Residential stamp duty:Time for a change

Andrew, Mark and Evans, Alan and Koundouri, Phoebe and Meen, Geoffrey

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Mark Andrews, Alan Evans, Phoebe Koundouri, Geoffrey Meen, University of Reading

- The tax yield from stamp duty has been rising sharply in recent years. In 2001/2002, the yield was £2.76 billion compared with £830 million only four years earlier.
- Yields have risen not because of an increase in volumes of transactions, but because of the boom in house prices. Rapid increases in house prices and the current 'slab' structure has drawn purchasers into higher stamp duty bands which increases the tax yield.
- Analysis of price 'bunching' supports the view that the current structure of stamp duty distorts the price distribution of transactions. Furthermore, by distorting relative prices, the tax leads to inefficiencies, such as avoidance, in the operation of housing markets.
- Distributional problems of the current stamp duty system fall in particular on those living in the south and on first-time buyers who face more constraints in accessing credit.
- This research puts forward a number of alternatives to the current system.
- Firstly, a graduated tax is suggested. Moving away from the current 'slab' structure to one in which higher tax rates are only imposed at the margin would reduce inefficiencies such as bunching.
- Secondly, indexation of thresholds is also recommended. The nil threshold was last uprated in 1993 (£60,000). If this threshold had been indexed in line with house price growth it would now be around £130,000.

Introduction

Although there were no changes to the rates and thresholds for stamp duty on residential transactions in this year's budget, there have been important increases in recent years. Table 1 shows how this has been particularly at the top end of the price distribution. Furthermore, the tax yield has risen sharply. In fiscal year 2001/2002, the yield was £2.76 billion compared with £830 million only four years earlier. Estimates suggest that the yield in 2002/2003 could approach £4 billion.

Although the increase in yield is clearly very valuable to the Exchequer at a time when tax revenues from other sources have been below expectations, there are important questions about stamp duty's underlying rationale and whether the current structure is optimal. These are the

questions tackled in a new report by a team from the University of Reading. More precisely, the report asks what are the inefficiencies in the current system, what are the effects on the economy and whether it is possible to devise an alterative system that avoids some of the current problems?

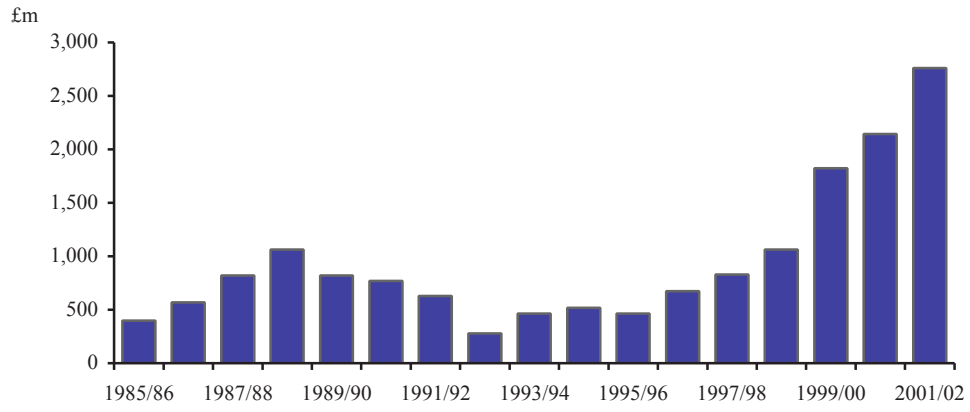
Revenues from stamp duty

Chart 1 shows the yield from stamp duty on residential transactions since the mid eighties. Two points are clear; first the rapid increase in recent years and, second, the volatility of the yield over the housing cycle. For example, revenues were more than £1 billion in 1988/9 at the peak of a housing boom, but fell to less than £300 million at the bottom of the subsequent slump in 1992/3[1]. Revenues have subsequently risen sharply again in recent years to reach £2.76 billion in financial year 2001/2. Variations in the yield depend on three factors:

- the level of property transactions,
- the level of house prices,
- the rates of stamp duty.

The second of these factors is quantitatively the most important. Transactions have been relatively stable over the nineties and changes in the rates of duty, illustrated in Table 1, cannot fully account for the rise in revenues.

Chart 1: Yield from stamp duty



Source: Inland Revenue

Furthermore, the regional disparities in house prices inevitably mean that most of the revenue from stamp duty occurs from property sales in the South of England. In 2001/2002, approximately 75% of the revenue collected in England and Wales was raised from the south of

the country. By contrast, less than half of transactions took place in those areas.

Table 1: Stamp duty rates on residential property, %

Commencing Date	Up to £30,000	More than £30,000, Up to £60,000	More than £60,000, Up to £250,000	More than £250,000, Up to £500,000	More than £500,000
13 March 1984	0	1	1	1	1
20 December 1991	0	0	0	1	1
20 August 1992	0	1	1	1	1
16 March 1993	0	0	1	1	1
8 July 1997	0	0	1	1.5	2
24 March 1998	0	0	1	2	3
16 March 1999	0	0	1	2.5	3.5
28 March 2000	0	0	1	3	4

Source: Inland Revenue
Notes: Between 20th December 1991 and 19th August 1992, rates were 0% up to £250,000 and 1% above. + from 8th July 1997.

Problems with the current system

There are a number of potential problems with the current system, notably:

- Stamp duty may reduce the efficiency of the economy.
- The duty produces distributional inequalities between locations and household types.

In terms of efficiency, in principle, the current system:

- Causes a distortion of relative house prices through the 'bunching' of house prices around the tax thresholds
- Affects the *volatility* of property transactions and house prices
- Raises the housing user cost of capital
- Influences household mobility.

Bunching of prices

The first of these issues is demonstrated in Table 2, which presents CML survey data on property transactions, disaggregated by price band. The bunching of transactions around the thresholds stands out clearly. Looking, first, at the £60,000 threshold, we see 1,265 transactions in the range £59,001-£60,000 (in fact 705 transactions were exactly at £60,000 and 1,113 between £59,950 and £60,000), whereas only 107 took place in the next price range.

Similarly at the £250,000 threshold, 707 transactions occurred in the range £245,001-£250,000

(451 at exactly £250,000) compared with a mere 54 between £250,001 and £255,000. Finally, at the upper threshold, 130 transactions took place in the £490,001-£500,000 range (87 at exactly £500,000) with only 15 in the next price class.

All of these figures support the view that the current structure of stamp duty distorts the price distribution of transactions. Furthermore, by distorting relative prices, the tax leads to inefficiencies in the operation of housing markets.

Table 2: Distribution of transactions by price band, UK, 2001/2002

£	Number of transactions
52,001-53,000	397
53,001-54,000	372
54,001-55,000	752
55,001-56,000	376
56,001-57,000	415
57,001-58,000	514
58,001-59,000	414
59,001-60,000	1265
60,001-61,000	107
61,001-62,000	304
62,001-63,000	396
63,001-64,000	350
64,001-65,000	849
65,001-66,000	338
66,001-67,000	402
67,001-68,000	566
68,001-69,000	371
240,001-245,000	206
245,001-250,000	707
250,001-255,000	54
255,001-260,000	117

Source: Survey of Mortgage Lenders, CML.

Volatility

Second, stamp duty may add to the volatility of housing markets both in terms of the number of transactions and house prices. In fact, our research finds that at the aggregate, national level there is little evidence that this has been a major factor. Stamp duty, particularly in times of booming housing markets, is swamped by other influences and this can be seen by looking at the

effects of stamp duty on the housing user cost of capital - the main way in which economists measure annual owner-occupier housing costs. The user cost has a number of components. The main ones are:

- The mortgage interest rate paid by the home-owner
- The price of the house
- The extent of debt gearing as opposed to equity finance, ie, borrowing versus the use of households' own funds
- Any tax relief available
- Expected capital gains on the house
- Local taxes, such as the Council Tax
- Maintenance expenditures on the property
- Stamp duty and other transaction costs
- Depreciation

Therefore, the transactions costs associated with the purchase of the property (of which stamp duty is one component) add to the user cost. But the importance of stamp duty, in practice, depends on (a) its size relative to the other components above, (b) the extent to which stamp duty can be spread over time. Some illustrative calculations are given in Table 3.

Table 3: Illustrative user cost calculations, based on 2001 figures

	North	Greater London
Mortgage interest rate (%)	6.0	6.0
National Savings rate (%)	4.5	4.5
House prices (£)	70,550	181,750
Loan to value ratio (%)	70	70
Rate of mortgage tax relief (%)	0	0
Local Council Tax rate	1.0	0.5
Maintenance expenditures (%)	1.0	1.0
Depreciation rate (%)	1.0	1.0
Stamp duty rate on average house price (%)	1.0	1.0
User cost of capital (assuming 8% expected capital gain)	1,093	1,908

Source: Inland Revenue, ODPM, CML, authors own calculations

The table distinguishes between the north of England and Greater London. Note, first, that at the

average house price in each area, the stamp duty rate is the same at 1%. Second, calculations of the user cost depend crucially on the expected capital gain. For the illustrative calculations, we assume a value of 8%. At these values, the user cost in London is a mere £1,908 pa and, in the North, £1,093. It is hardly surprising, therefore, that owner-occupation is popular. By contrast, should house prices be expected to fall in London, as some commentators have predicted, then the user cost rises dramatically. But importantly, at the average price, stamp duty is swamped by the other components of the user cost, notably the capital gain and the interest rate. This is why, at the aggregate level, stamp duty appears to have only limited effects on prices and transactions.

Housing mobility

Finally, stamp duty may reduce the mobility of households. But almost all previous work on this subject relates to the US, where transactions costs are considerably higher than in the UK and US conclusions cannot automatically be applied to the UK. Although further empirical work on this important question is much needed, there are good reasons to believe that the impact of stamp duty on mobility in the UK is likely to be less than in the US.

However, looking at the aggregate, the national picture disguises what are, in our view, the most important problems with stamp duty - its distributional consequences. We need to look at spatial differences and variations between household types.

Distributional inequalities

We have already seen that, spatially, stamp duty falls most heavily on the south of the country. This contrasts with another element of the property tax system - Council Tax - which falls most heavily on households in the North. But the most important distributional inequalities of stamp duty lie between first-time buyers and existing owner-occupiers. This arises because, typically, first-time buyers are closer to their credit limits and, therefore, are less able to borrow to cover stamp duty liabilities.

First-time buyers on average in 2001 made a deposit of 21%, which had risen consistently over the house price boom. But moving existing owner-occupiers provided a larger average deposit of 36%, reflecting the re-investment of equity from the previous home. This percentage has changed little over the boom. Typically, booming housing markets impose stronger constraints on first-time buyers than existing buyers. Since house price inflation leads to fiscal drag as properties move into higher tax brackets, first-time buyers are again heavily affected.

To illustrate, consider a first-time buyer and an existing buyer wishing to purchase an average priced house in the South East, costing £151,940 in 2001/2002 and who pay a mortgage interest

rate of 6%. Table 4 compares the effects of stamp duty for the two, under the assumption that the existing owner can add the payment to the mortgage, whereas the first-time purchaser is credit constrained and cannot.

Table 4: Effects of stamp duty on first-time buyers and existing owners

	First-Time Buyer	Existing Owner
Purchase price (£)	151,940	151,940
Deposit (%)	21	36
Mortgage (£)	120,032	97,242
Annual interest payment (%)	7,202	5,835
Stamp duty (£)	1,519	1,519
Annual interest payment, if stamp duty added to mortgages	-	5,926

Source: ODPM, CML, authors own calculations

Under these admittedly extreme circumstances, the constrained first-time buyer would have face an upfront stamp duty payment of £1,519, but by adding the duty to the mortgage, the existing owner would require an annual increased interest cost of just £91[2].

Although only illustrative, the calculations do show that the burden is likely to fall more strongly on first-time buyers - perhaps the group that the government would like to affect least - under conditions where credit constraints start to bite.

Alternatives to the current system

The effects of stamp duty are sufficiently important to consider proposals for reform. In fact relatively modest variations of the current system bring improvements. First, we consider a graduated system, where duty is only paid on the value above the threshold. Second, in conjunction with the graduated system, we discuss the effect of indexation of the thresholds. One of the anomalies of the current system is that thresholds are not automatically indexed. By contrast, indexation is the generally expected norm in the income tax and indirect tax system.

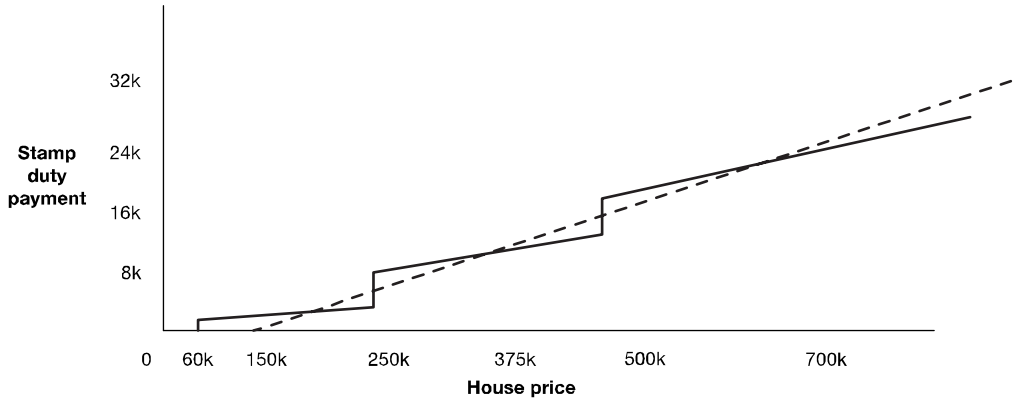
A graduated tax

Table 2 illustrates that the current slab system can lead to price bunching. This could be avoided by the introduction of a graduated tax - one in which higher tax rates were only imposed at the margin. It is clear that changing form a slab to a graduated system would have implications for both tax rates and revenue generated. While this report does not propose specific tax rates, it provides examples of possible rates for illustrative purposes.

The first illustration of a graduated form of stamp duty reflects the current form's structure, but without the slabs. Currently, the existing duty paid on properties valued at just less than £250,000 would be £2,500 and on properties which might be sold at just above £250,000 would be £7,500. The average tax payable, mid point of this step, is £5,000. On the same principle the mid point of the next step, at £500,000, is £17,500. Thus, between prices of £250,000 and £500,000, the tax payable should increase by £12,500, that is at a marginal rate of 5%.

This is shown in Chart 2, where a graduated tax at a marginal rate of 5% is shown by the dashed line. The solid line shows the current slab structure. It can be seen that this 5% rate would replace most of the current structure. It is nevertheless necessary to determine the rest of the structure. At the top end, the charge levied by the two forms becomes equal at £750,000 so that the graduated rate above, say, a million pounds might be reduced to 4% to replicate the existing rates on these higher values if so desired. However, we have assumed the rate would be 5%.

Chart 2: Stamp duty: The slab and graduated systems



Source: Inland Revenue, authors own calculations

At the bottom end the position is more difficult. There is no doubt that the simplest solution would be to charge no duty on sales at prices below £150,000, with a single marginal rate of 5% on sales at prices above that minimum. This would remove stamp duty from a very large number of house sales, indeed more than half, considerably reducing the negative effects of duty on household mobility. However, although the amounts collected are small on each dwelling, because the number of houses sold are large, a considerable tax revenue is collected from the sales of these lower value properties. Consequently, such a change would not be revenue neutral compared with the 2001/02 tax take. However, as an aside, we do stress that using the revenue of 2001/2002 as a benchmark may be restrictive as it was very high by historical standards and

there is a good case for considering neutrality with respect to some more 'normal' state of the housing market (for example the annual average over the economic cycle).

To preserve revenue neutrality two possibilities were examined. First, the exemption limit could be set at a lower level than the £150,000 above; second, reduced rates similar to the existing structure (without the slab) could be introduced on lower value transactions.

Our simulations suggest that, to preserve revenue neutrality at the 5% marginal tax rate, the threshold would have to be £115,000 rather than £150,000. Furthermore, even at this threshold, a high percentage of transactions would no longer attract duty. And it should be noted that a high proportion of these households would be first-time purchasers, who are particularly adversely affected by the current system.

Neutrality could also be achieved by introducing an additional 2% band between £60,000 and £210,000 with 5% above £210,000.

Indexation

Indexation is not an alternative to graduation, but is complementary. Under the current system, the responsiveness of revenues to a change in house prices is high because of fiscal drag, that is as house prices rise more and more properties are dragged into higher tax rates. But, under a graduated and indexed system, the responsiveness of tax yield with respect to house price changes becomes approximately proportional. In other words, indexation reduces the volatility of revenues over the cycle as house prices change.

Finally, a potential pitfall should be noted. If thresholds are indexed this creates an incentive for a bunching in the timing of transactions. If thresholds are expected to be increased (because prices are rising), households will delay their transactions until the uprating has come into effect. Similarly, if prices are falling, there is an incentive to bring forward purchases. However this becomes less of an issue if the number of bands is small. Consequently, our proposal for a 5% marginal rate above £115,000 minimises the problem, particularly since properties below the mean are taken out of taxation.

Conclusions

We have highlighted a number of inadequacies in the current system.

- The yield is highly volatile over the housing cycle. But the volatility of the yield is exacerbated by the current structure.

- The Government may be happy with rapidly increasing stamp duty revenues at a time when other tax revenues have failed to meet expectations. But this has only occurred because the housing market is booming at a time when other sectors of the economy have fared less well. This cannot be guaranteed to continue.
- The current 'slab' structure causes major 'bunching' of prices around the thresholds and distorts relative house prices.
- The distributional inequalities of stamp duty are particularly important. These inequalities exist over both space and household types. Spatially, stamp duty falls very heavily on the south of the country, where prices are highest.
- Stamp duty has differential effects between first-time buyers and existing owner-occupiers, falling particularly heavily on the former.

But modest changes to the current system would avoid many of the criticisms. In particular, we would recommend a graduated, indexed tax. The simplest revenue neutral solution would be a 5% marginal tax rate above a threshold of £115,000. Large numbers of transactions would then be taken out of the tax net altogether.

References

Andrews M., Evans A., Koundouri P. and Meen G. (2003) *Residential stamp duty: time for a change*, Council of Mortgage Lenders

Endnotes

[1] Although yield in 1992/3 was heavily affected also by the stamp duty holiday between December 1991 and August 1992.

[2] Plus a small annual repayment of the capital sum.