Excerpt from

"COORDINATING TAX INCENTIVES AND PUBLIC POLICY: THE TREATMENT OF LAND INCOME"

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A. Introduction: Tax reform and public goals

In the last few months the demand for tax reform has suddenly loomed into a towering force that will be served. Fixed postures of either satisfaction or fatalism have become ludicrous; old bastions indefensible. Here we stand, bewildered and unprepared as usual, as the opportunity of a generation passes before us.

This paper is an effort to pull together a systematic outline of one set of accumulated tax outrages, those bearing on land. I follow press releases, and scholarly and treasury and commission and task force releases on the subject with a growing impression of incompleteness, of a tendency to settle on one or two points as the major abuses to be remedied. These make it altogether too easy, and seriously underestimate the diligence and ingenuity of tax-avoiders, who have gone far towards converting the income tax into essentially a payroll tax, and who will not be put squarely in the income tax base with a few simple strokes. Nothing less than a thoroughgoing shakeup of the tax treatment of land income will avail. And this is exactly the time when such a project, hitherto a pipe dream, may be seriously entertained.

Distributive equity is one purpose; allocative efficiency another; employment and growth a third; international standing a fourth. We are not just interested in taxing property income, but in creating a good incentive pattern that respects the market and harmonizes with a host of public policies. Some major policies to be served are these:

1. Timely urban renewal. "Timely" implies an optimum, neither post- nor pre-mature.

2. Create employment opportunities, especially where needed most.

3. Economize on capital. This is an era of sharply limited disposable capital with urgent competing demands.

4. Counter inflation. This means encouragement of investment with short pipelines to consumer markets and quick supply impact. A counterpart of 3.

5. Contain urban sprawl. Again consistent with 3, for sprawl wastes capital.

6. Ample housing. This is where more capital should go, with quick supply impact.

7. Encourage small business, combat concentration of economic power.

8. Distributive equity. Most loopholes are tailored to the needs of those with large net worth and are regressive.

9. Clean air and water.

10. Decentralize detailed planning

- By local officials, subject to state and national needs.

- By the market. Tax policy should if possible lubricate sticky markets; and certainly not gum them up. It should make them respond to local planning powers.

11. Strengthen balance of payments. Consistent with 4, but also requires maintenance of competitive after-tax rates of return to investors with migratory (non-land) assets.

B. <u>Tax treatment of land</u>

1. The income tax

Favors to investors in new capital goods, such as accelerated depreciation, expensing, and the 7% investment credit, have positive macro-economic and balance-of-payments effects and may be necessary in spite of possible regressivity. Favors to land, on the other hand, have no macro-economic or allocative virtues to offset their distributive vices. It is not that economic land supply is altogether "fixed"; but the growth that occurs is not primarily a function of the private landowner as such. Rather, public spending plus the spillover benefits from the enterprise of neighboring land users enhance the potential service flow of land. It is these, rather than the landowner as such, whose motivation needs to be the concern of the framers of functional institutions.

It is possible to retain many tax advantages now essential to motivate private investment in real estate, and still collect as much or more taxes from real estate, by bearing down on the loopholes specific to non-functional land income. The following analysis seeks to identify these.

My explicit reference, unless otherwise noted, will be to the Federal personal income tax. Most of my points, however, apply as well to the Federal corporate tax, and the various state personal and corporate taxes.

I begin with an outline, a sort of Mendeljev Periodic Table which may help us find new devices as well as order the old.

a. Covert write-off of undepreciated and appreciated land value.

b. Exemptions

i. Imputed income

ii. Unrealized appreciation

iii. Capital gains at death

iv. Bequests

v. Capital gains of exempt owners

c. Deferral of tax on realized appreciation

d. Capital gains rate on appreciation, ordinary offset on losses and carrying costs.

e. Deferral of tax beyond date of sale

i. Sale of residence

ii. Barter

iii. Installment sale

iv. Prorating of principle and interest

v. Profit participation by seller

vi. Condemnation

f. Deferral of land-use income where there is intertemporal dependence of income

i. Sacrificing early rents for higher later rents: "implicit expensing" of capital investment.

ii. Explicit expensing of early operating losses to appropriate position

iii. Explicit expensing of capital outlays by "farmers"

a. Covert write-off undepreciated and appreciated land value

Land is non-depreciable for tax purposes, in deference to its physical indestructibility. If a non-depreciating asset were to be written off, its income would achieve complete tax exemption, as follows. Let $\underline{t}$ be the income tax rate. When the tax payer writes off the asset, he reduces his tax liability by that amount, and his tax payments by $\underline{t}$% of that amount. Now the Treasury has put up $\underline{t}$% of the value of the asset. It also receives $\underline{t}$% of the income of the asset. Thus the Treasury simply receives a return on its investment. As for the owner, he has now invested only (1-t)% of the value; and he gets (1-t)% of the income. On his equity[1/] he would earn a tax-free income in perpetuity.

The way to write off land is to buy it with an old building or orchard, etc., and allocate most of the cost to the capital, which is depreciable--and if its remaining life is short, rapidly depreciable, especially if the owner avoids repairs and maintenance. The IRS has no well-organized defense against this. Harold Groves reports cases of taxpayers even depreciating adjoining vacant lots! IRS invites taxpayers, if challenged, to use the land:building allocation reported by the local tax assessors as evidence supporting their allocation. In my research I have found these allocations consistently understate the land component by a very large factor. IRS lets owners use very short tax lives--10 years is about par--on slums and old farm buildings.

Covert write-off of land is a factor above and beyond the multiple write-off of buildings. This latter is a more or less intended consequence of accelerated building depreciation which reduces book value of the depreciable asset to below its remaining resale value. Land depreciation occurs when the buyer of an old building allocates less value to the land than it had originally, even though it has not declined; or allocates the same, even though it has risen.

There might seem to be recapture of land write-off when one sells and pays a tax on the excess of sale price over book value. But this

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1/ I assume 100% equity financing, for expository simplicity. Actually the game is leverage, and the mortgaged landowner who writes off land could easily end up receiving income on no equity at all.

tax is twice diluted. First, it is deferred until sale, whereas write-off came earlier. Second, it is at capital gains rates: write-off was from ordinary income. If the owner never sells there is never an occasion to recapture.

But actually taxpayers can do better by selling. For the buyer starts writing off both land and building all over again--never mind how many times it was done before. Thus land, which the law says is not supposed to be depreciated at all, is written off several times. The only proviso is that it must remain under an old building.

Were it not for this device, the income tax might serve to promote urban and rural renewal. Once the initial cost of a building was completely written off, accelerated or not, its current cash flow would be fully taxable.1/ Because it would be pure ground rent, a non-depreciating income source. Thus in the year after the last allowable write-off, the owner would suddenly face a much higher tax bill. If he wanted a tax shelter in real estate, he could get it only by actually building; not by redepreciating old capital.

But under present practice the surest way to lose the privilege of depreciating land is to clear it and erect a new building. For then the IRS, seeing through a glass darkly, finally perceives that what you bought--if you just bought--was not the depreciable building but the non-depreciable site underneath it. It denies write-off. Even demolition cost is non-depreciable. Or, if there was no recent purchase, they let one depreciate only the cost of building, not the land. The net effect: you can depreciate land so long as you do not improve it.

1/ Indeed, if a building underwent locational obsolescence due to land appreciation, write-off should end before the life originally contemplated, as soon as the "challenger" land value equalled the "defender" value of land cum old building.

Thus the tax law biases owners of older buildings to delay renewal, to milk the last drop of tax shelter out of old buildings before releasing the land for new. It raises the "defender" value of land--the capitalized value of the extant building--relative to the "challenger" or renewal value of the cleared site in the best succeeding use. Thus it increases the renewal gap (defender value less challenger value) that must be met by subsidy. Renewal subsidies are soaked up by land write-down, leaving less for the constructive employment-generating investment in rebuilding and actually supplying housing.

b. Exemptions

i. Exemption of imputed income

Durable goods used for the owner's consumption yield an income "in kind" that is not taxed. The price of land is more affected by this than is that of other assets because the service flow from land is 100% income--no wearing out. The price of appreciating land is even more affected. The untaxed service flow is supplemented by an untaxed growth of value each year stemming from progressive increments to the tax-free service flow. A depreciable durable good, on the other hand, must be of about 40 years life before the income flow equals the flow representing recovery of capital.

The availability of land that builders might use is reduced in urban fringes by the high propensity of the affluent to "reside" over considerable acreage. Teamed with large-lot zoning (which holds down assessed values and property taxes), expensing of taxes and interest, expensing of "conservation" investments, capital gains on breeding stock, indefinite deferral of tax on sale of "residence," and a host of favors to deferred land increments (all to be treated later), this exemption of imputed income serves greatly to fortify the holdout power of landowners of the "mink and manure" set that surrounds every city. Nearer in, the imputed income of elderly widows is likewise enhanced by its exemption from taxation.1/

It is true, of course, that buyers of new homes on this same land would also enjoy the exemption of imputed land income, partially neutralizing the bias. But there is normally a tax bracket differential--appreciating suburban land gravitates to the strongest hands. Higher prices mean higher credit barriers all around, screening out the poor. Where the new use is an apartment there is no offset at all2/--that is, there is a total and unmitigated bias against renters, a factor hitting low-income people with differential severity because of their low net worth. Finally, open space as a consumer good is clearly a superior one--indeed, throughout history it has been the ultimate luxury, the highest mark of status--and its tax exemption is worth much more to those who have risen farthest above subsistence. Those who would normally consume more open space anyway do so tax free while they contemplate with supplemental pleasure the untaxed appreciation of their net worth.

ii. Exemption of unrealized appreciation

The form of income known as capital gains is not taxed until realized by sale [Eisner v. Macomber (1920) 252 U.S. 189, 40 S. Ct. 189].

1/ It is evident that tax reform must come to grips with varieties of institutionalized sentimentality. However, consider that it is only the widow of means who can afford to value her feelings above the pecuniary blandishments of hopeful builders; and a high proportion of the national wealth is controlled by longevous widows. If we wish to subsidize widows let us help the needy through the welfare system; not the propertied through the tax system.

2/ There are other offsets, through fast write-off of income property, not treated here.

If the land is never sold, there is no tax. Some landowners therefore prefer to lease ripe land rather than sell--prominent examples are the Irvine Ranch of Orange County, California, and the Big Five of Oahu. Others prefer to buy many years in advance of their own anticipated needs, even very conjectural ones. When and if the needs materialize, they have on tap needed land, now of high value, acquired at a low value. The difference is tax-exempt income. The motive is strengthened by, and mutually strengthens, the motive to acquire advance reserves of a raw material whose supply is jeopardized by the absence of a vigorous free market. The combination magnifies the area of idle reserves which individuals and firms find it advantageous to hold. Thus it raises the holdout price of land.

iii. Capital gains at death

Capital gains taxes on appreciated assets are forgiven at death. There are death taxes to pay instead, but these would also be due on whatever asset was substituted for appreciated land. It is therefore folly for individuals to sell appreciated land during a period of several years before death. Elderly owners in their declining years are obviously below average in enterprise, so their land is often just held off the market, "locked-in".

iv. Bequests

Eleemosynary bequests of appreciated land enjoy exemption from capital gains tax; yet they are fully deductible at appraised value, and their carrying costs are expensible. Thus the taxpayer can deduct a value which he has accumulated tax free, in addition to enjoying the prestige and satisfaction of supporting his favorite church, college, tract society, or foundation. This adds to the motives to hold land for appreciation. The same is true for the factitious book capital gain created by having written off land (or having depreciated buildings too fast).

Another aspect is the gift with life estate. Under this arrangement, the taxpayer deducts the appraised value at time of bequest, but enjoys use of the home and grounds for life (no tax on the imputed income either, of course). During this period he cannot sell and the land is frozen.

v. Capital gains of exempt owners

Churches and other tax-exempt owners are normally not allowed exemption on business-type, profit-making activities. The exception is gain on land sales. The central city church that goes suburban takes its full selling price along with it. Thus initiated, it is altogether likely to select a large site with ample grounds and parking space, with one eye to future tax-free gains.

Cemetery associations are especially large land speculators to benefit from this provision. Cemeteries in Milwaukee County pre-empt more land than all industry--not a negligible item.

These speculators usually couple their income tax exemption with exemption from local property tax. In addition, interest on their bonds is exempt from income tax, an advantage to them as they borrow at very low interest rates.

c. Deferral of tax on realized appreciation

The most transcendent of tax loopholes is the least well understood. That is because it entails no specific "gimmick" that might serve as a handle to identify and popularize it, such as depletion allowance, capital gains rates, accelerated write-off, or forgiveness at death. Also, a rigorous demonstration that the loophole really is a loophole involves the use of some mathematics. However, the basic reasoning may be readily grasped.

Money in the bank doubles every 10 years at 7% compound interest. It follows that present dollars are worth more than future dollars, and a great deal more than remote future dollars. For example, at 7% one dollar today is worth \$32 in 50 years (2^5 x 32), so one dollar due in 50 years is worth 3¢ now. Therefore taxes deferred are taxes denied. Early tax payment to reduce later tax payment by an equal amount is an investment that yields no interest.

Suppose a piece of unused fringe land is ripening toward urbanization, the target date for sale at urban prices being certain--say 20 years hence. Or suppose a piece of wetland is ripening toward the higher use made possible by a federal flood-control dam. In a reasonably free market it would appreciate like a bank deposit, at compound interest. Consider what compound interest means: it means that the appreciation accrued in each year goes right back to work for the investor, earning income for him in all future years. Accrued appreciation is therefore income constructively received at the time of appreciation, just like interest paid by a bank and credited to one's account. Note the timing: appreciation is income in the year accrued, not the later year of "realization" by sale.

Now consider the contrast in time of tax liability between bank deposits and appreciating land. Interest is taxable each year as it accrues in your account. Appreciation is not taxed until "realized" by sale. With each passing year, the landowner defers taxes, not just on the value accruing currently, but also on the value accrued in all prior years.

The 16th Amendment authorizes taxation of "income from whatever source derived." The realization doctrine is not part of the Amendment. It rests on the shaky case of Eisner v. Macomber (1920).[1/] As a result of this decision and its implementation, appreciating land affords a sovereign tax loophole. The landowner constructively receives income at the time it goes to work earning more income for him. But he is not taxed until much later. He has contrived to receive income and plow it back without being taxed. He can even turn this accrued income into cash by mortgaging appreciated land, without tax liability--and deduct the interest payments to boot.

Appreciating land is like a corporation that does not distribute profits, to avoid taxation of dividends, but plows them back into capital and lets the shareholders realize the income at their tax convenience in the form of appreciated stock values at capital gains tax rates. This loophole for corporations has been recognized and somewhat compensated by the double taxation inherent in the corporate income tax. In the case of appreciating land, however, there is no such compensating device. There are rather a number of fortifying loopholes, discussed elsewhere.

Holding land for appreciation, therefore, is much favored. The extraordinarily favorable tax treatment encourages speculators to buy and hold land, and retards their releasing it to developers and builders, whose income is fully taxable at ordinary rates when produced.

1/ 252 U.S. 189, 40 S. Ct. 189

The desire of landholders to defer taxes on gains is often colloquially described as the "locked-in" effect. To show the force of the locked-in effect and its tendency to defer sale, I have worked out a formula for computing the land speculator's rate of return after taxes for differentholding periods, and from it constructed Table 1 showing how after-tax rates of return increase with holding periods.

The formula is based on supposing unused fringe land's selling price rises yearly at an assumed market rate of interest, $\underline{i}$. A tax rate, $\underline{t}$, is applied to the excess of sales price in any year, $(1+i)^x$, over cost of $1 at time zero. The landowner's rate of return after tax is $\underline{r}$.

(1) $$(1+r)^x = (1+i)^x (1-t) + t$$

Using any set of interest tables, it is easy to give numerical examples of how r rises with x, the year of sale. Table 1 is such an example.

Table 1

After-tax rate of return (r) to land speculator for different holding periods when the rate of appreciation before tax (i) is constant at 8%, tax rate (t) is 50%, and acquisition cost of $1 is deductible in year of sale (x).

Based on the equation:

$$(1+r)^x = (1+i)^x (1-t) + t = 1.08^x \cdot 1/2 + 1/2$$

%	1.08^x	$(1+r)^x$	r
1	1.080	1.04	.040
5	1.469	1.24	.043
10	2.159	1.58	.047
15	3.172	2.09	.050
20	4.661	2.83	.053
25	6.848	3.92	.056
50	46.902	23.95	.065
100	2199.798	1100.40	.072
00	--	--	.080

The speculator who sells in one year bears the full effective tax rate--his rate of return is halved, as the nominal tax rate of 50% contemplates. The speculator who sells in 20 years bears less than 3/4 of the nominal tax rate. The old settler who waited 50 years bears less than half.

A heuristic proof of the generality of this result is possible by rearranging the form of Equation (1)

$$(1A) \qquad (1+r)^x \left[1-t(1+r)^{-x}\right] = (1+i)^x (1-t)$$

$$(1+r)^x = (1+i)^x \frac{1-t}{1-t(1+r)^{-x}}$$

As $\underline{x}$ grows very large, $(1+r)^{-x} \longrightarrow 0$, so the fraction on the right side $\longrightarrow 1$, and $x \longrightarrow i$

A rigorous proof is available on request. It is for the mathematicians. Most readers will find it more drawn out than the residual doubt warrants, and less helpful quantitatively than Table 1.

It is easy to prove rigorously, however, that a tax has no locked-in effect--is intertemporally neutral--if its base is the yearly increment of value. It even makes sense: the tax cannot be deferred or changed by deferring sale; therefore it has no effect on time of sale.

Assuming as before that value grows at compound interest, the value at the end of any year $\underline{x}$ is $(1+i)^x$; the accrual of value is $i.(1+i)^{x-1}$; and the tax is $t.i.(1+i)^{x-1}$. $\underline{r}$, the after tax rate of return, is now that discount rate which makes the present value of selling price less tax costs equal the cost of \$1.

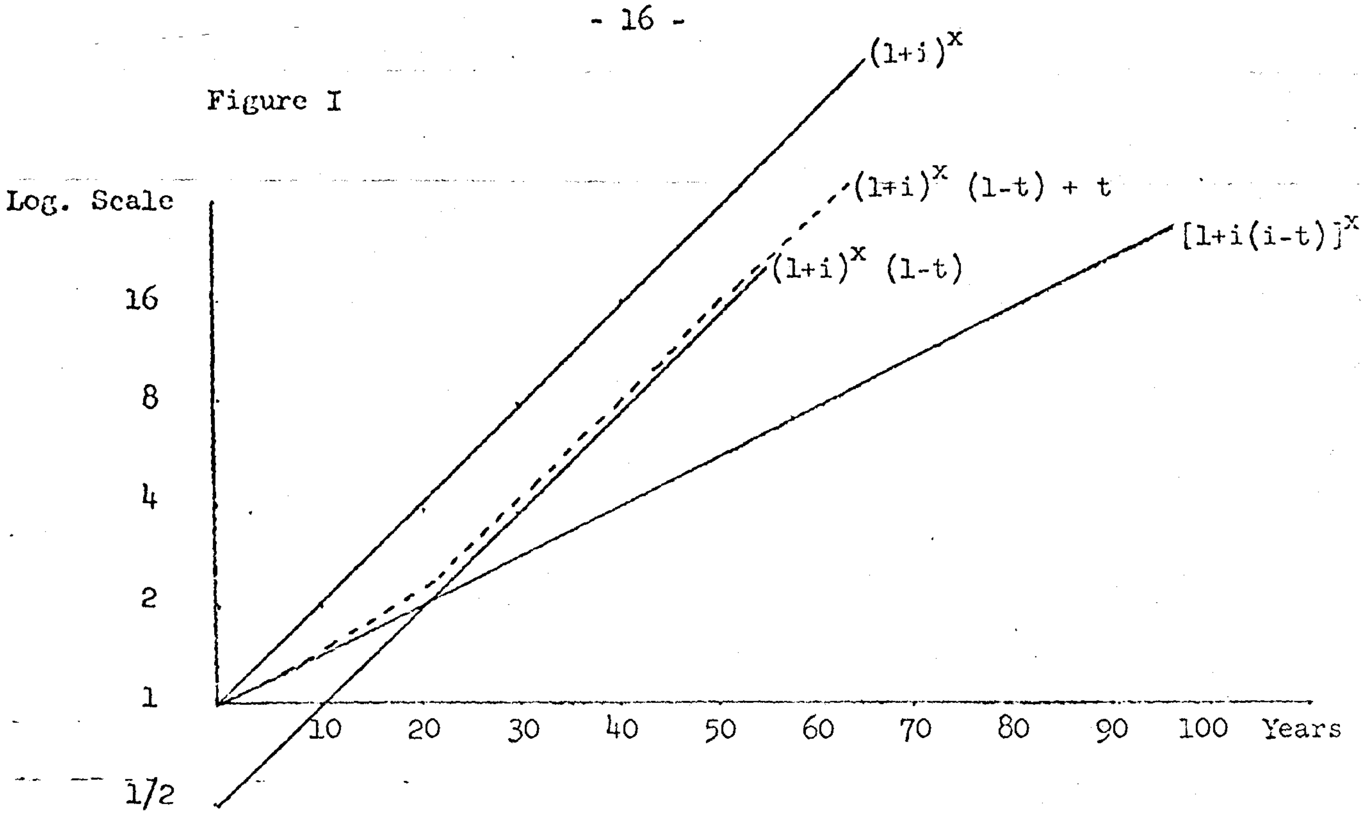
$$(2) \qquad \$1 = \frac{-it}{1+r} - \frac{i(1+i).t}{(1+r)^2} - \ldots - \frac{i(1+i)^{x-1}t}{(1+r)^x} + \frac{(1+i)^x}{(1+r)^r}$$

$$1 - \left(\frac{1+i}{1+r}\right)^x = \frac{-it}{r-i}\left[1 - \left(\frac{1+i}{1+r}\right)^x\right]$$

$$r - i = -it$$

$$r = i(1-t)$$

Figure I



Growth of taxpayer realized cash after taxes under different tax assumptions:

$(1+i)^x$ - no tax

$(1+i)^x (1-t)$ - gross tax, no deduction of cost

$(1+i)^x (i-t) + t$ - income tax on gain when realized

$[1+i(i-t)]^x$ - neutral tax

Under this tax, r is reduced below i by the full tax rate (t) impartially for all holding periods (x). There is no bias--no locked-in effect, no partial tax exemption, no encouragement to land speculation.

The difference between this tax on accrued income, which is intertemporally neutral, and the cash-basis tax policy now employed, gives an idea of how the Eisner v. Macomber rule biases investors to buy and hold appreciating land.

It is of some policy interest to note that the local property tax based on capital value tends to operate like this neutral tax. Because each takes a fixed percentage of the capital value each year.

At the same time that investors seek to defer tax liabilities they seek to advance deductions. The land speculator receives favorable treatment in this particular also. For he deducts his holding costs as he spends the money--i.e., he "expenses" local land taxes, and interest on borrowed money, even though the increment of land value which they finance will not be taxable for many years to come, if ever. He may also succeed in writing off part of the initial cost of land, if he buys land under an old orchard or building and allocates too little of this cost to the land. He may write this off through depreciation. In the alternative, he might demolish the building midway in his holding period and claim a loss. It is not hard to imagine how an ingenious taxpayer may become a non-taxpayer by combining these devices. By reducing his real cost basis and deferring his tax he may end up with a rate of return after taxes higher than the rate before taxes.

d. Capital gains rate on income, ordinary offset on losses, and carrying costs.

The sale of land for a gain, if the seller has avoided "dealer" classification, qualifies for capital gains rates. This of course encourages tax avoiders in high brackets to buy and hold appreciating land. The uncertainty about how to avoid "dealer" classification causes all landowners to avoid rapid sales, development, large sales, consistent selling, etc. The result is more land tied up. One must be either a passive investor, or use the land in a business other than real estate, a business such as a golf course, farm, nursery, drive-in, parking lot, junk yard, or what have you. One is encouraged to hold land in these lower uses and defer allocating it to its highest use.

Losses on land sales (up to $1,000) are deductible from ordinary taxable income, so long as one observes the elementary precaution of realizing losses in years of no realized gains. If the loser lacks taxable income, he can often merge with a winner before realizing losses. Both winner and loser are locked in while courting each other.

The costs of holding land--interest and local land taxes--enjoy ordinary offset. So does covert depreciation of land cost, where that is accomplished. After-tax rates of return may be much higher than before-tax rates of return.

e. Deferral of tax beyond date of sale.

i. Sale of residence

If it is a "residence" one sells, the tax is deferred so long as one buys another residence within a year. Under large lot zoning, five or ten acres of grounds would probably qualify as part of the "residence", although local administrative practice varies.

ii. Deferral of tax by barter

If the grounds qualify as a "farm" one can barter it, tax free, for a larger "like property". The new owner has a higher basis--the appraised value at time of barter--and can subdivide and sell off without tax on the pre-barter increment. Or he can hold for further appreciation, the tax on which he too can defer in the same manner. Section 1031 of the Internal Revenue Code provides: "No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock, etc.) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment." There is a good deal of "tailoring" of transactions to fit the letter of 1031. An investor whose intent is to buy a suburban farm for cash will first buy a rural farm, satisfactory to the prospective seller, and then barter farms with him. Or he might buy other suburban land for barter.

The other land of "like kind" might also be a golf course, dump, drive-in, airport, nursery, etc.

A network of brokers' clubs has developed to arrange such bartering. Thus a ready avenue is open to suburban land speculators to defer income taxation of capital gains.

1031 is not an unmixed evil. It unlocks some locked-in investors by letting them release their land to commerce without tax penalty on the transaction. On the other hand, it makes land speculating more attractive and brings in more speculative money, inflating the general level of land prices. The seller, too, is still locked into his "like property", which may be a rural farm--a big factor inflating farm land prices--but may also be another suburban farm.

iii. Deferral by installment sale

The affluent seller who is in no hurry for cash, or whose strong credit lets him monetize his illiquid assets by banking them, may defer tax on land sale by the installment device. He must be the mortgagee. He must not take a down payment of more than 30% of the selling price.

An important incidental benefit of this method of sale is that a large share of the interest on the deferred payments may be treated as part of the contract price and receive capital gains rates. Only ~~a~~ 4% rate must be treated as interest, at simple interest rates. Mortgage interest rates today are about double that, at compound interest, so contract prices are inflated to reflect the buyer's benefit from borrowing at 4% simple interest from the seller; and the seller takes his interest above 4% at capital gains rates.

The longer the installment period the greater the differences between simple and compound interest. So sellers who can wait a very long time for cash can get capital gains treatment on all compound interest above 2% or 3%, depending on the time involved. I have not worked out details on this, but the possibilities of deferred payment of inflated contract prices are evident. Farm economists have published a good deal on the subject.

A variant of installment sale is the "land contract". The seller, instead of conveying title and taking a mortgage, retains title until payments are completed. If payments come in slowly this is not too different from rental, but with the tax benefit of capital gains treatment for all payments on principal representing taxable gains to the seller, and all interest payments above 4% simple. Thus a good deal of ordinary rent income receives capital gains rates.

iv. Simple prorating of installment payments between interest and principal

Whenever a debt is paid off in level installments, the true proportion which is interest is a maximum in the first year, when the unpaid balance is a maximum, and falls nearly to zero in the last installment. The necessary sinking fund tables to find the true proportion are the common property of bankers, and no deep mystery. Simple prorating of level installments between interest and principal therefore constitutes a deferral of tax liability relative to an accurate accounting--another benefit from installment sales.

v. Contract price contingent on buyer's profits: "profit participation"

If the contract price is contingent on the buyer's profit from the land, the seller need not prorate early payments between interest and recovery. He treats all payments as non-taxable recovery of principal until he has recovered his full basis; and only then does he begin to pay taxes on his cash receipts.

vi. Condemnation

If land is condemned, as for highways or urban renewal, the tax on gains is deferred if the unwilling seller reinvests in like' property within a year. If a lessor is forced to convey title to his lessee under something like the "Maryland land law," now law in Hawaii, he receives the same privilege or better.

f. Deferral of income from land use, where there is intertemporal dependance of income.

i. Sacrificing early rents for higher later rents. "Implicit expensing" of foregone income

There is often an intertemporal dependence of land rents. Sacrificing early rents to get higher later ones is a form of investment, and basically quite legitimate. However, the income tax biases landowners toward an excess of this kind of investment, because the foregone early rent is plowed back without ever having been received and taxed.

The effect is the same as though the early foregone rent were received in cash and then reinvested, and granted the valuable tax privilege of being expensed. This is "implicit expensing". Expensing of capital investments is tantamount to 100% exemption from income tax.

An example of how implicit expensing causes land to be unavailable to builders is the following. As a district or neighborhood fills in, the early builders establish a pattern of use. The more of the land is developed, the more certain become the specifics of the highest use of the remaining undeveloped land. Thus certainty improves over time. This has always supplied a certain rationale for deferral of land development, even before income tax rates were significant. But now the early foregone rent--the investment in greater certainty--is expensible: implicitly, that is. This encourages individuals to withhold land to achieve greater certainty. Since the individuals gain of certainty is achieved by imposing uncertainty on other landowners, there is no net social gain to justify a subsidy to this kind of withholding.

Another familiar example is the effort of large developers to attract the highest possible stratum of the market, at the expense of some waiting. Early sales to wealthy buyers are thought to tone up a subdivision and enhance later sales prices, if not volume. Thus a bias toward high pricing and slow sales results. The income tax exaggerates it. The loss of potential income from idle land is "implicitly expensed". Implicit expensing is involved not merely in the year-to-year management but in the original decision to cater to higher tastes than the broadest and most frustrated stratum of the market can now afford.

A third example is the California zoning device whereby large landowners can have their development density measured as a whole. They can raise density in parts of their land if they keep the average down to the required level. Their response, as described by Eichler and Kaplan, is to begin at densities below the average, building up zoning "credits" to apply later to apartments after the integrated development has become established. The unreaped rents of the unused land, meantime, are implicitly expensed.

A fourth example, of some generality, is where a large owner avoids subdividing, at a time when that would be optimal, in order to preserve a large tract intact for future integrated development.

ii. Explicit expensing of early operating losses to establish position

It is possible in several ways to appropriate control over territory by establishing an early position. An example is the effort of retailers to establish an early position in growing suburban territory. Here the bias is toward premature development--but not of housing, as a rule. How does this work?

Knut Wicksell, astute Swedish economist who anticipated many of the ideas that have stirred the world since his time, once observed: "because of the local character of the firm and its market, . . . the large enterprise has an actual monopoly simply because it comes first on the scene, and this monopoly may be as good as a monopoly which is legally established." Competition by a second firm "would only lead to the ruin of both." (Lectures, Vol. I, p. 131)

Now observe retailers establishing new positions around every growing city. Where there is room for only one store, or shopping center, or only a few gas stations, to be there first is to establish a species of franchise over the trade area, at least for several years. The early losses are expensible; the taxable income is deferred, and might even be taken as capital gain by sale of land.

Today, it is also of value to establish a zoning position. The more offensive a land use is to its residential neighbors, who will ultimately dominate zoning, the more important for a firm to establish an early history of noise, traffic, signs, smoke and other nuisances. Likewise, if tight future zoning of some monopoly value is anticipated, it is good to establish one's future grandfatherhood today.

Thus, areas best suited for residential use are subject to premature invasion by commerce, a higher use. The "floating value" that results, diffused over wide areas, inflates values above the residential level, without, however, raising them enough to stop the commercial demand. This drives residential builders farther out, where high density residential use establishes a floating value over areas best suited for low density--and so on and on in a succession of centrifugal shock waves.

The appropriative doctrine of water law is a grand vehicle for expensing land acquisition. Under the doctrine, control of water is established by prior use: "first in time, first in right." The country is full of water sources currently submarginal but potentially rent-yielding. The only way to secure the future rents is to develop the water now, before a rival. The doctrine is pernicious enough without tax considerations, but on top of everything else, early operating losses are expensible. They actually should not even be depreciable, for they are the price paid to acquire land.

The natural resource field overflows with parallel examples, wherever a rule of capture applies. Expensing of exploration outlays and intangible drilling costs are among the largest of these.

One of the greatest urban land speculations in history is the current race for gasoline station sites by the largest collection of corporate wealth in the world, the international major oil companies and the several lesser ones, loaded with untaxed cash from depletion allowances. The early losses are expensible; the tax liability of income is deferred, and the land value increment is never taxed so long as there is no sale. The accumulated economic power behind the oil companies is impossible for home buyers and builders and most other retailers to match. Not stopping with station sites, some companies have gone into land speculation as a major enterprise. The tax relations between their retail outlets and their other land would make an interesting study. Meantime, the home buyer and small retailer know they must overcome the most powerful competition in the quest for land. The "implicit expensing" of early foregone rents, and the explicit expensing of operating losses of premature retail outlets, add to the power of the competition.

A subtle form of expensing is that resulting from pay-as-you-go municipal financing of capital improvements. The property taxpayer expenses his taxes; the money is used for public capital improvements of the most durable kind, whose payoff is in enhanced service flow to land.

iii. Explicit expensing of capital outlays by "farmers"

While the homesite seeker is pressed from above by the higher use of commerce, he is ground against the nether millstone of "farming", which also enjoys extraordinary privileges. "Farmers" may expense many capital investments in soil and water "conservation." The gentleman farmer and his horsey family, who thus sink money in farms, have become proverbial; the proverb is now documented by a recent U.S.D.A. study, based on 1963 tax returns, showing that most wealthy taxpayers who own farms report farming losses. Of 3.2 million individuals who file tax returns including farm income, 66,000 reported combined farm and non-farm incomes over $25,000. Of this top group two-thirds reported farm losses! Their alleged tax losses are only current. They are expensed from ordinary income, usually urban, to be recouped later at capital gains rates by sale of a greatly improved farm. Improved for what? Not for sale to lower income home buyers as a rule. Soil and water conservation are likely to hold the land in agriculture until the tax-motivated farm improvements have been used for farming.

The cost of establishing orchards also is expensable, and the unrealized rent of the land used for an orchard's early nursery years enjoys implicit expensing. The competitive strength of horticulture against housing is thus enhanced.

The combined result of factors a. through f. is that the income imputable to land is largely exempt from income taxes. This helps explain why landowners in high brackets hold out for higher prices than can be met by low-income workers whose wages are fully taxable.1/ It helps explain the paradox of high and rising land prices in the face of a vast surplus of vacant and underutilized land, and the twin paradox that islands of hyperintensive, high-density land use, appropriate to high land values, arise in oceans of empty space with which they have little complementary linkage. It helps explain why the land market is not nearly as responsive to consumer demands as a market has to be to be functional in a complex modern economy.

1/ More than fully taxable when you consider that the base is the gross wage before withholding wage taxes.