Transaction costs in commercial real estate: a european comparison

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Transaction costs are a widely discussed subject in real estate literature. Contributions have been dedicated to aspects as definition, typology, impact and relation with the institutional environment. Remarkably less attention has been paid to quantifying and explaining differences on country level. This paper has a threefold objective. At first, it attempts to define transaction costs based on communis opinio by renowned authors, followed by an accepted cost typology and emphasizing the relevance for the real estate industry. Secondly, an overview will be presented of formal transaction costs when commercial real estate is transferred within the EU27. Thirdly, explanations are looked for as far as cost differences can be noticed between the EU27 countries. Recommendations for further research finalize this contribution.

1. Introduction

Transaction cost has been a subject being widely discussed in literature for decades and from various perspectives. While some tried to arrive at the right definition, others wrestled with an encompassing typology. Some waged attempts to measure those costs at meaningful levels (municipality, investors'portfolio or the nation as a whole), others paid attention to its impact on the performance of portfolio's. The importance of transaction costs has hardly been been challenged; as long as there is no perfect information available, there will be transaction costs. Real estate markets are characterized by high transaction costs compared to other markets, in particular the stock market, owing to its relative intransparency and the involvement of many agencies.
This paper forms the start of an extensive research into transaction costs in commercial real estate with a focus on factors explaining cost differences between countries from an investors'perspective.
It starts with one generally accepted assumption, implying that in more transparent (mature) real estate markets transaction costs will be lower than in less transparent (emerging) markets. This assumption is mainly based on common sense although for instance De Soto (2000) has delivered evidence on the aspect of getting property rights registered. In well developed transparent markets the right information is supposed to be easily available and transfer of property rights being more efficiently organized than in less developed markets. Thus implying less effort and costs for citizens and companies in the former.

Knowledge about transaction costs is important because those costs increase costs of goods and services and thus prevent optimal efficiency. Some authors even suggest those costs prevent, optimal location of residences over households and in essence have negative welfare consequences (Van Ommeren 2008).
Williamson (1975) mentions three sources of transaction costs which not only applies to real estate but to all goods and services, viz bounded rationality, opportunistic behavior and asset specificity. As to the first factor there is both complexity of information and information insecurity. The complexity applies to the incapacity of individuals to value information within

the constraint of time and means. Information security applies to the fact that possible future developments are nearly impossible to take into account when involved in a transaction.
The second factor applies to individuals giving priority to selfinterest in their behavior. Without that it would be unneccessary to formulate complete or fullswing contracts. On the other way incomplete contracts give rise to opportunistic behavior and undesirable action.
The third factor applies to the extent in which the cost contract partners have to make being unnecessary at the next transaction. The stronger the focus of goods and services at individual requirements of the buyer the higher the asset specificity

The height of transaction costs is quite relevant to the real estate industry, both from private and public perspective or from a developers' and an investors' perspective.
In comparison to the stock market transaction costs of real estate are relatively high which is caused by the in transparency of the market. Geltner a.o. (2007) mention percentages between 2 and 12 for real estate transaction costs worldwide, while for buying shares normally charges will be less than 1.
On the other side we should be honest about the importance of those costs from an investor's perspective. Discussions with international investors reveal that management is much more focused at reducing corporate tax implications than diminishing transaction costs. The latter are considered as given. The former, mostly within the range between 25% and 35% on yearly profits, make it pay for companies to look for tax saving routes or vehicles.

Proving the aforementioned assumption depends on the answer to four questions:
1 Is there an accepted definition of transaction costs?
2 Given an accepted definition is there a clear cost typology?
3 Given a clear typology are comparable data available covering the differentiated cost types?
4 Given available data on cost types is there an accepted way measuring transparency?

The organization of this paper is as follows. Section 2 reviews the literature on the definition and typology of transaction costs and will be rounded up with a basic assumption. Section 3 reports the empirical methodology. The steps undertaken to acquire the right data and the statistics involved will be described. In section 4 the results will be presented and confronted with the assumption. Directions for further research follow in Section 5.

2. Transaction costs

2.1 Definition

Transaction costs have been defined by various authors.
The honor of being the first to mention the concept of transaction costs is Coase in his article "The nature of the firm" (1937). His simple definition is "The costs of using the price mechanism in the market".

Arrow (1969) defines transaction costs as "the costs of running the economic system. These have to be distinguished from the production costs being the main concern of neo-classical economics. So transaction costs refer to all costs other than the costs of physical production. These have to be made to increase information available and reduce uncertainty.

Later on Williamson (1975) has put it hardly different implying the costs of discovering what the price is and costs involved in negotiating and concluding every single contract.
Transaction costs are in essence associated with markets coping with frictions. A transaction is considered as a legal action to increase (or take) control over property rights

Most recently Den Butter (2009) formulates transaction costs as those costs to fine-tune the expenses of the different links in the production chain. It implies all costs made to realize trade transactions. Those costs are caused by formal and informal trade barriers.

Real estate transactions can be viewed as a special kind of transactions whereby immovable goods are transferred from one owner to another.

Reviewing all those definitions we conclude that irrespective the sector or the industry at stake, transaction costs should be considered as "all expenses involved in the process of transferring ownership rights"

2.2 Typology of transaction costs

The generic indication "transaction costs" needs some further differentiation.
Several typologies of transaction costs have been designed.
Buitelaar (2007), applying transaction costs analysis on planning and development, differentiates between information costs on one side and institutional costs on the other side. Institutional costs are the costs of and caused by governance structures.
From the perspective of a public developer four types of transaction costs are mentioned with the objective to analyze these, viz. Land exchange, Land use or zoning plan, Agreement and Planning permission
From the perspective of a private investor Geltner a.o. (2007) differentiate between property transfer tax, agent's fees and legal fees. Information cost are considered as crucial, these costs are partly comprised in agents' and legal fees, partly hidden in the costs of the internal organization or attributable to other external advisors
Information costs are well known under various names. Due diligence is probably the best known. In some publications due diligence is subdivided into six major categories: legal, financial, physical, building services, environmental and regulatory.
De Wit (1992) differentiates from an investors' perspective between fixed and variable transaction costs. The former comprising transfer tax, agents fee and transfer costs, the latter comprising all direct implementation costs. Direct implementation costs are defined as the difference between fair value and the execution of an order or the costs of market impact
De Butter (2009) connects transaction costs with the phase those costs are made. In that way three phases are chosen: contact, contract and control

This research confines itself to the perspective of a real estate investor. The perspective of a developer could be the theme of successive research. For that reason Geltner's typology will be followed.

2.3 Challenging hypothesis

Measuring transaction costs is a tough job as has been noticed by various authors (Furubotn & Richter 1991, Geltner a.o. 2007, Buitelaar 2007, Den Butter 2009). There is a multitude of problems to overcome connected with definition and data collection.

Moreover transaction costs can be measured at several spatial levels: national level or company level will produce huge differences.

Transaction costs are assumed to differ considerably between real estate transactions depending on

- size of the transaction (impact of degressive fees),

- national or transnational character of the transaction (impact of relative information advantage of local investors/developers)
- nature of the transaction (real estate development, real estate investment in completed buildings)

This article is focused on the difference in transaction costs for real estate between national markets and trying to find explanations for proven differences. As already mentioned the research has started based on the assumption that the higher the transparency of a market, the lower the transaction costs.

3. Research design

The EU27 offers an interesting example to test the aforementioned assumption. Especially Western European countries are considered as the most mature and probably the most transparent real estate markets while Central and Eastern Europe is considered as predominantly emerging and relatively intransparent. Southern Europe will have an intermediate position.

Being able to carry out the right analysis with the right data the following steps have been undertaken:

1. Transaction costs have been restricted to the following items: transfer tax, agent's fees, legal fees (split into notary fees and other legal fees) and VAT on fees. Fees for due diligence have been left out. According to experts within international real estate firms the magnitude of the latter is futile compared to the former.

2. Transaction costs have been approached from the perspective of an investor. The perspective of a developer is considered as more appropriate for another research. It is expected that especially the costs for due diligence spent by a developer could be different because much more effort has to be invested in acquisition of the land and planning permission.

3. Comparing transaction costs between countries could be approached in two ways. A hypothetical object with a fixed value could be taken as a starting point or relative ratios could be used irrespective of the exact amount. The former has the advantage of being able to calculate the exact costs but has the disadvantage of the inability of generalization. For the latter the opposite is the case. Because the emphasis is on generalization the latter method has been chosen.

4. Information about the exact magnitude of the defined transaction costs has been delivered by courtesy of Cushman & Wakefield (2010). For all 27 EUcountries these data were available for the same year. Most tax and fee data were presented as % of the sales price (or of the market value if higher).

5. The available information on the defined transaction costs contains some complications. Legal fees in some countries prove to be negotiable; agents' fees in most countries show a broad margin apparently depending on the negotiating capacities of parties involved but probably also depending on the magnitude of the transaction. In some countries there are exceptions for foreign companies or rulings. So various adaptations of the data for statistical calculations were necessary. Moreover, because of these variations, transaction cost could not be amalgamated. The various types will be treated separately.

6 Information about transparency has been derived from JonesLangLaSalle's Transparency Index 2008 being available for 23 of the 27 EUcountries (Cyprus, Luxemburg, Malta and Slovenia as exceptions). For the calculation method of that index we refer to the publication already mentioned.

7 The data on the transaction costs have been crossed with the data on the transparency level using a normal regression analysis technique. Both the level of significance and the strength of significance have been calculated as will be shown in the graphics below.

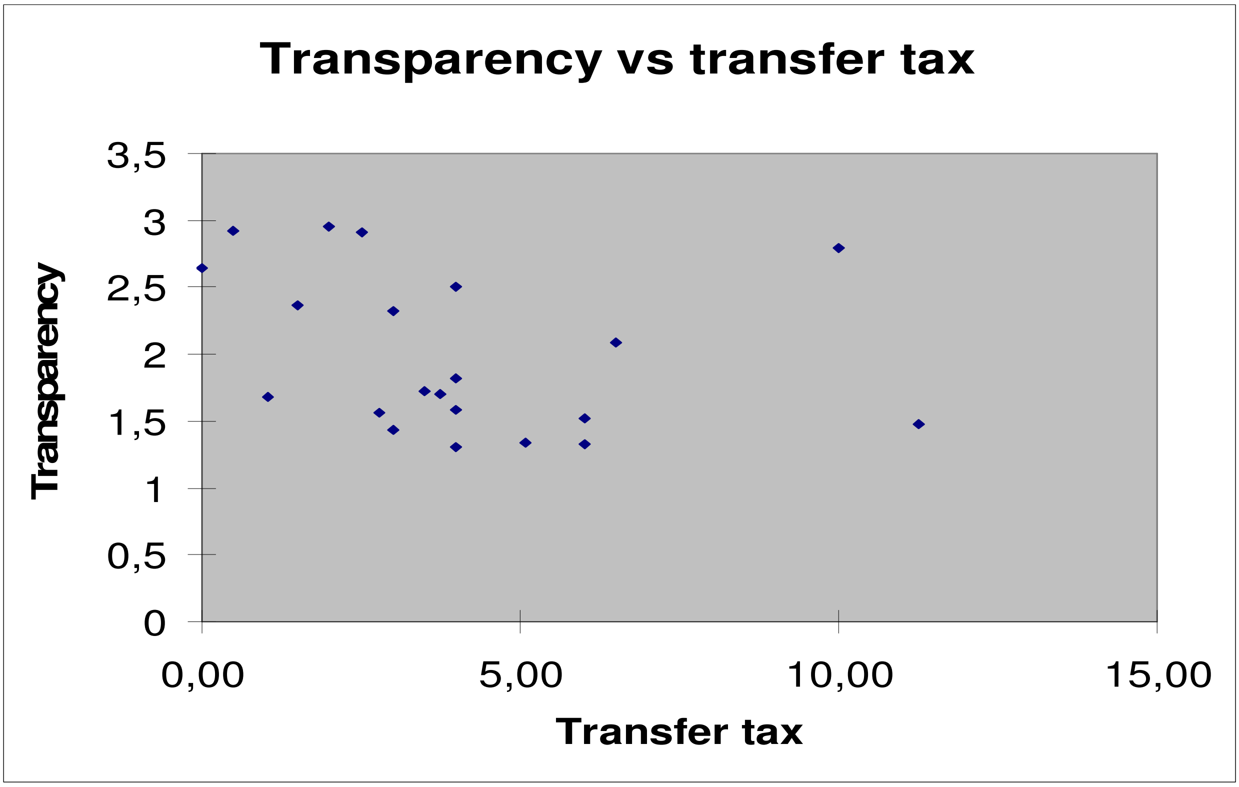
4. Results

Paying attention to the pure data remarkable differences between the EU23 as to the various types of transaction costs can be noticed (See Appendix).

1. Transfer tax varies between 0% (Estonia and Slovak Republic) and 12.5% (Belgium)
2. Agent's fees show both large variations within countries and between countries. Within countries variations go as far as between 1.0% and 3.0% (Romania) indicating that irrespective the magnitude of the transaction price one buyer could pay three times more for the agent's effort than another. Between countries agent's fees vary between 0.5% (Czech Republic, Italy and UK) and 5% (Finland)
3. Legal fees show an even greater variation. While in some countries the fee is negotiable (Bulgaria, Denmark, Netherlands), in other countries a fixed amount per hour (Baltics) or a standard rate (Belgium) is paid.
4. Notary fees too show a large variation. In three countries these are absent (Sweden, UK) or negligible (Czech Republic), in another one there is a standard rate (Belgium), in the remaining ones the fee is a percentage varying between 0,05 (Italy) and 1.50 (Germany)
5. VAT on fees varies from 17.5% (UK) to 25% (Denmark, Sweden). However, when companies opt for the VAT-regime that type of tax is mostly refundable.

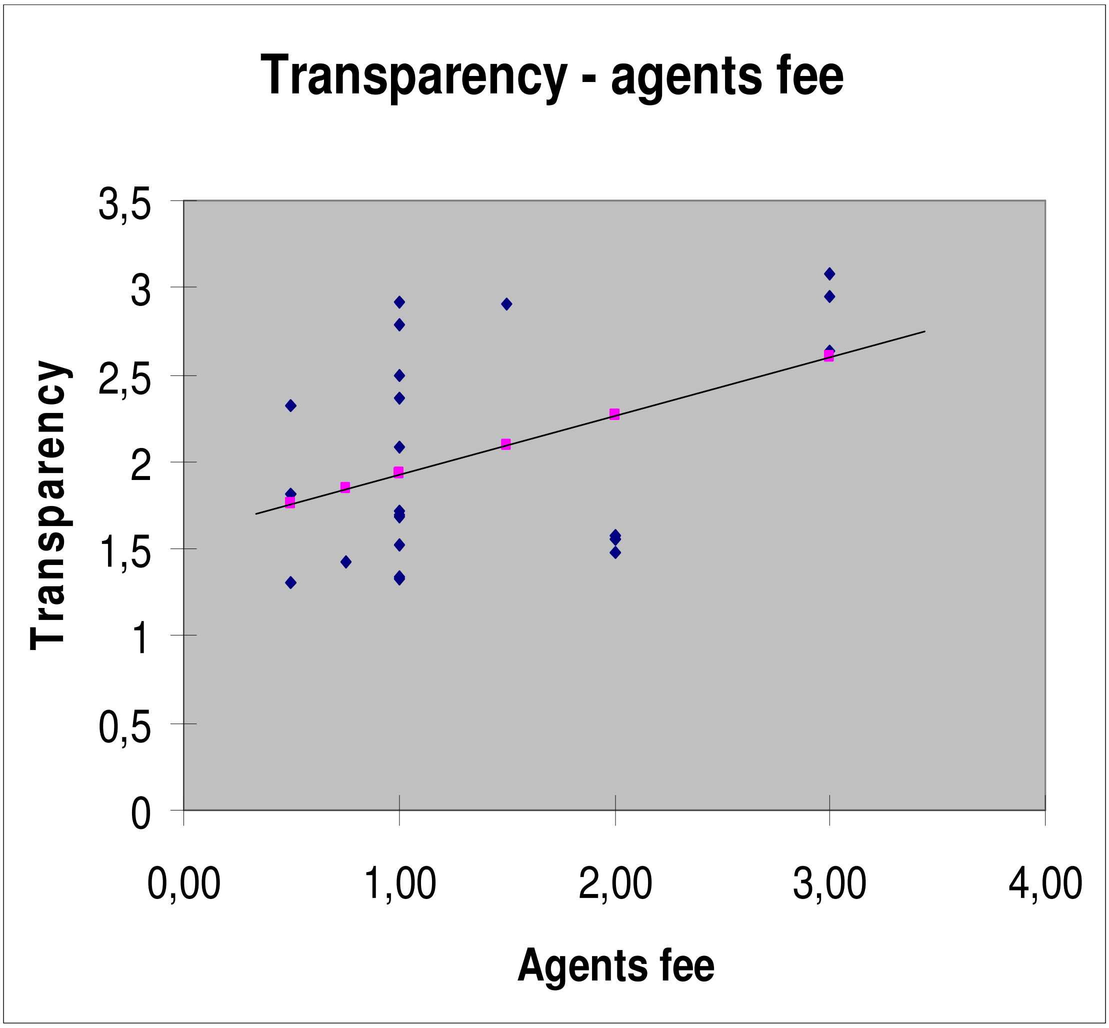
Paying attention to the results of the statistical test, relations of the transparency index with aspects of transaction costs proved to be weak.

As figure 1 shows, the regression analysis reflects a nonsignificant level. Apparently there is no relationship between the level of transparency of countries and the height of the transfer tax. We should of course take into account that the number of observations is very limited.



Number of observations 22 Multiple R 0,297827607 F-test 1,849365

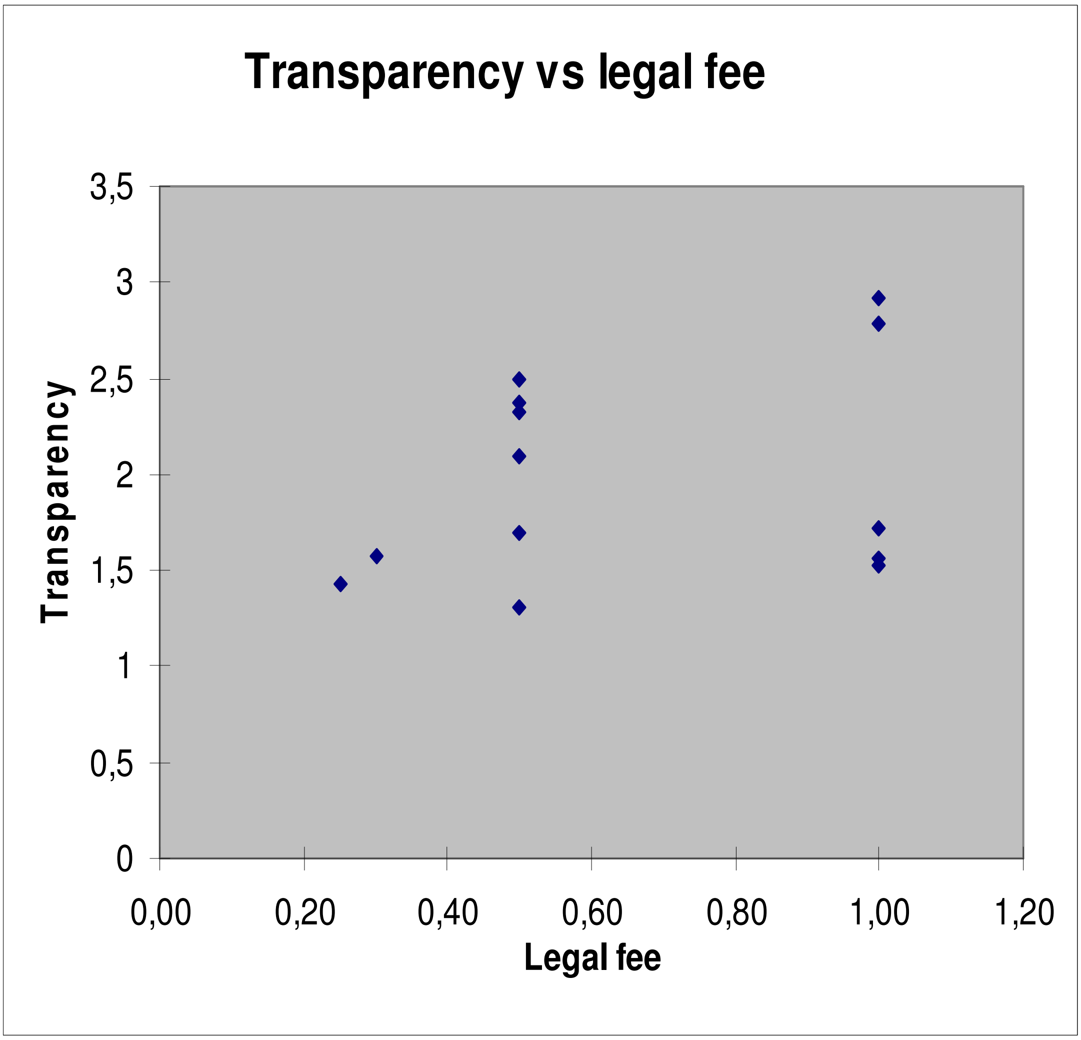
Figure 1 Transparency index crossed with transfer tax



Number of observations 22 Multiple R: 0,430172275 F-test: 0,045682503

Figure 2 Transparency index crossed with height of agent's fee

As figure 2 shows the regression analysis reflects a weak significance level (alpha < 0,05); 18,5% can be explained. Apparently there is some relationship between the transparency level of countries and the height of agent's fees; the less transparent the higher the fees?



Number of observations 14; Multiple R 0,268143; F-test: 0,375741389

Figure 3 Transparency index crossed with height of legal fee

As the f-test shows insignificance the conclusion should be that the height of legal fees has no relation with the transparency level.

In view of the formulated hypothesis the results make clear that the level of transparency and the level or magnitude of transaction costs has a weak to a nonexistent relationship.

This outcome raises interesting questions
When there is no correlation between the level of transparency and the level of transfer tax presumably others factors are responsible. Could institutional differences between countries perhaps be responsible for that; is maturity of markets not relevant in that respect?

When there is no strong correlation between the level of transparency and the level of agents fees there are other factors responsible. What kind of factors could that be?

When there is no correlation between the level of transparency and the level of legal fees and apparently the maturity of markets has no explaining power what kind of factors could be held responsible?

To answer those questions more research will be necessary.

5. Recommendations

Being able to explain differences in transaction costs between countries through the extent of transparency proves insufficient. Apparently other institutional factors are at stake. A few possible explanations:

1 Tax pressure varies between countries reflecting a difference in political attitude towards tax and toward public responsibilities or duties. Research will reveal that tax levels in Nordic countries have traditionally been at a much higher level than in Mediterranean countries. So the background of tax policy is important to grasp at least part of the revealed differences

2. Professionals in real estate industry, in particular notary clerks and real estate agents are organized in lobby groups, but their influence on individual members and their ability to enforce (fixed or guaranteed) fees will probably vary between the EUcountries owing to a difference in influencing power. Only in-depth research could reveal the role and influence of those interest groups.

3. Legal fees show a large variation; the fees itself hide possibly various categories as for instance registration fee to be transferred to the Land Registry Office (Cadastre). More detailed research could reveal that difference in those fees reflect differences in efficiency

Aforementioned examples emphasize the importance of extensive knowledge on the institutional framework within which real estate transactions take place.

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Transparancy vs transfer tax:
F-test:1,849365
Multiple R: 0,297827607

Kans op toeval 18% ver boven de overschreidingskans van wel 5%, dus model is niet significant

Transparancy vs legal Fee
F-test: 0,375741389
Multiple R 0,268143

Niet significant op basis van F test (0,375>0,05 overschrijdingskans)
rkwatraat: slechts 8% van de relatie kan uit het model worden verklaard.

Transparency vs agents fee
f-test: 0,045682503
Multiple R: 0,430172275

Zwakke significantie. R=0,43, 18,5% kan uit model worden verklaard, F test significant bij alpha <0,05

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