Interim Study Report on LR 232, Tax Increment Financing

Legislative Interim Study Resolution LR232 asks the Revenue Committee to undertake an examination of the fiscal impact of the practice of tax increment financing. Tax increment financing is a form of property tax financing in which all local government property taxes on certain newly developed properties are diverted from their normal use in funding public services and spending. These dollars are diverted to pay for public infrastructure development costs at the property site or area designated as blighted or substandard by a city council. All property taxes on the newly developed value, including school, city,county and community college taxes, as well the taxes of any other tax levying government are diverted from general fund budgets. Taxes paid for bond funds and building fund projects of these governments are also diverted to the redevelopment purpose established by the city council. Normally, the city share of these diverted funds is approximately 20% of the total funds diverted, with the bulk of the diverted property tax coming from school taxes. (Typically, a property would face a combined rate of tax that is 2.00 dollars or more, and of that, the city rate would be .40 cents.)

Provisions of this law and policy are found in state statutes 18-2101 to 18-2154. This act and its provisions are referred to as the Community Development Law. Use of this form of of financing is controlled and guided by language found in Nebraska's State Constitution, by virtue of a constitutional amendment approved by the voters in 1978. This amendment authorized the diversion of public funds to re-development purposes under certain circumstances where property is declared blighted. This amendment was necessary because Nebraska's constitution contained provisions limiting the use of public funds to public purposes. The use of tax funds to fund certain infrastructure costs benefiting new privately owned property development projects is authorized by this constitutional amendment, The authorizing constitutional provisions are shown below.

VIII-12. Cities or villages; redevelopment project; substandard and blighted property; incur indebtedness; taxes; how treated.

For the purpose of rehabilitating, acquiring, or redeveloping substandard and blighted property in a redevelopment project as determined by law, any city or village of the state may, notwithstanding any other provision in the Constitution, and without regard to charter limitations and restrictions, incur indebtedness, whether by bond, loans, notes, advance of money, or otherwise. Notwithstanding any other provision in the Constitution or a local charter, such cities or villages may also pledge for and apply to the payment of the principal, interest, and any premium on such indebtedness all taxes levied by all taxing bodies, which taxes shall be at such rate for a period not to exceed fifteen years, on the assessed valuation of the property in the project area portion of a designated blighted and substandard area that is in excess of the assessed valuation of such property for the year prior to such rehabilitation, acquisition, or redevelopment.

When such indebtedness and the interest thereon have been paid in full, such property thereafter shall be taxed as is other property in the respective taxing jurisdictions and such taxes applied as all other taxes of the respective taxing bodies.

Source

Neb. Const. art. VIII, sec. 12 (1978);
Adopted 1978, Laws 1978, LB 469, sec. 1;
Amended 1984, Laws 1984, LR 227, sec. 1;
Amended 1988, Laws 1987, LR 11, sec. 1.

Under this law, as authorized by the constitutional amendment, a newly developed real estate property at a site or in an area declared blighted or substandard by a city government is pays taxes on the new increment of real property value created at a site and added to the value and rolls in the area. However, this new property value and the taxes paid on this value are diverted from the tax base and tax revenues of each local government levying a property tax, including schools, cities, counties, natural resources districts, community colleges and all other taxing entities. The diverted property tax proceeds are used to fund development expenses incurred in creation of the newly developed property. These development or redevelopment expenses can include the costs of improving existing public infrastructure or creating new public infrastructure at the site or area of the new development. State laws do at this time contain a limit on the amount of physical territory or geographic area a city can declare blighted, which can be translated into a limit on the amount property value and taxes which can be diverted.

In effect, the taxes paid by the owner of the new property serve as a subsidy to cover the cost of developing the property in an area.

This can be done only when the city government has determined that the development would not be built were the subsidy not available to the property owner and developer. This diversion of all other local government property taxes by the city government deprives all the local governments of those funds for the life of the redevelopment project authorized by the city. On average, sixty to sixty five percent of these diverted taxes are school taxes. which are now diverted to another use. This development subsidy can continue for fifteen years. During these fifteen years the newly developed value is subject to annual reassessment of value, and annual application of all local government tax rates to that value.

The newly created, or excess property value is not tax exempt. However, it is not added to the value base of the local governments during the financing period authorized by the city. The proceeds of the taxation which occurs are not distributed to the local governments, because they are pledged to redevelopment purposes. Therefore the new increment of real property value is not included in the taxable value base of the local governments when these governments set their rate or tax levy. When calculating the tax rates for funding governments the increment or excess value is not used to determine the levy or tax rate they can apply. This rate or levy is calculated to generate the local governments property tax request for budgeted property tax revenues. Diversion of this value and tax to another city authorized purpose creates a need for a higher tax levy rate for other governments than would be otherwise be necessary to generate the same property tax revenue.

Fiscal impacts of tax increment financing.

Tax increment financing has several fiscal impacts. A brief list includes:

The proceeds of property taxes normally paid on a property continue to be paid, but are diverted to a development subsidy to the property owner. The local governments do not receive taxes for funding public services and spending from the new value growth, as they would if the new value had been added to their tax base rather than diverted to a development subsidy. These governments do continue to receive the proceeds of the tax rates applied to the preexisting taxable value, referred to as base

value. This base value remains a constant value, effectively freezing the value level for purposes of local taxation. All increases in value, and the taxes from that value, including those from reassessment of existing properties and from newly constructed property are diverted to the redevelopment project purposes approved by the city council. This includes redirecting school and county taxes, along with city taxes, and all other property taxes levied by governments like community colleges, natural resources districts, railroad transportation districts, and city county building commissions.

As a result of diversion from the tax base of local governments, property tax rates applied to a tax base yield less total revenue than they would if the value had been added to the tax base of each local governments. As a result tax rates must be set higher to generate the same funds for local budgets. In the typical situation, when property value is added to the tax base, the local government may realize a revenue gain without raising the tax levy rate on all other properties.

In the situation where a local government faces a tax rate limit, and is at that rate limit, the local government will, of course, experience a lower yield from that maximum rate, and therefore have less property tax funds for public services than they would have experienced with the addition of new value.

For some local governments, particularly school governments in Nebraska, this loss of available resources is mitigated or offset by state aid programs which recognize valuation capacity as a factor in distributing state aid. Nebraska's Tax Equity and Education Opportunity is this type of formula (See Section 79-1015.01 of state law.) In this type of aid policy, local needs that can not be met with local resources from prescribed rate of property tax are met with supplemental state aid, termed equalization aid. One other aid program is based on this principle, the Municipal Equalization Fund. Other programs with valuation capacity equalizing principles have been repealed, (County Property Tax Relief Fund, 2011) or so substantially modified as to make equalization of valuation based resources largely irrelevant. (Community College aid, with pending legislation in 2011)

The State of Nebraska budget is fiscally impacted when growth in value is diverted from school use. This occurs because the state aid to schools program is funded on basis of supplying state resources to schools based on their needs and their capacity to generate property tax revenues. The stronger the property tax base of a school district is, the less state funds are needed to fund local needs. If value growth is diverted to other purposes, schools will generate less local resources, and receive relatively more state aid. Our estimate of this impact of tax increment financing on state aid funding is that 21 million dollars of additional state aid. This additional state aid offset is experienced only for those schools where budgetary needs are more than than local resources which can be generated under prescribed levy rates, and this policy applies only to general fund operating budgets. Other school property tax levies for building funds and bond issues are effected, but the loss of tax capacity is not mitigated by increased state aid. The most common effect on these other funds is a higher tax rate on all taxpayers then would be necessary if the new value growth had not been diverted to a development subsidy.

No offsetting aid programs based on the relationship between valuation capacity and needs funding exist for school capital funding needs, which are met through imposing separate property tax rates for building fund and bond funds. In the case of the school building fund rate, which has a maximum rate limit under law, this rate will not yield as much funding for building needs, or a higher rate which is still below the limit will be set by the local school to meet those needs. In the case of bond fund obligations, no rate limit exists and a higher rate will result than would be the case if the new property value were added to the tax base. In these situations all taxpayers will face a higher tax rate than would

be the case if the newly created value were added to the tax base. This higher rate in turn generates a higher yield on the excess value, producing a higher dollar amount of development subsidy, or a faster payoff of a bond, where bonding has been used.

One further impact on local governments, including schools, which is worthy of note is the use of voter override of levy or rate limits. In certain situations a school, or other local government has sought voter permission to impose a higher rate than currently allowed by law, and the voters have specified a new maximum rate which can be imposed for five years. When value growth is diverted to tax increment financing use after imposition of the new higher rate limit, the yield from this rate will be less than if the value were added to the tax base of the government.

Other than school aid, only one existing state aid program, the Municipal Equalization Fund, is impacted. Distribution of aid amounts to individual cities may be differ from current funding amounts where tax increment financing is used. However, no additional impact on state general fund budget resources is felt as a result. This occurs because the the funding for the program is limited to the available dollar amount from two designated non general fund sources. Total state funding does not increase as a result of the valuation diversion, and the funds used are not part of the states general fund budget.

Other aid formulas that could be impacted by diversion of value growth have either been repealed or modified in recent years to eliminate or render less effective valuation capacity impacts. These include community college aid, and the county property tax relief act. These were aid programs created in 1997 and 1998 by the Revenue Committee and it's Chairman, Jerome Warner, as part of a package of property tax reform bills, where levy limits and equalizing aid were blended to reduce use of the property tax. Since then, these equalization aid formulas and policy principles have been modified or repealed.

Finally, the State of Nebraska's general fund budget also experiences an additional fiscal impact from these tax or levy rate increases in its state funded program to relieve the property taxes of elderly low income homeowners. This program is known as the homestead exemption program. This fiscal impact occurs when rates are set higher than they would need to be if the newly developed value was added to the tax base. Because the rate is higher and the state pays the obligations of the homeowner in part or in full, the cost to the state of this program is also increased when value is diverted and rates are set higher than they would be with the value growth. We make no estimate of this impact. The total cost of the homestead program is now nearly 80 million dollars, and has been growing at a rate of 5 to 10% per year. More persons will likely become eligible for this state funded property tax relief program for persons over age 65 as the number of elderly households increase in future years.

Interim Hearing

The Revenue Committee held a public hearing on October 28,2011,in Omaha Nebraska, on the south campus of Metropolitan Community College to examine these and all aspects of tax increment financing. Testifiers included city officials from Omaha, Lincoln, and the Nebraska League of Municipalities. These witnesses offered testimony on the impact of tax increment financing and its use, and were strongly supportive of its continued use to redevelop or develop blighted and substandard properties. (Transcripts of this hearing are available on request.)

Additional testimony in support of tax increment financing came from Larry Jobeun, an attorney who has been involved in tax increment financing projects done by private companies. In addressing the

questions asked by Committee members about the need to provide tax increment financing to such projects, Mr. Jobeun made it clear that developers he has worked with have expectations of a rate of return on investment of 10 to 12%, and would ask for tax increment financing when it was clear that the project would not generate this rate of return without the addition of the subsidy provided from tax increment financing.

The Committee also took testimony from Dr. Andy Rikli, of Westside Community Schools regarding the districts concerns about the use of tax increment financing in their school district. Their desire was to preserve and benefit from a strong tax base, and a growing one. The diversion of newly created valuation growth from their tax base to a development project was a concern, as was the determination of the base value which would remain as part of the tax base for future taxation by the district. They indicated that neighborhood residents in this portion of Omaha were also concerned that the blight designation of their area would affect their property value. They noted that the state aid impact would mitigate their loss of value through the diversion to development uses, as Westside is now part of the Metropolitan Learning Community. As a member district in that funding district, it does receive state capacity equalizing aid, despite a strong individual tax base. The district noted their long time use of a levy rate override, with a voter approved limitation on that rate. As they noted, the resources generated for school operations would be higher if the value base were allowed to grow with the addition of new value, or equal resources could be generated at a lower rate on their existing taxpayers. The district had become aware of proposed tax increment financing and blight designation by the City of Omaha in the summer of 2011. The original plan for redevelopment would have involved 50% of the districts geographic area and 80% of the commercial property, according to their testimony. The district indicated that they had successfully negotiated with the city to reduce the size of the designated zone.

Use of Tax Increment Financing by Nebraska Cities

The state laws on tax increment financing require an annual report on usage by local governments. This report is compiled by the Nebraska Revenue Department staff, specifically by the Property Assessment Division. Data compiled back to 1995 is available on projects by authorized by cities. Projects are identified by city, by value amounts, and by specific project locations and descriptions, including the rates applied to value. These are compiled and are available on the Departments website.

Staff of the Revenue Committee took some time to analyze this data and compile a history of the use of this financing tool by cities. One concept we attempted to measure is the level of use of tax increment financing as a portion of the local governments tax base. Rather than focusing totally on the dollars of value diverted, we attempted to examine the percent of the tax base of local governments which has been diverted to this use. We noted in our examination of the state laws on tax increment financing that the Legislature has previously imposed a physical space limit on cities using tax increment financing. Nebraska largest cities are allowed to use this development finance technique on 35% of the physical area of the city, while the states small villages could in fact designate their entire city as blighted and use this financing tool to freeze the existing tax base value of property in their city at a fixed amount. Schools, counties and all other taxing units which have this frozen value as part of their base would have to develop their budgets and property tax requests on a frozen base for this portion of their value. Value increases on existing property and from newly developed property would flow to a redevelopment plan authored by the city or village. This puts a city government in the position of impacting use of all growth in property tax base and resulting tax revenues from all local governments. A city government in Nebraska is normally in control of 20 to 25% of the tax yield from all properties. On average, 60 to 65% of the diverted property taxes are taken from school tax requests. In a city which declares itself totally blighted and in need of redevelopment of infrastructure all property taxes

paid to all other local governments can be diverted to this redevelopment project.

This puts those other governments in the position of financing their annual property tax requests on a partially frozen base with a fixed rate, producing zero growth from assessed value increases in that base value portion of their jurisdiction. In the case of the states larger cities, 35% of the geographic area of a city could easily represent more than 50% of the taxable value of the city, if the geographic areas included in the redevelopment plan included the cities central business district and its concentrated property value.

We suggest here that the Legislature consider revising this limit to better express its policy intent of limiting cities use and diversion of other governments property tax dollars. The Legislatures policy intent can be derived by examining the authorizing language of the Community Development Law, which speaks about tax bases and economy being strengthened by growth, and weakened by the declining value of private and public infrastructure assets. Using tax increment financing as a strategy to strengthen the local economy is believed to benefit citizens and taxpayers. Diverting all property value growth for fifteen years, and using those taxes to finance streets, street lighting, parking garages, and storm sewers surrounding large new private buildings will leave other public budget items to be funded using the remaining tax base and the growth in that base. Of course, these budgets could also be funded by other taxes and fees, to the extent they can be used. Examples could be sales taxes for cities, and state aid funded by sales and income taxes for schools. Another alternative is using an increasing rate on all the property value and property value growth which remains accessible to the local governments for other funding purposes. We note here that property tax rate limits do exist for all local governments in Nebraska. If a substantial portion of the value base is frozen, and all additional value growth in the local government tax base is diverted to redevelopment, property tax rates on the remaining base could be raised up to the state imposed limits to fund growth in tax requests for citywide or district wide public services. The larger the portion of value diverted, the higher these rates must be become, or the more other taxes or fees must be used in order to fund any desired growth in tax supported budgets. A scenario can emerge in which all new property taxes from value growth are used to fund the construction of development of public infrastructure to serve newly built large private and publicly owned structures, while leaving county and city operational budgets for public safety and law enforcement funding needs, and school operations and infrastructure needs, and other operational budgets to be funded by other forms of taxation or increasingly higher rates on remaining property value.

We suggest here that the Legislatures previous policy of limiting use of tax increment financing by the amount of physical area included be revised. A more strategic use of development incentives to fund new growth could emerge from a limit based on the amount of value and tax which can be diverted to other uses. This policy could be created by placing a limit on the percentage of a tax base diverted to finance redevelopment or new development. In the face of limit on use, allocation to the best redevelopment use may occur.

The current limit based on use of physical space for development could of course be enforced, and it would be possible to assemble a record of the physical space used by tax increment projects as a portion the physical space of cities through city and state officials efforts. To date this has not occurred. Analysis of the assessed value existing on that physical space would give a rough idea of much of the tax base would be diverted if the maximum physical space were to be used. Of course, the value and tax amount diverted from 35% of the geographic space within a city could vary dramatically. If, for example a blighted inner city residential neighborhood with below average house value were designated, and constituted 35% of the geographic space, the amount of tax base diversion from

taxation by schools and other local governments would be less than an designated area which was a downtown commercial district, or an industrial district with high manufacturing plant property value. Diverting all local school, city, county, community college, natural resource district and other local property taxes and value to financing improving public infrastructure such as streets, storm sewers, sewer,water and utility lines may be a very legitimate use of tax increment financing, as these infrastructure investments have a broad public benefit to all properties in the blighted neighborhood. However, diverting taxes to these purposes may result in higher taxes and tax rates to fund other local government operational expenses.

It seems feasible,and more relevant to the policy issue, to use to use the existing information on value diverted, and total value of each taxing jurisdiction to establish an upper limit on how much school, county, community college and natural resource district property taxes can be diverted to tax increment financing. Imposing any limit forces cities to more carefully examine which projects or proposals need tax increment financing subsidies to succeed, and those which would be successful absent the public subsidy. One difficulty with this policy is that excess value is not established until the property is developed and assessed for value purposes by the local county assessors office. Until that time, only an estimate of the use of excess value could be used.

With that policy change in mind, we analyzed the information on the amount tax increment financing done within 86 cities in Nebraska in 2010, using the Department of Revenues report for that year. We calculated the impact of the tax increment financed excess value on the tax base of city, school district and county that the value is located within. We did this by examining the reported excess value amount from all projects with the total valuation, or tax base, of the city, the school districts and counties in which the projects were located. In the case of schools, the 2011 valuations were available for our use. For cities and counties were limited to using the base reported in the 2010 certificate of taxes levied.

We determined that average use of city tax base for tax increment financing was 3.3% of the city base, and approximately 2.6% of the school tax base. We suggest as a policy recommendation that a city be limited to a percentage of its base and other tax bases that is diverted to an amount which is just over twice the average now found for all cities using tax increment financing. In round number terms, this can set at 7% percent, We do not recommend an ongoing or adjusted limit calculation based on the average use for each year, as this introduces an element of unpredictability which may make future planning difficult.

This 7% limitation would put 21 of the 83 cities we examined at a percentage higher than this limit, relative to their own city tax base. These 21 cities would not be able to approve any more tax increment financing projects until the local tax base grew sufficiently to allow for new projects, or until older tax increment financing projects were retired and the value returned to the tax rolls for general use by the other local political subdivisions. When current projects reach the end of their approved financing term, usually fifteen years, and are then added to the tax base of the local governments, this added value would increase the excess value which could be pledged to new projects and redevelopment subsidies.

We also examined school district tax base impacts for these cities projects, and found that in only 5 of the 83 communities were school districts tax bases impacted at a level exceeding 7%. No counties tax bases were impacted at a level approaching this 7% limit, even when multiple cities within the same counties were using tax increment financing.

Placing any limit on the use of this financing power does force city councils to choose between beneficiaries of the development subsidies. To illustrate this dilemma of choice, consider a city which is at or over the limit of excess value or geographic space which can be pledged, and has previously given the tax increment financing subsidy to one of three restaurant food providers that operate in that city. Having granted the subsidy to one of the three, they would also have to deny the subsidy to other competitors and any locally owned and operated food providers or other commercial businesses. This provides a competitive advantage to one business over another, and preserves this competitive advantage for an extended period of time. This same scenario can be constructed for hotels and other commercial businesses. Picking winners in the competition for public resources is always more controversial than allowing each applicant full access to a perceived unlimited resource. Traditionally, however, tax funding is viewed as a limited resource, and subject to allocation based on the best choices which can be made in using public tax dollars. In this case city councils are making a decision about the use of diverted school, county, community college and natural resource districts tax dollars. This means the city is allocating dollars which are in the main sacrificed by other political subdivisions. Imposing limits may force cities to more carefully allocate other local governments resources, and strategically use the subsidy for developments which provide a catalyst for other subsidized tax base growth, employment growth and economic growth. Since growth in the economy and population may create demand for more public service funding, the governments facing this demand may desire to alleviate the tax burdens of growth by financing this demand with the new property value, rather than by raising rates on all other property owners, or in the case of cities, raising the sales tax rate.

Summary

If Nebraska's Legislators are concerned about the level of use of tax increment financing by cities because it increases tax rates, shifts property tax burdens, increases state aid costs, and results in cities granting subsidies to development with the property tax funds normally used by other local governments to fund public services, they may wish to revise the limits found in state law at present.