

TEN QUESTIONS AND ANSWERS ABOUT THE ECONOMICS OF THE NORTH CAROLINA LAND TRANSFER TAX

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In 2007 the North Carolina General Assembly gave all counties the authority to levy *up to* a 0.4% tax on the sale of real property (land, structures) within their boundaries. Prior to implementing the tax, counties must receive approval through a vote of citizens. This paper attempts to answer common questions about the economics of such a land transfer tax in an informative and educational way without either supporting or opposing the tax.

1. *What exactly is a land transfer tax?* A land transfer tax is imposed on real property - land and structures - when the property is sold and ownership is transferred. The maximum tax is 0.4% of the sales value. So, for example, a building or a parcel of land selling for \$100,000 would have a tax of \$400. The tax is paid by the seller, although some or all of the tax could be passed on to the buyer, depending on economic conditions (question 4 below discusses this issue). County commissioners determine how the proceeds of the tax are used.

2. *Why has the land transfer tax option been proposed now?* Many counties have been seeking state approval to expand the types of taxes they can use to fund local public expenditures. Also in 2007, the state agreed to take over the portion of Medicaid spending previously paid by counties in exchange for 0.5% of local sales tax receipts. Counties were given the option of adding the land transfer tax or a 0.25% local sales tax, but not both.

3. *How much public revenue could a land transfer tax generate, and how does this compare to other tax sources?* In 2006, a 0.4% land transfer tax could have produced revenues of nearly \$215 million statewide. This is equal to 5% of local property tax revenues or 12% of local sales tax revenues in that year.

4. *Who would ultimately pay a land transfer tax?* Although the law stipulates the seller of the property pays the land transfer tax, the question is whether the seller could pass on that cost to the buyer. Existing research suggests at least part of the tax would be passed on to buyers. The effective split of the tax between the buyer and seller depends on conditions in the real estate market. In a "seller's market", where many buyers are competing for available properties, more of the tax will be passed on to buyers. In contrast, in a "buyer's market", where the real estate market is relatively slow and fewer buyers are competing for available properties, less of the tax will be passed on to buyers. Research also shows that over time, as the land transfer tax has been on the books for many years, real estate prices will adjust to reflect the amount of the tax, and a greater share of the tax will be effectively paid by buyers.

5. *What would be the impact of a land transfer tax on the local real estate market?* The answer to this question is - it depends. Importantly it depends on how residents - and specifically buyers of real estate - value the public services funded by the land transfer tax.

If buyers pay more for property as a result of the land transfer tax, then this result alone would reduce sales and economic activity. However, the impact doesn't stop here. If buyers see benefits from use of the tax revenues which exceed the cost of the tax, then sales could rebound and the local economy could be boosted.

Conversely, if buyers don't perceive many benefits from the use of the funds, then the tax will be considered a cost without offsetting benefits, and real estate sales and economic activity in the county will decline from what their levels would have been without the tax. So how the land transfer tax revenues are used and how residents evaluate those uses are crucial to their economic impact.

It should be mentioned that these benefit/cost comparisons associated with the real estate transfer tax are no different than similar comparisons people make about other taxes. How people respond to a tax, and whether they consider any tax a net plus or a net minus, rests on their evaluation of the benefits forthcoming from the spending of the tax revenues compared to costs of the tax.

6. *If a county adopts a land transfer tax and neighboring counties don't, will the adopting county be helped or hurt?* The answer to this question is essentially the same as the answer to question 5. If property owners and residents in the adopting county collectively value the public services provided by the tax more than the cost of the tax, then the adopting county will be benefited not only internally, but also relative to its neighboring counties. If the opposite is the case - property owners and residents of the adopting county evaluate the cost of the tax to be greater than the benefits of the resulting public services, then the competitive position of the adopting county will fall.

7. *Is it fair to tax only sellers (and buyers) of property for funding local public services that benefit all local residents? Wouldn't a tax paid by all residents be fairer?* These are important questions for residents and their elected representatives to consider. As noted in question 2, the legislation authorizing local consideration of a land transfer tax also authorized consideration of a ¼ % local sales tax. However, counties are not permitted to adopt both the land transfer tax and ¼% local sales tax.

One gauge for considering whether a tax is "fair" is to consider if those who pay the tax also benefit from it. Certainly, a local sales tax, which is paid by all buyers of retail goods in the county, directly affects almost every resident in the county, so it is a very broad-based tax. Even the local property tax - the largest source of locally raised public revenue - is spread across a large proportion of households. The property tax is paid either directly (by property owners) or indirectly (through rents) by most. So if local sales taxes and property taxes are used to fund public projects benefiting the majority of local residents, then by some standards these taxes could be considered "fair".

However, the land transfer tax is a much narrower tax, being paid only when a property is sold and changes ownership. If a land transfer tax is considered a form of a property tax, then it could be considered "fair" in the following way. If the proceeds of the tax are used to make infrastructure or other improvements in the county that enhance property values, then it could be said owners of the property are receiving the benefits (higher property values) from the costs of the tax. This logic depends on the public revenues from the land transfer tax being spent in a specific way.

8. *If the land transfer tax is considered a form of a property tax, then could it be avoided by increasing regular property taxes?* Property taxes are paid annually by property owners whether the property is sold or not. Property tax rates are expressed as cents per \$100 of property value. For a county to estimate what increase in the annual property tax rate would be needed to produce the same annual revenues as a land transfer tax, the following two steps would be followed:

- (a) Estimate the annual revenue raised by the land transfer tax: This would be done by multiplying 0.004 (or whatever land transfer tax rate the county chooses under 0.4%) by the value of annual real estate sales in the county.

Example: \$10,000,000 of annual real estate sales occur in the county, and the county adopts a 0.4% land transfer tax. The tax produces annual revenue of $0.004 \times \$10,000,000$, or \$40,000.

- (b) Divide the estimated annual revenue raised by the land transfer tax by the current assessed value of real property in the county. Convert this result to a cents per \$100 value. This is the amount by which the annual property tax rate would need to be increased.

Example: County records show the assessed value of real property is \$80,000,000. Producing \$40,000 more in property tax revenue annually would require a tax rate of $\$40,000/\$80,000,000$, or \$0.0005 per \$1.00 of value, which equals 5 cents per \$100 of value.

It is important to realize this is an estimate which is subject to change for at least two reasons. First, the annual amount of public revenue raised from the land transfer tax can vary from year to year based on changes in real estate sales in the county. Second, periodically - usually between 4 and 8 years for most North Carolina counties - counties must revalue real property. This revaluation can dramatically change the assessed value of real property used in part (b) of the calculation.

9. *Can't counties just reduce spending instead of increasing tax revenues through a land transfer tax?* This is a very controversial question on which there are many opinions and positions. While I won't take a position and provide a direct answer, I can direct people to information which can be used in discussing and debating the question.

For information on detailed spending by program and function for counties in North Carolina, go to the following website of the State Treasurer's Office: <http://www.treasurer.state.nc.us/lgc/units/unitlistjs.htm>. This website provides public spending information for each county for each of the previous six years. However, it is inaccurate to directly compare spending amounts for multiple years for two reasons. First, inflation makes the purchasing power of the dollars different in any two years. Second, if population growth occurs in the county, it tends to push up spending over time. A simple way to account for these two effects is to *divide spending amounts in a year by the county's total personal income in that same year*. This gives spending as a proportion of total personal income, and these proportions can be directly compared between years. Total personal income for North Carolina counties can be found at: <http://www.bea.gov/regional/reis/default/cfm?catable=CA1-3§ion=2> - then select "personal income", "North Carolina", and the years desired (make sure to notice the dollar amounts in this web site are expressed in thousands).

Example: County A spent \$3,500,000 on public safety in 2005 and spent \$3,000,000 on public safety in 2004. Total personal income in County A was \$460,000,000 in 2005 and was \$430,000,000 in 2004.

2005: $\$3,500,000/\$460,000,000 = 0.0076$, or 0.76% of total personal income spent on public safety

2004: $\$3,000,000/\$430,000,000 = 0.0070$, or 0.70% of total personal income spent on public safety

10. *What's the difference between a land transfer tax and an impact fee?* Impact fees are one-time public charges applied only to new residential construction. They are usually specified as a specific dollar amount per residence, although sometimes they can vary by the price of the residence. Their stated purpose is to pay for the off-site costs associated with new residences that are not covered by annual property taxes. Impact fees can have the same economic effects on homebuying and on the wider economy as land transfer fees (see questions 4 and 5).

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