Intelligence MEMOS

From: Benjamin Dachis and Jacob Kim

To: Toronto City Council Executive Committee

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Re: **Let's Get Off the Land Transfer Tax Roller Coaster**

Outgoing Toronto City Manager Peter Wallace laid down the gauntlet last week. In his presentation of the Roadmap to Financial Stability, Mr. Wallace made clear that the city has become too reliant on a hot property market feeding municipal finances through the Land Transfer Tax (LTT).

As you meet today to discuss his report, here are some factors to consider.

The 10-year-old tax in Toronto has been a golden goose for the city, driven by its soaring real estate market. Last year it poured more than $700 million into city coffers and budget-makers have rosily predicted even more for 2018.

But, numerous Canadian and international studies have found that LTTs have a high economic cost. Part of the reason why the LTT is an inefficient tax is because it is applied to a relatively narrow base. In contrast, residential property taxes, applied to the broad base of all properties in a municipality in a year, do not have the distortionary effects on mobility or the economic costs of an LTT, which applies only on the subset of properties sold in a given year.

If the economic costs of an LTT aren't enough to convince policymakers that they are bad taxes, they may be convinced when the revenues they are banking on from them dry up. The early indications for 2018 are not good, with Toronto home sales down almost 30 per cent from last year, and prices flat.

That's also the consequence of a narrow tax base, and why Mr. Wallace made the call for change for Toronto. What do the data say? To answer that, let's look at the latest Canada-wide statistics on local government financial data.

LTTs have a higher degree of year-over-year variability than other major revenue sources of municipalities – general property taxes, user fees, and even transfers from government. As measured by the coefficient of variation, land transfer taxes (which Statistics Canada measures as taxes on other property), had double the degree of variation of these other sources. This high variability of revenue is due to the cyclical nature of real estate markets, which makes budget planning difficult for cities with an LTT.

Toronto's LTT kicked in at the bottom of the last real estate cycle – the revenue volatility the city has faced since then has been all upside. That will not last forever, and may have even come to an end already. The city, along with other governments, both provinces and cities around the country that levy LTTs, will face a big budget hole the next time the real estate market swoons.

One reason policymakers cite for wanting to introduce an LTT is to curb speculation, and thus reduce the volatility of house prices. Although higher transaction costs might reduce such price volatility by reducing the number of speculative transactions, this effect is relatively small compared with that of other factors, such as banking supervision, increasing the responsiveness of housing supply to demand or decreasing the maximum loan to value ratios of insurable mortgages. Increasing house prices only presents a systemic, economy-wide problem if they are linked with increases in mortgage debt.

With Wallace leaving for Ottawa, it will be up to the next city manager and elected council to put Toronto back on the path to financial sustainability by cutting the reliance on an LTT. But you can get started at your meeting today.

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