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**The Lies of the Land: How and why land gets undervalued**  
by Michael Hudson

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**Turning land-value gains into capital gains**

YOU MAY THINK the largest category of assets in this country is industrial plant and machinery. In fact the US Federal Reserve Board's annual balance sheet shows real estate to be the economy's largest asset, two-thirds of America's wealth and more than 60 percent of that in land, depending on the assessment method.

Most capital gains are land-value gains. The big players do not want their profits in rent, which is taxed as ordinary income, but in capital gains, taxed at a lower rate. To benefit as much as possible from today's real estate bubble of fast rising land values they pledge a property's rent income to pay interest on the debt for as much property as they can buy with as little of their own money as possible. After paying off the mortgage lender they sell the property and get to keep the "capital gain." This price appreciation is actually a "land gain," that is, it's not from providing start-up capital for new enterprises, but from sitting on a rising asset already in place, the land. Its value rises because neighbourhoods are upgraded, mortgage money is ample, and rezoning is favorable from farmland on the outskirts of cities to gentrification of the core to create high-income residential developments. The potential capital gain can be huge. That's why developers are willing to pay their mortgage lenders so much of their rent income, often all of it.

Of course, investing most surplus income and wealth in land has been going on ever since antiquity, and also pledging one's land for debt ("mortgaging the homestead") that often led to its forfeiture to creditors or to forced

sale under distress conditions. Today borrowing against land is a path to getting rich -- before the land bubble bursts. As economies have grown richer, most of their surplus is still being spent acquiring real property, both for prestige and because its flow of rental income grows as society's prosperity grows. That's why lenders find real estate to be the collateral of choice.

Most new entries into the Forbes or Fortune lists of the richest men consist of real estate billionaires, or individuals coming from the fuels and minerals industries or natural monopolies. Those who have not inherited family fortunes have gained their wealth by borrowing money to buy assets that have soared in value. Land may not be a factor of production, but it enables its owners to assert claims of ownership and obligation, i.e., rentier income in the forms of rent and interest.

Over the past 40 years I have specialized in the study of the factors that raise or lower the nation's overall real estate prices -- rising income and savings levels, shifting interest rates and the financial sector's supply of mortgage credit, as well as changes in the tax laws and related market-shaping rules. This work for Wall Street banks and institutional investors was burdened by the absence of reliable data on the value of land and buildings. The official nationwide real estate statistics do suggest that a politically motivated asymmetry is at work in the economy, benefitting real estate, which I shall now attempt to identify.

### **Hiding the free lunch**

BAUDELAIRE OBSERVED that the devil wins at the point where he convinces humanity that he does not exist. The Financial, Insurance and Real Estate (FIRE) sectors seem to have adopted a kindred philosophy that what is not quantified and reported will be invisible to the tax collector, leaving more to be pledged for mortgage credit and paid out as interest. It appears to have worked. To academic theorists as well, breathlessly focused on their own particular hypothetical world, the magnitude of land rent and land-price gains has become invisible. But not to investors. They are out to pick a property whose location value increases faster rate than the interest charges, and they want to stay away from earnings on man-made capital -- like improvements. That's earned income, not the "free lunch" they get from land value increases.

Chicago School economists insist that no free lunch exists. But when one begins to look beneath the surface of national income statistics and the national balance sheet of assets and liabilities, one can see that modern economies are all about obtaining a free lunch. However, to make this free ride go all the faster, it helps if the rest of the world does not see that anyone is getting the proverbial something for nothing - what classical economists called unearned income, most characteristically in the form of land rent. You start by using a method of appraising that undervalues the real income producer, land. Here's how it's done.

### **Two appraisal methods**

PROPERTY IS APPRAISED in two ways. Both start by estimating its market value.

- **The land-residual approach** subtracts the value of buildings from this overall value, designating the remainder as the value of land. Building values may be estimated in terms of their replacement cost (which usually produces a very high estimate, leaving little land value) or their depreciated value (which gives an unrealistically low building estimate, inasmuch as maintenance and repairs save most buildings from deteriorating through wear and tear). Using the depreciated value method leaves a higher residual

land value. The Federal Reserve Board recently has experimented with a hybrid intermediate method that values buildings on the basis of their "historical costs."

- **The building-residual approach** starts by valuing the land, and treats the difference as representing the building's value. The first step in this approach is to construct a land-value map for the district or city. This displays fairly smooth contours for land values. Overlays would show zoning variations. Most of the variations in property prices around this normalized map will be for structures, along with a sizable component of "errors and omissions." This approach rarely is used, and most assessed land values vary drastically from one parcel to the next. The problem is especially apparent in the case of parking lots or one-story "taxpayers," that is, inexpensive buildings in neighborhoods that are heavily built up. Their purpose is simply to be rented out at enough to carry the property's tax bill, not to maximize the site's current economic value.

Note that the Fed's land-residual appraisal methods do not acknowledge the possibility that the land itself may be rising in price. Site values appear as the passive derivative, not as the driving force. Yet low-rise or vacant land sites tend to appreciate as much as (or in many cases, even more than) the improved properties around them. Hence this price appreciation cannot be attributed to rising construction costs. If every property in the country were built last year, the problem would be simple enough. The land acquisition prices and construction costs would be recorded, adding up to the property's value. But many structures were erected as long ago as the 19th century. How do we decide how much their value has changed in comparison to the property's overall value?

The Federal Reserve multiplies the building's original cost by the rise in the construction price index since its completion. The implication is that when a property is sold at a higher price (which usually happens), it is because the building itself has risen in value, not the land site. However, if the property must be sold at a lower price, falling land prices are blamed.

If it is agreed that any explanation of land/building relations should be symmetrical through boom and bust periods alike, then the same appraisal methodology should be able to explain the decline of property values as well as their rise. The methodology should be as uniform and homogeneous as possible. By that, I mean that similar land should be valued at a homogeneous price, and buildings of equivalent worth should be valued accordingly.

If these two criteria are accepted, then I believe that economists would treat buildings as the residual, not the land. Yet just the opposite usually is done.

### **How land gets a negative value!**

THE DRIVING FORCE behind the anomalies is the political lobbying eager to depict real estate gains simply as "protecting capital from inflation." In reality, it helps land owners and their creditors get a free ride out of land asset-price inflation -- that is, The Bubble.

For many years Federal Reserve Board in its Flow-of-Funds, Balance Sheet of the U.S. Economy, broke down its estimates of economy-wide real estate values between land and buildings. The problem arose when the Fed discovered that its methodology produced nonsensical results -- a negative value of \$4 billion for all land owned by non-financial corporations in 1993. This number resulted from imputing land values by subtracting the estimated replacement cost of buildings from overall property market prices. The "land residual" method left little

room for land value, as replacement values continued to rise even when market prices were declining. In such downturns the calculated replacement value absorbed nearly all the market value of corporately owned real estate.

Increases in property values were explained as construction cost increases, original cost times the annual rise in the Commerce Department's construction price index, typically 3 percent. Its tendency to rise steadily appears to explain the rise in property values by wage inflation and rising costs of materials. On this logic real estate prices seem merely to keep up with inflation. There is no hint of unearned gains or a free lunch.

In economic downturns, however, market values for properties dip below the estimated replacement-cost trend of their structures. The Fed estimated that it would cost more to rebuild the corporately owned structures than the overall market price of their properties would justify. On the basis of this calculation land was assigned a negative value so as to account for the excess of replacement cost over the market price.

Everyone recognized the absurdity of calculations depicting all the corporate land in America as having a negative value in 1993. Suppose somebody came to you and said: "I'll give you \$4 billion, but there's a catch. Along with the \$4 billion in cash, you will have to accept ownership of all the land owned by every non-financial corporation in the United States." Most people no doubt would see that they were being given assets much more valuable than \$4 billion, and would jump at the offer. The Fed's statistic would be dismissed as a comic exercise showing how economists tend to lapse into otherworldly speculation. But in this case the motive is all too worldly. Looking beneath the surface, one finds the not-so-invisible hand of self-interest by the real estate industry and its financial backers.

To give the Fed economists their due, they evidently came to the conclusion that their statistics were fatally flawed. The September 1997 balance sheet estimates made a start along new lines by including a calculation reflecting the original (historical) cost of buildings. This gave land a positive value. But nationwide totals were no longer compiled. No longer was there a line labeled "land," nor does the Fed publish a residual number for market value less the historical cost (or even the replacement cost) of buildings. Instead of making better land estimates, the Fed has dropped what had become a political and statistical hot potato. 1994 is the last year for which it has estimated economy-wide land and building values.

This leaves in limbo the macro-economists and business analysts whose business is to explain the finance, insurance and real estate (FIRE) sector's dominant role in the economy. According to the land-residual appraisal technique, high-rise buildings seem to have the lowest land values. Real estate interests argue that this is realistic, because at least in New York City the higher a building is, the more of a subsidy its developers need, given the economics of space involved for elevators, surrounding air space and so forth. The land itself is assigned a negative value as a statistically balancing residual reflecting the difference between the building's high construction costs and its lower market value.

On this basis much of New York's most highly built-up land would seem to have a negative value, including the World Trade Center even before its Sept. 11 destruction. While a low-rise building might be built on this site without subsidy, a skyscraper would need a subsidy, implying a negative land value.

## **Where did all the land value go?**

AS REAL ESTATE AGENTS explain to prospective buyers, the three keys are "location, location, and location." So we are brought back to the role played by land-value gains in the strategy pursued by investors and developers.

In view of real estate's dominant role in the economy, it is ironic that no attempt has been made to provide better statistics. My research has shown that the Fed's methodology undervalues land by as much as \$4.5 trillion. As matters stood in 1994, for instance, the Fed estimated the U.S. economy to hold some \$20 trillion in real assets (excluding human capital, for which no official statistics are published). The land's value was calculated to be \$4.4 trillion, and building values \$9 trillion. My estimates based on historical values suggests that land rather than buildings represents two thirds of the nation's overall real estate value -- \$9 trillion, leaving building values at just half this amount.

A partial selection of real estate statistics continues to be published. The Fed estimated that, for 1996, households and non-profit institutions held \$11.4 trillion in tangible assets. Nearly 80 percent (\$8.2 trillion) of gross household wealth took the form of real estate (whose \$3.6 trillion in mortgage debt represented nearly two-thirds of the household sector's liabilities). Non-profits held \$0.8 trillion. Real estate also accounted for nearly half (\$3.4 trillion) of the \$6.9 trillion in tangible assets owned by non-financial corporate business.

One obvious problem with the land-residual approach is that many buildings would not be rebuilt in their existing form. Occupancy use changes over time. In Lower Manhattan and many other inner-city areas, industrial factories, commercial loft buildings and even office buildings on Wall Street have been gentrified into residential properties. After New York City's near bankruptcy in 1975 over 40,000 manufacturing spaces in Manhattan were shifted from commercial to residential purposes. A similar conversion of industrial structures to residential or high-density commercial use is found in most large American cities. It is part of the economy's de-industrialization (euphemized as "the postindustrial economy"), as described for instance in Robert Fitch's *The Assassination of New York*. As formerly commercial and industrial districts have changed their character, site values have skyrocketed. That was all part of the Regional Plan developed early in the 20th century.

Many sites are worth more when they can be delivered vacant, any buildings are torn down, so that developers can start with a bare site. Buildings left standing are given new uses; most people would not want to reproduce these buildings as they are. For instance, Manhattan's highest-rent district until the World Trade Center bombing of September 11, 2001, was Tribeca, the downtown TRIangle BElow CANal Street into which artists and other individuals (including myself) seeking large roomy spaces at low prices moved in the late 1980s. These buildings had lost their value after New York City almost went bankrupt and industry began to migrate. Many landlords simply walked away from their properties and let them revert to the City, which auctioned them off at distress prices.

The commercial loft building in which I lived rose in price from \$40,000 in 1986 to \$120,000 in 1980 and \$4,000,000 in 2000. This sharp increase cannot be explainable by rising building costs. The building itself steadily deteriorated. All that increased was its site value. Today, of course, that property a block from the World Trade Center has fallen back in price, just as many new buyers had renovated their structures. The site's value changed without any significant reference to construction costs. One must infer that it is the site that determines the property's value.

## **A curious asymmetry**

IF THE APPRAISAL controversy is framed in terms of business cycle analysis, then the statistician finds no reasonable alternative to seeing that when the cycle rises and falls, the difference must be in the land, not buildings. What people are buying are not reproduction costs, whose fluctuations over the course of the credit cycle are relatively minor. They are buying site value, which is in limited supply, akin to a natural monopoly. Most of all, real estate investors and homeowners are buying the right to resell their property as prices are bid up by what they expect to become an increasingly affluent economy fuelled by an abundant supply of mortgage credit.

The land-residual approach appears to work as long as a fairly constant proportion of land to buildings is maintained. Statistically, this can occur only when property prices are rising at about the same rate as commodity prices and wages. But business cycles snake around the economy's basic trends, rising steadily and then plunging sharply. This fluctuation is what causes the most serious problems for statisticians.

In a thriving real estate market appraisers typically use a rule of thumb in allocating resale prices as between land and buildings to reflect their pre-existing proportions. Buildings typically are assumed to account for between 40 percent and 60 percent of the property's value. As a result, building values are estimated to grow along with a property's overall sales value. This appraisal practice is made to appear plausible as the pace of asset-price inflation tends to go hand in hand with rising construction costs, and hence in the theoretical replacement cost of buildings.

As noted, the anomaly occurs when real estate prices fall. Real estate prices are volatile, while construction costs rarely dip more than slightly, if at all. When real estate prices turn down, they often plunge below the reproduction cost of buildings. Hence, the residual ("land") rises and falls much more sharply than do building replacement costs (which are estimated as rising at a fairly steady pace) and overall property values.

The result is a curious asymmetry. Building prices seem to be responsible for the rise in real estate prices, while land prices are held responsible for their decline. When the fall in property values intersects the rising reproduction-cost trend, the land residual turns negative.

Because this land value often represents the owner's equity, this decline may prompt heavily indebted owners to default on their loans or even to walk away from their property, which reverts to the bank or other mortgage holder. In this sense the financial system itself is based largely on real estate, as the economy learned in the savings and loan (S&L) deposit insurance crisis of the late 1980s. Real estate prices reflect the supply of property (including a fixed supply of land) as compared with the fluctuating supply of mortgage credit, which tends to be a function of the economy's overall liquidity.

## **Site values as the economy's "credit sink"**

TO CLARIFY MATTERS it may help to think of "land" in the broad sense of comprising all elements of property value that cannot be explained in terms of capital investment and its profits. This category includes the site's locational value. Site value is the essence of long-term planning by real estate developers at the local level. But an examination of the economy-wide figures shows property prices to be determined by broad macroeconomic factors, headed by the availability of mortgage credit. Real estate is the major recipient of bank credit, and price waves or cycles are determined largely by the supply of mortgage loans and their interest rates.

Stated the other way around, the costs of reproducing buildings and structures are "sunk costs". Price trends are determined not by yesterday's supply prices but by today's market demand as supplemented by mortgage credit. If anything, buildings, plant and equipment wear out and depreciate, but their obsolescence is offset (and indeed, usually more than offset) by the rise in their site value. This rise reflects the desirability of real estate as an investment vehicle, the prime recipient of the economy's savings and source of new credit.

After 1990, for instance, when commercial banks found real estate to be largely "loaned up," they reduced the rates paid to depositors, as they did not have an alternative use for these deposits. The allocation of America's savings shifted away from banks and their real estate lending to other forms of investment as depositors began to shift their savings into money-market funds invested mainly in bonds, and then into mutual funds invested largely in stocks. This shift was largely responsible for the stock market's remarkable takeoff, substantially in advance of the real estate recovery.

One would think that land prices would play a central role in modern business cycle analysis, if only because a large share of stock market value consists of corporately owned real estate. Since the late 1940s "concealed value" in the form of properties carried at outdated book values reflecting low acquisition prices was a major factor behind corporate raiding, mergers and acquisitions. Aggressive firms employed accountants to pour over the Stock Exchange's 10K reports searching for such hidden values. But macroeconomists lacked the statistics needed to follow how the business cycle affected land prices, that is, the "non-building" aspect of real estate value. This made it difficult to provide meaningful analyses of corporate net worth and the causes of its rise and fall.

How, then, can business cycle statistics be collected without land values as a prime indicator? After all, it is the inflation of real estate asset prices that provides real estate owners with the collateral to justify further borrowing from banks to acquire yet more property. And by the same token, falling land prices extinguish the collateral that backs the banking system's savings, leading to financial insolvency.

The real estate cycle is essentially a credit cycle. Traditionally, land acquisition has been the object of recycling savings and extending new credit. Site values are the economy's "credit sink" as well as its ultimate "savings sink." This is why real estate values reflect the economy's rising and declining financial surplus. Profits fall as business upswings approach their crest and the economic surplus available for saving declines. A lower volume of loanable funds means that less credit is available to real estate developers, speculators and homebuyers, curtailing their ability to bid up prices with borrowed funds. Borrowing to buy buildings is discouraged by the fact that when interest rates rise, more of the rental income must be paid to lenders.

In sum, just as real estate lending fuels land speculation, so the withdrawal of such credit leaves property markets to decline, sometimes with a crash, as occurred in Japan after 1990 when its financial bubble burst. Should this rise and fall be attributed to buildings or to land? It seems to me that inasmuch as the price rise and fall is homogeneous, applying to parking lots as well as to skyscrapers, we should attribute it to land. This achieves the logical symmetry of applying to the downturns as well as upturns in the real estate cycle.

One clear sign of land-price inflation is that one category of land rises or falls much more rapidly than others. A widening disparity usually reflects a financial inflation. In Japan, for instance, high rates of saving were recycled to a remarkable extent into construction and real estate acquisition. Japanese authorities produced detailed land-value statistics for each category of land, showing property values during the Bubble years 1985-90 rising at an accelerating pace until 1991, and then turning downward. The A-shaped rise and fall was steepest for the

most expensive land surrounding the Tokyo palace, while land for single-story wooden residential housing rose and fell least steeply. A land-value map placing the highest values at the center and the lowest values in the outlying areas would tend to reflect a land-price bubble when price ratios steepened. On the other hand, a fairly level set of land values between the central city and its outskirts would indicate relatively less rent of location, and hence less land-value disparities. Using this analogy to examine New York City's midtown area, the steep land-value curve has been fed by credit as affluent buyers sought the most prestigious locations. Land sites have become the receptacle of the economy's surplus savings.

### **Immortally aging buildings**

INCOME TAX LIABILITY may be minimized in two ways.

- **The most general -- and also the most economically pernicious -- is through the tax deductibility of interest.** The working assumption is that interest charges are a truly inherent business expense, not simply the result of a business decision taken by investors to leverage their equity. For interest to be an inherent business expense, interest-bearing debt would have to be a factor of production, which it is not. Properties would yield their rent regardless of how they are financed. Investors choose to rely on debt rather than equity financing because the tax laws favor it, thanks to the political lobbying of institutional creditors ("the debt lobby"). Homeowners too deduct interest payments, which encourages borrowing.
- **The second way to minimize tax liability, is to depreciate the building, that is, annually deduct from taxable income part of the purchase price until it's all deducted and the building is "written off."** It's the most unique tax advantage enjoyed by the real estate industry. Investors are able to depreciate their buildings based on their assessed acquisition price, regardless of the actual building costs involved or the level of economy-wide land-price inflation. Investors depreciate buildings at rising prices even when prior owners already have depreciated these structures once or even many times. For real estate owned by households and partnerships (the latter being the preferred legal instrument for holding residential apartment buildings and office buildings), the Fed has estimated much higher proportions of land to buildings, but these estimates also overvalue buildings relative to land. Every time a property changes hands at a higher price, building assessments are raised proportionally - and begin to be re-depreciated for these higher valuations, regardless of how often the buildings already have been written off! There is no limit as to how often a building can be re-depreciated. What matters is simply how often the property changes nominal hands.

This fiscal privilege has created a phantom real estate economy. Buildings acquire death-defying lives, metamorphosing time and again for the purpose of enabling their owners to avoid paying income taxes. For commercial real estate investors as a whole, the repeated depreciation of buildings has made commercial real estate investment largely exempt from the income tax. Homeowners are not permitted to charge depreciation on their own residences, but only on buildings that they rent out.

The tax laws governing depreciation thus turn largely on how much value is assigned to buildings relative to the land, which is not depreciable. Like manufacturers, real estate owners are permitted to count part of the revenue over and above their current expenses as a return of their capital investment, as distinct from taxable earnings on capital. No income taxes are levied on this part of their revenue. That is only fair, because an investor who buys a \$100 bond only pays tax on the interest, not on the original \$100 principal. Likewise, industrialists can recover



their initial investment in plant and equipment without being taxed. Their "sunk cost" gets reimbursed, so that they get their capital back by the time the equipment wears out or becomes obsolete.

For real estate, however, the economics are unique. Machinery rarely can be re-depreciated, but this is not true of buildings as long as they are kept in proper repair. Maintenance and repairs typically consume about 10 percent of the rental value. For business owners, the explicit purpose of this expenditure is to maintain the building's value intact, so that it can survive year after year and avoid obsolescence while its site value rises. If a building is sold at a higher price, its assessment usually is raised. Suppose a property is sold for twice the \$1 million the owner paid for it. The local appraiser is likely to say; "I see you've sold your building for \$2 million. Under my rule of thumb, I appraise the land as half this value, and the building as half, so that gives you a \$1 million dollar building." Under this rule, the building that was formerly priced at \$500,000 can be re-depreciated at a price that builds in this \$500,000 gain. In this way a substantial portion of the rise in site value of non-depreciable land is treated as depreciable building value.

### **Real estate industry's priorities**

REAL ESTATE LOBBIES recognize that what is not seen is less likely to be taxed. What is not quantified for public policy-makers to see clearly may avoid taxes, leaving property owners with a larger after-tax return. They prefer land-residual's capital gains statistics at the national level, even as individual investors seek site-value gains at the local level.

This explains the seeming irony that investors in an industry dealing primarily with the development of land sites have campaigned to minimize the statistical treatment of land. Relegating land to merely secondary status enables the real estate industry to depict its "capital" gains as resulting from cost inflation and hence the reproduction costs of buildings -- whose value is allowed to be depreciated and re-depreciated at rising values over time. The free lunch of land-price gains is unseen as attention is diverted from the real estate bubble and land-price inflation to building costs. These fiscal considerations help to explain why it has been so hard to get Washington to produce national land value statistics.

The 2001 Nobel Prize was awarded to economists who recognized the unevenness of market knowledge. It would seem that this asymmetry exists especially in the real industry. Investors and developers know that the name of the game is capital gains. They use one set of statistics to calculate their Total Returns, but get government statisticians and Congressional authors of the nation's tax laws to support a different logic for their tax returns.

Tax favoritism for real estate was defended in Congress on the ground that it was in the public interest to provide a special inducement to the real estate industry to build more homes and office buildings. But as Adam Smith observed, every industry represents itself as serving the public interest. Can one really say that investors borrowing 70 percent of private-sector loans to ride the wave of asset-price inflation are more in the national economic interest than favoring direct investors to build new plant and businesses that employ labor rather than pricing homes, office buildings and industrial sites further and further out of reach of those who must earn their income by increasing society's productive powers?

## **THE FREE LUNCH:**

### **Its cost to citizens**

The recycling of savings into new mortgage lending has fueled an economy-wide inflation of asset prices for land, homes, and commercial properties, as well as stock market and bond prices. If what rises in value is mainly the land site, then the property owners appear as passive beneficiaries enjoying a free lunch. The property is their major asset and the mortgage their major debt. While doing little to increase the value of the building beyond having picked a good location and making the normal maintenance, they ride the crest of asset-price inflation of land. Indeed, take-home earnings have drifted down over the past two decades, but house prices have soared. These "capital gains" for households are part of the new phenomenon that has been popularized as "labor capitalism." As Margaret Thatcher's crowd has put it, "Sorry you've lost your job; I hope you've made a killing on your Council House or home in the real estate market." The free lunch.

For the two-thirds of America's and Britain's populations who are home owners, this free lunch from asset-price inflation of land has proved to be a silver lining in the post-industrial economy. For the remaining third of the population, however, the price of access to home ownership is receding rapidly. Today it hardly is possible for most renters to earn the money to acquire their own homes. The entry price has been bid up too high by those hoping to gain from asset-price inflation even as labor's earnings have been declining.

### **Its cost to the economy**

Once a building has taken all its depreciation, investors have a tax motive to sell the property and buy another. The sales price obviously will be higher if the new buyer can begin depreciating the building all over again, for the property will yield more after-tax revenue. This financial trick turns the real estate sector into a game of musical chairs, while enabling property owners to avoid income taxation. The end result is to free more of their cash flow to pledge to mortgage lenders as interest, in exchange for loans to buy more and more property that is rising in price. This is the anatomy of the dramatic increase in land-prices, called the real estate bubble. The tragedy of modern economies is this divergence of saving away from financing new direct investment and employment, to inflate a financial and real estate bubble. When the bubble bursts there will be little new tangible wealth creation to show for it, only a wave of insolvency, bankruptcy and foreclosures as the Western economies begin to look more like that of Japan since its bubble burst a decade ago. America's and Europe's largest economic expansion may similarly give way to a long depression. Its cause will remain invisible as long as the politically powerful real estate interests keep getting land undervalued and its income masked as capital gains on the national income and product accounts

## SUMMARY

For hundreds of years property's value has been calculated by discounting its flow of rental income at the going rate of interest. The lower the interest rate, the higher the price a given rental stream will justify -- or as property owners express it, the more years' rent a property will bring. What is so striking about land values today is that they are rising for reasons independent of their earnings stream. The major new consideration is their prospect for future "capital" (that is, land-price) gains. In sum, the ultimate aim of real estate investors no longer is so much to seek income -- most of which is pledged to their bankers as interest payments on the property they acquire -- as much as to seek property gains. Politically opportunities abound. Merely changing zoning in New York City in the 1980s to allow using commercial loft spaces for residential purposes had the effect of multiplying asset values five or tenfold.

Whether the gains come from selling the property or from borrowing more money against it, the essential phenomenon is the rapid growth in asset values and real estate's uniquely favored tax treatment. That's why investors choose real estate instead of bonds or stocks, and much of the strategy underlying corporate takeovers has followed the strategies they developed over the past half century.

Nationwide the capital-gains dimension needs to be incorporated into the rental revenue statistics to measure real estate's total returns. This sector's nearly complete success in escaping the tax collector has placed an enormous tax burden on everyone else.

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