# Property Tax Assessment in Iowa: Changes With HF692

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## By Thomas F. Pogue

Legislation passed in 2003 by the Iowa General Assembly would, if fully implemented, significantly alter the process by which the taxable value of Iowa property is determined.

This report explains both the prevailing system of assessment and the changes implicit in the 2003 legislation, HF692. It also addresses how HF692 could affect incentives facing property owners, growth of taxable valuations, distribution of property taxes among classes of property, debt and revenue ca-pacities of local governments, TIF district revenues, and state school aid. It further reviews the main effects of implementing HF692 and the problems that would arise in doing so.

## Iowa's Property Taxes: The Current System

Property taxes account for a large share of taxes collected by Iowa's state and local governments. They are the main source of revenue of Iowa's local governments. Total property tax levies increased some-what faster than inflation between 1979 and 2002; inflation-adjusted (real) taxes increased 14.8 per-cent. Inflation-adjusted state-level taxes increased more rapidly – 38 percent. Property taxes accounted for 42.7 percent of total state-local taxes in FY 1979, but only 38.3 percent in FY 2002. Property taxes have thus become a less important source of revenue; sales and individual income taxes have become more important (and in fact are used to finance property tax relief).

Property taxes are imposed by cities, counties, school districts, community colleges, townships, and a number of special purpose taxing districts. School districts account for the largest share of taxes – 44 percent. School districts, counties and cities together account for 95.5 percent of taxes levied.

### Property classes

For purposes of assessment, property is classified as one of the following: agricultural land and struc-tures, agricultural dwellings, residential, commercial, industrial, and centrally assessed (railroads and utilities). All property is to be assessed at 100 percent of market value with two exceptions: agricultural property, excluding agricultural dwellings, which is based on a productivity formula, and computers and industrial machinery and equipment, which with few exceptions are exempt from tax.

### Limits and rollback

As a result of statewide limits on the annual growth in assessed values enacted in 1977 and 1978, the assessed value of property may be less than its actual (market or productivity) value. Since 1980, the limit on annual growth has been 4 percent (8 percent for utilities). To hold the increase in assessed values below these limits, the Director of Revenue and Finance each November sets the limitation (rollback) percentages to be applied for each class of property by county auditors. The rollback percent-age is multiplied by the actual value to obtain the assessed value of the property. In recent years, the residential rollback has fallen to near 50 percent, while rollbacks for all other classes of property have been at or near 100 percent (that is, they are assessed at 100 percent of actual value).

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The effect of rollback has been to reduce the tax share of residential property, while increasing the shares of all other property classes. The residential property tax share increased from 36.9 percent in 1979 to 44.5 percent taxes in 2004, but that increase would have been greater – to 61 percent – in the absence of rollback. This was of course the intent of the rollback legislation – to slow the rapid increase in the share of taxes paid by residential property owners. Taxes on residential property nevertheless remained a larger share of total property taxes in 2004 than in 1979. Thus, rollback has reduced but has not eliminated increases in residential property's share of the overall property tax burden. Without rollbacks, residential property taxes would be 38 percent higher than they are, while taxes on other classes of property in the aggregate would be about 30 percent lower.

## How HF692 Would Change Iowa's Property Tax System

HF692 changes the valuation and taxation of all classes of property except agricultural land and centrally assessed property. It eliminates the rollback of assessed values. And it values the land and structure components separately. In contrast, under current law, the land and structure components of property are valued in the same way – market value for all except agricultural land and structures, which are valued on the basis of productivity.

Land is subject to a county-wide per-acre tax with the exception of agricultural land, which is taxed on the basis of productivity, as under present law. (The law is contradictory on this point, stating elsewhere that all land is to be taxed on a per acre basis; this report assumes that the actual intent was to leave agricultural land assessed as it is currently.)  It is unclear how the land tax will be implemented because HF692 does not specify how the tax rate on land is to be determined.

The changes in assessment called for by HF692 take effect July 1, 2005. They apply to assessment years as of January 1, 2006, and they apply to tax collections for fiscal years as of July 1, 2007. However, as HF692 is repealed June 30, 2005, its changes take effect only if reaffirmed in 2005 by new law.

### Taxation of existing property

HF692 in effect freezes the taxable values of existing structures – residential, commercial, industrial and agricultural – at their January 1, 2005, assessed values as determined under current law unless the properties are sold or are modified to increase their square footage.

***Sale of structure.*** When a residential, commercial or industrial structure is sold after January 1, 2005, its taxable value becomes its purchase price divided by the "cumulative inflation factor." (The cumulative inflation factor, a price index measuring the increase in prices since 2005, is designed to reduce or eliminate the jump in taxes that would otherwise occur when a property is sold, and its value "unfrozen.") To obtain a value per square foot, this assessed value is divided by the total number of square feet of the structure as of January 1 of the assessment year. The value of an agricultural structure sold after January 1, 2005, is determined similarly, except that value is based on productivity rather than market price.[1]

***Modification of structure.*** When a structure is modified, its taxable value does not change unless its square footage changes. A structure can therefore be modified in a manner that significantly increases its market value without increasing its taxable value as long as the modification does not add square footage.

Even if a modification increases square footage, the increase in taxable value is not the same as it would be under current law. Under HF692, taxable value increases by the amount of the additional

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[1] The taxable value per square foot of an existing agricultural structure purchased after January 1, 2005, is its productivity value divided by the cumulative inflation factor established for the assessment year following the year of purchase, divided by the total number of square feet of the structure as of January 1 of the assessment year.

square footage times the value per square foot of the existing structure. For example, if an existing structure's frozen value per square foot is $50, then a modification of the structure that adds 100 square feet adds $5,000 to the taxable value of the structure regardless of the cost and value of the modification. But under current law, taxable value would increase by the value of the modification. Given that construction costs typically increase over time, it is likely that the increase in taxable value resulting from modification of a structure will be less under HF692 than under current law.

## Taxation of newly constructed property

The taxable value of a residential, commercial or industrial structure newly constructed after January 1, 2005, is its market value divided by the cumulative inflation factor. This taxable value is divided by the total number of square feet of the structure to obtain value per square foot. The taxable value of a newly constructed agricultural structure is similarly determined except that productivity value replaces market value.[2] With general price inflation, the taxable value of a new structure would be less under HF692 than under current law because selling prices are divided by the cumulative inflation factor.

## The new land tax

Beginning July 1, 2007 (FY2008), a land tax is to be imposed on all non-agricultural land in each county. The tax is the product of the land tax rate times the number of acres of the property. Within each county, the land tax is to be distributed among the various taxing authorities – school district, city, county, and other – in proportion to the taxes, other than the land tax, that they levied in the preceding fiscal year. For example, suppose that a school district levies 40 percent of the taxes in a county in FY 2007. Then, that school district would receive 40 percent of the land tax collected in FY 2008. HF 692 is not clear whether agricultural land is to be subject to this new tax. Our working assumption in this report is that the new per-acre tax applies only to non-agricultural land, with agricultural land being taxed as under present law.

## Amount of tax

The tax imposed on any taxable property has two components: the land tax, which is the product of the land tax rate times the number of acres of the taxable property, and the so-called square footage tax, which is the product of the square footage tax rate times the valuation per square foot of the taxable structure times the number of square feet of the taxable structure. Thus "square footage tax" is something of a misnomer; since value per square foot times number of square feet equals total valuation, structures under HF692 are still taxed by multiplying a tax rate (in dollars per thousand) times the assessed valuation of the structure, a valuation that always starts with current or historical market value of that structure. The land tax, in contrast, is in fact on an entirely different basis: a uniform dollar amount of tax per acre of land, regardless of the market value of that land.

## School aid

Each school district receives state equalization aid based on the taxable value of property in the district. If taxable value increases (decreases) the district receives less (more) aid. HF692 does not specify whether and how the per-acre tax is to be incorporated into the measure of taxable value used to calculate school aid. Consequently, we do not know how HF692 will affect the amount of school aid the state must distribute. However, it is possible if not likely that the value assigned to non-agricultural land

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[2]  The specific language of HF692 is "The assessed value per square foot of a residential structure newly constructed after January 1, 2005, is the market value of the structure for the assessment year following the year construction was completed, as determined by the assessor, divided by the cumulative inflation factor established for the assessment year following the year construction was completed, divided by the total number of square feet of the structure as of January 1 of the assessment year." Exactly the same language defines assessed value for commercial, industrial, and agricultural structures, except that in the latter case market value is replaced by productivity value.

will be no greater with HF692 than with the current system. In that case, school districts' taxable values would be lower with HF692 than with the current system, and state school aid would be higher.

## Conclusions and Recommendations

If implemented, HF692 would make a number of significant changes in Iowa's property tax system. Some of the changes are not well-specified. Most important, HF692 fails to specify fully how the new per-acre tax on non-agricultural land is to be determined. For that reason alone, the property tax system implicit in HF692 is simply not a workable alternative to the present system. We can nevertheless identify a number of likely effects of implementing HF692. Among them:

■     Incentives for maintaining and improving existing structures would be improved, or, more accurately, disincentives implicit in the current system would be lessened. But the change in incentives would favor improvements that only add value, but not space, over improvements that add space. For example, an empty-nest couple adding a hot tub pays no more tax, but a young family adding a bedroom for an additional child pays a higher tax.

■     Owners would have an incentive to stay in existing structures instead of selling and either buying different structures or building new ones.

■     Depending on revenue generated by the land tax, the tax rates on investments in new and existing structures may be either higher or lower with HF692 than they are now. Consequently, it is impossible to predict whether HF692 will encourage or discourage investment in property.

■     Growth of local property tax bases would be slower, requiring higher tax rates on at least some classes of property to maintain spending. Faced with the choice of increasing tax rates or curtailing spending, local governments may adjust on both margins. Implementing HF692 may thus put downward pressure on public service levels.

■     The elimination of rollbacks immediately and dramatically increases the share of taxes paid by residential property, and lowers the share paid by other classes, but other features of the law reduce the residential share over time. Changes in tax shares would also depend on the amount of revenue obtained from the per-acre tax on non-agricultural land. How tax shares would evolve thus depends on how the per-acre tax rate on non-agricultural land is determined. The taxation of non-agricultural land is essentially a "wild card" in any effort to analyze and predict the effects of HF692.

■     Although the effects of HF692 are uncertain on debt and revenue capacities and state outlays for school aid, those effects are potentially large and adverse. If the value of non-agricultural land is not included in calculating debt and revenue limits and state school aid (because its assessed or market value is no longer relevant with a per-acre tax), debt and revenue capacities could be severely reduced, and state outlays for school aid could be sharply increased.

■     Taxes on new structures would increase relative to taxes on existing structures of equal market value. Taxes on newcomers' homes would increase relative to taxes on long-time residents' homes that are of equal market value. These two effects are clear instances of horizontal inequity – unequal treatment of equally situated citizen-taxpayers.

■     Taxing all non-agricultural land in a county at the same rate, as HF692 appears to do, would also generate significant inequities. Owners of higher value land would experience a large windfall gain upon shifting to the new system, because taxes on their land would be lowered, while owners of lower value land would suffer losses.

■     Compared to the existing system, HF692 favors established, higher income neighborhoods over both new neighborhoods and lower income neighborhoods that are in decline. Residents in established, higher income neighborhoods have an incentive to remain where they are (because taxes are frozen

below current values) instead of buying new homes. On the other hand, HF692 may hasten the decline of lower income neighborhoods because it increases the incentive to sell (because taxes are frozen at old levels higher than current valuations), which will in turn further depress house values.

■ A tax on land value that is independent of how the land is used could improve economic efficiency because it does not distort resource allocation decisions. It also captures some of the return on public infrastructure investments that serve the land, such as roads, which make property more valuable. Taxpayers would receive some of the return on such public investments. But a tax that is independent of land value, as a per-acre tax appears to be, would cause more distortions in resource allocation, making it cheap to speculate and hold onto valuable land that would be better put to productive use. A per acre tax would capture none of the increase in land value produced by public investments.

■ We cannot predict how tax shares would change, but we can predict that they would change, and likely change significantly. Implementing HF692 will redistribute taxes among property tax classes and among taxpayers within those classes. And as explained above, the redistribution in some case may be patently unfair, as in the cases of old vs. new structures and new vs. long-time residents.

■ The legislation is based in part on an assumption that inflation in taxable values produces "automatic" increases in taxes. The drafters wanted all tax increases to be the result of explicit actions by local officials to raise taxes. In fact, there are no automatic increases in taxes under the current system. Property tax rates are not fixed; they are set by local officials. Tax bills in the aggregate rise only when local officials make the decision to raise more total funds via property taxes.

**Given these likely effects of HF692, the Legislature should consider the following recommendations if it decides in 2005 to modify Iowa's property tax system along the lines of HF692:**

■ Equalization of inflation factors (Section 441.47A) should not be attempted. Data needed to construct meaningful county-level indices of inflation are not available, and inter-county differences in inflation are likely to be small.

■ The per-acre tax rates on non-agricultural land should increase with inflation and economic growth. Otherwise, taxes on non-agricultural land would diminish over time as a share of total taxes. This would make the property tax system less efficient, since land taxes, in contrast to taxes on structures and other improvements, do not distort decisions about the use of land and other resources.

■ It is questionable whether meaningful measures of the productivity value of agricultural structures can be obtained. It would be better to define taxable values of agricultural structures as their market values. This point applies to both HF692 and the current system.

■ The adjustment of taxable values for general inflation – by dividing market values by the cumulative inflation factor – should be reconsidered. So, too, should the freezing of taxable values on existing property until it is sold or modified. These changes in assessment rules break the link between taxable values and inflation. Yet that link is important in keeping the growth of revenue in line with the cost of providing public services. Breaking the link will in the long run cause higher tax rates and/or lower government spending. HF692 would reduce disincentives to invest in property. But that could also be accomplished by a less disruptive change in the assessment process. For example, new structures and modifications could be taxed at some fraction of their market value for a specified period of time.

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Legislation passed in the 2003 session of the Iowa General Assembly (HF692) would, if fully implemented, significantly alter the process by which the taxable value of Iowa property is determined. Lawmakers expressed their intent in the bill, to encourage transparency, equity, uniformity and predictability in the property tax system, to ensure good maintenance of property does not cause higher assessments, and that tax increases be tied to actions by local taxing authorities and not assessments.

This report explains both the prevailing system of assessment and the changes implicit in HF692. The first part of the report describes the current system. The second part explains how HF692 would change the current system, focusing on how HF692 would determine taxable values and tax rates for each class of property. Other questions addressed are how HF692 may affect incentives facing property owners, growth of taxable valuations, the distribution of property taxes among classes of property, the debt and revenue capacities of local governments, TIF district revenues, and state school aid. The concluding section reviews the main effects of implementing HF692 and the problems that will arise in doing so.

## Iowa's Property Taxes: The Current System

Property taxes account for a large share of taxes collected by Iowa's state and local governments, and they are the main source of revenue of Iowa's local governments. Table 1 shows how Iowa's taxes have changed since 1979. Total property tax levies increased somewhat faster than inflation; inflation-adjusted (real) taxes increased 14.8 percent. But inflation-adjusted state-level taxes increased more rapidly – 38 percent. Property taxes accounted for 42.7 percent of total state-local taxes in FY1979, but only 38.3 percent FY2002. Property taxes have thus become a less important source of revenue, while sales and individual income taxes have become more important.

Property taxes are imposed by cities, counties, school districts, community colleges, townships, and a number of special purpose taxing districts.[1] Table 2 shows the distribution of taxes levied by these entities for FY2004. School districts account for the largest share of taxes – 44 percent. School districts, counties and cities together account for 95.5 percent of taxes levied.

### Property classes

For purposes of assessment, property is placed in one of the following classes: agricultural land and structures, agricultural dwellings, residential, commercial, industrial and centrally assessed.[2] Centrally assessed property is assessed by the Department of Revenue and Finance; all other classes of property are assessed locally by either county or city assessors.[3]

[1] See Crowley (2002) pp. 4-6 for discussion of special purpose districts.
[2] Property classifications and assessed values are determined as of January 1 of each year. The value of prop-

All property is to be assessed at 100 percent of market value with two exceptions. The assessment for agricultural property, excluding agricultural dwellings, is based on productivity, defined

**Table 1. Changing Structure of Iowa Taxes, 1979-2002**

| | Distribution of Taxes (percent) | | | % Change in Inflation-Adjusted Taxes* | % Change in Inflation-Adjusted Taxes Per Capita* | Tax as Percentage of Personal Income | |
|---|---|---|---|---|---|---|---|
| | FY1979 | FY1996 | FY2002 | 1979-2002 | 1979-2002 | FY1979 | FY2002 |
| Individual income | 22.2 | 25.4 | 23.8 | 37.3 | 36.4 | 2.20 | 2.39 |
| Corporation income | 5.3 | 3.2 | 1.4 | -65.7 | -65.9 | 0.53 | 0.14 |
| Sales & use# | 18.3 | 24.8 | 26.7 | 87.4 | 86.2 | 1.81 | 2.68 |
| Franchise | 0.5 | 0.4 | 0.4 | -12.6 | -13.2 | 0.05 | 0.04 |
| Insurance premium | 1.5 | 1.5 | 1.6 | 39.0 | 38.1 | 0.15 | 0.16 |
| Cigarette & tobacco | 1.7 | 1.4 | 1.1 | -15.8 | -16.4 | 0.17 | 0.11 |
| All state taxes | 57.3 | 64.7 | 61.7 | 38.0 | 37.0 | 5.66 | 6.18 |
| Property | 42.7 | 35.3 | 38.3 | 14.8 | 14.0 | 4.23 | 3.84 |
| All state & local taxes | 100.0 | 100.0 | 100.0 | 28.0 | 27.2 | 9.89 | 10.02 |

Source: Iowa Department of Management
* Adjusted for inflation using the GDP implicit price deflator for state and local government, available at http://www.bea.gov/bea/dn/nipaweb/TableViewFixed,asp?Selected Table=144&FirstYear=2002&LastYear=2003&Freq=Qtr
# Sales taxes include local-option sales tax and hotel/motel tax collections

**Table 2. Property Tax Collections by Taxing Authority, FY2004**

| Taxing Authority | Tax levied ($ millions) | Percentage of Total Levies |
|---|---|---|
| School | 1,400.3 | 44.0 |
| City | 901.1 | 28.3 |
| County | 676.0 | 21.2 |
| Merged Area | 63.9 | 2.0 |
| Hospital | 66.4 | 2.1 |
| Assessor | 36.5 | 1.1 |
| Township | 20.7 | 0.6 |
| Ag. Extension | 11.9 | 0.4 |
| Miscellaneous | 5.8 | 0.2 |
| Total All Levies | 3,182.7 | 100.0 |

Source: Economic Policy Institute analysis of U.S. Census, income website.

erty determined for January 1 of a given year is the basis for taxes due and payable in the fiscal year beginning July 1 of the following calendar year – 18 months after the January assessment date. For example, the assessed value of a property for January 1, 2003, will be the basis for taxes due and payable in the fiscal year beginning July 1, 2004.

[3] All lands, buildings, machinery, and equipment belonging to electric companies including rural cooperatives), gas companies (including pipelines), railway companies, and telephone/telegraph companies are centrally assessed. However, for the assessment year beginning January 1, 1999, the property taxes on entities involved in the generation, delivery and transmission of electricity and natural gas were replaced with excise taxes. A property tax of only 3 cents per $1,000 of assessed value was maintained on the properties of these companies to cover the cost of administering the excise tax.

as net earning capacity capitalized at a rate of 7 percent.[4] Computers and industrial machinery and equipment are, with a few exceptions, exempt from tax.[5]

Table 3 shows how the distribution of property tax collections by property class has changed since 1979. The tax imposed on each class of property has increased in dollar terms. But when inflation is aken into account, real taxes have increased only for residential property (38.6 percent) and commercial property (107.8 percent). Taxes on other classes of property have increased less rapidly than the price level, measured by the prices of products and services purchased by state and local governments. In other terms, the purchasing power of the taxes on all classes of property except residential and commercial has fallen since 1979.

### Table 3. Iowa Property Tax Collections, 1979-2004

| | Property Taxes Collectible* (millions of current dollars) | | | % Change in Inflation-Adjusted Taxes# |
|---|---|---|---|---|
| **Class of Property** | **FY1979** | **FY1996** | **FY2004** | **FY1979-2002** |
| Residential | 414.1 | 1,013.9 | 1,417.8 | 38.6 |
| Agricultural Land | 280.0 | 450.1 | 539.5 | -22.0 |
| Agricultural Buildings | 67.3 | 47.8 | 68.0 | -59.1 |
| Commerical | 147.4 | 463.2 | 756.4 | 107.8 |
| Industrial | 65.4 | 88.5 | 127.2 | -21.2 |
| Utilities & Railroads ** | 94.6 | 231.7 | 109.2 | -53.3 |
| All Other | 54.2 | 113.5 | 164.6 | 23.0 |
| All Classes, Net Taxable | 1,123.0 | 2,408.7 | 3,182.7 | 14.8 |

Source: Iowa Department of Management
* Taxes collectible in a fiscal year are levied on assessed values at the beginning of the previous calendar year. For example, taxes collectible in fiscal year 1995 are levied on property valuations for January 1, 1993.
# Adjusted for inflation using the GDP implicit price deflator for state and local government, available at http://www.bea.gov/bea/dn/nipaweb/TableViewFixed,asp?Selected Table=144&FirstYear=2002&LastYear=2003&Freq=Qtr
** Due to a change in tax law in 1998, companies involved in the generation, delivery and transmission of electricity and natural gas pay excise taxes in lieu of property taxes.

### Limits and rollback

As a result of statewide limits on the annual growth in assessed values enacted in 1977 and 1978, the assessed value of property may be less than its actual (market or productivity) value. Since 1980, the limit on annual growth has been 4 percent (8 percent for utilities). To hold the increase in assessed values below these limits, the Director of Revenue and Finance in November of each year publishes the limitation (rollback) percentages to be applied for each class of property by county auditors. The rollback percentage is multiplied by the actual value to obtain the assessed value of the property. (Assessed value after application of rollbacks is also referred to as "taxable value.")

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[4] Productivity is determined by capitalizing each property's five-year average of annual net income per acre at 7 percent. For example, fiscal year 2003 taxes are based on average net income for the years 1997 – 2001. Average net income is based on actual crop yields, prices, and expenses.
[5] For these exceptions, see Crowley (2002), p. 12.

Further, increases in the statewide aggregate assessed values of residential and agricultural property are linked. Specifically, the annual increase in the aggregate assessed value of each of these two classes of property is limited not just to 4 percent, but to the smaller of the increases in the two classes of property. For example, if the actual values of residential and agricultural property increase statewide by 4 percent and 3 percent, respectively, then the assessed value of residential property can increase only 3 percent. The actual (market) values of residential properties in this case are "rolled back" by 1 percent.

Table 4 shows rollback percentages for recent years. Only residential property values have been subject to rollback in all years. The rollback percentages show taxable values as a percentage of actual values, the latter being productivity values for agricultural properties and market values for all other properties. To illustrate, in 1999 taxable values of agricultural properties were limited to 96.3381 percent of actual (productivity) values, and residential taxable values were limited to 54.8525 percent of actual (market) values. For 2002, there was no

### Table 4. Rollback Adjustments by Property Class, 1979-2002 (%)*

| Assessment Year | Agricultural | Residential | Commercial | Industrial | Utilities |
|---|---|---|---|---|---|
| 1979 | 97.6706 | 64.3801 | 88.9872 | 100 | 100 |
| 1980 | 99.0951 | 66.7355 | 93.1854 | 100 | 100 |
| 1981 | 95.7039 | 64.7793 | 87.8423 | 96.9619 | 100 |
| 1982 | 99.5711 | 67.2223 | 91.6331 | 100 | 100 |
| 1983 | 86.5024 | 69.8754 | 91.723 | 97.4567 | 98.3345 |
| 1984 | 90.0058 | 72.4832 | 95.4242 | 100 | 97.8637 |
| 1985 | 93.5922 | 75.6481 | 98.7948 | 100 | 100 |
| 1986 | 100 | 77.3604 | 100 | 100 | 100 |
| 1987 | 100 | 80.5966 | 100 | 100 | 100 |
| 1988 | 100 | 80.6384 | 100 | 100 | 100 |
| 1989 | 100 | 79.8471 | 100 | 100 | 100 |
| 1990 | 100 | 79.4636 | 100 | 100 | 100 |
| 1991 | 100 | 73.0608 | 100 | 100 | 100 |
| 1992 | 100 | 72.6985 | 100 | 100 | 100 |
| 1993 | 100 | 68.0404 | 100 | 100 | 100 |
| 1994 | 100 | 67.5074 | 100 | 100 | 97.209 |
| 1995 | 100 | 59.318 | 97.2824 | 100 | 100 |
| 1996 | 100 | 58.8284 | 100 | 100 | 100 |
| 1997 | 96.4206 | 54.909 | 97.3606 | 100 | 100 |
| 1998 | 100 | 56.4789 | 100 | 100 | 100 |
| 1999 | 96.3381 | 54.8525 | 98.7732 | 100 | 100 |
| 2000 | 100 | 56.2651 | 100 | 100 | 100 |
| 2001 | 100 | 51.6676 | 97.7701 | 100 | 100 |
| 2002 | 100 | 51.3874 | 100 | 100 | 100 |

* Table entries show taxable value as percentages of assessed value.

rollback of agricultural values, but residential values were rolled back to 51.3874 percent of actual value. The fact that the residential rollback percentage decreased from 2001 to 2002 while there was no rollback for agricultural properties indicates that agricultural values did not increase more than 4 percent, but residential values increased more than agricultural values.

Although the rollback adjustment assures that taxable property values do not increase more than 4 percent per year (8 percent in the case of utilities), it also requires taxable values to increase by that amount. This is because the rollback percentage increases by an amount that results in a 4 percent increase in taxable values when market values increase less than 4 percent. For example, Table 4 shows that such an upward adjustment was made in 1986 for agricultural, commercial, and residential properties. The rollback adjustment therefore places a lower limit as well as an upper limit on the increase of taxable values.

The effect of rollback has been to reduce the tax share of residential property, while increasing the shares of all other property classes, as shown in Table 5. The residential property tax share increased from 36.9 percent in 1979 to 44.5 percent taxes in 2004,  but that increase would have been greater – to 61 percent – in the absence of rollback. This was of course the intent of the rollback legislation – to slow the rapid increase in the share of taxes paid by residential property owners. Although residential property taxes would be much higher without rollback, they are nevertheless a larger share of total property taxes in 2004 than they were in 1979. So rollback has reduced but has not eliminated increases in residential property's share of the overall property tax burden.

Reducing the share of residential property necessarily increases the tax share of other classes of property. For example, in 2004 the tax share of commercial property is 23.8 percent with rollback, but it would be only 16.7 percent without rollback (Table 5). Considering all property

**Table 5. Property Tax Shares by Class of Property, 1979-2004**

| | Share of Property Taxes Collectible (percentage)* | | | | | |
| --- | --- | --- | --- | --- | --- | --- |
| | FY1979 | | FY1996 | | FY2004 | |
| Class of Property | With Rollback | Without Rollback | With Rollback | Without Rollback | With Rollback | Without Rollback |
| Residential | 36.9 | 46.7 | 42.1 | 55.3 | 44.5 | 61.0 |
| Agricultural Land | 24.9 | 20.8 | 18.7 | 14.4 | 17.0 | 11.9 |
| Agricultural Buildings | 6.0 | 5.0 | 2.0 | 1.5 | 2.1 | 1.5 |
| Commercial | 13.1 | 12.0 | 19.2 | 14.9 | 23.8 | 16.7 |
| Industrial | 5.8 | 4.7 | 3.7 | 2.8 | 4.0 | 2.8 |
| Utilities & Railroads | 8.4 | 6.9 | 9.6 | 7.4 | 3.4 | 2.4 |
| All Other | 4.8 | 3.9 | 4.7 | 3.6 | 5.2 | 3.6 |
| All Classes, Net Taxable | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Iowa Department of Management
* Calculations for "Without Rollback" assume that each taxing authority decreases its tax rate in proportion to the increase in taxable valuation resulting from the elimination of rollback, each taxing authority's collectible taxes therefore remain unchanged. For data sources, see notes for Table 3.

classes, without rollback taxes of $3.18 billion collectible in 2003-2004 could be collected with an average tax levy of $23 per $1,000 of taxable value instead of $33, a reduction of 30 percent. That is, the tax bill of all properties other than residential would be 30 percent lower; the bill for residential properties would of course be higher, by approximately 38 percent.

## How HF692 Changes Iowa's Property Tax System

HF692 changes the valuation and taxation of all classes of property except agricultural land and centrally assessed property. It eliminates existing limits on growth of property tax bases and the rollback of assessed values. And it values the land and structure components separately. In contrast, under current law, the land and structure components of property are valued in the same way – market value for all except agricultural land and structures, which are valued on the basis of productivity.

The taxation of structures under HF692 is complicated, but fairly well specified. Like current law, HF692 taxes structures on the basis of market value, except agricultural structures which it taxes on the basis of productivity. But HF692 replaces the existing assessment process, described above, with one that significantly limits increases in taxable values of structures. Specifically, it adjusts market values for inflation so that taxable values of residential, commercial, and industrial structures increase only if their market values increase more rapidly than prices in general. Similarly, the taxable values of agricultural structures increase only if their productivity values increase more rapidly than prices.

Land is subject to a county-wide per-acre tax with the exception of agricultural land, which is taxed on the basis of productivity, as under present law. But it is unclear how the land tax will be implemented because HF692 does not specify how the tax rate on land is to be determined. It simply states that "a land tax shall be imposed against each acre or portion of an acre in a county." (Section 443A.1)

HF692 creates a committee that is to make recommendations about implementation of the provisions of HF692 (see Section 41). This committee is also to "study the role of property taxes in funding local government services and the type of services currently funded by property taxes." The changes in assessment called for by HF692 take effect July 1, 2005. They apply to assessment years beginning on or after January 1, 2006, and they apply to tax collections for fiscal years beginning on or after July 1, 2007. However, HF692 is repealed effective June 30, 2005, so its changes will become effective only if the 2005 session of the General Assembly reinstates the legislation.

We next explain how HF692 determines taxable values for 1) existing property other than agricultural land, 2) newly constructed property, and 3) land.

### Taxation of existing property

HF692 in effect freezes the taxable values of existing structures – residential, commercial, industrial and agricultural – at their January 1, 2005, assessed values (before application of the rollback) as determined under current law unless the properties are either sold or modified in a manner that increases their square footage.

**Sale of structure.** When a residential, commercial, or industrial structure is sold after January 1, 2005, its taxable value becomes its purchase price divided by the cumulative inflation factor established for the assessment year following the year of purchase. To obtain a value per square foot, this assessed value is divided by the total number of square feet of the structure as of January 1 of the assessment year. The value of an agricultural structure sold after January 1, 2005, is determined similarly, except that value is based on productivity rather than market price.[6] When there is general price inflation, as has been the case since the 1930s, the taxable value of an existing structure that is sold will be less under HF692 than it would be under current law because selling prices are divided by the cumulative inflation factor.

**Modification of structure.** When a structure is modified, its taxable value does not change unless its square footage changes.[7] A structure can therefore be modified in a manner that significantly increases its market value without increasing its taxable value as long as the modification does not add square footage.

Even if a modification increases square footage, the increase in taxable value is not the same as it would be under current law. Under HF692, taxable value increases by the amount of the additional square footage times the value per square foot of the existing structure. In contrast under current law, taxable value increases by the dollar value of the modification. For example, if an existing structure's HF692 value per square foot is $50, then a modification of the structure that adds 100 square foot to the structure adds $5,000 to the taxable value of the structure regardless of the cost and value of the modification. But under current law, taxable value would increase by the value of the modification. Under HF692, the increase in taxable value resulting from modification of an existing structure may therefore exceed, equal, or be less than the increase under current law. But the most likely outcome, given that construction costs typically increase over time, is that the increase in taxable value resulting from modification of a structure will be less under HF692 than under current law.

**Taxation of newly constructed property**

The term "newly constructed" includes, but is not limited to, structural replacement, additions that substantially increase the square footage, conversion into another class of property, and conversion from exempt property under section 427.1 to taxable property. For commercial and industrial property, "newly constructed" also includes an addition or removal to a structure of personal property taxed as real estate under chapter 427A.

The taxable value of a residential, commercial, or industrial structure newly constructed after January 1, 2005, is its market value for the assessment year following the year construction was completed, divided by the cumulative inflation factor for that year.[8] This taxable value is divided by the total number of square feet of the structure to obtain value per square foot. The taxable value of a newly constructed agricultural structure is similarly determined except that

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[6] The taxable value per square foot of an existing agricultural structure purchased after January 1, 2005, is its productivity value divided by the cumulative inflation factor established for the assessment year following the year of purchase, divided by the total number of square feet of the structure as of January 1 of the assessment year.
[7] HF692, Section 441.21, paragraph 2.b.2 states: "If additions or modifications to an existing structure do not constitute a newly constructed structure, the valuation of the structure shall only increase if the square footage of the structure increases. The increased valuation, if any, equals the amount of increased square feet times the value per square foot of the structure prior to the additions or modifications."

productivity value replaces market value. [9] When there is general price inflation, the taxable value of a new structure will be less under HF692 than it would be under current law because selling prices are divided by the cumulative inflation factor.

Table 6 illustrates these effects for a hypothetical home of 2,000 square feet worth $120,000 as of January 1, 2005. As long as the owners did not sell and did not add square footage, the home would remain assessed at $120,000 indefinitely. In Scenario A, the owners make improvements, only some of which increase the assessment. Those improvements are valued at the original $60 per square foot value, not the actual cost. The home in January 2010 is worth almost $188,000 but is assessed at $128,400. In Scenario B, the owners sell the home in 2009. As a result, it is assigned a new assessed value as of January 1, 2010, that is higher

### Table 6: Illustration of Effects of HF692 Five Years After Going Into Effect

**Home Value as New Law Takes Effect in 2005**

| | |
|---|---|
| Actual value under current law as of 1-1-2005 = frozen assessed value | $120,000 |
| Square feet | 2,000 |
| Frozen assessed value per square foot | $ 60.00 |

**Scenario A: Owners Make Improvements in late 2009**

| | |
|---|---|
| Kitchen remodeled at cost of | $ 18,000 |
| Additional bedroom added actual cost @ $120/sq. ft | $ 16,800 |
| Square feet | 140 |
| Current market value with improvements | $ 187,954 |
|    ($120,000 plus 5% inflation plus cost of improvements) | |
| Additional assessed value (bedroom only) | |
| Square footage times 1-1-2005 value per sq. ft. (140 X $60) | $ 8,400 |
| New Assessed value as of 1-1-2010 ($120,000 + $8,400) | $ 128,400 |
| New assessed value per square foot (unchanged) | $ 60.00 |
| New actual value per square foot | $ 87.83 |

**Scenario B: Home is Sold in late 2009 (no improvements)**

| | |
|---|---|
| House sold for (5% annual inflation for five years) | $ 153,154 |
| Cumulative inflation factor (3% general inflation for five years) | 1.159 |
| Value reduced by inflation factor = 1-1-2010 assessed valuation | $ 132,112 |

**New Home Constructed in 2009**

| | |
|---|---|
| Cost (construction costs rise at 6% per year) | $ 160,587 |
| Cumulative inflation factor (3% general inflation for five years) | 1.159 |
| Cost reduced by inflation factor = assessed value 1-1-2010 | $ 138,524 |
| Square feet | 2,000 |
| Assessed value per square foot | $ 69.26 |

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[8] The cumulative inflation factor is a price index that shows how much the price level has increased since calendar year 2005. The price index to be used is the Gross Domestic Product Deflator (GDPF). See Section 441.21, paragraphs 7a and 7b. The cumulative inflation factor is set at 1.0 for 2005. If, for example, the GDPF were to increase 20 percent from 2005 to 2010, then the cumulative inflation factor for 2010 would be 1.2.

[9] The specific language of HF692 is "The assessed value per square foot of a residential structure newly constructed after January 1, 2005, is the market value of the structure for the assessment year following the year construction was completed, as determined by the assessor, divided by the cumulative inflation factor established for the assessment year following the year construction was completed, divided by the total number of square feet of the structure as of January 1 of the assessment year." Exactly the same language defines assessed value for commercial, industrial, and agricultural structures, except that in the latter case market value is replaced by productivity value.

than $120,000 because home prices have inflated faster than the general level of prices (which determines the cumulative inflation factor). Finally, an identical home constructed in 2009 with five years of inflation in home construction costs at 6 percent per year would be assessed at $69 per square foot, while the same home that remained unsold would continue to be assessed at $60.

### The new land tax

Beginning July 1, 2007, FY2008, a land tax is to be imposed on all non-agricultural land in each county. The tax on each taxable property is the product of the land tax rate times the number of acres of the property. Within each county, the land tax is to be distributed among the various taxing authorities – school district, city, county and other – in proportion to the taxes, other than the land tax, that they levied in the preceding fiscal year. For example, suppose that a school district levies 40 percent of the taxes in a county in FY2007. Then, that school district would receive 40 percent of the land tax collected in FY2008.

HF692 is not clear on the question of whether agricultural land is to be subject to this new tax. Section 35 of HF692 creates a new section of the Iowa Code, 443A.1, that states: "Effective for the fiscal year beginning July 1, 2007, and all subsequent fiscal years, a land tax shall be imposed against each acre or portion of an acre of land in a county." But another new section, 441.21A, states "Agricultural land shall be valued at its productivity value." These two sections are thus in conflict unless it is assumed that the new per-acre tax is to be a tax on land value, with value being determined by productivity for non-agricultural as well as agricultural land. It seems unlikely that such is the intent of HF692, so our working assumption in this report is that the new tax applies only to non-agricultural land, with agricultural land being taxed as under present law.

HF692 does not specify how the new land-tax rate is to be determined. In particular, it does not state whether or how the per-acre tax rate is to be adjusted in response to inflation. Failure to link this tax rate to the inflation rate, thereby indexing the tax rate, opens up the possibility that over time the land component of the overall property tax base will decrease relative to the structure component.

### Amount of tax

The tax imposed on any taxable property has two components: the land tax, which is the product of the land tax rate times the number of acres of the taxable property, and the so-called square-footage tax, which is the product of the square footage tax rate times the valuation per square foot of the taxable structure times the number of square feet of the taxable structure. The square-footage tax is computed separately for each structure. Although the tax is stated as an amount per square foot, the tax on any given property depends only on its taxable value.[10]

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[10] To illustrate, suppose structures A and B have the same market values, $100K, but different square footage – 1,000 sq. ft. for A and 2,000 sq. ft. for B. Suppose also that the tax rate is set at $.003 so the tax due is
$.003 x value per sq. ft. x sq. ft.
Then the tax on A would be
$.03 x $100 x 1000 = $3000,
and the tax on B would be
$.03 x $50 x 2000 = $3000.
The result of taxing on square footage is the same as taxing at $30 per thousand dollars of value. The tax is the same because the value is the same; that the structures have different square footage is irrelevant.

## Effects of Implementing HF692

In this section we discuss the likely effects of implementing the main provisions of HF692. The existing system is taken as a benchmark, so we try to determine how HF692 changes:

■        incentives to invest in property,
■        growth over time of property tax bases,
■        the distribution of property taxes,
■        tax  capacity with mill limits,
■        debt limits,
■        tax increments accruing to TIF districts,
■        state aid to schools, and
■        equalization of inflation factors.

### Incentives

A major concern of legislators in passing HF692 was that the current assessment system entails disincentives for investing in new property and maintaining existing property. The apparent intent of HF692 is to reduce such disincentives by reducing the tax on new structures and the tax increase resulting from modification and improvement of existing structures. That is, the intent is that a dollar spent on building a new structure or improving an existing one will lead to a smaller property tax increase with HF692 than with the current property tax system.

Does HF692 achieve this result? The answer is "We don't know" because HF692 does not specify fully how non-agricultural land, which is currently taxed as part of the tax on residential, commercial, and industrial property, is to be taxed. Yet, the tax rate on all property other than non-agricultural land is conditional on the revenue generated by this land tax:  that rate "shall in all cases be estimated and based on the amount of land tax available to the district …." (Section 441.1) Depending on how much revenue is generated by the land tax, the tax rates on investments in new and existing structures may be either higher or lower with HF692 than it would be with the current system. The clear conclusion is that we usually cannot know whether the additional tax payable because of investment in a new or existing structure will be lower with HF692 or with the current system.

One exception to this conclusion is when an existing structure is modified without increasing its square footage. Such modification does not increase taxable value and tax under HF692. But under the current system it increases taxable value by the cost (value) of the modification. In this case, HF692 provides an incentive for improving and remodeling existing structures regardless of whether the tax rate is higher or lower with HF692 than with the current system.

A second exception arises because HF692 updates taxable values only when structures are sold. When building costs and prices increase over time, as has been the case, the taxable values of existing structures as determined by HF692 will not keep up with increases in their market values because taxable values are updated only when structures are sold. This feature of HF692 provides an incentive for owners to stay in existing structures instead of selling and either buying different structures or building new ones. This incentive is opposite to the one in the preceding paragraph; it tends to make investment lower with HF692 than it would be with the current system.

To reduce this incentive, HF692 "indexes" taxable values, adjusting them for inflation so that they increase only if market values increase more rapidly than prices in general. Such indexing reduces the increase in taxable value that would occur if a property owner were to sell, and thereby reduces the barrier to selling. Stated differently, with indexing, owners are less likely to be "locked in" to their existing property holdings.

When enacting HF692, legislators were concerned not only with the effect of assessment rules on incentives to invest in and maintain property, but also with their effect on local taxing authorities' incentives to increase taxes and spending. Their intent is that any increase in taxes paid be the result of direct actions by the local budget authorities, rather than growth in the property tax base that allows higher spending without an increase in tax rates. (Section 441.20) They want increases in taxes paid to reflect explicit decisions by budget makers to spend more, rather than being the result of market-driven, "automatic" increases in taxable property values.

Preventing such "automatic" increases in taxable values undoubtedly provided an additional rationale for indexing taxable values, because indexing prevents taxable values from increasing with general inflation. HF692 also freezes taxes on existing property unless the property is sold or modified in a manner that increases square footage. These features of HF692 reflect a belief that taxes often increase "automatically," simply because the taxable property values increase. Their purpose is to deter "automatic" tax increases, and thereby reduce the incentive to tax and spend.

But there are no automatic increases in property taxes. Each year, a taxing authority determines its levy rate by dividing the total taxes to be collected by the total taxable value of property in its jurisdiction. Increases in the taxes collected by a county, city, or other taxing authority occur only if the authority decides to collect more taxes. If it holds total collections constant, any increase in taxable property values translate into a lower levy rate, rather than higher tax collections.

**Growth of property tax bases**

A locality's tax base consists of the taxable values of 1) residential, commercial and industrial structures, 2) agricultural land, 3) non-agricultural land, and 4) centrally assessed property. Compared to the present system, HF692 affects the growth of these components differently. To determine how HF692 may affect growth of a locality's property tax base, we therefore need to know how it affects growth of each component.

Since taxable values of agricultural land and centrally assessed property are the same for HF692 and the current system, their growth rates will likewise be the same. With HF692, the non-agricultural land component of the tax base will not grow because it is taxed on a per-acre basis. In contrast, with the current system, the taxable value of non-agricultural land increases as land values increase in response to inflation and economic growth.

Growth of the structures component will be slower with HF692 for the following reasons.

■        The taxable values of all structures (residential, commercial, industrial and agricultural)

existing at time of implementation will be frozen at their January 1, 2005, market values until they are either sold or modified in a manner that increases their square footage. Freezing taxable values slows growth of local property tax bases if market values increase over time, as has been the case in most localities.

■    Under HF692, any modification of an existing structure increases taxable value only in proportion to the increase in square footage. So improvements that do not increase square footage do not increase taxable value, even though they would do so under current law.

■    The value of square footage added by modification is the value per square foot of the existing structure. If construction costs continue to increase over time as they have in the past, the per-square-foot cost of any modification is likely to be greater than the value per square foot of the existing structure. The increase in taxable value from modification would therefore be less for HF692 than for current law. Under current law the increase in taxable value is determined by current construction costs.

■    The value of purchased and newly constructed property grows more slowly than its market value because any increase in market value is reduced by the cumulative inflation factor.

   ❍    For example, suppose a newly constructed house sells for $100K on January 1, 2005. Five years later, January 1, 2010, an identical newly constructed house sells for $121.67K, reflecting a 4 percent annual increase in housing prices. The taxable value of this new house in 2010 would be $121.67K under current law. But under HF692 the value would be reduced by the cumulative inflation factor – the five-year increase in the GDP price index. If the GDP price index increases 2 percent per year, the cumulative inflation factor is 1.1041. Dividing the market price by this factor gives $121.67K/1.1041 =  $110.19K as the taxable value under HF692.

   ❍    Similarly, if the house that sold on January 1, 2005, is sold again on January 1, 2010, for $121.67K, its taxable value under HF692 rules would be $110.19K if the GDP price index increases at 2 percent per year. In contrast, under the current system, the taxable value of the house would be its market value, $121.67K.

   ❍    The general point illustrated by this example is that the taxable value of purchased or newly constructed property increases under HF692 only if the market price of structures, new or existing, increases more rapidly than the GDP price index. In contrast, with the current system taxable values increase if market values increase.

To summarize, considering all tax-base components, the property tax base will grow more slowly with HF692 than with the current system. Taxable values of agricultural land and centrally assessed property will grow at the same rate, and the non-agricultural land and structures components will grow more slowly. Slower growth of the total tax base implies in turn slower revenue growth unless the tax rate on one or more components is higher with HF692 than with the current system.

Although the property tax base may grow more slowly with HF692 than with the current system, the size of the base may not be lower, especially in the first few years after implementation. The reason is that eliminating the rollback initially increases the taxable value of residential

structures.[11] Local governments may therefore experience an increase in their tax bases that will allow them to reduce tax rates and/or increase spending. But this initial "bonus" in tax capacity will be eroded over time by slower growth of the taxable value of residential and other structures, as just explained. And it may never materialize if the new land tax generates significantly less revenue than the current tax on the land components of residential, commercial, and industrial property.

The dollar cost of meeting demands for services provided by Iowa's local governments has increased over time due to inflation, and it will likely continue to do so. With Iowa's current system of property taxation, taxable property values also increase with inflation because the market value of property increases with inflation. And local governments' property tax bases therefore tend to grow in line with inflation-induced increases in the cost of providing their services.

But such will not be the case under HF692. Neither of the land components of the HF692 tax base increases with general inflation. More important, dividing market values by the cumulative inflation factor prevents the largest component of local tax bases – residential, commercial and industrial structures – from increasing along with general inflation. This adjustment for inflation will prevent local governments' tax bases from growing in tandem with the cost of providing their services; tax bases will grow more slowly than the cost of providing services.[12] Compared to the present system, local governments will have to have higher tax rates and/or lower spending and public service levels. Local governments will face a budgetary dilemma. To maintain existing service levels at any point in time they will have to increase tax rates; they must choose between higher tax rates and lower service levels. This dilemma is made even more severe by the fact that the cost of local government services tends to increase more rapidly than prices in general.[13]

As explained above, the taxable values of the various classes of property grow at different rates with either HF692 or the current system. The annual rate of growth of a locality's aggregate tax base (taxable value of property) therefore depends on the mix of properties in the locality. And localities will not be affected equally by changing to the HF692 system. Specifically, growth of a locality's tax base will be slower the larger is the share of residential, commercial and industrial property in its total tax base.

## Distribution of taxes

An apparent concern of legislators is that HF692 not redistribute taxes among classes of property (see Section 41.2). Despite this concern, a number of features of HF692 are likely to realign significantly taxes among property classes. But we cannot predict the net effect of these changes, and that net effect is itself likely to change over time.

The main reason for this uncertainty is that HF692 does not fully specify an alternative to the present property tax system. Specifically, it does not specify how the tax on non-agricultural

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[11] This potential increase in taxable values could of course be offset if the Legislature decides to impose a rate limitation on residential structures that cuts the rate in half compared to other classes (because the residential rollback is now about 50 percent). Then the effect of higher initial assessed values on revenue would be nullified, but the effect of slower growth in those values would not.

[12] In other terms, the property tax is made less elastic – less responsive to changes in the dollar magnitude of the economy.

[13] Specifically, the prices of state and local government goods, as measured by the deflator for state and local government purchases, increase more rapidly than prices in general, as measured by the GDP deflator.

land will be determined. Ideally, we would like to show for a given amount of taxes to be collected how the distribution of taxes under HF692 would differ from the distribution under the current system. But we cannot do so without knowing how much revenue the new tax on non-agricultural land will generate. Depending on the amount of this tax, the tax on any class of property under HF692 could be either higher or lower than it would be under the current system. Any statement about the effect of HF692 on the distribution of taxes must therefore be conditional on an assumption about revenue generated by the HF692 tax on non-agricultural land. The following discussion assumes that the HF692 land tax will generate the same revenue as would be generated by the current system of land taxation, with the same distribution of land tax for all classes of property and all taxpayers.

**Residential property.** For any assessment year after 2005, the assessment rules of HF692 reduce the taxable values of structures relative to what they would be under the current system.[14] The taxable value of residential structures will initially be greater under HF692, because of the elimination of rollback. But over time the taxable value of residential structures as determined by HF692 will fall relative to, and eventually become less than, value as determined by the current assessment rules.

Eliminating rollback immediately increases the share of property taxes borne by residential structures while decreasing the shares of other property classes. For any given amount of revenue collected (any given tax rate) residential property owners will be worse off with HF692 than with the current system, at least in the first few years after the switch to HF692.[15] But eliminating rollback has a one-time effect that diminishes over time. In the long run, the tax share of residential properties decreases, given the assumption that the revenue from non-agricultural land taxes is the same for HF692 and the current system.

**Commercial and industrial property.** The tax share of commercial and industrial property will decrease immediately upon implementation of HF692, and remain lower in all future years (again assuming revenue from the tax on non-agricultural land is the same for HF692 as the current system).

**Agricultural land.** HF692 does not change how the taxable value of agricultural land is determined; value continues to be determined by productivity. Further, the productivity value of agricultural land is not divided by the cumulative inflation factor to determine its taxable value. Because it is not adjusted downward by the rate of inflation, the taxable value of agricultural land may grow more rapidly that the value of other classes of property. And agricultural land may bear a larger share of the total property tax burden. That would in fact be the case if the taxes on non-agricultural land prove to be the same for HF692 and the current system.

**Centrally assessed property.** As is the case with agricultural land, the tax share of centrally assessed property will be greater in each year following implementation of HF692 than it would under the current system.

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[14] Taxable values for the assessment year 2005 are market values on January 1, 2005. For subsequent assessment years, taxable values are market values divided by the cumulative inflation factor.
[15] The Legislature may of course take action to prevent this outcome. Section 41.2 appears to call on the Property Tax Implementation Committee to consider the need for  limits on tax rates that will have a revenue neutral impact on classes of property and maintain equity among classes of taxpayers. Such limits would essentially mimic the current system of rollbacks.

**Non-agricultural land.** The preceding discussion assumes that non-agricultural land will be taxed the same with HF692 as it would be with the current system. But that of course need not, and probably will not, be the case. All that is certain is that the distribution of taxes with HF692 will depend critically on how non-agricultural land is taxed.

**New vs. existing structures.** The tax share of new structures may increase relative to the share of existing structures. Why? When building costs and prices increase over time, as has been the case, the taxable values of existing structures will not keep up with increases in their market values because taxable value is updated only when structures are sold. In contrast, the taxable values of new structures increase if the rate of increase in the market value of new structures exceeds the rate of inflation as measured by the increase in the GDP price index.

Of course, if building costs and prices fall over time, then existing structures are frozen into relatively high values, and their tax share could increase. Owners of existing property therefore do not always gain when taxable values are frozen. They may gain if market values are increasing, but they may lose if market values are falling. And the assessment rules of HF692 may cause a shift of tax burdens from sections of a taxing jurisdiction in which market values are rising to sections in which market values are falling. Freezing taxable values is not even-handed in its effects on taxpayers; it creates winners and losers.

**Type of neighborhood.** To further illustrate how some homeowners gain while others lose, let's contrast the effects of HF692 on three types of neighborhoods:

■ an old neighborhood where incomes are above average, people remain in their homes a long time, and house values are rising,
■ an old neighborhood where incomes are below average and house values are declining because that part of town is increasingly seen as an undesirable place to live,
■ and a newly developing fringe subdivision for middle-income families.

With HF692, homeowners in the first neighborhood will see their house values rise but not their taxes; their tax-to-value ratio will be relatively low. These homeowners will have an incentive to stay in their current homes, since selling and moving into a house of the same quality will increase their taxes. The reverse is true for homeowners in the second category. Their tax-to-value ratio will be relatively high, and they will have an incentive to trade houses, since by doing so their tax on a house of given quality will be lower. Homeowners in the third neighborhood – newly developing fringe – will also face relatively high tax-to-value ratios. In sum, compared to the existing system, HF692 favors established, higher income neighborhoods over both new neighborhoods and lower income neighborhoods that are in decline. Indeed, HF692 may hasten the decline of the latter neighborhoods because it increases the incentive to sell, which will in turn further depress house values.

**Existing vs. new residents.** With HF692, homeowners who have resided in the same home in a community for a number of years will pay lower taxes than newcomers to the community if housing prices have increased over time, which is usually the case. Specifically, two next-door-neighbor families residing in identical houses would pay different taxes if they bought their houses at different times; the family that most recently purchased its house would pay higher taxes. Even though these two families pay different taxes, they receive the same benefits from

local governments – the same schools, police and fire protection, parks, etc.  This is a clear instance of horizontal inequity – failure to treat equally situated taxpayers equally.

This horizontal inequity does not arise with the present system. Homeowners who reside in houses that are equal in market value pay equal taxes.[16] The result is that the share of taxes paid by newcomers to a community will be larger with HF692 than with the current system, the share paid by old-timers will be smaller.

The same conclusion holds for owners of business property. Under HF692, the more recently that a business has acquired its property, the greater will be its share of property taxes.

### Tax capacity with mill limits

As explained above, eliminating rollback may initially increase tax capacity, since it will result in a one-time increase in the taxable value of residential structures. This initial boost to property tax capacity could be either reinforced or reduced by revenue from the per-acre tax on non-agricultural land, depending on the tax rates initially set for that tax. Following these one-time effects, local property tax bases will not increase in tandem with general inflation.

The cost of public services will, however, increase with general inflation. When there is continuing inflation, local property tax bases will therefore increase more slowly than the cost of providing services. And the tax (mill) rate will have to increase continuously to maintain the real value (purchasing power) of property tax revenues. If local governments are unable to increase tax rates because of mill limits, the level and/or quality of local public services will have to decrease. [17]

### Debt limits

The value of property to be used in calculating debt limits appears to be determined by the HF692 method of assessment, but HF692 is far from clear on this matter. (See Section 441.21 paragraph 8.) Even if we assume that debt limits are to be based on values as determined by HF692, we cannot predict whether they would be higher or lower with HF692 than the current system.

The greatest source of uncertainty is that HF692 leaves unspecified whether and how the value of non-agricultural land is to be taken into account in calculating debt limits. With the present system, the value of non-agricultural land is included in valuations used to calculate debt limits. Therefore, if some measure of the value of non-agricultural land is not used in the calculation of debt limits under HF692, limits will surely be lower than with the current system. However, if a sufficiently large value is assigned to non-agricultural land, debt limits could be higher with HF692.

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[16] There may be some difference in net tax payments because of various credits available to particular types of homeowners – elderly, low-income, veteran. The presumption underlying such credits is that the homeowners are not equally situated even though they live in houses of equal market values. If this presumption is correct then the unequal net tax payments need not result in horizontal inequity.

[17] Tax collections = (tax rate) x (tax base). So if the tax base (taxable values) grows more slowly, the tax (mill) rate must increase over time to keep collections growing at a given rate.

Uncertainty also arises because some provisions of HF692 would increase taxable valuations and hence debt limits, relative to the current system, while others would decrease debt limits. Specifically, eliminating rollback would add to the value of property used in calculating debt limits. But applying the HF692 rules for determining the taxable values of structures would, as explained above, decrease taxable values and debt limits. The net effect of these two influences is not predictable with available information.

The bottom line is that implementing HF692 without modification would leave local governments with no clear way of determining their debt limits.

**Effect on TIF districts**

The funds flowing to TIF districts are determined by 1) increments to their tax bases and 2) the tax rates applied to those increments. Suppose, for example, that a district's tax base would be larger by $100,000 with HF692 than it is with the current system, and the tax rate is $30 per thousand dollars of taxable value with both HF692 and the current system. Then, the district would receive $3,000 more with HF692 in place than it does with the present system. As a second example, suppose that with HF692 a district's tax base would be larger, increasing from $1 million to $1.5 million, but its tax rate would be lower, dropping from $30 to $20 per thousand dollars of taxable value. In this second case, implementing HF692 would have no effect on the district's revenues.

These examples illustrate the general point that to determine how HF692 affects a TIF district's revenues, we must determine how it changes both increments to the district's tax base and the tax rate applied to that base. We turn to that task now, considering first how implementing HF692 would affect tax-base increments and then how it would affect tax rates.

**Tax base increments.** Because HF692 will eliminate the residential property rollback, it will immediately increase taxable value in each TIF district by the amount of the rollback in that district. But following this initial, one-time increase in taxable values, taxable values will likely grow more slowly, and the tax-base increments accruing to TIF districts in any given year will likely be smaller than under the present system.

There are two reasons why tax-base increments may be smaller in years following implementation of HF692. First, while TIF districts will still get the increase in value due to new construction, that increase will be reduced by the cumulative inflation factor. Second, with the current system, TIF districts benefit when the value of existing properties increases because of inflation. This will not happen under HF692 except when properties are sold, and even then the increase will be reduced by the cumulative inflation factor.

Considering both the one-time and continuing effects, tax-base increments to TIF districts will initially be larger with HF692 than with the current system. But over time this initial increase will erode, and eventually increments will be smaller with HF692 than they would be with the current system.

HF692 does not specify whether and how the value of non-agricultural land is to be treated in determining increments. It replaces the ad valorem tax on this land with a per-acre tax. Does

this mean that the value of property in each TIF district is reduced by the value of non-agricultural land subject to taxation with the current system? The answer is that we do not know, which creates additional uncertainty about how HF692 would affect TIF revenues.

**Tax rates.** The tax rates applicable to the tax-base increments of each TIF district are set by the local taxing authorities that have jurisdiction within the district. How will these tax rates change if HF692 is implemented? To answer this question we need to know how HF692 changes taxing authorities' tax bases (taxable valuation) and desired tax collections. (Recall that the tax rate is calculated as the amount of taxes that a taxing authority wishes to collect divided by the taxable valuation within its jurisdiction.)

It is plausible that taxing authorities' desired tax collections are determined by the cost of and demand for services provided to their constituents. There is no reason to expect that the demand for services and the tax collections needed to pay for them will be systematically higher or lower if HF692 replaces the current system. Consequently, if HF692 reduces tax bases, we would expect taxing authorities to increase their tax rates enough to offset the tax-base decreases, and thereby maintain tax collections and service levels. The opposite would be expected if HF692 increases tax bases.

To review, implementing HF692 would likely change the tax-base increments accruing to TIF districts, first increasing and then decreasing them relative to what they would be with the current system. Tax rates would also change, but opposite to the changes in tax-base increments. The effect of HF692 would thus be less pronounced than its effect on tax-base increments. When tax-base increments increase (decrease), revenue would increase (decrease) by a smaller percentage. And it is possible that the tax rate change would fully offset the change in tax-base increment, yielding a zero net effect on TIF revenues. In short, we cannot determine how TIF revenues would be affected by HF692 without a detailed quantitative model of local government taxing and spending decisions and detailed quantitative projections of taxable values under both HF692 and the current system.

## School aid

Each school district receives state equalization aid based on the taxable value of property in the district. If taxable value increases (decreases) the district receives less (more) aid. HF692 does not specify whether and how the per-acre tax is to be incorporated into the measure of taxable value used to calculate school aid. Consequently, we do not know how HF692 will affect the amount of school aid the state must distribute. However, it is possible if not likely that the value assigned to non-agricultural land will be no greater with HF692 than with the current system. In that case, school districts' taxable values would be lower with HF692 than with the current system, and state school aid would be higher.

## Equalization of inflation factors

Section 441.47A requires the Department of Revenue and Finance to equalize the effects of applying the cumulative inflation factor. This is to be done by using data from Iowa State University to calculate county-level values of the annual and cumulative inflation factors. Assessments are to be adjusted when the county-level cumulative inflation factor is 5 percent above

or below the cumulative inflation factor based on the Gross Domestic Product Deflator. Adjustments are to be made every two years beginning August 15, 2007. They would apply to purchases of property and newly constructed property.

The key question raised by this equalization requirement is whether reliable county-level indices of general price inflation can be constructed. There are no continuing and systematic surveys on which to base such indices, so it appears doubtful that meaningful equalization adjustments could be made.[18] Furthermore, adjustment for differential inflation rates may not be needed. Iowa is a small, fairly homogenous state. While there may be differences in price levels across counties, it is less likely, if not improbable, that there are significant inter-county differences in the inflation rate, the rate at which price levels increase.

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[18] See The State of Working Iowa 2001, pp. 58-61 for a critique of various approaches to measuring inter-city differences in price levels.

## Conclusions and Recommendations

If implemented, HF692 would make a number of significant changes in Iowa's property tax system. But some of the changes are not well-enough specified to be operational. Most important, HF692 fails to specify fully how the new per-acre tax on non-agricultural land is to be determined. For that reason alone, the property tax system implicit in HF692 is simply not a workable alternative to the present system.

We can nevertheless identify a number of likely effects of implementing HF692, with the predicted effects depending in some cases on how the per-acre tax on non-agricultural land will work.

■      Incentives for maintaining and improving existing structures would be improved, or, more accurately, disincentives implicit in the current system would be lessened. But the change in incentives would not be the same for all types of improvements; it would favor improvements that only add value, but not space, over improvements that add space. For example, an empty-nest couple adding a jaccuzi pays no more tax, while a young family adding a bedroom for an additional child pays a higher tax.

■      Owners would have an incentive to stay in existing structures instead of selling and either buying different structures or building new ones. HF692 would thus tend to increase investment in existing structures at the expense of investment in new structures.

■      Depending on how much revenue is generated by the land tax, the tax rates on investments in new and existing structures may be either higher or lower with HF692 than they would be with the current system. Consequently, we do not know whether implementing HF692 will encourage or discourage investment in property.

■      Growth of local property tax bases would be slower, requiring higher tax rates on at least some classes of property to maintain spending. Faced with the choice of increasing tax rates or curtailing spending, local governments may adjust on both margins. Implementing HF692 may thus put downward pressure on public service levels.

■      Eliminating rollback would tend to increase the tax share of residential property and reduce shares of other property. But tax shares would also depend on the amount of revenue obtained from the per-acre tax on non-agricultural land. How tax shares would evolve thus depends on how the per-acre tax rate on non-agricultural land is determined. The taxation of non-agricultural land is essentially a "wild card" in any effort to analyze and predict the effects of HF692.

■      Whether more localities would be restricted by mill limits, for debt service and other purposes, would depend on the combined effects of eliminating rollback and changing the way in which non-agricultural land is taxed. The balance of these two influences would also determine whether state school aid would increase or decrease.

■      Although we cannot predict with much certainty the effects of HF692 on debt and revenue capacities and state outlays for school aid, the effects are potentially large and adverse. If the

value of non-agricultural land is not included in calculating debt and revenue limits and state school aid, debt and revenue capacities could be severely reduced, and state outlays for school aid could be sharply increased.

■ Taxes on new structures would increase relative to taxes on existing structures of equal market value. Taxes on homes of newcomers to a community would increase relative to taxes on homes of long-time residents that are of equal market value. These two effects are clear instances of horizontal inequity – unequal treatment of equally situated citizen-taxpayers. Taxing all non-agricultural land in a county at the same rate, as HF692 appears to do, would also generate significant inequities. Compared to the existing system, owners of higher value land would gain, while owners of lower value land would lose. That is, the tax-to-value ratio would fall for higher value land and increase for lower value land. Taxing land differently than structures and other improvements could make the tax system more efficient.

■ A tax on land value that is independent of how the land is used could improve economic efficiency because it does not distort resource allocation decisions. And it captures some of the return on public infrastructure investments that serve the land. For example, when the roads serving an area are improved, the surrounding land becomes more valuable. But this increase in value is not due to investment by landowners. Instead, it results from public infrastructure investment. Therefore, by taxing land values and land value increments, governments can capture part of the return on public investment. That is, some of the return on such invest-ments will be returned to the taxpayers who finance the investments, instead of accruing fully to private landowners.

■ Although eliminating rollback would appear to increase the revenue accruing to TIF districts, the effect of HF692 is in fact unpredictable. One reason is that HF692 does not specify how the change in taxation of non-agricultural land would affect TIF tax bases; that change could work opposite to elimination of rollback. Another is that changes in the tax-base increments accruing to TIF districts would tend to be offset by opposite changes in the tax rate applied to those increments. In particular, the windfall increase in tax base due to elimination of rollback would likely lead to some decreases in tax rates applied by all taxing authorities.

■ We cannot predict how tax shares will change, but we can predict that they will change, and likely change significantly. Implementing HF692 will redistribute taxes among property tax classes and among taxpayers within those classes. And as explained above, the redistribution in some case may be patently unfair, as in the cases of old versus new structures and new versus long-time residents.

■ Given these likely effects of HF692, it does not appear to be an improvement over the present system. But if the Legislature decides in 2005 to modify Iowa's property tax system along the lines of HF692, it should consider the following recommendations for improving the end result.

■ Equalization of inflation factors (Section 441.47A) should not be attempted. Data needed to construct meaningful county-level indices of inflation are not available. And inter-county differences in inflation are likely to be small. Iowa's is a small, highly integrated economy in which price changes for products and services are likely to be fairly uniform

throughout the state.

■     The per-acre tax rates on non-agricultural land should increase with inflation and economic growth. (Note that this is accomplished in the present system by equating the taxable value of land to its current market value.) Otherwise, taxes on non-agricultural land would diminish over time as a share of total taxes. This would make the property tax system less efficient, since land taxes, in contrast to taxes on structures and other improvements, do not distort decisions about the use of land and other resources.

■     It is questionable whether meaningful measures of the productivity value of agricultural structures can be obtained. It would be better to define taxable values of agricultural structures as their market values. This point applies to both HF692 and the current system.

■     The adjustment of taxable values for general inflation – by dividing market values by the cumulative inflation factor – should be reconsidered. So too should the freezing of taxable values on existing property until it is sold or modified. These changes in assessment rules reduce the elasticity of the property tax by breaking the link between taxable values and inflation.[19] Yet that link is important in keeping the growth of revenue in line with the cost of providing public services. Breaking he link will, over the long run, necessarily entail higher tax rates and/or lower government spending. HF692 would reduce disincentives to invest in property. But that could also be accomplished by a less disruptive change in the assessment process. For example, new structures and modifications could be taxed at some fraction of their market value for a specified period of time.

[19] Elasticity measures the response of taxable values to changes in inflation and real economic growth; greater elasticity indicates greater responsiveness.

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