PUBLIC POLICY ADVISOR

TAX INCREMENT FINANCING: THE EFFECT ON LOCAL GOVERNMENT REVENUES

by Robert Kleine

Tax increment financing (TIF) is one of several economic development tools used by local governments in Michigan. It is a method of financing public improvements required for a development project from increases-- increments--in property tax revenues in the project area. It has become one of the principal mechanisms used to finance the local infrastructure needed for economic development projects.

Tax increment financing works in the following manner. A municipality creates a tax increment finance authority or downtown development authority and appoints a governing board. The authority's governing board establishes a TIF district and adopts a tax increment finance plan for the district. The plan shows the assessed value of the area before new development occurs--the initial assessed value--the anticipated value after development, and the difference between the old and new assessed valuation--the captured assessed value. (The captured assessed value can include property taxed under Public Act 198 of 1974 or Public Act 255 of 1987--industrial and commercial property tax abatements.)

To determine the amount of tax increment available for a project in any one year, the captured assessed value is multiplied by the total tax rate of the municipality. These captured revenues may be used to finance public improvements on a "pay-as-you-go" basis, to repay loans for improvements from the municipality or federal agencies, and to pay principal and interest on bonds issued by the TIF authority.

Michigan authorizes tax increment financing under three statutes. (1) Public Act (PA) 197 of 1975, known as the Downtown Development Authority (DDA) Act, permits tax increment financing in the downtown areas of any city, village, or township. (2) Public Act 450 of 1980, the Tax Increment Finance Act (TIFA), allows tax increment financing in cities. (3) Public Act 281 of 1986, the Local Development Financing Act, largely replaces PA 450.

The most recent statute, PA 281, was enacted to resolve several problems and concerns caused by the earlier legislation. For example, lawsuits have been filed by two school districts and one county. The lawsuits raise several significant issues, including a contention that tax increment financing is unconstitutional because it diverts to another use property taxes voted for a specific purpose.

The litigation has made it difficult for local TIF authorities to use tax increment financing because legal counsel has been reluctant to issue opinions on bonds that may later be ruled unconstitutional by the courts. The new act attempts to solve this problem in two ways. (1) It made changes intended to correct certain deficiencies in the earlier acts and to respond to concerns expressed by affected taxing units (these are discussed below). (2) The act requests the Michigan Supreme Court to issue an advisory ruling on the validity of tax increment financing.

One hundred sixty-two local governments have established either a downtown development authority under PA 197 or a tax increment authority under PA 450. Of these, 104 cities, 10 townships, 15 villages have established 188 TIF plans, 103 under the DDA act and 85 under the TIFA act. A number of localities have more than one plan; Grand Rapids and Lapeer each have five plans (1985 data). The number of TIF plans increased 63.5 percent in 1986 from the 1985 level.

The total 1986 state equalized value (SEV) and captured SEV of property in a tax increment plan was $3.26 billion and $921 million, respectively.

EXHIBIT 1

EFFECT OF TAX INCREMENT FINANCING ON SELECTED COUNTIES
(DOLLARS IN THOUSANDS)

County	SEV in TIFA	Percentage of Total SEV	Captured Taxes	Percentage of Total Property Taxes	Total Increment in County
Berrien	$48,282	2.3%	$47	2.2%	$500
Calhoun	117,474	9.5	246	3.3	2,642
Grand Traverse	3,005	3.1	228	3.7	2,352
Ingham	47,693	1.8	80	0.4	653
Kent	130,788	2.4	206	2.4	2,165
Oakland	818,035	5.0	757	1.0	10,954
St. Clair	18,990	0.8	128	0.9	1,185
Washtenaw	180,194	5.0	231	1.0	2,230
Wayne	822,295	4.5	1,722	1.3	18,667
STATE TOTAL	$3,258,717	--	$4,047	--	$44,945

SOURCE: Michigan Department of Treasury, Analysis of Tax Increment Financing in Michigan for 1986, April 1987.

Analysis of Effect on Counties, Selected Cities, and Out-of-formula School Districts

Tax increment finance districts are most widely used in Calhoun, Oakland, Washtenaw, and Wayne counties. (See Exhibit 1.) These four counties account for about 60 percent of the total captured SEV in the state. In each of these four counties, captured SEV is 4.5 percent or more of total county SEV. In terms of revenue foregone, Grand Traverse and Calhoun are at the top, with 3.7 percent and 3.3 percent, respectively, of total county property tax revenue.

As indicated in Exhibit 2, there are a number of cities that use tax increment financing extensively. Among major cities, Pontiac, Flint, and Battle Creek are the heaviest users in terms of total SEV in a TIF district as a share of total SEV in the city. However, Flint TIF districts have captured only 2.4 percent of total SEV and only 2 percent of property tax revenue. Pontiac TIF districts have captured 17.6 percent of total SEV and 10.8 percent of total property tax revenue, and Battle Creek TIF districts have captured 11.8 percent of total SEV and 7.6 percent of total property tax revenues. A number of smaller cities have given up even larger amounts of revenue to TIF districts. For example, McBain, Metamora, and Milan have given up 33.9

percent, 19 percent, and 17.1 percent, respectively, of total property tax revenue.

As will be discussed, out-of-formula school districts[1] did not always have, until the enactment of PA 281 of 1986, a voice in their municipality's decision to establish a TIF district. Yet, unlike in-formula districts, they receive no compensation for the revenue loss. Fortunately, the effect of TIF is not yet significant in any school district. In terms of revenue foregone as a percentage of total property tax revenue, the Saline school district (3.5 percent) and Avondale (3.1 percent) are the highest. (See Exhibit 3.) However, the use of tax increment financing is increasing rapidly and the revenue loss could become significant to some out-of-formula school districts. (See Exhibit 4 for a history of tax increment financing.)

EXHIBIT 2

EFFECT OF TIF ON OUT-OF-FORMULA SCHOOL DISTRICTS, 1986

School District	Captured Revenue (000)	Percentage of Total Property Tax Revenue
Alcona	$58	2.1
Ann Arbor	558	1.0
Avondale	231	3.1
Charlevoix	87	2.0
Dearborn	92	0.2
Grand Haven	120	0.7
Harbor Springs	47	1.7
Mona Shores	63	0.7
Northville	93	0.8
Petoskey	55	0.9
Rochester	276	0.9
Royal Oak	530	1.8
St. Joseph	139	1.8
Saline	278	3.5
Southfield	899	2.1
Tawas	51	1.5
Walled Lake	523	1.9

SOURCE: Compiled by Public Sector Consultants, Inc., from data provided by the Michigan Department of Treasury and the State Tax Commission.

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[1]An out-of-formula school district is one that raises more money locally than the state guarantee and therefore receives no membership aid payment.

EXHIBIT 3

EFFECT OF TAX INCREMENT FINANCING ON SELECTED CITIES

City	1986 SEV in TIFA (000)	Percentage of Total SEV	1986 Captured SEV (000)	Percentage of Total SEV	1986 Captured Taxes Retained	Percentage of total Property Taxes	Captured SEV PA 198/255 (000)
Auburn Hills	$58,670	32.2%	$40,667	22.4%	$927,859	8.5%	$19,299
Battle Creek	160,501	20.1	62,788	11.8	2,622,615	7.6	32,802
Benton Harbor	18,719	37.6	1,548	3.1	65,441	1.7	1,818
Buchanan	16,242	33.2	3,662	8.2	169,461	6.7	834
Dansville	2,675	100.0	324	12.1	18,752	12.1	-0-
Detroit	396,351	7.6	286,391	5.5	15,394,000	3.6	198,727
Flint	408,761	25.8	37,420	2.4	2,255,428	2.0	11,450
Grand Rapids	103,964	6.0	53,964	3.1	2,098,858	2.3	28,660
Hamtramack	28,374	29.3	27,660	28.6	995,687	14.4	27,515
Harbor Springs	6,756	18.4	3,054	8.3	100,746	7.6	-0-
Houghton/Portage	11,830	34.0	2,712	8.4	159,612	8.2	-0-
Lapeer	44,640	60.6	8,940	12.1	368,313	9.6	2,679
McBain	6,231	80.0	4,782	61.4	141,516	33.9	4,280
Metamora	5,947	108.7	1,038	19.0	58,044	19.0	-118
Milan	45,461	94.1	10,082	20.8	522,833	17.1	10,082
N. Branch	1,738	22.5	439	5.7	24,332	5.7	-0-
Pontiac	521,889	67.9	133,569	17.6	6,059,087	10.8	121,605
Port Huron	54,926	19.3	20,575	7.2	905,009	5.2	11,853
Reading	1,850	33.1	747	13.3	41,062	13.1	207
Richmond	10,357	34.9	1,242	4.2	96,587	4.2	540
Rochester	26,503	21.2	7,222	5.8	469,664	5.8	-0-
St. Ignace	17,687	17.4	804	3.3	41,439	2.7	-0-
Saline	66,264	57.8	16,226	14.2	473,504	6.4	2,384
Wayne	103,617	44.1	-0-	--	-0-	--	-0-
Webberville	7,415	51.8	1,850	12.9	66,079	6.9	1,740
Whitehall	24,795	58.8	3,486	8.3	109,621	4.2	3,548
Williamston	6,655	29.1	1,769	7.7	115,240	6.8	195

SOURCE: Compiled by Public Sector Consultants, Inc., from data provided by the Michigan Department of Treasury and the State Tax Commission.

EXHIBIT 4

HISTORY OF TAX INCREMENT FINANCING
(DOLLARS IN THOUSANDS)

	Number of Plans Formed	Initial Total SEV	Total Captured SEV (1986 Value)	Captured as Percentage of Initial SEV	Retained Taxes	Cost to State
1978	2	$111,417	$99,758	89.5%	$7,255	$3,115
1979	4	40,570	49,348	121.6	2,304	1,203
1980	8	60,062	59,905	99.7	2,666	1,452
1981	21	525,694	429,386	81.7	18,813	7,730
1982	14	297,125	51,524	17.3	2,894	473
1983	19	186,484	34,818	18.7	2,439	939
1984	29	551,251	107,065	19.4	4,270	1,749
1985	58	384,164	89,718	23.4	4,301	2,248
1986	33	181,413	0	0	0	0

SOURCE: Michigan Department of Treasury, <u>Analysis of Tax Increment Financing in Michigan for 1986</u>, April 1987.

Issues and Concerns

Schools, counties, and other affected taxing units have raised a number of issues regarding the use of tax increment financing in Michigan.

1. Tax increment financing diverts revenue from public services, such as education, to finance public improvements in tax increment districts. This is not the use for which the revenues were intended (as approved by the voters or the local governing body), and diversion can result in budget cuts or millage increases.

2. Tax increment financing is meant to be used in areas where property values are declining. It also is used, however, in many areas where property values are increasing, such as Ann Arbor, Rochester, and Grand Rapids.

3. Schools, counties, and other taxing units sacrifice the majority of the revenue captured to finance a TIF project--about 75 percent on average. (See Exhibit 5 for the millage rates levied by the various government jurisdictions.) Yet, these taxing units are not always represented in the decisions regarding the use of these revenues; many muncipalities, however, have included a school district member on the TIF or DDA board even though it was not required by law.

EXHIBIT 5

AD VALOREM PROPERTY TAX RATES LEVIED, 1985

Average County Mills	Average Township Mills	Average City Mills	Average Village Mills	Average School Mills	Average TOTAL Mills
6.10	3.07	16.28	12.18	38.24	54.47

SOURCE: Michigan Department of Treasury, State Tax Commission.

4. There is no limit on the revenue that may be captured for TIF. A few municipalities have attempted to draw the boundaries of their tax increment districts in such a way that most of the increased property value in the district may be captured for the project. Also, a TIF district may capture inflationary growth in property values as well as the value of new investment directly related to the project. Some municipalities have been responsive to this concern. Ann Arbor, Dansville, Hart, Howell, and Saline pass increases resulting from inflation on to other taxing units; Petoskey returns to other affected local governments a percentage of captured tax revenues equal to the normal inflationary increase in the tax increment area; in Wayne County, TIF authorities exclude from capture the debt millage levied for the Wayne County jail.

Debt millage is an important issue for schools, because debt is not equalized by the state school aid formula. If debt millage is diverted to finance a tax increment plan, the affected school district must use its general revenues to pay debt service and/or increase its millage rate. Some municipalities, Royal Oak, for example, pass through the debt portion of the captured taxes.

5. There is no limit on the duration of TIF plans; in theory, they can remain in effect indefinitely. This means that the schools, counties, and other taxing units, which forego most of the revenue captured for a TIF project, may never benefit from the increased revenue.

PA 281 of 1986, mentioned above, partially responded to some of these concerns. First, for new authorities, membership was expanded from five to seven members: one member appointed by the county board of commissioners, one by the local community college, and two members by each local government unit (other than the one creating the authority) that levies 20 percent or more of the total ad valorem property taxes levied in the district; in most cases, this is the school district. Second, the concept of "eligible" property has been added; that is, property from which increased property tax revenue can be captured for TIF is restricted to that owned by firms engaged in (1) manufacture of goods or materials, (2) agricultural processing, and (3) a high technology activity that has as its primary purpose research, product development, engineering, laboratory testing, or development of industrial technology. Thus, using increased tax revenues from the property of firms engaged in activities such as retail or wholesale trade or general service activity is no longer permitted under the new act. The previous laws focused on development areas. Third, the new act restricts the amount and use of captured revenues. Captured assessed value can consist only of the increase in value of the eligible property identified in a tax increment plan. Also, the tax increment revenues can be used only for public improvements for eligible property that generates the tax increment revenues. Fourth, TIF cannot be used for a project that results in the transfer of fifty or more jobs from another community unless that community consents by resolution. Fifth, the new act requires a complete reporting of information about the tax increment district to the State Tax Commission. All of these changes, particularly the new board membership and the tighter definition of eligible property, are expected to reduce the revenue loss to local governments.

However, out-of-formula schools districts and counties, in particular, are still likely to be concerned about losing revenue because there is no

guarantee that additional economic activity will be generated and, even if it is, they do not always stand to gain as much as the muncipality. The city, township, or village in which the district is located receives the major benefits and generally sacrifices only 25 percent, on average, of its own revenues. A city that levies an income tax receives additional revenues from the new economic activity and all cities, townships, and villages receive additional property tax revenues from increased property values in other areas of the jurisdiction. School districts and counties also benefit if property values increase in areas surrounding a TIF district.

Comment

The key issue is whether or not a tax increment district should be able to capture millage levied by units of government other than the authorizing city, village, or township. The inability to do so would, of course, seriously limit the effectiveness of tax increment finance districts as an economic development tool.

There are several options for dealing with this issue.

1. Repeal TIF legislation. This is an extreme solution that would eliminate an important economic development tool for local governments. On the positive side, elimination would save state government about $19 million in school aid to in-formula school districts and would save other local units of government about $26 million. The effect on economic activity in the state is unclear because there has never been an evaluation of the effectiveness of TIF in Michigan.

2. Restrict the millage that can be captured by a TIF district to only that directly levied by the authorizing unit of government. Although this would protect counties, out-of-formula school districts, and other local governments and save the state about $19 million, it would seriously limit the effectiveness of TIF districts.

3. Exclude county-levied millage increases from capture and provide state reimbursement for out-of-formula school districts. This would protect counties from revenue loss and would not seriously limit the effectiveness of TIF, as the average county millage rate is only 6.1 mills, about 11 percent of the statewide average millage rate. This option would cost the state about $2.5 million (1986 data) in compensation for millage revenue lost by out-of-formula school districts. The future cost to the state could increase substantially, however, because use of TIF could accelerate if the opposition from counties and out-of-formula school districts evaporates.

4. Provide formula reimbursement from the state for local units of government having high tax effort, high unemployment, and/or a below-average tax base. The rationale for this option is that local jurisdictions having high service demands but weak tax bases cannot afford to sacrifice revenues to a TIF district. The city, village, or township establishing the district should not be reimbursed, however, because the state has no voice in the local decision to establish a TIF authority.

   For example, a county could be reimbursed if the average unemployment rate in the previous quarter was more than 25 percent above the state

average or the SEV per capita was 20 percent or more below the state average. Under the latter criterion, 13 counties would qualify for state reimbursement: Calhoun, Chippewa, Delta, Gogebic, Houghton, Ionia, Isabella, Jackson, Luce, Marquette, Muskegon, Shiawassee, and Wayne. Based on 1986 data, 23 counties would qualify under the unemployment criterion; almost all are small, northern counties. One of the advantages of a formula using these criteria is that if a tax increment finance district generates new economic activity in a county, the unemployment rate will fall, the SEV per capita will rise, and the county may no longer qualify for, or need, state reimbursement.

Developing a need-based formula for an out-of-formula school district is not possible because these districts, by definition, are high SEV-per-pupil districts, and unemployment rates by school district are not available. Reimbursement for these school districts must be made on the basis of equity considerations. One of the other four options described in this paper would be more appropriate for compensating out-of-formula school districts. Other units of local government, such as community colleges and transportation or other authorities, likely would have to be treated similarly.

The cost to the state of this option would depend on the criteria used, but could not exceed $26 million (1986 data).

5. <u>Full reimbursement by state government of all local governments except the TIF granting authority.</u> Revenue loss to in-formula school districts from TIF is made up for by state government through the school aid formula; to be equitable, other units of government should be similarly reimbursed. (See Exhibit 6 for an example of how TIF currently affects the school aid formula.) Assuming TIF districts create new economic activity, these governments already receive partial reimbursement through state revenue sharing. (Local governments receive about 6.7 percent of the income tax, 15 percent of the sales tax, about 22 percent of the single business tax, and small amounts from several other taxes.) This, however, likely falls far short of the local revenue lost to TIF.

Tax increment financing has become a very popular economic development tool in Michigan. Unfortunately, as is often the case with these types of programs, its use has not been carefully monitored or evaluated. The 1986 legislation has the potential to correct some of the problems associated with TIF, but important issues remain, particularly the revenue loss to governments--such as counties and out-of-formula school districts--having no direct voice in the decision process. Should the millage of these governments be excluded from TIF districts or should they be reimbursed by the state for the revenue foregone? A second key issue is the long-term effect on the finances of governments using TIF. Currently, the revenue effect on most governments is small, but as shown in Exhibit 7, the captured SEV in TIF districts in some localities exceeds the recent growth in their tax base. This implies that TIF has not been effective in promoting economic growth and could mean that in the future some localities may not have adequate revenues to provide basic government services.

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EXHIBIT 6

ILLUSTRATION OF EFFECT OF TIF ON SCHOOL AID FORMULA

1. Example of calculation of a school aid payment before TIF is established.

    School Aid Formula: $345 + [$72.25 x 36 mills] $2,996
    Less: Locally raised revenue per pupil
       ($50,000 SEV per pupil x 36 mills)   - 1,800

    State membership aid payment per pupil $1,146

2. Example of calculation of school aid payment after SEV per pupil is reduced 10 percent to $45,000 per pupil by establishment of a TIF district (and capture of property tax revenues).

    School Aid Formula: $345 + [$72.25 x 36 mills] $2,996
    Less: Locally raised revenue per pupil
       ($50,000 SEV per pupil x 36 mills)   - 1,620

    State membership aid payment per pupil $1,326

EXHIBIT 7

TOTAL SEV AND CAPTURED SEV
IN TIF DISTRICTS, SELECTED CITIES AND TOWNSHIPS
(DOLLARS IN THOUSANDS)

Locality	Dollar Change in SEV, 1984-86	Percentage Change in SEV, 1984-86	Total SEV in TIF District(s)	Captured SEV	Base Year of DDA or TIF Plan
Auburn Hills	$61,638	46.9%	$58,671	$40,668	1984
Ann Arbor	104,521	7.9	107,800	18,594	1982
Battle Creek	25,389	5.0	106,501	62,790	1979/1981
Benton Harbor	1,806	3.8	18,719	1,549	1985
Commerce Township	74,786	24.7	53,412	15,196	1984
Detroit	-31,216	-0.6	396,352	286,392	1978/1981/1983
Flint	87,229	5.8	408,761	37,422	1979/1981/1984
Grand Rapids	131,763	8.2	103,966	53,965	1980/1985
Hamtramck	-6,169	-6.0	28,373	27,660	1981
Houghton	2,211	6.8	11,830	2,921	1984
Lapeer	11,200	17.9	44,640	8,940	1981/1982/1983/1984
Milan	690	1.4	45,461	10,066	1985
Pontiac	52,894	7.5	515,659	133,572	1979/1980/1981
Port Huron	847	0.3	54,926	20,576	1980/1981/1984/1985
Royal Oak	39,018	5.6	58,995	12,908	1980/1982
Saline	7,706	7.2	66,264	16,226	1981
Taylor	46,656	8.2	89,180	11,894	1982/1983/1984
Wayne	11,560	5.1	103,619	-0-	1982
Westland	63,195	8.5	52,648	10,863	1985
Whitehall	3,216	8.3	24,796	3,486	1984/1985
Williamston	866	3.9	6,655	1,769	1981/1985/1986

SOURCE: Compiled by Public Sector Consultants, Inc., from data provided by the Michigan Department of Treasury and the State Tax Commission.

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