

**TAX INCREMENT FINANCING  
and LOCAL ECONOMIC  
DEVELOPMENT**

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# Tax Increment Financing and Local Economic Development

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In November, West Virginia residents will vote on an amendment proposing a new local government financing method called tax increment financing (TIF). TIF originated in California in 1945 with the enactment of the Community Redevelopment Act. It was first adopted as a local revenue source designed to eliminate blight, expand housing opportunities and create jobs throughout communities in California (Johnson, 1999). Although it originated in 1950s, it was not widely adopted until the late 1970s. According to a survey conducted between 1986 and 1987 by Klemanski (1990), 55% of the 33 states with TIF legislations passed these legislations between 1974 and 1979.<sup>1</sup> Klemanski argues that the recession in the mid-1970s is a major factor in these TIF adoptions. Johnson and Kriz (2001) argue that several TIF-enabling legislative actions took place during the period from mid-1970s to late-1980s. Table 1 shows that this period also coincides with a significant decrease in federal aid to state and local governments. Between 1975 and 1990, federal aid to state and local governments as a percentage of GDP went down from 3.2% to 2.4%, a decrease of 25%. Federal aid in 2000 was still below its 1975 level.

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<sup>1</sup> By 1970, only seven states had authorized the use of TIF. These states are California, Minnesota, Nevada, Ohio, Oregon, Washington, and Wyoming (Johnson and Kriz, 2001).

**Table 1: Federal Grants-in-Aid to State and Local Governments as % of GDP**

| <b>Year</b> | <b>% of GDP</b> |
|-------------|-----------------|
| 1970        | 2.4             |
| 1975        | 3.2             |
| 1980        | 3.3             |
| 1985        | 2.6             |
| 1990        | 2.4             |
| 1995        | 3.1             |
| 2000        | 2.9             |

Source: U.S. Statistical Abstract, 2001.

Initially, TIF aimed at financing a variety of infrastructure improvements for economic development and growth. Today, this original goal can be extended to include lower unemployment, higher wages, higher property values, business attraction, industrial development, downtown development, overall infrastructure improvement, and increases in local tax revenues.

### **How Does It Work?**

TIF is usually associated with the issuing of local debt instruments such as bonds, which are paid by increased tax revenues collected from the benefiting locality.<sup>2</sup> For example, a local government issues bonds to raise the necessary funds to develop a blighted area. The development project is expected to increase local private investment and raise property values. This would result in higher property tax revenues collected from the developing area. The increment by which the property tax revenue increases is used to retire the issued bonds. TIF procedures may differ from state to state, but the

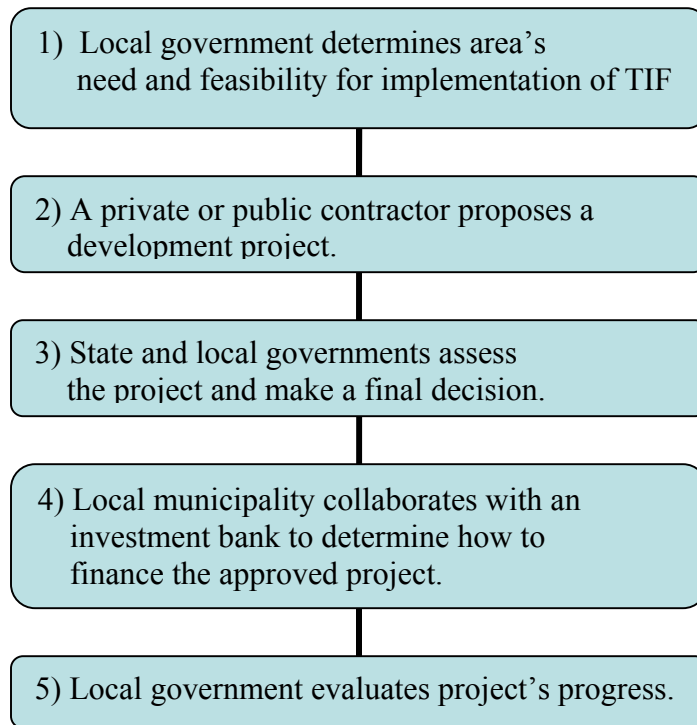
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<sup>2</sup> Local development can also be financed directly through a “pay as you go” method without issuing bonds. In this method, tax revenues are spent on various development projects, as they are collected.

main principle of targeted tax financing remains the same. The diagram below further illustrates a general planning and implementation process of tax increment financing.

At first, a development idea for a specific geographic location (usually a blighted area) emerges. The local municipality and community review the proposed development project, assess its feasibility, and submit it to the state government for approval. If the state government approves the project, the next step is to decide how to finance it. One way is to issue revenue bonds, for example, or spend tax revenue on the project as it is collected. Once the development project in the TIF district begins, the local government and community should monitor building of the tax increment and project's progress.

**Figure 1: Stages in a Standard TIF Process**



## **Advantages of Tax Increment Financing**

Tax increment financing has gained in popularity and spread nationwide quite rapidly. It is currently used by 46 states.<sup>3</sup> The arguments in favor of TIF focus on its unique financing mechanism and its effectiveness in enhancing economic development. Some of its major advantages include:

1. As an additional local government finance instrument, TIF gives flexibility to local governments in financing economic development projects.
2. It can provide duly needed capital in the economic development of blighted areas. It has been used in various development and redevelopment projects including reconstruction projects following natural disasters such as floods and earthquakes.<sup>4</sup>
3. It is a politically attractive tool because it does not directly involve any new tax increases.
4. It provides local taxing authorities with an improved tax base after the entire TIF debt is paid for.

## **Disadvantages of Tax Increment Financing**

Tax increment financing is not without its problems. Despite its advantages, a number of criticisms have been brought against this financing method. Some of the concerns with TIF are:

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<sup>3</sup> When this article was written, Arizona, Delaware, North Carolina and West Virginia were the only four states that had not used TIF.

<sup>4</sup> An example to this is the Earthquake Recovery and Reconstruction Project undertaken in Santa Cruz following the Loma-Prieta Earthquake in California in 1989. See Chapman (2001) for a description of the use of TIF in this project.

1. TIF is enacted in a local governmental setting where there are overlapping jurisdictions such as counties, municipalities and school districts. Since the property value growth in the TIF district is reserved for the repayment of TIF obligations, other non-benefiting jurisdictions that contain the TIF district may feel disadvantaged. This can lead to interjurisdictional conflicts and can possibly undermine the effectiveness of the TIF program.
2. TIF programs are costly to administer. This is due to the complexities involved in the implementation process.
3. Although TIF bonds do not generally count towards county or municipal indebtedness, municipalities can still be affected through possible reductions in credit ratings if TIF obligations default.

### **Is TIF an Effective Economic Development Tool?**

TIF is considered an important local development-financing tool. One way to assess its effectiveness is to look at its use by various cities. Considering its development objective, we expect that TIF would be used by cities that need development the most. These cities would generally be the ones that experience low or deteriorating growth in population and economic base. Empirical evidence on this, based on different case studies, is not very conclusive. The success of TIF programs in fulfilling the cities' economic development objective depends critically on the property value growth following the development effort. Table 2 shows an assortment of studies that addressed the effects of TIF on economic development.

**Table 2: Studies on the Effect of TIF Use on Economic Development**

| <b>Studies</b>                 | <b>Case Study</b>                 | <b>Year(s)</b> | <b>Effect of TIF on property values</b> | <b>Other Local Area Effects of TIF</b>  |
|--------------------------------|-----------------------------------|----------------|---|---|
| Huddleston (1984)              | 67 Wisconsin cities               | 1980           | ambiguous                               |   |
| Anderson (1990)                | 255 Michigan cities               | 1985 & 1986    | positive correlation                    |   |
| Forgey (1993)                  | 300 municipalities from 34 states | 1989           | positive correlation                    |   |
| Lawrence and Stephenson (1995) | Des Moines, Iowa                  | 1973-1993      | positive                                | lower property tax rates in later years |
| Man and Rosentraub (1998)      | 151 Indiana cities                | 1980 & 1990    | positive                                |   |
| Man (1999b)                    | 53 Indiana cities                 | 1985-1992      |   | positive effect on local employment     |
| Dye and Merriman (2000)        | Chicago metropolitan area         | 1980-1995      | negative                                |   |

Huddleston (1984) argued that tax increment financing in Wisconsin is not neutral with respect to the cities' development incentives. He provided evidence from 67 Wisconsin cities and showed that TIF subsidies, calculated as the percentage of development expenditures paid by governments other than the city that undertakes the TIF project, favored cities experiencing population growth. He further argued that this lack of neutrality in the development incentives might exacerbate the development pressures already felt by stagnating cities from their growing neighbors.

A study by Forgey (1993) summarizes responses to a survey sent to 300 municipalities from 34 states. While 77% of all responding municipalities using TIF reported that they had been experiencing growth in their economic base over a five-year period, 62% of the municipalities that did not use TIF also reported growth over the same

period. Furthermore, 48% of the municipalities that did not use TIF had populations under 10,000. Of the municipalities using TIF, only 8% had populations under 10,000. These survey responses led Forgey to conclude that larger cities (10,000 and over) are more likely to use TIF than smaller cities. He further concluded that population growth has acted as a trigger in TIF adoptions. Survey responses also showed that only 2% of the TIF-using municipalities reported decrease in property values in their TIF districts. The number of respondents that reported some increase in property values was 78% of the total. While Forgey asserted a positive correlation between TIF districts and property values, he does not argue whether the property value increases are necessarily due to the enactment of TIF.

Studies by Anderson (1990) and Man (1999a) examined the factors that led municipalities to adopt TIF. Anderson concluded, based on his analysis of Michigan cities, that TIF is used by faster growing cities. While he found an association between TIF adoption and growth in property values, he asserted that this growth might not necessarily be caused by TIF. Recently, Man (1999a) conducted a similar study on Indiana cities and showed that fiscal stress and the existence of TIF in neighboring cities are significant factors in the adoption decision of TIF. However, she did not find empirical evidence to support Anderson's conclusion that prior population growth increases the likelihood of TIF adoption. Additionally, she found that cities with low per capita income are more likely to adopt TIF than high-income cities. This gives support to the contention that TIF is intended mainly as a development tool.

Lawrence and Stephenson (1995) provide a study of tax increment financing in downtown Des Moines, Iowa. They calculated a time series of net increase in downtown



property values since the start of TIF. This net valuation increase is the difference between total increase in property values and an estimate of the valuation growth that would have occurred in the absence of TIF. Their evidence indicated that while taxpayers in the entire metro area subsidized downtown development projects in the earlier years of TIF use, the net increase in property values was high enough to lead to lower property tax rates in later years.

Man and Rosentraub (1998) showed that the TIF program in an Indiana city had raised the median owner-occupied housing values by 11% relative to what it would have been had the TIF not been implemented. They concluded that the TIF program successfully enhanced property value growth in Indiana cities between 1980 and 1990. Dye and Merriman (2000), on the other hand, showed evidence from the Chicago metropolitan area that cities that adopted TIF grew more slowly in equalized assessed property value than cities that did not. They alleged that this result is “consistent with the hypothesis that government subsidies reallocate property improvements in such a way that capital is less productive in its new location.” (Dye and Merriman 2000, pp. 324) They argued that while TIF subsidies might be helping growth within the TIF district, the negative impact on the growth in the local area outside the district might be so strong that the growth in the local area can be impaired.

While many studies examined the effect of TIF districts on the property value growth, only few studies addressed the effects on local employment. Man (1999b) is one of those few researchers who addressed the local employment effect by gathering data on 53 Indiana cities for the period 1985-1992. Her findings suggest that TIF had a positive and significant effect on local employment. She asserted that, on average, “cities that

adopted TIF programs created 4% more jobs than those non-TIF cities.” (Man 1999b, pp.426)

Finally, two case studies on Minnesota “Brownfields”<sup>5</sup> by Zachman and Steinwell (2001) suggested that TIF might not be viable in projects with substantial environmental cleanup costs. The authors argued that, in such cases, additional financial protection might be necessary to make up for inadequate revenue stream from TIF.

### **Municipal Debt and Tax Increment Financing**

TIF is a far-reaching financing mechanism in the sense that it ties the municipal debt financing to the property tax system. It brings, however, an important risk that debt repayments depend entirely upon future increments of property tax revenues. If the property tax base does not grow as expected, these debt repayments will be at serious risk.<sup>6</sup> Johnson (1999) showed that stronger property value growth is associated with higher credit ratings. While he found no direct relationship between property value growth and lower interest costs, he argued that property value growth indirectly caused lower interest costs through higher credit ratings. Thus, Johnson’s analysis emphasizes once again the importance of property value increase in a TIF district.

Although there is no explicit moral obligation for governments in the debt service payments, it is argued that there is still an implicit government support in the TIF mechanism. Johnson (2001) gives an example from Colorado where a development authority’s default on a \$27 million bond issue led to downgrading of the city’s general obligation bond rating. The dependence of the TIF mechanism on a single tax revenue

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<sup>5</sup> Brownfields refer to properties with a real or perceived stigma of pollution that complicated, or even inhibited, their purchase, sale, financing, refinancing, redevelopment, and ultimate reuse. See Zachman and Steinwell (2001) for a detailed examination of these case studies.

<sup>6</sup> Johnson (1999) gave the example of Colorado, which had actually defaulted on some of the TIF bonds.

source highlights also its vulnerability to various economic and natural mishaps. This makes it a risky and, consequently, a costly municipal debt instrument.

### **Tax Increment Financing in West Virginia: Local Option Economic Development Amendment (Amendment One)**

The West Virginia State Legislature enacted the West Virginia Tax Increment Financing Act during the 2002 regular session. This Act will not go into effect until West Virginia residents ratify it as an amendment to the state constitution in November. A similar amendment failed four years ago with strong opposition from labor organizations. However, the new amendment added safeguards for local labor such as prevailing wage requirements and local labor preference (see section 14, SB244). Consequently, the AFL-CIO gave its endorsement to the amendment and pledged its support in the campaign for its ratification (Miller, 2002).

The proposed TIF process incorporates an active public involvement in assessing the need and feasibility of a project compared to a general TIF process. The process starts with an economic development idea that can come from either the private sector or the public sector. A county commission or a municipality<sup>7</sup> reviews this idea with public input and approves or rejects the TIF project plan in a public meeting. Following the approval of the plan by the county commission or the municipality, the West Virginia Development Office reviews the plan to ensure that the project developer conforms to the requirements set forth in section 8 of the West Virginia Tax Increment Financing Act. The Development Office then reports its decision within 60 days. If the project plan is approved again, the county or municipality works with investment professionals to issue TIF obligations necessary to the financing of the project. Finally, the county commission

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<sup>7</sup> According to SB244, besides a county commission, only Class I and II municipalities are authorized to carry out the tasks related to a TIF project.

or the municipality must prepare a status report each year for each development and redevelopment project. This status report must be filed with the executive director of the development office.

### **Can TIF really help in local economic development in West Virginia?**

The ultimate goal of a TIF program is to help a local area develop. Being one of the least developed states in the nation, West Virginia and its municipalities appear to be good candidates for the use of this development financing mechanism. Besides, as mentioned earlier in the context of California earthquakes, TIF has been used in reconstruction and redevelopment projects following natural disasters. It can be particularly effective in dealing with flood damages in southern West Virginia.

The use of TIF in other states can also provide a simple guideline in our analysis. Table 3 ranks states according to the total number of TIF issues and total dollar value of TIF debt from 1990 to 1995.

**Table 3: Cumulative TIF Debt By State: 1990 to 1995**

| <b>State</b> | <b>Number of TIF Issues</b> | <b>Dollar Amount</b> |
|--------------|-----------------------------|----------------------|
| California   | 476                         | 8,245,616,720        |
| Minnesota    | 97                          | 486,470,000          |
| Oregon       | 41                          | 204,985,000          |
| Michigan     | 40                          | 233,142,451          |
| Colorado     | 23                          | 386,090,000          |
| Iowa         | 20                          | 26,045,000           |
| Florida      | 15                          | 155,825,464          |
| Nebraska     | 13                          | 22,775,000           |
| Missouri     | 12                          | 81,845,000           |
| Nevada       | 11                          | 123,935,000          |
| Indiana      | 10                          | 34,480,000           |
| Idaho        | 9                           | 32,375,000           |
| Utah         | 8                           | 44,120,062           |
| Montana      | 7                           | 27,120,000           |

|                |            |                       |
|----------------|------------|-----------------------|
| North Dakota   | 6          | 7,405,000             |
| South Carolina | 5          | 36,970,000            |
| South Dakota   | 4          | 13,975,000            |
| Texas          | 4          | 6,495,000             |
| Mississippi    | 4          | 1,355,000             |
| Rhode Island   | 3          | 26,500,000            |
| Maine          | 3          | 3,900,000             |
| Arkansas       | 2          | 15,275,000            |
| Alabama        | 2          | 5,710,000             |
| Massachusetts  | 1          | 13,700,000            |
| Kansas         | 1          | 6,160,000             |
| Wisconsin      | 1          | 5,100,000             |
| Louisiana      | 1          | 3,025,000             |
| <b>Total</b>   | <b>819</b> | <b>10,250,394,697</b> |

Source: Johnson (1999).

California dominates the TIF market in both the total number of TIF issues and the total dollar value of TIF debt. Mid-Western states also have large shares. Despite this geographical concentration of the biggest TIF users, there is considerable diversity especially in the economic structures of these states. This shows that TIF is not exclusive to states with specific economic profiles. States like Arkansas, Alabama, Florida, Idaho, Iowa, Kansas, Louisiana, Mississippi, Missouri, Montana, Nebraska, North Carolina, North Dakota and Utah are all comparable to West Virginia with respect to rural or natural resource based economic characteristics or demographic structures.<sup>8</sup> However, none of West Virginia's contiguous states is listed in Table 3. This indicates that TIF has not yet become popular in the immediate region surrounding West Virginia.

From our review of the literature on TIF and economic development, we found that there is no absolute consensus on the effects of TIF programs on the development of local areas. Earlier studies suggested that TIF is used more by growing cities than

<sup>8</sup> See Tosun and Takashima (2002) for the states used for comparison in the analysis of the West Virginia state tax system.

stagnating or declining cities. This has important implications for the prospect of TIF usage in West Virginia since the state population remained roughly stable in the past decade, even experiencing periods of population loss. However, this positive association between prior growth in population and the use of TIF was not confirmed by later studies. It was argued in these later studies that cities with lower per capita incomes are more likely to use TIF. Nevertheless, low or negative population growth rates in West Virginia may pose a serious threat to the actual use of TIF in the state.

The West Virginia tax increment financing legislation excludes from the proposed TIF mechanism all excess property levies, levies for general obligation bonds or any other levies that are not regular levies of counties, schools and municipalities. In Fiscal Year 2002, the total of these excluded levies<sup>9</sup> were around 40% of the total property tax levies (West Virginia State Tax Department, 2001). This means that, on average, only 60% of the property taxes levied on a TIF project would be eligible for the increment. This can be a serious drawback in the use of tax increment financing in West Virginia. With a weakened property tax revenue flow, the viability of a TIF project may be jeopardized.

### **What Have We Learned?**

Judging by the economic development objective of tax increment financing, West Virginia immediately appears as a potential candidate to use TIF. One of the most important advantages of TIF is that it makes resources available to stimulate economic development in local areas. For example, TIF could be an appropriate mechanism to deal with flood damages in southern West Virginia. This financing method has already been

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<sup>9</sup> Excess levies are by far the largest in this group with a share of 34% of total property tax levies.

used by municipalities in states that are structurally similar to West Virginia. This shows that TIF use is not exclusive to California and some Mid-Western states.

There are two major risks, however, that may affect the implementation of TIF programs in West Virginia. The first one has to do with the adoption decision of TIF by different municipalities. While there is no absolute consensus from the previous studies, growing cities have been found to be more likely to use TIF compared to cities experiencing population losses. The negative population growth rates observed in West Virginia in recent years lead us to wonder whether TIF would actually be used by many municipalities even if the Tax Increment Financing Act is ratified in November.

The second risk has to do with the revenue generating capability of the TIF mechanism. We argued that the success of a TIF program depends significantly on the property value growth it generates. Since TIF debt is paid entirely by the incremental property tax revenues generated by increasing property values, property value growth becomes the single most important aspect of the TIF mechanism. In general, studies showed a positive association between TIF programs and property value growth in TIF districts. Some of these studies provided more definitive results and concluded that TIF had a significantly positive effect on the property value growth. We also argued the significance of this in maintaining a healthy municipal debt financing system despite the fact that, in many states, municipalities do not have explicit moral obligation in the debt service. The exclusion of excess levies from the TIF mechanism may weaken the revenue flow significantly despite a strong growth in property values. This will also make TIF more vulnerable to external shocks such as economic recessions.

Finally, TIF also highlights the importance of data collection in the evaluation of both the progress of TIF projects and the impact on local economic development. A good record keeping and data collection system would enable better evaluation of current and future TIF projects. This would also help in spreading TIF across cities in the state.



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