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The incidence of transaction taxes: Evidence from a stamp duty holiday[☆]

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ABSTRACT

This paper exploits the 2008–09 stamp duty holiday in the United Kingdom to estimate the incidence of a transaction tax on housing. The average reduction in the after-tax sale price is found to be around £900 against the backdrop of an average tax reduction of about £1500. While we estimate an increase in transactions of properties affected by the tax holiday around 8%, most of this effect appears to have reversed rapidly after the policy was withdrawn, suggesting mostly a short-term retiming of transactions. The findings are calibrated to a simple bargaining model to show they imply that about sixty percent of the surplus generated by the holiday accrued to buyers.

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1. Introduction

The recent global crisis has heightened interest in the use of transaction taxes as a means of relieving the fiscal stress caused by falling government revenues. However, the use of transaction taxes is far from new. Real estate transaction taxes, in particular, are commonplace and are an important source of government revenues in a number of countries including Denmark, Germany, the Netherlands, the U.K. and the U.S. (Oxley and Haffner, 2010) as well as in a number of states of the U.S. (see Federation of Tax Administrators, 2006). Despite their widespread use, little is known about the consequences of such taxes — in terms of both where the incidence lies and their impact on the frequency of transactions.

This paper looks at both of these issues for the U.K. and exploits a natural experiment due to a tax holiday introduced at the height of the recent financial crisis. Tax incidence depends on how the price negotiated between a buyer and seller is affected by the tax, resulting in some sharing of the tax burden.[1] The frequency of transactions depends in turn on how it affects the decision to search by potential buyers and how sellers perceive it affects the selling price. The stamp duty holiday allows us to study the distribution of the surplus associated with this tax. However, the fact that the holiday was a short-term measure (which would have been understood by both buyer and seller) probably makes it a less reliable episode from which to assess how the steady-state transaction frequency changed.

Transactions of property in the U.K. are subject to tax called "stamp duty" which has a long history. Originally such taxes were applied to transactions of vellum, parchment and paper in 1694 to pay for war with France. Success saw the extension of items liable for stamp duty (despite the role of the 1765 Stamp Act in the movement for the U.S. Independence) with housing transactions incorporated by 1808. Today Stamp Duty Land Tax (SDLT) is charged on land and property transactions in the U.K. with a varying rate and band structure related to the nominal value of those transactions. They are also applied to transfers of shares in the U.K. listed corporations.

The tax holiday that we study was granted in partial response to the global down turn in 2008. It cut stamp duty for a particular range of

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[1] In practice, the bargaining protocols associated with bargaining over real estate in this context are complex — see, for example, Merlo and Ortalo-Magne (2004). Following the extensive experimental literature on bargaining and experiments, see for example Roth (1995), we would expect some kind of surplus sharing. Indeed ultimatum games frequently lead to surplus sharing, especially among inexperienced bargainers. In a wide-ranging meta-study, Engel (2011) finds that on average individuals give a little over 40% in the classic ultimatum game using a sample of over 600 laboratory studies.

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transaction prices as detailed below. It was worth approximately £1500 on the average transaction to which it applied. We use the stamp duty holiday to construct treatment and control groups by using two facts. First, the tax change was announced on the day immediately before its introduction, making its timing largely unanticipated.[2] Second, for a significant fraction of our dataset, we observe an independent valuation of the house by an approved mortgage surveyor which is demanded by lenders as a condition of granting a mortgage. This valuation reflects the resale value of the property in the event of default and we would not expect it to reflect the holiday: resale after default would almost certainly occur, if at all, after the tax holiday had ended. Thus, this independent valuation can be used to assign a property to the treatment group.

We estimate the average reduction in the post tax price of a house transacted during the holiday window to be around £900 and we show that this finding is robust to a variety of specifications and checks. We also find that housing transactions in the relevant price window increased at around 8%. But this effect is estimated to be insignificant if we exclude the months immediately before and after the holiday end, thereby suggesting that the significant rise in purchases during the window was – at least partially – compensated by a significant fall afterwards. This is consistent with most of the effect on volumes being due to a short-term retiming of transactions. Hence, when we calibrate the welfare effect we also present estimates based on a more conservative transaction elasticity of just 3% using the restricted sample that excludes the months characterized by bunching.

To give these effects an economic interpretation, we present a simple bargaining model of house price determination. This allows us to decompose the effect of the tax holiday into a term which reflects the distribution of bargaining power between buyers and sellers and a selection term reflecting the fact that the tax affects which transactions take place during the tax holiday. We show how our estimated effects can be used to identify these components separately. This is because bargaining power does not affect whether a transaction happens. We find that buyers were able, on average, to capture about *sixty percent* of the tax saving during the holiday window. The model can also be used to give a back of the envelope sense of the welfare cost of raising revenues via levying stamp duty on housing transactions.

1.1. Selected literature review

A recent literature has examined the effect of tax changes on housing transactions across geographical regions, over time and at different points of the sale price distribution.[3] Van Ommeren and Van Leuvensteijn (2005) study the impact of transaction taxes in the Netherlands on residential mobility. Dachis et al. (2012) use a regression discontinuity design to identify the effects of Toronto's imposition of a Land Transfer Tax on real estate purchases in early 2008. They estimate that the 1.1% tax generated a 15% decline in transaction volumes, a decline in sale prices about equal to the tax and a welfare loss of about \$1 for every \$8 in tax revenue.

Another strand of research analyses is the distortion in the house price distribution induced by different aspects of the tax system in the U.S. and in the U.K. Slemrod et al. (2012) report evidence of manipulative sorting around the price notch, but not around the time notch, generated by a reform in Washington D.C. on residential real estate transfer taxes. Kopczuk and Munroe (2013) study the incidence of a tax on houses transacted above \$1 million in the states of New York and New Jersey. Exploiting the discontinuity on the overall tax liability associated with the so-called 1% 'mansion tax' and the consequential bunching of transactions just below that threshold, they find that most of the surplus generated by the tax accrues to sellers. While sharing the emphasis on tax incidence, we look at a rather different segment of the market, namely houses transacted between £125,000 and £175,000, and rely on a tax holiday as source of exogenous variation.

This paper is most closely related to Best and Jacobsen Kleven (2013) which exploits notches in the U.K. stamp duty system to estimate the impact of a fiscal stimulus in the housing market on the aggregate economy. Using data on the universe of transactions available from the Land Registry office, they provide strong evidence of bunching just below the thresholds that trigger a higher rate on the wholesale price and estimate significant, but short-lived, effects of the 2008–09 tax holiday on real activity. Our analysis, in contrast, focuses on the incidence of the tax holiday using an empirical strategy that, while controlling for notches and holes in the distribution of sale prices, makes use of surveyor's valuations available in mortgage data.

2. Data and policy design

Our core dataset on mortgage transactions comes from the main financial regulator in the UK, the Financial Services Authority (FSA). It is compiled from mortgage lenders' returns which are submitted to the FSA for regulatory purposes. The dataset includes characteristics of the mortgage loan at origination such as the loan size, the date at which the mortgage is issued, the purchase price of mortgaged property and an independent surveyor's valuation of the property. It also includes borrower characteristics such as the age of the main borrower, the total household income on which the mortgage advance is based and the previous tenure of the household. We also know the region of the U.K. in which the house was purchased.

Independent valuations play an important role in mortgage financed house purchases. The process for commissioning surveyor valuation reports is articulated on the Council of Mortgage lender website (www.cml.org.uk). They outline the standard valuation process as follows:

> "Before approving a mortgage application, most lenders will commission a report on the value of the property being offered as security for the mortgage. The lender is the client for the purposes of the mortgage valuation, and will select and instruct the valuer who carries it out."

The valuer visits the property and is aware of the proposed transaction price. Valuations are typically carried by independent professional surveyors who belong to the main self-regulating body, The Royal Institution of Chartered Surveyors. The buyer may also conduct a more structural survey in addition to obtaining a valuation report, but this is optional. A mortgage offer is not typically made until after the valuation has been made and the lender is satisfied that the property meets its lending criteria.

2.1. The 2008–09 stamp duty holiday

Following the onset of the global financial crisis in 2007–08, activity in the U.K. housing market and the economy more broadly slowed sharply. By the summer of 2008 economic surveys suggested that the economy would suffer a second successive quarter of falling output in 2008 Q3. In the residential housing market, house prices had declined by around 4% in 2008 Q2, and were around 9% down on a year earlier. As shown in Fig. 1, indicators of activity had also declined substantially with the number of loan approvals falling by 70 in the year to June 2008.

The U.K. government decided to try to stimulate the housing market by cutting stamp duty land tax (SDLT) on housing transactions for lower value transactions. Fig. 2 charts media speculation on the topic which reached fever pitch in late summer just before the government announced a change on 2nd September 2008.

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[2] Political leaks and media speculation may have led to some form of anticipation for which we control using an independent database on media citations among the most widely circulated British newspapers. We come back to this issue in section two.

[3] See Kotlikoff and Summers (1987) for a summary of the older tax incidence literature. While there is a sizeable literature on standard property taxes levied on owners or tenants, see for example Zodrow (2001), little attention has been paid to the incidence of transactions taxes on property.

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