Appraisal Comments on Tax Increment Financing Effectiveness in the Context of Evaluating Iowa Tax Policy Alternatives

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In recent weeks several Iowa policymakers, leaders, and citizens have become interested in proposals involving significant policy reforms and tax increment financing. Much of the discussion is based on the results of a single study based on aggregate approaches that were never designed for the context of evaluating policy alternatives. At the request of several leaders, provided herein is a limited appraisal of the context and content of the study, "Do Tax Increment Finance Districts Spur Social and Economic Growth?" The author benefited from comments by Dr. Arne Hallam, Chair, ISU Department of Economics, on earlier drafts of this document. The author accepts responsibility for any errors or deficiencies that remain.

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Summary of Comments

1. In recent decades, tax increment financing has become a widely used economic development tool. Municipalities in 48 states and counties in 33 states are authorized to use some form of Tax Increment Financing. So Iowa is currently not unique from 48 other states. However, change is hard and often involves more risk.

- Unilateral elimination of TIF would be unique and perhaps would potentially create competitiveness issues for Iowa communities that are attempting to attract prospective firms that are also considering prospective sites in other states. If in fact TIF is a negative drag on the national economy, a negotiated multi-state compact agreement strategy could potentially reduce the use of TIF and other similar tools without competitive disadvantages accruing to any one state.

- Replacing local property tax and TIF authority with a statewide TIF authority potentially replaces local priorities with state priorities and potentially reduces local fiscal flexibility in order to increase state fiscal flexibility. This potentially represents a gain for communities with prospective firms or characteristics favored by state/regional criteria but represents a potential loss for communities that are not able to attract the favored prospective firms or develop the favored characteristics.

- Communities have over a dozen economic sectors that may contribute to local vitality or lack thereof. Many of these sectors operate in a context of competitive international, national, and local markets. TIF allows community leaders to respond to any sector that may present an opportunity or potential loss. State defined priorities target biotechnology, advanced manufacturing, and information systems. A tradeoff between flexible tools that can serve a comprehensive set of opportunities versus categorical tools that serve targeted opportunities would likely emerge. Risk averse investors may suggest pilot testing programs to determine whether the track record and performance of state investment initiatives are in fact superior or inferior to community investment initiatives.

- Sorensen and Yosha (2001) suggest that state fiscal policy is asymmetric over the business cycle and due to macro economic effects there is not a lot that states can do to jump start their economy, however they can do many things to make matters worse by creating instability and loss of confidence by investors and consumers. The history books contain examples of states like Indiana that bonded to build canal infrastructure and nearly took the state into bankruptcy when railroads developed. State government currently benefits from the incremental sales and incremental income taxes from economic growth. Under some proposals the state would also usurp incremental property tax revenues from which local governments have historically benefited. Some may suggest that the public risk and wisdom of significant borrowing in the middle of a downturn is tantamount to a family that has one member out of work going into debt to

start a new business. While opportunity for success is present, the risk is elevated by many factors that can result in failure. Appropriate financial due diligence is warranted for public funds. State policymakers have not always been kind to previous state initiated "pump priming" funds. For example, the Iowa Seed Capital Fund was dismantled and a state AgriVenture initiative was then created. Has performance been evaluated?

2. Before major well-established economic development tools are eliminated, perhaps equivalent due diligence should be conducted to assure that the least effective tools are being eliminated, that all underutilized assets are being considered and that the new initiatives will out perform the ones replaced. The Swenson-Eathington study does not analyze the relative performance of TIF to Iowa's other economic development tools such as enterprise zones or abatement districts, nor does it develop a comprehensive list of "redeployable underutilized assets" in the property tax code for Iowa policymakers to consider and evaluate in an evenhanded assessment process for informed policy decisions.

- Enterprise Zones for Iowa were developed with arbitrary criteria that becomes more obsolete each year. Recent academic literature on the subject (Wilder and Rubin, 1996; Fisher and Peters 1997; and Peters and Fisher, 2002) suggests "the econometric literature on the effects of enterprise zones incentives in particular is small…and most evidence suggests that zones have almost no influence on local growth." Swenson and Eathington (1998) criticized housing abatements, again particularly in non metro cities.

- Underutilized assets might include ag buildings. Due to Iowa's administrative rules that only consider land productivity when agricultural assessments are equalized, all property tax payments on agricultural buildings such as animal confinements are usurped from local government and used to lower property taxes on all agricultural property instead of increasing the local tax base for cities, counties, and schools (Confirmed: Story County Assessor; Iowa Department of Revenue and Finance, Property Tax Division).

- Iowa ranks 49th in new business startups. Small business accounts for a majority of the new jobs created. Redeployment might include entrepreneurship--a bottom up strategy for promoting economic development for which the odds for successful new startups can be increased if community institutions and resources are better coordinated with regional expertise so that anyone with the right idea, commitment, and hard work is supported in their entrepreneurial endeavors with mentoring networks, appropriate access to resources, and a culture of success. Iowa traditionally has focused on retention and expansion programs and marketing to attract prospective external firms (CVC, 2003).

3. The applicable broader range of academic literature--much of which is cited in Swenson-Eathington (April 2002) study suggests a range of results—including some studies with positive TIF findings that contradict the conclusions and findings of the Swenson-Eathington study. One difficulty highlighted by the various studies results from differing state rules and availability of data for analysis.

- Although the causality was not clear, Anderson (1990) found that TIFs in Michigan corresponded with increased property growth. Mann and Rosentraub (1998) looked at the effects of TIF on property wealth and concluded that in Indiana, the housing values in TIF adopting places were much greater than in those without TIF and concluded that the TIF mechanism is an important tool for economic development with the potential to benefit a wide range of people and income classes in a community. Dye and Merriman (2000) found that cities in northern Illinois that adopted TIF grew more slowly than those that did not.

- Lawrence and Stephenson (1995) assessed the localized outcomes of TIF districts in the city of Des Moines, Iowa. They found in this case that non-TIF property owners initially subsidized the TIF region but that over a reasonable period of time the TIF began to generate returns to the entire property tax paying region. Byrne (2002) found that the size of the TIF district has positive influence on property value growth and that a variety of demographic factors influence the location of TIF districts and opportunities for growth.

- Much of the literature on economic development incentives may potentially contain a metropolitan bias. The Swenson-Eathington study cites literature that suggests that overcoming "market failures" surrounding blighted areas is one of the goals of using TIF. Several studies suggest the greatest efficiency in the use of incentives for jobs and growth results if blighted areas are targeted. But does this apply to Iowa? It is not great "rocket science" to suggest that building expensive skyscrapers where depressed ghettos once stood has greatest opportunity to achieve incentive efficiency, but most non metro areas have neither. Most of the academic literature does not take the time to articulate the characteristics of "market failures" that persist in non metro areas and how they may be different from metropolitan areas. In non metro areas, lack of liquidity in real estate markets and lack of venture capital may persist in the community without depressed blighted areas or surrounding high valued property areas. Efficiency is not necessarily sufficient if a differential in market failures exists in non metro areas. Equal opportunity may be a goal that resonates with some policymakers. Forcing non metro communities to use metro definitions of blighted areas resembles a one size fits all approach that may not address the market failures in non metro communities.

- Some aspects of the Swenson-Eathington results may be interpreted by others to represent a measure of success. "TIF net valuation grew from $721 million to just over 4 billion or by 456 percent [between 1989 and 1999]. TIF increment property taxes grew from $22 million to 118.8 million or 442 percent [between 1989 and 1999]. For the urban remainder…taxes grew by nearly 59 percent, while the base grew by just 43 percent." Others may argue that TIF increases would not likely have existed without TIF to provide infrastructure and to make projects work locally for the prospective firms and developers. Economic theory suggests that providing economic stimulus incentives generates additional investment at the margin. The Swenson-Eathington study, does not precisely measure magnitude of marginal impacts or what would have happened in absence of TIF.

4. The Swenson-Eathington (April 2002) study identified limitations of the research methods used and potential for inaccuracy, but failed to acknowledge these same limitations in the study conclusions presented to the public in the June 2002 report and press release. The Swenson-Eathington study concluded there was a universe of two approaches for analyses and in the process excluded a range of micro analysis approaches that would have more accurately measured TIF district and TIF project costs, benefits and performance.

- Swenson-Eathington cite several limitations to TIF research. These include: (1) Generalizing findings from one state to another is of limited value due to differences in local government authority, fiscal capacity, and opportunities; (2) Generalizing findings across different kinds of TIF districts is of limited valued; (3) Some states have rigid standards with bureaucratic process, while others do not; (4) Some have state mandated set-aside requirements others do not; and (5) the 2002 TIF Study researchers acknowledge limitations in the ability to accurately tally the public benefits and public costs due to the timing considerations concerning the evolution of TIF districts. Items 2 and 5 are key issues in analyzing the applicability of the Swenson Study for the current policy debate.

- Swenson-Eathington state that their "goal is to compile sets of direct outcome measures that help us to categorize the overall efficacy of TIF adoption in …Iowa. We are much more interested in discerning both the extent of the phenomenon, the costs as measured by direct public investment in business growth, and the possible outcomes that can be attributed to these investments." The Swenson-Eathington study was limited to the data that were available and costs associated with a more complete micro level analysis and collection of primary data resulted in analysis based on aggregate data alone.

- Swenson-Eathington state that the literature provides "two particular approaches [for] measuring TIF districts' worth … (1) [comparison] of differential growth rates among TIF versus non-TIF areas (either within a city or across cities)… and (2) a comparison of tax rates over time in TIF cities and non-TIF cities." Other academic researchers may question whether the universe of studies is limited to only two approaches. In theory, a third approach would be to collect detailed observations on local goals, costs and outcomes, to make comparisons across all TIF projects including the amount of added valuation returned to the tax base after each project matures. A fourth approach would be to conduct a life cycle analysis for a cross section of TIF projects and TIF districts similar to the third approach and then to use fiscal impact simulations to evaluate what would likely have happened in the absence of TIF. These approaches may provide a more accurate accounting and locally relevant assessment of the timing of TIF investments and outcomes by actual projects over the life of selected TIF districts to overcome the major limitation of TIF research based solely on secondary data. The difficulty with these approaches is that they require detailed longitudinal micro data typically not available without expensive project by project surveys.

5. One difficulty with the Swenson-Eathington June 2002 study--which reduces its value to the general public is that all of the various data assumptions and limitations are not as clearly discussed as in the April 2002 TIF study. Many people, unfortunately, tended to jump toward what they like and dislike without evaluating the earlier paper and the limitations of data and analysis noted therein. Due to availability of data the analysis appears to be dominated by TIF projects less than 7 to 10 years old and still encumbering funds. This means the full impacts and benefits of TIF projects embodied in the data used in the Swenson-Eathington study were not likely to be experienced during the period examined in their analysis.

- Swenson-Eathington state that their analysis is limited by the availability of county level data. There may be significant potential for loss of accuracy in assessing the performance of individual TIF districts by using countywide indicators because the countywide indicators may be influenced by many other factors. TIF valuations typically amount to only a small portion of total county valuations. Across Iowa counties there are likely to be varying numbers of TIF projects per county, varying numbers of governmental units that use TIF in the county, and a variety of local objectives, goals, and circumstances that exist, such as the local preferences for economic diversification, replacement of lost jobs, or stimulus for middle income housing. The researchers use countywide jobs and population indicators as the primary criteria for judging TIF performance. In this regard, Swenson-Eathington's conclusions are based on researcher preferences for TIF criteria and based on what can be measured. A similar analogy would be to say that "farm programs should be eliminated, because after 60 years farm numbers are still declining."

- Perhaps the most problematic implication regarding the methods and data is lack of distinction between: (1) TIF districts and TIF projects and (2) a lack of segregation of TIF projects for which the agreement has expired and other TIF projects that are still encumbering TIF dollars. The distinction between TIF districts and TIF projects is important because in non metro areas of Iowa with slower growth, economic development leaders consider it to be prudent to have TIF districts ready with sites and infrastructure for prospective businesses to consider rather than to create a new TIF district for each new TIF project. Thus proposals to shorten the legal life of TIF districts would appear to represent a potential bias against the flexibility that non metro areas need for accomplishing a measure of growth and sustainability. Having larger TIF districts that can be utilized over several decades keeps TIF district development costs low and helps the community and developers to designate areas for development so that unintended spillovers are minimized long term.

- The researchers earlier acknowledged that timing is an important aspect in appropriately tallying the costs and benefits, however, the methodology and data used do not operationalize the timing concept in a way that accurately tally the costs and benefits for TIF projects. The distinction between TIF projects that have expired and those that have not are important because most TIF agreements are for 7 to 10 years. The Swenson-Eathington TIF Study shows that TIF valuations doubled between 89 and 92, doubled again by 95 and doubled again by 99. This means the TIF study is likely based on data

for which a majority of the TIF agreements being analyzed are likely to be in the phase of encumbering TIF dollars rather than returning TIF valuation to local taxing jurisdictions. Swenson-Eathington lament the extent that TIF may influence higher non-TIF tax collections relative to the increase in non-TIF valuations. However, much of the dramatic growth in the use of TIF during the 1990s is likely to have been due to the historic economic expansion in the national economy rather than the poor performance of TIF. Given the slowdown in the economy, it would be interesting to see whether there has been a corresponding slow down in TIF projects during the current decade as the benefits from the last decade's TIF projects are coming to fruition.

- Swenson-Eathington do not clearly specify the disposition of the unused portion of potential TIF revenues generated by the TIF District that are not requested for use in the TIF Projects. Are these dollars included as an offset from the taxes collected in the TIF District? Since these dollars are returned to the taxing units, are they excluded or included in non-TIF tax revenues? Because of the lack of documentation of methods in the reports, other academics and local officials who read the study are left to presume that the researchers handled these offsets in a conceptually appropriate manner without error. Perhaps the researchers could provide a sample of data and calculations for one county to allow academics and local officials to verify the level of accuracy and appropriateness of data manipulations used.

- Swenson-Eathington fail to fully acknowledge the potential differences in outcomes from the more restrictive TIF policies passed since 1996. As a result, their methods and data are not of sufficient specificity to assess the differences. Housing developers that have used TIF might suggest that some are discontinuing use of TIF due to lack of profits, more bureaucracy, regular changes in policies, and increased TIF taxes used for state mandated programs. In recent years, up to 40 percent of the TIF increment generated from residential TIF projects are taxed and set aside with a mandate that they be used for developing Low and Moderate Income (LMI) housing whether or not the local community possess an assessed need or preference for such housing. Many non metro communities have plenty of pre-WWII low and moderate income housing. What many development leaders have expressed needs for in recent conferences, is housing for middle-income workers and to upgrade and modernize the local housing stock. Such TIF taxes and mandated programs add additional risks and costs to a developer's TIF project. These factors are hard to reconcile with the researcher's characterization of TIF as being a *de facto* entitlement. Not all TIF projects are profitable, the developers bear unique risks, and not all TIF projects are acceptable to community leaders. Those who are taking risks and investing in Iowa's future do not view TIF as being an entitlement.

- The 2002 TIF study methods and data are not of sufficient specificity to separate new valuation in TIF districts from inflationary valuation of pre-TIF construction.

- Finally the 2002 TIF study does little to clarify the best practices for improving TIF performance or to distinguish between successful use of TIF and non-successful use of TIF.

6. Some social scientists may regard a correlation of social indicators with r=.10 to r=.25 as being "inconclusive" rather than being an indicator of non performance by TIF Districts. Both positive and negative factors were inconclusive. The results may be due to the limitations of the methods and limitations of aggregate data used rather than the lack of localized TIF project and District performance.

- Regarding TIF tax collections, Swenson-Eathington report the following variables with correlates for:

1.	Manufacturing jobs	(r=.254)
2.	Taxable value of commercial and industrial property	(r=.198)
3.	Net non-TIF taxable values	(r=.156)
4.	Net non-TIF property taxes	(r=.223)
5.	Non farm earnings	(r=.139)

To the extent that such analysis of secondary data can accurately measure TIF performance, the inconclusive correlations for the first, second, third and last factors could potentially indicate a positive performance by TIF and the fourth would indicate a negative performance by TIF. For comparison, an exhaustive study by the Aldrich and Kusmin for the USDA-Economic Research Service (1997) reviewed 35 studies and 24 factors of growth and found that these factors explained only 40 percent of the variation in growth of non metro U.S. counties.

- The authors state "it is not possible to study [Iowa] TIF cities with enough comparable control cities to determine both spatial and temporal efficacy. Consequently we have been forced to simply try to isolate reasonable sets of correlates to see whether TIF increments spending in Iowa has led to discernible fiscal, economic and social outcomes." Again the study was limited to data available, which limited the potential accuracy of the study.

7. Dividing aggregate countywide TIF spending (which may include residential, economic development and other public infrastructure projects) by countywide jobs growth and/or population growth does not necessarily provide accurate indicators of fiscal or social costs relating to TIF. Only a portion of the jobs created in a county are likely to be directly related to TIF projects. The cost of higher quality jobs may in fact be higher than the aggregate numbers reported in Swenson-Eathington, but these costs must be weighted against the additional private sector dollars leveraged and the benefits for the community. In addition, TIF costs are primarily paid from the property taxes generated by the new valuation added by the TIF projects, not by the public at large as implied in the Swenson-Eathington study. While some of the costs may be financed by the public at large, this can and has been offset in some municipalities by passing through a portion of the TIF increment to the residual governments. For example a new house in a residential TIF project may typically pay 2.5 times the property taxes as the house with an average assessment for the community. Therefore, allowing a third of the TIF

increment to flow through to the residual governments potentially holds harmless local taxpayers.

- The public costs per new job or new population are likely to be influenced by many factors. The behavior parameters of local officials across the country partially determine the market for public investment in job creation. Spending $3,000 to $10,000 per job was not viewed as being an unreasonable market price during much of the 1990s. Higher paying jobs may require higher costs. More capital or knowledge intensive jobs may involve higher costs than unskilled labor-intensive jobs. For example, some media reports suggest a biotechnology proposal may request about $220,000 of public investment per job for the direct jobs created by the reported project. But this funding also leverages a larger amount of private investment. Thus, more detailed financial due diligence is required to determine the project benefits from both public and leveraged private funds and whether the returns to the community and state justify the public investment. Dividing aggregate TIF investment by aggregate new jobs and new population would seem to provide indicators that are subject to other influences and that are much less precise than analyzing an appropriately sized sample of actual TIF projects.

In conclusion, the broader academic literature has more mixed results and some other studies seem to contradict the results of the Swenson-Eathington study. To their credit, Swenson-Eathington acknowledged limitations in the methods and data. In addition, the approaches used say little about what would likely have happened in the absence of TIF. Other analysts have previously suggested a more intensive micro analysis approach to examine the performance of a sample of individual TIF projects across the state. This would identify best practice guidelines and to assure that accuracy in timing issues for tallying costs and benefits are achieved. The Lawrence and Stephenson (1995) study of a Des Moines TIF District used a more micro community approach in their attempt to assure greater accuracy in tallying costs and benefits. The results of their study suggested that TIF worked as expected—returning benefits to the tax base after the initial encumbrances.

Finally, there is some risk to imposing radical changes in TIF: (1) that are not consistent with local development objectives, and (2) without more detailed micro-analysis and data that accurately measure costs and benefits of TIF projects. Focusing on "TIF abuses and worst practices" at the expense of "TIF successes and best practices" can result in policies that are detrimental rather than policies that improve performance of TIF projects and vitality of Iowa communities.

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