Tax Structure Should Favor Capital Goods Production Over Housing

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 also are gaining in vogue.

Contrasts between the public policy dialogue on the nature of the tax cut to come is a very significant difference among these bills. The difference between those which will deliver mainly on target—that is, focus on stimulating capital goods and the infrastructure—and those which will also spur consumption.

Compare, for example, a reduction in the capital gains tax-reduction from the present 28% to 20% as suggested by Rep. Jack Kemp (D-N.Y.) in 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 residential houses. In contrast, the Capital Recovery Act concentrates its benefits chiefly on productive capacity. "Collectibles" would not benefit, nor houses.

Those who believe that the American economy'sills 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. 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 United States 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 key elements of the nation's industrial infrastructure such as railroads, ports, and bridges, as well as in many basic industries. 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, this thesis concludes before a free market can function well again, investment in the infrastructure and capital goods sectors needs boosting, and savings needs incentives, if only to correct for past government excesses.

What has all this to do with residential housing? For the last three decades these houses have absorbed a large segment of total American investment. In 1978-79, gross investment was 15.5% of gross national product; 4.9% of GNP, or nearly a third of all U.S. investment (32%), was dedicated to residential houses. In the 1965-69 period, the proportion was 4% (or 26% of gross investment). Data for America's first industrial period are not quite comparable, but the proportion of GNP invested in residential homes appears to have been lower. From 1868 through 1881, for instance, private nonfarm residential construction averaged 3.3% of GNP, or about 16% of gross investment. In proportionate terms, the seemingly small difference between 3.3% and 4.3% is actually a growth of roughly 50%.

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 residential 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 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% 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 on rising equity, while interest rates on margin loans on stocks and bonds were adjusted upwards. Thus, those who invested in houses in the 1960s and early 1970s still pay mortgage rates below 8%, while those who margin their stocks in the same era have been paying interest rates well above 18% 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 residential houses also are more lenient than on other forms of investment. Robert J. Samuelson has referred to the situation succinctly as "capital perversity."

Housing experts disagree on the net consequence of all this preferred treatment; they range all the way from those who think it might well have resulted in overbuilding of houses to those who are quite sure this is the case. George Sternlieb, director of the Center for Urban Policy Research at 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, a level of production already exceeded in the six years from 1970 to 1976. In the 1970s, 16 million units were built."

Anthony Downs, of Brookings, will not flatly state that the United States is over-investing in housing, but he makes a good case that this is the situation. He asks, "Do people 'need' as much housing as they are..."
TAX: Favor Production Over Individuals

Continued from Third Page

buying? In 1979, for example, 22% of all persons. Many bought houses large enough to shelter sizable 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 the sizable parts of the country 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—that is, owned a piece of an American corporation—over the last decade (from 1969-79) was down 23%; in contrast, the average residential home appreciated 155% during the same period.

Sternlieb points to a snowball effect which makes houses absorb particularly large amounts of capital: the fact 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.

Spur Consumption

Aside from deflecting resources from investment to a consumer product, residential 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.

Free-standing houses retard reindustrialization in one other way; they are energy wasteful as compared to apartments. In the past, developers found it more attractive to build separate houses because of greater demand, zoning laws, and rent control. The very recent shifts to higher return on rental units and to condos provide no cure for the basic problem, but at least they correct a bit for a tilt away from energy conservation in the housing market.

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 from their income tax (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 No. 1 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 resulting resentment, revolt, and political backlash is difficult to imagine. Indeed, it is about the only sure-fire scheme I know for inducing a full-fledged revolution in America. Considering that the IRS caved in when it tried to collect new taxes from groups far weaker than home owners—from airline personnel (on free airline tickets) and from professors (who get free tuition for their kids)—not to mention Congress' response to the banking lobby when the Treasury sought to withdraw at the source taxes already due by law on dividends and interest, it would be easier to make all American rivers flow upstream than to remove the main housing tax privileges. 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 residential houses, created by government in the golden era of excess 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 residential houses: Shortages are being rapidly overcome. This highly targeted approach, however, singling out a few items for tax favors, only creates new distortions (for example, one must expect barges soon to swing from under- to over-supply). The best cure 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 last through cuts in capital gains taxes. Particularly counterproductive, from this viewpoint, are new government incentives to induce further investment in residential houses. The Federal Home Loan Bank Board, which the Wall Street Journal characterizes as "the S&Ls' chief regulatory ally," 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.