The Unintended Consequences of Excessive Transfer Taxes

EXECUTIVE SUMMARY

In recent years, there have been notable increases in real estate transfer taxes, which are levied on the sale of property by local and/or state governments and are typically defined as a percentage of a property's sales price. In California, for instance, there were 20 ballot initiatives to raise transfer taxes between 2010 and 2020, 13 of which were approved by voters. Sage Policy Group (Sage) was commissioned to examine their economic and fiscal effects in the context of a post-pandemic world.

This report makes no attempt to assail the validity of transfer taxes as instruments of public policy. It also does not seek to diminish the importance of public revenues to support the provision of key services ranging from education and public safety to park and road maintenance. Rather, this report is intended to supply insight for policymakers and other stakeholders regarding the myriad considerations that should enter assessments of appropriate transfer tax rates.

KEY FINDINGS

Based on a combination of literature review, economic analysis, hypothetical case studies, and logic, Sage analysts conclude the following:

- Transfer taxes tend to be regressive, meaning that they disproportionately impact lower income households in the market for property, and seemingly small increases in transfer taxes can result in substantial decreases in housing affordability. This has an outsized impact on first-time homebuyers.
- In a case study of a first-time homebuyer with $41,300 saved for upfront costs, a 2-percentage point increase in closing costs causes a 16 percent decrease in the homes they can afford.
- There is outsized need for adaptive reuse of existing commercial properties given significant office vacancy in the context of remote work, retail closures as e-commerce continues to acquire market share, and under-occupied hotel space, for which the occupancy rate fell from 65.9 percent in 2019 to 57.6 percent in 2021. Higher transfer taxes would make these properties less likely to be redeveloped.
- Sizable transfer tax increases can render large commercial transactions infeasible. In an analysis of the 3.5 percentage point increase in San Francisco's transfer tax on sales of $100 million or more, the increase leads to a nearly 20 percent reduction in the rate of return on the sale of a large commercial property.
- A recent analysis by the San Francisco Comptroller estimated that the doubling of transfer taxes on high value properties would reduce investment in commercial properties by $193 million annually and reduce investment in residential properties by $300 million annually. If half of that investment was spent on construction, the higher transfer tax rates would cost the city 2,300 jobs, nearly $150 million in labor income, and over $420 million of economic activity.
- Transfer taxes present a number of important public revenue considerations. Governments prefer consistent revenues in forming annual budgets and fashioning long-term strategies. Transfer tax revenues tend to be highly volatile, particularly in communities associated with the highest transfer tax rates like San Francisco.

- By lowering property valuations, therefore reducing property tax revenues over time, and pricing out first-time homebuyers, therefore limiting population growth, higher transfer taxes can reduce funding for public school systems. As of 2016, more than 70 percent of all local government tax revenue was generated by property taxes, and local governments provided nearly half of the funding for public education.

Sage's findings are consistent with those reached by others:

- A 1993 study found that when Philadelphia increased transfer tax rates from 3.5 percent to 5.07 percent, sales prices of homes declined by more than 8 percent.
- A 2020 analysis conducted by the San Francisco Office of the Controller concluded that because of the increase in transfer tax rates, "real incomes of San Francisco households would decline, on average, because of the lower incomes and higher housing prices. San Francisco would become less attractive economically as a place to live."
- A 2005 analysis that examined 16,000 households in the Netherlands demonstrated that a 6 percent transfer tax paid by purchasers would significantly affect the likelihood of households moving. Specifically, a one percentage point increase in the cost of purchasing a home would decrease residential mobility by at least 8 percent.
- A 2011 study in Toronto determined that the city's 1.1 percent transfer tax caused a 15 percent decline in the tally of sales and a decline in home prices roughly equivalent to the tax. The authors conclude that, "relative to an equivalent property tax, the associated welfare loss is substantial, about $1 for every $8 in tax revenue."
- A 2016 study in Germany estimated that an increase of a single percentage point in transfer tax rates diminishes the number of sales of single-family homes by 6 percent. That analysis also found that each additional dollar in revenues generated by transfer taxes causes a 67-cent deadweight loss.
- An alternative perspective is provided by a 2017 study that examined transfer tax exemptions available in Great Britain in 2008 and 2009. These exemptions produced a 20 percent increase in sales in the residential market in the short term.

IN SUMMATION

Transfer tax increases have negative economic consequences for both the residential and nonresidential segments. They are regressive and can lead to decreases in population, real incomes, real estate transactions, investment in structures, and quality of the built environment. They are also associated with higher rents, lower property valuations, reduced residential mobility, and diminished homeownership.

The negative impacts of elevated transfer tax rates stand to be exacerbated by the increased prevalence of remote work, lingering weakness in office space net absorption, elevated mall vacancy rates, and diminished hotel occupancy. Many properties will need to be upgraded and/or adaptively reused to remain viable. Excessive transfer tax rates can frustrate the exchange of property that is often required to return to commercial viability.

Communities that support significant adaptive reuse and investment will prosper, while those that do not will experience increasing vacancy and abandonment, declining property values and quality of life, and sagging commercial real estate assessments. This is the context in which transfer tax rate-setting should be considered.