

POLICY REPORT

The Iowa Policy Project

Child & Family Policy Center

April 2003

Tax Increment Financing in Iowa: What Should Be Done?

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Much attention has been given recently to problems with Tax Increment Financing in Iowa. The Farm Bureau has called for an end to TIFs, while the League of Cities has proposed some modest reform measures. Assertions have been made that TIFs are ineffective, and claims have been made that they are an essential tool for economic development. Meanwhile, the valuation under TIFs has increased more than five-fold in the last decade, and the state will spend \$28 million in fiscal 2003 just to fund additional state aid to school districts caused by the TIF value lost to those districts. This amount is expected to increase substantially each year.

In all of this debate there are some fundamental questions about TIFs that have yet to be raised, and there are a number of specific problems with current TIF law that have not been addressed. In this report we pose those broader questions and catalogue at least some of the specific problems. We then suggest some changes in TIF law that would address those problems.

The Idea of Tax Increment Financing

The problems with Iowa's current TIF law, and the potential benefits from a reformed system, become clearer once one understands the basic rationale for TIFs. TIF was originally conceived as a method for "bootstraps" financing of public investment. It evolved out of the urban renewal laws of the 1950s and 1960s and so was focused on the redevelopment of "blighted" urban areas. The belief was that such areas would be unlikely to be rejuvenated on their own without an infusion of public capital. If such public investment — in streets, streetscaping, parks etc. — succeeded in jump-starting private redevelopment of the area, then the expanded property tax base would generate sufficient revenue to repay the city for its investment. The city project would be self-supporting; hence it was "bootstraps" financing.

But why was a new approach to financing needed? Why wouldn't cities undertake such investment anyway, if it paid for itself? In some circumstances, they would. The argument, however, is that cities would underinvest in such projects because they would capture only a portion of the benefit in increased property taxes. The majority of the revenue from the new property would go to overlying jurisdictions taxing the same property tax base — school districts, counties, community colleges, special districts. The core idea of TIF is that it would help the city to undertake potentially risky investment in blighted areas by allowing it to capture all new property taxes from the increased property tax base to pay off the investment. The city and other overlying jurisdictions would benefit in the long run by the additions to the tax base that would not have occurred but for the city-directed investment. But first, the city would be allowed to recover its costs.

This is a simple and straightforward argument, one that appeals to both fairness and to efficiency. It is the cities, after all, who must play the lead role in redevelopment efforts in declining downtowns or distressed neighborhoods, not schools or counties. TIF merely creates the mechanism for cities to reduce their risk by augmenting the revenue stream dedicated to repaying the bonds the city issues to finance its projects. Everyone benefits in the end.

Public intervention in the redevelopment process through TIFs was justified, in the language of economists, by a failure of markets. In blighted areas, private redevelopment is thwarted by the neighborhood effect. It is difficult for investors to recoup the costs of rehabilitating properties in such an area because the deteriorated condition of the neighborhood will depress property values generally. In short, no one will pay enough rent to cover the costs of rehabilitation if they still have to live or work in a blighted neighborhood. In such instances the public sector must take the initiative in reversing neighborhood decline in order to create the conditions where private redevelopment can once again be profitable.

It is important to recognize also that TIFs were intended to be a financing tool that served a larger process of revitalizing neighborhoods or communities. This process, to be effective, requires long-range planning, and it requires the involvement of the residents of those neighborhoods and communities to ensure that the redevelopment process actually benefits them.

Let's recap the basic principles of this classic, redevelopment TIF system:

- (1) The city identifies a blighted or economically distressed neighborhood or business district in which private investment has been lacking and is unlikely to be forthcoming, and designates it a TIF district.
- (2) The city develops a plan for the redevelopment of the district.
- (3) The city undertakes investments in public improvements in the area in order to jump-start private redevelopment efforts.
- (4) The city issues bonds to pay for these investments.
- (5) The bonds are retired from the property tax revenues from the increment in value within the TIF district. The increment is defined as the increase in total taxable valuation that occurs in the district subsequent to designation as a TIF. The valuation prior to the creation of the TIF project is the base year valuation. Almost all property tax revenues on the increment, including regular school and county taxes as well as city taxes, are diverted to the repayment of the TIF bonds. The only exception is property taxes for debt service.
- (6) When the bonds are retired, the TIF revenues revert to the overlying taxing jurisdictions and the TIF district ceases to exist.

TIFs under the classic system are created to finance a particular project, although that project could entail a number of elements phased in according to the plan. An entirely new project, even in the same area, then requires establishing a new TIF district, or at least establishing a new base year. The reason for this is simple. The public project is supposed to generate private investment, since that is the whole reason for allowing TIFs in the first place and is the only rationale for allowing a city to use other jurisdictions' property tax revenue to finance a city project. Those other jurisdictions will eventually enjoy a larger tax base.

Let us consider an example: Suppose the city establishes a TIF in 2000 and issues bonds to finance major street and utility improvements and build a neighborhood center as the focal point for a rejuvenated neighborhood. The TIF bonds for those improvements are retired from the increases in value that occur after 2000 within the TIF district, because those increases in value can reasonably be attributed to the public project. Five years later, in 2005, the city decides to invest in another project in the neighborhood, which in turn will further stimulate private growth, it is hoped. But only the increment that occurs after 2005 can possibly be attributed to the investment that the city made in 2005, so for purposes of retiring the 2005 TIF bonds the base year must be 2005.

The only justifications for allowing cities to divert other jurisdictions' property tax revenue without their consent are if there is a reasonable expectation that private redevelopment will be forthcoming, that it would not occur but for the city's investment, and that it would benefit people living and working in those neighborhoods or communities. In such circumstances, the city is creating the tax base that will eventually benefit the other jurisdictions, and that tax base would not be expected to be created without it.

Do TIFs Work?

While the logic behind tax increment financing is straightforward, its implementation is more complicated. The real, underlying purpose behind TIFs is really two-fold: (1) to increase economic activity that would not otherwise have occurred and that benefits the economy of the jurisdiction as a whole, and (2) to improve the lives and conditions of those people living or working in the blighted neighborhoods or declining communities.

On the first point, TIFs may simply publicly finance investments that would have occurred in the jurisdiction in any event (although not necessarily in the blighted area). The ensuing increase in property tax valuation would have occurred anyway, but now it is the city that draws all the benefit, and schools and other users of the property tax funds are slighted. This violates the tax principles of accountability and fairness, particularly as schools and other public users of the property tax are provided no representation in the decisions to establish TIFs.

On the second point, if TIFs are used to finance "gentrification" efforts that displace residents in blighted neighborhoods to their detriment, TIFs can actually do harm. Moreover, if they do not noticeably improve the lives of those within the blighted areas (through better, more affordable housing, through new opportunities for employment in the redeveloped commercial or industrial areas, in greater access to quality and affordable goods and services), they cannot be justified on the grounds of truly addressing one of the implicit purposes: to reduce blight and improve the lives of residents.

It appears, in fact, that we actually know very little about how effective the original, blighted area TIFs have been in achieving urban revitalization objectives in Iowa in a way that genuinely benefits area residents. There are several important questions here that need to be answered with regard to such TIFs historically in Iowa:

- (1) Was Tax Increment Financing necessary for the redevelopment to occur, or is it likely that it would have happened anyway?
- (2) Who benefited from the development that did occur? Was there displacement of residents? Was there gentrification and rising rents that priced existing residents out of the neighborhood?
- (3) How have the blighted neighborhoods where TIFs were used fared since the TIF districts were created? What has happened to property values, incomes, poverty rates, and crime rates, for example?
- (4) Were there other tools that would have been equally effective, or more effective, in revitalizing those areas?

While TIFs have been employed widely in Iowa both in blighted areas (their original purpose) and for other purposes, little actual detailed analysis has been conducted to determine if they actually stimulated investments that would not have occurred otherwise or produced gains for the residents with the most at stake in seeing blighted areas improved.

As for economic development TIFs, other questions arise. Here there need be no finding of blight or decline. The failure of markets to bring about revitalization, through the neighborhood effect, need not be demonstrated. The rationale, instead, is simply “economic development,” which has come to mean the creation of jobs and the expansion of the tax base. Here the presumption of those who use and defend economic development TIFs is that the development that occurs with the assistance of TIFs would not have occurred but for the TIFs. In the absence of blight or other neighborhood or community impediments to development, this is a more difficult position to defend. There is a large body of scholarly research, in fact, that makes it clear that many, if not most, subsidized investments would have occurred anyway. This is particularly likely to be the case for commercial projects, especially retail, where location is of prime importance.

It can be the case for industrial projects as well, as was evidenced in the case of the TIF provided by Muscatine County for IPSCO steel. When the TIF was challenged in court, the company was asked whether a finding against the TIF would change their plans for building the plant, and their answer was “No, we will go ahead anyway.” In other words, the TIF did not affect their decision to build. A thorough analysis of the use of economic development TIFs would have to ask the fundamental question of how we can more effectively limit TIFs to instances where the TIF-financed subsidy actually makes a difference to a firm’s investment decision. If TIFs are too easy to use, and appear to be cheap to the cities and counties that use them, there is a high likelihood that they will be overused at considerable expense to taxpayers.

Specific Problems With Iowa’s Current TIF Law

The use of TIFs has expanded well beyond its original purposes because of the looseness of the law that allows cities to divert other jurisdictions’ revenues from increased private investment that has nothing to do with the city’s original borrowing for a public project. If that private investment would have occurred anyway then the underlying rationale for a TIF diversion is simply not there. The two examples below show how this happens.

Example 1: ABC corporation announces that it will build a major commercial facility in an older neighborhood on the fringe of Prairie City’s central business district in February, 2000. Ground is broken for the facility in August and it is scheduled for completion in the summer of 2001. In the spring of 2001, Prairie City designates a 10 block area around the new facility as a TIF district and announces that it will issue bonds to finance a program of street and sidewalk improvements in the surrounding area. The base year of this TIF district becomes January 1, 2000, at which time there was no new ABC facility on the tax rolls; therefore the entire valuation of the ABC facility, when finished, becomes the increment.¹ Taxes on the ABC facility, instead of going to all the overlying jurisdictions, go to the TIF fund to pay for the city improvements. Yet it would be more accurate to say that the ABC investment caused the TIF than to say that the TIF caused the ABC investment. There is no rationale for diverting these taxes to the TIF. The city has just found a way to use TIF to make school and county taxpayers help pay for city infrastructure improvements that could and should be financed entirely by the developer, or with city bonds. Yet this is entirely within the law.

Example 2. Prairie City agrees to invest \$10 million in infrastructure improvements in order to accommodate a new industrial facility that would not be financially viable without the public improvements

¹ Under Iowa law, the base valuation is the valuation as of January 1 of the calendar year immediately preceding the calendar year in which the TIF debt or other obligation is incurred.

and that the city hopes will be a catalyst for further development. The city designates a TIF district encompassing the facility site and issues \$10 million in bonds. The facility and infrastructure are built, and all the increment in value generates taxes to repay the city. So far, so good. But just as the city's bonds are about to be retired, the city expands the TIF district and issues \$50 million in debt to build a civic center on adjoining property. It announces that the original TIF will be used to retire this \$50 million bond issue for the civic center. Again, there is no pretense that the civic center project produced the increment in value that will be used to pay for it. While the original TIF may be justified, it subsequently becomes simply a cash cow for the city to finance a succession of projects that should instead be financed by city bonds repaid entirely from city property taxes.

There are other problems that can arise with TIFs under Iowa law:

- (1) It is possible for school district A to see its revenues diverted to pay for a project that will stimulate private development and hence tax base in school district B. This is because there are no limits on the size of TIF districts and no requirements that the properties be related economically or even contiguous in any real sense. A single TIF district can contain parts of two or more school districts.
- (2) It is possible to use TIF revenues to finance development projects that have little or no prospect of generating additional tax base because the project that will be forthcoming will be not-for-profit and exempt from property taxation and there is little prospect of that project triggering investment that will go on the tax rolls.
- (3) It is possible to use TIF to get around limits on Iowa's tax abatement law instead of using them to finance any public investment at all: The city simply declares that it is creating an obligation to repay a private business for a portion of its property taxes, and asserts that this "obligation" is TIF debt. These are tax abatements by another name, but they have no limit: A city could abate 100 percent of the taxes for 20 years if it liked.

Another set of problems associated with Iowa's Tax Increment Financing law has to do with the absence of accountability. TIF law allows cities and counties to circumvent referendum requirements. The classic use of TIFs is to finance public improvements that generally would be found in the list of "essential corporate purposes" in the Iowa Code, and debt issued for such purposes does not require voter approval in Iowa.² Debt used to finance "general corporate purposes" (anything not on the list of essential corporate purposes) does require a referendum.

Under the TIF law, all TIF debt, regardless of purpose, is defined as an "essential corporate purpose" and so can be issued without voter approval. (While citizens can petition for a referendum, they have only 10 days to do so and the public notice requirements are so minimal as to be nonexistent; no one knows they have this right.) Thus we have a mechanism whereby a city can fund a project of dubious value without any approval required of its own citizens, and without any approval from the other jurisdictions whose tax revenues will be diverted. In fact, it is possible to issue TIF debt in the form of "annual appropriation debt" that technically is not debt at all and so does not even come under the constitutional limits on

² Section 384.24 of the Iowa Code defines essential corporate purposes to include most infrastructure (streets, sidewalks, street lighting, sewage collection and treatment, solid waste disposal, storm water drainage, pollution control facilities, flood protection, water mains) as well as police and fire equipment, cemeteries, ambulances, acquisition and demolition or rehabilitation of dilapidated buildings, and the reconstruction (but not acquisition or new construction) of dams, airports, and parks.

indebtedness, no less referendum requirements. Such lack of accountability is a formula for fiscal irresponsibility.

TIF Reforms

To address some of the problems with TIFs as we have identified them, we propose that Iowa TIF law be reformed along the following lines.

Ensuring that TIFs Serve a Public Purpose

- Tax increment financing should be used only if: (a) the investment serves a public purpose, (b) a legitimate finding of blight can be made, and (c) subsequent private redevelopment would not reasonably be expected to happen “but for” the public investment. There must be a reasonable expectation that the public investment itself will cause an increase in the property tax base. The burden of proof should be on the city and the private developer to satisfy the “but for” requirement, as is done in some state economic development programs.
- There should be a showing that a TIF in a blighted area will benefit the residents of that area. In particular, TIFs should not be used to finance gentrification of a neighborhood that forces local residents to move or forces rents up beyond affordability to current residents. TIFs should spell out how that benefit will occur — in such areas as improved housing quality and affordability, improved economic activity and employment opportunity, and improved access to quality and affordable services.
- Any TIF project that will displace residents should be put to a referendum, regardless of the nature of the public investment, and the project should be required to provide replacement housing for such displaced residents of a kind and location satisfactory to those residents. Existing residents and businesses should be involved from the beginning in the planning process for redevelopment of any TIF area.
- The base period valuation for purposes of calculating the increment available to retire TIF bonds should be the valuation as of the January 1 nearest to the issuance of TIF debt (that is, the January 1 immediately preceding or immediately following, not the January 1 of the previous year).³

Limiting TIFs to Prevent Overuse

- There should be a requirement that TIF districts be compact, and that the property to be included within a TIF district be contiguous. All the property within a single TIF district should be in the same tax administration district.
- No more than a certain percentage of a city’s total land area or total valuation should be designated as a TIF district.
- All TIF areas should expire in 15 years.
- TIF should not be used to finance tax abatements, which are already allowed under other sections of the Iowa Code.
- Base valuation should be increased each year by the general rate of inflation in the value of properties within the TIF area, by class of property, as is done in Minnesota. This protects other

³ Even this restriction by itself does not prevent situations where a private project undertaken, say, in February is part of the increment for TIF debt issued in May. Still, it would considerably narrow the scope for abuses of the type given in example 1 above, combined with strengthened “but for” requirements.

jurisdictions from reductions in the real value of the base and ensures that the increment includes only new construction or rehabilitation.

Enhancing Accountability and Democratic Process

- TIF projects should be financed only with actual indebtedness, and that indebtedness should be considered a general obligation of the city, subject to constitutional debt limits.
- All TIF debt should fall under the same voter approval requirements as other general obligation debt; i.e., if it is not for an “essential corporate purpose,” there should be a referendum, and provisions allowing for citizens to petition for a referendum should be brought to public attention in public hearings in a timely fashion.

Limiting Use of Economic Development TIFs

- A provision could be made for use of economic development TIFs, defined as a TIF where there is no finding of blight or where the project entails a subsidy to private development rather than the financing of public investment. However, economic development TIFs should be allowed only to the extent that TIF financing is approved by the other jurisdictions involved. Diversion of school revenues to repay the TIF bonds can occur only to the extent that the school board approves, and similarly for other jurisdictions.
- Any private project financed through the economic development TIF mechanism should be required to satisfy the same criteria as in Iowa’s New Jobs and Income Program. That is, the firm being assisted must pay a certain wage level, must pay 80 percent of the cost of health and dental insurance for all full-time employees, and must meet at least three of seven additional requirements. Furthermore, the firm should not be a violator of labor law, environmental law, or work safety law.
- Assistance under an economic development TIF should not be allowed for any firm relocating from elsewhere in Iowa.
- Economic development TIFs should not be allowed for retail uses. In the absence of neighborhood blight, there is rarely a case that can be made for public subsidy of retail development. We all know the adage, that real estate is all about “location, location, location;” it is not about “taxes, taxes, taxes.” Retail development outside blighted areas will not pass the “but for” test, nor will most retail activity satisfy the wage and benefit standards.

If reform measures are instituted, a moratorium should be placed on TIFs and issuance of TIF debt and all existing districts should be sunsetted as of the date the current debt is retired. Existing TIF districts should have to be reconstituted under the new law in order to finance any further projects.

At the same time, we believe that a more detailed review and analysis of prior TIF activities be conducted regarding their achievement of the public purposes for which they were designed, and the elements or characteristics that contributed to or subverted those achievements. They should be examined for the degree to which they can reasonably be expected to contribute to reducing urban blight, in particular, in the context of the other public policies to achieve that purpose.

Conclusions

The TIF system in Iowa is fraught with problems. Some of these are due to quite specific features of the current law, and could be remedied by changing that law. There are also some more fundamental problems. TIFs have been used to finance residential development that contributes to urban sprawl, raises costs for the region's taxpayers through increased investment in highways and reduced environmental quality, and puts increased demands on the schools while denying school districts the additional funding base to pay for those schools. TIFs have been used to lure firms from one part of Iowa to another, or from a city to its suburbs.

The availability of TIFs encourages cities to engage in economic warfare with one another. One city's "creative" use of TIFs causes neighboring cities to respond with expanded use of TIFs for fear of losing out in the competition for new business investment. This economic warfare results in the proliferation of TIFs, with county and school district taxpayers (and state taxpayers, through the school aid formula) the losers.

Many parts of the country are recognizing the need for regional solutions to problems of urban decline and urban sprawl, and regional cooperation is being embraced as a more cost effective approach to economic development in metropolitan regions. Some have called for a merger of city and county government in Polk County, or for regional tax base sharing. Tax Increment Financing, it should be recognized, is the exact opposite of tax base sharing, for it allows a city to capture, for a time, tax base that would otherwise have to be shared with the overlying governments. We should be asking whether this is the right approach to be taking to economic development in Iowa's metropolitan areas.

We should also be asking: What can the TIF mechanism accomplish that cannot be accomplished by other financing tools already available to local governments, tools that do not suffer from the same lack of accountability and that do not pit cities against counties and school districts? And we should be asking whether TIFs are the right tool to revitalize Iowa's urban neighborhoods that remain poor, segregated, and blighted.

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This report, and a two-page summary, are available to the public, free of charge, at www.iowapolicyproject.org.