Iowa Fiscal Partnership

EXECUTIVE SUMMARY

November 2008

City Revenue and Smart Growth

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Iowa's cities, whether large or small, are hubs for much of the state's economic growth. They also provide arts and culture venues and important local services such as emergency response, sanitation services and public safety. But cities in Iowa face tough challenges when it comes to generating sufficient revenue to meet the growing demands associated with shifts in population and the economy.

Cities must balance a need for economic development with the need to ensure that this development is sustainable, responsible and fair. Although this balancing act increasingly means that economic development requires regional as well as local planning, current development strategies often undermine regional cooperation and lead cities to engage in a zero-sum game of competing tax incentives. At the same time, the limited set of tools that cities can use to generate revenue often disproportionately affects the budgets of low-income households.

This report analyzes constraints on city finances and systems of local taxation in Iowa and suggests ways to encourage smart, fair and sustainable local and regional economic development through reforming sources of city revenue. Utility franchise fees, local-option excise taxes on alcohol or cigarettes, increased gambling taxes, and the local-option sales tax are not sensitive to the income of those that they tax, and disproportionately impact low-income residents. On the other hand, the local-option income tax, the use of impact fees, and the application of payments in lieu of taxes by tax-exempt properties are all ways for cities to meet their budget needs without undue impacts on low-income families. These revenue options would also help cities move away from their excessive reliance on tax-increment financing (TIF); although at one time targeted at blighted urban areas, TIF is now primarily used in the suburbs and can undermine regional cooperation among cities.

Over the past decade, cuts in state support for local governments during the 2001-04 fiscal crisis, paired with a stagnant tax base and rising costs, have led cities to increase their reliance on property taxes as a source of revenue. Between FY2001 and FY2005, the share of all Iowa cities at the $8.10 general fund levy limit increased from 71 percent to 78 percent, while the share of cities using at least 90 percent of the emergency levy increased by over a third, rising from 23 percent to 31 percent. Although the state fiscal crisis ended in 2004, local government dependence on property tax revenue has continued to increase, although at a slower rate. The share of all Iowa cities at the general fund levy limit increased only slightly between FY2005 and FY2009, moving from 78 percent to 79 percent, while the share of cities using at least 90 percent of the emergency levy increased more substantially, to 35 percent.

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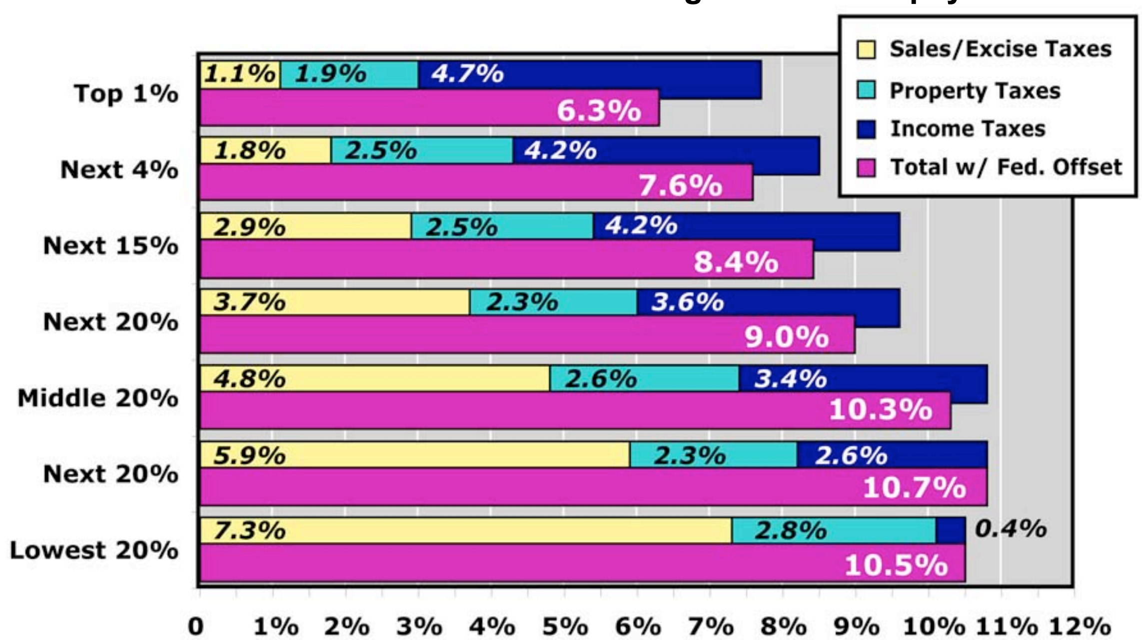
In Iowa, increases in the property values that are the basis of cities' abilities to raise revenue through the property tax are limited by the state "rollback." A rollback is a way of limiting assessments so that the annual growth in assessed values statewide doesn't exceed a certain level. The original purpose of the law, enacted in the late 1970s, was to prevent a dramatic shift in the property tax onto homeowners due to rapid increases in housing prices. For assessment year 2007, the rollback percentage for residential property was 44.1 percent (meaning that residential property is taxed on 44.1 percent of its assessed value).

Faced with a declining tax base, statutory limitations on property-tax increases, and falling levels of intergovernmental aid, cities have turned to fees and local-option taxes as ways to raise necessary revenue. Various forms of local revenue generation have different sets of consequences for Iowans at different income levels.[1] For instance, income taxes are based on a taxpayer's ability to pay, so families with lower incomes pay a lower percentage of their income in income taxes compared with high-income families. On the other hand, sales and excise taxes and property taxes are levied without regard to a family's income. Both wind up taxing lower-income families more heavily as a share of income than higher-income families. For Iowans in the lowest income quintile, for example, sales and excise taxes account for the largest share of their taxes (7.3 percent of income) while income taxes are the smallest (0.4 percent of income).

Iowa State and Local Taxes Favor High-Income Taxpayers



Taxes by Share of Income, Non-Elderly Taxpayers*

* Estimates reflect 2006 income data, 2008 Iowa tax law.

Source: Institute on Taxation and Economic Policy

Because of a heavy reliance on property taxes, city revenues in Iowa are already skewed toward a less fair form of financing. Property taxes take up a decreasing share of income as income increases, although this is most evident at the upper end of the income scale. The fairest way for city governments to raise additional revenue would therefore be to base new taxation on income, rather than on purchases or property. Instead, cities have often sought to increase the tax base through short-sighted economic development policies that undermine opportunities for regional cooperation.

Policies to Avoid

Utility franchise fees, local option excise taxes on alcohol or cigarettes, increased gambling taxes, and the local-option sales tax are not sensitive to the income of those that they tax, and disproportionately affect low-income residents. In addition, although it was at one time targeted to blighted urban areas, tax-increment financing (TIF), is now primarily used in the suburbs and can undermine regional cooperation among cities.

Local Option Sales Tax (LOST) — The sales tax already makes up a greater proportion of low-income households' budgets than it does for families at any other income level. Increasing the local-option sales tax would merely build upon this disparity and generate revenue for city budgets at the expense of those families who can least afford it. Cities may see expanded local-option sales tax authority as an alternative to raising property taxes, but replacing property-tax increases with sales-tax increases simply substitutes a very regressive tax for a roughly proportional tax. The same is true with regard to local-option excise taxes such as cigarette and alcohol taxes.

Utility Franchise Tax — Taxes on utilities also disproportionately affect low-income Iowans, who spend a greater percentage of their income on utility purchases than do Iowans in upper-income brackets. Recognition of this regressivity was one of the principal arguments made in favor of exempting utilities from the sales tax in 2001. Allowing cities to impose an increased franchise tax or fee would essentially reverse this legislative decision and put new strains on low-income families' budgets.

Local Option Excise Taxes — Like sales taxes, excise taxes take up a greater share of incomes at the lower end of the income scale than they do at the upper end. Iowans in the lowest income quintile, earning less than $16,000 a year, pay 1.5 percent of their income in excise taxes, while Iowans in the fourth quintile, earning between $50,000 and $78,000 a year, pay only 0.5 percent of their income in excise taxes. More so than a statewide excise tax, local excise taxes can also distort local commerce if certain products are taxed within city limits but are not subject to taxes outside of cities.

Tax Increment Financing (TIF) — TIF has become the primary economic development tool of local governments, but its misuse can create situations where it is a policy of first resort — going to retail businesses that would have located in a community even without a subsidy, diverting property tax revenue from counties and school districts, and intensifying local competition instead of encouraging cooperation in strengthening the regional economy.

Gambling Taxes — Only a few cities in Iowa receive gaming wager and pari-mutuel wager taxes, which are levied on gambling revenues. Even so, proposals to expand these taxes would generally affect low-income gamblers more than high-income gamblers. Research finds that gambling taxes constitute a larger share of income for gamblers at the lower end of the income scale.

Policies to Embrace

Revenue options that take account of families' ability to pay taxes and promote regional growth decisions are already available to local governments in limited ways but could be substantially expanded as cities look to meet growing needs.

Local Option Income Tax — School districts in all of Iowa's 99 counties already levy a local-option income surtax, which is added to the state individual income tax and remitted back to school districts. If cities were authorized to levy a local-option income tax as well, they would have a progressive revenue generation tool that is simple to administer. According to the National League of Cities, cities in states that authorize the local-option income tax have less reliance on the property tax as a source of revenue.

Impact Fees — Impact fees are one-time fees levied by local government on builders or developers in order to generate a portion of the revenue that will be needed to fund public services and infrastructure for new residents. Iowa law does not explicitly allow local governments to impose impact fees, although cities are able to negotiate with developers and levy other charges that function similarly to impact fees. If expanded, impact fees could incent more efficient land-use patterns by encouraging development near existing services.

Payments In Lieu Of Taxes (PILOT) — Payments in lieu of taxes are voluntary payments made on behalf of tax-exempt property, negotiated to compensate cities for fire and police protection of those properties. Iowa cities could in some cases raise substantial amounts of revenue by negotiating with tax exempt properties to contribute to public safety protection. If cities were given authority to exercise greater discretion in determining the terms of exemption, they could choose to phase in or phase out an exemption in order to prevent sharp adjustments to a city tax base, use zoning to limit qualifying areas where an exempt property would be located within the city, or set a dollar amount limit on the property's exempt value.

Cities should be allowed new revenue sources that bring them together rather than driving them to compete ever more intensely for the prizes of commercial or industrial tax base. Cities recognize that they are part of a regional economy and it is time that Iowa's system of local finance is transformed to align with this fact of regionalism. As a result, when identifying new revenue sources for local government in Iowa, policymakers must consider the distributional impacts of these choices, as well as their consequences for sustainable economic development.

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[1] For a full discussion of how different kinds of taxes affect Iowans at different income levels, see the recent Iowa Fiscal Partnership analysis, *"Who Pays Iowa Taxes?"* Available from: http://www.iowapolicyproject.org/2008docs/081110-WhoPays.pdf.

Iowa Fiscal Partnership

The Iowa Fiscal Partnership is a joint initiative of the Iowa Policy Project and the Child & Family Policy Center, two nonprofit, nonpartisan Iowa-based organizations that cooperate in analysis of tax policy and budget issues facing Iowans. IFP reports are available on the web at http://www.iowafiscal.org.

The Iowa Fiscal Partnership is part of the State Fiscal Analysis Initiative, a network of state-level organizations and the Center on Budget and Policy Priorities to promote sound fiscal policy analysis. IFP work is supported by the Stoneman Family Foundation and the Annie E. Casey Foundation.