TAX INCREMENT FINANCING PROJECT

An Estimate of the State Intergovernmental Aid Costs of Tax Increment Financing

Working Paper #3

April 1986

This working paper provides an estimate of the cost implications of tax increment financing for the state's major intergovernmental aid programs--education aids, local government aids, and state property tax credits.

OUTLINE OF CONTENTS

PREFACE

This paper is the third in 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 to real estate development and has taken on major cost dimensions both for local property taxpayers and the state.

This working paper provides an estimate of the cost implications of tax increment financing under the state's major intergovernmental aid programs--education aids, local government aids, and state property tax credits. The estimates were made using the Research Department's computer simulation models of the aid formulas and the Minnesota property tax system. The paper only includes estimates of the intergovernmental aids cost of tax increment financing. Estimates are not made of the effect on the property tax refund, a program which makes payments directly to individuals, and on state income tax collections.

The other topics covered in the series include:

Working Paper #1	AN INTRODUCTION TO TAX INCREMENT FINANCING
Working Paper #2	BACKGROUND DATA ON THE USE OF TAX INCREMENT FINANCING
Working Paper #4*	TAX INCREMENT FINANCING: THE "BUT FOR" TEST

*Forthcoming.

EXECUTIVE SUMMARY

I. INTRODUCTION: WHY TIF HAS STATE AID COST IMPLICATIONS (pp. 4 and 5)

Tax increment financing (TIF) uses the increased property taxes generated by a new real estate development to pay for the costs of development, rather than contributing to general local government revenues. This is done by "capturing" the increased property value of the development in a TIF district.

The state pays aid to local governments under three major intergovernmental aid programs--education aids for local school districts, local government aids for cities, counties, and towns, and property tax credit reimbursements for all local taxing districts. The calculation of aid under each of these programs is affected directly or indirectly by the amount of assessed value in the local taxing district. As assessed values increase, state aids generally decrease.

The value captured in tax increment districts ("captured assessed value") is not considered in calculation of the amount of these state intergovernmental aids. Thus, to the extent that assessed value is captured that otherwise would pay regular property taxes, use of tax increment financing causes aid payments under these intergovernmental aid programs to be higher than they otherwise would be.

II. METHODOLOGY: HOW THE ESTIMATES WERE MADE (pp. 5 to 19)

To estimate the increase in state intergovernmental aid payments resulting from tax increment financing, the amount of education aids, local government aids, and property tax credits were recomputed including tax increment captured assessed values in the local property tax base. This method implicitly assumes that the entire amount of captured assessed value would have occurred without TIF. This assumption seems counter to the idea that tax increment financing is to be used only to induce development that otherwise ("but for") TIF would not have occurred.

Several factors suggest that this methodology nevertheless is reasonable and will produce a relatively reliable estimate of the state costs of tax increment financing.

- Tax increment financing is primarily used to finance commercial developments such as office and retail space. The total amount of commercial development is determined by the demand in the local or regional market and will be largely unaffected by TIF subsidies. Thus, tax increment primarily affects where commercial development locates within a market area, rather than the total amount of development (or assessed value).

- Overall state aid costs are largely insensitive to the changes in location caused by TIF subsidies. State aid costs will go down in the local area with the induced development, but state aid costs will generally rise by an equivalent amount in the other localities that have less development because of the use of TIF.

- Tax increment financing probably does increase the total amount of development in the state somewhat and this effect may cause the estimates to be too high. However, this tendency to overestimate the state costs will be offset by the negative effect that tax increment financing has on the value of non-TIF sites. Also tax increment causes local mill rates to rise; local government services must be provided to the developments and no compensating increase in value offsets this effect, since the increased value is captured. Higher mill rates cause state property tax credits to increase.

- Tax increment financing is also used by local governments (mostly cities) to finance services that the city would otherwise have paid out of direct property tax levies. To the extent this is true, estimates of property tax credit costs may be too high since local government levies will be underestimated. However, the majority of the state costs occur in the education aids programs and would be unaffected by higher city spending.

III. RESULTS: THE ESTIMATES OF STATE COSTS (p. 19 to 28)

Education Aids. The basic foundation aid program guarantees school districts a specific dollar amount of revenue per pupil to be provided by state aid and local property taxes. State aid is determined by subtracting local property tax revenue from the guaranteed revenue. The local property tax revenue is determined by multiplying the district's local property tax base by a state mill rate. If TIF captures assessed value that otherwise would pay this local share of the foundation aid program, state aid payments are higher. Other education aids are calculated in a similar manner.

If TIF captured assessed values were available to local schools, the additional property tax base would generate local property taxes of $19 million for the 1985-86 school year and $23.1 million for 1986-87 under the education aid formulas. This increase would result in lower state aid payments of $17.6 million for the 1985-86 school year and $20.6 million for 1986-87.

Local Government Aids. The local government aid (LGA) formula provides state aid to cities, counties, and towns that is calculated in a manner similar to foundation aid. However, the calculation of local government aids for cities (the principal component of the program) is dominated by limitations on the maximum increase that a city can receive and by a guarantee that no city will receive less than it did in the prior year. As a result of these constraints, local government aid payments would decrease by only a small amount, approximately $100,000, for calendar year 1985 if tax increment values were included in the local property tax bases.

The 1985 Legislature made significant changes in the LGA formula for 1986. The structure of these formula changes suggests that the LGA formula is intended to function more as a mechanism for dividing up a fixed state appropriation among the local units of government than to determine the "absolute need" of a local

government for state aid. This implies that the addition of captured values to the tax base would not affect total state spending on LGA. As a result, the 1986 estimates assume that TIF has no state cost impact under the LGA formula. However, TIF will cause a slightly different distribution of aids among cities and towns and will result in higher property taxes.

Property Tax Credits. The homestead and agricultural school credits pay a portion of the gross tax on a home or farm. Property tax is determined by applying the local mill rate to the value of the property. Since the use of tax increment generally causes local mill rates to be higher than they otherwise would be, tax increment financing will increase state credit payments.

If the property value captured in tax increment districts were available to pay local districts, the statewide mill rate would decline from 98.6 to 97.0 mills for taxes paid in 1985 and from 104.8 to 102.7 mills for 1986. Total property taxes would have been $46 million lower for 1985 and $59 million lower for 1986. The state homestead credit would have been about $4.4 million less in 1985 and $6.2 million less in 1986, while the agriculture school credit would have increased the total savings to $4.8 million for 1985 and $6.7 for 1986.

The total state costs are displayed in the TABLE below.

TABLE
TOTAL STATE COST OF TAX INCREMENT FINANCING

STATE INTERGOVERNMENTAL AID PROGRAM	ESTIMATED COST* 1985	1986
Education Aids		
Foundation Aid	$15.90	$18.89
Transportation Aid	0.90	1.32
Other Categorical Aid	0.82	0.37
TOTAL	$17.63**	$20.58
Local Government Aid	$ 0.10	$ 0.0+
State Property Tax Credits		
Homestead	$ 4.47	$ 6.25
Agricultural	0.34	0.45
TOTAL	$ 4.81	$ 6.70
TOTAL STATE COST	$ 22.54**	$27.28

*Millions of dollars.
**Numbers may not add to totals due to rounding.
+Assumes that all savings (approximately $1.45 million) would accrue to local taxpayers rather than the state. See discussion in part II, D, pages 14-17.

AN ESTIMATE OF THE STATE INTERGOVERNMENTAL AID COSTS OF TAX INCREMENT FINANCING

I. INTRODUCTION

Tax increment financing (TIF) is a program widely used by cities to finance real estate development costs. Under TIF the additional property taxes generated by the development are used to pay development costs, rather than contributing to the general government revenues. This is done by "capturing" the increase in assessed value in a tax increment financing district and dedicating the property taxes (tax increment) paid by this captured assessed value to the TIF district.

Minnesota pays intergovernmental aid to its local governments. The amounts paid under many of these aid programs depend upon or are sensitive to the property tax wealth of the local government unit. Because the property wealth (assessed value) captured in tax increment districts is not available to the local governments whose jurisdictions include TIF districts, aids and credit amounts are higher as a result of TIF.

The foundation aid program for local school districts and the state paid property tax credits provide the largest and most important examples of this effect of tax increment financing.

Foundation Aid. The basic foundation aid program guarantees school districts a specific dollar amount of revenue per pupil, to be provided by a combination of state aid and local property taxes. The state aid amount is determined by subtracting the local property tax revenue from guaranteed revenue. Local property tax is determined by multiplying each district's equalized assessed value by a statutory mill rate. Thus, when tax increment financing captures assessed value that otherwise would be included in equalized assessed value and would pay the local share of foundation aid, state aid will increase.

State Property Tax Credits. Minnesota's property tax provides state property tax credits that are sensitive to local mill rates. For example, the homestead and agriculture school credits pay a percentage of the gross property tax on a home or farm (up to a maximum amount for the homestead credit). The property tax on a parcel is determined by multiplying the assessed value of the property by the local mill rate. If the mill rate is higher, the gross tax amount will be higher and state credit payments will also be higher, unless the property already receives the maximum credit amounts.

Tax increment financing may cause local mill rates to be higher. Local mill rates are determined by dividing the property tax levy (i.e., local spending less other revenues) of the taxing district by its assessed value. Thus, if spending remains the same and assessed values are higher, the mill rate will be lower. To the extent that tax increment financing captures assessed value that otherwise would pay local taxes, the local mill rate will be higher. Also, if local governments must provide additional public

services (such as police and fire protection) as a result of the TIF development, local spending will be higher and generally the property tax levy and mill rate will be higher.[1]

This paper attempts to estimate the increased cost of the state aid programs that results from local governments' use of tax increment financing. The paper consists of two parts. The first examines a variety of general methodological issues connected with estimating the state costs and discusses how these were resolved in preparing the estimates. The second part presents the estimates, as well as the specific assumptions that were used for individual aid programs.

II. ESTIMATING STATE TIF COSTS: METHODOLOGICAL PROBLEMS

A. The "But For" Test

The easiest and most straightforward method of estimating the state cost of tax increment financing would be to recompute state aids and property tax credits after including TIF captured assessed values in local tax bases. The validity of this approach depends upon two critical assumptions:

(1) The subsidized developments would have occurred without TIF, and

(2) The developments would have occurred in the same location (or at least the same taxing districts) without TIF subsidies.

These two assumptions run headlong into what is commonly referred to as the "but for" test. In theory, tax increment financing is to be used only for development that otherwise ("but for" TIF) would not have taken place. The municipality must find that the development would not occur solely through private investment before it may provide TIF incentives.[2]

One could argue that if the subsidized developments would not have occurred without tax increment, then the assessed value of the developments would not have been available to local governments and would not have reduced the cost of state aid programs. Under this theory TIF would not affect the state cost of the intergovernmental aid programs.[3] In fact, if tax increment induces new

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[1]The Legislative Auditor's study reports that at least one city is charging developers for the cost of providing city services. This is unusual and the charges would not pay for county and school district services. Office of Legislative Auditor, Tax Increment Financing, 36 (1986).

[2]See Minn. Stat. §273.74, subd. 3.

[3]This also assumes that, in the aggregate, the TIF subsidized developments do not demand additional local services, causing local levies and state aids to rise. As discussed later, this may not be a valid assumption.

development it would reduce state aid costs when the increase in assessed value is no longer captured by the TIF district.

Notwithstanding the "but for" test, tax increment financing districts probably capture a good deal of development that would have occurred anyway, somewhere in the state. At best, the "but for" test only guarantees that the development would not have occurred in the TIF district. It may be that some other development would have occurred in the district or that the development will displace developments that would have occurred elsewhere in the state. In other words, the "but for" test may only affect where, not how much, development occurs in the state. Furthermore, the "but for" test may be satisfied, but may not justify the full amount of increment that is collected.[4]

As a theoretical matter, to estimate the state costs accurately, it would be necessary to determine the pattern of real estate development that would have occurred statewide if tax increment financing had not been available. It would also be necessary to determine whether the hypothesized pattern of development would have affected the political decisions that were made in constructing the state's intergovernmental aid programs. Such an effort likely exceeds the capacity of even the most skillful builder of economic (and political) models.

A more realistic alternative is to examine the general economic effects of tax increment financing and to assess (theoretically and intuitively) the implications of these effects for three key questions that affect the cost of state aid programs:

(1) To what extent has the use of TIF caused total investment in taxable real estate in the state to increase? Conversely, how much of the total captured assessed value would have occurred (anywhere in the state) without TIF?

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[4]For example, it may only be necessary to expend X to induce the development to occur--i.e., to satisfy the "but for" test. However, the city may collect an amount of increment equal to X + Y from the development. The additional amount of increment (Y) may be used to subsidize other developments or to pay for other city services. In order to pay the Y portion of the increment, the property is captured in the TIF district for a longer period of time than otherwise would be necessary. In this circumstance it seems fair to say that the TIF property would be available to pay for regular city, county and school district services, regardless of whether the "but for" test was originally satisfied. With the growing use of the "master project" method of financing TIF projects this situation seems likely to be a more common phenomenon.

The Legislative Auditor's report on tax increment financing also points out that the but for test is also used by some cities to mean not that development would not have occurred but for TIF, but that the expenditures would not be made but for TIF. See Office of Legislative Auditor, Tax Increment Financing 41-52 (1986). The but for test and these issues will be discussed in greater detail in "Evaluating Tax Increment Financing: The But For Test and Cost-Benefit Considerations" (Tax Increment Financing Project, Working Paper #4, House Research Department).

(2) To what extent has TIF altered the location where increases in assessed value occurred in a way that affects state aid costs?

(3) To what extent have TIF subsidized developments increased the total cost of state and local government services?

Based on an assessment of these questions, one may conclude that recomputing state aids after including captured assessed value in local tax bases will provide reasonable estimates of state costs.

B. Economic Effects of TIF

Tax increment financing appears to have five primary economic effects. Each has cost implications for state aid programs.

(1) The location of new investment in taxable real estate improvements will be affected. More investment will occur in TIF districts and conversely less investment will occur outside of TIF districts.

(2) The aggregate investment in taxable real estate improvements in the state will increase.

(3) The amount of investment in the types of property typically included in TIF districts will increase.

(4) The value of developable sites which do not qualify (or are unlikely to qualify) for TIF subsidies will decline somewhat.

(5) Tax rates in jurisdictions with TIF districts may be somewhat higher to reflect the cost of providing additional public services to the developments.

Each of these effects will be discussed briefly, in turn. The implications of these effects for state costs are discussed in the succeeding section (Section C).

(1) Effect on the Location of New Development

The most likely effect of tax increment financing is the redirection of investment in taxable real estate to sites in TIF districts. The resulting increase in investment in TIF districts reduces the amount of investment at other sites in the state. This conclusion is based on two considerations.

First, by providing development subsidies to sites in TIF districts these sites become cheaper to develop than they otherwise would be. The expected market response is that more development will occur in TIF districts because the return on investment is higher. For example, if Developer A evaluates two potential sites, one of which would receive TIF subsidies and the other which would not, the TIF subsidies will increase the expected return on his investment in the TIF

subsidized site. If this increase is sufficient to provide a higher expected return on investment than at the competing (non-TIF) site, A will likely invest in the site in the TIF district. Thus, A's development was shifted by the TIF subsidies from the non-TIF site.

Of course, the situation is more complex than this. If Developer A rejects the non-TIF site, Developer B (or C or D) may decide to develop the site. Thus, one may conclude that development of the site was not affected. However, Developer B in making that decision will evaluate the price that can be charged to users (or buyers) of the development and whether this price will provide an adequate return on investment compared with other uses of B's money. The price B can charge is a function of supply and demand for a good (here rental or sale of B's development). Developments that occur in TIF districts affect the supply and thus the price that B can charge. For example, construction of a new office development in a TIF district will expand the supply of office space. As a result, other potential developments may not be undertaken or may be delayed because of the increased supply of office space.

Second, although precise data are not available, it is generally recognized that TIF subsidies are provided predominately to commercial developments, principally retail and office developments. The market for office and retail space is largely local or regional in scope. Thus, to the extent that new development occurs in TIF districts it seems likely that the displaced developments would have occurred primarily in Minnesota.

(2) Increase in the Total Investment Amount

Tax increment financing subsidies probably increase the total amount of investment in taxable real estate in Minnesota somewhat. This seems likely for two reasons.

First, some of the redirection of the location investment described above will be of development that would have occurred in other states. Tax increment is used to some extent for manufacturing facilities. Manufacturers generally are able to locate their facilities in wider geographic areas. Thus, the competing sites are more likely to be in other states. Furthermore, some commercial development will be attracted away from other states. For example, this would be true in border areas or in the case of regional offices of national firms that could locate in any of several states. It seems likely, however, that these effects will be fairly limited.

Second, tax increment financing subsidies will tend to lower the cost of real estate development generally, because of lower development costs in the district and falling values outside of the district. This suggests that the supply or total amount invested in real estate will increase, given a standard supply and demand function. Put another way, if the cost of developing commercial real estate is lower and the return on investment is higher, investors will shift

more of their investment to real estate, in the short run.[5]

This second point is likely to have only a small effect. Costs are lower because developers are essentially able to use a portion of their property taxes to reduce the cost of development. However, this frequently is done at a site with higher costs than alternative sites, reducing the value of the subsidy from its nominal value. The reduction also is only temporary; tax increment financing does not provide a permanent tax reduction or abatement to the development.

Furthermore, tax increment financing probably does little to lower total property taxes. TIF does not reduce the revenues of local governments. Rather local governments continue to levy the amount necessary to meet their budget and this levy amount determines the tax rate. Tax increment will only lower total property taxes if it causes local governments to reduce their budgeted spending. As a result, tax increment will increase the effective property tax rate on property outside of the TIF district, thereby tending to depress investment at those locations.

These factors suggest that the predominate effect of tax increment is to alter the location of investment, rather than to increase the total amount invested.

(3) Modification of the Amounts Invested in Different Types of Properties

Although precise data are not available, tax increment financing tends to be used primarily for two types of developments: commercial-industrial and multi-unit residential properties.[6] Under Minnesota's classified property tax system, commercial-industrial and multi-unit apartment buildings are subject to classification ratios of 43 percent (for amounts over $60,000) and 34 percent respectively. These are among the highest classification ratios imposed. For example, the highest ratios imposed on agricultural and homestead properties are 18 and 29 percent respectively.

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[5]In the long run this will increase real estate prices, lowering the return on investment to that comparable with other investments of similar risks. In other words, the lower property taxes--i.e., the expectation of the receipt of tax increment financing subsidies--will be capitalized into the value of the properties. When all the dust settles, however, there will be more commercial real estate than there otherwise would have been.

[6]The reasons for this are twofold. First, TIF plans typically provide for borrowing money to pay interest on the TIF bonds until the development begins generating increment revenues. This is done by issuing a larger amount of bonds than otherwise would be necessary, commonly referred to as "capitalizing interest." As a practical matter, repayment of the capitalized interest requires substantial tax increment revenues that can only be provided by a development with a relatively high property tax value. Second, redevelopment activities which comprise a large share of TIF activities usually involve conversion of property to more intense uses such as commercial and industrial or high-rise residential.

If tax increment financing is used extensively to provide development incentives for commercial-industrial and high rise apartment buildings, it will shift the relative tax burden toward homestead and other types of property. This should increase the amount invested in commercial and industrial properties by lowering their relative share of the property tax burden. If this is so, TIF will tend to increase the total amount of assessed value. Assessed value is determined by multiplying estimated market value by the classification ratio.

Relatively more investment in high classification ratio properties, such as commercial and industrial, will increase total assessed value, even if total investment in real property remains unchanged. Since state aid costs depend, in part, upon the amount of assessed value, this may be important.

Some available data suggest that this effect of altering the mix of investment in different types of properties may be significant. According to Department of Revenue data, for assessment year 1984 the assessed value of new construction of commercial and industrial properties was approximately $184 million. For the same period the growth in captured assessed value was $119 million. This growth in captured value includes other types of properties such as residential and also includes increases in the value of existing properties. Nevertheless, most of this growth probably represents new construction of commercial and industrial properties. Thus, it appears that a significant proportion (perhaps 40 to 50 percent) of the new investment in commercial and industrial structures receives TIF subsidies.[7]

Thus, tax increment financing probably does shift the relative tax burden away from commercial-industrial properties and to other types of property. This should increase the total investment in commercial-industrial property and the total amount of assessed value in the state.

(4) Effect on Non-TIF Development Site Values

One of the purposes of tax increment financing is to provide development subsidies to overcome the cost disadvantages of developing "blighted" properties. For example, it is generally more expensive for a developer to acquire several parcels of property from different owners and demolish substandard buildings on the properties than it is to purchase and develop a parcel of raw land. TIF is commonly used to overcome this cost disadvantage by

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[7]The 1984 data, the most recently available, may be something of an aberration in this regard. The ratio of growth in captured value to the value of new construction (approximately 65 percent for 1984) was significantly lower (about 35 percent) for 1983. Even this lower ratio, however, is substantial. The primary difference between the 1984 and prior years' data is that the value of new construction was significantly lower in 1984.

using the increase in the development's property taxes to "write down" the cost of the land--i.e., to acquire the land and make site improvements so the total price is comparable to the raw land site.

The general effect of this use of TIF should be to increase the supply of developable sites. Parcels, the development of which was not economically feasible, become developable with TIF subsidies. This should have two effects.

First, since price is a function of supply and demand, an expansion in the supply of developable parcels should reduce the price (or market value) of parcels. Thus, the market value of sites that compete for the types of developments that receive TIF subsidies, but that do not qualify for TIF subsidies, should go down.

Second, the value of sites that are likely to receive TIF subsidies should increase somewhat. Stated another way, if a developer in buying a site expects to receive tax increment financing subsidies, the developer may be willing to pay more because TIF lowers the cost of development. The value of potential or probable TIF subsidies may be capitalized into site values. This effect, thus, offsets the first effect.

The extent to which TIF subsidies are capitalized into site values is probably relatively small in the aggregate. TIF is subject to the discretion of local government officials and the resulting vagaries of the political process. In many instances, purchasers and property owners may have difficulty assessing whether tax increment subsidies will be granted or the likely amount of the subsidies. This uncertainty should reduce the willingness of buyers to capitalize the subsidies into site values.

(5) The Cost of Supplying Public Services to TIF Developments

TIF developments may increase the demand for public services that are paid with general tax revenues. For example, construction of a large retail facility may require more police and fire personnel and equipment. At the same time, because the increased assessed value of the development is captured, the development does not provide any additional tax base that compensates for the cost of providing the services. As a result, the local mill rates may need to be increased to pay for the cost of supplying the public services. This may affect state costs since some state intergovernmental aid programs are sensitive to local mill rates or to the level of local spending generally.

In some instances TIF developments may reduce the cost of supplying public services. For example, a vacant building that is a fire trap and a site for criminal activity may be demolished and replaced with a modern building that requires fewer local government services. Similarly, tax increment financing may be used to demolish substandard housing used by low income families, replacing it with housing for middle and upper income households. Since the cost of providing services for low income people is generally thought to be

higher than for upper income persons, this should reduce local government costs somewhat.[8]

C. Implications for State Costs

(1) The Principal Effect: Shifting the Location of New Development

Based on the discussion in the preceding section, it seems likely that the principal effect of tax increment financing is to alter the pattern or location of new investment in commercial and high density residential properties, rather than to increase the total amount of new investment. Given this, it seems reasonable to assume that essentially the same amount of assessed value statewide would have occurred without TIF.

State aid costs appear to be relatively insensitive to the location of increases in assessed value. Education aids, the largest cost component, are paid to nearly all the school districts in the state. Increases in the assessed value in any of these districts will increase the amount of revenue which must be generated locally and reduce the state aid paid in the same proportion, regardless of the district.

The one exception to this general rule is school districts with such a large amount of assessed value that under the aid formulas all the necessary revenues are generated locally. (These districts are commonly called "off-formula" districts.) If tax increment financing systematically caused development to shift away from off-formula districts, the estimates of state costs could be too high. This seems unlikely. The number of off-formula school districts is relatively small (33 out of a total of 436 districts for the 1985-86 school year). Furthermore, there is no reason to conclude that TIF systematically shifts development away from those districts. In fact, a significant number of off-formula school districts have substantial amounts of captured assessed value and it is possible that TIF actually shifts development into off-formula districts. If this is so, an underestimation of state costs may occur.

(2) Secondary Effects: Increasing Total Assessed Values

As discussed in section B, subsections (2) and (3), tax increment financing probably increases the total amount of investment in industrial, commercial and

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[8]Unless the low income persons move out-of-state, other local governments will continue to provide services for them; so costs may only be shifted from one jurisdiction to another with no savings to the state. For example, it has recently been suggested that the increased numbers of homeless people have been caused, in part, by the demolition of single room occupancy hotels. Most of these structures were regarded as substandard and their demolition or rehabilitation to higher uses was accomplished in Minnesota through a combination of federal grants and tax increment financing.

high density residential properties. The increased investment in commercial and residential structures occurs principally because TIF shifts the relative burden of the property tax away from commercial and high density residential properties to other types of properties. The net result should be, however, that total assessed values (including captured values) in the state are higher.

Estimates that do not take this effect into account may overestimate total state costs. The magnitude of this effect is difficult to assess. It depends upon the percentage reduction in property taxes on new investment in commercial structures that is provided by tax increment financing and upon the elasticity of demand for investment in such structures. Put another way, it is necessary to know how much more investment is made in new structures in response to reductions in the property tax rate. No effort was made to quantify this effect. However, one intuitively expects the overall effect on state costs to be relatively low.

A significant amount of tax increment financing subsidies do not actually reduce the property tax rate. Rather, tax increment is designed for and used to overcome unusual costs of development such as removing substandard structures. Also, some tax increment revenues are used to pay transaction costs--the fees for planners, consultants, lawyers, and investment bankers that are a necessary part of TIF.

Other secondary effects will tend to offset some of the impact on state costs. As discussed in section B, TIF will tend to lower the value of other developable (non-TIF) sites. In addition, TIF tends to increase local mill rates to pay for the cost of delivering additional public services to the TIF developments. Both of these effects reduce the potential state cost savings of any increases in the total amount of assessed value in the state caused by TIF.

(3) Property Tax Refund

The tendency to overestimate state costs is further offset by the effects of the property tax refund program. Under the property tax refund program the state pays property tax credits or refunds directly to renters and home and farm owners. These payments are in addition to the homestead and agricultural school credits. Calculation of the credit amounts depends upon the property tax paid relative to the claimant's income. As with the homestead credit, increases in mill rates that result from the use of tax increment financing will cause larger amounts of property tax refunds to be paid.

The estimates presented in this paper do not include an estimate of the property tax refund component of state costs.[9] As a result, the estimates will tend to

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[9]A sample of property tax refund data by taxing district is not available. This sort of data would be necessary to relate the location of TIF captured assessed value to the amounts of property tax refunds paid.

underestimate the total cost of tax increment financing to the state.[10]

(4) Conclusion

Thus, estimates based on the assumption that captured assessed value would be available to local governments seem likely to provide reasonable estimates of the state intergovernmental aid costs. This method will tend to overstate state costs, since it overestimates the total amount of assessed value in the state. This effect will be relatively small and is likely offset by the tendency of tax increment to depress site values and raise mill rates, and by the failure to take into account the state costs under the property tax refund program.

D. Fiscal Effects of Tax Increment Financing

(1) Introduction

Sections B and C discuss the economic effects of tax increment financing and their impact on state costs. They assess how TIF might affect the economic activities of private individuals and entities and ask "what if" questions regarding TIF and private economic behavior: What if TIF had not been available? Would more or less real estate development have occurred? Would it have occurred in different places?

Tax increment financing not only affects the economic behavior of private individuals, but also the fiscal actions of governments in allocating public resources. This section focuses on the effect of TIF on fiscal decisions made by state policymakers: Has the use of TIF by local governments affected legislative decisions on spending for state intergovernmental aid programs? Would the state have spent the same amount on intergovernmental aid, even if the property values captured in TIF districts had been available to fund the general costs of local government?

(2) Assumptions

There are essentially two different ways of looking at how the aggregate amount of spending on intergovernmental aid programs is determined.

On one hand, the Legislature may determine how much to spend on state intergovernmental aid programs based on factors such as local government fiscal

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[10]This paper also is limited to the discussion of the cost under the intergovernmental aid programs. Through the use of tax exempt bonds, TIF also reduces state income tax collections. The cost impact of this likely is significant. The state's tax expenditure budget estimates the total cost of all tax exempt bonds as $136 million for fiscal year 1986. Minn. Revenue Dept., Tax Expenditure Budget 35-37 (Feb. 1985).

conditions and program needs, perceptions of the appropriate level of property tax burdens, and competing demands for state budget dollars. Once that decision is made the Legislature allocates the available dollars among the various intergovernmental aid programs--education aids, local government aids, property tax credits, and so forth--through formulas that allocate the allotted moneys across individual units of government.

Under this assumption, state spending under the intergovernmental aid programs is relatively insensitive to the use of tax increment financing. The Legislature would independently determine the amount to be spent, regardless of how much or little property value was captured in TIF districts. The formulas are simply the means of allocating these funds to different programs and units of local government.

On the other hand, one may view the aid/credit formulas as policy goals in and of themselves, with the state making whatever commitment is necessary to pay the formula amounts. Under this assumption tax increment financing would directly affect the amount of state aid paid.

In reality, the level of intergovernmental aids for each program and for all the programs together probably is determined through a political process that contains elements of both views or assumptions. The aid formulas and the total state costs are debated interactively. Each is an essential ingredient both in making overall state budget allocations and in enacting aid formulas. For example, property tax burdens are directly affected by the various aid formulas (and by the use of TIF) and property tax burdens may be important in the legislative determination of the total amount to be spent on intergovernmental aid.

Finally, the size of the tax increment financing program relative to the state intergovernmental aid programs may suggest that the availability (or unavailability) of TIF values does not affect state fiscal decisions. The TIF program, according to the estimates outlined in part III, costs on the order of $23 to $27 million per year, while total state intergovernmental aid costs exceed $1 billion. However, most of the TIF costs are focused on one program--foundation aids--and the education aid committees of the Legislature examine state spending of much smaller amounts for other programs fairly closely.

(3) Individual Aid Programs

Examination of individual aid programs is, perhaps, suggestive of the extent to which the two factors bear a greater or lesser role in the decision-making process.

Education aids. As outlined in part III, the basic foundation aid formula, the largest and most important of the education aid formulas, provides a guaranteed amount of revenue for local school districts. The formula determines what proportion of that revenue will be provided by local property taxes vis-a-vis state aid by fixing a statutory mill rate that determines the local property tax effort. The state pays the balance of the guaranteed revenue above this amount. This structure suggests that the Legislature independently determines the amount

of spending for education (i.e., the guaranteed revenue) and the appropriate local effort. Additional property tax base would, under this view, yield lower state spending rather than more spending on education.

Of course, the Legislature's judgment about the appropriate level of property tax burdens is a factor in setting the local effort mill rate, as well as the amount of guaranteed revenue. Thus, if higher total spending could be achieved with equivalent property tax burdens and state aid levels (as would be the case if TIF values were available to schools), the Legislature may decide to spend more for education.

The 1985 Legislature modified the foundation aid program so that in the future the local effort mill rate will not be set statutorily. Rather, the Legislature will determine a fixed dollar amount of local property tax revenues to be raised statewide under the foundation aid program. The Education Department will calculate the appropriate mill rate. This was done to "fix" the relative shares (statewide) of state versus local spending on education, rather than allowing the state and local spending shares to differ dramatically from their expected levels based upon the difficult-to-anticipate idiosyncracies of the real estate market, the assessment process, and property equalization procedures. While some would argue that this change makes it more appropriate to consider added tax base as reducing local property tax levels, viewing added tax base as reducing state aid payments is equally valid under this scheme.

Local government aids. The formula for distributing local government aids (LGA) to cities has undergone two major changes over the period of its existence. (The LGA formula for counties and towns has also undergone frequent change, but aid amounts are so small relative to the city portion of the program that it will not be discussed.) Each of the three major phases of the LGA formula has different implications for the relationship between the formula and the total program appropriation.

In its first phase, the LGA formula was clearly used only to determine each city's relative need; the Legislature decided how much it wanted to spend on LGA, and this amount was divided among the cities in proportion to the formula need measure. In its second phase, the LGA formula determined an absolute need for each city, with the state paying out whatever amount was called for by the formula. In some years the appropriation was capped so that aid had to be scaled back slightly from the formula-determined amount. This phase lasted through the 1985 distribution.

In the third phase, beginning with the 1986 distribution, the formula embodies some elements of both the previous phases. While the formula calculation seemingly yields an absolute need amount, the formula yield is well beyond what the Legislature has been willing to spend, so that the formula amount actually functions as a relative need indicator to allocate the total appropriation. In 1986, each city was allowed only 22.5 percent of the increase in aid to which it was entitled according to the formula.

It seems appropriate therefore, to consider the inclusion of TIF captured value as having no impact on state costs during periods where the formula produced a relative index (phase I and III), but as yielding actual state savings when the formula produced absolute need amounts (phase II). Of course, these conclusions

need to be tempered with the notion that the Legislature always pays attention to both appropriation levels and formula amounts, and may make changes in one based upon perceptions of the other, so that the effect of adding captured TIF value can never be stated with absolute certainty.

Property tax credits. The property tax credits probably present the strongest case for the view that the Legislature simply sets the parameters of the credit formulas and pays the amounts necessary to fund the credits. The credits formulas continue from year to year without the need for legislative action. The amount expended is provided through an open appropriation with no specific dollar limit. (During the budget crisis of 1980-83, maximum limits were placed on the appropriations with provision for proportionate reduction of the reimbursement amounts.) Nevertheless, the Legislature regularly modifies the credits and these modifications may be made in response to state budgetary concerns.

(4) Conclusion

It is impossible to say exactly how much the Legislature would have expended on intergovernmental aids if TIF captured values had been included in the local property tax base. Because of the impossibility of resolving this dilemma, the estimates were generally made on the theory that all the savings would have accrued to the state, except in the case of 1986 LGA where any savings are assumed to accrue to local taxpayers. This likely overstates the amount by which state expenditures would have been reduced. However, the estimates provide insight into the amount of state aids that could have been paid to yield equivalent (or lower) property tax burdens.

E. Other Methodological Considerations

Several caveats should be noted regarding the general methodology used in preparing the state cost estimates.

(1) Estimates of Gross Costs

The cost estimates presented in this paper are estimates of gross, not net, costs. No effort was made to estimate the public benefits that are derived from the use of TIF and thus offset costs, providing a lower net cost.[11]

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[11]The most commonly cited public benefit of TIF is increased tax base for the local unit of government or more generally increased economic activity in the local community. In other words, the local government is temporarily forgoing the increased tax base to induce the development to occur, hoping that it will come out ahead in the long run. See generally, Huddleston, Local Financial Dimensions of Tax Increment Financing: A cost-Revenue Analysis, 2 Pub. Budgeting & Finance 40 (1982), for a method for local governments to evaluate the costs and benefits of TIF projects from this perspective. If these are the public benefits sought, the discussion outlined in section B of part II does take them into account, since it focuses on the question of whether TIF increases the amount of assessed value in the state.

Most of the benefits of tax increment financing are likely to be local in nature and absent TIF would presumably be financed with local property tax revenues. If this were done, state property tax credit costs would increase, but education aids, the principal component of the state cost of TIF, would decrease substantially. Thus, from the state perspective the gross cost of TIF seems likely to be close to the net cost taking benefits into account.

An exception to this is when tax increment revenues are used to finance public expenditures that otherwise would be paid directly with state funds. Perhaps the most common example of this is the use of tax increment revenues to pay for state highway improvements. It could be suggested that these expenditures of tax increment revenues provide a dollar-for-dollar reduction in state highway costs. Three observations are in order in this regard.

First, use of tax increment revenues to finance state highway expenditures (or other state functions) circumvents the state budget process and the established method of assigning priorities to projects competing for public funds. Under the method of budgeting state highway expenditures, the available moneys presumably are assigned to the projects with the highest expected return of public benefits to costs. Allowing local governments to use TIF for highway improvements that would not have been funded (or would have been funded later) under the normal method of budgeting highway revenues means that lower priority projects with lower amounts of expected public benefits will receive funding. This subverts the state budget process and means that the return in terms of public benefits will be less than dollar-for-dollar.[12]

Second, the source of state highway funding is changed from user based charges--the motor fuels excise tax, license plate fees, and motor vehicle excise taxes--to local property taxes and other state revenue sources (income and sales taxes).

Third, although precise data are not available, the amount of highway improvements that are financed with tax increment revenues apparently is relatively small. Thus, the impact on net state costs relative to gross state costs will be relatively minor.

(2) Distribution of State Costs Across Local Government Units

The estimates of state costs reflect the aggregate reductions in state aids that would be paid to local units of governments. As discussed above, these estimates are reasonable approximations of total state costs. However, the change in aid (or property tax burden) for an individual unit of local

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[12]The Legislative Auditor's report suggests that the state's method of assigning priorities to highway projects undervalues the economic development benefits of highway projects. Office of Legislative Auditor, Tax Increment Financing 77 (1986). If this is so, subverting the state budget process may increase the return in public benefits. This also suggests that the state's project selection criteria for highway improvements may need to be reevaluated.

government is much less reliable, since TIF principally affects where development occurs, rather than the total amount of development. Thus, although estimates of these local amounts were prepared as part of the overall estimates, the results are not displayed for individual local government units.

III. THE RESULTS: ESTIMATES OF STATE COSTS

A. Education Aids

(1) Introduction

Although the proportion varies significantly from district to district, state education aids provide almost one-half of the general operating funds for Minnesota school districts. The foundation aid program provides the largest source of both state aid and local operating funds. This program guarantees a specific amount of revenue per pupil, the formula allowance, to be provided by a combination of state appropriated aid and local property taxes. The amount of state aid is determined by subtracting local property taxes from the guaranteed revenue. Local property tax revenues are determined by multiplying the district's equalized assessed value (commonly referred to as EARC value) by a statutory mill rate (23.5 mills for school year 1985-86).[13]

Thus, the basic foundation aid is calculated as follows:

State Aid = formula allowance X pupil units - (mill rate X EARC value).

The foundation aid program also provides "tier revenue" to districts that meet certain special criteria. The aid paid under the tier formulas (there are five separate tier aid and levy formulas) is calculated in a manner similar to basic foundation aid. A guaranteed revenue amount is calculated and local property tax revenue (based on an equalized local effort levy) is subtracted to determine state aid.

In addition to the foundation aid program, school districts participate in categorical aid and levy programs to collect revenue for community education, early childhood family education, interdistrict cooperation, transportation, and so forth. In general, these programs also guarantee an amount of revenue per pupil. Local property taxes are limited to a specific amount, and state aid is provided, as required, to make up the guaranteed revenue.

When tax increment "captures" assessed value that otherwise would be available to pay the local share of these education aid programs, the state share of the educational costs increases. To estimate this effect, the amount of additional school district levies that would occur if captured values were included in

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[13]As discussed above, beginning for the 1986-87 school year the mill rate was not set statutorily but by the Education Department based upon a statutory amount for the total (statewide) property tax levy.

school district property tax values was determined. Second, the resulting decrease in state aid required to provide the guaranteed education revenue was calculated.

(2) Assumptions

In general. As discussed in part II, the analysis assumes that the assessed values captured in increment districts would be available to pay school district levies. Therefore, for those school districts in which TIF districts are located, the analysis calculates an expansion of school district property tax base equal to the equalized captured assessed value of the TIF district.

The analysis is conducted for school district property taxes which were certified on 1983 and 1984 EARC values, and collected in 1985 and 1986 for the 1985-86 and 1986-87 school years. A baseline simulation was performed to determine the local and state shares of the aid programs when TIF values are not available to school districts. An alternative simulation calculated local levy and state aid required when captured assessed value is equalized and added to EARC values.

Underlevies. If a school district levies less than the maximum permitted for the foundation aid program or for most categorical aid and levy programs, state aid is reduced in proportion to the amount of the underlevy. Because few districts underlevy for the foundation aid program, the simulation assumes that all districts levy the maximum amount. Thus, the alternative simulation assumes that any additional school district property value will result in an increase in the foundation levy and a decrease in the required state aid.

For other categorical state aid and levy programs, however, the alternative simulation assumes that if a district underlevied for a program and bears the penalty of reduced state aid, then the district desires a specific amount of revenue to operate the program. Therefore, it is assumed that the district would levy the amount necessary to provide the same amount of program revenue as received under the baseline simulation. Conversely, if the district levied the maximum permitted mill rate, the district will continue to levy the maximum amount under the alternative simulation. In this event, the additional tax base provided by the captured assessed value generally results in an increase in local levy and a decrease in state aid.

Programs simulated. The aid and levy programs simulated were:

- Foundation Aid, including Basic Maintenance, Tiers 1 through 5, and for the 1985-86 school year only, Foundation Revenue Equity
- Basic and Non-Regular Transportation, including Transportation Revenue Equity for the 1985-86 school year only
- Interdistrict Cooperation
- Basic Community Education
- Early Childhood Family Education
- Summer Program Instructional Revenue.

For capital expenditure levy and aid programs, the few districts that receive state aid do not have TIF captured value. Therefore, no simulation was made of these programs.

Other local levies. To estimate the total increase in school district levies under the alternative simulation, the following levies, which do not have corresponding state aid, were also simulated:

- Referendum
- Operating Debt
- Statutory Operating Debt
- Desegregation.

The same assumptions with regard to underlevies were used in simulating these levies. If a district underlevied, the alternative simulation assumes the same dollar amount would continue to be levied. If a district levied the maximum permitted by law, the simulation assumes the district would continue to levy the maximum.

Finally, the additional property tax value under the alternative simulation was assumed to have no effect on the amount of other levies, such as debt service, liability insurance and retirement levies. These levies are largely "cost driven" and would not vary if property wealth changed.

(3) Results

Table A displays the results of the simulations for the 1985-86 school year and the 1986-87 school year

If TIF captured assessed value were available to school districts, the additional property tax base would generate a local property tax increase of over $19 million for 1985. This increase in local property tax effort would result in lower state education aid payments of $17.6 million. The largest amount of this savings (just under $16 million) is in the foundation aid program.

A special note needs to be made regarding the revenue equity program. The estimates displayed in Table A reflect the effects of this program which was repealed by the 1985 Legislature beginning for the 1986-87 school year. The Revenue Equity program increases the estimated state cost of tax increment financing for the 1985-86 school year by approximately $485,000. This cost was eliminated with the repeal of the program.

Under the revenue equity program, urban school districts were required to levy the full statutory mill rates for the foundation (basic maintenance) and transportation aid programs, even if the revenue generated exceeded their foundation and transportation revenue amounts. (This affects "off-formula" districts whose local property tax base is so large that the foundation or transportation aid formula does not provide any state aid.) The resulting excess reduced (or "recaptured") the categorical aids that the state would have paid to the district. This program was enacted by the 1983 Legislature and was to be phased-in over a six year period (one-sixth was to be recaptured in the first year, one-third in the second year, and so forth). For school year 1985-86 one-third of the excess local levy was used to reduce state aids.

With the repeal of revenue equity, if this TIF captured value was available to an off-formula district, it would not reduce state education aid payments. Rather, the district's mill rate and local taxes would be reduced. The 1986-87 school year estimates displayed in Table B thus do not include the state costs reflect in the revenue equity program.

TABLE A
EDUCATION AIDS--TIF COSTS
1985-86 School Year: Payable 1985 Taxes

	LEVY AMOUNT CURRENT LAW (000s)	LEVY AMOUNT ALTERNATIVE WITH TIF ADDED* (000s)	LEVY INCREASE (000s)	STATE AID DECREASE (000s)
TOTAL FOUNDATION (Basic + Tiers 1-5 + rev. eq.)	928,029	943,932	15,903	(15,903)
Transportation	61,612	62,699	1,087	(905)
Interdistrict Cooperation	5,293	5,300	7	(7)
Community Education Basic	18,176	18,190	14	(14)
Early Childhood	6,534	7,155	621	(621)
Referendum	79,720	80,640	920	0
Operating Debt	1,368	1,375	7	0
Statutory Operating Debt	8,245	8,702	457	0
Desegregation	2,374	2,415	41	0
SUBTOTALS			19,057	(17,450)
1986 Summer School Programs	9,397	9,580	183	(183)
TOTALS			19,240	(17,633)

1983 EARC = 30,856,953,300
EARC 1983 with TIF added = 31,453,003,800
Total Equalized TIF Value = 596,050,500

*Alternative levies are based on 1983 EARC values, modified to include the captured assessed value of tax increment financing within each school district.

The results displayed in Table B for school year 1986-87 (property taxes paid in 1986) show approximately a 20 percent increase over 1985-86. The share of education costs that would be borne by local property taxpayers increases from $19.2 to $23.3 million, while the total state cost rises to $20.6 million from $17.6 million. Again, the largest amount ($18.9 million) of this cost is in the foundation aid program.

TABLE B
EDUCATION AIDS--TIF COST
1986-87 School Year: Payable 1986 Taxes

	LEVY AMOUNT CURRENT LAW (000s)	LEVY AMOUNT ALTERNATIVE WITH TIF ADDED* (000s)	LEVY INCREASE (000s)	STATE AID DECREASE (000s)
TOTAL FOUNDATION (Basic + Tiers 1-5)	939,946	958,837	18,891	(18,891)
Transportation	77,273	79,125	1,852	(1,320)
Interdistrict Cooperation	5,610	5,623	13	(13)
Community Education Basic	18,695	18,751	56	(56)
Early Childhood	9,029	9,107	78	(78)
Referendum	95,019	96,674	1,655	0
Operating Debt	683	686	3	0
Statutory Operating Debt	7,260	7,691	431	0
Desegregation	5,042	5,187	145	0
SUBTOTALS			23,124	(20,358)
1987 Summer School Programs	9,377	9,601	224	(224)
TOTALS			23,348	(20,582)

1984 EARC = 30,733,300,590
EARC 1983 with TIF added = 31,449,849,044
Total Equalized TIF Value = 716,548,454

*Alternative levies are based on 1984 EARC values, modified to include the captured assessed value of tax increment financing within each school district.

B. Local Government Aids

(1) Introduction

Local government aids (LGA) is a state aid program providing formula determined aid amounts to counties, cities, and towns for their use as a general purpose revenue source. LGA is a significant source of revenue for cities and towns, accounting for approximately 15 percent of city revenues and 10 percent of town revenues statewide. For counties, LGA does not constitute a significant proportion of their revenues.

(2) Assumptions

Section D of part II discusses the various phases of the LGA formula for cities, focusing particularly on the question of whether the appropriation is legislatively determined or formula driven. Although there is no clear-cut answer to this question, we have assumed that the appropriation in 1985 was formula driven, and in 1986 was legislatively determined. These assumptions seem the most appropriate given the formulas in effect for each of those years. This means that the inclusion of captured TIF value would result in state savings in 1985, but that in 1986 there would be no state fiscal impact. We have simulated 1986 LGA including captured assessed value under the alternative assumption that the formula savings would be passed through to the state. This result is presented as a footnote to the table. There would, however, be a distributional impact in that some cities would get more and others less by including captured assessed value.

(3) Results

Counties and Towns. Counties and towns account for a small percentage of local government aid payments, receiving 5.0 percent and 3.2 percent respectively in 1985. Aid formulas for those two types of governments have been based exclusively on historic aid levels for the past several years. That is, each county's and town's aid is a function of the amount of aid it received in the preceding year. Since the aid amounts are not related in any way to the size of the jurisdiction's tax base, county and town aids would not change if TIF projects were included in the local tax base.

Cities. Cities are the major recipients of aids under the local government aids program, accounting for 91.7 percent of the total in 1985. The formula suggests a high sensitivity of TIF captured value status to state costs. However, further investigation makes it clear that the effects are considerably weaker.

The nominal formula for city local government aids in effect for 1985 is:

State Aid = Local Revenue Base - (10 mills X EARC value).

The structural similarity to the school aids formula is obvious, except that the measure of "need" in this case is the local revenue base, rather than a fixed dollar amount per pupil unit. Each city's local revenue base is the sum of its

local government aid and its property tax levy in a base year (1979), increased by overall inflation and local population growth factors since that time.

As with school aids, one expects the appearance of EARC value as a direct subtraction factor in the formula to cause the state aid cost to change significantly with the inclusion of TIF captured value in the measure of EARC value. However, that is not the case with the local government aids formula because restrictions are overlaid upon the basic formula stating that (1) no city may receive less aid than in the previous year (1984), or (2) no city may receive an increase of more than six percent over its 1984 aid. Only 13 of the 855 cities did not fall under the protection/limitation of one or the other of these provisions. Assuming that these provisions remained in effect, the state savings from the inclusion of TIF values in each city's tax base for formula purposes would be approximately $100,000. A more accurate simulation would attempt to also alter the 1984 distribution based upon including TIF captured value in that year, but the 1984 distribution is also contingent upon the 1983 distribution which would be affected, and so on down the line. Suffice it to say that under alternative methodologies of this type the apparent cost would increase substantially.

The 1985 Legislature made significant modifications to the formula for 1986 local government aids. The new formula altered the definition of local revenue base and replaced the 10 mill local effort factor with one based on a sliding scale, so that higher local effort is required at higher levels of local revenue base.

In addition, limitations on aid increases were changed and a new mechanism was installed to reconcile formula amounts with the appropriation level. As previously discussed in part II, section D, this latter fundamental change significantly affected the relationship between formula amounts and appropriation levels to the point where we deemed the changes in formula amounts to have no impact on the appropriation level.

One further effect was to put a fair number of cities back "on the formula," so that they were no longer (directly) affected by the minimum and maximum provisions. This was borne out by our simulation of the alternative assumption, wherein $1.4 million was saved by the state as a result of the captured value inclusion.

C. State Property Tax Credits

(1) Introduction

Under the state property tax credit programs, the property tax on a qualifying parcel of property is reduced by a credit equal to a specified percentage of the gross tax up to a maximum amount. The state, in turn, reimburses the local governments for the reduction in tax paid by the property.

Two major property tax credits, the homestead and agricultural school credit, are provided under state law. For taxes payable in 1985 and 1986, the two credits are determined as follows:

The **homestead credit** reduces the gross tax on the first $67,000 ($68,000 for 1986) of market value of a home by 54 percent. The credit may not exceed a maximum of $650 for taxes payable in 1985 and $700 for taxes payable in 1986.

The agricultural school credit reduces the gross tax on farm land or other qualifying property by the following percentages:

Type of property	Payable 1985	Payable 1986
Farm homestead, farm buildings and first 320 acres of farm land	33%	36%
Farm homestead 320 to 640 acres Nonhomestead farm first 320 acres	15%	26%
All other farm land and timber land	10%	26%
Seasonal-recreational properties	15%	15%

The maximum agricultural school credit for farm or timber land is $4,000 for taxes payable in 1985. The $4,000 maximum limit on the credit for farms was eliminated for 1986 taxes. The maximum credit for seasonal-recreational property is $100.

(2) Property Tax Credits and TIF

Tax increment financing affects the amount of property tax credit reimbursements paid by the state because TIF causes mill rates to be higher. Gross property tax is determined by multiplying the mill (or tax) rate by the property's assessed value. The higher the mill rate is, all other things being equal, the higher the gross tax will be and the higher the state credit will be, unless the property already qualifies for the maximum credit.

Mill rates are determined by dividing the property tax levy (i.e., the local government's spending less other revenue such as direct state aid payments) by the total assessed value of the local government. Tax increment financing affects mill rates in two ways. First, capturing or lowering available assessed value increases the mill rate. Since spending remains constant, the mill rate will be lower if assessed value is increased. However, lowering assessed value will increase the amount of state education aid paid to the school district, as described in section A, and thereby reduce the school levy. Thus, the school mill rate is much less severely affected by TIF than are the mill rates of other types of local governments. This effect is partially offset by the fact that some of the local services provided to TIF developments would now have to be financed through the city levy, thus increasing the mill rate.

(3) Assumptions

The estimates were prepared for taxes payable in 1985 and 1986. A simulation of the credits that would have been paid was computed using the House Research Department property tax model and the following assumptions. The 1985 results were compared with the actual property tax paid in 1985. The 1986 results were compared with the House Research Department estimates of property taxes payable in 1986.

- The assessed value of each taxing district was increased by the amount of captured assessed values in the district.

- Property tax levies were not changed, except that the school levies were increased by the amount determined under the simulation of the TIF alternative described in the section on education aids. Levies were not changed to reflect the changes in local government aid, because of the small change in state aid that was involved. More importantly, levies were not increased to reflect any amount of local government services currently financed with tax increment revenues which would have to be financed with direct property tax levies.

(4) The Results

The results are displayed in Table C.

TABLE C
PROPERTY TAX CREDITS--TIF COSTS

PROPERTY TAX CREDIT	YEAR PROPERTY TAXES ARE PAYABLE 1985 (000)	1986 (000)
Homestead	$ 4,412	$ 6,145
Homestead, agricultural	59	100
Agricultural school	337	454
TOTAL	$ 4,908	$ 6,699
Mill rate (in mills):		
Baseline	98.6	104.8
Alternative	97.0	102.7
Change in net total tax burden	$46,575	$58,686

As shown in the table the average mill rate would decline from 98.6 to 97.0 mills and total property taxes would decline by over $46 million. For 1985 property taxes, the amount of homestead credit paid would be reduced by approximately $4.4 million, while the amount of agricultural school credit would

be reduced by approximately $300,000. The total reduction is slightly less than $5 million.

The property tax credit costs increase by almost 40 percent to $6.7 million for taxes payable in 1986. The homestead credit costs rise to $6.2 million and the agricultural credit to over $450,000. This substantial rate of increase is caused by the growth in TIF captured value, the overall increase in mill rates, and the 1985 legislative changes to the credits increasing the maximum homestead credit to $700 and raising the agricultural credit percentage rates.

D. Total State Costs of Tax Increment Financing

Table D summarizes the total estimated state cost of tax increment financing. All estimates are for property taxes payable in 1985. These costs will occur principally, but not exclusively, in fiscal year 1986.

TABLE D
TOTAL STATE COST OF TAX INCREMENT FINANCING

STATE INTERGOVERNMENTAL AID PROGRAM	ESTIMATED COST* 1985	1986
Education Aids		
Foundation Aid	$15.90	$18.89
Transportation Aid	0.90	1.32
Other Categorical Aid	0.82	0.37
TOTAL	$17.63**	$20.58
Local Government Aid	$ 0.10	$ 0.0+
State Property Tax Credits		
Homestead	$ 4.47	$ 6.25
Agricultural	0.34	0.45
TOTAl	$ 4.81	$ 6.70
TOTAL STATE COST	$ 22.54**	$27.28

*Millions of dollars.
**Numbers may not add to totals due to rounding.
+Assumes that all savings (approximately $1.45 million) would accrue to local taxpayers rather than the state. See discussion in part II, D, pages 14-17.