CHAPTER 23

SPECULATORS

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"Is a tax on real estate speculators a good idea?"

One of the earliest accounts of speculation is found in the Old Testament. Joseph forecast seven years of feast for Egypt, to be followed by seven years of famine. He persuaded Pharaoh to acquire cheap grain in the flush years to be released later. Had this not been done, grain prices would have fallen through the floor during the crop-surplus years, and gone through the ceiling when crops failed. By stabilizing the grain market, Joseph and Pharaoh earned both profit and praise.

There is clear contrast between our positive attitude toward Joseph and Pharaoh, and prevailing negative attitudes toward today's speculators in land and housing.

Numerous antispeculation-tax bills were introduced at the State Legislature during the late 1980s and early 1990s, but none was enacted. Unquestionably, the issue will surface again.

Speculation defined. Several preliminary questions need to be answered before we can justify taxing speculators. To begin, what is speculation in real property?

Technically, anyone who buys a house is speculating, even if it's used as a principal residence, with no intention of a quick resale. For all home buyers hope that their purchase will be a good investment. But to most people speculation is buying nonpersonal-use property and trying to resell it as quickly as possible for as much as possible, without significantly improving it.

In a notorious 1990 case, a Honolulu property was bought for $166,000 and resold for $285,000—the same day! Obviously, the first buyer had no time to fix up the place or otherwise add to its intrinsic value. A quick profit of $119,000—not bad for a day's work.

Another highly publicized transaction involved five persons with very high city connections. Their *hui* made a $125,000 profit on a cash outlay of $5,000. The "market-priced" house they bought and sold on the same day was in a city-sponsored development. Observers grumbled more about influence peddling than about speculation, but no specific accusations were ever leveled, so I'll assume it was nothing more than another extreme example of speculation.

This kind of speculation (gigantic short-term profits) is simply a *symptom* of a troubled market. Nevertheless, in view of incidents such as these, it is easy to understand why many people think of speculation as *causing* the trouble by raising the price of housing in an unproductive and unfair manner.

Productive activities. Most speculation in real estate is accompanied by other activities that add substantial value. Developers (who, in a sense, are speculators) assemble land, make plans and get permits before construction can begin, and they put up or find the capital that makes new housing possible. All speculators produce useful information about the availability and value of property. This information sometimes leads to new construction and at other times to the sale of existing housing from one who values it less to another who values it more. Based on this, perhaps even the speculators described above did something productive!

In further defense of even extreme examples of speculation, quick resales do not establish value. Market value is determined by a large number of suppliers and demanders. Individuals cannot raise a house's value simply by wanting it to be more valuable. They can only search for potential buyers to whom the property has a higher value.

Can a large number of speculators raise home prices? Sure they can, but only for as long as they hold onto the housing. When they sell, the price tends to fall. Like their predecessors Joseph and Pharaoh, today's speculators do not raise the price permanently. Rather, they tend to even out fluctuations. In the long run, speculation actually reduces prices!

Are speculative profits fair? People concerned about the apparently unfair wealth distributive effects of speculation should think of the folks in the extreme examples provided above as lottery winners. (Again, I'm assuming only legal speculation was involved.) Their six-figure profits were far greater than the normal value of information and brokerage service provided, but "society" was not affected by these two-party transactions. Basically, it was a transfer of wealth from the original seller to the speculator.

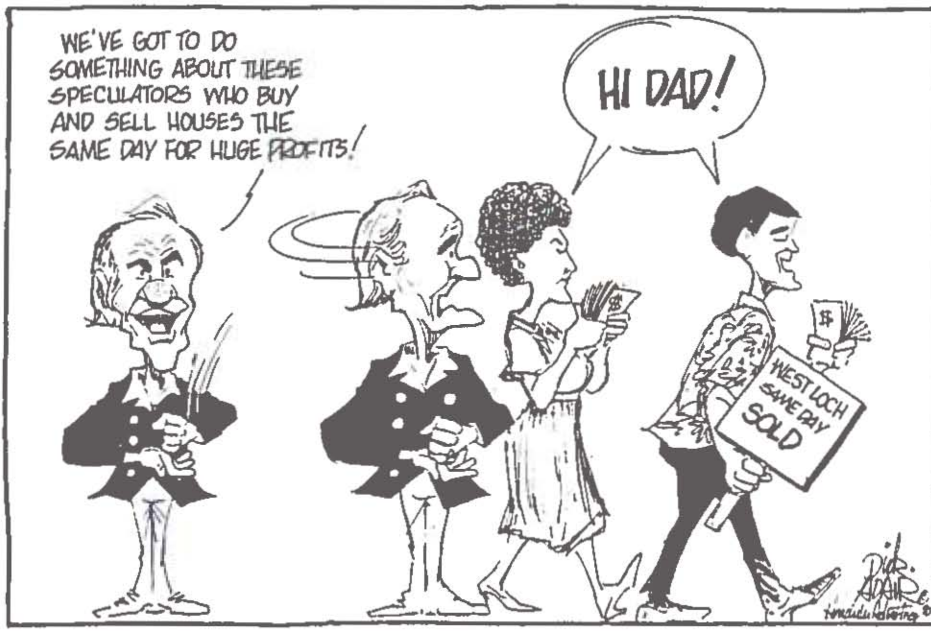
But is it fair for the speculator to retain it all? To answer that we must first agree upon some rule of fairness. Suppose we accept the following productivity ethic: if profits are unearned because they result from community forces or government decisions or just plain luck, they should be taxed away and used to benefit the community. Under this fairness rule, profits could be kept only by those whose physical improvement of property causes the value to increase. The speculators I cited would be taxed on 100 percent of their gains.

Justifying a tax. Many people think it fair to tax speculators because they dislike opportunism or success based on luck. Others are envious of people whose wealth gives them the opportunity to speculate. To them a call for preventive or punitive measures seems only right.

There are two legitimate reasons for imposing any tax. One is to deter activities that we don't like. The other is to raise money to finance government. In many minds, these two reasons merge in the case of real estate speculation as surely as they do in alcohol and tobacco. Because they assume speculation is worse than just unproductive, that it *causes* permanently high prices, many people believe a special tax on real-estate profits would be just another "sin tax."

Tax on speculators could backfire. A substantial tax on speculative profits at a time when considerable housing is held by speculators surely would reduce the price of housing in the short run, and thereby temporarily make home ownership more accessible to first-time buyers. But it also would discourage increasing the supply of housing and this would lead to higher prices in the long run.

Approximately half of Honolulu's households are tenants.

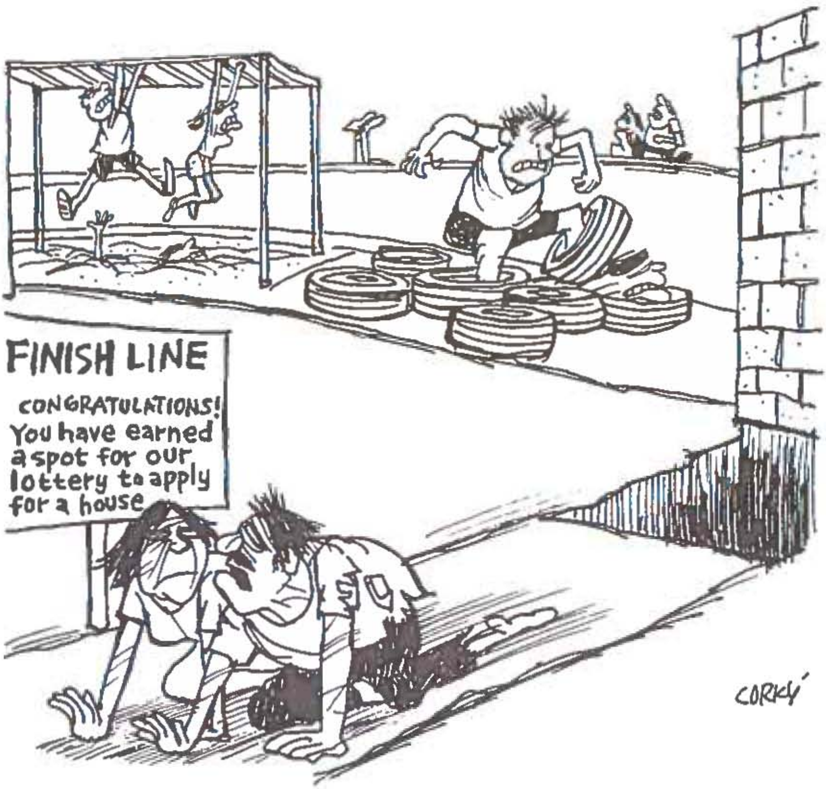

WE'VE GOT TO DO SOMETHING ABOUT THESE SPECULATORS WHO BUY AND SELL HOUSES THE SAME DAY FOR HUGE PROFITS!
HI DAD!
WEST LOCH SAME DAY SOLD

Most of them are concerned about their monthly rents. A tax on speculation would have little effect on rents in the short run because speculators do not compete with tenants for actual use of housing. However, because the tax would discourage construction of new housing, after a few years the stock of rental units would dwindle and rents would rise.

It is impossible to design a tax that can effectively capture profits from real-estate traders without also adversely affecting developers, and (in the long run) both tenants and first-time home buyers. In all probability, the specific speculation tax bills considered by the legislature during the 1990, 1991 and 1992 sessions would have deterred development, construction and rehabilitation, as well as pure speculation. Besides, if someone wants to pay more for land or a house than it cost the current owner, why discourage the sale? A tax on speculative profits can do that.

Given all this, why do our modern Pharaohs even *propose* speculation taxes? It's because many are less interested in long-run solutions than in satisfying constituents to whom they are accountable at election time. And since elections occur frequently, short-run "gripes" get handled first. Thus, the long-run disadvantages of a speculation tax—a lower supply of housing with higher prices and higher rents—do not always receive much attention.

A few colleagues disagree. Several of my colleagues at the University of Hawaii agree with my analysis in the abstract, but not with my suggestion that it applies to Hawaii. They contend factors such as heavy-handed land regulation make our real estate market totally unique. They don't advocate a speculation tax, but neither do they believe such a tax would necessarily lead to less housing and higher prices. We have wonderful debates and are hopeful that this chapter will inspire equally lively discussions elsewhere.



"MAYBE THEY JUST WANT TO DISCOURAGE US FROM AFFORDABLE HOUSING..."