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Information Brief

Joel Michael, Legislative Analyst (296-5057)
Tim Strom, Legislative Analyst (296-1886)
Steve Hinze, Legislative Analyst (296-8956)

Update of
An Estimate of the State Intergovernmental
Aid Costs of Tax Increment Financing

This information brief updates the estimates presented in *Tax Increment Financing, Working Paper #3: An Estimate of the State Intergovernmental Aid Costs of Tax Increment Financing,* published in April 1986 by the Research Department. This information brief presents estimates of the 1988 intergovernmental aid costs of tax increment financing (TIF).

Table 1 contains a summary of the state intergovernmental aid cost of tax increment financing.

Table 1
Total State Cost of Tax Increment Financing
(in millions)

	1986	1988
Education Aids		
Foundation Aid	$18.89	$36.47*
Transportation Aid	1.32	2.89
Other Aid	.82	1.63
TOTAL	$20.58	$40.99
State Property Tax Credits		
Homestead Credit	$6.25	$10.09
Agricultural School Credit	.45	.81
Small Business Credit	NA	1.60
TOTAL	$6.70	$12.50
TOTAL STATE COST	$27.54	$53.49

*Includes aid recapture cost.

Table 1 shows a nearly doubling of state costs in the two year period. Estimated costs have risen in step with the dramatic increase in the use of TIF and the amount of tax increment captured assessed value. TIF captured value has increased at an annual rate of 25 percent over the last several years. Some of the increased state costs are attributable to two other factors: (1) changes in the aid formulas and (2) increases in property tax rates.

Why TIF affects the amount of state intergovernmental aid

Tax increment financing (TIF) uses the increased property taxes generated by real estate development in tax increment financing districts to pay for development costs, rather than general local government costs. The value that is "captured" (i.e., the increases in value over the year the TIF district was created) continues to pay property taxes. These taxes go to the development authority or city, rather than the school, county, city and other taxing districts. The taxes are used for subsidizing development, not the general cost of local government.

The state pays aid to local government units under a variety of intergovernmental aid formulas. The largest of these are education aids to schools, reimbursements for property tax credits to all types of local governments, and local government aids to cities and counties. Calculation of aid under these formulas is affected by the amount of property wealth in the taxing districts. As property wealth increases, the amount of state intergovernmental aid, as a general rule, will decrease.

Tax increment financing or captured values are generally excluded in determining the amount of property wealth under the intergovernmental aid formulas. Thus, to the extent that TIF captures increases in property value that otherwise would have paid property taxes, TIF results in higher state aid payments under the formulas.

Methodology

The estimates presented here were prepared using the same methodology employed in the original Working Paper #3, *An Estimate of the State Intergovernmental Aid Costs of Tax Increment Financing* (April 1986). The reader should refer to the original working paper for a discussion of the assumptions that were used with regard to (1) how much additional real estate development in the state is stimulated by TIF and (2) calculation of the aid formulas.[1]

In general, the estimates assume that TIF does not increase total real estate investment in Minnesota, although it affects the location of that investment. Thus, the estimates should be regarded as an upper bound of the state intergovernmental aid costs. It is conceivable, however, that TIF actually decreases the total real estate investment in Minnesota. This may occur because TIF raises effective property tax rates on properties not qualifying for TIF subsidies and because the availability of TIF subsidies may cause sub-optimal location decisions. If this is so, the actual state cost could be higher than the estimates.

The estimates continue to assume that TIF has no impact on the total amount of local government aids that are paid to cities and counties. In addition, the estimates are limited to intergovernmental aid program costs. TIF imposes additional state costs under the property tax refund program and under the income tax through the use of tax exempt bonds. These state costs are not included in the estimates. Thus, the estimates should not be regarded as measures of the total state cost of tax increment financing.

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[1]The methodology has been criticized by some TIF proponents. A brief paper responding to the critics, **Response to Criticism of Methodology**, by Joel Michael, is available from the House Research Department (296-6753).

Notes on Changes in the Aid Formulas since 1986

Education Aids

The school finance formulas were substantially changed between the 1986-87 (taxes payable 1986) and the 1988-89 school years (taxes payable 1988). The foundation aid program was replaced with the general education revenue program. The basic maintenance mill rate was substantially increased and the foundation tier levies were eliminated. Many categorical programs were eliminated as categorical programs and the basic general education formula allowance was increased accordingly. The net result is a more uniform general education mill rate among districts and a higher mill rate statewide. The average increase in the general education (foundation) mill rate between taxes payable in 1986 and taxes payable in 1988 was 3.2 AAV mills (from 31.4 to 34.6).

The changes in estimated state costs of TIF for education aids are due to a combination of

(1) increased school levy levels,

(2) redistribution of the adjusted assessed tax base, and

(3) increased tax increment values.

Property Tax Credits

The parameters of the 1986 property tax credits--the homestead and agricultural school credits--were not changed by the Legislature between taxes payable in 1986 and 1988.[2] Therefore, the changes in estimated state costs under the homestead and agricultural school credit programs are due to a combination of the effects of

(1) increased tax increment values,

(2) changes in tax levies and mill rates, and

(3) changes in the composition and size of the tax base.

Unlike education aids, program changes are not a factor.

Although the Legislature did not change the homestead and agricultural credits, it did enact a new small business property tax transition credit which has TIF state cost implications. This credit applies to the tax on the first $120,000 of market value of commercial and industrial property. The credit equals 50 percent of the tax in excess of 3 percent of market value. This credit is in effect only for property taxes payable in 1988.

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[2] The maximum homestead credit was increased from $700 to $725 for taxes payable in 1989. For taxes payable in 1990 the homestead and agricultural credits are eliminated and replaced by reduced assessment ratios and direct transition aid payments to local government units.

State Cost Estimates

Table 2 displays the education aids cost of tax increment financing for the 1988-89 school year (taxes payable in 1988). This table corresponds to Table B in the original Working Paper #3. The far right column of the table (State Aid Decrease) shows the reduction in state education aids that would be paid if the tax increment value were available to pay regular property taxes. Thus, the total state cost of the aid programs rises by slightly less than $45 million as a result of tax increment financing.

Table 2
Education Aids--TIF Cost
1988-89 School Year: Payable 1988 Taxes

	Levy Amount Current Law (000s)	Levy Amount Alternative with TIF Added (000s)	Levy Increase (000s)	State Aid Decrease (000s)
General Education Aid	$1,047,707	$1,084,175	$36,468	$35,583
Aid Recapture				885
Basic Transportation	69,955	72,846	2,891	2,891
Community Education				
Basic Community Education	20,290	20,470	180	180
Early Childhood	11,642	12,737	1,095	1,095
Basic Capital Expenditure	80,697	81,055	358	358
Referendum	133,344	135,890	2,546	--
Desegregation (St. Paul only)	2,000	2,100	100	--
Operating Debt	1,200	1,300	100	--
Statutory Operating Debt	4,000	4,000	--	--
TOTALS			$43,738	$40,992

Table 3 compares the relative amounts of the state aid decrease for 1986 and 1988 by individual programs. The education aids cost of TIF rose from $20.6 million in 1986 to $41.0 million in 1988. Thus, the cost nearly doubled in the two year period between 1986 and 1988. Stated another way, the cost rose at a compound, annual rate of 41.1 percent.

Table 3
Education Aids–TIF Cost
Comparison of 1986 and 1988

	1986*	1988**	% Change***
General Education Aid	$18,891	$35,583	37.2%
Aid Recapture	NA	885	NA
Basic Transportation	1,320	2,891	48.0
Community Education	56	1,275	377.2
Basic Capital Expenditure	NA	358	NA
Other	91	NA	NA
TOTAL	$20,582	$40,992	41.1%

*School year 1986-87, taxes payable 1986.
**School year 1988-89, taxes payable 1988.
***Compound, annual percentage increase.

It seems apparent that the dramatic increase in state education aid costs of tax increment financing is due in large part to the steady and rapid increase in the amount of tax increment values over the 1986-88 period. These values increased at roughly a 25 percent annual rate during this period.[3] However, this is obviously insufficient to account for an annual growth rate in excess of 40 percent. The balance of the change probably is due to changes in the aid formula parameters, as described above.

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[3] See House Research, *Tax Increment Financing 1986 and 1987 Captured Assessed Values* (August 1987) which shows a 30.5 percent and 27.2 growth rate for 1986 and 1987.

Table 4 displays the property tax credit costs of tax increment financing. This table corresponds to Table C in the original Working Paper #3.

Table 4
Property Tax Credits– TIF Costs

Property Tax Credit	1986	1988	Pct. Change*
Homestead Credit	$6,145	$9,874	26.7%
Homestead, Agricultural	100	225	50%
Agricultural School	454	809	33.5%
Small Business	0	1,596	NA
TOTAL	$6,699	$12,504	36.6%
Mill Rate (in mills):			
Baseline	104.8	118.0	6.1%
Alternative	102.7	114.4	5.5%
Change in Net Total Tax Burden	($58,686)	($106,421)	34.7%

*Percentage change is expressed as a compound annual rate.

Table 4 shows that the property tax credit cost of tax increment financing grew at a 36 percent annual rate over the two year period. This increase is due to three factors. The first and most important reason is the growth in tax increment values. Second, enactment of the new small business credit increased the cost by $1.6 million. Third, increases in mill rates contributed to some of the increase. Mill rate increases resulted from either local government decisions to increase spending (in excess of tax base growth) or a decline in tax base. Since the baseline mill rates increased only at a little over 6 percent annual rate of growth, mill rate increases appear to have a relatively small effect in explaining the rapid growth in credit costs.