

TAX INCREMENT FINANCING PROJECT

An Introduction

Working Paper #1

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This working paper provides an introduction to tax increment financing. It summarizes in relatively simple terms how this complicated development tool is used and briefly explains the limits the Legislature has placed on its use.

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PREFACE

This paper is the first of a series of working papers prepared by the House Research Department on the subject of tax increment financing.

The use of tax increment financing by Minnesota development authorities and cities has grown dramatically over the last five to ten years. For example, expenditures of tax increment revenues increased from just over \$10 million in 1980 to just under \$100 million by 1986, a compound annual rate of increase of over 42 percent. The program has become the primary means of providing state and local government assistance for real estate development and has taken on major cost dimensions both for the state and for local property taxpayers.

This working paper provides an introduction to tax increment financing. It summarizes in relatively simple terms how this complicated development tool is used and briefly explains the limits the Legislature has placed on its use.

The other topics to be covered in the series include:

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| Working Paper #2 | BACKGROUND DATA ON THE USE OF TIF |
| Working Paper #3 | THE STATE COSTS OF TIF |
| Working Paper #4 [*] | TAX INCREMENT FINANCING: THE "BUT FOR" TEST. |

^{*}Forthcoming.

EXECUTIVE SUMMARY

How Tax Increment Financing Works (pp. 3 to 6)

Tax increment financing (TIF) uses the additional property taxes (the "tax increment") generated by a real estate development to pay for development costs. Although the development continues to pay property taxes, the taxes do not pay for the general cost of local government. Rather, the additional taxes pay for the cost of acquiring the land for the developer, preparing the site for development or other development costs.

Tax increment financing generally uses tax exempt bonds to pay for these costs. The bonds are repaid by the dedicated property tax payments--i.e., the tax increment.

- Tax increment financing has many of the characteristics of a property tax abatement. Although the developer continues to pay property taxes, these taxes are used to pay development costs, such as the cost of buying the land. For the developer this is the economic equivalent of paying for the land and not paying property taxes, as would be the case with a standard property tax abatement. In some ways it is more attractive financially to the developer, since the benefit is received immediately. With a property tax abatement the benefit is received only as property taxes are paid. Also the developer receives the benefit of the lower tax exempt interest rates.
- Tax increment financing can be used to finance city services and facilities more cheaply than it is possible to do with direct financing techniques. TIF is commonly used to pay for installation of streets, sewer, water, and other public costs associated with real estate development. It is cheaper for a city or development authority to finance these costs through TIF than with a direct property tax levy. With tax increment financing, all of the new taxes paid by the development are available to pay for the costs. If the development instead paid regular property taxes, some of the taxes would go to the overlapping taxing districts--the county, school district, and so forth.

Local Governments Authorized to Use TIF (p. 6)

The use of tax increment financing is generally controlled by cities or special development authorities under the control of cities. The local governments authorized to use TIF include

- Housing and redevelopment authorities
- Port authorities
- Cities
- Rural development finance authorities and counties for certain limited types of projects.

General Limitations on the Use of TIF (pp. 7 to 12)

Three basic factors limit the extent to which TIF can effectively be used as a development incentive or to finance associated public facilities.

- (1) The law limits the types of costs that may be financed with TIF. In general only the cost of land acquisition, site preparation, and related public facilities such as streets, sewers, and water improvements may be financed with TIF revenues.
- (2) The law limits the areas that may be designated as tax increment districts and the length of time that increments may be collected. TIF was originally designed to be used for redevelopment and as a result was limited to areas in need of redevelopment--e.g., areas with high percentages of substandard structures. When TIF was made available for other purposes, shorter time limits were placed on these TIF districts.

The following is a summary of the time limits imposed on TIF districts.

<u>Type of District</u>	<u>Characteristics</u>	<u>Duration Limit</u>
Grandfather	Established before 7/1/79	30 years from 7/1/79
Redevelopment	Substandard buildings or other development problems	25 years
Housing	Use for low or moderate income housing	25 years
Economic Development	Create employment or tax base	8 or 10 years

- (3) The need to "capitalize interest" limits the effective use of TIF to redevelopments involving more intense uses of land such as commercial-industrial and high rise residential properties. Tax increment financing involves an inherent mismatch in the timing of TIF expenditures and the collection of TIF revenues. To overcome this mismatching, additional bonds must be issued to finance the interest payments until increment revenues become available (i.e., these interest payments are "capitalized"). Repayment of these capitalized interest payments requires the larger increment revenues that are generated by large increases in property tax values. Sufficiently large increases generally only occur with commercial/industrial and high rise residential developments.

Special Limitations on the Use of TIF (pp. 12 to 15)

In addition to these general limits the Legislature has enacted a series of special limitations designed to curb perceived or actual abuses of TIF. These limitations fit into three major categories:

- (1) Limiting the ability of development authorities to capture increases in value that are not attributable to or caused by TIF incentives;
- (2) Restricting the use of TIF to pay for the general cost of local government; and
- (3) Preventing local governments from undertaking excessive or speculative risks in using TIF to attract new development.

TAX INCREMENT FINANCING: AN INTRODUCTION

A. TAX INCREMENT FINANCING: THE CONCEPT, HOW IT WORKS

Tax increment financing (TIF) is a method of financing the public cost of real estate development with the additional property taxes generated by the development. Tax increment financing also commonly involves issuance of tax exempt bonds, generally backed by the general obligation of the city in which the development is located. How this all works can, perhaps, most easily be explained through an example.

EXAMPLE

Developer X is considering building an office building on a site consisting of three parcels of property (parcels A, B, and C in the FIGURE). Parcel A is vacant and Parcels B and C contain substandard commercial buildings. Construction of the office building will require demolition of the two buildings, new utilities (sewer and water), and moving a road. The cost of acquiring the property, demolishing the substandard buildings, and putting in the utility and road improvements is \$1.5 million. However, X could obtain a comparable site elsewhere for \$500,000. The three parcels currently pay \$40,000 a year in property taxes, but if X builds the planned \$5 million office building, the tax will rise to \$240,000 per year.

To induce X to build on the site, the city designates a project area and creates a tax increment financing district that includes the development site.¹ The district consists of parcels A, B, C, and D. The district is illustrated in the FIGURE.² The city agrees with X to acquire the site, demolish the substandard buildings, and put in the utility and road improvements. The city, in turn, sells the site to X for its market value of \$500,000. This is commonly called "writing down" the cost of the land. The city's \$1.5 million cost is "written down" to \$500,000.³

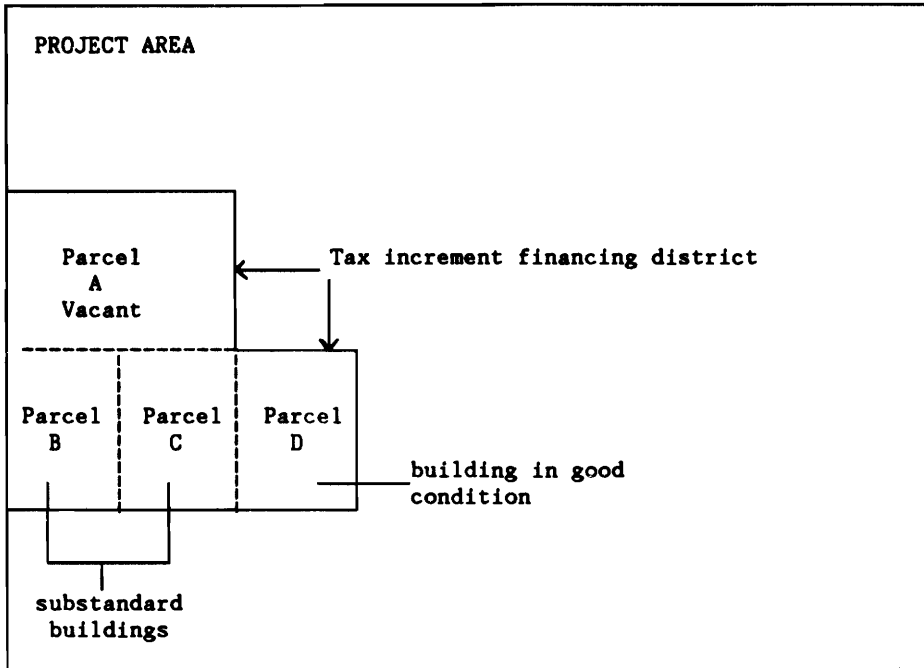
To finance these costs, the city issues tax increment financing bonds. The principal and interest on this bond issue will be paid with the additional \$200,000 a year in property taxes paid by the new development (the tax increment). Thus, X's development pays its regular property tax, except the tax is placed in a dedicated account and is used to pay the development costs associated with the site.

¹In most cases these actions would be undertaken by the Housing and Redevelopment Authority or HRA. However, to simplify matters the example refers to actions of the city.

²Even though parcel D is not being developed, it must be included to meet the "blight" definitions of the tax increment law. See below section C(2)(b), pages 9 and 10.

³The city could write it down to zero--in effect, giving the land to X.

FIGURE



Computation of the Tax Increment

<u>Parcel</u>	<u>Original Assessed Value</u>	<u>Post Development Assessed Value</u>	<u>Captured Assessed Value</u>
A	\$300,000		
B	50,000	\$2,400,000	\$2,000,000
C	50,000		
D	<u>120,000</u>	<u>120,000</u>	<u>0</u>
TOTAL	\$520,000	\$2,520,000	\$2,000,000

Mill rate - 100 mills
 Tax increment - \$200,000 (mill rate X captured assessed value)

There are numerous variations on the chosen example. It is not intended to represent the "typical" tax increment project, but only to illustrate how the mechanism works. The example illustrates the classic case original supporters of tax increment intended it to serve--i.e., the redevelopment of sites containing substandard structures.

Two general points regarding the tax increment mechanism should be noted.

- (1) Cities can use tax increment financing to grant capitalized property tax abatements. To illustrate: if the facts of the example are changed slightly and X's site is actually worth \$1.5 million, rather than only \$500,000, X in effect receives a \$1 million grant through tax increment. This grant represents the value of \$200,000 of X's annual property taxes for the duration of the district. Even though X is paying his regular property taxes, they are financing acquisition of the land, not paying for the general cost of government. Furthermore, this "grant" can be larger because it is financed with bonds that have lower interest rates since the interest is exempt from federal and state income taxes and because their repayment is guaranteed by the city's credit and taxing authority.⁴

However, if X's development proves to be more valuable than projected (i.e., has a higher assessed value) or the tax rate is higher than expected, tax increment financing may not be as advantageous as an outright property tax abatement. The amount of the "abatement" is established (and limited) at the outset of the development, unlike a true property tax abatement which will depend upon the value of the property and the tax rate. Thus, tax increment financing is both more than and less than an outright property tax abatement.

- (2) The cost of the development subsidies provided through tax increment is shared by all the levels of government that tax the property or provide services to the development. Although only the city decides whether to provide TIF, in the absence of tax increment the development's property tax would go to the county, school district, and other taxing districts. The state also would benefit through the state school and property tax aid formulas.

It is commonly said that TIF does not impose extra cost on these overlapping taxing districts if the development would not have occurred without ("but for") TIF. Whether or not this is true depends upon a variety of factors.⁵

Even if the development would not have occurred in any of the taxing districts without TIF subsidies and it does not displace other development in the taxing districts, the local governments still must pay the cost of providing the additional public services to the development until the property is placed on the regular tax rolls. For example, if X's development was an apartment building, the cost of educating the children who reside in the building would not be offset

⁴Tax increment bonds in Minnesota are usually general obligations of the city.

⁵These issues are discussed more fully in the forthcoming "Tax Increment Financing: The But For Test," (Working Paper #4), House Research Department.

by any additional tax base. This cost would be divided between the state and school district with the state usually bearing the major share of the cost.

The school district and county will receive the benefit of the additional property tax base generated by the development when the value is no longer captured. This may or may not provide a net benefit. Whether it does will depend upon the public service costs incurred, the value of the development, whether the development would have occurred without tax increment subsidies, whether the development displaced other developments in the taxing districts, the time value of money, and various other considerations.

B. LOCAL GOVERNMENTS AUTHORIZED TO USE TIF

Tax increment financing powers are primarily exercised by cities or by entities that are subject to direct or indirect control by a city. The following is a listing of the entities authorized to exercise tax increment financing powers.

Housing and Redevelopment Authorities (HRAs) are the most frequent users of tax increment powers. Minn. Stat. §§462.411 to 462.585. The commissioners of an HRA are appointed by the mayor, subject to approval by the governing body of the city. Minn. Stat. §462.425, subd. 6. Members of the governing body may, and frequently do, serve as commissioners.

Port Authorities may use tax increment powers for industrial development districts. The commissioners of a port authority are appointed by the mayor, subject to the approval of the city council. Minn. Stat. §458.10, subd. 1. In the case of the Duluth port authority, two of the commissioners are appointed by the St. Louis county board and two by the governor.

Cities may exercise tax increment powers directly under the municipal development district act. Minn. Stat., chap. 472A.

Municipalities (principally cities, but also urban towns, counties for projects outside of incorporated areas, HRAs, and port authorities) are authorized to use tax increment financing for industrial revenue bond projects. Minn. Stat., chap. 474.

Rural Development Finance Authorities are authorized to use TIF for agricultural processing projects. Rural development finance authorities are nonprofit corporations formed by a county or counties. Minn. Stat. §362A.01, subd. 1. Counties may also exercise these powers directly.

Various local governments are also granted tax increment powers by special law. For example, a number of cities are authorized by special law to create or directly exercise the powers of a port authority.

C. THREE BASIC FACTORS GOVERNING THE USE OF TIF

Three basic factors determine whether (or to what extent) tax increment financing can effectively be used for a development project or other purpose. Two of these factors are legal limitations, while the third is simply a practical limit that results from the nature of the financing mechanism.

- The types of development costs that may be financed with tax increment revenues. The law limits the types of costs that may be financed with increment revenues. If the city or the developer needs to pay for other costs, tax increment may not "work." For example, if TIF could only be used to provide land write-downs and if land costs were only a very small portion of the development costs, TIF may not provide a large enough incentive to make the proposed development feasible.
- The types of areas that may be designated as TIF districts and the length of time that tax increment revenues can be collected. The tax increment financing law was originally enacted to finance redevelopment of "blighted areas"--areas containing substandard buildings or exhibiting other undesirable or inappropriate land uses. As a result, the law generally limits the areas that may be designated as tax increment project areas and as TIF districts to areas with blight characteristics. If the proposed development or surrounding area does not qualify under these restrictions, then TIF may not be a viable method of subsidizing the development. Furthermore, the law limits the length of time the increment can be collected. These limits, in effect, determine the amount of subsidies that may be provided.
- The need to "capitalize interest" in using tax increment financing. Tax increment revenues are generated only after the development has been constructed and begins paying property taxes. TIF costs, however, are generally incurred at the very beginning of the development (e.g., to acquire the site and demolish the existing structures). To overcome this mismatching of costs and revenues, TIF plans typically provide for "capitalized interest" by issuing a larger amount of bonds than are necessary to pay the direct TIF costs. The proceeds of these bonds are used to pay the interest (hence the term "capitalized interest") until the project begins generating tax increment revenues. As a practical matter, repayment of these additional bonds requires substantial increment revenues that can only be generated by projects with relatively high property values.

(1) Costs That May Be Financed with Tax Increment Revenues

The types of development costs that may be funded with tax increments determine the type and, implicitly, the magnitude of the subsidies that may be provided to a development.

Tax increment is traditionally used for site acquisition and preparation costs, rather than other development costs such as construction. Thus, in the example outlined above, tax increment financing is used to acquire, prepare, and improve the site of X's office building development, but is not used to finance the actual construction of X's office building. This is only a general rule and there are significant exceptions to it.

The following is a list of the major types of development costs that may be financed with tax increment revenues. The list is not exhaustive and it should be noted that whether particular costs are permissible is a topic of occasional dispute among development lawyers. The determination of whether given costs are permissible is not generally determined under the tax increment law, but rather under the individual development laws (the housing and redevelopment authority law, the port authority law, and so forth). Minn. Stat. §273.75, subd. 4. The restrictions on the use of tax increment revenues apply equally to the use of the proceeds of tax increment bonds. Minn. Stat. §273.77.

The cost of the following activities may be financed with tax increments:

- Acquisition of "blighted" properties, "marginal land," vacant or under-utilized land or properties or of any property as part of a development plan to eliminate or prevent the development of "blight" (See, e.g., Minn. Stat. §§458.191-458.192, 462.421, subd. 13)
- Sale, lease or other disposition of acquired properties at or below market value (i.e., "land write-downs") (See, e.g., Minn. Stat. §§458.192, subd. 9 and 10;; 462.421, subd. 13(5))
- Demolition and removal of "blighted" buildings or other structures (See, e.g., Minn. Stat. §§458.192; 462.421, subd. 13)
- Elimination of physical characteristics of the land that make development difficult, such as ground water problems (See, e.g., Minn. Stat. §462.421, subd. 13)
- Engineering, planning, and administrative costs, including the allocated administrative costs of the authority (See, e.g., Minn. Stat. §462.545, subd. 1)
- Installation of streets, utilities, and other site improvements (See, e.g., Minn. Stat. §462.421, subd. 13(4))
- Relocation payments to displaced residents and businesses (See, e.g., Minn. Stat. §462.445, subd. 4(17))
- Construction of housing for low and moderate income persons or veterans (See, e.g., Minn. Stat. §462.421, subd. 12)
- Relocation, restoration, or rehabilitation of buildings of historical or architectural value (Minn. Stat. §§462.421, subd. 13; 462.445, subd. 4(3))
- Interest rate reduction payments for low and moderate income housing developments, both rental and owner-occupied, and small commercial developments (Minn. Stat. §462.445, subd. 10 to 12)
- Acquisition and construction of agricultural processing projects including site, building, and equipment (See Minn. Stat. §352A.01, subd. 2(a))
- Capital investment loans for rail line rehabilitation (made indirectly to rail users) (Minn. Stat. §362A.01, subd. 2(h))

- Acquisition and construction of parking lots and ramps, pedestrian skyways and related facilities (See Minn. Stat. §472A.03)
- Guarantees or insurance for industrial development or mortgage subsidy bonds (See, e.g., Minn.Stat. §§462C.07, subd. 3; 474.10, subd. 10).

This list shows the significant number of exceptions to the commonly cited general rule that tax increment financing is limited to financing site preparation and related costs. The last seven items do not fall within this category, since they directly or indirectly permit financing of buildings, nonsite preparation improvements, and equipment.

(2) Areas Qualifying as TIF Districts and the Duration of TIF Districts.

Tax increment financing was originally enacted to permit redevelopment of blighted areas with a large proportion of substandard buildings and structures. As a result, the use of TIF was generally restricted to project areas that met broad definitions of blight. In 1974 and more fully in 1979, the Legislature explicitly authorized the use of TIF for development (rather than redevelopment) of areas that did not meet any of the traditional characteristics of blight.

As part of this expansion of the authority to use TIF for districts with no special redevelopment problems, the Legislature imposed duration limits on TIF districts that varied based on the type of district. Districts that meet more traditional blight characteristics are allowed to capture increments for longer periods of time.

The length of time that a development's increase in assessed value may be "captured" and dedicated to the payment of project costs effectively determines the magnitude of the subsidies that can be provided to the development. For example, if tax increment is thought of as a simple property tax abatement program, the duration limit spells the difference between a five, ten or twenty-five year property tax abatement. Obviously, a twenty-five year abatement is more valuable than a five year abatement.

Tax increment districts are divided into four different categories for purposes of these duration limits.

(a) Pre-1979 Districts

Districts that were certified prior to August 1, 1979 are permitted the longest duration--30 years from August 1, 1979. Minn. Stat. §273.75, subd. 1. Depending upon when the district was originally created, a pre-1979 district could last for 40 years.

(b) Redevelopment Districts

Redevelopment districts are subject to duration limits of twenty-five years. Minn. Stat. §273.75, subd. 10. The twenty-five year limit begins with the receipt of the first tax increment.

In order to qualify as a redevelopment district the district must satisfy one of five statutory criteria. These criteria focus on the special development problems of the district:

- (1) -70 percent or more of the parcels of property in the district are occupied by buildings, streets, and utilities, and
-50 percent or more of the buildings are substandard;
- (2) -70 percent or more of the parcels are occupied, and
-20 percent or more of the buildings are substandard, and
-30 percent or more of the buildings require substantial renovation or clearance to overcome planning difficulties;
- (3) -less than 70 percent of the parcels are occupied, but
-80 percent of the total acreage of the land has terrain or soil deficiencies and the site preparation costs of overcoming those difficulties exceed the anticipated fair market value of the parcels after completion of the site preparations;
- (4) -the district consists of underutilized air rights over a street or highway;
- (5) -the district consists of a vacant or underused railroad yard.
Minn. Stat. §273.73, subd. 10.

Tax increment financing districts are not required to be contiguous. Minn. Stat. §273.73, subd. 9. As a result, the authority may assemble a group of noncontiguous parcels in order to satisfy the criteria. This can be done even though the authority does not expect to redevelop all of the parcels.

(c) Housing Districts

Housing districts are defined by the purposes for which the tax increments are used. In order to qualify the increments must be used to finance low and moderate income housing. Minn. Stat. §273.73, subd. 11. Housing districts, like redevelopment districts, are subject to duration limits of twenty-five years that begin with the receipt of the first tax increment. Minn. Stat. §273.75, subd. 1.

(d) Economic Development Districts

Economic development districts, the final category of TIF districts, includes all districts not in the three preceding categories. Minn. Stat. §273.73, subd. 12. Economic development districts do not need to have any of the blight characteristics typically associated with TIF districts. As a result, they are subject to the shortest duration limits.

Economic development districts are limited in duration to the lesser of

- ten years from the approval of the tax increment financing plan, or
- eight years from the receipt of the first tax increment.
Minn. Stat. §273.75, subd. 1.

(3) The Need to Capitalize Interest

A final important element of tax increment financing is the mismatching of redevelopment expenditures and increment revenues. This mismatching is not the result of any legal limits, but rather is inherent in the nature of the tax increment financing mechanism.

Tax increment is usually used to finance development expenditures that are incurred at the very beginning of the development. The most common TIF development costs are site acquisition and preparation (demolishing buildings, putting in utilities, and so forth). These costs commonly are paid before or as the actual private development begins.

By contrast, tax increment revenues--the additional property taxes paid by the development--are not received until taxable improvements have actually been made. To exacerbate this, the property tax system has at least an 18-month lag between when improvements are made and when the additional property tax that they incur must first be paid. Property values are assessed annually on January 2. However, it is not until May of the following year that one-half of the property taxes based on the January assessment are due. To illustrate the lag, if a new building were constructed between January 2 and March 1, 1986, the value of the building would first be assessed on January 2, 1987. The first taxes paid on the value of the building would be due on May 15, 1988, over 27 months after the construction occurred.

To overcome this mismatching of revenues and expenditures, users of tax increment financing generally issue more bonds than are necessary to pay the direct development costs of a project. The additional bonds that are issued are used to pay interest and principal to the bondholders until increment revenues become available. Thus, in effect, the TIF district is borrowing money to pay its creditors. This is commonly referred to as "capitalizing interest."

Capitalizing interest effectively requires the tax increment district to generate relatively large amounts of increment. If relatively large increments were not collected, there would never be enough revenue to pay back the capitalized interest. In effect, this means a relatively high value building or structure, such as high rise residential or commercial-industrial development, must be built to provide the necessary increments.

Two observations may be made in this regard. First, if TIF is simply used as a quasi-property tax abatement to induce development, this factor is not important. The developer doesn't need property tax relief from increased property taxes until he actually starts to pay them. Second, it is important when TIF is used as a redevelopment financing tool to eliminate substandard structures and uses. In those circumstances, the need for large increments to pay for the costs of acquisition and demolition usually dictates that TIF financed redevelopment will involve conversion of the land use pattern to higher density uses. For example, low density residential properties will need to be converted to high rise residential or commercial uses. As a result, TIF redevelopment is generally thought not to work for

low density commercial or residential developments.⁶

D. TAX INCREMENT BONDING POWERS

The law authorizes the use of three types of tax increment bonds: (1) general obligation bonds, (2) general obligation authority bonds, and (3) revenue bonds. Minn. Stat. §273.77. The law also permits temporary bonds to be issued in anticipation of the issuance of permanent obligations of any of the three types.

All tax increment bonds are exempted from the net debt limitations. The net debt limitations generally do not apply to bonds that are payable out of nontax revenues; however, the revenues of tax increment districts could in some sense be considered to be tax revenues. See Minn. Stat. §475.51, subd. 4.

(1) General Obligation Bonds

General obligation bonds are the most commonly used type of tax increment bonds. They are payable out of the increment generated by the district. If the increment of the district is insufficient, the city agrees that it will use its taxing power to levy a tax sufficient to pay the bond obligations. In other words, the bonds are backed by the full faith and credit of the city and if the project provides insufficient revenues, the property taxpayers in the city will make up the difference.

Unlike the general obligation bonds of most local governments, tax increment general obligation bonds are exempt from the referendum requirements. Bonds qualify for this exemption if they meet the conditions for exempting special assessment bonds--i.e., if it is estimated that twenty percent of the cost will be received in tax increment revenues. See Minn. Stat. §475.58, subd. 1(3).

(2) General Obligation Authority Bonds

General obligation authority bonds are bonds which are backed by the full faith and credit of the development authority (e.g., the housing and redevelopment authority), but not the city or county. Thus, if the district revenues prove insufficient the authority will use any available moneys that it has to pay the obligation. However, because the authority has only limited taxing authority, these bonds are less secure than city general obligation bonds. In addition to exemption from the referendum requirement, these bonds are not subject to interest rate limits or the requirements of a public sale. Minn. Stat. §273.77(b).

⁶These obstacles can, of course, be overcome if the government simply appropriates more money to make up the difference. Creative TIF planners use TIF to accomplish this by collecting TIF revenues from another district longer than is necessary to pay the development costs of that district. This excess is collected in a development fund and is then loaned to the new district interest free, eliminating the need to "capitalize interest" for that district. This is effectively the equivalent of appropriating more government money to the district. More taxes have been paid to create the development fund and the taxpayers and the government lose the use of that money during the time that it is loaned interest free to avoid capitalizing interest. There is no financial magic to this, it simply replaces bond proceeds with property tax revenues. The largest beneficiary is the federal government, since fewer tax exempt bonds are issued.

(3) Revenue Bonds

Finally, revenue bonds may be issued. These bonds are backed only by the revenues generated by the district itself--i.e., the tax increments and any other revenues such as the proceeds of land sales, lease revenues and so forth. These bonds are exempt from the referendum, public sale, and interest rate limitations.

E. PLANNING, DISCLOSURE, AND PUBLIC COMMENT REQUIREMENTS

Prior to formation of a tax increment financing district, local governments are required to prepare and approve a tax increment financing plan, provide an opportunity for the affected county and school district boards to comment on the plan, and hold a public hearing. Minn. Stat. §273.74, subd. 2 and 3. The tax increment financing plan must include a statement of objectives, a description of the development program, development contracts entered into, expected development, and cost and revenue estimates for the district. Minn. Stat. §273.74, subd. 1. If the authority is not a municipality, the tax increment plan must be approved by the governing body of the municipality.

At the time of approving the tax increment financing plan the municipality must make a series of additional findings with regard to the district including written statements of reasons and supporting facts. The municipality must find that the development in its "opinion" would not "reasonably be expected to occur solely through private investment within the reasonably foreseeable future" and that the development is consistent with the municipality's development plan. Minn. Stat. §273.74, subd. 3. This is commonly referred to as the "but for" finding. The municipality's but for findings are "conclusive" as to the public "need" for the proposed tax increment financing. Id.

F. ADDITIONAL LIMITATIONS IMPOSED ON TAX INCREMENT FINANCING

In addition to limitations on the types of costs that may be financed with tax increment revenues and the duration of tax increment districts, the Legislature has imposed a variety of special limits to prevent specific, perceived abuses or misuses of tax increment.

(1) Capturing Increases in Value that Are Not Attributable to the Provision of Tax Increment Financing Incentives

One general concern is that local governments will use tax increment financing to capture the assessed value of developments that would have occurred without the provision of tax increment incentives. A variation on this concern is that tax increment will be used to capture general inflation in property values, rather than increases resulting from induced development. Capturing this value will give city officials additional flexibility in providing development incentives. Furthermore, it will come at a relatively low cost since most of the value would have gone to provide tax base to overlapping taxing jurisdictions. City taxes generally constitute between 20 and 30 percent of the total tax burden. Thus, 70 to 80 percent of the increase would have benefited the county, school district, and state (through reduced state aid payments), rather than the city.

The Legislature has imposed a variety of restrictions in response to this concern. These limits generally do not apply to districts which were certified before August 1, 1979.

- The value of improvements for which building permits were issued less than 18 months but more than 3 months prior to certification of the district may not be captured in a tax increment financing district. Minn. Stat. §273.76, subd. 4.
- For economic development districts, captured value is reduced by the rate of inflation in property values in the district prior to certification. Minn. Stat. §273.76, subd. 1.
- If within four years after certification a parcel has not been developed or if the city has not acquired the parcel or made improvements to, or adjacent to, the parcel, increments may not be collected from the parcel. Minn. Stat. §273.76, subd. 6. However, the parcel remains in the district. (Retention of the parcel may be critical to satisfaction of the redevelopment district criteria and thereby the ability to collect increments for longer than an eight year period.) Similarly, if within three years of certification the city has not acquired property, issued bonds or made public improvements, no tax increment may be collected. Minn. Stat. §273.75, subd. 1. These two provisions limit to a certain extent the ability to simply use an increment district to capture general inflation in property values.

(2) Use of Tax Increment Financing to Pay for the General Cost of City Government

Because a portion of the cost of tax increment financing is shifted to overlapping tax jurisdictions, the tax increment law provides a natural incentive for city officials to use tax increments to pay for the general cost of city government. If the increment generated by a development can be used to provide city services or facilities that the city would otherwise pay for out of general city revenues, the entire tax paid by the increased value will go to the city rather than be shared with the county and school district. Thus, this will hold down property taxes in the city while increasing taxes in the portion of the county and school district outside of the city. It will also tend to hold down the city levy and mill rate, while increasing the mill rate of the overlapping taxing jurisdictions. By contrast, if the city simply returned the captured assessed value to the regular tax rolls (or did not use tax increment financing at all) and levied a tax for the costs, it would receive a benefit of the additional tax base equal only to the city's share of the total mill rate.

In response to a concern that local officials may use tax increment financing to pay for the general costs of government, the Legislature has imposed a series of restrictions on the purposes for which increments may be used. Again these restrictions do not generally apply to districts certified before August 1, 1979.

- Tax increments may not be used to finance municipal buildings, other than parking ramps and buildings for recreational and social uses in public parks. Minn. Stat. §273.75, subd. 4.
- The total amount of a district's increment which may be expended for administrative expenses is limited to ten percent of the increment. Minn. Stat. §273.75, subd. 3. This limits the ability of an authority to use tax increment to pay staff and related costs, as well as somewhat limits the amount of transaction costs associated with a project.

- The use of tax increment to circumvent levy limitations is prohibited. Minn. Stat. §273.75, subd. 4.
- If the district's increment exceeds projections and the district generates a larger increment ("excess increments") than is necessary to pay the district's obligations, the law specifies that the excess increments must be used to pay off the district's bonds or be returned to all the taxing districts in proportion to their mill rates. Minn. Stat. §273.75, subd. 2. Similarly, the law restricts the ability to amend the tax increment financing plan and increase the size of the district, the amount of bonded indebtedness, and other changes that would permit use of excess increments. See Minn. Stat. §273.75, subd. 4.

(3) Undertaking Speculative Risks to Stimulate Development

The Legislature has also been concerned that cities would use tax increment financing to acquire property or make investments in site improvements and public infrastructure when there were no firm development prospects for the site. This is the converse of the concern that cities will capture development that would have occurred even without tax increment financing. The danger is that general tax dollars would need to be used to pay these costs if the hoped for development does not occur. For example, the city may be required to levy general property taxes to pay general obligation bonds that were used to finance acquisition of property or site improvements.

To prevent excessive speculation the law restricts the amount of land which may be acquired with the proceeds of tax increment bonds to no more than 25 percent of the land in the district for redevelopment districts and 10 percent for economic development and housing districts. Minn. Stat. §273.75. These restrictions do not apply to land for which the authority has entered into a development agreement.