

Sales Tax TIFs: A Bad Idea Rears its Ugly Head Again

Transfer Funds from Taxpayers to Developers, Without Promoting Development

By Peter S. Fisher

In 2005, when the Iowa Legislature approved the state's first diversion of sales tax revenue from the general fund to a local project — the Iowa Speedway in Newton — we warned that this unfortunate precedent would prompt other cities to seek similar subsidies from state funds. Our concern was dismissed. Nevertheless, a bill recently introduced in the Iowa House would allow all Iowa cities and counties the power to redirect state sales tax revenues to local projects. Like the 2005 legislation, this would create authority for Sales Tax TIF (Tax Increment Financing) districts, because it takes the increased state sales taxes from a new project and rebates them to the project instead of allowing them to flow into the state general fund.

An overarching concern must be that incentives rarely if ever are decisive in retail location decisions, making such incentives wasteful. The primary effect will be a transfer of funds from Iowa taxpayers to developers, with no more development than we would have had anyway. This fundamental concern is ignored by the proposed legislation, House File 2480 (HF2480 — formerly House Study Bill 680).

The bill appears to be limited to a particular project site and is being pushed by the owner: Trilogy Raceway Development. Trilogy on its website promotes the 66-acre parcel, adjacent to the Iowa Speedway, as “ideal for casino, retail, hospitality, and entertainment development.” Revenues from the TIF diversion would presumably subsidize projects on that site and adjacent land that is available. The bill has limitations that appear to exclude smaller scale projects that other cities might devise. History tells us, however, that these limitations will be short-lived, as other cities push to get on the state gravy train for their own projects. In fact, promoters of the bill are already touting it as a boon to large scale projects across the state. The long-run fiscal implications of such a bill are thus very harmful to the state general fund.

The bill would also allow cities to pull future increases in Local Option Sales Tax (LOST) revenues out of the revenue sharing feature of the LOST law after the fact, negating the countywide pooling approved as part of the tax in a voter referendum. This leaves rural voters holding the bag — paying city sales tax that the county and small towns can no longer share in. Furthermore, cities already have more than enough ability to divert taxes to development projects through property tax TIFs and abatements. The site targeted by this bill is in fact already in a TIF area. This bill would guarantee a new round of wasteful competition among Iowa cities for a fixed pot of new retail activity, masquerading as “economic development.”

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The Legislation

HF2480 authorizes the creation of “sales tax bonding districts.” These districts are modeled after property tax TIFs: A base year is established at the time the district is created, and most of the increases in sales taxes over the base year amount collected within the district are returned to a special city fund. The sales taxes diverted include 4 cents out of the 6 cents in state retail sales and use tax, any Local Option Sales Taxes (LOST), and hotel-motel taxes. The bill thus allows a city council or a county board of supervisors to establish a district within which increases in these three taxes are diverted from the state general fund or from the county LOST distribution pool to either retire bonds issued for projects in the district, or simply to “fund the development of projects within the district.” There are no restrictions on what constitutes “funding,” while a “project” is defined as a “structure that is wholly or partially above ground.” The diverted revenues could be used for everything from direct subsidies to a private developer, to financing public facilities in the district that are normally financed from city or county funds.

The potential for creating sales tax bonding districts appears to be limited by eligibility provisions in the bill: the district must be a contiguous area of at least 400 acres, and at least 90 percent of the land must be vacant; and the project or projects in combination must entail a capital investment of at least \$50 million, created at least 200 permanent new jobs, and generate at least \$25 million in annual gross revenue. However, the history of similar tax deals in Iowa suggests that these limitations will not remain part of the statute, should it become law. Special tax provisions designed to benefit a particular project, such as the incentives for the IPSCO steel plant in Muscatine County, have within a few years been extended to all comers. Iowa’s Tax Increment Financing law has been broadened and loosened numerous times as more and more cities and counties seek to take advantage of its provisions for more and more kinds of projects. The criteria for qualifying as an enterprise zone have been weakened to allow more places to take advantage of these state tax subsidies. This bill itself is a child of the Newton TIF, and sends us further down the road to creating ubiquitous Sales Tax TIFs for commercial projects of all sizes and kinds, draining the state treasury and undermining the provisions for countywide sharing of LOST revenues.

Sales Tax TIF Encourages Unneeded Subsidies for Retail Activity

A sales tax TIF is designed to subsidize development precisely where subsidies are least justified: for retail activity. A nationally recognized economist and expert on state and local development policy, Timothy Bartik of the Upjohn Institute, has said quite plainly that retail activity is not economic development.¹ Economic growth occurs by bringing outside money into the local economy through export industries or industries producing local goods and services that previously had to be imported. Retail is not an export activity; it is supported by local household spending. New retail simply competes with existing retail to divide up the market.

As markets grow, they can support more retail space. If a market grows to the point that it can support a new mall, for example, developers will figure that out and build a mall. If the market can’t support the mall, banks won’t finance it and developers won’t build it. Retail location is all about the size of the market, and access to that market. Incentives can’t overcome a bad location, and they aren’t needed if it is a good location.

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Subsidies to retail activities do not promote economic development; they bring in no new outside spending, but simply shift sales around among establishments competing for the same pool of local consumer dollars.

Proponents will argue that there is no revenue loss because the retail activity would not have been there but for the subsidies. Yet new retail construction occurs every day in Iowa with no help from subsidies — because the market can support it and banks will finance it. So why is the retail supported by this bill different? If the claim is true that it wouldn't happen without subsidy, it would mean that the purpose of the bill is to promote the construction of retail space that the private sector is staying away from because the market cannot support it. Why is it in the interest of the state to create excess retail square footage and drive existing retailers out of business?

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If the response of proponents of this legislation is that this won't happen, then apparently the purpose of the bill instead is to subsidize the construction of retail space that the market *can* support and therefore that the market would provide on its own — in other words to pad the pockets of developers with no benefit to the community. One way or the other, it appears that taxpayers and local store owners are the losers, and large developers the most likely winners.

It is true that a large-scale development that offers some unique attraction and becomes a “destination” can draw some spending from outside the state. The Legislative Services Agency (LSA) has assumed that 20 percent of the sales within the Newton district will come from non-Iowa residents. The other 80 percent, in other words, represents spending from Iowa residents that has been shifted from existing local retail and entertainment activities to the Speedway development, with no net gain to the Iowa economy. As a result, the net ongoing fiscal effect of the bill under the LSA assumptions is a loss of \$750,000 to the state general fund even under the assumption that the project would not occur but for the sales tax bonding district.

This loss of revenue should be taken as the best case scenario. It is far more likely that the sales tax bonding district will merely subsidize an activity that is viable in that location on its own, and that therefore the net loss to the state is the entire amount of diverted state revenue: \$1 million. Similarly, the one-time impact of the TIF on the sales taxes on construction materials is zero, because the project would have happened anyway. Furthermore, weakening of the limitations will lead to use of these districts for projects that draw in little or no out-of-state money, making the net fiscal effect worse under any assumptions.

Sales Tax TIF Undermines Voter Approval

Under the proposed law, a sprawling 40-acre retail mall project could be subsidized with taxpayer money simply by action of the city council or county board of supervisors. Even if bonds are issued, no referendum is required. We then have the anomaly that bonding for a new school, arguably the most essential of local public facilities, must be approved by 60 percent of voters and bonds for a new library by 50 percent, but bonds for a shopping mall could be issued with no voter approval at all.

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Additional questions of legality and fairness arise when considering the LOST portion of the proposed TIF. While the LOST must first be approved in a countywide referendum, a city council can subsequently adopt the sales tax TIF simply by vote of the council. When citizens vote to approve a LOST they are voting for a tax that by law must be shared countywide according to formula. One city should not be allowed to unilaterally pull revenue out of that sharing agreement after the fact, negating a key feature of the tax as approved by voters.

Sales Tax TIF Undermines LOST Sharing and Leaves Rural Voters in the Cold

The LOST is by far the largest local option tax available to cities and counties, diversifying the revenue base and relieving pressure on the property tax. Under Iowa law a proposed LOST must be voted on throughout the county, and the revenues collected in all places adopting the tax must be pooled and shared. This provision recognizes that retail activity is often concentrated in certain cities within a county, yet all residents of the county pay the LOST, and all should share in the revenues. This bill would allow cities to circumvent the revenue sharing feature of LOST. Under the new sales tax TIF, all increases in LOST revenues collected from retailers in the district are diverted from the countywide LOST pool and instead go into the city's TIF fund. Compounding the inequity, the *city would still get its share of the countywide pool of taxes* collected in every other city in the county.

This bill would allow cities to circumvent the revenue sharing feature of LOST.

Any city that is home to substantial retail activity would have a powerful incentive to create a sales tax bonding district around that retail tax base. It is not hard to imagine how this will play out over time, as neighboring cities retaliate by doing the same. The likely eventual result is that every city with a sales tax base of any significance will TIF that base to protect its revenue stream. The pooling of shared revenues will become ever smaller and the unincorporated county and small towns with little or no retail activity will get little or no LOST revenue, but still have to shop in the neighboring cities and pay sales tax to them. That is why, in the long run, this law spells the effective demise of shared revenue, leaving rural Iowa footing the bill for subsidized and sometimes unwise city retail development.

Conclusion

This bill is unnecessary and costly. The most likely beneficiary is the development company that owns the land and hopes it will become more valuable if new incentives are attached to it. But development of that land will occur if demand will support it, incentives or no incentives. The taxpayers of Iowa are the losers.

ⁱ Timothy Bartik, "What Works in State Economic Development?" Upjohn Institute for Employment Research, Kalamazoo, Michigan, for the Wisconsin Family Impact Seminars.

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Iowa Fiscal Partnership

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