POLICY
brief
Washington Research Council

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Washington's Real Estate Excise Tax

BRIEFLY

Washington's real estate excise tax is among the nation's highest. The tax raises the cost of housing, contributing to the state's relatively low rate of homeownership. This is a particular hardship for first-time homebuyers. The higher cost of housing and the burden of the REET on businesses reduces the competitiveness of the state's economy.

Washington's real estate excise tax is among the nation's highest. It generates a relatively small stream of revenue for state and local government, about 5 percent of the state general fund (Department of Revenue). And, it is highly volatile, increasing and declining with the ups and downs of the real estate market. Recent experience highlights this volatility. According to the Economic and Revenue Forecast Council, the real estate excise tax collected from February 11 to March 10, 2005 was 54.4 percent higher than in the corresponding period in 2004. The number of transactions was up by 21.0 percent while the average value per transaction was up by 27.6 percent. Volatility in the revenue stream increases the risk associated with relying on the tax to fund ongoing programs.

Seized upon by state and local lawmakers throughout Washington as an expedient way to tap into the state's extended economic growth, the real estate excise tax makes home buying more expensive and creates an especially heavy burden for lower- and middle-income purchasers. The added expense is also a drag on businesses that are looking to relocate to the state or expand here. The high tax rate impedes growth.

WASHINGTON'S REET

In Washington, the real estate excise tax is collected by state and local government.

Chapter 82.45 RCW imposes an excise tax on every sale of real estate in this state at the rate of 1.28 percent of the selling price. Unless otherwise specifically exempt from tax, all sales of real property are subject to the real estate excise tax. That is, for every $100,000 of a property's sales price, the state assesses $1,280 in state real estate excise tax. Sale of a median-priced single-family home in King County (about $342,500 in February of 2005) would thus generate $4,384 in state real estate excise tax (Northwest Multiple Listing Service 2005).

Chapter 82.46 RCW authorizes counties, cities and towns to impose additional taxes on sales of real property based on the same incidences, collection and reporting methods, as applicable under Chapter 82.45 RCW. The taxes imposed are due at the time the sale occurs…"

Only New Hampshire's 1.5 percent and Delaware's 2 percent rates are higher than Washington's state rate. Thirteen states do not tax real estate transfers at all. And in a number of other states, the tax amounts only to a minor recording fee (National Association of Realtors 2004).

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The base to which the real estate excise tax applies also varies among the states. Some states, like Washington, have a broad base, taxing the entire purchase price. Others tax only the buyer's equity. With its broad base and high rates, Washington's tax stands out.

Chart 1: Real Estate Excise Taxes in Washington
(maximum authorizations)

	Rate		Taxes Due on $200,000 Home	
State Tax	1.28%		$2,560	
Local Taxes	2.50%		$5,000	
For general capital purposes [1]		*0.25%*		*$500*
For growth-related capital projects [2]		*0.25%*		*$500*
Conservation purchases [3]		*1.00%*		*$2,000*
In lieu of sales tax [4]		*0.50%*		*$1,000*
For low/moderate income/special needs housing [5]		*0.50%*		*$1,000*
Total authorized	3.78%		$7,560	

[1]Most cities and counties impose the action.
[2]Voter approval is necessary in counties not required to plan under the Growth Management Act.
[3]Requires voter approval. Adopted only in San Juan County. This REET is imposed on the buyer. All others are imposed on the seller.
[4]Only a few cities impose this option.
[5]Authorized in 2002; tax levied only if local conservation tax imposed by 2003.
Source: Tax Reference Manual, State of Washington, Department of Revenue, 2005

In 2003, Washington citizens paid $72.63 per capita in REET. (For 2005 the figure will be much higher.) The national average was $21.64, and in 30 states per capita REET was less than $6.50. (Gilliland 2004)

County treasurers collect the real estate excise tax for the state. In return, counties keep one percent of the collections for administrative purposes. Of the net proceeds to the state, 7.7 percent goes into the Public Works Assistance Account, which helps local governments pay for public infrastructure and facilities. The remaining 92.3 percent goes into the state general fund.

Besides the high rate the state imposes, Washington is one of only 12 states that also allow local jurisdictions to tax real estate transfers. Cities and counties were given the option to levy the tax locally in 1982 at a rate of 0.25 percent in order to pay for capital projects associated with a capital facilities plan. In addition cities and counties were allowed to levy up to 0.50 percent in lieu of their second 0.5 percent local-option sales tax. In 1990, two additional local options were authorized: Cities and counties were allowed to levy an additional 0.25 percent to fund capital projects associated with growth management, and counties were given the option to levy an additional 1.0 percent to purchase and maintain conservation areas. Finally, in 2002, counties were allowed an additional 0.5 percent to fund affordable housing facilities. However, to be eligible to levy this tax, a county must have imposed the 1.0 percent conservation tax by January 1, 2003. Only San Juan County meets this condition.

With these options, the total local REET allowed has grown to 2.50 percent, bringing the maximum combined state and local real estate excise tax rate in Washington to 3.78 percent. Most jurisdictions impose a combined rate of either 1.53 percent or 1.78 percent, according to the state Department of Revenue, with the majority of transactions subject to a 1.78 percent rate.

INCREASES DISCUSSED

Increases in the REET have been discussed this legislative session, both as a potential revenue source to help close the general fund budget shortfall and as a local option to fund various programs and services or as an alternative to impact fees. The characteristics of the REET make it a particularly poor choice for these purposes.

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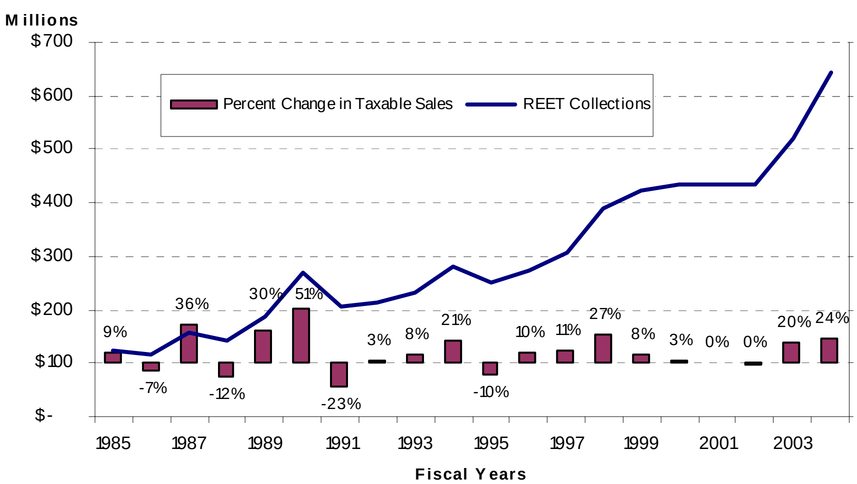
Consider first the REET as an impact fee replacement. To be sure, as the Research Council has written previously, impact fees have substantial problems themselves, having seriously increased housing prices, contributed to a lack of affordable housing, and disproportionately burdened some homebuyers while allowing others to coast as free riders. (Washington Research Council 1995 and 2001a) Yet the REET alternative would present many of the same problems. In many jurisdictions, REET already adds more than impact fees do to the price of a new home, particularly if the jurisdiction does not impose school impact fees. (See, for example, our calculations of taxes and fees on a new home built in Kirkland, Washington Research Council 2001b.)

More generally, REET is volatile; it reduces home ownership; it decreases mobility; and reduces economic activity.

REET IS VOLATILE

A strong housing market, fueled by exceptionally low interest rates, has generated record-level REET collections in recent years. Just as some investors in the late 1990s saw the dot-com boom as the lift off of a “new economy” in which the traditional laws of economic gravity no longer applied, some policymakers may have forgotten that the REET has historically fluctuated wildly. Markets contract, booms turn to busts, and revenue collections fall dramatically. What goes up generally does come back down.

Chart 2: REET Revenues and Annual Changes in the Value of Taxable Sales



Source: Department of Revenue; 1985--1987 includes conveyance tax.

Revenue produced by the real estate excise tax was at an all-time high in 2004, generating over $615 million for the state and accounting for nearly five percent of general fund revenues. As Chart 2 shows, increasing numbers of transactions and increasing average transaction values have driven receipts from the tax up considerably since the mid-1980s . (On the chart, collections for 1985 to 1987 include the conveyance tax, which was folded into the REET beginning July 1, 1987.) The state Forecast Council estimates that state REET revenue will approach $800 million for FY 2005. The most recent data on local REET collections are for CY 2003, when they totaled $213.6 million.

Although robust real estate market conditions have resulted in a general upward trend in REET collections over the last decade, they bounce around quite a bit and can be expected to fall off again when the economy cools. On Chart 2 we also show for each year the percentage change from the previous year in the value of transactions subject to the REET. The growth rates vary dramatically from year to year. (For this reason, the REET is poorly suited as an earmarked funding source for activities requiring steady, on-going expenditures.) The recent growth rates are actually less than those experienced in 1987, 1989, and 1990. The record shows that large increases in REET revenue are often followed by large decreases.

TAX HARDER ON FIRST-TIME HOMEBUYERS

REET is properly viewed as a peculiar type of property tax, one that is collected only on the occasions when property changes hands (O'Sullivan et al 1995). In any given year REET is collected on only about 8 percent of property in the state. Typically, tax policy experts prefer taxes that apply the lowest possible rates to the broadest possible bases. By this norm, the standard property tax is a better tax than the REET. Like the standard property tax, the REET has a proportionally greater impact on low- and middle-income households.

Who actually pays the REET has been a subject of a certain amount of confusion. All but one of the state and local options are taken directly from the seller's proceeds at closing, which makes it appear that these taxes are not a cost to the buyer. Legislative requirements, however, do little to avert the marketplace, which, in the end, will determine who pays, and economic theory indicates that the seller-paid REET is passed on to the buyer in the form of a higher house price.

The higher prices discourage homeownership. In 2003, Washington ranked only 43rd in the nation in homeownership, with a rate of 65.9 percent. The national homeownership rate was 68.3 percent. (Washington Alliance for a Competitive Economy 2005, Table 38)

The REET's effect on first-time homebuyers is particularly troublesome. Three important factors determine whether a household will be able to finance the purchase of a home. The first two factors are the mortgage interest rate and the household's income, which together establish the amount the household can borrow towards the purchase. The third factor is the availability of funds to cover those costs beyond those covered by the mortgage loan. Of these, the availability of initial funds provides the greatest barrier for first-time homebuyers. By raising the house prices, the REET raises the initial funds required and squeezes out some first-time buyers.

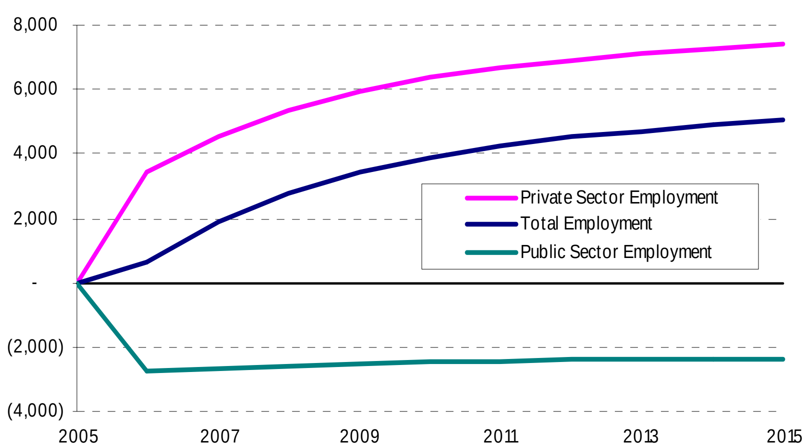
Calculations by Lawrence Yun, Manager of the Statistics and Forecasting Group at the National Association of REALTORS®, indicate that were the average REET increased from 1.78 percent to 2.45 percent, 7,600 fewer Washington households (with 19,000 members) would be able to afford to purchase the median priced home in the state. (Yun 2005)

REET DISCOURAGES BUYING AND SELLING

To tax an activity is to discourage it. Because of the REET, people who own homes are less likely to move when their circumstances change. 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. (O'Sullivan et al 1995) Consequently our housing stock is used less efficiently than it could be, and road congestion is higher.

Those people who expect to move relatively frequently are discouraged from owning at all and instead rent housing.

Chart 3: Impact of Eliminating State REET beginning in 2006



Source: WRC/REMI Model

The result of all of this is a thinner market for owner-occupied housing, with less inventory on the market at any time and a smaller number of transactions. The number of real estate transactions is strongly correlated with construction spending and sales of lumber, hardware, home furnishings and appliances, which generate significant sales tax revenues for the state and local governments.

ECONOMIC IMPACT

We have used the Washington Research Council/Regional Economic Modeling Incorporated model of the Washington Economy to simulate the impact of the state REET. The basic scenario we model removes the tax beginning in 2006. General state government spending is reduced by the amount of REET revenue lost.

The effects of the REET on business and residential property enter the model separately. We assume that the average property turns over every 12½ years. (In recent years, the value of property subject to the REET has averaged 8 percent of the value subject to the property tax.) For business property, we treat the 1.28 percent REET as equivalent to a 0.1 percent annual property tax. For residential property, we assume that the REET raises housing prices by 1.28 percent.

The lower cost of housing and lower taxes paid on business property improve the competitiveness of the state's economy. The simulation shows that eliminating the state REET would increase employment. (See Chart 3.) Government sector employment falls because of the decrease in state spending. Private sector employment rises. The negative impacts of the reduction in state spending are felt more immediately than the positive effect of lower taxes. Because of this, the gain in total employment builds over time. In 2010, there is a net gain of 3,900 jobs. By 2015 this grows to a net gain of 5,000 jobs.

Eliminating the state REET increases personal income by $544 million in 2010 and by $851 million in 2015.

RECAPITULATION

Because of the volatility of the real estate excise tax and its associated economic impacts, lawmakers should not rely on it to pay for ongoing government activities. The tax raises the cost of housing. This contributes to the state's relatively low rate of homeownership and presents a particular hardship for first-time homebuyers. The higher cost of housing and the burden of the REET on businesses reduces the competitiveness of the state's economy. Simulations with the WRC/REMI model indicate that elimination of the state REET would add 3,900 jobs and $544 million in personal income to the state by 2010. Conversely, increasing the REET would likewise decrease jobs and personal income.

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