Washington Research Council

ePOLICY brief

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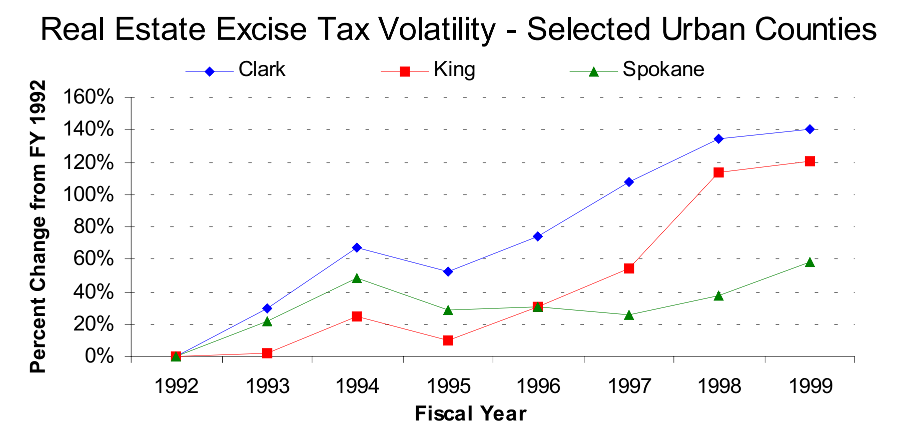
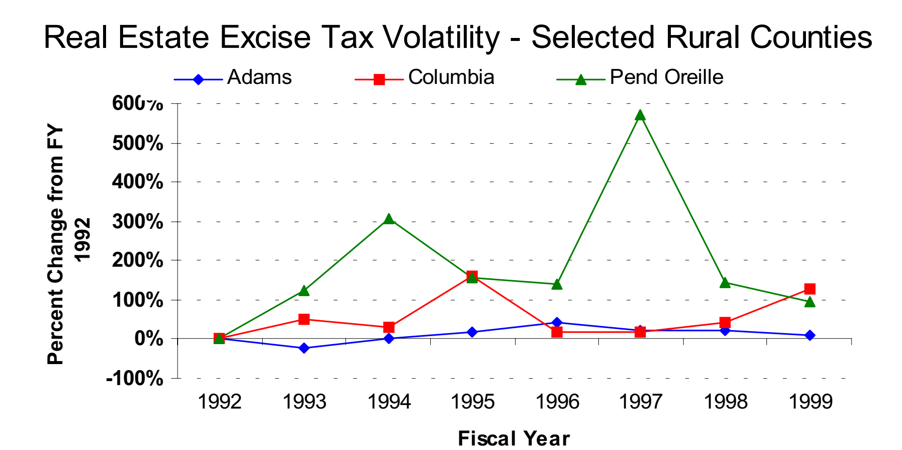
Local Option REET Magnifies Volatility



Source: Washington Research Council and Washington Department of Revenue



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Washington's real estate excise tax is a highly volatile source of state and local government revenue.

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.

In Washington residential and commercial property sales are subject to state and local real estate excise taxes (REET). The state imposes a 1.28 percent tax on sales and other transfers of real property. That is, for every $100,000 of a property's sales price, the state assesses $1,280 in state real estate excise tax. Local governments are authorized to levy up to a maximum of 2.00 percent on such sales. In most cities and counties in Washington the combined state and local rate levied is either 1.53 or 1.78 percent, according to the state Department of Revenue.

Problems More Apparent

When local governments levy the tax, all of the tax's basic problems, especially those of volatility, are magnified.

In this paper we review the real estate excise tax experience in three metropolitan counties – King County, Clark County and Spokane County, and three rural counties – Adams, Columbia and Pend Oreille.

Not surprisingly, collections in the rural counties, where real estate markets can be sporadic and heavily impacted by a few sales, are more volatile than they are in the urban counties. As the volatility graphs show, collections in Pend Oreille County demonstrate the most dramatic swings. The graphs illustrate the increase in collections each year compared with Fiscal Year 1992 (FY 92). For example, Pend Oreille collections grew by about 300 percent from FY 92 to FY

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94. Their growth rate then fell back to near-FY 93 levels in FY 95 and FY 96, shooting up again in FY 97, when collections were 570 percent more than they were if FY 92.

Urban County Volatility

Real estate excise tax volatility is similar between the urban counties shown here, with Spokane County having predictably less dramatic real estate activity, compared with King and Clark Counties. In the urban counties there has been a decidedly upward trend in tax collection from real estate activity (even with a cooling period in 1995) – a trend much less apparent or predictable in rural Washington.

These growth illustrations capture the increased real estate sales activity of the 1990s associated with a strong economy, especially in the Puget Sound area in 1997. In addition, the numbers reflect the more recently authorized local option real estate excise taxes and their greater use by local governments around the state.

With passage of the state Growth Management Act in 1990 came additional authorizations for local governments to assess the real estate excise tax. These local options can now run as high as two percent, bringing the maximum combined state and local tax rate to 3.28 percent, or $3,280 on each $100,000 in sales price.

Caution Advised

State law requires most real estate excise taxes levied locally to be spent on capital projects. This would seem to solve much of the issue with the tax's volatility, since it is not being used to fund on-going operations. However, the same volatility in revenue collections makes it an inappropriate stand-alone funding source for servicing the long-term debt associated with large capital projects.

Even for small capital projects, the tax's volatility suggests that local lawmakers should be cautious in relying solely on this revenue source for debt repayment. By keeping the term of indebtedness as short as possible for those capital projects using revenues from this source, lawmakers can minimize the amount of interest paid and be more confident of being able to make potentially important annual adjustments.

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