

# The Fiscal Impact of Residential Development in Mount Vernon

*A Report to the City Council  
of Mount Vernon, Iowa*

Peter S. Fisher

November 2006

## **The Iowa Policy Project**

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## **Preface**

This report was prepared under a contract between the City of Mount Vernon and the Iowa Policy Project. The report relies on published audited financial reports, real estate records, city budgets, and other public information. It also relies heavily on information supplied by the Mount Vernon City Manager, Mike Beimer. I would like to thank Mr. Beimer for his prompt and thorough replies to my many requests for information. It has been a pleasure working with him.

Peter Fisher  
Research Director  
The Iowa Policy Project

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# The Fiscal Impact of Residential Development in Mount Vernon

## Introduction

The purpose of this report is to determine whether recent residential development has generated revenue to the city in excess of the additional city costs attributable to that development, and to determine the conditions under which future residential development will generate positive or negative fiscal effects, or will be fiscally neutral. The assessment of future fiscal impacts is based on alternative policy scenarios regarding how such development will be taxed and how public improvements necessitated by that development will be financed, focusing particularly on the use of Tax Increment Financing.

## What is Meant by the Fiscal Impact of Development?

The fiscal impact of development is measured by the additional revenue generated by the development less the additional public spending attributable to the development. The impact can be positive (revenue exceeding expenditures), neutral, or negative. Often the question is posed in this fashion: Does development pay its own way? In other words, is the fiscal impact neutral or positive?

In this report we estimate the fiscal impacts of residential development. This requires isolating the effects of residential development on the city budget from other factors, including the growth of commercial establishments, that could have affected revenues and expenditures during the period in question. But what if one kind of development causes the other? Does it make sense to talk about residential development in isolation?

Some kinds of commercial development, as well as industrial development, bring with them additional residential growth. This is the case for what is called basic or export economic activity, such as manufacturing or offices, where products or services are sold outside the community. These activities require labor and this tends to draw additional population as a result. Other commercial activity, called local sector, tends to follow rather than produce population growth. Retail and service activity involves the selling of goods and services locally, and hence tends to expand when the local market expands through population growth. Thus any evaluation of the fiscal impact of residential growth should be viewed in the context of the overall economic growth of the community, since residential and non-residential growth will tend to go hand-in-hand over the long term.

There are exceptions to the rule that residential and non-residential development will occur, to some extent, in tandem. A community may embark on a deliberate policy of zoning out commercial and industrial uses in order to remain purely a bedroom community relying on neighboring cities for jobs, shopping and services. Some places, of course, can achieve a deliberate unbalance in the other direction, by becoming an industrial enclave (and hence a

regional job center) or a regional shopping center (by virtue of a fortuitous location for retail activity). In these cases the non-residential sector would be “overdeveloped.”

It appears that Mount Vernon does not aspire to these extremes, preferring to remain a balanced small town with a vibrant local commercial sector and some export activity (Cornell College being the major example), along with its residential areas. The 1995 comprehensive plan reflects such a view, envisioning controlled growth in commercial land uses along with residential development.

So what does it mean to ask whether residential growth pays its own way? If the goal of the community is to continue on a path of balanced growth, with continued expansion of export activity and local-sector commercial activity going hand in hand with the development of new subdivisions, then we would not necessarily expect residential growth by itself to pay its own way. Rather, we would expect that the overall growth of all kinds of property would generate sufficient revenue to finance services to the additional population. In fact, there is often a presumption that residential development does not by itself pay its own way (unless it consists of expensive homes housing families with few demands on public services—and few school children in particular). Commercial and industrial property, it is presumed, generates revenue in excess of the direct costs of providing services to that property, since the majority of public expenditure is for the benefit of people rather than property. Thus balanced growth pays its way. And balanced growth will tend to occur through the normal workings of the market, additional resident population generating demand for more commercial development, and additional non-residential development generating jobs that in turn generate demand for places to live.

A community may, however, decide to embark on a path that deliberately produces more residential growth than would result from the normal workings of the market. One way to stimulate residential growth would be to invest in a high level of public services and amenities that would make Mount Vernon a more attractive place to live. The community, for example, could build parks and schools and recreation facilities to increase the demand for residential building lots. An alternative strategy would be to subsidize new housing development by having current taxpayers pick up more of the costs of services to new subdivisions. This would stimulate demand for housing by making it cheaper.

The fiscal effects of such a strategy depend in part on whether residential growth in and of itself generates a fiscal deficit, as is often assumed, or a surplus. It also depends on whether or not the city can count on sufficient growth in the commercial sector to follow from the population growth. Such development may be needed to finance the costs of stimulating the residential sector, as well as to cover any fiscal deficit from residential development.

## **Residential Growth in Mount Vernon**

Since 1999, most new residential construction has occurred on the fringes of Mount Vernon: In the Twin Creeks subdivision along Palisades Rd. and Highway 30, in the Stonebrook subdivision on the southwest, in the Meadowbrook Condos on the west edge of town, in the Oak Ridge Estates development on the southeast side, and in the Wolfe-Martin, Hobbie, and other small

subdivisions on the east.<sup>1</sup> A total of 146 homes were completed in these areas between 1999 and 2005. Infill development does not appear to have occurred to any extent, nor does there appear to be much undeveloped land in the older parts of town to permit infill in the future.

**Table 1: New Homes Completed and On the Tax Rolls in Mount Vernon, 1999-2005**

Year	Number	Total 2005 Actual Value	Average value	Total 2005 Taxable Value
1999	14	\$ 3,014,399	\$215,314	\$ 1,386,503
2000	18	3,907,930	217,107	1,797,491
2001	16	3,863,054	241,441	1,776,850
2002	18	4,300,938	238,941	1,978,259
2003	27	5,774,012	213,852	2,655,815
2004	39	8,225,660	210,914	3,783,475
2005	14	3,132,467	223,748	1,440,810
Total	146	32,218,460	224,334	14,819,203

Future residential growth in Mount Vernon very likely will occur in patterns similar to those experienced in the past six years. That is, new construction will be accommodated in fringe subdivisions. There are many platted but vacant lots in existing, approved subdivisions: About 175 lots in Stonebrook, and another 20 lots in the subdivisions to the east. (Furthermore, streets are stubbed out to accommodate more subdivisions on the east side.) Our best estimate is that household size in new subdivisions in Mount Vernon in recent years has averaged about 3.2 persons.<sup>2</sup> Therefore, if future development also mirrors current household sizes, then lots already on the books could accommodate an additional population of 625.

The 1995 Mount Vernon Comprehensive Plan recognized two major kinds of development pressures on the city. First, regional population growth, combined with continued decentralization of population within the Cedar Rapids and Iowa City metro areas, would create increased demand for housing in Mount Vernon. The drafters of the plan anticipated, and argued

<sup>1</sup> This was determined by comparing a 1999 aerial photograph of the city with a 2006 photograph to identify new homes, which were then confirmed using the Linn County GIS system. The latter includes links to the assessor’s page, enabling us to identify the year built and the most recent valuation of each home.

<sup>2</sup> 2000 census data for Linn County shows that there were, on average, 3.2 persons per household for all households living in a dwelling that was built in the previous five years (1995-2000) and that was worth between \$100,000 and \$400,000, which approximates the range of values for homes built in Mount Vernon in recent years. Such data specific to Mount Vernon is not available, but we think this is a reasonable estimate of average household size in new subdivisions in the city. While 3.2 persons per household may seem low, other data suggest that is it not. Between the 2000 census and the special census in 2004, the population of Mount Vernon increased by 363. However, enrollment at Cornell College increased by 152 students from October 1999 to October 2003, and 92 percent of students live on campus. This suggests that off-campus population growth was about 220, or 55 per year, mostly non-students. Over this period, about 20 new homes were constructed each year, which implies an average household size of only 2.8. Furthermore, Mount Vernon school district enrollment increased by only about 50 students from 2000 to 2005. If all of the new school age children resided in the 114 new homes built in Mount Vernon from 2001 through 2005, and if there was one pre-school age child for every school age child (which is probably too high) and on average two persons age 18 or over per household, that would be consistent with an average household size of about 2.9 (228 adults and 100 children, divided by 114 homes). This calculation is obviously somewhat speculative, but the school enrollment figures certainly do not imply an average household size *greater* than 3.2.

that the city should plan for, growth to a population of 5,000 by 2015. Second, the location of the city at the intersection of highways 1 and 30, combined with the population trends, would put increasing pressure for commercial development along the highway 30 bypass, and the plan calls for controlling that development to minimize negative impacts on downtown.

Despite concerns expressed in the 1995 comprehensive plan, residential growth was actually slower than anticipated for the 1990s, population growing by just 151 persons for the decade. However, the population increased by 363 in the next four years. If the average annual increase of 91 persons that prevailed between 2000 and 2004 continued through 2015, the city would have a population of about 5,600 in that year, overshooting the goal by 600 persons. It should be pointed out, however, that the first five years of this decade were a period of robust new housing construction nationally, a trend that has slowed considerably in 2006 and is expected to slow more in 2007. Residential building permits in Mount Vernon averaged 23 per year from 2000 through 2005; they total 14 so far in 2006.

## **The Fiscal Impact of Recent Growth**

Is it possible to estimate the impact of the 146 homes built between 1999 and 2005 on the city budget? Since the homes built in 2005 are not yet generating property taxes, we will consider the 132 homes built from 1999 to 2004. The revenue effects are fairly straightforward. January 1, 2005 taxable valuation for Mount Vernon (for the 2006-07 budget year) totals \$94.0 million, of which \$13.4 million consists of the taxable value of homes built in 1999 through 2004.<sup>3</sup> Thus the tax base for the current fiscal year is about 17 percent higher than it would have been in the absence of new residential development over the six year period 1999-04. Potential property tax revenues (at the maximum general fund tax rate) are therefore also 17 percent higher. (Whether actual revenues are higher by that amount depends on what tax rate the city would have levied if that \$13.4 million in new valuation had not occurred).

Other city revenues no doubt also increased as a result of residential growth. State road use tax revenues are shared with cities strictly on the basis of population. Cities receive \$85 per capita, based on the most recent census. The special census in 2004 counted 4,171 residents in Mount Vernon, an increase of 363 over the count in 2000. Mount Vernon is therefore now receiving about \$31,000 per year more than the city would have without the population growth from 2000 to 2004. New residents also pay their share of city fees, fines, and charges. In recent years, such revenue has amounted to about \$67 per capita each year.

The revenue effect of population growth is quite substantial. We cannot say, however, that non-residential development would have been the same without that growth. No doubt some, perhaps most, of the commercial development of the past six years would not have occurred were it not for that population growth. If so, then one could argue that the revenue effect of population growth is even larger, the property taxes from new commercial property also being attributed to the residential growth.

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<sup>3</sup> Houses built in 2001 first appear on the tax roles for January 2002 (taxes payable in fiscal year 2004) and houses built in 2004 first appear on the tax roles for January 2005 (taxes payable in fiscal year 2007).

The expenditure impact of residential growth in Mount Vernon over the past six years is difficult to estimate because this growth occurred within a climate of statewide fiscal stringency. Imagine a world where property tax bases are allowed to rise with actual property values (and hence with growth and with inflation), state per capita aid to cities is constant, unfunded state mandates are unchanged, and state funding of property tax relief is maintained. In such a stable climate one could reasonably expect that city expenditure increases above inflation represent increases in services, due either to an increasing population or to new kinds of city services being provided. Since we would know if the city began offering new services, and could account for that, we could reasonably attribute the remainder of expenditure growth to population growth.

The actual fiscal context that cities have operated in since 2000 is quite different. Residential valuations have been severely constrained by rollbacks, and state aid to cities and state funding of property tax relief has been cut. Furthermore, public employee labor costs have risen dramatically due to rising health insurance premiums. Since personnel costs are a large portion of total city expenditures, this has meant that city costs have risen more rapidly than the general level of inflation. As a result, cities and counties across the state have been forced to retrench. From 2001 to 2005, the population in Mount Vernon grew by about 9.5 percent. From fiscal year 2002 to fiscal year 2006, city general government operating expenditures grew 13.4 percent in current dollars but actually declined 5.7 percent in inflation-adjusted terms, despite the increase in population requiring services.<sup>4</sup>

One should not conclude from this that the additional population occurring in the past six years produced no additional spending or somehow enabled the city to cut spending; the spending patterns were driven by the other factors identified above. It is impossible in this context to identify the impact of recent population growth on the city's ability to maintain services or on the city's costs. It is thus impossible to provide any reliable estimate of the net effect of population growth on the city budget.<sup>5</sup> The only exceptions are for water and sewer service, since recent expansions (1998 for sewer facilities, 2006 for water treatment and wells) were at least partly driven by population growth. However, both of these services are self-supporting; the investments are recovered from water and sewer fees, not taxes.

## Prospective Fiscal Impacts of Residential Growth

The effect of future residential growth on the city budget has more bearing on the policy choices facing Mount Vernon in the next few years. Here again, we must first address a conceptual issue. Are we concerned with the short term or the long term impact of development? In the short term—the next one to three years—there may be sufficient capacity in many city facilities, and

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<sup>4</sup> Expenditures are converted to 2006 dollars here and elsewhere in this report using the Bureau of Economic Analysis implicit price deflator for state and local government services, a price index for the cost of government.

<sup>5</sup> To do that we would need to be able to estimate what the city would have spent in fiscal 2006 if the 2006 population were the same as it was in 1998, and compare that spending to actual 2006 spending. Suppose the city were at the general fund levy limit in all those years; then general fund revenues would have simply been 17 percent higher in 2006 with the population growth than without, enabling city general fund spending to be 17 percent higher. This approach guarantees that we would find the fiscal impact of new residential development to be exactly zero, because increases in spending attributed to the new development are exactly equal to the increases in revenue. This is not a useful exercise.

sufficient city staff, to accommodate growth of 75 to 100 new residents each year. Thus many kinds of city costs may not rise with population growth. Over a longer time period, on the other hand, almost all city services are subject to capacity constraints. A new fire station may be needed to keep response times to outlying subdivisions within reasonable limits. Larger demands on city government may require more city staff, and more division of responsibilities within the city administration.

The short run perspective may be useful for purposes of forecasting capital expenditures in next year's budget. But for purposes of making policy decisions that will affect the pattern of development for years to come, it is hard to justify taking a short run perspective on fiscal impacts. Short run easily becomes short sighted. For this reason, we focus primarily on estimates of the long run impacts of residential growth.

Let us consider an example to illustrate the difference. Because of growth in the recent past, the city embarked on expansions of its water facilities (wells and treatment plants). This leaves the city in the position now of having a substantial amount of unused capacity in its water system (which is the inevitable result of taking advantage of economies of scale in the water facilities, which means building larger but less often.) The city has all the capacity needed for the foreseeable future. The short run perspective would therefore produce an estimate of zero impact of future population growth on water costs.

Suppose we had done this analysis in 2004 instead of 2006. The water system would have been near capacity and a short-run analysis would have identified substantial new water costs in the next year or two if population growth continued. Attributing the new water facility costs to the 20 homes built in 2005 would have made this residential growth look very expensive for the city (about \$60,000 per dwelling). This sort of attribution of costs is, of course, as arbitrary as the assignment of zero costs to future development now. Instead we attempt to estimate the long run cost of capital improvements and operating expenditures in this report.

A fiscal impact analysis deals primarily with the effects of development on tax-supported services and on revenues paying for those services. Tax-supported services are financed from the city's "governmental funds," which include the general fund plus special revenue, debt service and other minor funds. "Business type funds," also known as proprietary or enterprise funds, account for the rest of the city budget, and are treated differently in this analysis, as explained below. We will use the terms "general operations" or "general operating budget" to refer to services and revenues budgeted in the general fund and other governmental funds.

"Business-type funds" include water and sewer service, along with storm water and solid waste. These services operate like a business, on a self-supporting basis. Both the debt service for bond issues financing major capital projects and the annual costs of operating the water and sewer systems are covered by user charges: fees based on water consumption. Since these operations are self-financing, they could perhaps be eliminated from the analysis on the grounds that population growth will have no fiscal impact. However, the better approach is to ask whether or not long term population growth will bring about an increase or a decrease in water and sewer fees. Fee changes have a financial impact on Mount Vernon residents just like tax changes. If population growth enabled the city to achieve significant economies of scale in water or sewage

treatment, it is possible that costs per gallon, and hence fees per gallon, would decline. On the other hand, if population growth requires expensive system upgrades, fees could increase.

Major improvements to the city's water and sewer systems have been made over the past several years, and there is substantial excess capacity in both systems. It does not appear that growth will drive up costs in the foreseeable future such that water and sewer fees will need to be increased beyond the small annual increases necessary to keep pace with inflation in operating costs. Therefore we have assumed that growth will not impact Mount Vernon residents through higher fees for business type services in the foreseeable future.

### ***Expenditure Impacts***

The effects of residential growth on the general operating budget of the city are estimated using the commonly accepted "per capita multiplier" approach. The first step involves the division of public services into two categories: services exclusively to people, and services to both people and property. The distinction is not so much whether the services are used by persons, or benefit property, but whether or not increases in services are driven by increases in population or by increases in property. This division is of necessity somewhat arbitrary.

All services to people are attributed simply to population. The total expenditure on such services is divided by total city population to arrive at per capita cost. Most governmental services, however, flow to both people and property. Police and fire protection, for example, serve both people and property, and expenditures can be expected to rise with increases in property alone (non-residential construction, for example) and with increases in population alone (more college students living in the same number of dorms). Here we attribute half of such services to population, and the other half to property. The half assigned to property is then allocated to residential versus non-residential property in proportion to the value of property. The validity of this assumption is difficult to test, but no reasonable alternative suggests itself, and allocation of costs in proportion to value is standard practice.

That non-residential property should be assigned some costs rather than attributing all costs to the population residing in the city and using such property becomes clear when one conducts a simple mental exercise. Suppose all commercial property were just outside the city limits; hence all police and fire calls to these locations would be the responsibility of another jurisdiction. City expenses could be lessened. Or suppose on the other hand that the commercial sector in the city were twice as large and served a regional population; then the presence of non-residents using that property would add to the city's expense, and this would be captured by the size of the commercial sector, in square footage and value.

The second step is simply to divide all services to residential property (all "people services" plus the residential share of "property services") by the population of the city. This is taken to represent the long run per-person operating cost of providing city services.

What about major capital expenditures that are financed using general obligation bonds retired from the debt service property tax levy? The examples would be fire stations, administrative buildings, major street construction or improvement projects, and community or recreation centers. Here the appropriate fiscal impact method is the "case study" approach. Each kind of

facility is considered separately to determine if population growth is likely to affect the size or timing of investments.

Mount Vernon has a relatively new administration building. While we know the cost of this building, it is difficult to assign it a “capacity.” Governmental expenditure data, however, does allow us to determine the extent to which spending on city administration tends to increase with city size. Among Iowa cities with a population of 3,000 to 5,000, average per capita spending on general government administration was about \$50 in 2002. (Mount Vernon was well below average in this category, spending just \$27 per capita.) Cities in the next size class, 5,000 to 7,000, spent about \$54 per capita on general government, primarily because of increased expenditures on staff.

Both a new fire station and a recreation center are under consideration by the city of Mount Vernon. The present fire station does not have adequate room for all the equipment currently in use, nor is there space for training. The current location is also not ideal. Population growth may have been one factor contributing to equipment needs and hence the need for a new station, but a desire to upgrade service (through training, and through a location that is less congested) is probably more important. It is not anticipated that growth will produce a need for a second fire station in the foreseeable future. Therefore it does not appear that there will really be a capacity problem per se in the long run that warrants assigning any fire protection capital cost to new residential development.

A recreation center would represent a new service for the city. It would probably not be fair to attribute this to the demands of new residents, yet recreation facilities tend to be something that cities begin to consider at a certain population scale. To count this as an expenditure necessitated by new development is in a sense perverse, tallying it as a “negative” fiscal effect of growth when in fact many residents will no doubt see it as a new and desirable amenity made possible by growth—a *benefit* of getting bigger. The logic of fiscal impact assessment is to calculate the effects of growth on city revenues and expenditures holding the level of services constant. If growth generates a fiscal surplus, it creates possibilities for financing new services with less impact on tax rates, or maintaining services and reducing taxes. If growth generates a deficit, that will make new services more difficult to finance and may threaten existing services or force taxes higher. For this reason, we do not consider the recreation center as part of the basic fiscal analysis. However, the fiscal dividend or deficit from growth will make the recreation center more or less feasible.

Finally, what about street improvements? First of all, population growth obviously creates a need for more streets to provide access to new homes. Local streets within subdivisions are built entirely at developer expense, however, and their cost is reflected in the price of building lots. Secondly, there may be need for construction of collector streets providing access to new subdivisions, and population growth will increase traffic levels on existing streets, particularly arterials and other streets providing access to the main street businesses and to destinations such as schools. At some point, arterials may need to be widened to maintain reasonable traffic flow.

The city is considering several substantial street projects in the coming decade. A reconstruction and redesign of the intersection of highways 1 and 30 is being studied, as is a new street leading

to the new high school. These projects have not been committed to, nor have they reached the stage where an estimate of the city’s share of costs can be produced. Should they require bonding, it is likely that they would replace debt service payments currently being made for earlier projects, leaving the city’s overall debt service levy at something close to its current \$1.31 per thousand rate.

The repair and reconstruction of streets in the older part of the city will also be an on-going expense in future years, costing an estimated \$150,000 annually.<sup>6</sup> This amount will fit within the average expenditure of \$350,000 per year on capital projects (excluding those associated with the water and sewer enterprises). The upshot is that it is difficult to identify with any precision the impact of future growth on street expenditures. At the same time, it appears that recent levels of overall capital spending (about \$550,000 annually on debt service and capital projects combined) will not increase appreciably as these new street expenses replace existing project expenses in the city budget. In fact, general obligation (GO) debt service could decline in the next few years; the swimming pool debt was retired in fiscal 2006 and the only other GO debt currently on the books (for city hall) will be retired in fiscal year 2008. For this reason, we take the average level of capital spending (the sum of the debt service and capital projects levies for governmental funds) for the past four fiscal years as the best estimate of future general government capital spending. This will be roughly accurate to the extent that recent capital spending reflects the capital needs associated with the growth of the city since the latter 1990s, and that future growth will be of a similar magnitude and will generate similar needs for capital improvements of one sort or another.

A third method was used to identify possible long run changes in cost as Mount Vernon grows. Data from the 2002 Census of Governments was obtained for all Iowa cities within the general population size class of Mount Vernon: the 92 cities with a population between 2,000 and 8,000. Table 2 shows per capita spending by category for Mount Vernon and the average among the 92 cities.

**Table 2. Per Capita City Expenditure in 2002**  
Iowa Cities between 2,000 and 8,000 population

Service Category	Per capita expenditure	
	Mount Vernon	Average city
Public Safety	\$ 112	\$ 119
Highways	71	88
Parks & recreation	50	51
Libraries	9	34
Housing & community devel.	0	8
General government	27	49
Sewerage	77	75
Solid waste	85	38
Water	70	95

Source: US Census Bureau, 2002 Census of Governments

<sup>6</sup> Email correspondence from city administrator Mike Beimer.

We sought to determine through statistical analysis if there was a discernible tendency for city per capita expenditures on particular kinds of services to increase or decrease with population size. We take the experience within this group of cities to reflect what Mount Vernon might expect if it were to grow from its 2000 population of 3,808 to a size of 5,000 or 6,000 in coming decades. The analysis produced no discernible effect of population size on per capita spending for most service categories.<sup>7</sup> The only significant exception was public safety (mostly police and fire protection). The results indicate that for every additional 100 persons, per capita spending for public safety would increase 60 cents, a 0.5 percent increase over the average spending level of \$119 per capita. Airport spending also increases with population; the larger cities in this group tend to have airports, most of the smaller ones do not.

The conclusion is that spending is likely to increase with population, but not much more rapidly than population, as Mount Vernon grows. The increases in per capita spending for a few services would not have much of an impact on the overall city budget. Whether or not overall spending increases significantly depends much more on the choices Mount Vernon makes: Will the city at some point want an airport or switch to a professional fire department, or will it decide to offer more recreation services?

The final step in the expenditure analysis is to add the per capita operating expense and the long run per capita capital expenditures for general operation services to arrive at the total estimated expenditure impact of an additional resident. The results are shown in Table 3, which includes an estimate of costs per new residential dwelling, based on an average of 3.2 persons per unit. The detailed calculations behind the summary numbers in Table 3 are shown in appendix tables A.1 and A.2.

**Table 3: Prospective Long Run Cost of Residential Development in Mount Vernon**

Projected expenditure for governmental services in FY 2006 dollars*	
<b>Annual expenditure per capita</b>	
Services to people	\$ 70
Services to people and property assigned to residential	
Operating	257
Capital	120
Total expenditure per capita	\$ 448
<b>Annual expenditure per dwelling</b>	
Persons per dwelling	3.2
Expenditure per dwelling	\$ 1,432

NOTE: See appendix tables A.1 and A.2 for derivation of per capita expenditures

\*Self-supporting enterprises (water, sewer, storm sewer and solid waste) excluded

<sup>7</sup> We performed a simple regression analysis to determine if population size explained a significant portion of the variation among the 92 cities in per capita spending for each service category. Only for public safety and airports was the coefficient on the population variable significantly different from zero at the 10 percent level.

## Revenue Impacts

The impacts of residential development on revenues are more straightforward. The most important revenue effect, of course, is the property taxes collected on new homes. For purposes of projecting tax revenue, we use the average January, 2005 actual value of new homes built in Mount Vernon between 1999 and 2005. We then apply the fiscal 2007 rollback to this actual value, and fiscal year 2006 city tax rates (because expenditures are in 2006 dollars).<sup>8</sup> We calculate property tax revenues for such a home inside and outside a Tax Increment Financing (TIF) area, to highlight the fiscal effects of residential TIFs (the focus of the next section of the report). To property taxes we add the average per capita revenue from non-property tax sources: fees and fines, building permits, state road use tax funds and other grants, rental income, interest income, and other miscellaneous revenue. As discussed above, fees and other revenues flowing into business type funds, such as water and sewer service, are not included since these services are self-supporting through fee revenue.

The results of the analysis are shown in Table 4. Total revenue per new residential dwelling is estimated at \$1,829 for a home outside a TIF area, while expenditures per dwelling (from Table 3) are \$1,432. The result is a fiscal surplus of a little under \$400 per home.

**Table 4: Prospective Long Run Fiscal Impact of Residential Development in Mount Vernon**

Projected revenue and expenditure for governmental services in FY 2006 dollars

	Outside TIF Area		Inside TIF Area	
	Average Dwelling*		Average Dwelling*	Break-even Dwelling
<b>REVENUE</b>				
<b>Property valuation</b>				
Actual value per home	\$ 224,334	\$	224,334	\$ 66,072
Taxable value per home (using FY 2007 rollback)	103,185		103,185	30,390
<b>Property tax revenue per single-family home</b>				
City tax rate (dollars per thousand) for FY06**	\$ 12.9999	\$	31.0809	\$ 31.0809
City tax revenue per dwelling	1,341		3,207	945
<b>Fees and Grants</b>				
General fund fees & miscellaneous revenue per capita***	\$ 67	\$	67	\$ 67
State grants per capita	85		85	85
Total per capita fees and grants	\$ 152	\$	152	\$ 152
<b>Total Revenue per Dwelling</b>				
Property taxes per dwelling	\$ 1,341	\$	3,207	\$ 945
Fees and grants per dwelling (at 3.2 persons per unit)	488		488	488
Total revenue per dwelling	\$ 1,829	\$	3,695	\$ 1,432
<b>NET ANNUAL FISCAL IMPACT PER NEW DWELLING</b>				
Revenue per dwelling	\$ 1,829	\$	3,695	\$ 1,432
Less: Expenditure per dwelling for governmental services	1,432		1,432	1,432
Net fiscal surplus per dwelling	\$ 397	\$	2,263	\$ -

\* Average January 2005 actual assessed value of homes built between 1999 and 2005

\*\*Actual city levy rate applies outside TIF; tax rate inside TIF area is the sum of the TIF levies of all overlying governments

\*\*\*See appendix table A3. Fees for self-supporting enterprises not included.

<sup>8</sup> We use FY2007 rollbacks because we are projecting future revenues and expenditures and we want to take into account the latest rollback percentages that are known, since the rollback will affect future revenue figures regardless of whether we project using 2006 dollars or some other year. We have no basis for projecting rollbacks beyond FY2007, however.

The above analysis does not incorporate inflation. Housing values will probably continue to increase over the long run, even if prices stagnate (or even decline) in the next year or two as some predict. However, the rollback percentage will probably continue to fall over the long run as well, eliminating all of the inflation in housing prices beyond the four percent statewide average mandated by the rollback formula, unless the legislature takes action to freeze the rollback at current levels.

While the prospective fiscal impact analysis does not include any revenue effects from increases in taxable values, it also does not include any effects on expenditures from inflation in costs. The analysis, in other words, is in “real” terms, which will reflect future realities as long as there is not a significant difference between inflation in taxable property values and inflation in city operating costs in the years to come. Should the rollback continue to decline, and/or housing prices stagnate for several years, while health insurance and other costs rise rapidly, the fiscal dividend from growth would shrink or even disappear.

Why is the fiscal impact of residential growth in Mount Vernon positive, when the opposite is often presumed? The primary reason is that recent residential growth in Mount Vernon has consisted largely of single-family homes with above-average valuation, so that population growth in the city generates more revenue per capita. With 3.2 persons per household and an average January 2005 taxable value of \$103,185 for homes built in the last six years, per capita taxable value in new subdivisions is \$32,245. Total residential taxable value in the city as of January 2005 was \$63.5 million, or about \$14,400 per capita.<sup>9</sup> As long as new development drives up city costs only by the average expenditure per capita, while it produces over twice the average property tax revenue per capita (even in the absence of TIF), continued development of homes in this price range will continue to generate a fiscal surplus.

If residential growth generates a surplus, either non-residential growth generates a deficit (and the budget is balanced) or growth in general produces a surplus, allowing additional services to be financed or tax rates to be lowered. It is beyond the scope of this report to estimate the fiscal effects of commercial or industrial development. We can, however, shed some light on the issue of whether residential growth appears to have generated more commercial (retail and service) development. Residential valuation on a 100 percent basis (before rollbacks) has become an increasing share of the total value of property in Mount Vernon since 2000, rising from 79.7 percent in fiscal 2001 to 81.3 percent for fiscal 2007. During this same period, commercial 100 percent valuation declined as a share of the total, from 17.5 percent in FY01 to 16.7 percent in FY07. Thus in terms of market value, commercial development has not quite kept up with residential development over the past six years. While residential property grew 54 percent from 2001 to 2007, commercial value grew by 43 percent (from \$19.8 million to \$28.4 million). Still, commercial valuation per capita grew 25 percent over the period.

However, the residential rollback percentage fell from 55 percent in FY01 to 46 percent in FY07. As a result, residential valuation now accounts for 66.8 percent of the tax base, down from 68.5 percent in FY01. The taxable value of commercial property, on the other hand, rose from 27.1

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<sup>9</sup> The disparity is due in part to the college population, which enters into the denominators (total population) but produces little taxable residential valuation.

percent of the tax base in FY01 to 29.6 percent in FY07. Commercial development's increasing share of the tax base is thus due entirely to the declining residential rollback.

It should be emphasized that the estimates produced in this report are of necessity based on a number of assumptions regarding the appropriate allocation of expenditures and revenues to residential property. While we believe these assumptions have a rational basis and are consistent with general practice in the estimation of fiscal impacts, they can certainly be challenged. Changes in these assumptions would produce a higher or lower fiscal surplus from residential development.

It is unlikely that reasonable alternative assumptions would alter the basic conclusions of this report, however. Take, for example, our assumption that 50 percent of expenditures on services to people and property are attributable to people, 50 percent to property, an admittedly arbitrary assumption. If instead 100 percent of these services (which include the bulk of general government spending) were allocated to people, per capita expenditure would rise from \$448 to \$488 and the fiscal surplus per new dwelling would fall from \$397 to \$271. If, at the other extreme, all services to people and property were assigned to property (and then a share allocated to residential property), per capita costs would fall to \$408 and the fiscal dividend would rise to \$523 per residence. It might be better to say, then, that the fiscal dividend per residence in a non-TIF area is probably between \$300 and \$500, and in a TIF area between \$2100 and \$2400. The basic conclusion, however, remains.

## The Role of Tax Increment Financing

One of the options for financing public improvements in Iowa communities is Tax Increment Financing (TIF). Since TIF is often poorly understood, we begin with a description of how it operates.

### *The Basics of TIF*

TIF began in Iowa in 1958 as a form of "bootstraps financing" of redevelopment projects in blighted urban neighborhoods, which could be designated TIF areas by a city. Such areas generally suffered from stagnant or declining tax base, and TIF was seen as a mechanism for cities to invest in such areas to stimulate private redevelopment efforts. If the city investment succeeded in reversing the decline in property values, the increased tax base would generate revenues that repaid the city for its investment. Since such projects tend to entail risk, the city was allowed to capture all the revenue on the increment in property valuation inside the TIF area—including school and county taxes on that property—until the city had retired the project debt. At that point, the TIF area would cease to exist and the overlying governments would benefit from the higher tax base. Thus TIF provided cities the incentive to invest in redevelopment that would eventually redound to the benefit of taxpayers in the city, the school district and the county.

When a TIF area is first established and the boundaries set, taxable valuation of all properties in the district as of January of the preceding year becomes the base valuation. (This is sometimes called "frozen" valuation, a misleading term.) Properties in the TIF area continue to be

reassessed annually just as they would in the absence of the TIF. All increases in value within the district after the base year, whether from inflation or new construction or rehabilitation, become the increment in valuation. If a TIF district were established in September, 2005, for example, the base valuation would be as of January 1, 2004. The increment as of assessment year 2006 would be the January 1, 2006 valuation minus the January 1, 2004 (or base) valuation.

After the TIF area is established, property tax revenues on the increment flow to a city TIF fund. The tax increment revenues are determined each year by applying the consolidated property tax levy (the sum of the city, county, school district and other tax levies that apply within the TIF area, exclusive of any debt service levies and the school PPEL, or physical plant and equipment levy) to the increment in value. These revenues are used to retire TIF debt or fund tax rebates or for other lawful uses within the TIF area, and do not flow to the various overlying taxing jurisdictions. All taxing districts do continue to collect their levies against the *base* valuation, however, and all debt service levies are applied to the *total* valuation in the district, including the increment. The main effect of TIF, then, is to divert property taxes that otherwise would have gone to the county and the school district to a city fund used to finance city projects or to subsidize private development in the TIF area.

Changes in Iowa law over the past 20 years have produced a TIF financing system that no longer bears any resemblance to the original rationale for TIF. TIF areas can now be for any “economic development” purpose and need not be in blighted areas. (An economic development TIF area, however, expires after 20 years; blighted area TIFs are still possible and can run indefinitely.) The idea of bootstraps financing of risky city projects now seems quaint. Instead of undertaking a city investment in public facilities in the hopes of spurring private development, cities often designate a TIF area after private development has begun, eliminating risk and leading some to argue that development causes TIFs instead of TIFs causing development. TIF law also allows cities to incur debt to finance projects by vote of the city council when such debt would otherwise require a referendum, because the state code says that any TIF project is automatically for an “essential corporate purpose” and therefore exempt from referendum requirements.

### ***The Effects of TIF Financing in Mount Vernon***

Regardless of the wisdom of Iowa’s current TIF law as a matter of public policy for the state, that is the law within which Mount Vernon and every other city is operating. The question for the city is the extent to which it should take advantage of TIF, given the effects of doing so on city finances and on Mount Vernon taxpayers and taxpayers outside the city. We turn now to an analysis of how TIF affects the fiscal impact of residential development in Mount Vernon.

Table 4 above shows the effect of TIF on the flow of property tax revenue from a typical new home in Mount Vernon. The homeowner pays the same total property tax, \$3,898, whether the home is in a TIF area or not. Outside a TIF area, 34 percent of the taxes on the average home flows to the city, 47 percent to the school district, and 16 percent to the county and other entities (primarily Kirkwood Community College). With TIF, the city captures 85 percent of the property taxes, while 14 percent flows to the school district (the result of applying the school debt service and PPEL levies to the entire value). The school district loses about \$1,288 in property taxes, or about 70 percent of what it would otherwise receive in taxes from a new home. Of the \$1,288 in school taxes diverted to the TIF fund, about 43 percent, or \$549, is offset by an

increase in state foundation aid. The net effect on the district is a loss of \$739 in revenue, or about 40 percent of the \$1,842 it would normally receive. About \$606 in revenue to the TIF fund is diverted from other governments (mostly Linn County).

School districts are insulated from the effects of TIF by the state school funding formula. The enactment of TIF does not affect school spending per pupil, which is set by state law. Instead, the effects of TIF are passed on to school district taxpayers through a higher “additional levy” needed to fund the per pupil spending set by the state formula, and to state taxpayers through higher state taxes to fund foundation aid to the district. In FY 2006, \$293,616 was diverted from the Mount Vernon school district to the City of Mount Vernon TIF fund. Of the amount diverted, \$125,156 was offset by state aid; the remainder was recovered by a higher additional levy in the amount of \$.95 per thousand.<sup>10</sup> Thus the school taxes paid by Mount Vernon residents and all others in the Mount Vernon School District have increased about five percent (95 cents divided by the total school levy of \$18.19) to fund infrastructure investment and other city projects in the Mount Vernon TIF area.

The county is also affected by TIFs. The diversion of revenue through TIF will produce either lower county expenditures or higher county tax rates. It is not possible to determine which of these outcomes has resulted from the use of TIF in Mount Vernon, but we know the effect is very small. The \$135,000 in Linn County taxes diverted to the city’s TIF fund in FY2006 amounted to just three-tenths of one percent of total county property tax revenue.

Of the taxes diverted to the TIF fund, 51 percent are in fact paid by property owners within the City of Mount Vernon, who of course are also school district and county taxpayers. This is in part because the City of Mount Vernon accounts for 52 percent of the total valuation of the Mount Vernon school district. About 11 percent of the TIF revenue comes from school district taxpayers residing outside the city, another 17 percent is paid by state taxpayers through higher foundation aid to the school district, and the remaining 21 percent is paid by county taxpayers and others living outside the city (see Appendix Table A4).

The net effect of TIF financing in residential areas, then, is to draw tax revenues from taxpayers elsewhere in Linn County and statewide to finance development expenditures in the TIF area. If the use of TIF results in spending by the city of Mount Vernon that otherwise would not have occurred (and this is the stated rationale), then about half of the cost of that additional spending is borne by city residents through the higher school and county property taxes that result, while the other half is borne by property taxpayers elsewhere in Linn County and by state taxpayers.

Table 4 also shows the revenue and expenditure from a “break-even” home in a TIF area. What this shows is that, during the 20 years in which the TIF area is in effect, a home with a market value of just \$66,000 would generate sufficient revenue to offset the expenditures associated with the average residence. This should provide some guidance to the city as it undertakes to develop more housing for low and moderate income families.

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<sup>10</sup> Iowa Association of School Boards, “FY 2006 Impact of Tax Increment Financing (TIF) Districts on State General Fund and School Additional Levy Property Tax Rates,” on IASB web site.

The city recently expanded the Mount Vernon TIF area (the Urban Renewal Area) to include the entire city. They also extended the expiration date of the earlier TIF areas to 2026, 20 years from the amendment expanding the TIF area. Over time, with inflation in property values and continued new construction, an ever larger share of the valuation of the City of Mount Vernon will be a tax increment, with about 85 percent of the revenue captured by the city. TIF valuation currently represents 19 percent of the total taxable value in the city. If the city valuation were to grow at the same rate for the next 20 years as it has in the past six years, by 2026 over 70 percent of the taxable value of the city would be TIF valuation.<sup>11</sup> Such growth may be unlikely, but even at half of that rate of growth, TIF valuation will have grown to 45 percent of the tax base in 20 years. In other words, by 2026 around half of the total valuation in the city could well be off limits to the school district and county, except for the debt service and PPEL levies. At that point, about a quarter of the city's property taxes would come from rural Linn County taxpayers and from the state.

## Conclusions

Continued residential development of the kind Mount Vernon has experienced in the past several years will generate a substantial fiscal surplus to the city. This is due largely to the use of TIF financing, though a modest surplus would have resulted even in the absence of TIF. The surplus per dwelling of about \$2,250 would generate a total of \$45,000 annually for every 20 new homes, or 1.6 percent of total revenue, over the 20 year life of the TIF.

The fiscal dividend from growth can be used to improve existing services or add new services, with little impact on property tax rates, or to maintain current service levels while reducing taxes. The fiscal benefits of TIF, however, will be partly offset by higher school taxes, and to a lesser degree by higher county taxes. About half of the revenue diverted from the county and the school district to the city TIF fund will be made up by higher county and school property taxes on Mount Vernon residents. The rest will be shifted to taxpayers outside the city, including state taxpayers.

What about alternative means of financing growth? Were the city to begin financing internal subdivision improvements at city expense rather than at developer's expense, the fiscal dividend would diminish substantially. The initial cost of streets, sidewalks, storm sewers, water and sewer mains, and the engineering associated with that infrastructure, can easily amount to \$4,000 to \$5,000 dollars per residence. Furthermore, this does not seem necessary. Growth in recent years has been strong, and if those growth rates were to continue, the city would overshoot the population target expressed in the comprehensive plan. Subsidies to future development, in the form of city-paid infrastructure, could accelerate growth.

The fiscal dividend does mean that the city can consider future development plans on their overall merits: the effects on the city's character and quality of life. It appears that recent

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<sup>11</sup> This assumes that the residential rollback has declined to 35 percent by 2026. If it declines less, perhaps because the legislature freezes it, a greater share of the taxable value will be TIF. If it declines more, then a smaller share will be TIF. Residential 100 percent valuation grew 7.4 percent annually and commercial 6.2 percent from Jan. 1999 through Jan. 2005. If those growth rates continued, residential 100 percent valuation would be \$519 million by 2026 and commercial valuation would be \$79 million.

development will continue to generate revenue in excess of additional costs in future years, easing budget problems and making investment in new recreational facilities or other services more feasible, even if future development slows. The analysis also clearly shows the feasibility of promoting or subsidizing the development of affordable housing for low and moderate income families since even the most modest new homes will generate a fiscal surplus.



## Appendix

**Table A.1 Expenditures on Governmental Activities**

From City of Mount Vernon Audited Financial Reports

	Fiscal Year Ending June 30				Average
	2003	2004	2005	2006	
<b>Expenditures on Services to People</b>					
Operating expenditure (current dollars)*	\$ 238,634	\$ 265,166	\$ 310,357	\$ 269,225	
Total services to people in 2006 dollars	276,801	296,834	329,098	269,225	\$ 292,990
<b>Expenditures on Services to People &amp; Property</b>					
Operating expenditure (current dollars)					
Public Safety	\$ 505,845	\$ 477,261	\$ 518,300	\$ 528,275	
Public Works	269,850	297,335	363,862	380,354	
Community and Economic Development	3,980	7,240	21,715	38,541	
General government	238,995	203,634	265,671	265,636	
Subtotal: Operating expenditure (current dollars)	\$ 1,018,670	\$ 985,470	\$ 1,169,548	\$ 1,212,806	
Subtotal: Operating expenditure (2006 dollars)	\$ 1,181,596	\$ 1,103,163	\$ 1,240,171	\$ 1,212,806	\$ 1,184,434
Capital expenditure (current dollars)					
Total GO Debt Service	\$ 502,608	\$ 511,520	\$ 518,900	\$ 511,753	
Less: GO debt for enterprise activities	315,743	322,417	318,418	324,193	
Debt service for governmental activities	\$ 186,865	\$ 189,103	\$ 200,482	\$ 187,560	
Capital projects: governmental activities	372,963	216,604	316,288	568,756	
Subtotal: Capital expenditure (current dollars)	\$ 559,828	\$ 405,707	\$ 516,770	\$ 568,756	
Subtotal: Capital expenditure (2006 dollars)	\$ 649,367	\$ 454,160	\$ 547,975	\$ 568,756	\$ 555,064
Total services to people & property					
In current dollars	\$ 1,578,498	\$ 1,391,177	\$ 1,686,318	\$ 1,781,562	
In 2006 dollars	1,830,963	1,557,323	1,788,146	1,781,562	\$ 1,739,498
NOTE: Price index (FY2006=100) / 100 **	0.86	0.89	0.94	1.00	

\*Consists of total expenditure on culture and recreation services

\*\*Based on the implicit price deflator for state and local government services from the US Department of Commerce, Bureau of Economic Analysis, web site.

**Table A.2: Real Per Capita Expenditures**

Average per capita expenditure on governmental activities for FY2003-FY2006, in 2006 dollars

	Total	Per Capita*
<b>Expenditures Assigned to People &amp; Residential Property</b>		
Total services to people and property (from Table A.1)	\$ 1,739,498	
Times: Proportion assigned to property	50%	
Dollars assigned to property	\$ 869,749	
Percent of 100% valuation that is residential	81.1%	
Services to property assigned to residential property	\$ 705,137	\$ 169
Plus: Services to people & property assigned to people	869,749	208
Total assigned to people & residential property	\$ 1,574,887	\$ 377
Plus: Expenditures for services to people (from Table A.1)	292,990	70
<b>TOTAL</b>	<b>\$ 1,867,876</b>	<b>\$ 448</b>

\*Based on average population for fiscal years 2003 - 2006 of 4,173 (see table A.3).

\*\*Average of 2003-2005 assessment years.

**Table A.3 Per Capita Non-Property Tax Revenue**

Average per capita revenue to governmental funds; FY2003-FY2006, in 2006 dollars

	Fiscal Year Ending June 30				Average
	2003	2004	2005	2006	
<b>Total non-property tax revenue assigned to residential</b>					
Licenses & permits					
Total	22,081	44,181	72,072	90,086	
Building permits*	20,262	40,541	66,135	82,665	
Percent residential	53%	51%	39%	31%	
Building permits assigned to residential	10,677	20,506	25,492	25,442	20,529
Use of money and property					
Total	31,831	24,856	29,333	43,348	
Residential share of other revenue**	78%	76%	74%	73%	
Use of money and property assigned to residential	23,429	18,295	21,591	31,577	23,723
Total non-property tax revenue					
Charges for services (100%)	93,205	103,887	93,816	113,589	101,124
Miscellaneous revenue (100%)	119,841	132,311	117,918	84,448	113,630
Building permits assigned to residential	10,677	20,506	25,492	25,442	20,529
Use of money and property assigned to residential	23,429	18,295	21,591	31,577	23,723
Total in current dollars	247,153	275,000	258,816	255,056	259,006
Total in 2006 dollars	286,682	307,842	274,445	255,056	281,006
<b>Per capita non-property tax revenue</b>	<b>71</b>	<b>75</b>	<b>65</b>	<b>59</b>	<b>67</b>
Population***					
	4,031	4,124	4,219	4,316	4,173
Price index (FY2006=100) / 100 ****					
	0.86	0.89	0.94	1.00	

\* Building permit revenue as a percent of total licenses and permits for FY2003 used to estimate building permits in subsequent years. Percent residential is based on the average value of residential building permits as a percent of total value of building permits for fiscal years, which is the average of two calendar years.

\*\* Revenue from use of money and property is assigned to residential property in proportion to the residential share of all other revenues (that is, the share attributable to population or residences as opposed to business property).

\*\*\* Census 2000 population was 3,808, while 2004 special census population was 4,171. This implies an average annual population growth rate of 2.3%, which was then used to estimate population in the intervening years and in 2005 and 2006. Fiscal year populations are averages of the two calendar year population figures.

\*\*\*\* See note to table A1.

Table A4. Fiscal Effects of Mount Vernon TIF Area, FY 2006

	City	School	County*	Total**	Percent of Total
<b>Taxable value Jan. 2004 (\$ thousands)</b>					
Net non-TIF taxable valuation without G&E	63,901	144,245	6,791,223		
TIF valuation	23,177	23,177	444,488		
Net taxable valuation without G&E	87,079	167,423	7,235,711		
Valuation outside Mount Vernon	0	80,344	7,148,632		
Valuation inside Mount Vernon	87,079	87,079	87,079		
Total valuation	87,079	167,423	7,235,711		
Mount Vernon valuation/total valuation	100.0%	52.0%	1.2%		
<b>Tax Rates (\$/1000) FY2006</b>					
Total levy	12.9999	18.1892	5.9995	37.8925	
Less: Debt service & PPEL levies	1.1261	5.5209	0.1646	6.8116	
TIF levy	11.8739	12.6684	5.8348	31.0809	
<b>TIF revenue (TIF levy X City TIF valuation)</b>	275,201	293,616	135,234	720,365	
<b>Source of TIF revenue</b>					
City taxpayers	275,201	87,618	1,627	364,509	51%
School district taxpayers outside city		80,842		80,842	11%
County taxpayers outside city			133,607	133,607	19%
Other area taxpayers				16,251	2%
State taxpayers through higher school aid		125,156		125,156	17%
Total	275,201	293,616	135,234	720,365	100%

\*includes county assessor

\*\*Totals include Kirkwood Community College and other area governments that tax property in Mount Vernon