



The American Assembly, *Columbia University*

THE GOOD EARTH
OF AMERICA
PLANNING OUR LAND USE

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Taxation and Land Use

Introduction

Taxes have power to destroy or to buy civilization, according to the varying half-truths of our distinguished forbears. In any event, tax policy has a decided impact on patterns of land use. Some tax critics may say taxation almost literally consumes the land—meaning by that something more specific than the usual diatribe about tax burdens. How does tax policy eat up the land? This chapter attempts to count the ways.

The great decentralization movement which has been superimposed on urbanization trends in recent decades, the flight to suburbia and exurbia, central city decay, sprawl and leapfrog development, the accessible second home, and the gentleman's farm are all great land gobblers. They reflect the operation of powerful sociological, economic, and technological factors (including abundant and relatively cheap energy). The nation's tax structure cannot assume prime responsibility, but it has made important contributions to the lavish and disorderly use of land inherent in the centrifugalization of our urban centers.

The basic thrust of federal income tax inducements has been toward ownership of conventional single family homes, giving added momentum to suburban development. Part of this stimulus is toward more spacious lots and acreage than would otherwise be consumer-feasible. The poten-

RICHARD E. SLITOR is a private economic consultant specializing in taxation and public finance. He served for over 30 years as economist for the U. S. Treasury Department in relation to housing and land use and has been Professor of Economics, Graduate Faculty, the University of Massachusetts. He has prepared special studies on taxation for the National Commission on Urban Problems, the Rand Corporation, and the Department of Housing and Urban Development. Mr. Slitor is the author of numerous books, articles, and academic papers in economics.

tial of condominium or cooperative-type apartment ownership which extends the income tax benefits of owner tenure to high-density land use has only recently begun to emerge.

Property taxes have accentuated centrifugal trends in various ways. Tax assessment is often on the basis of less than the best and highest use of land. This slows economic adaptation to the highest and best use. Moreover, the impact of property taxes on land has not altered the supply of land, which is fixed, but the tax burden on man-made capital outlays has restrained capital commitments for buildings and improvements. This has militated against investment needed for more intensive use of land. The result is a thinning of the proportion of man-made capital to land in the land-capital mix. This thinning generally means spread and sprawl in land use.

In the income tax area, another standout is the real estate tax shelter device, rooted in highly leveraged financing plus liberal tax depreciation formulas and the possibility of repeated rounds of tax depreciation write-offs on the same property by successive "generations" of investors. This has stimulated some multi-family housing development. It has also assisted the concomitant commercial and rental housing development which accommodates the basic sprawl trend. Part of this accommodation is the apparent revitalization of the central city, with high-rise offices and related commercial and residential construction. Another aspect is the creation of suburban shopping plazas and related facilities for the support of suburban living. Some variety is added to this general pattern by the occasional suburban high-rise spurred by the tax shelter device in tandem with the windfall profits attendant upon rezoning to permit conversion of low-density suburban land into more valuable sites for high-density utilization.

Property Taxation

The existing impact and potential of property taxation relating to land use have been widely recognized. Both states and localities are involved. States determine the general patterns to be applied by the local governmental jurisdictions—the primary revenue recipients—and increasingly participate in the administration of the property tax. If the states are to be the initiating and controlling agencies in land-use reform, property tax changes in the interest of improved land utilization may be one of the important instruments to be used. The treatment of the property tax under the federal income tax, specifically deductibility by homeowners, is significant in modifying its ultimate burden and land-use effects.

DOUBLE DUALITY OF THE PROPERTY TAX

The dual nature of the property tax is reflected in two separate aspects. (1) It is both a business tax and a tax on housing consumption. (2) Part of

the real burden of the tax rests upon the "pure" land value component of real estate values; part of it is borne by the man-made capital investments, chiefly buildings and other land improvements, which are necessarily made in any intensive use of the land.

The property tax increases the cost of, or reduces the return to, capital investments required in land utilization. This is true even if applied at uniform rates and with consistent valuation assessment procedures to land and man-made capital instruments. Actually, land values tend to be under-assessed so that the tax bears more heavily upon the man-made capital investment component. The reduction in the return to land is without general effects on land supply. But the compression of net yields restricts the related man-made capital until its after-tax return is brought into alignment with alternative uses for mobile capital. Pre-tax rates of return on man-made capital subject to property tax are thus raised to absorb the tax while the flow of capital elsewhere reduces returns in non-property tax areas.

EXCESS BURDEN EFFECTS

In the adjustment process just described, land is utilized less intensively and less efficiently than otherwise. The apologists for high property taxes are usually silent about the "excess burden" effects, the distortions of investment away from optimal patterns, and the adverse "externalities" which add hidden costs that accompany this process and increase the burden of the tax to society:

- the obstacles to urban renewal due to the encouragement to hold on to decrepit buildings and the discouragement of new construction;
- the disincentive to maintenance and rehabilitation, with consequent impetus to the spiralling process of urban deterioration;
- the inducement to smaller structures with consequent sacrifice of the potential benefits of larger construction economies which would permit lower per cubic foot costs;
- barriers to vertical growth and more intensive land use with consequent spur to horizontal expansion and attendant social costs of sprawl in terms of transportation, sewer and water supply, and other services.¹

Since the property tax ranges up to 2.5 or 3 percent a year (sometimes more) on fair market value in the more populous sections of the country which accounts for a large portion of its industrial and residential investment, it is evident that these excess burden effects are substantial. Housing being by nature a capital-intensive form of industry with a large part of the gross receipts consisting of return on capital, a property tax of 2.5 or

¹ The foregoing discussion owes much to an analysis in C. Lowell Harriss, "Property Taxation," Ch. 15, *Modern Fiscal Issues*, pp. 296-302. See also the same author's "Property Taxation: What's Good and What's Bad," *Challenge, The Magazine of Economic Affairs*, September-October 1973.

3 percent represents the equivalent of an excise or sale tax in the vicinity of 25 to 35 percent of the gross rental value of housing.

The property tax may also constitute a substantial element in the cost of professional, commercial, and industrial operations involving the use of buildings. It produces erratic impacts on the prices paid by consumers, depending upon the relative importance of property-taxed investment in furnishing the end-product or service. The equity results in the distribution of the burden are generally bad. The impact on economic efficiency and rational land use is probably worse.

DIFFERENTIAL ASSESSMENT OF LAND AND BUILDINGS

We have just seen how property tax reduces the intensiveness of land use by decreasing the relative amount of building and improvements in the land-capital mix. This results in more expansive, horizontal growth. It thus contributes to the process of economic decentralization and suburban sprawl which has characterized urban development and land-use patterns in the postwar decades. This analysis, by and large, has implicitly assumed that land and building values are in fact equally taxed in a given location. In reality, uniform assessment of land and building values very frequently does not occur. Land tends to be assessed at a lower figure in relation to fair market value than are the buildings or other improvements. This inequality prevails whether the practice is to assess property at a customary fraction of fair market value or at a full 100 percent of market figure. Relative underassessment of land takes various forms. One, but not the only, factor in land underassessment is the tendency not to value land in its highest and best use but to reach evaluation in terms of its current, possibly inferior, use.

The result is an accentuation of the tax impact on capital investment in buildings and other improvements. The pattern of events is familiar. The overall tax base tends to be narrowed by the omission of some of the land value components. The tax rate must therefore be higher to reach a given revenue target. In some situations investors recognize the implicitly higher effective rate of tax on improvements than on site value and respond in the classic way by reducing their building investment in relation to land. The supply of land is not affected by these adjustments but the man-made capital investment component is held back. As compared with a system of uniform assessment and taxation of land and improvements, the initial impact of higher tax rates is greater reduction of after-tax rates of return on capital. Pre-tax rates of return on these investments are driven higher than otherwise in order to cover both tax and acceptable after-tax return. Capital has to earn premium rates in heavily taxed uses and to do so it has to be kept "scarce" in these uses. This enhances the spread and sprawl effects of property tax on land use. A property tax system which bore more heavily on site values and less heavily on man-made capital would ease the

deterrent pressure on buildings and improvements. The present system tends to do just the opposite.

PROPERTY TAX EXEMPTIONS

Effects—The large revenue obtained from the real property tax as the mainstay of local government finance calls for a broad, intact base. Unfortunately, the tax rests on a base that is considerably narrowed by numerous exemptions and exceptions. This of course means higher tax rates than would be necessary if the integrity of the base were better preserved. The exemptions can be of material influence—both direct and indirect—on economic behavior and land-use decisions. Paradoxically, the granting of exemptions and exceptions itself enhances (1) the economic behavioral influence of the existing exemptions or exceptions, (2) the disincentive effect of the tax itself on man-made capital investment, and (3) the natural taxpayer drive to escape tax by whatever adjustments are feasible. The reason for this effect is that at the decision-making margin each narrowing of the base entails a higher rate of tax to achieve given desired revenue goals.

Rising Trend of Exemptions—There has been a decided trend in the past century toward proliferation of exemptions and the expansion of the exemptions as a percentage of the potential real estate value base. A 1968 study developed the following data on the growth of tax exempt real property:

	1880	1922	1961	1968
	(Estimates of market value in \$ billions)			
All Real Property	\$43.6	\$176.4	\$1263.7	\$1748.6
Exempt Real Property	\$ 2.0	\$ 20.5	\$ 294.7	\$ 569.5
Percent Exemption	4.6%	11.7%	23.4%	32.6%

Source: Harold B. Meyers, "Tax Exempt Property: Another Crushing Burden for the Cities," *Fortune* (May 1969) p. 79. Cited in "The Erosion of the Ad Valorem Real Estate Tax Base," Report of the Property Taxation Committee, National Tax Association—Tax Institute of America, 1973, p. 3.

Estimates of the ratio of exempt property to total real estate property range around one-third, the proportion varying widely among the different states.²

Impact on Tax Rates—Shrinkage of the effective tax base by one-third

²"The Erosion of the Ad Valorem Real Estate Tax Base," Report of the Property Taxation Committee, Arthur P. Becker, Chairman, National Tax Association—Tax Institute of America, *Tax Policy*, Vol. XL, No. 1, 1973, pp. 4-5.

requires a 50 percent increase in the otherwise applicable property tax rate to produce the same revenue. Thus a base of \$100X at a 2 percent rate yields revenue of \$2X; with the base narrowed to \$66 $\frac{2}{3}$ X, the rate must be increased to 3 percent to produce a revenue of \$2X.

There are, it is true, some offsets. Social benefits and services produced by the tax-exempt operation may save some spending by the local government, enhance surrounding land values and therefore the revenue base, and attract income and spending from the rest of the economic system. Frequently, however, these relationships are tenuous; and competitive exemptions in other jurisdictions may cancel out the local "booster" effect.

Types of Property Tax Exemptions—The range of property tax exemptions is wide: (1) governmental bodies, including federal, state, and local levels, and their authorities often engaged in semi-public, semi-private economic enterprise and development; (2) non-profit organizations, including those dedicated to education, religion, charitable activities, and welfare; (3) special groups of individuals, including veterans, widows, disabled persons, senior citizens, and other homeowners; and (4) favored businesses, industrial enterprises, and agriculture.

Some Specific Land Use Effects—Whether the rationale of exemptions is (1) conformity with the principle of intergovernmental immunity, (2) the elimination of the "pointless" circuit whereby a local government inflates tax collections and expenditures to pay its own taxes, (3) encouragement and cost sharing activities which lighten some of the burden of government, or (4) humanitarian assistance to the needy or distressed, the practical effect is almost always a tax subsidy. The subsidy of property tax exemption in reality constitutes a form of hidden expenditure on specific uses of land and related structures.

Property tax exemption helps the worthy cause only to the degree the recipient's operations involve use of real estate and on the condition that it own that real estate. Since the tax subsidy process is one so directly related to the carrying of a normal cost of using real estate, it clearly is related to a specific form of resource allocation more incontrovertibly than the much publicized federal income-tax-expenditure system under attack by fiscal reformers in recent years.

The removal of property tax obligations has the effect of encouraging the use of land and structures in endeavors which would not otherwise "pay the freight" or would not be economically feasible on the scale stimulated by the property tax exemption benefit. Ownership tenure is of course necessary to achieve this result, since mere use of rental property by a tax-exempt organization does not qualify the owner or tenant for tax benefits. The over-all economic consequence is use of scarce land resources in a manner which does not involve full cost accounting in the determination of resource use and combination proportions.

Tax Exemption and Budget Decisions on Land Use—Even from the standpoint of public budgeting and funding decisions, the social cost of operations conducted by the taxing jurisdiction itself using tax-exempt land and buildings is understated by the omission of property taxes from the calculation. Land dedicated, however meritoriously, to the public schools or hospitals is land which yields no property tax. The property tax foregone by this diversion of land from alternative taxable uses is a cost of public education as truly as the salaries, equipment, and fuel expenses of educational facilities. There is no taxpayer inequity since the effects on the distribution of costs to be borne by taxes (except for possible short-run differences in the recognition of costs and the budgetary response thereto) would be the same whether or not the county paid its own property tax on school or other property.

Property taxes reflect a social cost of using property. If they are not included in the perceived cost of certain uses, such as that for streets or schools, errors in resource allocation will result. More land and buildings tend to be allocated for tax-exempt uses than otherwise. Three inter-related but distinguishable sources of enlarged expenditure on land and buildings result from the tax-exemption arrangement:

1. Public services such as education are expanded because a major cost item, the land and buildings, is underpriced. This affects the decisions of the managers of the public funds.
2. In the mix of factors or economic resources producing a given amount of the governmental service, land and buildings will be used more liberally than other components because their use is underpriced due to the tax-exempt feature.
3. Ownership tenure as against rental occupancy becomes a "must."
4. In the budgetary process, expenditure items using real estate (land and buildings) have an illusion of cheapness.

Distortions in the Subsidy Process—It is extremely difficult and hazardous to fault a feature of the property tax law—the exemption of property of churches, universities, museums, hospitals, and numerous other welfare organizations which occupy such an honored status in our society—because it seems to accomplish what it is supposed to accomplish. But encouraging use of self-owned real estate by these organizations is not identical with encouraging them in their general functions.

Exemption is a special form of financial aid which is effective only in proportion to self-owned real estate use. It tends to distort the relative use of real property, other forms of capital, and labor. It probably encourages continued traditional patterns of operation by the exempt organizations—patterns which would not survive the test of the market place and which do not necessarily best serve the ends to which the institutions are dedicated.

URBAN DEVELOPMENT EFFECTS

The inherent effect of the property tax (even if levied at equal effective rates on land and buildings values) is not neutral, as we have seen. Land supplies are unaffected. But there is a deterrent to the construction of buildings which must earn a satisfactory return on investment after tax to compete with alternative uses outside the property tax gambit. Partly because of the way improvements are taxed, many areas are held in low use. This effect of discouraging more intensive site development promotes leapfrog development and urban sprawl.³ This impact is enhanced to the extent that more favorable tax rates are available in new suburban areas or there are other special tax-related hindrances to construction on the closer-in sites.

COMMUNITY DECISION EFFECTS

The property tax, within the institutional context in which it functions, is open to the criticism that it has a distorting influence on community decisions which in turn influence land use. We have already examined the budget decision aspects. Another is the influence, sometimes asserted and as often denied, of income tax deductibility by homeowners in encouraging community decisions favoring over-reliance on the property tax. Another is the phenomenon sometimes called fiscal zoning.

The Lure of Income Tax Deductibility—Despite the underlying drive toward tax minimization, there is ground for believing that property taxes are sometimes pushed to otherwise unacceptable levels by the fact of income tax deductibility. Affluent suburbanites are likely to be less resistant to 2.5 and 3 percent property tax rates (on full capital value each year) since income tax deductibility may well shift 50 to 70 percent of the burden to the federal revenues (and some additional if the state has an income tax). The high property tax rates which such taxpayers are prepared to pay are considerably less tolerable for the lower-bracket resident, particularly the occasional “non-itemizer.”

Collective consumption financed by an appropriately localized property tax which can be “taken off” income tax offers some interesting possibilities. One is an exclusionary effect on potential newcomers who are less well equipped to use the deduction feature. A second effect is the blunting locally of the economic tendency to deter man-made capital outlays and home improvements, examined earlier.

Fiscal Zoning—The Regional Plan Association has outlined some of the serious problems attributable to the property tax as disclosed in its re-

³ *Financing Schools and Property Tax Relief—a State Responsibility*, Advisory Commission on Intergovernmental Relations, Ch. VI, p. 78.

search on development patterns in the New Jersey-New York-Connecticut urban region.⁴

One is the distortion of local planning. "Home rule" in planning and zoning is justified on the ground that local people should have the right to determine the kind of community they want and desire to live in. However, debates on planning and zoning ordinances seem to focus almost entirely on property tax effects in relation to the public (especially school) expenditure requirements expected to flow from alternative zoning decisions.

Tax-restraining zoning techniques involve favoring (1) one-family houses on lots of a half acre or more, to keep down the number of families with school age children and assure that each has a substantial house for tax assessment, (2) apartments with units too small to allow many school children, and (3) industry and commerce.

A range of unfortunate consequences for land use have occurred because of the combination of zoning and high property tax rates, including:

- lag in low- and moderate-income housing construction,
- sprawl and community inaccessibility due to overly liberal use of land,
- limited housing choice,
- higher cost of delivery of certain public services (fire protection, water, sewer, transportation, etc.) because of sprawl and large-lot zoning,
- and misarrangement of job locations and commercial facilities (in which commercial and industrial "ratables" spread along every highway, factories jump far into the countryside, and office buildings fail to be clustered as they should be for efficiency in compact planned centers).

URBAN BLIGHT AND ABANDONMENT

The role of the property tax in discouraging rehabilitation of rental housing, and to some extent of other types of property, is magnified as property tax rates rise as they have in decaying urban areas where costs of municipal service can rise out of proportion to the tax base.

Where expenditures are made to rehabilitate old buildings, a corresponding addition to the assessed value of the improvement should be the normal, expected result. However, a substantial rehabilitation may tend to precipitate a whole new assessment of the underlying property. Such action can result in a considerably greater increment in property tax than the added tax on the rehabilitation outlay itself. The tax increase may nearly or completely wipe out the added net return expected from the rehabilitation. Special income tax treatment may encourage rehabilitation, but the property tax effects tend to stand as a hurdle which other stimuli must help the investor to surmount.

The role of property tax collection procedures in tax delinquency situa-

⁴ Statement of the Regional Plan Association to the New Jersey Tax Committee, December 1970.

tions is far from innocent in the dreary procession of blighted urban structures through various stages of dilapidation into boarded-up derelicts. The possibility of "milking" rundown buildings for whatever they may pay above minimal operating outlays is enhanced by the opportunities for protracted postponement and eventual escape from property tax payments.

AGRICULTURAL LAND IN TRANSITION

Agricultural land values are often pushed up by subdivision activity and residential construction in the vicinity. In such cases tax assessment based on the value determined by the potential for immediate or future subdivision can impose a severe financial burden on the owner who seeks to continue agricultural use. At some point the heavy property tax payments will force the farmer or dairyman to fold up and sell out at a profit rather than continue losing operations or incur indebtedness to meet the cash flow requirements of paying the property tax. This may be viewed as a cause of disorderly and environmentally disruptive change which hastens horizontal growth and suburban sprawl.

On the other hand, if tax policy unbends by permitting the farm property to continue to be assessed on the basis of its value in agricultural production, the result may be to slow and divert normal expansion of residential areas. Development is then forced further out than otherwise. The special tax relief subsidizes the continued holding of property to await more intensive development, in anticipation of further appreciation.

This phase of property tax policy indeed poses a dilemma. Slowing the conversion from agricultural to more intensive use shifts the expansion process elsewhere. It stimulates further price increases on other plots. Accelerating conversion by allowing property taxes to reflect the social cost of continued holding of the land in an "inferior" use seems to put the government on the side of change which may appear to be disruptive.

Legislative action providing forbearance on agricultural land assessment is frequently justified on grounds that it serves the public interest to:

- maintain a readily available source of food and dairy products near metropolitan areas at relatively low social cost,
- preserve green open space and related environmental values at relatively low social cost,
- prevent the forced conversion of such open space to more intensive uses as a result of tax pressures incompatible with the practical use of such land for farms,
- and reserve relatively unspoiled areas for future more leisurely development consistent with longer range goals of land use, thus avoiding commitments to intensive use which could not subsequently be reversed without substantial capital sacrifice and community resistance.

Apart from questions of inter-personal equity, the agricultural land preference is suspect on several specific grounds relating to optimal land-use policy:

1. It offers too easy a haven for the land speculator who can achieve lower carrying costs for his speculative holdings by meeting in one way or another the statutory requirements for a bona fide agricultural operation.⁵
2. Extensive additional holding of otherwise available subdivision land off the market enhances the rise in prices of other land at public expense. The general body of taxpayers are required to pay higher tax rates both to provide the services for a growing community and to make up for the tax subsidy to the agricultural "holdouts."
3. The land impacted most heavily by potential property tax increases will usually be close in. This is the land that can be held in agricultural use because of the exemption. Therefore, the property tax relief pushes development out further horizontally than if it occurred where market forces would determine. Since the pattern of continued holding for agricultural use is likely to be irregular, leapfrog development is likely to result. The cost of public services for the new, further-out communities will be greater than if development were more regular.

Federal Income Tax Structure

The impact of the federal income tax on land use is wide. It affects many actors in the drama of housing supply and use, commercial construction, agriculture, and land speculation. It operates through various tax mechanisms and linkages. It is for the most part inadvertent—tax effects have flowed in large measure from provisions of the law which were not consciously designed to modify or distort land use in the ways they have. Nevertheless, sprawl, artificial land scarcity, leapfrog development, high property turnover rates, and urban blight have all been their unintended by-products. Homeowners, multi-family housing syndicators, land speculators, residential and commercial investors and their entourage, farmers and gentleman tax shelter farmers, slumlords and urban revitalizers—all have felt the magnetic pull and titillation of the tax dollar saved via adroit use of land and its improvements.

While the property tax inhibits intensive land use involving investment exposure to the tax, the federal income tax (and largely parallel features of the typical state income tax) has both dampening and reinforcing impacts:

⁵ States providing this relief may specify certain criteria of bona fide agricultural use such as the applicable zoning, present and past use of the land, and its productivity including uses as timberland and reforestation areas. See, for example, Maryland Annotated Code Sec. 19, Art. 81, as reported in Consumers Clearing House, State Tax Reporter, Maryland, Vol. 1, para. 20-164, pp. 2119-2120.

- the deductibility of property tax for income tax purposes reduces its effective burden both on land and on the owner-occupied home,
- depreciation, capital gain, homeowner benefits, and other features stimulate investment and land use in ways which, broadly speaking, spell out a pattern of horizontal growth and sprawl, with accompanying waste and disorder.

Property tax varies of course from locality or region to another, so that it has geographic differentials and locational impacts. One jurisdiction can compete with another in terms of property tax requirements relative to community services furnished. Federal income tax effects, by contrast, are essentially uniform nationwide, subject only to the pattern of geographical distribution of activities or property income sources which may enjoy federal tax preferences.

DEPRECIATION ON BUILDINGS AND THE REAL ESTATE TAX SHELTER

A key tax impact on land use is exercised by the accelerated depreciation methods⁶ allowed on buildings, including rental housing, hotels and motels, offices, shopping plazas and malls, and industrial construction. These allowances in combination with highly leveraged mortgage financing gave rise to the well-known real estate shelter device.

Depreciation—in contrast with other expenses of operating real estate, such as mortgage interest, repairs and maintenance, utility services, property taxes, and operating personnel—is not an out-of-pocket expense representing an actual cash outflow from the operation. It is merely an accounting set-aside, representing the fact that the building will eventually be used up or become obsolete and at some estimated future date will need to be demolished and replaced.

Depreciation allowances based on the entire cost of the property are large in relation to a relatively thin margin of equity investment in mortgaged-financed real estate. They normally exceed any realistic estimate of the actual decline in usefulness (or value) of the property in the early years. They typically eliminate any taxable net income on the leveraged investment. The net loss they frequently generate from a well-designed tax shelter spills over and may be used to offset or “shelter” other sources of income.

As the depreciation allowances decline, the tax shelter becomes less effective; and the property may be resold at a capital gain, reflecting both possible appreciation of the land and building and the excess depreciation

⁶ For the post-1969 period, these are 200 percent declining balance or sum of the years-digits for the new residential buildings; 150 percent declining balance for other new buildings; and 125 percent declining balance for subsequent-owner rental housing with a remaining useful life of 20 years or more. All subsequent-owner nonresidential buildings and residential buildings with a useful life under 20 years are limited to the straightline method.

taken without corresponding decline in value. The next buyer repeats the process using a shorter remaining life to offset the loss of the accelerated methods.

The real estate cycle thus represents "borrowing" of the income tax savings on the depreciation at ordinary rates without interest and repaying only part of the loan representing the depreciation calculated as capital gain, years later, and again without interest. Conversion of ordinary into long-deferred capital gains is thus the essence of the operation. "Recapture," or the partial recapture, i.e., the taxing of some of the gain reflecting prior overdepreciation at ordinary rather than capital gains tax rates, has moderated but far from eliminated, the tax advantage. Even full recapture would still permit the lengthy deferral of tax. At present discount rates the deferral represents a greater advantage than in the fifties and early sixties.

This device stimulates construction. It also encourages instability of tenure by causing the turnover of properties so that the next owner, having reestablished the depreciable basis at the sale price, can repeat the process, although possibly at a lower level.

The depreciation allowances on buildings have been cut back under the Tax Reform Act of 1969, but they remain liberal, particularly for housing. Recapture rules on gain from sale of depreciable real property have also been tightened under the 1969 tax reform legislation. Nevertheless, the real estate tax shelter device has not entirely lost its charm. Tightening the rules of the game has made it necessary for the aggressive seeker of tax shelters to look more closely at the finer points and readapt to the new, tighter framework.

Depreciable Cost Allocation—The income tax law, perhaps more than before the 1969 reform, places a premium on placing a high valuation on the building or improvements (which are depreciable) and a low valuation on land (which is not depreciable for income tax purposes). This tends to put pressure on the property tax assessor to allocate more of the appraised value to the depreciable investment and less to land. By doing so, he can assist the local investor in economizing on federal income tax payments to a distant Internal Revenue collector. Regrettably this side-effect worsens the impact on the property tax in relieving site value and burdening active investment in improvements.

Land-use Effects—The over-all impact of this untidy complex of tax laws is, interestingly enough, one of "simultaneously encouraging slum deterioration in the cities and encouraging urban sprawl in the suburbs."⁷ Depreciation tax savings create a built-in incentive for quick turnover,

⁷ Robert A. Levine, "San Jose, the Urban Crisis, and the Feds," paper prepared for presentation before the Legislative Action Committee, U. S. Conference of Mayors, San Jose, California, May 15, 1972, p. 6.

getting in and out with minimum maintenance. Initial construction may be designed with this in mind, without regard to the longer-run economies of better construction. The old-fashioned virtues of long-range property stewardship tend to be sacrificed. Tenement owners buy up buildings, obtain the quick tax advantages of rapid depreciation, and then sell to another owner who repeats the cycle with minor variations.

The possibility of allocating land value to depreciable basis tends to artificially perpetuate the continued use of old rundown buildings as tax-saving vehicles, some of which have an overall property value that would otherwise be less than the worth of the bare land. In effect, land value is depreciated and redepicted by successive owners. The practice makes it economic for investors to keep in use buildings otherwise overdue for demolition merely because they can qualify for periodic apportionment of a fictitious depreciation base for income tax purposes.

Depreciation allowances thus have apparently conflicting effects on construction and the urban landscape. They increase the supply of new buildings but prolong the life of the old.

The depreciation provisions—which might in isolation be expected to stimulate vertical growth counter to the general horizontality of tax incentive effects—is ideally designed to promote suburban commercial developments, shopping malls, office buildings, as well as high rise apartments. The tax laws thus support the suburban commercial investment needed to serve the sprawling population distribution encouraged by the homeowner tax benefits. This general effect predominates over the tax-sheltered oases of urban revitalization in the form of the towering modern office structures and commercial development appearing in the center of the older downtown areas.

TAX ADVANTAGES FOR HOMEOWNERS

The federal income tax (and the typical state income tax structure) assures important income tax benefits for owner-occupied housing. These are generally regarded as increasing housing consumption relative to other unsubsidized components of the consumer budget. Homeowner tax advantages comprise three interrelated elements:

- the exclusion from the concept of taxable income of the net imputed rental value (gross rental value less repairs, maintenance, insurance, and depreciation),
- the deduction from this narrowed income concept of mortgage interest payments, and
- the deduction of property tax payments.

Smaller consumer benefits accrue to renters in the form of additional rental housing supplies and therefore lower rents, reflecting the accelerated tax depreciation allowances given to rental housing investors, and the

competition of owner-occupancy as an alternative supply mechanism. Over-all, however, the direct tax benefits for homeowners outweigh the indirect, pass-through benefits to tenants. There remains, then, the equity issue of balance in the tax treatment of homeowner and tenant, a favorite theme of postwar tax reform literature.

The anti-homeowner bias of conventional tax reform doctrine—about as much anti-middle class as it is pro-tax uniformity—dwells upon the income tax benefits for homeowners as tax subsidies which: (1) favor taxpayers whose economic circumstances and mode of earning a living make it possible to own a home; (2) adversely affect resource allocation by overstimulating housing consumption, including second homes, luxury features, such as swimming pools, tennis courts, barbecue patios, etc., which involve expansive use of land; and (3) contribute to the growth of the sprawling suburbs and doughnut-shaped cities which characterize the present economically wasteful form of human settlement and land utilization for metropolitan living.⁸

Little is said by the tax reform school about the favorable social externalities of owner occupancy. The rationale for encouraging homeownership under the income tax law is in fact a substantial one, despite the efforts of the tax reformers to brush it aside.

The tax policy objectives of the present federal income tax rules in this area go beyond upgrading housing and fostering civic virtue or a sense of stability and identity with the community. Family economic security in a troubled, insecure, and economically unstable world is promoted in a major way if the family owns its own home. Tenancy tends to be the most socially costly form of housing since it affords little if any incentive to careful usage and day-to-day maintenance by the occupant. The tenant, especially if fortified with a modicum of alienated psychology, tends to give the property hard, indifferent usage, too often bordering upon vandalism. The social costs of housing would rise enormously if the whole housing complex were shifted to universal tenant tenure.

Ownership tenure eliminates the risk-inflated rates of return and management compensation to equity owners required for rental housing. The owner can in effect earn this return on his own commitment rather than having to pay it to a landlord investor. It also obviates the social cost of administering and adjudicating landlord-tenant relations in a judicial system which functions at conspicuously less than ideal efficiency and at considerable cost.

Homeownership affords opportunities for do-it-yourself projects. These permit use of the spare time of the owner and his family in creating wealth and income. From the standpoint of the homeowner, these may yield only

⁸ Point 3 is stressed, for example but without regard to the causative role of taxation, by Daniel Rose in an article entitled "The Economic Future of New York City," *New York Times*, November 25, 1973, p. F-12.

a modest net gain over and above the personal or psychic cost of his efforts; but from the social standpoint, it is essentially the gross contribution of wealth and saving of resources needed for home repair and improvement which counts as the beneficial externality.

Homeownership adds inflation hedging with respect to a basic part of the household budget. Not entirely external to the housing decision and the related market forces, it is clearly a significant part of the rationale of social policy regarding the taxation of homeowners. Having failed signally in the art of achieving reasonable price stability, society should at least strive to help people to live with the chronic inflation process, narrow the area which may need rent or similar administrative controls, and possibly reduce pressures for continuing cost and price escalation.

Even if homeowner tax benefits boost land and housing consumption, the latter reduces housing costs in this largely unexplored range of ways. For those concerned with land use, the present situation leaves an uneasy balance between the substantial social and economic advantages of widespread homeownership on the one hand and the equity problems and overexpansive land consumption attributable to the present tax set-up.

CAPITAL GAINS TAX AND LAND USE

The traditional concessions to long-term capital gains under the federal income tax, designed primarily with the fluidity of organized security markets in mind, have a substantial impact on land use.

Despite the tightening of tax preferences in recent years, capital gains of individuals are taxed at no more than half the applicable income tax rate and frequently less than half on the sizeable portion of gains of affluent investors still qualifying for a 25 percent ceiling rate. Corporations also enjoy a maximum rate well below the ordinary top rate.

Unrealized capital gains held until the individual bequeaths the underlying property to his heirs are entirely exempted from even capital gains tax. The tax basis is automatically stepped up to fair market value at the time of estate tax valuation, thus canceling out the unrealized appreciation for income tax purposes. The estate or the heirs may sell the property without income tax on the gain which was accumulated during the period the property was held by the previous owner.

Stimulus to Land Speculation—One major effect is the substantial incentive this tax structure gives to land speculation as compared with other economic activities which generate ordinary income taxed at regular rates. This adds an additional income tax fillip to the boost given speculative land holdings by the underassessment of "underutilized" land for property tax purposes. The ultimate reward is taxed cheaply under the income tax; the costs of attaining it are lowered by favorable property tax treatment. Carrying costs are further absorbed up to as much as 70 percent

(more in some states) by the income tax deductibility of property tax and mortgage interest on speculative land holdings.

Exemption of Unrealized Gains in the Estate—The land-use impact of this area of the tax system is further complicated by the internally inconsistent and inadvertent effects of the capital gains tax rules. The lower rate is designed to encourage market fluidity and willingness of owners to realize speculative gains once they have materialized and their rate of accrual no longer justifies further holding. But the potential exemption of unrealized gains means that it becomes advantageous purely for tax reasons to hang on to property beyond the otherwise advantageous time of sale. The capital gains tax preference is thus brought into a competitive juxtaposition with a zero alternative rate rather than the higher ordinary tax rate. Wealthy elderly landowners become “frozen into” their holdings, seeking to pass their gains intact and income tax-free to their heirs.

Astute middle-aged investors may deliberately seek out land investment as a vehicle to build up non-taxable accruals to their net worth which may some day be passed on to their heirs without even capital gains tax. The tax differential between this kind of wealth accumulation and the hard route of saving out of ordinary income after tax, or even of successful investment in securities which need to be sold before the unrealized appreciation may be swallowed up by the vicissitudes of the stock market, is remarkable, even in a tax structure marked by deliberate preferences and anomalies.

The freezing of land holdings for income tax-exempt transfer to heirs may block normal patterns of land use and community development for decades, creating artificial scarcities, higher land prices, and irregular patterns of sprawl and leapfrog growth.

SCENIC AND ENVIRONMENTAL EASEMENTS

One of the instruments of public policy for preserving scenic beauty and carrying out environmental purposes is the set of income tax provisions relating to the donation (and bargain sale equivalent to partial gift) of scenic and other environmental easements to conservation trusts and public bodies. Such easements are equivalent to covenants whereby the owner of real estate accepts restrictions on its use such as limitations on the height of buildings constructed on it, its preservation as open space, or granting public access to it under specified conditions.

Charitable contributions in kind are generally valued at their fair market value, and the ability to deduct donations of environmental easements on that basis provides important tax savings to the donor. Such savings would partially compensate him for the sacrifice of unfettered use of the property and thus provide an incentive for land use in accordance with environmental objectives.

Treasury procedures in implementing the valuation of environmental easements in various types of situations and certain restrictions on the deductibility of such gifts introduced, possibly by inadvertence, under the Tax Reform Act of 1969 have apparently impaired the incentive value of this tax instrument.

The Tax Policy Advisory Committee to the Council on Environmental Quality addressed itself to this problem among others in 1971-72. Its Report to the Council indicated that until 1971 "the method of valuation of so-called scenic easements, by which owners of land gave to a charitable organization or to a government body a permanent right to prevent the construction of buildings, or to maintain a shoreline or otherwise limit development, was so constricted that there was little tax benefit from such contributions."⁹

The Committee then went on to state that a more liberal interpretation of the tax law was under consideration by the Treasury to permit the development of more effective programs to secure scenic easements and that the Committee had encouraged action along these lines to improve environmental quality.

Both concepts of valuation and uncertainties about the value ultimately accepted by the tax authorities as a measure of the gift seem to be involved. Sometimes scenic easements may seem to protect the existing use—probably the highest and best for an indefinite period, for example, where it represents a beautiful and exclusive residential area—so that property value is protected and even enhanced rather than sacrificed by the grant of the easement. Also, taxpayers often hesitate to place restrictions on the use of their property for an indefinite period if they are not assured at the time of the gift what value and therefore what deduction is attached to it—an assurance which is difficult indeed to obtain where advance valuation with definitive review and approval by tax authorities is not feasible. Temporary scenic easements, which although less satisfactory than those in perpetuity may gain time for environmental and community planning agencies to secure a more lasting protection of land resources, seem to have questionable standing as a basis for a tax deduction claim under present law.

These and other difficulties have left environmentalists who are concerned with land use and with the protection of the nation's legacy of scenic beauty and earth resources both uneasy and dissatisfied.

Here the possibilities of bending the tax law to create attractive tax savings to land donors or dedicators which will serve scenic, environmental, or other meritorious public purposes have run afoul of the drive to prevent income tax manipulation and the hidden tax expenditures which reformers seek to bring into public view and to eradicate from the tax

⁹ Report of the Tax Policy Advisory Committee to the Council on Environmental Quality, February 1973, p. 36.

system. Those who place environmental objectives, including scenic preservation and land conservation in various forms, above the purities of tax uniformity want exception from the tighter tax provisions for specified forms of real estate easements. They may succeed in some degree, but it seems doubtful that any such changes will revive the more objectionable forms of tax manipulation under the guise of environmental protection. Direct measures outside the tax incentive field may have to be called upon to do the job.

TAX BENEFITS FOR AGRICULTURE

A substantial array of tax provisions are of special benefit to farmers: special deductions representing the "expensing" of capital outlays, capital gain treatment on certain items of income, lenient accounting rules which permit the deduction of costs of building up inventories, and rules permitting the play-off of expense deductions of raising livestock with capital gains rates on the proceeds of their sale. Despite recent safeguards and loophole plugging aimed at tax avoidance by non-bona fide farmers, these provisions still attract affluent investors, businessmen, and professional practitioners seeking tax shelter. So-called hobby farming has long been a source of both erosion of the income tax base and in some areas serious competition for bona fide farmers and ranchers. In the citrus fruit industry the deduction of development costs apparently resulted at times in speculative planting, overproduction, and waste.

As so often happens in the tax field, there is a bright side to the farm tax haven rules. They have probably been a strong stimulus to the creation and financial support of picture farms, rural showplaces, affluent beef cattle breeding operations, horse farms, and racing stables. They have also contributed to the development of citrus and almond groves and similar aspects of the nation's agricultural capacity. They are doubtless responsible for the rehabilitation of many rundown working farms, the appearance of attractive whitewashed fences, and other eye-appealing changes which improve much of our rural landscape, particularly in the general vicinity of large metropolitan centers populated by eligible tax-conscious farm investors. On the less attractive side, they have nurtured the development of a tax avoidance industry which literally peddled participation by high-bracket absentee owners in the raising of fine beef and breeding cattle. Some of these beef cattle operations were inherently uneconomic and virtually dependent upon the tax subsidy. Some have collapsed of their own weight or folded with the slightest doubt as to their acceptability.

These are the highlights of the enormously complex and essentially unsatisfactory state of the law applicable to hobby-suspect and tax-shelter agricultural operations. Despite occasional declarations that the farm tax shelter is in ruins, substantial tax avoidance opportunities remain. Some

farm groups still call for tax reform legislation to restrict tax-loss farming and investment in farming by non-farm individuals and corporations to gain tax advantages. The structure still tends to support an artificial sector of the industry in the hot-house environment of the tax haven.

A superficially brighter, more decorative, and prosperous-looking farm countryside is purchased at the cost of taxpayers generally. Along with inflation, the structure helps bid up land prices to reflect the capitalized value of expected tax benefits. It also supports the retention of land in speculative holding patterns and uses which would not be economically desirable or feasible for ordinary farmers. The overall result is a less flexible and less efficient use of agricultural land, along with resource malallocation, since hobby farmers and tax shelter seekers are not paragons of economy. The fact that not all farm operations lend themselves to the major tax avoidance opportunities complicates the resource distortions.

Estate and Gift Taxes

The estate and gift taxes are by their nature taxes on wealth. More specifically, their economic incidence is on savings. Financing government by estate and gift tax revenue is tantamount to channeling savings into the payment of government operating expenses. If liquid savings of the decedent are not available to pay the estate tax, assets are liquidated by the estate to absorb capital funds from the capital market in competition with new security issues for capital development purposes.

Assets which individuals have accumulated or developed through their lifetimes may need to be liquidated to meet estate tax liabilities. If non-liquid assets are readily divisible and marketable, there is relatively little economic dislocation in paying estate tax. If the estate is illiquid and contains substantial assets which cannot be partially liquidated to meet tax liabilities, there may be hardship.

Some types of assets may be passed on to the next generation by means of gifts, which are taxable at a lower rate than bequests, are eligible for a \$3,000 annual exclusions per recipient, and are covered by a \$30,000 cumulative lifetime exemption on gifts above the \$3,000 per donee annual exclusion. Farms and sizeable indivisible landholdings are not always readily adaptable to the gradual gift method of intergenerational transfer.

The complex impact of the estate and gift tax structure on land use is not open to facile generalization. It does involve appreciable effects on family holdings which may include substantial real estate components:

- The necessity for eventually meeting estate taxes puts pressure on the prudent owner to accumulate and maintain a greater degree of liquidity, a pressure which may tend to starve the farm or business operation for capital funds needed for improvement and expansion.

- Payment of estate tax may strip the next generation of the liquid capital reserve needed to provide working capital and a safety margin for contingencies.
- Estate tax payment problems may lead to the break-up or disposition of family farms and land holdings.

The moderate rates of estate tax on medium-sized estates, the \$60,000 exemption, the marital deduction, and deferred payment relief may seem to ease these problems. But they are nevertheless real. The "gift tax route" is not as well adapted to farm and land transfers as it is to the passing of stock and other business interests. The rapid rise in land values in the expanding, inflationary economy of the postwar decades has often made it difficult to accumulate the liquidity to assure orderly transfer of farms and landholdings.

Whether good or bad from other viewpoints, estate taxation has thus had some tendency to compel break-up of farm and other unitary landholdings. There are related effects: increase in the available land in the current supply-demand equation, alteration in past patterns of land use, and accelerated subdivision and conversion of farm open space into more intensive residential use.

The estate tax savings from charitable bequests encourage transfers of real estate to eleemosynary and public use. This aspect of the estate tax mechanism is one which is responsible for many transfers which further the preservation, beautification, and conservation of our natural and cultural heritage.