TAX INCREMENT FINANCING PROJECT

The "But For" Test and Public Costs and Benefits

Working Paper #4

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This working paper outlines a method, benefit-cost analysis, for evaluating public expenditure decisions. It examines the "but for" test, the legal test that must be satisfied before tax increment financing (TIF) can be used. It also discusses some of the major categories of public benefits and costs of TIF redevelopment project expenditures.

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PREFACE

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

Tax increment financing (TIF) diverts the incremental property taxes generated by a real estate development to pay for the costs of the development, rather than the general cost of government. Because this diversion or capturing of revenues is the peculiar distinguishing characteristic of TIF, most observers have focused on TIF as a tax or revenue raising tool. An equally important element of the tax increment program is the expenditure of public moneys for real estate development costs. This paper focuses on tax increment financing as a public expenditure program and suggests a framework for analyzing the costs and benefits of the expenditures commonly associated with tax increment financed redevelopment projects.

This working paper consists of the following parts.

The Introduction outlines a method, benefit-cost analysis, for evaluating public expenditure decisions.

Part I examines the "but for" test, the legal test that must be satisfied before TIF can be used. It suggests that the only function of the "but for" test is to assure that TIF does not confer windfall benefits on real estate developments. The test provides no guarantee that use of TIF for a development is justified by the public benefits that are generated.

Part II of the paper lists and briefly analyzes some of the major categories of public benefits and costs of TIF redevelopment project expenditures.

The other topics covered in the series include:

Working Paper #1	AN INTRODUCTION
Working Paper #2	BACKGROUND DATA ON THE USE OF TAX INCREMENT FINANCING
Working Paper #3	THE STATE COSTS OF TAX INCREMENT FINANCING

OUTLINE OF CONTENTS

EXECUTIVE SUMMARY

Benefit-Cost Analysis (pp. 4 and 5)

Tax increment financing (TIF) projects annually involve substantial expenditure of public moneys by Minnesota governmental units. The widely accepted method of evaluating public expenditures is to compare the public costs and benefits of the expenditure. The benefits of each program are, then, compared with the other potential uses of public moneys in constructing the budget of the governmental unit.

The benefits of tax increment projects are difficult to measure because many of the effects are indirect and the benefits intangible. The project's costs and benefits may also extend beyond the boundaries of the governmental unit in which a project is located.

The "But For" Test (pp. 6 to 11)

TIF expenditure decisions are not made as part of the local governments' budget processes. Instead, state law requires the authorizing municipality to find that a proposed TIF development would not have occurred without public assistance. This test is referred to as the "but-for" test (but for TIF, the development would not have occurred).

The test is commonly regarded by local governments and many other participants in and observers of the development process as the benchmark of whether TIF expenditures are justified for a particular development project. In other words, the test functions as a substitute for an explicit weighing of the costs and benefits of proposed TIF subsidies.

This view seems to be grounded in a theory that TIF is primarily, if not exclusively, designed as a program to attract tax base to the municipality. If the "but-for" test is met, then, the project is assumed to yield a net benefit to the community at no or low cost.

The "but-for" test provides no assurance that a TIF project will provide public benefits in excess of its costs. The statutory version of the test is so loosely worded and subject to varying interpretations that virtually any development could satisfy it.

Even a strengthened version of the test (which some local governments profess to follow or suggest that the state require) does not provide a reliable method of insuring that a TIF project will provide net public benefits.

- The "but-for" test suggests a focus on only one potential benefit of TIF expenditures--enhanced tax base--and ignores other benefits.

- The test fails to account for all the potential costs of TIF, particularly the costs that are shifted to the state and other local jurisdictions. The "but-for" test shifts attention away from those costs by implying that the primary benefit of an expanded tax base comes at no cost. The implication is that the only cost is the development's taxes and those taxes would

vanish without TIF because TIF caused the development to occur. This view overlooks the fact that subsidizing development at one site affects the amount and timing of development at other sites. Thus, the tax base and taxes in other municipalities, if not the approving municipality, are affected.

The "but-for" test functions best as a threshold test to insure that TIF will not be used to provide subsidies to developers for actions that they would have undertaken anyway. Once the threshold is met, however, public officials still must assess the benefits and costs that will be derived from a project.

Elements of Benefit and Cost (pp. 12 to 26)

TIF expenditures on redevelopment projects have several potential public benefits. They include:

- Enhancement of the property tax base
- Improvement of the fiscal condition of local governments
- More efficient use of public infrastructure
- Reduced "social costs" of slums or blighted commercial buildings
- Expanded employment opportunities.

When viewed from the perspective of the state, the two most commonly cited goals of TIF redevelopment projects--expansion of the tax base that results from construction of improvements (buildings and so forth) and employment opportunities resulting from the development--should not be considered as generating true public benefits. TIF subsidies may change the location or the type of new investment and employment positions, but they probably do not expand the overall supply in the state or nation. The capital and resources employed in developing the TIF project in all likelihood would be productively employed elsewhere in economy if TIF subsidies were unavailable.

Use of TIF for redevelopment projects may, in economic theory, increase total tax base in the state by promoting more efficient use of land (higher land values) and may reduce public infrastructure costs by encouraging more intense land uses that use public infrastructure investments more effectively.

It is unclear whether the tax base relocation that results from TIF subsidies equalizes the capacity of Minnesota local governments to provide public services. TIF is used by most Minnesota cities, including those with proportionately high tax base and relatively low effort levels. These cities may counter the equalization effect that use of TIF by low wealth cities has.

The primary costs of TIF redevelopment projects include:

- Foregone property tax revenues (the tax increment)
- Foregone state income tax revenues on tax exempt TIF bonds

- The cost of locally provided credit enhancements for the project's debt
- Relocation costs.

The financing structure of TIF projects encourages local governments to miscalculate the actual public costs and benefits of TIF projects.

- TIF spending decisions are made outside of the normal operating and capital budgeting processes.
- TIF spending decisions are made by local governments that bear only a small portion of the cost of providing the subsidies, but nevertheless reap most of the benefits.

Both of these factors encourage more TIF spending than otherwise would occur, since local governments will have a natural incentive to under-count the public costs of TIF projects.

INTRODUCTION
EVALUATING PUBLIC EXPENDITURES; BENEFIT-COST ANALYSIS

Under commonly accepted principals of public finance, public moneys should be expended only if the public benefits exceed the costs and thereby yield a net public benefit. Specifically, policy makers must decide whether the benefits generated by the expenditure will exceed the benefits that could be derived from spending the money on another public project or by not spending the money at all (i.e., the benefit of leaving the funds in the private economy). These decisions are usually made in constructing the governmental unit's budget. The budget process encourages policy makers to compare the benefits and costs of alternative government programs.

Application of benefit-cost analysis to local government spending on urban redevelopment programs presents a series of difficulties. Perhaps the most important of these is the difficulty (impossibility) of quantifying or measuring many of the elements that comprise the benefits of the program. For example, one of the principal rationales advanced for urban renewal and redevelopment programs is the reduction of crime and other "social costs" associated with slums and blighted properties. However, measuring the effect of redevelopment on these conditions is extremely difficult. The causal relationships are difficult to demonstrate and the benefits may be largely intangible.

Second, the distributional effects of a program or project present difficulties. Most governmental expenditures redistribute resources. Money is taken from one group of individuals (i.e., taxes are levied) and is paid to another group, directly or indirectly. When all the dust settles, some individuals end up with more, while others have less. Generally, simple redistribution is not thought to yield a net benefit to the community as a whole. One individual's gain is another's loss. However, some may feel that if, as a result, the distribution of resources becomes more "equitable," then a net public benefit is realized. For example, if the program redistributes resources from high income to low income individuals, this may be considered beneficial.[1] The benefits of this type of redistribution, however, are impossible to quantify objectively and will depend upon one's view of the importance or the value of modifying the distribution of wealth. Therefore, these sorts of benefits are not addressed in the paper.

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[1]It may be that urban renewal and similar urban redevelopment programs have the opposite result. See, e.g., J. Rothenberg, Economic Evaluation of Urban Renewal pp. 14-15; 223-26 (Brookings Institution, 1967). These programs typically provide for demolishing low quality housing occupied by low income individuals (single room occupancy hotels, "slums," "blighted" buildings, etc.) and replacing them with either fewer units of higher quality low income housing or with middle and upper income housing or commercial buildings. As a result, the supply of low income housing is reduced and the rents that low income households pay will rise. If this occurs, income probably will be redistributed from poor to more affluent individuals.

Furthermore, the goal of this paper is not to measure the benefits or costs of one or more tax increment financed projects. The more modest purpose is to identify the likely elements of benefit and cost of TIF expenditures. The more difficult task of weighing the relative benefits and costs is left to state and local policy makers who are considering specific projects or proposals.

Third, as will be discussed more fully below, the relevant population for measuring costs and benefits may be unclear. Should the costs and benefits of a program be measured only for the city in which the project is located? for the metropolitan area? for the entire state? or for the nation?[2] A program may impose costs and scatter benefits across local and state jurisdictional boundaries. The paper assumes that the relevant population for analysis is the state. It should be noted, however, that this perspective runs the risk of under-counting the costs of the program, since a portion of the costs will be shifted to the federal government through the use of tax exempt bonds and to other states by influencing business location decisions.[3]

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[2]For example, in describing the costs and benefits of advance refunding of tax exempt bonds, a U.S. Treasury Department official was quoted as saying "It doesn't make any sense for a state to save $1 and it costs us [the federal government] $5." "Bond issuers cash in on lower interest," Minneapolis Star and Tribune 1M, at 6M (August 18, 1986). Nevertheless, state and local governments routinely advance refund their bonds because they do not take into account the costs that are borne by the federal government. In the view of the state or local decision makers the relevant population is the taxpayers of the state or the local jurisdiction, not the nation as a whole.

[3]By contrast, the benefits seem likely to be almost exclusively local in nature.

I. THE "BUT-FOR" TEST

Overview of the Budget Process, TIF Spending, and the "But-For" Test

Local governments generally weigh the benefits and costs of public spending as part of the process of adopting an annual budget. In passing a budget the governing body of the local government must consider how it will allocate scarce resources (tax dollars) among competing programs and policies. The process of adopting a budget naturally leads policy makers to consider the relative costs and benefits of the various programs. The law generally requires local governments to prepare and adopt a budget as part of the process of establishing their annual property tax levies.[4] Even if the law did not require preparation of a budget, the governmental unit must decide each year how much to levy in property taxes. This amount would, then, need to be allocated among competing priorities as an ad hoc budgeting of the moneys. In any case, allocation of scarce resources among competing uses naturally leads to measurement and comparison of their respective benefits and costs.

Public spending financed with tax increments, however, is not considered as part of the local government's budget. The revenues are not paid out of the direct property tax levy, rather they are received "automatically" by applying the general property tax rate to the captured value.[5] Thus, there is no practical need to include TIF spending in the budget and the law does not require it to be included or considered in preparing the budget. As a result, TIF spending need not compete with other types of local government spending as part of the budget process. This omission also means that the natural incentive to evaluate the benefits and costs of programs as part of the budget competition for scarce resources does not apply to TIF projects.

Instead of requiring a weighing of benefits and costs in light of competing budget priorities, state law requires a municipality to find, prior to certifying a tax increment financing district, that the development would not have occurred without the provision of TIF subsidies. Specifically the municipality must find

> That the proposed development or redevelopment, in the opinion of the municipality, would not reasonably be expected to occur solely through private investment within the reasonably foreseeable future and therefore the use of tax increment financing is deemed necessary.[6]

This provision is commonly referred to as the "but for" test. ("But for" the provision of TIF subsidies the development would not have occurred.) The "but for" test is commonly regarded by both proponents and opponents of tax increment

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[4]See, e.g., Minn. Stat. §§412.701-412.731 (1984) (statutory cities).

[5]See House Research Dept., Tax Increment Financing: An Introduction (January, 1986) for a description of how tax increment financing works.

[6]Minn. Stat. §273.74, subd. 3(b).

financing as the litmus test of whether the use of tax increment financing for a development is justified or inappropriate.[7] Indeed, the language of the statute implies that satisfaction of the "but for" test sanctions, if not impels, the use of TIF ("therefore the use of tax increment is deemed necessary").

The "But-For" Test Theory

Local officials commonly view the primary purpose of tax increment financing as the attraction of development to expand their jurisdictions' tax bases. In order to attract this new tax base the city is willing to temporarily forgo the tax paid by the development (i.e., the tax increment). Implicit in this theory is the premise that certain types of developments generate an increase in property tax base that yield (at current tax rates) taxes in excess of the cost of meeting the demand for additional public services that is generated by the development. Thus, after the temporary period is over, this excess (the city hopes) will permit recovery of the cost of inducing the development.

Given a purpose of attracting new tax base, the need for satisfying a "but-for" test is clear. If development would have occurred without the use of TIF, then the benefits (expanded tax base) would occur without expending public moneys (tax increments) for the project. The expenditure pays the developer for doing what he would have done any way; in short, a windfall. Thus, the "but-for" test is a necessary condition for the use of tax increment. If it is not satisfied, the public development subsidies are clearly wasted.

However, city officials commonly view the "but-for" test as not only a necessary condition for the use of TIF, but as a sufficient condition. Under this view, if the development would not occur without TIF, then the use of TIF is justified.

The origin of this view of the "but for" test is easy to see. The primary cost of TIF is the temporary loss of tax revenue while the incremental tax is dedicated to the payment of development costs.[8] If the development would not have occurred without TIF, then the tax base would not have been available to the local government and the primary element of cost (the increment) completely disappears. In short, the city is expending money that it wouldn't have had any way. Under this view when the "but for" test is met, TIF will appear to "pay for itself" by generating benefits in excess of costs in almost all cases.

The validity of this notion that the "but-for" test guarantees that TIF does not have a net cost to the city depends upon two critical factors.

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[7]One exception to this view is the report of the Office of Legislative Auditor which states that a principal shortcoming of the "but for" test is that it provides "no indication of the public costs and benefits of subsidized development." Tax Increment Financing 42-43 (January, 1986).

[8]A second, and often overlooked, cost element is the cost of supplying additional public services as a result of the development. For example, many developments will generate additional demands, either directly or indirectly, for police, fire, school, and other public services.

(1) No development of the project site would occur without tax increment subsidies.

(2) The use of TIF at the project site will not displace or delay development that would have occurred elsewhere.

The common versions of the "but-for" test, as described below, make no such guarantee. As a result, the idea that the "but-for" test insures that the use of TIF imposes small or no public costs is of questionable validity.

The Statutory "But For" Test

The report of the Office of Legislative Auditor suggests that the statutory language of the "but-for" test is subject to a variety of interpretations and is not applied in a consistent manner by local officials. The Legislative Auditor lists seven different interpretations of the test and suggests that "it is difficult to imagine a development that would not meet the 'but for' test in some sense." The statutory language contains many qualifiers and legitimately lends itself to widely varying interpretations and applications.

The looseness of the statutory language and the variety of ways that the test is applied suggest that the statutory version of the "but for" test fails to insure that TIF will not provide windfalls to developers, much less that the public benefits of a project exceed the costs. The following list describes some of these interpretations and ways of applying the test. Each of them suggests circumstances where the "but-for" test is met, but does not insure that the costs of foregoing increments are minimal. In each instance these interpretations of the test are based on a supportable (if not the best) reading of the statutory language.

- Focus on the project site. The "but-for" test focuses exclusively on development of the project site. Without TIF the development may have occurred elsewhere in the city (or the county or state); however, the test is still satisfied. Development of the site may displace or delay development of other sites.

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[9]Office of Legislative Auditor, Tax Increment Financing 43-45 (January, 1986).

[10]Id. at 43.

[11]Minn. Stat. §273.74, subd. 3(b) ("in the opinion of the municipality," "reasonably," "solely through private investment," and "reasonably foreseeable future").

[12]The statutory language focuses on whether "the proposed development or redevelopment" would have occurred solely through private investment. Minn. Stat. §273.74, subd. 3(b) [emphasis added]. A reasonable conclusion is that the effect on development of another site is irrelevant, even if it is essentially the "same" development constructed by the same developer.

- Timing of the development. The test is satisfied if TIF causes the development to occur sooner. The law requires that the development would not "in the opinion of the municipality" be expected to occur within the "reasonably foreseeable future."

- Size or value of the development. The statutory test is satisfied if TIF is necessary to cause a larger development to occur. For example, the city may prefer that a site be developed with a high rise, luxury apartment building, rather than the three story walk-up apartments that would be built without tax increment subsidies.

- Type of development. The test is satisfied if TIF is used to induce a type of development that would not occur without TIF. For example, a site might be developed as an office building through private investment alone. However, the city may prefer construction of a hotel as part of a plan to attract conventions to the city. Use of TIF for the hotel development would satisfy the "but-for" test (even if the office building would have a higher assessed value).

- Use of increment from one development to subsidize another. If the "but-for" test is satisfied and thus justifies initially subsidizing a development, it places no apparent limit on the amount of increment that may be captured. For example, assume that it is necessary to expend $2 million to induce development A to occur. The city provides $2 million in subsidies to A, but captures $3 million in increment. The additional $1 million is expended to induce development B to occur. If development B would not have occurred without TIF, the "but-for" test is satisfied according to some interpretations, even though development B's increment is insufficient to pay back the $1 million subsidy derived from A.

Each of these factors suggests that satisfying the statutory version of the "but-for" test does not insure that the project will yield a net public benefit. For example, if the development would have occurred elsewhere in the city (i.e., other than at the project site) or if the development displaces other development in the city, then the city would have realized the increased tax base without using tax increment. Similar considerations apply to the use of TIF to accelerate the time of development of a site, to change the type of development or to increase the size of a development.[13]

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[13]If development of the site would have occurred sometime later and the development is captured for a longer period of time than the delay, then the city has clearly expended more than it gained. For example, if the development would have occurred within 10 years without TIF and the city captures the assessed value of the development for 15 years to induce it to occur now, the city (and the school, county and state) has lost 5 years of increment.

Perhaps more importantly, an interpretation of the "but-for" test that permits a development to be subsidized if it would be larger because of TIF effectively permits any development to receive TIF. To illustrate, assume that a site would be developed with a $10 million development without TIF. If the city provides $2 million in TIF subsidies, any developer would presumably be willing to construct a $12 million development instead. It is unlikely that $2 million in additional public benefits are generated under the circumstances.

Indeed, the "but-for" test does not guarantee that TIF will not result in windfalls to developers or other property owners. The statutory standard is simply: would the development have occurred in the reasonably foreseeable future without TIF subsidies. If the development would not have occurred without TIF, then the threshold is satisfied and there is no requirement that the full increment captured or expended was necessary to induce the development. For example, it may be necessary to expend $1 million to induce Development C to occur, but $1.2 million in subsidies may be provided. The statutory standard simply requires that some use of TIF be necessary.

Costs and Benefits and the "But-For" Test

One could posit, and perhaps some cities use, a strong or more rigorous version of the "but-for" test.[14] Under this hypothetical "but-for" test a development would qualify only if the conditions cited above are met--i.e., (1) no development of the site would occur without TIF and (2) developments at other sites in the city would not be delayed or displaced by the TIF development.

This strengthened "but-for" test would insure that the city was not foregoing potential tax base by using TIF. However, it would not function as an effective means of assessing the relative benefits and costs of a tax increment project and would tell the local government officials very little about whether the use of tax increment is appropriate or prudent in specific instances. This is so for at least three reasons.

First, the reformulated test focuses on the increment and tries to guarantee that the city would not have received the increment without the use of TIF. It fails, however, to take into account the costs of meeting the demand for government services that is generated by the development. For example, police and fire service costs may increase[15] or for a residential development additional school children may be brought into the school district.[16] These costs may be

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[14]For example, a task force of the League of Cities and the Minnesota Chapter of the National Association of Housing and Redevelopment Agencies has suggested that the statutory "but for" test needs to be strengthened in response to the criticisms of the Legislative Auditor and others. League of Minnesota Cities, Tax Increment Finance: An Analysis 61 (1986). The changes suggested by the League of Cities, however, fall short of the strengthened version of the test suggested in the text.

[15]This could be significant if the development was large relative to the community. For example, one can imagine that if the development involved the first high rise building in a city and it was necessary to acquire fire equipment to fight fires in tall buildings or more commonly if traffic and crime increase because of the increase in economic activity associated with a development.

[16]The state school finance formula insures that most of the marginal cost of educating the children will be borne by the state. However, it may create a need for an expansion of the capital facilities of the school which must be paid for locally.

small or actually negative, but the "but-for" test simply fails to take them into account.[17]

Second and more fundamentally, the "but-for" test fails to account for the potential costs that are imposed on other local government units and the state. Inducing development of one site will almost invariably affect the viability or timing of development of other sites.[18] Since the hypothetical, strengthened "but-for" test focuses only on the effects in the city, the costs imposed through the loss of tax base in other jurisdictions is ignored. If the "but-for" test is strengthened further by requiring that the development have no effect on development in other jurisdictions in the state, it would be virtually impossible to satisfy. Since the amount of real estate development is a function of supply and demand, additional development at one site will affect development at other sites.

Third, it is possible that there are circumstances where the strengthened "but-for" test is not satisfied but that the benefits of completing a TIF project still justify it. The strong "but-for" test insures that the use of TIF does not capture any tax base that the city would have had without TIF. Thus, it is designed to minimize the cost side of the equation. In this sense, the "but-for" test seems to suggest that the only possible benefit to be derived from TIF is enhancement of the tax base. However, other forms of benefit may be derived. For example, redevelopment of a slum or blighted area of the city may reduce crime or other social costs. The "but-for" test does not account for these potential benefits.

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[17]The costs could be negative, for example, if the project involves removal of slum housing or blighted commercial buildings that use a greater amount of services than the middle and upper income housing or new commercial developments that replace them.

[18]This is so because new development and investment is a function of supply and demand. Assume that TIF is used to subsidize development of a large office building that otherwise would not have been built. With the increased supply of office space the price of office space (i.e., rents) will be lower than it otherwise would be. As a result of these lower prices, potential investors will be able to find other investments that provide higher returns than new office developments. New investment will flow into other types of assets until prices (rents) rise to provide a competitive rate of return.

In short, the amount of real estate development is determined by supply and demand for real estate and by the rate of return provided by competing investments. When the government decides to subsidize real estate development at a limited number of sites, this will primarily affect the location of new development. Developers will locate at the sites necessary to get the subsidies. Unless the subsidies are large enough to permit overall lower prices (rents), the total amount of investment probably will not increase much at all. Thus, the primary effect will be to reduce development of nonsubsidized sites.

II. ELEMENTS OF BENEFIT AND COST

Tax increments are used to finance essentially three types of government activities:

(1) Redevelopment. In a typical redevelopment project the city or redevelopment agency acquires parcels of property containing substandard buildings (slum housing or blighted commercial-industrial structures), demolishes the structures, combines several parcels to provide a site suitable for development, and sells the tract to a developer at less than the cost of acquisition, demolition and assembly.

(2) Housing. A housing or redevelopment agency may use TIF to finance acquisition or construction of residential properties to provide housing to low or moderate income households (usually at below market rates).

(3) Infrastructure Improvements. Cities use TIF to finance construction of roads, highways, sewer and water, or other similar public improvements.

Redevelopment activities are the original and classic use of TIF. They are similar to the federal urban renewal programs of the 1960s that spawned development of tax increment financing. They remain, in most people's minds, the essential tax increment financing program. By contrast, constructing public infrastructure improvements--building roads and sewers--is a traditional and widely accepted function of local and state government. The tax increment program simply provides an alternative method of financing the activities. Similarly, providing low income housing assistance is commonly thought of as a traditional government function, along with other public welfare functions. These expenditures are routinely evaluated by policy makers in establishing state and local government budgets, determining whether to undertake special assessment projects, and so forth.

The second part of this paper focuses on the benefit and cost elements for redevelopment or economic development expenditures, financed with TIF. The part concludes with a section that discusses the effects that the peculiar cost structure of TIF may have on the way public officials weigh the benefits and costs of infrastructure improvements and housing programs.

The discussion of the benefits and costs of tax increment financed redevelopment activities is intended solely to suggest the items or elements of benefit and cost. It relies heavily on two studies of the federal urban renewal programs that were published in the 1960s and 1970s by the Brookings Institution and the American Enterprise Institute.[19] The discussion is not intended as an analysis

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[19] J. Rothenberg, Economic Evaluation of Urban Renewal (Brookings Institution, 1967); J. Weicher, Urban Renewal (American Enterprise Institute, 1972). Other studies have applied the methodology to specific urban renewal cases, i.e., by measuring actual benefits and costs. See, e.g., S. Messner, A Benefit-Cost Analysis of Urban Redevelopment (1968); J. Mao, "Efficiency in Public Urban Renewal Expenditures Through Benefit-Cost Analysis," 32 Am. Institute of Planners J. 95 (1966).

of the actual benefits and costs of specific TIF projects or of the TIF program as a whole.

Benefits of Redevelopment Expenditures

Enhancement of the Property Tax Base: More Efficient Use of Land. The most commonly cited benefit of the TIF program and goal that motivates most TIF use by local officials is expansion or enhancement of the local property tax base. Cities use tax increment because they hope to increase their tax base and thereby lower the tax rates imposed on their residents or increase the amount of services that can be provided at the same tax rate.

The increase in tax base that results from TIF projects has two separate components that must be distinguished in measuring benefits, especially if the perspective is that of the state as a whole, rather than the local jurisdiction: (1) the tax base that results from construction of the improvements on the site and (2) the increase in land value that results from government intervention that yields an overall more efficient pattern of land use.

(1) Construction of Improvements. Obviously, the largest component of the increased property tax base is the value of new improvements that are constructed. This is the major generator of increment and from the perspective of a local official the major goal that is sought. However, as a matter of economic theory it is generally recognized that this is not a legitimate benefit when viewed from a broader state or national perspective.[20] It is commonly accepted by public finance economists that public redevelopment programs affect the location of new construction, but do not themselves cause or create new construction. Shifting new investment from one local jurisdiction to another, does not in itself yield a net benefit.[21]

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[20]The cost-benefit studies of the federal urban renewal programs have agreed on this point. See J. Weicher, supra note 19, at 37-38; J. Rothenberg, supra note 19, at 135-138; N. Lichfield, Cost-Benefit Analysis in Urban Redevelopment (Research Report No. 20, University of California, 1962). For example, Weicher states: "It has been argued that this new construction creates a benefit to the nation which should be included in an evaluation of urban renewal. However, this is generally inappropriate. The value of the new buildings should be included only if they represent a clear gain to the economy, and have no possible offsetting costs. That is, their value should be included only if the resources used in constructing them would not be used to produce any other commodities of value. This is, to put it mildly, unlikely. * * * The urban renewal program merely relocates the construction; it does not by itself cause the construction." [Emphasis added.]

[21]There may be distributional advantages that are sought, however. For example, tax base may be redistributed to a poorer community. This may be a desirable goal, but it does not provide a benefit if the measure of "benefit" is an increase in total wealth or income in the state. It may be that relocation of property tax base improves the fiscal position of local governments in a beneficial fashion. This issue is discussed below.

(2) More Efficient Land Use. By contrast, it is generally recognized that urban redevelopment programs have the potential for increasing the efficiency of land use patterns and that this should have a positive effect on the property tax base by increasing land values. The reasons for this effect result from the market externalities associated with property ownership. The value of a property depends upon both the quality of the property and how well it is maintained and the state of maintenance and quality of the surrounding properties (the neighborhood effects). Because of this each owner has an incentive to undermaintain his property--expenditures to improve or maintain a property not only benefit the owner, but his neighbors. Thus, the rational owner hopes he can avoid maintaining or improving his property while his neighbors do so.[22] However, failure to maintain his property adversely affects the value of his neighbor's. Redevelopment programs can help overcome this difficulty by "internalizing" these neighborhood effects. The most common manner in which this is done is by assembling a number of small tracts of land into one large parcel.[23]

Improve the Fiscal Condition of Local Governments. A corollary of the goal of increasing the property tax base is to improve the fiscal condition of local governments. In undertaking redevelopment efforts, local governments commonly cite a goal of increasing their ability to provide public services by expanding

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[22]This is sometimes analogized to the "prisoner's dilemma" strategic game. See J. Rothenberg, supra note 19, at 40.

[23]Weicher provides an illustration of why land assembly may require government intervention and the effect of the "prisoner's dilemma" aspect of real estate transactions:

> Suppose two houses on adjacent lots each have a market value of $10,000. If the two lots were both vacant and available for sale, an apartment builder might be willing to pay $25,000 for the land alone, because he can erect a multi-unit building on the two lots. If the cost of razing the two houses is less than $5,000, the developer will want to buy the houses. He could, in fact, offer each homeowner more for his property than it is worth in its current use.
>
> However, the builder may be unable to acquire both properties, even in a situation where each owner is willing to sell and would have no psychological costs in moving for which he would wish to be compensated. If either owner discovers the intention of the builder, he may reason that, if the two properties are worth $25,000 together, and his neighbor's property is worth $10,000, his own must be worth $15,000 (less razing costs) to the builder. If each owner, on this reasoning, demands $15,000 (less razing costs), the builder will find that the project is no longer profitable * * *. J. Weicher, supra note 19, at 28-29.

the commercial-industrial tax base.[24] The state expends a large share of its revenue as intergovernmental aids to school districts, cities, and counties to equalize and expand the capacity of local governments to provide public services. In the seven county metropolitan area, the fiscal disparities program is intended to equalize the distribution of tax base and the capacity to provide public services.

If tax increment financing either expands the capacity to provide local government services or equalizes the distribution of tax base among local communities, this could yield a public benefit from a state perspective. The potential benefits can be divided into two categories.

First, tax increment financing may increase the total market value of taxable property in the state--i.e., the property tax base. If this occurs, local governments implicitly have greater capacity to provide property tax financed, local services. This benefit, however, is no different than the benefit of increased property tax base outlined above under Enhancement of the Property Tax Base. Second, tax increment financing may redistribute tax base (or indirectly state intergovernmental aids)[25] in a way that comports more closely with the distribution of tax capacity desired by policy makers. This "benefit" does not meet the criterion of benefit outlined above, however. It does not increase the total income or wealth of residents of the state, but rather reallocates that income among local governments (i.e., their residents or other beneficiaries of their services) in a pattern that meets the goals of the majority.

Poorer communities tend to have higher public service needs, since it is generally more expensive to provide public services to poorer groups. Crime levels are higher, public health and welfare expenditures tend to be higher, and it is more expensive to educate children from lower socio-economic environments because they receive less support at home, and so forth. At the same time, poorer communities usually have lower tax bases to finance these services.

It is difficult to assess whether tax increment contributes much to the goal of equalizing the capacity of Minnesota local governments to provide public services. There is little agreement, outside of education finance, on the appropriate measures of need for public services. Furthermore, it is not clear how much influence the use of TIF has on the location of new tax base and whether this shifts investment from high to low tax capacity communities.

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[24]For example, the City of Minneapolis' tax increment financing policy states that one of the purposes of TIF is to "increase the tax base of the City to insure the long-term ability of the City to provide adequate services for its residents while relieving the significant tax reliance on residential property." City of Minneapolis and Minneapolis Community Development Agency, Tax Increment Policy 2 (undated mimeo).

[25]Tax increment financing functions as a state intergovernmental aid through its interaction with the education aids, local government aids, and property tax credit programs. See the discussion in An Estimate of the State Intergovernmental Aid Costs of Tax Increment Financing, House Research Department (April 1986).

Virtually all communities of any significant size in Minnesota use TIF. Many of these communities have proportionately high tax bases and low levels of tax effort. Also, as Professor Huddleston has pointed out, cities with low mill rates in counties and school districts with high mill rates have the greatest incentive to use tax increment financing. These cities can provide the largest development subsidies at the lowest cost to the city. Cities with low mill rates are not generally the communities with low tax capacity and high effort levels or need for public services. Thus, TIF may actually work contrary to the goal of equalizing fiscal capacity of local governments.

More Efficient Use of Public Infrastructure. Tax increment redevelopment projects generally convert land to more dense uses. Low density residential and commercial buildings are replaced with more intense uses such as high rise residential or larger commercial developments. Generally, the project areas will already be served by public infrastructure--streets, highways, sewer and water. Alternative development sites in suburban or ex-urban areas in many instances require public investment in new infrastructure improvements. Thus, using public subsidies to encourage redevelopment and construction of new developments in already developed areas that are served by public infrastructure may result in more efficient use of existing infrastructure and may permit local governments to avoid the cost of new infrastructure. More dense land uses also may permit more cost effective transportation systems, such as lower levels of operating subsidies for public transit systems.

Each project, however, must be examined to determine whether this is actually the case. In some circumstances redevelopment projects may require replacement or substantial improvement of existing infrastructure that would be more expensive than the construction of new infrastructure at alternative sites. Furthermore, tax increment financing is increasingly being used by suburban communities to finance developments of raw land sites where soil conditions make development difficult. These sites may not be served by public infrastructure and encouraging development of these sites may result in demands for additional infrastructure improvements. In many instances these additional infrastructure demands will be financed, in part, with the increment generated.

As an alternative, developments could be required directly to pay for the infrastructure costs that they cause. For example, state law could require special assessments or other exactions equal to the full infrastructure costs generated by the development. Under this approach infrastructure costs would be reflected directly in the development costs of each competing development and the development with the lowest costs, all other things being equal, would be

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[26]Of the cities in the metropolitan area with populations of 5,000 or more, only eleven have not used tax increment financing.

[27]J. Huddleston, "Variations in Development Subsidies Under Tax Increment Financing," 57 Land Economics 371 (1981).

developed. This would "internalize" the public infrastructure costs and should lead to development of the most cost efficient development.[28]

Reducing the Social Costs Associated with Slums and Blight. A primary purpose of redevelopment projects is to reduce the social costs associated with slum housing and dilapidated commercial buildings.[29] For example, improving the quality of the housing stock and of commercial buildings may reduce crime levels, delinquency, health problems, and fires.

Three observations may be made regarding the extent of these social benefits of urban redevelopment. First, there is wide disagreement among analysts whether improvements in these social conditions result from urban redevelopment. In any case, most of the discussion has focused on the effect of improved housing conditions on crime, delinquency, illness and so forth. The link with commercial redevelopment, the primary use of TIF, is even less clear.

Second, the benefits are intangible. That is, they are hard to measure and compare with costs, even if one is convinced that they occur.

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[28]There are, however, substantial legal and practical difficulties with this approach. The United States and Minnesota constitutions only allow imposition of special assessments to the extent that the subject property is benefited by the improvements. Norwood v. Baker, 172 U.S. 269 (1898); Minn. Const. Art. X §1; Quality Homes, Inc. v. Village of New Brighton, 289 Minn. 274, 187 N.W.2d 555 (1971). Benefit is measured by an increase in the value of the property as a result of the improvement. City of St. Louis Park v. Engell, 283 Minn. 309, 168 N.W.2d 3 (1969). Many infrastructure improvements provide general, rather than special, benefits and thus may not be financed with special assessments. For example, a large suburban development may generate increased traffic flows that require expansion of the highway system. Yet the highway expansion may only result in a small increase in the market value of the development.

Even if the constitutional rules could be repealed or avoided, practical problems would be presented by the measurement of the infrastructure costs generated by a particular development. As a theoretical matter should this be done on a marginal or average cost basis? Should the straw that breaks the camel's back be required to purchase the new camel? How is infrastructure usage to be attributed to a particular development for improvements (such as highways) that cannot easily be metered?

These and other problems reduce the real world feasibility of charging developments for all of the public costs that they impose. Thus, despite the theoretical attractiveness of such a financing system, it still may be necessary to consider efficiency of public infrastructure usage in decisions to grant public subsidies to real estate development.

[29]Reduction of social costs was widely cited as a primary goal of the national urban renewal programs of the 1950s and 1960s and is examined in the major studies of those programs. However, it is less commonly discussed a focus for TIF redevelopment projects. In part, this may be due to the fact that TIF generally is not directed to provide housing for low income individuals but rather for either commercial development or middle and upper income housing.

Third, the discussion of the social benefits of urban renewal and redevelopment have focused on providing better housing for the poor. Higher quality housing for the poor, it is argued, will improve health and sanitary conditions, improve the performance of the residents' children in school, reduce crime and so forth. However, tax increment financing is used largely for commercial redevelopment and, this discussion of benefits is limited to redevelopment projects and thus excludes housing projects.[30] Thus, the social benefits are limited to those that are derived from better quality office and retail developments in center city or other developed areas or from having a more heterogeneous mixture of high, middle and low income residents of center city areas.

In sum, it is hard to assess in concrete terms the extent and the value of the social benefits of commercial or mixed use, redevelopment projects. Given this, a potentially important element of the cost-benefit equation must be left to the intuition or political judgment of policy makers.[31]

Expanded Employment Opportunities. A commonly cited goal of tax increment projects is to increase the number of "jobs" available to residents of the city. For example, Minneapolis's Tax Increment Policy cites goals of expanding job opportunities within the city, retaining industrial jobs, and expanding jobs for target groups.

From a state or national perspective, it is improbable that tax increment financing redevelopment expenditures increase total employment in the economy. Indeed, to focus on matters that are overwhelmingly determined by macroeconomic policies and management of the national economy would seem to be a misplaced function of local or state government.[32]

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[30]Redevelopment projects include mixed commercial and housing projects. Housing districts are limited to spending their increment revenues solely on providing low and moderate income housing. Many redevelopment projects include housing components; however, an impressionistic view suggests that these housing projects typically provide more moderate and upper income housing than housing for the poor. Most involve high rise condominium or apartment buildings with prices and rents out of the reach of the poor, unless federal rent subsidies are provided. For an extreme example of tax increment subsidized high income housing, see "The Cliffs offers luxury and service to renters who could afford to buy," Minneapolis Star and Tribune, 6/20/87, 1S, at 2S (tax increment project described as providing the most expensive rental property in the metropolitan area). If federal rent subsidizes are provided (as they are in many instances), it seems more appropriate to attribute the social benefits of better quality housing for the poor to the federal program expenditures, not tax increment financing.

[31]Weicher (who may be safely categorized as one who discounts the existence or value of social benefits) argues that most of the benefits should be reflected in higher land values or through lower service costs (i.e., lower fire and police protection costs). He therefore contends that to the extent that many of the social benefits are considered separately (from land values) benefits are double counted. Weicher, supra note 19, 35-37.

[32]It, nevertheless, has become a pervasive feature of the political landscape. In some sense, state and local government officials' political rhetoric about creating "jobs"--if viewed from the narrow perspective of expanding the aggregate employment level in the economy--seems akin to an effort

The "jobs" effect of tax increment redevelopment, as with the value of improvements to real estate, is to relocate jobs or possibly to modify the mix of available jobs. For example, more jobs may become available in center cities or more jobs of one type--industrial rather than service or vice versa--may become available.

Relocation of jobs may be a net benefit to the state, if the jobs that are relocated would have occurred outside of the state. It seems unlikely, however, that tax increment financing has much effect on the interstate competition for business expansion. Conventional wisdom has it that most commercial developments (office and retail) are tied closely to the location of their markets and thus are not much affected by the availability of development subsidies, land costs, tax rates or other similar forms of government intervention outside of their market areas. Some industrial firms, by contrast, are thought to be relatively footloose. However, TIF is largely used for commercial developments and thus would seem to be a small and probably insignificant factor in the interstate competition for business expansion.

The conventional wisdom may be wrong with the changes in the structure of the American economy, however. As has been widely observed, the economy is becoming increasingly service based. The expansion in communications capabilities and the reduction in costs make much of this expanding service industry more footloose than in the past. Nevertheless, the regional and national service providers still tend to cluster in larger business centers for better access to their principal clients.[33] For example, the large money center banks are unlikely to relocate the facilities and personnel that provide the national and international components of their services from the financial centers of New York, Chicago, Los Angeles and San Francisco except in extreme circumstances. Similarly, advertising agencies still are likely to cluster in cities where corporate headquarters and the entertainment and creative industries are located. Relocation or decentralization of such service industries seems most likely to occur where there are either special circumstances, such as regulatory

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to modify the weather through human action. Although a rain dance may have preceded a shower, the relationship was fortuitous, not causal.

State and local government actions do affect the location and types of jobs through regulatory, tax, public investment, and subsidization decisions. However, for each job "created" it is likely that other jobs are destroyed (relocated) or other jobs that would have been created are not. These sorts of effects are discussed in the text, but it must be noted that again they do not meet the more rigorous definition of public benefit--i.e., increasing the total income or wealth of residents of the state--except to the extent that the negative effects (the jobs destroyed) are located outside of the state.

[33]For a review of the economics literature that focuses on the factors affecting location decisions, see G. Mulligan, "Agglomeration and Central Place Theory: A Review of the Literature," 9 International Regional Science Rev. 1 (1984).

advantages or labor cost savings.[34] On balance, it seems unlikely that TIF is a very effective tool for attracting national and regional service industry away from other states.

Thus, it seems likely that most of the efforts of local government officials to use tax increment financing to "create jobs" is destined to be used in the competition for business expansions that otherwise would occur at other locations in Minnesota. Although this would not satisfy the definition of public benefit outlined above, it may meet a goal of the legislature to revive declining center cities or to make more jobs available to targeted populations, such as the poor, welfare recipients, or chronically unemployed.

Is TIF likely to further such goals? In large measure the answer to this question depends upon how well the subsidies provided are targeted either by the law or by local governments' practices. Since TIF is available for use by all cities and in both blighted and non-blighted areas and since there is a natural tendency for cities to compete for tax base capacity that exceeds its service costs, one reasonably can be skeptical that there will be much effect in shifting the location of jobs to the advantage of center cities or providing jobs for targeted populations of the disadvantaged.[35]

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[34]A classic example of special circumstances is the decision by Citibank (and later by other money center banks) to locate its credit card operation in South Dakota, where it could take advantage of the absence of a usury rate limit that would apply to its national operations.

Service industries are by their nature labor intensive and labor costs, rather than real estate costs, are likely to be a larger factor cost and location determinant. Note: labor costs need to be broken into two categories--(1) the cost of creative talent, such as executives, professional and creative types, and (2) "back office" type labor, such as clerical and administrative. The former seems much less likely to be subject to relocation; the difficulty being for the service business to attract the necessary talent. The latter, by contrast, is much more fungible and subject to the relocation. The Citibank example seems particularly relevant here, since most of the employees and operations involve clerical and administrative tasks.

[35]Indeed some of the original rationale for aiding center cities may no longer be valid. Originally suburban cities were largely "bedroom" communities, whose residents continued to work and shop in the business district of the center city, using government services in the process. Suburban cities are becoming much more self-contained with large business districts of office, retail, and industrial development. Given this, there are probably fewer external costs associated with suburban development--i.e., suburban residents probably use fewer center city services than they have in the past.

Public Costs of TIF Redevelopment Programs

The public costs of tax increment financing redevelopment programs are easier to identify and measure, than the benefits. There appear to be four major categories, the first three of which correspond to the major subsidies provided by TIF:

- Forgone property taxes on the development
- Forgone state income taxes on the TIF bonds' interest
- Lending of local governments' credit to private real estate development
- Relocation costs for current occupants of the development site.

Foregone Property Taxes, the Tax Increment. The major cost component of TIF projects is the tax increment, the foregone property taxes on the increased assessed value of the development that are used to pay development costs rather than for local government services. These costs fall on the city which decides to use TIF, as well as the county, school, and special taxing districts that would derive tax revenues from the increased value. The state also bears a share of the cost through the operation of the state intergovernmental aid programs.

As discussed above, the portion of the tax increment that is attributable to increases in the land values resulting from overcoming market inefficiencies or externalities should not be considered a public cost. However, the "but-for" test notwithstanding, the tax increment generated by the improvements (and by general market inflation) is a public cost. The capital that is invested in those improvements would be employed elsewhere in the economy and likely would generate property or other tax revenue.[36]

Foregone Income Tax on TIF Bonds. Interest paid on tax increment bonds generally is exempt from state and federal income taxation. Thus, a public cost of TIF is the income tax revenue that would be collected on the income yielded by alternative investments if TIF bonds were taxable or if TIF was not available

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[36]In the absence of tax increment, investors would not take their capital and convert it into gold or into currency and stuff it into socks or mattresses. The capital undoubtedly would be productively employed elsewhere in the economy.

Again, the issue is raised whether TIF diverts investment from another state, in which case it may not be an item of cost viewed from a narrow Minnesota perspective. As an alternative, the investment could be diverted from an investment which is taxed at a lower rate and thus the increment overstates the actual public cost. For example, the TIF may shift investment from equipment (which is exempt from property taxation) into real property structures which are taxable.

as a financing mechanism.[37]

The changes in the tax law made by the Tax Reform Act of 1986 will result in many new issues of traditional tax increment, redevelopment bonds being taxable, rather than tax exempt.[38] These changes also apply to the tax status of the bonds under the state income tax.[39] As a result, the amount of foregone state income tax revenues will decline as outstanding exempt TIF bonds are repaid.

Lending of Local Government Credit To Private Developments. In Minnesota, tax increment bonds traditionally have been general obligations of the issuing city, that is, the bonds are backed by an unlimited pledge of the city's property taxing authority.[40] The local government's general obligation pledge increases the security for the bonds, lowers the interest rate, and thereby permits a larger amount of improvements to be financed with the same amount of tax increment. In order to reduce the risk that a TIF district will require a general property tax levy to meet its obligations, local governments have undertaken many practices to shift some of the risk back to the private developer.[41]

There are several ways of measuring the cost of the local government's credit guarantee or enhancement. One is to look at the interest savings that results from the local government's general obligation by comparing the interest rates

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[37]Estimating the amount of foregone income tax revenues presents a series of methodological difficulties. If TIF bonds were not exempt, investors will shift to the investment that provides the next highest after-tax rate of return on their investment. Some of these funds, thus, will flow into other forms of tax advantaged investments. As a result, the cost may be less than the amount of income tax that would be paid if TIF bonds were taxable to their holders. Since the Tax Reform Act of 1986 dramatically reduced the universe of tax advantaged investments, this will likely be a smaller problem in the future.

[38]See generally J. Michael, "Tax Increment Financing in Era of Tax Reform" 21-47 (paper presented at Hamline University seminar, "Tax Reform in Minnesota: Policy Options for the Future," October 31, 1987) for a discussion of the limitations on the use of tax exempt TIF bonds for redevelopment.

[39]Laws 1987, chap. 268, art. 1 §§11-13.

[40]1985 data show over $500 million of general obligation tax increment bonds as compared with $165 million of tax increment revenue bonds. In most instances the revenue bonds were issued to refund general obligation bonds after the developments were completed and there is little credit risk. For example, of the $165 million total over $140 million consists of refunding bonds issued by the City of Minneapolis to refund a number of separate issues of general obligation bonds.

[41]For example, it has become common practice for cities to require developers to enter into assessment agreements whereby the developer agrees to a minimum market value for tax purposes.

on comparable revenue bonds.[42] Another alternative is to examine what a financial institution, such as a large bank or insurance company, would charge to provide a similar credit guarantee in the form of a letter of credit, bond insurance, or other instrument.

Relocation Costs. Redevelopment projects frequently involve acquiring properties that are occupied housing units or are in use by businesses. State law in some, but not all, instances requires that compensation be made to these occupants for the cost of relocation.[43] These costs generally reimburse for moving expenses--i.e., the cost of moving a business or home and perhaps an additional small bonus in the case of some residential tenants. However, they do not generally cover the cost to a business of the loss of good-will or market access that was tied to the original location.[44] As a result, the businesses may suffer uncompensated loss of profits. Similarly, residential tenants may have difficulty finding other housing units that provide equivalent value in terms of quality of the housing stock and locational advantages for the price. As a result, these costs are borne by the occupants of the property and are not accounted for as a part of the financial costs of the development.[45]

Creating Incentives to Miscalculate the Costs and Benefits of Tax Increment Financing Projects

Finally, it must be noted that two characteristics of tax increment financing provide incentives for local governments to miscalculate the net public benefit or cost of TIF projects. First, public expenditures on TIF projects are not considered as part of the overall local government budget process. Second, the costs and benefits of TIF projects extend beyond the boundaries of the local government units that must approve the use of TIF. These factors apply to all TIF projects, not just redevelopment projects.

Tax Increment Financing is "Off-Budget." The budget is the basic framework in which a governmental unit makes decisions about what it should be doing, i.e., to which activities it should allocate its scarce resources. As the Assistant Comptroller General of the United States has observed: "The budget is the only reasonably comprehensive framework available in which to make decisions about

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[42]This approach assumes that the bond market is efficient in evaluating the risks involved. Some may contend that the city and developer are better able to assess the risks of a development and thus can provide a credit guarantee more cheaply than the bond market.

[43]See, e.g., Minn. Stat. §§472A.12, 117.50 to 117.56 (1986).

[44]See, generally, Weicher, supra note 19, at 27-28.

[45]It should be noted, however, that some similar costs occur in non-subsidized redevelopments. Owners of property will not suffer such losses because they will insist upon adequate payment for their property to compensate for relocation, but tenants of property that is sold and demolished or rehabilitate may.

what government should be doing, and how."[46] By considering most, if not all, of the government's spending alternatives together, policy makers must make judgments about the relative merits--the net public benefits--of each of the competitors for limited resources. Although the programs with the highest public benefit may not always win in this competition, policy makers and elected officials must weigh the relative merits of the competing programs. If for "political" or other reasons a program with lower net public benefit receives funding, at least the decision makers consciously decided to do so to the detriment of other alternatives with higher yields of public benefits.

TIF spending is off-budget. Tax increment financing decisions are make outside of the budget setting framework. In part, this result is inherent in the structure of the financing mechanism. The flow of the revenues to pay for project costs does not come through the general fund, but rather indirectly as a dedicated stream of payments.[47] The law allows tax increment projects, districts, and expenditures to be authorized at any time during the budget cycle. The use of increment revenues for general government purposes is not permissible. Thus, local government officials are discouraged from comparing the relative benefits of constructing, say, a new fire station and subsidizing a shopping center or housing development.

As with any tax expenditure program, because TIF spending is off-budget one would expect that local government officials will not examine its merits as rigorously as programs subject to the competitive pressures of the budget process. Project's costs and benefits simply will not be weighed as carefully and compared as scrupulously with alternative uses of the resources. In short, this will create a bias in favor of more TIF spending than otherwise would occur.

One could argue that most local government spending for public capital improvements is also off-budget and, thus, tax increment financing is consistent with this practice. Capital spending generally is financed with the issuance of bonds, not general revenues, and decisions are made separately from the general operations budgeting process.

Two factors suggest that regular local government capital spending decisions are subject to at least a de facto budget evaluation process, unlike TIF. First, many local governments, especially larger units, develop a capital budget for making decisions on capital improvements. Tax increment projects are rarely, if ever, subject to such a process. Second, bond obligations issued to finance regular capital improvements must be repaid out of general tax revenues and

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[46]H. Havens, "Integrated Evaluation and Budgeting, 3 Public Budgeting & Finance 102 (1983).

[47]To make TIF "on-budget," one would simply have to repeal the capturing of increased assessed valuation and require each local government unit to impose the higher tax rates necessary to repay bonds financing project costs out of their general funds, as they would for bonds financing a public building, streets or roads.

become a budget item in the regular general operations budget. Thus, policy makers generally will realize that authorizing new capital spending projects constrains their ability to allocate resources to other purposes unless they are willing to raise the general tax rate directly. The same is not true for TIF.

Spillover Costs and Benefits. Many government programs have spillover effects on other jurisdictions. They impose costs and sprinkle benefits that extend beyond the borders of the governmental unit. For example, the effluent from a municipal sewage treatment plant affects property owners and those who live downstream, but outside of the municipality. Discharge of noxious or hazardous waste imposes costs on those downstream; government expenditures to reduce or neutralize those discharges benefit those downstream.

The financing structure of TIF inherently imposes substantial spillover costs and may confer benefits on other jurisdictions.

Although cities primarily determine whether TIF will be used in Minnesota, the costs of the expenditures are shared by overlapping taxing districts--the county, school district, and special taxing districts--and by the state. These jurisdictions either temporarily forgo increases in property tax base in order to provide TIF subsidies or pay increased amounts of aid because of TIF.

In fact, it is likely that the costs of TIF fall much more heavily on overlapping taxing districts and the state than on the city that decides whether to grant TIF subsidies. One of the primary effects of and rationales for tax increment financing is to shift the location of new development. TIF is commonly justified as a way of stimulating redevelopment of center city sites that have higher development costs than unimproved vacant sites outside of the city. Thus, tax increment financing shifts the location of new tax base. The alternative sites that would have been developed are frequently outside of the city, but they are less likely to be outside of the county or the state, both of which comprise larger geographic areas. In many cases, from the perspective of the city the "but-for" test works--the city is not giving up tax base that it would have had, since the development would have occurred at locations outside of the city. However, the same is less likely to be true for the county and even less likely for the state.

By contrast, the benefits generated by TIF expenditures will tend to be limited to the city that is authorizing the use of tax increment financing. It is true that if land values are increased or if development is shifted or relocated from alternative sites outside of the school district and county, the county and school will benefit. However, the county and school are contributing by temporarily foregoing the developments' tax revenues while still providing governmental services. In short, spillover costs are a given with TIF projects, but spillover benefits are much less likely to occur or if they do, they will tend to be smaller.

In deciding whether to use tax increment financing city officials will naturally focus upon the costs to the city. After all, their official responsibilities

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[48]Of course, if the bonds are general obligations, once the bonds are issued the budget item cannot be changed since the governmental unit is legally obligated to repay the bonds.

extend only to the city and the voters that elect them care primarily about their own interests. Thus, in evaluating projects there will be a natural tendency to focus on the costs to city taxpayers and the benefits to city residents. At the same time, the costs that are exported to the state and to county and school district taxpayers (located outside of the city) will be under-counted or overlooked altogether. The result is that important elements of the cost benefit equation will be ignored.[49] In general, this should create a bias for financing more projects since spillover costs will systematically exceed the small amount of spillover benefits.

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[49]For example, assume that a city is considering approving a tax increment financing district. The total mill rate (city, county, and school) in the city is 100 mills. The city's mill rate is 25 mills, the county's 30 mills, and the school district's 45 mills. Assume that the city comprises one-tenth of the assessed value of the county. For convenience assume that the school district funding is all state equalized, i.e., any loss of tax base will simply increase state aids and will not affect the actual school mill rate.

In this example, the city taxpayers will bear approximately 28 percent of the cost of providing TIF subsidies, if an equivalent value development would have occurred in the city without the use of tax increment financing. In that case the city mill rate provides 25 percent of the subsidy (25 of 100 mills) and city taxpayers provide for an additional 3 percent through the county mill rate (one-tenth of 30 percent). The remaining 72 percent is paid by taxpayers located outside of the city. By contrast, if the use of TIF displaces development that would have occurred outside of the city but in the county, then city taxpayer pays only for 3 percent of the cost of the TIF expenditures (i.e. their proportionate--one-tenth--share of the county subsidies).

One expects that city decision makers may be willing to authorize the use of TIF if the development provides benefits to the city that exceed 28 cents for every dollar spent in the first instance or even lesser amounts in the second instance. The tendency to stimulate higher levels of TIF spending and to approve projects that have negative net public benefits is apparent.

CONCLUSION

Benefit-cost analysis by providing a method of measuring the net benefit of a project is a widely accepted method of evaluating public expenditure programs. The budget process provides a systematic mechanism for comparing the relative benefits of different programs and setting spending priorities among them.

The "but-for" test provides no assurance that the public benefits of TIF projects exceed the costs. The statutory "but-for" text is so loosely worded that it can be read so that virtually any TIF project will satisfy it. Even a stronger "but-for" test makes no guarantee that public benefits exceed the costs and will misdirect the attention of local policy makers away from the task of weighing the costs and benefits of redevelopment projects and then comparing them with other uses of the resources.

Redevelopment projects have a series of potential benefits: expansion of the local property tax base, improvement of the fiscal condition of local governments, more efficient use of public infrastructure, and reduction of social costs.

When viewed from the perspective of the state, two commonly cited benefits of TIF redevelopment projects--the expansion of the property tax base that results from construction of improvements (buildings and so forth) and the employment opportunities resulting from the development--should not be considered as generating public benefits. Tax increment subsidies change the location or the type of new investment and employment positions, but do not expand the overall supply when viewed from a state or national perspective.

The primary costs of TIF redevelopment projects include: the foregone property tax revenues, the foregone state income tax revenues on tax exempt TIF bonds, the costs of locally provided credit enhancements, and relocation costs.

Finally, the financial structure of TIF projects encourages local governments to miscalculate the actual public costs and benefits. TIF spending decisions are made outside of the normal operating and capital budgeting processes. TIF spending decisions are made by local governments that bear only a small portion of the cost of providing the subsidies, but nevertheless reap most of the benefits. Both of these factors encourage more TIF spending than otherwise would occur, since local governments will tend to under-count the public costs of TIF projects.