## Appendix 2 - Review of Tax Revenue Impacts to the County Resulting from Annexations and Incorporations

**Introduction**

Since 1990 and the adoption of the Growth Management Act, King County has undergone a transformation in the way local services are provided to urban communities. In 1989, King County had 29 incorporated cities, and 41% of the population lived in the unincorporated area. In 2019, there are 39 incorporated cities and according to the 2019 estimates by the Washington State Office of Financial Management only 11% of the County's population lives in the unincorporated area. The ten incorporations and numerous annexations since 1989 have had an impact on both the revenues collected by King County and the services the County provides.

This document reviews which revenue streams are affected by incorporations and annexations but does not evaluate the net impact of each annexation and incorporation. It would be extremely difficult to evaluate what services and costs are no longer being borne or provided by King County because of the smaller unincorporated area. In some cases, loss of a revenue source is outweighed by the savings realized by no longer serving an area. In others the opposite is true.

**Affected Revenues**

**<u>Sales Tax</u>**

**Description**

The retail sales tax in Washington State provides a revenue source for multiple entities. State government, city government, county government, and special districts may all collect revenue through this mechanism, collected as a percentage of the selling price on retail transactions.

Chapter 82.14 RCW authorizes local retail sales and use taxes. Counties in Washington State may impose a rate of 0.5% on any taxable event within the county, with revenues supporting general county functions. In incorporated areas, revenues are split between the county and the city, with the city getting 85% of generated revenue and the county receiving the other 15% (for an effective rate of 0.425% for the city and .075% for the county).

Counties and cities may also impose an 'optional' additional sales tax increment on top of the 0.5%, in 0.1% increments up to an additional 0.5%. Revenues are again available to support general government functions. Counties and cities share revenue, as described above, for those cases where both are levying the optional increment. As of this writing, all cities in King County collect the full 0.5% optional increment, as does the County in the unincorporated area.

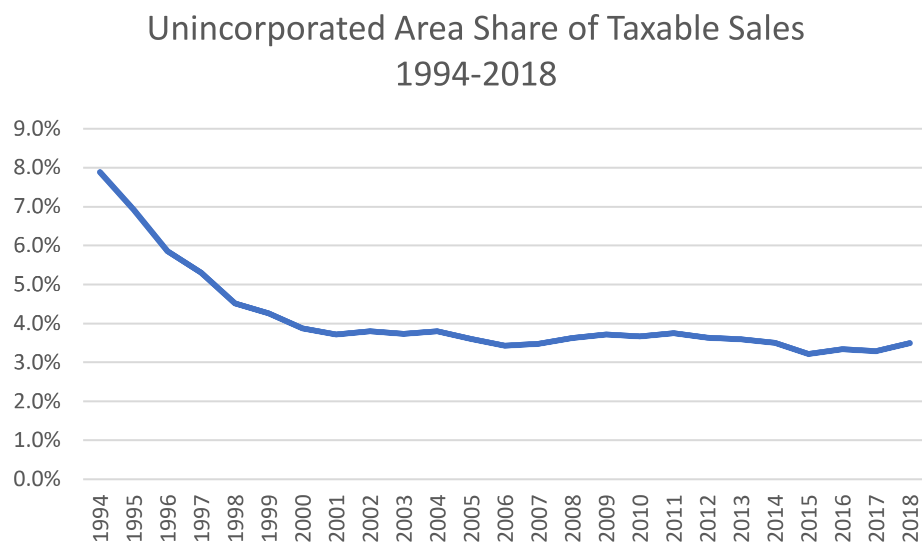
Counties may also levy several other sales taxes with revenues dedicated to specific functions. King County currently imposes three of these increments (on top of the 0.5% and 0.5% optional described above): a 0.1% sales tax to support criminal justice purposes (with counties receiving 10% of gross revenue and the remainder split with cities based on population), a 0.9% sales tax for public transportation (transit) purposes, and a 0.1% sales tax to support behavioral health services (known as the Mental Illness and Drug Dependency tax, or MIDD).

**Effect**
Annexations and incorporations affect county retail sales tax collections to the extent that transactions that formerly took place in unincorporated areas now occur in incorporated areas, and insofar as annexations and incorporations affect those revenues allocated based upon city populations.

For instance, a county's effective tax rate in unincorporated areas, assuming that both the 0.5% base and the 0.5% optional increment are imposed, is 1%. Once an area is annexed or incorporated, revenue is now split with the city such that the county's effective rate is now 0.15% (with the other 0.85% supporting the city).

For tax increments partially allocated by population, such as the 0.1% criminal justice increment, incorporations and annexations reduce the share of population within unincorporated areas, thus reducing the share of revenue that county government would receive.

**Impact**
In 2018, sales taxes collected by King County totaled just under $717M, $144.4M of which went to the General Fund. An analysis of the distribution of taxable sales in the County shows that from 1994 to 2018 the share of taxable retail sales occurring in the unincorporated area has declined from 7.9% in 1994 to 3.5% in 2018. This decline roughly follows the decline in the proportional number of residents living in the unincorporated area, which fell from 31.5% in 1994 to 12.5% as of 2013.




<u>**County Road Levy**</u>

**Description**
Chapter 36.82 RCW authorizes Washington counties to impose a property tax to support county roads (called the Road Levy) up to $2.25 per $1,000 of assessed value in their unincorporated areas. These funds may be used for planning, constructing, altering, repairing, improving, and

maintaining county roads, bridges, and wharves necessary for vehicle transportation and other county transportation issues.

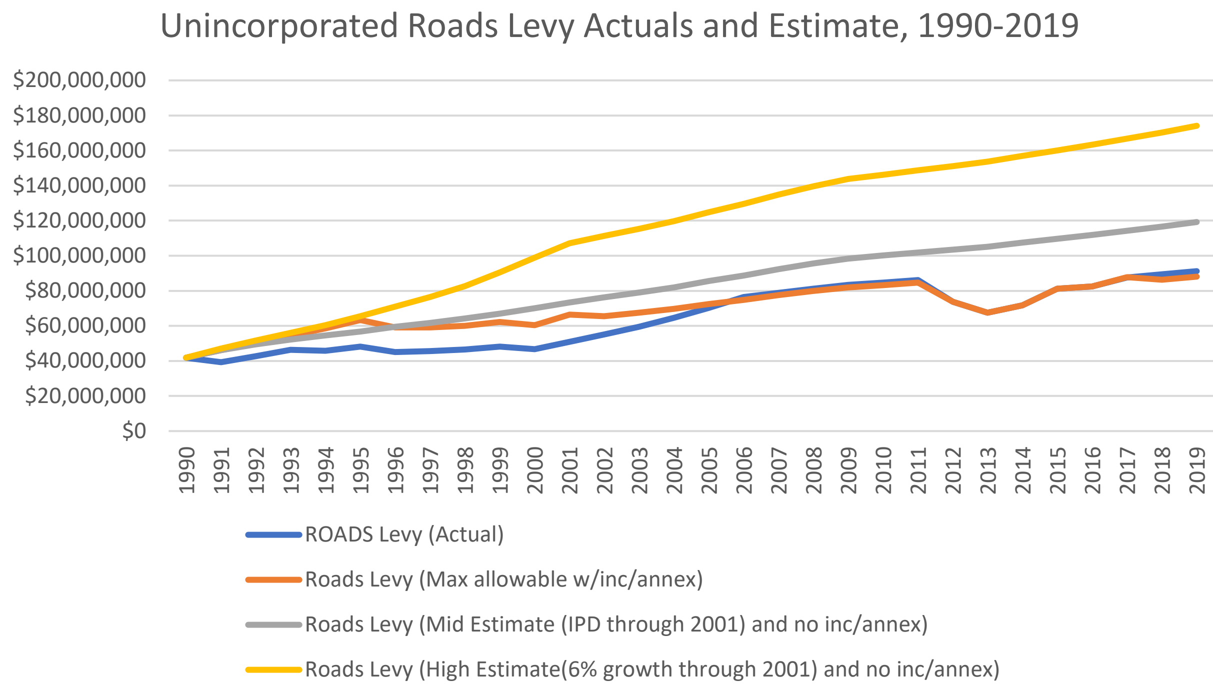
**Effect**

Annexations and incorporations impact the County Road Levy by decreasing the number of parcels subject to the levy. When an area is annexed or incorporated, that area's levy is shifted to the remaining unincorporated area, up to the $2.25 per $1,000 of assessed value limit. When the annexation or incorporation of an area would move the levy above $2.25 per $1,000 of AV cap, the cap supersedes the 1% growth rule. The King County Roads levy was at the $2.25 limit from 2012 to 2016.

**Impact**

The County Road Levy is the Road Fund's largest source of revenue. In 2018, property tax collections for the County Road Levy totaled $89.26M, which was equivalent to 78.67% of all revenue in the fund. The Office of Economic and Financial Analysis created a model to show the long term impacts of annexations and incorporations on the County Road Levy, which shows three alternative scenarios to the current levy. The high estimate shows the maximum allowable levy from 1990 to 2019, without any incorporations or annexations. The middle estimate limits the growth of the levy before 2001to the level of inflation as measured by the Implicit Price Deflator (IPD). The lowest estimate shows the maximum allowable rate from 1990 to 2019 including the impact of recessions. This is higher than the actual rate in some cases because the County elected to levy less than the maximum allowable amount to prevent large increases in property taxes in the unincorporated area. [1]

[1] The limit on property tax revenue growth of 1% per year plus new construction without a vote of the people stems from Initiative 747, approved in 2001. Although the initiative was subsequently ruled unconstitutional by the State Supreme Court, the Legislature immediately reinstated it.




| MODEL | 2018 REVENUE ESTIMATE | 2018 DIFFERENCE FROM ACTUAL | 1990-2018 CUMMULATIVE DIFFERENCE FROM ACTUAL |
|---|---|---|---|
| ACTUAL ROADS LEVY | $89,353,349 | $0 | $0 |
| MAX ALLOWABLE LEVY | $86,317,818 | $0 | $148,626,796 |
| MIDDLE ESTIMATE | $116,611,874 | $27,258,525 | $523,742,494 |
| HIGH ESTIMATE | $170,288,088 | $80,934,739 | $1,443,928,593 |

The modeled estimates show that without any annexations or incorporations between 1990 and 2018, the County Road Levy could have been as high as $170.28M in 2018, 95% more than actual 2018 road levy income. The model also shows that cumulatively over the last 28 years, annexations and incorporations have reduced total County Road Levy collections by as much as $1.4B. While annexations and incorporations have reduced the revenue from the County Road Levy, they also reduce the area in which King County is required to provide road services. Because of the difficulty in estimating what costs in annexed areas would have been, it is not feasible to estimate the net impact of annexations and incorporations on the County Road Fund in this report. However, it is clear that the revenue losses are proportionally greater than the avoided expenditures, so the cumulative effect on the Road Fund has been negative.

## Real Estate Excise Tax

### Description

Chapter 82.46 RCW authorizes counties to collect Real Estate Excise Taxes (REET) totaling 0.50% of the sale price of real estate in the unincorporated area of a county. These taxes are collected when the documents of the sale are presented for recording by the county. State law separates the tax into two portions called the "first quarter percent" (REET 1) and the "second quarter percent" (REET 2). REET 1 can be used for planning, acquisition, construction, reconstruction, repair, replacement, rehabilitation, or improvement of roads, sidewalks, water systems, parks, law enforcement buildings, and several other public investments. REET 2 is more restricted in its use and can only be used for roads, sidewalks, water systems, and parks. In addition to restrictions in state law, King County Code 4A.510 restricts the use of both REET 1 and 2 to the unincorporated areas.

### Effect

Because annexations and incorporations decrease the amount of real estate in the unincorporated area, they effectively shrink the pool of transactions that are subject to King County's REET. It is important to note that REET revenues are also very sensitive to local economic conditions and recent volatility in REET revenues is not solely associated with annexations and incorporations.

### Impact

Collections from REET 1 and 2 combined totaled $31.88M in the 2017-2018 biennium. Those funds supported nearly all of the Parks Open Space Construction fund and 24% of the Parks Capital Fund, as well as debt service on other King County capital investments.

Annexations and incorporations have had a significant impact on the areas that King County collects REET revenues from and the amount of revenue collected. In 2018, cities in King County that incorporated after 1989 collected a total of $26.52M in real estate excise tax revenue. Additionally, annexations have incorporated an estimated 219,839 residents of King County. If those residents engaged in REET eligible transactions at the same rate as the current unincorporated population, those transactions would have generated $14.12M in additional REET revenue in 2018. Using these rough estimates, the 2018 impact of annexations and incorporations on King County was over $30.6M.

## Gambling Tax

### Description

RCW 9.46.110 empowers counties to tax any gambling activities in the unincorporated area. The law also imposes maximum rates based on the type of activity, as well as exceptions to limited amounts of gambling revenue by charitable organizations. These funds may be used by a county for any purpose. The table below shows the tax rate imposed by King County by type of permitted gambling activity and the maximum rate allowed under state law.

| Gambling Activity | King County Imposed Rate | Maximum Tax Rate |
|---|---|---|
| **Amusement Games** | 2% of net receipts | Actual costs of enforcement, not to exceed 2% of net receipts |
| **Bingo and Raffles** | 5% of net receipts | 5% of net receipts |
| **Punch Boards and Pull-tabs*** | 5% of gross receipts or 10% of net receipts | 5% of gross receipts or 10% of net receipts |
| **Social Card Games** | 11% of gross receipts over $10,000 | 20% of gross receipts |

**Counties may impose either up to a 5% tax on gross receipts or up to a 10% tax on net receipts for commercial operators of punch boards and pull-tabs. Charitable operators must be taxed on the net receipts basis.*

### Effect

Because the County only collects the tax in unincorporated areas, annexations or incorporations of areas that contain licensed gambling establishments reduces the amount of tax that the County is eligible to collect. Currently there are over 40 organizations licensed by the Washington State Gambling Commission that operate in the unincorporated area of King County. Annexation of the areas where these organizations are housed could have a significant impact on the total amount of gambling tax collected by the county in the future.

### Impact

Gambling tax collections are a small part of King County's general fund revenue. In total in 2018, gambling taxes generated $2,205,000 for the fund. The vast majority, over 88%, were generated by the tax on social card games. Altogether, gambling taxes represented 0.25% of general fund revenues in 2018.

## State Transfers

### Description

Several chapters of state law set out formulas by which revenues collected by state entities are distributed to local governments. Two of these formulas, for liquor revenues and motor vehicle fuel taxes, use the unincorporated population as part of the calculation.

***Liquor revenue* –** Liquor revenues are comprised of two sources, excise taxes on the sale of liquor across the state and revenue from license fees for liquor distributors and retailers in the state (known as "liquor profits"). Most of these funds can be used for any purpose, but 2% of each distribution must be used for an approved alcohol or drug addiction program, and 20.23% of the liquor profit distribution must be used for public safety programs. Liquor revenue distributions are placed in the County general fund.

***Motor Vehicle Fuel Taxes*** – Washington State currently collects a 49.4 cents per gallon excise tax on gasoline. RCW 46.68 sets aside a portion of the collected funds to be distributed to counties. These revenues must be placed in the county road fund and are subject to the same restrictions as the county road levy.

### Effect

***Liquor revenue*** – The formulas for distribution of liquor revenues both allocate 80% of eligible money to cities, and the remaining 20% to counties. The 20% county portion is distributed among counties on the basis of the unincorporated population. Annexations and incorporations, by reducing the unincorporated population, also reduce King County's overall share of the county liquor profits.

***Motor vehicle fuel taxes* –** The county portion of shared gas tax revenues is determined by a formula administered by the County Road Administration Board (CRAB). The CRAB formula has four factors it considers: equivalent population, money needs, road cost, and equal distribution.[2] For the purposes of the formula, equivalent population is determined by adding the sum of a county's unincorporated population to 25% of the total population residing in incorporated areas of a county. The net effect of incorporations and annexations on this revenue is that they reduce King County's overall share of equivalent population by moving people from being fully counted to being counted in the 25% of incorporated population.

### Impact

***Liquor Profits* –** Liquor profit distributions are a small portion of the County's total revenues. In 2018 liquor profit distributions to King County totaled $1,478,000, which is equivalent to 0.17% of all general fund revenues.

[2] For additional information on how CRAB determines the non-population elements of the formula, visit the CRAB website: http://www.crab.wa.gov/mvft/mvft.cfm

***Motor vehicle fuel tax*** – Shared gas tax revenues are an important component of the County Road Fund's funding structure. In 2018, state gas tax distributions totaled $13,780,000, which was the fund's second largest source of revenue behind the county road property tax levy.

## <u>Fees and Charges for Services</u>

### Description

King County, as the local service provider, imposes a variety of fees and charges for services in the unincorporated area. These fees and charges include permitting fees on development in the unincorporated area, surface water management fees, and fines and forfeitures in King County District Court, as well as many others. In addition to charges for local services in the unincorporated area, the County also is a contractor for many local governments to provide services like law enforcement, road maintenance, and animal control.

### Effect

Annexations and incorporations have a mixed effect on overall County revenues from fees and charges for services. In most cases, annexations and incorporations reduce County revenues by shifting delivery of local services to the annexing or incorporating city, which then charges for those services. In some cases, annexations and incorporations by cities that contract with King County for local service delivery may increase revenue, as the County may now be compensated for a service that was previously covered by the General Fund.

### Impact

As stated above, it is extremely difficult to quantify the impact of annexations on fee and service revenues across County government. The Department of Local Services' Permitting Division is likely one of the agencies most severely impacted by annexations and incorporations. In 2018, charges for services in the permitting fund totaled $13,267,000, which was 92.8% of the fund's total revenue. It is important to note that permitting fees, by law, are set equal to the cost of issuing the permit, therefore the county does not financially benefit from issuing more or fewer permits. Another impacted service is surface water management, which collects fees from the unincorporated area to pay for surface water management infrastructure and programs. Annexations and incorporations often move rate-payers into municipal systems, but do not capture all of the infrastructure that supports the surface water system, leaving the County to bear those costs.

### Discussion

Annexations and incorporations, especially since 1989, have had significant impacts on King County's revenues from taxes, state transfers, and charges for services. They also have had significant impacts on what services the County provides and to whom. The decrease in the percentage of the county's population living in the unincorporated area, from a high of 41% in the early 1980s to an estimated low of 11% in 2019, has affected a wide range of taxes and state transfers that use the ratio to allocate resources. While incorporations and annexations relieve the County from providing some local services, the unsystematic pattern of annexation and incorporation leaves King County bearing local service costs in disparate areas in both urban and rural communities. While the County has lost potential revenue because of annexation and incorporation, the net impact on the County's finances is difficult to estimate. While the County will continue to implement its master plan under the Growth Management Act, it is incumbent on state-level policy makers to address the impacts of the act on local government finances and provide adequate funding sources for both regional and local services in Washington.