

# QUANTIFYING RENT: Tax Reform & the Barriers to Research

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THE OBJECTIVE of the real estate industry is to obtain capital gains, but no land-value statistics are collected or published. Evidently the reason is so as not to let the public know that this is the secret of wealth-making - for otherwise, the government would want to tax these gains.

The financial and real estate sectors form a unit, the FIRE sector (finance, insurance and real estate). The banking system puffs up real estate values by mortgage lending, and extracts interest. In fact, most of the economy's rental income is paid out by landlords to their financiers. What they hope to obtain is capital gains upon sale.

The financial sector recycles its interest receipts into yet more new lending - about 70% to the real estate industry (including home mortgage borrowers). This creates yet more capital gains, enabling yet more money to be borrowed.

My research seeks to integrate rental income with land-value gains to derive "total returns." My research therefore reviews rent's role in the U.S. national income and product accounts (NIPA), and real estate's capital gains as reflected in the annual balance sheets of assets and liabilities published by the Federal Reserve Board. After tracing these shifts, I estimate how much rent and capital gains are attributable to land as distinct from buildings and other improvements.

These statistics show real estate to be the economy's most important sector. Gross rental revenue amounts to some 14% of national income, a proportion that has remained fairly stable in recent years. Real estate also is the economy's major asset, with land representing the major component (about 40%). It thus is not surprising that for most years until the real estate bubble began to be deflated in 1989, most capital gains were generated by real estate.

Capital gains are much more important for real estate investors than would be suspected merely by tracing the economy's rising property values. Most net rental income (after paying interest and taxes) is written off as capital consumption allowances. Building book values are depreciated accordingly. When it comes time to sell their buildings, real estate owners declare these back-charges as "capital gains."

Interest rates and other financial charges have risen since the end of World War II to a point where they now absorb the lion's share of rent revenues. Indeed, the real estate industry typically shows no net taxable income at all. Its cash flow consists mainly of tax-exempt capital consumption allowances (which are used to amortize bank loans). On balance, real estate owners have aimed less and less at generating operating income for themselves, but have been willing to pledge virtually all this income to their creditors as mortgage interest, hoping that they can reap a capital gain upon selling the property.

Favourable tax treatment for building depreciation in the face of rising property values, for interest paid on leveraging mortgage debt, and most of all for capital gains has sharply reduced real estate's share of taxes. This in turn has contributed to the economy's fiscal squeeze, while shifting the tax burden onto labour and capital as income and sales taxes. The tax shortfall threatens to worsen if the capital gains taxes are cut for the real estate industry. The proposed changes would, in effect, render it virtually exempt from income taxation.

### Rent as a tax base

One by-product of calculating the magnitude of rent is to provide a basis for assessing real estate's traditional capacity to serve as a tax base. In view of the rising extent to which gross rental income has been pledged to bankers as mortgage interest, however, taxing it more at this point would leave little margin for property owners to absorb. This poses the danger of having to default on mortgages as the real-estate bubble is deflated.

The composition of rental income has shifted away from real-estate profits and local taxes to interest paid to mortgage lenders. In fact, real estate traditionally has been the major generator of interest in the private sector, far outweighing manufacturing, transportation and retail and wholesale trade.

Capital gains for land and buildings are much more volatile. In the 1980s these capital gains often represented as high a source of gain as current income. Indeed, capital gains are more beneficial to landlords, in that they are taxed at lower rates than income. In calculating the returns to investors, it thus is appropriate to calculate "total returns," that is, the sum of current income plus capital gains. Indeed, on a taxable basis, real estate shows no net income at all, year after year. This is because capital consumption allowances absorb all the net revenue after paying property taxes and mortgage interest. For tax purposes, this is partly compensated by taxing capital gains, but these capital gains are not reported as part of the NIPA statistics.

One of my central findings is that if we want to present a picture of the economy "as it really operates," we must take a landlord's eye view (supplemented with the economist's perspective) and integrate asset-value gains with current revenue to derive a measure of "total return." For this is what investors seek, whether they do so as landlords, stock-market speculators, or industrialists.

*Integrating NIPA and Federal Reserve real-estate value statistics* shows that the objective of most real estate developers is *to reap capital gains*.

My objective is thus to describe the pragmatic businessman's view of his real-estate undertakings. His measure is a combination of current income (which the tax collector finds to be zero or even negative) and the capital gain with which he ends up by the time he sells his property. Stock-market analysts call this the "total return" to investment, and calculate it as a percentage of the invested capital. To indicate how the magnitude of these savings out-weighs real estate's current earnings, I use the Federal Reserve Board's calculations of land values and other real estate prices to derive preliminary estimates of changes in land value.

In making these estimates I use the economist's definition of rent, not that of the tax collector (for if we believed *him*, we would find no rental income at all). The real-estate industry appears to be something in the character of a vast charitable foundation, supplying the economy with housing, office space and other services without taking any net income for themselves at all (after adjustment for the physical depreciation of their buildings). On an industry wide basis, all their rental income over their depreciation allowances are turned over to the local tax authorities, and to their bankers. In the end, they hope to achieve a capital gain for their astuteness in having performed this public economic service.

The first lesson of this study is therefore that given the imaginative techniques of modern tax accountants, to tax what landlords declare as rent under current law, is a far cry from taxing what economists have long defined as rental income, land rent or differential rent. To take a landlord's-eye view of matters (as told to their tax collector) they earn no rent at all, after taking their capital consumption write-offs to compensate them for the wear and tear of buildings or other capital improvements. They are no longer in the game for the rental income, but for the capital gains they reap at the time they sell their real estate. This explains

their urgent support for abolishing the capital gains tax (having already drastically reduced it in recent years).

My approach explains the famous economic rule that inequalities of wealth historically are greater than inequalities of income. Stated another way, the wealthiest layers of society monopolize even more of the economy's assets (and hence, capital gains on these assets) than they do its income. This phenomenon has long been known, but not well explained. For instance, one recent observer (Wolff 1995:27) leaves capital gains out of account in his focus on explaining how the American economy has grown more top heavy in its wealth and income. Yet it is wealth that generates the income kept mainly by the wealth-holders.

When we talk of how much rent is generated, we therefore use the economists' view of matters.

### **The economic consequences of rent-taxation**

Suppose the government were to tax all the \$600 billion or so land-rent immediately, or even phase it in. And what if it taxed capital gains? (Of course, if it taxed all the land rent, there would be no capital gains; but if it taxed only some of the landrent, there would still be some capital gains left to the landlord.) What would be the economic consequences?

First of all this money would be unavailable to the banks. They currently obtain much of the rent of land, as well as that of buildings. Landlords would default on their mortgages. Would the FDIC guarantee their deposits?

In any event, we can demonstrate the degree to which the real estate sector has become so thoroughly merged with the financial sector that it is well called the FIRE sector: Finance, Insurance and Real Estate. A single tax would break this combination. Bank and insurance-company lending would be directed more towards industry.

This would slow the real-estate bubble, which has been swelled in country after country by the fact that the largest category of bank lending and national savings is recycled into the real estate market. As these savings accrue interest and plow it back into yet more savings year after year, this obviously will mean an exponentially rising flow of savings into the real-estate market. It will create a bubble, to the extent that real-estate prices will rise so high that just to pay the interest on their mortgage debt will exceed the income that renters or other users are paying.

Calculation of the quantitative dynamics of this bubble, the rate at which savings increase, the proportion recycled into the market for land and other real-estate, and the mortgage interest charged on this recycling, must be the subject of research. An awareness of the bubble's existence is critical for understanding the dynamics that are responsible for shaping the real estate market and the evolving disposition of its rental income as between taxes, mortgage interest and net rental income left to the landlord.