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To: Taxpayers, Elected Officials, and Policymakers of Indiana

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Subj.: Policy Options for Replacement of Property Taxes – The Real Estate Transfer Tax

It is impossible to discuss, analyze, or debate the real estate transfer tax without recognizing the state of the housing markets in Indiana. Although price declines are not as common – or as large – as those on the coasts, homeowners are struggling. Historically, Indiana housing value appreciation is at the low end of the scale; we rank 48th among the states for the most recent five year period.

Foreclosure rates are high – currently, tenth highest in the nation. Our foreclosure rate is increasing, as well, with 2007 seeing nearly 1 ½ times more foreclosures than one year ago. In some counties, 40% to 50% or more of all real estate transactions are homes in foreclosure. Even more disturbing, the long term outlook is not encouraging. Indiana, and the Midwest, can expect flat to very slow home value appreciation over the next several years, at least.

Given the turmoil in Indiana's real estate markets, no serious consideration should be given to the real estate transfer tax as a new or replacement revenue source for any reason. Besides the negative economic impact a transfer tax would have on homeowners, home builders, developers, and real estate investors, the inherent volatility of a transfer tax would jeopardize the fiscal integrity of the state's budget. As an alternative, a user fee for some portion of local government services – such as public safety – could provide a stable, benefits-based revenue stream that could in turn reduce the reliance on property taxes.

In perhaps the most timely journalistic look at the wide ranging issues of the housing slump, increasing foreclosure rates, and the pitfalls associated with a transfer tax, the Wall Street Journal found transfer tax revenue falling in several states. The shortfalls are causing states to reexamine and cut state budgets at the same time that taxpayers are demonstrating against property tax increases¹.

It is important we keep in mind the seriousness of the issues facing homeowners and other owners of real estate as well as hard earned state budget balance as we discuss, analyze, and debate solutions to the current property tax challenge. Whatever we do, let us be sure to not place more or additional burdens on Hoosiers who own homes or invest in real estate.

This memorandum discusses the policy issues associated with the imposition of a real estate transfer tax. Should a transfer tax be contemplated, two very important points need to be made. First, a real estate transfer tax is another property tax and brings with it all of the unpopularity of the property tax. Second, imposing a second property tax at the time when homeowners are experiencing the double barrel impact



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of increasing property taxes and a declining housing market with historically high foreclosure rates would add yet another layer of distress.

Background: In the United States, 37 states have some form of a real estate transfer tax. Rate structures vary, with some fee based (i.e., \$1.00 for each \$500 of sales price), some percentage based (i.e., 1.0% of sales price), and some have marginally higher rates as the sales price increases. Generally, rates are less than about 1.0%, with some as low as 0.1% (one tenth of one percent). A few states have marginal rates above 1.0%.ⁱⁱ

State Real Estate Transfer Taxes					
Rates and Revenue Received - 1999 - 2001					
(in thousands (000) of dollars)					
State	Tax	Rate	1999	2000	2001
Connecticut	Real estate conveyance	0.5% up to \$800,000 and 1% of value over \$800,000, plus 0.11%	103,635	113,246	111,043
Delaware	Realty transfer	1.5% to 2.0%		48,507	59,210
Georgia	Real estate transfer	0.1%	262	294	338
Hawaii	Realty transfer	0.1% to 0.3%	7,691	9,452	10,368
Illinois	Realty transfer	Chicago 0.75%, Cook County 0.05%, State 0.1%	54,057	57,654	57,787
Maine	Real estate transfer tax	0.44%	15,999	18,637	17,328
Massachusetts	Real estate transfer	0.456%	108,501	127,371	151,193
Michigan	Real Estate Transfer Tax	State 0.75%, County 0.11% - 0.15%	261,696	257,093	252,894
Nebraska	Real estate transfer	0.175%	6,398	7,181	6,712
New Hampshire	Real estate transfer	1.5%	52,927	85,010	91,645
New Jersey	Realty transfer	0.4% to 1.21% on amount > 1.0 mil.	104,816	116,435	122,277
New York	Real estate transfer	0.4% to 1.425% on amount > \$500k	312,369	340,230	404,745
Oklahoma	Real estate transfer	0.15%	8,985	9,043	9,132
Pennsylvania	Realty transfer	1.0% plus \$2.00	303,536	320,179	315,863
Rhode Island	Real estate transfer	0.4%	5,084	2,167	2,018
Vermont	Real estate transfer	Tax on gains, varies with time owned	19,212	20,831	21,266
Washington	Real estate excise	1.28% plus local taxes	424,446	433,810	435,305
Wisconsin	Real estate transfer	0.3%	43,971	45,293	44,224

Source: Bureau of the Census

Although the data is somewhat dated, three general points can be made. First, the revenue is not robust. Second, it is common to see both state and local rates. This would clearly add a level of complexity and potentially create distortions in real estate markets within the state. Finally, only five of the 18 states listed have rates above 1.0%. Two of those states use higher rates only on higher sales prices. The real estate markets and political “markets” appear to have set a ceiling for transfer tax rates above which either significant economic distortion or political upheaval – or both – occurs.

In addition, revenue appears to be somewhat volatile over the three years in some states. Of course, this data does not indicate if any rate or base changes occurred during the period, which would account for some changes in revenue collection. However, there is not a consistent pattern across the states, as some states’ revenue increased every year while others increased in 2000 and then decreased in 2001.



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This volatility would manifest itself in the current real estate market uncertainty. With housing values flat or declining in most of the country – there is evidence of declining home prices in Indiana, particularly where foreclosure rates are highest – transfer tax revenue would decline. While one hopes that once the current challenges are conquered, we won’t see a repeat, the potential for volatility remains.

Tax Policy Implications: Should the property tax on homesteads be completely eliminated, the following economic consequences can be expected.

- In the short term, owner occupied housing values would increase
- The cost of homeownership would decrease
- The differential treatment of owner occupied vs. rental housing would result in more demand for owner occupied and less demand for rental
- Less demand for rental property would increase supply and cause a decrease in value

Other distortions would occur (within the commercial real estate markets) as well, although they would be less distinct.

The decrease in rental (and other, non-homestead) property values is a serious distortion and cause for concern. However, the National Association of Realtors Report on Housing Wealth Effectsⁱⁱⁱ found that the net worth of homeowners far outpaced that of renters.

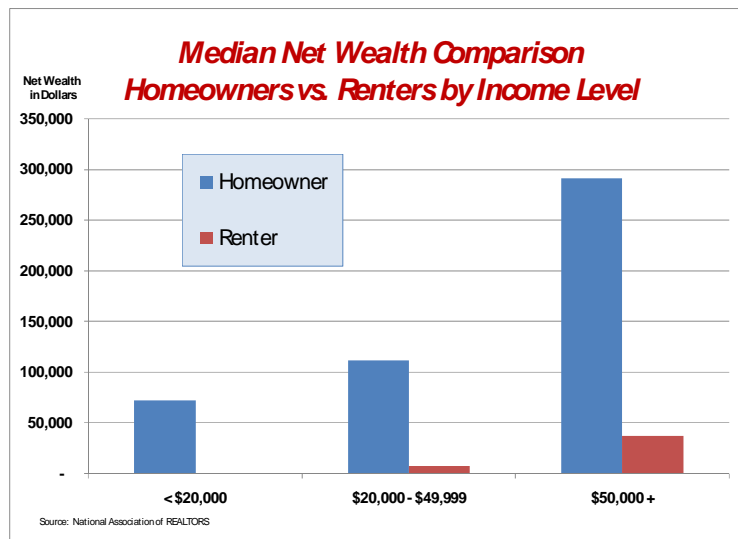
Even at relatively high incomes (greater than \$50,000 annually), the median net wealth of homeowners was nearly \$300,000, compared with less than \$40,000 for renters, a ratio of nearly 8 to 1.

Clearly, there are public policy advantages to Indiana’s having a higher home ownership rate.

The negative impact of decreasing rental housing value is also a cause for concern. In the short term, providers of rental housing will experience

decreases in both value of their assets and income. There will be less return on investment in rental housing. Some public policy to lessen these impacts should be considered. However, the imposition of a transfer tax – particularly one that has relatively higher rates to mitigate the changes in rental housing values, will be counterproductive.

If the public policy value of increased home ownership is clearly positive, it does not make sense to impose a tax that increases the cost of home ownership and decreases home values. Some other method of offsetting the negative impacts on rental housing should be found.





Yield and Pros and Cons of a Real Estate Transfer Tax:

A basic, conservative estimate of the yield from a 1% transfer tax imposed on residential single family/condo sales would be approximately \$150.0 million. Put in perspective, that is less than 2.5% of the current net property tax bill, certainly not worth the additional negative impacts on real estate markets and homeowners the tax would cause. Even more, it is easy to see that the transfer tax rate necessary to generate even a small part of the money to replace property taxes would be completely unworkable and would wreak havoc on Indiana’s real estate markets.

The following table lists the policy “pros and cons” of a real estate transfer tax on residential property with a corresponding elimination of the property tax on homesteads.

Pros	Cons
<p><u>Assumes Complete Elimination of Property Tax on Homesteads</u></p> <ul style="list-style-type: none"> ✓ At reasonable rates (less than 1.0%), less onerous than property tax ✓ Pay tax only upon purchase of home, not annually ✓ 	<ul style="list-style-type: none"> ✓ Narrow tax base and volatile revenue stream ✓ Likely significant exemptions will apply <ul style="list-style-type: none"> * Foreclosure, bankruptcy, estate transfer, low value, etc. * low income, veterans, mortgage debt, elderly, and farms ✓ Horizontal equity – one taxpayer owns home free and clear vs. another with 90% mortgage ✓ Households that move frequently do not require more services that those who don’t, but pay much more in transfer taxes ✓ Negative impact on economic development ✓ Minimal revenue yield – cannot come close to replacing property tax ✓ Detriment to housing values and activity, especially in time of market difficulty(such as now)

Two of the “cons” merit additional discussion and clarification. First, the potential for exemptions could significantly reduce revenue and perhaps lead to higher rates, with associated negative repercussions. It seems unlikely that any transfer tax would apply to foreclosure sheriff’s sales. Likewise, they would probably not apply to “short” sales, which are the last resort before foreclosure. There would be support for excluding estate sales, sales within families, perhaps sales below a certain level to assist low income buyers, and perhaps some consideration depending upon the debt level (amount of mortgage). All of



these would be in addition to the groups currently receiving special treatment, such as the elderly, farms, and veterans.

Second, while the narrow tax base means relatively insignificant revenue generation, that is not the case for the individual home buyer or seller. A percent or two of the sales price is a large sum for the individual.

An Alternative – User Fees:

There are two basic, underlying philosophies regarding the application of tax burden. The first is one should pay based on their ability; the other links the tax burden to the benefits one receives. In shorthand, they are referred to as “ability to pay” and “benefits received.”

Because the benefits of locally provided public services such as police and fire protection accrue locally, there is a very direct link between the benefit and the cost. That is, the area that receives public safety services can be relatively well defined. It is possible, therefore, to determine the “cost per unit” of public safety and allocate that cost to parcels of real estate.

Local units of government apply user fees currently for a variety of services. Some collect fees for trash removal or recycling, others for parks and swimming pools. Municipally operated utilities are common examples of the application of user fees. Sewer and stormwater districts often incorporate user fees. In 2004, Senator Larry Borst floated a proposal (SB 491, 2004) that estimated the revenue from a public safety “assessment,” or user fee. LSA estimated the revenue to be approximately \$700 million from one and two family residences. The proposal also included an estimate of a \$25 million savings from property tax assessment “simplification. We have attached a document with detail on this proposal.

While user fees could not completely replace the property tax, they could be a viable alternative to a real estate transfer tax. There is a clear link between the benefits of publicly provided services and a user fee – something that is lacking with a transfer tax. Because of that link, the taxpayer would see it as fairer and simpler, as well.

Finally, if combined with replacement revenue from an increase in the income tax, the income tax could be structured to mitigate some of the regressivity of property user fees. User fees are regressive when applied to real estate in that the cost of a service is allocated equally across those who receive it, regardless of the market value of property.



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- ⁱ “Housing Slumps Strains Budgets of States, Cities.” By Amy Merrick, Wall Street Journal, September 5, 2007.
- ⁱⁱ Data is from the Bureau of Census compiled by Prof. John Mikesell at Indiana University School of Public and Environmental Affairs.
- ⁱⁱⁱ Belsky, Eric, Joint Center for Housing Studies of Harvard University and Joel Prakken, Macroeconomic Advisers, LLC. “Housing Wealth Effects: Housing's Impact on Wealth Accumulation, Wealth Distribution and Consumer Spending.” National Association of REALTORS, November 2004.