



Fiscal Policy BULLETIN

1990:2

September 1990

Impact Fees and Other "Designer" Taxes: Alternatives to General Taxation

The Report in Brief

Several alternatives to the local general property tax have developed in recent years. Special taxing districts, special assessments, tax increment financing, and most recently, impact fees are directed at financing capital costs of development or redevelopment.

These revenue sources are limited to specific purposes and imposed in customized districts rather than uniformly across general purpose governmental units.

Although these sources provide local units with expanded ability to provide service to new development, their piecemeal and incremental character make them less visible than the property tax and create the potential for growth of "backdoor" taxation.

IFPI is a non-profit organization established in 1987 to conduct independent non-partisan research and analysis of taxing and spending policies in Indiana. Contributions to the Institute are deductible under 501(c)(3) of the Internal Revenue Code.

Introduction

In order to enhance their taxing capacity and accommodate growth and development, communities have adopted funding sources other than the general property tax to provide roads, water and sewage treatment plants, schools, parks, police and fire service, and other community facilities. In Indiana, these finance vehicles are: special taxing districts, special assessment districts, tax increment financing, user connection charges (tap-in-fees), negotiated developer contributions (development exactions), and impact fees. The effect of these mechanisms is to shift the cost of new growth from the general taxpayer to the new resident or landowner making it possible to raise revenue without increasing general taxes.

A relatively new tool available to localities across the U.S. to finance development is the impact fee. Impact fees are intended to finance off-site improvements associated with development projects. Local units in fourteen states have specific authority to levy impact fees, while units in the other twenty-five states levy the fees under home rule authority. (Impact fees were the subject of proposed legislation in the 1990 session of the Indiana General Assembly.)

Regarded as an innovation, the impact fee is actually part of a family of specialized fees and taxes that have come to be called "designer" taxes by some because of the tailor-made character of the districts in which they are imposed. Some of these tools, such as special assessments, have a long history; others are of relatively recent origin. The purpose of this *Fiscal Policy Bulletin* is to describe designer taxes in Indiana and the issues related to impact fees.

"Designer" Tax Districts

Local governments face the challenge of constructing a wide range of capital facilities. Deciding how to finance this infrastructure can be a complex task. When considering what resources are available to fund infrastructure improvements, it is important to explore all possible financing alternatives.

The tools used by local government in Indiana to help finance commercial-industrial and residential development are: special taxing districts, special assessment law, Barrett law funding, tax increment financing (TIF) and sales tax increment financing (STIF), which was enacted in the 1990 session of the General Assembly for the City of Hammond.

Special Taxing District

A special taxing district is a limited purpose unit of government created to carry out a specific function, with the right to levy user charges as well as property taxes. Examples of these special districts include sewer or storm drainage facilities, parks, flood control, redevelopment districts, and airport authorities. These districts have the authority to finance projects by issuing their own bonds payable from a special tax levied on all of the taxable property in each district. Special taxing districts differ from special assessment districts in their relative fiscal and administrative autonomy from local government. Generally speaking, they are governed by an appointed board that is empowered to perform designated public functions with little or no oversight by local governments.

Special taxing districts offer an opportunity for providing services in instances where the financial or administrative capacities of local governments are constrained. They can also operate within more logical geographical boundaries than can general purpose units of government. For example, a flood control district that intersects several local governmental boundaries, but serves all the residents of a particular floodplain, may be more desirable than flood control services limited to areas within legally specified political boundaries.

Each year, the special taxing district board establishes a tax rate on the taxable property in the district for the purpose of providing for the cost of operation, maintenance, and repair of the infrastructure. The property within the district is presumed to be benefited to the extent of the annual tax. Although the law specifies that the area is the recipi-

ent of a special benefit, the assessment on the parcel of property in the designated area is an ad valorem tax and consequently bears only coincidental relationship to benefit. Each special taxing district has an express statutory limitation on indebtedness.

Special Assessment District

A special assessment is levied on property owners for such public works as pavement improvement, drainage, parking facilities, and other capital improvements. Because these public works often enhance the value of nearby property, it is deemed logical to charge part or all of the cost of the works to the landowners. Special assessments are derived by a formula whereas the property tax is determined by a rate.

They may be levied within a sub-area of either cities or counties called a special assessment district. Special assessment districts are not independent of the local unit that created them; they are a convenient designation for the group of properties that receive a specific benefit. In Indiana, there are three special assessment options available to local communities:

Barrett Law

Barrett finance is the primary mechanism by which a city or county in Indiana may assess individual property owners for the cost of public improvements that benefit their property. For counties, revenues derived from the assessment are limited to sanitary sewers and sanitary sewer tap-ins, sidewalks, streets, and curbs. For cities, assessments may be levied for sidewalks, curbs, streets, street lighting, alleys, and other paved public places.

The local fiscal officer collects and

enforces special assessments. Usually, local governments give property owners the option of paying the assessment in a lump sum or pledging payments over time. However, an assessment of less than one hundred dollars must be paid in full. If a property owner elects to pay the lump sum, the local unit may elect to borrow the money to pay for the capital improvements and use the special assessment revenues to pay debt services.

Special Improvement District

Redevelopment commissions may request the legislative body of a unit to establish a special improvement district for redevelopment purposes (see chart). Once the district is established, the unit may assess individual property owners. To date, there is no record of an Indiana municipality using this tool.

Economic Improvement District

A petition may be filed with the legislative body of a unit to establish an economic improvement district. Once the district is established, assessments are paid into the economic improvement fund which is under the control of the Economic Improvement Board. The money in the fund may be used as specified in the ordinance establishing the economic improvement district (see chart). Unlike special improvement districts, economic improvement districts may not issue notes or bonds. No economic improvement district has yet been established in Indiana.

Tax Increment Financing

Municipal and county governments have made extensive use of tax increment financing to provide infrastructure improvements. Tax increment financing is intended to:

1. Strengthen the tax base;
2. Salvage a declining area and create a new economic climate; and,
3. Improve housing and create new job opportunities.

The unique feature of this funding method is that local units capture the increment in the ad valorem tax generated by a particular redevelopment project and earmark that revenue for capital improvements. In effect, the project area generates its own funding. TIF is not a new tax; rather TIF is a reallocation of tax dollars. Affected taxing bodies may object to TIF on the grounds that the TIF district will capture taxes which would otherwise go to them. However, to the extent that the captured increment is concentrated in the TIF district and not available to be allocated among the other overlapping taxing jurisdictions, a redistribution of the local tax burden occurs to ensure that those jurisdictions receive the same levy that they would have if the TIF district had not been established.

To determine the assessed valuation of the project area, the redevelopment commission refers to the assessment date immediately preceding the effective date of the allocation provision. This calculation establishes the "frozen" tax base. The increment generated from the taxes levied on the growth in assessed value of real property in the TIF district is used by the redevelopment commission to subsidize redevelopment activities. TIF assumes that sufficient growth in assessed value will occur in the district and that the tax rate applied to that anticipated growth will generate funds sufficient to repay any outstanding debt. (see chart)

Local agencies may fund improvements from tax increment proceeds in one of three ways:

1. Pay-as-you-go basis; using tax increments each year as they are

- collected and distributed, or
2. Issuing tax anticipation notes or bonds in advance of the actual collection of the tax revenues so that a larger sum is available for funding up front, thus accelerating the redevelopment process, or
3. TIF leasing, in which the locality establishes a redevelopment authority. This not-for-profit corporation constructs the infrastructure and leases the improvement to the redevelopment commission which in turn pays the lease with the TIF revenue. Establishing this relationship circumvents the requirements of voter approval and the constitutional limit on municipal indebtedness.

Property Tax Replacement Credits (PTRC) for TIF Districts

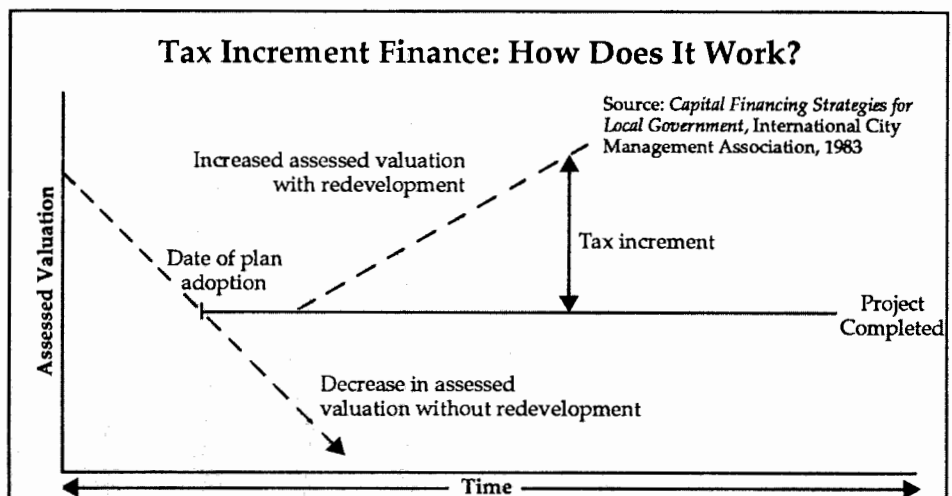
Each year, Indiana taxpayers are entitled to a property tax replacement credit (PTRC). This annual credit, as currently calculated, approximates 15% of average property tax liability and is paid from the State's property tax replacement fund.

Prior to 1988, when TIF was employed, the taxpayer was not entitled to PTRC for that portion of the tax levied for repayment of principal and interest on outstanding debt incurred by the TIF district.

This served as a disincentive for businesses to locate or expand in re-development areas.

The 1988 Indiana General Assembly passed PL 38-1988 which allows the taxpayers in TIF district to take a credit for that portion of PTRC which relates to the increase in property taxes required to pay TIF district debt service. However, the additional credit reduces the amount of proceeds allocated to the redevelopment district. With the 1988 change in the statute, each taxpayer in the TIF district was entitled to an additional credit and therefore in the same position whether in or out of an allocation area. However, the part of the PTRC attributable to incremental tax proceeds is derived from local funds and not from state funds.

Two local TIF districts were not included in the statutory change. They are: Courtyards Construction (Fort Wayne); and Circle Center Mall (Indianapolis). These districts were excluded because their respective redevelopment commissions had issued bonds or other contractual obligations payable from allocated tax proceeds of the TIF district. Pledging that revenue to taxpayers to refund applicable PTRC might adversely affect the interest of the holders of bonds or other contractual obligations. The



Sales tax increment finance (STIF) provides a municipality with a means of financing local public improvements in connection with retail projects that are expected to generate a greater amount of sales tax. STIF works in a fashion similar to tax increment finance except that the incremental sales tax is allocated rather than property tax. As an incentive, all the new sales tax generated after the establishment of the base year may be used to support the financing of the redevelopment project. In Indiana, this mechanism has been authorized by statute on two occasions. The City of Indianapolis was the first to receive authority (but never utilized the authorization) and the second is Hammond.

Essentially, the sales tax, a state revenue, is diverted to local use under this approach. Historically, the retail sales tax has been considered a state revenue. With the addition of sales tax increment financing, the state has altered this policy. To the extent that local units are able to use the retail sales tax, a new direction in local taxation is being taken.

Impact Fees

An impact fee is a fee charged to developers to cover, in whole or in part, the anticipated cost of improvements that will be necessary as a result of the development (Government Finance Officers Association, 1988). The actual dollar amount is calculated in such a way as to represent the anticipated additional costs to local government for providing increased services to the developing area. Typically, they are paid at the time an area is being developed. The imposed fee helps the local government pay for the off-site capital facilities and augmented public services necessitated by new development, such as recreational

facilities, sewage and water facilities, arterial roads, public safety, landfills, libraries, and schools.

This type of fee is separate and distinct from charges that developers pay, by law or ordinance, for capital improvements within the development site necessary for permit approval. There is also a distinction between impact fees and negotiated exactions, which are the result of bargaining between municipalities and developers on a project-by-project basis over specific improvements which are immediately off-site, such as traffic lights, turning lanes, and sewer line extensions. The amount and type of contribution varies with each project and can take the form of cash payments, in-kind contributions, or both.

In Indiana, developers and local government officials agree that there should be enabling legislation to ensure that impact fees are imposed in a uniform manner throughout the state. Local governments desire such

legislation to confirm their authority to impose impact fees. Developers hope that state-wide enabling legislation would reduce the uncertainty they face when determining the economic feasibility of a development. Many impact fee programs have been subject to legal challenge by home builders and developers principally on the basis of whether the local government has the authority to levy the fee, and whether the fee is in fact a fee or a tax. Authority to levy the fee is generally not in question when state statute explicitly permits the use of impact fees.

According to a recent report issued by the Government Finance Officers Association, impact *taxes* are another means of assessing new development. Impact taxes are defined as taxes imposed on particular use of or power over property. An impact tax is considered a general revenue source of the local government, not subject to the same legal restrictions placed upon the use of impact fees.

Pros and Cons of Impact Fees

Pros

1. Potential to reduce the growth-induced pressure on community capital resources.
2. Allows localities to manage growth more effectively.
3. Enhances local tax base.
4. Proper impact fee procedure requires improved planning which should result in better infrastructure planning.

Cons

1. The fees are absorbed by the developers in the form of lowered profit.
- or
2. The fees are passed along by the builders to consumers in the form of a higher sales or rental price.
3. Since developers profit may be reduced, the amount that they are willing to pay for land will drop.
4. Impact fee systems are complex and require planning agencies to have adequate technical expertise.

Summary of State Enabling Impact Fee Legislation

State	Effective Date	Who May Assess	Types of Improvements	Refund ³ Requirement
Arizona	1982	Limited ²	Necessary public service	None
California	1989	General ¹	Public facilities, Public services and community amenities	Yes
Florida	1975	General	Governed by local determination	Yes
Georgia	1990	General	Public works, public facilities	Yes
Illinois	1989	Limited	Road improvements	Yes
Maine	1989	General	Infrastructure facilities	Yes
Maryland	1986	Limited	Public schools, public works and transportation facilities	None
Nevada	1989	General	Public works projects	Yes
Oregon	1991	General	Public works projects	None
Tennessee	1988	General	Public works projects	Yes
Texas	1987	General	Capital improvements	Yes
Vermont	1989	General	Any physical improvement	Yes
Virginia	1990	Limited	Road improvements	Yes
Washington	1988 1990	General General	Transportation Expanded to include public streets, roads and fire protection	Yes Yes

¹ = General Application

² = Limited to certain local units

³ = Fees must be collected and spent in a reasonable period of time or developer is eligible to receive a refund.

Source: Governmental Finance Officers Association

Conclusion

Pressures on the limited revenue-raising capabilities of local government have engendered an assortment of alternative means of financing public improvements and services. Special taxing districts, special assessments, tax increment finance, sales tax increment finance, and impact fees have developed outside the bounds of conventional funding techniques. Moreover, three forms of local option income taxes are available to local units to supplement property tax revenues. The proliferation of income taxes and designer taxes contributes to the diversification of the local revenue structure and gives local jurisdictions greater autonomy in reaching solutions to specific problems.

By the same token, the use of these options by local jurisdictions can be viewed as a means of avoiding the limits placed by Indiana law on the general property tax as well as a means of "backdoor" taxation. Their incremental and piecemeal nature tend to make them less visible than the property tax. Yet, their revenue-raising potential is considerable and they can contribute a significant amount to the local tax burden.

Board of Directors

Daniel B. Seitz, Chairman
 Niel C. Ellerbrook, Vice Chairman
 Francina Dlouhy, Treasurer
 Donald E. Coover, Secretary
 Charles Arthur
 A. Gerald Backstrom
 James M. Hemphill
 Maynard Hokanson
 Marcia Horton
 James P. Lathrop
 Charles Schalliol
 Gregory A. Schenkel
 Miles Stipanovich, Jr.
 Larry Stroble
 William Styring, III
 Roger Utzinger
 Charles Winger

Earl M. Ryan, President



Indiana Fiscal Policy Institute

251 N. Illinois Street, Suite 980
 Indianapolis, Indiana 46204

Non-profit
 U.S. Postage
PAID
 Permit #8
 Indianapolis, IN