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Tax Treatment of Land Income

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Remember when market economics "triumphed" over socialism? Since then, it has exhibited more than enough failures to temper our hubris. Among them: growing concentration of economic power, stagnant or falling real wage rates, homelessness and beggary, chronic unemployment, growing crime rates and personal insecurity, obsolescence in the face of rising foreign competition, dangerous dependence on oil, growing recourse to the underground economy, falling literacy and educational attainments, anomie and substance addiction, rampant self-seeking and predation and rising social divisions leading toward class warfare.

** Extracted from "Coordinating tax incentives and public policy: the Treatment of Land Income." The original paper was presented at a Brookings Institution seminar on The Role of Incentives in Public Policy, and published in Economic Analysis and the Efficiency of Government, 1970, Joint Economic Committee, US Congress.*
*** The term "wealth" here is used here in the conventional sense of an individual's (or firm's) stock of assets, not in the classical sense as used by Henry George. — Ed.*

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.

The tragedy for capitalism is that the role of unearned wealth is kept invisible. That was one of the goals of J. B. Clark and other pioneers of "neo-classical" economics. For a century, 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.

Many conservatives argue for decreasing the tax on capital gains, in order to encourage "venture capital" and raise the rate of return-after-taxes on new investments. In 1987, when President Bush (Sr.) was proposing such a cut, Professor James Poterba estimated that "venture capital" accounted for only about 1% of capital gains. That encourages a suspicion that much of "capital" gains come from old assets — particularly land.

Most modern Georgists believe the property tax is the best means to tap rent, but it is not the only means. Income taxes socialize billions in land rent, and could socialize much more. The first task for Georgist reformers is to seal off landowners' escape route from property taxation. Landowners' strategy has long been to secure property tax relief by raising income taxes, while converting the income tax into mainly a payroll tax.

An allied issue is how to stimulate domestic capital formation. It's claimed that lowering capital gains taxes will do this. What issue could be more Georgist than capital formation? "Tax land to untax capital" is the Georgist idea. The aim of untaxing capital is to free up forces that induce investment and create new capital.

To do that we need policies that distinguish old capital from new — a key difference that is recognized by many economists. More basically, we need recognize that "old capital," as commonly defined, includes the oldest asset of all: land. We must distinguish man-made capital, the fruit of saving and real investment, from natural resources or land. It is the old capital, and mainly land, that yield "capital" gains.

The beauty and vigor and challenge of Georgist reform is precisely its attainability and immediate relevance to a wide range of public issues. Anti-Georgists would love to narrow Georgism to the one modest goal of reforming local real estate taxation. I honor and support those who focus on the attainable goal of urban property tax transformation, and hope I may be counted among them. Let's redouble those efforts, but let us also move into the larger public dialogue on the grand issues George used to inspire and move a generation.

So long as we have income taxes, it is a Georgist policy to see that land pays more income tax, and earned income pays less. The income tax taps a lot of land rent, and also commands the public dialogue. Henry George himself called income taxation a second choice — not first, but not last either. George and Georgists were "present at the creation" of the American income tax. You will be surprised at what a key role they played. Let's review some history.

Congress enacted an income tax in 1894. There were fifty Populists in the House then, and six avowed Georgists. They all supported an amendment to the income tax act, by Judge James Maguire of California, to make it a direct tax on land rents. The amendment failed, but we still owe a debt to those six.*

We may reasonably surmise a bloc of six committed, zealous Congressmen, within a larger bloc of fifty Populists, was what kept land rents in the base of the 1894 Act,

blocking any income tax bill that excluded land income. This in turn provoked the Supreme Court into holding the 1894 Act unconstitutional, 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 to direct taxation of land rents. Congress has been taxing land rents ever since; it never had before.

It even has the power, if it wishes, to exempt all other forms of income and limit the tax to rent. Is that an impossible dream? Not really. The maligned 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? We had a "graded tax plan" nationally, and never knew it!

Eight decades of creeping regress

Reviving the capital gains exclusion would nearly complete an anti-Georgist transformation of the income tax to a tax on work and enterprise of the median citizen. Here is a list of the anti-Georgist changes to date. They are enough to make a Georgist feel like a chess player facing mate.

a. Wage and salary withholding 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 pushed workers into higher rate brackets, with no increase of real income. This effect has been reinforced at the bottom, where most wage and salary income is found.

c. At the top, where most rents and capital gains are, the top rate was lowered from 70% to 28%.

d. Corporations, meanwhile, 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. In addition, in 1986 Congress lowered the flat corporate rate from 46% to 34%.

e. Preferential treatment of land rents and gains has grown in several dimensions, as we will discuss.

The cumulative effect of those changes has been to utterly transform the income tax. 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 does. Nearly all local revenues were then from property; today much less than half is. Sales and income taxes have replaced them.

One bright, or at least light gray spot in this dark history was the relief of new investment from taxation under JFK, in a compact known as "business Keynesianism." CEA chair Walter 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 high tax rate applies in full force to land rents; new investment gets major relief. Net result: an income tax that achieves nationally the same goal property tax reformers have to chip at laboriously from town to town. 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. Investors who responded to the lures of accelerated depreciation, and lawyers who worked on intricate moves to exploit them, never dreamed they were responding to ideas originating with a radical reformer from the 19th century.

The provenance of Heller's idea shows the influence of a Georgist academic, John R. Commons (1862-1945), a leading "Institutionalist" thinker at The University of Wisconsin. Commons's views on taxing land and exempting capital and wages are set forth strongly in his *Institutional Economics:* "…the man who gets his wealth by mere rise in site-values should pay proportionately higher taxes than the one who gets his wealth by industry or agriculture. In the one case he extracts wealth from the commonwealth without adding to it. In the other case he contributes directly to an increase in both private wealth and commonwealth."
Commons favored the fast write-off of new investments, the very idea Walter Heller put across in Washington. His purpose was explicitly to make the income tax bear heavier on land rents than on the returns to capital. When the purpose of Congress is really to encourage new investment, fast write-off of new capital is the obvious tool.

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. Thus, the effective tax rate on most new investment was raised. Traditional liberals applauded this as closing loopholes; economists, conservative or liberal, have been enchanted by

"uniformity." Uniformity between mutually convertible things is a good rule — but land and capital are inconvertible, so sensible tax policy may treat them differently.

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

The main effect of untaxing land gains is simply to redistribute wealth and overprice land. Incentives to buy and hold land will raise the demand, not the supply. Such incentives stimulate the production of nothing and the employment of no one. They simply raise asking price and exclude marginal buyers from the market.

Covert depreciation of land

In the tax code, land is not depreciable and should not enjoy the benefits of 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 have made land depreciable, for they maintained vehemently that land is no different from other capital.

Rent-seeking outlays

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 this. Rational rent-seekers incur deductible 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.

Water law. Riparian rights are secured by the appropriative doctrine: "first in time, first in right." Prior use establishes a perpetual license. The only way to secure the future rents is develop and use the water now, before a rival. The winner absorbs the losses of premature use, and deducts them from taxable income — thus the fisc shares the cost of land acquisition.

Zoning. The race is to get grandfathered in on NIMBY or LULU (Locally Undesirable Land Use) activities

before they are zoned out. 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.

Air pollution. The current approach is not to make the polluter pay, but to reward him with 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 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.

Radio spectrum. Rights 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).

Mineral rights. 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.

Once one gets the concept, one sees more and more resources being distributed on this appropriative principle. All are ways of acquiring landownership, *de jure* or *de facto*, by incurring early losses.

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 lose value with time, while land does not. So far, so good — but, 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 not just the building or trees, but a major part of the land value.

The IRS 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. However, 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.

Most remarkably, land is written off again every time taxable property changes hands. Every succeeding owner overallocates his basis to depreciable capital. Thus every piece of land may be partly written off as many times as it sells. In result, the contribution of much land to tax revenues is negative, and heavily so.

Land appreciation produces nothing

Increased land values are not caused by holding title to and "financing" appreciating land; interest payments do not "produce" increments to land value. Appreciation would occur anyway. 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.

The only functional reason for deducting carrying costs, then, is to avoid discriminating between equity holders and mortgaged holders of title. This encourages the pledging land as security for loans. 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.

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

Aren't excessive depreciations eventually taxed?

Anyone defending the system would insist the Treasury recoups excess depreciation when property is sold. 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.

A long period of tax deferral, tantamount to tax exemption, is still very advantageous, considering the time value of money. Such laggard treatment is in stark contrast with the unforgiving withholding and full rates levied on salaries, wages and current profits from the "ordinary" production of goods and services. It seems that paying taxes on time "is what the simple folk do."

Furthermore, landowners routinely defeat recoupment. Excess depreciation, and unrecouped deduction of carrying costs, have accumulated over several generations, and will accumulate in perpetuity until the system is radically revised. Recoupment is a certainty only for careless taxpayers, or pinched taxpayers who lack room to

maneuver. In general, excess depreciation is not recouped. Tax exemption is achieved in perpetuity — and the next generation does it again! Landowners have been running circles around Georgists, who foolishly took 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. The income tax, the dream of Warren Worth Bailey, evolved into a nightmare. It became class legislation, the more sinister because invisible.

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 two investors, Alice and Bob. Both are subject to a tax rate of 50%.

Alice puts $1 in a savings account paying 7.2% compounded annually. (That is the rate at which money doubles every 10 years.) She 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 her wealth has grown to $8.

Bob puts his $1 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. Bob's wealth has grown to over 4 times Alice's wealth, although both made the same rate of return, and both paid taxes at the same rate. The difference is timing.

Much land has been written off already, in whole or in part, and some more than 100%. Who's counting? In general it is a good rule to let bygones be bygones. In this case, however, 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.

Income taxation can be constructive and useful if we follow Commons's 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." Land gains should be fully taxed as they accrue, using any of various methods proposed by William Vickrey, James Wetzler or Mason Gaffney. Locked-in effects can be more than offset by coupling gains taxes with annual property taxes, as Taiwan does.

The result would be greatly to strengthen capitalism — meaning by this a system where capital proper, a.k.a. capital goods, 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.