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APPENDIX II: PART J

REPORT OF THE WORKING GROUP ON FINANCE,
INSURANCE, AND REAL ESTATE WEALTH

Prepared by DAVID J. HYAMS

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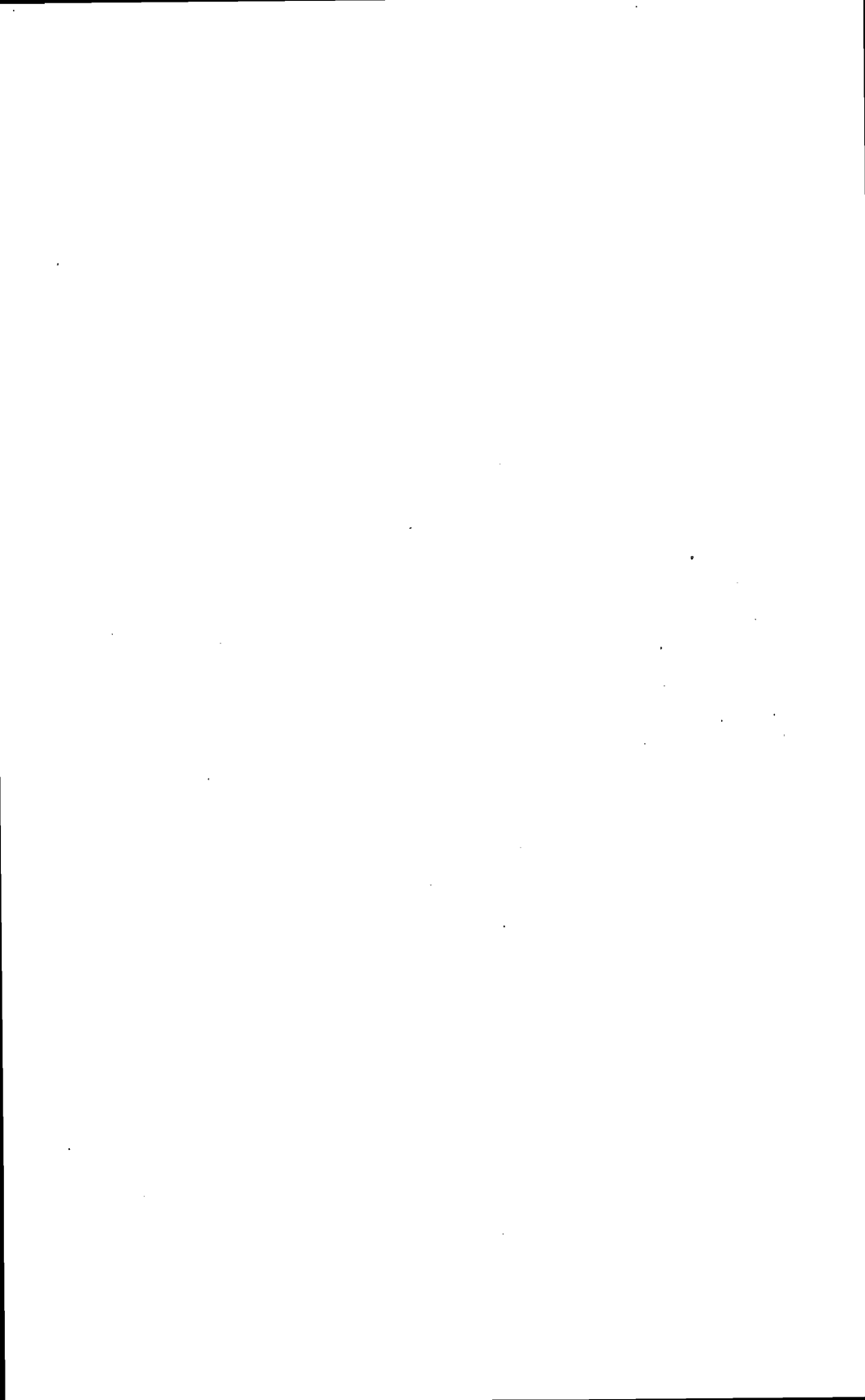
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PREFACE

The Working Group on Finance, Insurance, and Real Estate Wealth held two meetings to discuss the topics covered in this report. The writer of this report, who served as group secretary, wants to thank members for their participation and to acknowledge their very large contribution to the report.

However, the wording of the report is the responsibility of the secretary. While he has attempted to reflect the consensus of the group, no member should be held responsible for all the views expressed.

DAVID J. HYAMS.



FINANCE, INSURANCE, AND REAL ESTATE

I. PURPOSE AND SCOPE OF REPORT

This report examines major sources of information relevant to the making of wealth estimates for the sector. The kinds of data needed for wealth estimates are discussed, and recommendations are made about the collection of basic data and the presentation of final estimates.

The scope of this report is limited formally to the finance, insurance, and real estate (FIRE) industries described in the "Standard Industrial Classification Manual"; i.e., all those in Division G. Real estate, of course, is the most important class of tangible asset owned by business units within the FIRE sector, and the interests of the working group center on this class of asset. Since real estate also is an important asset in other economic sectors, certain recommendations are applicable to real estate, whether owned by this or another sector of the economy.

Estimates by Raymond W. Goldsmith indicate that over two-thirds of the Nation's tangible wealth consists of land and structures. Provision of benchmark value data in the detail herein recommended will serve in the analysis of a variety of economic problems, which are described in chapter 2 of the staff report and will not be repeated here.

Availability of supplementary physical measures would enhance the usefulness of the value data, particularly if the physical measures are cross classified by type of economic activity. For example, a major data gap would be closed if measures of land area could be related to site activity. The eventual availability of time series relating these variables would help in filling out the structure of urban land development theory.

II. REVIEW OF EXISTING DATA

At the beginning of the current decade, the FIRE sector owned tangible assets with a gross book value of over \$120 billion. This estimate, based largely on Internal Revenue Service data, can be broken down into three major components. About \$10 billion belong to the financial industries (banking, insurance, etc.). Somewhat more than \$40 billion represent the tangible assets of business units which filed corporation, partnership, and sole proprietorship returns and were classified within the real estate industries. The remaining \$70 billion represent the income properties of individuals claiming depreciation on rental property as an expense on their IRS form 1040's.¹

¹ The estimate of \$70 billion is equal to the depreciation expense claimed by individuals in connection with rental properties times the ratio of the cost of related assets reported by partnerships to the depreciation claimed by partnerships classified in real estate.

IRS DATA

The Internal Revenue Service currently is the only source of data on the bulk of the assets of the FIRE sector. Alternative collection vehicles do exist for data about the tangibles owned by credit institutions subject to Federal supervision and the tangibles owned by insurance companies. IRS data on the FIRE industries are generated from the returns filed by corporations, partnerships, and individuals reporting rental or sole proprietorship income. Balance sheets are received from corporations and, based on the experience of a recent year, about 45 percent of the partnerships. (These partnerships account for 70 percent of the receipts.) The balance sheet completed by corporations and partnerships spreads beginning and end of year tangible asset balances among the following asset classes: buildings and other fixed depreciable assets, depletable assets, and land. Depreciable assets are shown both gross and net of accumulated amortization and depreciation.

Depreciation charged against current income, whether that of a corporation, partnership, sole proprietorship, or an individual with rental property, is supported by a schedule which calls for one of two sets of supporting data. Taxpayers who have not adopted the new depreciation guidelines (Revenue Procedure 62-21) show the following items of information:

- Description of property.
- Date acquired.
- Cost or other basis.
- Depreciation allowed in prior years.
- Method of computing depreciation.
- Rate (percent) or life.
- Depreciation for this year.

Taxpayers who choose to follow the new procedure provide these items of information:

- Group or guideline class.
- Cost or other basis at beginning of year.
- Asset additions in year.
- Asset retirements in year.
- Depreciation allowed in prior years.
- Method of computing depreciation.
- Class life.
- Depreciation for this year.

The cost or other basis of fully depreciated assets still in use is a newly required item of information. The total shown is not distributed by asset type.

The IRS tax forms also call for data on rentals. Corporations and partnerships report gross rents received and paid as separate items. Partnerships report rents received on a supplementary schedule in which each rental property is identified. Sole proprietorship schedules attached to individual income tax returns shows gross rentals paid but not those received. Those received may be found grouped with other proprietorship income, or they may be reported in the rental schedule of form 1040. This schedule also is used by individuals to detail their rental incomes.

In addition to the data they report to the IRS, the business units considered below file annual or more frequent reports with certain Federal and State supervisory agencies. Consideration should be given to the use of the statistical programs of these agencies as vehicles for the collection of needed additional data in the benchmark year.

BANKING

The great bulk of the tangible assets of this industrial group is owned by business units which report to one of the three Federal agencies which supervise banking. Nonreporting institutions which are a part of the industrial group as defined in the "Standard Industrial Classification Manual" include some State-chartered banks and certain units performing bank-related functions, e.g., clearinghouses, check-cashing agencies, etc.

Federally regulated banks file a call report four times each year. Additional information is collected during annual bank examinations. Identical condition reports are used by the Federal Reserve System for State member banks, and by the Federal Deposit Insurance Corporation for insured nonmember banks, and at most call dates by the Comptroller of the Currency for national banks. Tangible assets are thrown into the following accounts: Bank premises owned; furniture and fixtures; real estate owned other than bank premises. Balances shown are book values rather than historical costs. Book values may not be related at all closely to market values.

The bank examination reports provide some additional data on bank tangibles. The examination forms differ among the supervisory agencies. The form used by Federal Reserve examiners spreads the book value of premises among land, buildings, and leasehold improvements. An estimated or appraised value is placed on each of these categories and on furniture and fixtures. Other real estate holdings are itemized, including cost of acquisition, book value, and estimated or appraised value. The national bank examination form used by the Comptroller of the Currency provides an estimated market value for real estate other than bank premises. Land costs in connection with present or future bank premises are shown. The FDIC form provides an assessed value for bank premises.

In order to estimate the reproduction cost of tangible assets in banking, historical costs (in addition to book values) by year or period of acquisition will have to be reported. Also required and not currently reported are total rental payments and receipts, by major asset type.

CREDIT AGENCIES OTHER THAN BANKS

Three data sources at the Federal level exist for the major part of this industrial group. Savings and loan associations accounting for more than 95 percent of that industry's assets report data to the Federal Home Loan Bank Board. The great bulk of the institutions extending agricultural credit file reports with the Farm Credit Administration. About half of the credit unions are federally chartered and report to the Bureau of Federal Credit Unions (HEW). In addition to reports from federally chartered organizations, the Bu-

reau receives summaries from the States of major items on the reports filed by State-chartered credit unions.

The annual report filed by members of the Federal Home Loan Bank System treats tangible assets in the following accounts:

Real estate owned.

Office building.

Less allowance for depreciation.

Furniture, fixtures, and equipment.

Less allowance for depreciation.

Real estate owned is valued conservatively and may reflect a write-down of acquisition cost.

Rental receipts are thrown into "Gross income from operation of real estate owned" or "Gross income from office building." Rental payments for office space are grouped with utility expenses. Rentals for the use of property other than office space may be grouped with other classes of operating expenses.

The Farm Credit Administration receives periodic reports from the agricultural credit institutions which it supervises. These include Federal land banks, Federal intermediate credit banks, and banks for cooperatives. The FCA also receives the reports filed with the intermediate credit banks by production credit associations as well as the reports filed with the land bank associations. The periodic reports of these various institutions are similar in their treatment of tangible assets. The value of banking premises is separated from the value of other owned (defaulted) real estate. Furniture, fixtures, and equipment are grouped into a single account. A separate account exists for automobiles in balance sheets filed by most types of agricultural credit organizations. Both gross and net balances are shown for premises and furniture. Net figures may reflect unrealistically high depreciation rates. Other real estate usually is carried at acquisition cost.

Gross receipts from the rental of bank buildings are not shown. Expenses associated with the lease of bank space are grouped with payments for utilities. Similarly, rental payments for other types of assets are grouped with other categories of expense.

The balance sheet filed by federally chartered credit unions shows premises separately. Other tangible assets are grouped with miscellaneous financial claims.

Rental payments are included with other expenses of building operation. Rental expenses associated with other types of assets are merged with other kinds of expenses.

SECURITY AND COMMODITY BROKERS AND EXCHANGES

Brokers and dealers regulated by the Securities and Exchange Commission are required to answer an annual questionnaire. Security exchanges are required to file an annual balance sheet with SEC. Tangible asset accounts are not standardized.

The Commodity Exchange Authority (USDA) receives annual balance sheets from brokers dealing in regulated (agricultural) commodities. A standard report form is not prescribed. Commodity exchanges are not required to file an annual statement.

The SEC and CEA could collect data in the benchmark year by providing brokers with a special schedule on tangible assets and rental receipts and payments.

INSURANCE CARRIERS

Practically all business units falling within the scope of the insurance industries defined in the SIC are regulated by State commissions. Each commission requires the filing of an annual financial report by each carrier operating within its jurisdiction. The report forms used by the States have been standardized through the efforts of the National Association of Insurance Commissioners (NAIC).

Within any one State, four different annual statement forms exist, each corresponding to one of the following classes of carriers: life, accident, and health; fire and casualty; title insurance; and fraternal orders.

In connection with the assembly of data from these reports, most insurance carriers are required to file a copy of the NAIC report along with their Federal income tax returns. Stock casualty, benevolent life, and certain mutual companies, including those that are tax exempt, may but are not required to file a copy of the NAIC statement with their tax return. Some 1,500 life insurance companies belonging to the Institute of Life Insurance (New York, N.Y.) file a copy of the annual statement with that organization. The companies hold more than 95 percent of the assets of the life insurance industries. We note that summary data from these reports currently are being made available to the Office of Business Economics. The annual statement filed by life, accident, and health carriers is similar in structure to the statements filed by other carriers, although details do vary.² The book value (after depreciation) of admitted and non-admitted tangible assets are recorded in exhibit 13 of the report. Separate totals are shown for these standard categories of property:

Real estate:

Properties occupied by the company.

Properties acquired in satisfaction of debt.

Investment real estate.

Other assets:

Furniture.

Other types of property (investment and otherwise) are thrown into categories chosen by the reporting carrier. Historical costs rather than book values should be the basic data for wealth estimates.

Real property is the only category for which supporting detail is available. Schedule A of the report provides the following selected information on real estate owned at yearend:

Location and description of property.

Date acquired.

Year of last appraisal.

Amount of encumbrances.

Cost to company.

Book value less encumbrances.

Market value less encumbrances.

² In statements filed by fire and casualty, title, and fraternal insurance carriers, statement A shows data on each piece of real estate owned whether acquired in the current or in an earlier year. On the other hand, the statements filed by fire and casualty, and title insurance carriers do not show the amount of interest deducted from recorded rental receipts.

This information is provided for each property acquired during the current reporting year; properties relating to an earlier year and valued at less than \$100,000 may be grouped.

A separate section of schedule A shows the amount of real estate owned in each State (and foreign country). Aggregate market values for each State are divided between farm and nonfarm properties. This geographical classification provides the basis for the State-by-State allocation of insurance realty. We note that estimates of market values are not arrived at uniformly by reporting companies.

Estimates of gross wealth must rest on an age distribution of original costs adjusted through the use of appropriate price indexes. The amount recorded under "Cost to company" in schedule A may reflect acquisition rather than original cost. In addition, the "Cost to company" includes a value for land as well as structure, two major asset types which should be separated.

Rental payments are recorded in exhibit 5, "General Expenses." Payments associated with insurance activities are separated from those relating to the management of investments and shown on one of several lines: Line 1 "Rent" is used for premises occupied by the company, including rent on space owned by the company. Expenses associated with tenancy also are included in the balance for this line. Line 5.6 shows amount paid for the rental of office machines. Line 9.1 "Real estate expenses" includes some rents associated with this investment operation.

The allocation of wealth from sector of ownership to sector of use requires that all rental payments be shown separately and associated with particular asset types.

Aggregate real estate income is shown in exhibit 3. Rental income includes rent for the company's occupancy of its own buildings. Schedule A, discussed above, relates rental income to particular properties or groupings of real property. Rental data exclude interest payments on encumbrances, although the annual statements of some classes of insurance carriers footnote interest payments on encumbrances. It is necessary to know gross rental receipts since allocation of real estate to other economic sectors is based on reported rental receipts and payments.

LESSORS OF RAILROAD PROPERTIES

Lessors of railroad properties are required to file annual reports with the Interstate Commerce Commission. The report form (E) used by lessors is an abridged version of that used by large line-haul and switching roads. The form used by the latter roads is reviewed in the "Report of the Working Group on Transportation." For a discussion of the contents of that report, see appendix II, part L.

III. DATA REQUIRED FOR WEALTH ESTIMATES

BASIC DATA

It is desirable that estimates of tangible wealth be made available in these three planes of detail: industrial, geographic, and type of asset (see ch. IV for specific recommendations). The first part of the present chapter discusses required basic data and their relation to currently

available data. The latter part of the chapter considers the valuation of real estate.

The raw data for wealth estimates are the gross (undepreciated) values from the books of account (actual or constructed) of economic units within the FIRE industries. These data can be gathered by global enumeration and by sampling. The relative extent to which the two collection techniques are employed depends on the degree of detail at which wealth estimates are to be published.

Book values must be collected in a detail sufficient to make wealth estimates by asset type within geographic area within industry. For example, data from a multiactivity company must be spread among the several industries to which the company belongs. The tangible assets of economic units operating at several locations must be related to specific geographic areas. Finally, since the number and contents of company accounts vary, some restatement of the book values will be necessary. This may involve nothing more than aggregating or spreading existing accounts. On the other hand, it may be necessary for some reporting units to recast balances in a number of existing accounts.

Existing data collection vehicles generally fall short of providing the information needed for wealth estimates. The IRS tax reporting system represents the only vehicle currently covering all segments of the FIRE sector. Of the economic units filing returns, corporations and, to a lesser extent, partnerships, file balance sheets. Sole proprietors and individuals with rental properties do not provide data on nondepreciable assets.

With reference to depreciables, each of the four classes of taxpayers is expected to complete a detailed schedule supporting his claimed depreciation.¹ Experience shows there is wide variation in the way in which taxpayers complete the schedule. Thus, it was expected that the IRS "Life of Depreciable Assets Study," which developed information on the ages of various classes of depreciable assets, would be based exclusively on depreciation schedule data. However, data reported in the schedule proved inadequate. In a substantial number of cases, it became necessary to contact the taxpayer for additional data. The experience suggests that it may be preferable to collect needed information directly from the respondents rather than through their tax returns. Aside from the problem of getting adequate and consistent detail in terms of asset type, the tax form represents the report of a company which may engage in more than one SIC industrial activity in more than one geographic area. Of course, the schedule supporting claimed depreciation does not request information on these two variables.

It is too early to know whether there will be an improvement in the quality of reported data in the returns of firms adopting the new depreciation guidelines.

¹ Assets for which no depreciation is claimed, i.e., those that are fully depreciated, and which are still in use are grouped and their total cost is reported.

THE VALUATION OF REAL ESTATE

Wealth statements contain two measures of reproducible assets. The first is a gross value and is equal to the cost of reproducing given assets at price levels obtaining in a particular year. The second measure of wealth is the market value of given assets at a particular time. When market values are not available, attempts to approximate them often are made by adjusting gross values for the depreciation that has occurred since the assets were new. This technique is less than ideal since at any point in time the market may place different values on similar buildings on similar sites. This results from variations in the rates of occupancy and other factors affecting income.

Some of the problems associated with making estimates of the gross and market values of buildings are discussed in the following paragraphs. Gross values are obtained by adjusting "aged" book costs with price indexes appropriate to the asset type being revalued. Two problems can be pointed out in connection with these book costs.

First, since wealth estimates of the various economic sectors will include separate values for land and structure, the cost of the latter must be separated from the total original cost. Many economic units maintain this separation since they are entitled to charge depreciation against income for tax purposes, e.g., most members of the FIRE sector. However, other economic units either file no tax returns, as in the case of governmental entities, or have no reason to separate the two assets, e.g., households.

Even when cost data are available, they doubtlessly refer to acquisition rather than original costs when the current owner is not the original owner. This creates a major valuation problem when dealing with assets having long lives and which have had several owners. The problem of obtaining original costs also arises in connection with additions and alterations to structures. Determining what alterations have taken place (even assuming one owner) and the associated costs is troublesome where the structure is old and property records are poor.

Price indexes used in revaluation should reflect changes in input prices, efficiencies in production techniques, and regional differences in both prices and techniques. Traditional construction indexes do not allow for improvements in construction techniques.

Unless the structure is new the estimation of a separate market value for land and another for structures raises both conceptual and practical problems. If the structure is new, its market value is assumed to be equal to the cost of construction, although, as mentioned above, prospective occupancy rates can create a spread between cost and market. The problems arise in developing a basis for depreciating a less-than-new structure since that is what is done, in effect, when market price is decomposed into values for land and structure. The lifespan of structures often is associated less with physical wear than with changes in the demand for the site land. The conventional linear curve based on life experience does not reflect the erosion of value due to wear. Recourse to market data is necessary to develop curves reflecting the changes in value due to age. Market depreciation studies require the collection of the market prices of properties (sites and buildings) similar in all respects (including occupancy) but the age

of the structure. The resulting array of values provides the basis for market depreciation rates. As a practical matter, of course, assembly of such data is difficult.

The need for market depreciation data exists whether wealth in buildings is approached by applying ratios to collected estimates of real estate values or by adjusting estimates of reproduction cost to account for physical wear. Ratios of land to total real estate values can be obtained from assessment data in many jurisdictions, although their accuracy in reflecting true market values of land and buildings is open to question.

IV. RECOMMENDATIONS

1. Wealth should be valued on two alternative bases. The first corresponds to gross reproduction cost; the second, to market value. Wealth estimates should be distributed by asset type, i.e., land, buildings, equipment, materials and supplies, and inventory. Land and buildings whether or not owned within the FIRE industries, should be associated with major site uses, i.e., residences, retail stores, multi-use offices, manufacturing activities, etc.

2. The major goal of a wealth inventory is the generation of value estimates. However, there is a need for better data describing the physical characteristics of real estate whether or not owned within the FIRE industries. To the extent practicable, we recommend the simultaneous collection of both categories of data. We call attention to the need for the following measures of the characteristics of buildings: type of structure; number of floors; whether or not equipped with elevator; whether or not air conditioned. Collection of data showing the space (square feet within structures and land areas) dedicated to various economic activities would fill a major data gap. The activity classification chosen should be consistent with whatever uniform land-use coding system emerges from the current efforts of the Housing and Home Finance Agency and others.

3. In collecting raw data for value estimates and information on physical characteristics, maximum use should be made of current Federal reporting vehicles. In the benchmark year, reports should be expanded to collect required data. Agencies currently collecting data include those supervising banks, savings and loan associations, and farm credit institutions; also those supervising Federal credit unions, security and commodity brokers. The fact that most insurance carriers file copies of the annual NAIC statement along with their Federal tax returns provides a central source of data from these statements.

The contribution that IRS can make in providing data for wealth estimates needs early and thorough study. It is a fact that IRS has the only statistical reporting system covering the bulk of the tangible assets in the FIRE sector, i.e., the more than \$40 billion owned by business units other than financial intermediaries and individuals with rental property. However, IRS experience with the "Life of Depreciable Assets Study" shows that tax returns (at least, those filed by corporations) fall short of providing all needed data. It is doubtful whether that tax-collecting agency would be willing directly to sample taxpayers for additional data unless the needs of the wealth estimator and tax collector coincide. There are some grounds for expecting such a coincidence, given their mutual interest in the lives of depreciables.

Where tax returns are inadequate and recourse to the taxpayer by IRS is not possible, then a new Census Bureau program represents an alternative vehicle for collecting benchmark data from corporations, partnerships, and sole proprietorships in the FIRE industries. In the case of individuals with rental properties, it may be more efficient to collect required data as part of the enumeration of household wealth, even though these rental properties are not classified as household wealth.

4. The usefulness of data on real estate is increased with the degree of geographic detail since markets for building space are essentially local and nonmovable. The provision of data at the county level is a desirable longrun goal, since counties are the building blocks of standard metropolitan statistical areas. Counties, unlike SMSA's, are remarkably invariant to change.

5. Data on the tangible assets of business units within the FIRE division should be presented in some industrial detail. Each two-digit industry should be distinguished. Finer detail should be shown within certain of the two-digit industries. These are indicated below by appropriate indentation.

Banking (60)

Mutual savings banks (603)

Credit agencies other than banks (61)

Savings and loan associations (612)

Bond and mortgage companies (6152)

Security and commodity brokers, dealers, exchanges, and services (62)

Insurance carriers (63)

Life insurance (631)

Insurance agents, brokers, and service (64)

Real estate (65)

Operators of nonresidential buildings (6512)

Operators of apartment buildings and of dwellings other than apartment buildings (6513-14)

Lessors of agricultural, forest, mining, oil, and public utility properties (6515-16, 6518)

Lessors of railroad property (6517)

Lessors of real property, n.e.c. (6519)

Agents, brokers, and managers (6531)

Title abstract companies (6541)

Subdividers and developers (6551)

Operative builders (6561)

Combinations of real estate, insurance, loans, law offices (66)

Holding and other investment companies (67)

Real estate investment trusts

Our recommendations respecting industrial detail are consistent with the SIC with one exception. We suggest that data on real estate investment trusts be shown separately. These trusts do not now correspond to any SIC industry.

While it is necessary that the industrial divisions selected for the presentation of financial data (which is the responsibility of another working group) will differ in detail from the industries used for tangible assets, both should be capable of collapse into identical groupings at the two-digit level.

6. Estimates of wealth used by industry (as companions to estimates of wealth owned) require the collection of additional data from business units within the FIRE industries. Lessors will have to report the value of leased properties by major asset type (single-family residence, multifamily residential building, office building, etc.) and associated rental receipts. Lessees of property will report rental payments by major asset type. With these data, it will be possible to allocate wealth from industry of ownership to industry of use.

