Tax Increment Financing:
A Theoretical Inquiry

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Abstract

This paper offers an analysis of tax increment financing, adding to a small theoretical literature on this important fiscal instrument. The analysis exploits the theoretical connection between property values and public-good levels, which is the subject of a large literature in local public finance. Using this approach, the paper shows that localized public improvements are likely to be opposed by property owners outside the affected area, who pay higher property taxes with no offsetting benefits. By using tax revenue captured from overlapping jurisdictions, TIF may circumvent this opposition, allowing the city to implement the public improvement without an increase in its tax rate. TIF is not always viable as a financing method, however, because it may not generate enough additional revenue. The analysis shows that TIF's viability is ensured only when the public good is at least moderately underprovided relative to the socially-optima level. In the case where the public good is slightly underprovided, a public improvement is desirable, but TIF is not viable. Finally, the analysis shows that the public-good levels ultimately chosen under TIF need not be efficient, with both under and overprovision being possible outcomes. Thus, while TIF may allow a city to carry out needed public improvements, the stimulus it provides may be excessive.

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Jan K. Brueckner is Professor of Economics and a member of the Institute of Government and Public Affairs at the University of Illinois at Urbana-Champaign. He is an expert in the areas of urban economics and local public economics, and serves as editor of the *Journal of Urban Economics*.

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