Executive Summary

Iowa's State Fiscal Crisis and Its Impact on Local Government

Peter S. Fisher
Victor Elias
Jeremy Varner

December 2004

Iowa Fiscal Partnership

www.iowafiscal.org

The Iowa Policy Project
318 2nd Ave. N,
Mount Vernon, IA 52314
(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

Iowa Fiscal Partnership

EXECUTIVE SUMMARY

December 2004

Iowa's State Fiscal Crisis and Its Impact on Local Government

By Peter S. Fisher, Victor Elias and Jeremy Varner

The State of Iowa has experienced severe revenue shortfalls every year since fiscal 2001, creating budget problems that have impacted Iowa's local governments as well as state government. The capacity of Iowa's 99 counties and 949 towns and cities to provide basic local public services — police and fire protection, parks and recreation, planning and zoning, street and secondary road maintenance, and public health services — has been compromised. Cities and counties have been forced to lay off workers and increase service fees. They have spent down fund balances and increased property tax levies, in many instances to the maximum levy allowed by law.

One of the reasons that local governments have struggled is that the State of Iowa has passed them its own financial problems. The state has cut support for local governments by 42 percent — or $119 million — since FY01. The financial troubles of cities and counties were compounded by another problem: sluggish growth in the property tax base. Total non-TIF valuation rose just 6.5 percent between FY01 and FY05 (1.6 percent per year), while inflation in the cost of state and local government services was 9.4 percent (2.3 percent per year). With a stagnant tax base, rising costs, and reduced revenue from the state, many cities and counties increased property tax rates to maintain services. Between FY01 and FY05, the number of counties that had reached or exceeded their general fund levy limit increased from 70 to 97, and the percent of cities at the general fund limit rose from 71 percent to 78 percent. Seventeen counties now exercise their authority to exceed levy limits due to unusual circumstances, while only one county did so in FY01.

The spiraling cost of heath insurance has increased the cost of doing business for all employers, and local governments are no exception. From FY01 to FY04, the cost for county health insurance premiums increased by 78.4 percent. With general fund levies constrained, cities and counties turned to special levies to finance the rapidly increasing cost of health insurance. While other city property tax rates changed very little between FY01 and FY05, the average tax rate for employee benefits grew 32 percent. Meanwhile, the number of counties using the general supplemental levy rose from 72 to 92. On average, about three-fourths of the increase in overall city property tax rates is attributable to employee benefit levies.

More cities and counties have adopted local option sales taxes. This has not solved the financial problems facing local governments. Sales tax revenue has grown much more slowly than property taxes over the past four years. The local option sales tax, like the state tax, suffers from an eroding base due to the rising share of untaxed services and the shift to untaxed internet sales.

The Property Tax Base

Real property (land and buildings) remains the principal tax base for local governments in Iowa, despite the growth in local option sales taxes. While population and income growth drives

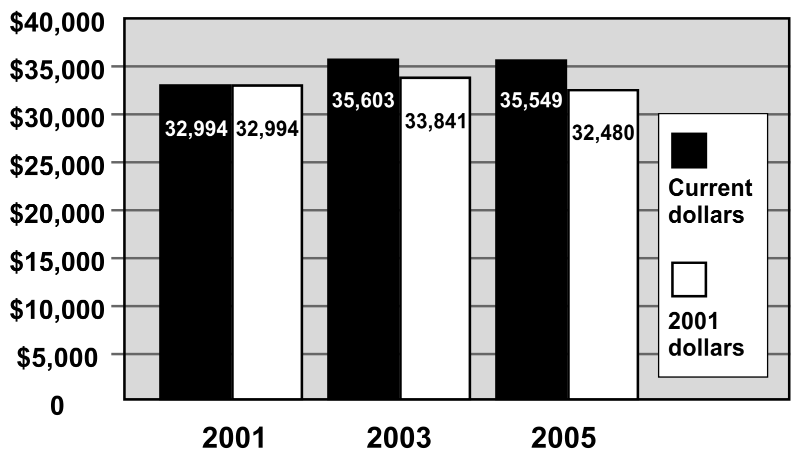
Peter S. Fisher *is research director of the Iowa Policy Project.*
Victor Elias *is a senior associate at the Child & Family Policy Center.*
Jeremy Varner *is a University of Northern Iowa student who interned at the IPP.*

increased demands for city and county services, and more revenue is needed to keep up with higher costs, the property tax base has not generally grown proportionately. This is primarily due to the state system of rollbacks, which has had the effect of reducing residential valuation to less than half its market value, and to the system of agricultural valuation (based on productivity rather than market value).

Overall gross taxable valuation in the state increased 8.3 percent between FY01 and FY05. Residential taxable value increased 16.4 percent over this period despite the rollback, and commercial and industrial property value grew almost 28 percent. Other classes of property — primarily agricultural land and buildings, and utility property — decreased. The fastest growing component of gross valuation was Tax Increment Financing (TIF) valuation, which grew in part because of the creation and expansion of TIF areas. TIF valuation grew by almost 50 percent over the four-year period (though it still accounted for just 5.7 percent of total value). Much of TIF valuation is dedicated to economic development or rebated to the property owner. Non-TIF valuation, which is a better measure of the tax base available to local governments to fund general city and county services, grew more slowly than total gross valuation — just 1.6 percent per year. The growth in total non-TIF valuation — 6.5 percent for the four years — is well below the rate of inflation as measured by the federal government's index for the cost of state and local government purchases, which increased 9.4 percent over that four-year period.

Combined with the tax rate limits, this slow growth in taxable valuation has clearly constrained the ability of cities and counties to finance services. For tax rates to remain constant while costs rise and population expands, taxable property values must increase enough to maintain a constant valuation per capita, after adjusting for inflation. Real (inflation-adjusted) per capita taxable valuation statewide did increase from FY01 to FY03, but has declined each year since, and in FY05 was 3.6 percent below its 2001 level.

Figure 1. Per Capita Property Tax Base, Statewide

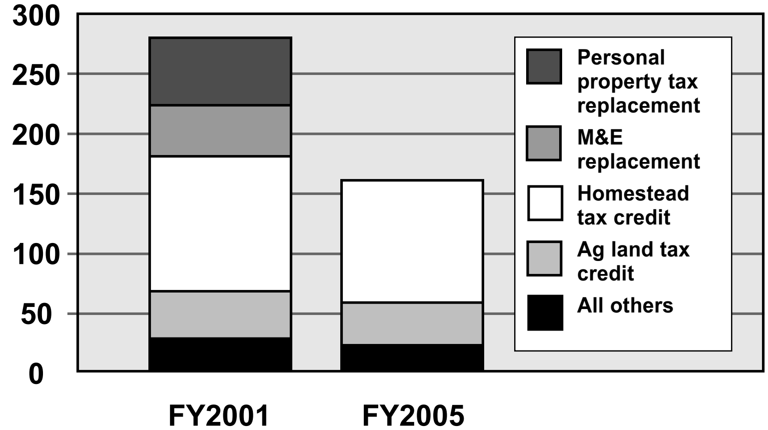


Property Tax Replacement Funds

All local governments, including cities, counties, school districts and community colleges, rely to a significant extent on state property tax replacement funds as a source of revenue. These replacement funds represent state revenue provided to local governments to compensate them for the state eliminating a local source of revenue (such as the property tax on machinery and equipment, livestock, or personal property) or to compensate for state mandated property tax breaks (homestead credit, military credit, and elderly and disabled credit). In FY01 these property tax replacement funds accounted for $280 million in revenue to all of Iowa's local governments. By FY05 these replacement funds from the state had been reduced by 42.4 percent to $161 million, a loss of $119 million in revenues to Iowa's local governments. By FY05, the only remaining property tax replacement money provided to local governments was to compensate for state-mandated property tax breaks. The state addressed its revenue shortfalls by transferring the problem to local governments.

The City of Keokuk was probably the hardest hit by the elimination of machinery and equipment from the property tax base (and now the elimination of the reimbursement), losing over 10 percent of total valuation. This contributed to budget problems that led Keokuk to eliminate 10 full-time positions, or 9 percent of the city's workforce. Among counties, Clinton lost 12 percent of its property tax revenue (second only to Monroe County's 26 percent loss). Scott County lost $3.1 million in state tax replacements between FY03 and FY05, making up for the lost revenue by increasing property taxes $3.2 million.

Figure 2. Total Property Tax Replacement Funds to Local Governments ($ millions)

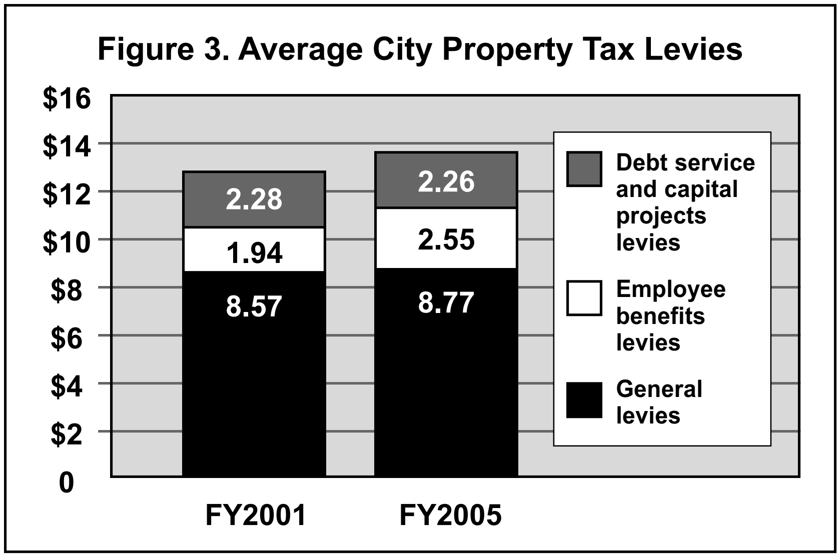


City Revenues

One measure of the stress that the fiscal crisis has put on city governments is the actions that cities have taken to raise additional revenue. In Iowa, the property tax levy used to support the bulk of services, which are financed out of the city's "general fund," is effectively limited to $8.37 per thousand dollars of assessed valuation (the general fund levy of $8.10 plus the 27-cent emergency levy). In FY01, 71 percent of Iowa municipalities were at the $8.10 limit, and 23 percent also levied all, or nearly all, of the allowable emergency levy. By fiscal year 2005, those proportions had increased; 78 percent of cities are now at the $8.10 limit, and 31 percent use at least 90 percent of the emergency levy.

Most cities have had little room to raise tax rates to offset the declining real per capita tax base, since most have been at the general fund levy limit for some time and many are using the entire emergency levy as well. Still, average property tax rates increased 6.2 percent from FY01 through FY05. However, 78 percent of that increase was attributable to the employee benefits levies, which are not subject to limit. These levies fund health insurance coverage and pension fund contributions. The City of Guttenberg, for example, has experienced increases in health insurance costs of 12 percent to 14 percent every year for the past several years, and has had to increase employee contributions, in addition to raising the property tax rate, to pay for these increases. Employee benefit costs have increased in Council Bluffs by 24 percent to 35 percent each of the past four years. Other cities have also passed on part of the cost increase to employees in the past two years: Cedar Rapids and Mason City are two examples. On average for all cities, the employee benefits levy was raised almost 32 percent over the past four years. General levy rates, in contrast, increased only 2.3 percent over this period.

Despite an increase in the number of cities employing the local option sales tax, budgeted real per capita local option tax revenue increased just 3 percent from 2001 to 2005 for all cities. Among Iowa's 34 largest cities, local option tax revenue actually grew more slowly than the cost of producing services, so that actual real per capita revenues declined from FY01 to FY03, and were expected to decline further in the next two years. These trends reflect two factors: (1) the long-term decline in the sales tax base as purchases shift from goods to services (which are less likely to be subject to the sales tax) and as consumers rely more on mail order and internet purchases, on which state sales tax is rarely paid; and (2) the effects of the recession, which reduced consumer spending, particularly on goods subject to the local sales tax.



Intergovernmental aid also fell during the past four years. As a result, cities turned to increases in property tax rates and increases in fees, fines and charges to make up for the lost revenue. In percentage terms, the largest revenue growth was in fees, which increased 41 percent per person from FY01 to FY05. The City of Des Moines, for example, raised every one of the nearly 50 fees it charges.

City Expenditures and Fund Balances

In the face of declining revenues and a declining property tax base, cities have generally tried to preserve the most essential public services, such as police and fire protection. Cuts have been concentrated on public works and cultural and recreational programs. Overall, city government spending increased $10 in real per capita terms, a 1.8 percent increase, from 2002 to 2005. Most of this increase is attributable to the $14 increase in per capita spending for public safety, an area that accounts for about a third of city operating budgets. Because of rising costs, particularly of employee benefits, increased spending has often been accompanied by program cuts and elimination of positions, and many cities over this period reduced spending. Cedar Rapids cut over $3 million from its budget in the past two years, and eliminated 22.5 full-time-equivalent positions. Des Moines has eliminated 140 positions since FY02.

One means of maintaining services as much as possible and minimizing layoffs is to draw down fund balances. This is a one-time source of money and cannot be relied upon for more than two or three years in succession. When and if revenues recover, some of the increased revenue may be needed to restore fund balances as well as restore services. While cities are wary of digging too large a hole for themselves, many in the past two years have decided to deplete fund balances rather than lay off more city employees and cut services further. Council Bluffs, however, had to spend down its general fund balance from $6.8 million in FY01 to $4.6 million by the end of FY03, leaving little flexibility to deal with revenue shortfalls in FY04. As a result, the city eliminated eight positions that year in the fire and police departments, and cut one of the four ambulances, and then was forced to lay off eight additional workers mid-year when it was hit with $754,000 in cuts in state revenue. The city followed with further cuts in FY05: 12 more positions were eliminated, including eight in public safety.

Of the 34 cities with populations over 10,000, increasing numbers have drawn down fund balances to make up for revenue shortfalls. By FY04 and 05, about three-fourths of these cities had dipped into their fund balances. Twenty-nine had declining general fund balances in FY04, and the median change during that fiscal year among the 34 was -7.6 percent. Twenty-three of the cities project balances to decline again in FY05. During this period, the median city among the 34 largest saw its general fund balance at the start of the fiscal year decline from 27.0 percent of fiscal year expenditures in FY03 to 25.6 percent in FY04 and a projected 22.7 percent in FY05.

County Revenues

As is the case with cities, the recent economic recession has impacted the capacity of county governments to meet the needs of their residents. During an economic contraction, there is a continued demand on county services, but not a commensurate growth in property values, which is the primary source of county revenue. As a result, counties have struggled with a mismatch between revenue and services demands over the last few years.

As with city governments, state actions have exacerbated county financial troubles. Cuts in state tax replacements have put pressures on counties to draw upon their reserves or to increase property taxes. From FY01 to FY05, state tax replacement payments to counties declined by $38.6 million, or 25.4 percent. With this decline in county revenue, counties were forced to look at their major revenue source, the property tax, in order to meet continued need for county services including public safety, human services, elections and recording mortgage transactions. County property taxes increased by 19.4 percent from FY01 to FY05. In FY01, 29 counties were below their general fund levy limit of $3.50 per $1,000 valuation. Currently only two counties are below that limit. In FY01, 72 counties used their general supplemental levy. Currently, 92 of Iowa's 99 counties are using that levy. Currently 17 counties are exercising their authority to exceed levy limits due to unusual circumstances, while only one county did so in FY01.

County Expenditures and Fund Balances

Counties have worked to hold the line on county expenditures as they have dealt with declining state tax replacements and an increasing demand and cost for services. County total expenditures increased by a modest 8.8 percent between FY01 and FY05, below the 9.4 percent inflation rate as measured by the index for the costs of state and local government services. Even while trying to hold the line on expenditures, counties still saw an increase in the cost of public safety services, including law enforcement, jails, and criminal prosecution from FY01 to FY05. Over this period, county public safety costs increased by 22.9 percent, or $7.6 million. A significant portion of the increase in county cost is the increase in health insurance. From FY01 to FY04, the cost for county health insurance premiums increased on average by 78.4 percent. Winneshiek County saw its health insurance premiums for single coverage rise 240 percent between FY01 and FY04.

In an attempt to limit the need for property tax revenue, counties have spent down their balances by $31.7 million, so that in FY05 those balances are expected to be below 25 percent of county expenditures. Maintaining at least a 25 percent balance to avoid cash flow problems is considered important for good fiscal management, since county expenses occur throughout the year, while property tax revenues come in during the spring and fall.

Conclusion

Both city and county governments faced budget challenges from FY01 to FY05 that stemmed from common sources:

- An overall tax base (primarily property taxes) in which growth has not kept pace with the economy or demands upon local governments;
- Rapidly expanding health care costs for employees that represent an increasingly large part of local expenditures; and
- Declines in state property tax replacement funding, as a result of state efforts to deal with the state fiscal crisis.

While different city and county governments acted differently, in general city and county governments acted to maintain essential services, particularly police and fire protection, through:

- Raising property tax levies to the maximum rate allowed and, when necessary, adopting emergency levies;
- Spending down their budget reserves; and
- Raising fines, permit fees and charges for services.

Even with these actions, city and county budgets grew more slowly than the inflation rate, and the result has been some elimination of services and laying off of local government employees. The loss of state property tax replacement funds, totaling over $110 million, produced particular challenges. In many instances, these state actions had the effect of raising local property tax levies.

As cities and counties look into the future, many must replenish their budget reserves and seek sustainable funding bases for local services, with the current property tax base unlikely to be able to fully play that role.

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.