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Action without information is dangerous. Information without action is futile.

Tax Increment Financing in Arizona

A POLICY REVIEW

SEAN MCCARTHY

Every few years the Arizona State Legislature debates the merits of Tax Increment Financing (TIF) as an economic development tool. City leaders howl that Arizona remains "the only state" without TIF and has missed out on economic growth. The truth is, there are many states who do not allow the mechanisms Arizona cities have requested. TIF is a complex public finance mechanism with impacts that reach far beyond city finances. Understanding its many variations and policy outcomes in other states is vital for policymakers.

A brief history of TIF in Arizona

In 1977, the Arizona Legislature enacted a TIF law which granted cities the authority to create "redevelopment districts" that would be financed by redirecting the incremental growth in property taxes to the cities that would otherwise go to counties, schools, community colleges, and the state. The 1977 law also granted the authority to issue bonds that would be backed by the incremental tax collections. Ultimately, the Arizona Court of Appeals ruled the issuance of the TIF bonds, without prior voter approval at an election, violated the Constitution. Specifically, the court ruled that because the revenue source backing the bonds (ad valorem property taxes) was a "general tax" of the city, the bonds were a debt of the city and required an election under the Constitution.

TIF remained dormant until 1986 when there was an unsuccessful attempt to refer a Senate Concurrent Resolution to the voters to make property TIF debt financing legal. There were a couple of attempts to advance property TIF legislation during the early 1990's that were designed as pay-as-you-go TIF; however, those attempts were also unsuccessful.

Cities have always had the ability to increment their own city sales and property taxes for pay-as-you-go projects, which have been used to varying degrees. On a few occasions, the state allowed a sales TIF to increment all sales taxes for a project such as the Cardinals Stadium and Rio Nuevo in Tucson but those examples caused enough controversy to compel lawmakers to remove that particular mechanism from state law. Most recently, state lawmakers have expanded the state sales TIF law to allow for the recapture of incremented sales taxes for major manufacturing to defray certain public infrastructure costs. State lawmakers rejected a bid to allow state sales TIF for an arena for the Arizona Coyotes during the 2017 legislative session. Finally, during that same session, the Arizona Tax Research Association led an effort to defeat two separate proposals for pay-as-you-go property TIF in HB2177 and SB1146.

Why do municipalities insist on TIF?

Although TIF can be used by other jurisdictions, it has most dominantly been used by cities and towns across America. The single most attractive feature of TIF is the ability to pledge the incremental tax revenues of other jurisdictions towards a benefit cities alone control. A close second is the governance of a TIF district, which provides the city control over the design, location and use of private development. The combination of leveraging other jurisdiction's money and heavy influence over all aspects of the economic development project is very alluring to city planners.

In property TIF, the city takes a very low financial risk because cities are the lowest users of the property tax by percentage, relying more on sales taxes and state shared revenues. In Arizona, city property tax levies make up just 6% of total primary property taxes.[i] School districts, counties, community college districts and even the state general fund depend more heavily on property taxes than cities. By creating a TIF district, cities can leverage revenues which would otherwise support other jurisdictions. In fact, in states where cities cannot pledge TIF revenues from other jurisdictions, TIF is rarely used, such as Virginia and New York.[ii]

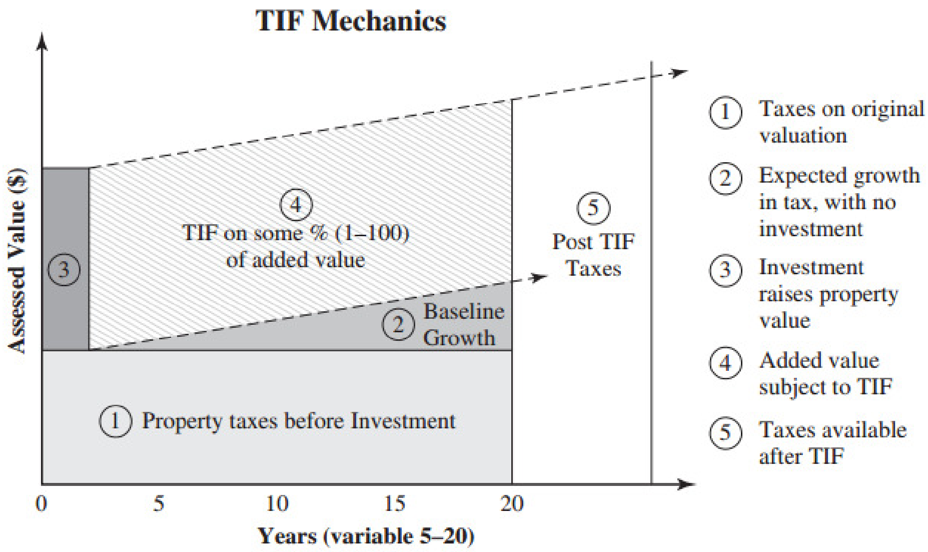
THE DESIRE TO PLAY "SIM CITY" IS UNDERSTANDABLE. WHO HASN'T DRIVEN BY A VACANT LOT AND THOUGHT OF A BUSINESS THEY'D LIKE TO SEE OCCUPY IT?

Politically, TIF is a safe bet for city policymakers. TIF adopters can claim they didn't give a private concern a direct gift because TIF bonds are paid by the new growth in property valuation. They can also argue they didn't abate someone's taxes or raise tax rates. For these reasons, TIF is viewed to be the most politically acceptable economic development tool.[iii] For lawmakers contemplating reelection, the prospect of bringing a popular commercial activity to their municipality is undoubtedly tempting. The ability to influence private enterprise allows councilmembers to "leave their legacy" in a very tangible way.

TIF fundamentals and their limitations

One critical feature of TIF which explains its popularity is its fairly simple structure, which seems almost too good to be true. TIF advocates will use a graphic similar to the one on the next page to explain the mechanics. The city simply draws a boundary around a certain area and pledges all new tax revenues from valuation growth towards a new "district" which is also controlled by the city council. The district can direct these revenues to repay debt service or pay-as-you-go for capital infrastructure costs among other more creative uses. In return for the public subsidy, the private enterprise commits to a particular project which is intended to spur overall growth in the assessed value of the TIF district. In the meantime, all jurisdictions inside the TIF district receive tax revenues at a static or "frozen" value through the duration of the district. When and if the TIF district is terminated, all jurisdictions will have access to present day valuations. It can be particularly enticing to the uninitiated.

The first fundamental limitation of a TIF deal is the guesswork at the outset, which begins with a "but for" determination. Most states demand a "but for" calculation in order for the TIF deal to advance, whereby the municipality (or state, in rare occasions) somehow determines the project would not happen because it is economically infeasible "but for" a TIF subsidy. In practice, these determinations are hardly a discriminating effort and are merely an easy bureaucratic hurdle. Consultants dazzle city planners with projections they cannot prove and some cities even rely on data provided by the benefitting private concern.[iv]



The "but for" argument is critical to the deal because the underlying assumption is the business subsidy is paid for with revenue that wouldn't exist without the deal. Several research studies on the "but for" growth of TIF districts using regression models to control for a variety of variables show that when TIF districts did cause growth, it was a non-unique phenomena and further that TIF adoption had no statistical positive impact on the city as a whole. [v] From a comprehensive Loyola Chicago study: "When we use….a multivariate regression model with statistical controls for local characteristics and sample selection, we …find no positive impact of TIF adoption on the growth in citywide property values. Any growth in the TIF district is offset by declines elsewhere."[vi]

TIF research doesn't suggest the districts do not produce growth; it is true that property values inside TIF districts often rise. In fact, early studies which were leveraged to propagate TIF laws admitted to lacking data to prove causality for growth in TIF districts.[vii] Comprehensive studies show the value increase is not statistically significant compared to the gain expected from natural inflation in that area, meaning it was likely to happen with or without TIF. Additionally, spurring growth in one section of a municipality has the effect of shifting commercial activity to the detriment of other areas. "Commercial and industrial TIF districts both show a significantly negative impact on growth in commercial assessed values outside the district."[viii]

"Because local officials rarely possess familiarity with the underlying economics of complex real estate deals, they have difficulty being sure when a developer is just bluffing who claims that a proposed project will result in huge losses without a massive public subsidy." –George Lefcoe, USC Gould School of Law

The trouble with TIF and "slum and blight"

Since TIF was invented in the 1950's, the original purpose was to create economic development in urban areas where businesses or neighborhoods had vacated and the area was designated "blight." Many states followed suit and created statutory "blight" requirements for TIF creation. Unfortunately, history has shown TIF projects in truly blighted areas have some of the lowest chances of success because assessed valuations don't rise as fast as projected and the overly leveraged TIF district cannot afford the debt service payments it has committed.[ix] In practice, cities with many TIF districts like Chicago are forced to use revenues from TIF districts in wealthy areas to cover for deficits in others.[x]

With the knowledge that TIF isn't successful in the areas it was designed for, policymakers moved the goalposts.[xi] Most statutory blight definitions have been so watered down, the requirement essentially has no meaning and fully one-third of states have no requirement at all.[xii] When blight is statutorily required, it is often delegated to the municipality to determine the definition or merely requires the creation of an "economic development zone." In Arizona, the Tempe Town Lake area and downtown Phoenix continue to be areas defined as slum and blight. Jake Haulk, the Director of the Pittsburg-based Allegheny Institute famously noted: "You could declare the entire Western world blighted."[xiii]

Why do businesses ask for it?

Benefitting commercial enterprises encourage the use of TIF and expend great political capital to expand its usage. For the business which stands to benefit from the use of TIF, it becomes fairly obvious why they seek TIF: they stand to benefit financially from the deal. TIF districts typically pay for a variety of costs such as public improvements which would otherwise be paid for privately or be cost-shared with the city. In other situations, a business may benefit more directly from TIF such as acquiring city land at a discounted rate or even offsetting the private cost of construction.

Companies such as Costco, Cabela's and Walmart leverage their popular brands to lure city leaders to use TIF to reduce their up-front infrastructure costs. Who could blame a business for trying to get the best deal available? Those with the ability to locate in a variety of areas use TIF as a negotiating tool between municipalities as they look to expand or relocate.

TIF WARS

"There is little clear evidence that TIF has done much to help the municipalities that use it, and it is also a source of intergovernmental tension and a site of conflict over the scope of public aid to the private sector." Richard Briffault in "The Most Popular Tool" *University of Chicago Law Review*

Why does the business community oppose it?

While it is true that many commercial enterprises encourage the use of TIF, many efforts to curtail or stop TIF originate from the business community, who has witnessed and seeks to avoid the policy problems TIF creates. Particularly when used to subsidize commercial retail, the business community recognizes that because per capita retail spending remains relatively flat, new activity simply cannibalizes existing sales.[xiv] Despite this truism, TIF for retail remains popular as evidenced by 2008 *TIF: Best Practices Reference Guide*, authored by the International Council of Shopping Centers, who specializes in large suburban retail malls.

Sporting goods titans Cabela's and Bass Pro Shops are notorious for demanding tax incentives and are archetypes for the unfairness associated with development subsidies. Bass Pro Shops alone acquired over $560 million in location subsidies (mostly TIFs) from just 25 communities.[xv] CEO Mark Baker of Gander Mountain (the third largest sports store behind Bass Pro Shops and Cabela's which recently declared bankruptcy) remarked: "We consider these demands [for subsidies] to be anti-competitive and fundamentally inappropriate," arguing that "incentives to lure retail into a community often do harm to businesses already located in the area."[xvi]

Competition fairness is self-evident but TIF causes additional burdens for business. Because the tax revenue for all jurisdictions within a TIF district is "frozen" at the old value, the cost of providing new or additional government services like public safety or a community college for this area must be levied on those outside the TIF district. Additionally, non-TIF areas in the municipality alone must account for inflationary costs of government. This is often referred to as the hidden TIF tax. In Arizona, businesses have effective property tax rates roughly double that of other classes of property and must remain vigilant of schemes which complicate the property tax system and put upward pressure on rates.

Can TIF work in Arizona?

Despite the court ruling against debt-financed property TIF, state lawmakers could statutorily expand sales or property TIF to allow municipalities to siphon revenues from other jurisdictions. However, there are significant hurdles.

The first is between municipalities and other jurisdictions, who remain suspicious of economic deals which impact their access to the tax revenues. Randal O'Toole of the *Cato Institute* notes: "City managers view school districts, fire districts, and other agencies funded out of property taxes as rivals for the limited tax dollars paid by the public."[xvii] Jurisdictions sharing property tax revenues inside a proposed TIF have understandable concerns with their valuation being frozen. In the past, TIF opponents in Arizona have included these jurisdictions as they remain suspicious of the impact of development deals.

Even if approved at the state level, opposition from other jurisdictions won't naturally subside. School and community college districts, county government and fire districts become keenly aware of the financial impact associated with the creation of a TIF district and battles ensue. Ted Wheeler, county manager in Multnomah County Oregon (where Portland is located) noted: "If you invested in an area that is not truly blighted, you're simply taking dollars away from a jurisdiction that would be providing important community services…TIF is easy money, and it shouldn't be easy money. It should be the dollars of last resort. There are other ways you can fund projects..."[xviii] In the best of circumstances, policymakers should be aware that TIF will cause significant infighting between cities and amongst the jurisdictions which share the property tax.

Arguably the largest hurdle to TIF in Arizona is negotiating the K-12 equalization aid formula which is the bedrock of K-12 finance and interwoven into statewide property taxes. Put simply, Arizona law directs all school district taxpayers pay roughly the same primary school tax rate, the Qualifying Tax Rate (QTR) and the state will fund the remainder of the district's budget in the form of state aid, so taxpayers and schools are treated equitably. If a TIF district is created inside a school district or worse, overlaps multiple school districts, their QTR levy will remain frozen through the life of the district since the district does not control the QTR. Therefore if the TIF "works" and development begets population growth, state aid must increase at a faster rate than the state formula dictates. The same is true for routine inflation or general increases to K-12 budgets. This puts pressure on the state general fund and means taxpayers from around the state are now subsidizing economic development projects in the TIF district.

The equalization formula has already caused lawmakers to pass legislation in response to another economic development tool: Government Property Lease Excise Tax (GPLET), which allows cities and counties to abate property taxes for up to 8 years. Arizona law demands that for the purposes of calculating state aid for school districts, the state will include any GPLET property in their net assessed value so other Arizona taxpayers are not subsidizing local school district budgets as a result of an economic deal.[xix] This directly increases the local primary school property tax rate, representing the cost of GPLET for all taxpayers in the school district. This has caused rancor in communities where GPLET is common, such as Phoenix Elementary.[xx] At minimum, state lawmakers have made it clear they will not ask other Arizonans to subsidize local economic development plans. Ultimately, this means the "hidden tax" TIF generates will be all too visible in the form of higher tax rates.

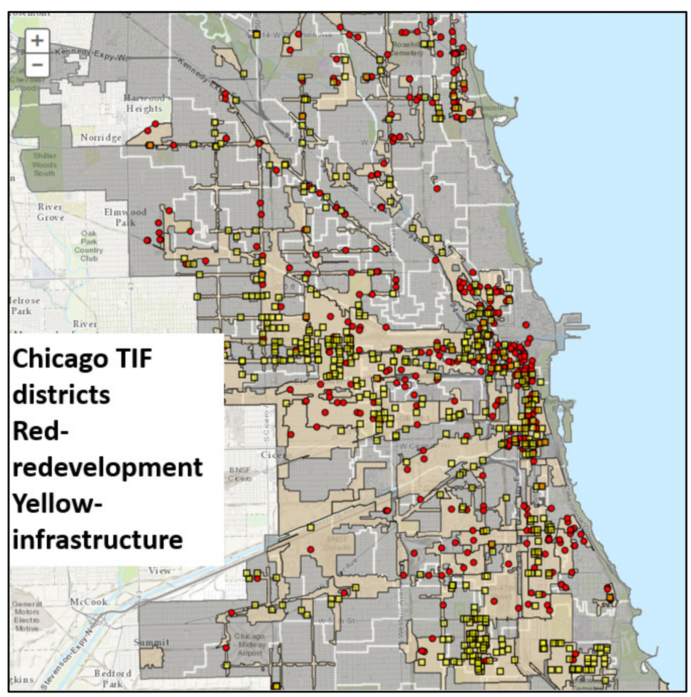
Is Arizona the Only State without TIF?

It is often said Arizona is the only state without TIF in hopes that an appeal to popularity will override more persuasive policy arguments. Arizona certainly allows *some* forms of TIF, constitutionally prohibits others, and statutorily bans the rest. It is true most states including Arizona have dabbled with one form of TIF or another in very different ways. The one commonality in the economic subsidy world is every state in the union struggles with them and TIF is perhaps the most beleaguered.

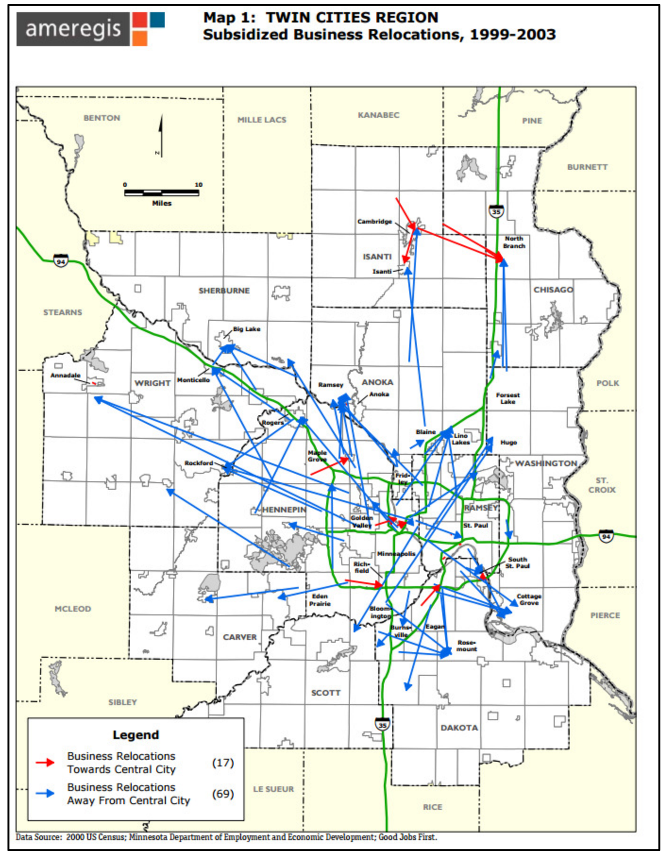
The epicenter of TIF is in the state which birthed it, maximized its usage and subsequently was forced to commit filicide by eliminating it. California first authorized the concept in 1952 and by 2011, roughly half of all TIF collections nationwide were from the Golden State.[xxi] It wasn't without controversy: California ended sales and use TIF in 1994 because inter-city bidding wars over retail were simply cannibalizing existing enterprise, amongst other unintended abuses.[xxii] Governor Jerry Brown, who used TIF to consolidate power and create numerous development deals while mayor of Oakland, gained a new perspective as governor when TIF collections topped $5.7 billion statewide, eating away at the state General Fund.[xxiii] Political leaders like Governor Brown who knew TIF most intimately made the decision to end the policy and phase out existing TIF districts.

REDEVELOPMENT "SEEMED KIND OF MAGICAL," GOVERNOR BROWN STATED WHEN MAYOR OF OAKLAND. "IT WAS THE WAY THAT YOU COULD SPEND ON STUFF THAT THEY WOULDN'T OTHERWISE LET YOU." (DIAZ)

TIF usage across the nation is spiky with the most significant activity occurring in Midwestern states and Texas, Connecticut, Colorado, and California. As mentioned earlier, in states where cities cannot increment other jurisdiction's revenues such as Virginia and New York, TIF activity is almost non-existent. Washington doesn't have TIF because it conflicts with its property tax system and uses different economic development tools. North Carolina didn't adopt TIF until its voters approved it in 2004 but created a requirement the county approve all TIF projects. The first and most famous project was the Randy Parton Theatre in Roanoke Rapids, a music venue built to house Dolly Parton's brother and spur tourism. Its dramatic failure shied state leaders from TIF.[xxiv] Some cities have taken it upon themselves to ban the practice although the state may permit it.[xxv] The notion that 49 other states have adopted consistent TIF laws is false. Each state has applied unique economic development models which attempt to cooperate with their finance structure.



In a similar vein as California, TIF has become such a monstrous lifeform in Chicago politics that many have called for its removal. For decades, TIF was the primary tool used by Chicago policymakers to control economic development deals, consolidate power and direct revenue towards special projects. By the late 2000's, over $500 million or 20% of the city budget was siphoned for TIF projects which had secretive budgets. Former Mayor Richard Daley refused to publish or even itemize TIF activity on property tax bills.[xxvi] Fully one-third of the city was within the hundreds of overlapping TIF districts, including 75% of industrial/commercial areas. Eight of the ten highest revenue generating TIF districts were in wealthy areas in the city center, which were leveraged to backfill losses in other areas. City leaders of all stripes admit TIF has caused significant policy problems, not the least of which is crony-capitalism and government corruption. Chicago has undergone significant reforms and now publishes its budgets but further reforms are naturally inhibited by the significant power TIF places in the mayoral office.[xxvii]



The Twin Cities area of Minneapolis and St. Paul used TIF to spar with each other for several decades before local leaders admitted it was creating job piracy and accelerated suburban sprawl. By 2004, 450 TIF authorities had created 2,210 TIF districts because their “but for” rule was largely meaningless and state regulations were minimal. Eighty percent of the 86 intra-metro business relocations in the early 2000’s were outbound.[xxviii] Growing suburbs were seeking to add commercial activity, which accelerated sprawl and undermined urban areas. Seventy-five percent of all business relocations involved TIF, meaning it rapidly became a requirement businesses demanded in order to relocate.[xxix] The Minnesota State Legislature has gone back to the drawing board every few years to attempt to adjust their TIF laws, all earnest attempts to corral a popular tool which continues to create undesirable consequences.

TIF has been used across the nation in many unique ways, often times with unfortunate outcomes. Kansas City spent two decades fighting “border wars” where TIF was used to poach businesses across state lines. Relocations were often to wealthier neighborhoods at the expense of poorer ones while politicians discussed but failed to create “anti-piracy” agreements.[xxx] Portland and Denver both used it for social engineering purposes to encourage dense urban living because it was considered an enlightened model.[xxxi] A review of state reform efforts show a consistent struggle to further define “blight” and “but for” to reel the program back within its original scope. TIF supporters constantly stress the need to add oversight, budget transparency, and restrictions to curb crony capitalism and corruption, which is perhaps the best indicator of the flaws inherent to TIF.

Conclusion

The notion that Arizona is losing the economic development battle because it lacks TIF flies in the face of the state’s historical growth. It certainly has not been an elixir for the heavy TIF users in the Midwest. Randall O’Toole puts it succinctly: “There is little evidence that city governments are better than private developers at determining the type and location of new development that cities need, and plenty of evidence that they are not as good.”[xxxii] Additionally, the sordid relationship cities engender with private developers in these dealings creates the appearance— at minimum, of crony-capitalism. Cities facing tight budgets due to rising pension, healthcare, and other employee costs are often looking for ways to cooperate in nonessential spending outside the general fund rather than face the difficult task of asking their voters to fund debt-service or trimming the budget. Policymakers should force city leaders to engage their citizens, not provide financial loopholes to avoid them.

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