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Tax Increment Financing: Getting it Right

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by

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Tax Increment Financing: Getting it Right

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Tax increment financing (TIF) is a mechanism that was introduced during the 1950s to help cities redevelop blighted and economically distressed urban areas by granting cities, for an impermanent period of time, sole authority over the increased value in property tax (the increment) in a given area.

Because cities are reluctant to invest in these depressed areas, infrastructure in these sectors has traditionally tended to languish, further forestalling private capital investment and leaving these areas in a state of municipal impoverishment and dysfunction. TIF intended to solve this problem by allowing municipalities the authority to freeze property taxes at their current level — usually referred to as the base — and granting them sole access to the increment.

However, the primary purpose of TIF is no longer the revitalization of blighted areas; instead, TIF is now primarily an economic development tool. There are many problems with the structure of TIF law in Iowa, which is one of the most indulgent in the nation.

However one may feel about TIF as an economic development tool, and strong cases can be given both for and against the process, two things can generally be agreed upon: 1) TIF should enhance tax revenues, and 2) the process should be transparent and scrutable.

Unfortunately, neither of these requisites are being met as Iowa TIF guidelines are currently enforced. This is because TIF funds are not isolated in city budgets; instead these funds are lumped together with an assortment of funds — federal grants, road use taxes, etc. — into one great hodgepodge called a "special revenue fund."

Consequently, it is not currently possible to precisely track the way TIF funds are being used. This a problem, considering that TIF spending accounted for $237 million spent in Iowa in Fiscal Year (FY) 2007/2008.

However, in May 2007 the Iowa Legislature changed this when House File (HF) 923 was signed into law. Sections 3 and 4 of the Act amended sections 384.16 and 331.434 of the Iowa Code so that TIF revenues and expenditures will be isolated starting in FY 2009.

The Legislature should be commended for taking this initiative. Because of these changes Iowans will soon be able to monitor how a significant amount of their property taxes are being spent.

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Introduction

Tax increment financing (TIF) is a mechanism that was introduced during the 1950s to help cities redevelop blighted and economically distressed urban areas by granting cities, for an impermanent period of time, sole authority over the increased value in property tax (the increment) in a given area.

Because cities are reluctant to invest in these depressed areas, infrastructure in these areas has traditionally tended to languish, further forestalling private capital investment and leaving these areas in a state of municipal impoverishment and dysfunction. TIF intended to solve this problem by allowing municipalities the authority to freeze property taxes at their current level and granting them sole access to the increment.

However, the primary purpose of TIF is no longer the revitalization of blighted areas; instead, TIF is now primarily an economic development tool. There are many problems with the structure of TIF in Iowa. Not only is Iowa's TIF law extremely lax, but there is very little oversight; citizens are also often completely left out of the decision making process unless they can file a shotgun petition.

The potential problems with TIF are palpable. Much of Iowa's public infrastructure is supported through property taxes, which make up approximately one-third of all taxes paid to the state. It is not difficult to imagine scenarios of public officials diverting public funds for personal reasons to fund projects that may not be in the public interest.

However one may feel about TIF as an economic development tool, and strong cases can be given both for and against the process, two things can generally be agreed upon: 1) TIF should enhance tax revenues, and 2) the process should be transparent and scrutable.

Unfortunately, for the last several years neither of these requisites have been met in Iowa. This is because TIF funds have not been isolated in city budgets; instead these funds have been lumped together with an assortment of funds — federal grants, road use taxes, etc. — into one great hodgepodge called a "special revenue fund."

Fortunately, however, in May 2007 the Iowa Legislature changed this when HF 923 was signed into law. Sections 3 and 4 of the Act amended sections 384.16 and 331.434 of the Iowa Code. Henceforth county and city budgets "shall include estimated and actual tax increment financing revenues *and all estimated and actual expenditures of the revenues*, proceeds from debt and all estimated and actual expenditures of the debt proceeds, *and identification of any entity receiving a direct payment of taxes funded by tax increment financing revenues.*" Essentially, TIF revenues and expenditures, beginning in 2009, will no longer be part of a "Special Revenue Fund;" instead, cities and counties will be required to provide a separate "TIF Budget."[1]

This is a positive change and the Legislature should be commended for its initiative and foresight. Because of these changes, Iowans will have the ability to monitor and better understand how hundreds of millions of their property tax dollars are being spent.

TIF: How it Works and How it Has Changed

The original rationale for TIF was that cities were reluctant to finance costly municipal improvements and projects in depressed areas because cities often found it difficult to recoup the costs of their investment. Essentially, cities were pouring dollars into the revitalization projects while property tax revenue was being divided between a number of collecting jurisdictions (e.g.: counties, school districts). Because of this, infrastructure in these areas tended to dilapidate, leaving these areas in a state of municipal impoverishment and dysfunction.

TIF was intended to alleviate this problem by permitting cities to freeze property taxes at their current level — usually referred to as "the base" — and granting the city sole access to the increase in property taxes — usually referred to as "the increment" — for an extended period of time. This meant that all increases in property tax value could be collected by the city to retire the bonds it issued to pay for improvements intended to attract investment. School districts and counties would continue to collect property tax revenues, but only at the base level.

The formula seemed simple: Cities would invest in public infrastructure, private investment would follow, and once the investment bonds were retired, all jurisdictions would once again collect property taxes at the new increased level. However, the purpose of TIF has changed. In 1985 the requisite that TIF was restricted to blighted areas deemed "injurious to the public health" was removed.[2] Subsequently, TIF could be used to finance whatever projects city or county officials felt necessary. Furthermore, Iowa has one of the most indulgent TIF statutes in the United States. As David Swenson and Liesl Eathington of Iowa State University point out, in Iowa "there are virtually no effective state or local oversight mechanisms of TIF usage by cities, counties, and other authorities." This

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"The formula seemed simple: Cities would invest in public infrastructure, private investment would follow, and once the investment bonds were retired, all jurisdictions would once again collect property taxes at the new increased level."

means Iowa has "one of the most lenient and lucrative statutes for TIF usage in the U.S." TIF users do not have to negotiate increment revenue sharing. There is no overseeing body to determine if a TIF district is serving a real purpose (bringing in private capital investment) and not simply cornering property tax revenue that was already coming into a district. There is no clearly defined mechanism to prohibit "rollovers" — a device used to keep a district a TIF zone long after the original project has been completed and the debt has been repaid.[3]

Finally, there is no prohibition on the use of TIF funds to create structures which are themselves tax-exempt, which will prevent the other taxing authorities with jurisdiction over the area from reaping any benefit in the future to make up for the foregone revenues while the TIF district is in place. For example, West Des Moines included a fire and EMS station, a police sub-station, parks, and a bike/pedestrian trail in a TIF district surrounding the Jordan Creek Shopping Center.[4] While roads, sewers, storm drains, and water mains are also non-taxable public works which are designed to make an area more attractive to potential tax-paying businesses, who monitors the line as to what is and is not an acceptable increase or decrease in the project's future taxable value?

The creation process for TIF districts is also questionable. Decisions are made by city councils, absent referendum, or negotiation among taxing entities. Citizens can petition for a referendum, but have only ten days to do so. Since TIF can be used to circumvent Iowa's limit on tax abatements, theoretically vast amounts of public funds could pass directly to private entities with little or no public knowledge or input. TIF reporting guidelines have also been extremely lax. Because of this it is difficult to determine if TIF funds are being spent on legitimate economic development purposes.

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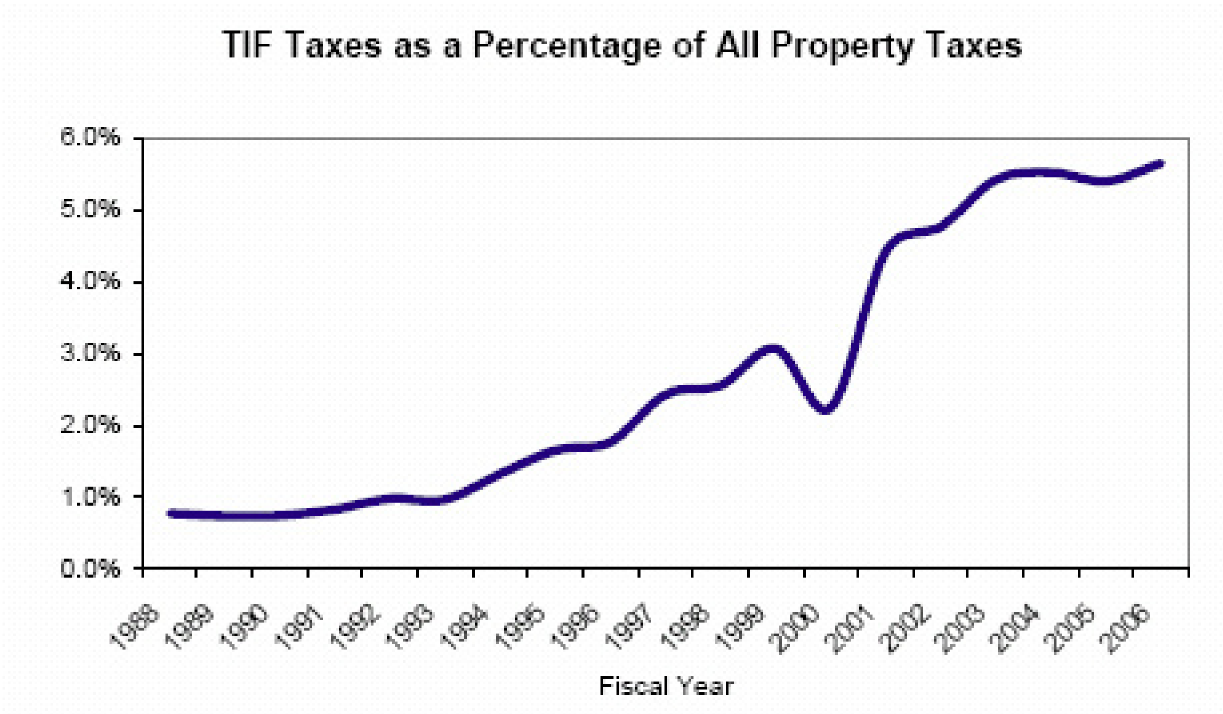
Additional Problems With TIF

It has been shown that TIF is highly deregulated. Advocates of limited government often applaud any policy that opposes increased government regulation; however, it must be emphasized that TIF districts are NOT private enterprises (although they may transfer funds to private industries). Rather, TIF is simply a method local governments use to enhance tax revenues quickly and easily. Indeed, city planners and developers argue that without TIF they could not get done many of the projects considered indispensable to their cities.

Figure 1.



(Source: Swenson and Eathington, "Tax Increment Financing Growth in Iowa," Iowa Sate University, 2006).

In short, it is far easier for municipalities to TIF a district or two to fund projects than to have a bond measure passed by 60 percent of voters. But this is just it. TIF is easier and quicker because cities and counties are able, for the most part, to circumvent the voters whose property taxes are funding these projects. City planners can argue that these projects are necessary, but if they are indeed "necessary" they should have little difficulty getting the votes to pass a bond initiative.

Because TIF makes it so easy to raise funds there has been a virtual explosion of TIF in Iowa. In 1991 there were 746 TIF zones in Iowa. By 1997 this figure had risen to 1,014, and by 2006 there were a total of 2,058 TIF districts or projects.[5]

As TIF has become increasingly popular it is important to understand two things about it. First, TIF diverts funds that would otherwise be collected by other districts, such as the county, schools districts, and the state; these entities must make these funds up elsewhere through fees and taxation. Second, TIF is borrowing against the expectation of future income, not a guarantee. If property tax valuations fail to meet anticipated benchmarks, taxing entities will find themselves mired in debt and having to make it up elsewhere.

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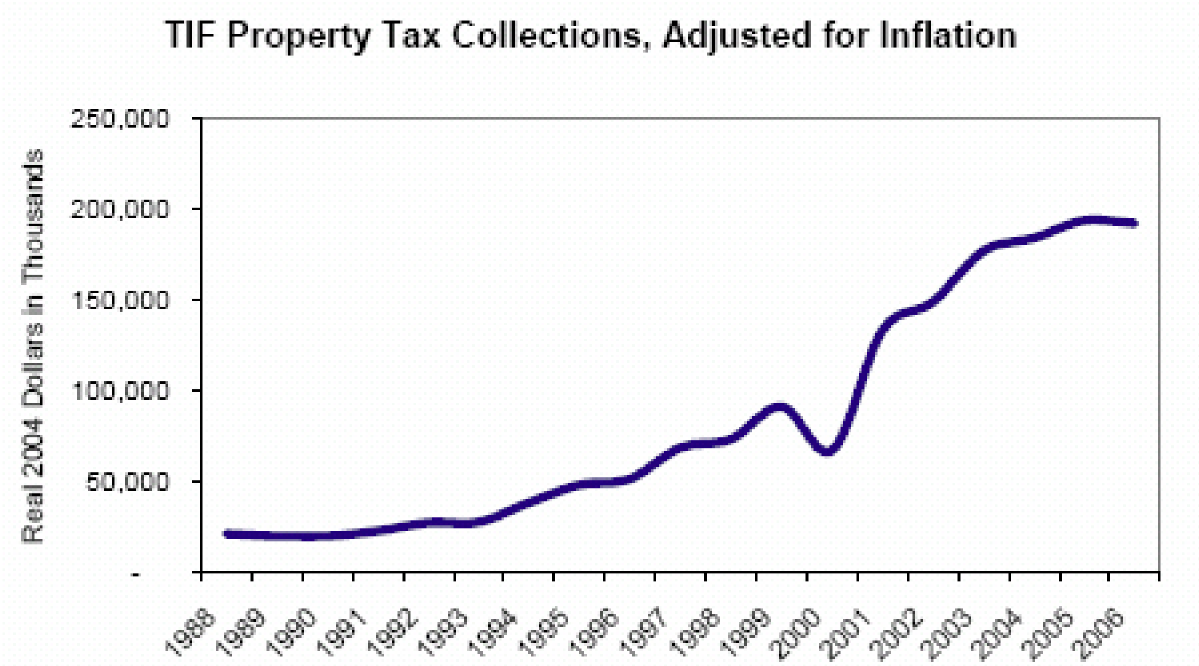
Figure 2.



(Source: Swenson and Eathington, "Tax Increment Financing Growth in Iowa," Iowa Sate University, 2006).

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"The problem, as some Iowa cities are finding out, is that depending on future returns is, well, risky."

The problem, as some Iowa cities are finding out, is that depending on future returns is, well, risky. Consider the small town of Dike, Iowa. According to *The Des Moines Register,*[6] in 1997 the city, in an effort to transform a parcel of farmland into a recreation haven that included a lake, golf course, and 130 luxury homes, created a TIF to help a local developer absorb costs. The influx of property tax dollars from the initial phase of development were used to partially reimburse the developer for the costs of expanding local infrastructure, including roads and sewers.

Yet Dike may have extended itself beyond its financial capacity. Over the years TIF proceeds have been less than anticipated and the city seems to have surpassed its $3.5 million constitutional debt limit; the city's audit report stated that compliance with its debt limit is "currently in review." Wayne Paige, Dike's former mayor, claims that "the city [is] broke," although it seems to be continuing on its spending bonanza.[7]

Because it is extremely difficult to determine the actual long term debt of cities because of infrequent audits and irregular debt reporting, it is difficult to determine if the debt situation in Dike is an anomaly or is the beginning of a trend. Warren Jenkins, chief deputy state auditor, hinted that the problems "are symptomatic of what others may be facing down the road." Jenkins warned that cities are "pursuing economic development at a time in the economy when there may not be enough to go around." The recent nation-wide housing slump could be an ill indicator of things to come for cities banking on prospective property tax revenues to pay creditors.[8]

The notion that TIF is a "win-win" without palpable risk is untrue. The overall benefits of TIF are also uncertain. In Chicago, Illinois, TIF has become "the economic development tool of choice;" in fact, taxpayers in Chicago paid more property taxes to TIF than to Cook County.[9] Yet research on the greater Chicago area has shown that the correlation between TIF and economic growth is minimal in areas not suffering from blight.[10] Other studies found that "municipalities that adopt TIF grow more slowly after adoption than those that do not." The authors conclude that TIF is merely trading faster growth in one area for slower growth in another.[11]

In Iowa, the research on TIF has been even more pessimistic. In a work titled "Do Tax Increment Finance Districts Spur Regional Economic and Demographic Growth?" David Swenson and Liesl Eathington, whose research on TIF is the most extensive in the state, present data suggesting that the average cost of a TIF created job in Iowa is over $3,000; the authors conclude, "the costs of TIF activities in the state appear to be very high."[12] In a different study the authors make the case that outside of a few metropolitan areas TIF has resulted in little economic growth, and conclude that "It is very hard to demonstrate that TIF usage has, on the while, benefited the state of Iowa in any uniform manner."[13]

TIF Reporting

However one may feel about TIF, most can agree that more transparency in the process is a good thing. There are concerns that TIF funds are being used for purposes other than economic development. However, the way city budgets are currently reported it is difficult to tell exactly what TIF funds are being used for because TIF funds are lumped together in a massive "Special Revenue Fund."

Yet it is clear that in some cases TIF funds are being used for purposes other than economic development. To take just one example, in the fiscal year ending in 2008, Des Moines collected $24 million in TIF revenue. However, the city only spent $12 million on community and economic development. Of its $85 million "Special Revenue Fund," $34 million was transferred out for other purposes.[14] While cities may appreciate such flexibility in

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their budgets, it is clear that TIF funds are being used for a number of purposes other than economic development.

This changed in May 2007 when the Iowa Legislature passed HF 923. Sections 3 and 4 of the Act amended sections 384.16 and 331.434 of the Iowa Code so that TIF revenues and expenditures will be isolated beginning in FY 2009. Hereafter, cities and counties will be required to provide a separate "TIF Budget." The new law states that county and city budgets "shall include estimated and actual tax increment financing revenues and all estimated and actual expenditures of the revenues, proceeds from debt and all estimated and actual expenditures of the debt proceeds, and identification of any entity receiving a direct payment of taxes funded by tax increment financing revenues."[15] This should make analyzing and understanding TIF revenues and expenditures considerably easier in the future.

Conclusion

"Hereafter, cities and counties will be required to provide a separate 'TIF Budget.'"

It is apparent that Iowa needs to reconsider the way TIF is being used. HF 923 is a step in the right direction. By requiring taxing entities to create a separate "TIF Budget," lawmakers and policy analysts will be able to better understand TIF expenditures. The rapid increase of TIF in Iowa is a phenomenon that will have a palpable impact on the future of local governments and Iowans. It is imperative that Iowans are able to better understand the way TIF is being used, so, if necessary, changes can be made in the law to restrict TIF usage to purposes within the purview of the public interest.

Endnotes

[1]Chapter 384.16 & 331.434 of the Code of Iowa. See also House File 923 sections 3 and 4. Emphasis added by author.
[2]David Swenson and Liesl Eathington, "Do Tax Increment Finance Districts Spur Regional Economic and Demographic Growth?" Iowa State University, 2002, p. 3.
[3]David Swenson and Liesl Eathington, "Tax Increment Financing Growth in Iowa," Iowa State University, 2006, p. 1.
[4] *McMurray v. City Council of City of West Des Moines*, 642 N.W.2d 273 (Iowa, 2002), at 282.
[5]"Tax Increment Financing Growth in Iowa" p. 1.
[6]Lee Rood, "An Iowa Town's 'Gamble on Future' Stirs Concern," *The Des Moines Register*, January 28, 2008.
[7]Ibid.
[8]Ibid.
[9]Mike Quigley, "A Tale of Two Cities: Reinventing Tax Increment Financing," Cook County Commissioner Report, April 2007 <http://www.heartland.org/pdf/21830.pdf> (May 1, 2008).
[10]Paul Byrne, "Determinants of Property Value Growth for Tax Increment Financing Districts," *Economic Development Quarterly*, 2006, pp. 317-329.
[11]Richard Dye and David Merriman, "The Effects of Tax Increment Financing on Economic Development," *Journal of Urban Economics*, 2000, pp. 306-328.
[12]"Do Tax Increment Finance Districts Spur Regional Economic and Demographic Growth?" p. 10.
[13]"Tax Increment Financing Growth in Iowa," p. 33.
[14]"Adoption of Budget and Certification of City Taxes," for city of Des Moines, City Budget Files – Zipped, FY 2008, Iowa Department of Management, <http://www.dom.state.ia.us/local/city index.html> (May 10, 2008).
[15]Chapter 384.16 & 331. 4 of the Code of Iowa. See also House File 923 sections 3 and 4.

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