February 16, 2016

Ken Nordvedt
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Dear Prof. Nordvedt:

I am writing concerning "The Dark Side of Tax Increment Financing," the statement which you provided to the Revenue and Transportation Interim Committee last November. As I explain below, I believe that an important claim you make in that statement – that the designation of a TIF will necessarily lead to an increase in property taxes outside the TIF district – is in error. While such tax increases can indeed happen, they are not inevitable. Under realistic conditions that are in fact likely to prevail, designation of a TIF can *reduce* the rate at which taxes would otherwise increase elsewhere in the taxing jurisdiction.

I take it that what we should be concerned with is the impact of TIF designation on what would *otherwise* be the growth of taxes on *existing* property outside the TIF district. Taxes paid by property owners in the area outside the TIF would typically be growing even without the TIF designation, and what is of interest is the impact, if any, of TIF designation on the rate of that growth. Also, any increase in taxes in the area outside the TIF that results solely from the addition of newly taxable property is not of interest, in the sense that it does not represent an increase in the tax burden on any existing property.

Consider a city that is contemplating TIF designation for a particular neighborhood. Typically, such neighborhoods are underperforming economically, and taxable value of the properties within them is appreciating more slowly than it is in the rest of the city. This differential growth in taxable value implies that the tax base is shifting out of the candidate neighborhood and into the rest of the city, and that the area outside the candidate neighborhood will, even without TIF designation, be paying a growing share of total tax collections. Taxes in the area will be growing more rapidly than in the city as a whole, and the rate of growth of taxes will be greater, the greater the rate of growth in

taxable value in that area relative to the rate of growth of taxable value in the candidate neighborhood itself.

TIF designation is equivalent to freezing the taxable value of property in the candidate neighborhood; i.e. the rate of growth of taxable value in the TIF is now, in effect, zero; any increase in value will be used to generate the TIF increment. In this situation, what happens to the growth of taxes outside the TIF district will depend on what was happening before the TIF was formed.

Consider first that prior to TIF designation, taxable value of existing property in the candidate neighborhood was appreciating, albeit less rapidly than in the rest of the city. Freezing taxable value in the TIF means that the shift of the property tax base to the rest of the city is accelerated, and taxes on existing properties outside the TIF will increase more rapidly than they otherwise would have. I believe that this is the effect you identified in your statement to the committee.

But now consider the situation in which taxable values in the candidate neighborhood were stagnant prior to TIF designation. The tax base and tax liability were already shifting to the rest of the city, and since taxable value in the candidate neighborhood was already frozen, i.e. stagnant, freezing it through TIF designation will have no effect. Taxes in the rest of the city will increase at the rate they did before the TIF was formed.

Finally, consider the situation in which the candidate neighborhood was “blighted” and taxable value was declining before TIF designation. Due to legislative mitigation of reappraisal, this will commonly occur in areas where market values are growing at below average rates. Such areas obviously impose a significant burden on the rest of the community, which is required to pick up a larger share of the total tax liability as the share paid by the blighted area declines. In this case, the TIF, if it is successful, will arrest this shift in tax burden and taxes in the area outside the TIF will grow less rapidly than they otherwise would.

There are clearly neighborhoods in most cities in which property values, and in particular, taxable values are in decline. These neighborhoods constitute a growing burden for taxpayers in other parts of the city as the taxes they pay decline without a commensurate, or indeed, any, decline in the cost of providing services to them. Cities typically choose neighborhoods of this type to become TIFs, and when successful, such TIFs arrest neighborhood decline and the shifting of tax burdens onto more economically successful parts of the city.

My characterization of the types of neighborhoods that get converted to TIF districts is based on conversations with local government officials and planners (for which I am grateful). I wish that there were more systematic data available to corroborate it, and indeed developing such data might be a useful thing for the committee or the

Department of Revenue to do. It does seem to me, however, to be an important factor to consider in characterizing the impact of TIFs on taxpayers in the surrounding area.

Sincerely,

P.S. I began thinking about the point I raise here by doing a little algebra. For your information, I enclose a note showing that work.

Electronic copies:
Members of the Revenue and Transportation Interim Committee
Ed Caplis, Montana Department of Revenue
Chris Behan, Missoula Redevelopment Agency

Note: Impact of TIF Designation on Tax Growth in Surrounding Areas

Assume we are looking at a city that consists of two geographic areas (H and L) within its boundaries, with taxable values appreciating more rapidly in H than in L, so L may be considered a candidate for a TIF district. Let the taxable values of the property in these two districts in year 0 be H_0 and L_0 respectively, so total taxable value, TV_0, equals H_0 + L_0, and let the rates of appreciation in property in the two districts be r_H and r_L respectively; $r_H > r_L$. Finally, let R_0 be the maximum revenue that the local government and school district can raise under MCA 15-10-420 and the school funding formula.

We are interested in the taxes imposed on properties in H (outside the potential TIF district), which will equal those properties' share of total taxable value times total revenue to be raised. Let c_0 be that share, so $c_0 = H_0/(H_0+L_0)$. Then area H taxes (T_H) are given by

(1) $T_{H,0} = c_0*R_0$

In the following year, year 1, we have

(2) $T_{H,1} = c_1*R_1$

The percent change in taxes paid by properties in area H, call it g_{TH}, is

(3) $g_{TH} = (c_1*R_1/c_0*R_0) -1.$

Revenue in year 1 equals revenue in year 0 increased by the percentage allowed under 15-10-420 (half the average annual rate of inflation in the CPI in the past three years) and the school funding formula. Call that percentage i, so that

(4) $R_1 = R_0*(1 + i).$

In year 1, the taxable value of properties in H (excluding newly taxable) are equal to their value in the previous year increased by their rate of appreciation, so H_1 equals $H_0*(1 + r_H)$, and similarly L_1 equals $L_0*(1 +r_L)$. The share of H properties in total taxable value in year 1 is then given by

(5) $c_1 = H_0*(1 + r_H)/[H_0*(1 + r_H) + L_0*(1 +r_L)]$

Substituting from eqs.(5) and (4) into eq. (3) yields the following expression for g_{TH}:

(6) $g_{TH} = \{(1 + i)/[c_0 + (1 – c_0)*r]\} – 1$

where r equals $(1 +r_L)/(1 + r_H)$.

The expression in eq. (6) is useful. It can be used to show that

(a) If property values in both areas are growing at the same rate, i.e. $r_L = r_H$, so the term r in (6) equals 1, taxes in both areas will increase at same rate, equal to the growth of revenue, i.

(b) In the "normal" case in which $r_L < r_{H,}$ so $r < 1$, taxes in H will increase even if allowable revenue does not (i.e. if $i = 0$) at the rate $\{1/[c_0 + (1 - c_0)*r]\} - 1$. This is happening, of course, because the tax base is shifting towards H, due to its more rapid growth.

(c) Again for the normal case, the value of g_{TH} varies inversely with the value of c and r_L. This means that the larger the share of total taxable value in H, the smaller, other things equal, in increase in taxes on property in H will be. Also, the larger (smaller) the rate of appreciation property in L, the lower (higher) will be the rate of increase in taxes on property in H.

(d) The effect of designating L as a TIF district can be illustrated by setting r_L equal to zero; any growth in the taxable value of L property once it is in a TIF is not included in the tax base.[1] Assuming that r_L was positive, that is, that L property was appreciating in value, setting r_L equal to zero (designating the TIF) means that r_L declines and taxes on H property will grow more rapidly. But note that if taxable value in the TIF area was not appreciating prior to designation, so that r_L was already zero, TIF designation would have no effect on the rate of increase in taxes outside the TIF. If taxable value in the TIF area was declining prior to designation, so $r_L < 0$, designation of the TIF would reduce the rate of increase in taxes outside the TIF.[2]

[1] "Tax base" here means the taxable value on which taxes *other than the TIF increment* are imposed.

[2] This will happen only if the TIF is successful in arresting the decline in taxable value that was occurring prior to designation. If taxable value continues to decline after the TIF is formed, the rate of increase in taxes outside the TIF will be unchanged. This is because while the tax base within a TIF district cannot increase, it can decrease.