Volume Title: The Impact of Government on Real Estate Finance in the United States

Volume Author/Editor: Miles L. Colean

Volume Publisher: NBER

Volume ISBN: 0-870-14140-6

Volume URL: http://www.nber.org/books/cole50-1

Publication Date: 1950

Chapter Title: The Indirect Impacts of Government

Chapter Author: Miles L. Colean

Chapter URL: http://www.nber.org/chapters/c5933

Chapter pages in book: (p. 134 - 146)

The Indirect Impacts of Government

DIRECT governmental influence, vast as it has become, does not include all phases of the state's impact on real estate financing. Numerous other means of influence exist, and, although these exert their force indirectly, they are nonetheless real and important. The area of indirect impact is, indeed, almost as broad as the whole range of legislation dealing with economic conditions. A tariff law, immigration, labor, or transport policies, a revenue measure, or any act affecting farm or urban prosperity will ultimately have some influence on real property. It is not practicable here to identify all these manifestations of government nor even to examine thoroughly the major indirect forces. But even a limited discussion of a few of them will suffice to show how the real estate market is dependent upon political action.

THE PROPERTY TAX

The property tax is one of the most important secondary influences. From a time when wealth was largely in land and chattels, and manufacture and trade were incidental, the property tax remains the main support of local government and, with a number of exceptions, a contributor to the financing of state government. Since, as the tax is administered, property has come mainly to mean real property, its incidence has a definite influence on real estate investment. In an area with high property taxes, the property tax may well amount to one-fifth or more of the gross income on an income-producing property such as rental housing. If conditions in the market do not permit the shifting of the property tax to the tenant, net income may be reduced relative to other investments, the value of the property reduced relative to other investment goods of similar cost, and hence the volume of new investment retarded. On the other hand, if the tax can be shifted the effect is to direct new investment to properties that will appeal to tenants financially able to carry the load. The property tax also has an influence on the location of residential and other structures, a drift to relatively low tax areas being inevitable where the choice of location is optional. As between comparable properties within a locality, but in different taxing jurisdictions, a difference in the current property tax tends to become capitalized into a difference in property value, so the effect of the tax is to create artificial differences in real estate investment opportunities. Even compensating differences in services rendered in high tax areas are likely to offset only to a limited degree the attraction of lower property tax rates.

Because real estate is necessarily a long-term investment offering a slow return of total capital and because, at the same time, the income from real property is highly variable, the property tax creates special hazards. The tax is relatively inflexible and, over long periods, its tendency has been to rise. Thus in bad times a property may suddenly be thrown into a deficit, while, on older properties, taxes may be borne only at the neglect of maintenance. The total influence of the property tax is not only to limit the amount and type of real estate investment but also to increase its speculative character, and to induce "milking" of property in its early years and neglect thereafter.[1]

The search for new sources of local and state revenues has been proceeding rapidly. New York City with its telephone and sales taxes and Philadelphia with its payroll tax are but two examples. Additional franchise taxes, tobacco, gasoline, and liquor taxes, and special charges for city services are other methods pursued.[2] These efforts, however, amid the constantly increasing costs of municipal government, have at best served to retard or prevent increases in the property tax. Through income taxes, general or specific sales taxes, license fees, and other means, many of the states and some municipalities have reduced their dependence for revenues on direct levies on real estate. So far, however, the basic difficulty with respect to financing local governments has hardly been met, and the uneven load on realty investment remains. The remedy offered

1 For more detail on the impact of the property tax on realty investment, see Miles L. Colean, *American Housing* (The Twentieth Century Fund, New York, 1944) pp. 236 ff. See also, Carl Shoup, Roy Blough, and Mabel Newcomer, *Facing the Tax Problem* (The Twentieth Century Fund, New York, 1937) pp. 10 ff.; Harold M. Groves, *Postwar Taxation and Economic Progress* (New York, 1946) pp. 344 ff.

2 Urban Land Institute, *News and Trends in City Development*, Vol. 5, No. 4 (April 1946).

by the limitations on the property tax, which are a feature of some state constitutions, are only a partial remedy. They set bounds to the amount of the load but do not solve the problem of inequality.

THE INCOME TAX

The income tax creates additional problems for corporate-owned real estate. Applied to an investment that already is carrying a large share of the total cost of local government, the corporate income tax further reduces a relatively thin margin of net income.[3] For real-estate-owning corporations, the only escape is through the creation and maintenance of a high proportion of debt, since interest payments are deductible in the tax calculation. In this case the result is to induce dependence on mortgage rather than on equity financing and even to encourage disguising, as some form of fixed debt, that which would normally be equity financing.

Another hazard is created by the incompatibility of the tax system with the repayment of mortgage debt, since amortization payments are made from net income and are not deductible for tax purposes. The situation creates an incentive either to maintain a high fixed debt or to substitute for it an arrangement involving a sale of property and taking back under a long-term lease with fixed rental payments (which are deductible). The latter device, applied mainly to industrial and store properties, has been a feature of insurance company investment since the war.[4] The difficulty created by the corporate income tax system is especially sharp in connection with loans having a fixed regular payment compounded of decreasing interest and increasing amortization shares, such as is characteristic of most insured mortgage loans on rental property. The interest portion is deductible from income in calculating taxable net income; the amortization portion, on the other hand, is not deductible. The depreciation allowance is deductible and this may exceed amortization, but, whereas amortization requirements increase under the level payment plan, depreciation allowances are fixed, and when the former equal the latter (usually

[3] According to U. S. Treasury, *Statistics of Income*, Part 2, 1938-42, the net return to urban real estate corporations, figured on its relation either to total invested capital or to equity capital, was lower than for any other form of corporate enterprise. It is probable that this unfavorable dividend status for real estate corporations is at least partly offset by heavier salary payments to owner-officers of these corporations.

[4] See Chapter 4.

at an early point in the life of an individual investment) the mortgagor is required to pay an increased income tax and to continue to disburse cash to meet amortization and interest requirements. This may be a very heavy burden on the cash resources of the owner, and, under some circumstances, might be serious enough to cause a default. The net effect is to induce the equity holder to be more concerned with the quick recoupment of a minimum equity than with considerations of long-term investment. The tax system thus aggravates the speculative character of the equity investment and, in doing so, adds to the risk of the mortgagee.[5]

In respect to owner-occupied housing, the interest payment deduction allowed under the personal income tax is often looked upon as a special benefit to the homeowner. But it is a benefit only as long as he remains in debt. Consequently, there is a lessened incentive to repayment of debt in order to maintain a maximum income tax benefit. Another income tax advantage to the homeowner, which indirectly influences housing investments, is the exclusion from gross income of any amount for the rental value of owner-occupied homes.

Tax Exemption

Both the property and income tax systems contain exemptions or abatements that give special advantages to certain types of investment or investing institutions. Thus, public housing developments are generally relieved of any substantial contribution to the maintenance of the municipalities in which they are located. New York and Massachusetts, for instance, provide for less-than-normal taxes for property developed and operated under their urban redevelopment statutes. Tax concessions on industrial property are widespread,[6] and a number of the states have laws exempting

[5] For a fuller treatment of the investment problems raised by the corporate income tax, with particular reference to the "constant payment" plan of mortgage financing, see Randolph E. Paul and Miles L. Colean, *Effect of the Corporate Income Tax on Investment in Rental Housing* (National Committee on Housing, Inc., New York, 1946). Also to be noted is the fact that the capital gains feature of our income tax is biased in favor of investment in securities as against investment in real estate. A man who buys and sells real estate is more readily regarded as a dealer than is a securities trader and his gains are taxed as ordinary income rather than as capital gains (H. M. Groves, *op. cit.*).

[6] H. M. Groves, *op. cit.*, pp. 341-43.

homesteads from all or part of the property tax.[7] Federally-owned property is not subject to state or local taxation. And religious and eleemosynary institutions receive substantial tax concessions in many states.

Designed as incentives to certain types of investment and as a special protection to others, all such concessions add to the inequalities already existing in property tax assessments; and, even more important, they inevitably increase the burden on the remainder of real property excluded from the benefits. While by no means a general rule, the tendency is to favor industrial property, owner-occupied dwellings, and "social purpose" housing to the corresponding disadvantage of investment in income-producing property of commercial and conventional residential types.

Income tax exemptions are also significant in the realty investment picture, since certain types of mortgage lending institutions obtain a competitive advantage both as to the interest rates that may be charged and the income that may be returned. Thus, national farm loan associations, federal savings and loan associations, state-chartered savings and loan associations, and mutual savings banks enjoy immunities under the federal income tax laws and in general are also given favored treatment under state and local tax laws. National banks and state commercial banks are not thus privileged. Life insurance companies, by special arrangement, are taxed only for the amount of income in excess of that allocable to legal reserves, with the result that the incidence of the tax on total income is minor.[8] Government corporations and agencies (federal, state, and local) engaged in realty financing pay no income taxes, a circumstance which, combined with the low interest at which they can obtain their funds, gives them a strong advantage if their activities become competitive with unprivileged private institutions.

The Problem of Municipal Organization

Adding to the difficulties created by the property tax is the problem created by the organization of our municipalities and metro-

[7] See Chapter 3.

[8] The minor burden of income taxes on insurance companies makes it advantageous for these institutions to invest in income-producing properties suitable for long-term lease to substantial tenants. In such cases, the tenants avoid income taxes on the rental paid and the investing insurance company also has the advantage of comparative tax immunity.

politan districts. As the demand for additional services from government has grown, the tendency has often been to set up independent taxing authorities to provide the services. Thus, we have not only an overlapping of state, county, and municipal levies on property, but often a congeries of levies from school, park, and sanitary districts, special assessment areas, and others, all independently computed, but all placed against the same property. Rarely is there a single authority to correlate the claims of all agencies in terms of their relative importance and with due regard for the ability of property owners to pay.

Even more far reaching in its effect on urban realty investment is the independent jurisdiction of satellite communities. In most metropolitan areas the central city is prevented from extending its limits by the suburban communities that surround it. The satellites depend on the central city for their existence and profit from the services it provides; yet they are free from the burden of its support. At the same time the movement of industry and population to outlying sections deprives the central city of revenue. The result is an increasing burden of taxes on centrally located properties, a decrease in their ability to pay (and consequently in their value), and discouragement of new investment in core areas. On the other hand, lower taxes and frequently more lenient building regulations tend to cause new real estate investment to follow population to the suburban regions.

Various attempts have been made to compensate for this situation. New York led the way with its Redevelopment Companies Acts of 1942 and 1943, which provided that taxes on housing properties built in reclaimed areas might be frozen for twenty-five years at the level existing before redevelopment.[9] This measure has an effect on the financial structure of a housing investment more than equivalent to the complete writing off of land value during the period of the abatement. Massachusetts offered a more complex but less beneficial plan of the same nature.[10] Legislation with a similar purpose had, by September 1, 1949, been passed in twenty-seven states and the District of Columbia.[11] Indiana, for instance, authorized Indianapolis to levy a special realty tax to furnish funds

[9] New York Laws c. 845 (1942); New York Laws c. 234 (1943).
[10] Acts and Resolves of Massachusetts c. 654 (1945).
[11] Data from Urban Land Institute, Washington. See also Chapter 8.

for the purchase of blighted urban areas, and empowered the redevelopment authority to resell the land at prices compatible with its earning power when redeveloped.[12] Illinois provided for outright state and municipal grants to support these functions.[13] The federal Housing Act of 1949 supplements state and local funds for redevelopment activity.[14]

Such efforts to induce private investment in central areas are usually accompanied by some extension of governmental control over management. Generally, a requirement is made that the re-use be in keeping with approved redevelopment plans or general city plans. Among the more common controls established are those that regulate the capital structure and restrict rental charges and return on the investment. The regulation may, directly or indirectly, affect the physical character of the development, methods of operation, and selection of tenants.

Influence of Fiscal Policies

Because of the direct bearing of municipal, and often of state, expenditures on the tax load carried by real property, the fiscal policies of these authorities obviously have a very considerable effect upon the returns from realty investment. The fiscal and monetary policies of the federal government, while perhaps less direct, may be more profound in their influence. For example, the need for intervention to save mortgagors from economic catastrophe in the panic of 1837 can be traced closely to the loose credit and monetary practices of the 1830's followed by the suddenly instituted hard money policy of the federal government.[15] Other periods of strain on the mortgage credit system need thorough study to determine the extent of their relationships to the general monetary situation. The present time is a case in point.

The increase in the public debt following fifteen years of depression and war (1930-45) naturally caused the federal government to be much concerned not only with the sale of its bonds but also with the bond interest rate. The heavy dependence placed by

12 Indiana Laws c. 276 (1945).
13 Illinois Senate Bills 39 and 201, Session of 1945.
14 Public Law 171, 81st Congress; Chapter 8.
15 See Ray Allen Billington, *Westward Expansion* (New York, 1949) pp. 364-68.

the Treasury on the banking system for absorption of successive issues (resulting in an increase in the money supply) and the low interest rate policy maintained throughout this period had two effects on real estate investment. One was to contribute to the inflation of capital values, already stimulated by a short supply of residential and commercial structures during and after the war; the other was to create a downward pressure on the mortgage interest rate.

During 1947 and 1948, fear of further inflation caused some modification in Treasury policy, which tended both to reduce the amount of debt held by the banks and to relieve some of the pressure on interest rates. Demands for new industrial loans added to the upward movement of rates. These influences were reflected in some tightening in mortgage credit. Although the new trend was welcomed in some quarters for its presumed counterinflationary effect, it faced opposition in other directions as endangering the expansion of residential construction and as increasing the federal burden of debt financing.

Up to this time, the policy of direct pressure on the mortgage interest rate (through the Federal Housing Administration and the Veterans' Administration) as a means for increasing the housing supply had harmonized with, and benefited from, the general fiscal policy. The modification of fiscal policy thus created a new realm of conflict and gave impetus to proposals to fix mortgage interest rates independently of fluctuations of rates in the financial markets and indeed of the broader governmental attitude on credit expansion. However, by mid-1949 general fiscal policy of the government, as well as housing policy, again favored low interest rates.

It should be noted that the stress on the maintenance of low interest rates on mortgage loans threatens to remove one means of effecting market readjustments. If rates are kept at low levels during an inflationary period, further reductions to provide a stimulus in any subsequent period of deflation become difficult or impossible except in combination with a government subsidy. A settled policy of low mortgage interest rates would thus point to an expansion of governmental controls to compensate for the weakening of automatic market adjustments.

Public Works

Public works affect real estate investment by their cost, location, and timing. The majority of community projects are financed either from special assessments or from general property tax funds; in either case the cost is carried by the owners of real estate. A community which, in spite of high tax charges, carries out well-devised programs of public improvement is likely, within limits, to have an investment advantage over a community where a low tax rate is combined with inadequate services. However, the possibility of excessive burdens from such expenditures is one of the hazards of realty investment.

The building of a bridge, tunnel, or rapid transit extension may open a dormant urban area to investment. Such improvements may also drain value from older areas. In Chicago, for instance, the subdivision boom of the 1920's resulted mainly from a series of actual or projected transit extensions. Streets, schools, and parks all play a vital part in determining the point and profitability of investment. The power of public works to contribute to, or detract from, the investment potentials of an area is thus exceedingly great.[16]

Real estate investment is also affected by the timing of public works in so far as the coincidence of high public and private activity aggravates a construction boom. Traditional methods of financing and public demand both for necessary extensions of community services, such as water and sewer facilities, and for additional improvements in times of prosperity and high building activity tend to concentrate locally financed public works in periods of prosperity. Public construction under such circumstances becomes directly competitive with private investment for short supplies of labor and materials and so contributes to higher costs and nonmaintainable levels of property values. On the other hand, state and local public works, which ordinarily constitute the bulk of the total, tend to be sharply reduced during the early stages of a contraction. Thus, customary public works policies not only tend to increase costs during expansions but also tend to add to defla-

[16] See Herbert D. Simpson, "The Influence of Public Improvements on Real Estate Values," *Annals of the American Academy of Political and Social Science,* Vol. 148, March 1930, for a review of a case in which the supposed benefits to specific property owners from a public works program were badly miscalculated.

tionary pressures during contractions.[17] Actually, therefore, they must be looked upon as important contributors to the instability of realty values and to the hazards of real estate investment.

Security Legislation

A new type of impact on real estate investment is developing from a wide range of state and federal social security measures, such as old age and health benefits, unemployment insurance, minimum wage laws, parity prices, subsidies for production or nonproduction, crop insurance, and so forth. This source of impact on realty investment is too complex for analysis in this study, yet it warrants brief consideration.

All of these measures affect the level and continuity of private income. Those affecting agriculture directly influence farm income and hence will tend to be reflected in farm real estate prices, while security benefits for urban workers may help to determine the rents and prices that may be afforded for urban houses, modifying in some degree the trend of investment. To the extent that such benefits are constant, or increasing in value, they may tend to give an element of stability to real estate finance and to improve the opportunity for investment. To the extent, however, that the payments are of limited or of limitable duration, the results may be to the contrary.

Governmental Research Activities

The technical and economic research carried on by governmental agencies has had, and promises increasingly to have, profound influences on realty investment. Early in the thirties, following the leadership of Cleveland, the first "real property inventories" appeared. Prior to that time, land-use maps had been prepared in a number of places, but the inventories disclosed, for the first time, organized facts regarding the type, size, condition, age, and rental of urban dwellings. Financed with relief funds and carried out under the direction first of the Department of Commerce and later of the Works Progress Administration, these surveys were conducted in a large number of cities. Some of the inventories were

[17] For a discussion of the difficulties involved in expanding public works during depression periods, see Miles L. Colean, *Stabilizing the Construction Industry* (National Planning Association, Washington, 1945).

supplemented by the "Financial Survey of Urban Housing" (also financed as a relief project) which provided information not hitherto available on values, rents, debt and debt delinquency, type of tenure, and similar data for sixty-one cities or metropolitan areas.

The Home Loan Bank Board and the FHA undertook a considerable amount of research useful to investors and mortgage lenders. All this led up to the general Housing Census of 1940, in which comprehensive data on the nation's housing supply were brought together. Related to these data are the building permit figures of the Bureau of Labor Statistics (Department of Labor), the construction estimates of the Construction Division (Office of Domestic Commerce, Department of Commerce), the population and business data of the Bureau of the Census (Department of Commerce), and other material collected by a number of federal agencies. There remain, however, many serious gaps in the economic data needed by realty investors to formulate sound judgments.[18]

In 1935, the Division of Economics and Statistics of the FHA listed the following series as essential in the field of housing: rents, occupancy and vacancy, building operating expenses, real estate values, real estate transfers, subdividing activity, new construction, construction costs, mortgage recordings, foreclosures, real estate taxes and delinquencies and population data (growth, shifts, marriages, etc.). At that time, current information on only a few of these subjects was available and most of that was inadequate. Yet the inadequacies of the data on housing were as nothing compared to those on other types of real estate. During World War II, the Census, by the use of sampling techniques, contributed greatly to current knowledge, particularly of congested centers. But the effort was scattered and sporadic and no means have been provided for its continuance. Fourteen years after the FHA report referred to above, the situation was much the same. The Housing Act of 1948, passed during the special session of the Eightieth Congress, authorized the Housing and Home Finance Agency to conduct technical research to promote standardized building codes and standardized dimensions for building materials. In the Housing Act of 1949, this authorization to the Housing and Home Finance

18 Many of the existing series are subject to grave shortcomings. See *Report of the Conference on Housing Statistics,* Housing and Home Finance Agency, January-March 1947.

Agency was extended to permit a broad range of technical and economic research in the field of housing.[19]

In the past, construction (much the same sort of small local business as agriculture) has received little from the government for technological research compared with the scientific and developmental work done for agriculture. During the twenties the Department of Commerce made a beginning in this field. Programs were instituted for simplifying the variety of manufactured products and processes, for model building codes, planning laws, zoning ordinances, mechanic's lien laws, and for making tests necessary to substantiate code requirements.

Modest as this endeavor was, and fruitful as it promised to be, nearly all the activities mentioned were drastically curtailed in 1933, just at the time when the government was assuming a major part of the risk and direction of farm and residential mortgage activity. Since that time, in spite of meager appropriations, the Forest Products Laboratory of the Department of Agriculture has done notable original research beneficial to construction, particularly in the development and use of plywood,[20] while the National Bureau of Standards of the Department of Commerce has carried on simplification and construction standards programs and a much limited testing program.

War and postwar pressures disclosed the desirability of a more advanced technology of construction, particularly housing construction. Emergency funds were allocated to the War Production Board and the National Housing Agency for specific research projects. After the end of hostilities the technical research functions of the War Production Board were transferred to an Office of Technical Services in the Department of Commerce, where, during 1945 and 1946, a relatively small allocation was made for research in construction methods.

This chapter has tried to suggest, without attempting to be inclusive, the ramifications of indirect governmental influences on realty finance. It is clear that the impacts are numerous and that their effects are substantial; certainly remoteness is no criterion of their consequence. For example, there are many influences on real

19 See Chapter 8.

20 The main impetus to prefabricated house construction in the prewar period came from this activity.

estate finance resulting from the numerous impacts of government upon the construction industry through such matters as local licensing laws for contractors, engineers, architects, and artisans (which in some cases serve to enforce local restrictive practices and hence to raise costs), the federal antitrust laws (which are designed to maintain competition and hence to keep costs down), the relatively weak state antimonopoly legislation (which fails to prevent local restraints beyond federal reach), and the broad immunity of labor organizations from federal antitrust action. While it is clear that these conditions are significant elements of the essentially political environment in which real estate financing operations are carried on, their ramifications are too complex to be described satisfactorily in a study of this scope.