

Tax Increment Financing

EXECUTIVE SUMMARY

Cities are the primary users of TIF, but the state and county governments share in its costs.

Tax increment financing (TIF) is a tool used by cities and other development authorities to finance certain types of development costs. The public purposes of TIF are the redevelopment of blighted areas, construction of low- and moderate-income housing, provision of employment opportunities, and improvement of the tax base.

Tax increment financing enables a city to use the additional property taxes generated by a new development to pay for certain development expenses. With TIF, a city "captures" the additional property taxes generated by the development that would have gone to other taxing jurisdictions and uses the "tax increments" to finance the development costs.

TIF requires different taxing jurisdictions to share in the costs of financing local development. The state finances more TIF costs than other taxing jurisdictions because it compensates school districts for most of their tax revenue losses through increases in state education aids. The House Research Department has estimated that total state costs were \$100 million in 1994, assuming that the development would have occurred elsewhere in Minnesota without TIF.

Cities used TIF extensively in the late 1970s and 1980s. However, perceived misuse of TIF prompted the Legislature to place restrictions on the program in 1988, 1989, 1990, and 1995. Conflicting opinions about whether current laws are too restrictive or too permissive prompted our study. Our evaluation addressed the following questions:

- **How has the use of tax increment financing changed over time? Are there geographic variations in the use of tax increment financing in Minnesota?**
- **How have cities and other development authorities used tax increment financing in recent years?**
- **Have legislative restrictions, particularly those enacted in 1990, been effective in correcting the misuses of tax increment financing? Are further restrictions or other legislative approaches needed?**

To conduct our study, we visited 43 cities and 3 counties and interviewed local officials. Prior to our site visits, we reviewed TIF plans and bonded indebtedness reports filed with the Minnesota Department of Revenue and the TIF annual disclosure statements and financial reports filed with the Office of the State Auditor. We also analyzed data reported by county auditors to the Revenue Department in the Abstract of Tax Lists and Tax Increment Financing Supplement.

BACKGROUND

The Minnesota Tax Increment Financing Act of 1979 permits cities and other development authorities to establish tax increment districts for: (1) redevelopment, (2) renewal and renovation, (3) soil conditions, (4) housing projects, (5) economic development, (6) mined underground space, and (7) hazardous substance clean-up. Districts established prior to August 1, 1979, when the TIF Act took effect, are referred to as "pre-1979 districts."

The TIF Act placed significant restrictions on the use of tax increment financing. For example, it limited the duration of districts, the geographic areas that may be designated for certain districts, and the type and amount of tax increment spending. The act also required cities to develop TIF plans and make annual financial reports on their districts.

Between 1988 and 1990, the Legislature enacted many additional restrictions. For example, the Legislature: limited the ability of cities to capture tax increments from development not stimulated by TIF; adopted stricter blight requirements for redevelopment districts; required larger portions of increments generated by redevelopment districts to be spent on blighted properties; restricted the use of economic development districts to manufacturing and related activities; and limited the ability of cities to "pool" increments from multiple districts. The Legislature also reduced state aid paid to local governments that created districts after April 30, 1990, referred to as "post-1990 districts," but amendments in 1995 reduced the impact of these aid reductions.

RECENT USES OF TAX INCREMENT FINANCING

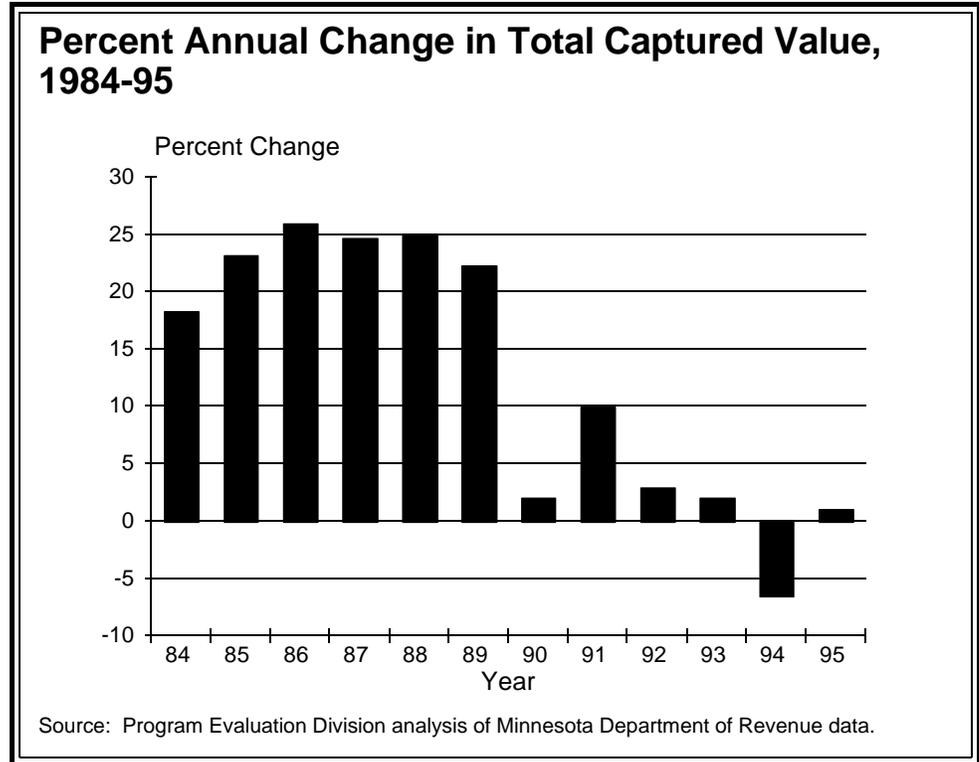
Overall, we found that:

- **Legislative restrictions on the use of tax increment financing have addressed many of the previously identified problems with TIF and helped slow the growth of TIF activity.**

Captured tax capacity increased by an average of 24 percent per year between 1984 and 1989, but increased by only 1.9 percent per year between 1990 and 1995. The number of districts with captured tax capacity grew by 25 percent annu-

ally between 1986 and 1989, compared with only 3.4 percent between 1991 and 1995. In 1995, Minnesota had 1,436 tax increment districts in 363 cities and towns. The districts had \$203.3 million in captured tax capacity, or 8 percent of these local governments' total tax capacity.

Captured tax capacity increased by an average of only 2 percent per year in the 1990s.



All of Minnesota's large cities, 90 percent of medium-sized cities, and about one-fourth of small cities had at least one tax increment district in 1995. Districts in large cities were larger and captured more tax capacity, on average, than those in smaller cities. We also found that:

- **Pre-1979 districts were larger and captured more tax capacity, on average, than districts created later, and post-1990 districts were smaller, on average, than older districts.**

Although the 110 pre-1979 districts represented only 8 percent of all TIF districts, they accounted for 30 percent (\$61 million) of the total 1995 captured tax capacity. In contrast, the 346 post-1990 districts represented 24 percent of all districts but accounted for only 5 percent of the captured tax capacity. In part, this is because many post-1990 districts are just starting to generate tax increments; over half were certified in 1992 and 1993. However, post-1990 districts were also smaller than older districts. The average number of parcels per district declined from 146 for pre-1979 districts to 25 for August 1979-April 1990 districts and 8 for post-1990 districts.

Since late 1990, for the most part Minnesota cities have used tax increment financing productively to induce the redevelopment of blighted areas, to encourage the

Captured Tax Capacity and District Size by Time of Creation

<u>Time of District's Creation</u>	<u>Number of Districts</u>	<u>Average Number of Parcels per District</u>	<u>Captured 1995 Tax Capacity</u>	<u>Percent of Statewide 1995 Captured Tax Capacity</u>	<u>Average Captured Tax Capacity Per District</u>
Pre-1979	110	146	\$61.1 million	30%	\$555,007
August 1979 - April 1990					
August 1979 - December 1985	336	40	68.5 million	34	\$203,863
January 1986 - December 1988	339	19	43.0 million	21	126,971
January 1989 - April 1990	<u>305</u>	<u>14</u>	<u>21.4 million</u>	<u>11</u>	<u>70,062</u>
Sub Total	980	25	\$132.9 million	65%	\$135,622
Post-1990	346	8	\$9.3 million	5%	\$26,967
All Districts	1,436	30	\$203.3 million	100%	\$141,568

Source: Program Evaluation Division analysis of Department of Revenue's 1995 TIF Supplement data base.

construction of low- and moderate-income housing, and to assist with expansion of manufacturing businesses. Based on our review of 172 post-1990 tax increment districts in our sample cities and counties, we found that:

- **About two-fifths of the post-1990 tax increment districts in our sample were created to assist new or existing manufacturing businesses, while office developments, retail facilities, and housing projects each accounted for one-fifth of the districts.**

Most recent retail projects were in areas needing redevelopment.

As a result of 1990 restrictions on economic development districts, retail and office projects have occurred, for the most part, in areas that needed redevelopment, rather than on vacant land. Some cities used TIF to facilitate the development of retail stores and office buildings on bare ground that had poor soils. However, legislative amendments in 1995 required that increments from soils condition districts be spent only for pollution clean-up, so tax increments from these districts can no longer be used to finance extensive excavation, soil compacting, grading, and filling.

Legislation tightening the "blight" criteria for redevelopment districts and requiring that large portions of increments to be spent on blighted properties have reduced the tendency of cities to create very large redevelopment districts or to use redevelopment districts for purposes other than rehabilitating blighted parts of a city. We found that:

- **Most post-1990 redevelopment districts were smaller than pre-1990 districts, were contiguous, and were focused on individual projects.**

Plans for post-1990 redevelopment districts usually include assistance with demolition and renovation of existing structures and site preparation for new facilities.

It is difficult to quantify the extent to which cities have not pursued development projects because of possible state aid reductions, although some city officials told us that the potential aid changes have caused them to reduce the number of tax increment districts they otherwise would have certified. So far the state aid reductions have had a relatively small fiscal impact because they only applied to districts certified after April 30, 1990, and most districts qualified for a five-year grace period. State aid payments will be reduced by a total of \$1.6 million in 1996, affecting 64 cities, 2 counties, and 1 town.

Because most of the legislative restrictions on TIF have not applied to existing districts, we also found that:

- **Legislative restrictions on the use of TIF have not addressed the use of tax increments from districts established between 1979 and April 30, 1990.**

Some cities have created large "project areas," or areas in which increments from TIF districts may be spent. Sometimes these project areas encompass entire cities or large portions of them. The TIF law allows cities to "pool," or combine, tax increments from multiple districts a within project area, and to spend tax increments anywhere within the project area. We found that:

- **Of the 45 cities and counties that we visited with more than one TIF district, two-thirds have pooled tax increment revenues between districts or have project area configurations that would permit pooling.**
- **Many cities and development authorities have amended tax increment plans for their pre-1990 districts in order to spend tax increment dollars for general public improvements and community projects.**

Many cities use tax increments from pre-1990 districts as a general purpose funding source.

As a rule, cities do not terminate districts before their expiration dates and frequently use tax increments as a general purpose funding source. We found cities spending tax increments on park improvements (ice arenas, playground equipment, land acquisition), community centers, freeway interchanges, bridges, water towers, and wastewater treatment plants. Some cities have used tax increments from pre-1990 districts to capitalize economic development funds and business loan programs and to establish reserve accounts for various purposes. If TIF districts were retired after serving their original purpose - rather than being continued to finance activities that many cities pay for with their own tax dollars - then counties and other taxing jurisdictions would be able to reduce their tax rates and state aid to school districts could be lowered without affecting educational programs.

In contrast, we found no cities pooling increments from post-1990 districts at this time. Legislative limits on the pooling and spending of tax increments from post-1990 districts limit the degree to which increments from these districts can be used to fund general public improvements. However, since most post-1990 districts are less than five years old and are not yet generating large amounts of tax

increment revenues, it is still too early to evaluate the impact of these restrictions on post-1990 districts.

While we did not conduct a financial audit, we reviewed the financial status of over 400 TIF districts in our sample cities. We found that:

- **The vast majority of tax increment districts are financially stable and generate sufficient tax increment revenues to pay for project costs. Only a few cities have needed to levy general taxes to make up for revenue shortfalls.**

Some cities have used pooled increments from two or more districts to support districts that were not able to generate enough increments to pay project costs. Other non-performing districts involved "pay-as-you-go financing," where developers provide the up-front financing and bear the risk of non-performing projects.

Although the extent of pay-as-you-go financing is difficult to estimate, we think this type of financial arrangement has increased. Among the 172 post-1990 districts we examined, over half used pay-as-you-go arrangements, one-quarter used internal loans from other city funds, and less than one-fifth issued bonds to finance the project costs. One concern we have is that some cities using pay-as-you-go financing have not specified project activities and expenditures in their TIF plans, making it difficult to ensure that developers are spending TIF funds for activities allowed by state laws.

COMPLIANCE ISSUES

The purpose of this study was to gain insight into how cities are currently using TIF, not to comprehensively audit cities' finances or their compliance with state law. However, we found that:

- **The quality of annual financial reports for tax increment districts is mixed.**

While nearly all cities and development authorities filed annual disclosure statements and financial reports, some did not file reports for all districts. For instance, some cities only filed reports for districts with captured value. Several cities filed one combined statement for all pooled districts, making it impossible to analyze revenues and spending for individual districts. In addition, some cities filed incomplete statements. Finally, nine of the cities we visited filed unaudited annual financial statements.

According to the TIF Act, before a city creates a TIF district it must find that the proposed development or redevelopment would not occur within the reasonable foreseeable future "but for" the use of tax increment financing. While the TIF Act requires cities to "set forth in writing the reasons and supporting factors" behind the "but for" finding, we found that:

Legislative restrictions have been reasonable, but have made TIF more difficult to use.

- **Some cities were unable to provide documentation or analysis on how their TIF districts met the "but for" requirements.**

State law also requires cities and development authorities to file TIF plans with the Department of Revenue. Five of the cities we visited had not filed any TIF plans with the Department of Revenue and nearly half filed some but not all plans. Some cities submitted plans using "boilerplate" language, which did not identify specific development objectives or activities, making it difficult to determine how they are using TIF.

Finally, cities with housing districts are required to monitor the incomes of residents to ensure that the project is fulfilling its commitment to provide housing for low- and moderate-income people. We found that some cities do not appear to have any monitoring procedures in place or do not appear to be enforcing the income requirements.

RECOMMENDATIONS

In our view, the changes made to the TIF law in recent years have been reasonable, even though they have made TIF more difficult to use. However, we believe that more comprehensive monitoring and oversight will be needed to ensure that the new laws are properly enforced. As a result of 1995 legislation, the Office of the State Auditor has assumed new enforcement responsibilities for the TIF Act this year, and we offer several suggestions for implementing those responsibilities. We also suggest policy options the Legislature may wish to consider for dealing with pre-1990 tax increment districts.

Enforcement Suggestions

We think the Office of the State Auditor should focus its monitoring efforts on those areas we have identified as problems with tax increment financing. In particular, we suggest that:

- **The State Auditor should monitor compliance of cities and development authorities with state laws governing: (1) the pooling and spending restrictions for post-1990 districts as they mature, (2) the types of TIF spending in all districts (especially those using pay-as-you-go financing), (3) restrictions on economic development districts, (4) the "but for" requirement, and (5) the "blight" requirements for redevelopment districts.**

Also, as noted in our report, the quality of TIF plans, annual disclosure statements, financial reports, and debt reports has been mixed. We are particularly concerned about financial reporting for pay-as-you-go arrangements, which do not rely on bonded debt. We suggest that:

Oversight is needed to ensure that TIF laws are properly enforced.

- **The State Auditor should work with cities and development authorities to ensure that all tax increment financing users are aware of and comply with the reporting requirements contained in state law.**

The consolidation of the TIF reporting requirements under the State Auditor's Office, which is also responsible for financial and compliance auditing, should result in higher quality financial data.

Options for Legislative Consideration

We think that the continued use of tax increment revenues from pre-1990 districts to finance general public improvements and community projects is an issue requiring legislative attention. Under normal circumstances, cities would finance these projects with their own funds, special assessments, or other sources of funding, such as user fees. Although some types of public improvements may contribute to development activity, most improvements have little direct impact on tax base or employment growth. Tax increment financing is being used to provide a state and county subsidy for functions that most cities finance from other sources.

Therefore, we recommend that:

- **The Legislature should consider placing additional restrictions on the use of tax increment revenues for general public improvements and community projects. Restrictions should apply to all districts certified between August 1, 1979 and April 30, 1990.**

Restrictions on using TIF for general public improvements could be structured in several different ways.

These districts account for the majority of 1995 captured tax capacity, and some of them could last for up to 19 more years.

Restrictions on using tax increment revenues to finance general public improvements could be structured in a number of ways. One option would be to prohibit the use of tax increments from pre-1990 districts for specific purposes, such as park improvements and recreation facilities, community centers, civic centers, ice arenas, wastewater treatment plants, water towers, freeway interchanges, or bridges.

A second option would be to prohibit any future amendments to existing TIF plans that authorize increased tax increment spending for general public improvements and community projects. If the Legislature pursues this alternative, it should consider making this change retroactive to, say, January 1, 1996, to prevent cities and development authorities from approving amendments before a future effective date.

A third option would be to address those cases involving cities that have already adopted amendments to TIF plans for pre-1990 districts. The Legislature could allow the use of tax increments for new projects for which cities have issued bonds or entered into other legally binding commitments by a specified future date. After the specified date, any projects remaining in the city's amended TIF budget could not be financed with tax increments. This option could be structured similar

to the five-year spending restriction that is in the law for post-1990 districts. Most tax increments collected from a post-1990 district must be spent on activities for which bonds have been issued or binding legal commitments have been made within five years after the district's approval. To prevent cities from continuing to approve amendments for increased spending, this option could be combined with the option that prohibits future amendments to increase TIF spending for general public improvements.

Finally, the Legislature could require that future tax increments from all pre-1990 districts be used to pay outstanding bonds or contractual obligations entered into by some date in the near future. This could be similar to limitations already approved by the Legislature for pre-1979 districts. In 1988, the Legislature required that all tax increments collected from pre-1979 districts after April 1, 2001 be used to retire bonds that were issued before April 1, 1990. By law, cities must decertify pre-1979 districts as soon as those bonds are retired. The Legislature could require that all tax increments received after April 1, 2001 (or some other date) from tax increment districts created between 1979 and 1990 be used to retire bonds issued by April 1, 1996 (or some other date). This option is more restrictive than the prior option because it could limit the ability of some cities to complete initial projects identified in approved TIF plans. For instance, it is possible that weak market conditions or failures on the part of a developer have prevented some cities from issuing bonds for projects in the original TIF plan.

Under existing law, the Revenue Department is charged with enforcement of the income requirements for housing districts, but it is not currently enforcing this provision because of limited resources within the Department. When the Legislature transferred TIF enforcement responsibilities to the State Auditor's Office in 1995, enforcement of the income requirements remained with the Revenue Department. We recommend that:

- **The Legislature should consider whether the Revenue Department or the State Auditor's Office should be responsible for enforcing the housing district income requirements.**

The Legislature could retain the enforcement responsibilities with the Revenue Department and provide funding for that function or it could transfer the function to the State Auditor's Office and consolidate it with other TIF enforcement responsibilities. Alternatively, the State Auditor's Office could monitor compliance with the income requirements as it conducts its other TIF audit and compliance responsibilities and refer any violations to the Revenue Department for enforcement.

The Legislature may want to clarify its intentions related to the use of TIF for government-leased buildings. The TIF Act limits the use of TIF for buildings that are government-owned and used primarily to conduct government business. Some cities have used tax increments to support development projects which lease space to government agencies. On the one hand, developers do not always know who their tenants will be, and they cannot refuse to lease to government agencies. On the other hand, it is hard to argue that office space for government agencies would not develop in the absence of TIF.

Finally, the Legislature may want to require that cities with economic development districts or projects providing TIF assistance to manufacturing, office, or retail developments report on wages paid as part of the TIF annual disclosure statement. The Legislature may also want to require that the Minnesota Department of Trade and Economic Development analyze the wage data and report to the Legislature.