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REFORMING THE RULES ON WISCONSIN'S TAX INCREMENT DISTRICTS

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Good afternoon, Chair Stroebel, Vice Chair Kapenga, and members of the Wisconsin Senate Committee on Government Operations, Technology and Consumer Protection:

I am grateful for the invitation to discuss Tax Increment Financing (TIF) and the economic effects of using Tax Increment Districts (TIDs) to foster local economic development. The evaluation of government efforts to create economic development is a primary area of inquiry for my research team, and I'm happy to contribute toward the conversation regarding Senate Bill 560.

My testimony today has three main points:

1. Wisconsin introduced TIF 45 years ago, in an effort to solve a potential problem of underinvestment by municipalities, but the solution created conditions that may have led to a host of additional problems.
2. The typical economic analysis of potential TIDs likely overstates their economic effect by failing to model the crucial "but for" factor appropriately.
3. Senate Bill 560 offers a good step forward, especially by requiring an expanded analysis for a TID's economic feasibility study. The bill, however, does not succeed in ensuring that future TIDs lead to net economic development across the state.

UNDERSTANDING TIF AND TIDS

Wisconsin first enacted legislation that allowed municipalities to create TIDs in 1975 and has expanded the legislation several times since.[1] The original intent of the enabling legislation was to solve a problem caused by overlapping tax jurisdictions (counties, school districts, and technical college districts) that share the property tax revenue from the same piece of property with the local municipality. A municipality may wish to improve the infrastructure serving that property or provide expanded public services that would benefit the property owners, increasing the value of the property and potentially motivating new real estate development, which would expand the property tax base. The problem lies in

[1] Wisconsin Department of Revenue, *Tax Incremental Financing Manual* (Madison, WI: Wisconsin Department of Revenue, December 2019), 4.

the fact that the municipality would not be able to fully capture the increased property taxes resulting from its investment, since the property tax base is shared among the different tax jurisdictions.

In general, economic theory suggests that this situation would lead to an underprovision of municipally-provided infrastructure and services because the municipality can't reap the full value of the property tax increase. In essence, the other taxing jurisdictions are "free riding" on the municipality's investments. TIDs are an attempt to provide a second-best solution to this free-rider problem by allowing municipalities to reap the full benefit of the expanded property tax base attributable to municipal investments, so long as that revenue is used to pay off the cost of the property improvements. After the initial investment is paid off, the revenue from the increased property tax base is supposed to be shared with the other tax entities.[2]

TIF and TIDs are common around the United States, and some politicians view TIDs as municipalities' only viable means of encouraging economic development within their jurisdictions. Economists, however, can identify a wide range of policies that municipalities implement that make a particular area relatively better or worse to conduct business.[3] More to the point, however, I believe that Wisconsin erred 45 years ago in allowing municipalities to create TIDs because their solution to one problem has created the conditions that allow a host of others.[4]

POTENTIAL PROBLEMS WITH TIDS

The Wisconsin Department of Revenue's *Tax Incremental Financing Manual* makes it clear that TIDs are subsidies for private developers, shifting some of the project costs they face onto taxpayers in order to make a presumably unprofitable project worthwhile.[5] This means that TIF is akin to government officials making a risky investment with taxpayers' money in the hopes that the long-run tax base will increase, benefiting future taxpayers.

Because TIF is inherently a gamble, the most critical consideration regarding TIDs is the "but for" factor, which comes from the idea that the development encouraged by the TID would not otherwise occur but for the use of tax increment financing. After all, if a private developer were going to pursue the project anyway, then a TID would simply be a waste of other taxpayers' money. This is because TIDs, by their very nature, increase taxes for other taxpayers throughout the county (or reduce the provision of public services and infrastructure, or both).[6] As the Department of Revenue writes,

> If there are no TIDs in a county, the county tax rate is lower for everyone. However, if there are TIDs, every taxpayer in the county pays a higher rate to generate the increment paid to the municipality operating the TID.[7]

As a result, the entire value proposition of TIF depends on the idea that TIDs substantially influence firm location and expansion decisions—the "but for" factor—meaning that a proper economic analysis of how TIDs affect these decisions is critical.

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[2] Economists would consider this a second-best solution, since it only partially assigns the full, long-run value of the investment to the entity making the investment and therefore only partially solves the free-rider problem. Also, it appears that the rules that govern TIDs enable local government officials to repurpose TID funds for various other projects, making the simple definition of how TIDs work more complicated and introducing the possibility that TIDs may be misused. Bill Osmulski, "Analysis: Tax Increment Financing in Wisconsin," *MacIver Institute*, March 29, 2019.

[3] Michael D. Farren and Andrea O'Sullivan, "Want to Attract the Next HQ2? Become the Best Place to Live," *The Bridge*, December 6, 2018.

[4] In addition to my discussion later regarding a race to the bottom, the Wisconsin Department of Revenue has identified seven other risks associated with TIDs. Wisconsin Department of Revenue, *Tax Incremental Financing Manual*, 33.

[5] Wisconsin Department of Revenue, 32.

[6] Wisconsin Department of Revenue; Osmulski, "Analysis."

[7] Wisconsin Department of Revenue, *Tax Incremental Financing Manual*, 6.

Unfortunately for TIDs, the academic economic development research suggests that government subsidies don't have a substantial effect on where companies decide to locate.[8] That decision is driven primarily by concerns relating to production (access to resources and talented workers), logistics (nearby ports and transportation routes), and access to customers, rather than the level of taxation.[9] For example, the cost of locally-supplied labor is about 14 times larger than the state and local tax costs, suggesting that a small difference in labor costs between possible locations can have a greater effect than a larger difference in taxes or infrastructure or project startup costs.[10] In summarizing the research on economic development subsidies, economist Timothy Bartik finds that the typical subsidy only sways between 2 and 25 percent of company relocation, expansion, or retention decisions, suggesting that on the other 75 percent or more of occasions, such subsidies have been a waste of taxpayer money.[11]

In fact, Wisconsin may have caused a larger problem in allowing municipal TIDs, because while subsidies aren't likely to sway a company's location decision between regions, subsidies *can* have a larger effect on where a company locates *within a region*.[12] For example, a company might want to locate near Milwaukee to take advantage of the skilled manufacturing workforce there, meaning that a state subsidy to encourage the company to choose the Milwaukee area may not materially affect that decision. However, subsidies offered by Waukesha, Racine, or other suburbs in the metropolitan area may influence the particular site the company selects for its new operation, since all such sites provide access to the manufacturing workforce.

The danger is that by allowing municipal TIDs, Wisconsin may inadvertently encourage municipalities to engage in a "race to the bottom" competition for jobs. This could mean that municipalities overpay for what they're getting, since jobs would already be coming to their region anyway. A better approach would be for Wisconsin to encourage neighboring municipalities to collaborate to avoid an unhealthy intercity subsidy competition (as opposed to the normal and healthy tax and regulatory competition that cities typically engage in), similar to what has been done in several other regions around the country.[13]

IMPROVING TID ECONOMIC FEASIBILITY STUDIES

SB 560's additional requirements to expand the scope of economic feasibility studies required for TIDs are a step in the right direction, helping to ensure greater confidence that future TIDs lead to net economic development. However, the economic feasibility studies required for TIDs should be further improved by adding these particular requirements:

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[8] Michael D. Farren and Anne Philpot, *With Amazon HQ2, the Losers Are the Winners: Why Economic Development Subsidies Hurt More than They Help* (Arlington, VA: Mercatus Center at George Mason University, 2018), 5.

[9] Natalie Cohen, "Business Location Decision-Making and the Cities: Bringing Companies Back" (working paper, Brookings Institution, Washington, DC, April 2000).

[10] Timothy J. Bartik, *Who Benefits from State and Local Economic Development Policies?* (W.E. Upjohn Institute, 1991), 49.

[11] Similarly, University of Texas political scientist Nate Jensen has found that Texas policymakers have given out economic development subsidies even after a company has made a firm commitment to relocate to the state, suggesting that the structure of such programs can encourage the overuse of subsidies. Timothy J. Bartik, "'But For' Percentages for Economic Development Incentives: What Percentage Estimates Are Plausible Based on the Research Literature?" (Upjohn Institute Working Paper No. 18-289, W.E. Upjohn Institute, Kalamazoo, MI, July 1, 2018); Nathan M. Jensen, "Bargaining and the Effectiveness of Economic Development Incentives: An Evaluation of the Texas Chapter 313 Program," *Public Choice* 177, no. 1–2 (2018): 29–51.

[12] Cohen, "Business Location Decision-Making and the Cities," 16.

[13] Megan Randall et al., *Partners or Pirates? Collaboration and Competition in Local Economic Development* (Washington, DC: Urban Institute, 2018); Brett Common, "Regional Cooperation Agreements in Economic Development," accessed January 3, 2020, https://www.nlc.org/regional-cooperation-agreements-in-economic-development; Nancy Cook, "A Truce in the War between Cities and Their Suburbs," *Atlantic*, April 29, 2015.

1. The economic feasibility study should use the expected effect of the TID subsidy itself, not the full economic effect or tax base increase of the project supported by the TID, to model the benefit *specifically attributable to the TID*. Doing so would account for the likelihood that the TID may not be the primary factor motivating redevelopment of the property. One way that this could be done is by multiplying the estimated economic effects or tax base increase by the midrange value (13.5 percent) of Bartik's "but for" factor range (2 to 25 percent). However, regardless of the particular method and values utilized, the "but for" probability used should be objectively determined.
2. The economic effect (reduction in economic activity, jobs, etc.) of the TID's corresponding tax increase on all other taxpayers should be explicitly estimated and incorporated into the net effect of the TID subsidy.
3. In addition to evaluating the previous scenario, in which the TID is approved and the new development occurs, four other scenarios should be considered and compared:

SCENARIO 2: TID APPROVED, NO DEVELOPMENT

In this scenario, the TID is approved and the municipality spends the money to improve the property, but the redevelopment of the property by private interests does not occur. The economic effect (decrease in economic activity, jobs, etc.) attributable to the TID tax increase across the county should be explicitly estimated, along with the economic effect of potentially higher municipal tax rates needed to pay off the TID investment.[14]

SCENARIO 3: TID NOT APPROVED, DEVELOPMENT OCCURS, TAXES CUT

In this scenario, the redevelopment of the property is assumed to occur despite the TID not being approved. Meanwhile, local policymakers decide to keep the existing tax levy, meaning that the property tax rates will decrease for all taxpayers in the country owing to the expansion of the property tax base. The economic effect (increase in economic activity, jobs, etc.) attributable to this tax decrease should be explicitly estimated. And because the redevelopment of the property isn't certain, the final estimated economic effect should account for this uncertainty by multiplying the total benefits attributable to the new development and associated tax cut by a objectively determined probability that the property would be redeveloped without the TID district (a good candidate for this probability would be the inverse of Bartik's "but for" factor, the midrange value of which would be 86.5 percent).

SCENARIO 4: TID NOT APPROVED, DEVELOPMENT OCCURS, SERVICES EXPANDED

In this scenario, the redevelopment of the property is assumed to occur despite the TID not being approved, but local policymakers decide to increase the tax levy proportionally and keep existing property tax rates constant, using the additional tax revenue to fund expanded infrastructure and public services. The economic effect (increase in economic activity, jobs, etc.) attributable to this expanded government spending should be explicitly estimated. Since this effect isn't certain—because the redevelopment of the property isn't certain—the final estimated economic effect should account for this uncertainty by multiplying the total benefits attributable to the new development and expanded public services by a probability that the property would be redeveloped without the TID district (a good candidate for this probability would be the inverse of Bartik's "but for" factor, the midrange value of which would be 86.5 percent).

SCENARIO 5: TID NOT APPROVED, DEVELOPMENT DOES NOT OCCUR

In this scenario, the TID is not approved and the redevelopment of the property is assumed not to occur. The economic effect of no property redevelopment and taxes remaining constant should be explicitly evaluated and quantified over the same period of analysis used in the previous scenarios. This will be the baseline scenario from which the value of the other scenarios should be evaluated.

[14] Wisconsin Department of Revenue, *Tax Incremental Financing Manual*, 33.

CONCLUSION

Wisconsin's proposed changes to tax increment financing are a good step forward, but the problems associated with TIDs are larger and will require more robust reforms to solve.

There is reason to move with urgency too. The total value of TIDs in the state has increased from $25.1 billion in 2013 to $36.2 billion in 2019.[15] That's an increase of 44 percent in just six years, which corresponds to an annual growth rate of 6.3 percent, more than quadruple both the rate of inflation and the rate of increase in statewide net new construction over the same time period.[16] In other words, the total value of projects that use tax increment financing is accelerating. To the extent that this tax revenue is diverted unnecessarily, other Wisconsin taxpayers are left holding the bill for no benefit. They'll be better off, and the state will be more prosperous, if the rules governing tax increment districts are improved.

[15] Wisconsin Department of Revenue, "Tax Incremental District (TID) Statement of Changes," accessed January 3, 2020, https://www.revenue.wi.gov/Pages/EQU/tidchanges.aspx.

[16] Wisconsin Department of Revenue, "Net New Construction," accessed January 2, 2020, https://www.revenue.wi.gov/Pages/EQU/nnc.aspx; Federal Reserve Bank of St. Louis, "Consumer Price Index for All Urban Consumers: All Items in U.S. City Average," December 11, 2019, https://fred.stlouisfed.org/series/CPIAUCNS.