
**Economic Implications of the Proposed City of
Toronto Land Transfer Tax**

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Summary

If the City of Toronto introduces a land transfer tax (LTT) that duplicates rates and exemptions currently used in Ontario, revenues of approximately \$290 million a year will be generated, based on recent experience with the Ontario LTT. This amount is 9.3% of the current revenue from City property taxes.

In Toronto in 2006 there were 56,227 property transactions on which the Ontario LTT was paid. Across all transactions, the average LTT was \$5,155 which represented 1.25% of the property value. Almost 80% of the transactions were of properties having a value of \$400,000 or under and on these properties the average LTT was slightly under 1%. Commercial properties with values above \$400,000 face an LTT rate that approaches 1.5% as the transactions value increases; residential properties above \$400,000 are charged at a higher rate that approaches 2% for extremely expensive properties.

Although the Ontario LTT, and presumably the proposed City LTT, is formally an obligation of the property buyer, the operation of the property market will determine who ultimately bears the LTT cost, as sellers adjust their asking prices and buyers decide their reactions to any increases in total cost. A best estimate is that, across the whole City, about $\frac{3}{4}$ of the LTT will be borne by the seller. This share will be lower in those parts of the City that have unique qualities of location or amenity values, such as the central area, and higher in those areas that face greater competition either from elsewhere in the City or from outside the City. A person who sells one City property and buys another will of course pay both the sellers' and the buyers' side of the LTT.

The burden on the selling side may, in some circumstances, come to be reflected entirely in reduced values for undeveloped land. There may also be pressure on the real estate industry to lower its transactions charges in the face of a City LTT, which would shift some of the burden to that industry; and to the extent that the LTT gets incorporated into the capital value of newly purchased commercial properties, it will result in higher

depreciation charges which, other things remaining the same, will lower corporate tax liabilities and so entail a sharing of the City LTT burden by both the federal and the provincial governments.

From the perspective of residents, commercial tenants and other City taxpayers, the burden of the LTT will be offset by benefits that are at least as great as the burden of the LTT. However, these benefits will be distributed somewhat differently than the LTT burden, both across individuals and through time, so those who bear the cost at any one time will not in general be those who also benefit at that time, or at least not benefit to the full extent of the LTT burden.

Offsetting benefits will come in the form of enhanced City services or lower-than-otherwise property taxes, or both. If the LTT revenue were used simply to replace what would otherwise be an increase in property taxes, the LTT burden, in money terms, would be exactly offset by the lower property taxes.

An average property owner (i.e., one paying the average property tax rate of 1% of assessed value and attracting the average LTT cost of 1.25% of transactions value) will find that the present value of reduced property taxes will just equal the present value of the LTT cost if their property is sold and another bought after 10 years. A person who doesn't own a property but contemplates buying one will find that 3 years of the property tax savings enabled by LTT revenue will cover the cost of the buyer's side of the LTT.

These results mean that a person owning a City property and paying average property and LTT taxes will be, at the time of sale, a net beneficiary of the LTT if the property is sold and another bought 10 years or more after the LTT is introduced. One who sold and bought less than 10 years into the program will be a net loser, again at the time of sale. However, after such a sale and purchase, benefits continue to accrue in the form of lower-than-otherwise property taxes so that even someone who sold a City property and bought another in the first year of the LTT program would ultimately recover the LTT cost, but, for an average taxpayer, this would now take about 23 years with time discounting.

Large commercial properties will attract a higher-than-average LTT of approximately 1.5%, but they also pay higher-than-average property taxes and so save more through the property tax savings. Complicating the calculation with respect to commercial properties is the rate rebalancing policy of the City by which incremental tax increases for commercial (including multi-unit residential properties) will be only one-third of the residential tax increases.

Taking all of these considerations into account, a large commercial property (or a similarly valued multi-residential property) will do better than the average in terms of recouping LTT costs through lower-than-otherwise property taxes. By contrast, a residential property, even one attracting an LTT of only 1%, will find that the payback period will be longer than average.

The impact of the proposed City LTT on the number of property transactions will be small, partly because the proposed percentage LTT itself is small and partly because, with buyers and sellers sharing the incidence of the tax, both sides of the market are able to absorb the reduced volume. If the number of transactions without a City tax were the 2006 volume of 56,227, that number would be between 56,098 and 56,171 with the City LTT, a negligible reduction. Applied to transactions value, the Provincial LTT revenue in Toronto of \$289,825,308 for 2006 would be reduced to between \$289,158,710 and \$289,535,483 with a City LTT, again a negligible reduction.

Although any negative economic effect of the LTT on the volume of property transactions will overall be very small and offset by lower property taxes, the effect on properties for which development or redevelopment is planned will be larger. The reason for this is that the LTT for a completed development is charged on the whole selling value, including buildings. Because the cost of producing the buildings cannot be lowered in order to absorb some of the LTT, the whole of the LTT charge must fall on the undeveloped site value.

The percentage effect of the LTT on undeveloped site value will depend on the expected ratio of the final project value to the original site value, but it could easily reach 10% or more of the site value. If the project is sold more than once before ending up in the hands of the final owner or owners, this effect could be multiplied. The economic impact depends on the particular site, but development could be delayed for some sites. For others, the use could be affected. If a site could be used for either commercial or residential purposes and if, without the LTT, a commercial project was the more valuable, the LTT could swing the calculation in favour of a residential project.

This effect on development activity and development patterns could be avoided by exempting new developments from the City LTT, or it could be mitigated by reducing the LTT charged on new developments. Whether or not this is a policy to be recommended depends in part on the revenue loss associated with the foregone LTT. Recall as well that the proposed LTT rates combined with current and rebalanced property-tax rates favour commercial over residential development and so offset to some extent the problem of new developments described here.

Economic Implications of the Proposed City of Toronto Land Transfer Tax

1. Background

In June 2006 a new *City of Toronto Act, 2006* was enacted by the Ontario Provincial legislature and proclaimed on January 1st 2007. Among other things, this *Act* provides new powers to the City of Toronto to impose taxes in areas and on activities that were previously precluded from City taxation. One of these new taxes is a City real-property transfer tax. This tax, which is currently used by the Province of Ontario, applies, with some exceptions, to the value of real property when title passes from a seller to a buyer. It is commonly called a “land transfer tax” (LTT) although it applies to the selling value of structures as well as land, but not to personal property.¹

An initial review of some of the tax options available under the new legislation, including an LTT, was undertaken by Hemson Consulting Ltd. in a March 2007 report.² This was followed by a discussion paper prepared by the Corporate Finance Division of the City of Toronto, also dated March 2007.³ Both the Hemson report and the City report identified the LTT as one of the least difficult of the potential new taxes to implement. It was referred to in the City report as one of the “reasonable alternatives to incremental property taxes in the medium term.”⁴ In a report to the City’s Executive Committee meeting on June 25th 2007, City staff recommended that Council adopt a new “Land Transfer Tax within the City of Toronto ... for implementation in fiscal 2008.”⁵ The rates recommended for this tax are those currently used by the Province of Ontario. A further recommendation in this report is that staff report back in the fall of 2007 on “appropriate exemptions, rebates, collection and administrative procedures, enforcement provisions, administrative agreement and any other implementation issues” arising from the new-tax recommendations.

¹ See the Ontario *Land Transfer Tax Act* at www.e-laws.gov.on.ca/DBLaws/Statutes/English/90I06_e.htm

² Hemson Consulting Ltd., “Assessment of Potential New Tax Measures Under the *City of Toronto Act, 2006*,” March 2007.

³ Corporate Finance Division, “A Discussion of Public Policy Revenue Tools under the *City of Toronto Act, 2006*,” March 2007.

⁴ The others were a vehicle registration tax and an alcohol tax.

⁵ Executive Committee of the City of Toronto, “Agenda,” meeting number 10, June 25th, 2007.

2. The Ontario LTT Rate Structure and its Revenue Potential if Applied in the City

On June 25th the City’s Executive Committee approved the staff recommendation that the City adopt an LTT at rates equal to the current Provincial rates, including presumably any exemptions that are part of that rate structure. This current rate structure is shown in Table 1. It is a tiered structure with different tax rates applied to successive tranches or slices of the total value.

Table 1
Ontario Tiered Land Transfer Tax Rates

Value Tranches	Tax Rate
up to \$55,000	0.5%
between \$55,000 and \$250,000	1.0%
between \$250,000 and \$400,00	1.5%
over \$400,000, residential	2.0%
over \$400,000, commercial	1.5%

For the portion of transactions values above \$400,000, residential and non-residential or commercial properties are assessed at different rates. For this purpose, residential properties are defined as those that contain one or two single-family residences. There are some exemptions from these standard rates. In 2006, of the 60,168 registered property transfers in the City, about 6 per cent were exempt from the LTT. Most of these exempt transfers were purchases of newly constructed homes by first-time home buyers. If a City LTT were to mirror the current Provincial rate structure, properties of various selling values would be assessed at amounts and percentages of value shown in Table 2.

Table 2
LTT as an Amount and as a Percentage of Property Sales Value:
An Example of a City Land Transfer Tax at Ontario Rates*

		Residential or Commercial Value (\$000's)			Residential Value (\$000's)			Non-residential Value (\$000's)	
		\$200	\$300	\$400	\$600	\$800	\$1,200	\$5,000	\$10,000
City LTT at Provincial Rates	amount	\$1,725	\$2,975	\$4,475	\$8,475	\$12,475	\$20,475	\$73,475	\$148,475
	percentage	0.86%	0.99%	1.12%	1.41%	1.65%	1.71%	1.47%	1.48%

*These numbers are based on the standard Provincial rates and do not take into account various exemptions or rebates.

By way of comparison, the average price of home sales in Toronto last year is generally given as about \$380,000 and the average price of a single detached home was estimated at \$529,000 in 2006 according to Toronto Economic Development, *Economic Indicators*, June 2007.

The revenue generated by the Provincial LTT in the City of Toronto in recent years is shown in Table 3. This is also shown as a percentage of the value of transactions that generated the tax. In 2006, the LTT in Toronto amounted to 1.25% of the total transactions value. For the last two years the annual Provincial LTT revenue has been about 9.3 % of the 2006 City annual revenue from property taxes.⁶ Clearly a City LTT implemented at the current Provincial rates has the potential to be a significant substitute for or addition to the City's property-tax revenue.

Table 3
Provincial LTT Revenue in Total and as a Percentage of Property Values from Property Transfers within the City of Toronto

	Transfer Value of Property				
	\$250,000 and under	from \$250,000 to \$400,000	above \$400,000 residential	above \$400,000 commercial	All Transfers
2004					
# of transactions	25,051	20,127	9,151	1,515	55,844
transactions value	\$3,806,225,276	\$6,171,304,950	\$6,117,821,025	\$4,458,930,917	\$20,554,282,168
LTT paid	\$35,056,746	\$61,604,699	\$90,099,145	\$64,488,604	\$251,249,195
LTT as % of sales	0.92%	1.00%	1.47%	1.45%	1.22%
2005					
# of transactions	24,544	20,845	10,733	1,738	57,860
transactions value	\$3,852,307,037	\$6,573,025,176	\$7,345,474,328	\$5,951,567,870	\$23,722,374,410
LTT paid	\$35,339,731	\$63,994,240	\$109,075,661	\$86,369,021	\$294,778,653
LTT as % of sales	0.92%	0.97%	1.48%	1.45%	1.24%
2006					
# of transactions	21,973	20,544	12,031	1,679	56,227
transactions value	\$3,445,907,446	\$6,395,628,682	\$8,326,500,384	\$4,959,510,489	\$23,127,547,001
LTT paid	\$31,292,452	\$62,745,302	\$124,120,733	\$71,666,821	\$289,825,308
LTT as % of sales	0.91%	0.98%	1.49%	1.45%	1.25%

Source: Teranet

Note: The transactions shown are only those that were not exempt from the LTT and represent 93.5% of all transactions.

In the following sections, the economic implications of introducing a City LTT are discussed, beginning with an explanation of the incidence of such a tax, the possible tax burden on sellers and buyers and the offsetting benefits of lower property taxes, the effect on the volume of sales transactions and the special case of new developments. In this analysis, the existing set of taxes and other transactions costs associated with buying and

⁶ In 2006, total property tax revenue in the City of Toronto (not including education taxes set by the Province) was \$3,131,828,342. Data from the City's Corporate Finance Division.

selling a property are assumed to remain in place. Only the incremental effect of adding a City LTT is relevant.

3. The Incidence of the Proposed Land Transfer Tax

The incidence of the proposed LTT refers to the question of who bears the cost and who shares the benefit of the tax. In other words, it deals with how the burden and the benefit of the tax are distributed. On the surface, a City LTT designed like that of the province to be paid by the buyer of property would seem straightforwardly to be borne by the buyer alone. But the economy is more complex than this and a tax like the LTT that drives a wedge between the price that sellers receive and the price that buyers pay – generally known as an excise tax – may have complex distributional effects. These effects will be the same whether the tax is paid in the first instance by either the buyer or the seller. In recognition of this, some jurisdictions with an LTT require the payment to be made by the seller of property; others, like Ontario, require it to be paid by the buyer.

The most basic distributional issue is the extent to which the burden of the LTT is shared between the buyer and the seller, which is the focus of the next section. But the tax incidence goes beyond this. The burden on the selling side may, in some circumstances, come to be reflected entirely in reduced values for undeveloped land. There may also be pressure on the real estate industry to lower its transactions charges in the face of a City LTT, which would shift some of the burden to that industry; and to the extent that the LTT gets incorporated into the capital value of newly purchased commercial properties, it will result in higher depreciation charges which, other things remaining the same, will lower corporate tax liabilities and so entail a sharing of the City LTT burden by both the federal and the provincial governments.

Beyond this sharing of the burden, the benefit of the LTT must be taken into account. Enhanced City revenues as a result of the LTT could result in either or both of lower property taxes or improved City services. In this way, the benefit of the LTT is distributed across the City to all residents and businesses, including those who have recently bought properties and paid the LTT. Over time, the buyers of property this year

continue to share in the benefits -- in the form of lower property taxes or improved services -- of the LTT paid by buyers in subsequent years and so gradually offset their initial LTT costs. Those who buy later, benefit in the initial years and only later bear the burden of the LTT.

4. LTT Sharing between Buyers and Sellers

The burden of the transfer will fall on both buyer and seller in a proportion that depends upon the price elasticities of demand and of supply in the property market. An elasticity in this sense is just a technical term for a measure of the responsiveness of buyers and sellers to price changes caused by the LTT. Thus if buyers significantly curtail or downgrade their purchases because of the imposition of a City LTT, then this would count as a very responsive or highly elastic reaction to the tax, but if there was little change in buying activity, that would indicate very weak responsiveness or a very low demand elasticity.⁷ These elasticities are hard to estimate, as academics have found, and complicated by the fact that they are interdependent in this case – the seller, especially of residential property, is frequently also a buyer as younger families upgrade their housing and retired families downgrade.

In the likely case that elasticities are greater in the buying than in the selling market (since buyers have alternatives but sellers have just the one property to sell), the larger share of the LTT will be borne by the seller. If you think about elasticities as the responsiveness of the two sides of the market, this makes intuitive sense. If the sellers are very unresponsive to price decreases while buyers run away from purchases if the price rises, then the only way sellers can sell their properties is by lowering the price, which means that they will bear most of the tax burden while the buyers will bear little, which is what keeps them in the market buying properties. Of course if the

⁷ There is sometimes confusion over the algebraic sign of demand elasticities. They obviously should be negative since a higher price normally results in fewer purchases, and in mathematical work have to be treated as negative. But it is usually easier to talk and to write about demand elasticities as if they were positive, so a very responsive demand reaction to a higher price is referred to stemming from a large elasticity whereas algebraically it is very small, i.e., a large negative number. As long as we all know that as price goes up, purchases (usually) go down and vice versa, then communication should not be a problem. (See also the technical note to Table 4.) On the supply side there is no such confusion, since higher prices generally bring forth a greater supply, and vice versa.

responsiveness on each side of the market is reversed, then prices must rise to keep sellers in the market while at the same time the rise in price does little to deter buyers. From this it's straightforward and correct to intuit that if the responsiveness or elasticities are equal on both the selling and buying side, the two sides will bear equally the burden of the tax.

The elasticities or responsiveness also determine the effect on the volume of transactions of any given increase in tax, such as the proposed City LTT. The more responsive both buyers and sellers are to price increases, the greater the reduction in overall sales transactions, and the less responsive the less the reduction in transactions. This is dealt with in greater detail below.

The magnitude or burden of a City LTT will depend of course on the magnitude of the transfer tax itself. As Table 3 above has shown, the overall average current provincial LTT as a percentage of sales value is 1.25%. For properties selling at or below \$400,000, the LTT was a little below 1% of the sales value. For such relatively small percentages, such as the City is proposing, the burden as a percentage of purchase price on each of the buying and selling side will be small no matter what the responsiveness on each side, as will too be any change in the volume of transactions.

Table 4 shows the incidence of a new LTT on buyers and sellers, and the overall effect on the volume of transactions for LTT percentages of 1% and 1.25%, for different elasticities or degrees of responsiveness from strong to weak. As the table shows, the greater burden will fall on the seller if the demand response is strong and the supply response is weak. In this case, a 1% increase in the LTT will decrease the price received by the buyer by 0.89% (shown in column A) and increase the price received by the buyer by 0.11% (shown in column B -- these two effects have to add up to the original LTT increase if we're looking only at the incidence on the buyer and seller since the tax has to be paid somewhere – but see above for a comment on the possible sharing of this burden by the real estate industry and by the federal and provincial governments). On the other

Table 4
Market Response to Increases in the LTT of 1% and 1.25%

given	given 1% increase in LTT			given 1.25% increase in LTT		
market reaction	% decrease in selling price	% increase in buying price	% reduction in number of transactions	% decrease in selling price	% increase in buying price	% reduction in number of transactions
column	A	B	C	D	E	F
STRONG DEMAND RESPONSE						
strong supply response	0.57%	0.43%	0.34%	0.71%	0.54%	0.43%
medium supply response	0.73%	0.27%	0.22%	0.91%	0.34%	0.27%
weak supply response	0.89%	0.11%	0.09%	1.11%	0.14%	0.11%
MEDIUM DEMAND RESPONSE						
strong supply response	0.45%	0.55%	0.27%	0.57%	0.68%	0.34%
medium supply response	0.63%	0.38%	0.19%	0.78%	0.47%	0.23%
weak supply response	0.83%	0.17%	0.08%	1.04%	0.21%	0.10%
WEAK DEMAND RESPONSE						
strong supply response	0.25%	0.75%	0.15%	0.31%	0.94%	0.19%
medium supply response	0.40%	0.60%	0.12%	0.50%	0.75%	0.15%
weak supply response	0.67%	0.33%	0.07%	0.83%	0.42%	0.08%

Notes: Strong, medium and weak demand responses are defined as demand elasticities of -0.8, -0.5 and -0.2 respectively. Strong, medium and weak supply responses are defined as supply elasticities of 0.5, 0.3 and 0.1 respectively. Using the symbols ε_D , ε_S for demand and supply elasticities respectively, with $|\varepsilon_D|$ denoting the absolute value of the demand elasticities (i.e., this changes the negative elasticity to a positive number), and using %LTT to mean the initial percentage increase in the LTT, Δ_S to mean the burden that falls on the sellers (columns A and D above), Δ_D to mean the burden borne by buyers (columns B and E above) and %TV to mean the percentage reduction in transactions volume (columns C and F above), then the formulas for calculating the numbers in the above table are these:

$$\Delta_S = \frac{|\varepsilon_D|}{\varepsilon_S + |\varepsilon_D|} (\%LTT), \quad \Delta_D = \frac{\varepsilon_S}{\varepsilon_S + |\varepsilon_D|} (\%LTT) \quad \text{and} \quad \%TV = \frac{\varepsilon_S |\varepsilon_D|}{\varepsilon_S + |\varepsilon_D|} (\%LTT).$$

The derivation of these formulas is available on my web page: www.chass.utoronto.ca/~nowlan/teaching/note10.doc

hand, if the supply response is strong and demand response weak, the selling price will be driven down by only 0.25% with a 0.75% price increase to the buyer.

In columns D, E and F of Table 4, the results for a 1.25% City LTT are shown. The percentage changes in the buying and selling prices and transactions volumes are a naturally little higher than the respective changes shown in columns A, B and C but the *relative* incidence or burden on the seller and the buyer is the same. That is, with a strong demand response and a weak supply response, the sellers' price would decrease by 89% of the LTT whether that LTT was 1% or 1.25%.

One purpose of Table 4 is to show that even with wide limits on the assumed demand and supply elasticities, the sharing of the burden between buyers and sellers and the effect of the LTT on transactions volumes is relatively narrow. Looking down column A, for example, it is evident that in all cases but three the seller's price will fall by more than the buyer's price will rise, and in two of those three cases the relative prices changes are quite close. Similarly, the percentage effect on transactions volumes shown in columns C and F is one-third or less than the LTT percentage. In most cases it is under 20% of the LTT.

My best estimate is that if the tax is introduced the demand response will be medium and supply response somewhere between medium and weak.⁸ These results are shown in bold in Table 4 and suggest that the sellers will bear a larger share of the City LTT, perhaps within the range from 63% to 83% of the burden. In other words, about $\frac{3}{4}$ of the cost of the LTT will likely be borne by the seller in the form of lower property prices. This burden would be less in highly desirable parts of Toronto where the demand responsiveness is weaker and greater in areas where competition from properties outside Toronto is greater and the demand responsiveness is greater.

These comments have focused on the sharing of the LTT between a seller and a buyer of a particular property. But for a considerable number of transactions, especially in the

⁸ See the note to Table 4 for the corresponding demand and supply elasticities.

residential market, a City seller is also a City buyer, whether because of a move to another part of the City or because of upgrading or downgrading a home. Such individuals will incur both a seller's burden and a buyer's burden.⁹ Those who sell and move outside the City of course bear just the burden on the seller's side, but even those who sell in the City and then rent but don't buy in the City will feel a buyer's side burden as the buyer's incidence works its way through into higher rents.

Save for those who sell and move outside the City, these burdens, whether falling on an individual who is just a buyer or on one who is both a seller and a buyer will be offset by LTT benefits, mainly in the form of lower-than-otherwise property taxes or better-than-otherwise City services. This is discussed below.

One final point: the selling and buying price changes that are discussed here are not changes that will take place through some form of buyer-seller negotiation over each transaction. Some of that may occur, of course, but the market operates more impersonally. With a new LTT, sellers will find that demand may be weakening a bit (which in a rising market may itself be difficult to discern). This leads the sellers to be a little less aggressive in their asking prices, so overall this dynamic leads to a small fall in this asking price. At the same time, buyers may find that sellers are not willing or don't need to absorb all of the LTT, so they will face slightly higher buying prices. The equilibrium between these two forces occurs where the reduction in properties for sale just equals the reduction in properties demanded (which is why the elasticities are the driving force since they determine where this equilibrium will occur). In this way, given all of the other real estate and closing costs, the two sides will come to share the burden of the City LTT almost imperceptibly, even though the buyer continues to have to pay the full amount as part of the closing costs.

⁹ The sum of these burdens will not necessarily equal the whole of the LTT on either of the bought or sold properties, or even the average LTT across the two properties, since seller and buyer demand elasticities may be different if there is a move from one area of the City to another.

5. Offsetting Benefits of a City LTT

From the perspective of residents, commercial tenants and other City taxpayers, the burden of the LTT discussed in the above section will be offset by benefits that are at least as great as the burden of the LTT. However, these benefits will be distributed somewhat differently than the LTT burden, both across individuals and through time, so those who bear the cost at any one time will not in general be those who also benefit at that time, or at least not benefit to the full extent of the LTT burden.

Offsetting benefits will come in the form of enhanced City services or lower-than-otherwise property taxes, or both. If the LTT revenue were used simply to replace what would otherwise be an increase in property taxes, the LTT burden, in money terms, would be exactly offset by the lower property taxes.¹⁰ If some portion of the City LTT revenue is used to improve or introduce new municipal services that would not otherwise have been available, then the magnitude of offsetting benefits will depend on the benefit value attached to the new or improved services, and this will in general be different for each taxpayer. Assuming the City spends wisely such that each dollar of new expenditure is perceived to have, on average, at least a dollar's worth of benefit to taxpayers then lower-than-otherwise property taxes or improved services may be considered to provide on balance equivalent benefits.

6. The Average Effect of Offsetting Benefits

In general the benefit offset, whether from lower property taxes or better City services, will be wide spread in the City and affect all property-tax payers, including the buyers of property subject to the LTT. Each buyer paying the LTT and each resident receiving better services or lower property taxes will of course be affected differently, but broad averages may be looked at in order to see the pattern and the aggregate result.

¹⁰ In fact, the total benefit could exceed the total burden if some of the burden is borne by the federal and provincial governments in the form of lower corporate taxes, or by the real estate industry, or by sellers who then leave the City.

To understand the benefit offset, suppose that the revenue from a City LTT becomes used entirely to offset higher property taxes.¹¹ As we have seen, the proposed LTT would annually provide for the City an amount equal to about 9.3% of the annual City property-tax revenue. Property taxes could be lower-than-otherwise by this amount in the first year of the new LTT and then remain lower in each of the subsequent years because of the continuing revenue from the City LTT.

Continuing with this assumption, a property buyer in the first year of the City LTT would find their property taxes lower than otherwise by 9.3%, as would all other property-tax payers. The benefit initially of the LTT burden would be spread very widely. But in subsequent years, the first-year buyer would continue to enjoy lower property taxes while other buyers (and sellers) contributed the LTT revenues that supported these lower property taxes.

Consider an average person or business who sells one property in the City and buys another. This person would bear the whole burden of the new LTT, which, as shown in Table 3, was 1.25% of the transaction value in 2006. Across all property classes, annual property-tax revenue represents about 1% of the total assessed value of City properties, so a reduction 9.3% in the property tax would equal about 0.093% of the total assessment base. Leaving discounting of future burdens and benefits aside for the moment, and assuming the assessed property values and the actual transactions values are roughly the same, then the LTT burden of 1.25% will be equivalent to about 13 years of average City property taxes.¹²

¹¹ This clearly includes the possibility that City services are improved but that such improvements would occur with or without the LTT revenue.

¹² This payback period may be independently checked in the following way. There were 666,678 assessed City properties at the end of 2006 and, from Table 3, 56,227 sales transactions in that year that paid the LTT (this number includes new properties along with the turnover of existing properties). If this number of transactions occurred in each subsequent year then in about 12 years 666,678 properties would have been transferred and would have paid an LTT. If these properties all paid an average LTT, then the property tax savings for the original 56,227 transferred properties would, after 12 years, just equal the LTT they paid in 2006. The difference between the 13 years calculated in the text and the 12 years here is likely attributable to the possible difference between the assessment and the transactions values for properties. Assessment and property tax data are from the City's Corporate Finance Division.

A person who is a buyer only – someone coming from outside the City or someone moving from rental to ownership accommodation¹³ – will pay only a portion of the LTT. This portion was estimated in section 4 above to be about 25% (with the seller bearing the remaining 75%) of the LTT or about 0.3% of the average transactions cost.¹⁴ In this case, the reduction in the property tax of 9.3% for between 3 or 4 years will offset the buyer's portion of the LTT.

7. Offsetting Benefits with Time Discounting

In these examples, whether the benefit of the lower property tax (or enhanced City services) occurs before or after the burden of the LTT depends on when a property is bought and sold, but this does not affect the net result since the value of future benefits and costs has not been discounted. If a discount rate is introduced, as it should be, the benefits and the burden of an LTT need to be reduced to present values to make an appropriate comparison between them.

If a discount rate of 5% a year is used, then an average property owner (i.e., one paying the average property tax rate and attracting the average LTT cost) will find that the present value of reduced property taxes will just equal the present value of the LTT cost if their property is sold and another bought after 10 years. A person who doesn't own a property but contemplates buying one will find that 3 years of the property tax savings enabled by LTT revenue will cover the cost of the buyer's side of the LTT.

These results mean that a person owning a City property and paying average property and LTT taxes will be, at the time of sale, a net beneficiary of the LTT if the property is sold and another bought 10 years or more after the LTT is introduced. One who sold and bought less than 10 years into the program will be a net loser, again at the time of sale. However, after such a sale and purchase, benefits continue to accrue in the form of lower-than-otherwise property taxes so that even someone who sold a City property and bought

¹³ In this case, the owner of the rental unit will bear the seller's burden.

¹⁴ This is 25% of the 1.25% average LTT yield in 2006.

another in the first year of the LTT program would ultimately recover the LTT cost, but, for an average taxpayer, this would now take about 23 years with time discounting.

8. Offsetting Benefits for Lower Priced Residential and for Commercial Properties

The discussion in the previous two sections has been based on average property and LTT tax rates of 1% and 1.25% respectively. But those who buy, or sell and buy property having transaction values below \$400,000¹⁵ will pay 1% or less of that value in City LTT charges, while more valuable residential properties will be charged an amount that gradually approaches 2% as the selling price increases. This will have the effect of decreasing the beneficial property-tax payback period for less expensive residences and increasing it for more expensive properties.

Large commercial properties will attract an LTT of approximately 1.5% but whether this will lengthen or not the payback period beyond the average depends on another factor, namely the property tax rate.

For residential properties, the current property tax rate is a little under 0.6% of assessed value, well below the average rate of 1%, while for commercial properties (including multi-residential properties), the current tax rate is 2.1%, about 3.6-times the residential rate. For residential properties, this means that the benefit of a 9.3% reduction in property taxes (see section 5 above) will be less than average but for a commercial property it will be more than average. Since the difference in LTT rates between lower priced residential properties and higher priced commercial properties is less than the 3.6 differential between residential and commercial property-tax rates, the benefit payback period will be shorter than average for the commercial properties and longer than average for the residential properties, if property tax rates were to retain their current relationship across property classes.

¹⁵ As Table 3 shows, of the total LTT transactions in 2006, 76% were of properties valued at \$400,000 and below.

The City has, however, adopted a policy of rebalancing commercial and residential property tax rates,¹⁶ so the current rate structure will presumably change. The result of the rebalancing policy is that commercial tax rates will increase by only about one-third of the increase assigned to residential properties. This, paradoxically, has the effect of decreasing the value and increasing the required payback period of the property-tax savings to commercial properties while increasing the value and decreasing the payback period to residential properties.

Taking all of these considerations into account, it turns out that the large commercial property (or a similarly valued multi-residential property) with an LTT rate of close to 1.5%, a property-tax rate of 3.6-times the residential rate and incremental tax increases at one-third the residential increases will in fact do better than the average in terms of recouping LTT costs through lower-than-otherwise property taxes. In other words, the payback advantage that existed without considering the rate rebalancing policy of Council will continue to favour commercial properties, although not to the same extent as would have occurred without rebalancing.

The average time-discounted payback period of 10 years (see section 6 above) will be more like 6 or 7 years for large commercial properties. By contrast, a residential property attracting a 1% LTT will find that the payback period will be longer than average, lengthening perhaps to as much as 15 or 16 years. Taking into account the higher LTT and the effect of rate rebalancing, the payback period for more expensive residential properties will be even longer. For less expensive commercial properties that attract a lower LTT, the payback period will be shorter than that for more valuable commercial properties.

9. Effect on the Volume of Transactions

Turning now to the real effects of the proposed LTT on economic activity in the City, the impact on the volume of sales transactions should first be considered. This impact will in

¹⁶ See Policy and Finance Committee and Economic Development and Parks Committee, "Joint Report 2," which was approved by City Council in October 2005.

fact be small, partly because the proposed percentage LTT itself is small and partly because, with buyers and sellers sharing the incidence of the tax, both sides of the market are able to absorb the reduced volume so the reduction is less than it would be if only the buying or the selling side were bearing the burden. Looking down columns C or F in Table 4, we can see that at most the percentage reduction in the volume of transactions will be one-third of the LTT percentage and usually much less. Under the most likely scenario, with a medium demand response and a medium to weak supply response, shown in bold in the table, the percentage reduction in transactions volume will be between 8% and 19% of the LTT. Thus if the City LTT is 1.25%, last year's Provincial average in Toronto, the reduction in transactions volume would be between 0.23% and 0.10% of what it otherwise would be. For example, if the transactions volume without a City LTT were 56,227 property transfers, the number shown in Table 3 for 2006, a new City LTT at Provincial rates would lower the number of property transfers to between 56,098 and 56,171, a negligible reduction.

In fact, the reduction in the number of properties bought and sold would undoubtedly be less the above numbers show. This is because some of the reduction in buyers' demand will take the form not of lost transactions but of transactions downgraded from higher priced properties to lower priced ones. In this case the number of transactions would not change, but the overall value of the transactions would fall. This means that the transfer reductions shown in columns C and E in Table 4 might better be applied to the transactions values and the LTT paid shown in Table 3. Using this approach, the LTT revenue of \$289,825,308 shown in that table for 2006 would be reduced to between \$289,158,710 and \$289,535,483 with a City LTT that averaged 1.25%, again a negligible reduction.¹⁷

¹⁷ In the Toronto Real Estate Board's submission to the City regarding the proposed City LTT the Board refers to a study by Clayton Research Associates in which each resale housing transaction in Ontario was estimated to generate \$27,000 in "spin-off spending." By reducing sales, the Board suggests that the proposed LTT would reduce such spin-off spending and could "hurt Toronto's economy." However, if we believe the Clayton figures, exactly the opposite would occur. LTT costs are included in the \$27,000 so an addition of a City LTT to the Provincial LTT would raise this figure by 10% or so, to over \$30,000. Since the reduction in transactions would be only a fraction of 1%, the spin-off spending referred to by the Real Estate Board would increase, not decrease, and so, by their reasoning, enhance Toronto's economy. However, the argument itself is wrong. Any increase in spin-off spending would simply be at the expense of spending by property buyers and sellers – in essence, real estate lawyers and brokers would have more to

While the results given above are for the average proposed tax rates and based on total transactions volumes and LTT collected across the whole City, these results will vary depending on the type and location of the properties that are transferred. For areas of the City with desirable attributes and few equally desirable competitive locations, the demand response will be weak (a low elasticity) with the transactions volume and the LTT revenue from these areas therefore little affected, but in areas more in competition with other locations, including competitive areas in jurisdictions outside the City, the transactions volumes and the LTT revenue will be more affected. Among those properties where results may depart noticeably from the average, the case of those about to be developed or redeveloped is of particular interest and will be discussed below.

10. Effect of the LTT on New Development or Redevelopment

An excise tax such as the LTT introduces some economic inefficiencies in the process of buying and selling properties because it drives a wedge between what buyers pay for a property and the price that sellers receive. At an average LTT rate of 1.25%, this inefficiency is very small and may be measured in part by the reduction in the volume of transactions which, as shown in the preceding section, will be negligible. Aside from having a small economic impact in the property market, what is often forgotten by those criticizing a City LTT on grounds of economic inefficiency is that the tax it will replace, the property tax, is similarly inefficient. Since the property tax applies to structures and improvements as well as to land, it too divides the value to builders or property owners of such improvements from their economic cost. The amount of building or improvement activity that takes place is thus inefficiently reduced, again by only a small amount.¹⁸

Although any negative economic effect of the LTT on the volume of property transactions will overall be very small and offset by lower property taxes, there is a class

spend (since more than half of the \$27,000 constitutes payments to professionals) and people buying or selling houses would have less. Similarly, if the transactions costs went down, others besides the real estate industry would have more to spend. This will alter the type of spending but not in ways that would have any obvious effect on the Toronto economy.

See The Toronto Real Estate Board, "A Toronto Land Transfer Tax: Unfair, Unprecedented, Unjustified," June 2007. The quotations are from p. 2.

¹⁸ It's hard to find a tax of any kind that does not entail such inefficiencies.

of properties for which the economic effect will be larger. These are properties for which development or redevelopment is planned.

To understand this, consider a developer contemplating a new building or redevelopment on some site. In thinking about whether to go ahead with the project, or whether to purchase the site if that has not already occurred, the City LTT on the completed project will have to be taken into account. If the largest share of this falls on the seller, i.e., the developer, as it usually will, then it could have a significant effect on the value to the developer of the land to be developed. The reason for this is that, although the LTT is charged on the whole property value, i.e., buildings as well as land, the building or construction portion cannot be adjusted to absorb any of this cost. Construction costs, including financing costs, are given to the developer because they are determined, in an open economy like Toronto's, in the wider market. Thus the whole of the seller's share of the LTT must fall on the value of land, the so-called residual value.

The exact effect on values for developable properties will vary and depend on the individual situation, but certainly a reduction in land values of 10 per cent or more is not unlikely, especially for high-density buildings. Unless the cost of assembling land rises exactly in proportion to the expected density, the greater the anticipated density the greater the effect on land values and therefore on the willingness to pay for developable land. To give a concrete example, if a 20-times coverage commercial building is envisaged with an expected selling price of \$4,000/square metre and with 10% of this price counted as residual profit to be put towards the price of land, and if the LTT is 1.48%¹⁹ with the seller's share being 75% (see section 4 above), then the residual value will be reduced by about 11% as a result of the LTT. A 3-times coverage condominium development with similar selling prices and profit margins would see the residual or land value reduced by perhaps 8%. Basically, the effect of the proposed LTT on the anticipated residual value, which will determine the value of the land to a developer, will vary according to the ratio of the total project market value to the original land or site value. A project to site value of 10:1 will result in an 11% reduction in the residual

¹⁹ This is the proposed City LTT rate on a \$10,000,000 commercial sale. See Table 2.

value, given an LTT of 1.48% and a seller's share of 75%, provided the project is sold only once.

Since land is immobile, a residual capitalization effect of 11% or more may not seem to be a problem, but it could affect both the type of development and the pace at which new development occurs. The most direct effect will be to delay some developments, to keep the affected property in its original use for longer than anticipated. This could be the case with respect to sites that are already earning an income and for which a decision to redevelop is marginal. These are the so-called "hard" development sites for which small changes in residual value can affect development decisions.

Development contemplated for "soft" sites, with low or no current earnings, will not be so affected by a reduction in the residual land value, although whoever owns the land will bear the burden of the drop in value. However, even with respect to soft sites, the capitalization of a new LTT into lower land values could affect the type of development. For example, given a City LTT, the reduction in land or residual value for a contemplated residential building is likely to be less than the reduction that would be associated with a commercial building, because the commercial density is likely to be greater and so the LTT relative to the land value will likely be higher for a commercial development. If a developer was undecided between a residential and a commercial development on some given site, this could tip the balance in favour of the residential project.

If a new building is likely to change hands more than once before being bought by its ultimate owner, or owners in the case of a condominium development, then this effect on the residual will be repeated with each sale. The effect on the residual land value could thus double or more, depending on the number of ownership changes, thereby introducing even stronger biases towards holding the land back from development or switching from one type of contemplated development with strong residual-value effects to another with weaker effects.

This effect on development activity and development patterns could be avoided by exempting new developments from the City LTT, or it could be mitigated by reducing the LTT charged on new developments. A full or partial exemption from the new LTT for commercial buildings only would of course encourage commercial development over residential development for sites on which either could be contemplated and would be consistent with a policy of encouraging commercial development.

Any exemption from the City LTT for new developments could be in the form of a City rebate if it was efficient to continue to collect the full tax in conjunction with the Provincial tax. Newly constructed buildings would have to be defined, with a definition perhaps related to building permits issued or, in the case of residential buildings, to development charges.

Whether or not this is a policy to be recommended depends in part on the revenue loss associated with the foregone LTT. Recall as well that the proposed LTT rates combined with current and rebalanced property-tax rates favour commercial over residential development and so offset to some extent the problem of new developments described here.

11. Conclusions

The proposed City LTT will generate revenue equivalent to 9.3% of current property-tax revenue and so constitute a significant new revenue source. Its effect on the volume and the value of real estate transactions in the City will be negligibly small.

Although the burden of this tax will fall initially on property buyers and sellers, with sellers bearing the larger share, the benefits will be more widely distributed across the City. The LTT revenue may be used to keep City property taxes lower than they otherwise would be or to provide City services that would otherwise not be affordable, or both. Thus all City residents and property-tax payers will benefit, year by year, from the LTT.

For a property owner who pays average property taxes and who sells one property and buys another at average LTT rates, approximately 10 years worth of lower taxes will be equivalent to the whole of the LTT burden. For a similar person buying but not selling a property, the lower property taxes will pay for the LTT in about 3 years (without taking into account the exemption for first-time buyers of new residential properties.)

The payback period will be greater than average for residential properties but, interestingly, large commercial properties, while attracting a greater-than-average LTT also save more through the property-tax reduction and so have a benefit payback period that is less than average.

Individuals and individual properties of course vary widely in their circumstances and so too will the individual economic impacts vary widely. But the only broad, City-wide economic impact of any significance could be on the process of property development and redevelopment. For newly developed properties, the sellers' share of the LTT will have to fall on the residual or site value of the land. This will alter that value by an amount that could affect the decision to develop, or the decision about what type of development to undertake. This effect would be magnified if the property changed hands more than once before possession is taken by its final owners. Whether this economic impact warrants an exemption or rebate for new developments depends in part on the revenue loss that such an exemption would entail.