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# The Ontario Land Speculation Tax: An Analysis of an Unearned Increment Land Tax<sup>†</sup>

Lawrence B. Smith\*

The imposition of a special tax on unearned increments in land values has long been advocated by economists as an equitable means of recapturing socially created land values, of curbing speculation in real property and of encouraging development.<sup>1</sup> However, many of the theoretical advantages of such a tax are often lost when it is translated from a concept into specific legislation. The purpose of this paper is to analyze the economic implications of a specific tax on unearned increments, the Ontario Land Speculation Tax,<sup>2</sup> a tax designed to "reduce the escalation of land and housing prices" by discouraging speculation, and to "recover for the public a major share of windfall gains from land speculation."<sup>3</sup>

The paper begins with a summary of the major features of the tax (Section 1). Section 2 discusses the role of speculation in real estate markets and the general effects of the tax on this speculation. Section 3 analyzes the effects of the tax on various classes of real estate, and Section 4 considers the implications of the tax for the degree of concentra-

tion in the construction industry and in the ownership of residential investment property. Section 5 summarizes the major findings of the analysis and considers their policy implications.

## 1. MAJOR FEATURES OF THE LAND SPECULATION TAX ACT

The Land Speculation Tax is a provincial tax imposed on April 9, 1974, to tax gains realized after that date on the disposition of real property, including buildings and fixtures, situated in On-

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<sup>1</sup> See, for example, statements by Harriss [1972, pp. 567-72], Netzer [1966, pp. 212-13], and Walker [1971, pp. 3-16].

<sup>2</sup> Province of Ontario [1975]. An Act to impose a tax on Land in respect of certain speculative Transactions affecting the Control or Ownership of Land.

<sup>3</sup> Province of Ontario [1974, p. 6].

tario. The tax was originally to be at the rate of 50 percent, but since the tax was not allowed by the federal government as a deduction in the calculation of federal income or capital gains taxes, the tax rate was reduced to 20 percent on December 11, 1974. Nevertheless, the combined provincial and federal rate of tax on gains realized in real estate transactions is still prohibitively high, since most short-term gains in real property are treated as income and the combined rate of tax is in the range of 81 percent when the transaction is treated as income and over 50 percent when the transaction is treated as capital gain. The tax applies on all realized gains from nonresource properties except when the disposed property:

- (a) is a principal residence or vacation property,
- (b) is a developed industrial or commercial property,
- (c) is disposed to a government body or agency or Canadian charity,
- (d) has been substantially improved by the transferor after April 9, 1974, by building a new structure or renovating an existing structure,<sup>4</sup>
- (e) is a residential investment property owned by the transferor for at least 10 years and containing a structure worth at least 40 percent of the total value,<sup>5</sup>
- (f) is a farm property owned by the transferor for at least 10 years,<sup>6</sup>
- (g) is included in a registered plan of subdivision and has at the expense of the transferor been wholly or partially serviced to the extent that construction of a building can be commenced.

A disposition is deemed to arise from any transfer of real property whether by

sale or assignment of the property or an option pertaining to the property, by lease of the property for more than 50 years (including renewal options), by sale or transfer of the controlling shares of a corporation for which real property in Ontario comprises at least half of its assets, or by change in the composition of a partnership, syndicate, etc., if control is exercised by a different person or group of persons.

## 2. THE ROLE OF SPECULATION IN REAL ESTATE MARKETS

### *A Model of Speculation*

Since the primary purpose of the land speculation tax is to restrain the rate of increase of land and housing prices by curtailing speculation, the impact of the tax depends first on the extent to which it will curtail speculation, second on the extent to which reduced speculation will restrain land and housing price increases, and third on the extent to which it will affect land and housing prices by altering nonspeculative activities. This section considers the extent to which the Act will reduce speculation and the general implications of reduced speculation. The next section considers the effects of reduced speculation and altered nonspeculative activities on prices and construc-

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<sup>4</sup>The structure must be worth at least 40 percent of the disposition value of the property, and renovations must cost at least 20 percent of the initial value of the property.

<sup>5</sup>A partial exemption of 10 percent of the tax for every full year the property is owned by the transferor is given for residential investment property.

<sup>6</sup>A partial exemption of 10 percent of the tax for every full year the property is owned by the transferor is given for farm property. Intra-family transfers of farm property are also exempt.

tion activity in specific real estate sectors.

In order to analyze the consequences of reduced speculation in real estate markets it is necessary to distinguish between competitive speculation where the speculator "does not consider himself to have any influence on the market price but believes that the price is going to rise or fall quite independent of his own actions," and monopolistic speculation where a speculator attempts to buy or control a significant portion of the existing commodity in order to influence the market price.<sup>7</sup>

The implications of speculation in competitive markets such as the capital, foreign exchange and commodity markets are well known.<sup>8</sup> If speculation is stabilizing it dampens fluctuations in the market price and speeds the adjustment of the market price to its equilibrium or true level. It also increases the efficiency of the market and the liquidity of the commodity traded by supplying additional capital to the market. If speculation is destabilizing it accentuates fluctuations in the market price and impedes the adjustment of the price to its true level. However, destabilizing speculation causes speculators to suffer losses and if speculators are persistently wrong these losses will force them out of business. Thus, competitive speculation is usually considered to be stabilizing.<sup>9</sup> In either case, because this speculation is competitive, the price will ultimately go to its "true value" and speculators will have only a temporary effect on the price.

Unfortunately, the usual analysis of competitive speculation cannot be directly applied to real estate markets even if real estate speculation is assumed to be competitive because speculative purchases of real property are often held for long time periods rather than the short

period assumed in traditional analysis, and because stabilizing speculative activity may generate destabilizing expectations for nonspeculators.<sup>10</sup>

In traditional analysis the market is assumed to adjust quickly, speculative activity is assumed to be short lived in the sense that the speculation cycle—the time from the purchasing to selling of a commodity—is short, and speculators are assumed not to alter the form of the commodity in which they speculate. Real estate markets, on the other hand, often adjust slowly, the speculation cycle can be quite lengthy, and speculative activity is often combined with developmental activity in the sense that speculative purchases are made to obtain property cheaply for future development.<sup>11</sup> The slow market adjustment, the absence of short sales and the existence of speculative purchases for development purposes mean that speculative holdings may be positive for a long period of time and thus have a considerably longer than "temporary" influence on the price, and a substantial effect on commodity liquidity.

Normally stabilizing behavior on the part of speculators can trigger destabilizing expectations and behavior for nonspeculators in real estate markets because of the heterogeneous nature of real property and slow market adjustments. These features distort the information

<sup>7</sup> Lerner [1946, p. 69].

<sup>8</sup> See, for example, Baumol [1957, pp. 263–71], Grubel [1966], Houthakker [1957, pp. 143–51], Meade [1950, pp. 159–67], and Stein [1962].

<sup>9</sup> For empirical evidence see Stein [1962].

<sup>10</sup> In addition, even within classes, real property is not homogeneous, and there are no short sales. For a discussion of speculation in real estate markets see Carr and Smith [1975].

<sup>11</sup> Since property could be purchased just before it is to be used, the acquisition of advance holdings should be considered as speculative purchases.

process and generate uncertainty as to equilibrium market prices. Consequently, the observation of speculative purchases or of a rising price brought about by these purchases is occasionally taken as an indication of a below equilibrium market price. Final users may thus be induced to move future purchases forward, creating a temporary excess demand and causing the price to rise above the equilibrium level. The market price will eventually return to its equilibrium level because the long-run stock demand is unaffected by a temporary shifting forward of flow demand. Although the destabilizing purchases have a speculative element, they should not be considered speculative since they are purely user purchases and are not for future resale. Thus, stabilizing speculation can trigger destabilizing behavior on the part of final users.

In addition to competitive speculation, monopolistic speculation is possible in real estate markets. This possibility is considerable in some sectors of the market because of the heterogeneity of real property and relatively small supply of some classes of real estate,<sup>12</sup> and can take the form of both short-term holdings or long-term holdings for future development. The effect of monopolistic speculation is a reduction in the supply of the commodity available to the public and a price above the long-run competitive equilibrium.

#### *Effect of the Tax on Speculative Activity*

Since both the existing and proposed tax rate on the disposition of real property are extremely high when the land speculation tax is combined with the income tax or capital gains tax, the tax

will eliminate most activities that would attract the speculation tax. A good example of the significant reduction in taxable activities arising from a tax of this sort is provided by the British Betterment Levy 1967–1970, which imposed a 40 percent tax on the increase in land value attributable to changes in value arising from public improvements or planning permission and which was deductible for income and capital gains tax purposes, since this tax sharply reduced the supply of land on the market and caused delays and postponements in land use changes and development activity.<sup>13</sup>

Although the tax was meant to eliminate all speculation it is clear from the discussion of the types of speculation and the exemptions in the Act that only some forms of speculative activity will be eliminated, and these will not necessarily be those activities with undesirable effects. The tax will also affect some nonspeculative activities. The tax clearly falls most heavily on short-term competitive speculators and investors in residential properties and exempts long-term speculators, whether competitive or monopolistic, who acquire real estate for future development, provided they eventually undertake their improvements. Moreover, the tax is more likely to curtail the activities of the small speculator who has insufficient resources to engage in long-term holdings and development than those of the large speculator who combines speculation with development activity. Since the small short-term speculator is likely to be engaged in competitive speculation while the large speculator-developer may be en-

<sup>12</sup> Examples are underdeveloped serviced land and land with special zoning attributes.

<sup>13</sup> Denman [1971, p. 39], Harriss [1972, p. 571], and Saldji [1970, pp. 20–21].

gaged in monopolistic speculation,<sup>14</sup> the tax discourages a beneficial form of speculation and encourages an undesirable form. The tax will thus reduce liquidity in many real estate markets, increase market fluctuations and contribute to the increased concentration of holdings by large-scale speculators and developers.

The foregoing analysis indicates that the land speculation tax will in general have undesirable effects on real estate markets and prices in the long run, but that it could have a beneficial one-time effect in the short run if it were imposed during a time of destabilizing speculation or destabilizing user expectations. The beneficial effect is a one-shot affair because it occurs upon imposition and because the removal of the tax in order to reimpose it at a later date will create expectations of subsequent removals that will eliminate its short-run effectiveness.

Although empirical evidence of the effects of the tax is difficult to obtain, an indication of the impact effect can be seen in Tables 1 and 2. Table 1 indicates an extremely rapid increase in the price of residential properties and a very high ratio of multiple listing service (mls) sales to listings in Toronto immediately preceding the imposition of the tax. After the tax was imposed the price of residential properties declined slightly, and the mls sales to listings ratio fell sharply as a result of depressed sales and increased listings. This pattern is consistent with destabilizing expectations prior to the introduction of the tax, and the reversal of these expectations after the tax. It is also consistent with reduced speculative purchases and increased attempts to sell speculative holdings immediately after the imposition of the tax. However, after the tax had been in effect for about 6 months the price of

residential properties began to rise again and sales activity recovered, so that one year after the tax was introduced the price of residential properties in Toronto exceeded the previous peak price.<sup>15</sup> The upturn in sales activity, in the mls sales to listings ratio and in the price is consistent with both the hypothesis that the tax caused a temporary reduction in the price of houses and the hypothesis that it caused a once-and-for-all reduction in the price but left the upward trend unaffected.

Table 2 indicates the effects of the tax on housing prices in Ontario by comparing housing prices in Ontario with the rest of Canada on the assumption that monetary and other non-tax factors were similar across Canada.<sup>16</sup> The table indicates that housing prices in Ontario rose less quickly than in the rest of Canada immediately following the imposition of the tax, but this difference (2.1 percent vs. 0.8 percent) is neither large absolutely nor statistically significant at the 5 percent confidence level. Between August 1, 1974, and December 1, 1974, housing prices in Ontario fell slightly more quickly than in the rest of Canada, and between December 1, 1974, and April 1, 1975, housing prices in Ontario rose slightly less quickly than in the rest of Canada. Although the differences in each individual time period are not significant (except in the last period when Alberta and Saskatchewan are included),

<sup>14</sup> By definition the small speculator cannot be engaged in monopolistic speculation, although he may benefit from it.

<sup>15</sup> Multiple listing sales are recorded within a few days of the entering into of an unconditional agreement of purchase and sale.

<sup>16</sup> Alberta and Saskatchewan are excluded in much of the analysis because their oil and gas resources caused their economies to behave differently from the rest of Canada.

TABLE 1  
 MULTIPLE LISTING SERVICE SALES, LISTINGS AND AVERAGE  
 SELLING PRICE OF RESIDENTIAL PROPERTIES IN TORONTO

Month/Year	MLS Listings	MLS Sales	Average MLS Sale Price	MLS Sales-to-Listings Ratio
1973 Jan.	1,815	883	\$33,445	.49
Feb.	1,819	1,018	34,782	.56
March	2,233	1,227	35,582	.55
April	2,005	1,152	36,915	.57
May	3,002	1,391	38,783	.46
June	3,275	1,505	40,973	.46
July	3,258	1,278	42,290	.39
Aug.	3,833	1,470	42,389	.38
Sept.	3,977	1,533	43,056	.39
Oct.	4,150	1,861	43,527	.45
Nov.	3,634	1,809	44,022	.50
Dec.	2,056	1,228	44,261	.60
1974 Jan.	2,748	1,658	45,187	.60
Feb.	2,591	1,915	47,148	.74
March	3,004	2,206	50,435	.74
April*	3,512	1,435	54,391	.41
May	7,258	1,287	57,461	.18
June	6,523	1,222	56,169	.19
July	6,103	1,082	56,884	.18
Aug.	6,628	1,182	56,020	.18
Sept.	6,838	1,130	54,321	.17
Oct.	7,063	1,523	53,819	.22
Nov.	5,787	1,569	54,052	.27
Dec.	3,169	1,109	55,518	.35
1975 Jan.	5,459	1,233	54,847	.23
Feb.	5,574	1,250	56,562	.22
March	6,809	1,848	58,205	.27
April	7,858	2,115	57,181	.27

Source: Data by the Toronto Real Estate Board.

\*Land Speculation Tax Act introduced April 9, 1974.

the increase in the price of houses in Ontario for the whole year following the tax (1.2 percent) was significantly less at the 5 percent confidence level than the increase in the price in the rest of Canada, including (5.3 percent) or excluding (3.5 percent) Alberta and Saskatchewan.

However, although significant, the actual difference is small, being only 2.3 percent when Alberta and Saskatchewan are excluded. Moreover, the data fail to indicate whether or not this effect is temporary since they cover such a short time period.

TABLE 2  
PERCENTAGE CHANGE IN HOUSING PRICES IN ONTARIO AND THE REST OF CANADA\*

	April 1, 1974– August 1, 1974	April 1, 1974– December 1, 1974	April 1, 1974– April 1, 1975
British Columbia	0.8	3.7	6.1
Alberta-Saskatchewan	4.1	5.6	14.4
Manitoba	—	-4.7	-2.3
Quebec	1.1	-2.5	-0.8
Maritimes	3.1	2.7	6.7
Newfoundland	3.6	6.0	8.4
Average	2.1	1.7	5.3
Average excluding			
Alberta-Saskatchewan	1.7	0.9	3.5
Ontario	0.8	-0.3	1.2

Sources: Royal Trust Company of Montreal survey of housing prices, *Toronto Globe and Mail*, September 27, 1974, p. B14 and *Toronto Globe and Mail*, May 10, 1975, p. B12.

\*Weighted by survey observations.

### 3. IMPLICATIONS OF THE TAX FOR SPECIFIC REAL ESTATE SECTORS

#### *Principal Residences and Principal Vacation Properties*

The implications of the tax for the price of principal residences and principal vacation properties, two prices the tax hoped to restrain, are unlikely to be very great. The impact effect of the tax, shown in Tables 1 and 2, appears to be a slight reduction in the price of these properties, since the tax discouraged short-term nondevelopmental speculative purchases and induced holders of nondevelopmental speculative properties to sell their holdings. The magnitude of the long-run price effect depends upon the amount of pure speculation in these markets, and this is difficult to estimate.

Some indication is given by the changes in the volume of mls sales and listings, shown in Table 1, preceding and following the tax, and relative change in the price of houses in Ontario and non-Ontario cities after the tax, shown in Table 2. The magnitude of these changes suggests that speculative holdings were a relatively small proportion of the total stock and that the long-run reduction in price will be minor. The effect on vacation properties will also be influenced by the fact that exemption from the tax applies only to sales to Canadian residents, which will reduce foreign demand and the equilibrium price, and the fact that a vacation property is virtually the only exempted investment open to small investors, which will increase demand and price.

The elimination of short-term non-development speculation will substantially reduce the liquidity of these prop-

erties.<sup>17</sup> This will be especially true of properties in need of minor repair or renovation since these properties were often purchased by speculator-renovators who performed a dual speculating and renovating function. Evidence of this reduced liquidity is already apparent in the sharply lower mls sales to listings ratio in Table 1 after the introduction of the tax, since this indicates that a much longer time is required to sell a residential property.

### *Residential Investment Properties*

For some peculiar reason the speculation tax treats all residential investment property similarly and does not distinguish between large multi-dwelling rental projects and single-family rental dwellings. However, there are considerable differences between the characteristics of these properties and of their investors; and hence single-family and multiple-family dwellings should be considered separately.

*Single-Family Dwellings.* The speculation tax reduces the demand for investments in single-family dwellings (and other small-unit dwellings) because capital gains in these investments will be taxed more heavily than gains in alternative investments unless they are held for ten years, and because the liquidity of these investments will be reduced as short-term speculation is eliminated. Initially, the price of these dwellings will decline slightly as speculators and some investors try to adjust their portfolios. The price decline will be slight because investment properties are a relatively small component of the total single-family dwelling market, and selling pressure will result in the conversion of dwellings from rental to owner-occupancy use.

These conversions will also cause the rental price to rise as the supply of these dwellings is reduced.<sup>18</sup>

The tax also provides incentives for investors to allow their properties to deteriorate. This happens because the tax is a tax on inflation in that it taxes the increment in price regardless of how it occurs. Investors can avoid this inflation tax by reducing maintenance and capital expenditures and allowing the real value of their property to deteriorate at the same rate as the rate of inflation so that the nominal value remains the same as their initial value. In this way capital appreciation is exchanged for current income and cash flow, and the speculation tax is avoided.<sup>19</sup>

*Multiple-Family Dwellings.* The speculation tax will have a somewhat different effect on the multiple-family dwelling sector because the possibility of conversion from rental to owner-occupancy dwellings via conversion to condominiums is quite limited. Nevertheless, many of the effects will be similar. First, the reduced liquidity and expected after-tax income over the holding period reduces the relative desirability of these investments. Although some condominium conversion is possible, most of the initial adjustment in this market will take the form of a reduction in the price

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<sup>17</sup> It should be noted that liquidity is a positive attribute of an asset, and reduced liquidity reduces the value of an asset.

<sup>18</sup> An increase in the supply of owner-occupancy housing will not cause an equivalent reduction in the demand for rental housing since there are leakages in the filtering process. For a discussion of the operation of market adjustments see Smith [1974b].

<sup>19</sup> This effect could be avoided by indexing the "initial value" of the property to keep up with inflation, i.e., by exempting from the tax annual percentage increments not in excess of increases in an appropriate price index.

of these investments.<sup>20</sup> Second, a reduction in the value of investment properties will reduce the volume of new construction since developers will be less willing to undertake new projects when the market value of these projects falls. This reduction in construction will ultimately mean a smaller supply of rental accommodation and a higher rental price. Third, as in the single-family dwelling sector, incentives are provided to reduce maintenance and capital expenditures and allow the housing stock to deteriorate. However, this effect is likely to be less pronounced than in the single-family sector since larger buildings are less often sold and since shareholders of public realty corporations can obtain a similar result by selling a portion of their shares. Fourth, the tax encourages an increase in the concentration of the ownership of residential investment property by reducing the liquidity of investments, since both the ten-year holding period and liquidity of an individual investment are less important as size increases, and by exempting the sale of noncontrolling shares in real estate companies. The latter point enables controlling shareholders to divest of some and minority shareholders all of their holdings without attracting tax, while a divestiture of real property directly would attract tax. Fifth, some offsetting tendency to increase construction might arise as developers are able to obtain land at a lower price as a result of the elimination of nondevelopment speculators and short-term investors from the land and small unit residential markets. On the other hand, since the tax will lead to increased concentration in the construction and ownership of residential investment properties there will be an increased tendency to translate acquisition gains into monopoly profits.

### *Industrial and Commercial Property and Land Used in Farming*

Since industrial and commercial properties are exempt from the tax and many qualifications are provided for the tax on farmland, the tax will have little effect on these sectors. The exemption for these sectors could cause some portfolio shifting in their favor; however, this is likely to be offset by the negative climate created by the tax for real estate investment in general.

### *Land for Potential Development*

The land speculation tax will reduce the demand for nondevelopment speculative holdings of land for potential development. In the short run this will substantially reduce the cost of this land as these speculative holdings are placed on the market, and in the long run this will reduce the cost of land as aggregate demand is lowered by the amount of the speculators' normal inventory. However, whether this reduction in land cost will be reflected in the price of new development projects is uncertain because the tax encourages concentration in the development industry.

The tax provides few disincentives for speculation on the part of large speculators for future development since they will obtain exemptions via their development and since their size reduces the likelihood the land will have to be sold before development. On the other hand, small speculators for future development have some disincentives since their financial capacity makes it less certain they

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<sup>20</sup> Rents will be relatively constant in the short run because they are determined by the stock demand and supply for rental accommodation. See Smith [1974a, pp. 478-81].

will be able to develop the land as planned, and since they rely more heavily on subsequent sales, which the tax makes less certain if development is of residential investment properties. Consequently, as land for potential development is made available by existing owners a much higher proportion will be purchased by large-scale developers. This will increase the proportion of development land controlled by large-scale developers and increase the possibility of oligopoly behavior. Whether in the long run the pressures from increased market concentration will outweigh the reduced land cost effect or not is uncertain. In the short run the reduced acquisition price of land is likely to increase developer-speculator tax-exempt profits and also lower the supply price to the final user.

#### 4. MISCELLANEOUS EFFECTS

##### *Industrial Structure Effects*

Throughout the preceding analysis reference was made to industrial structure or concentration effects. These effects are summarized here by noting that the tax provides major disincentives for nondevelopmental speculation, but relatively few disincentives for large developer speculation. Since the role of short-run nondevelopment speculators is to provide capital and liquidity to the market and hold property until small developers are ready to develop it, the elimination of these speculators (together with the relatively large disincentives for small developer-speculators) means that a greater proportion of property will go to large-scale developer speculators for future development, and the small developer with limited re-

sources will have a much more difficult problem in obtaining property for development. The development industry will thus become much more concentrated with fewer and larger firms dominating. Moreover, since large developers tend to retain their investment properties more than small developers who need the cash flow generated by sales, the ownership of investment real estate will also tend to become more highly concentrated.

This tendency toward increased concentration of real estate ownership will be further reinforced by the fact that the reduced liquidity of real estate investments affects the small investor more than the large investor, and that investors in public real estate companies can dispose of their shares without attracting tax if corporate control does not change, while the disposition of an equivalent equity position directly held in real estate probably would attract tax.

##### *Revenue Effects*

A secondary purpose of the Act according to the Ontario Budget was to "recover for the public a major share of windfall gains from land speculation."<sup>21</sup> This objective conflicts with the primary objective of eliminating speculation, since the complete elimination of speculation would mean there would be no speculative revenues to be taxed. If, in fact, the tax had two objectives then the optimal rate of tax should be determined by the trade-off between the social benefits of reduced speculative activity and increased government revenues. The present tax rate does not appear to be optimal in this sense since it will eliminate most taxable transactions and is

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<sup>21</sup> Province of Ontario [1974, p. 6].

likely to generate revenues far below the administrative costs and lost transfer tax, income tax and capital gains tax revenue that would otherwise have gone to the province. In this regard it is worth noting that the British Betterment Levy, 1967–1970, generated revenues 90 percent below those estimated, and even in its final year when revenues were highest betterment levy income barely exceeded the cost of foregone tax revenue and the administration of the levy.<sup>22</sup>

#### *Effects on the Form of Business Activity*

The prohibitive level of the tax can be expected to alter the form of business activity to avoid the tax. First, as previously discussed, owners of residential investment properties can be expected to allow their properties to deteriorate and take their return in the form of higher current income rather than realize increased capital values. Second, dispositions of properties will be reduced and real property will instead be used more for collateral or mortgaged to satisfy liquidity needs. Third, long-term leases up to 50 years will be substituted for taxable forms of dispositions. Fourth, uncertainties created by the tax initially will sharply reduce business activity until the uncertainties are removed. Thus, the tax will alter the form of business activity, and thereby increase the costs of transacting business.

#### 5. SUMMARY AND POLICY CONCLUSIONS

The preceding analysis indicates that the Ontario Land Speculation Tax will have quite different effects than those envisioned by its proponents, and that the major difficulties with the tax are primarily long term in nature. In the

short run a land speculation tax could be beneficial, in the sense of removing market excesses, if it were imposed during a period of destabilizing speculation or destabilizing user expectations, since it would be likely to curtail the destabilizing behavior and thereby lower real estate prices. The use of a speculation tax for this purpose, however, is complicated by the fact that there are considerable long-run problems associated with it and that its premature removal would generate expectations of subsequent removals that would reduce its effectiveness if it were to be reimposed in the future.<sup>23</sup> Moreover, the benefits from reducing destabilizing behavior are temporary in the sense that the destabilizing behavior would likely have been curtailed eventually by normal market pressures.

Offsetting the short-run benefits of the tax are considerable long-run costs. First, the Ontario Land Speculation Tax, and probably most taxes of this nature that try to avoid taxing increased values created by developmental activity, will tend to increase concentration in the construction industry and in the ownership of residential investment properties, and thereby encourage an oligopolistic market structure. Second, the tax will reduce the liquidity of real property and thereby reduce the efficiency of the market (i.e., increase the bid-ask price spread). Third, the tax will increase the rental price of residential investment properties since it will substantially reduce the supply of rental accommodation by conversion to owner-occupancy use and will lower the volume of new construction of residential investment

<sup>22</sup> Denman [1971, pp. 37–40].

<sup>23</sup> The threat of such a reimposition, however, might now be sufficient.

property. Fourth, the tax will encourage the deterioration of residential investment properties. Fifth, the tax will reduce the availability of funds for investment in real property. Sixth, the tax will require a considerable bureaucracy for its implementation with no certainty that it will generate sufficient revenues to cover implementation costs. On the other hand, the tax might have some long-run benefits by reducing slightly the price of single-family residences and cost of land for future development,<sup>24</sup> although the increased concentration in the development industry makes it uncertain that this reduction in land cost would reach the final user.

The above analysis indicates that, on balance, the long-run costs of a tax similar to the Ontario tax make it undesirable in all but the most urgent of short-run situations. On the other hand, the analysis also suggests that it would be possible to design a more moderate land speculation tax which would exempt investment, development and value-adding market activities, and for which the long-run costs would be substantially reduced.

<sup>24</sup> The benefits of a lower price may be offset by the reduced liquidity of the residence.

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