What is missing from the capital gains debate?

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The call for an across-the-board cut in the capital gains tax rate has won growing bipartisan support in recent months. Advocates claim that a tax cut would spur new investment, reward productive enterprise, serve as a simple proxy for inflation indexing (which is rejected by the Treasury because of administrative complexity), diminish the "lock-in" effect by which high tax rates at realization deter asset sales,[1] and generate additional tax revenue from the consequent increases in asset turnover and productivity. Opponents contend a capital gains tax cut would disproportionately benefit the wealthiest taxpayers, that productive investment is relatively insensitive to capital gains tax rates,[2] and that any boost to asset turnover would be merely temporary.

Unfortunately, much of the public discussion has been conducted with little reference to empirical research as to the actual character and composition of capital gains in the U.S. economy. While capital gains are defended on the plausible assumption that they constitute both the source and the reward of risky direct investment, it turns out that a large and expanding share of the economy's capital gains—as they are defined, measured, and taxed—has little discernible impact on socially productive investment or employment.

Much of the current debate focuses on the stock market. Business recipients of capital gains are characterized as small innovative firms earning capital gains by virtue of their wise use of financial capital attracted through initial public offerings. However, data collected by Department of Commerce, the IRS, and the Federal Reserve Board indicate that roughly two thirds of the economy's capital gains are taken, not in the stock market (much less in IPOs) but in real estate.[3]

Reliable aggregate capital gains estimates are hard to come by in official statistics—and national income accounting methodology frustrates attempts to measure the total return to investors, which includes asset appreciation as well as current income. Statistics based on tax returns conceal and thereby perpetuate real estate tax loopholes. Consider, though, that the Federal Reserve Board estimated land values at some \$4.4 trillion and building values at \$9 trillion for 1994. This \$13.4 trillion of real estate value represents two thirds of the total \$20 trillion in overall assets for the United States economy.[4] The real property tax is the economy's major wealth tax, although its yield has declined as a proportion of all state and local revenues, from 70 percent in 1930 to about one-fourth today. Real estate also accounts for three-fourths of the economy's capital consumption allowances—deductions from taxable income intended to allow investors to recover capital as it depreciates.

The central point for tax policy is that taxable gains in real estate consist of more than just the increase in land and building prices; they represent the widening margin of sales price over the property's depreciated book value. In real estate, CCAs have historically been excessive relative to true economic depreciation, particularly during the 1980s. The fiction of fast write-off is eventually "caught" as a capital gain when the property is sold or refinanced. The more generous are the capital consumption write-offs for real estate, the more rapidly a property's book value is written down. Excessive depreciation allowances thus convert ordinary income into capital gains.

Factory owners usually must junk their machinery when it wears out; depreciation allowances properly ensure that only net income, not gross revenue, is taxable, and rarely need to be offset by subsequent capital gains declarations. Thus direct investors suffer less from capital gains taxation than from the ordinary income tax, which is applied sooner and at higher rates. Unlike other industrial assets, however, buildings that have been depreciated once seldom are scrapped. The properties typically are sold at higher prices than were originally paid. In the aggregate and over the long run, rising land values tend to more than offset the decline in building values—and in practice, a significant portion of land appreciation tends often to be imputed erroneously to buildings, expanding CCAs still further.

Our tax code allows for properties to be redepreciated by their new owners after a sale or swap. The logic for this is seemingly parallel to that for homeowner's exemptions in selling a home to move somewhere else, but the analogy is specious—homeowners cannot take a depreciation tax credit unless their property generates explicit rental income (although, on the other hand, they are not taxed on the imputed rental income of their homes). The greatest accounting distortion for the real estate industry occurs in the case of re-depreciation of buildings that already have been depreciated at least once, permitting real estate investors to recapture principal again and again on the same structure as a building is resold at rising prices. Most capital gains in real estate today represent repeat gains over unrealistically written-down book values. This accounting fiction enables real estate investors to continue indefinitely to take their income in the lightly taxed form of capital gains.

Furthermore, tax-deductible mortgage interest is the real estate industry's major cost, and as such, has helped to minimize the industry's tax liability. Mortgage interest now absorbs seven percent of national income, up from just one percent in the late 1940s. The real estate sector generates well over \$300 billion in interest payments, more than it contributes in income taxes and state and local property taxes together. Real estate is the major form of collateral for debt, generating some two-thirds of the interest paid by American businesses. Mortgage debt of \$4.3 trillion represented some 46 percent of the

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economy's $9.3 trillion private nonfinancial debt in 1994.

Capital consumption allowances exempt much of what remains of cash flow after interest costs, so real estate generates little ordinary taxable income. Many investors operate at a nominal loss, leveraging their properties to the hilt. Their hope is to ride the wave of increasing land values and "cash out" by selling their property for more than they paid. On an industry-wide basis, in fact, NIPA statistics show that real estate corporations and partnerships have recently reported net losses year after year. The capital gains tax is thus the only major federal levy paid by the real estate industry.

Capital gains already are being taxed at lower rates than ordinary income. Even more important is the fact that capital gains taxes are paid only at the time of realization, not as the gains actually accrue, so the effective burden (what economists call the present value of the tax) is substantially lower than the nominal rate. In addition, numerous exemptions shield many capital gains from taxation: Major commercial real estate investors such as pension funds, insurance companies and other large institutions are exempt from capital gains taxes, as are foreign investors. (In addition to playing a dominant role in real estate, these institutional investors own nearly half of all U.S. equities.[5]) There are substantial exclusions for capital gains from owner-occupied home sales, which President Clinton's recent proposal would further extend. No capital gains duties are levied on estates passing to heirs. Assets given as gifts are taxed only at the time they come to be sold.[6] Real estate swaps, transfers via mergers, and certain acquisitions are not taxed on their capital gains. The authors of a recent Levy Economics Institute brief estimate the effective capital gains tax rate by halving the statutory rate to account for the numerous exclusions and exemptions, and then halving it again to reflect the benefits of deferral.[7] If this is correct, then for today's nominal 28 percent capital gains tax, the average effective tax rate is just 7 percent.

While it is true that the prospect of earning long term capital gains is an inducement to new and risky investment (and thereby employment), the fact is that under present fiscal rules, most taxable capital gains do not reward such activity. A general rate cut would benefit mainly the real estate industry, and even here, it cannot be expected to spur much new construction.

Published statistics do not permit reliable estimates, but there can be little doubt that most true "capital" gains in real estate are really land gains. The value of any building tends eventually to decline, until finally it is scrapped and replaced. It is the value of land which tends to rise as population and income grow (over the long run, with cyclical swings), because no more land can be produced. Thus, capital gains in real estate result mainly from land appreciation. Building values fall because of physical deterioration, but also because buildings undergo locational obsolescence as neighborhood land uses change over time, so market prices tend to fall below replacement cost. As the land value rises, a rising share of the property income must be imputed to the land and a falling share remains to be imputed to the improvements. Indeed, where ill-maintained old buildings occupy prime locations, a parcel may be more valuable once the building is demolished and the lot cleared for reuse. Unfortunately, Federal Reserve Board statistics estimate building values at replacement cost and subtract this estimate from the total real estate value to derive land value as a residual. This method seriously understates the land share of real estate. (Recently this has led to nonsense results—Fed statistics show the land value component of corporate real estate reduced to near zero over the past five years.) Clearly, a "capital" gains tax cut cannot cause the production of more land; land is made by nature, not by people. As for buildings, preferential tax treatment of capital gains, combined with excessive depreciation allowances for real estate and the income tax deduction for mortgage interest, tends to foster, not new productive enterprise, but speculation in land and old buildings.

One effect of favorable depreciation and capital gains tax treatment is to spur debt pyramiding for the real estate industry. The tax structure provides a distortionary incentive for real estate holders to borrow excessively, converting rental income in to a nontaxable mortgage interest cost while waiting for capital gains to accrue. This, alongside financial deregulation of the nation's S&Ls, was a major factor in the over-building spree of the 1980s, which followed the reduction of capital gains taxes and the extreme shortening of schedules for capital consumption write-offs in 1981.

Official statistics should provide a sense of proportion as to how the economy works. Especially when it comes to land and real estate, however, national income statistics tend to obfuscate more than they reveal. They are the product of income-tax filings, hence are distorted for both administrative and political reasons; they do not reflect fundamental categories of economic analysis. The present GNP/NIPA format fails to differentiate consistently among land, produced wealth, and financial claims. In the real estate sector, most "capital gains" in the colloquial sense of rising market prices accrue to land, but IRS statistics mainly catch the landlord's fictitious declaration of the loss in building values through over-depreciation.

It can only confuse matters to debate capital gains taxes without separately considering three major sources: real estate as the economy's largest recorder of capital gains (separable in turn into land and improvements); other direct capital investment; and financial claims on the income generated by this capital (stocks, bonds, and packaged bank loans that are "securitized"). The failure of our national accounting system to distinguish these makes it easier for the real estate industry to get its own taxes reduced along with industries in which capital gains tax cuts do indeed tend to spur productivity. Wealthy investors have won congressional support for real estate exemptions in large part by

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mobilizing the economic ambitions of homeowners. The real estate industry (and the financial sector riding on its shoulders) have found that the middle classes are willing to cut taxes on the wealthy considerably, as long as their own taxes are cut even lightly. It is no surprise that President Clinton's first major concession to the pressure for cutting capital gains taxation was directed at homeowners, despite the fact that further preferences for home ownership cannot readily be justified as a boost to industrial enterprise.

Economic policy should distinguish between activities which add to productive capacity and those which merely add to overhead. This distinction elevates the policy debate above the level of merely carping about inequitable wealth distribution, an attack by have-nots on the haves, to the fundamental issues. What ways of getting income deserve fiscal encouragement, and how may economic surpluses best be tapped to support government needs? Policies that subsidize rentier incomes while penalizing productive effort have grave implications, not only for allocative efficiency and economic development, but also for distributive justice.

Given the current U.S. depreciation laws and related institutions, to reduce the capital gains tax rate across the board is to steer capital and entrepreneurial resources into a search for unearned rather than earned income. Far from being a potent stimulus to new investment, such a policy preferentially benefits owners of already depreciated buildings and speculators in already seasoned stocks, leading to further deterioration of economic well-being. It rewards real estate speculators and corporate raiders as it shifts the burden of taxation to people whose primary source of income is their labor. In the real estate industry, for which the capital gains tax is the only significant remaining source of federal revenue, a rate cut would discourage new direct investment and employment while diverting more savings into the purchase and sale of existing buildings.

We also doubt that a further rate reduction is likely to accelerate real estate turnover (and increase government revenue) by reversing a "lock-in effect." Lock-in results less from high capital gains tax rates than from the step-up of basis at death; and in real estate, turnover is strongly affected by depreciation rates. In periods of rapid write-offs—most strikingly during the 1980s, when real estate could be written off faster than in any other period—buildings tend to be sold as soon as they are depreciated. The 1986 reforms reduced the incentives for this rapid turnover, but the principle is clear: When depreciation rates are high, there is a powerful tax-induced incentive to sell a building when it is fully depreciated. One therefore must doubt the claim that cutting the capital gains tax would encouraging investors to sell their assets. While it is true that that "trillions of dollars are locked up in mature, relatively non-productive low-cost assets,"[8] most of these "mature" assets take the form of depreciated real estate. Although real estate prices have stagnated, the book value of buildings has been diminished by much more. Now that these buildings are fully depreciated, owners have an incentive to sell or swap them once again so as to continue sheltering their income. The effect has been to leave substantial capital gains to be declared in the near future, while the properties can be sold for much more than their depreciated value.[9] This lends renewed urgency to the campaign to cut capital gains tax rates. Even without a rate cut, however, turnover in real estate may surge as investors exploit depreciation rules to maximize their gains from properties acquired under the accelerated depreciation rules of the 1980s. A rate cut at this time would be a mere giveaway, making permanent the income tax deferral from excessive CCAs.

The budget crisis aggravated by such a policy also ends up forcing public resources to be sold off to meet current expenses—sold to the very wealth-holders being freed from taxation. In this way wealth consolidates its economic power relative to the rest of society, and translates it into political power so as to shift the tax burden onto the shoulders of others. The first element of this strategy has been to defer revenue into channels that are taxed only later, as capital gains. The second has been to tax these gains at a lower rate than earned income—a fight that has now broken out in earnest.

Any capital gains tax relief should selectively favor productive enterprise relative to mere trading of nonproduced land or depreciated buildings produced years ago. At minimum, a general capital gains tax cut should be accompanied by both reform of depreciation rules and an increase in the ad valorem taxation of land. Moreover, capital gains policy should be evaluated in comparison to alternative means of effecting similar results. A cut in the payroll tax rate, for example, would be a surer stimulus to employment that an across-the-board capital gains tax cut.

For scholastic references, you may contact the authors. Dr. Michael Hudson is a Wall Street analyst and a co-author of A Philosophy for a Fair Society (London: Shepheard-Walwyn, 1994). Dr. Kris Feder, Professor of Economics at Bard College, is a co-author of A Philosophy for a Fair Society.