Research Update: WHAT IS TAX INCREMENT FINANCING (AND WHY SHOULD ANYONE CARE)?

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Introduction

Tax Increment Financing (TIF) is one of the most widely used policies for fostering economic development in states and localities. According to Kriz (2001), 48 states have adopted TIF to make financial resources available to facilitate economic development. Because of the importance of TIF in state and local economic development programs, many scholars have conducted research on the effectiveness of TIF. In particular, studies have examined two major issues: (1) the impact of TIF on economic development, and (2) the effect of TIF on municipal revenues.

Some studies contend that state and local governments can expect that TIF stimulates economic factors such as "economic activity, more jobs, lower unemployment, higher wages, greater property values, more tax revenues, and the revitalization of the blight areas" (Johnson and Man, 2001, p. 3). However, the empirical evidence on the effectiveness of TIF in stimulating economic development is mixed. Some researchers argue that there is no empirical evidence that TIF programs directly affect local economic development, and there is no difference in economic growth between blighted areas that have TIF programs and other areas (Dye and Merriman, 2000). Also, Johnson and Man (2001) does not reach firm conclusions about the effectiveness of TIF on economic development. On the other hand, Wassmer (1994) concludes through an analysis of 25 cities in the Detroit area that some economic programs including TIF play a crucial role in facilitating local economic development, specifically through improving the labor market and purchasing power in local areas (as cited in Dye and Merriman, 2000).

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Another stream of research on TIF concerns the management of municipal revenues (see for example Kriz, 2001; Anderson, 1990; Kratz, 1983; Forsythe, 1982). Once state and local governments approve TIF projects, they lose some revenues because the purpose of TIF is in essence to lend the developer a portion of local development costs by providing tax money which will be collected in the future. In a worst case scenario, if municipalities cannot collect projected taxes from TIF projects, they would suffer a large loss of revenues. But in a more general sense, the impact of TIF on local government revenues depends on whether the project funded in part through TIF (or another project of a similar value) would have been developed without the use of TIF. Here, the results are somewhat mixed. Anderson (1990) suggests that property values are affected by factors such as city size effects, changing city population, and property tax millage rates (p. 161). As property value in areas under TIF programs become higher, municipalities could expect much more taxes from developers because the municipalities decide the extent of loans providing TIF projects depending on the possibility of growing property values. However, Kriz (2001) concludes that TIF most likely has a negative effect on financial conditions on municipal governments by simulating the Monte Carlo model using four variables affecting revenues in Minnesota.

One important result of several studies is that the context of TIF development is extremely important in determining the economic and financial effects of TIF. To this end, the previous study done by Dunn (2011) on Omaha area TIF projects is a model for understanding the impacts of TIF locally. In the light of the Kriz (2001) article, this paper updates the Dunn (2011) report to provide sources for analyzing economic development and the management of revenues in the city of Omaha. First, this paper investigates the trend for TIF plans which were approved by city-council meetings. Through examining the number and type of approved TIF projects in each year, we can gain insight into the reasons why Omaha uses TIF as the primary instrument to foster economic development (Johnson and Man, 2001). For example, if the City approves many TIF projects in a recessionary period compared with other periods and those projects are mostly of the type that are likely to lead to strong gains in employment, it may suggest that the City employs TIF programs for economic development.

We rely on five pieces of information for the bulk of our analysis: (1) The number and type of active TIF plans; (2) The number and type of approved TIF plans; (3) Comparative number of TIF plans approved between for-profit and for-nonprofit organizations; (4) Taxes foregone through the use of TIF, by project type; and (5) Cumulative taxes foregone since inception. Second, this paper examines factors for managing revenues. To this end we analyze the following additional variables: (1) Taxes foregone in 2011 based on projects initiated in various years; (2) Cumulative taxes foregone since inception; (3) Comparative cost of total anticipated city income foregone; (4) Ratio of total anticipated City revenue foregone between for-profit and for-nonprofit projects, and (5) Comparative tax expenditures. Additionally, we examine two other factors important in determining economic and financial effects: (1) The use of the but-for clause in TIF project deliberations; and (2) Approved TIF plans and the commencement of improvements. City-council meetings are intended to evaluate whether TIF proposals can help improving revenues and fostering economic and community development. As we discuss later, but-for clauses are supposed to ensure that projects that would have gone forward without TIF will not be funded using foregone tax revenues. If they would have gone forward, then any foregone revenue is a true net loss to the city.[3] Further, because but-for clauses are private comments on approving TIF proposals, we can infer standards of evaluating TIF proposals through them. If city-council meetings contain many but-for clauses concerning TIF proposals, it is suggestive of tough standards on approving TIF proposals. Through examining the ratio of approved projects that contain improvements, we can infer the proportion of TIF projects contributing to municipal revenue in the year after project approval. In doing so, it helps local managers planning expenditures.

We use two primary sources of data to complete our research, one from the city of Omaha and the other from the state of Nebraska. The city of Omaha annually provides city-council journals[4] including results of approving TIF proposals and TIF contracts between the City and developers. From those documents, this report gets the data on 'project name,' 'TIF amount,' 'project site,' 'status,' 'project cost,' 'type,' 'interest rate,' 'prior valuation,' 'final valuation,' 'term,' 'date approved,' 'but-for clause,' and 'bank'. The Nebraska Department of

3 In Nebraska, the "but-for" clause is found in the Nebraska Revised Statutes 18-2116(b)(ii) requirement that: "..the redevelopment project would not occur in the community redevelopment area without the use of tax-increment financing..."

4 These sources could be found on the Internet website, "http://www.cityofomaha.org/cityclerk/archived-city-council-documents"

Revenue offers annual TIF reports[5] including actual taxes collected from TIF projects. This report includes information on ‘forgone taxes’ and ‘cumulative foregone taxes’ from TIF projects. Because this report updates Dunn’s earlier article (2011), we include information on the years 2008 to 2011.

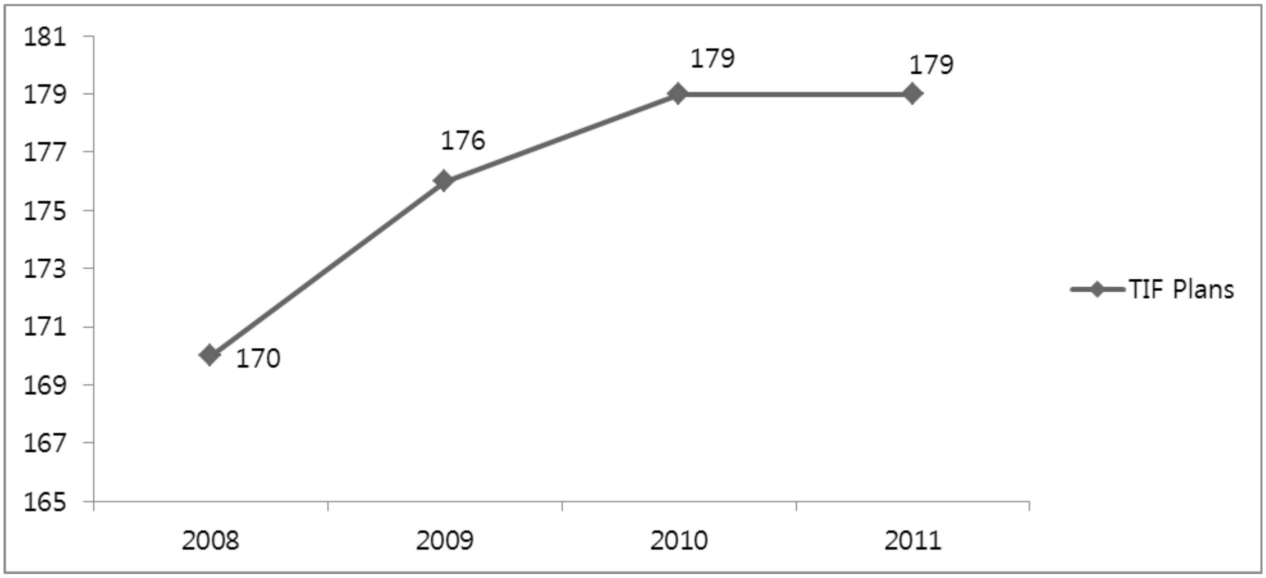
Trends on TIF projects

The Change of TIF Plans

In Dunn’s earlier report the number of TIF projects in the city had grown to 176 in 2009. It grew further to 179 in 2010. But, in 2011, the number of TIF plans remained constant at 179 (Figure 1). Dunn also brings up the point that since the reports are prepared in “August 1 of each year and since the time periods are not the same, the numbers will vary” (p. 8). Since the numbers do not cover a calendar year but reflect the period August 1 to July 31, we use data (such as journals of city-council meetings) reflective of a similar period. For example, a review of the City-Council journals in 2010 shows that 2 TIF plans were approved prior to August 1, this number is lower than the TIF plans approved in 2009 prior to August 1, so the numbers for 2010 and 2011 appear to not be skewed by this effect.

5 The Nebraska provide this sources on the Internet website, http://www.revenue.ne.gov/PAD/research/tif_reports.html”

Figure 1. The Number of TIF Plans, 2008 to 2011



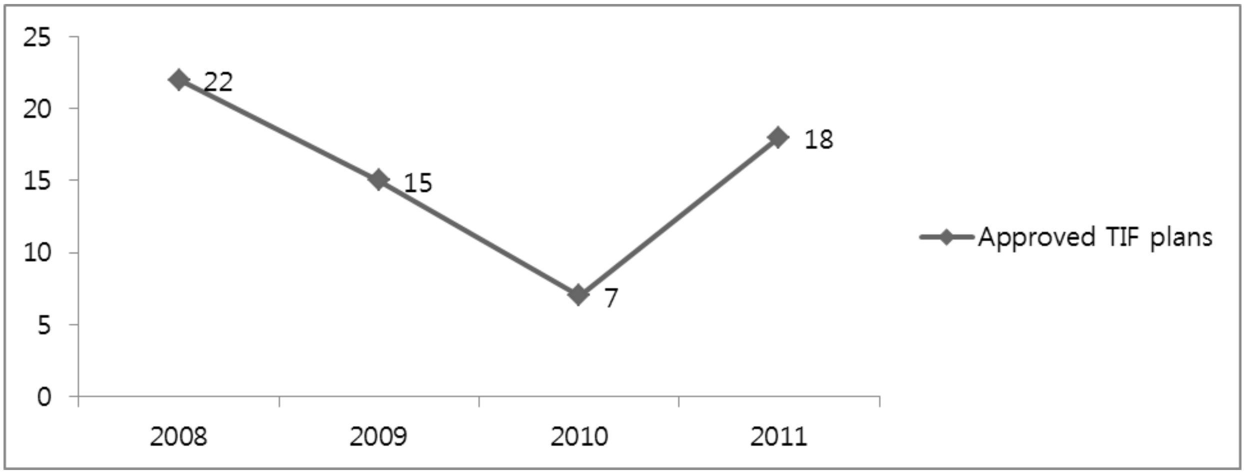
Source: http://www.revenue.ne.gov/PAD/research/tif_reports.html

Approved TIF Plans

Between 2008 and 2011, the number of approved TIF plans has fluctuated. From 2008 to 2010 the number of the approved TIF plans has continuously decreased. In 2008, 22 TIF plans were approved by the Omaha City Council. It decreased to 15 plans approved in 2009 and to 7 in 2010. However, in 2011 the number of the approved TIF plans increased once again to 18.

A review of the City-Council minutes for 2011 shows that 7 TIF plans were approved prior to August 1 of that year. Adding these to the 5 TIFs approved on or after August 1, 2010 would result in 12 TIF plans approved during the reporting year.

Figure 2. Approved TIF Plans, 2008 to 2011



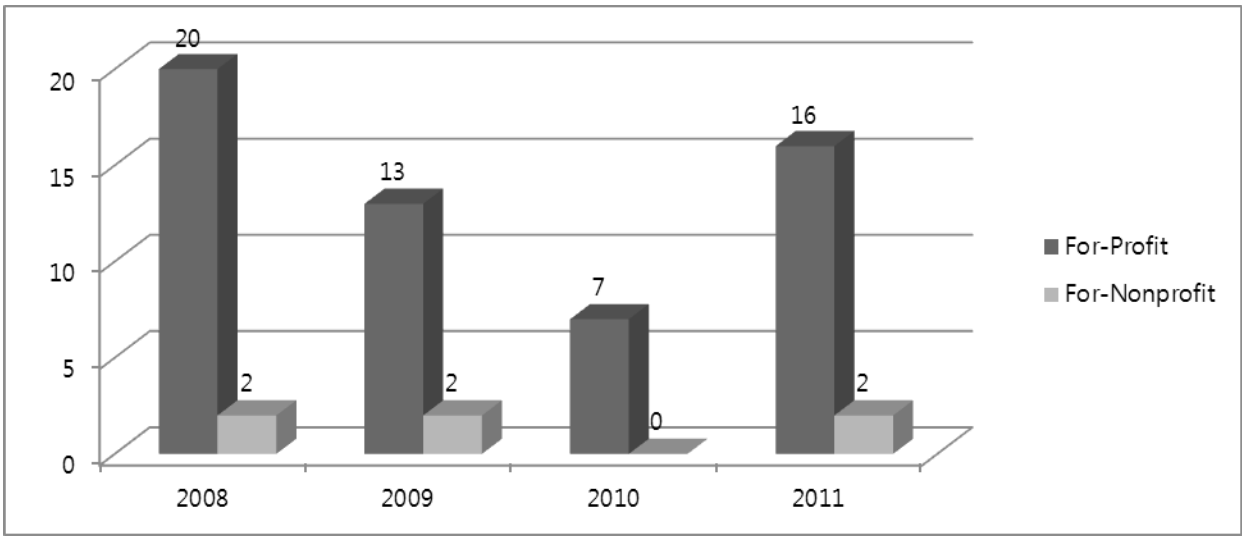
Source: Omaha City-Council Meeting Journals from 2008 to 2011

One reason why the number of approved TIF plans might have decreased from 2008 to 2010 is that the City was undergoing fiscal stress due to the national financial and economic crisis and because the federal government responded with increased infrastructure grants. Man (2001) finds that if local governments received lower levels of Federal grants, they more actively use TIF for constructing infrastructure and facilitating new jobs. TIF programs could also potentially result in higher levels of financial debt in state and local governments (Johnson, 2001). Since governments are less likely to borrow during times of economic and financial crisis, this could also reduce the use of TIF.

Comparative Number of TIF Plans between For-Profits and For-Nonprofits

Dunn found that the majority of TIF projects approved by the Omaha City Council were for the benefit of for-profit businesses, despite provisions in the Nebraska statutes that allow for projects benefiting non-profits. We find this trend continuing. In 2008, 20 of 22 projects approved went to for-profits. In 2009, the ratio was 13 for-profit projects to 2 non-profit ones. In 2010, there were 7 for- profit TIF projects approved with no non-profit projects. In 2011, the ratio returned to 16:2. The reason for the lack of non-profit projects being approved in 2010 may go back to the economic and financial crisis. Many non-profit organizations had a large decrease in donations at the start of the financial crisis, therefore many retreated to a defensive posture regarding capital expansion.

Figure 3. Comparative Number of TIF Plans between For-Profit and For-Nonprofit Organizations

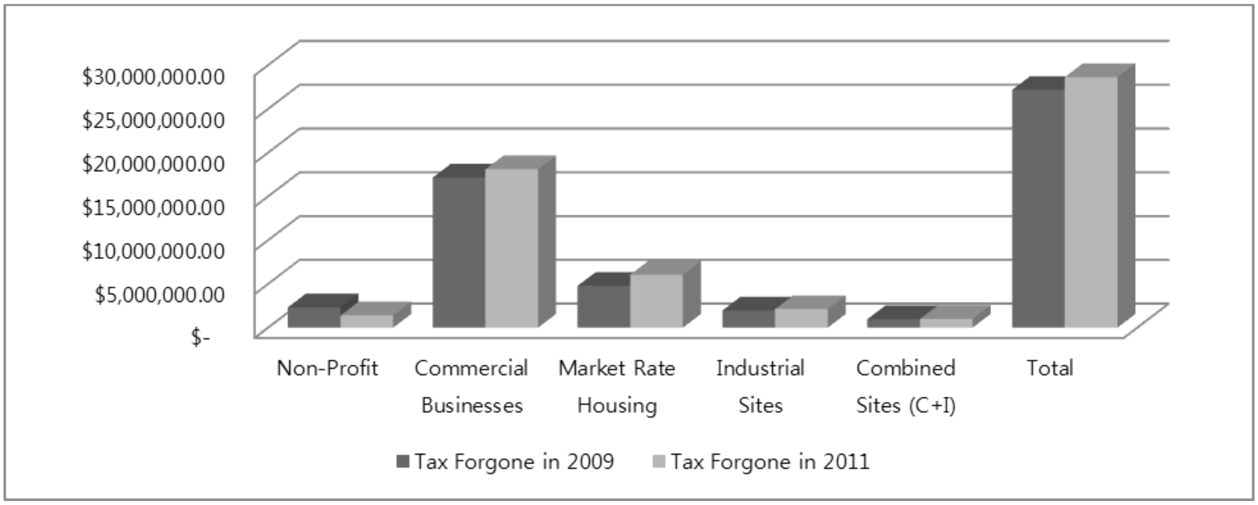


Source: Omaha City-Council Meeting Journals from 2008 to 2011

Forgone Taxes by Type of Projects and Cumulative Foregone Taxes since Inception

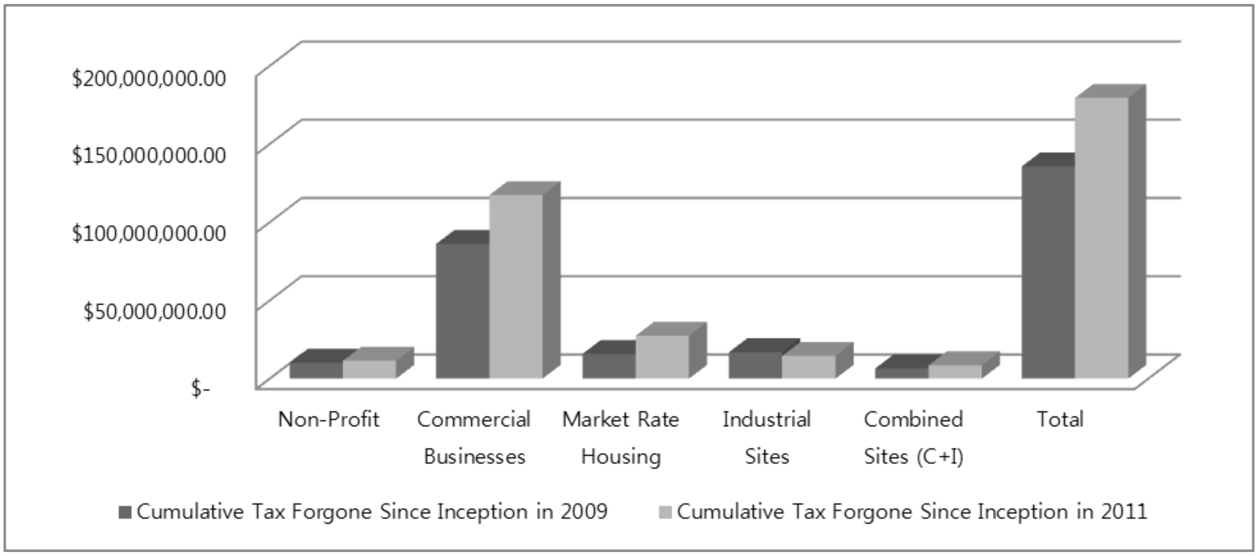
The relatively small part played by non-profit projects in terms of total TIF projects is confirmed when looking at the amount of taxes foregone through TIF. Figures 4 and 5 show that non-profits account for a very small portion of those foregone revenues. Industrial projects and combined commercial/industrial projects also account for a small portion of taxes foregone. The overwhelming portion of foregone taxes from TIF in the city of Omaha is going to commercial projects and market-rate housing. This is somewhat concerning given the stated goal of TIF to promote economic development. Commercial projects and market-rate housing projects are less likely to promote long-term job gains than are industrial projects. One could see the use of TIF in Omaha as a way to subsidize the commercial/retail land market. And the lack of non-profit projects and foregone revenues undermines a public service rationale for the technique.

Figure 4. Taxes Foregone between 2009 and 2011, by Type of Projects



Source: http://www.revenue.ne.gov/PAD/research/tif_reports.html

Figure 5. Cumulative Taxes Foregone since Inception between 2009 and 2011



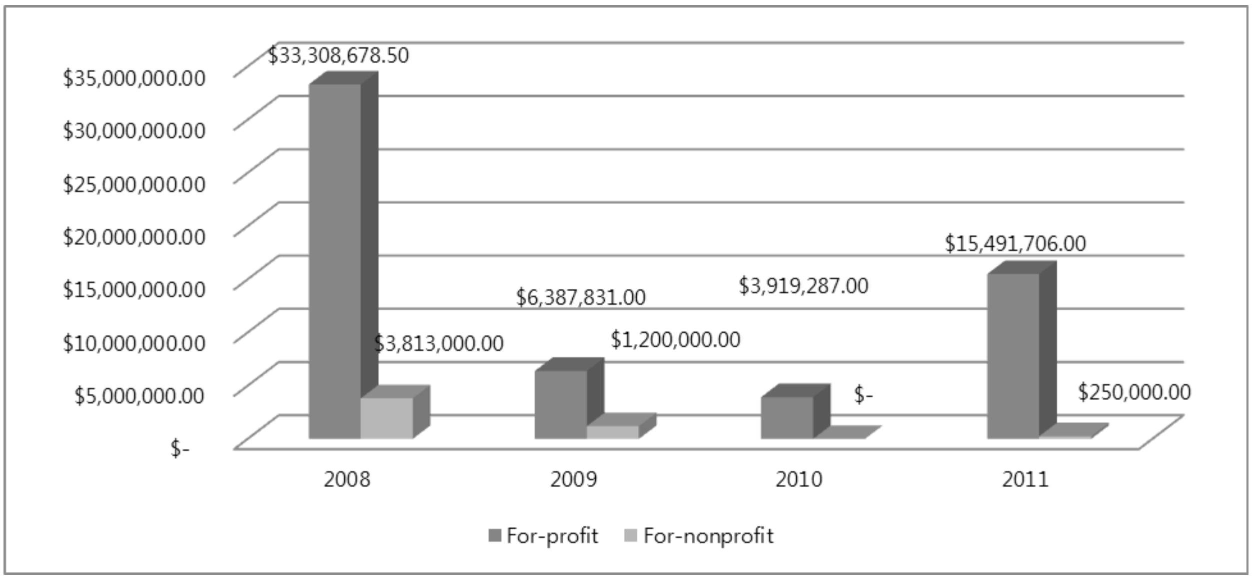
Source: http://www.revenue.ne.gov/PAD/research/tif_reports.html

The Management of Tax Increment Financing (TIF)

Total Anticipated City Income Foregone

Between 2008 and 2011, total anticipated city income from TIF plans has changed in two ways. First, by 2010, the cost expected to be collected from TIF plans decreased continuously. In particular, the total anticipated cost in 2008 was considerably different from the cost in 2009. Second, such a cost is partly recovered in 2011.

Figure 6 Comparative Cost of Total Anticipated City Income Foregone



Source: http://www.revenue.ne.gov/PAD/research/tif_reports.html

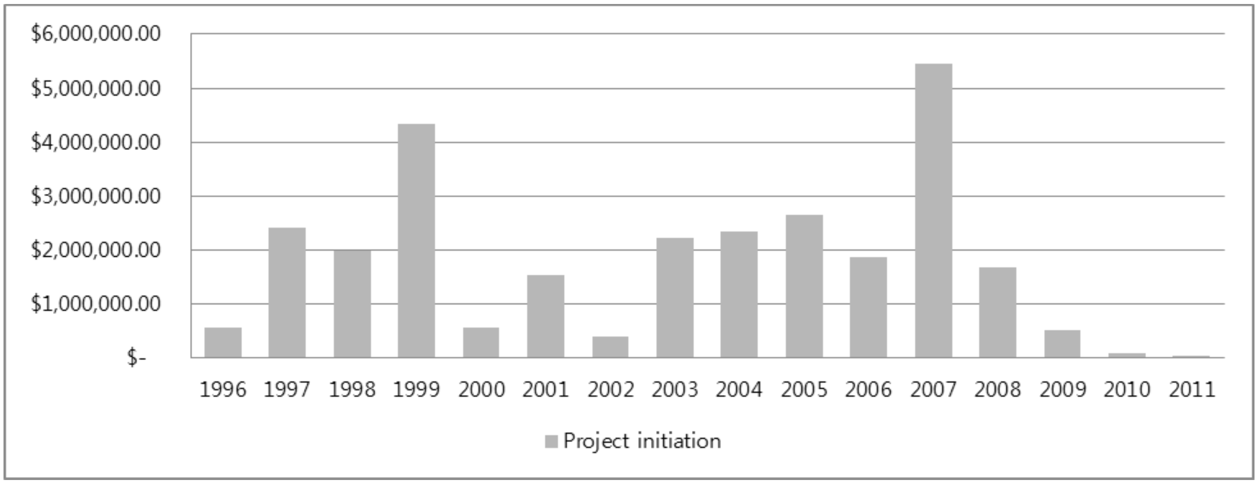
There are no state statutes or city ordinances mandating that the city should pass a certain portion of TIF projects benefiting nonprofits. However, many 'Substandard' and 'Blighted' areas as defined by Nebraska statutes need substantial services from nonprofit organizations because developers of for-profit projects are limited in that they focus on the return on investment from their projects. For this reason, local governments or nonprofit organizations should address the problems such as "ill health," "transmission of disease," "infant mortality," “juvenile delinquency,” and “crime” (Nebraska Community Statutes, 18-2013). Nevertheless, we observe that the ratio of nonprofit to for-profit TIF plans has decreased recently in spite of deteriorating economic conditions. According to figure 6, if all of the TIF plans approved by the City in 2008 were successful, we would expect foregone taxes to be $33.3 million from 22 for-profit TIF projects and $3.8 million from 2 nonprofit TIF projects. In 2009, the revenue expected to be collected from TIF projects was $6.3 million from 13 for-profit projects and $1.2 million from 2 nonprofit projects. In 2010, the total cost declined to $3.9 million from 7 for-profit TIF projects but there were no nonprofit TIF projects in 2010. Lastly, projected foregone revenue from TIF plans increased in 2011 to $15.4 million from 16 for-profit TIF projects and $0.2 million from 2 nonprofit TIF projects.

Comparative Tax Expenditures and Taxes Foregone in Various Year

In his earlier report, Dunn showed that in 2009 the City lost $27.1 million in tax expenditures from TIF projects and that by 2009, the total cumulative tax expenditures from TIF plans since they were initiated in the city was $135.7 million. By 2011 the City Tax Levy Spreadsheet shows that a total of $28.6 million in tax expenditures from TIF plans was realized by the City in that year. Cumulatively over the past 15 years, $179.5 million has been lost in potential city tax revenues from TIF plans. Figures 7 and 8 show the pattern of revenue losses over time that the city realized in 2011. Figure 7 shows that there was a slowdown in TIF usage in the early 2000s subsequent to recession of that period, and that there was resurgence in 2003 through 2007 (with a strong peak in 2007). There was another drop in TIF revenue losses in recent years, corresponding to the most recent recession.

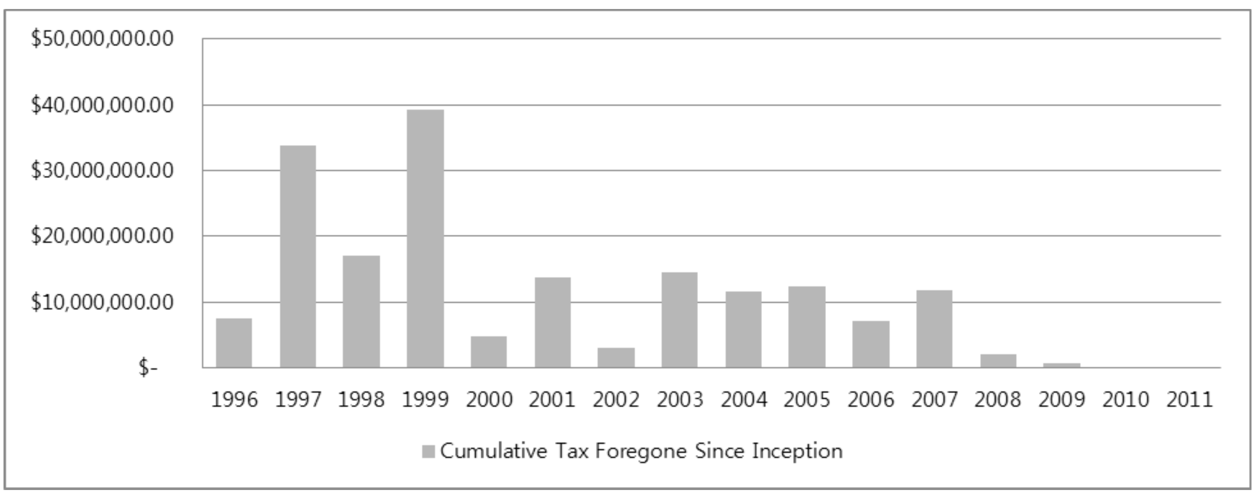
Because TIF projects have a maximum life of 15 years, cumulative taxes foregone for TIF projects approved earlier are likely to be higher than for recently approved projects. Nevertheless, cumulative taxes derived from some projects initiated in the late 1990’s and early 2000s are relatively lower than recent plans (Figure 8).

Figure 7. City Tax Revenue Foregone in 2011, Projects of Various Years Indicated



Source: http://www.revenue.ne.gov/PAD/research/tif_reports.html

Figure 8. Cumulative Taxes Foregone Since Inception, Projects of Various Years Indicated



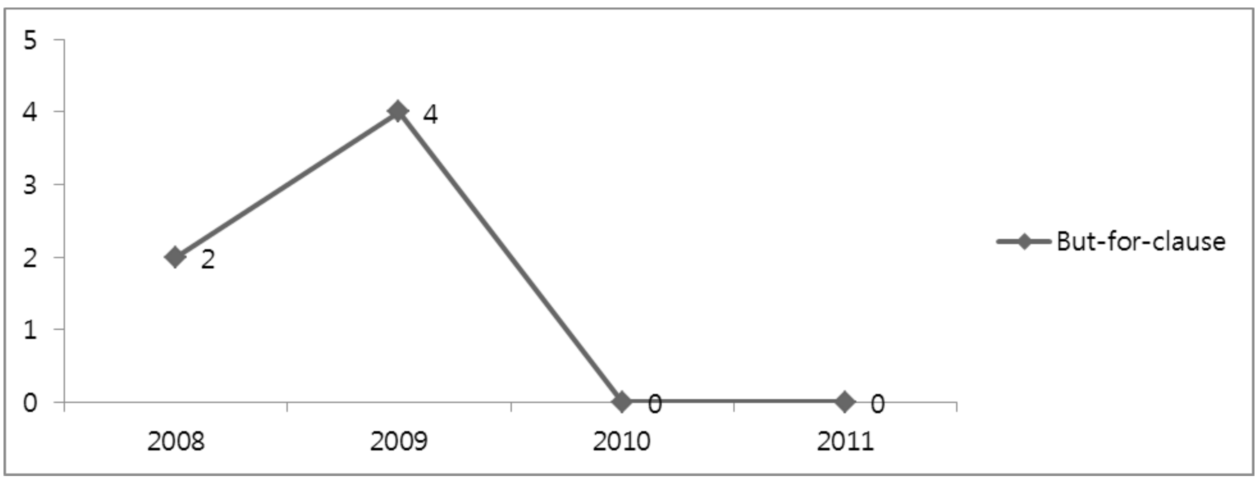
Source: http://www.revenue.ne.gov/PAD/research/tif_reports.html

The But-for Clause Finding

Nebraska statutes require a specific "but-for" finding when a TIF project is approved.

Despite this provision, Dunn found in his earlier report that the “but-for” language occurred in city council meetings for only a few projects approved. We find that the number of projects where the “but-for” is discussed has effectively become zero (Figure 9). This is an alarming development. Perhaps City Council members are not educated about the requirements in Nebraska statutes. Or they are exercising willful ignorance. Whatever the case, all or the vast majority of TIF projects in the City of Omaha are approved without considering whether they would have gone forward without the use of TIF. This was recently highlighted when the City Council approved a TIF project for the new TD Ameritrade campus in West Omaha even though the project was already underway (Wynn, 2012).

Figure 9. The Appearance of But-for Language in City Council Deliberations, 2008 – 2011

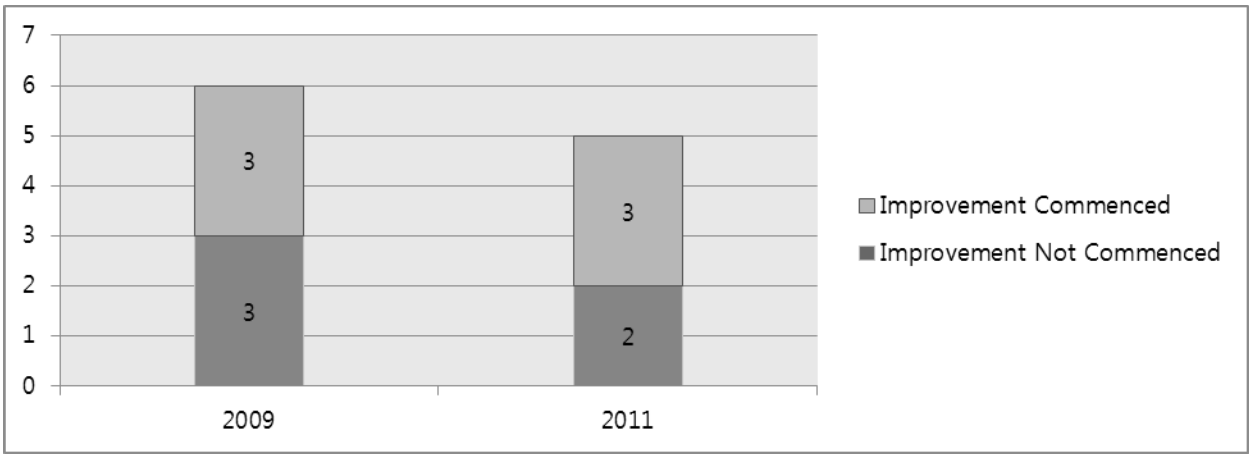


Source: Omaha City-Council Meeting Journals from 2008 to 2011

Approved TIF Plans and Commencement of Improvements

In 2011, 40 percent of TIF projects which were initiated in a year ago are still unimproved. This percentage is not considerably different from the results in the earlier report which showed that 50 percent of TIF projects were improved in 2009 among TIF plans which were initiated in 2008. Between 2008 and 2011, the Tax Increment Financing Report from the State shows that 6 TIF plans were initiated in Omaha in 2008. But of the 6 TIF plans only three were improved in 2010. Then, of the 5 TIF plans reported to the State as initiated in 2010, only three had improvements made on them warranting increased (incremental) taxes by 2011 (State of Nebraska, 2011).

Figure 10. Approved TIF Plans and Commencement of Improvements



Source: http://www.revenue.ne.gov/PAD/research/tif_reports.html

Policy Recommendations

There are many areas suggested by this and the previous Dunn study where the Nebraska TIF policy could be strengthened. One of these is in the targeting of TIF dollars. As shown in Figure 4, a relatively small portion of TIF dollars by the city of Omaha is going toward industrial investment. The majority is going toward commercial enterprises. If TIF is viewed as an investment in the way of foregoing tax dollars to spur economic and job growth, then it makes much more sense to invest in industrial enterprises as they typically provide higher levels of employment. This higher level of employment would carry a higher multiplier in terms of economic effects.

Some areas of TIF "investment" seem particularly hard to justify. One is market-rate housing. It is difficult to see why housing projects with a true market rate would not proceed even if TIF dollars were not invested. The Nebraska Legislature may want to consider banning or at least limiting the use of TIF for market-rate housing. Another area of investment that may be the source of possible policy action is nonprofit projects. As we show, nonprofit projects constitute a minor use of TIF funding. If the goal of TIF is to address social problems, then nonprofits certainly should absorb a larger share of TIF funding. The Legislature may want to build incentives for the use of TIF for nonprofit projects.

The point on market-rate housing relates to another area that the Legislature should certainly take up. This is the obvious abuse of the requirement in state statutes for a "but-for" finding to accompany TIF project approval. The city of Omaha appears to be thumbing their nose at the requirement. The Legislature should reemphasize the but-for requirement and provide tough sanctions for jurisdictions found to not be in compliance with its provisions.

One final area that deserves attention by the Legislature is to potentially require cities to provide on a regular basis benefit-cost analyses of projects funded through TIF. If TIF is indeed a means of providing public investment in order to stimulate economic growth, a natural question to ask is what cities are getting for the massive investments they are undertaking. The city of Omaha had foregone revenue from TIF projects of $28 million in 2011. It would be valuable for city residents to understand the rate of return on their investment in terms of jobs and business investment. Also, any proposed TIF projects should be subject to a prospective benefit-cost analysis.

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