985 Grandview Road
Williamstown, Vermont 05679 U.S.A.
Telephone: (802) 433-1360
Cellular: (802) 272-8385
Fax: (802) 433-1480
E-Mail: KAVET@aol.com

Kavet, Rockler & Associates

Economic, Demographic and Public Policy Consulting

Memorandum

To: Steve Klein

From: Tom Kavet

CC: Sara Teachout, Senate Finance Committee

Date: March 31, 2004

Re: Review of S.296 Tax Increment Financing Proposal

Per your request, I have performed a brief review of the economic and fiscal impacts of Section 23 of S.296, as described in Draft No. 3, dated March 30, 2004.

Although S.296 offers a broad range of laudable economic development initiatives with clearly defined costs, the expansion of tax increment financing (TIFs) in Section 23 of the proposed legislation could result in a substantial increase in Education Fund tax exemptions and concomitant reductions in State property tax revenues over an extended period of time. Although there is no limit to the potential fiscal costs the State could incur as a result of this component of the bill, they could easily approach or exceed $1 million per year. Since these exemptions are cumulative and endure for 20 years, this could represent a loss to the Education Fund of $20 million per year or more (in 2004 dollars) by 2024.

The use of a yet to be defined "cost-benefit model" and a subjective "but-for" test do not protect the State against net fiscal loss associated with this proposal. A rigorous cost-benefit model such as that maintained by the Vermont Economic Progress Council (VEPC) would help minimize State costs and focus development on the most advantageous projects , but as demonstrated with VEPC, cannot guarantee neutral or positive net fiscal impacts.

Since the benefits of development financed by TIFs are highly localized, their costs are most appropriately borne locally – not at the State level. If there is a compelling State interest in such economic development, an annual allocation from the legislature should be used to control the level of exemptions awarded. They should be based on need and the value of potential public benefit as measured by a meaningful cost-benefit model.

BACKGROUND

Tax increment financing – the use of additional property and other tax revenues generated by new or re-development to finance public improvements to an area - was developed as a mechanism for stimulating economic re-development in post WWII slums and other economically distressed urban (primarily) geographic areas. TIFs were designed to attract private investment to blighted areas that would otherwise not be likely to attract any development activity.

The public good accomplished by this tax expenditure is essentially locational: It encourages economic development in a geographic area in which it might otherwise not occur (such as in a brownfield, economically depressed downtown area, toxic waste site, etc.) or, to a lesser extent, of a type that might not otherwise occur (such as the development of affordable housing or historic building preservation).

Some TIFs involve local tax jurisdictions subsidizing developments with local tax revenues. Others, however, extend to broader taxing jurisdictions, such as the state, to shoulder some or all of the costs of financing public infrastructure and/or development in a locale, by directing state property, sales or other tax revenues to the TIF locale.

It is important to note that although a TIF can represent a net fiscal gain to a given locale (assuming “but for” the TIF, no development would otherwise occur in the locale), rarely does it represent anything but a net fiscal cost to the State. In this way, TIFs are not generally analogous to Vermont Economic Progress Council (VEPC) EATI development subsidies.

Only with TIFs approved by the Vermont Economic Progress Council as a part of a an EATI application subjected to VEPC standards, can there be some chance that a TIF does not represent a net fiscal cost to the state.

Assuming planned development occurs in the TIF, the cost of a TIF involving foregone state tax revenues is primarily borne by taxpayers outside of the TIF area. There must, thus, be a public benefit to these taxpayers that offsets the costs to them. Such benefits may include:

- Encouragement of desired settlement and development patterns (reduced sprawl, concentrated downtown development, preservation of open lands, historic preservation, etc.),
- Economic assistance to a distressed area (enhancement of its property tax base, expanded employment opportunities in the area, etc.), and/or
- Economic assistance to distressed individuals (through affordable housing, local job opportunities, enhanced local property values, etc.).

Without strict guidelines regulating their use, most TIFs simply shift the tax burden of local public capital expenditures from taxpayers in selected TIF areas to those in the remainder of the State. It is no surprise that those in TIF districts are likely to be outspoken proponents of TIFs and the primary beneficiaries of such legislation. Those in the remainder of the State may have a harder time seeing benefits that are worth the additional tax expense.

GENERAL OBSERVATIONS AND COMMENTS ON SECTION 23

- 20 years is an excessively long commitment for a business tax subsidy, given the likely life of such ventures, changing economic and real estate market considerations and the administration of such subsidies. Shorter term awards can be capitalized into comparable benefits if a project is viable, even if other financing or bonding is longer term.

- The evaluation of specific projects (as is done for most VEPC applications) rather than broad geographic areas (districts, towns, etc.) is a more appropriate and targeted approach to subsidized economic development, with significantly lower potential State costs.

- Why the existing VEPC cost-benefit model is not considered adequate for the analysis of the proposed TIFs is unclear. VEPC has developed protocols and standards for the evaluation of projects and has a consistent method of measuring State costs and benefits. Though not recommended, as noted above, it would be relatively easy to extend the VEPC cost-benefit model to accommodate 20 year analyses In an e-mail to the Joint Fiscal Office dated March 25, 2004, the Executive Director of VEPC surmised that the purpose of the "new" cost-benefit model proposed in S.296 might be to "overlook" competitive job substitution, low quality jobs and other factors that would reduce expected benefits, "for the sake of achieving downtown development." If so, any such model would be meaningless as an indicator of net fiscal costs.

- If the current VEPC cost-benefit model were used to evaluate S.296 TIFs, it would reduce State exposure to potential revenue loss.

- If a "new" cost-benefit model is developed, as proposed in S.296, it should be done so with review and input by the Joint Fiscal Office and formal approval by the Joint Fiscal Committee, as was the case with the original VEPC model. Per the current VEPC arrangement, any changes in the model should be reviewed and approved by the Joint Fiscal Committee.

- As is the case with VEPC, it is impossible to know whether or not a project would have occurred "but for" the small TIF or other economic development subsidy

offered by the State. Despite the best efforts of well-informed and well-intentioned individuals, this so-called "but for test" is highly subjective and cannot be relied upon to guarantee net fiscal benefits to the State. It should be noted that all cost-benefit model calculations rely upon the veracity of this assumption in order to yield meaningful results. This is the reason that, even with a good cost-benefit model, net fiscal neutrality cannot be assured.

- The guidelines on pages 2 and 3 of the proposed draft are so general as to allow virtually any municipality in the State to participate. This is not an appropriate policy application for TIFs and supports the above recommendation that this be project-based and not geography-based. For example, guideline (j)(iii) includes any area that "has been identified by the municipality for development." Such broad criteria for program inclusion will likely result in a preponderance of TIFs in the fastest growing areas of the State with the least need for State development subsidization, and significantly impact program expense.

- If there is a State need and public interest in supporting such development, it should be paid for via an annual State appropriation for the gross amount of tax revenues foregone in any given year. This is a more accurate, more honest and more fiscally responsible approach to State development financing than the fiction that a cost-benefit model reliant on subjective assumptions can definitively calculate actual net State impacts and control State costs. Use of the VEPC or other cost-benefit model should be for the purpose of identifying the projects with the highest likely net beneficial impacts to the State, and allocating State development funds accordingly.

SUMMARY

Tax increment financing can be an effective tool for focused economic development in blighted or other economically distressed areas that would not otherwise be likely to attract private investment. *As a widely available financing option for any municipal or other local development in Vermont, however, it threatens to become a significant drain on the State's Education Fund that will increase the tax burden on all other State taxpayers. Any such State tax expenditure should be controlled via an annual legislative appropriation on the total outstanding value of tax exemptions, and not reliance on subjective determinations or theoretical cost-benefit models to control costs.*