



# BEYOND THE CALL OF DUTY

## Why we should abolish Stamp Duty Land Tax

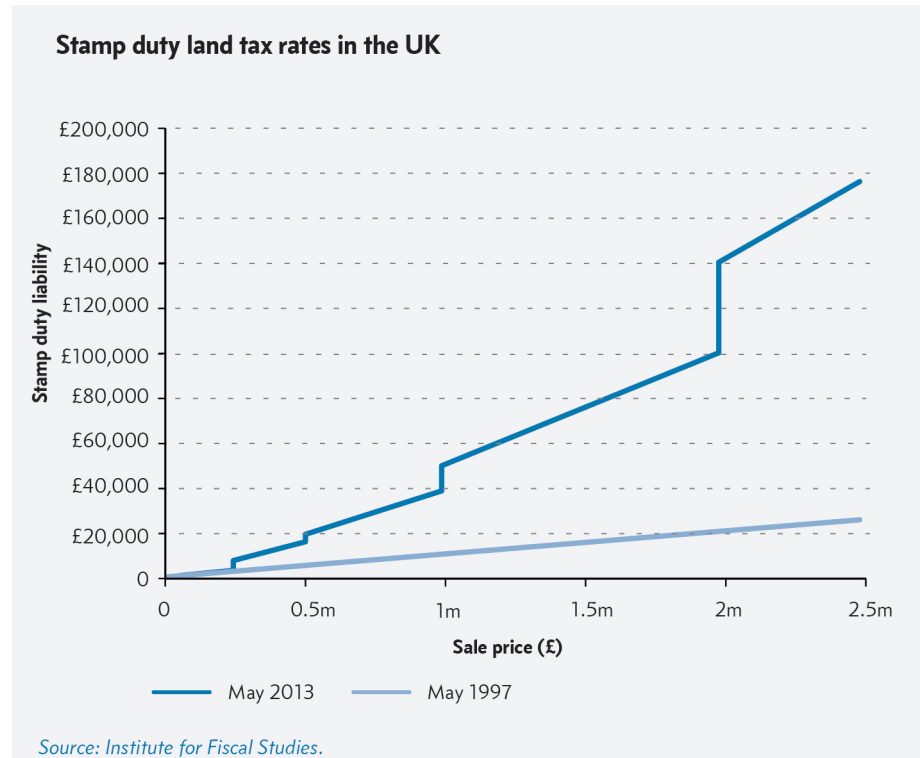
By Ben Southwood

BRIEFING PAPER

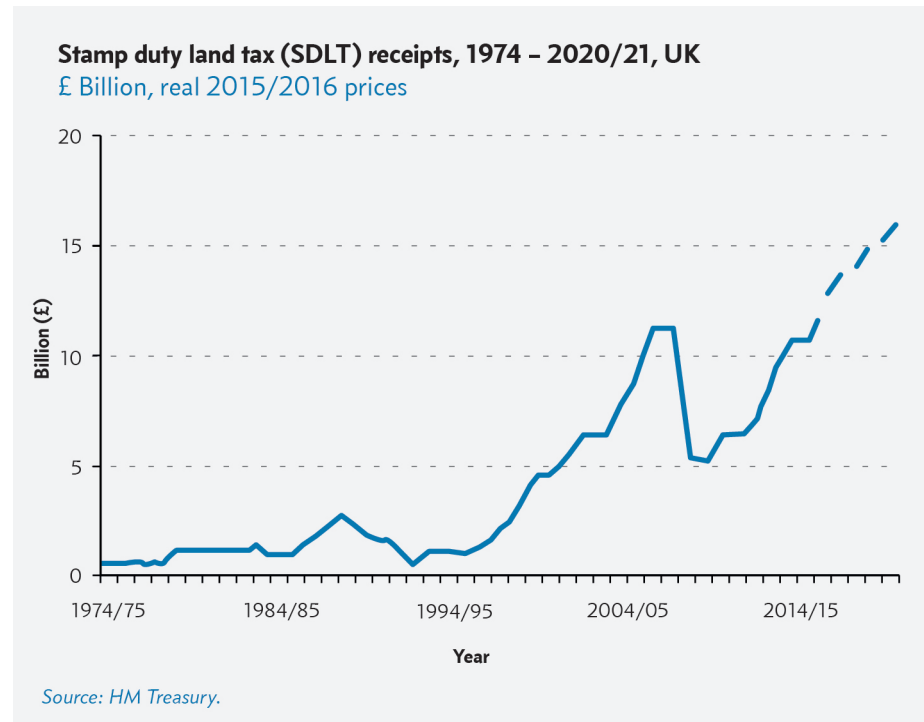
### EXECUTIVE SUMMARY

- There is about £7.5 trillion worth of property in the UK, but we tax it in strange and inconsistent ways: residential council tax is regressive and its valuation system hasn't been updated since 1993; businesses pay at high rates; and homeowners pay rapidly escalating transactions taxes (stamp duty land tax), but private residences are part-exempted from inheritance tax and exempted from capital gains tax.
- Transactions taxes are widely seen as especially damaging levies by economists: a representative Australian government review found their stamp duty destroyed 75p of wealth per £1 raised.
- This makes stamp duty land tax around 4x more harmful per pound than income tax and 8x more harmful than VAT; some alternative taxes, like a carbon tax, would have small economic benefits rather than harming efficiency.
- Taxing housing transactions keeps people in houses that are either too small, too big, or too far away from jobs, which are especially harmful when the housing supply is so tight, as it is in the UK today.
- In the short term the Treasury should abolish SDLT and replace the lost revenues by reforming council tax – fixing the regressive top end of the system with a more proportional, or even progressive, tax on rental and imputed rental values would bring in the needed revenues easily, with far smaller economic costs.
- Eventually the UK should rationalise its property taxation system by abolishing SDLT altogether, and then rolling council tax, and business rates into one system, with everyone paying the same rate, set at roughly 20% of imputed rental income, comparable to extending VAT to property services. This would be roughly fiscally neutral on a static analysis, but may lead to large increases in revenue over time, which should be used to reduce other taxes.
- The UK should consider decentralising property taxation, but this is a separate step which does not need to be considered simultaneously. Abolishing SDLT is attractive whether or not the overall local taxation and governance system is reformed.

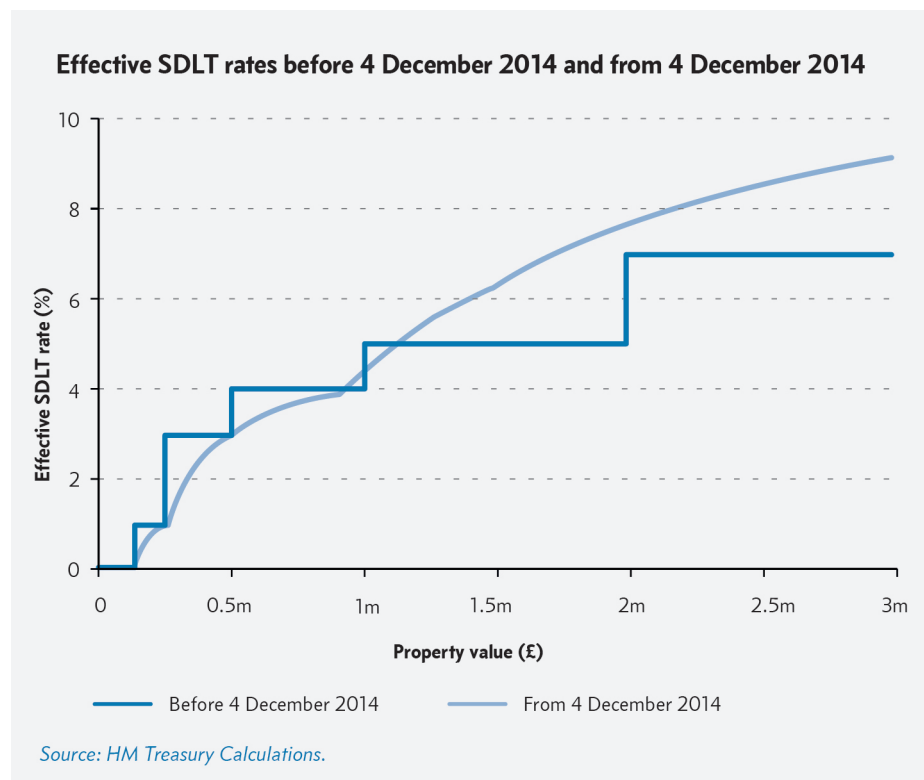
Stamp duty land tax is a transactions tax on residential and commercial property. It is paid by buyers when residential properties change hands for more than £125,000, and when commercial properties are sold for £150,000 or more.



In the 2014 Autumn Statement, George Osborne’s Treasury reformed the old “slab system”, where marginal tax rates on higher sale prices went far above 100% at several points. Selling a house for £999,999 incurred a tax liability of £39,999.96—selling it for £1m incurred a tax of £50,000, or a 1,000,004% marginal tax rate. Predictably, this led to huge bunching effects at certain price points, and it was finally reformed to a more sensible system, where rate rises only affect the “chunk” of the price above that level. This got rid of the massive “knife edge” kinks in the tax schedule introduced by Labour in 1997 and worsened between then and now (see graph above). However, to fund this effective tax cut, Osborne hiked rates at the top of the schedule. Additional properties, including second homes and buy-to-let properties, are subject to a 3pp surcharge on top of the regular rate.



As we'll see, even a more rationally structured stamp duty has severe economic costs—costs so serious that they militate in favour of complete abolition.



Property or lease premium or transfer value	SDLT rate
<£125,000	Zero
>£125,001 and <£250,000	2%
>£250,001 and <£925,000	5%
>£925,001 and <£1.5m	10%
>£1.5m	12%

## THE CURRENT SYSTEM - COMMERCIAL

Property or lease premium or transfer value	SDLT rate
<£150,000	Zero
>£150,001 and <£250,000	2%
>£250,001	5%

The problem with stamp duty is that it taxes transactions—movements of assets between households and among firms. In theory, transactions taxes are a relatively inefficient way of raising an extra pound of state revenue, because they gum up markets, reducing liquidity—meaning it's harder to buy & sell when you want to. Compare with VAT. If you buy a house for £1m, improve it so it's worth £1.2m, under a VAT-like system tax must be paid only on the £0.2m from the improvement, since you can deduct the cost of your inputs. If they did no improvements and sold it for £1m, they'd face no VAT bill at all. Under a transactions-tax system tax must be paid on the entire amount above the initial tax-free threshold. This is borne out in practice: empirical evidence suggests that stamp duty land tax reduces economic activity far more than other levies per pound it raises.

## INCIDENCE

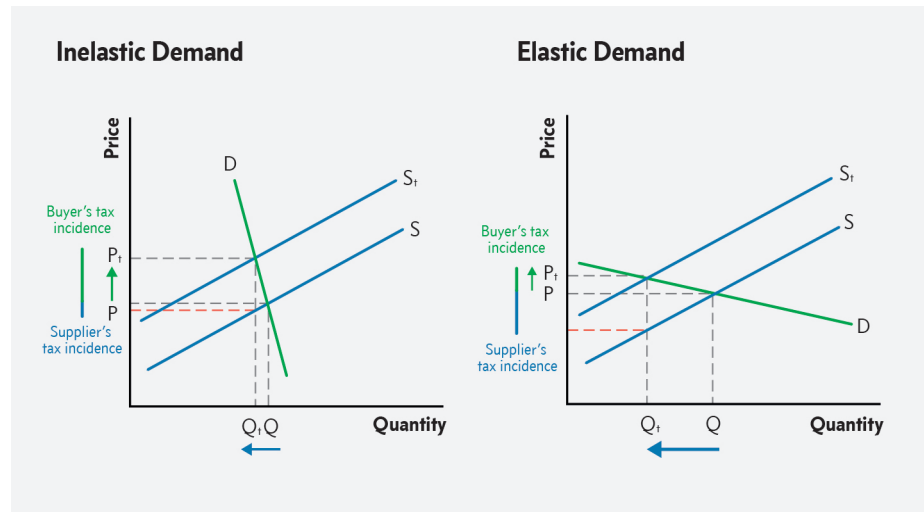
In the optimal tax theory and public finance literature there are usually said to be three rules of tax incidence:

1. The statutory burden of a tax does not describe who really bears the tax
2. On which party to an exchange the tax is imposed is irrelevant to the distribution of the tax burdens
3. Parties with inelastic supply or demand bear more of the burdens of taxes; parties with elastic supply or demand avoid more of them

A tax's incidence describes not the accounting reality—who hands over the tax to the exchequer—but the analytical economic reality—who is made worse off by the existence of the tax. For example, shops hand VAT over to the government, but they pass VAT on to the customer, and it appears on their bill. However, because consumers care about the total price of goods, and not the pre-tax price, they also reduce their consumption of taxed goods, which reduces the pre-tax price. In total, the burden is split between the shop, in the form of lower sales, and the consumer, in the form of higher prices, except in special cases of perfect inelasticity

or elasticity. Simply tracking who hands over the payment tells us very little about who bears the burden of the tax.

To understand (2), consider the market for labour. We can tax firms for the wages they pay (a payroll tax) or tax workers for the wages they earn (a wage income tax). But economically, these are identical. An employer doesn't care if money they pay goes to their workers or to the govt—either is a (predictable) cost of employing someone. An employee doesn't care if their wage is lower because the initial offer is lower from the employer, or because the govt will (predictably) take a chunk—either makes the return to working lower.



Regarding (3), those whose demand is more elastic tend to avoid burdens; those whose demand is more inelastic tend to bear them. Petrol, alcohol, and tobacco consumers tend to have inelastic demand for those goods: their demand changes very little in response to higher prices—like the chart on the left. So taxes, which shift the supply curve up, mostly result in higher prices, not lower quantities supplied, and the incidence falls on consumers. By contrast, consumers of cigarette lighters are highly elastic, since matches are a close substitute, and a tax on them would largely be borne by the vendor—like the chart on the right.

That is: if vendors were taxed some significant amount when they sold cigarette lighters they would not be able to raise prices to “pass the tax on” to buyers, as they would simply stop buying lighters, and buy matches. But at the existing price the tax would come out of their margin, possibly wiping it out entirely. If buyers faced the tax the situation would be identical: buyers would switch to untaxed matches unless sellers dropped their prices. In either situation vendors face losing out on sales or wiping out their profit margins on the item.

Evidence from the UK suggests that the buyer pays only around two thirds of stamp duty, even though they hand over the full amount. In 2008 and 2009 the government temporarily cut stamp duty—a brief tax “holiday”. The average tax burden fell about £1500, while the corresponding average sale price rose £600—implying

around 60% had been borne by homebuyers and around 40% by owners.<sup>1</sup> Extrapolating this across the entire market is fraught with difficulty: elasticities will vary widely with locations, prices, incomes and wealth.<sup>2</sup> But it gives us a rough guideline for how house prices will adjust to take account of property transactions levies, and a guide to the distributional effects of the tax.

## HOW TAXES HAVE ECONOMIC COSTS

When non-economists talk about the “costs” of taxes, they are typically thinking about the burden on the taxpayer. However, the economic costs can be much smaller, or much larger than this number. Her Majesty’s Treasury (HMT) reckons SDLT will bring in £12.9bn during the 2016-17 tax year.

Economists are typically thinking of two types of cost when they assess taxes:

**Administrative costs:** all taxes cost some amount to collect. In the absence of these taxes we could use the land, labour and capital tied up in assessing and collecting liabilities for other social purposes. Her Majesty’s Revenue and Customs workers are high skilled and many could be doctors, teachers, lawyers, bankers, or entrepreneurs. This is equally true if assessing liability and making payments is largely a responsibility of the firms and individuals who owe tax: from an economic perspective each of these wastes valuable assets in the same way. Recent estimates put the total administrative cost of the UK tax system at around £11bn, compared to receipts of around £700bn.<sup>3</sup>

### Summary of the total operating costs of the UK tax system

KPMG estimate of business tax administrative burdens	£5.1bn
OECD estimate of aggregate HMRC administrative costs	£4.8bn (exc. outsourced IT costs)
Boys Smith et al. estimate of amount spent on tax advisers by those subject to self-assessment	£1.25bn
The total of these gives us a starting point for total combined administrative and compliance costs (operating costs)	£11bn +

Source: Institute of Economic Affairs (see footnote 3, below)

**Behavioural costs:** markets work because decentralised prices coordinate individual behaviour toward social welfare—the “invisible hand” of the marketplace.<sup>4</sup> This is called the First Fundamental Theorem of Welfare Economics.<sup>5, 6</sup> A price one person pays represents an estimate of the cost of that activity to other

<sup>1</sup> Besley, T., Meads, N., & Surico, P. (2014). The incidence of transaction taxes: Evidence from a stamp duty holiday. *Journal of Public Economics*, 119, 61-70.

<sup>2</sup> Elinder, M., & Persson, L. (2014). Property Taxation, Bounded Rationality and House Prices.

<sup>3</sup> Chittenden, F., Foster, H., & Sloan, B. (2010). Taxation and Red Tape: The cost to British business of complying with the UK tax system.

<sup>4</sup> Butler, E. (2012). *The Condensed Wealth of Nations: And the Incredibly Condensed Theory of Moral Sentiments*. Centre for Independent Studies.

<sup>5</sup> Mankiw, N. (2006). *Principles of microeconomics* (Vol. 10). Cengage Learning.

<sup>6</sup> Tan, K. T. K. (2008). *The First Fundamental Theorem of Welfare Economics*. Unpublished.

individuals and society—that person is giving a signal that they value that economic arrangement by more than the amount they are willing to pay.<sup>7</sup> Entrepreneurs, constantly reorganising capital, labour, and land into new configurations, will succeed when they find better ways of satisfying demands, and fail when they use assets in ways that generate worse outcomes, i.e. outcomes that people are less willing to pay for.<sup>8,9</sup>

If a tax alters the payoff to different structures of production and behaviour, even though the rewards in terms of happiness, utility and consumer preferences have not changed, economists call it “distortionary”. Imagine a tax of £1 on apples. Apples still give everyone as much pleasure as they did before. Their trees still take up as much scarce space. They still take as much labour to pick, as many trucks and as much fuel to transport. But, after the imposition of this tax, consumers will consume fewer apples and more substitutes. Society will shift toward producing other goods, because incentives will now push in that direction.

This spanner in the works of the economic calculating machine has created a “deadweight loss”. As well as successfully transferring money between consumers and the government, which was its purpose, it has made the total pie smaller. It might still be worth the taking, because we can use the funds to counteract market failures and make the pie bigger overall. But the taking of it, considered on its own without the use of it, reduced welfare, not just through taking money out of taxpayers’ pockets, but an extra amount through stymying economic calculation.

Assuming that there are some activities that the government must fund—for example true public goods like defence—it must raise some money in taxes. But not all taxes have the same administrative costs—some are simpler to assess and collect—and not all taxes have the same economic costs—some distort economic behaviour far more than others. Good fiscal policy seeks to minimise the behavioural costs of taxation, both because they are welfare-destroying and because they erode the tax base.

In the 21st century, administrative costs are typically a small (though non-trivial) fraction of the revenues a tax will raise. But we still use many taxes with gigantic economic costs, including SDLT.

There are three main classes of taxes, with respect to their costs:

**Pigovian taxes:** though most taxes have net economic costs, not all of them do. Some economic activity affects not just the buyer and seller, but third parties. If transactions are costly, then parties will be unable to contract to alleviate these, even if the costs to one party outweigh the benefits to others.<sup>10</sup> If there are many

<sup>7</sup> Hayek, F. A. (1945). The use of knowledge in society. *The American economic review*, 519-530.

<sup>8</sup> Kirzner, I. M. (1997). Entrepreneurial discovery and the competitive market process: An Austrian approach. *Journal of economic Literature*, 35(1), 60-85.

<sup>9</sup> Friedman, J. (2007). There is no substitute for profit and loss. *Society*, 44(3), 48-53.

<sup>10</sup> If transactions costs are sufficiently low, then the Coase Theorem shows us that third parties will simply pay the buyer and/or seller to reduce or increase the activity to the optimal level. If the activity

similar cases, and if administrative costs are sufficiently low, the government may be able to impose a tax that raises efficiency, and reduces distortion. In practice, this is difficult, because the government may set the tax at the wrong rate, either due to lobbying or due to a lack of information. But in principle this sort of tax can have economic benefits as well as raising money.

A Pigovian Tax is calibrated to perfectly internalise the cost of an activity. The polluter pays the amount their pollution costs other members of society, meaning they will only pollute if the benefits to them of polluting are worth more to them than the costs they impose.

Although we should impose Pigovian taxes where necessary, there will most likely not be sufficient cases of market failure that aren't solved by natural market bargaining forces to cover the entire government's budget through their revenues.

**Lump sum taxes:** while Pigovian taxes improve economic behaviour, balancing out a market failure distortion, lump sum taxes are those that have no effect on behaviour or have no distortionary cost—because they are unavoidable. The classic example is a poll tax, an annual tax on each adult or each individual which is levied on everyone at the same fixed amount. The problem with lump sum taxes is that they either cannot achieve our distributional goals, or they seem unfair.

Poll taxes may be useful in a society with widespread wealth and few redistributional goals, but typically a country will contain many in poverty, and governments will want to redistribute money.

Other lump sum taxes include height taxes (height is hard to change, and strongly associated with income) and taxes on genetic variants associated with income and/or education (even harder to change), but many consider this to be a “slavery of the talented”, since you face the burden whether or not you want to work for the high wage that your talents make possible.<sup>11, 12</sup>

**Distortionary taxes:** most taxes have significant distortionary costs. As well as raising funds, they stop economically productive activity from happening—they cause fewer preferences in total to be satisfied, destroy wealth, or prevent wealth from being created. These costs are not recoverable by anyone. In extreme cases, they may even fail to generate revenue, for example when a tax discourages an activity completely.

A VAT reduces the incentive to earn income, since each extra hour worked will be able to buy fewer goods than without a VAT. Your nominal pay may be the same,

---

costs them £1m, they will be willing to pay up to that much—if it benefits the original parties less than £1m, they will accept. If they can't do a profitable exchange, then society doesn't benefit anyway, so we wouldn't want them to.

<sup>11</sup> Mankiw, N. G., & Weinzierl, M. (2010). The optimal taxation of height: A case study of utilitarian income redistribution. *American Economic Journal: Economic Policy*, 2(1), 155-176.

<sup>12</sup> Dworkin, R. (1981). What is equality? Part 1: Equality of welfare. *Philosophy & public affairs*, 185-246.

but it buys less of the stuff that you work a job for in the first place. In the long run, this also cuts the incentive to build up skills, and to follow lucrative (but less intellectually satisfying or emotionally rewarding) careers. An income tax does the same, but also reduces the incentive to save, because each year you save and invest your income you also pay tax on the interest or returns it generates.<sup>13</sup> Corporation tax keeps firms out of the corporate form. Capital gains tax shifts the balance between risk and reward.

Stamp Duty Land Tax discourages people from moving house.<sup>14</sup> This keeps people in houses that are too small, too large, not to their aesthetic taste, or away from their family or friends. It also prevents people from finding the best possible job (or any job), and reduces spending on repairs, renovations, removals and durable goods.<sup>15</sup> Misallocating housing among individuals is potentially very costly.<sup>16</sup> The question is, empirically, how large these costs are.

## THE EMPIRICS OF SDLT

The existing empirical work is fairly clear in supporting the predictions of the theoretical models: higher transactions taxes distort house prices, the volume of housing transactions, the timing of transactions, and a whole host of complementary spending on related goods.<sup>17, 18</sup> This is particularly bad in the UK, because British planning law is particularly restrictive, even compared to other developed countries. And it doesn't just affect the rich: the especially high rates at the top drive demand down into more modest houses, elevating prices throughout the entire housing market.

---

**13** Feldstein, M. (1999). Tax avoidance and the deadweight loss of the income tax. *Review of Economics and Statistics*, 81(4), 674-680.

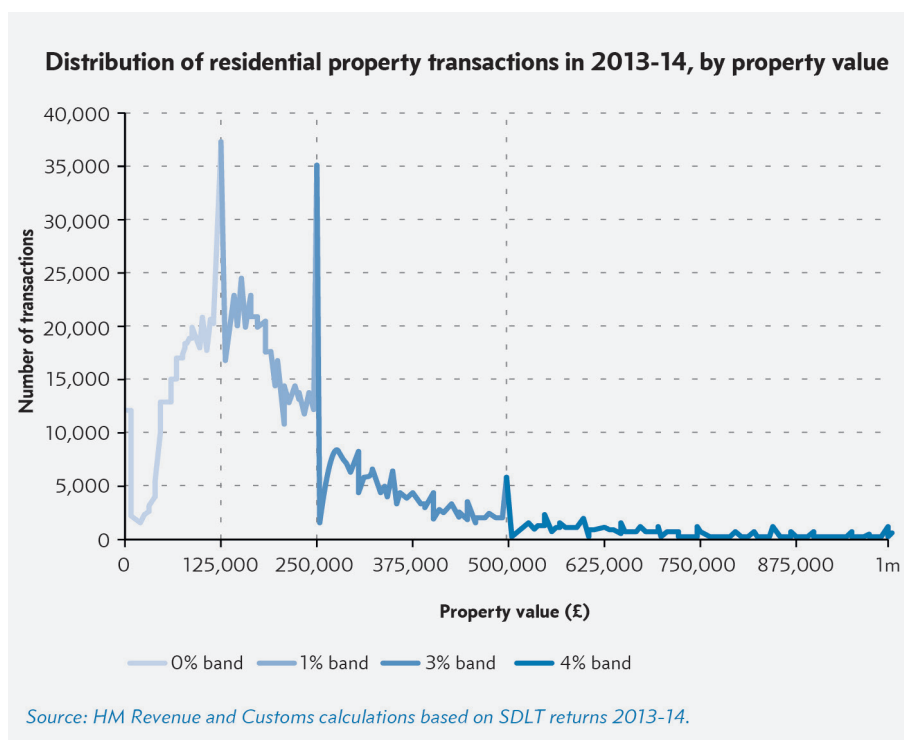
**14** Johnson, P. (2014). Tax without design: recent developments in UK tax policy. *Fiscal Studies*, 35(3), 243-273.

**15** Van Ommeren, J. (2008). Transaction costs in housing markets.

**16** Glaeser, E. L., & Luttmer, E. F. (2003). The misallocation of housing under rent control. *The American Economic Review*, 93(4), 1027-1046.

**17** Hilber, C. A. (2015). UK Housing and Planning Policies: the evidence from economic research.

**18** Benmelech, E., Guren, A., & Melzer, B. T. (2017). Making the House a Home: The Stimulative Effect of Home Purchases on Consumption and Investment (No. w23570). National Bureau of Economic Research.



In 2008 the UK government introduced a stamp duty holiday for 16 months, eliminating stamp duty on houses selling for between £125,000 and £175,000 (before houses valued £125,000 to £250,000 had faced a 1% levy).<sup>19</sup> Michael Best & Henrik Kleven, with a database including all property transactions between 2004 and 2012, around 10 million, find that this boosted housing market activity by a fifth in the affected range.

This came through two effects: a timing effect, where households always intended to transact, but did it earlier or later than intended, in order to face a lower stamp duty bill; and an extensive effect, where households engage in more transactions in total over the lifespan, ones they wouldn't otherwise have found worthwhile. They compare bunching—large sudden rises in volume—at the very beginning and end of the holiday, to increased activity throughout, and judge that most of the change was extensive. They back up this conclusion by looking at a permanent change: raising the bottom notch from £60,000 to £120,000 in 2005. Since this led to an even bigger increase in transactions than the temporary switch, they judge that:

*This extremely high response indicates a high tax elasticity of housing transactions, suggesting a large efficiency cost to burdening them so heavily. Yet this study looked only at a 1% tax. The current UK system taxes the most expensive houses at approaching 10%, implying even larger deadweight losses at the top of the market.*

Ian Davidoff and Andrew Leigh do a very similar study for Australia, with a database covering every housing sale for 13 years, and finding similar results: a 1pp rise

<sup>19</sup> Best, M. C., & Kleven, H. J. (2013). Housing market responses to transaction taxes: evidence from notches and stimulus in the UK. London School of Economics.

in stamp duty cuts housing market turnover 8%.<sup>20</sup> They also find that the incidence of the tax is entirely on the seller, or in many cases more than entirely: house prices fall more than \$1 for every extra \$1 in tax. These papers tell a story that the rest of the economic literature echoes.<sup>21</sup>

Paper	Drop in transaction volume from 1pp higher housing transactions tax at current margins
Best & Kleven (2013)	20%
Davidoff & Leigh (2013)	8%
van Ommeren & van Leuvensteijn (2005) <sup>22</sup>	8%
Dachis et al. (2012) <sup>23</sup>	14%
Hilber & Lyytikainen (2012) <sup>24</sup>	20%

Yet all of these papers are likely to understate the true costs of stamp duty land tax. Kopczuk & Munroe show that a New York City mansion tax not only reduced activity at and around the notches where it kicked in, but across the market.<sup>25</sup> Potential buyers did not always know the costs of potential houses, and, since they might stray into higher tax territory, were dissuaded from searching at all, adding a further dimension to the misallocation. This thinner market leads to less informative and more volatile prices, according to Singaporean evidence.<sup>26</sup>

An Australian Treasury comparative analysis of various taxes found that their housing transactions tax was the most economically costly of all their major levies.<sup>27</sup> On their numbers, stamp duties imposed a \$0.80 welfare cost for every \$1 raised in tax, over and above the \$1 loss to those paying the tax burden. This is consistent with other research across the developed world.<sup>28</sup>

<sup>20</sup> Davidoff, I., & Leigh, A. (2013). How do stamp duties affect the housing market?. *Economic Record*, 89(286), 396-410.

<sup>21</sup> Shan, H. (2011). The effect of capital gains taxation on home sales: evidence from the Taxpayer Relief Act of 1997. *Journal of Public Economics*, 95(1), 177-188.

<sup>22</sup> Van Ommeren, J., & Van Leuvensteijn, M. (2005). New evidence of the effect of transaction costs on residential mobility. *Journal of Regional Science*, 45(4), 681-702.

<sup>23</sup> Dachis, B., Duranton, G., & Turner, M. A. (2011). The effects of land transfer taxes on real estate markets: evidence from a natural experiment in Toronto. *Journal of Economic Geography*, 11r007.

<sup>24</sup> Hilber, C., & Lyytikainen, T. (2012). Stamp duty and household mobility: regression discontinuity evidence from the UK. London School of Economics and Political Science.

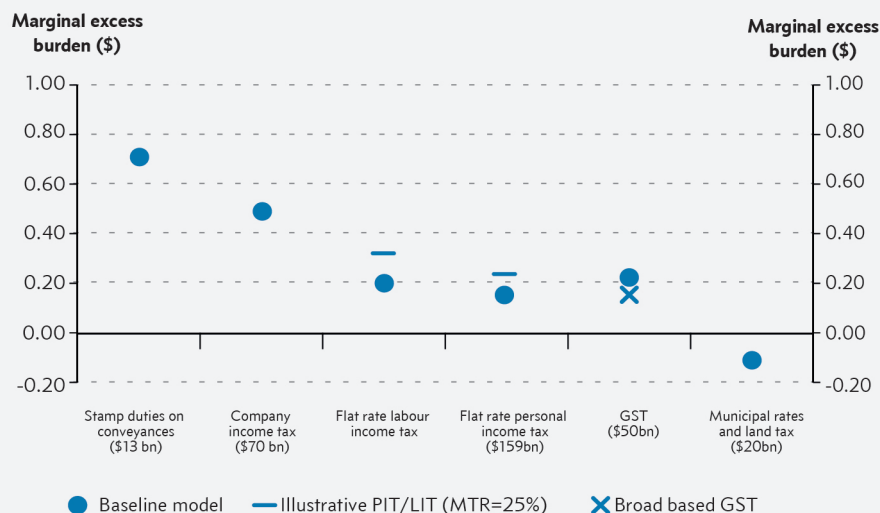
<sup>25</sup> Kopczuk, W., & Munroe, D. J. (2014). Mansion tax: the effect of transfer taxes on the residential real estate market (No. w20084). National Bureau of Economic Research.

<sup>26</sup> Fu, Y., Qian, W., & Yeung, B. (2013). Speculative Investors and Tobin's Tax in the Housing Market (No. w19400). National Bureau of Economic Research.

<sup>27</sup> Cao, L., Hosking, A., Kouparitsas, M., Mullaly, D., Rimmer, X., Shi, Q., ... & Wende, S. (2015). Understanding the economy-wide efficiency and incidence of major Australian taxes. Treasury WP, 1.

<sup>28</sup> O'Sullivan, A., Sexton, T. A., & Sheffrin, S. M. (1995). Property taxes, mobility, and home ownership. *Journal of Urban Economics*, 37(1), 107-129.

### Marginal excess burden of major Australian taxes



Source: Australian Treasury estimates.

This welfare loss isn't just coming from the cost of being in a house you don't like, or in a location you don't like, or one that has too few or too many bedrooms. One other potential cost is lower labour mobility: workers move less after jobs, resulting in lower pay, fewer jobs, and poorer match between worker and job.

One way we can test the impact of immobility on the labour market is looking at the relationship between homeownership in general and employment. Stamp duty land tax is not the only thing that causes housing immobility and illiquidity: there are lots of "organic" costs to movement that will always exist when people own, or even just occupy homes. These range from the concrete and mundane, like moving costs and estate agent costs, to the more abstract and intangible, like the costs of shifting communities and disrupting peer groups. It costs resources, and hence money to move possessions from one place to another, and it costs real resources to match buyers and sellers, whether mediated through estate agency fees or just in terms of the time and effort it takes to discover, browse, and visit lots of different properties.

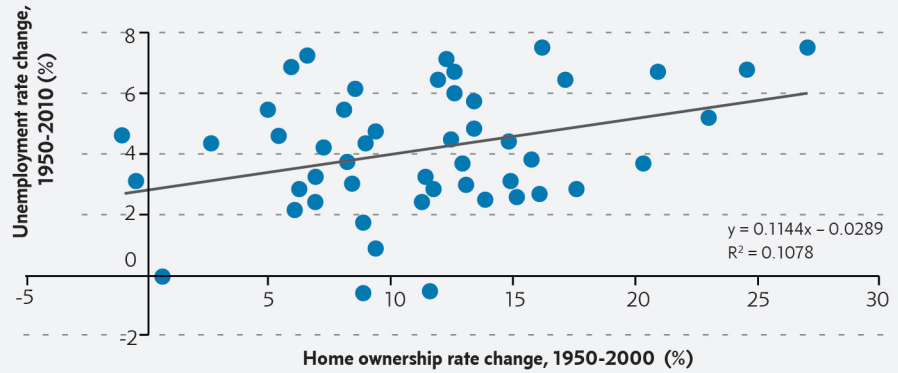
These "frictions" reduce mobility, and thereby reduce employment. One paper by David Blanchflower and Andrew Oswald finds a strong relationship both around the developed world, between homeownership rates and unemployment, and across time, within US states. In their central estimate, 1% higher homeownership raises unemployment 2.2%.<sup>29</sup>

However, in those cases where homeownership reduces employment, or raises unemployment, we can assume that this cost is mostly or entirely balanced out by the benefits the homeowners enjoy. This is because most of the costs and benefits are internalised in the homeowners decision to buy: they are themselves balancing their lower ability to get a job, or the job they want, with the benefits of owning their own property—security of tenure, a sense of rootedness and place, the

<sup>29</sup> Blanchflower, D. G., & Oswald, A. J. (2013). The Danger of High Home Ownership: Greater Unemployment. The Comparative Advantage in the Global Economy, Chatham House Series, 10.

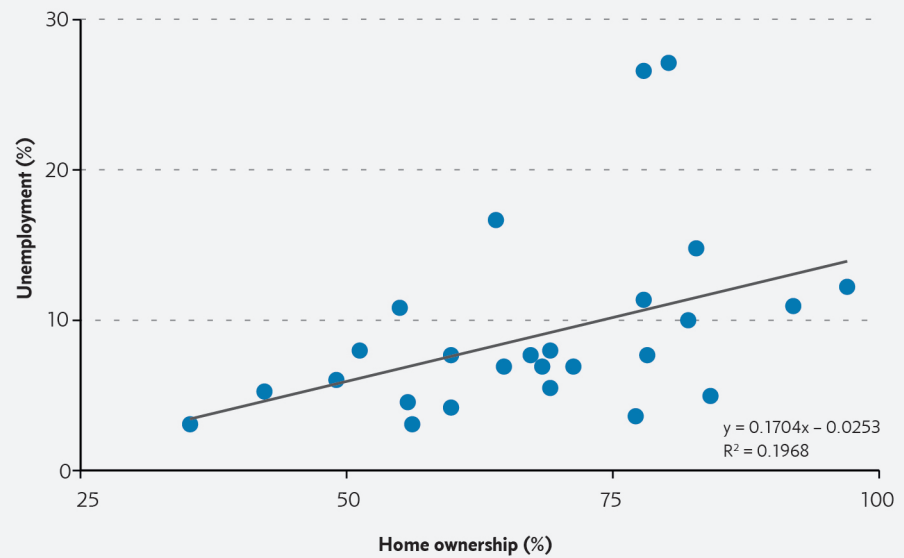
ability to decorate and alter their home as they like, and so on. This is not the case with stamp duty land, tax, where any lower or worse employment is not voluntarily borne in return for benefits, but is imposed as a revenue-raising measure.

#### Changes in unemployment and home-ownership rates in the US states



Source: Blanchflower and Oswald (2013).

#### Unemployment and home-ownership rates across 28 EU and OECD countries



Source: Blanchflower and Oswald (2013).

However, the evidence on this area is not conclusive: it is possible that stamp duty land tax's costs, huge as they are, are primarily or solely from misallocating housing, and not so much from misallocating labour.<sup>30</sup> This does not imply that the costs of the tax are low. Where someone lives—what sort of buildings, rooms, flatmates, and of course what location—is an incredibly important part of their life, even if they can get the same job.

What's more, housing market regulation, like the restrictive planning system, amplifies the cost of mismatch, even when it comes through regulations e.g. on vacancies.<sup>31</sup> When housing is scarcer the importance of allocating it correctly is even larger: if we can build lots more in Hackney, or build many more traditional terraced houses, or easily build new, larger, or smaller, properties, then it is less important that we shuffle the existing properties between people efficiently. Instead of transferring houses, we can build new ones.

But the UK policy seems to be the worst of both worlds: extremely strict housing regulations so new properties cannot be built to service changing demand, and large transfer taxes, so properties cannot be shifted between owners to accommodate changing demand. When housing supply is elastic, it doesn't matter much if people have lots of spare bedrooms—but when housing supply is inelastic it is important to put as few impediments in the way of transferring houses to those who demand them most.

## PROPOSALS FOR REFORMING PROPERTY TAXATION

Total UK housing wealth is about £7.5 trillion, according to analyses from Zoopla and the Property Industry Alliance; the Office for National Statistics and Savills put the number at around £6.9 trillion. Rental yields are about 4%.<sup>32</sup> This means that if everyone sold and then rented their house, and every business sold and rented its property, we'd pay about £300bn in total in rents.

Of course, we already have taxes on property rents: council tax for owners or tenants, and business rates. Council tax, brought in in 1993 to replace the deeply unpopular Community Charge system—seen as a poll tax—is levied on property occupiers based on the property's valuation in 1991. Properties were then sorted into one of eight “bands” ranging from Band A for properties worth up to £40,000 to Band H for properties then worth more than £320,000. Councils are free to set the Band D council tax, but the relationship between Band D and other bands is set by central government. New properties are also added based on these valuations—so luxury flats in areas like Brixton, depressed in 1991, are often in Band C (worth £40,000-£52,000), despite being worth many hundreds of thousands of pounds. Since the property boom of the last two decades has been concentrated in

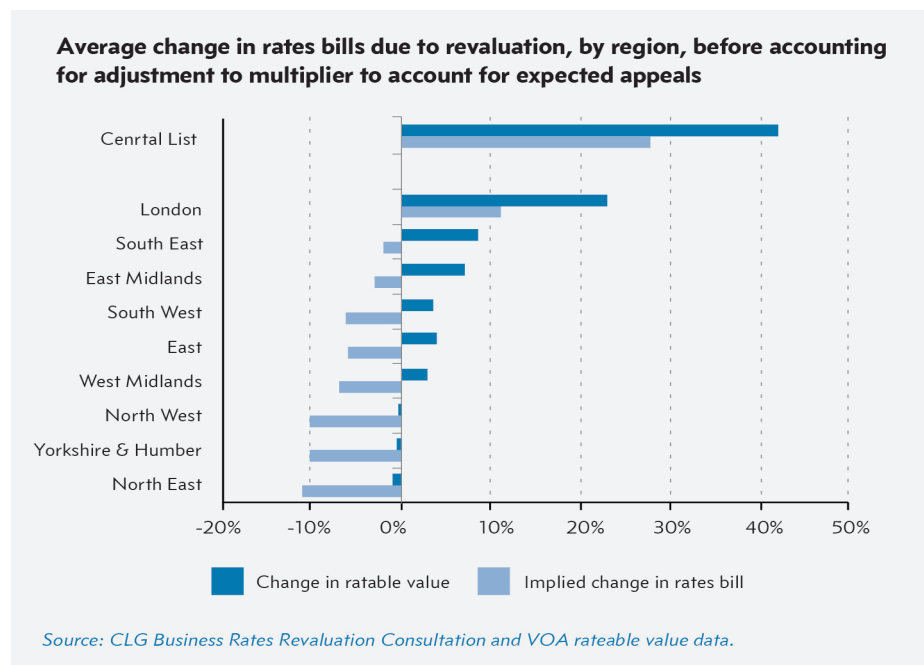
<sup>30</sup> Hilber, C. A., & Lyytikäinen, T. (2015). Transfer taxes and household mobility: distortion on the housing or labour market.

<sup>31</sup> Cheshire, P., Hilber, C., & Koster, H. (2015, October). Regulating vacancies away? The paradoxical effects of mismatch in the housing market. In ERSA conference papers (No. ersa15p1524). European Regional Science Association.

<sup>32</sup> See [lendinvest.com](https://lendinvest.com)'s BTL index for an overview

the South East, this means the regressivity is also exacerbating regional inequality. Councils largely retain the revenues they levy, but most council revenue comes from a complex central grant system that is intended to “balance out” differences between local authorities’ tax bases. There are also a set of reliefs and benefits that work to try and reduce the burden for households with fewer adults or lower incomes.

Business Rates is the analogous system for commercial or business property, and has a much longer history. It is currently levied at a rate of 49.7p in the pound, based on 2015 valuations (since April 2017), this time with an even more dizzying array of exemptions, reliefs and reduced rates for smaller businesses and for farmers, as well as higher rates for bigger firms. Revaluations are always controversial, since they necessitate higher burdens for some, and lower for others, but unlike with council tax, they have been carried out. What is more, firms face a smooth rate across the rent schedule, in comparison to the banding seen in council tax.



Though many business lobbies argue that firms are hampered by their business rates bills, a large body of evidence suggests that it is the owner of property, not the occupier, that bears its burden.<sup>33</sup> That is: since firms don’t care whose pockets their rent ultimately ends up in, and only care about the total cost of renting a place, any rise in rates makes a place more expensive for any given rent. The supply of property is inelastic because of the UK’s tight planning regulations, but firms can use less space, or less ideal locations, and so demand is somewhat elastic. Thus, any given rise in rates tends to be counterbalanced by a similar fall in rents. A recent report jointly put out by the British Property Federation, the British Council of Shopping Centres, and the British Council for Offices found that around 75% of a rates hike

<sup>33</sup> DCLG (2016). Business Rates Revaluation 2017 Consultation on the transitional arrangements for the 2017 business rates revaluation

was capitalised into lower rents within three years.<sup>34</sup> Other studies find very similar results.<sup>35</sup> And while it certainly stings when you hand over council tax as a tenant, the economic logic and evidence points in the same direction there too: higher tax on property occupiers is mostly counterbalanced by lower rents.<sup>36</sup>

Households and firms use property for two different things. Firms use land and property as inputs into production. Households consume the housing services that land and property provide. If they are owners, they also speculate on the future value of those housing services. Theory tells us that we should tax firms on their outputs through, for example, a VAT, or a cashflow tax; but be agnostic about which inputs they use to get there (as long as they don't impose any externalities). If we do tax certain inputs, we will distort firm production structures towards less efficient models, models they only use to get around the tax. If we tax all inputs equally there is no distortionary effect on input use, but it is a more complicated and administratively costly way of taxing the value added at the end.

Thus, theory calls for business rates to be zero. Property is an input into production: firms choose how much to hire (or own), along with labour and capital, in order to most efficiently produce their outputs, and service consumer demand, in turn in order to make profit for their owners. When we tax it, we give a signal to firms to use less property, and more of other inputs.<sup>37</sup> In the long run, it would be best to tax business use of property at zero, by raising other taxes such as VAT. In the short run, we should leave the business rates system untouched: there is no need to bundle any SDLT reform with full property system revaluation, especially when under our current planning system business rates do little economic harm. The lost revenues can be adequately covered by fixing the banding and lack of revaluation that makes council tax so regressive.

Currently stamp duty land tax brings in about £12bn. Council tax brings in £29bn, but an across the board tax on property wealth of 1% would bring in £40-60bn if we

**34** Regeneris Consulting (2015). Business Rates: Who Pays and Why it Matters

**35** Mehdi, N. (2003). The capitalisation of business rates: An empirical study of tax incidence in six London boroughs (Doctoral dissertation, London School of Economics and Political Science (United Kingdom)).

**36** Hilber, C. A. (2015). UK Housing and Planning Policies: the evidence from economic research.

**37** This concern is muted somewhat by the finding that the supply of business property is inelastic. We might think that although the supply of new buildings is inelastic, because of strict planning regulations on building and development, the supply of buildings between uses is elastic. Whoever pays business rates, there is a large tax on business-to-landlord transactions that is not mirrored by a large tax on household-to-landlord transactions (since council tax is so low and rarely updated). However, if this were of large practical impact in the medium run we'd find a larger elasticity of supply in the data, and more of the tax would be in practice borne by business tenants. Since we do not in fact find this—the standard finding, as noted, is that 75% of the tax is borne by landlords—it must be sufficiently different to change buildings between uses (presumably for regulatory reasons), at least in the medium run. Perversely, business rates are less costly in a tight planning environment than they would be if it were easy for landlords to switch buildings between uses based on objective financial considerations. However, it must be noted that this body of research typically does not and is not able to look into the long run. It may be that over the long run, business rates does compete away property from business uses and into housing. It is certainly notable that so many new London towers are much more valuable as luxury housing than as office space, contrary to trends across time and across the world.

excluded businesses to account for the fact they pay business rates.<sup>38, 39</sup> This would fall almost entirely on those with very expensive properties. A tax of 20p in the pound on imputed rental values, roughly equivalent to extending VAT to housing services, would raise a similar amount at current yields, and fluctuate less with interest rates. Taxing property values would also discourage investment; taxing rents only hits consumption. Either levy would cover the cost of abolishing SDLT, and would have the side benefit of getting at hard to tax groups like rich non-doms who buy and hold property, or rent property instead of buying it.

Implementing this system—taxing imputed rents on all residential property—would require a system for calculating rental values where no market data exists, but the large databases of prices, yields, rents, house sizes, and trends therein make this a straightforward, albeit technically detailed, endeavour. Zoopla and Rightmove only use very simplistic, cheap, and straightforward mechanisms to give a rough estimate of house prices across the country, but are able to give decent attempts anyway with the paucity of open information they can get hold of. Her Majesty's Treasury and Her Majesty's Revenue and Customs already do infrequent rental valuations for business rates. It would be technically trivial to estimate a regression model that works out imputed rents for landowners where no rental transaction goes on.

Whereas stamp duty land tax taxes property when it changes hands, and as many times as it changes hands, this new “VAT on imputed rents” would raise the same revenue but would tax property equally whether or not it changes hands. However, as with any major tax system change, there will be concerns about fairness—what economists usually call “equity”—even if it is agreed that there will be large efficiency gains. There will be winners and losers.

## DISTRIBUTIONAL EFFECTS OF PROPERTY TAX REFORM

Questions of fairness or equity are usually about two things: progressivity, and rights-based justice.

The overall effect of tax and benefits in Western countries is usually highly progressive: those on high incomes pay much more in tax than they receive in benefits, while those on low incomes have their incomes topped up, as well as goods provided in kind. The GINI coefficient of income before tax and benefits is around .375, where 1 indicates perfect inequality (one person owning everything), and 0 indicates perfect equality; it falls to around .275 after redistribution.<sup>40</sup> If publicly

<sup>38</sup> Private Residence Relief, which exempts primary residences from capital gains, is highly distortionary, causing too much housing investment, and costs around £18bn a year in foregone revenue. Any move towards bringing PRR in line with the rest of the CGT system should be centred around using extra revenues from reducing PRR to reduce the main rate of CGT. Eventually, CGT should hit zero, with other less distortionary levies making up the gap (e.g. VAT or income tax) if absolutely necessary.

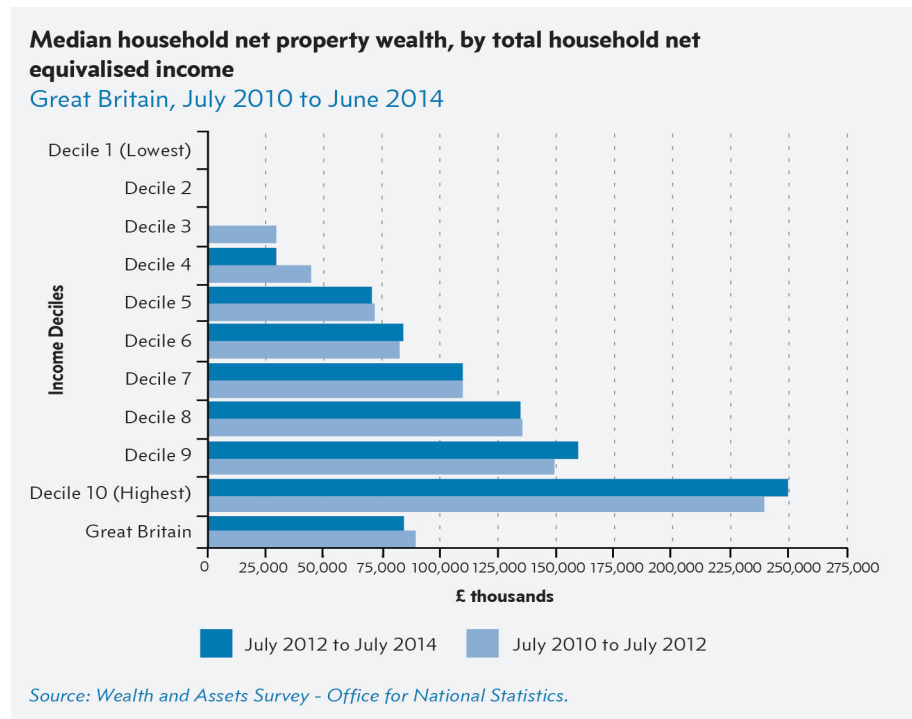
<sup>39</sup> Some commercial property faces VAT through deliberate choice, but most residential property is “outside the scope” of VAT, or specifically exempted.

<sup>40</sup> Brewer, M., Dias, M. C., & Shaw, J. (2012). Lifetime inequality and redistribution (No. W12/23). IFS Working Papers.

provided goods like the NHS or education were counted, it would go yet lower. And over the lifecycle, the GINI coefficient is around .18.

This is mostly intentional: successive governments have intended to have a highly progressive system. Consequently, although any major tax reform will involve adding burdens to some households, and/or lightening burdens on other households, this one will attempt to remain roughly distributionally neutral, neither especially progressive nor especially regressive. If policymakers want to make the tax and benefit system more progressive they ought to raise taxes on consumption by increasing higher income tax rates but exempting savings and investment, and/or boost benefits that go mainly to low earners. The justification for this reform is its large benefits in efficient allocation of assets, and in the medium- to long-run, to economic output. Such a reform should in principle be attractive to all policymakers, whatever their distributional goals.

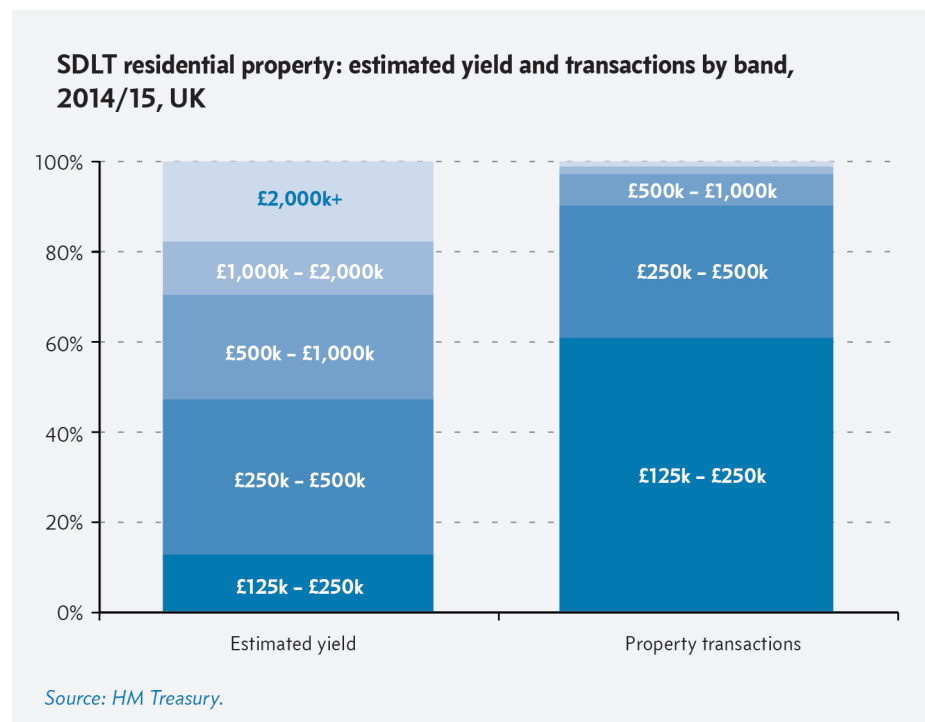
Property consumption taxation is, in principle, highly progressive. Those on higher incomes usually own more valuable property not just in proportion to their income, but greater than in proportion. Recent ONS statistics find that the top decile owns an average of £250,000 in property wealth per household on average; the bottom three deciles own nothing at all.<sup>41</sup> The situation is the same in most European countries.<sup>42</sup> However, the current council tax regime is designed to be highly regressive. Properties worth £320,000 in 1991 face a burden only double those worth £80,000, and properties worth above £320,000 face an identical burden, however valuable they are.



<sup>41</sup> Chamberlain, E. (2015). Property wealth, Wealth in Great Britain, 2012 to 2014, Office for National Statistics.

<sup>42</sup> D'Ambrosio, C., & Gigliarano, C. (2007). The distributional impact of imputed rent in Italy. Accurate Income Measurement for the Assessment of Public Policies working paper (Colchester: University of Essex).

In comparison SDLT is highly progressive. The 2% of properties sold for more than £1m account for about 30% of total receipts.<sup>43</sup> Abolishing council tax and SDLT at the same time, but implementing VAT on imputed rent (the rental value of property) will replace one regressive tax and one progressive tax with another progressive tax.<sup>44, 45</sup> Typically, shifts to property taxation are found to be progressive in total.<sup>46,47</sup> Without detailed distributional analysis it is impossible to be precise on the resultant consequences—the move should still be roughly progressive, and will bring in far more in revenue from, e.g. foreign long-term investors in London property. But within the group of extremely wealthy property owners some will face higher tax liabilities, e.g. if they had intended never to move house under any circumstances, and others will face lower liabilities—those who move often.



<sup>43</sup> Seely, A., & Keep, M. (2017). Stamp duty land tax on residential property, House of Commons Briefing Paper Number 07050

<sup>44</sup> Sommer, K., & Sullivan, P. (2013). Implications of US Tax Policy for House Prices, Rents and Homeownership. Working Paper, Federal Reserve Board of Governors.

<sup>45</sup> See e.g. Anderson, J. E., & Roy, A. G. (2001). Eliminating housing tax preferences: a distributional analysis. *Journal of Housing Economics*, 10(1), 41-58.

<sup>46</sup> Figari, F., Paulus, A., Sutherland, H., Tsakoglou, P., Verbist, G., & Zantomio, F. (2016). Removing homeownership bias in taxation: The distributional effects of including net imputed rent in taxable income. *Fiscal Studies*.

<sup>47</sup> Paetzold, J., & Tiefenbacher, M. (2016). Shifting the tax burden from labor to property: The case of Germany (No. 2016-3).

After progressivity, the other main consideration is rights. Some object that taxes on property amount to the government owning a stake in any land you own, implying you own it in name only. Some argue it effectively “abolishes property ownership”. To some extent such moral intuitions are irreconcilable with an alternative pragmatic worldview based on maximising social welfare and efficiency—the greatest good for the greatest number. It is however worth noting that the principle of property ownership entailing obligations is not unknown in English land law. Some obligations, including Chancel Repair Liability (the requirement to keep up ancient parish churches on some tracts of land) effectively a regular financial commitment paid through insurance subscription. And all landowners must make property reasonably safe for guests and trespassers.

## FLOWS & STOCKS: PAYING THE TAX

The fact that liability is accrued in an annual basis, calculated based on rental values, does not mean the money must be handed over this way. It is important that the economic liability is identical, but a property owner’s obligation could be disbursed in a way that looks superficially like SDLT—when the property is transferred through sale, inheritance, or gift. Until then it would accumulate based on rental values at the time, compounded with nominal interest rates.<sup>48</sup>

Economically, this tax would be very different to SDLT:<sup>49</sup>

- SDLT is progressive through notches and thresholds; our alternative is proportional, although it could be structured progressively.
- SDLT is based on sale price at one time; our alternative would accumulate based on rental values at different times: if the price only just shot up, you wouldn’t pay higher tax, it would reflect the value that houses had when you occupied them.
- SDLT is based on ownership values; our alternative is based on rental values. Ownership includes the investment component of a house, capitalising in expected future rental values—but we only wish to hit the actual market rental value of a property. SDLT also hits houses harder when interest rates go down—ours is unaffected.
- SDLT hits properties harder when they change hands more often; our alternative taxes in exact proportion to length of occupation: owning a house for one month makes an owner liable for one month of tax. A property worth £10,000

<sup>48</sup> The obvious candidate for which nominal interest rate to use is gilt rates, but since these are lower than the rates people could get on the open market, people would have an incentive to delay payment and let the tax accumulate in this way. This isn’t necessarily a problem if there is no chance of non-recovery, and no extra cost of recovering the tax at this way, because it would be neutral—the government would be getting and paying the same interest rate. But there may be some case for gilt rates plus some small margin.

<sup>49</sup> It is more similar to abolishing Private Residence Relief on Capital Gains Tax, combined with removing the to-be-introduced new reliefs on Inheritance Tax for private main residences, above the regular inheritance tax (IHT) threshold. Since CGT only falls on changes in price, it imposes less of a disincentive to moving. And IHT backstops this by preventing infinite avoidance. This system would be patchy and inconsistent, but even a rationalised version of it would not work similarly to our alternative system: our system is based on rental values not sale values, and the liability is based on the past, not the present. The IHT/CGT system makes households vulnerable to rapid changes in property prices in a way our alternative avoids.

in rent per year will face £2,000 of tax however its ownership changes, and whoever owns it; transfers of ownership merely change who pays.

- SDLT can be infinitely avoided by never transferring the house; our alternative uses inheritance as a fallback. But our alternative is not analogous to an inheritance tax: at inheritance you pay only liability incurred in the past; current property value is not taken into account. There is no disincentive to accumulating assets, and nor is there any link to any other estate taxation, which is outside the scope of this paper.

Allowing property owners to pay at the end of their tenure, when they sell their property or give it to their heirs, obviates their need to take out a mortgage on their property to meet their liability. Any tax could be absorbed by the sale money—comparable to the social care policy in the 2017 Tory manifesto that they U-turned on, where homeowners can defer any payments until after their death if they so choose.

## CONCLUSION

Tax systems should aim for neutrality and efficiency: maximising economic activity—given the desire or need to raise revenue—and limiting tax-driven bias between different choices individuals and households might want to make. Stamp Duty Land Tax made perfect sense in the 17th Century, when the British government began to levy it. When bureaucracies were smaller and less sophisticated, data less widespread, communication more costly and difficult—clear, obvious “flow” sources were the best base for taxation. However, in 2017 we have better tools at our disposal.

The current SDLT system hugely biases against mobility, despite an almost universal acceptance that within-UK mobility is too low. The end of the slab system only partly mitigates the issue, since it comes with huge rate hikes at the top end that increase misallocation at that end of the market, reducing economic welfare. The issue is particularly pressing during a housing crisis where every spare bedroom counts; slapping sellers—who bear 40% the burden of the tax—with a large penalty for moving disincentives using our scarce space efficiently.

The government must reform the system. It should abolish SDLT whether or not it can find the revenue elsewhere. But a rationalised, simplified, and neutral property tax system is an ideal way of replacing the lost revenue—indeed such a tax is a far better revenue raiser than most the UK currently has on its books. First, it should fix council tax so it no longer hits cheaper properties more heavily, and so very expensive properties no longer get off the hook almost entirely. The UK has about £7.5 trillion of property wealth: a 20% tax on the rental yield of this property—equivalent to extending VAT to property—would raise most of the £70bn needed to abolish all three of these baleful levies forever.