's Quarterly Review, economists Ethan Harris and Charles Steindel argue that any measure of saving related to the acquisition of productive assets showed a clear decline in the 1980s.

Household saving averaged just 3.8 per cent of gross national product in the 1980s (and was even less in the second half of the decade), compared with a 5 per cent average over the previous 30 years. Corporate saving has also fallen and the government deficit risen. The overall net national savings rate was 3 per cent in the 1980s, against a historical average of 7.5 per cent.

Depending on the measure used, the fall in savings has cost the US the equivalent of 15 per cent of its capital stock which, on present trends, could rise to 28 per cent by the end of the century. The respective losses in output are 5-7 per cent now and 10-15 per cent by the end of the century.

Temporarily higher personal consumption has been gained at the cost not only of lost output but also a substantial worsening of the US's external debt position. The savings rate would have to climb 5.5 percentage points, as a share of GNP, to offset the decline of the 1980s, restore the trend in capital growth and end the deterioration in the external position.

The authors argue that most of the gap could be closed by balancing the federal budget (excluding the social security surplus). The goals in last October's budget agreement go two-thirds of the way in that direction. This will require lower current consumption.

However, a higher level of savings will not mean an end to the gross inflow of foreign capital, though it would probably reduce the US's net foreign indebtedness.

Moreover, the growth benefits of higher saving could be greatly increased by eliminating tax distortions favouring less productive investments.

April 3, 1991

Mason: Since this is referring to the propensity to shift to land purchases, in the latter period of a business cycle, it would be legitimate (wouldn't it?) to quantify these figures and attribute them to land speculation: the price of allowing people the freedom to invest in land. This is relevant to Capital, right? These ^{numbers} are perfect, for book-promoting purposes!

F.

CIT

Prof. M. Gaffney

April 2, 1991

Dear Mason,

Thank you for your many contributions to the IU conference: you were worked hard, leaving you with no decent chunk of time for sight-seeing. And you didn't complain. I am grateful. We all benefitted from your many insights; I remarked to Rita how I wished we lived in the same town....some relaxed conversations with you would yield many brilliant ideas for articles/books, etc; distance is our enemy.

✓ You can see (reverse) that Barnes & Noble have learnt their lesson, over the Noyes book, and are anxious not to lose out on the Gaffney and Andelson books. As I told you: they are chasing us! We must have something saleable...

Re Appendix 1, on interest rates. You agreed to incorporate a new intro, to make the arithmetic alluring to readers who would otherwise not touch statistics with a barge pole; and the angle we cooked up related to the fate of banks. Would this title serve our purpose?

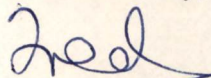
✓ *How* APPENDIX I
~~Why~~ Booms can cause Banks to go Bust
 Interest rates and collateral damage
 in the land market

✓ You will recall that I asked this question: how come the price of other assets do not drop as fast as land prices? Could you incorporate your two-sentence answer into the appendix? Because the investment implications, for entrepreneurs, are very important. And here, also, is a logical endorsement of the Georgist view that money ought to flow into productive capital, rather than land.

✓ *redeemable bond.*
 There is also to be a second appendix. Was it the formula that you put on the board, during Fred Jones' catastrophe theory session?

I'll keep in touch by phone; you did say you didn't mind the occasional reminder....

Yours sincerely,



FRED HARRISON

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April 1, 1991

FAX FAX FAX FAX FAX FAX FAX

To: Anthony Werner
Shepherd-Walwyn Publishers Ltd.

From: Kelly L. Rogers

Fax: 011 44 71 379 5770

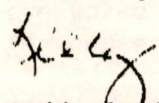
Dear Mr. Werner:

I was unable to reach you by phone today, however, I wanted to make certain you received my fax of March 25, outlining our interest in your two forthcoming books entitled, Commons Without Tragedy and Capital.

I noted from your fax that you needed an answer before April 3 so I wanted to make certain we didn't miss out on these!

I look forward to hearing from you at your earliest convenience.

Sincerely,



Kelly L. Rogers
Editor, Rights & Permissions

cc: Fred Harrison, Fax: 011 44 81 943 3352