ISSUE REVIEW

Iowa Legislative Fiscal Bureau

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Tax Increment Financing (TIF)

ISSUE

The use of tax increment financing by local governments has grown rapidly over the past five years. This ***Issue Review*** explains how TIF areas are created and quantifies the impact to the State, local governments, and taxpayers.

CODE AUTHORITY

Sections 260E, 260F, and 403, Code of Iowa

BACKGROUND

Local governments have been using tax increment financing since 1958 after authority was granted by the 57th General Assembly. A TIF area is established when a local government (city, county, or community college) adopts a resolution or ordinance establishing an urban renewal project, or in the case of a community college, a jobs training project. The resolution or ordinance causes the valuation of the TIF area to remain at the prior year's taxable valuation for the purpose of establishing the *base value* of the TIF area. The TIF area base value is taxed at the total combined tax rate by all taxing authorities (county, city, school, and others) with the revenues distributed to each taxing entity.

The increased value of a TIF area is called the *incremental value*. The incremental value is taxed at the consolidated tax rate of the taxing district, but the revenues are pledged to the TIF project. The exception is bonded indebtedness levies. The incremental value of a TIF area is levied against all taxing authorities that have bonded indebtedness levies, and the revenues are distributed to the appropriate taxing entity.

Generally, bonds are issued which raise the funds required to finance the TIF project, and the property tax revenues generated by the incremental value in the TIF area are used to retire the bonds.

Urban Renewal TIF

Urban renewal projects are defined in Section 403.17(24), Code of Iowa, as follows:

> *"Urban renewal project" may include undertakings and activities of a municipality in an urban renewal area for the elimination and for the prevention of the development or spread of slums and blight, may include the designation and development of an economic development area in an urban renewal area, and may involve slum clearance and redevelopment in an urban renewal area, or rehabilitation or conservation in an urban renewal area, or any combination or part thereof in accordance with an urban renewal program.*

Urban renewal projects may include, but are not strictly limited to: acquisition of areas; construction of streets, utilities, parks, playgrounds, parking garages or other necessary improvements; and demolition, rehabilitation, or conveyance of properties.

Urban renewal areas can also be assigned for residential development. The 1996 Legislative Session added a new restriction (Chapter 403.22, Code of Iowa) so a residential TIF area could not be created unless a municipality can assure the development will include assistance for low- and moderate-income family housing. The legislation also established a maximum ten-year lifespan for the project, after which property tax revenues will be distributed to the appropriate taxing authorities (schools, cities, counties, etc.).

Jobs Training TIF

The 1983 Session of the General Assembly established the Industrial New Jobs Training Program (Chapter 260E, Code of Iowa) to provide training funds and services for new and expanding companies. A separate program in Chapter 260F, Code of Iowa (Iowa New Jobs Training Program) addresses the needs of small businesses. Loans under Chapter 260F are also used to retain jobs that might otherwise be eliminated.

Funding for the Program comes from proceeds of certificates issued by community colleges on behalf of eligible companies. The certificates are retired with proceeds from State income tax withholding of the new employees or new property taxes paid by the business, or both.

Since the phase-out of the property tax on machinery and equipment (M&E) originally passed during the 1995 Legislative Session, it is anticipated that job training TIF projects will become increasingly reliant on withholding from new employees rather than from traditional property tax TIF activity. The data and analysis in this ***Issue Review*** focus exclusively on traditional TIF projects, which include only the property tax component.[1]

Impact of TIF Areas

The impact of TIF areas' incremental value on taxing entities is the removal of the incremental value from the taxing entities' taxable valuation. This is translated either into a reduction in revenues raised by a specific local government or a shift in tax burden to other property taxpayers residing in areas served by the same local government. Due to the school aid formula, there is also a shift to the State, wherein the General Fund appropriation is increased to offset part of the lost valuation. This effect is explained in more detail below.

[1] For a more detailed report concerning the 260E Program, see the ***Issue Review*** entitled "Industrial New Jobs Training Program", published by the LFB in January 1995.

CURRENT SITUATION

In FY 1997, there were 1,453 TIF areas statewide.[2] Of these, 896 (61.7%) have valuation in the increment. The total incremental value of all TIF areas was $2.366 billion of net taxable valuation, and generated $71.2 million for TIF projects. This represents an increase of $41.1 million (136.5%) since FY 1992, the last year an ***Issue Review*** was released on this subject. (The amount generated for TIF projects was determined after adjusting for bonded indebtedness levies for all taxing entities. Bonded indebtedness levies on TIF districts totaled $8.1 million in FY 1997.)

In general, when a TIF is created three primary outcomes are possible:

- State appropriations for school aid increase.
- Local governments reduce spending in other areas.
- Taxes are shifted to other property owners.

The following three subsections detail how these factors play out for the schools, State, cities, and counties.

Effect on Schools and the State

School districts generate property tax revenue by setting a tax rate and multiplying the rate by the taxable valuation. If taxable valuation is lost due to TIF projects, then property tax revenue is lost. However, school districts have a unique funding formula (school aid formula) that sets a budget. The lost revenue due to the uniform levy rate portion ($5.40 per $1,000 of taxable valuation) is automatically replaced by the State General Fund appropriation. The remaining portion can be recovered by increasing the tax rates to property owners in the school district.

The impact of TIF areas' incremental value being excluded caused the State to increase General Fund appropriations $12.8 million in FY 1997, for revenue not generated by the uniform levy rate. **Chart 1** shows the impact on State aid from FY 1992 through FY 1997.

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Another impact of TIF is forcing property owners in school districts to absorb the remaining budget with a higher levy rate, since the property tax portion of the budget is spread over a smaller taxable valuation base.

[2] Although there were 1,453 TIF areas, there are more than 1,453 individual TIF projects. Community colleges are required to report projects individually to the Department of Economic Development. However, there is no requirement to report individually to the Department of Management, which compiled the data for this report; nor is there any requirement for local governments to individually report urban renewal projects. Thus, two TIF projects in the same taxing district are sometimes, though not always, reported aggregately.

The concept that lost revenue due to TIF projects is totally absorbed by other property owners in school districts is an outgrowth of the theory behind the school aid formula. In practice, a school district budgets in various ways. If a school district is under pressure to maintain property tax rates, they may be unable to pass the lost revenue to the other property owners. Under this scenario, the impact would be imparted to the school district itself.

Impact on Cities

Most incremental TIF value in Iowa is located in cities, although we are currently unable to quantify this value. The nature of the impact on cities is slightly different than the impact on school districts. Cities face a levy rate limit of $8.10 for general fund revenues. Of course, other levies may be raised as service requirements grow. To the extent that demand for city services increases in response to economic activity generated within the TIF area, a city will generally lose at least $8.10 per $1,000 of TIF incremental taxable value. It should also be noted, however, that the city that typically creates a TIF area is under no requirement to do so.

Impact on Counties

Counties are impacted differently than either cities or school districts. Although counties can create TIF areas in some situations, it is usually a city that passes an ordinance or resolution. Since FY 1993, counties have been budgeting under a property tax limitation. The limitation provides that a county can not raise more property tax revenues than the prior year.[3] The limitation carries two principal implications. First, if a TIF area's incremental value were captured by a county, it would probably fall under the category of new construction, and the county would have additional revenue to expend. On the other hand, if the TIF value was netted out by demolition and other retired valuations (or if the increment was solely a function of valuation growth of existing property), taxes raised from the increment (if the county could capture them) would have been reflected as a reduction in taxes for other property owners within the county.

The county situation becomes more difficult to address beginning in FY 1999. Under current law, the property tax limitation expires at the end of FY 1999. Counties will no longer operate under a total levy limit, but will still be faced with a $3.50 per $1,000 levy rate limit.[4] However, over the past four years, more counties have fallen below the rate limit. As of FY 1997, 42 counties have levy rates below $3.50 per $1,000 of taxable valuation. Beginning in FY 1999, new and existing TIF areas that previously affected county governments' expendable resources will more likely be shifted to other property owners. The cost of increased county services due to expanding TIF areas will increasingly be paid by other property taxpayers in the county. Without the rules of the property tax limitation, counties will be less likely to reduce services elsewhere and more likely to shift property taxes to other taxpayers.

TRENDS

As indicated in the ***Background*** section, community college job training TIF projects are expected to decline as they are gradually replaced with a different funding stream. The accuracy of the data displaying whether a TIF is a job training TIF, a county TIF, or a city TIF, is in serious question due to reporting inconsistencies. As a result, this section will focus strictly on aggregate TIF activity.

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[3] There are a few exceptions to the limitation. Most counties are granted an "unusual need" adjustment equal to the inflation rate. Also, new construction and debt service operate outside the limitation. For a more detailed report on the county property tax limitation, see an ***Issue Review*** entitled "County Budgeting Under the Property Tax Limitation" published by the LFB in January 1996.

[4] Counties have four primary levy rates, the largest of which is the general basic levy, which is the levy being discussed in this section. The issue can appropriately be extended to the other county levies as well.

The impact of the M&E phase-out discussed earlier should not dramatically affect an analysis of the trends because the data only extends through the 1995 assessment year (FY 1997), which was the first year affected by the legislation.

The incremental value in TIF areas statewide has grown considerably over the last five years. **Chart 2** illustrates TIF valuations from FY 1992 to FY 1997.

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Future TIF area growth will probably be mitigated somewhat due to the 1996 legislation restricting TIF for housing developments. Residential property value, which accounted for 20.4% of FY 1997 statewide TIF value, represented 71.2% of the growth since FY 1995.

Charts 3 through 6 illustrate TIF growth trends for the four classes of property that make up most of the statewide TIF value.

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As the bar charts show, all classes of property have been subjected to increased TIF activity over the past five years, although M&E TIF valuations have declined recently as expected. The line graphs (the right-hand axis), show the change in the percent of total TIF value represented by each class. The five-year trend shows an increase in residential TIF valuations compared to the other classes. As little as three years ago, residential TIF value was virtually non-existent. In FY 1997, it grew to $482.6 million.

Although the growth appears extensive, it is not entirely due to new construction projects. The incremental value in a given year is a function of four factors:

- Growth in the base valuation.
- Growth in last year's increment valuation.
- New construction and improvements.
- Expiration of TIF districts.

Currently, it is not possible to accurately break out the natural valuation growth from net new construction and expired districts.

ECONOMIC DEVELOPMENT IMPACT

The economic development impact of TIF areas on the communities in which they reside or on the State as a whole also cannot be quantified. Whether or not TIF areas lead to unique economic activity that would not have occurred elsewhere in the State without the incentive is a difficult question. Given these uncertainties, there is no clear consensus regarding the economic cost of TIF projects. In general, the cost to local governments will be a function of the ability of governments to shift taxes to other taxpayers and the demand for government services generated by the TIF.

ALTERNATIVES

Most of the suggested reforms of the TIF laws address criteria for the establishment of an area and oversight on the part of the State.

Require a "but for" Test

When a TIF area is under consideration, however, there is one issue that should be addressed prior to approval: Does the TIF satisfy the "but for" condition. This criteria asks the question, "would the development have occurred *but for* the TIF assignment. This is also an important issue with respect to other economic development and tax incentive programs.

In the case of new jobs training TIF projects in Iowa, there is virtually no expectation that newly created jobs would not have been created in the absence of the job training subsidy. The Program operates essentially as an entitlement for non-retail companies that locate or expand in Iowa. [5]

Enhance Auditing and Reporting

Reports on job training TIF projects are considerably more detailed than reports on urban renewal TIF projects. There is no requirement stipulating an annual report for each TIF project be submitted to the State, although reports are submitted to county auditors. In many cases, TIF projects that exist in the same taxing districts are reported jointly. Given current law reporting requirements, however, there is no way to ensure individual urban renewal TIF projects can be monitored and evaluated. One option would be to require a certified annual report be submitted to the Auditor of State for each TIF project.

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[5] Although new jobs training acts as an entitlement, companies are required to show need if they apply for community college awards for retraining of existing employees.