Challenging the Conventional Wisdom on the Property Tax

EDITED BY

Roy Bahl, Jorge Martinez-Vazquez, and Joan Youngman

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Foreword

The chapters in this volume appraise the strengths and weaknesses of the property tax for both high-income and developing countries. This appraisal revisits what people think they know about the property tax itself—the conventional wisdom—and begins to compare the performance of the property tax with that of other revenue sources that are commonly used by local governments.

The timeliness of this review is reflected in the slow decline in the share of local revenue raised by the property tax in the United States, from 76 percent of own-source revenue for local governments in 1970 to 65 percent in 2006. This decline accompanies the spread of popular initiatives to curtail the growth of property tax revenues. These initiatives have mainly occurred after the approval by California voters in 1978 of Proposition 13, which limited growth in property tax rates and assessed values. These initiatives, in turn, provide behavioral evidence supporting the opinion polls that frequently rank the property tax as the most unpopular tax in the United States.

Visibility is thought to be a virtue for taxes, especially at the local level, because it enables voters to weigh the cost against the benefits of the local services provided. Ironically, the property tax may have too much of this virtue. Many view the visibility of the property tax as a key to its unpopularity. Moreover, the limits that have been placed on property tax revenues suggest that voters really do not like surprises in their property taxes, as many of the limits restrict the size of annual changes in property tax bills.

The performance of a tax is often measured in terms of its efficiency and related economic distortions summarized in measures of excess burden—the extra cost to the economy of raising one dollar of revenue. In the "benefit" view, property taxes are payments for local services and the excess burden is rather small, reflecting mainly administrative costs that comprise a few percent of revenues. Another view holds that property

taxes are mainly a tax on capital, and calculations indicate that their additional excess burden ranges from 6 to 16 percent and even larger under some parameter combinations. While these burdens are not small, they are likely to be less than the excess burdens associated with other sources of local revenue, such as local sales taxes. Local sales taxes are also likely to be more regressive relative to income than property taxes. While this volume address these issues of excess burden and income incidence for the property tax, it is clear that more analysis of these issues and careful comparisons of performance across different taxes is still needed.

In developing countries, property tax practice varies much more widely than in high-income countries in terms of what is taxed (land, buildings, both combined), the government level setting the tax rate (local, provincial, national), and how property value is assessed (market transactions, value bands, rents, land area, etc.). Administrative capacity in developing countries is often weak. Because developing countries' revenue from the property tax as a share of GDP is about 30 percent of that in high-income countries, their administrative costs are likely to be a larger share of tax revenue.

Several ideas for improvements in the design and implementation of property taxes in both high-income and developing countries are presented here. Suggestions for additional analysis are discussed, particularly studies that provide consistent comparisons of the performance of the property tax relative to other local tax alternatives. Several of these ideas are under consideration by the Lincoln Institute.

I am pleased to thank the editors for their work on this volume, and to give special thanks to the Andrew Young School of Policy Studies at Georgia State University, which helped organize the conference in April 2008 where these ideas were first presented.

Gregory K. Ingram
President and CEO
Lincoln Institute of Land Policy

7 Taxing Property Transactions Versus Taxing Property Ownership

Terri A. Sexton

The taxation of property transfers in the United States dates back to the War Revenue Stamp Act of 1898. Under the War Revenue bill, "each deed, instrument, or writing, whereby any lands, tenements, or other realty sold, shall be transferred, must bear a fifty-cent internal revenue stamp when the consideration or value is between $100 and $500, and an additional fifty-cent stamp for each additional value of $500 or fractional part thereof" (*New York Times* 1898). When the federal government repealed its documentary stamp tax on 31 December 1967, it urged state and local governments to implement similar taxes. Currently the transfer of real property is subject to ad valorem taxation in 38 states.

Taxes on real property transactions are levied on some measure of the value of the property, usually the sales price, and collected at the time a deed is legally recorded. Unlike the property tax, they are nonrecurring. The tax is referred to by many names, including property transfer tax, real estate transfer tax, real estate excise tax, deed transfer tax, mortgage transfer tax, documentary stamp tax, and conveyance tax.

The stamp duty originated in Holland in 1624 and remains a part of the tax system in most countries today (Bahl 2004). Even in less developed economies, it is considered an easy way to raise revenue. When property is sold, title must be transferred and a deed recorded. What may have started as a simple service charge to cover the cost of filing documents has evolved into a much more complicated, but cost-effective, revenue source.

Few studies have examined the use and effects of real property transfer taxes, especially in the United States. This chapter examines the variety of transfer tax programs currently in use in the United States and compares them to annual property taxes in terms of equity, efficiency, and revenue potential and stability. The following section examines the widespread use of property transfer taxes in the United States and other countries and compares them in terms of tax rates, tax base, tax authority, and use of

revenues. The third and fourth sections focus on the impacts of transfer taxes on residential property. In the third section the distributional impact is discussed, including the questions of who ultimately bears the burden of the tax and whether the tax is regressive or progressive with respect to income. The fourth section looks at the efficiency effects of transfer taxes including the excess burden of the tax and its effect on household mobility. The fifth section examines the revenue potential of transfer taxes and their volatility, and the sixth section summarizes and concludes the chapter.

Features and Prevalence

The first states to impose a transfer tax were Virginia in 1922, South Carolina in 1923, and Florida in 1931. Alabama, Maryland, Tennessee, and Washington all had transfer taxes by 1940 (Behrens and Gravelle 2005). Transfer taxes are currently collected by state or local governments in 38 states including the District of Columbia. Nineteen states have statewide taxes only, sixteen have both statewide and local taxes, and three states collect transfer taxes only at the local level. Details regarding the transfer tax in each state are shown in table 7.1.

There are three basic types of property transfer taxes: real estate transfer or excise taxes are the most common and are levied on the sales price or gross receipts from the sale of real property; documentary or stamp taxes are also imposed on the sales or purchase price of property and must be paid before the transfer of ownership can be legally recorded; and mortgage taxes are levied on the amount of the mortgage used to purchase real property. Some states that levy a real estate transfer or documentary tax also impose a mortgage tax that generates revenue from refinancing mortgages when no actual sale or transfer occurs. New York City imposes both a real property transfer tax and a mortgage recording tax. Despite the obvious overlap of the two taxes, there are cases where one or the other, but not both, apply. For example, sales of co-op apartments are subject to the property transfer tax, but not the mortgage tax since financing is technically not a mortgage, and mortgage refinances are subject to the mortgage tax, but not the property transfer tax if there is no deed transfer.

Tax Rates

State transfer tax rates range from 0.01 percent in Colorado to as high as 4 percent in parts of Pennsylvania. Four states and the District of Columbia apply different tax rates on different classes of property—residential, commercial, and agricultural—while the remaining 33 states do not distinguish

TABLE 7.1 Property Transfer Taxes by State (as of April 2008)

State	*Description*	*Tax rate*	*2003 revenue per capita*	*2004 revenue ($ thousands)*	*2004 revenue per capita*
Alabama	Deeds: $.50/$500	0.1%			
	Mortgages: $.15/$100	0.15%	$6.57	$45,080	$9.95
Alaska	None				
Arizona	$2 per deed or contract to be recorded			NA	NA
Arkansas	$3.30/$1,000 of consideration in excess of $100	0.33%	$6.44	$25,972	$9.43
California	$.55/$500 to $8.05/$500 varies by city	0.11–1.61%		$1,064,263	$29.69
Colorado	$.01/$100 of consideration in excess of $500	0.01%			
	Municipal tax: 0–4.0%			NA	NA
Connecticut	0.5% of consideration up to $800,000	0.75%			
	1.0% of consideration over $800,000	1.25% of value over			
	Plus 0.25%	$800,000	$32.60	$175,816	$50.18
Delaware	1.5–3% (depending on local tax, 3% minus local rate of at most 1.5%) on transfers in excess of $100; 1% on contracts for improvements to realty in excess of $10,000	1.5–3%	$74.33	$98,566	$118.74
District of Columbia	1.45% deed transfer tax plus 1.45% deed recordation tax (1.1% and 1.1% for residential property with value < $400,000)	2.2% if residential < $400,000			
		2.9% all other		$286,269	$485.20
Florida	Deeds: $.70/$100 ($.60/$100 in Miami-Dade County)	0.7%			
	Mortgages: $.35/$100	0.35%	$93.97	$1,950,402	$111.99
Georgia	$.10/$100	0.1%	$0.04	$420	$0.05

(*continued*)

TABLE 7.1 (*continued*)

State	*Description*	*Tax rate*	*2003 revenue per capita*	*2004 revenue ($ thousands)*	*2004 revenue per capita*
Hawaii	$0.10/$100 for consideration up to $600,000	0.1%			
	$0.20/$100 for consideration from $600,000 to $1 million	0.2%			
	$0.30/$100 for consideration over $1 million	0.3%			
	Nonhomeowner single-family residential property:				
	$0.15/$100 for consideration up to $600,000				
	$0.25/$100 for consideration from $600,000 to $1 million				
	$0.35/$100 for consideration over $1 million		$8.45	$18,426	$14.59
Idaho	None				
Illinois	State: $0.50/$500	0.10%			
	County option: $0.25/$500	0.05%			
	Municipal option: ranging from $0 to $5/$500	1.0%	$4.62	NA	NA
Indiana	None				
Iowa	$0.80/$500	0.16%	$3.17	$13,869	$4.69
Kansas	Mortgage: $0.26/$100	0.26%		$52,569	$14.59
Kentucky	$0.50/$500	0.1%	$0.78	$3,434	$0.83
Louisiana	None				
Maine	$2.20/$500	0.44%	$13.99	$29,380	$22.31
Maryland	0.5% (0.25% for first-time buyers) state tax	0.69–3.2%			
	Local deed: $4.40–$12.00/$1,000				
	Local transfer: 0–1.5%		$19.42	$183,189	$32.96

Massachusetts	$4.56/$1000	0.456 % state			
	Nantucket and Martha's Vineyard: 2 %	2.456 % state and local			
	Barnstable County: $3.42/$1,000	0.798 % state and local	$23.62	$245,906	$38.32
Michigan	State: $3.75/$500	0.75 %			
	County: $0.55/$500–$0.75/$500 depending on population	0.11–0.15 %	$25.27	$317,480	$31.39
Minnesota	Transfer: $1.65/$500	0.33 %			
	Mortgage: 0.23 %	0.23 %	$31.96	$352,354	$69.08
Mississippi	None				
Missouri	None				
Montana	None				
Nebraska	$2.25/$1,000	0.225 %	$3.90	$9,215	$5.27
Nevada	$1.95/$500 for all counties plus	0.39–0.51 %			
	$0.10/$500 for Washoe and Churchill Counties				
	$0.60/$500 for Clark County		$1.76	$96,704	$41.41
New Hampshire	$1.50/$100	1.5 %	$72.77	$145,386	$111.82
New Jersey	For consideration up to $350,000:				
	$2.00/$500 first $150,000	0.4 % first $150,000			
	$3.35/$500 from $150,000 to $200,000	0.67 % $150,000 to $200,000			
	$3.90/$500 from $200,000 to $350,000	0.78 % $200,000 to $350,000			
	For consideration in excess of $350,000:				
	$2.90/$500 first $150,000	0.58 % first $150,000			

(*continued*)

TABLE 7.1 (*continued*)

State	*Description*	*Tax rate*	*2003 revenue per capita*	*2004 revenue ($ thousands)*	*2004 revenue per capita*
	$4.25/$500 from $150,000 to $200,000	0.85% $150,000 to $200,000			
	$4.80/$500 from $200,000 to $550,000	0.96% $200,000 to $550,000			
	$5.30/$500 from $550,000 to $850,000	1.06% $550,000 to $850,000			
	$5.80/$500 from $850 to $1 million	1.16% $850,000 to $1 million			
	$6.05/$500 amount over $1 million	1.21% above $1 million			
	For consideration in excess of $1 million (residential only) in addition to above: $5/$500	1.0%			
	County: up to 0.1% additional tax	Up to 0.1% county tax	$14.37	$246,503	$28.34
New Mexico	None				
New York	State transfer: $2/$500 up to $1 million value 1.4% of total if over $1 million	0.4% if less than $1 million; 1.4% if over $1 million			
	New York City transfer:				
	Residential: 1% up to $500,000 value 1.425% over $500,000	1%			
	Commercial: 1.425% up to $500,000 2.625% over $500,000	1% 1.425%			

	New York City mortgage: All: 2.05% if < $500,000 Residential: 2.175% if ≥ $500,000 Commercial: 2.80% if ≥ $500,000		$26.13	$510,443	$26.55
North Carolina	$1/$500 state 1.0% in six counties	0.2% state 1.2% total in 6 counties			
	0.4% maximum for new county taxes	0.6% max. in remaining	$4.10	$54,940	$6.43
North Dakota	None				
Ohio	Local taxes ranging from $0.10/$100 to $0.40/$100	0.1–0.4%			
Oklahoma	$75/$500	0.15%	$2.63	$12,048	$3.42
Oregon	No state tax. Washington County has a $1/$1,000 transfer tax	0.1% (Washington County only)			
Pennsylvania	State: 1% Local: 1% (3% in Philadelphia)	2% (4% in Philadelphia) state and local	$25.76	$470,789	$37.95
Rhode Island	$2.00/$500	0.4%			
	Block Island: 3%	3.4%	$2.17	$12,645	$11.70
South Carolina	$1.30/$500 state	0.37% combined			
	$0.55/$500 county		$9.62	$50,493	$12.03
South Dakota	$50/$500	0.1%	$0.18	$141	$0.18
Tennessee	Transfer: $0.37/$100	0.485%			
	Mortgage: $0.115/$100 of indebtedness in excess of $2,000		$20.49	$174,206	$29.52
Texas	None				
Utah	None				

(*continued*)

TABLE 7.1 (*continued*)

State	*Description*	*Tax rate*	*2003 revenue per capita*	*2004 revenue ($ thousands)*	*2004 revenue per capita*
Vermont	1.25 % If principle residence: 0.5 % of first $100,000 of value 1.25 % of value above $100,000 If agricultural or forest land or farm property: 0.5 % of entire value	1.25 % max.	$34.69	$20,762	$33.43
Virginia	State: $2.50/$1,000 of sales price plus $1/$1,000 for transfer of realty	0.43 % combined state and local rate			
	County: $0.834/$1,000 of sales price		$23.19	$340,591	$45.66
Washington	1.28 % state rate plus up to 2.5 % local rate	1.28 % state 3.78 % max. state and local	$72.63	$640,086	$103.17
West Virginia	$1.10/$500 state tax	0.22 % state rate			
	$0.55/$500 or $1.10/$500 county tax	0.11 % or 0.22 % county rate	$3.68	$10,129	$5.58
Wisconsin	$0.30/$100	0.3 %	$8.18	$66,325	$12.04
Wyoming	None				

SOURCES: National Association of Realtors, Federation of Tax Administrators, and various state Web sites. 2004 revenues are from Federation of Tax Administrators (2006); 2003 revenues are from Gilliland (2004).

among property types. New York City and the District of Columbia tax residential property at a lower rate than other property. Vermont levies a lower rate on the first $100,000 of value of owner-occupied residential properties and the entire value of agricultural properties and forest land. In New Jersey, a surtax is imposed on residential properties worth more than $1 million. In 2007, the Hawaii House Finance Committee approved a bill to increase the transfer tax rates on nonhomestead single-family residences and condominiums to discourage speculation, especially the practice of "flipping" residential property shortly after it is acquired, in the hopes of stabilizing rents, home prices, and property taxes.

Transfer taxes can be designed to discourage speculation without penalizing long-term property owners by basing tax rates or exemptions on the amount of time the property is held. For example, tax rates can be set very high for properties held for six months or less and decrease as properties are held for longer periods. Similarly, a portion of the sales price could be exempt from the tax, with the exemption increasing with the length of time the property is held.

Progressive tax rate schedules are used in five states. The District of Columbia's combined transfer and recordation tax rate is 2.2 percent on residential transactions less than $400,000, but jumps to 2.9 percent on transactions of $400,000 or more. The cutoff point in Connecticut is $800,000, below which value is taxed at 0.5 percent, and any value above $800,000 is taxed at twice that rate, or 1 percent. New York State defines its two brackets as up to $1 million and over $1 million, while New York City uses a lower cutoff of $500,000. As in the District of Columbia, once the $500,000 threshold is exceeded under the New York City tax, the entire value of the transaction is taxed at the higher rate. This feature provides a strong incentive to divide parcels prior to sale, a practice that may be inefficient and wasteful. Hawaii has a three-bracket tax with cutoffs at $600,000 and $1 million. New Jersey has the most complicated rate structure, with entirely different sets of rates applying to properties worth up to $350,000 and those worth more. Maryland taxes sales to first-time home buyers at a lower rate (0.25 percent) than other sales (0.5 percent), and in Michigan the county tax rate varies with population.

In California, real property transfer taxes are levied by local governments. Tax rates vary by jurisdiction and have both a city and county component. The sales of properties located in unincorporated areas of the state are subject to a 0.11 percent transfer tax payable to the county. If the property is located in a general law city, the 0.11 percent tax is split equally between the city and county. Charter cities have the authority to establish a higher transfer tax rate, in which case the sale is subject to a 0.11 percent

TABLE 7.2 2009 Transfer Tax Rates for the 10 Largest California Cities (percent)

Sorted by Rate	*City*	*County*	*Total*
Oakland	1.5	0.11	1.61
San Francisco	0.5%–1.5*	0.5%–1.5	0.5%–1.5*
Los Angeles	0.45	0.11	0.56
San Jose	0.33	0.11	0.44
Sacramento	0.275	0.11	0.385
San Diego	0.055	0.055	0.11
Long Beach	0.055	0.055	0.11
Fresno	0.055	0.055	0.11
Santa Ana	0.055	0.055	0.11
Anaheim	0.055	0.055	0.11

*The San Francisco rate is four-tiered, depending on the value of the transaction, with rates of 0.50%, 0.68%, 0.75%, and 1.5% applying to value ranges below $250,000, $250,000 to $1 million, $1 million to $5 million, and above $5 million, respectively.

Source: California League of Cities, http://www.californiacityfinance.com/#OTHERTAX.

county rate plus the city rate. Table 7.2 shows the transfer tax rates for the 10 largest cities in California.

Tax Base

The base to which property transfer taxes apply varies among the states. Some states have a broad base, taxing the entire purchase price of all real estate. Others tax only certain classes of real estate or tax only the buyer's equity, the sales price exclusive of any mortgage, or liens attached to the property.

Most state and local governments exempt the first $100 of value from the transfer tax. Colorado, Iowa, and New York exempt transfers under $500, and Connecticut and Tennessee exempt transfers under $2,000. Some Maryland counties exempt the first $50,000 from the transfer tax for all transfers, while others offer the same exemption to principal residences only. Other Maryland counties offer smaller exemptions of $30,000, 1 percent up to $22,000, or credits up to $330 to buyers of owner-occupied residences. A transfer tax recently proposed in New Mexico would exempt the first $100,000 of value and all new home sales.

Some of the most common exemptions relate either to the type of entity or to the type of transfer involved in the transaction. Examples include a transfer directly to a creditor to secure a debt; a transfer without payment between a husband and wife, parent and child, or grandparent and grand-

child; transfers to or between the federal, state, or local government; the balance owed on an assumed mortgage; and transfers to a corporation, partnership, or LLC (limited liability corporation) at the time of formation, if no gain or loss is recognized. Gifts of real estate between unrelated individuals are generally not exempt.

Tax Authority

The authority to collect the transfer tax varies across states. In some states the tax is collected by county governments, but the revenues go into the state general fund. Some states that collect the tax also authorize local governments to levy their own tax, while in still others, only local governments are authorized to levy transfer taxes.

Massachusetts granted the authority to collect transfer taxes to both Nantucket and Martha's Vineyard in the 1980s, and they both set a rate of 2 percent. In 1996 Barnstable County residents overwhelmingly approved a petition requesting legislative approval to levy a similar tax. The legislature granted approval for 15 Cape Cod communities to impose a 1 percent tax on the sale of homes. Following a veto by the governor, the measure was sent back to Cape residents for another vote. By this time the state realtor's association had organized its opposition, and the measure was defeated (Trust for Public Land 2007).

Following a hard-fought battle in the state legislature, realtors and voters joined in support of a 2 percent transfer tax in Block Island, Rhode Island, in 1985. Block Island is an 11-square-mile island off the coast of Rhode Island famous for its natural beauty and historic buildings. Instead of opposing the tax, realtors recognized that preserving open space and the island's history would enhance the value of property and ultimately their profits. In response to criticism that the tax might be a significant barrier to first-time home buyers, they are granted an exemption of the first $75,000 of the purchase of a primary residence (Endicott 1993).

In 1990, Washington State passed legislation establishing a statewide 1.28 percent real estate transfer tax to fund local capital projects and allowing counties to levy an additional 1.0 percent tax, with voter approval, to acquire and maintain conservation areas. The total local rate allowed has grown to 2.5 percent, bringing the maximum combined state and local transfer tax rate in Washington to 3.78 percent. Most jurisdictions impose a combined rate of either 1.53 percent or 1.78 percent, with the majority at 1.78 percent.

The property transfer tax in North Carolina dates back to 1985, when the legislature gave two counties, Dare and Currituck, authority to levy a

land transfer tax of 1 percent to help meet growing infrastructure needs. The same authority was extended to Chowan and Camden Counties in 1986, and the tax was passed in two additional counties in 1989. The 2007 State Appropriations Act (H1473) gives the remaining North Carolina counties the authority to levy either a 0.25 percent sales tax increase or a new real estate transfer tax up to 0.4 percent. In November 2007, 16 counties tried their luck with a transfer tax referendum, but it failed to pass in every county, with strong resistance coming from the North Carolina Association of Realtors.

Use of Revenues

The volatility of transfer tax revenue makes this tax an unstable and unpredictable funding source. Nevertheless, it is becoming increasingly common for state and local governments to earmark transfer tax revenues for specific purposes. Maryland's tax funds Chesapeake Bay protection, and Florida uses a portion of its tax proceeds to finance land acquisition, and habitat and wetlands protection and restoration. Montana finances state park programs, while New York, North Carolina, and Vermont have used tax revenues to fund environmental bonds. Other state and local governments have targeted revenues for affordable housing development, and 12 state-level housing trust funds receive transfer tax revenues. New Jersey splits its transfer tax revenue between the county where the sale took place and the state, with a major portion of the state's share going to environmental protection and neighborhood preservation. Michigan has directed revenues from its real estate transfer tax to the School Aid Fund. Hawaii earmarks 10 percent of its transfer tax receipts for a land conservation fund and 30 percent for an affordable rental housing fund.

Twelve Colorado municipalities, all associated with ski resorts, impose a real estate transfer tax ranging from 1.0 percent in Breckenridge, Frisco, Gypsum, Minturn, Snowmass Village, Vail, and Winter Park to 1.5 percent in Aspen (0.5 percent on the first $100,000 and 1.5 percent on value above $100,000), 2.0 percent in Avon, 3.0 percent in Crested Butte and Telluride, and 4.0 percent in Ophir. Several have earmarked the receipts for specific purposes. Aspen and Crested Butte impose two separate taxes, with the revenues dedicated for different purposes. Since passage of the Tax Payers Bill of Rights Amendment (Article X, Section 20(8a)) in 1992, new or increased transfer tax rates are prohibited. Communities that had real estate transfer taxes prior to 1992 were grandfathered and allowed to continue collecting them.

Other Countries

Transfer taxes are common in other developed countries, and they are a popular source of revenue in developing countries. For example, Bangladesh imposes a transfer tax, a stamp duty, and a registration fee, all of which depend on the declared value of the property. The transfer tax is 1 percent of value, and the tax rates for both the stamp duty and registration fee increase with the value of the property. Average and marginal tax rates for all three combined range from 8 to 20.5 percent (Alm 1989).

Both a stamp duty and a property transfer tax are levied on the sale of real estate in Jamaica. Stamp duties are charged for registering legal documents, while the transfer tax is levied on the transfer of real property by sale, gift, or inheritance. As of 2004, the stamp duty was set at 5.5 percent of value and the property transfer tax was set at 7.5 percent. For within-family transfers, the stamp duty is a fixed amount, but the transfer tax remains at 7.5 percent. Transfers at death are subject to a 15 percent transfer tax and no stamp duty. The declared value of a transaction is accepted as the base of the stamp duty, so with the relatively high combined rate of 13 percent, there is a significant incentive to underdeclare the true value (Bahl 2004).

Bahl (2004) reports property transfer tax rates in selected other countries that range from as low as 1 percent of value up to 10 percent. Portugal, Slovakia, Mauritius, Swaziland, and El Salvador have graduated rate structures in which the rate increases with value. Among the countries reported, Taiwan has the second highest single rate, after Jamaica, at 7.5 percent. Next is the Netherlands at 6 percent, Pakistan and Bhutan at 5 percent, Kenya at 4 percent, Germany at 3.5 percent, the Czech Republic at 3 percent, and Costa Rica at 1.5 percent.

Property transfer taxes are also common in Canada. Under the Toronto land transfer tax that went into effect in February 2008, the first $55,000 of value is taxed at 0.5 percent, value from $55,000 to $400,000 is taxed at 1 percent, and value above $400,000 is taxed at 2 percent in the case of single-family residential property. The value of other types of property between $400,000 and $40 million is taxed at 1.5 percent, and property above $40 million at 1.0 percent.

Distributional (Equity) Effects

The legal or statutory incidence of a tax refers to who is legally obligated to make the tax payment, while economic incidence refers to who ultimately bears the burden of the tax after all market adjustments are complete. In

terms of the legal incidence of the transfer tax, some state and local governments require the buyer to pay the tax at the time of closing, some withhold the tax from the seller's proceeds, and still others split the nominal burden between buyer and seller. The economic burden of the tax, however, has nothing to do with who is statutorily obligated to pay the tax. The division of the burden of the transfer tax between buyer and seller is determined in the same way as any commodity tax, by the elasticities of demand and supply. Elasticity measures responsiveness to a change in price, and those that are the least responsive will bear the bulk of the burden. Using residential property as an example, if the supply of housing is relatively inelastic, as in the case of strict growth controls, sellers will bear most of the tax burden. In the case of a fixed (perfectly inelastic) supply, housing prices will be driven down by the amount of the tax. In this case the tax is said to be fully capitalized into lower property values, and property owners at the time the tax is imposed will bear the burden. If instead demand is relatively inelastic, buyers will bear a larger burden.

Empirical analysis of the incidence of property transfer taxes has focused on the tax on residential property. Benjamin, Coulson, and Yang (1993) examine the effect of a 1988 increase in the Philadelphia real estate transfer tax on the sale price of residential property. On 1 July 1988, Philadelphia's property transfer tax rate increased from 3.5 to 5.07 percent, a 45 percent increase. The authors find that sales prices were unaffected prior to implementation of the tax increase, but afterward decreased by 8 percent, significantly more than expected. These results suggest that the burden of the transfer tax in Philadelphia rests on the seller and is larger than what would occur under full capitalization of the tax increase. The authors attribute the larger than expected decrease in housing prices to mortgage market imperfections or the possibility that the tax increase served as a signal of future tax increases, further decreasing the demand for housing.

The burden of a tax is said to be distributed progressively, proportionately, or regressively if the tax as a proportion of income increases, is constant, or decreases as income increases. In other words, if high-income households pay a larger share of their income in taxes than low-income households, the tax is progressive; if they pay a smaller share than low-income households, the tax is regressive.

Whether the transfer tax burden will be distributed progressively, proportionately, or regressively depends on the distribution of land and property ownership, differences in mobility, and the specific tax base definitions and tax rate structures. If the value of property owned is a larger proportion of income for low-income households, and if they move with the same frequency as high-income households, the transfer tax burden will be

distributed regressively. Alternatively, if the value of property owned increases faster than income, the tax will be distributed progressively.

The distribution of the burden from a tax on real property transfers is believed to be progressive because property ownership is concentrated in the higher income classes, and lower income property owners buy and sell less frequently. If the tax is capitalized into property values, then the property owners at the time the tax is imposed will bear the burden of the tax. But to the extent that the tax reduces investment in the housing market, housing costs and rents will be driven up, and a portion of the burden will fall on all consumers of housing, both renters and owners.

As part of their opposition to property transfer taxes, the National Association of Realtors (2003) challenges the belief that the burden of the transfer tax on residential property is distributed progressively. Based on homeowner data from the 2001 American Housing Survey, they report that the ratio of home value to income decreases steadily from 8.4 at an income of $12,500 to 1.7 at an income of $150,000. Included in their report are estimates of effective property transfer tax rates that measure the tax as a percentage of income. The survey data were used to determine the average home value for different income ranges, and applying the same tax rate to these home values, they determined the average tax bill for each income range. This, divided by the average income in the range, provided their estimate of the effective tax rate. According to their estimates, a 0.5 percent transfer tax results in an effective tax rate of 4.2 percent at an income of $12,500 and a much lower effective rate of 0.8 percent at an income of $250,000, supporting the conclusion that the transfer tax on residential property is regressive.

However, if higher income households tend to move more frequently than lower-income households, then over the course of their lifetime, higher income households will pay transfer taxes more often and may end up paying a larger proportion of their lifetime income in transfer taxes. The National Association of Realtors reports that the average $100,000-income household moves twice as often as an average $12,500-income household, but that this difference does not reverse the regressivity of the transfer tax, according to their estimates. After accounting for the differences in moving frequency, the effective tax rate for the more mobile $100,000 household is 2.2 percent compared to 4.2 percent for the $12,500 household.

Another factor that may contribute to the regressivity of transfer taxes is that they are often discriminatory, applying to only one type of asset—real estate. According to Aizcorbe, Kennickell, and Moore (2003), housing equity exceeds the value of stock holdings at low income levels, but stock holdings increase faster than income, so that at incomes above $90,000, stock holdings exceed housing equity. As income increases, an increasing

share of income is used to purchase assets other than real estate. The National Association of Realtors (2003) estimates that for an average family with annual income in the $40,000–$60,000 range, a 0.5 percent property transfer tax equals 0.41 percent of the value of all assets, but only 0.15 percent of assets for a family with income in the $90,000–$100,000 range.

Some state and local governments attempt to increase the progressivity of the tax through the use of exemptions and progressive rate structures. These features were discussed in the previous section.

Opponents of transfer taxes argue that buyers bear at least a portion of the transfer tax burden in the form of higher housing prices, and that the higher prices discourage homeownership. If this argument is accurate, one would expect to find a negative correlation between property transfer tax rates and homeownership rates. Using the tax rates reported in table 7.1 and homeownership rates for 2005 from the U.S. Census Bureau, Division of Housing and Household Economic Statistics (http://www.census.gov/hhes/www/housing/hvs/annua104/ann04t13.html), we calculated a correlation of –0.18. Although the negative value supports the conclusion that transfer taxes are associated with lower rates of homeownership, this result is not statistically significant. Moreover, it is only one of many determinants of the homeownership rate.

Transfer taxes are also viewed as inequitable from a benefits received standpoint. If the proceeds of the tax are used to fund local programs that benefit the entire community, it is hard to argue that households that move more frequently should pay a disproportionate share of the costs if they do not derive more benefits from those services or impose additional burdens on the community.

The property transfer tax places a larger share of the burden on a small share of the population relative to broader based taxes like the property tax. Replacing the transfer tax with a higher property tax would benefit frequent movers over infrequent movers. Since low-income and senior households tend to be infrequent movers, the tax burden would shift in their direction, resulting in a less progressive or more regressive distribution of the tax burden.

Efficiency and Mobility Effects

Optimal tax policy generally calls for low tax rates applied to broadly defined bases to minimize the excess burden or deadweight loss of taxation. A tax causes a deadweight loss for society when the tax results in a reduced number of transactions. These are sales that, prior to the tax, would have been beneficial to both buyers and sellers and therefore socially efficient.

The magnitude of the deadweight loss depends on the tax rate and how responsive buyers and sellers are to changes in prices (the price elasticities of demand and supply). In the extreme case when the supply of the taxed commodity is fixed (perfectly inelastic), the tax will have no effect on the number of sales and therefore will generate no deadweight loss. In general, the deadweight loss is larger when buyers and sellers are more responsive to price changes (more elastic demand and supply), and the deadweight loss increases with the square of the tax rate. Therefore a revenue-neutral expansion in the base of a tax and a cut in the tax rate can significantly reduce the deadweight loss.

The property transfer tax is a onetime cost associated with selling (or buying) a home. Faced with this added moving cost, people who own homes are less likely to move when their circumstances change, creating a lock-in effect. Young households may choose not to move to larger houses as their families grow in size, and older households may not downsize as their children leave. Homeowners may not move if their job location changes and may not accept a job offer if it necessitates a move. Households may not "vote with their feet" by choosing to move to communities that provide their desired local services and taxes. People who expect to move relatively frequently are discouraged from owning at all and instead rent housing. These choices result in inefficient resource allocation and decreased economic welfare.

Van Ommeren and Van Leuvensteijn (2005) measure the lock-in effect caused by a transfer tax in the Netherlands. The authors use a sample of over 16,000 Dutch households from the Income Panel Research (IPR) database. They demonstrate empirically that the 6 percent ad valorem transfer tax paid by buyers in the Netherlands has a strong negative effect on the owners' probability of moving. They find that a 1 percentage point increase in the transfer tax decreases residential mobility rates by at least 8 percent.

Other tax revenue may also be affected. A decrease in the number of real estate transactions, which is strongly correlated with construction spending and sales of lumber, hardware, home furnishings, and appliances, will result in reduced sales tax revenues for the state and local governments. And to the extent that the transfer tax is capitalized into lower home prices, property tax revenues will also decline.

The Washington Research Council (2005) estimated the impact of repealing the Washington State real estate excise tax in 2006. They assumed that the 1.28 percent tax increases housing prices by 1.28 percent (i.e., the buyer bears the full burden) and is equivalent to a 0.1 percent annual property tax on business property. Removal of the tax, according to their simulation results, would add 3,900 jobs and $544 million in personal income

to the state by 2010. While it is unlikely that the transfer tax burden falls entirely on the buyer, and thus these results are exaggerated, they do illustrate the potential impacts of the property transfer tax on other markets and revenue sources.

Transfer taxes imposed at a higher rate in one city compared to surrounding jurisdictions could encourage home buying outside city limits and lead to increased urban sprawl and its associated increase in commuting, traffic, and environmental impacts. This is the argument used by Toronto realtors in their effort to block a proposed Toronto land transfer tax. They argued further that reduced home sales in Toronto would have a significant impact on the city's economy:

> According to a study conducted by Clayton Research for the Canadian Real Estate Association, each re-sale housing transaction in Ontario generates approximately $27,000 in spin-off spending for things like furniture, appliances, renovations, etc. In recent years, this means that re-sale real estate transactions have contributed more than $2 billion per year to Toronto's economy. (Evans 2007)

Another feature that could cause inefficient land development is the exemption of new home sales, which is a part of the proposed transfer tax in New Mexico. If new home purchases are exempt from the transfer tax, prospective home buyers will be driven to new developments and away from established neighborhoods. Increasing demand for new homes and decreasing demand for existing homes would likely lead to rapid unplanned growth and increased urban sprawl.

The transfer tax can be thought of as an extreme version of an acquisition value–based property tax. Under an acquisition value system, the taxable value of a property is set equal to its market value at the time of sale. In subsequent years, provided the property is not resold, its taxable value is allowed to increase at a limited rate below its true rate of appreciation. A pure acquisition value system would allow no increase in taxable value between sales. The property's real taxable value and the real tax liability will decrease each year, provided ownership does not change and tax rates do not increase. As the inflation rate increases, the real tax liability will drop more rapidly; for a sufficiently high inflation rate, the real tax liability approaches zero and remains close to zero until the property is sold. This is virtually the same as the transfer tax, under which the property owner pays the transfer tax in the first year, but then pays no tax in subsequent years on the same property.

Because the transfer tax is an extreme version of an acquisition value property tax, it will have an even larger negative impact on household and

business mobility. The mobility effects of acquisition value taxes have been analyzed by O'Sullivan, Sexton, and Sheffrin (1995a); Sjoquist and Pandey (2001); Ferreira (2004); Wasi and White (2005); and Stansel, Jackson, and Finch (2007). The transfer tax is equivalent to a large tax on mobility. A revenue-neutral switch from a market value–based property tax to a transfer tax would require a tax rate equal to the market value tax (say, 3 percent) times the equilibrium time per dwelling. If the time per dwelling under the transfer tax is 10 years, the transfer tax on a $300,000 home would be $90,000. If the moving cost is $10,000 per move, the transfer tax is equivalent to a 900 percent tax on moving costs. Although the acquisition value tax also imposes a moving penalty in the form of higher lifetime taxes, O'Sullivan, Sexton, and Sheffrin (1995a) estimate a much smaller moving tax (about 30 percent).

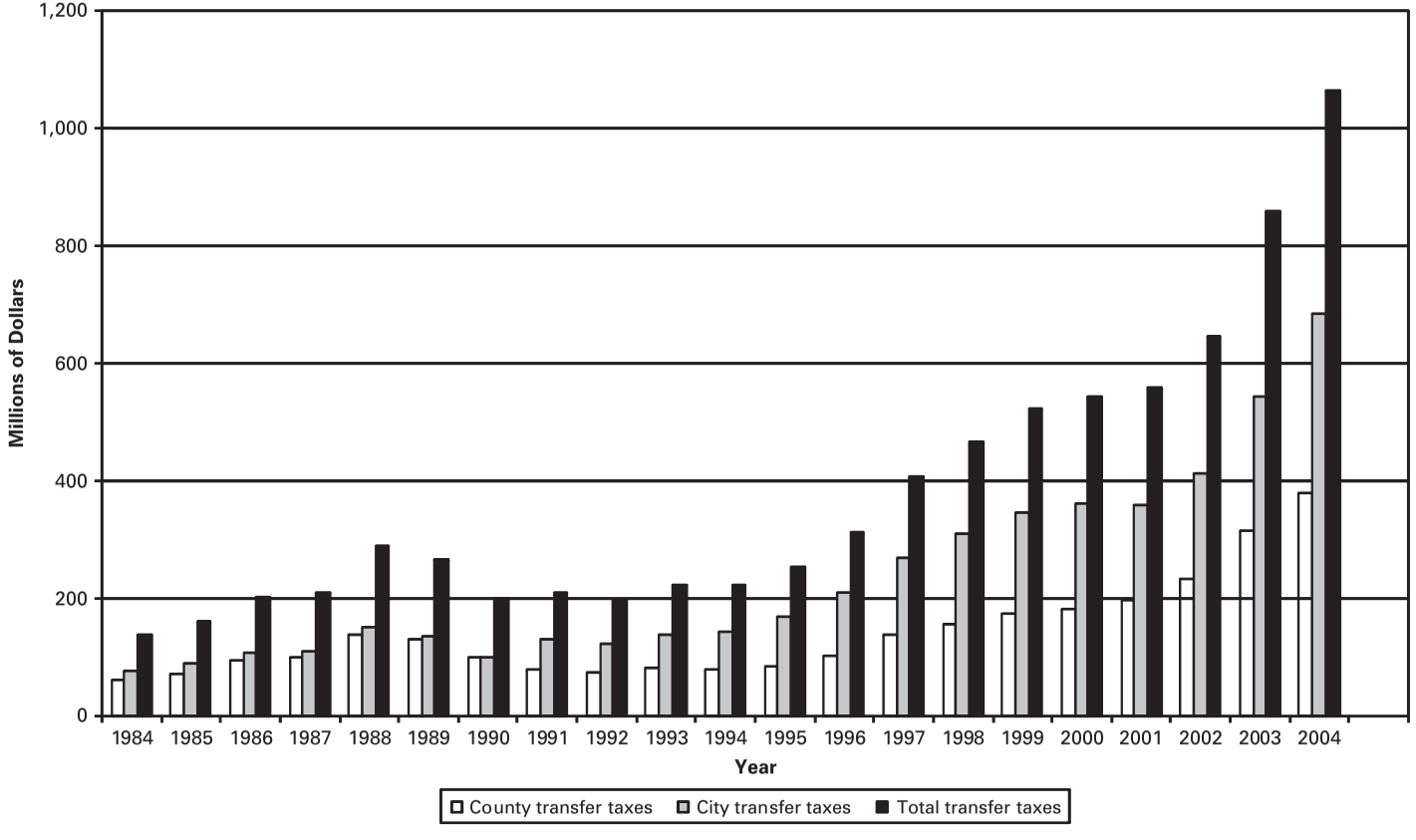
The larger moving penalty means that the transfer tax will result in a much larger excess burden than an equal-yield acquisition value tax. O'Sullivan, Sexton, and Sheffrin (1995a) estimate that the excess burden of the transfer tax will be about 10 times that of the acquisition value tax. In a related study they use a simulation model to estimate the excess burden resulting from an acquisition value tax. Their results suggest that a revenue-neutral switch from a conventional property tax to an acquisition value tax, assuming a 3 percent tax rate and annual property value appreciation of 6 percent, results in a differential excess burden of about 4.5 percent of total tax revenue (O'Sullivan, Sexton, and Sheffrin 1995b).

Stability and Reliability as a Revenue Source

Transfer taxes contribute a small share of state and local revenue. Detailed revenue data are difficult to identify because many states report property transfer tax revenue in the broader category of transfer or documentary taxes, which include taxes on the transfer of stocks, bonds, debentures, and certificates of indebtedness. The entire category of documentary taxes represented less than 2 percent of total state tax revenue in 2003, ranging from less than 1 percent for most states to as much as 10 percent (Behrens and Gravelle 2005).

In California, city transfer tax revenues grew from $76 million in 1984–1985, equal to 5.7 percent of city property tax revenues, to $686 million, or 17.5 percent of property tax revenues, in 2004–2005. Over the same 20-year period, county transfer tax revenues grew from $61 million, 2.3 percent of county property tax revenues, to $379 million, 6.7 percent of property tax revenues (see figure 7.1). In neither cities nor counties did this growth occur smoothly. In fact, the property transfer tax is far more

FIGURE 7.1 California City and County Transfer Taxes



SOURCES: California State Controller, *Counties Annual Report* and *Cities Annual Report,* various years.

volatile than the property tax. Figure 7.2 compares the annual growth rates in transfer taxes and property taxes for cities and counties combined. Except for 1993, when the state shifted property tax revenues from cities and counties to schools, local property tax revenues experienced fairly steady growth over the 20-year period. In comparison, the growth in local transfer taxes was very erratic.

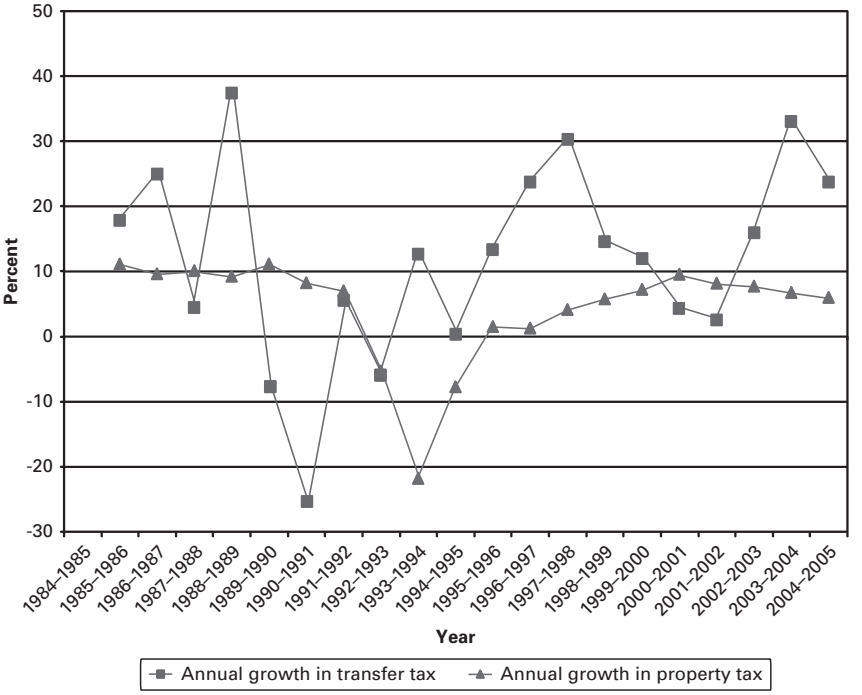
The volatility of transfer tax revenues poses problems for the local governments that rely on these revenues to support ongoing programs. Less populated jurisdictions are more challenged than large cities and counties. Their transfer tax revenues tend to be less stable because they are based on fewer property sales, so even small fluctuations in sales can lead to large percentage changes in revenues. Figure 7.3 compares the annual growth in transfer tax revenue for two of the smallest California counties, Alpine and Modoc, and two of the largest, Los Angeles and San Francisco. Growth rates in the two smallest counties range from 250 to –50 percent, while in the large counties, growth rates range from 53 to –24 percent, with the least variation occurring in Los Angeles, the largest county in the state.

California may not be the best state to use for comparison of the volatility of transfer taxes and property taxes. With the passage of Proposition 13 in 1978, California adopted an acquisition value–based property tax system that restricts the growth in the assessed value of all properties to at most 2 percent per year unless there is a change in ownership. So during periods of rising property values, the property tax base grows at 2 percent per year plus increases due to reassessment of newly sold properties and new construction. During periods of declining property values, downward adjustments in assessments are generally needed only for recently sold properties whose market values drop below their assessed values. In addition, Proposition 13 imposed a property tax rate limit of 1 percent. These limitations have helped to stabilize property tax revenues in California.

However, transfer tax revenues are also more volatile than property tax revenues in states without assessment and rate limits. Vermont is one example, and the growth rate of its property transfer tax revenues and its state and local property tax revenues are illustrated in figure 7.4. Between 1992 and 2000, state and local property tax revenue growth in Vermont ranged from 0.5 to 7.7 percent per year, while property transfer tax revenues grew at rates as high as 37 percent per year and as low as –18 percent per year.

Transfer tax revenues are volatile and hard to predict in other countries as well. Alm (1989) estimates a model of the yield from property transfer taxes in Bangladesh (expressed as revenues per capita or revenues per acre). Independent variables include gross district product, the proportion of population living in cities, and land area. An increase in

FIGURE 7.2 Annual Percentage Change in California County and City Transfer Taxes and Property Taxes

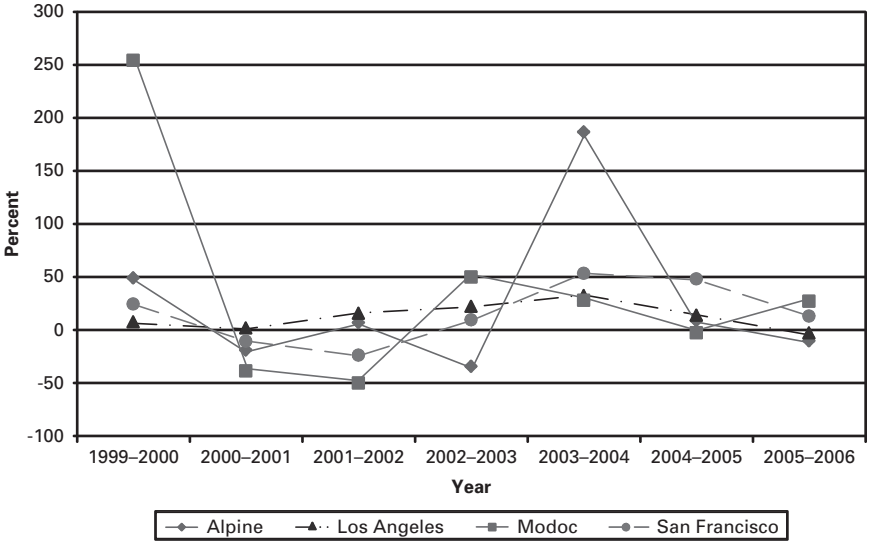


Sources: California State Controller, *Counties Annual Report* and *Cities Annual Report,* various years.

gross district product indicates an increase in general economic activity that should increase property values. Larger urban populations should lead to a greater rate of turnover and higher property values. However, none of these variables are statistically significant in explaining transfer tax revenues per capita, and the gross district product actually has a negative impact on transfer tax revenues per acre.

Transfer tax revenues depend upon the tax rate, types of properties subject to tax, number of properties sold, and sales prices. Revenues will increase if property values increase or if the number of sales increases. Revenues tend to be sensitive to changes in economic conditions such as interest rates, mortgage rates, and employment rates. Increases in sales and values usually occur during periods of economic growth, as increases in income lead to increases in the demand for property. The income elasticity of the transfer tax, that is, the ratio of the percentage change in revenues to

FIGURE 7.3 Annual Percentage Change in Transfer Tax Revenues: Select Counties



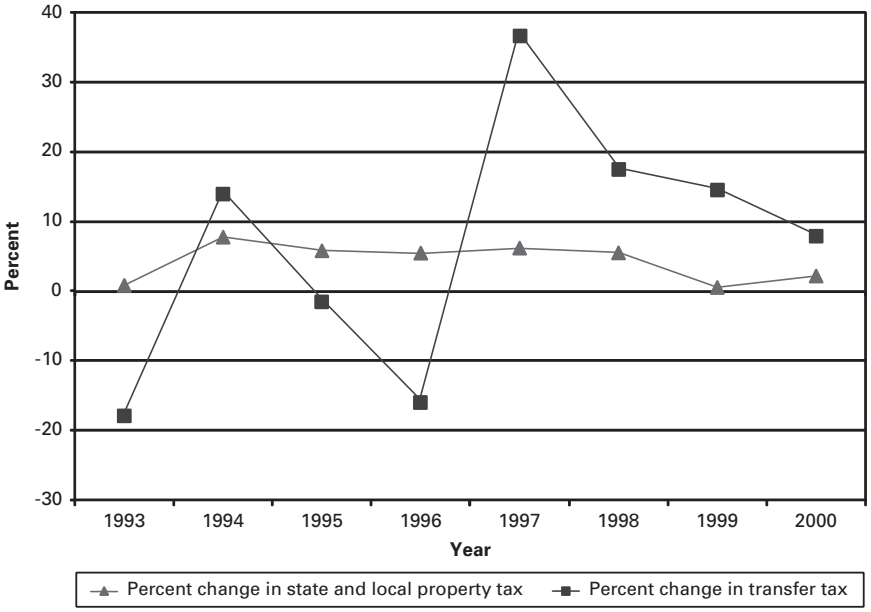
Sources: California State Controller, *Counties Annual Report* and *Cities Annual Report,* various years.

the percentage change in income, measures the responsiveness of transfer tax revenues to changes in economic conditions.

Income elasticities for Vermont's property transfer tax, California's combined city and county transfer tax, and Los Angeles County's transfer tax are illustrated in figure 7.5. Although the transfer tax responded to changes in income quite differently in Vermont, California, and Los Angeles County between 1992 and 1997, the patterns are very similar after 1997. The variability in these elasticities over time, however, further underscores the difficulty in predicting transfer tax revenues.

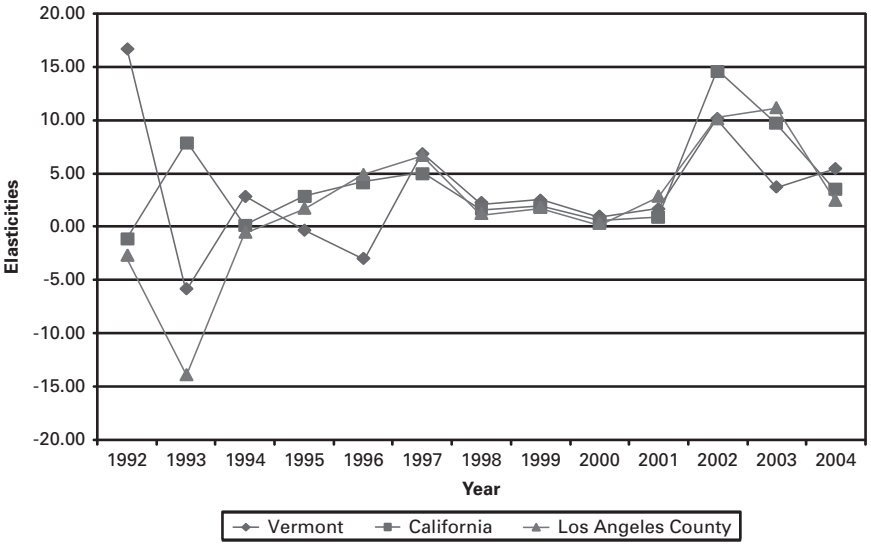
The relationship between property transfer tax revenues and income shows similar variability in other countries. Bahl (2004) reports elasticities of stamp duty and property transfer tax revenues with respect to gross domestic product (GDP) in Jamaica from 1988 to 2004. The volatility of revenues is evident in the wildly fluctuating elasticities ranging from a high of 1.99 in 1989–1990 to a low of –1.33 in 1997–1998. In contrast, Alm (1989) reports income elasticities averaging between 0.8 and 0.96 in Bangladesh, suggesting that transfer taxes are roughly proportional, growing slightly slower than income.

FIGURE 7.4 Annual Percentage Change in Vermont Transfer Tax and State and Local Property Tax



SOURCES: Vermont Department of Taxes, Property Valuation and Review, *Annual Report,* various years; http://www.state.vt.us/tax/statisticsproptrans.shtml.

FIGURE 7.5 Income Elasticity of Property Transfer Tax Revenue



Various features of the property transfer tax can contribute to its volatility. For example, commercial sales can be a large part of the transfer tax base, but they occur much less frequently, and their large size can induce huge swings in the tax base. Thus, excluding commercial property from the tax base can help stabilize revenues. Progressive rate structures can also contribute to volatility when appreciation in property values pushes more properties into higher tax rate brackets, increasing the number of transactions subject to the higher rates. As a result, tax revenues grow even faster than property values.

In terms of administrative and compliance costs, the property transfer tax compares favorably to most other revenue sources, including the property tax. Most governments have a system in place for recording sales, so collection is relatively easy and costless. And because deed registration is legally necessary, evasion of the transfer tax is generally not a problem. Although there is an incentive to understate the reported sales price when possible to reduce the tax obligation, this is difficult to do in the United States but is reportedly more common in developing countries where property sales are not subject to the same bureaucratic and legal requirements.

Should transfer taxes be considered as an alternative to property taxes? In 2004, Texas considered substituting a 1 percent tax on real property transfers for a 0.25 percentage point reduction in the school property tax rate. This proposal was analyzed by Gilliland (2004) and found to be unrealistic. At the time, a property tax reduction of $0.25 per $100 of assessed value would have resulted in a loss of approximately $2.6 billion in revenue per year, while the proposed 1 percent tax on property transfers would have only produced $650 million per year. The 1 percent transaction tax would only allow a property tax rate reduction of $0.06 per $100 of assessed value. In order for this swap to work, the transfer tax rate would have to be significantly higher than 1 percent. Also, though property taxes are deductible for federal income tax purposes, transactions taxes are not, so a switch to a transfer tax would further increase the Texas taxpayer burden.

The property transfer tax rate would have to be extremely high to generate the same amount of revenue as the property tax because the transfer tax base includes so few properties. Using California cities and counties as an example, in 2004–2005 property transfer taxes would have had to be six times higher in cities and 15 times higher in counties to replace property tax revenues. Tax rates would, in fact, have to increase by even larger factors because the increased rates would lead to fewer sales and lower prices. Increases in tax rates of this magnitude would lead to significant increases in the excess burden or deadweight loss due to the property transfer tax.

Summary and Conclusions

Voters in four North Carolina counties were asked to approve a property transfer tax in their 6 May 2008 primary elections, and they overwhelmingly rejected it, just as their predecessors in 16 North Carolina counties had done in November 2007. Counties in Maryland also considered adopting local taxes on real estate sales in 2008. Hawaii, Wisconsin, Virginia, Connecticut, Illinois (Chicago), and New York all proposed increases in their transfer taxes in 2007. On 12 March 2008 the *Idaho Mountain Express* warned readers that Idaho legislators may be thinking of a transfer tax option.

The recent proposals for new or increased transfer taxes are all being met by stiff resistance. A bill introduced in the 2008 Legislative Session in New Mexico would prohibit municipalities from imposing a tax upon the transfer of real property. The National Association of Realtors and most state realtor associations are among the most vocal opponents of transfer taxes. This is no surprise, since property transfer taxes lead to a reduction in the number of sales and, to the extent that the tax is capitalized into lower prices, a reduction in realtor profit per sale.

There are many good reasons to oppose property transfer taxes. For one, property transfer taxes in excess of the costs associated with transferring title are arbitrary, unrelated to a household's ability to pay or benefits received from public services. Also, the high degree of volatility in revenues derived from transfer taxes makes them unreliable and unpredictable sources of funding for ongoing programs. In addition, the burden on buyers and sellers and the excess burden of the transfer tax are much greater than the corresponding burdens from a more broad-based tax designed to generate the same amount of revenue. Property transfer taxes discourage mobility among current homeowners and discourage frequent movers from becoming homeowners. This lock-in effect is even stronger than occurs with an acquisition value–based property tax.

In summary, transfer taxes would be a poor replacement for traditional property taxes for several reasons:

- They are far more volatile than the property tax and thus would not provide a stable revenue source.
- To generate the same amount of revenue as the property tax, the rate would have to be extremely high.
- The high rate would result in a much greater mobility effect, moving tax, and excess burden.

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