# City Revenue and Smart Growth

Beth Pearson
Peter S. Fisher

November 2008

Iowa Fiscal Partnership
www.iowafiscal.org

**The Iowa Policy Project**
20 E. Market Street
Iowa City, IA 52245
(319) 338-0773 (phone) • www.iowapolicyproject.org

**CHILD & FAMILY POLICY CENTER**
1021 Fleming Building • 218 Sixth Ave.
Des Moines, IA 50309
(515) 280-9027 (phone) • www.cfpciowa.org

## Acknowledgments

The authors thank Steve Ford at the Department of Management, Cary Halfpop and Carmen Putzier at the Department of Revenue, and Shannon Paseka at the Iowa League of Cities for their assistance in compiling data for this report. We are grateful for the support of the Center on Budget and Policy Priorities, the Stoneman Family Foundation, and the Annie E. Casey Foundation.

## Authors

***Peter S. Fisher*** is research director at the Iowa Policy Project. He is a Professor in the Graduate Program in Urban and Regional Planning at the University of Iowa. A national expert on public finance, his reports are regularly published in State Tax Notes and refereed journals.

***Beth Pearson*** is a research associate at the Iowa Policy Project, where she analyzes economic and fiscal trends in the state of Iowa. She received her master's degree in Development Studies from the University of Oxford in 2007.

## 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.

November 2008

# City Revenue and Smart Growth

By Beth Pearson and Peter S. Fisher

## Introduction

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 impacts 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 affect low-income residents. Revenue generation can be done, however, in a way that recognizes the differences in residents' ability to pay taxes and supports a regional economic development agenda. 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.

The local-option income tax in particular is an excellent way for cities to reduce their dependence on property taxes while making their revenue system more progressive. 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. 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.

**The Iowa Policy Project**
20 E. Market Street
Iowa City, IA 52245
(319) 338-0773 • www.iowapolicyproject.org

**CHILD & FAMILY POLICY CENTER**
1021 Fleming Building • 218 Sixth Ave.
Des Moines, IA 50309
(515) 280-9027 • www.cfpciowa.org

## City Finances in Iowa

This report relies on data collected directly from Iowa's local governments as part of the city budgeting process for FY2009. During this process, each city submits a budget form detailing its revenues and expenditures to the Department of Management. In order to fund operations, infrastructure and public services, cities in Iowa rely on revenue from local taxes, state and federal aid, and charges and fees. As Figure 1 illustrates, the main source of revenue for city general funds is property taxes.[1] Property taxes are raised through the general fund levy, as well as any additional levies that have been approved by the city council. A "levy" is an amount of money required for collection by a taxing authority, and is usually expressed as the amount of tax paid for every $1,000 in taxable valuation. Some levy rates are statutorily limited so that they may not exceed a certain level. For instance, the general fund levy rate cannot exceed $8.10 per $1,000 of taxable assessed valuation. And the emergency levy rate, which can be used only when the general levy is already at $8.10, is $0.27 per $1,000 of taxable valuation. Other levy rates are unlimited, such as the employee benefit levy, levies that fund a city's liability insurance, or the debt service levy.

**Figure 1. Iowa Cities Rely Most on Property Taxes, FY2009**

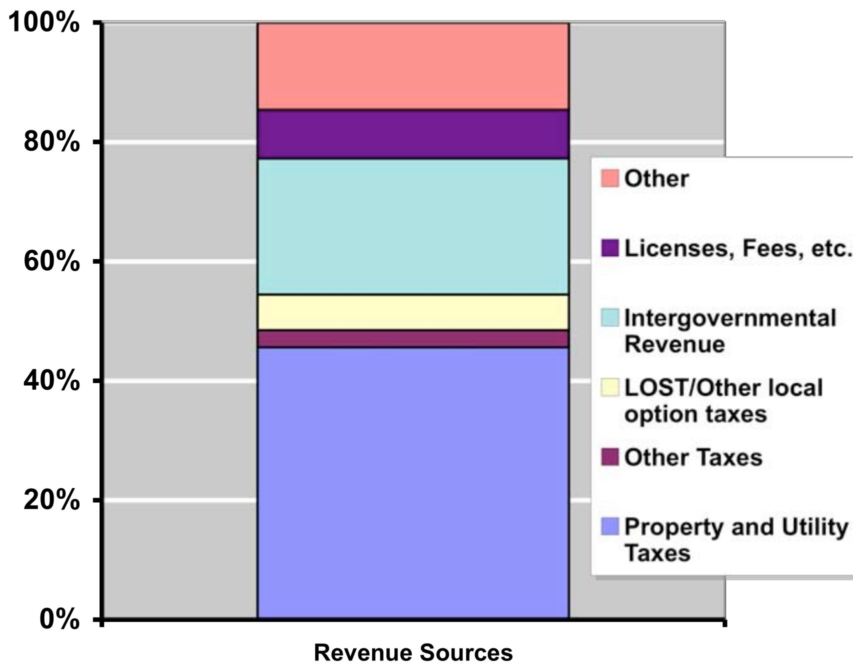



Table 1 and Figure 1 provide more detailed breakdowns of the share of city revenue in Iowa that comes from various sources. Property taxes account for about 46 percent of city revenue, while intergovernmental aid is 23 percent. Licenses and fees, which include charges associated with city-run enterprises such as trash collection, municipal utilities, parking fees or airport usage, make up 8 percent of city revenues. Other taxes comprise about 9 percent of city revenue (the local-option sales tax, or LOST, makes up 6 percent of city revenue, while the "other taxes" category that includes the hotel/motel tax and gambling taxes is an additional 2.9 percent).

**Table 1. Revenue Sources for Iowa Cities, FY2009**

| | Share of Total Revenue |
|---|---|
| Property and Utility Taxes | 45.6% |
| Intergovernmental Revenue | 22.8% |
| LOST/Other local-option taxes | 6.0% |
| Other Taxes | 2.9% |
| Licenses, Fees, Etc. | 8.2% |
| Other | 14.6% |
| Total Revenues | 100.0% |

*Source: Iowa Department of Management*

[1] This chart relies on budget year totals from the FY2009 budget forms, which means that it includes revenue deposited into the special revenues fund, TIF fund, debt service fund and capital projects fund as well as the general fund. The licenses and fees category excludes proprietary fund revenue. The category "other taxes" includes revenue from the gaming wager tax, mobile home taxes, hotel/motel tax, pari-mutuel wager tax and the utility franchise tax.

Revenue flows into city funds, each of which is used for certain purposes. For instance, the largest fund in the city budget is the general fund; revenues deposited in the general fund are used for basic services such as police and fire protection, maintaining city streets, and city administration.

Our analysis does not focus on how Iowa cities compare to those across the nation; however, a 2002 report by Dave Swenson and Liesl Eathington at Iowa State University used Census data on local government finance from 1992 and 1997 to compare the sources of revenue and the place of property tax revenue in city budgets for Iowa and the nation.[2] Swenson and Eathington found that, on a per capita basis, Iowa cities rely more on property taxes and general charges and less on intergovernmental aid, business and vehicle licenses, and local taxes — most notably, local option income and sales taxes — than average U.S. cities. A more recent analysis by the National League of Cities confirms that Iowa cities continue to be more reliant on the property tax, and less reliant on local sales and income taxes, than the national average.[3]

## The Problem: Increased Demand Leads to Need for New Revenue Sources

City budgets must balance the revenues raised from a local tax base against public demand for services and a backdrop of rising costs. Population and income growth drive demand, but such growth does not necessarily produce a larger tax base as state laws limit increases in the taxable value of property.

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.[4] 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, Table 2 and Figures 2 and 3 show how 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, while the share of cities using at least 90 percent of the emergency levy increased by 4 percentage points.

### *Impacts of 2008 Flooding*

*Beyond the challenges of financing public services with a stagnant tax base, the need for new local revenue sources has been particularly emphasized in cities experiencing flooding during the summer of 2008. In the case of these cities, the tax base may actually have declined due to loss of business or residential property at the same time that a need for services and revenue is even greater. Although the reduction in taxable value from flooding will not show up until the January 2009 assessments, which determine the tax base for fiscal 2009-10, there are additional and immediate losses of revenue. The city of Cedar Rapids, for example, has estimated that it will lose in excess of $2 million in property tax revenue in this fiscal year and again next year due to an increase in delinquencies caused by the flood rendering hundreds of homes uninhabitable.*

---

[2] Swenson, Dave and Liesl Eathington (2002). *An Investigation of City Government Finances in Iowa and the Nation*. Iowa League of Cities. Available from: http://www.iowaleague.org/Downloads/Legislative/2003/Swenson.pdf.

[3] Hoene, Christopher and Michael Pagano. *City and State Fiscal Structure*. Washington, DC: National League of Cities, 2008. Available from: http://www.nlc.org/ASSETS/131BB38D990B4B8C9A703AFDE4B4563E/CitiesandStateFiscal.pdf.

[4] For a full description of the effects of the state fiscal crisis on local governments in Iowa, see Fisher, Peter S., Victor Elias and Jeremy Varner. *Iowa's State Fiscal Crisis and Its Impact on Local Government*. Iowa Fiscal Partnership, 2004. Available from: http://iowafiscal.org/documents/041215-ifp-local-full.pdf.

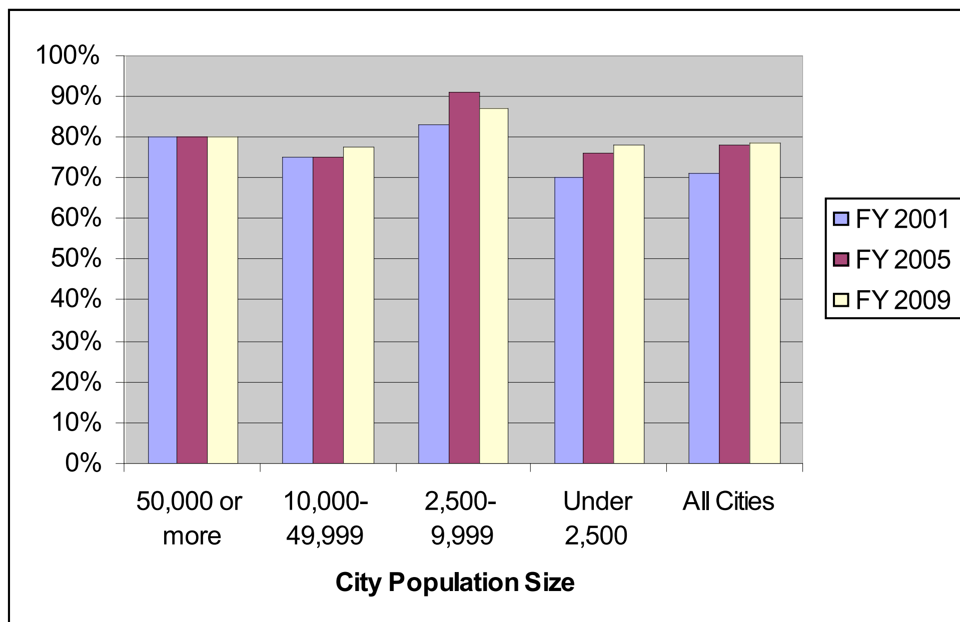
**Table 2. Increasing Share of Iowa Cities Reaching Levy Limits, FY2001-09**

| | City Population Size | | | | |
|---|---|---|---|---|---|
| | **50,000 or more** | **10,000-49,999** | **2,500-9,999** | **Under 2,500** | **All Cities** |
| Total Population (est. July 2007) | 865,207 | 549,297 | 460,643 | 462,882 | 2,338,029 |
| Number of Cities | 10 | 27 | 93 | 817 | 947 |
| Percent of Total Population in Cities | 37% | 23% | 20% | 20% | 100% |
| ***Percent of Cities at $8.10 General Fund Levy Limit*** | | | | | |
| FY2001 | 80% | 75% | 83% | 70% | 71% |
| FY2005 | 80% | 75% | 91% | 76% | 78% |
| FY2009 | 80% | 78% | 87% | 78% | 79% |
| ***Percent of Cities Using at Least 90 Percent of Emergency Levy*** | | | | | |
| FY2001 | 30% | 25% | 32% | 22% | 23% |
| FY2005 | 50% | 33% | 44% | 29% | 31% |
| FY2009 | 40% | 37% | 48% | 33% | 35% |

*Source: Iowa Department of Management*

Cities of different sizes have experienced different trends with regard to property-tax levies. Iowa's largest cities have been more stable, with no change between FY2001 and 2009 in the percentage of cities at the general fund levy limit, while the share of the state's smallest cities at the general-fund levy limit has grown more than 10 percent since FY2001.

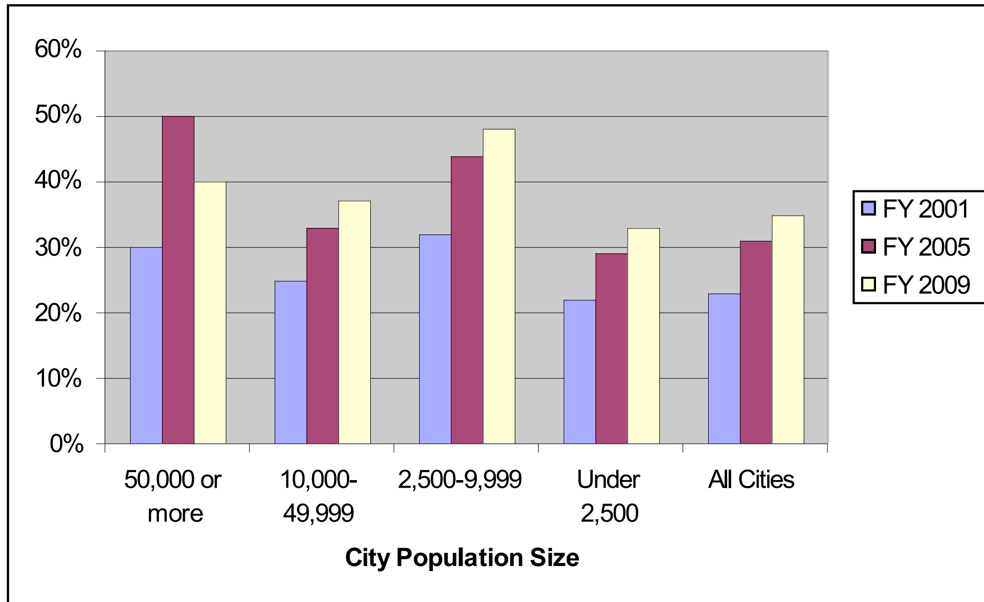
**Figure 2. More of Iowa's Smallest Cities at General Fund Levy Limit**
***Percent of Iowa Cities at General Fund Levy Limit by Size, FY2001-09***




Iowa's largest cities have retreated from 2005 when fully half of them used the entire allowable general fund levy as well as at least 90 percent of the emergency levy. However, they have not returned to pre-

fiscal crisis levels when only 30 percent of large cities were in this predicament. Cities of all other sizes saw steady increases in the share of their numbers relying on a large percentage of the emergency levy.

**Figure 3. Growing Share of Small Cities Using Most of Emergency Levy**
***Percent of Iowa Cities at 90 Percent of the Emergency Levy by Size, FY 2001-09***




### *Assessment Limitations*

Levy limits are not the only constraint on the amount of revenue that cities may raise through property taxes. Property tax revenue also depends on the value of the property that is being taxed. In Iowa, increases in property values 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.

Since 1980, the rollback has been set at 4 percent, which means that aggregate taxable valuations for each class of property (residential, agricultural, commercial, industrial) cannot increase more than 4 percent each year. The rollback percentage is multiplied by the assessed value in order to obtain the taxable value of the property; the tax due is then calculated by multiplying taxable value by the tax rate. The assessed value of property is its actual or 100 percent market value for all classes of property except agricultural; the assessed value of agricultural land and buildings is based on a productivity formula.[5]

Over the past 30 years, the application of the rollback has been effective in greatly limiting the taxable value of residential property. 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), while the rollback percentage for commercial property was almost 100 percent (meaning that it was basically taxed on its full assessed value). Industrial property was also taxed on 100 percent of its assessed value. Increased crop prices and yields in 2005 — the most recent year incorporated into the five-year rolling average used to calculate agricultural productivity value — led to higher assessed values of agricultural

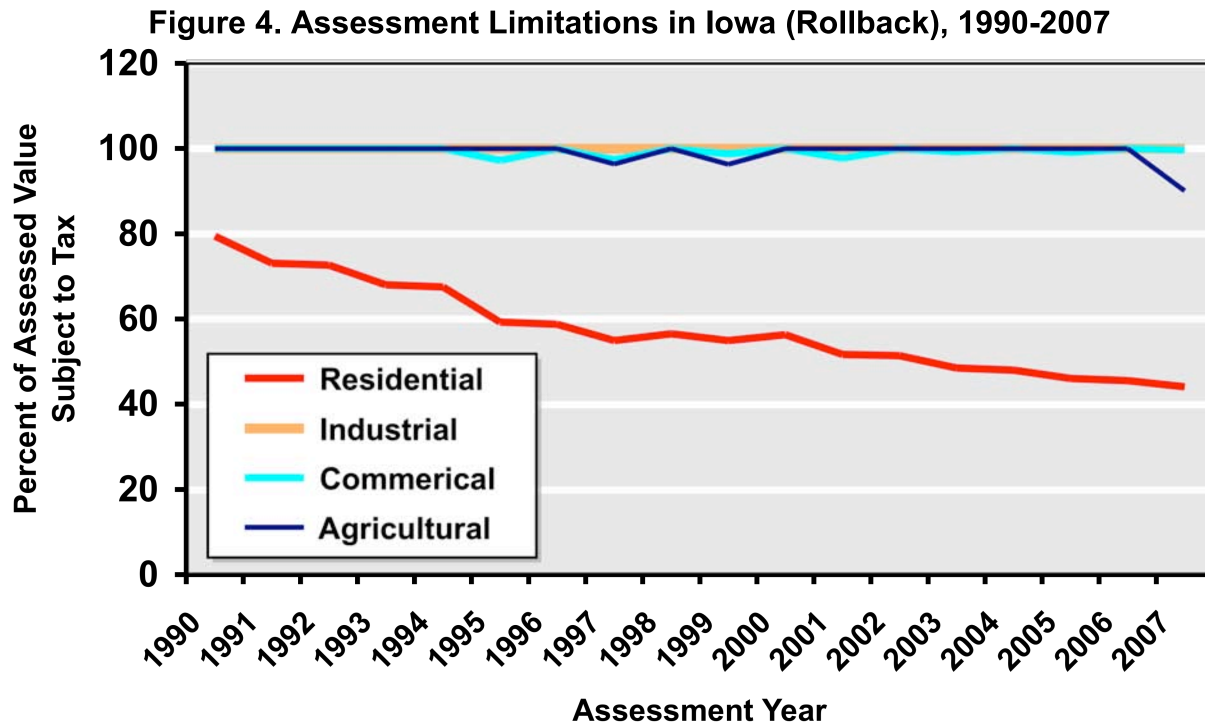
[5] For a full discussion of the assessment and taxation of agricultural property in Iowa, see Pearson, Beth and Peter Fisher. *Grounds for Confusion: Iowa's Distorted Assessment of Farm Property*. Iowa Policy Project, 2008. Available from: http://www.iowapolicyproject.org/2008docs/080717-agprop2.pdf.

property in 2007 and the first application of the rollback to agricultural property since 1999. A rollback factor of 90.1 percent was applied in 2007, meaning that the taxable value of agricultural property was 90.1 percent of its so-called productivity value.

The rollback calculation is best explained through an example. Suppose the statewide total actual value of residential property in 2004 was $100 billion, and the rollback that year was 50 percent. Then the statewide total taxable value would be $50 billion. Suppose by 2005 that residential market value had risen 6 percent to $106 billion. Taxable value, however, cannot by law increase more than 4 percent statewide, which means that taxable value for 2005 must instead be $52 billion. The rollback percentage is therefore the ratio of taxable to actual value that will produce a maximum 4 percent growth in taxable value. In other words, the rollback for 2005 must be 52/106, or 0.4906 (49.06 percent).

Over the past several decades, application of the rollback has meant that steady growth in housing values has caused consistent decline in the share of residential property subject to taxation. This trend has been amplified by the fact that, in addition to being limited by the rollback, residential and agricultural assessed values are tied together such that annual increases for each class of property are limited to the smaller of the two increases in either class of property. For example, if in a given year the increase in residential property valuations was 4 percent (remember that it cannot be higher than 4 percent due to the rollback limitation) and the increase in agricultural property valuations was only 2 percent, then the increase in residential property valuations would be reduced to 2 percent as well. Like the rollback, this tie was seen as a way to limit increases in the taxable value of residential property. As Figure 4 illustrates, the effect of the rollback and the tie between residential and agricultural property has been to institutionalize a decline in the residential property tax base.

**Figure 4. Assessment Limitations in Iowa (Rollback), 1990-2007**




Because assessors must apply the same ratio to the actual value of each residential parcel, regardless of how rapidly or slowly home prices are increasing in their jurisdiction, the rollback tends to limit government revenues more in slow-growing areas than in rapidly growing areas. Take, for example, the change from 2006 to 2007, when the rollback declined from 45.56 percent to 44.08 percent. A home worth $100,000 in 2006 in a declining area might still be worth just $100,000 on the market in 2007, but

its taxable value will decline about 3 percent, from $45,560 to $44,080, because of the decline in the rollback. On the other hand, a $100,000 home in a growing area might have increased in value to $110,000, in which case its taxable value will increase from $45,560 to $48,488 (44.08 percent of $110,000), a 6 percent increase. Rapidly growing areas can see an increase in the tax base, though a smaller one than would result in the absence of a rollback. Slow-growing areas, however, may see an actual decline in taxable value over time even while the costs of government increase simply due to inflation.

## Local Revenue and Fairness

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. Although there is no question that cities need additional flexibility in diversifying revenue sources so that they can meet their needs, not all local financing mechanisms are created equal in terms of their ability to fairly generate sustainable revenue. Many proposed local revenue strategies are not structured progressively, meaning that they are not based on the ability of residents to pay these fees or taxes and ultimately generate dollars for the city with disproportionate impacts on low-income residents.

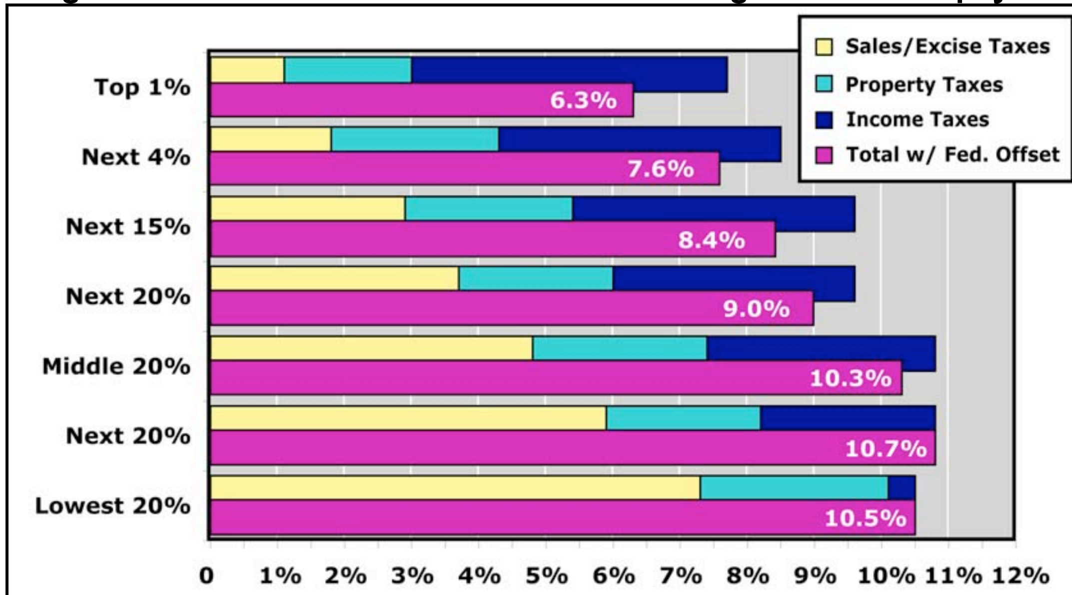
Various forms of local revenue generation have different sets of consequences for Iowans at different income levels. For instance, income taxes are based on a taxpayer's ability to pay, so families with lower incomes pay a lower percentage of their income in income taxes compared with high-income families. 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, making them "regressive" taxes. The sales tax is the most regressive in this regard. Figure 5 (next page) uses data from the Institute on Taxation and Economic Policy to illustrate the share of family income taken up by different kinds of state and local taxes at each income level. For Iowans in the lowest income quintile, 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).

Because of a heavy reliance on property taxes, city revenues in Iowa are already skewed toward a less fair form of financing. As Figure 5 shows, 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 model used here to estimate tax incidence assumes that both homeowners and renters pay property taxes, either directly or as a portion of their rent. Although property taxes are fairer than the sales and excise tax, they are not as fair as the income tax, which increases in tandem with income. Mobile homes and manufactured homes located in mobile home parks are subject to property taxes based on the square footage of the home but at a graduated rate depending on income.[6] The property taxes on these types of property are therefore more progressive, although there is a flat rate of 20 cents per square foot if the resident has an annual income of greater than $16,500. This rate declines over time to account for the depreciation in value of the property. Since mobile homes and manufactured homes located within mobile home parks are affordable forms of housing, their treatment in the tax code helps improve the fairness of property taxes in general, but the overall structure of local government finance in Iowa remains regressive.

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. In the following section, we review the various options available to city governments for raising non-property tax revenue and we assess how these options

[6] Iowa Code Chapter 435

**Figure 5: Iowa State and Local Taxes Favor High-Income Taxpayers**




**Taxes by Share of Income, Non-Elderly Taxpayers***

| **Income Group** | **Lowest 20%** | **Next 20%** | **Middle 20%** | **Next 20%** | **Next 15%** | **Next 4%** | **Top 1%** |
|---|---|---|---|---|---|---|---|
| Income Range | Less than $16,000 | $16,000-$33,000 | $33,000-$50,000 | $50,000-$78,000 | $78,000-$127,000 | $127,000-$320,000 | $320,000-plus |
| **Avg Income** | **$8,600** | **$24,500** | **$41,300** | **$62,600** | **$96,500** | **$183,800** | **$831,100** |
| **Sales/Excise Taxes** | **7.3%** | **5.9%** | **4.8%** | **3.7%** | **2.9%** | **1.8%** | **1.1%** |
| *General Sales-Individuals* | *4.2%* | *3.6%* | *3.1%* | *2.5%* | *2.0%* | *1.2%* | *0.8%* |
| *Other Sales & Excise-Ind.* | *1.5%* | *0.9%* | *0.7%* | *0.5%* | *0.3%* | *0.2%* | *0.1%* |
| *Sales & Excise on Business* | *1.6%* | *1.3%* | *1.0%* | *0.8%* | *0.6%* | *0.4%* | *0.2%* |
| **Property Taxes** | **2.8%** | **2.3%** | **2.6%** | **2.3%** | **2.5%** | **2.5%** | **1.9%** |
| *Property Taxes on Families* | *2.6%* | *2.1%* | *2.4%* | *2.1%* | *2.3%* | *1.9%* | *0.8%* |
| *Other Property Taxes* | *0.2%* | *0.2%* | *0.1%* | *0.2%* | *0.2%* | *0.6%* | *1.2%* |
| **Income Taxes** | **0.4%** | **2.6%** | **3.4%** | **3.6%** | **4.2%** | **4.2%** | **4.7%** |
| *Personal Income Tax* | *0.4%* | *2.6%* | *3.4%* | *3.6%* | *4.2%* | *4.1%* | *4.5%* |
| *Corporate Income Tax* | *0.0%* | *0.0%* | *0.0%* | *0.0%* | *0.0%* | *0.1%* | *0.2%* |
| Total Taxes | 10.5% | 10.7% | 10.8% | 9.7% | 9.7% | 8.4% | 7.7% |
| Federal Deduction Offset | 0.0% | 0.0% | 0.4% | 0.8% | 1.3% | 0.8% | 1.4% |
| **Total With Federal Offset**** | **10.5%** | **10.7%** | **10.3%** | **9.0%** | **8.4%** | **7.6%** | **6.3%** |

* Estimates use 2006 income data and 2008 Iowa state tax law.

** Federal Offset: Figures account for deduction of state income and property tax on individual federal tax returns.

*Source: Institute on Taxation and Economic Policy, 2008*

measure up in terms of equity for low-income Iowans. We also consider the question of how these taxes would affect location or purchase decisions since, because they are imposed locally, cities' use of local-option taxes will create intrastate tax rate differentials. In general, these effects are likely to be small. Intrastate tax rate differentials already exist in Iowa under the local-option sales tax and, until recently, the locally authorized school infrastructure finance tax. Property tax rates are different in every

community in Iowa, and there is little evidence that they affect location decisions to any measurable extent. All taxes distort economic decisions to some degree; however, there is little evidence that local-option income taxes would create serious distortion as long as enabling legislation limited localities to imposing a specific range of rates. These limitations are common, as in the case of the state decision to allow cities to levy a 1-cent (and no greater) local-option sales tax.

### *Local Option Sales Tax*

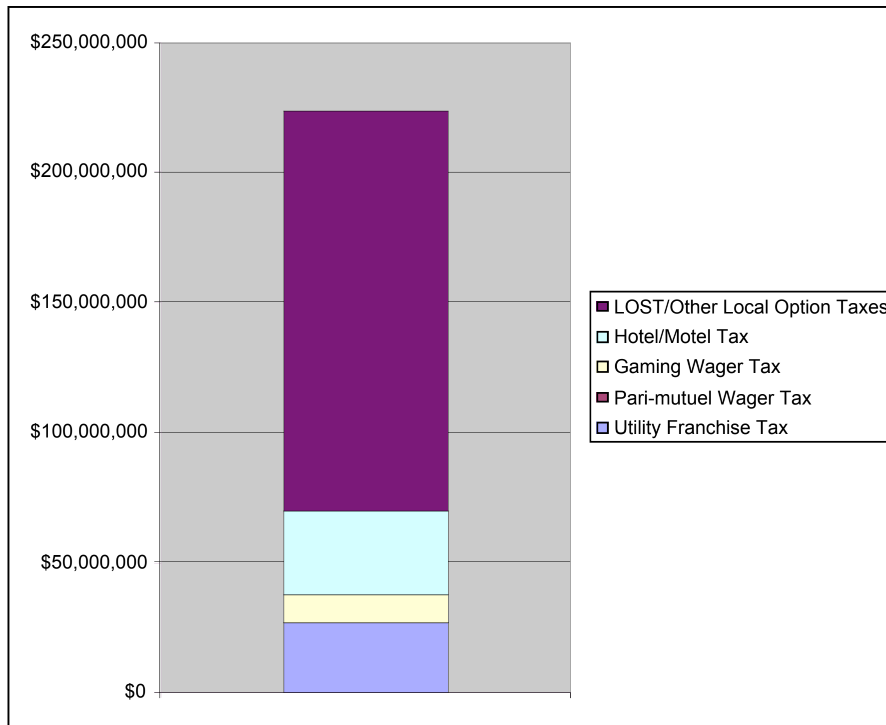
Currently, local-option sales tax (LOST) revenue makes up the bulk of non-property local tax revenue in Iowa. In fact, as Table 3 and Figure 6 illustrate, almost 70 percent of non-property local tax revenue

**Table 3. Non-Property Sources of Local Tax Revenue, FY2009**

| | FY2009 Revenue | Share of Non-Property Tax Revenue |
|---|---|---|
| LOST/Other Local-Option Taxes | $153,753,112 | 68.7% |
| Hotel/Motel Tax | $ 32,517,435 | 14.5% |
| Utility Franchise Tax | $ 26,670,327 | 11.9% |
| Gaming Wager Tax | $ 10,862,784 | 4.9% |
| Pari-mutuel Wager Tax | $ 118,262 | 0.1% |
| Total Non-Property Tax Revenue | $223,891,920 | 100.0% |

*Source: Iowa Department of Management*

**Figure 6. Local Option Sales Tax Accounts for Bulk of Non-Property Tax Revenue**




*Source: Iowa Department of Management*

comes from the local-option sales tax.[7] Local-option sales taxes are added on to the state sales tax and for the most part apply to the same goods and services as does the state sales tax. The principal exceptions are residential energy (the local-option sales tax applies to residential electric and natural gas bills, which are no longer subject to the state sales tax, as long as those utility sales are not already subject to a franchise fee) and motor vehicles (which are subject to the state use tax but not the local option tax). The 2008 addition of a statewide, 1-cent tax for school infrastructure increased the statewide sales tax rate from 5 percent to 6 percent (though the motor vehicle use tax remains at 5 percent). In areas where a local-option sales tax is also in effect, the total tax rate therefore stands at 7 percent.

Originally approved by the Legislature in 1985, local-option sales taxes cannot exceed 1 percent. LOST elections are held on a countywide basis and LOST then applies in those jurisdictions where it receives voter approval. A county election could therefore result in LOST approval only for certain cities or unincorporated portions of the county. Local-option sales taxes are collected and pooled by county and then remitted to localities by the state Department of Revenue based on a formula involving the population and property-tax levies of the jurisdictions imposing the tax. Only those jurisdictions that have approved a LOST will receive any revenue. Cities and counties may use LOST revenue for any lawful purpose, including bond collateral and property-tax relief.

The majority of Iowa's cities and unincorporated places have passed local-option sales taxes, and local-option sales tax revenue has grown quickly over the past two decades.[8] Some cities have imposed sunset provisions on local-option taxes, although this is optional. Currently, 1,191 out of a total 1,342 jurisdictions in Iowa have a local-option sales tax, or 89 percent of all jurisdictions in the state. According to analysis by the Iowa Legislative Services Agency, 62 counties had a LOST in 100 percent of their jurisdictions during FY2008, while another 26 counties had a LOST in at least 75 percent of their jurisdictions. Johnson County is the only county in Iowa without any jurisdictions with a local-option sales tax. The five counties in the Des Moines metro area (Polk, Dallas, Guthrie, Madison and Warren) include only 22 smaller cities with LOST, out of 83 jurisdictions (less than one-third of cities within the metro area).

Although expanding city authority to levy additional local-option sales taxes may be tempting because of the magnitude of potential revenue relative to other local-option taxes, such a choice would disproportionately and negatively impact middle- to low-income households in Iowa. 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.

Other efforts to expand local-option sales tax authority have proposed allowing cities to retain all tax revenue generated from the imposition of the tax, rather than sharing the revenue under the countywide distribution formula now used. The countywide sharing is an important feature of Iowa's tax, recognizing that sales-tax revenues are generated from a broad retail market, not just from the residents

[7] Mobile home taxes have been included in the category of property tax since they function as property taxes, although with a different set of assessment criteria.

[8] For information and analysis related to local-option sales taxes in Iowa, see Iowa Legislative Services Agency (2007) *Local Option Sales Tax*. Available from: http://www.legis.state.ia.us/lsadocs/IssReview/2008/IRSLS001.PDF. Also see http://www.iowa.gov/tax/educate/localoption.html for Iowa Department of Revenue data and information on local option sales taxes.

of the city where the retail center happens to be located. A small city that is home to a large regional shopping center could derive an inordinate amount of revenue relative to the size of its budget with a 1 percent tax, if it were allowed to keep all of the revenue. While the market region can be much larger than a county, the countywide sharing at least acknowledges that the source of revenue is much broader than any one city and prevents cities that are home to large retail centers from financing their city government largely at the expense of residents of neighboring cities and rural areas.

Allowing cities to retain LOST revenue was in fact partially accomplished through legislative changes made to Iowa's tax code during the 2008 session that authorized cities to capture local-option sales tax revenue if it was generated in urban renewal areas. This extension of tax-increment financing (TIF) means cities can prevent revenue from going into a countywide pool for distribution, which reduces equity and increases the incentive for each locality to create its own sales-tax TIF. The new law is a particularly unfortunate expansion of TIF as it focuses exclusively on retail activity. Retail is local-market driven and the private market can be counted on to build more retail space whenever local market conditions can support that space. Subsidies to developers in most cases are either unnecessary (if the market would support the additional activity) or counterproductive (if the market cannot, in which case the city is subsidizing the overbuilding of the retail sector and helping create vacancies in existing retail centers). In some cases, the market can support additional retail development without the subsidy but the subsidy is believed to be effective in shifting the location of the new retail space. In this instance, state policy is encouraging localities to engage in a beggar-thy-neighbor strategy that in the end merely shifts retail development from one place to another within the same market, creating no new jobs or tax base and wasting taxpayer funds.

### *Hotel/Motel Tax*

After local-option sales taxes, the hotel/motel tax is the most lucrative local-option tax for city governments in Iowa, making up 14.5 percent of non-property tax revenue. According to the Department of Revenue, 133 Iowa cities currently have a hotel/motel tax, which taxes the rental of hotel or motel rooms at a rate not to exceed 7 percent. All Iowa cities with a hotel/motel tax currently set the tax between 5 percent and 7 percent, except for Elk Horn's 3 percent tax and Sioux Center's 1 percent tax. The total tax on the purchase of a hotel room in Iowa will therefore range between 6 percent (the statewide sales tax rate in a locality without the local-option sales tax) to 14 percent (a city with a local-option sales tax and the full 7 percent hotel/motel excise tax allowed under Iowa law).

Hotel/motel taxes are generally a way to export taxes to nonresident taxpayers since most people renting hotel rooms are not city residents. It is difficult to estimate the incidence of the hotel/motel tax because it will depend on the distribution of spending on motel rooms by income class and could therefore vary greatly based on geography and other circumstances. For instance, if hotel/motel rooms in a city are predominantly used by business travelers or vacationers, the tax may be distributed progressively in that city because it tends to be paid by people with higher incomes. On the other hand, if the rooms are used primarily by visitors who have come for consultation at a hospital, they will tend to affect people without regard to income and will be decidedly less progressive.

### *Utility Franchise Tax*

A utility franchise tax (also called the city franchise fee) can be imposed on any privately owned utility (such as those providing electricity, natural gas, water, cable TV or telephone service) where the city has a franchise agreement with the utility to provide service to city residents. The tax, which is passed on to utility consumers, cannot exceed the city's costs of inspecting or regulating the utility. If a city chooses to adopt a franchise fee, it forfeits its ability to collect local-option sales tax revenue from gas and

electric sales since Iowa law provides that gas and electric sales may not be taxed by a local-option tax if these sales are already subject to a franchise fee.

There have been proposals to allow cities to impose a franchise tax of up to 5 percent of the gross revenues of utilities and to allow the revenues of all franchise fees, new and existing, to exceed the costs of regulation, with the excess being transferred into the city general fund. Such a change in the law would, in effect, reverse the 2001 utility-tax exemption that phased out state taxes on the sale of gas and electricity to residential customers. Such purchases would be subject to what is the exact equivalent of a 5 percent sales tax. Cities would gain from any franchise fee above 1 percent since franchise revenue would then exceed what the city loses from the 1-cent local-option sales tax exemption.

Taxes on utilities again disproportionately affect low-income Iowans, who spend a greater percentage of their income on utility purchases than do upper-income Iowans. Recognition of this regressivity was one of the principal arguments made in favor of exempting utilities from the sales tax in 2001.

**Table 4. Impact of Local 5 Percent Tax on Utilities, by Income Class**

| Income Range | $5,000-<br>$19,999 | $20,000-<br>$49,999 | $50,000<br>and more |
|---|---|---|---|
| Average income before taxes | $12,732 | $34,041 | $99,492 |
| Average expenditures | | | |
| Natural gas, electricity and fuels | $ 1,272 | $ 1,746 | $ 2,352 |
| Expenditures as a percent of income | | | |
| Natural gas, electricity and fuels | 10% | 5.1% | 2.4% |
| **Impact of sales tax** | | | |
| **5% sales tax on utilities** | **$ 63.59** | **$ 87.31** | **$ 117.60** |
| **Additional taxes as share of average income** | **0.5%** | **0.3%** | **0.1%** |

*Source: Table 32. Midwestern region by income before taxes: Average annual expenditures and characteristics, Consumer Expenditure Survey, 2005-2006*

As Table 3 shows, Midwesterners earning less than $20,000 a year spend 10 percent of their income on utility purchases, while Midwesterners earning over $50,000 spend less than 3 percent of their income on utilities. Increasing the franchise fee by 5 percent would cause low-income Iowans to pay a greater share of their income in utility taxes than Iowans at other income levels.

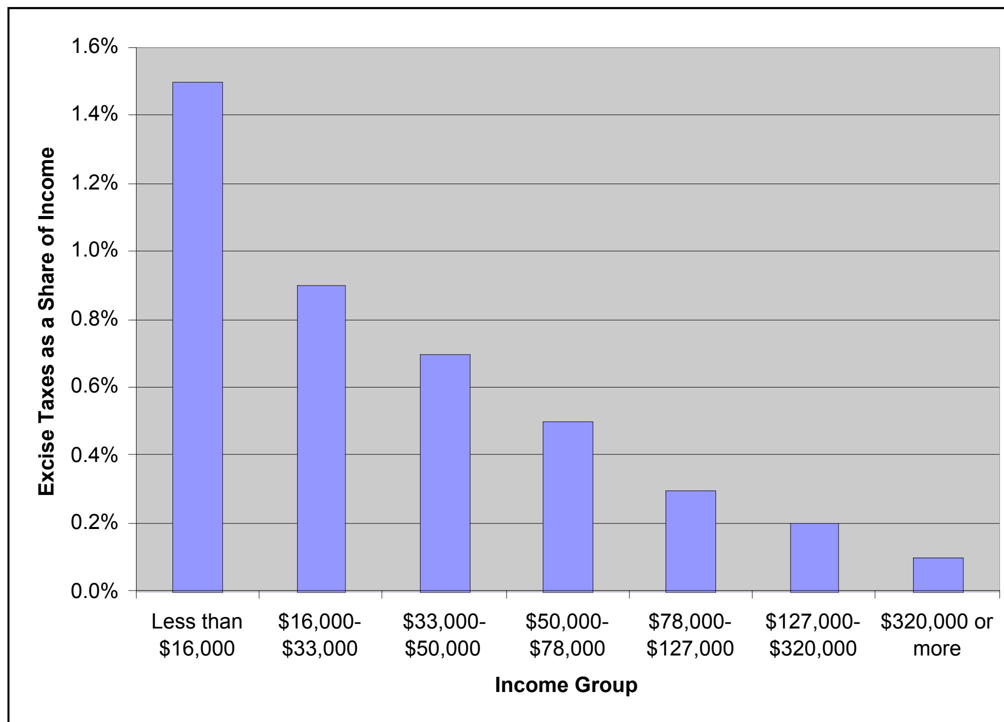
### *Local Alcohol, Cigarette and Tobacco Excise Taxes*

Cities in Iowa are not currently authorized to impose excise taxes. An excise tax is a per-unit tax on a specific service or commodity; the most common excise taxes in Iowa are those on motor fuel, cigarettes and tobacco products, and alcoholic beverages. Cigarettes are taxed by the state of Iowa at $1.36 per pack and other tobacco products are generally subject to a tax of 50 percent of wholesale.[9] Beer in Iowa is taxed at 19 cents per gallon while wine is taxed at $1.75 per gallon.

[9] Excise taxes on tobacco products vary according to the product, with cigars being taxed at $.50 per cigar or 50 percent, whichever is lower, and snuff taxed at $1.19 per ounce. All other products are taxed at 50 percent of wholesale price.

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. Figure 7 shows that Iowans in the lowest income quintile, earning less than $16,000 a year, on average 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.

**Figure 7. Lower-Income Iowans Pay Greater Share of Income in Excise Taxes**




Source: Institute on Taxation and Economic Policy, 2008

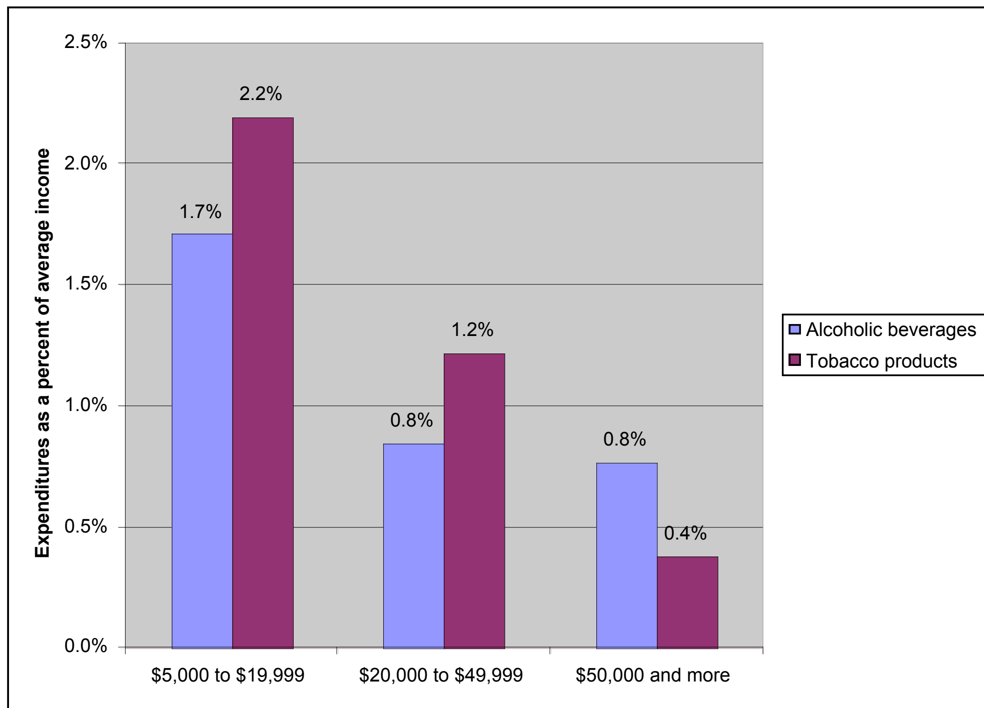
Figure 8 (next page) shows one reason why this is the case, presenting data for the Midwestern region on consumer expenditures on tobacco products and alcoholic beverages. Consumers at the lower end of the income scale spend more on these products as a share of their income than do consumers at the upper end of the income scale and, as a consequence, taxes on those items take up a greater share of lower incomes.[10] In fact, to the extent that spending by higher-income groups is concentrated on more expensive brands of beer or wine rather than larger quantities, the expenditure data in the chart overstate the impact of the tax on higher-income groups and understate regressivity.

More so than a statewide excise tax, local excise taxes can distort local commerce if certain products are taxed within city limits but are not subject to taxes outside of cities. The Legislature was sensitive to this issue in passing Iowa's local-option sales tax, requiring the tax to be approved by contiguous cities as a group, and to be put on the ballot countywide. A local tobacco excise tax, if it were at a level sufficient to produce significant revenue, would provide incentives for consumers to drive to nearby places without the tax, and for tobacco shops to open just outside the borders of taxing cities.

---

[10] In a 1995 study, Lyon and Schwab measured regressivity of alcohol and cigarette taxes over the course of a lifetime, allowing for changes in income and consumption. They found that cigarette taxes remain highly regressive whether measured annually or over the course of a lifetime. Alcohol taxes remained regressive, but less so over the course of a lifetime than when measured on an annual basis. See Lyon, Andrew B and Robert M. Schwab. "Consumption Taxes in a Life-Cycle Framework: Are Sin Taxes Regressive?" in *The Review of Economics and Statistics*, Vol. 77, No. 3 (August 1995), pp. 389-406.

**Figure 8. Spending on Alcohol, Tobacco Greater Share of Low-Income Budgets**




*Source: Table 32. Midwestern region by income before taxes: Average annual expenditures and characteristics, Consumer Expenditure Survey, 2005-2006*

### *Gambling Taxes*

The gaming wager and pari-mutuel wager taxes are levied on gambling revenues; while the majority of gambling tax revenue goes to the state general fund, cities where a gambling operation (a casino, racetrack, or excursion gambling boat) is located receive one-half of 1 percent of the tax revenue. Twelve cities in Iowa received gambling tax revenue in FY2009, totaling almost $10.9 million. The state also taxes the gross sum wagered each year in pari-mutuel gambling, used in dog and horse racing. The city where a racetrack is located receives one-half of 1 percent of the tax revenue. In FY2009, only four cities in Iowa received revenue from a pari-mutuel gambling tax, totaling $118,262.

Gambling taxes are generally considered regressive because research finds that low-income gamblers spend a higher proportion of their income on gambling than do high-income gamblers.[11] As a result, gambling taxes constitute a larger share of income for gamblers at the lower end of the income scale. The regressivity of gambling taxes has been emphasized by the relatively recent spread of gambling facilities beyond Las Vegas, giving more people access to gambling activities and increasing the share of low-income gamblers. In any case, gambling taxes are a poor vehicle for increasing local government revenue since only a few cities in Iowa host a gambling facility and the amount of revenue collected is relatively low, comprising only 5 percent of non-property tax revenue in the state.

## Progressive and Sustainable Revenue Options

Although many local option taxes frequently discussed as solutions to city revenue challenges fall short in terms of fairness and sustainability, there are alternatives that promote smart growth while fairly

[11] Borg, Mary O., Paul M. Mason, and Stephen L. Shapiro. "The Incidence of Taxes on Casino Gambling: Exploiting the Tired and Poor," in *American Journal of Economics and Sociology*, Vol. 50, No. 3 (July 1991), pp. 323-332.

distributing taxes on the basis of ability to pay. For instance, local option income and earnings taxes diversify city revenue sources, helping reduce reliance on property tax. Impact fees recognize the costs associated with new development and help cities direct growth in sustainable, strategic ways. Cities in Iowa would benefit from enabling legislation at the state level that would allow them to choose financing tools that support diversified and sustainable revenue generation.

### *Local Option Income Tax*

Local-option income taxes relate to the state income tax in the same way that a local-option sales tax relates to the statewide sales tax; the local-option tax is simply added on as a percent surcharge to the state income tax. This makes the local-option income tax inexpensive to administer and collect. In fact, 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.[12] This surtax may not exceed 20 percent of state income tax liability. Counties may also levy a local option income surtax not exceeding 1 percent of state income tax liability in order to fund emergency medical services. According to the Iowa Department of Revenue, Appanoose County is currently the only county in Iowa to make use of this local revenue option.

Importantly, the local-option income tax recognizes low-income households' limited ability to pay taxes. This makes it a much fairer form of tax than other proposed local revenue options. The Institute on Taxation and Economic Policy (ITEP) reports that Iowans in the lowest income quintile (earning less than $16,000 a year) pay 0.4 percent of their income in income taxes, while Iowans in the top quintile of income (earning over $78,000 a year) pay between 4 percent and 5 percent of their income in income taxes. Unlike property taxes, the local-option income tax is very responsive to changes in family income, which can make it a more volatile revenue source for local governments. Like property taxes, however, the local-option income tax would be deductible on federal tax returns; this provision tends to lower effective rates only for upper-income taxpayers who itemize their tax returns. The local-option income tax is a tax on individual, not corporate, income, which means that corporate businesses do not bear any of the cost of generating additional local revenue. Residents and small business owners (most of whom are proprietors or partners, or have formed an S corporation or LLC) may therefore end up financing property tax relief for branch plants of multistate corporations or for absentee owners of rental property or office towers.[13]

According to the National League of Cities, 11 states in the U.S. grant municipal income-tax authority to some or all of their cities.[14] The Midwestern states of Indiana, Michigan, Missouri and Ohio all make use of a local income tax to generate city revenue. States that authorize the local-option income tax also have less reliance on the property tax as a source of city revenue. Although Iowa local income-tax rates vary by school district, with some school districts not making use of the local income surtax, others using it at a low rate, and others levying the maximum 20 percent rate, there is no evidence that the surtax has affected resident location decisions.

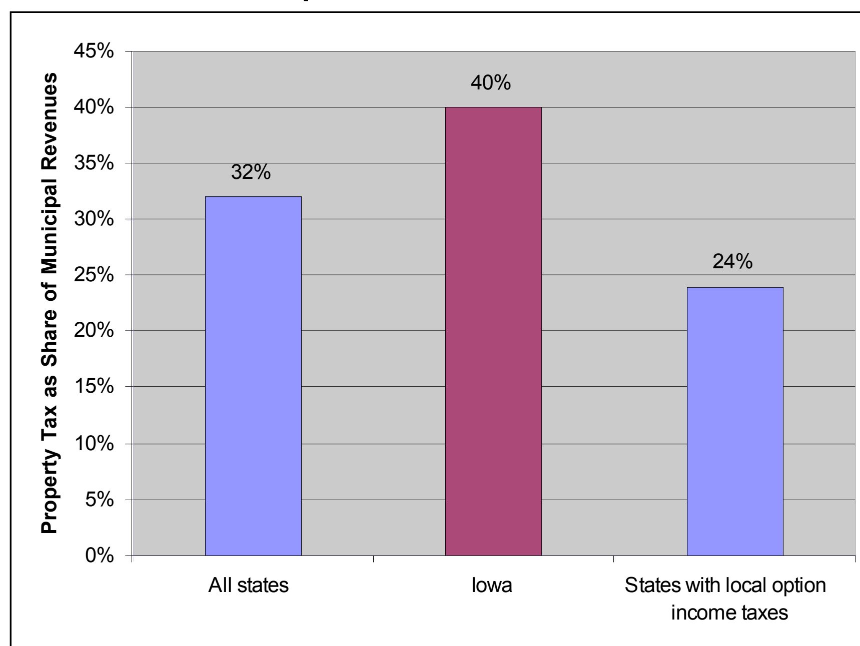
---

[12] Iowa Department of Revenue. *Iowa Counties, School District Numbers, Surtax Rates for 2007*. Available from: http://www.iowa.gov/tax/forms/0741027.pdf.

[13] Only traditional "C" corporations pay the corporate income tax. Small businesses tend to be organized in one way or another as "pass through entities" (partnerships, limited liability companies, or subchapter S corporations) that pass the profits through to the individual owners, who then pay taxes on the profits as individuals. The profits are not taxed at the business level.

[14] Hoene, Christopher and Michael Pagano. *City and State Fiscal Structure*. Washington, DC: National League of Cities, 2008. Available from: http://www.nlc.org/ASSETS/131BB38D990B4B8C9A703AFDE4B4563E/CitiesandStateFiscal.pdf.

**Figure 9. Cities with Local Option Income Tax Less Reliant on Property Tax**




*Source: National League of Cities, 2008*

Figure 9 shows that, in Iowa, 40 percent of municipal revenue comes from property taxes, compared to a national average of 32 percent. However, cities in states with local-option income taxes rely on property taxes for only 24 percent of their revenues. A local-option income tax has the ability to generate substantial revenue for cities; to raise the equivalent of a 1-cent increase in the statewide sales tax would require about an 11.6 percent surtax on the existing statewide income tax. The actual surtax needed for a city to generate revenue equivalent to a 1-cent local-option sales tax would depend on the size of that city's sales and income tax bases.

Local-option income taxes apply only to residents, meaning that cities cannot generate revenue from commuters who work in the city and benefit from city services but live outside of city limits. Payroll or earnings taxes levy a tax on wages and salaries by place of employment; a city collects taxes based on the income earned within the city, regardless of the place of residence of the income earner. Earnings constitute a larger share of income when families move off transfer programs such as Food Stamps and then decline as a share at the upper end of the income scale, where property income (rent, dividends, interest and capital gains) becomes a larger percent of income. As a result, an earnings or payroll tax disproportionately affects families where a large percentage of income comes from earnings rather than other income sources. Two families with the same income could pay substantially different amounts of local option earnings taxes if one family's income was entirely based on taxable wages while the other family's income was based on wages plus dividends and interest, or pension income.

One way to address this problem is to pair the local-option earnings tax with local-option income taxes. Individuals pay an earnings tax based on their place of employment, but receive a credit on their local-option income tax for the amount of the earnings tax. This combination operates just like existing state and federal income taxes, where tax is withheld from paychecks by the employer on the basis of earnings, and the taxpayer is credited with the withheld tax when filing the tax return. This combination makes the tax system equitable at the individual level and provides revenue for local governments where an individual works as well as lives. It also means that there is a simple way of collecting much of the local tax at the place of employment, piggybacking on the existing state withholding system, and ensuring that taxpayers contribute periodically and are not hit with the entire bill at filing time.

### *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.[15] The fees must go directly to pay for the costs of new development. For instance, revenue from fees may fund infrastructure such as local roads, water and sewer system expansion, or new parks and libraries. 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. Cities can, for example, implement what are referred to as "tap-on fees," which charge homeowners for connecting to newly constructed infrastructure such as water or sewer lines, and they can charge developers all or part of the costs for the provision of infrastructure serving a new development.

Impact fees function as an alternative to property taxes and allow cities to charge the costs of new development to those benefiting from the development, rather than assigning it to all residents through a tax-rate increase.

When they are structured such that new development must cover its marginal cost to the city for access to services such as sewer and water, impact fees can incent more efficient land-use patterns by encouraging development near existing services. The developer in most circumstances will be able to pass the cost of the impact fee back to the landowner (by offering less for the land) or on to the home buyers.[16] Buyers will pay a greater proportion of the impact fee to the extent that homes in those locations are in high demand and close substitutes (such as subdivisions with no impact fees) are not available. Where infill development is possible and contiguous locations are available that have few or no impact fees, the high-impact fee locations become less attractive and land there is held out of development. However, where neighboring jurisdictions or the unincorporated county have no impact fees, impact fees can actually shift development further from existing infrastructure. This highlights the need for regional cooperation to bring about smart growth patterns. Impact fees are structured progressively to the extent that they fall on landowners and higher income home buyers where new development occurs on the urban fringe.

Another way of controlling urban sprawl would be to allow cities to impose deferred assessments on farmland on the urban fringe. As long as the land continued to be used in agricultural production, it would be taxed as agricultural property (according to its income potential rather than its higher market value). However, if the land were converted into commercial or residential development, the developer would owe back taxes based on market assessment. This type of assessment practice would help cities manage growth and, similar to impact fees, provide incentives for infill development.

### *Payments In Lieu of Taxes*

State law exempts certain types of properties — including religious institutions, war veterans' associations, retirement and nursing homes, educational institutions, other charitable institutions and racetracks — from paying property taxes.[17] Government property (state, federal and municipal) is also exempted. Each exemption is limited to 320 acres and must be filed with the city assessor. If these types

[15] For a helpful discussion of impact fees, see: Carrion and Libby (2001). "Development Impact Fees: A Primer." Working Paper. The Ohio State University. Available from: http://aede.osu.edu/resources/docs/pdf/910676B4-2A3C-408B-B6CB09223CBC2EA7.pdf
[16] To the extent that the impact fee is a developer cost that reduces the net profit from developing the land, developers will figure this into their project pro formas. This has the effect of lowering the maximum land price the developer can offer while maintaining the project's required profit rate. The developers can take their projects elsewhere if the landowners do not agree; the landowner can't move the land.
[17] Iowa Code Chapter 427.1.

of property take up an increasing share of city property, exemptions can reduce the city tax base and lower cities' abilities to raise revenue. This has been a particular problem in large cities where a declining tax base has been exacerbated by exempt properties continuing to locate in the central city.

Table 5 uses data from the Department of Revenue on the value of tax-exempt properties in Iowa and from the Department of Management on total taxable values of city property to estimate the share of the city tax base taken up by exempt property, as well as the potential revenue that cities could gain from requiring payments in lieu of taxes. Values from the eight cities in Iowa that have a city assessor's office are reported below; most cities assess property through the county assessor's office. Table 5 shows that cities vary in the amount of property located within their boundaries that is exempt from property taxes. Only 5 percent of Ames property is exempt from property taxes, while just over 20 percent of property in Dubuque is exempt.[18]

**Table 5. Revenue from Exempt Properties Could Contribute to Public Safety Costs**

| | FY08 Levy Rate General Fund Levy and Emergency Levy | 2007 Value of Exempt Property | Value as Percent of Total Valuation | Potential PILOT Revenue | Revenue as Share of Property Tax Levied |
|---|---|---|---|---|---|
| Ames | $5.49 | $ 103,032,080 | 5.3% | $ 233,455 | 1.2% |
| Cedar Rapids | $8.10 | $ 555,279,086 | 11.4% | $ 1,857,575 | 2.8% |
| Clinton | $8.37 | $ 143,143,189 | 18.8% | $ 494,818 | 4.3% |
| Davenport | $8.37 | $ 498,721,958 | 14.3% | $ 1,723,987 | 3.3% |
| Dubuque | $8.10 | $ 397,787,685 | 20.4% | $ 1,330,719 | 7.6% |
| Iowa City | $8.10 | $ 203,188,220 | 8.1% | $ 679,726 | 1.7% |
| Mason City | $8.10 | $ 123,102,031 | 13.1% | $ 411,813 | 3.8% |
| Sioux City | $8.37 | $ 419,511,400 | 19.4% | $ 1,450,171 | 4.2% |

*Source: Iowa Department of Revenue, Iowa Department of Management*

Payments in lieu of taxes (PILOTs) are voluntary payments made on behalf of tax-exempt property, negotiated to compensate cities for fire and police protection of those properties. For instance, the federal government reimburses localities for the protection of federal tax-exempt land such as national parks. Other cities require that non-profit hospitals, which do not have to pay property taxes, pay a fee to the city in exchange for their share of public safety benefits. The Regents universities in Iowa have followed a policy of providing payments in lieu of taxes for fire protection.

As Table 5 shows, cities could in some cases raise substantial amounts of revenue by negotiating with tax-exempt properties to contribute to public safety protection. For instance, with over $400 million in tax-exempt property (almost 20 percent of its tax base), Sioux City could generate 4.2 percent of its FY2008 property tax revenue from payments in lieu of taxes. The calculations in Table 5 assume that exempt properties should only pay for the share of the levy that goes to public safety expenditures. Since

[18] The value of exempt property will also vary depending on the practices of individual city assessors, who are required to submit assessments even for properties that do not pay taxes but may not give these assessments high priority. The city of Ames, for instance, reports $0 in exempt educational institution assessments, which may or may not reflect the status of university property, depending on arrangements reached with the Regents and the city, as well as on how those properties are assessed.

expenditures on police, ambulance, and fire protection account for 41.3 percent of the general fund, we adjust the levy rate accordingly.

In order for changes to be made to property tax exemptions in Iowa, the Legislature would have to amend eligibility for exemption or allow cities to exercise greater discretion in determining the terms of exemption. For instance, legislators could authorize cities to 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 value, rather than limiting by the number of acres it can occupy.[19]

## Sustainable Economic Development Policies

Cities must apply the same criteria of fairness and sustainability when evaluating economic development politics as they do when choosing new financing options. Economic development policies play an important role in growing the local tax base so that city revenues can increase in tandem with new residents. Attracting business, creating more jobs and increasing the income of residents keeps cities strong by generating tax revenue that enables cities to provide important services to residents. Cities have a number of different tools available to encourage local economic development. Investments in local amenities such as recreation, landscaping and parks projects, trail systems, farmer's markets and cultural programs enhance quality of life and make a city more attractive to potential residents. Cities also invest in maintaining and improving local services such as emergency response systems, local transportation options, affordable housing, and community medical care. School boards have a crucial function in shaping educational opportunities and helping the local education system meet future workforce demands, and the quality of local schools is important to residents in choosing where to live, and employers in choosing where to locate. Local decisions about tax incentives such as property tax abatement and tax increment financing districts also play a role in determining the structure of new development.

A local economy is not defined by city or county boundaries, but rather by a market area: the region from which employers draw their labor force, and the region in which households make most of their local purchases. Labor markets are generally multicounty metropolitan areas, and this has become more the case over time as the counties surrounding Iowa's major cities have come to house an ever larger share of the workforce. The market areas for major shopping malls are multi-county as well, and even smaller retail centers draw from well beyond the borders of the city in which they are located. Many Iowa cities have come to recognize that their fortunes are dependent on the health of a regional economy and have begun to work together on economic development. At the same time, there has been increasing recognition of the social costs of far-flung, low-density development. As commuting distances increase, fuel consumption and air pollution increase, prime farmland disappears, and traffic congestion worsens. This has again led to recognition of the interdependence of localities and the need for regional cooperation in reducing urban sprawl and promoting more efficient development patterns.

Unfortunately, Iowa's system of local government finance has not evolved to accommodate or encourage the kind of regional solutions needed for smart growth and sustainable economic development. In fact, over the past twenty years the local tax system has moved in the opposite direction, increasingly towards one that rewards and encourages destructive competition among cities for tax base and revenue. Tax-increment financing, in particular, works at cross-purposes with regionalism and cooperation.

[19] Pomp, Richard. "The Collision Between Non-Profits and Cities over the Property Tax: Possible Solutions" in *Property Tax Exemption for Charities*, Ed. Evelyn Brody. Urban Institute Press, 2002.

Faced with shrinking revenues as a result of a decline in tax bases associated with an unchecked residential rollback and reductions in state aid to local governments, cities have sought forms of economic development that maximize revenue while minimizing spending. This limits the amount of investment that can be done in the name of economic development. Furthermore, although a substantial body of academic literature concludes that tax incentives are a small and often insignificant factor in shaping business location decisions, political rhetoric has largely succeeded in identifying tax incentives as the sole effective strategy in driving local economic development.[20] As a result, local economic development policies in Iowa often encourage competition for commercial and industrial tax base at the expense of promoting more sustainable, regional economic growth.

### *Tax Increment Financing*

The prime example of an unsustainable economic development policy that undermines regional cooperation and smart growth planning is unrestrained use of tax-increment financing (TIF). Originally a product of the push for urban renewal in the 1950s and 1960s, TIF was designed to facilitate redevelopment of blighted areas in cities. The idea was to help investors recoup costs of rehabilitating properties in a neighborhood with depressed property values, using public resources to reverse the decline and make private redevelopment profitable. Such an initiative could be financed by using future gains in tax revenues, instead of dipping into existing revenues counted upon by cities, counties, schools, community colleges and special taxing districts. Eventually, it was argued, the increased tax base would benefit all those jurisdictions levying property taxes in the redeveloped area.

Under the original “blighted area” concept of TIF, the city would identify an area where private investment was lacking but would benefit the community, and would then designate the area a TIF district. The city would then undertake needed public improvements to prompt private development or redevelopment, issuing TIF bonds to finance the public investments. These bonds would then be retired or repaid out of the property tax revenues from the “increment,” or increased taxable valuation within the TIF district, that resulted from the city’s improvements. TIF only affects use of revenue from the increase in property valuation. The valuation prior to the TIF project is the “base year” valuation; revenues from this valuation continue to flow to cities, schools and counties. Almost all property tax revenues on the increment — revenues that otherwise would have gone for general city, school and county use — are used to repay the TIF bonds. Finally, when the bonds are fully retired or repaid, the TIF revenues flow to all taxing jurisdictions and the TIF district ceases to exist. This, at least, was how TIFs were originally meant to be used.

The focus of TIF changed in the 1980s, when Iowa cities were allowed to start using TIF for economic development, broadly defined. For an economic development TIF there need be no finding of blight or decline. TIF use is simply intended to create jobs or expand the tax base. Use of TIF in Iowa has exploded over the past decade and a half. While there were only 746 TIF districts in Iowa in fiscal year 1991, that number had more than tripled by fiscal year 2006, to 2,358 TIF districts.[21] TIF districts have become Iowa’s largest economic development program. In FY2006, statewide budgeted TIF revenue was $174.7 million.[22]

---

[20] See, for example, Lynch, Robert. *Rethinking Growth Strategies: How State and Local Taxes Affect Economic Development*. Washington, DC: Economic Policy Institute, 2004 and Peters, Alan and Peter Fisher. “The Failures of Economic Development Incentives.” *Journal of the American Planning Association*, 70 (1), Winter 2004: pp27-38.

[21] Swenson, Dave and Liesl Eathington. “Tax Increment Financing Growth in Iowa.” Iowa State University. April 2006. Available from: http://www.econ.iastate.edu/research/webpapers/paper_12586.pdf

[22] Iowa Legislative Services Agency (2006) *Tax Increment Financing Outstanding Obligations Report* — 2005. Available from: http://www.legis.state.ia.us/lsadocs/IssReview/2006/IRJWR001.PDF.

While its original purpose was as a targeted strategy designed to stimulate re-investment in blighted, urban areas, TIF is now employed almost indiscriminately and in ways that undermine rather than promote sustainable growth. Unchecked TIF use promotes urban sprawl and can end up subsidizing retail businesses building on undeveloped land, as happened in West Des Moines when Jordan Creek Town Center took advantage of TIF funds to develop a large retail park on what had been farmland.[23] TIF projects in Scott County and surrounding areas have helped accelerate the decline of Davenport's downtown, arguably adding to urban blight rather than reducing it. In seven of Iowa's nine metro areas (metropolitan statistical areas or MSAs), average TIF revenue per capita is higher in each MSA's suburbs than it is in the central city.[24] None of the top 10 users of TIF, as measured by per capita levels of outstanding TIF obligations, are metropolitan cities; rather, they are all suburbs of metropolitan areas or cities located in non-metro areas of the state.[25]

Because TIF is being most heavily used in the suburbs, it no longer targets its benefits toward low-income residents of central cities. The Des Moines-West Des Moines metropolitan statistical area (MSA), for example, encompasses the counties of Polk, Dallas, Guthrie, Madison and Warren. This five-county region includes the "central cities" of Des Moines and West Des Moines, suburban areas around the central cities, and rural areas on the outskirts of urban development. While the central cities of Des Moines and West Des Moines are home to 76 percent of the MSA's individuals living in poverty, they account for only 36 percent of the MSA's TIF revenue. Under the original, "blighted area" concept of TIF use, most or all TIF areas would exist in urban areas with high levels of poverty, which most often exist in the central cities. Currently, however, per capita TIF revenue for individuals living in poverty in Des Moines and West Des Moines amounts to $823, while there is almost $5,000 in TIF revenue for every poor individual living in the suburbs.

Using TIF to stimulate general economic development rather than specifically to address blight is within the bounds of Iowa's current TIF law. However, the looseness of Iowa's TIF law and cities' eagerness to use it as their primary tool of economic development gives rise to some significant problems that may actually undermine local economic development goals. Promoting suburban development on open land often means attracting big-box retailers that compete with local businesses, undermine Iowa's median wage,[26] and require the extension of city infrastructure related to sewer, water, electricity and transportation. In addition, because TIF allows the city to capture all the property taxes from new property valuation in a TIF district, this can erode the capacity of other taxing districts such as counties and school districts to meet their obligations. This problem arises when TIF ends up funding projects that would have occurred anyway and would have caused natural growth in the property tax base from which all taxing jurisdictions would benefit. And, if a city uses TIF to take advantage of already-occurring investment, by designating the area around a recently-completed facility as a TIF district whose base year falls prior to the investment, this again captures tax revenue that otherwise would have gone to overlying jurisdictions. When counties and school districts face such constraints on their revenues, their own capacity to invest in alternative forms of economic development is hampered.

It is important to recognize the extraordinary power granted to cities under the TIF law. While counties, school districts and community colleges share the same property tax base, under TIF a city is allowed to

---

[23] LeRoy, Greg (2008) "TIF, Greenfields, and Sprawl: How an Incentive Created to Alleviate Slums Has Come to Subsidize Upscale Malls and New Urbanist Developments." *Planning and Environmental Law* 60 (2): 3-11. Available from: http://www.goodjobsfirst.org/pdf/apa.pdf.

[24] IPP analysis of FY 2006 Iowa Department of Management data.

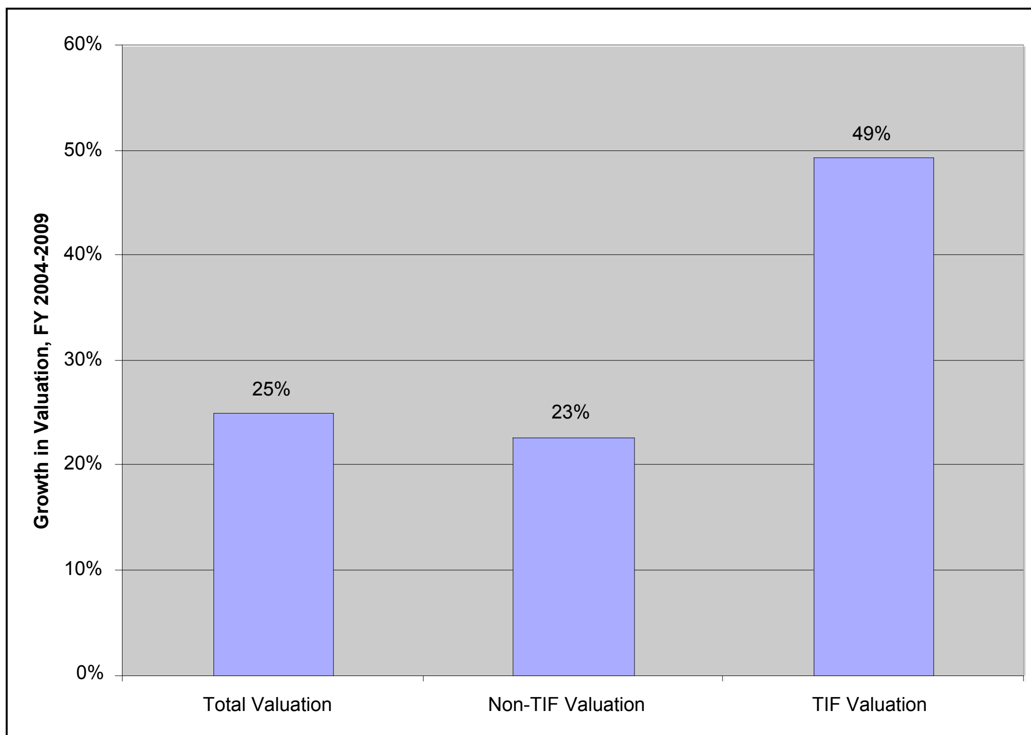
[25] Iowa Legislative Services Agency.

[26] Gordon, Colin and Beth Pearson (2008). The State of Working Iowa 2008. Available from: http://www.iowapolicyproject.org/2008docs/080828-SWI2008.pdf. The average weekly wage for retail trade in Iowa is $401, while the average weekly wage for all industries is $660.

pull a portion of that tax base out from under the overlying jurisdictions: the school district, the county, and the community college. When TIF is used properly, say to promote the expansion of a city's manufacturing base, and where the incentives provided through the TIF were actually necessary to bring about new manufacturing investment, then that new tax base would not have been there but for the TIF. The school district, the county, and other jurisdictions are eventually made better off by the city's use of TIF (again assuming a proper use of TIF, where the TIF expires and the overlying jurisdictions then are able to fully tax the new property.) But in far too many instances, the TIF is not used properly—it is used to attract retail or other local-market activity that needs no incentives, or the district never disappears and the TIF valuation never gets to be fully taxed by the schools and the county. In these instances, the city, in effect, is allowed to appropriate other jurisdictions' taxes, and in the process forces the school district and the county to raise their property tax rates to make up for the lost revenue. County supervisors and school boards then must absorb taxpayer resentment for higher taxes, while the city gets use of a substantial pool of money with very few restrictions on how it can be spent. It is this ability to shift costs onto taxpayers outside the city that has made TIF so attractive to cities and stimulated the proliferation of TIF districts, some of which now encompass entire cities. This is the opposite of regional cooperation.

As a result of rapid growth in TIF use in Iowa, the value of the tax base available to local governments is now growing more slowly than overall gross taxable valuation. Although it still accounts for only 6.5 percent of total valuation, TIF valuation was the fastest-growing component of gross valuation over the past five years. TIF valuation increased almost 50 percent between 2004 and 2009, while overall gross taxable valuation in the state increased 23 percent, or an average of 4.6 percent annually. Non-TIF valuation — which provides a better measure of the tax base available to local governments — grew more slowly than total gross valuation at an average of 4.2 percent annually.

**Figure 10. TIF Growth Dwarfs Growth in Overall Valuation, FY2004-09**




*Source: Iowa Department of Management*

As discussed above in the section on local-option sales taxes, local TIF authority in Iowa expanded through a provision inserted into the standings bill at the end of the 2008 legislative session, allowing

cities to capture local-option sales taxes generated within TIF districts. Passing an ordinance to this effect allows the city to retain the additional increment of local-option sales tax revenue generated from within the district, instead of passing all revenue to the county pool for distribution.

Sales-tax TIF districts are subject to the same types of problems as are TIF districts associated with property tax. In addition, they provide incentives for retail development that are likely to be unnecessary given the nature of the retail market. Because retail is heavily dependent on the local market, development decisions are based on location and customer base rather than incentives. Retail developments in one area of a county will tend to draw market share away from existing retail in other parts of the county, which could mean a decline in the local option sales tax revenue available for shared distribution and, eventually, an erosion of the sales tax base. Expanding the local-option sales tax by allowing cities to impose their own 1-cent tax on top of the existing LOST they now may capture through a TIF district would also exacerbate these unsustainable forms of competition. Local economic development policies can actually shrink the tax base for localities when they encourage competition among cities within a region and remove large chunks of property from the pool of taxable valuation.

Tightening Iowa law to prevent the overuse of TIF would help restore TIF as a more effective, well-targeted economic development strategy closely tied to goals of sustainable growth. In particular, economic development TIFs should not be used for retail or residential development since retail location decisions and residential subdivisions are driven by location and local market conditions, rather than by tax incentives. While blighted area TIFs are appropriately used more broadly, economic development TIFs should be limited to assisting projects that expand the economic base of the region — export activities such as manufacturing and wholesaling — rather than merely shifting the location of retail or residential activity within the region, to the detriment of some. There should be constraints on the size of TIF areas: They should be limited to a certain percent of a city's land area or tax base, so that they remain true to the targeted redevelopment intent of TIF. Some cities have already made the entire city a TIF area, and there is no reason to expect many more cities to restrain themselves from following suit. Finally, the new sales-tax TIF law should be rescinded quickly, before widespread use makes this politically impossible.

## Conclusion

Revenue options that score well on equity and fairness and take account of families' ability to pay taxes are available to some local governments and, in many cases, are already in limited use. For instance, the local option income tax is used in all of Iowa's 99 counties to fund school districts and could easily be expanded for use by city governments as well. Cities already aware of the need to raise revenue to accommodate new development should be allowed to utilize impact fees rather than be forced to rely on tax increment financing as their sole tool for directing and incenting growth.

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. Local revenue generation that relies on regressive taxes such as additional sales taxes or franchise taxes will disproportionately impact middle to low-income families in Iowa. Any form of revenue generation will affect the shape of economic development in a city; the challenge for local and state officials is to adopt solutions that build on regional strengths rather than pitting cities against each other in a race to attract low-wage retail jobs.

New revenue options for cities could be designed to promote cooperation among local governments. A local-option income tax, for example, could be provided as an option to cities and to the county only if a major portion of the revenues were used to fund regionally provided services, and only if the remainder

were shared among localities on the basis of need (perhaps simply population). There are many opportunities for local governments to combine particular services to achieve economies of scale, to promote the regional economy, to begin to plan development on a regional scale, or to provide regional amenities that will enhance the quality of life and the development potential of all cities in the region. Regional transit systems, sewage treatment facilities, cultural and recreational facilities, emergency services, economic development offices, recycling facilities — the list is long.

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. In exchange, they should be willing to accept constraints on the use of TIF to eliminate the wasteful and competitive uses of TIF incentives. Cities recognize 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.