Sidetracked!

Counting the cost of the Two-Rate Tax

Michael Hudson and Richard Noyes

TAX CUTS on income and capital can be financed either by cutting public services, or by taking an increased share of land rents for the public exchequer. The two-rate reform favoured by some Georgists is not the solution, argue the authors, for the property tax accounts for only 21% of state and local revenues. Instead of advocating taxation on the full rental value of land, the two-rate taxers would leave existing real-estate tax rates unchanged. So 79% of state and local revenues and all federal taxation would remain as sales taxes and income taxes, or other non-land levies.

HISTORIANS of 20th Century economic thought will be puzzled by the way land speculation remained the major get-rich strategy even in industrial and post-industrial economies.

A more modest irony also needs to be explained. There was a body of theory (indeed, at one time a political movement) devoted to collecting land values for the public. Why did the followers of Henry George fail to bring to the public's attention the key role played by land-value gains? Why has the annual value of land and other natural monopolies not been authoritatively calculated, and why has the scale of the "capital gains" from land and land-like natural monopolies remained shrouded in mystery?

A related irony is this: why did the land-value tax movement use most of its resources to advocate that real estate taxes be reduced, rather than to raise the tax to capture the capital gains in land value? The essence of what has become the "two-rate" tax movement is not to raise overall real estate tax collections, but merely to redistribute the existing tax to focus more on land. *This change is mainly only nominal.* It will capture slightly more of the site value of under-utilized lands. But it will still leave substantial land-rent (and hence, land-value gains) in the hands of private holders and speculators.

Dr Michael Hudson is a Wall Street analyst and a co-author of *A Philosophy for a Fair Society* (London: Shepheard-Walwyn, 1994). He is currently writing a history of land privatisation.
Richard Noyes is a Representative of the General Court of New Hampshire (the state assembly), on whose Local and Regulated Revenue Committee he serves as chief of local revenue.

Rental income for the U.S. real estate industry is running at about $800 billion per year - *about 14% of national income*. At least, this is what the National Income and Product Accounts (NIPA) report for residential and commercial real estate. The figure does not include mining or the oil and gas industries, farming, forestry or ranching, or the income generated by land-like monopolies such as the electromagnetic broadcasting spectrum. Even for the real estate sector, it misses the implicit rental value of much owner-occupied land and underutilized sites. And it does not include revenue taken by owners as capital gains, that is land-value gains.

The $800 billion figure only reflects residential property and commercial real estate investment, after defraying all direct operating expenses. From this, real estate owners pay over $300 billion to mortgage lenders as interest. This *substantially outstrips* the $225 billion paid in local real estate taxes. Virtually nothing is paid in federal income tax, largely because landlords are able to set aside about $200 billion as a reserve for the presumed decline in the value of their buildings as a result of wear and tear. Also, as more and more revenue is paid out in interest - as landlords "pyramid" their equity by putting down as little of their own money as they can - this leaves less for the tax collector.

While buildings and their fixtures wear out, land values rise over time (despite some years of price corrections following real estate bubbles). On balance, landlords come out ahead. They deduct from their taxable income the interest they pay to mortgage lenders, as well as the local property tax, and a fictitious amount representing the pretended loss of the value of buildings.

Nothing is left for the federal government after the tax accountants walk through the winding and rather tricky maze of loopholes, small print and blatant giveaways that legislators

have provided for the real estate industry.

INCREASES in land value are not reported in the National Income and Product Accounts, despite the fact that they represent a major part of business enterprise's "total returns." Land values are drastically underestimated by the Federal Reserve Board in its "Balance Sheet of the U.S. Economy." Even so, these statistics show that land values in the United States are now rising at about $1 trillion per year.

This amount is commonly dismissed by national income economists on the ground that it is not "earned" income. The national income and product accounts focus on earned income (and interest and taxes).

Land is not a "product": no more of it is being produced. What today's landlords and speculators obtain is not so much a flow of revenue, but a capital gain. However, this capital gain is realized only at the point where the land is sold, or where the property is refinanced. Landlords may borrow the added land value from the banks, simply by taking out a larger mortgage. Thus, because the land is not "sold," the landlord gets his money from the bank without having to pay tax on it! Indeed, refinancing the property often is taken as an excuse for beginning to re-depreciate its buildings all over again - that is, writing off their value as if the overall property were falling rather than rising in price.

The important point is that capital gains from land substantially outstrip the property's rental income (except, of course, when real estate bubbles burst).

The existing real estate tax captures only a small fraction of overall capital gains from land. This means that even if the two-rate tax were levied entirely on the land, it would collect only about 28 to 30% of the rental value, and less than an eighth of the total return.

The two-rate tax leaves the great bulk of these capital gains in the hands of speculators and other property owners - unless the overall tax rate is sharply increased. Real estate will continue to get special tax treatment denied to industrial manufacturing, and to all recipients of "earned income."

Lower taxes on capital gains than on "earned" income (industrial profits and wages) induce investors to take their returns in the form of speculation in real estate and the stock market (The key to much of the stock market's gains represent the growth in underlying land values, especially for newly privatized enterprises which tend to underutilize their land value).

SPECIAL tax breaks for the real estate industry are often rationalized on the ground that they are necessary to spur construction. This approach would reclassify what Georgists (and indeed, classical economists) call "rent" and turn it into "profit," that is, what Frank Knight called "compensation for risk."

By the early 1990s the real estate industry's gross rent was about $700 billion annually. But only 0.3 percent of this was paid as income taxes. The industry avoided income taxation by using many loopholes, most of all by over-depreciating buildings even as rising land prices more than made up for the wear and tear. The upshot was that rental income appeared as a "capital gain" rather than income - and low capital-gains rates provided an incentive to hoard, rather than to build and actually earn income.

To the real estate industry, mortgage interest now represents the most important cost. Most of the rental value of US land has been pledged to mortgage lenders as interest to carry the property. This creates a political problem. Collecting more of the land's rental value for the public would be at the expense not simply of the landlords holding title to this land, but at the expense of the bankers behind them. Landlords could rightly claim that they are being "squeezed," because the gamble they took - that they could hold out by always using the land's rental value to pay interest to their bankers in their belief that land prices would rise indefinitely - did not provide them with the pot of gold they had anticipated.

Examine the chart (from a study by Michael Hudson and Kris Feder, published for the Levy Institute at Bard College on "Real Estate's Role in the Capital Gains Debate"). The mortgage figures show that even a half-point increase in the mortgage rate is more important, quantitatively, than a total shift of the real estate tax from buildings to land. For the local real estate tax itself is only 1% or 2% - nowhere near as high as interest rates. Shifting this marginal tax from buildings to land thus is an insignificant shift. It gets easily lost in the wash of overall mortgage debt and depreciation manoeuvring.

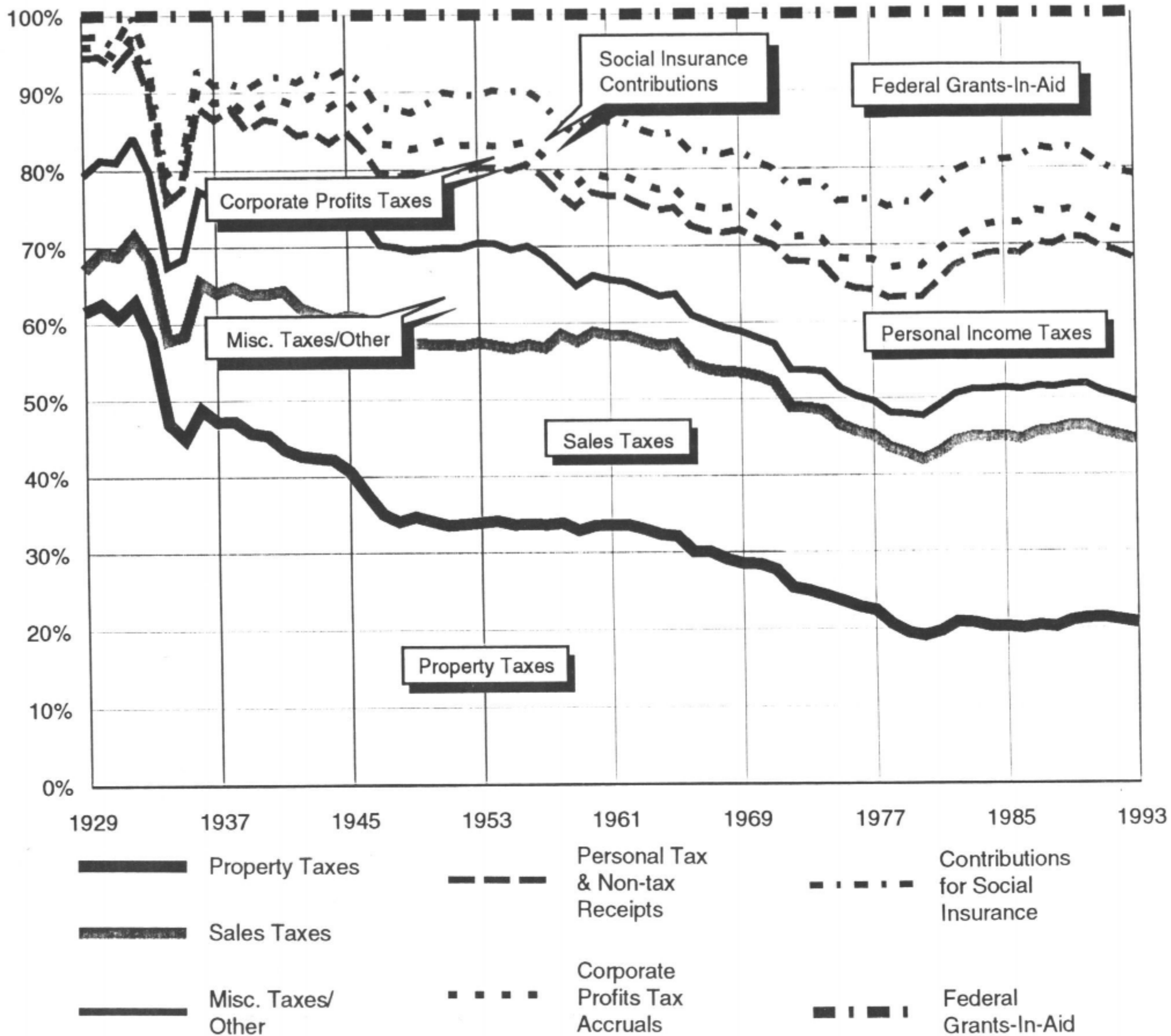
The important point is that a switch to two-rate taxation would not add significantly to the revenue of owners of buildings, except to the fraction of a percentage point of the property's value representing that portion of community-wide taxes that can be shifted to underutilized land such as parking lots or vacant lots. The tax obligations of statistically "normal" real estate would be unaffected. All that occurs is a reclassification of the nominal tax from one category to another. Heavily built-up sites would benefit slightly, but as long as the total real estate tax rate is only a few percentage points of the property's actual value - and most land is not underutilized - the effect is more symbolic than real. The two-rate tax certainly does not capture anywhere near the land's full rental value, and hence the gains in land-value.

THE MAJOR objectives of real estate investors are to secure capital (that is, site-value) gains; to minimize (and defer) taxes on this gain; and to cover the holding cost (or hoarding charge) by borrowing from banks, S&Ls, insurance companies, pension funds or other lenders. So little of the land's rising value has been collected by government that mortgage interest is now of much greater concern to the real estate industry than are property taxes. (Meanwhile, the income tax barely touches real estate at all!)

Real estate developers typically are willing to turn over all their net operating income to the banks as mortgage interest, in the hope of "cashing out" at the end and selling their property for a mark-up - not a "profit" as such, but a return in the form of the more lowly-taxed capital gain.

These gains are almost entirely land-

State and Local Government Receipts — Percentage Composition



value gains, as buildings themselves do indeed depreciate. Rising land values are so large that their recipients have been able to gain control of the political process to shift federal taxes onto labour and industry, via sales taxes and income taxes on wages and other earned income. In effect, government is manipulating the tax system to subsidize unearned income.

The effect is to warp the economy. What has been welcomed as "post-industrial" growth turns out to be merely a gentrification process. The major way to get rich today remains the same as it was in industrial and pre-industrial economies: to reap land-value gains. Yet Georgist institutions have not made this seeming anomaly an issue of national debate. Indeed, no one seems to know about it, except landlords and their bankers!

The public is left to imagine that stock-market gains reflect the financing of new industrial investment (initial public offerings, or IPOs), whereas in fact they reflect the recycling of land rent into new real estate lending, which puffs up land prices. Until the public recognizes how savings are recycled to inflate the land bubble, little will be done to close the loopholes that divert income away from industrial investment to real estate speculation.

Only when people realize that industrial investment and consumption are being taxed (or public services cut back) mainly to free more income for land speculators will the anti-tax movement achieve a meaningful focus.

THE two-rate tax movement had some logic early in the century, when real estate taxes made up the bulk of state and local budgets. But today, property taxes make up only about 21%. Thus, the allocation of this tax as between land and buildings is nowhere near as important as it once was. This is especially important in states such as Pennsylvania, where real estate is taxed at slightly over 1 percent of the property's assessed value.

Today's two-rate tax movement aims at shifting the existing real estate tax from buildings and other capital improvements to the land. This is to be done without raising the overall level of

revenue. "At the margin" it raises taxes for land without buildings: parking lots, used-car dealerships, and other underbuilt property. And by the same token, it would lower taxes on the community's largest buildings, electric power utilities and other expensive structures.

Advocates of the two-rate tax system want to promise that property taxes for most residents will decline. But if the existing real estate tax captures only a portion of the land's rental and sales value, this means that the two-rate tax will still leave a major part of "total returns" in the hands of private holders.

This is a far cry from what Henry George advocated. Indeed, the two-raters have sought to win votes for their program by trying to find communities where they can appeal to most property holders that their real estate taxes will be *reduced*. This can occur only in communities that have substantial underdeveloped land, with no major buildings - in other words, rather poor communities.

To be sure, this reduction in most peoples' property tax rates probably was not how the two-tax movement began. No doubt its early proponents were searching for some kind of "real world" victory, some way of putting before the public - and enacting into law - the economic distinction between land and capital improvements. But in attempting to attract voters, appeals were made to their narrow self-interest: their own property taxes could be reduced by shifting the burden marginally onto underutilized land (as long as an even higher tax yield of large commercial buildings would be shifted onto residential homeowners, that is!).

THE BASIC theme of Georgism is society-wide economic interest. This theme is lost in the two-rate campaigns. Even worse, two-raters have sought to direct as much of the movement's resources as possible into their campaign, leaving advocates of the larger economic picture out in the cold. Academic efforts and serious research efforts have even been discouraged on the ground that they distract attention from their own local efforts.

If communities have some major, highly expensive structures - a public utility, or a few very large buildings - shifting the existing property tax onto the land will free these large capital developments from taxation, and distribute former tax levy among the remaining landholders. Obviously, this is not a vote-catching idea.

Why are voters (and for that matter, most Georgists, as the Plotch Report [*Open Forum, Land & Liberty*, Winter 1996] has shown) so cool to the two-rate tax? The answer is simple: there is little to get excited about. It is a very marginal tax, symbolic almost only to Georgists. Most people have grown tired of voting for symbolic gestures.

Indeed, the two-rate tax shift is so marginal that the voters of Amsterdam elected to return to the prior system. Voters in Harrisburg, Pennsylvania - one of the first cities to try out the two-rate system - likewise are now swinging against the two-rate system. As used-car dealers found the tax bills on their unbuilt lots rising, they combined with parking lot owners and real estate hoarders who had built "taxpayers" (that is, one-story structures rented out at a nominal fee to cover their local tax costs and mortgage payments to their bankers), while waiting for land prices to escalate.

If the two-raters have been unable to convince voters of the justice of taxing unearned income in the face of such seemingly obvious special-interest pleading, is it not time to renew the discussion at the national level? And while doing so, isn't it time to begin a serious annual report on the real estate industry's special loopholes, and how these loopholes are becoming increasingly parasitic in character? Such quantification would enable the cost of the real estate industry's special pleading to be measured, and land-value returns could be compared to industrial and commercial profitability.

Would not voters be more excited to be shown the extent to which the U.S. economy - an economy which most people imagine to be powered mainly by industrial innovation - is really a *rentier* economy based on gentrification to inflate the real-estate bubble and the privatization of hitherto public natural monopolies?

With all the news about buying political influence, is there not good publicity to be made of the fact that the largest political contributors at the federal, state and local level are real estate developers? Their payoffs are made in local property-tax variances and public subsidies for favoured contributors, and nationally in the form of the loopholes that have virtually freed the real estate industry from income tax liability. Property taxes also are being reduced relative to other taxes.

IN ONE state after another, legislatures have limited the property tax to represent less and less of state and local revenues. In 1978, California passed the infamous Proposition 13, limiting to 2% the rate at which property taxes could be raised each year. The upshot was that while land values doubled and redoubled in the 1980s, property taxes did not keep pace.

Iowa limited its annual property tax increase to 4% in 1979, while Arizona imposed a 10% limit. In 1981, New York City limited the property tax increase on residential apartments to 8% (30% in five years), while a 6% limit (or 20% in five years) was imposed on residential property taxes in the city and neighbouring Nassau County. Land values soared so far ahead of tax rates that a real estate bubble ensued during 1985-91.

Other states are jumping on the bandwagon to replace property taxes with sales and payroll taxes. In 1994, Florida limited the annual increase in residential homestead property taxes to 3%. Michigan chose the lower rate of either 3% or the consumer price index percentage increase. In 1996, Oregon limited the tax increase on individual property to 2%, while Oklahoma limited the annual rise in the real property taxes to 5%.

Without reducing the nominal tax rate, states have thus found ways to limit the increase in real estate taxes. Under these conditions, shifting the property tax from buildings to land would capture a shrinking part of the land value gains. The speculators, greed-mongers and the politicians representing their interests are way ahead of Georgists in finding ways to shift these local taxes from their land onto labour and capital.

THE BEST counter-strategy would be to inform voters of how the economy is warped by taxes on new direct investment and employment, while land speculation is encouraged. At the end of this path, businessmen will make their money off the land bubble rather than from entrepreneurial ventures.

To focus attention on battles fought in the past, voters (and many Georgists themselves) lose sight of the big picture. Georgism becomes marginalized: the two-raters are arguing about a real estate tax that is shrinking.

The irony is that property owners accept jumps in mortgage interest rates as long as their land values and rents are being inflated at an even higher rate. To increase their returns (they cannot do much about the mortgage rate) speculators have mobilized homeowners to fight against the much less burdensome increases in property tax rates.

In the end, peoples' behaviour reflects their overall world-view. The contribution of Henry George was to demonstrate the dominant importance of land in the broad economic picture. Voters and lawmakers became vigilant. Reawakening today's voters to land's importance requires the presentation of statistics at national and local levels. Armed with such a data bank, calculations would show the real-world consequences of deciding what kinds of economic activity to tax: active investment gains by capital, labour and its living standards, or the passive "unearned increment" of land appreciation.

Such an educational initiative costs money. By having lost the public's attention (not to speak of land's shrinking role in academic economics), Georgism has allowed its intellectual capital to become depleted in recent decades even as the endowments of some Georgist institutions have grown!

Rather than fighting yesterday's two-rate battle, we need to invest to help people put their economic frustrations in the context of an overall economic philosophy. The property tax has become America's least popular tax. It represents a shrinking proportion of personal income - just 3.5 percent today, down from 3.8 percent in 1992, and 4.3 percent in 1978. It seems that voters would rather tax labour and capital than land!

Only an overall philosophy will enable people to make sense of the chaos in the economy. Once people gain this broader sense of proportion, their fiscal perspective will follow. A logical first step would be to prepare an annual chartbook and economic atlas. This would illustrate a body of theory that may excite people today as much as *Progress and Poverty* excited them a century ago and explain why our epoch has failed to provide prosperity for many outside the upper *rentier* layer.

Land & Liberty invites its readers to express views on the case for and against the two-rate tax strategy. Is it sufficient that the two-rate tax draws attention to the distinction between land values and capital improvements? Or is the tax reform movement disadvantaged by the significant proportion of resources being devoted to this strategy at the expense of other initiatives?

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