Special Report

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# Washington's Real Estate Excise Taxes

*Within Washington state, transfers of real property (as well as certain transfers of controlling interests in corporations) are subject to state and local real estate excise taxes (REETs). Local rates vary. For most jurisdictions, the combined state and local REET rate is 1.78 percent. This represents a tax of $1,780 on the sale of a $100,000 house. Currently, the highest rate in the state is 2.78 percent in Friday Harbor.*

*Washington's REETs are generally paid by the seller. State government levies a REET of 1.28 percent on the value of each sale, which is estimated to generate $513.8 million for the general fund and $41.7 million for the public works assistance account during the 1995–97 biennium. The tax is a relatively minor revenue source, accounting for only about 2.9 percent of total general fund-state revenue in 1995-97.*

*The Legislature in 1982 authorized cities and counties in Washington to impose a local–option REET at a rate not exceeding 0.25 percent on the seller. These proceeds are placed in a capital improvement fund to be used for local projects. Currently 247 of 271 cities and 33 of 39 counties impose this basic local REET.*

*The Growth Management Act (GMA), passed by the Washington Legislature in 1990, restricted the uses of the basic local REET revenues in counties and cities planning under the act. The GMA also authorized an additional 0.25 percent local option REET for these jurisdictions. Local voter approval is required before cities and counties that voluntarily plan under GMA can impose this REET; voter approval, however, is not required in jurisdictions where planning is mandatory. Revenues from the GMA REET may only fund capital projects listed in the county or city's comprehensive plan.*

*Counties planning under the GMA may also impose a REET of up to 1 percent for the acquisition and maintenance of conservation areas. Only San Juan County has adopted this tax. Unlike the other REETs, this tax is imposed on the buyer rather than the seller.*

*In 1992 the Legislature narrowed the list of capital projects that could be funded from basic local REET levied in counties or cities with populations in excess of 5,000. The same act further restricted the kinds of capital projects that any city or county, whatever their size, may fund through the GMA REET.*

*The REET is a highly volatile revenue source, reacting strongly to fluctuations in the economy and real estate market. Total collections rose by 55 percent in the 1989-91 biennium before falling by 15 percent in 1991-93. This volatility makes the REET a poor tax to earmark.*

*Washington taxes real estate transfers more heavily than most other states. The REET adds significantly to closing costs, especially at the higher local-option rates. As a result, it discourages real estate transactions. The REET poses a particular obstacle to first-time home buyers.*

*In the pages that follow, we examine the history of the real estate excise tax in Washington, the amounts and uses of the revenue it generates, how it compares to real estate taxes in other parts of the country, and the general characteristics of the tax, including its elasticity, stability and proportionality.*

1301 5th Avenue, Suite 2810 ♦ Seattle, Washington ♦ 98101-2603 ♦ (206) 467-7088 ♦ 1-800-294-7088 ♦ FAX (206) 467-6957

# Washington's Real Estate Transfer Taxes

In Washington, state government, counties, and cities are authorized to levy taxes on transfers of real property. The first tax on real estate transfers was the state conveyance tax, which was introduced in 1935. The real estate excise tax (REET) was initially authorized as a local tax in 1951; it became a state tax in 1981. Since then, several local-option REETs have been authorized for cities and counties. What follows is a brief history of those taxes and a discussion of the revenues they produce and the uses made of these resources.

## Conveyance Tax

The conveyance tax was introduced to Washington in the Revenue Act of 1935, which laid the foundation of much of the state's current tax system. The initial rate was 50 cents per $500 of value (0.1 percent) on transfers of real property by deed or other written instrument. Conveyance tax revenues were deposited in the general fund-state account. Transfers by the state of Washington were exempted from the tax in 1945.

Surtaxes were imposed on the conveyance tax during the 1982 recession, and in 1983 the temporary rate of 53.5 cents per $500 of value was made permanent.

The Legislature increased the rate to $1.00 per $500 in 1985, and dedicated the increase to the state's public works assistance account. Money in the account was used to guarantee and make loans for local government public works projects.

The conveyance tax was administered until 1987 through the use of tax stamps sold by the Department of Revenue. The tax was collected locally by county auditors and land title companies, who affixed the stamps to the appropriate documents at the time of transfer.

The administrative burden of the conveyance tax was high relative to the revenue it produced. As the state Tax Advisory Council observed "the compliance cost to the taxpayers of the state is disproportionate to the amount of revenue produced by the state. If the stamp is removed, the tax compliance relating to real estate transfers will be greatly simplified." The conveyance tax was eliminated on May 18, 1987, and the state REET increased to recapture lost revenue.

## Real Estate Excise Tax

Local governments in Washington were authorized in 1951 to levy a REET of up to 1 percent on the sale of real property as a revenue source for local schools.

The 1980 Legislature made the REET a state rather than local tax, effective Sept. 1, 1981. This change followed the 1977 Basic Education Act, which had shifted the responsibility for funding basic education to the state government.

A number of tax increases were imposed by the state during the recession of the early 1980s. Among these was a temporary surtax of 0.04 percent added to the state REET in 1982. The surtax was increased to 0.07 percent on Aug. 1, 1982. Before its scheduled expiration on June 30, 1983, however, the surtax was made permanent, fixing the state REET rate at 1.07 percent.

**Table 1**
**Real Estate Excise Taxes in Washington**
(maximum authorizations)

| | Rate | Taxes Due on $100,000 Home |
|---|---|---|
| State tax | 1.28% | $1,280 |
| Local–option taxes | 2.00 | 2,000 |
| *For capital purposes* | *0.25* | *250* |
| *Associated with growth management*[1] | *0.25* | *250* |
| *Conservation purchases*[2] | *1.00* | *1,000* |
| *In lieu of sales tax*[3] | *0.50* | *500* |
| Total authorized | 3.28% | $3,280 |

1. Voter approval is necessary in counties not required to plan under the state's 1990 Growth Management Act.
2. Requires voter approval. Adopted only in San Juan County. This REET is imposed on the buyer. All others are imposed on the seller.
3. Clarkston is the only jurisdiction imposing this option.

In 1987, the state REET was further increased to 1.28 percent to replace revenue lost with repeal of the conveyance tax.

An additional temporary, two–year increase of 0.06 percent in the REET was adopted in 1987, bringing the rate to 1.34 percent. The surtax raised about $15 million for purchases of natural resource conservation areas by the Department of Natural Resources, including Woodard Bay in Thurston County, Willapa Divide in Pacific County and Cypress Island in Skagit County. This temporary increase expired June 30, 1989, and the rate returned to 1.28 percent.

## Local Option REET Reintroduced in 1982

Cities and counties were given the option of levying a local REET of 0.25 percent in 1982 to pay for improvements listed under the local improvement district (LID) authorization. This tax does not require local voter approval. Cities may impose the tax only within municipal boundaries; counties, only within unincorporated areas.

Local governments in Kitsap, Pierce and Snohomish counties began levying the additional tax in 1982. As of November 1996, 247 of the state's 271 cities and 33 of 39 counties levied the basic local REET.

Cities and counties that choose not to impose the 0.5 percent local–option sales tax may instead impose a REET of up to 0.5 percent. This tax does not require voter approval. All but three counties and a handful of cities choose to collect a local option sales tax, and Clarkston is the only jurisdiction to impose the alternative REET. Given the stability of the sales tax and the amount of revenue it generates, it is unlikely that any of the jurisdictions currently imposing the local option sales tax would choose to impose a REET instead.

## 1990 Changes in Washington's Real Estate Excise Tax

The last major expansion in Washington's real estate excise tax came in 1990, when the Legislature authorized cities and counties to levy additional local–option REETs for capital projects and conservation areas under the state's new Growth Management Act. These changes brought the tax up to its current maximum authorization.

*Funding for Conservation Areas*

The 1990 Legislature gave counties planning under the Growth Management Act the authority to impose a county-wide REET of up to 1 percent to fund the acquisition and maintenance of conservation areas.

Voter approval must be obtained in order to levy the tax. The tax may be initiated by the county commissioners or by a petition signed by 10 percent of the total number of voters voting in the last county election. The act requires that the county prepare an expenditure plan in consultation with cities and that the funds be spent in conformance with the plan.

This particular local option, unlike the other local-option REETs, is imposed on the buyer rather than the seller. According to state Sen. Dan McDonald (R–Bellevue), the Legislature's intent was to more directly tax property purchasers who are adding to growth, and to use the money for the preservation of open space.

At the time it was adopted, the Department of Revenue estimated that the one percent conservation REET could generate up to $160 million a year if it were levied by all counties. Thus far, however, only San Juan County has adopted this tax.

*Growth Management*

The state's Growth Management Act requires fast–growing counties and the cities therein to adopt comprehensive land–use plans and development regulations. In December 1996, the GMA mandate applied to 18 of the state's 39 counties. An additional 11 counties have opted to plan under the act.

For local governments that plan under the act, GMA restricted the uses of the revenue from the basic 0.25 percent local REET and required that projects funded from the REET be listed in the capital facilities element of the comprehensive plan. The use of REET proceeds by cities and counties not choosing to plan under the act was not affected.

A new 0.25 percent local-option REET was authorized in 1990 to help carry out the purposes of the Growth Management Act. This GMA REET increment may be imposed without voter approval by cities and counties that are required to plan under the act. Revenue generated by the tax is to be used by these local governments solely for financing the capital projects specified in the capital facilities portions of their comprehensive plans. Cities and counties that choose, but are not required, to plan under GMA may also impose the tax, but only with voter approval.

The tax is placed on each sale of real property in unincorporated areas of the county for the county tax and in the corporate limits of the city for the city tax. The GMA REET, like the basic 0.25 percent local REET, is formally imposed on the seller of the property.

As of November 1996, 75 cities and seven counties had adopted the GMA increment, and thus levied combined REETs of 1.78 percent or more.

Cities and counties that plan under the growth management act are also authorized to charge impact fees on new development. Cities and counties had only limited power to charge impact fees in the early 1980s, when the original local-option REET was authorized.

## Uses of REET Restricted Further in 1992

In 1992 the Legislature became concerned that local governments were spending REET proceeds on projects not consistent with the intent of the authorizing legislation. As a result the Legislature revised the restriction on capital projects fundable from the basic local REET by cities or counties with populations in excess of 5,000.

Such cities and counties now may use funds from the basic local REET only for streets, roads, highways, sidewalks, street lights, traffic signals, bridges, water systems, sewers, parks, recreational facilities, trails, libraries, and law enforcement, fire protection, administrative, and judicial facilities. In addition, those cities and counties that, prior to June 11, 1992, had used REET funds for flood control projects can continue to do so.

The Legislature clarified the eligible uses for the GMA REET. These uses are a subset of those eligible for the basic local REET. Cities and counties are not allowed to apply the GMA REET to recreational facilities, trails, libraries, judicial, fire protection, administrative and law enforcement facilities, or flood control projects.

## Certain Corporate Transfers Made Subject to REET in 1993

In 1993 the state Legislature found that transfers of ownership of entities may be essentially equivalent to the sale of real property held by the entity and therefore should be subject to the same excise tax burdens. As a result, the REET was extended to the acquisition of a controlling interest (50 percent or more of the voting power or beneficial interests) in an entity which owns real property within the state. The tax applies only to the real property which the entity owns in Washington. This change was enacted to counter the growing practice of structuring transactions involving commercial and industrial property to legally avoid the tax.

## Uses of the Tax

The REET is collected by county treasurers who pass on to the state and to the cities their shares of these revenues. REET collections for the state government are estimated at over $561 million in the 1995–97 biennium. Approximately 91.4 percent of the total, $513.8 million, goes to the general fund-state account. The public works assistance account receives about 7.6 percent of the state's collections, or about $41.7 million for 1995-97. County governments retain 1 percent of the state REET, or $5.6 million, to cover the administrative cost of collecting the tax.

The REET money that is paid into the general fund is to be applied "for the support of the common schools." The state property tax goes into the general fund with a similar restriction. The Legislature's appropriations from the general fund to support the common schools, however, far exceed the revenues from these two taxes. Thus, the formal restriction on the general fund REET money is of no practical significance.

## Table 2
## Real Estate Excise Tax Collections

| County | Fiscal Year 1996 State | Fiscal Year 1996 Local | Fiscal Year 1996 Total | Percent of FY96 total | Inflation-Adjusted Percent Change From FY 89 Total |
|---|---|---|---|---|---|
| Adams | $460,619 | $89,633 | $550,252 | 0.2% | 139.4% |
| Asotin | 566,946 | 151,649 | 718,594 | 0.2% | 123.1% |
| Benton | 4,375,570 | 1,132,508 | 5,508,078 | 1.5% | 128.2% |
| Chelan | 2,965,421 | 579,069 | 3,544,490 | 1.0% | 92.0% |
| Clallam | 2,499,908 | 488,672 | 2,988,581 | 0.8% | 7.4% |
| Clark | 17,936,008 | 3,503,034 | 21,439,042 | 5.9% | 103.2% |
| Columbia | 102,219 | 19,318 | 121,538 | 0.0% | 33.5% |
| Cowlitz | 2,852,977 | 303,133 | 3,156,110 | 0.9% | 33.3% |
| Douglas | 1,115,221 | 249,014 | 1,364,235 | 0.4% | 26.1% |
| Ferry | 203,216 | 39,928 | 243,144 | 0.1% | 9.6% |
| Franklin | 1,372,539 | 274,047 | 1,646,586 | 0.5% | 115.0% |
| Garfield | 85,557 | 16,641 | 102,198 | 0.0% | 447.8% |
| Grant | 2,162,730 | 160,208 | 2,322,937 | 0.6% | 98.2% |
| Grays Harbor | 2,556,042 | 760,661 | 3,316,703 | 0.9% | 69.9% |
| Island | 3,538,548 | 1,267,229 | 4,805,777 | 1.3% | 44.9% |
| Jefferson | 1,589,473 | 386,389 | 1,975,862 | 0.5% | (0.3%) |
| King | 106,765,485 | 38,986,920 | 145,752,404 | 40.2% | 15.2% |
| Kitsap | 9,278,115 | 3,624,264 | 12,902,379 | 3.6% | 70.2% |
| Kittitas | 1,214,062 | 236,498 | 1,450,560 | 0.4% | (39.5%) |
| Klickitat | 661,891 | 129,229 | 791,120 | 0.2% | 71.3% |
| Lewis | 2,213,749 | 433,798 | 2,647,547 | 0.7% | 34.8% |
| Lincoln | 338,983 | 64,027 | 403,010 | 0.1% | 63.4% |
| Mason | 1,888,775 | 368,526 | 2,257,301 | 0.6% | (14.5%) |
| Okanogan | 1,440,782 | 280,898 | 1,721,680 | 0.5% | 28.8% |
| Pacific | 1,057,382 | 208,230 | 1,265,611 | 0.3% | (28.4%) |
| Pend Oreille | 493,318 | 8,639 | 501,958 | 0.1% | 12.0% |
| Pierce | 26,326,658 | 7,028,699 | 33,355,357 | 9.2% | 51.9% |
| San Juan | 1,608,521 | 1,586,170 | 3,194,691 | 0.9% | 63.1% |
| Skagit | 4,387,492 | 1,058,557 | 5,446,049 | 1.5% | 40.5% |
| Skamania | 369,198 | 9,541 | 378,739 | 0.1% | (2.0%) |
| Snohomish | 31,453,138 | 11,661,449 | 43,114,587 | 11.9% | 27.9% |
| Spokane | 14,840,131 | 5,696,512 | 20,536,643 | 5.7% | 106.5% |
| Stevens | 1,350,179 | 50,756 | 1,400,935 | 0.4% | 76.6% |
| Thurston | 8,655,781 | 3,333,851 | 11,989,632 | 3.3% | 68.2% |
| Wahkiakum | 381,186 | 2,679 | 383,866 | 0.1% | 253.8% |
| Walla Walla | 1,442,732 | 39,013 | 1,481,746 | 0.4% | 82.4% |
| Whatcom | 7,944,608 | 2,207,068 | 10,151,676 | 2.8% | (4.4%) |
| Whitman | 941,695 | 181,299 | 1,122,994 | 0.3% | 73.6% |
| Yakima | 5,419,255 | 1,000,055 | 6,419,310 | 1.8% | 58.0% |
| **Total** | **$274,856,110** | **$87,617,812** | **$362,473,921** | | **33.1%** |

Source: Department of Revenue
Note: Numbers may not sum to totals due to rounding.

As noted above, local governments' use of the local–option REET is also limited by state law. With the exception of the option levied in lieu of the second half–cent sales tax, the local–option taxes may only be used for capital projects or conservation area acquisition.

## Real Estate Excise Tax Collections

State, city and county governments in Washington collected $362.5 million in real estate excise taxes in FY 96. As shown in Table 2, most of the state and local revenue generated by the REET comes from transactions in the central Puget Sound counties.

State government received $274.9 million, or 75.8 percent of total state and local collections in FY 96, an increase of 19 percent over FY 89 collections after adjusting for inflation. In FY 96, King County generated 38.8 percent of state REET revenue. Snohomish County accounted for 11.4 percent of total state receipts, and Pierce County 9.6 percent. Spokane County, with the second-largest population in the state, accounted for 5.4 percent of REET receipts in FY 96. The REET generated almost $87.6 million for cities and counties in Washington during FY 96. This represents an inflation–adjusted increase of 114 percent over FY 89. Together, local governments in King, Pierce and Snohomish counties accounted for $57.7 million, or about 66 percent, of local REET collections in FY 96.

## Factors Affecting Collections

The number of transactions and the value of the property sold directly affect the amount of revenue generated by the REET. As shown in Figure 1 on page 8, annual changes in tax collections track closely the number of real estate sales. Both series, though, are much more volatile than state personal income.

Figure 2 on page 8, compares the number of real estate transactions to the number of new housing units approved for construction. The two series tend to move together, with sales leading approvals somewhat. Typically, the number of approvals equals about 15 percent of the number of real estate transactions.

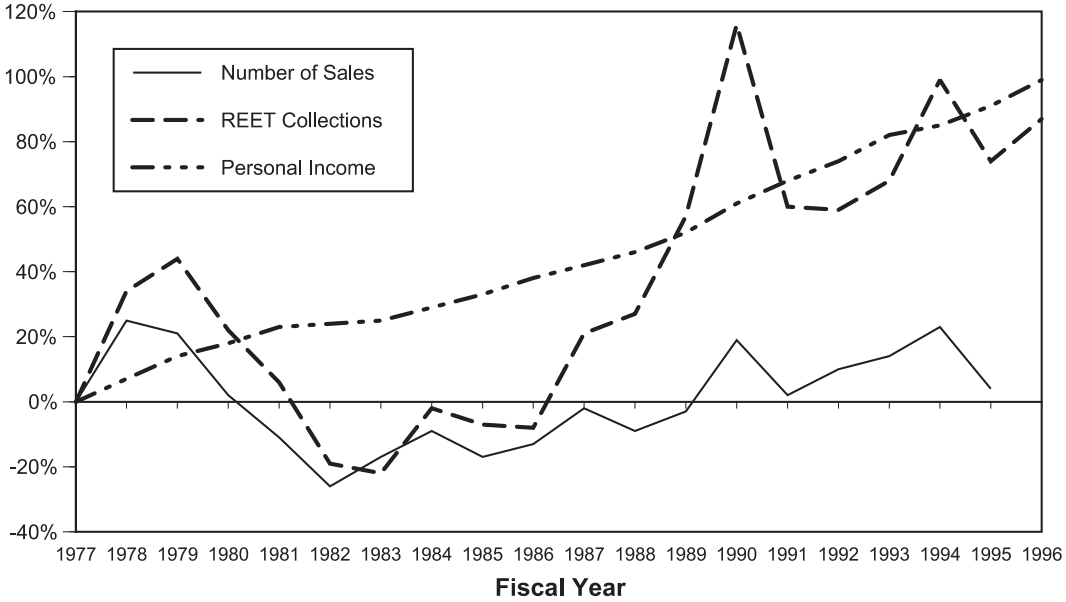
The model used in Washington state to predict REET revenues shows that revenues are generally sensitive to the overall level of state economic activity. However, as Chuck Gusak of the Office of the Forecast Council explained, "The REET has extreme ups and downs which makes it a headache to forecast."

Interest rates have an indirect effect on REET receipts. According to Gordon Folkman of the Minnesota Department of Revenue, a model developed to forecast receipts from his state's mortgage and deed taxes shows that when interest rates fall, mortgage and deed tax collections tend to increase. Folkman added, however, that "the relationship between the change in interest rates and (mortgage and deed) tax collections is relatively unstable, and is not very useful by itself to reliably predict these tax revenues."

## Some Transactions Exempt

Certain transfers of property are exempt from state and local REETs. For example, cemetery plots are not taxed. Property transferred through inheritance, gift, divorce decree or condemnation is not taxed. Neither is the real estate transfer that occurs when a mortgage is foreclosed.

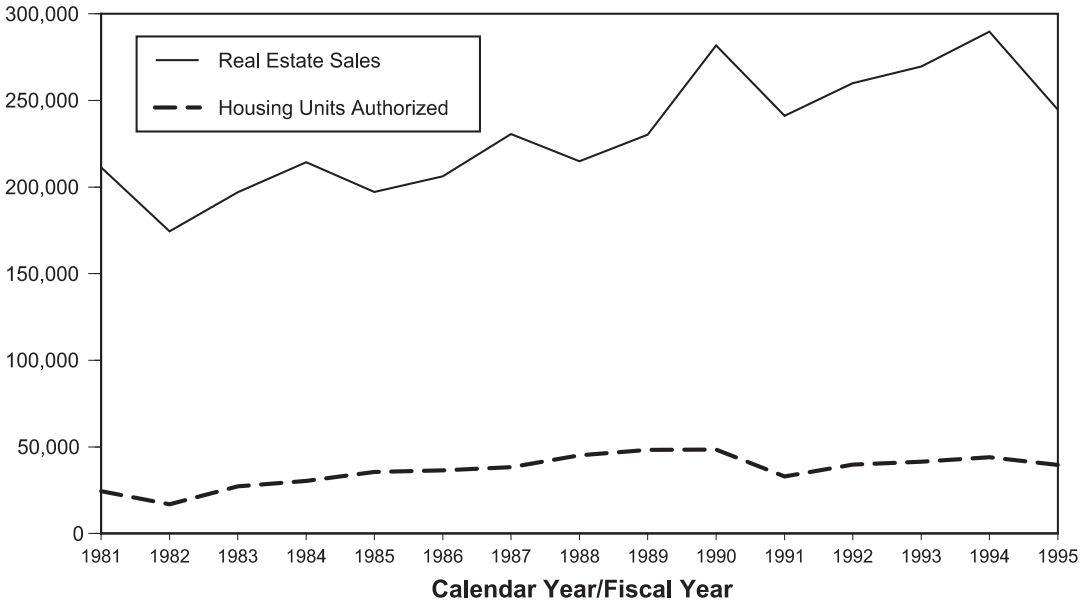
**Figure 1**
## State Real Estate Excise Tax Collections
(percent change from FY 77)




Note: Taxes and personal income are adjusted for inflation.

Sources: Department of Revenue and Office of the Forecast Council

**Figure 2**
## Housing Units Authorized




Note: Housing units in calendar year, sales in fiscal year.

Sources: Department of Revenue and Office of the Forecast Council

Transactions where a party transfers property that is burdened by a debt and receives in return no consideration are exempt from the REET if the debt is not a personal liability. The transaction is simply a gift. Formerly, similar transactions where the debt is a personal liability were exempt also, but the state now holds that the relief of personal debt is sufficient consideration to trigger REET.

The REET exemptions have an estimated state-local revenue impact of $166.2 million for the 1995–97 biennium.

# Taxes On Real Estate Transfers Around the Country

Nationally, states impose three types of taxes on the buyers and sellers of real estate. These taxes are all imposed at the time of the recording or transfer and are non–recurring. The primary difference in the taxes is the base to which they apply.

Real estate transfer taxes are generally assessed on the total purchase price of property; Washington's REET falls into this category. Some states, however, only impose the tax on the excess of the purchase price over the value of the mortgage. (That is, these states only tax the new owner's equity.) The obligation to pay the tax may be imposed on either the seller or the buyer, or on both.

Mortgage taxes are assessed on the value of the mortgage secured to purchase real property. The tax liability declines as the down payment increases. Mortgage taxes are typically assessed on the party obtaining the mortgage, the lender. The lender will pass these taxes directly to the buyer as a cost of obtaining a loan. Generally, states with mortgage taxes also impose realty transfer taxes that exempt the value of the mortgage.

Deed recording and stamp fees are based on the value of the property or are set at a fixed amount, and are generally paid by the buyer. Washington's former conveyance tax fell into this category.

## Washington's State REET is Second Highest

There is wide variation among U.S. states in taxation of real estate transfers. State tax rates range from a low of 0.01 percent in Colorado to a high of 2.00 percent in Delaware. Washington's 1.28 percent rate places it second highest. (See Table 3.) Caution should be exercised in making direct comparisons among state real estate transfer tax rates, however, since tax bases vary widely from state to state. Some states tax the entire purchase price, for example, while others only tax the buyer's equity. Moreover, some states provide a special exemption for residential property below a certain value or tax it at a different rate.

Only twelve states besides Washington provide for local option real estate transfer taxes. The maximum rate currently levied in Washington for the combined state-local REET is 2.78 percent, with most jurisdictions levying a REET of 1.78 percent.

By any comparison, Washington's REET stands among the highest property transfer taxes in the nation due to its high rates and broad tax base.

At least nine states, including Washington, earmark all or part of their REET. These taxes are typically dedicated to one–time or capital projects, such as land acquisition, and economic development projects. The volatility of the REET makes earmarking an important issue. The REET should not be relied upon as the primary funding for an ongoing operation, because its receipts tend to vary dramatically from year to year.

## Table 3
# Statewide Real Estate Transfer Taxes: 1995
### (rates in percent of value)

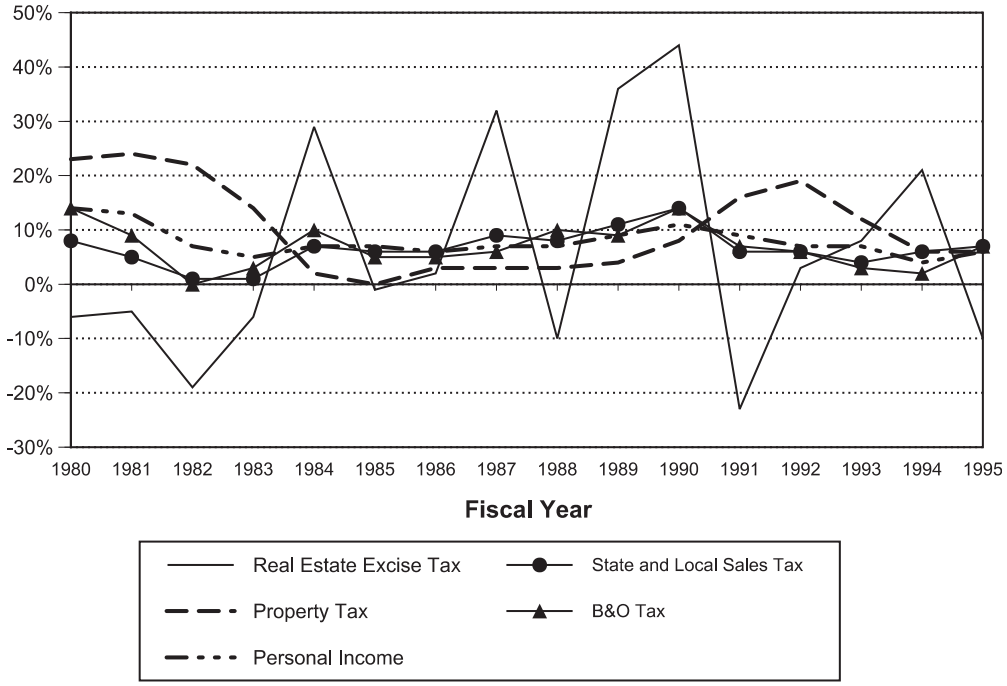
| | Transfer Tax | Mortgage Tax | Additional Local Taxes Levied in 1994 |
|---|---|---|---|
| Alabama | 0.10%[1] | 0.15% | — |
| Arizona | — | — | x |
| Arkansas | 0.33 | — | — |
| California | — | — | x[1] |
| Colorado | 0.01 | — | — |
| Connecticut | 0.61[2] | — | — |
| Delaware | 2.00 | — | x |
| District of Columbia | 1.10 | — | — |
| Florida | 0.70 | 0.35 | x[3] |
| Georgia | 0.10[1] | — | — |
| Hawaii | 0.10 | — | — |
| Illinois | 0.10 | — | x |
| Iowa | 0.16 | — | — |
| Kansas | 0.26 | — | — |
| Kentucky | 0.10 | — | — |
| Maine | 0.44[4] | — | — |
| Maryland | 0.50[5] | — | x |
| Massachusetts | 0.456[1] | — | x |
| Michigan | 0.75[6] | — | x |
| Minnesota | 0.33[1] | 0.23 | — |
| Nebraska | 0.175 | — | — |
| Nevada | 0.13[1] | — | x |
| New Hampshire | 0.35[7] | — | — |
| New Jersey | 0.35[6] | — | — |
| New York | 0.40[1,7] | 0.75 | x |
| North Carolina | 0.20[1] | — | — |
| Ohio | — | — | x |
| Oklahoma | 0.15[1] | 0.10[8] | — |
| Pennsylvania | 1.00 | — | x |
| Rhode Island | 0.28 | — | — |
| South Carolina | 0.26[1] | — | x |
| South Dakota | 0.10 | — | — |
| Tennessee | 0.37[1] | 0.12 | — |
| Vermont | 0.50[9] | — | — |
| Virginia | 0.10[1,10] | 0.15 | x |
| **Washington** | **1.28** | **—** | x |
| West Virginia | 0.22 | — | x |
| Wisconsin | 0.30 | — | — |

Note: Transfer taxes are generally paid by the seller, mortgage taxes by the buyer. Most states grant a variety of exemptions. See CCH *Tax Guide* for detail. Alaska, Idaho, Indiana, Louisiana, Mississippi, Missouri, Montana, New Mexico, North Dakota, Oregon, Texas, Utah and Wyoming do not levy real estate transfer taxes.

1. Part or all of tax base is sale price less value of mortgage.
2. Rate is 0.50% for residential property valued at less than $800,000, plus 0.11% surtax. Rate is 1% on value over $800,000, and 1% on nonresidential property.
3. Local surtax does not apply to single family residences.
4. 0.22% tax levied on both buyer and seller.
5. First $30,000 of owner–occupied residential property is exempt from state tax.
6. Additional tax of 0.15% is levied on sales over $150,000.
7. Additional tax of 1% levied on residential property valued at more than $1 million.
8. Rate for mortgages of 5 years or more. Lower rate for shorter periods.
9. Rate for residential property valued less than 100,000. Value above $100,000 taxed at 1.25%. Rate is 1.25% on non–residential property.
10. Rate declines on property worth more than $10 million.

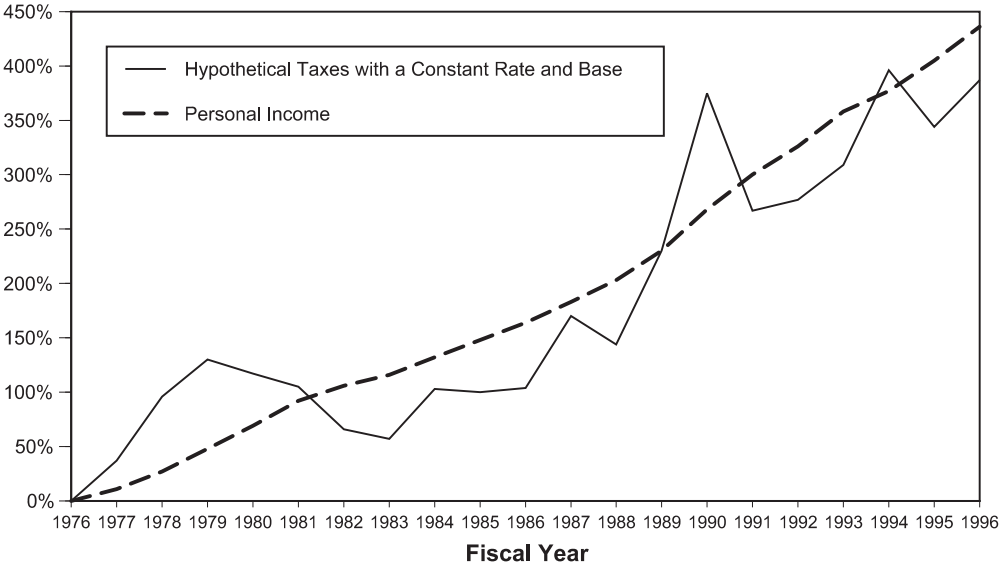
*Sources:* *Advisory Committee on Intergovernmental Relations* and *Commerce Clearing House.*

**Figure 3**
**Stability Comparison**
(annual percent change)




Note: Taxes are hypothetical constant rate and base estimates.
Sources: Department of Revenue, Office of Forecast Council and W.R.C. calculations

**Figure 4**
**Real Estate Excise Tax and Economic Growth**
(percent change from FY 1976)




Sources: Department of Revenue, Office of Forecast Council and W.R.C. calculations

# REET a Volatile Revenue Source

Washington's REET is a highly volatile source of revenue, fluctuating primarily with the number of transactions in a given year. Volatility can best be illustrated by graphing annual growth rates in revenue over time. Figure 3 on page 11, shows the annual percent change in hypothetical collections (adjusted to reflect constant tax rates and bases) of Washington's state REET along with annual percent changes in collections from several other state taxes. Between FY 80 and FY 95, the annual change in constant rate/base REET collections ranged from a high of 44 percent in FY 90 to a low of -23 percent in FY 91. The REET is much less stable than the property tax, the B&O tax, or the sales tax.

REET is a small share of total state tax revenues, so its volatility is not a major concern under normal circumstances. Caution should be exercised, however, in earmarking the tax for a specific program. Relying on such a fluctuating revenue source to fund an ongoing program requiring a regular flow of revenue should be avoided. Earmarking the REET for one–time expenses such as land acquisition or capital construction, as Washington has generally done, is less of a problem. There are examples, however, where jurisdictions have issued bonds to fund capital projects with REET proceeds earmarked to interest and principal payments. This practice is inappropriate given the tax's volatility.

## Elasticity

Figure 4 on page 11, shows the growth of hypothetical REET receipts, assuming a constant rate and base, relative to state personal income for the period 1976-1995. Over the long term the receipts do appear to grow with the state's economy, though over the shorter run the linkage is not as tight.

One measure of the relationship between revenue and income over a period of time is the elasticity of the tax. The elasticity is the ratio of the percent change in tax revenue over the period (assuming no change in the structure of the tax) to the percent change in state personal income. An elasticity of one indicates that the tax yields the same share of state personal income at the end of the period that it yielded at the beginning.

REET had an elasticity of 0.85 between FY 76 and FY 95, indicating that collections grew at only 85 percent of the growth rate of the overall economy over this time. This measure, however, does not reflect extreme peaks and valleys in the intervening years, as shown in Figure 4. Elasticities calculated over single years vary dramatically. The high during this period, for example, was 3.8 in FY 90, and the low was –2.6 in FY 91.

During the recession of the early 1980s and in some subsequent years, hypothetical REET collections actually declined (reflecting the volatility of the real estate market), while state personal income continued to grow. After a boom in collections in FY 90, receipts lagged well behind economic growth in FYs 91 and 92. REET collections grew faster than income in FYs 93 and 94, slowed in FY95 and accelerated in FY96.

## Proportionality

Questions of proportionality, or how the burden of taxation varies across income classes, often arise when a tax is evaluated. A number of issues must be considered when looking at the proportionality of the REET.

Surveys show that home values increase less than proportionally with family income. For example, Denise DiPasquale and William Wheaton estimate from the 1989 American Housing Survey that a doubling of reported income is associated with an 80 percent increase in home value for married, homeowning couples. The tax on a residential transaction is proportional to the value of the property. But as DiPasquale and Wheaton explain, their calculation underestimates the degree to which home value increases with income: Buyers make housing choices on the basis of their permanent income, i.e. “the average income likely over the expected occupancy of the house." Further, they note that "studies using some measure of permanent income generally report higher estimated income elasticities than those based on reported current income.”

Several factors beyond the distinction between current and permanent income may mitigate the regressivity of the tax. The proportion of households that rent, rather than own, falls with income. Renters do not fully escape the REET, it is a cost to the investors in rental housing that is in part passed on to tenants. Nevertheless, the burden of the REET is probably lower for renters than for owners. In addition, a study by Price Waterhouse has found that people at higher income levels tend to move slightly more frequently than those at lower income levels. As a result, higher–income households pay the tax more often.

## Impact on Home Buyers and Sellers

Although the conservation REET is formally imposed on the buyer and the other REETs are formally on the seller, this distinction is of little economic consequence. The taxes are paid from the funds that the buyer and his lender bring to the table at closing, and they reduce the proceeds available to the seller and her lender. To know the ultimate burden requires knowledge of the bargain that would be struck between buyer and seller in the absence of the taxes. Plausibly, the tax savings would be split equally between the buyer and the seller, but we cannot know for sure.

To tax an economic activity is to discourage it. The REET reduces the number of real estate transactions. As a result of the tax, parents are less likely to downsize their housing when their children leave the nest, and workers who change jobs are less likely to change houses to shorten their commutes.

Particularly important is the impact of the REET on prospective home buyers. Does the relatively heavy taxation of real estate transfers in Washington keep first-time and lower-income buyers out of the market?

Peter Linneman, Chairman of the Real Estate Department at the University of Pennsylvania’s Wharton School, told the Research Council that there are three important factors that determine whether a household will be able to finance the purchase of a home: the mortgage interest rate, the household’s income, and the availability of funds to cover those costs that cannot be covered by the mortgage loan. Of these, the availability of initial funds provides the greatest barrier for first time home buyers. As Linneman expressed it: “The biggest constraint on first time home owners is coming up with the money up front.”

The money required up front includes both the down payment and what are called closing costs. Closing (or settlement) costs include such items as loan fees, appraisal fees, credit reports, mortgage insurance and taxes. These costs typically run between 4 and 8 percent of the property value, depending on the size of the down payment and the type of loan. To the extent that the REET is born by the buyer, it is directly a closing cost. To the extent that the REET is born by the seller, the lender is forced to require a higher down payment to achieve a given level of security for the loan. Either way, the REET increases the amount of money that is required up front.

A tax of 1.78 percent may seem rather small, relative to the value of the property it is being levied against. But it can represent a large amount relative to the income of the family trying to buy a first house. Consider a family with an annual income of $36,000 which wishes to purchase a house with a value of $90,000. A 1.78 percent REET on this transaction would be $1,602. After social security and income taxes the family would be lucky to take home $2,500 per month. If the family were able to save 10 percent of their take home pay, it would require over six months to accumulate the amount of the REET.

The 1990 Legislature authorized cities and counties to levy up to an additional 1.25 percent REET: not more than 1.00 percent on the buyer for conservation area purchases, and 0.25 percent on the seller for counties required or electing to plan under the Growth Management Act. During legislative hearings on these new authorizations, the Washington Association of Realtors and others expressed concern about the effect the added taxes would have on the ability of consumers to purchase homes.

Because of its high rate, Washington's REET has a significant impact on home purchases, especially those of first-time home buyers trying to accumulate the savings needed for the down payment. The taxes due in Washington may require people to wait longer than they would have otherwise before purchasing a home, or to purchase a lower–priced home. Moreover, if housing prices are rising rapidly or there are few homes available in an affordable price range — as has been the case in many areas in recent years — the potential home purchaser could be precluded from buying a home in a particular housing market.

Several states attempt to mitigate the effect of transfer taxes on home purchases through special features of their taxes. These include exempting all or a portion of residential property from the tax, taxing it at a differential rate, or taxing lower-priced properties at lower rates.

## Conflicts Over the Use of Local REET Funds

Since the passage of the Growth Management Act in 1990, there have been continuing disputes over the uses to which local governments apply REET revenues. Growth Management requires that public infrastructure investments occur concurrently with private development. The local option REET was expanded as part of the Growth Management Act. The conflicts over REETs involve the extent to which local governments apply proceeds for uses other than funding the public investments mandated by Growth Management.

In 1992, responding to these disputes, the Legislature tightened the range of projects that could be funded from the REET. These changes have helped to reduce the perception that local governments abuse the REET. The conflict, however, has not been completely eliminated. Two recent cases illustrate the continuing questions.

One case appears in Clark County where the county commissioners in their 1996 budget approved the construction of a new 800 megahertz emergency communications system for use by the county's police and fire departments. The county issued bonds to pay the construction cost of $13.5 million and dedicated proceeds from the REET to service this debt. It is intended that the county will reimburse the REET Fund from proceeds of the 911 tax over a period of 20-plus years.

It was determined that the diversion of REET dollars to the communication system would not compromise any existing projects funded by the REET. The communications system formally qualifies for REET funding as a combined countywide "fire protection facility" and "law enforcement facility." To the extent that the Legislature intended that REET proceeds fund those public investments specifically needed to accommodate growth, however, this use is arguable.

Growth increases the demand for parks and recreational facilities, and Clark County has traditionally used REET funds to meet these demands. Some have questioned whether dedicating REET funds for the communication system would divert future dollars away from park and recreation projects. Terry Connolly, the Government Affairs Director for the Clark County Association of Realtors testified to the Clark County Planning Commission: "We are very concerned that this type of action could bring to a halt a lot of good work from both the private sector and the public sector that's come up with a plan to fund parks." Steve Dearborn of the Greater Vancouver Chamber of Commerce also addressed the Planning Commission, "The Chamber is concerned, however, with the message that is being sent in dedicating these REET dollars at this time to this communications system. . . . The parks issue is . . . at the center of our concern."

In a letter to the county commissioners on behalf of the Clark County Association of Realtors, Randall B. Printz noted that "the proposed amendment to the capital facilities element has significant impact on the existing 1/4 of one percent of real estate excise tax which has previously been utilized in part to fund parks and recreation projects. . . . [T]he proposed amendment would summarily strip parks and recreation of a key funding source without receiving broad based public comments and comments from parks and recreation staff."

Another example of arguable REET fund usage occurred in Snohomish County.

In June of 1996, an emergency appropriation in the amount of $30,000 from the REET fund was used for the replacement of bull corrals at the Evergreen Fairgrounds. The money specifically went to replace worn down pins in the corral fences. The corrals are used year-round for holding stock for events such as rodeos and horse shows. Safety reasons were cited in declaring the appropriation an emergency, and the funds went solely toward the purchase of materials.

Questions have arisen regarding this use of REET dollars. First, was this a legitimate use of REET funds? Neither fair grounds nor animal shelters were specifically listed by the Legislature as acceptable uses. "Reconstruction of recreational facilities," however, is an allowed use. Are the bull corrals a recreational facility? Second, granting that bull corrals are a recreational facility, is this the sort of use that the Legislature intended for the local REET?

## Summary and Conclusions

The REET is a highly volatile revenue source. The relative inelasticity of the REET causes it to exaggerate tendencies toward slow revenue collections during economic downturns and rapid collections during economic booms.

This volatility is not a major concern when considering it as a source of general revenues, because its proceeds only make up a small portion of the general fund-state account.

Excise taxes are often, however, earmarked for specific purposes. Because of its volatility, the REET is not a good source of revenue for programs requiring ongoing funding. To the extent that the REET is earmarked, it should be for programs which require one–time appropriations, such as capital projects or property acquisition.

As with other excise taxes, the tax is probably regressive. In other words, it may take a larger portion of the income of lower–income households than of higher–income households.

The tax discourages real estate transactions. Families are less likely to move when they experience a change in job or household structure. The tax may keep first–time home buyers out of the housing market.

There may be a significant impact on lower–income home buyers if the tax adds significantly to the cash cost of closing a home purchases. Some states have attempted to mitigate this effect through special features of their transfer taxes.

Data on the revenue produced by cities through local REETs is not easily obtainable. There are now several local REET authorities and a variety of purposes for which the revenue can be used. As the Legislature passes more and more taxing authority to local governments, it will be increasingly important to have reliable and comparable figures on the revenue each tax generates for specific local jurisdictions and the purposes for which the taxes are being levied.

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