Additional Dwelling Supplement Preliminary Outturn Report

November 2016

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Executive Summary

This commentary produced by the Scottish Fiscal Commission compares the forecast for revenues from the Additional Dwelling Supplement (ADS) component of Land and Buildings Transaction Tax (LBTT) to the initial outturn data, while recognising that a proper picture of outturn revenues against actual forecast can only be made once full information is available on receipts. In the case of ADS, this will be 18 months after the end of the financial year, by which time all potential refunds should have been made.

The key findings from the commentary are:

- The absence of data for the number and value of additional dwelling transactions made it very difficult for forecasters to gauge the potential size of the tax base to which the ADS applies.

- Initial outturn data suggest that the typical price of properties for which ADS is ultimately liable is lower than for other residential LBTT transactions. However, the volume of ADS transactions appears to be higher than inferred from buy-to-let mortgage data. Combining realised price and volume data for the year-to-date and recomputing expected revenues using the SG's forecasting model suggests that the model performs well. Therefore the underprediction of revenues is largely driven by the inability to estimate accurately the size of the tax base due to the lack of information available on additional properties at the time the forecast was produced.

- While it is difficult to disentangle forestalling effects from other sources of forecast error, it appears that the forestalling estimates applied to LBTT in 2015-16 were not unreasonable in terms of their absolute size, but were slightly overstated when applied to ADS in 2016-17.

- Finally, it is not possible to definitively assess the extent to which there is an ongoing behavioural response to the new tax. There is simply insufficient information on the size of the tax base prior to the introduction of the tax to be able to assess how it has responded to the tax. Data on buy-to-let mortgages for the UK as a whole suggest that these have not yet recovered to pre-March 2016 levels which could be consistent with an ongoing behavioural response, although it may reflect other factors weighing on the market.

1. Additional Dwelling Supplement (ADS)

1.1 In December 2015 the Scottish Government (SG) announced a supplement of 3 percentage points of the total price to be applied to additional residential property transactions in excess of £40,000 from 1 April 2016. This coincided with a similar measure introduced by the UK Government to supplement Stamp Duty Land Tax. The Scottish Government's headline forecast was for the supplement to increase overall LBTT receipts in 2016-17 by between £17m-£29m.[1] By the end of the first six months of the financial year gross liabilities of the tax amounted to £46m, which after realised repayments[2] implied a net liability figure of £41.9m.[3] It therefore could appear as though the tax is on track to raise more revenues than forecast in the Draft Budget 2016-17.

1.2 However, the forecast of £17m-£29m is actually a policy costing which takes account of a wider set of potential behavioural repercussions resulting from the imposition of the new tax. Some of these repercussions involve reduced Land and Buildings Transaction Tax (LBTT) transactions in general, and the shifting of such transactions from the 2016-17 tax year to the 2015-16 tax year. Therefore, it is necessary to adjust the policy costing to infer what the forecast revenues from the Additional Dwelling Supplement (ADS) alone would be in the 2016-17 fiscal year. This is the issue to which we first turn.

2. Forecasting ADS

2.1 The revenues from ADS were forecast as follows.[4] Firstly, an estimate was derived of the current number of transactions likely to be subject to the new tax. By combining data on buy-to-let mortgages, the proportion of house purchases typically mortgage financed, council tax data on second home ownership and typical turnover rates in the residential market, a range of estimates for the number of potential transactions of between 8,500 and 12,500 emerged as the basis for the forecast.

2.2 Secondly, Council of Mortgage Lending data on the value of buy-to-let mortgages indicate that these are typically 10% lower than other mortgages, suggesting that the price of the buy-to-let property is also lower. These two

[1] The figure used in the Draft Budget of £23m is the centre of this range.
[2] ADS paid may be reclaimed when the tax payer sells their previous main residence within 18 months of the date of transaction that was liable to the ADS supplement.
[3] This outturn data comes from data provided by Revenue Scotland to the SFC which is published to a higher level of granularity and precision than the online publication "Land and Buildings Transaction Tax Monthly Statistics – September 2016". This accounts for the small difference between these and the published data.
[4] Scottish Government (2015) Draft Budget 2016-17: Devolved Taxes – Forecasting Methodology http://www.gov.scot/Resource/0049/00491259.pdf

elements were then combined in the SG's LBTT model to obtain a 'static' estimate of the revenues generated of between £45m-£70m.

2.3 These first-round estimates do not include any behavioural response to the new tax. However, unlike the rest of the residential LBTT forecast, SG forecasters sought to undertake some assessment of the likely behavioural response to the new tax. The OBR had evaluated the impact of the same policy in the rest of the UK and the SG forecasters applied the highest of the elasticities the OBR use to infer a permanent behavioural response to changes in the average SDLT rate, to this tax change. This reduced the forecast revenues from ADS by 18% to £37m-£57m.

2.4 The SG then included an estimate of the impact on wider LBTT revenues if the number of transactions is reduced. Using OBR estimates that the tax change would reduce overall transactions by 3%; this reduces LBTT revenues by another £7m. SG forecasters assume this £7m reduction is made up of a reduction in main residence LBTT transactions with no further reduction in ADS transactions. As a result, whilst this reduces the overall LBTT forecast revenues it does not reduce the revenues received from ADS directly.

2.5 Finally, there was an assessment of the temporary forestalling effects which might arise as a result of announcing an April 2016 tax change in December 2015. This was expected to bring forward some transactions into the 2015-16 tax year, before reducing the number of taxable transactions in 2016-17. Using the same elasticities employed in the SG's computation of residential LBTT forestalling the Scottish Government estimated that forestalling would reduce anticipated ADS revenues by £8m-£14m in 2016-17, additionally £5m-£7m of LBTT receipts would be brought forward into 2015-16. This led to the final policy costing for ADS increasing overall LBTT receipts by between £17m-£29m.

2.6 In summary, implicit in the Scottish Government's original policy costing is a forecast for revenues in 2016-17 accruing to ADS. Based on the foregoing discussion we take that baseline forecast for ADS revenues in 2016-17 to be £29m-£43m, along with additional reductions in LBTT revenues in 2016-17 of £12m-£14m, and an increase in 2015-16 of £5m-£7m. It should be noted that this forecast of revenues accruing to ADS is based on net revenues (i.e. after all repayments have been made) rather than on gross revenues.

3. ADS Outturn Data

3.1 We begin our analysis of the outturn data for ADS by comparing the monthly liabilities generated by ADS relative to what were expected. To do so, we assume that the seasonality in the additional dwelling segment of the residential market is the same as that in the residential housing market as a whole. These seasonality factors are reported in the first column of Table 1. At this stage we have no evidence regarding the seasonal pattern of sales for additional properties; we will monitor the validity of this assumption as further data become available.[5] The second column shows expected revenues by month based on the forecast of £29-£43m. The next column reports the gross ADS liabilities reported by Revenue Scotland. However, since ADS may be reclaimed provided the tax payer's previous main residence is sold within 18 months, these gross figures overstate the revenues received and the difference may increase in future months.

3.2 Analysis of the rate of repayments suggests that these are currently around 14.5% of gross liabilities for each of the first three months of the tax, but are lower for the subsequent months possibly indicating further repayments to come. However, even for the first three months the level of repayments has not yet fallen to zero and there may well be further repayments associated with transactions incurred in these months too. This possibility is reinforced by the fact that when homeowners file their ADS returns they can also indicate an intention to reclaim. These intentions imply that up to 25% of transactions subject to ADS (34% by value) may be reclaimed. Accordingly in this first pass assessment of the in-year outturns of ADS we employ a repayment rate of 14.5%, but then consider the implications of a higher repayment rate in para 3.4 below.[6] The final columns then compute the monthly forecast error which is positive after April 2016.

[5] The issue of seasonality is complicated by the fact that while there is one transaction which gives rise to the initial ADS liability, in some cases this may be followed by a subsequent one which triggers the repayment of that liability.

[6] The range of repayment rates we employ in this report, namely 14.5%-34%, lie between the current level of repayment observed for the first three months of 2016-17 at the time of writing the report and the level of repayment implied by households' intentions to reclaim. It is likely that the rate of repayments will rise above this lower rate, but we do not yet know if it will ultimately reach the upper bound.

Table 1: Additional Dwelling Supplement – Monthly Forecast vs Outturn

Month	Expected Tax Revenues (%)	Range of Expected Tax Revenues (£m)		Gross Revenues (£m)	Estimated Net Revenues (£m)	Difference between expected and estimated revenues (£m)	
		Lower	Upper			Lower	Upper
Apr	7.5	2.2	3.2	2.1	1.8	-0.4	-1.4
May	8.1	2.3	3.5	6.2	5.3	3.0	1.8
Jun	9.3	2.7	4.0	8.3	7.1	4.4	3.1
Jul	10.3	3.0	4.4	9.8	8.4	5.4	4.0
Aug	9.2	2.7	4.0	10.0	8.6	5.9	4.6
Sep	9.6	2.8	4.1	9.7	8.3	5.5	4.2
Oct	9.1	2.6	3.9				
Nov	8.4	2.4	3.6				
Dec	9.8	2.8	4.2				
Jan	5.5	1.6	2.4				
Feb	6.1	1.8	2.6				
Mar	7.2	2.1	3.1				
Total	100	29.0	43.0				

Notes to Table:
The estimation of monthly Tax Revenues is based on SFC calculations building on SG estimates of seasonality in house prices and transactions. The Gross Revenues are from Revenue Scotland, 'LBTT Monthly Statistics', September 2016. The Estimated Net Revenues column deducts 14.5% from Gross Revenues to capture repayments if the current rate of repayments for the first quarter of 2016-17 remains the maximum rate, i.e. those months see no further repayments over the remainder of the 18 month reclaim period.

3.3 The final column of Table 1 indicates that the revenues received were in excess of what was expected, particularly in the second quarter of the fiscal year where the forecast errors appear to have settled at a fairly constant level. This suggests that the forestalling impacts were concentrated in the first quarter of 2016-17.

3.4 The computation of the extrapolated revenues from part-year outturn data is complicated by the fact that households can reclaim ADS paid if they sell their main residence within 18 months of the ADS liability being generated. Table 1 assumed that 14.5% of gross liabilities will ultimately be reclaimed in line with the highest reclaim rates seen to date. This reflects the experience of the first three months of the new tax where the rate of repayment is at this level across all three months. However, in none of these months has the rate of subsequent repayment fallen to zero and it remains possible that further repayments may be claimed and the net outturn figures will lie below our estimates. This is also reflected in the fact that households have indicated that they hope to reclaim around one third of the value of ADS liabilities generated so far.[7]

3.5 In order to assess the implications of alternative repayment rates Table 2 conducts the same analysis as Table 1, but contrasts the SG's central forecast for ADS revenues with the extrapolated outturn figures based on a value-based repayment rate of either 14.5% or 34%.

Table 2: Additional Dwelling Supplement – Monthly Forecast vs Outturn with Alternative Repayment Rates

Month	Expected Tax Revenues (%)	Mid-Range of Expected Tax Revenues (£m)	Adjusted Net Liabilities (£m)		Difference (£m)	
			(1)	(2)	(1)	(2)
Apr	7.5	2.7	1.8	1.4	-0.9	-1.3
May	8.1	2.9	5.3	4.1	2.4	1.2
Jun	9.3	3.3	7.1	5.5	3.7	2.1
Jul	10.3	3.7	8.4	6.5	4.7	2.8
Aug	9.2	3.3	8.6	6.6	5.2	3.3
Sep	9.6	3.5	8.3	6.4	4.8	2.9
Oct	9.1	3.3				
Nov	8.4	3.0				
Dec	9.8	3.5				
Jan	5.5	2.0				
Feb	6.1	2.2				
Mar	7.2	2.6				
Total	100	36				

Notes to Table:
The estimation of monthly Tax Revenues is based on SFC calculations building on SG estimates of seasonality in house prices and transactions. The adjusted liabilities are calculated from

[7] The data on "intent to reclaim" was provided to the SFC by Revenue Scotland. It suggests that that homeowners hope to reclaim around 25% of transactions, representing around 34% of the value of ADS receipts.

Revenue Scotland data with gross liabilities; two scenarios for the net liabilities are modelled. (1) deducts 14.5% from Gross liabilities to capture anticipated repayments. (2) deducts 34% from gross liabilities to capture anticipated repayments.

3.6 The higher repayment rate reduces outturn numbers, but still implies that the original forecast underestimated the revenues from ADS. A 34% repayment rate would reduce the expected extrapolated tax take from ADS to £61.8m in 2016-17. Therefore, the in-year outturn numbers suggest an extrapolated outturn for the year as a whole of between £61.8m and £79.3m depending on where the rate of repayment lies between 34% and 14.5% (in contrast to an original forecast of £29m-£43m).[8] We will only be able to reach a final conclusion on this 18 months after the 2016-17 tax year has ended.

3.7 It should be noted that the proportion of transactions subject to ADS which households hope to reclaim is around 25%, while the proportion of total gross ADS liabilities these represent is 34%. In other words, as noted above, it is particularly high value properties which may incur an ADS charge which the homeowners then hope to be refunded upon sale of the initial main residence.

3.8 What might account for the underprediction of revenues, even after stripping out the anticipated behavioural impacts of the tax on LBTT revenues, other than ADS itself? There was a significant amount of uncertainty around the number of transactions that would be subject to the ADS. The initial estimate of the level of transactions was between 8,500 and 12,500. However, the transactions where ADS was declared due in the first six months and has not yet been refunded amounted to 8,770, with 6,980 transactions indicating no intention to reclaim ADS. This suggests that the baseline underestimated the size of the tax base.[9] Even after adjusting for the possibility that up to a quarter of gross transactions may ultimately be repaid, and using transaction seasonality that would suggest 53.4% of all transactions should occur in the first six months of the fiscal year, this would still imply an annualised transaction level of around 13,000. While, extrapolating the gross transactions for Q2 alone, on the grounds that Q1 transactions may be subdued due to forestalling effects, and then applying a 25% repayment rate would imply annualised net transactions of around 15,500.

3.9 At the same time, SG forecasters assumed that the average price of an additional dwelling was 10% less than for LBTT transactions in general. Here

[8] In calculating these estimated outturn revenues we extrapolate an annual gross revenue figure from the revenues received in Q2 of 2016-17, given standard estimates of price and transactions seasonality. This is then adjusted for an assumed rate of repayment. The degree of forestalling estimated to have occurred in Q1 is then deducted to arrive at the extrapolated net revenues for the year.

[9] Research by the Central Bank of Ireland (Coates, D., J. McNeill and B. Williams, “Estimating Cash Buyers and Transactions Volumes in the Residential Property Sector in Ireland, 200-2014”, Quarterly Bulletin, July 2016) found that there could be substantial variation in the proportion of cash-only purchases of residential properties which, if this was also true of Scotland, could affect the ADS tax base.

the evidence is quite subtle. We begin by exploring the prices of properties for which an initial payment of ADS is triggered, before considering how those mean and median prices are adjusted when repayments are factored in. In the second quarter of the fiscal year, based on the gross tax take observed, the average price of a property subject to ADS was £172,500 which is slightly above the Registers of Scotland average house price of £170,309 in Q2 of 2016-17 and very similar to the average price of standard LBTT transactions in the same quarter of £172,000.[10] This suggests that the prices of the houses in transactions triggering an initial ADS liability are not obviously lower than house prices in general. However, the median house prices were significantly different. In Q2 of 2016-17, the median price of a house subject to ADS was £131,000 compared to the RoS figure for the median price in the market as a whole of £145,000 and for standard LBTT transactions over the same period of £144,333. These three corrections would have implied gross revenues of £93m, falling to £61.4m -£79.5m after allowing for a 34%-14.5% repayment rate which contrasts with outturns extrapolated from (adjusted) Q2 revenues of £61.8m-£79.3m, respectively. This suggests the model performs well when fed appropriate price and transactions forecasts.

3.10 When we look at the net tax take,[11] the average and median house prices subject to ADS in Q2 2016-17 fall to £168,800 and £128,333, respectively. This reflects the fact the properties for which ADS is reclaimed tend to be high value properties. To the extent that there may be further significant repayments of ADS and these are focused on higher value properties this will tend to imply a reduction in the average price of properties forming the ADS tax base. It is only once the full extent of any repayments is known that we will be able to assess the validity of the assumption that the prices of property transactions for which ADS is ultimately paid are 10% lower than general residential LBTT transactions.

3.11 To explore this issue another way, the intention to reclaim ADS paid implies that up to 25% of transactions and 34% of the value of those transactions will be reclaimed. If this level of repayment was realised and the average price of gross ADS transactions is no different from standard LBTT transactions, then the implied price of reclaimed transactions would be 36% above standard LBTT transactions and the average price associated with ADS transactions net of repayments would be 12% below average. To the extent that repayment rates are lower than the intention to reclaim figures then, other things being equal, the reduced price for ADS transactions will lie between this 12% discount and the average price for standard LBTT transactions.

[10] We draw comparison with transactions in Q2 2016-17 to avoid the possibility that, due to forestalling effects, the transactions observed in Q1 may be atypical. Indeed, the transactions observed in Q1 do appear to be lower in value than those observed in Q2.
[11] ADS revenues net of repayments.

4. Forestalling

4.1 In the original forecast SG analysts suggested that there would be between £5m-£7m additional LBTT revenues brought forward in the 2015-16 tax year as a result of people attempting to avoid paying the new ADS. The Scottish Fiscal Commission's outturn report for 2015-16 found that there was a substantial increase in transactions and revenues in March of 2016. Using the Scottish Government's estimates of seasonality in transactions, the SFC allocated the realised transactions for 2015-16 of 103,700 across months, and found that transactions in March 2016 were 2,937 higher than would be expected based on normal seasonal patterns. Combining the seasonality estimates for prices and transactions suggests that revenues in March 2016 were £7.3m higher than would normally be expected. This is in line with the upper end of the SG's estimates of £5m-£7m.

4.2 At the same time, the lower rate of revenue generation from ADS in the first quarter of 2016-17 may be, partly, the counterpart to the forestalling observed in March 2016. To compute the extent of possible forestalling in ADS revenues in 2016-17 we extrapolated Q2 outturn data to the whole of 2016-17. This was then used to generate, given usual patterns of seasonality in prices and transactions, a level of revenues one would expect to receive in Q1. The difference between this and actual revenues received was taken to be a measure of the extent of forestalling in Q1. In this case revenues were reduced by £7.4m. This compares to the SG's adjustment for forestalling in 2016-17 of £8m-£14m which appears to overstate slightly the extent to which forestalling has reduced ADS revenues directly.

4.3 Assessing the remaining behavioural effects relies on being able to construct a meaningful counterfactual which captures the transactions that would have occurred in the absence of the new tax. However, the fact that the estimate of the underlying size of the tax base, before taking account of the behavioural effects, was significantly lower than the post-tax outturns means that it is not possible to place too much confidence in the computation of the baseline scenario. Therefore, although the magnitude of forestalling effects in 2016-17 appears slightly lower than anticipated, these factors alone cannot account for the high revenues generated relative to forecast. Instead the underlying pre-tax volume of transactions must have been higher than expected and/or the magnitude of the (non-forestalling) behavioural responses must be lower. It is not currently possible to disentangle these two effects with the available Scottish data.

5. Comparison with the UK

5.1 One way of assessing the magnitude of the ADS tax base is to contrast the rate of transactions in Scotland relative to those in the UK as a whole. The OBR's forecast of the revenues from the Additional Property Surcharge (APS) in England was built on an estimate that the volume of relevant transactions (before taking account of any behavioural impacts) was around 15% of total residential property transactions.[12] This is above the level of transactions assumed by SG analysts which would have implied a rate between 8.5%-12.5% given standard LBTT transactions of approximately 100,000 per annum.

5.2 In the first quarter of the fiscal year the rate of Additional Property Surcharge (APS) transactions was 14.6% of total Stamp Duty Land Tax (SDLT) transactions, rising to 23.9% in the second quarter of 2016-17.[13] We can compute the corresponding figures for Scotland as 12.8% and 20.6%, respectively, once accounting for ADS transactions already refunded. Therefore there does appear to have been a similar recovery in (gross) ADS transactions in the second quarter for Scotland and rUK, which even after allowing for up to a 25% repayment rate in terms of transactions, takes the level of transactions above that implied by the SG and OBR estimates of the tax base for this tax.

5.3 Does this recovery imply that, outside of the forestalling effects discussed above, none of the behavioural effects highlighted by the OBR and SG forecasters actually manifested themselves? Not necessarily. It could be that the pre-tax base was even larger than the level of transactions we have observed following the imposition of the surcharge. In order to assess this we need a measure of activity in this sector of the market before and after the imposition of the tax. The OBR plot the total number of mortgages by purchaser type, revealing a clear spike in mortgages associated with the forestalling activity in March 2016, as well as the subsequent fall.[14] We recreate that chart below for the UK. However, the important point to note is that the rate of mortgage issuance for BTL properties has not recovered to the levels seen before March 2016. To the extent that this also applies in Scotland and is correlated with ADS tax revenues this may imply that there have been behavioural impacts from the new tax despite the fact that revenues are higher than forecast.

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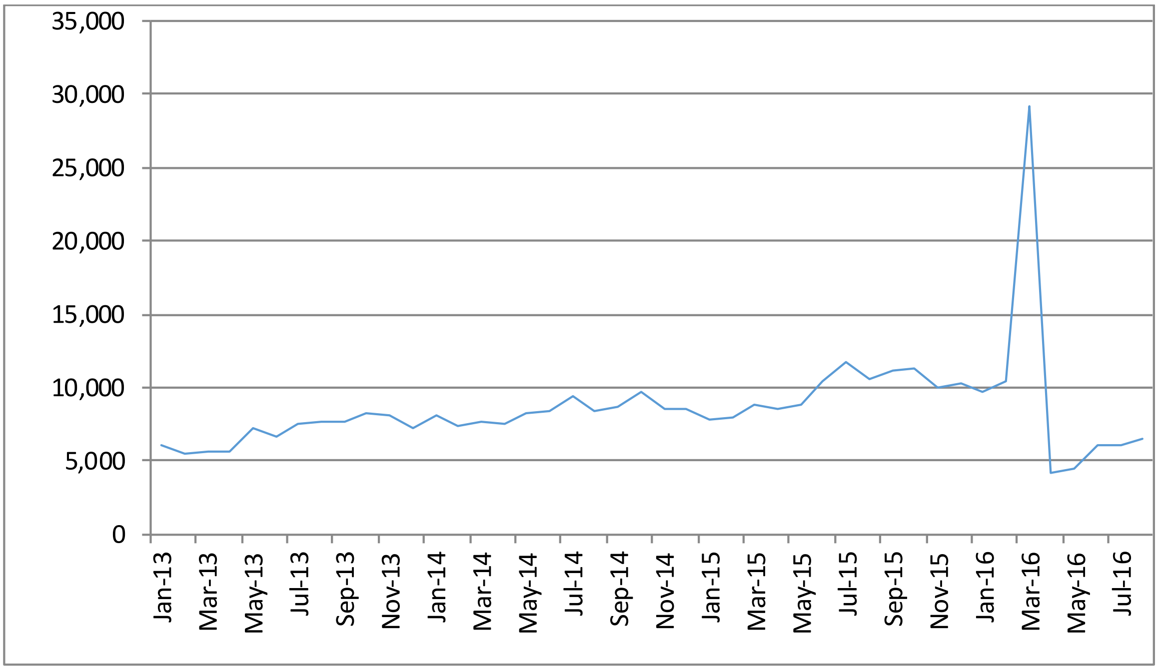
[12] See Mathews, Paul (2016), "Forestalling Ahead of Property Tax Changes", OBR Working Paper No. 10. (link)
[13] HMRC, "Quarterly Stamp Duty Statistics", September 2016. (link)
[14] See Chart 2.11 in Mathews, Paul (2016), "Forestalling Ahead of Property Tax Changes", OBR Working Paper No. 10. (link)

Chart 1 – Number of Buy-to-Let New Mortgages for Property Purchases in the UK



Source: Council of Mortgage Lenders

5.4 The OBR also found that the assumption that additional property transactions would be at a lower price than the average across all transactions has not been supported by the outturn data to date. Similarly, the base level of transactions subject to the Additional Property Surcharge appears to be higher than estimated.

6. Conclusions

6.1 The absence of data for the number and value of additional dwelling transactions made it very difficult for forecasters to gauge the potential size of the tax base to which the ADS applies.

6.2 Initial outturn data suggest that the typical price of properties for which ADS is ultimately liable is lower than for other residential LBTT transactions. However, the volume of ADS transactions appears to be higher than inferred from buy-to-let mortgage data. Combining realised price and volume data for the year-to-date and recomputing expected revenues using the SG's forecasting model suggests that the model performs well. Therefore the underprediction of revenues is largely driven by the inability to estimate accurately the size of the tax base due to the lack of information available on additional properties at the time the forecast was produced.

6.3 While it is difficult to disentangle forestalling effects from other sources of forecast error, it appears that the forestalling estimates applied to LBTT in 2015-16 were not unreasonable in terms of their absolute size, but were slightly overstated when applied to ADS in 2016-17.

6.4 Finally, it is not possible to definitively assess the extent to which there is an ongoing behavioural response to the new tax. There is simply insufficient information on the size of the tax base prior to the introduction of the tax to be able to assess how it has responded to the tax. Data on buy-to-let mortgages for the UK as a whole suggest that these have not yet recovered to pre-March 2016 levels which could be consistent with an ongoing behavioural response, although it may reflect other factors weighing on the market.

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