MN HOUSE RESEARCH

Tax Increment Financing: State Interests and Restrictions

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Overview

Minnesota law allows local governments to use tax increment financing (or TIF) to finance real estate development. Cities and counties can use TIF without state approval but regularly ask state lawmakers for both exceptions and changes to the general laws governing TIF, for example, requesting changes to the rules regarding when TIF can be used and how increment can be spent. This publication provides background information on TIF mechanics, outlines certain state interests in TIF, and summarizes TIF restrictions and how they relate to state interests.

More information on TIF is available on the House Research website at www.house.mn/hrd/issinfo/tifmain.aspx.

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Background Information on TIF

TIF allows local governments to "capture" increases in property value caused by real estate development and then to redirect revenues from property taxes on that captured value to pay development costs.

When a local government decides to use TIF, it must identify the area where TIF will capture value and any other area where revenue from TIF might be spent. Once the TIF district is established, those identified areas become the TIF district and the project area, respectively. After a TIF district is established, the revenues from property taxes on any subsequent increases in value within the TIF district become increment, and increments are dedicated for expenditures within the district and the project area. Any expenditure of increment must comply with the restrictions outlined in TIF law.[1] Those restrictions generally limit the situations

[1] Minn. Stat. §§ 469.174 to 469.1799.

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when TIF may be used, how increment may be spent, and how long TIF districts may remain active; those restrictions are discussed beginning on page 5.

While a TIF district is active, local governments taxing the district (the city, county, school district, and any special taxing districts) have largely stagnant property tax revenues from properties in the district because the revenues derived from increases in property values in the district are increment, earmarked for the purposes of the TIF district. TIF development often results in substantial increases in property values, but local taxing jurisdictions see very little growth in their tax bases as a result of the development until districts are decertified.

Until development occurs, TIF will generate increment only on inflationary, typically small increases in property tax values. Because TIF generates only insubstantial increment until after development occurs, it cannot pay for upfront development costs and is always paired with a form of debt financing, most often through an agreement with the developer to reimburse the developer for up-front costs using increments. After development occurs, property values typically increase, allowing increment to be used to repay development debt.

TIF districts come in types, including, most prominently, redevelopment, housing, and economic development districts. Each type serves a different purpose and is subject to type-specific restrictions.

State Interests in TIF

Local governments can use TIF without state permission, and TIF primarily impacts local government finances. Nevertheless, state policymakers may see state interests implicated by TIF. Some potential state interests are outlined below.

Achievement of TIF Purposes

The predominant TIF district types were designed to remediate urban blight, to develop housing affordable to low- and moderate-income families, and to promote job creation and retention within the state. These purposes align with the objectives of several state expenditures. For example, housing projects eligible for TIF are eligible for development subsidies through various programs of the Minnesota Housing Finance Agency, and the Department of Employment and Economic Development offers grants both to redevelop blighted sites and to promote job creation. State policymakers seeking to promote these purposes may also wish to ensure that TIF is effective at furthering those ends.

Local Governments' Tax Bases

The state annually invests billions of dollars in general purpose and categorial aids to its local governments, whose primary, and often only, means of raising revenues independently is through property taxation. The state may have an interest in ensuring that local governments can successfully raise property tax revenues both to promote the efficacy of state investments and to reduce local governments' reliance on those investments.

Larger tax bases allow local governments to raise the same amount of revenue with lower tax rates. All other things being equal, lower tax rates are generally thought to be desirable in a tax system, because when rates are low, they are less likely to impact behavior in a way that distorts the market. Because property forms the base of the property tax, having higher property tax values in the base allows for lower rates and promotes the efficiency of the real estate market.

TIF implicates this interest in two ways. First, real estate development generally increases property values, and TIF promotes development, often in areas or for projects with impediments to development. Moreover, except for housing districts, TIF law requires that local governments establish TIF districts only if they find that the market value of properties in the districts will exceed what could be expected from the site without TIF. For these reasons, TIF may promote tax base growth in the long term.

Second, TIF impacts local governments' tax bases in that parcels in many TIF districts contribute less to the local governments' tax bases while those districts are active than the parcels would have contributed if TIF had not been used. In the short term, this facet of TIF may constrain the revenue-raising abilities of governments taxing properties in a TIF district.

Public Dollars and State Costs

TIF uses public funds to finance private real estate development. State policymakers may want to ensure both that these expenditures provide public benefits and that those benefits outweigh not only their costs but also the benefits that alternative uses of the funds might yield.

Even if state policymakers' interests in this regard extended only to direct state expenditures and not to the expenditures of its political subdivisions, TIF use would still bear on this interest as the state indirectly pays for the use of TIF in two ways. First, TIF imposes state costs through school aids. The state distributes certain school aids based on formulas that increase payments depending on the amount of school districts' tax bases that have been captured by TIF.

Second, TIF imposes state costs through property tax refunds and the renter's credit. The state distributes property tax refunds to homeowners when property tax payments exceed a certain portion of homeowners' income and when homeowners experience a large property tax increase from one year to the next. Additionally, the state assumes property taxes on residential properties are paid indirectly through tenants' rents, and it provides a refundable income tax credit to lower-income renters when the portion of their rent attributed to property taxes exceeds a certain portion of their income. Because TIF often reduces tax base growth in the short term and occasionally reduces it in the long term, TIF sometimes has the effect of requiring higher property tax rates than what rates would have been without TIF; these increased rates result in increases in property taxes and, resultantly, in increased state payments through property tax refunds and (assuming that property tax burdens are ultimately passed by landlords to tenants) through the renter's credit.

It is not possible to estimate the amounts of state costs with any degree of certainty because doing so would require counterfactual knowledge not only of how property values would have changed in the absence of TIF use (whether or not alternative developments occurred) but also of whether expenditures financed by TIF might otherwise have been levied for by local governments.

Intercity Competition; Intercity Equity; State and Regional Costs of Local Benefits

Cities compete to attract and to retain businesses and individuals as residents, primarily through attempts to pair desirable municipal services with acceptable property tax rates. TIF can be a tempting means of competing in these arenas in that, in some instances, TIF provides cities opportunities to increase municipal services while exporting some of the costs of those services to nonresidents located within the county, school district, and other local taxing districts. In its 1986 and 1996 survey of local governments' use of TIF, the Office of the Legislative Auditor found that cities often used TIF not only to pay for public improvements that would normally be funded by property tax levies and special assessments but also to provide financial incentives for businesses to locate within their borders rather than within other Minnesota cities.

Use of TIF in intercity competitions implicates a number of potential state interests. On the one hand, use of TIF in these competitions may promote advancements in the cost-efficient provision of municipal services or in the cultivation of a business-friendly environment within the state.

On the other hand, use of TIF in these ways may sometimes impose state and regional costs while yielding only local benefits. As an example, a city may use TIF to induce a business to relocate from another city located within the same county; the relocation may bring jobs and increases in tax base to one city, at the expense of another city, while imposing regional and state costs and yielding little to no net increases in jobs or tax base for the county and state over what would have existed without TIF. Similarly, when TIF is used primarily to finance city services that would ordinarily be paid for through property taxes or special assessments, city residents pay less for their services but only because those expenses are being defrayed through property taxes on residents throughout the school district, the county, and the other local taxing jurisdictions. At times, TIF use in these situations may provide another public benefit, such as the remediation of blighted property.

Last, because some aspects of TIF law are ambiguous, cities may face pressure to adopt more permissive interpretations of these laws if doing so provides a competitive edge; to the extent that these laws serve to protect state interests, gamesmanship in the interpretation of TIF law may erode those guardrails. Moreover, if some cities are unwilling to adopt expansive interpretations of TIF law while others are, intercity equity issues may arise.[2]

[2] Comparable concerns may arise if certain cities regularly request and receive exceptions to or exemptions from general TIF law.

Policy Considerations

The following questions may help lawmakers keep these state interests in mind when considering proposed changes to, or exceptions from, TIF law:

- If the proposal relates to only one type (or a few types) of TIF districts, what public purpose is that type of TIF district designed to further? Does the proposal foster achievement of that purpose or of another public purpose?
- In both the short term and the long term, how would the proposal affect the tax bases of impacted local governments (both those establishing the TIF districts and the other jurisdictions relying on properties within those districts for their tax bases)?
- What public benefits would the proposed law yield? What public costs would the proposed law impose? Would public benefits exceed public costs, and are there more beneficial alternative uses of those funds?
- How would the geographic spread of the benefits from TIF districts established under the law compare to the geographic spread of the costs? Will the law promote intercity competition, and if so, will that competition foster or hinder state ends? Might the law create, exacerbate, or correct inequities among cities?

TIF Restrictions

The table below summarizes foundational TIF restrictions and how they relate to the state interests discussed above. All the statutory citations are to Minnesota Statutes.

TIF Restriction and Statutory Citation	Summary of Restriction	Relation of Restriction to Listed State Interests
But-For Test § 469.175, subdivision 3, paragraph (b), clause (2)	To establish a TIF district, the responsible local government must find both: (1) that the development could not be expected to occur in the reasonably foreseeable future solely through private development; and (2) that the value of the site as developed by TIF would exceed the value of the site if it were developed without TIF by at least the present value of the expected amount of increment. The latter finding is not required for housing districts.	The but-for test promotes state interests in protecting local governments' tax bases, in obtaining public benefits from public costs, and in ensuring that the public benefits of TIF usage are not purely local to the city using it. Allowing use of TIF to capture preordained property value growth or to subsidize lower-than-expected tax base growth in the absence of a countervailing public purpose being furthered by the development, such as an increase in the affordable housing stock, would serve little public purpose and would incentivize use of TIF to export municipal costs.

TIF Restriction and Statutory Citation	Summary of Restriction	Relation of Restriction to Listed State Interests
Type-Specific Findings Requirements § 469.174, subdivisions 10, 10a, 12, and 19	Except for housing districts, for each TIF district, the municipality must find that there are circumstances warranting establishment of the specified type of district. For example, redevelopment districts are established based on a finding of one of several types of blight.	These requirements help to limit TIF use to situations in which use of TIF is necessary and has the potential of serving one of the public purposes of TIF.
Pooling Restrictions § 469.1763, subdivision 2	Most of the increment generated by each TIF district must be spent within the district. The required percentage ranges from 65% to 80% depending on the type of district and whether the district plan sets aside 10% of increment for housing purposes. This requirement is largely inapplicable to housing districts.	Pooling restrictions, along with the five- and six-year rules, promote early decertification of TIF districts. By limiting when TIF debt can be incurred, dedicating a majority of increment toward repayment of TIF debt, and requiring decertification of TIF districts upon repayment, these rules expedite the return of TIF properties to the tax rolls, benefiting the tax bases of all local taxing jurisdictions and limiting opportunities for cities to use profitable TIF districts to export municipal costs to other local taxing jurisdictions.
Five-Year Rule § 469.1763, subdivision 3	For an in-district expenditure to qualify as in-district for the purposes of pooling restrictions, either the activity must occur or debt for the activity must be undertaken within the first five years after the district is certified. Expenditures may be made on new activity within the district following that deadline, but those activities are considered out-of-district for the purposes of pooling requirements.	The five-year rule limits expansion both of the scopes of TIF projects and of the incurrence of TIF debt. Together, these limitations promote early decertification, promoting return of these properties to the tax base and limiting opportunities to expand use of increment in profitable TIF districts beyond their original purpose.

TIF Restriction and Statutory Citation	Summary of Restriction	Relation of Restriction to Listed State Interests
Six-Year Rule § 469.1763, subdivision 4	After the five-year rule period expires and in-district TIF debt has been incurred, the six-year rule requires that districts be decertified once the in-district percentage of increment is sufficient to satisfy TIF debts.	Requiring decertification after increment is sufficient to satisfy TIF debt returns properties to the tax rolls after the primary purpose of the TIF district is achieved, allowing other local governments to realize tax base increases before time duration limits are reached. This rule prevents cities from using pooled increment from profitable TIF districts to export municipal costs.
Duration Limits § 469.176, subdivision 1b	Each TIF district has a duration limit. These limits range from nine years of increment collection for economic development districts to 26 years of increment collection for housing and redevelopment districts.	Local governments employing TIF may slow TIF decertification under the five- and six-year rules by modifying TIF plans (for example, to increase the amount of increment allowed to be spent outside the district). Without duration limits, cities utilizing TIF might seek to prolong TIF collection as a way to use pooled increment to export municipal costs.
General Limitations on Increment Use § 469.176, subdivisions 4, 4g, and 4l	The law allows expenditure of increment only on project costs as defined under the enabling legislation for the various development authorities that often employ TIF on behalf of counties and cities (for example, housing and redevelopment authorities). Additionally, the law specifically prohibits local governments from using TIF to finance the construction of public parks or government buildings, except for parking facilities.	General limitations on expenditure of increment limit its use to real estate development. The prohibition on using TIF to develop government buildings increases the likelihood that TIF use will develop taxable real estate, growing local governments' tax bases in the long run. Additionally, these prohibitions prevent use of TIF on services and projects ordinarily paid for through local governments' general fund resources, limiting opportunities to use TIF primarily to lower city levies.

TIF Restriction and Statutory Citation	Summary of Restriction	Relation of Restriction to Listed State Interests
Type-Specific Limitations on Use of Increment § 469.176, subdivisions 4b, 4c, 4d, and 4j	For redevelopment and renewal and redevelopment districts, 90% of all increments must be spent on correcting the blight conditions used to justify establishment of the district. For all other district types, increments must be spent on administrative expenses or on the sorts of projects associated with the district type, (for example, housing for housing districts).	These requirements promote use of TIF districts for the public purposes for which the various types of districts exist. These requirements also further limit opportunities to use TIF primarily as a means of lowering city levies.

For more information about TIF in general, see the House Research Department web page *Tax Increment Financing in Minnesota* (https://www.house.mn.gov/hrd/issinfo/tifmain.aspx).

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