Income Taxation and the Future of Free Enterprise
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Income Taxation and the Future of Free Enterprise

Mason Gaffney

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I. RISE AND FALL OF INCOME TAXATION

Unearned income and the case for free enterprise

The victory of market economics over socialism is alloyed with failures, more than enough of them to temper our hubris. Some of these are the same kinds that spoiled the good name of economic freedom in the laissez-faire climacteric of the late 19th century, and led to Populism and then The Progressive Movement in the U.S.A., and radical Liberalism, Fabianism and then the Labor Party in Britain. They are the same kinds that spoiled The New Era of the roaring 'twenties and led to The New Deal, Keynesian "socialization of investment," and all that.

We scarcely have time to congratulate ourselves on "winning" before confronting failures like the growing concentration of economic power, growing inequality of income and especially wealth, stagnant or falling real wage rates, homelessness and beggary, chronic unemployment, growing crime rates and personal insecurity, low domestic capital formation, obsolescence in the face of rising foreign competition, dangerous dependence on foreign oil, growing recourse to the underground economy, falling literacy and educational attainments, anomie and substance addiction, rampant self-seeking and predation, falling affordability of housing, and rising social divisions leading toward class warfare.

After centuries of trial and error capitalism still suffers from a deep-seated flaw serious enough to overwhelm the vulnerable most of the time, and topple the strong in periodic crashes. Each time we slip into another recession, as in 1990, we have to ask "Is this The Big One?" When we see the rich grow richer by unproductive means, and workers grow poorer by producing wealth, we have to ask "Is this capitalist justice?"

The thesis here is that the structural flaw in capitalism is our tolerance of unearned income and wealth. The idea of free markets is that income should go to incite and reward productive activity; wealth should incite and reward saving and capital formation. Unearned income and wealth do neither. Unearned wealth today (like slave-owning in the past) actually deters saving by the fairly obvious route of satisfying the owners' need

for the security of wealth, without their actually creating any capital.

Unearned wealth stigmatizes all wealth as the beneficiaries wrap themselves in the flag of free enterprise. Too many leftist critics in effect join semantic forces with the beneficiaries of unearned wealth by letting them misuse that flag, undenounced. Then leftist critics use the drones as cause to attack the very flag that covers their nakedness. Karl Polanyi attributed depression, Bolshevism and Fascism to "the Utopian endeavor of economic Liberalism to set up a self-regulating market system" - not a word there about unearned wealth. It is this camouflage and confusion we must penetrate if we are to gain from the fall of the Berlin Wall. Let Analysis separate free markets from unearned wealth, clearing our minds to build a new and better Synthesis.

Many friends of the free market lend credence to the view that capitalism is merciless and predatory. They would have us resign ourselves to its failures as the price we must pay for an otherwise efficient, dynamic economy that raises living standards for many people. "Greed is Good" recites actor Michael Douglas in Wall Street, epitomizing the message preached by dominant economic gurus of the Avaricious 'Eighties.

Workmanship turns to predation, and self-interest to greed when, in Veblen's term, there are "runs of free income" available.

> "... being in no way related quantitatively to a person's workmanlike powers or to his tangible performance, (this cupidity) has no saturation point. ... Their passion for acquisition has driven them ... to an indefinitely extensible cupidity ... (for) more than their proportionate share of the soil; not because they were driven by a felt need of doing more than their share of work ... but with a view to cornering something more than their proportion of the community's indispensable means of life and so getting ... something for nothing in allowing their holdings to be turned to account, ..."[1]

Veblen was writing about land, the prime source of unearned income and gains. The ambitious writer can produce a new book to share with thousands; the builder raise a new house to increase the total stock. The ambitious land speculator, however, only acquires more land by taking it from others. Supply being fixed, there is no other source, hence the link of greed and land

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[1]Thorstein Veblen, 1923. Absentee Ownership. New York: B.W. Heubsch Inc., pp. 139-40.

acquisition, and the link of this greed and market power. Those who have land can extract fortunes without (as landowners) giving anything in return.

The greed that concentrates market control will restrain economic growth overall. Even those who deny this happens at home see it clearly when it is called OPEC. Greed also unequalizes the distribution of any given amount of wealth, which leads to an indirect obstacle to employment and production. The political system cannot deny help to the losers, even in ancient monarchies and ever-so-much moreso in today's democracies. That means taxation, whose burden may further shackle production and create more losers, in a vicious circle.

The tragedy for capitalism is the role of unearned wealth is kept invisible. That was one of the goals of J.B. Clark and others, and the achievement of the "neo-classical" economics they sired. For a century many scholars have succeeded in distorting the concepts and data needed to lay bare the problem. In the face of vested interest and blinkered scholarship statesmen miss the main point and formulate wrong policies. Capitalist philosophers have to rely on the collapse of Marxism for a brief interlude of smug self-congratulation before turning back to our real world of worsening social problems.

Public debate in the United States, re cutting taxes on capital gains, should have exposed the contradictions. It is claimed this tax cut would leave greater profits to promote capital formation and the flow of new investment. In truth, many of the gains go to landowners who take without giving, who milk the cows without feeding them.

Yet debate in the salons of Washington and the pages of leading economics journals contained hardly a whiff of this analysis. The mighty American economy was allegedly pointed one way but actually steered another, a deceptive, destructive performance. Where did things start going wrong?

We will see that policy-makers in The Progressive Era, when income taxation was young, well understood the difference of earned and unearned income. They set out to tax the latter and spare the former - that's what the 16th Amendment was all about. We will see the early principles of income taxation progressively subverted, reshaping income taxation to the present destructive travesty. We will see how we may reform the tax to fulfill its early mission of meliorating, and so saving, capitalism.

<u>"Capital gains," the leading U.S. domestic issue of 1989-90</u>

Income-tax alteration is a fervid current issue, and a recurrent one. Tax revision dominated national politics in 1986.

Candidate George Bush put the tax in play again in 1988 when he ran for office on very few specifics but one, a proposal to exclude part of capital gains from the income tax base. As the proposal evolved the definition of "capital" assets broadened widely; and it took the first step toward "indexing" gains for inflation, another way of lowering the tax base.

My purpose here is to examine the case for abating taxes on gains, by whatever method, with special attention to rising land prices. It will be shown that these make up a large share of what are now conventionally termed "capital gains." We will also look at the traditional case for higher taxation of land gains, as expressed for example by Professor John R. Commons: "... the man who gets his wealth by mere rise in site-values should pay proportionately higher taxes ..."[2]

There is prominent academic support today for some form of tax relief for gains. The current consensus position is strongly for indexing, endorsed by centrists like Alan Blinder and the late Joseph Pechman, among others. An articulate and more extreme group has long held taxing capital gains is double taxation. The idea goes back at least to C.C. Plehn[3], and doubtless before. The current group favors scrapping income taxation in favor of a VAT. The group includes Charls Walker, Norman Ture, Paul C. Roberts, Joel Barlow[4], Arthur Laffer and others. Their rationale runs counter to the Haig-Simons concept of taxable income, to be sure, but there is dire wavering at Brookings, once a Haig-Simons bastion, as Henry Aaron and Alice Rivlin line up with Walker.

Walker's American Council for Capital Formation has secured and circulated signatures from Henry Aaron, Benjamin Friedman, Paul McCracken, Charles McLure, James Schlesinger, Lawrence

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[2]John R. Commons, Institutional Economics. Madison: University of Wisconsin Press, 1961; first published by The Macmillan Company, 1934. Vol. II, p. 819.

[3]C. C. Plehn, Introduction to Public Finance (5th ed.), p. 272. There is an unfortunate tendency of the modern group to "kidnap" J.S. Mill and Irving Fisher to support exempting land gains, when in fact they would have taxed them heavier. Mill did write savings should be deductible from taxable income to avoid what he called (erroneously) double taxation, and encourage saving; but he emphatically favored high taxation of land gains, or total confiscation. Irving Fisher's position is like Mill's.

[4]Barlow, an older writer, was mainly concerned with fast write-off of new capital, and it is not clear he would have made common cause with the others named. George Terborgh took a position like Barlow's on fast write-off.

Summers, and Lester Thurow in support of a VAT which is "consumption-based" (i.e. which excludes capital gains), "or other form of national sales tax."

Joseph Pechman himself, who long favored a comprehensive tax base including "Haig-Simons" capital gains, in his last years seemed to accept the view that an expenditure tax is intertemporally neutral, and had endorsed state sales taxes.

The support behind VAT and other consumer taxation shows us how the wind is blowing on Washington weathervanes. There are other winds, however, outside the Beltway. The fate of England's Charles I in 1642, of France's Louis XVI in 1789-93, of Russia's Nicholas II in 1917-18, of Indiana Senator Albert J. Beveridge in 1922, of House Ways and Means Chairman Al Ullman in 1980, of Japanese Premier Uno in 1989, and of Canadian Prime Minister Brian Mulroney in 1993, all manifest a tendency of voters to retire statesmen who identify with consumer taxes. The politically viable approach to exempting land gains is, for the present, through altering the income tax. We will focus on that.

You may gauge the intensity of the issue, and the high stakes, by its having tied up The U.S. Congress and stalled other business for several months: from early summer to November 4, 1989, when Bush's forces fell back to regroup. They promised to return and did within a week, making capital gains a rider to a housing bill. The President's push is extraordinarily persistent as he sacrifices most other initiatives and programs to this single goal, to the point of jeopardizing his relations with Congress and staking his whole administration on it.

The 1989-90 line-up of forces was quite partisan, although not entirely so. Democrats were split; barely enough opposed Bush's initiative to block it. However it was Republican Ronald Reagan whose administration had raised the rate on gains in 1986; some Democratic administrations have lowered the rate. It was a Democrat who challenged his colleagues, "Why should we do anything to anger the rich?"[5]

The approach here is economic, not partisan. The writer brings to this work an assumption that land income constitutes a peculiarly taxable surplus, and the income of new capital should be taxed much less. In those terms, each Party has its rights and wrongs, and shifting positions. Our present business is to sort out only the economics.

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[5]Tom Redburn, "Bush Capital Gains Tax Plan Periled by Political Reality", Los Angeles Times, 20 February 1989, p.20. The Democrat was Congressman Beryl Anthony, Arkansas.

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

Professor James Poterba, on the other hand, recently estimated "venture capital" accounted for only about 1% of capital gains in 1987[6]. That encourages a suspicion much of "capital" gains come from old assets, including land.

One must watch the shifting definition of "capital gains." The tax code says they are gains from sales of "capital assets," but what are "capital assets"? In the 1988 campaign candidate Bush proposed favoring only a limited class of gains arising from investing in and creating actual capital of limited, specified kinds. Investment real estate and corporations were to be excluded from the tax break[7]. This narrow proposal, targeted on incentives, evolved quietly into a broad break for all the same assets classified as "capital" assets before 1986. Most of these are not capital at all, but forms of land.

An allied issue is how to spur domestic capital formation. Champions of lowering capital gains' taxes hold this will stimulate it. The aim of untaxing capital is to free up forces that induce investment (a point in common with J. M. Keynes) and create new capital.

To do that we need policies that distinguish old capital from new. Many economists do emphasize this difference[8]. We must distinguish man-made capital, the fruit of saving and real investment, from natural resources or land. This paper analyzes "capital" gains ever mindful of that distinction. It is the old capital, and mainly land, that yield "capital" gains.

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[6]Business Week 24 April 89 p. 20. For what it proves, savings rates have headed up since the capital gains exclusion was repealed.

[7]Tom Redburn, "Bush Capital Gains Tax Plan Periled by Political Reality". Los Angeles Times, 20 February 1989, p. 20.

[8]On this honor role we may include Thomas Downs and Patric Hendershott (NTJ XL 183); Joel Barlow, pleading for faster write-off of new capital (NTJ XXVI (3) 429); Hatsopoulos, Krugman and Poterba (op. cit., p. 16); Richard Musgrave (J. of Economic Perspectives I(1), summer 1987, p.69); Alan Auerbach (J. of Economic Perspectives I(1) Summer 1987, p. 83; and many other tax economists.

Present at the creation: genesis of the U.S. income tax

Congress enacted an income tax in 1894. There were 50 Populists in the House then. They supported an amendment to the income tax act, by Judge James Maguire of California, to make it a direct tax on land rents. The constitutionality of Judge Maguire's amendment was assured by apportionment of the tax among states by population.

Judge Maguire's specific amendment failed. We may reasonably surmise, however, that a bloc of committed, zealous Congressmen was what kept land rents in the base of the 1894 Act. They could block any income tax bill that excluded land income. At any rate, Congress included land income in the base of the 1894 tax.

This in turn provoked the Supreme Court into holding the 1894 Act unconstitutional[9], on grounds that a "direct" tax had to be apportioned among states by population. (Such apportionment was unacceptable in Congress, just as James Madison and Alexander Hamilton had planned a century earlier.)

Since they couldn't get an income tax exempting rents, income taxers were forced into engineering the 16th Amendment (1913) which removed the original constitutional roadblock (apportionment) to direct taxation of land rents. Congress has been taxing land rents ever since.

It even has the power, if it wishes, to exempt all other forms of income and limit the tax to rent. Is that off the agenda politically? Not really. The corporation income tax is a tax purely on property income. In the 1960s new capital achieved partial de facto exemption via fast write-off. Expensing is tantamount to total exemption. If we tax the profits of property, and relieve new capital, what is being taxed but land rent?

Most Populists were retired in the McKinley landslide of 1896, but that was not the end of Populism in Congress. In the early 20th century Populists bounced back, retreaded as Progressives. It was during The Progressive Era the income tax was molded and cast.

A key player was Congressman Warren Worth Bailey of Johnstown, Pa. Bailey was not just present at the creation of

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[9]Pollock v. Farmers' Loan and Trust Co., 157 U.S. 429 (1894); rehearing, 158 U.S. 601 (1895).

modern income taxation, he was the mid-wife. These excerpts from historian W. Elliot Brownlee[10] bring out the point.

> ...Wilson had to ask for significant tax increases. ... he supported new taxes that shifted the American tax system in a highly progressive direction. ... The boldness of the progressive shift is without equal in the history of American taxation. ...hostility to concentrations of power and wealth was politically potent. ... it was necessary for him to confront the powerful support for pursuit of social justice through redistributional taxation. The result was a commitment to not only income taxation, but highly progressive forms of income taxation.
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> ... with the Underwood Tariff of 1913, ... Wilson ... accepted the risk that tariff revenues might fall short. (Note: this was George's strategy in pushing free trade: substitute land revenues for tariff revenues. -- M.G.) ... Wilson firmly rejected the options of borrowing ...
>
> ... the Democratic critics of Wilson attacked the plan to broaden the income taxation to lower income groups and to add new excise taxes.
>
> ... The Democrats (abovementioned) ... were a diverse group of single-taxers, socialists, and inheritors of Populist traditions. ... For Warren Worth Bailey, for example, the war confirmed a belief in single-tax doctrine, in the necessity of taxing away economic rent not only to insure equality of opportunity but also to prevent destructive international competition.
>
> ... They wished to replace taxes serving the appetites of special privilege with taxes that would ... confiscate monopoly profits.
>
> ... The most vigorous leadership of the income tax movement rested with labor, representatives of farmers, and single-taxers. They believed that income taxation should reach only those incomes earned by monopoly power.
>
> ... Lending a powerful thrust ... was Congressman Warren Worth Bailey, from Johnstown, Pa. His personality and ideas dominated much of the early legislative activity behind the development of an alternative to Wilson's December program. ... Bailey was an articulate, energetic spokesman for single-taxation. ... he became an important liaison figure between the Wilson Administration and the single-tax movement, which, fueled

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[10]W. Elliot Brownlee, "Wilson and Financing the Modern State: The Revenue Act of 1916". Proceedings of the American Philosophical Society 129 (2), 1985, pp. 173-210.

by the capital of messianic Joseph Fels, gained significant strength in 1912 and 1913.

Bailey also became the leader of a small band of single-tax congressmen ... on behalf of taxes on the 'unearned increment' stemming from landownership ...

Bailey's career illustrates how the single-tax movement, reinforcing the Populist heritage, advanced the adoption of a progressive income tax. ... Louis Post ... supported income taxation ...

...Bailey wrote ... urging ... financing preparedness by wealth taxes. ... he called for 'an increase in the tax on incomes exceeding $25,000 a year.' He advocated, as well, 'an inheritance tax levied upon swollen fortunes,' a measure that single-tax Senator Edward Keating of Colorado had proposed to him.

...a surtax ... on incomes in excess of one million dollars. This measure surfaced as the recommendation of ... a diverse group of radical urban-progressives, single-taxers and socialists. John Dewey, Frederic C. Howe, Amos Pinchot, and George L. Record were among the founders. ...

Wilson even moved towards taxing unearned increments as they accrue, not waiting for realization in cash. This would give the income tax some of the character of a property tax. Now hear this, you who despair of professional economists. Are you ready? Most mainline tax theorists agree with Wilson. The names of Professors Haig and Simons make up the codeword. "Haig-Simons" taxable income includes land gains at the time they accrue, regardless of any sale.

The U.S. Supreme Court ruled against Wilson[11] because Congress hadn't authorized what his Treasury officers did. But The Court then and later clearly opined Congress may tax unearned increments when and how it will[12]. That gives a notion how intimate is the nexus between property and income taxation.

Seven decades of creeping regress

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[11]Eisner v. Macomber, 252 U.S. 189 (1920)

[12]"...Congressional taxing power is not seriously restricted by such an implied requirement (Macomber) ... Congress is free to treat gains and losses as 'realized' pretty much whenever it chooses." Marvin Chirelstein, Federal Income Taxation (1979). 2nd Ed. Mineola NY: The Foundation Press, p. 69. Chirelstein is a Yale law professor, and this source is "the law student's bible".

If the capital gains exclusion is revived it will nearly complete a transformation of the income tax from its original form, the handiwork of Warren Worth Bailey, to a tax on work and enterprise of the median citizen. The transformation will never be literally "complete": property never sleeps. Already the road leading down to McKinley is posted and blazed all the way with the "cash flow tax,[13]" and VAT. Here, however, we just look at changes to date. They are enough to make a Jeffersonian feel like a chess player facing mate.

a. Wage and salary witholding came in 1941, along with higher rates in lower brackets, converting a tax primarily on property income into a mass payroll tax. State and local public employees, previously exempt, were added to the base in 1939.

b. "Bracket creep" during inflation has pushed most workers into higher rate brackets, with no increase of real income.

c. The effect of bracket creep has been reinforced at the bottom, where most wage and salary income is found. The real value of personal exemptions has fallen, as the dollar allowances have fallen behind inflation. Labor-oriented favors to earned income have been all but wiped out.

d. The effect of bracket creep has been offset at the top, where most rents and capital gains are, by lowering the top rate from 70% to 28%.

e. Bracket creep has raised the average tax rate applied to personal income, because of the graduated rate structure. At the same time it has <u>not</u> raised the average rate applied to corporations, which are immune to bracket creep because the corporate rate is basically flat (with trivial exceptions at the bottom). The corporate share of total tax revenues has fallen sharply. Now, in addition, Congress has lowered the flat corporate rate from 46% to 34%.

f. The high, rising payroll tax (FICA) today raises more money than the corporate income tax, which originally dwarfed it. FICA takes over 14% off payrolls, adding the employer and employee portions.

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[13]Aaron and Galper actually propose expensing all land purchases under such a tax. This is proposing to exempt land 100%. An owner is only taxed if he cashes out, at which time the buyer expenses the purchase so the exemption is passed on to each successive landowner, and land as such is never taxable. Henry Aaron and Harvey Galper, <u>Assessing Tax Reform</u>. Washington: The Brookings Institution, 1985, p.76.

g. Preferential treatment of land rents and gains has grown in several dimensions. This entails much more than the partial exclusion of gains from taxable income. The details comprise most of what follows.

The cumulative effect of those seven changes in federal taxation is totally to transform the income tax from the original ideas voters had before them in 1913, and what Congress had in mind in 1916 when it passed the first important revenue measure following the 16th Amendment. A tax on the privileges of the idle rich ("idle" meaning with unearned income) has become a tax on the necessities and earnings of the working poor.

The shift of taxes off rent-yielding property is the more striking when we add in the States. In 1920 fully 50% of State revenues came from State property taxes; today hardly any. Almost all local revenues were then from property; today much less than half. Sales and income taxes have replaced them.

One bright, or at least light gray spot in this dark history is the relief of new investment from taxation under JFK, in a compact known as "business Keynesianism." Walter Heller was Chair of the CEA, perhaps the only really influential Chair that group ever had. Heller sold the idea of offsetting the effect of high income tax rates by allowing fast write-off of most new investments, plus an investment tax credit (ITC).

The policy is effective in theory, and proved so in practice. The high tax rate applies in full force to rents from old assets; new investment gets major relief. It was not a golden age, but neither was it an age of rust. It was a time when the economy refused to take its expected dive.

1986: retrogression dressed as The Tax Reform Act

In 1986 Congress eliminated the preferential treatment of new investment in real capital formation. The three changes were:

1. Repeal of Investment Tax Credit (ITC).
2. Lengthening tax lives.
3. Decelerating depreciation pathways.

These changes have raised the effective tax rate on most new investment. Traditional liberals applaud them as closing

loopholes[14]. Economists, conservative or liberal, have been enchanted by "uniformity." Even Citizens for Tax Justice, a labor union tax lobby, has chimed in with praise and support for the 1986 reform[15]. Their zest for taxing new investment seems now to override their former support of a progressive rate structure.

Uniformity is a good rule as between mutually convertible things. Land and capital are inconvertible, so incentive taxation may treat them differently. Incentive taxation is not uniform, it is -- pardon the ancient expression -- Keynesian. Why Keynesian? Keynes always focused on the "marginal efficiency of capital," which in modern business lingo translates into the rate of return at the margin. The average rate of return includes rents; the marginal rate of return does not, it is the incentive to invest, the pure return to new capital as such. Incentive taxation distinguishes new assets from old. It takes a smaller bite from new investment and a larger bite from old, especially from land, the oldest of all.

Before 1986 a high-bracket professional -- physician, lawyer or actor -- could avoid the effects of high marginal tax rates by investing in certain kinds of real new capital: buildings, equipment, machines, rolling stock, furnishings and fixtures, trees, vines, or livestock. This did, it is true, make for overcapacity in certain kinds of capital, e.g. avocado trees in California, offices in Texas. Some forms of capital received much more exemption than others. I will not defend the abuse. But today that professional is better off buying up old capital and land. Corporations are moved to join the merger-mania which creates no new wealth at all.

This poses worse problems, like overpricing land, and pricing median investors out of the market. It also tends to reduce saving and domestic capital formation. This is the message of many new economists like James Poterba[16], whose chapter is in these covers.

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[14]Walter Heller's son, Professor Walter P. Heller of U.C. San Diego, tells me that in 1986 Walter Heller opposed accelerated depreciation because it was used too much to shelter income from old assets. He continued to favor ITC, his "baby," because it can only be applied to new capital.

[15]Bruce Fisher, "Bush Crowd has a Plan", L.A. Times, 2 Oct 89, Section II p. 5. Fisher is research Director, Citizens for Tax Justice, Washington D.C.

[16]George Hatsopoulos, Paul Krugman and James Poterba, Overconsumption. Waltham, Mass.: American Business Conference and Thermo Electron Corporation, 1989.

What are "capital gains"?

The 1986 tax reform was a massive shift of income tax liabilities off land (by lowering the top rates), and onto new investment (by decelerating write-off). Its only saving grace, from the viewpoint of incentive and redistributive taxation, was eliminating the preferential lower tax rate on capital gains. (Technically, it eliminates the exclusion of part of long-term gains from the base). The "saving grace" was a political bargain, to maintain some of the social compact while lowering the top rates from 70% to 28% in history's most massive shift toward a flat rate income tax. Now one side of the bargain is being reneged, "driving a stake in the heart" of the 1986 compact[17]. The Administration knowingly lost much goodwill with Congress on this single issue, even risking its ability to govern in 1989. What are capital gains to warrant such hazards?

The term "capital gains" is a disguise, artfully contrived, growing more obfuscatory with long usage and growing complexity. It is the nature of most actual capital to depreciate, usually fast. There are few true resale gains to capital as such. It is rather land, irreproducible and limited, whose nature is to appreciate and yield unearned increments. There are exceptions, which the champions of downtaxing gains may use in debate; but exceptions are no basis for framing generalities or public policy. As a broad rule we are on the mark to read "land gains" where the world writes "capital gains."

As Lester Thurow wrote, "If lower capital gains taxes were limited to plant and equipment investment in new, high-risk venture capital situations, one could understand the proposal ... But the lower ... rates will also apply to antiques, ... land, ... assets that have nothing to do with reindustrialization. For every dollar's worth of reindustrialization incentives offered, several dollars worth of incentives will be provided for nonproductive investments."[18] James Poterba, as we have seen, estimates a very small share of capital gains derive from "venture capital."[19]

Corporate shares also yield "capital" gains. What makes these shares rise is the rise in value of corporate assets. The

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[17]Tom Redburn, loc. cit.

[18]Lester Thurow, "Getting Serious about Tax Reform". Atlantic M? date? Thurow's later endorsement of VAT does not seem very consistent with this passage.

[19]James Poterba, loc cit.

writer has shown elsewhere[20] that a large share of corporate assets consist of land (in the generic sense of natural resources).

The strongest reason for favoring capital gains is this. Another source of the rise in stock prices is the plowback of undistributed profits. Some of this actually does go to create real capital. (The rest goes to acquire old capital and land.) By this indirect route, a portion of any cut in capital gains taxes does actually foster real investment, as claimed. But the portion is too small, and the productivity of the investment often low, because this captive internalized undistributed profit comes to management free of any competitive market cost or test.

When the purpose of Congress is really to encourage new investment, fast write-off of new capital is the obvious tool. The tool was highly developed and applied during the 1960s, as noted above. It would also help to allow full deduction of capital losses, a provision conspicuously missing from current proposals, and indeed all reform proposals since 1932 or so.

The main effect of untaxing land gains, on the other hand, is simply to redistribute wealth and overprice land. When tax benefits go to land, the word "incentive" takes on a new and lesser meaning. Land, by definition, is not created by capital formation. Incentives to buy and hold land will raise the demand, not the supply. The incentives created are not the kind that produce anything or employ anyone. They simply raise asking price and exclude marginal buyers from the market.

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[20]Mason Gaffney, "Adequacy of Land as a Tax Base". In Daniel Holland (ed.) The Assessment of Land Value (1969). Madison: University of Wisconsin Press.

II. PERVERTING THE INCOME TAX: A CASE STUDY

Loopholes for land

In 1986 Congress closed loopholes which encouraged investment in new capital, but did not close them for land. It drastically lowered the top rates, a radical redistribution in favor of landowners, as we will see in detail. Here is an comprehensive systematic list of special loopholes open to those who own or buy and sell land.

Deferral of tax

The basic preference for land gains is tax deferral. Land gains are not recognized and taxed as income when they accrue, but only later upon sale for cash. To grasp the advantage of this deferral, consider this comparison of investors A and B. Both are subject to a tax rate of 50%.

"A" puts $1 in a savings account paying 7.2% compounded annually. (That is the rate at which money doubles every 10 years.) He gets 3.6% after taxes, and plows it back, at which rate it takes twice as long, 20 years, for money to double. After 60 years his wealth has grown to $8.

"B" puts his $100 in land whose value rises at 7.2% per year. After 60 years its value has doubled 6 times, to $64. He sells it and pays taxes of 50% on the gain of $63. He thus clears $32.50 after taxes. B's wealth has grown to over 4 times A's wealth, although both made the same rate of return, and both paid taxes at the same rate. The difference is timing.

This is why the standard Haig-Simons concept of income says increases of wealth should be taxed when they accrue. Tax

NOTE TO READER: Pp. 16-20 deleted; go to p. 21, next sheet.

economists, sadly, have finessed this issue by agreeing with Haig-Simons in theory, but closing the matter by saying it is not practical. Thus they please both the theorist in the classroom and the landowner in the event. There are exceptions like James Wetzler, who has shown some simple practical ways to adjust taxation for this factor.[21] Where there's a will there's a way; the will has been too weak.

Deducting costs of buying and holding

A. Covert depreciation of land

The tax code is clear that land is not depreciable, and should enjoy none of the benefits of fast write-off, or any write-off. This is obviously part of the heritage we owe to Judge James Maguire, Warren Worth Bailey and others present at the creation. Left to their own devices standard-brand economists like John Bates Clark and Frank Knight would doubtless have said, as they maintained vehemently in their writings, that land is no different from other capital[22]. They would have made it depreciable.

But the Internal Revenue Code still says land is different. When an investor buys land under an old grove, or old building, the Code says he must allocate his basis between the depreciable capital and the non-depreciable land. The requirement is reasonable, since buildings and fruit trees generally do lose value with time, while land does not.

So far so good. The problem is that property never sleeps, and reformers have hibernated or been subverted. As the watchdogs dozed, IRS became extremely lax and "generous" in letting buyers overallocate basis to the depreciable building or grove of trees. Thus they contrive to depreciate for income tax

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[21]James Wetzler, loc cit. See also M. Gaffney, "Tax-induced slow turnover of capital", ...

[22]Clark and Knight both attacked George and his ideas vigorously, Clark in the flesh and Knight in the spirit. See J.B. Clark, "The Moral Basis of Property in Land", J. of Social Science, containing Transactions of the American Social Science Association, No. XXVII, October 1890, Part I, The Single Tax Debate, pp. 21-28; and "Capital and its Earnings", Publications of the American Economic Association, vol. 3, No. 2, pp. 1-61. Frank Knight, "The Fallacies in the Single Tax", The Freeman, 1953, pp. 809-11; and "Some Fallacies in the Interpretation of Social Cost", in G. Stigler and K. Boulding (eds.) Readings in Price Theory. Chicago: R.D. Irwin, 1952, orig. 1924.

not just the building or trees, but part of the land value. Often that part is major.

When is a tax not a tax? When the Treasury compensates an owner for his land in advance, before beginning to tax its income. A taxpayer in a 70% bracket, for example, reduces his taxes by $70 per $100 of land he writes off. The Treasury has paid for 70% of the land written off. Later on the Treasury gets 70% of the land's income, which is only a return on its own investment. The taxpayer put up 30% of the cost and nets 30% of the income. On that investment he gets a tax-free return, which may well continue forever.

It is now familiar doctrine that to "expense" durable capital when it is first acquired is tantamount to tax exemption over its life. What is so special about writing off land, then? Expensing capital is an alternative to regular write-off that would occur otherwise, a little later. Expensing land is a write-off that should not be allowed at all, ever.

Writing off land <u>at any time</u> has the same effect as expensing, from that year forward. With capital, the value of tax exemption begins dwindling right away, as the capital loses value. With land, the full benefit continues unabated <u>forever</u> -- forever unless the illegal depreciation is recouped, which we will see it seldom is.

Herbert Spencer and John Stuart Mill advanced the notion of compensating landowners in advance for the right to tax them. Even the more radical Alfred Russel Wallace seemed to go along (although only in token fashion[23]). The matter was taken quite seriously in the 19th century, and was often thrown up at George. In recent times it lost real force as a debating ploy, what with high tax rates confiscating everything else, and the draft confiscating conscripts' lives.

But as regards land, the IRS has actually been following Spencer and Mill for many years, while debaters played in their sandpiles. The Treasury has bought the land so it may later tax it. But IRS has gone beyond Spencer and Mill: after buying the land it often fails to tax it anyway, as we will see.

The landowner gets this tax-free return forever, unless he sells. At that time there may be some recoupment. We show later this is minimal in practice, so the public purchase is not fully recouped, and the landowner's benefit goes on forever.

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[23]For Wallace's carefully crafted proposal see his <u>Land Nationalization</u>, 1880.

Taxpayers do not write off all their land purchases, but only part. It is on the part written off they achieve tax-exemption. Much evidence indicates they write off large fractions of their land value. Here, for example, is an ad from the Los Angeles Sunday Times, Nov. 25 1962, telling buyers they can depreciate over 80% of what they pay for citrus groves in Redlands[24]. Redlands at that time was a city rapidly converting citrus to housing, where only 20% of what they paid was likely to be for the depreciable trees (which weren't depreciating physically so much as suffering locational obsolescence from rising land value).

Is the Redlands case exceptional? For systematic evidence, consult IRS advice to taxpayers.[25] This counsels and invites taxpayers to use the local property tax assessor's allocation between land and buildings. Here is another intimate relationship of income and property taxation. Underassessing land for property taxation actually has more impact on income taxes than on property taxes. The same property tax rate is applied to both land and buildings. But buildings are depreciable for income tax; land isn't.

Reams of evidence have been published finding these assessors' allocations consistently understate land values relative to building values. This evidence includes the nationwide sales/assessment ratio studies published regularly by the U.S. Census of Governments. The writer's research in Milwaukee found the local practice is to understate land values by about 2/3[26], that is to report them at 1/3 their true value relative to old buildings, which are correspondingly overassessed.

Most remarkably, land is written off again and again, every time taxable property changes hands. Every succeeding owner gets a new basis, the price he "pays" (cash is not required). The new owner again overallocates his basis to depreciable capital, setting himself up to depreciate the land again. Thus every piece of land may be partly written off as many times as it sells. Recoupment, we will see, is often zero or trivial.

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[24]Ad placed by Citrus Investments, 11 N. 5th St., Redlands CA

[25]U.S. Internal Revenue Service, Your Federal Income Tax, annual.

[26]Mason Gaffney, "Adequacy of Land as a Tax Base." In Daniel Holland (ed.), The Assessment of Land Value. Madison: University of Wisconsin Press, 1970, pp. 157-212.

In result, the contribution of much land to tax revenues is negative, and heavily so. Remember, these write-offs yield perpetual benefits, and are cumulative. Over several transfers, a given parcel of land may have been written off well over 100%, as of now. But there is no end to it, it just goes on, and on, and on.

The writer has often urged the need for a Federal Board of Equalization, to correct local underassessment of land and prevent the depreciation of land[27]. This idea will fall on deaf ears in Washington until citizens concerned with tax justice wake up to the issue and its massive impact on equity, incentives and employment.

B. Fast write-off of land

In the Redlands ad cited, full depreciation is promised in 10 years. The tax code has elaborate guidelines and (at that time) "reserve ratio tests" to avoid fast write-off of new capital. Those rules and guidelines do not apply to old capital, and the land value that bleeds into it.

The slow write-off that came in 1986 applies only to new capital. For old buildings, very short tax life is routinely allowed. Every case is individual and a matter of judgment. Nothing stops most taxpayers from claiming their buildings or farm capital are destined for early salvage. They have little to lose. The worst an auditor might do is say "no, make me a better offer." It is a matter of judgment and individual negotiation, not willful violation of rules, or criminal intent. The auditor is not going to examine the building, the IRS lacks the staff and expertise.

C. Carrying costs during appreciation

Interest on debt incurred to acquire or refinance land is "expensed," i.e. fully deductible when paid. So are property taxes. Consider a parcel of vacant land held for the rise, yielding no taxable cash flow. Interest is recognized as a cost of "producing" the current appreciation. ("Financing" a land gain does not truly produce it, actually. We will return to that.) Costs are recognized long before gains; they should rather be synchronized. The increment that each year's deductible expense finances is not recognized as taxable until years later when (and if) the land is sold and cash is received (credit sales get additional deferral).

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[27]Mason Gaffney, "An Agenda for Strengthening the Property Tax". In George Peterson (ed.), Property Tax Reform. Washington: The Urban Institute, 1973, at p. 78.

Neither interest nor property taxes are ever deducted from basis, as depreciation is. The fisc only recoups them if there is a gain, and the gain is fully recognized.

In today's market nearly all land is held for appreciation in part, even if the land is fully used. All land prices include a premium above the price derived from current cash flow, because of expected future increases. Any interest paid on debt secured by that speculative premium is expensed currently, even though the later taxable income, which presumably[28] justifies the deduction, will not be recognized until sale.

Interest on debt secured by rising land should not be deductible until the gain is taxable (and possibly not even then, we will see). The advantage of deducting it currently can be great, if the holding period is long, because of the time-value of money. Thus, a dollar a year for 60 years comes to $60; but a dollar a year with interest at 9% comes to $1945, or 32.4 times as much.

The points just made are accepted by many tax economists, and occasionally articulated. The following, more basic points are generally avoided. That is a pity, although sadly predictable, because they get right to the heart of some things that need radical rethinking.

Holding title to and "financing" appreciating land is not what makes the value rise. Interest payments do not "produce" increments to land value. Appreciation would occur anyway, owners don't cause it by financing land, holding title and paying interest. Arbitrage creates the illusion land is just another investment, but with land the future income is cause, the "cost" of the investment is an effect. To master the real issues one must grasp that basic difference between land and man-made capital. That requires one to overcome the biases suffocating objective thought in a society whose culture and semantics are catered to a wealthy class with an interest in obscuring the matter.

From that it follows, an owner needn't be allowed to deduct his "carrying costs," his costs of holding title, in order to make land rise in value. Demand makes it rise, not cost. This is implicit in Austrian or demand-side value theory, but moderns who brand themselves Austrians avoid the subject (and aren't earning the brand they claim).

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[28]I say "presumably" because the later income does not result from the the expenditure. The gain will occur regardless. The landowner who "carries" title does so to capture or acquire a rise in value that he does not cause. This point is discussed below.

The only functional reason for deducting carrying costs, then, is to avoid discriminating between equity holders and mortgaged holders of title; to encourage pledging land as security for loans. Whether that is desirable is beyond the scope of this paper, but the issue is arguable and should be aired. There is a traditional case against it, as developed by the "banking school" of 19th century Britain and the "commercial loan" school of the early 20th century. These have waned in recent times, but the S&L collapse and bailout should bring them roaring back to life - if not, we are ready for extreme unction.

There is no overwhelming case for letting owners deduct holding costs even for land with level cash flow, fully taxable, and with no price appreciation. An owner has not created land but simply outbid everyone else for it. Supply is fixed. Non-deductibility would simply lower the price, possibly broadening entry into the market. In these conditions, any deductibility seems gratuitous.[29]

D. "Rent-seeking" outlays

The ownership of natural resources, de facto or de jure, is often given in return for occupying and/or using the resource first. "Grandfather rights" is a generic name for ownership so established. "Rent-seeking" is the process. Some of it happened long ago, but it is still occurring actively as demands on land grow more intense, new kinds of resources are exploited, and tenure is tightened and extended.

In order to secure future rents, rational seekers incur losses today, as an investment to secure the resource. These losses are basically costs of acquiring land, and should not be written off at all, yet they are. Current operating losses are expensible; capital outlays are at least depreciable.

A good example is the appropriative doctrine of water law: "first in time, first in right" is the slogan and the law. Prior use establishes a perpetual license. The country is full of water sources currently subeconomic, but potentially rentable. The only way to secure the future rents is develop and use the water now, before a rival. That is constantly being done. The winner absorbs the losses of premature use, and deducts them from taxable income. Thus the fisc shares the cost of land acquisition.

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[29]A case may be made for allowing deduction of interest, but not property tax. The argument is that interest rates discriminate against poorer buyers, an effect that should be offset; while property taxes are independent of who owns property.

Zoning is another example. With the spread of zoning, the race is to get grandfathered in on NIMBY or LULU (Locally Undesirable Land Use) activities before they are zoned out. Thus one secures not only a property right but a monopoly of it. The more offensive a land use is to its neighbors, the more lucrative for a firm to establish an early history of noise, traffic, on-street parking, odors, high-rise building, crowding lot lines, smoke, fumes and other nuisances.

With air pollution the current approach is not to make the polluter pay, as once seemed like such elementary justice and efficiency, but to reward him.[30] The reward is called an "offset right," a pollution right he may keep and use, or sell to others if he abates his own. "His own" is based on his history of prior pollution, which thus acquires a positive market value. The rent-seeking incentive is to pollute liberally today to secure the offset right tomorrow. Losses incurred are deductible; offset rights, if sold, yield "capital gains." The pliability and corruption of the word "capital" is remarkable.

Rights to radio spectrum are allocated the same way. The license is "free," but one must use it or lose it. The incentive is to use it prematurely, suffering losses, taking the gain in the rising value of the license as demand rises. Rights to air routes, and time-slots and gates at airports, were allocated the same way (although some of these were lost during deregulation).

Rights to produce price-supported crops are secured and retained the same way, maintaining a history of acreage in production of supported crops. Whenever quotas are lifted this provides a strong fillip to expanding acreage to establish histories to gain future quotas. A well-known such case is the transfer of cotton production to southern California counties during the Korean War.

When a land developer pays out for streets and their improvements, these are deductible over some period. The capital in streets wears out, like all capital, but what the developer bought for his outlay is the community's duty to maintain, repair, police, service and replace those streets forever. That benefit is capitalized into land prices. The premium of urban value over farm value is thus acquired by spending deductible

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[30]This puts into practise the oddly fashionable theories of Chicago Professor Ronald Coase, surely one of the best friends polluters ever found. Even more oddly it has survived the more recent fashion of analyzing "rent-seeking" behavior, which would seem to demolish whatever structure there is to the Coase position.

money. It's tantamount to writing off part of the cost of land purchase.[31]

Exploration costs for oil, gas and hardrock minerals are largely expensible, but mineral deposits, once found, are "capital" assets for tax purposes. The other tax favors for minerals make a list too long to recite here, discussed elsewhere.[32]

Once one gets the concept, one sees more and more resources, or sticks in the bundle of rights to resources, being distributed on this appropriative principle. Familiar concepts and phrases are squatters' rights, use it or lose it, rights of use, beneficial use, due diligence, prior possession, residence requirement, homesteading, work requirement, duty to serve, franchise, trade territory, first in time first in right, adverse possession, quota basis, history of use, customary rights, ancient lights, grandfather protection, vested interest, established use, etc. All these are ways of acquiring landownership, de jure or de facto, by incurring early losses.

For Knut Wicksell, one of the greatest economists, it was even more general. "Because of the local character of the firm and its market ... the large enterprise has an actual monopoly simply because it comes first on the scene, and this monopoly may be as good as a monopoly which is legally established."[33] Thus it is that firms subsidize branches in growing regions, neighborhoods and markets, absorbing early losses to establish effective territorial franchises. Often these are buttressed with legal franchises like bank charters, liquor licenses, and such exclusionary devices, which are forms of tenure, called "capital" assets in the tax code.

E. Leasehold abandonment

Costs of acquiring oil and gas leaseholds may be written off about 80% before production begins, through the device of

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[31]This is not entirely a capital gains issue, because some developers get classified as "dealers" and denied capital gains on sales. Others contrive to avoid dealer treatment, however, and even those who do not get a big break by writing off land acquisition at all.

[32]Mason Gaffney, "Oil and Gas: the Unfinished Tax Reform". A paper presented to annual conference of TRED, Cambridge MA, Sept. 1982, pp. 1-53. Being updated for submission to Natural Resources Journal. MS available on request.

[33]Knut Wicksell, Lectures on Political Economy. Vol. I, p. 131.

abandoning leases. In the normal course about five leases are acquired for every one that produces commercial oil or gas. Those are the odds of the game, known by the players. The cost of the four dry leases is really part of the price paid for the one producing lease. The Code, however, lets one "abandon" the dry leases (at one's convenience) and expense their full bases. Thus most of the leasehold cost is written off up front.

Part of exploration cost and dry-hole cost should also be attributed to land acquisition; these, too, are expensible.

F. Unitized developments: the "ski-lift economy"

A typical ski-lift operation loses money, making it up on sale of surrounding real estate. The losses are ordinary losses, fully and currently deductible. The sales (if one is careful) qualify as capital gains.

Large unitized land developments generally follow this pattern. The developer loses on or subsidizes certain uses thought to shed positive externalities. A more general pattern is the effort to attract the highest stratum of the market at the cost of some waiting. Early sales are restricted to wealthy buyers at low density, to tone up an area and enhance later sales.

Waiting for sales entails foregoing early rents. The tax consequences are well conceived as "implicit expensing." The foregone early rent is plowed back, in effect, without having been received and taxed. The tax effect is the same as though the rent had been received in cash, reinvested, and expensed. In this case, foregoing the early rent is calculated to enhance the value of adjoining land, and is analogous to land acquisition.

Defeating "recoupment"

Anyone defending the system would insist The Treasury recoups excess depreciation when property is sold. Excess depreciation, including depreciation of land, lowers the "basis" and results in higher gains at time of sale. Thus the tax exemption is not perpetual, but ends with the sale.

A defender would also point out unrealized appreciation is not exempt forever, but is finally recognized and taxed at time of sale. So those deferred taxes are also recouped. I treat these two matters jointly in what follows.

A long period of tax deferral, tantamount to tax exemption, is still very advantageous, considering the time value of money. Early dollars are heavier than later dollars, a point that is often made, but bears frequent repetition until Congress shall

have done something about it.[34] The laggard treatment is in stark contrast with the unforgiving witholding and full rates levied on salaries and wages and interest and current profits from the "ordinary" functions of producing goods and services that constitute the real national income. "Ordinary" is a remarkably invidious word for a democracy. It seems to say, paying taxes on time "is what the simple folk do."

Evenso, at least the exemptions would not accumulate if each exemption and deferral were finally recouped. In fact, however, landowners routinely defeat recoupment. Excess depreciation, and unrecouped deduction of carrying costs, have accumulated over several generations, continue to accumulate, and will accumulate in perpetuity until the system is radically revised.

About $327 billions of capital gains were reported in 1986, a weighty number. It is only a trace of what is there, however. Most capital gains are never recognized. Landowners defeat recoupment in at least seven ways: deferring sales indefinitely; stepping up basis at death; being non-resident aliens; giving bequests; excluding part of gains; recouping at lower tax rates; and recouping in devalued dollars. We now describe these ways.

A. Never selling

1. "Dynastic" owners. Some owners never sell as a "matter of policy." (As a practical matter, indefinitely deferred equals never.) In Hawaii the "Big Five" have followed this rule for a century. One, the Bishop Estate, owns 340,000 acres, or 8% of Hawaii, including 11,000 lots in metro Honolulu. Ground leases are for 55 years. As they expire, the landowner takes his gains in the form of higher rents. In the early '80s, some ground rents were jumped from $200/year to $10,000/year[35].

In California the SPRR, the largest landowner since the railroad land grants, follows this policy. So does the Irvine Company, with some 60,000 or 70,000 acres in Orange County. (The Irvine Ranch Water District in 1958 had some 50,000 registered voters, but only four voters qualified to vote in District elections, because these were limited by State law to landowners[36].)

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[34]The writer's method of showing the advantages of deferral is in "Tax-induced slow turnover of capital", Western Economic Journal, Sept. 1967, pp. 308-23. Unabridged version in AJES January, April, July and October, 1970, and January 1971.

[35]Dan Morain, "Hawaiian Land Reform Law Loses Court Test". Los Angeles Times, 30 March 1983, p.1

[36]Merrill Goodall, Politics of Water, 1958.

The Wrigley Company apparently hews to this policy on Sta. Catalina Island. Most of Avalon ground is leased on medium terms to the owners of the buildings. Wrigley even owns and controls the land in streets, and imposes its own traffic laws.

Dynasties are not lightly relinquished. The Hawaii Land Reform Act of 1967 gave lessees rights to buy, but the Bishop Estate challenged the law and had it overturned in the U.S. 9th Circuit Court, 29 March 1983[37]. (1993, G. Grossmor)

2. Advance buying. Many owners buy well in advance of their own anticipated future needs, e.g. for "future expansion" of an industry or store; or for personal retirement. They benefit from the gain, but are not taxed because they need not sell to themselves. In the process they turn many urban land markets to glue.

3. Reserving valuable rights. An owner may sell the shell of land title to another for a low price, reserving for himself valuable land rights. One of these is a covenant not to compete, such as Gimbels' Store reserved long ago when it sold the adjoining block at 3d and Michigan Streets, Milwaukee. The value of such a reservation may be appreciated by the fate of my friends, an East Bay builder and his wife who in 1981 put up a motel at a well-selected site by a new interchange, not controlling the other sites. They did so well at first that four major chains built around them; now they struggle to survive.

Other owners do not bother with the covenant not to compete, but hold full title to competing land, preemptively. They take their gains in monopoly rents from the land they retain.

4. Refinancing: realization without recognition. To take cash out of appreciated land without selling, it is common to mortgage. One "realizes" the value by borrowing on it; but no taxable income is "recognized."

This creates a powerful tax motive to hypothecate land rather than sell it. It is one reason deregulated S&Ls overexpanded so fast in the '80s. In the corporate world it is a reason for junk bonds, debt-financed mergers, and ballooning of corporate debt.

Statistically, an interesting result is that the share of interest in national income has risen rapidly. Much of that interest is an indirect way of collecting ground rent. Fiscally, the result is that de facto ownership of land changes hands without any taxable event, so prior excess depreciation is not

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[37]Morain, loc cit.

recouped. Unearned increments are realized, with no recoupment of expensed carrying costs.

5. Draining the "cash cow." A common way to take out cash from income property, plant and equipment is to tap the capital consumption allowances, treating the whole cash flow like disposable income. The owner makes the asset into a "cash cow," milking off cash for other uses. The calf starves.

The proverbial penalty for drinking the calf's milk (or "eating the seed corn," in the more common metaphor) is loss of asset value without provision for replacement. But when the land value under the building or industrial plant is rising, this rise offsets depreciation and replaces the lost value. Here, drinking the calf's milk, or eating the seed corn, is a way of turning the increments into cash without paying tax on the gains.

A recent business article brings this out as follows. "...'free cash flow' ... measures truly discretionary funds, -- company money that an owner could pocket without harming the business. ... real estate and energy have long been viewed through a cash-flow prism. In real estate, depreciation usually wipes out (taxable) 'profits' -- even though the property is actually appreciating. ... "[38]

"Real estate" of course is not a separate business. Owning real estate is what many corporations are mostly about. Many businesses therefore are cash cows for the same reason as real estate - they are real estate. The cash properly allocable for replacement is arrogated or pirated as land income, both as land gains and as higher ground rent. A recent example from Philadelphia is the sale of Atlantic Oil Co. by a Dutch owner who had neglected maintenance for some years to increase cash flow, but still managed to sell the company for a large gain.

No sale need occur, so there is no taxable event, and no realized gain to tax. Sale is also possible, however. In a sale, capital depreciation offsets land appreciation, countervailing the taxable gain. The building has already been written off once. This way it does double duty.

A cash cow may be milked faster by neglecting maintenance and repair. This could result in a capital loss at time of sale. Capital losses are tax disasters, being nondeductible beyond a small token amount. Where land appreciation offsets a loss that would otherwise "go to waste" -- i.e. be nondeductible -- the gain is in effect tax free.

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[38]Laderman, Jeffrey. "Earnings, schmernings -- look at the cash". Business Week, July 24 1989, pp. 56-57.

6. Bartering. Under Section 1031 no gain is recognized when a capital asset is exchanged for property of a like kind. "Like kind" is construed very broadly; almost anything qualifies, including swaps of raw land for improved. Triangular exchanges are allowable. Deals are carefully tailored to the letter of the law. A network of broker's clubs has long existed to engineer such swapping, now called "Starker swapping."

This traditional route to deferring gains taxes grows ever more sophisticated. The "3-way corporate swap" is a new wrinkle too complex to describe in a few words here. For $700 you might have attended USC's 42nd Annual Institute on Federal Taxation, held at the posh Century Plaza Hotel, 18 January 1990, to hear an expert discussion of "Like-kind exchanges of real estate" by Joseph Knott, CPA, of Kenneth Leventhal & Co. Deferral of recognition is big business, with top experts.

7. Getting condemned. No tax is due when real estate is condemned: the gain is rolled over. Condemnation used to be a rarity. Now, with extensive use of redevelopment districts by cities, condemnation has become more common, and highly political.

Cities foster renewal in these districts by offering some tax abatement. This costs them more than they get, because the abated taxes would have been deductible, meaning the U.S. would help the taxpayer pay the city. Another method has more favorable federal tax consequences.

That method is land write-down, i.e. selling acquired land cheap to developers. The method has an obvious drawback, the developer is tempted to acquire more of this cheap land than he is sure to need. Cities do this anyway, in part because of the power of the favorable federal tax consequences.

These consequences are that the subsidy takes the form of land gains, whose federal tax treatment is so favorable. The developer receives an immediate unrealized gain on the land, which he may turn into working cash by banking it. Interest and property taxes are expensable. Future resale, if any, is eligible for various capital gains benefits, exclusions and deferrals described herein. Gains at death are nullified by step-up of basis (v. "B," below).

8. Deferring payments after a sale. Even after a sale, no tax is due until payment is received in cash. Sellers often finance buyers over long periods, deferring taxable recoupment. Their gain is recognized one little piece at a time, as payments are received. But it is 100% at work earning interest for the seller, who makes an ordinary installment sale contract with the buyer, and collects interest on the full contract price of the land.

The buyer, meantime, begins depreciating from the new basis, the contract price. Thus the buyer can redepreciate an old building he has bought well before the seller's gain is recouped and taxed. If the payment period is 40 years, and the tax life of the building is 6 years, the possibilities for layering up unrecouped excess depreciation by succeeding buyers are titillating.

Another way of deferring payments is profit participation, No tax on a gain is due if the seller takes payment as a share in the buyer's partnership. Partnership profits are treated as the capital gain. This looks like complete exemption, for these profits would otherwise be taxable anyway as ordinary income.

These are shark-infested waters, as many an artless seller has learned in sorrow. The blood in the water, however, is spilled by other taxpayers, the simple folk who work for ordinary income. Biting the unwary land seller doesn't improve the public revenues, but only redistributes his untaxed gains.

Another deferral technique is the land sales contract, where the seller retains title over a long period until payments are completed. Yet another, perhaps minor technique is the sale of options to buy. Cash received is not taxable until the option is exercised. These and the other techniques work in conjunction with step-up of basis at death to defeat recoupment completely.

Yet another deferral technique is renting land to the real buyer at a premium rent which is actually an instalment purchase of an interest in the land. The agreement is to lower the rent later. The buyer deducts the early rent. The seller pays tax, to be sure, but later than if he sold outright. This method works best if the buyer is in a higher bracket than the seller.

9. <u>"Rolling over" residential sales</u>. No taxable gain is recognized on sale of a primary residence provided a replacement residence is bought within 24 months before or after the sale -- a four-year window. In effect the sale is treated like barter, even though cash was received.

When and if an owner does cash out he may exclude $125,000 of any gain from taxable income, provided one spouse is over 55 (the Gray Panther lobby was at work), and neither has done this before. They add to their basis all capital improvements made over the period of ownership, with no depreciation, even though they have enjoyed the full service flow of those improvements.

A seller's motive is to stretch the definition of a "residence." To most sellers a residence is a residence, but not to gentlemen farmers in the rural-urban fringe. For example, in the "Hunt Club" neighborhood along River Road in Potomac, Montgomery County, Md., each residence used to come with about

100 acres. In the 1970s these estates were being sold to developers. How much land is "curtilage," and therefore part of the "residence"? There is no easy answer, but we would underestimate tax lawyers not to surmise the allocation to curtilage is more generous than an objective observer might think reasonable.

Residential owners must eventually sell or die. When death comes, as we see below, all accumulated unrecognized gains are forgiven forever.

10. The corporate rollover, a new wrinkle, is too complex to describe here.

In sum, recoupment is a certainty only for careless taxpayers, or pinched taxpayers who lack room to maneuver. In general, excess depreciation and illegal depreciation are not recouped. Tax exemption is achieved in perpetuity. But then the next generation does it again, so over time there accumulates on each parcel of land a large sum of perpetual tax exemptions. Landowners have been running circles around Georgists because Georgists have foolishly taken their eyes off the income tax, which raises more revenue than any other tax. While we had our noses to the grindstone of local policy, Congress gave away the store! And we are just getting into the story.

B. Step-up of basis at death

At time of death, all property is appraised when passed on to heirs or other legatees. The legatee's basis is the appraised value at time of transfer. All prior appreciation is wiped out, tax-wise. Hence tax deferral over any period of ownership before death culminates in total exemption, in perpetuity.

Recall that earlier excess depreciation lowers the "basis" of property, resulting in a higher gain upon sale. With step-up of basis, recoupment is denied forever. Gone, too, is any compensation for years of expensing the carrying costs of appreciating land. Gone is any recoupment for years of deferring taxes on unrealized gains.

Taxes deferred are taxes partly denied, because of the time value of money; but here we have a final sacrament making the denial total and final. The basic value of the deferral devices discussed herein is much enhanced by their being used in anticipation of step-up at death.

Few people anticipate death willingly to avoid taxes, but most face it and plan for it. Those who approach death with substantial assets unimpaired are a minority, but a minority with

much of the nation's property. They can still "take it with them" by providing for heirs. Others who cannot or will not provide for heirs can still benefit before death by borrowing on, or otherwise taking cash out of appreciated land, using as collateral the value it would not have were its accrued gains to be taxable at death. Such a tax would be a public lien on land and take priority over private debt, thus deeply impairing land's value as collateral.

The benefit of excess depreciation, followed by step-up of basis, is cumulative, because the heirs may do it all over, from the new basis. Note the asymmetrical attitude toward cash payments, favoring the owner of capital assets. The Internal Revenue Code seldom recognizes gains as taxable until they are realized in cash (and not always then, as we have seen). But the basis which owners deduct from taxable gains need not have been paid in cash. Legatees are an extreme case: they receive the advanced basis totally free and clear. If it includes an old building they may start depreciating it immediately.

C. Non-resident aliens are exempt

Under international tax treaties, non-resident aliens are exempt from the U.S. tax on capital gains (Code Sec. 871(a)(2)). So are foreign corporations (Code Sec. 881). For most taxpayers the costs of earning untaxed income are not deductible, but this case is different. Aliens may take excess depreciation, and expense carrying costs, just like others. But there is no recoupment. (The case is just the reverse for the average American worker, whose wages are fully taxed but who cannot deduct many of the basic costs of keeping himself able to work, these being labelled "personal consumption," not deductible.)

The ostensible reason for this apparent giveaway to foreigners is reciprocity --Americans abroad get the same treatment. The net result, however, is a handful of Americans who invest abroad benefit there so a handful of foreigners can benefit here, at the expense of simple folk who are taxed mainly on wages and salaries and interest. An international comity of property prevails, eclipsing domestic equity.

In addition this provision opens a wide loophole for tax evasion by American citizens posing as non-resident aliens and foreign corporations. It is not otherwise evident why residents of Curacao, for example, have such an interest in farmland in Imperial County, California.

D. Step-up by bequest

Over many years, one could donate appreciated land to a favorite eleemosynary institution (church, college,

Nature Conservancy

foundation, bible tract society, TV evangelist, etc.), deduct its current value, and wipe out tax liability on the gain. It was often more gainful to give than to sell. It is no longer so simple, but that is still the general idea. Now you can convert your home into a lifetime income for yourself and a surviving spouse or other person, without paying tax. You give the home to a charitable trust, which sells it, invests for high yields, and supports you and yours for life. Your alma mater or church will be glad to supply the specifics on glossy paper.

E. Excluding gains from taxable income

For several decades at least 1/2 of each "long-term" (held over a year) gain was excludible from taxable income. If one's marginal tax bracket was over 50% the deal was better, there was a maximum tax bite of 25% on each gain. More recently, 60% of gains had become excludible. That meant the effective tax rate one paid on ordinary ("what the simple folk do") income was 2.5 times higher than that on gains, for any given tax bracket. It meant one gained 2.5 times as much for deducting one dollar of interest as one paid on the gain it financed. This was on top of the advantage of deferring tax liability.

With the Tax Reform Act of 1986 no realized gains were excludible, beginning with 1987. The House Bill of 1989 would have revived the exclusion, at 30%. The House Bill failed in the Senate, through threat of filibuster by a large minority.

With an end to exclusion it is tempting to consider the matter closed. "Let bygones be bygones" is often good advice, beloved by economists. Who's counting? However, if one wants to keep score, much of the land in the country, which sold during this period at least once, carries an invisible moral lien of deferred tax liabilities which were only 40% or less recouped, long after they were incurred, and wiped off the books.

However one may feel about that, note this exclusion is just one of many preferences for land gains. The President has raised a major storm by pushing a 30% exclusion, but no one is pushing to abate the many other favors. The President's loss of his initiative leads many to assume gains are now being taxed like ordinary income. In fact, this exclusion is rather well down a long list of favors for land. The others remain untouched.

F. Selling at lower tax rates

There has been great rejoicing over the fall of income tax rates after the 1986 Act. Who would be so churlish to question it and spoil the party? In the general celebration the most vocal doubters are those who fear deficits and debt. They are being put off with a strained "Ricardian Equivalence Theorem," which serves to rationalize conservatives' debts the way

War of the generations.

"infinite liquidity traps" used to rationalize liberals' debts. In the noise over this issue, the distribution of benefits has been overlooked. Let us now, at last, look.

A fall of tax rates is a giant bonanza for those carrying previously unrecognized accrued gains. Excess and illegal depreciation were taken off historically at high tax rates like 70%. So were expensible carrying costs. Now, if these are recouped, it is to be at 28% (or a max of 33% in odd cases). With corporations, the rate drop was from 46% down to 34%.

Unrecognized gains are basically a debt owed by landowners to The Treasury. They are a debt bearing no interest, which is outlandish enough. They are payable at the debtor's convenience, which is also worth a lot. Now, with a fall of tax rates, a debt of $70 incurred 30 years ago may be cleared by a payment of $28 today. That sums a lot of it up nicely. It helps one understand why landowners were willing in 1986 to trade off the exclusion of 60% of gains in return for lower rates in the high brackets. Think of it as temporary.

The unpaid debt of landowners to The Treasury has its counterpart in ~~unpaid~~ outstanding Treasury debt to bondholders. The Treasury pays interest on its debt, and the principal is due in full at maturity. Other taxpayers make up the difference and pay the interest, from taxes on income earned by useful productive activity.

(debt incurred bcs. taxes are deferred.

G. Recoupment in devalued dollars: indexing and all that

When a landowner takes gains at a higher price level than he took earlier deductions, part of recoupment is a phantom. Learned books and scholarly articles flow like water deploring taxes on "phantom income," but who is denouncing this other phantom? A balanced treatment should consider both. We begin with the conventional case alleging overtaxation of land gains.

During inflation land rises in dollar value with no necessary rise of real value. Purely inflationary rises are "phantom income." Many apparently temperate or moderate economists, like Alan Blinder, would index land gains so as to limit taxation to only the real gain[39]. "Indexing" means multiplying the unrecovered basis of a gain by a price index which is adjusted to unity in the year or years when the historical cost was incurred.

The late Joseph Pechman, generally a champion of taxing capital gains, called this adjustment "essential," and knew that

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[39]Business Week, 1 August 1988, p. 14.

"economists agree."[40] When the traditional leader of capital gains taxers[41] concedes so much to the untaxers, indexing would seem to be the consensus position. The House Bill that failed to pass the Senate in November 1989 provided for indexing capital gains, to be phased in. Indexing is a fallback position for the untaxers of capital gains; there will surely be more attempts to achieve it (although President Bush now opposes it).

It is apparently the opinion of some enthusiasts that all land gains are phantom ("my gain is illusory because my replacement cost went up just as much"). If that were the end of it, indexing would eliminate the whole tax. Let us begin by denying that. Land prices in most regions and sectors have outpaced other prices over a long period. Demand has risen while natural supply remained fixed, and available supply dropped owing to local no-growth policies. The 1986 drop in tax rates was a windfall for owners of land yielding cash flow. Property tax rates fell sharply in tax-revolt states like California and Massachusetts. Land prices rose because after-tax returns rose. That is not general inflation, but real redistribution.

If a land seller's replacement cost has risen as much as his sale price, that alone makes him better off than the entry buyer who is unambiguously worse off. Are we to believe that higher prices make entry buyers worse off, but owners no better off? If that were so (which it isn't) it then follows overall welfare would rise if land prices fell to zero - think about it. But in fact what we have when real prices rise is a redistribution from workers as such to owners as such.

Consider also that cap rates fell after 1986 because Congress decelerated cost recovery on new investments, lowering the opportunity cost of capital. There has been a massive shift of tax burdens off land onto new capital, and labor. The corresponding shift of asset values is real. Hence rising stock mkt.

Nevertheless there is no denying much of the nominal gain when land is sold is phantom income. The problem must be faced, and indexing faces it, in what seems a reasonable way. However, this seemingly reasonable proposal is in fact unbalanced and

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[40]"Tax Reform: Theory and Practise", J. of Economic Perspectives I(1), Summer 1987, p. 23.

[41]Pechman and Walter Heller were students together at Wisconsin, both taking degrees in public finance with Harold Groves, and working closely with him. Pechman's lifelong support of capital gains taxes is not inconsistent with this background.

discriminatory[42]. All assets are taxed by inflation, not just "capital assets" (read land), which inflation taxes least of all, as we will show; and which receive so many other special favors.

First, those with monetary assets and fixed incomes are the obvious, immediate, primary victims of inflation. Indexing for capital gains does nothing for them. It is unbalanced to leave this immediate loss unredressed while making special provision for unearned increments to land value. It is also regressive because the share of wealth held in monetary form falls sharply with total wealth. It is also extremely dangerous for the future, because indexing gains does more than adjust for past inflation: it creates a powerful lobby to push for future inflation, setting up savers and creditors for a total wipeout.

Second, most real assets, not just "capital" assets, yield phantom income. In some inflationary years over half of reported business earnings come from inflation-induced marking up of inventories before sale.[43] Inventories yield their phantom income early and often, compared to land. The more deferred is the tax-recognition of phantom income, the less is the real burden.

LIFO (Last-in, First-out) accounting abates the inventory problem in part, which leads some to dismiss the point. LIFO poses other problems, however, and is not universally used, especially by small businesses.

Land yields phantom income only when the title is sold for a "capital gain." Depreciable assets, in sharpest contrast, yield phantom income in the ordinary course of use in production or for rental. Depreciation is limited to historical cost, which is less than the true allowance required for capital consumption and replacement.

Consider an office building leased with inflationary escalator clauses. The owner is selling the corpus of the building to the tenants, as it were, brick by brick, as they use it and it ages. Every rental payment includes some phantom

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[42]Blinder and Pechman would also tax gains at death. This partly tempers the bias of their position, but adds a major new one in favor of deathless corporations, (and a minor one against short-lived individuals). They are silent on the many other favors cited herein.

[43]The U.S. Department of Commerce reports this "inventory valuation adjustment" (IVA) regularly. Many economists have noted, some with missionary zeal, the malignant tendency to overstate profits and incur excess taxation. No modern tax economist can really be unaware of this.

income because the owner is selling the tax basis as he depreciates the building. Likewise the UPS driver delivers us with each parcel some skin off his truck, penny by pennysworth, until the truck is retired. The customers have bought the truck bit by bit. Each layer of value delivered includes its share of phantom income because the tax basis is less than the current dollar value.

Many reformers have championed indexing depreciation bases, and rightly so. But the present proposal to index capital gains does not do so. Building rentals are ordinary income; so are delivery charges. Only by selling the assets in toto would an owner get his basis indexed. But old trucks sell for nearly nothing, and have no basis left to index anyway. Old buildings sell for something mainly because they stand on good land. Old buildings retain an undepreciated basis to index mainly because land is not depreciable. What could be more obvious? Indexing gains is mainly for landowners as landowners, not as building owners.

Congress has never defined a "capital asset" clearly. A long line of court rulings has pieced in some of the missing details. Chirelstein's long chapter[44] goes over many of those, from which one can distill this essence: a "capital asset" is something one holds as an investment, with a primary view to appreciation rather than use or income or sale to regular customers.

Harold Groves compressed it nicely. "Capital gains ... arise not as a flow of income from the fountain, but from the sale of the fountain itself."[45] Nothing fits those descriptions like land gains. The primary benefits of indexing capital gains would go to landowners.

Third, the ordinary cash flow of land, or ground rent, includes no phantom income because there is no depreciation. It is not like the building being sold to tenants "brick by brick"; or the delivery truck, "layer by layer." The cash flow of land is pure income without impairment of the corpus or tax basis of the asset.

Depreciable capital yields a constant flow of phantom income as the corpus and basis are sold piecemeal by use or occupancy. That is a basic difference that should be elementary and universally acknowledged, but has been entirely overlooked in the extensive literature and public comment on phantom income. To be

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[44]Chirelstein, op. cit., pp. 270-311.

[45]Harold Groves, op cit., p. 166.

sure no one misses the point I flag it: the cash flow from land contains no phantom income.

Land in ordinary use is therefore immune to taxation of phantom income, it just doesn't yield any. Any depreciating capital is fully vulnerable, and gets overtaxed routinely. So does capital in inventories, constantly turning over in ordinary course of sale to customers. Land is the last, not the first asset needing further special protection through indexing. But it would be the main beneficiary.

Fourth, land is vulnerable only if title is sold, which is seldom. Sale of title is the only taxable event when land yields phantom income to tax. Indexing is designed specifically to protect land from that one potential liability to share the common burden of inflation. Under indexing, it is the undepreciated basis of old assets that is to be inflated by multiplying times the index. That undepreciated basis is mostly land, because land is not depreciable.

With true capital, as we stressed above, there is constant real turnover in the normal course of sale of services to customers. With land it is entirely different. Ownership only turns over in a "sale of the fountain itself."

Selling the flow from the fountain is continuous, routine and necessary to production and exchange. Selling the fountain itself, on the other hand, is an option, one exercised rarely or never. More or less 1%-3% of land parcels turn over annually, and these average below the mean in value. Even that overstates it. Many of these turnovers are tax rollovers, as we have seen, with no taxable event.

Slow turnover creates a fallacy of selective perception. If land finally sells and is taxed after 50 years of inflation the accumulated phantom gain is large and noticeable. The same original sum invested in inventories, turning early and often, would have paid tax on the same phantom income, and paid it much sooner. Because the land gain is all bunched at the end it is conspicuous, so the very advantage land enjoys is popularly perceived as a peculiar hardship. That fallacy should not, however, fool professional economists; the irony should not escape them.

Fifth, equities gain when inflation lowers the real value of debt. The inflationary loss by creditors is not all a hidden "tax," as sometimes alleged. It does not all inure to The Treasury. Much of the loss is a gift to debtors, a redistribution of wealth. Most debt is mortgage debt so the creditors' loss is a gift to landowners. To the extent land is mortgaged the phantom rise of land price is offset by an equal fall in the real value of debt.

The latter is "realized" immediately (but not recognized and taxed) in a fall in the real value of interest and other debt service; the phantom rise of land value is only recognized if the land is sold. James Wetzler pointed out the discrepancy years ago, in a Pechman-edited Brookings volume. A fall in the real value of debt should be taxed as current income to the equity owner.[46]

Enter indexing. It offers succor to the landowners who have already gained, and nothing to those who have lost -- nothing, that is, but higher taxes needed to make up the landowners' shortfall. It is hard to see the equity of such a measure.

Sixth is the matter of phantom recoupment, the point at which we entered this question. All recoupment of excess depreciation, illegal depreciation, and expensed carrying costs is paid in depreciated dollars. Remember a landowner is a debtor not just to his private creditors but to the fisc. He has accrued liabilities on the understanding he will repay The Treasury at time of sale. These liabilities include excess depreciation, illegal depreciation of land, and expensed carrying costs. Most tax economists, following the Haig-Simons definition of taxable income, would also see them as including deferred tax liability on accruals dated long before sale.

As to the depreciation (illegal and excess), this lowers the basis which is to be indexed, and I find no fault with indexing. But expensed carrying costs, and deferred tax liability, those two are something else. They do not come off the basis. Those are liabilities accrued in good dollars, to be repaid in bad. This is "phantom recoupment," the logical counterpart of phantom income.

Accrued tax liabilities are the Treasury's basis in the land. If the owner's basis is to be indexed, so should the Treasury's basis. This would make indexing neutral and fair. However, no spokesman for indexing has made the point, to my knowledge.

Such ideas may seem novel and alien. Why? Are they logically unsound, or simply new? If they are sound (as I believe), why are they not already old? If old, why now suppressed? Tax economists are not stupid. The current one-sided approach to indexing suggests the profession is in the grip of a class bias, or is just a Washington weathervane. Something is suspending the application of superior intelligence,

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[46]James W. Wetzler, "Capital Gains and Losses". Chapter 4 in Joseph A. Pechman (ed.), Comprehensive Income Taxation. Washington: The Brookings Institution, 1977, pp. 115-62, at p. 129.

suppressing logical balance and fair play. That is harsh, but not intended as scolding or ad hominen. Rather, I am puzzled and deeply disturbed. I would welcome some other reason. I simply do not know how else to explain it.

More is at stake than adjustments for past inflation. The greater fault of indexation is in the future: it would add overwhelming power to the pro-inflation lobby. Now, taxes on phantom income at least generate some political force against inflation. If we exempt land from its already small share of the inflation tax, we reinforce its timeless status as the world's refuge from inflation.

Land is more than a defensive refuge from inflation: it gains what others lose. With inflation landowners not only clear their private mortgage debt, not only clear their unrecouped prior carrying costs and illegal depreciations, but also the public debt for which, as Ricardian Equivalence Theorists tell us, they might otherwise be held partly liable. Adding it all up, indexing land gains would be an invitation to disaster along the lines of Germany, 1923.

House, Grounds and Playgrounds

One reason for downtaxing gains is to spare homeowners. Indexing would be especially targeted to relieve homeownership because the capital in homes is not depreciable and is never eroded below its historical basis. Indexing, recall, means multiplying the undepreciated basis by a number greater than one, before subtracting the basis from sales price.

Such a benefit would come on top of the fact that land used for homesites is otherwise exempt from income tax. The "ordinary income" from a home is its imputed income, a notional cash flow equal to the rent one would pay if someone else owned the home. As often noted, imputed income is already untaxed, a giant exemption for those who can afford to own, not rent.

At the same time, homeowners' costs serve to shelter other income. Mortage interest and property taxes are deductible from ordinary income, a glaring exception to the rule that costs are only deductible when the income they are to produce or acquire is to be taxable. The value of this exemption and these deductions rises with soaring homesite prices. Those have soared faster than the other elements in home prices, while home prices soar faster than the CPI.

Most of the untaxed imputed income of a home is from the homesite, not the building. Owner-occupied houses are not depreciable, but they depreciate anyway. Much of the service flow from a building is not net income, but recovery of capital.

For a simple example and estimate, say a house has an economic life equivalent to 50 years.[47] Assume, further, the real interest rate is 4% (10% nominal rate less 6% inflation rate). Then the present value of a 50-year service flow of $1/yr is $21.50, meaning in equilibrium it will be built for that cost. $21.50 is 43% of the lifetime service flow. Only the other 57% is true imputed income.

In addition, much of a house's service flow is the product of current repair and maintenance. An old house, like an old car, has little residual capital value; the aged carcass is simply a medium through which current inputs are converted into shelter or transportation.

Land, in sharp contrast, suffers no depreciation and requires no maintenance or repair. Its service flow is pure imputed income: imputed, untaxed income.

"Home," "shelter," "residence" and "fireside" have good connotations. Surely these warrant protection, to a point. Recreational land, however, also yields imputed income. Indeed all land not yielding cash income may be presumed to be yielding imputed income proportionate to its value, else the owner would have sold it.

Even more generally, all land not yielding cash income enough to explain its owner's reservation price may be presumed to be yielding imputed income to make up the shortfall, for the same reason. Economists of the Rational Expectations School should be the ones driving home this point, which follows so logically from their views. In their dereliction it devolves on us to make the point here. Now we are onto something big.[48]

This is the age of leisure. Those who can afford it take their leisure with generous portions of land. It begins with the yard and garden, and escalates. Vacation homes, resorts, ski chalets, marinas, cabanas, duck clubs, golf courses, tennis courts, hunt clubs, hobby farms, beaches, summer places, seaside cottages, hunting lodges, lakes, yacht clubs, fishing resorts, horse farms and race tracks ... the list goes on. The noble game preserve is the prototype of landed leisure, and emulation knows

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[47]By "equivalent" I mean adjusted for the countervailing facts that a), the house actually yields a declining service flow; and b) the carcass of the old house actually endures more than 50 years.

[48]The general point is bigger than is relevant here. It is further developed in M. Gaffney, "Tapping Rents after Prop. 13", Western Tax Review (annual), 1988, pp. 1-55.

no bounds. To modify the familiar, "The difference between a man and a boy is the cost of his playground."

All land consigned to such uses yields imputed, untaxed income. The conventional aspersions economists cast on "the homeowner's" tax shelter are out of balance, missing the larger share of the point. A quota of 500 square feet of floor space per person, and 5,000 square feet of land with it, would take ample care of protecting basic shelter needs. Above that we are protecting luxury consumption, including extremes like the private golf course of a Palm Springs owner who entertained President Reagan there every Christmas season, but has his primary residence in Pennsylvania.

The only contribution of such owner-used land to national revenues is when it sells for a taxable gain. Much of it is well sheltered from that, too, by the rollover provisions, step-up of basis at death, and the $125,000 exclusion when you cash out. The case for further exclusion, on equity or efficiency grounds, is hard to accept.

There is a well-nurtured fallacy in currency that any tax bearing on housing is regressive, because everyone needs about the same amount, regardless of income and wealth. The writer has adduced contrary evidence elsewhere[49], in an article widely circulated and cited, but never to my knowledge refuted or even challenged. John Stuart Mill's opinion merits a look: "No part of a person's expenditure is a better criterion of his means, or bears, on the whole, more nearly the same proportion to them. A house-tax is a nearer approach to a fair income-tax than a direct assessment on income can easily be; ... it is a test ... of what he thinks he can afford to spend."[50]

A passing acquaintance with Beverly Hills real estate should persuade the hardiest skeptic the rich do not skimp on housing. A modern observer thereof echoes Mill: "A big house is a clear demonstration that you've got a lot of money, so much so that you can build something you don't even need."[51]

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[49]M. Gaffney, "The Property Tax is a Progressive Tax," Proceedings of the National Tax Association, 64th Annual Conference, 1971, pp. 408-26.

[50]J.S. Mill, Principles, Book V, Chap. III, Section 6.

[51]Dana Cuff, Professor of Architecture and social critic, USC School of Architecture, cited in Jeannine Stein, "Be it ever so humongous". L.A. Times, 1 December 1989, p. E-12. Cuff is a fashionable critic of modern taste and taste-making.

The writer has also shown the land share in housing rises with the value of the house and land.[52] Beverly Hills, again, makes a splendid example. The poor, if they own housing at all, live in stable or declining neighborhoods which usually yield no gains. The rich live in appreciating neighborhoods, where gains are a normal expectation.

The gains come from the land. Beverly Hills knows more obsolescence than Levittown. "Tear-downs" are everyday news from the former. Here is the latest. "...almost every house in Beverly Hills and Bel-Air that is more than 20-30 years old is a candidate for a tear-down, ... As homes come on the market they are immediately snapped up and torn down. ... It's the land. The land is everything, that's the bottom line. And location is everything. We are now up to ... $5 million ... for a prime acre in Holmby Hills. And of course, the house goes as soon as the bulldozer can be called."[53]

It follows that tax shelter for "house, home and hunt club" has already been carried beyond reason; that the shelter is greatest where least needed; and the shelter given to land gains is least needed of all. There is no good reason to give more.

Financial institutions that foreclose

Foreclosures make an interesting case. Today many banks have unwisely loaned on soft collateral, and had to foreclose. Say the collateral is worth 50 cents on the dollar. The bank carries the loan at par and tries to hold the account until the market rises so a sale will clear the books. If this plan succeeds (as it often did, 1935-50) there would appear to be a tax exempt gain from 50 cents up to $1.

To be sure, the 50 cent value was bought for $1, and the point is arguable. A proper accounting, however, would call for recognizing the loss at time of foreclosure (a taxable event), and beginning from a tax basis of 50 cents.

Gains of exempt owners

Non-profits may increase their wealth without limit, and pay no gains tax. These include churches, cemetery associations, colleges, government agencies, TV evangelists, etc. These may seem meritorious in the abstract, and doubtless some of them are, but most pass through their benefits to specific private parties. A "government agency" like the Irvine Ranch Water District, with

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[52]M. Gaffney, loc cit.

[53]Bruce Nelson, real estate agent, cited in Jeannine Stein, loc cit.

50,000 residents and only four landowner-voters, gives an idea how these public powers and exemptions may be used to centralize power for private gain.[54]

Some non-profits are quite secular and profane, like golf clubs. On what grounds of distributive equity, or public service, these warrant tax exemption is not clear, especially to minority taxpayers who still find many of them to be hard-shelled bastions of racism.

The religious subsidy is not to church and charity as such, but only to those holding land, TV licenses, or other "capital" assets in rising markets, and to the degree they hold such assets. The clergy are taxed on their salaries, which are just as "ordinary" to Congress as yours or mine. Churches that lease out property to serve human needs pay taxes on the "ordinary" rentals. However, churches that sell their downtown sites and adjoining parking lots for gains are not taxed. The old "bricks-and-mortar" bias caused by property tax exemption is not dead, but has evolved into a parking-lot bias, and a TV-license bias. Store-front churches, renting space to serve the poor in declining areas, receive no subsidy.

There is no intent here to pick on churches, which are only bit players today. The volume of property held by other non-profits is astonishing, however. Stanford University, colloquially "The Farm," manifests the "campus bias." It preempts an area equal to 1/3 of the City and County of San Francisco. The aggregated University of California campuses preempt 50,000 acres. Tiny Loma Linda University, in Riverside, CA, includes over 100 acres of urban land as a "campus dairy," whose appraised value exceeds the University's other endowment. Anyone familiar with higher education in America can add to those data[55].

Counties that foreclose on delinquent land, hold it for years, and finally sell for a gain are exempt from gains taxes.

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[54]Merrill Goodall, op cit. The voting method in the specific Irvine case has been altered by recent court action, but other such cases have not. Goodall has shown how the cumulative impact of such representation leads to control of the Board of the all-powerful Metropolitan Water District of Southern California by a tiny minority of landowners.

[55]This theme is further developed, with many examples, in M. Gaffney, "Why Research Farmland Ownership and Values?" In T.A. Majchrowitz and R.R. Almy (eds.) Property Tax Assessment. Chicago: U.S.D.A. and I.A.A.O. in cooperation with The Farm Foundation, 1985, pp. 91-109.

Much of California's surplus, wasting water is held by irrigation districts. One of them, Imperial I.D., may some day sell some of its large surplus, held and wasted since 1902, to meet growing urban demands. If it does, the gain will be tax exempt.

The conclusion that that is tax exemption must be tempered because the benefits will inure to the private landowners in the District, for whom the District, legally, holds the water rights in trust. The landowners' benefit might some day become taxable. A likely outcome is the district would distribute its cash proceeds indirectly by lowering its current charges on landowners. Some of these charges are water rates, based on use. Other charges take the legal form of benefit "assessments," some of which are expensible, and some of which are added to the basis of the landowner. If expensible, their abatement would result in higher federal taxes. If added to basis, there is only a chance their abatement might some day add to landowner taxes.

Since the gains of non-profits are already exempt, current proposals to exclude gains from taxation would not make them more exempt. We may ask, however, should we make their gains fully taxable? In general, "Yes." They are, after all, "non-profit." When their lands yield ordinary income it is taxable; their gains income should be no less so.

There is a special problem as to government agencies like the Imperial Irrigation District that hold property in trust for landowners. If their gains from selling water rights are taxed, and the member landowners' gains are also taxed, is it double taxation? Probably "No," if we look at the front end of the holding period. Public agencies acquire resources by collecting taxes, and these taxes are generally deductible. Thus the public district is a means for acquiring land and expensing the cost of acquisition.

If there were to be some double taxation, the case would resemble the corporate income tax, justified on grounds of compensating for the advantages and preferences otherwise granted to the form of organization. That is arguable, we will not presume to resolve it here. If private gains were to become fully taxable, and non-profits gains also fully taxable, it would then be timely to weed out any cases of unintended double taxation.

Perhaps the greatest contribution of tax-exempts to our subject is the history they provide to test the thesis of a "locked-in effect." Downtaxers of capital gains have leaned heavily on the revenue gains to be realized when a lower tax rate spurs sale and "unlocks" unrealized gains. Tax-exempts are not locked in by any tax at all, but are generally known for holding surplus lands tightly and long.

One reason seems to be their exemption from local property taxes lowers their motive to sell by a much larger factor than their freedom from gains taxes raises it. On this point the Taiwan experience is instructive. Taiwan levies a high tax on gains when land is sold, and also levies high annual land taxes based on value. This gains tax provides more revenue than the annual land tax, about 10% of all revenues.[56] Thus the annual land tax raises revenue twice: first in its own right; second by spurring sales. The clever Taiwanese withdraw tax exemption from all surplus property held by exempt owners, including government agencies.

Storing up rents

Some kinds of capital serve as media for storing up rents. Capital has been described as stored-up labor, but some kinds are mostly stored-up land rent. Timber is one example; breeding cattle another; race horses may be a third. All are treated as "capital" assets in the tax code.

Wherever there is intertemporal dependency of land rents a landowner may sacrifice early rents to secure higher later rents. These are a way of converting ordinary income (annual rent) into an enhanced property (a grove of fruit trees, e.g.) to enjoy, to operate for the cash flow, or sell as a capital asset. As to the foregone early rents, they have been "implicitly expensed." It is the same as though they had been received in cash and expensed.

There is also wide scope in the code for explicit expensing of capital outlays to build up durable capital in land. Soil and water "conservation" outlays are all expensable, including some that are essentially for farm swimming pools. Much of the cost of planting new groves and orchards may be expensed by the technique of thinning culls from pre-bearing plantings and claiming an "abandonment." In this manner some 3/4 of the planting cost may be taken off before production begins. Operating expenses and overhead during the pre-bearing years are

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[56]Wei-Shin King, "Land Value Taxation in Taiwan: Present Status". Paper distributed and delivered at International Seminar on Real Property and Land as Tax Base for Development, sponsored by Land Reform Training Institute and Lincoln Institute of Land Policy. Taoyuan, Republic of China, November 1988. Pp. 1-25, xeroxed, at pp. 9-10. Data cited are from Yearbook of Financial Statistics of the Republic of China, MOF. King's paper will be a chapter in the conference Proceedings, edited by Isaac Ofori.

See also a number of articles by and available from Professor John Riew, Department of Economics, Penna. State University, University Park, PA.

expensable. Terracing and levelling and water supply and drainage are expensed as soil and water conservation. The improved land, if sold later, is a "capital asset" for tax purposes.

Those are some of the more obvious instances. More generally, every time current cash from land use is traded off for future cash there is a tax benefit. Readers who try can supply more specifics from their own experience and "what-if" imagineering skills. Some of these trade-offs are socially and economically desirable. The question here is whether they should all automatically be subsidized; the presumption is "No."

Conclusion

This is how the income tax, the dream of Warren Worth Bailey, evolved into the present nightmare. This is how it became class legislation, the more sinister because invisible. Everyone in 18th century France knew the landed nobles were tax-exempt, but few modern Americans, economists or not, have much knowledge or insight into what very preferential tax treatment is accorded to land gains.

At very least, we have shown there is no case for excluding part of gains from taxation. Neither is there a case for indexing gains, unless as part of a general package adjusting for phantom gains and losses for all assets. Rather, there is a case for levying special surtaxes on land gains, as Taiwan does so successfully.[57]

Much land has been written off already, some in part, some whole, and some more than 100%. Who's counting? We are told to let bygones be bygones. The next tax reformer might with justice declare the state has already purchased the land, some of it more than once. "The state" as such may have no moral standing, but it has purchased the land with money extracted from income earned by useful working and investing. In general it is a good rule to let bygones be bygones and begin again, but to forget these moral liens would be quite unbalanced unless we also let unequal property rights be bygones and begin again with an equal

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[57]Taiwan has shown that heavy taxation of property is compatible with, and I would hold necessary to extremely rapid economic development. Taiwan has also shown there is a huge tax base to tap. Taiwan's progressive property tax on land rises to rates over 5%, while in addition its tax on land gains is so productive it raises four times as much revenue as its property tax. This is partly because land gains are kept in current prices, while property tax assessments lag badly. Wei-Shin King, op. cit.

distribution. That is not what the "bygones be bygones" counselors generally have in mind; but to forget selected bygones, and insist on others, is unbalanced and discriminatory.

Income taxation can be constructive and useful if we follow Commons counsel to tax "... personal (work effort) income at the lowest ...; investment incomes at a medium ...; site value incomes at the highest rates, also progressive on large holdings."[58] Land gains should be fully taxed as they accrue, using any of various methods proposed by William Vickrey, James Wetzler or Mason Gaffney.[59] Locked-in effects can be more than offset by coupling gains taxes with annual property taxes, as Taiwan does.[60]

The result would be greatly to strengthen capitalism, meaning by this a system where capital proper is privately owned and free of punitive taxation. Now, all property and property income are tainted by association with unearned income from land. Removing this taint would help purify property in theory, ideology and practice.

[58]Commons, op. cit., p.834.

[59]Wetzler, loc. cit. Gaffney, "Tax-induced Slow Turnover of Capital"; William Vickrey, Agenda for Progressive Taxation, and various articles on "cumulative averaging."

[60]Wei-Shin King, op. cit.; John Riew, opera cit.