Housing: An Early Reagan Reindustrialization Test

By Amitai Etzioni

Plans for an across-the-board income tax cut, aimed chiefly to benefit individuals, are competing with a rapidly rising chorus of calls for tax cuts aimed at stimulating productive capacity and investment. Reduction of the capital gains tax, lower taxes on corporate earnings, and quicker write-offs for new equipment and plants are cases in point. A variety of "roll-over" bills, which would allow investors who sell a stock or bond and reinvest the proceeds to pay lower or no taxes, are gaining in vogue.* They are favored by the National Association of Manufacturers and championed by Charles E. Walker, the chairman of the American Council for Capital Formation. Indeed, there are some early indications that the new Administration might include some of these measures in its first tax package.

Omitted from the public policy dialogue on the nature of the tax cut to come is a very significant difference among these production/investment-promoting bills, the difference between those which will deliver mainly on target, i.e., focus the stimulant on capital goods and the infrastructure, and those which will also spur consumption. Compare, for instance, a reduction in the capital gains tax to the Capital Recovery Act, which provides for accelerated write-offs for new equipment and plants. At first blush, both would stimulate investment and help business. Actually, however, a reduction (or elimination) of the capital gains tax would stimulate investment in all items which might appreciate, stocks and china, bonds and antiques, business and stamps—and, of particular concern here, for reasons to become evident soon, in houses. In contrast, the Capital Recovery Act concentrates its benefits on productive capacity. "Collectibles" would not benefit, nor houses.

Similar, albeit less radical, differences are to be found among other suggested measures. Thus, a cut in corporate income tax would do little or nothing for weakened basic industries, from steel to autos, textiles to rubber, as they have little or no profit on which taxes can be saved. And such a tax cut would benefit both corporations which serve the infrastructure (e.g., energy, communication, transportation, R&D) and capital goods (e.g., machine tools), as well as those which provide consumer goods and services (e.g., department stores, mail order houses), though it would do nothing for collectibles and houses. (There is a loophole here, through REITs, real estate corporations which issue stocks.) Hence, in terms of stimulating production versus stimulating consumption, a lower tax on corporate earnings falls between the Capital Recovery Act and a reduction in capital gains tax, as less pro-production than the first, more than the second. Various "roll-over" bills are similar in their effects to a cut in corporate income tax.

Behind this exercise in comparing various tax reduction schemes which are now under active consideration is a basic policy question: Will the retreat from government and greater reliance on the private sector be completely untargeted, or will there be some semi-targeted signals built into it? Those who believe that the American economy's ills are due to excessive political intervention in private decisions tend to prefer an across-the-board tax cut, letting the market do all the rest. As Herbert Stein, former chairman of the Council of Economic Advisers, put it, "If individuals wish to consume more and save less—it's their money. The Government is not to tell them what is the 'right' amount to save." Others might add, let those who need more capital pay more for it (i.e., offer higher, "real" interest). This line of argument hence favors an untargeted, across-the-board income tax cut.

The competing thesis calls not merely for floating free the resources snatched from the jaws of the government, but also for guiding them, to some extent, as to where they will end up. According to this thesis, the U.S. has under-invested and over-consumed through the last decades, and the result is rising obsolescence and an accumulation of deferred maintenance, evident in the condition of many railroads, ports and bridges (infrastructure) as well as in several basic industries (e.g., steel). Moreover, the transition to equipment which is more energy-efficient and which relies on alternatives to oil is very costly in capital. Lastly, hyperinflation has driven savings down. For all these reasons, before a free market can function well again, investment in the infrastructure and capital goods sectors needs boosting, and saving needs incentives, if only to correct "artificially" for past government excesses. This is the essence of the reindustrialization thesis.

HOUSING VERSUS REINDUSTRIALIZATION

What has all this to do with housing? For the last three decades houses have absorbed a large segment of total American investment. In 1978-79, gross investment was 15.5 per cent of GNP, 4.9 per cent of GNP, or nearly a third of all U.S. investment, was dedicated to residential construction. In the 1965-69 period, the proportion was 4.0 per cent (or 26 per cent of gross investment). Data for America's first industrial period are not comparable, but the proportion of GNP invested in houses appears to have been lower. From 1869 through 1881, for instance, private nonfarm residential construction averaged 3.3 per cent of GNP, or about 16 per cent of gross investment.

*My own version calls for not taxing dividends or interests if within 30 days they are reinvested in stocks or bonds which are then held at least a year, or for a tax-free account for the first $5000 of savings per family, as Japan has it.
Free-market advocates may reiterate their point: if people want to buy houses instead of other items, why should public policy seek to direct their dollars elsewhere? The first-line answer must be that this is not what “the people” want, but where they have been driven by a combination of hyperinflation and a bunch of tax laws and regulations which accorded houses preferred status compared to stocks and bonds, the source of capital for the infrastructure and capital goods.

The answer starts with the fact that owner-occupied houses are the main tax shelter one can use both to reduce one’s income tax and to meet an everyday need. Compare a home to a boxcar, oil well, even land, and the point stands out: the other tax “shelters” provide precious little service other than a lower tax bite. Houses add to tax advantages a major service and psychic income as well. (On the minus side, they exact maintenance costs but, in turn, save rent.)

Second, leverage is often higher. While there is a regulated limit to the amount one can borrow ("margin") against one’s investment in stocks or bonds, there is no such limit on houses, and borrowing 80 per cent of equity is quite common.

Third, interest rates on houses are fixed for 25 or 30 years, and hence in recent decades have provided low cost loans while interest rates on margin loans on stocks and bonds were adjusted upwards. Thus, those who invested in houses in the sixties and early seventies still pay mortgage rates below 8 per cent, while those who margined their stocks in the same era have been paying interest at rates well above 8 per cent for quite a while.

Other tax privileges on residences include deferment of the capital gains tax on the sale of a house if a new one is acquired within 13 months of sale and a new once-in-a-lifetime $100,000 exclusion from capital gains tax (after age 55). Inheritance taxes on houses are also more lenient.

Housing experts disagree on the net consequence of all this preferred treatment; they range from those who might well have resulted in over-building of houses to those who are quite sure this is the case. George Sternlieb, of Rutgers University, and his colleague, J.W. Hughes, put it flatly: “We have been over-investing in housing through the 1970s. Before 1980, the greatest addition of housing for any 10-year period was approximately 10 million new units.... In the 1970s, 16 million units were built.”

Anthony Downs, of Brookings, will not flatter state that the U.S. is over-investing in housing, but he asks, “Do people ‘need’ as much housing as they are buying? In 1979, for example, 22 per cent of all home purchases were made by single persons. Many bought houses large enough to house sizeable families—far more space than one person must have for shelter. They bought for investment reasons.”

Anyone who follows the pop literature of investment is aware of an increasingly frequent piece of advice: buy real estate. In circles in which making money is considered a proper topic for conversation, “killings” in real estate have long replaced stock market talk. No wonder. A person who held an average stock over the last decade (from 1969-79) was down 23 per cent; in contrast, the average house appreciated 155 per cent during the same period.

Sternlieb points to a snowball effect which makes houses absorb particularly large amounts of capital: that they were such good inflation-hedges led to transfer of ownership at highly inflated prices, resulting in ever larger commitments of credit—for the same product.

Aside from deflecting resources from investment to a consumer product, houses have a secondary consumption-spurring effect. As Downs points out, the rising equity in houses lets their owners borrow against it and use the funds for consumption. Moreover, when houses are sold, only part of the yield is being used to buy new houses, the rest is used to consume more. In 1979, 34 per cent of the equity left after repurchase was used in this way.

THE REINDUSTRIALIZATION CURE

Theoretically, in the present mood of deregulation and “free the market,” the various government-provided special incentives for purchasing homes could be removed. Practically, such steps would be extremely provocative. If people were no longer allowed to deduct mortgage payments (even if such a modification were introduced over a few years rather than all at once), it would not only push middle class Americans into much higher income tax brackets, but destroy their number-one inflation hedge and their main asset. Lower deductions and anticipated future cuts in deductions (assuming a phased-in scheme) would knock the bottom out of the real estate market and destroy a good part of the equity of most home owners. The magnitude of the resulting resentment, revolt, and political backlash is difficult to imagine. At best some marginal trimming is possible: say putting a ceiling on the amount of deductible interest, and prohibiting deductibility for second homes.

If the tilt of capital flow toward housing, created by government in the golden era of consumption, is to be corrected, to secure more capital for reindustrialization, the most practical way is to make investment in the infrastructure and capital goods as attractive as investment in houses, or at least reduce the relative disadvantage. Indeed, this was already achieved, in a limited way, when boxcars and, most recently, barges were awarded some of the privileges of houses: shortages are being rapidly overcome. This highly targeted approach, however, singling out a few items for tax favors, only creates new distortions (e.g., one must expect barges soon to swing from under- to over-supply). The best course is to use a much broader, semi-targeted approach, one which favors major segments of the economy, not specific industries. This would be achieved best through the Capital Recovery Act; second through various “roll-over” schemes (especially if REITs were excluded); and least through cuts in capital gains taxes. Particularly counterproductive, from this viewpoint, are new government incentives to induce further investment in housing. The Federal Home Loan Bank Board is reported to favor exempting savings accounts from tax if the funds are used for mortgage lending. Reindustrialization requires exactly the opposite approach. It is time to favor investment in the infrastructure and capital goods, not consumer goods.