Citizens League Report

ACCOUNTABILITY FOR THE DEVELOPMENT DOLLAR

Prepared by
Role of Cities in Real Estate Development Committee
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Approved by
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MAJOR IDEAS IN OUR REPORT

Public assistance for private real estate development in Minnesota needs to be reformed, not rejected. City governments should be commended for their active roles in fighting deterioration and in promoting quality real estate developments.

But today's system of providing assistance has shortcomings:

* Too much emphasis is given to real estate assistance as an economic development tool. Its influence is felt mainly on the location of jobs and tax base, not their creation.

* Instead of being targeted to areas of real need, financial assistance is available almost anywhere, for any type of real estate project.

* Taxpayers often have no knowledge of how much public money is being spent on a real estate project, where it is coming from and who is receiving the benefit.

* Dollars of real estate assistance don't show up in the regular operating budgets of city councils. Consequently, city councils don't have to weigh the importance of real estate subsidies against competing needs for dollars.

* More help probably is given than is necessary to make a real estate project go because city officials have little incentive to be tough negotiators.

To correct these and other problems we recommend a system of real estate assistance that emphasizes direct, not indirect, sources of revenue; appropriations, not entitlements; on-budget decisions, not off-budget, and assistance that is targeted, not general. Specifically the Legislature should:

* Give each city government access to a new redevelopment fund that would be financed from direct state and local revenue sources.

* Allow expenditures from the fund only for renewal of properties, consistent with a previously-adopted plan.

* Instruct the Metropolitan Council and other regional planning bodies in the state to develop guidelines to prevent unnecessary spending in inter-city competition.

* Give cities incentives to be tough negotiators with developers, including incentives: (a) to negotiate for recovery of financial assistance provided to developers, (b) to establish before negotiations begin a point beyond which no further city assistance will be offered, and (c) to use only experienced negotiators.

* Phase out tax-increment financing as the redevelopment fund is established. In the meantime, tighten up tax-increment financing by: (a) repealing its use where no redevelopment is occurring, (b) requiring a city government to reimburse the state partially for its loss of revenue, (c) disallowing accumulation of surpluses in tax-increment districts, beyond allowing the placement of up to three years' surplus

in the proposed redevelopment fund, (d) discontinuing the practice of pooling tax-increment funds, (f) requiring that the actual tax burden of each tax-increment district be made known, (g) requiring that city administrative expenses be financed from sources other than tax-increment financing, and (h) repealing a provision that allows a decline in market values to be ignored in tax-increment districts.

THE FRAMEWORK

Rebuilding is a continuous, permanent phenomenon—The Twin Cities metropolitan urban area and other urban areas in Minnesota have been going through a continuous process of growth-maturity-decline-rebuilding since the state was settled in the mid-1800s. The process is not uniform, of course. Some locations renew themselves easily; others may decline without evidence of renewal.

The downtowns of Minneapolis and Saint Paul have been built three times. Initial settlement was in the mid-1800s. The next began in the 1880s and continued through the 1920s. The third began after World War II and still is going on. In the future the downtowns undoubtedly will be rebuilt again and again. This process isn't unique to the downtowns, of course. They are just the most visible parts of the urban area. The process is going on everywhere. Some post-World War II shopping areas in suburbs, for example, now are being rebuilt.

Some of the current rebuilding in Minnesota's urban areas is related to a restructuring of the nation's economy.—The current rebuilding process involves more than just tearing down old buildings and replacing them with new buildings. What is going on inside the buildings is changing, too, as information and services become more important. The relative importance of manufacturing is declining or owners are moving to large tracts of land that accommodate one- or two-story buildings and employee parking, while offices grow ever taller downtown.

The Twin Cities metropolitan area has adjusted to change in the economy better than many other urban areas.—Because this area has not been dominated by a few large manufacturing firms, as has been the case in some other urban areas, it has prospered as change has occurred in the nation's economy. Some urban areas not as diversified as this area have encountered severe problems of building abandonment as the economy has changed. Even in the Twin Cities area, however, decline has been very severe in certain locations.

Maintaining the strength of urban areas is an important part of national interest in economic growth.—The nation as a whole and individual states have similar interests in keeping their urban areas strong. With the coming of the information-services economy, urban areas have become key generators of wealth. The strength of a state's economy and the nation's economy are dependent upon strong urban areas. Urban areas provide the infrastructure and services necessary to maintain economic health.

Of particular importance to the deliberations of this committee is the overall strength of the Minneapolis-Saint Paul metropolitan area--because of its favorable business, cultural and scientific environment--in fostering the growth of new enterprise.

The metropolitan area's technology-intensive industry was a forerunner of the emerging information-based economy. Much of this industry is "home-grown". Its antecedents are the area's entrepreneurs of expansionary vision who prospered from the fortunate, if not fortuitous, juxtaposition of high finance, high education and high performance of work force--all sharpening the cutting edge of private and public enterprise.

It is this past that now can help shape this area's future in a yet emerging information society. It is not yet clear how the public sector should direct its resources. For example, what is the relative importance of providing dollars for education, for street maintenance, or for real estate development? Far-sighted and prudent deployment of always scarce public resources is an over-riding concern in establishing the role of cities as active participants in building the urban-industrial environment.

CONTEXT OF OUR STUDY

City governments are significant agents for maintaining the strength of the nation's urban areas. But how they carry out this task is immensely controversial today, particularly as city governments in the last 10 years have begun to play more aggressive roles than ever before in becoming financially involved with real estate development within their borders. The national and state governments are the centers of the debate, because they have been the main sources of financing available to cities.

In Minnesota, the Legislature has begun to ask fundamental questions as the dollar investment has risen rapidly: (a) What is the purpose of this assistance? (b) How much is being provided? (c) How prudently are the dollars being spent? (d) Are the results worth the effort? (e) What negative results, if any, are evident? (f) Do cities need more money? (g) Who is accountable for the way the money is being spent? (h) What is the "opportunity cost" of real estate assistance? That is, what public or private service investment is not provided or supported because of the real estate expenditure? (i) If cities were not to spend the money, how would it be spent in the private sector? (j) What is the social cost to taxpayers in sustaining the existing role of cities in real estate development? What is the social cost to taxpayers in abandoning that role? This report is intended to help public officials think through these questions.

FINDINGS

Federal urban renewal programs for slum clearance helped inaugurate a new role for city governments in real estate development.—The first major use of public dollars for private real estate development occurred in the national program to get rid of dilapidated buildings in the years following World War II. Saint Paul and Minneapolis were among the main beneficiaries of this program in Minnesota; many square blocks of residential and business property were cleared, particularly in and near the downtowns. Federal aid paid two-thirds, local dollars the balance. Then the land was sold on the private market for redevelopment.

Urban renewal helped change city governments' awareness of their potential role in real estate.—Before urban renewal, city governments had recognized that they played a significant role in regulation of real estate, through comprehensive planning, zoning ordinances, building codes, building permits, and the like. City governments also played an informal role in promoting real estate sites, but they largely left initiative on location, type, design, financing and timing of development to the private sector. With urban renewal a new public policy was born: City governments could assemble land, tear down the old buildings, and resell the property to private developers for less than the cost of acquisition, consistent with a previously-adopted plan. In doing this city governments became financial contributors to development of new structures in previously blighted areas.

Federal urban renewal funds were not available everywhere; they could only be spent in blighted areas. But the precedent had been established. Even those city governments technically ineligible to participate were being prepared psychologically for a new role in real estate. City councils were transforming themselves from passive regulators of real estate to active banker/developers.

Most city governments, not just those struggling with blight, have become participants in real estate assistance programs which have followed urban renewal.—The federal government dropped its original urban renewal programs in the late 1960s, bringing to an end the era of large, direct grants of federal aid. A complex system of indirect federal and state assistance plus a few limited programs of direct aid have been employed since then. The total public dollar investment through the new programs vastly exceeds that of urban renewal. Eligibility has been broadened, too. In the Twin Cities metropolitan area today, city governments in all growth stages and income levels actively provide assistance for private real estate development. An important dimension of their participation is that they are designing unique agreements one-on-one with developers of specific parcels.

Many city officials are enthusiastic about their involvement.--City officials who participate are proud of their involvement and are convinced that the overall quality of real estate development is enhanced considerably. They usually state that without their help the same projects would not have been undertaken. They welcome the chance to help new development, even though their initial motivation may have been to remove blight or to keep new or expanding businesses from locating elsewhere. They are extremely protective of the tools that federal and state governments have given them.

However, a few city governments say they use the tools just because they are available, irrespective of whether need can be demonstrated.

City governments seem to be much more concerned about their competitive positions today than they were previously.—City governments always have tried to attract business within their borders, to enhance tax base, to improve job opportunities, or to make their communities more attractive. Today, however, they are more competitive than ever before, despite the existence of state laws that insulate them from extraordinary loss of revenue if new development locates outside their borders. These laws include state aid to schools, state aid to cities, and metropolitan tax-base sharing (also known as fiscal disparities).

They are motivated, too, by other objectives.—Some of the motivation behind city government involvement relates to such "soft" concepts as aesthetics and quality of life, not just their interest in attracting businesses. Quality of life itself is often said to be a factor in attracting business. City governments see themselves as key participants in the overall beauty and liveability of their areas.

Leadership in influencing real estate development clearly resides at the level of city government today. Beyond the incentives and rewards provided by the U.S. Tax Code, city governments have become the prime movers in public financial assistance to real estate development. They rely heavily on federal and state statutes for money to stimulate such development. But city governments are left largely on their own in deciding eligibility. Except for a few national and state programs that target assistance for distressed areas, national and state purposes make it possible for cities almost everywhere to provide help. As a whole, city officials seem satisfied with such policies because they avoid setting one city against another in a political context and cost them little or nothing directly. The political rewards are enormous. However, implementation of such policies requires more dollars than a targeting approach, because dollars must be provided to the cities whose need is of lower priority to assure that dollars also are provided to those in need.

Leadership covering an entire urban area is limited—The Twin Cities metropolitan area has one of the most respected organizations in the nation for attacking urban problems: the Metropolitan Council. The Council is empowered by state law to assure that cities design their comprehensive plans to be consistent with their assigned capacity in regional infrastructure systems. But no policy of the Council speaks to whether federal and state real estate assistance should be consistent with regional plans. Neither the Council nor any other regional or state agency in Minnesota today is advising city officials on whether potential assistance for a given real estate development represents a way: (a) to help renew a geographic area or (b) to encourage development in one location rather than another within the same state or urban area, with no special renewal effect.

Dollars invested have risen very fast.—The investment of public dollars for real estate assistance by cities in Minnesota has increased 10-fold over the past nine years. To illustrate, industrial revenue bonds approved during a 12-month period by local governments increased from $165 million in 1974 to $1.3 billion in 1983. During that same time, the amount of property taxes captured annually for development purposes under tax-increment financing increased from $437,000 to $46 million. Enactment of a federal cap on industrial revenue bonds is producing a cutback in the amounts available for Minnesota cities for 1985 and coming years. In fact, if existing federal law is not changed, industrial revenue bonds will be discontinued by the end of 1988.

Real estate development now is one of the most significant activities of city government in the Twin Cities metropolitan area.--Some mayors, city council members, and top city staff spend 50 percent or more of their time on city development. The position of city development officer--formerly associated mainly with blight clearance and low income housing--has become a key position in city government. City officials engage in numerous negotiating sessions with commercial-industrial firms and developers. Developers usually concentrate on designing projects uniquely suited for certain locations. Sometimes certain firms contact several city governments, shopping around, so to speak, for the best deal.

It is obvious that city governments need to look beyond the day-to-day provision of public services, to the long term health of their communities. Yet growing numbers of persons, particularly in the U.S. Congress and in state legislatures worry whether city governments might end up spending too much time on real estate development, thereby draining energies from their other responsibilities: providing essential public services such as street maintenance, garbage collection, police and fire protection, and planning for the future.

Minnesota city governments are among the most active in the nation in providing real estate assistance.--Although cities in all the 50 states are involved, evidence indicates a particularly heavy activity in Minnesota. For example, in 1983, Minnesota ranked third in the nation in absolute dollars of subsidized-interest bonds issued for private business and industry, according to the Advisory Commission on Intergovernmental Relations (ACIR). Minnesota also is a leading state in dedicating growth in local property taxes to financing development, according to the ACIR.

Investment in Minneapolis and Saint Paul has been particularly high--Urban Development Action Grants awarded since the program began in 1977 totalled $54 million in Minneapolis and $50 million in Saint Paul through 1984. Taxes captured for tax-increment purposes in that year totalled $22 million in Minneapolis and $6.8 million in Saint Paul. Industrial revenue bonds authorized in Minneapolis in 1984 totalled $165 million and in Saint Paul, $185 million, according to a report from the research staff of the Minnesota House of Representatives. Results are clearly visible. Both cities have major developments downtown and elsewhere that involved public financing of some kind, including City Center, Riverplace and Calhoun Square in Minneapolis and Town Square, Galtier Plaza and Bandana Square in Saint Paul. These cities are extremely proud of these investments.

Meanwhile, other cities have not been idle.--Data show extensive use of financing tools in Twin Cities area suburbs and, to a lesser extent, in other parts of Minnesota. Suburban use is particularly large and growing. Activity occurs intensively in the most affluent suburbs as well as the less-fortunate communities. In 1984 the total value of industrial revenue bonds authorized by suburbs, $425 million, exceeded the amount authorized by central cities, $350 million. The combined central city-suburban total represented 87 percent of all such bonds authorized throughout the state. Suburban use of tax-increment financing is growing, too. In 1984, of a total of $516 million of tax base then captured statewide for tax-increment purposes, about 51 percent was in the central cities of Minneapolis and Saint Paul combined; 32 percent in the rest of the seven-county metropolitan area, and 16 percent in cities elsewhere in Minnesota. Ironically, most public assistance is being provided in the metropolitan area, where the economy is the healthiest, and the least is being provided in the rest of Minnesota, where the economy is in serious trouble or declining. This raises the question of what connection exists between the level of economic activity in a region and the use of public financial assistance for real estate development.

Areas that might be regarded among the most desirable development sites in the entire metropolitan area now are receiving public assistance, including Hwy. 12 and Hwy. 100 in Golden Valley; 50th St. and France Ave. in Edina; I-494 and Cedar Ave. in Bloomington, and I-494 and Hwys. 212/5 in Eden Prairie.

It is hard to identify a guiding political philosophy behind city government assistance to real estate development.—The controversies over whether and how public dollars should be used to provide assistance to private real estate developments do not line up along conventional lines of political philosophy. Strong supporters of aggressive involvement are as likely to be liberal Democrats as conservative Republicans; conversely, opponents, too, are likely to fall in both camps. These programs seem not to be founded on any traditional philosophy of government or of economic organization.

Involvement in real estate has meant that city officials have developed new, complex, relationships with many interest groups.—Mayors, city council members, professional city staff, plus a host of financial advisers, consultants, bond underwriters, bond attorneys and other private firms are working closely together as cities play active roles in stimulating financially-rewarding real estate activity.

Lines between the regulation and promotion of real estate development are disappearing.—Today city governments are regulating the use of real estate within their borders and providing infrastructure as well as promoting and financing development of selected parcels. Consequently, city governments may encounter conflicts as they impose regulations that apply to all properties and provide public dollars to promote the development of a few properties.

Ingenious financing mechanisms are employed.—City governments have been able to offer assistance without using dollars from their own general revenue budgets. Federal and state laws have made it possible for city governments to provide assistance without having to make tradeoffs with such competing programs as public safety, parks, sewers, streets or libraries. This obviously has meant that they have not had to make politically difficult choices on allocation of funds. For example, with industrial revenue bonds, cities do not use any of their own money. Instead they issue tax-exempt bonds on behalf of businesses making capital improvements. Witn tax-exempt bonds the interest earned by the investors who purchase the bonds is exempt from taxation by the state or federal governments. Therefore, a tax-exempt bond carries a lower interest rate than a taxable bond, thereby reducing the cost to the affected businesses. However, such bonds reduce revenue to the state and federal governments. Cities are allowed to decide which businesses receive the help. Through another program, tax-increment financing, city governments can dedicate in advance all growth in property tax revenues from selected new developments for up to 25 years to pay for development expense. Development expense is paid off before any of these funds ever is deposited in the general revenue budgets of the cities themselves or the school districts and counties in which they are located.

Sometimes the term "creative financing" is used to refer to a variety of mechanisms that are used to provide assistance to real estate projects. Among these "creative" approaches are those that make tax money available outside the conventional budget process, thereby avoiding the politically difficult process of making choices among competing services, such as police, parks and libraries.

Existing financial mechanisms are enormously productive as revenue sources, which gives cities considerable flexibility.—Cities often can make commitments of assistance without having to pick and choose among applicants. The result is that city governments are able to spend dollars on real estate assistance with greater freedom than with almost any other function. This freedom enables them to respond to specific requests or to take initiative on developments with much greater ease and flexibility than if they were limited to specific appropriations. Consequently, they are able to respond to developers' requests at any time during a calendar year, even though they already may have provided packages of asssistance to others.

Several problems are present with the mechanisms:

Heavy use, lack of selectivity.—Because the benefits can be granted by every city—rural or urban, inner city, first-ring suburb, or any other suburb--for any real estate development purpose, some city governments may be over-using the mechanisms by not limiting them to clearly identified problems that should be corrected for the best interests of the public. If city governments provided real estate assistance to all applicants, then the only result of that assistance would be the indiscriminate subsidy of private real estate development.

Incentives for tough negotiations are lacking.--Because the direct financial burden on local taxpayers either is nonexistent or so diffuse as to defy identification, cities may be providing more assistance than is needed.

City governments can commit revenue from other taxing jurisdictions.—City governments are able to divert taxes from other taxing jurisdictions, such as schools and counties, to help pay for real estate assistance.

City governments have their own revenues diverted in the same process, although they don't really forego revenue in the same fashion as school districts and counties. Their own city staffs are reimbursed from development dollars for the expense that the city incurs. Moreover, a city government in all cases receives less than one-half of all property tax revenue and in some cases the share is less than 15 percent. These other units of government do receive the benefit, of course, from any additional tax base that comes to that specific community as the result of city assistance.

Property taxes can be higher than needed.—Too generous use may produce property taxes that are higher than they need to be. Defenders of the existing system contend that the tax rate is not higher than it would be without the financial assistance, because "but for" the assistance the growth would not otherwise have occurred at that location. Ultimately, the defenders argue, the tax rate will decline because of the new growth. Critics say the "but for" claim is too exaggerated and that some, if not all, of the growth would have occurred anyway, very likely elsewhere in the same urban area and possibly in the same county, school district or city. Defenders usually don't disagree that development would have occurred somewhere. They point out that assistance still can be justified if, for example, the beneficiary is a built-up city needing to undergo redevelopment.

Resistance to reducing property taxes may result.--Some types of assistance appear to conflict with the state's interest in holding down property taxes. Promoters of certain property-tax-related assistance may resist state programs to reduce property taxes, not on the merits, but out of fear that such reductions also would reduce the amount of subsidy they can provide. Under the provisions of one popular mechanism, tax-increment financing, the amount of real estate assistance varies directly with the size of the tax rate. If property taxes rise, so do the dollars available for real estate assistance. A possibility exists that city governments might be tempted to lobby against property tax changes out of fear for what such changes would do to their revenue stream for real estate assistance, irrespective of whether broader public policy might call for reduced property taxes. For example, lobbyists for city governments already have urged that the Legislature protect dollars for real estate assistance in any property tax reform.

Serious problems could result if property values were to decline.--Property values in urban areas could decline. Few are predicting such a change, but few predicted in the 1970s that farm values would drop, either. The result of a major decline in values could be devastating for tax-increment financing, which depends on an increase in valuation to succeed. If property values declined, other property taxpayers in a community would be required to make up the shortfall in tax-increment districts.

It is possible that commercial-industrial and rental residential values could fall in 1986-88, which is five to seven years following the passage of a federal law in 1981 which provided for accelerated depreciation of buildings. That act increased the demand for investment opportunities in these buildings. Properties usually provide maximum yield to an investor if sold in about five to seven years. Consequently, a greatly increased supply of properties may be offered for sale beginning in 1986, as investors begin selling the properties they acquired under the provisions of accelerated depreciation. A glut in the market would force market values down. In addition to these factors a general "softening" of the overall residential market, including homestead, already may be occurring. A significant drop in market values would threaten the stability of tax-increment districts, which depend upon property values not declining to keep their revenue stream steady.

A provision already in state law anticipates that a drop in property values could occur. It allows a city government to keep valuation in a tax-increment district at an initially-established level, even if prevailing property levels drop in the city. The provision enables a city to require that the developer/owner during the contract period will not challenge the valuation of property in the area receiving assistance.

Surplus dollars may be made available.--Some publicly-assisted real estate projects produce more tax dollars than needed to finance them. City governments can then channel the extra money into other real estate projects instead of returning it to the taxpayers. (Some city governments see the generation of surplus dollars as an advantage. They say that it makes improvements possible in areas where not enough assistance could be made available in any other fashion.)

Extensive use probably produces higher interest rates.--A risk exists that city governments may be paying higher interest rates for conventional borrowing because of excessive use of real estate assistance. This can occur in at least two ways.

First, a city's bond rating may be downgraded--which, in turn, means higher interest rates--if it is committing too much of the growth in its property taxes to real estate assistance. This reduces the availability of property taxes for other purposes, such as paying for principal and interest on bonds. Such a warning was given to at least one city in the Twin Cities metropolitan area in 1984 by a New York bond rating firm.

Second, cities may be paying higher interest rates for borrowing for sewers, streets and other public infrastructure because they also are issuing large amounts of industrial revenue bonds. A New York state financial official estimated that the volume of private purpose, tax-exempt debt issued in 1982 raised overall tax-exempt interest rates by a premium of 1.2 percentage points.

Others disagree that the addition of industrial revenue bonds causes interest rates to rise for regular city bonding. According to the counter-argument, interest rates paid by cities for general obligation bonds fluctuate directly with the interest rate the federal government pays when it borrows money. This relationship is much more powerful in determining the interest rates paid by cities than the impact of a flood of industrial revenue bonds, say persons who support the counter-argument. They also contend that many investors buy only general obligation bonds and, therefore, would not consider the option of an industrial revenue bond.

The counter-argument is faulty, say those persons who believe cities' interest rates are higher, because even though city rates rise and fall with federal rates, they still are higher than they would be in the absence of industrial revenue bonds. Also, they say, investors who stick faithfully to general obligation bonds do not set the marginal rate on those bonds.

Other sectors of the economy might need more assistance than does real estate.--Some critics of national and state economic development efforts contend that tax policy in the U.S., with few exceptions, has implicitly favored such sectors as office buildings and shopping centers, while disregarding the competitiveness of U.S. manufacturing operations in international competition.

Moreover, high vacancy rates seem increasingly more common in office space in recent years, which raises the question of whether the availability of real estate assistance is contributing to overbuilding.

CONCLUSIONS

Cities have a legitimate and continuing role in real estate development. All in all, the concerns displayed by Minnesota cities in working for quality development are commendable. City councils and their professional staffs are not satisfied with being passive observers of development. These officials want to intervene. They are concerned about the quality of the development, the design, the location, the timing. They usually have a vision of a substantially improved community. These concerns need only be channeled in the right directions. They should not be thwarted.

But too much emphasis is being placed on interstate and intrastate rivalry today. In some respects, a state has no choice but to participate aggressively in the interstate poker game of competition for business, because every other state is doing the same thing. For example, Minnesota actively pursued the General Motors Saturn plant in 1985 by trying to outbid several other states. The Saturn plant, however, is almost unique because of its size. It is not surprising to see competing states up the ante, to the delight, of course, of the plant's owners. But the public interest will not be served by a Saturn-type bidding war for every business thinking about a new location. States--particularly states in the same economic region of the nation--would do well to consider "arms control" agreements in their competition for new business.

The state has the authority to determine the "weapons" that cities may use. However, it has done little but set up a system in which every city has an incentive to offer the most lucrative financial package, out of a fear that if it fails to do so, neighboring cities will.

Cities ought to be encouraged to compete with each other on the quality of their public services and in other ways to make their environment attractive to developers. But an uncontrolled financial bidding war helps no one other than perhaps giving businesses that receive assistance a leg up on their competition.

The Twin Cities metropolitan area needs a much better strategy for providing private real estate assistance. In the Twin Cities metropolitan area some 130 city governments compete with each other for real estate development as if they were separate states or regions. A rational policy is lacking here. The Metropolitan Council has established a regional growth control plan, but it is essentially a non-participant in the question of city assistance to private real estate development. The Council has sponsored seminars for local government officials on how, mechanically, to make use of such devices as tax-increment financing and industrial revenue bonds, but the Council has not made policy recommendations on their use. Cities are allowed to compete with each other with no overall regional framework. What this also means, of course, is that the Twin Cities area does not compete as a single unit with metropolitan areas in other parts of the nation, beneficial as such an approach might be.

The major impact of real estate assistance lies in the location, timing, and design of new developments, and not in promoting aggregate growth. City governments can influence to a limited extent where a new development is built, when it is built, and how it is designed, through the use of financial assistance. What this means is that their assistance can help determine the geographical locations where economic activity occurs. Such action can be immensely helpful, economically, to the immediate vicinity where assistance is provided.

But city assistance is not the decisive factor in determining whether the economic activity will occur, irrespective of location. The assistance does not create new jobs; it helps influence the location of the jobs. It does not create new tax base; it helps influence the location of the tax base. There are three reasons for this. First, real estate assistance often has been granted to firms competing with other firms nearby. Employment and tax base gains are partially or wholly offset by employment and tax base losses in the competing firms. Second, real estate assistance is by nature a subsidy to capital investment, rather than to job creation <u>per se</u>. Employment subsidies, such as those provided in a new state program begun in 1983, may be a more cost-effective means of stimulating job creation than is real estate assistance. Third, the granting of real estate assistance may encourage other communities to "retaliate" with their own assistance, which may negate any favorable impact remaining after the above two effects have been considered.

To illustrate the exaggerated nature of claimed job growth, the Minnesota State Auditor reported that the total job growth claimed by industrial revenue bond issuers from 1970 to 1983 was about 134,000 jobs, about one-third of the total increase in Minnesota employment during that time. Further, a recent statistical study by the research department of the Ninth District Federal Reserve Bank of Minneapolis found that industrial revenue bonds have had no effect on state employment and property tax base growth.

Cities should be relieved of having to demonstrate--through alleged job creation or any other claims of economic impact--that their involvement is helping alleviate macroeconomic problems. Rather, cities should be asked to illustrate how the assistance will help make possible the renewal of blighted or obsolescent areas or prevent further deterioration where it is emerging. Correspondingly, when federal and state officials provide authority to city governments for real estate assistance, they should not use overall economic growth as a basis for such assistance. Instead they should be explicit about trying to influence the location of development in one place rather than another, for renewal purposes only.

<u>A good system of public assistance to real estate development has the following characteristics:</u>

<u>Resources should be used to overcome problems in the market</u>--The assistance should make it possible for a project to overcome problems in the real estate market, traceable to the current character of or use given to real estate in the area to be redeveloped. Such problems include:

* The presence of deteriorated or functionally obsolescent buildings that need to be redeveloped to keep the location competitive with other parts of the same urban region.

* The availability of tax writeoffs that make it possible for owners to continue to earn income from such buildings rather than rebuild or rehabilitate them.

* Lenders' perceptions that certain locations, such as "inner city", should not be treated the same in terms of size of loan, term of loan, or interest rate, as properties elsewhere in an urban region, irrespective of the financial viability of a given project.

* The difficulty of building rental housing that is competitive with owner-occupied housing because of government policies which favor owner-occupancy.

* The difficulty in assembling built-up land for redevelopment because ownership is more likely to be divided among many different owners than is likely on vacant land.

* The ready availability of an immense amount of open land on the fringe of the urban area, which makes built-up land less competitive. To illustrate: Approximately 265 square miles of urbanization were added to the Twin Cities metropolitan area from 1960 to 1980. That required expanding the region's perimeter by only two miles, which is the equivalent of about adding only one city block a year to the urban fringe.

Elected officials should be held responsible—The primary decision-makers should be the officials who represent the persons bearing the costs and sharing the benefits. Elected public officials should be directly accountable to the voters for deciding whether to deny or approve assistance. It now is possible for these officials to provide help without having to vote to levy taxes or appropropriate dollars from their general fund budgets. Moreover, some financial mechanisms now available place decisions in the hands of public officials who do not have to stand for election before the voters who are bearing the burden of those decisions. For example, a city council can vote to issue an industrial revenue bond, with the cost, in reduced revenues to the federal treasury, shared by all taxpayers in the nation. Or a city council can enact tax-increment financing, under which state, county and school taxpayers share more than one-half the cost.

Awareness of other negotiations—City governments should keep each other and the region informed about firms or developers with whom they currently are negotiating. This may help keep cities from getting into undesired bidding wars with each other and reduce unproductive competition. A firm or developer, seeking the best financial arrangement, may be negotiating with more than one city for the same development. Of course, the existing systems for providing financial assistance offer little incentive for cities to cooperate in this fashion.

Consistent with plans—The project should be consistent with previously-adopted city and areawide land use plans. Indeed, public assistance logically should be used only to advance public goals.

Dollars known in advance—The total public dollars being invested in a private real estate development, both direct and indirect, including the value of tax deductions and credits, should be estimated in advance for each project assisted. The approval process by other levels of government may make it difficult to know the ultimate size of a financial package at the time the initial commitment is made by the city government. Nevertheless, a city government should be able to prepare alternative estimates of the size of the final package, under different assumptions about what specific mechanisms, in what amounts, are finally approved.

The affected city government's "overhead"--that is, the expense it incurs in making the assistance available--should be estimated publicly at the same time.

Costs should be carefully defined and measured and be based on the economically valid notion of opportunity cost (actual costs are measured and compared to other opportunities foregone). What this means is that a city government needs to compare the benefits of an investment in real estate assistance against the benefits of spending the dollars on something else.

<u>Determine in advance the potential consequences of redevelopment projects on persons who are living in areas targeted for redevelopment</u>--Sometimes so much attention may be given to the claimed benefits of the proposed new buildings that any negative impact on persons who may be displaced is overlooked. It is likely that such persons will be low income. Consequently, a good system of public assistance to real estate development should include some method of fully analyzing the potential impact on existing residents and providing that they are assured continuing access to affordable housing.

<u>Projects should be audited</u>--A credible system should be established for auditing: (a) the results of assistance and (b) the specific uses of the dollars.

<u>Estimate how burdens and benefits among taxpayers will be distributed</u>--City councils should make efforts to estimate how the tax burden and the benefits of assistance will be distributed among its resident taxpayers, to avoid imposing costs on lower-income taxpayers and benefits on higher-income taxpayers.

<u>Today's system is failing to live up to these expectations. The system is generating enough revenue. But several flaws should be corrected:</u>

<u>The beneficial impact of selective assistance is diluted if help is available in almost any location.</u> When dollars for real estate assistance are made available broadly, the impact of the assistance on location of development is significantly diluted. Thus the total public investment is much higher, but its impact on guiding growth is much less.

<u>Dollars of investment are not always known.</u> It is possible for a city government to approve an assistance package for a developer without ever estimating the total current value, in dollars, of all assistance, direct and indirect, being provided now and in the future. Public money should not be spent in this way.

<u>Taxpayers might not understand what is happening.</u> Because of the way assistance is provided, taxpayers might have an impression that the assistance is cost-free or, because of the mechanisms being used, have no way to understand the package of benefits.

Accountability often is missing. With taxpayers not knowing what is happening, they have no way of holding elected public officials accountable for their actions.

The risk is too high that more assistance than needed will be provided. Any system of public assistance for private real estate development has some risk that more help is given than is needed. But the present system carries too much risk. City governments do not have enough incentives to restrict the size of their offers. In fact, because of indirect financing, city governments are tempted to offer as much as they legally can in order to minimize risk of losing the prospective developer. Some city governments do not even contemplate "walk-away" positions in negotiations, fearing that if they don't put all potential assistance on the table, neighboring cities will offer the assistance and gain the development.

They have not realized that developers know what can be offered. They have not measured carefully enough the consequences of losing a development. They have been so concerned about their perception that "but for" their assistance, the development would not have occurred, that they may have failed to ask, "so what?"

It is possible that in some cases only the city's power of condemnation need be utilized to assemble the land, with no public subsidy. Yet few examples exist where a city government condemned the land without also writing down the cost to the private buyer.

In negotiations city governments have not concentrated enough on spelling out what they want from developers, as contrasted with the emphasis given to deciding how much to give developers. For example, some city governments do not put forth proposals of their own for recovering their subsidies, or parts thereof, over the long run. Consequently, an opportunity for recovering investment may be lost. Some developers syndicate their publicly-assisted real estate investments for large profits, none of which goes to repaying the public for its assistance.

Public officials become caught up in the enthusiasm for the tangible results of development and seduced into giving up too much. Because the costs to the officials of proceeding with development are so low or nonexistent, the heady benefits of seeing the buildings rise bias decisions in favor of proceeding with development no matter what obstacles appear.

Controls on overhead expense are hard to find. A city government has little incentive to hold down the overhead expense--the varieties of payments made to outside consultants and its own staff--since the money to pay for this expense is coming from the same indirect source as is the money used for the assistance itself.

Too much emphasis is given to real estate development as a way to create economic growth. Sustainable growth in an urban area is affected mainly by access to markets, access to essential production and marketing skills, availability of venture capital financing, and other resources. Real estate development is more a result of economic growth, not its cause. Too often public officials regard real estate development, by itself, as economic growth. Use of public dollars to assist real estate development does serve to redistribute growth. But in some cases it may promote unsustainable growth.

Risks of conflict of interest and corruption are too high. Any time public officials are involved in providing financial assistance to private real estate development, risks of conflict of interest and corruption are present. The absence of any major problem so far should not delude the State Legislature (as the major body establishing rules for city government) into thinking that potential for scandal is not present. With millions of dollars in public assistance being offered, businesses stand to gain or lose large profits, depending upon whether they are awarded assistance. The heavy involvement of city governments in real estate assistance is relatively recent. Therefore, some types of risks--which have been present historically in other situations involving public officials and private interests--are now discernable in the real estate area, too. For example, is it likely that firms which stand to gain financially from real estate projects will become major contributors to the election campaigns of city officials? Or, is it likely that these firms would be future sources of employment for city officials and their staffs? Would either of those possibilities affect the independence of the officials and their staffs as they act on proposed real estate projects?

Citizens' confidence that government is working for each of them may be undermined. The current role of city governments in providing assistance to real estate developments is new. It differs from traditional government regulation and public works. The complexity and obscurity inherent in existing real estate assistance programs make it difficult for citizens to have a clear view of who is receiving what. At the same time those individuals and groups with an economic interest in development subsidies play central roles in local political activity.

Consequently, citizen confidence that officials are devoting their energies to activities of general benefit may be undermined.

The above-listed flaws, while detailed, represent a need to change, not discard, the practice of providing city assistance for private real estate development. Moreover, as can be seen from the recommendations which follow, we envision mainly changing incentives, not imposing a set of restrictive regulations.

If properly directed, a new set of incentives can assure that: (a) public assistance is distributed very selectively, only to the projects with real need and potential public benefit, (b) taxpayers are informed of the actual distribution of burden and benefit from the public assistance, (c) elected officials are held accountable for their actions, (d) officials will negotiate firmly, giving as much assistance as is needed, not more, (e) overhead expense is minimized, (f) risks of conflict of interest and corruption are reduced, and (g) citizen confidence that government serves the broad public interest, not narrow private interests, is enhanced.

RECOMMENDATIONS

SUMMARY: These recommendations help shift the governmental financing of private real estate development from: (a) indirect sources to direct sources, (b) entitlements to appropriations, (c) off-budget to on-budget, (d) non-targeted assistance to that which is targeted specifically for renewal. The recommendations recognize that providing help for real estate assistance is mainly designed to influence business/job location, not business/job creation.

We recommend that the state:

> Give each city government access to a redevelopment fund, a new mechanism for cities to use in investing in renewal of properties. The fund would be financed from direct revenue sources and repayments of assistance previously provided to owners/developers.
>
> Impose legislative restrictions on tax-increment financing to stop excess use and to encourage cities to shift to the redevelopment funds.
>
> Allow cities to use both redevelopment funds and tax-increment financing until a specified future date when tax-increment should be discontinued.

DETAILS:

1. Establish Redevelopment Fund—We recommend that the Minnesota Legislature in 1986 pass a law permitting any city government to establish a redevelopment fund, set up according to provisions outlined below. The fund would give cities flexibility in use of dollars and access to new revenue sources. It would replace "pooling" devices now used by cities in tax-increment financing.

2. Use redevelopment fund for public infrastructure, acquisition of real estate, and private loans and grants—A city government should be allowed to use its redevelopment fund for the physical renewal of properties within its borders. The following types of activities would be permitted uses of the fund: (a) construction of public infrastructure, including sewer, water, streets, sidewalks, lighting, parking, skyways, and parks, (b) acquisition of real estate, and (c) loans and grants to private developers for renewal (new construction and rehabilitation) of properties, including reducing the interest rate paid by developers. Because it would not be necessary to relate the amount of public assistance directly to likely growth in property taxes, this approach would give cities more flexibility than is allowed by tax-increment financing.

City governments would not be limited to the redevelopment fund as a source for financing the construction of infrastructure. Other traditional forms of financing, such as special assessments and general obligation bonds, would continue to be allowed.

3. Authorize many sources for a redevelopment fund—The Legislature should provide that a redevelopment fund include revenues from any or all these sources:

> General fund transfers—State law should be changed to make it clear that cities can use their general revenues directly for redevelopment. This means a city council could make a conscious decision to enrich its redevelopment fund from general sources available for city operations.

Transfers should be allowed from the redevelopment fund to the general fund if a city council wants to return to the general fund any amounts transferred to the redevelopment fund earlier.

Direct property tax levy—The Legislature should allow city governments to levy property taxes directly for redevelopment funds, without being subject to levy limits or voter referendum.

Limited "surplus" revenues from tax-increment districts--We recommend that a city government should be allowed to transfer to a redevelopment fund from a tax-increment district the equivalent of up to three years' tax increment revenues, after enough money is accumulated in tax-increment revenues to finance the redevelopment expenditures in the affected tax-increment district. This is the one exception to our proposal, outlined below, that would prohibit tax-increment districts from accumulating more funds than are necessary to pay off commitments made when the districts were established.

UDAG repayments—Repayments to city governments of Urban Development Action Grant (UDAG) loans. Under existing federal law a developer is required to repay a UDAG to the city, but the city then can use the money for other development-related purposes. It does not have to return the money to the federal government.

Other repayments—Repayments to city governments of loans and other types of recoupment which might be negotiated with developers, such as, for example, a repayment to the city of subsidies at the time the property is sold to a different party.

State aid--We recommend a special state aid program for cities' redevelopment funds. State dollars would be apportioned according to a formula weighted for redevelopment. For example, the amount a city government receives could be related to the age or physical condition of its buildings.

General obligation bonding—We recommend that state law provide explicitly that a city can issue general obligation bonds and place the proceeds in its redevelopment fund. Such general obligation bonds should be permitted only if they are issued in a manner which guarantees that they count as part of the net bonded debt of the city.

4. Tighten use of and ultimately discontinue tax-increment financing--Our proposals are designed to encourage city governments to use redevelopment funds instead of tax-increment financing. We propose that tax-increment financing be allowed to continue for several years, limited to physical renewal of property. During that time cities should be allowed to use both redevelopment funds and tax-increment (with the restrictions we outline below). We recommend that the Legislature set a date after which no additional tax-increment districts may be created and no additional improvements financed with tax-increment dollars may be undertaken in previously-existing districts. A reasonable date would be 2 1/2 years from the date of passage of a statute embodying our proposals. If these recommendations are adopted by the Legislature by mid-1986, cities would be able to make additional commitments using tax-increment financing until January 1989. Of course, the allowable period under state law for committing tax-increment revenues may be as long as 25 years. Consequently, tax-increment would not disappear totally until up to 25 years after the approval of the last tax-increment project.

Our recommendation for phasing out tax-increment financing is contingent upon the establishment of the redeveopment fund, as recommended above. We would not support elimination of tax-increment financing without a satisfactory replacement.

We recommend that the Legislature in 1986 impose the following restrictions on the use of tax-increment financing:

Repeal the provisions of tax-increment financing which allow districts to be formed where no redevelopment is occurring--The Legislature should repeal an existing provision which allows tax-increment to be captured for up to eight years in so-called "economic development" areas. This is a provision of law which allows tax-increment to be used in locations where any finding of redevelopment need is impossible, because nothing can be redeveloped.

Require that a city government partially reimburse the state for the state's loss of revenue because of tax-increment financing--The amount need not be very large, but even a small amount of reimbursement likely would encourage prudence by cities in using tax-increment. Such action should be required for all additional improvements authorized in existing tax-increment districts as well as for all new or expanded districts. The mechanics of partial reimbursement could be accomplished by the state's deducting a portion of local government aid to the affected city government. (The fact that the Legislature provides state aid for tax-increment districts may not be widely understood. It occurs indirectly, through the formula which provides state aid for schools. In 1983 the state paid an additional $10.3 million in aid to school districts because the captured value in tax-increment districts is not counted as local wealth in the aid formula, according to Dennis Erno, assistant state commissioner of revenue.)

Disallow accumulation of surpluses in future tax-increment authorizations, except as outlined above—The amount of revenue captured for tax-increment purposes should be the amount needed to pay expenses authorized when the tax-increment district was created, no more. Once those dollars have been accumulated, no more tax-increment dollars should be captured, and the property would be returned to the tax rolls, with one exception allowed. The exception that we would allow, as noted above in our recommendation on the sources of revenue for the redevelopment fund, is that a city could capture up to three years' additional tax-increment revenue in a district for the redevelopment fund. Such a capture would be possible only if revenues are accumulated enough years before the legally-prescribed expiration date for tax-increment districts. We would not propose an extension of that expiration date.

Discontinue pooling tax-increment dollars other than the pooling that would be made possible by a transfer of limited tax-increment dollars to the redevelopment fund.--The Legislature should repeal existing laws which allow revenue generated in a tax-increment district to be used for expenses in areas outside the originally-established tax-increment project area. The following types of pooling approaches plus any others would be discontinued and no additional such approaches would be allowed: (a) so-called master project tax-increment plans, in which revenues from all tax-increment districts in a city may be used anywhere in the city, irrespective of the district where the dollars were generated, and (b) pooling of tax-increment districts' debt service through refinancing of bonds, as authorized in a special law adopted in 1984. Of course, the flexibility that has been available to city governments by pooling will be possible through use of redevelopment funds.

Require that the actual distribution of burden of tax-increment authorizations be made public—County tax officials should be instructed to prepare public reports showing the actual effect on all overlapping taxing jurisdictions, including the state, of tax-increment financing. This means that voters would be able to identify exactly how burdens would be distributed if a system of direct levies and aids were in existence instead of tax-increment financing. (See a detailed explanation on page 29 of how burden is distributed.)

Require that city administrative expenses be financed from sources other than tax-increment financing—We recommend that the Legislature prohibit city governments from using tax-increment financing receipts to pay for salaries and related administrative expenses of city employees who handle certain responsibilities for the projects. This means that the existing practice by which cities apportion a percentage of the expense for various city offices to the tax-increment projects would be discontinued. Cities would be required to pay for such administrative expenses from other sources, such as their redevelopment funds or their general funds. This would remove any possible incentive a city government might have to continue to approve additional tax-increment projects as a way to provide revenue to balance the city budget.

Repeal the provision in tax-increment financing that allows property values to be kept artifically high—We recommend that the Legislature repeal the right of city governments to obtain from developers contractual pledges that keep property values in tax-increment districts at predetermined levels, even if the selling price of those properties happens to drop in coming years. Part of the risk in setting up a tax-increment district is that the estimated growth in taxes will be insufficient to pay the public expenses in the district. Such estimates are made with the hope that property values will remain at certain levels. If for some reason the market value of property drops in coming years, the tax-increment district would generate less revenue than anticipated. In anticipation of such a possibility, existing law makes it possible for the city to instruct the assessor to keep values at initially determined levels, even though market conditions in coming years might call for a reduction in values. In turn the city is empowered to obtain a pledge from the developer not to challenge the higher value during the contract period, even though this means property taxes will be higher than on comparable properties outside the tax-increment district. This is unsound from an economic standpoint and from an equity standpoint.

5. Plan required—We recommend that any city government desiring to help developers through its redevelopment fund or through tax-increment financing be required to adopt a city renewal plan, identifying selected geographic areas where the city anticipates providing assistance. Such a plan would be subject to periodic modification. The intent of this approach is to emphasize renewal of existing urbanized areas, not new construction on raw land. Consequently, a city government's renewal plan—to make the city eligible for using a redevelopment fund or tax-increment financing—should be allowed to encompass

only those geographic areas which have been classified as nonagricultural land for tax purposes for at least 15 years.

A renewal plan should be sufficiently detailed so that prospective developers understand what is expected of them and could submit proposals. Expenditures would be permitted only if consistent with the plan.

6. Require regional guidelines—The Metropolitan Council, other regional development agencies in the state and the State Planning Agency (for parts of the state without regional planning bodies) should be required to help city governments develop renewal plans that avoid wasting money through unnecessary inter-municipal bidding but recognize that some competition among cities is healthy. City governments today are forced to decide on assistance with virtually no input on whether their actions are consistent--or in conflict—with areawide land use plans. The Metropolitan Council and other agencies should not be given power to decide whether assistance should be granted. That power should continue to reside at the level of city government. Instead regional and state agencies could develop suggested guidelines for cities to follow.

7. Make total assistance explicit for each project--At the time a city government makes its initial commitment of public assistance, whether through the assistance fund or tax-increment, even though the total amount of commitments are not yet known, the city should be required to make public estimates of the total value, in current dollars, of all assistance, direct and indirect, from federal, state and local sources combined, including the value of tax deductions and credits for each publicly-assisted development. Such estimates can be prepared for different scenarios of what the total package might look like.

8. Separate "overhead" expenses—Some of the expenses would be services provided by city government staff and consultants. City officials should be required to make separate allocations for such "overhead," so that amounts for that purpose always are clearly known. Overhead expenses would be chargeable to the redevelopment fund or to tax-increment accounts along with other expenses of a renewal project, such as infrastructure construction or financial assistance to a developer. However, as noted earlier, city governments should not be allowed to charge salaries of city employees to tax-increment accounts.

9. Require periodic audits and periodic review—The Legislature should require periodic random audits of city real estate assistance funds and of tax-increment districts, covering a detailed analysis of receipts and expenditures. The Legislature also should require periodic review of real estate assistance projects to compare results to date and the outlook for the future, measured against projects' original objectives. Part of periodic review should be recommendations to the Legislature on the need for state dollars in redevelopment funds in coming years. Regional agencies such as the Metropolitan Council could be instructed to make such recommendations.

10. Allow use of condemnation even if financial assistance is not provided--State law should clarify the right of any city to use its power of condemnation in carrying out a previously-adopted renewal plan, but without an accompanying requirement that a city also provide financial help. Condemnation authority should be used sparingly, because it represents the public's taking of private property when the private owner does not want to sell. It should be used primarily to help the private developer acquire hold-out parcels.

11. Negotiate for recovery of city assistance--We recommend that city officials recognize that negotiations with developers are two-way streets and that they as well as developers should place negotiable items on the table. Specifically, city officials should take the initiative in suggesting ways that the city could recover part or all of its financial assistance, even that provided in loans. Among the possibilities:

> Receiving a share of any capital gain that the developer might realize when the property is sold to a new owner. (Developers might insist, in return, that the city share in any loss, too.)
>
> Retaining ultimate ownership or interest in the land.

To guard against a city government's providing assistance with the hope that a project will return great profits to the city, a city should not seek to recover more than its original investment. This recommendation of limitation arises out of our dual concern about: (a) pressures on city officials to approve proposals for publicly assisted real estate development, and (b) the difficulty of holding today's political leaders accountable for the profit of tomorrow. We believe that the expectation of future profit to the city from real estate development could soften a city's bargaining resolve, thereby making it easier for city officials to grant more public assistance than can be justified.

12. Use only negotiators experienced in real estate development--We recommend that city governments exercise great care in assigning individuals to negotiate financial assistance packages with developers. It is doubtful that someone without direct personal experience in development will be skillful enough to understand the approach of the developer across the table. Therefore, the most desirable negotiator for a city could well be someone who has been on the other side of the table in the past or someone who is a developer or represents developers in other parts of the nation.

13. Phase out industrial revenue bonds--We support the phase-out schedule for industrial revenue bonds now in federal law. The bonds for commercial-industrial purposes, other than manufacturing, are set to be discontinued at the end of 1986, and for manufacturing, at the end of 1988.

DISCUSSION OF RECOMMENDATIONS

According to our proposal, for the next several years city governments would use both a new redevelopment fund and tax-increment financing. The new fund would give cities access to revenue which they do not now possess, plus greater flexibility in the use of dollars for real estate assistance.

City governments have become highly protective of tax-increment financing, believing nothing else will be made available. Thus we are recommending that the two tools exist side-by-side for several years.

However city governments use redevelopment funds and tax-increment, we believe that renewal of obsolete and/or blighted real estate should be the guiding motivation. Consequently, we are recommending that expenditures only be made which are consistent with previously-adopted renewal plans. We are trying to discourage the use of dollars only for the purpose of enticing development to locate in one city rather than another. We think intermunicipal competition is healthy but the use of subsidies to fuel this competition is ill-advised.

To encourage city governments to select the redevelopment fund, we are proposing steps that would make tax-increment less appealing. Those steps are: (a) requiring a city to reimburse the state partially for the state's loss of revenue because of tax-increment financing, (b) preventing the accumulation of surpluses in tax-increment projects, (c) discontinuing pooling of funds in tax-increment districts but allowing a slight diversion of tax-increment revenues to the assistance fund as a replacement for pooling, (d) prohibiting use of tax-increment financing in locations where no redevelopment is occurring, (e) spelling out the real effect of tax-increment financing in direct levy and aid terms, (f) prohibiting the use of tax-increment funds for employee salaries and related city administrative expense, and (g) repealing a provision which allows city governments to keep valuation in tax-increment districts at initially-established levels, even if prevailing property values drop. City governments using tax-increment option would continue to have access to resources of school and county governments because we propose to continue--not repeal--the provision of tax-increment financing that allows school, county and city mill rates to be imposed on the captured value with the revenues used for redevelopment.

Our purpose is to encourage movement from tax-increment financing to the redevelopment fund. We think the fund has several advantages:

* It gives a city government much more flexibility in the use of dollars. A city government can provide assistance in other parts of the city, not just in tax-increment areas. It won't be necessary to worry about whether a project which receives assistance generates higher property taxes.

* It gives city governments real incentives to exercise great discretion in providing help to private developers, because those dollars will come out of the same fund which will be used to help finance other types of city assistance for renewal.

* It increases the likelihood that only projects with real need will receive assistance because dollar amounts are limited and would be apportioned directly.

* Dollars of investment will be clearly visible to elected officials and the public.

* City officials will have incentives to provide as much assistance as is needed, no more.

* Overhead expense will be clear, with incentives present to hold down amounts committed to overhead.

Of course, while these are good public policy reasons, city officials probably have other things on their mind, such as the ability to generate substantial dollars with minimum public reaction. Thus it will be the totality of the proposal--the advantages of the redevelopment fund balanced against the disadvantages of tax-increment financing--that will affect city officials' choices.

The Legislature can observe the experience and decide whether to encourage city governments to move more rapidly to the redevelopment fund. We believe a gradual, steady shift is desirable. Cities won't find themselves threatened overnight by a major transformation.

If our recommendations are adopted, renewal plans could cover whatever areas a city government might choose, except that the plans could not include land which is classified for tax purposes as agricultural or has been converted from agricultural purposes within the last 15 years. That is our way of keeping the emphasis on renewal, not development on raw land, without precluding the use of funds on long-standing vacant land within the urban area.

As can be seen, our recommendations do not discuss industrial revenue bonds in detail. We support the current schedule for their phase-out, as provided by Congress. Industrial revenue bonds should be discontinued. They are indirect, off-budget, non-targeted assistance.

A few details of our proposal need more elaboration:

Why allow three years of "excess" tax-increment dollars to be transferred to the development fund? Theoretically, no excess should be permitted. However, we are keenly aware that cities already are finding ways to pool revenues from their tax-increment districts and to keep property off the tax rolls longer than is needed. Our proposal for allowing up to three years of excess increment to be transferred to the redevelopment fund is a practical acknowledgment that cities should receive something in return for elimination of the pooling provisions allowed now.

Would the possibilities of corruption be reduced? According to one argument, the current system is more vulnerable because elected officials don't have pressure coming from competing users of the dollar, which means the existing system is not self-policing. Thus, an official may be more susceptible to granting favors because competing users for the dollars aren't concerned about who else gets them. A counter-argument, however, is that the proposed system--with limits on total dollars available--is an invitation to corruption, because, with resources limited, interested parties might try to receive favored treatment by passing money under the table. Nevertheless, dollars of subsidy would be known, not concealed, under the proposed system, which should help reduce the potential for corruption.

What is the rationale for requiring a city to provide partial reimbursement to the state if a tax-increment district is created or expanded? This is our way to make sure that a city government commits some of its on-budget resources to a tax-increment district. The state would withdraw some of its regular aid to the city's operating budget. Consequently, the city government would be required to adjust some of its spending priorities, or increase its local tax levy, if it chooses to use tax-increment financing.

Would taxpayer understanding of tax-increment financing be helped if the mill-equivalent of the tax-increment levy appeared on the property tax statement? Possibly. Our recommendation is not specific on how taxpayers would be informed of the way the tax-increment burden actually is distributed. Expressing the mill-equivalent on the tax statement certainly would elevate the level of taxpayer interest.

We are calling for changes in the development assistance system for the following reasons:

Accountability is lacking—Today's system of financing redevelopment offers little accountability to the voters. Elected officials don't debate how much money to invest in redevelopment relative, say, to public safety or street maintenance. Instead, the dollars for redevelopment are made available from separate revenue streams which don't flow through the regular operating or capital budgets of city governments.

Some businesses lose when favored treatment is given to others—Unsubsidized hotels, offices, retail stores, warehouses and other establishments exist side-by-side with subsidized competitors. The result can be that reduced interest rates, land write-downs or other types of assistance make it possible for the subsidized firms to enjoy a competitive advantage over those that are unsubsidized.

This problem is not universal, by any means. In fact, substantial evidence is available that an entire downtown, for example, receives benefits when new buildings are constructed with subsidies. Thus the possibility that certain firms could receive special advantage over their competition doesn't call for doing away with public assistance. It does, however, mean that the tools of assistance should be used with great care. Existing rules governing the major tools available to cities (industrial revenue bonds and tax-increment financing) are not sufficiently restrictive to protect unsubsidized businesses from the consequences of overly-generous subsidies to others.

Too much tax base may be captured—Elected officials may be committing excessive amounts of tax base for tax-increment purposes. The amount of tax base captured for tax-increment (that is, held out of the official assessed valuation and not available for regular city, school and county government expense) is growing very fast. No restrictions are present on the amount that can be captured. Statewide, the captured assessed valuation in 1985 exceeds $600 million, which is equivalent to the tax base of the entire city of Edina. At present rates of growth the amount easily can exceed $1 billion before the end of the decade. Minneapolis is the heaviest user. For 1985, 8.8 percent of Minneapolis' assessed valuation is captured in tax-increment districts. This percentage is projected to grow to 9.7 percent in 1986 and to 10.3

percent in 1987, according to the Department of Property Taxation, Hennepin County.

Revenues of the federal and state governments are committed without specific appropriations—The federal and state governments both forego revenue with industrial revenue bonds. The state government automatically increases its aid to school districts as a result of tax-increment financing. Such approaches might be justifiable, but not without limits.

The purposes for which the assistance is provided are too broad—Originally, public assistance for private real estate development was designed exclusively to help get rid of dilapidated buildings and encourage new construction on the newly-vacant land. Now, however, assistance is possible without any demonstration of blight.

Other possibilities explored—Before settling on our recomendation for a redevelopment fund coupled with restrictions and phase-out on tax-increment financing, we explored several options:

First, we looked at the consequences of leaving the current system largely unchanged. Despite the problems outlined in our conclusions this option still might be considered because: (a) no really major scandals have been uncovered, and (b) public officials are encountering no great cry of public indignation. But we felt the problems identified demand action in any event.

Second, we seriously considered transforming the mechanics of the tax-increment system from indirect levies and aids to direct levies and aids. This possibility intrigued us because it would create more visibility without changing existing authority of city governments or the distribution of burdens and benefits. But such a change involves direct levies on the assessed valuation of school districts and counties as well as direct aid from the state, which would not be easily understood by school, county or state officials. Also some of us feared that the direct levies might make the tax-increment system so visible that no city official would dare use it. We preserve an element of this proposal, however, in that property tax officials would be required to report the actual effect of tax-increment financing in these terms, even if the mechanics aren't changed.

Third, we considered only imposing restrictions on the use of tax-increment financing, such as: (a) limiting the amount of assessed value which may be captured, (b) requiring school districts and counties to approve new districts or expansions of existing ones, (c) removing the indirect state subsidy in the school aid formula, (d) limiting the types of development for which tax-increment may be used, and (e) preventing the accumulation of surpluses in tax-increment accounts. Some of these restrictions seem reasonable, but we did not believe it is desirable to impose restrictions without giving city officials some other choice.

Fourth, we considered immediate replacement of tax-increment financing with a city redevelopment fund that would be financed by a direct property tax levy and by other sources. We like this approach very much, but we are reluctant to recommend such a radical change all at once, knowing that city officials will want to see some experience with such a fund before being confident that it is an acceptable alternative to tax-increment financing.

Fifth, our preferred option, we selected parts of options three and four. During the last 10 years of increasingly heavy use, tax-increment financing has enabled city governments to undertake major development projects. For such a relatively short time we believe tax-increment financing, with its ability to commandeer, indirectly, resources of overlapping units of government, including the state, can be justified. Minneapolis and Saint Paul, particularly, urgently needed a spark in the early to mid-1970s, to make their downtowns strong metropolitan centers. Few persons would challenge the assertion that both downtowns are becoming showplaces for the metropolitan area. Private investment in the last 10 years in the downtowns has been accompanied by a significant dose of public assistance, much of it in the form of tax-increment financing. While the indirect system may have been appropriate in the short term, it is not appropriate for the long term. The state should move to a direct system.

A sixth option--really different from all other options discussed above--would vest decision-making on development assistance at a higher level of government, not the city level. We considered this approach briefly but concluded that city officials probably are in the best position to determine needs within their own communities. One attractive argument in favor of decision-making at a higher level is a reduced risk that decision-makers could be influenced by special favors from developers seeking assistance.

A seventh option would be to discontinue all forms of governmental financial assistance to private real estate development. A few members of our committee believe government should concentrate on delivery of public services, leaving development to the private marketplace. A majority believes, however, that deterioration and obsolescence, competitive disadvantages, and undesirable land use will not be ended fast enough without public assistance.

An eighth option--discussed very slightly--is somewhat of a modification of the seventh. Under this option the property tax system would be changed so that a much higher proportion of the tax falls on the land and a much smaller proportion, on the buildings. Supporters of this option contend that owners could not afford to keep deteroriated or obsolescent buildings on highly valued land, and, therefore, would redevelop the property on their own, without the need for public subsidy. Most of us felt this idea holds such slight promise of being implemented in the next few years that other, more immediate, steps need to be taken. Also the idea is not easily grasped and needs much more discussion before it could be tried.

* * * * *

<u>Reporting the effect of tax-increment financing in direct levy and aid terms</u>

One of the most helpful exercises in our deliberations was to express tax-increment financing in direct levy terms. Based on this experience we concluded that tax officials should be instructed to report the effect of tax-increment financing in these terms, even though the mechanics of tax increment would not be changed.

Under tax-increment financing, the new growth is held out of the tax base, with the total mill rate applied to the growth to generate the tax-increment revenue. This makes the assessed valuation of the city, school district, and county less than it would be if the growth were part of the tax base. Consequently, the mill rates are higher than they would be, assuming government spending would be the same and assuming the tax base growth would have occurred there anyway. Also state aid to school districts is higher than it would be, because state aid goes down as assessed valuation increases.

We prepared the following example to illustrate these impacts:

The illustration is a hypothetical situation, not real numbers for a real city. First we illustrate how tax-increment works now. Then we show what the numbers would be if the new growth were made a part of the tax base and direct levies and aids were used to produce the dollars of public investment. Under both alternatives, compare the mill rates for each unit of government, the dollar levy for development/redevelopment, and the amount of state aid. They are identical, which shows the actual distribution of burden and benefit.

Example showing use of tax-increment financing, current law

A tax-increment district has been created. Assume, for purposes of this example, that growth in assessed valuation available for tax-increment purposes is $5,000,000, which also is known as the "captured" valuation.

The dollars of tax levy, the assessed valuation (exclusive of the valuation captured in the tax-increment district) for the affected units of government are as follows:

Unit of Government	Dollar Tax Levy	Assessed Valuation	Mill Rate
City	$ 2,250,000	$ 101,000,000	22.277
School District (foundation levy)	7,498,000	326,000,000	23.000
School District (other levy)	7,869,000	326,000,000	24.138
County	39,576,000	1,302,000,000	30.396
Metro Agency	5,100,000	5,431,000,000	.939
Total			100.750

Under the provisions of the tax-increment law, the total mill rate, 100.750 mills, is multiplied by the captured value in the tax-increment district, $5,000,000, to arrive at the tax-increment levy in dollars. This is the annual amount available to pay the public's development or redevelopment expense. The result of multiplying 100.750 mills (also expressed as 10.0750 percent) by $5,000,000, is $503,750.

Example showing the same impact, but through direct levies and aids

Step 1—The "captured" value of $5,000,000 is added into the assessed value of every unit of government. The table below shows an increase in assessed value of $5,000,000 for each unit of government. Expenditures of the units of government remain the same; therefore, the dollar tax levies are unchanged (except for the school district foundation levy, which will be explained in the next paragraph.) Mill rates are recalculated to produce the same amount of revenues with the inclusion of an expanded base. The result, of course, is that the mill rates decline because of the growth in valuation from adding the $5,000,000.

The school district foundation levy increases by $115,000, but the mill rate for the school district foundation levy remains unchanged. A provision of state law requires that the school district levy the same mill rate, 23 mills, for foundation purposes, irrespective of the size of the tax base.

Unit of Government	Dollar Tax Levy	Assessed Valuation	Mill Rate
City	$ 2,250,000	$ 106,000,000	21.226
School District (foundation levy)	7,613,000	331,000,000	23.000
School District (other levy)	7,869,000	331,000,000	23.773
County	39,576,000	1,307,000,000	30.280
Metro Agency	5,100,000	5,436,000,000	.938
Sub-total (without direct tax levies for tax-increment purposes)			99.217

Step 2--Calculate special tax-increment levies to raise $503,750. The table below shows the amount needed is apportioned among the various units of government in the same proportion as each unit of government's mill rate bears to the total mill rate. That amount then is divided by the assessed valuation of each unit and a mill rate is calculated to raise the necessary funds. The result is as if the decision by the city government to levy the taxes for development/redevelopment would trigger action by the appropriate tax administration official to impose the tax-increment levies on the overlapping units of government.

You will note that the tax-increment mill rate for the foundation levy portion of the School District is zero. The state would make a payment of this levy amount, $115,000, to the city as its share of the expense of the tax-increment district. In effect, the state is making such a payment under existing law because keeping the "captured" value out of the total assessed value requires an increase in state aid to school districts to make up for the loss in tax base.

Unit of Government	Dollar Tax Levy	Assessed Valuation	Mill Rate
City	$111,385	$ 106,000,000	1.051
School District (foundation levy)	115,000*	331,000,000	0.000
School District (other levy)	120,690	331,000,000	.365
County	151,980	1,307,000,000	.116
Metro Agency	4,695	5,436,000,000	.001
Total:	503,750		1.533

*As mentioned above, this amount would be paid directly by the state, not levied on property.

The total mill rate necessary to raise the $503,750 is 1.533 mills. When that amount is added to the other mill rates as determined in step one, 99.217 mills, the total mill rate is 100.750 mills, which is identical to the mill rate under existing law. As can be seen, too, the mill rates of the individual units of government, when added together in steps one and two are identical to the mill rates under existing law.

And, of course, the amount raised from the special levies, $503,750, is identical to the amount raised under existing law.

To summarize: the actual distribution of burden in a tax-increment district as described above, is a burden of 1.051 mills on city property, .365 mills on school property, .116 mills on county property, .001 mills on metropolitan property, and a state appropriation of $115,000.

WORK OF THE COMMITTEE

Background on formation of the committee

The establishment of Role of Cities in Real Estate Development Committee was authorized by the Citizens League Board of Directors in the summer of 1984. Its establishment is an outgrowth of a previous committee in the same general subject area, authorized in the summer of 1982. The previous committee submitted its report to the Board of Directors in February 1984. The Board debated the report at three separate meetings before concluding that the best approach to take would be to start a new committee, instead of acting on the report of the first committee. The report included major recommendations for changing the system, which had support from a substantial majority of committee members, but also included a strong dissent from a minority of members.

The new committee included eight persons who served on the first committee.

Charge to the Committee:

The Board of Directors adopted the following charge to the Role of Cities in Real Estate Committee:

"Cities have always been involved with real estate development, mostly through planning and zoning decisions and provisions of basic infrastructure. In recent years cities have called on new tools to guide development. These tools, which are primarily financial, have ushered in a new working relationship between municipal officials and private developers, a kind of partnership in investing and developing. The context of this partnership includes the federal attention to local real estate development inaugurated by the urban renewal program and the more recent interest manifest by state governments.

"While there are relevant state statutes, as well as procedural protocols observed by cities individually, there is no well understood and articulated policy framework for this new relationship. Ths committee shall recommend the elements of such a framework. The committee should, specifically:

1. Review the rationale for the role of cities as investors and developers and the public purposes served, identifying the kinds of needs that suggest some form of public assistance.

2. Identify existing or potential hazards.

3. Develop a policy framework for the management of cities' role in real estate development. In developing the policy framework, the committee should:

    Identify: a) the criteria by which cities decide whether to provide financial assistance for projects, b) what form the financial assistance should take, and c) the extent to which they should use their own funds and those of other levels/units of government.

    Identify, insofar as possible, improved ways to provide financial assistance.

    Show how cities can carry out their regulatory and development functions compatibly.

4. Evaluate the adequacy of existing governing structures for decision-making and accountability, including the intergovernmental dimensions of the policy."

Committee procedures

The committee began its work with a six-hour Saturday meeting on October 27, 1984. The committee met for two-hour weekly meetings during November and December, followed by another six-hour Saturday meeting on January 5. With that meeting the committee finished its time of receiving testimony from resource persons. (The resource persons are listed below.) During the rest of January and early February the committee concentrated on identifying central issues. In late February the committee began work on the first draft of its findings and conclusions. In late March the committee began debating recommendations. From that time until the final meeting, May 28, the committee revised the full report several times.

Committee Membership

A total of 34 people participated actively in developing the report. They are:

Tom Swain, Chair
John Adams
Earl F. Colborn, Jr.
Jack Costello
Jack Davies*
Robert Dildine
Robert Ehlers
Richard Erdall
Harley Handegard
Royce Hanson
Ray Harris
Paul Hilstad
John Hoeschler
Terry Hoffman
Edward Hunter
Stephen Kotvis
Lyn Krieger
A. Scheffer Lang
John Lilja**
Dean Lund
Wilbur Maki
Scott Nessa
Philip Raup
Rosemary Rockenbach
David Rodbourne
Gerald Sandey
David Schaaf
Fred Speece
John Stockman
Michael Stutzer
Albert Trostel
Parker Trostel
Connie Waterous
Lois Yellowthunder

*Jack Davies dissented from the recommendation that general obligation bonding be a revenue source for the redevelopment fund.

**John Lilja dissented from the recommendation that state aid be a revenue source for the redevelopment fund.

Resource Guests

During the first stage of the committee's work it relied upon testimony from resource people. The Citizens League and the committee members would like to thank the following people for assisting the committee's work in this way:

JOHN ADAMS, professor, Department of Geography & Public Affairs, U of M
BEA BLOMQUIST, mayor, City of Eagan
ARNE CARLSON, state auditor
CHARLES DARTH, finance director, City of Brooklyn Park
MARK DAYTON, commissioner, MN Department of Energy & Economic Development
DENNIS ERNO, assistant commissioner, MN Department of Revenue
DONALD FRASER, mayor, City of Minneapolis

RAY HARRIS, real estate developer
CURT JOHNSON, executive director, Citizens League
ROBERT JORVIG, economic development consultant
STEVE KEEFE, chair, Community Development Agency; commissioner, MN Dept. of Labor and Industry
GEORGE LATIMER, mayor, City of St. Paul
ELLEN LAVIN, council member, City of Hopkins
ROBERT LEWIS, mayor, City of Coon Rapids
JAMES LINDAU, mayor, City of Bloomington
JAMES McCOMB, James McComb & Associates
JANE McGREW, executive vice president, Housing and Development Law Institute, Washington, D.C.
NEAL PEIRCE, Nationally-syndicated columnist
PAUL REDPATH, council member, City of Eden Prairie
TONY SCALLON, council member, City of Minneapolis
JEFF SPARTZ, member, Hennepin County Board of Commissioners
GARY STOUT, president, Public-Private Ventures, Inc.
MICHAEL STUTZER, economist, Federal Reserve Bank
JOHN SWANSON, community planning & development specialist, Dept. of Housing & Urban Development
VICTOR WARD, senior planner, Metropolitan Council

Staff assistance to the committee was provided by Paul Gilje, Jody Hauer, Donna Keller and Joann Latulippe.

BACKGROUND

I. Scope of Report

This background section describes the various tools used by the public sector to guide real estate development. Real estate subsidies are but one piece of what is commonly called economic development. The economic development of our cities is contingent upon demographic changes, national and international economic trends, and a host of other factors upon which cities exert very little control. This report only deals with those efforts on the part of the federal, state and local governments to influence the development of real estate.

II. Major Tools Cities Use to Finance and Influence Real Estate Development

Because development assistance comes from a variety of sources, this listing groups the development tools into four categories: those tools generally initiated by cities, those initiated by the state, those initiated by the federal government, and those initiated by individuals. For each tool there is a brief description of what it is, where it is used, how much money it involves, and possible modifications of it.

Incentives the City Initiates

A) Industrial Revenue Bonds

What they are.--State and local governments may issue industrial revenue bonds (IRBs) to provide financing for private investment in plants and equipment. The IRBs' tax exempt status enables businesses to borrow funds at below-market interest rates. Unlike general obligation bonds which are backed by the full faith and credit of the governmental unit issuing them, revenue bonds are backed by the income from the assisted business. The issuing unit of government has no liability.

The federal and state governments regulate IRB use by local governments. In June 1984 Congress determined the use of IRBs would sunset December 31, 1986, except for those IRBs used for manufacturing facilities which would sunset at the end of 1988. Congress further limited the uses of IRBs and the amount cities and states could issue. The amount of IRBs allowed in the state is restricted to the greater of $150 per capita, or $200 million (except for an unlimited amount of bonds available for publicly owned facilities like airports, docks, wharves, mass transit facilities, convention and trade show facilities, and certain parking facilities.) About $612 million was authorized for Minnesota in 1984. As noted above, in 1983 when amounts of IRBs were still unrestricted, cities and other governmental units across the state authorized $1.3 billion of IRBs.

States are allowed to allocate those limited bonds authorized by federal law. Last year the Minnesota Legislature allocated specific amounts to three designated users (the Higher Education Coordinating Board, The Iron Range Resources and Rehabilitation Board, and the Department of Energy and Economic Development). Of the remaining state ceiling, 80 percent goes to entitlement issuers, that is, those cities who issued an average of over $1 million IRBs in three of the last four years. The remaining 20 percent of the state ceiling is pooled and available to all other cities on a competitive basis.

Because the entitlement portion of the allocation was based on cities' historical use of IRBs, some cities were entitled to large amounts and others had little or no entitlement. The cities of Becker and Silver Bay which had used large issues in the past were in 1984 entitled to large percentages of the limited IRB allocation which they may or may not have needed. Cities that did have a need for more IRBs than their entitlement allowed in 1984, would contact those cities with the large entitlements in an attempt to buy or borrow part of the IRB entitlement. For this reason 'trading' of IRB allocation between cities became common.

Proposed changes.—The 1985 Minnesota legislature modified the IRB distribution. According to this plan the HECB, IRRRB and DEED still receive an allotment. Entitlement issuers are defined differently: cities of the first class are entitled to an allotment of $200 per capita, and the largest city in a standard metropolitan statistical area without a city of the first class is entitled to a flat $5 million allotment.

The remaining allocation would go into a pool to be distributed on an application basis around the state. Applications for manufacturing projects will receive first priority for the bonds. Second priority goes to pollution control projects or waste management projects, and third priority goes to commercial redevelopment projects.

To further focus the IRBs on manufacturing projects, the Legislature set limits on what share of the pool can be allocated to pollution control and commercial redevelopment projects. The amount allocated to pollution control and waste management projects may not exceed 35 percent of the total pool, and commercial redevelopment projects may not exceed 20 percent of the total pool amount. The amount available for commercial redevelopment may increase to 30 percent if by June 30 the authority available for commercial projects has been allocated and 45 percent of the total pool still remains available.

Where IRBs are used.—According to data from the Minnesota House of Representatives Research staff, in 1984 the communities outside the seven county metropolitan area approved approximately 14 percent of the total amount of bonds issued for the year.

The dramatic increase in the use of IRBs and the shift in use of IRBs towards commercial development since 1977 has been mostly in the Twin Cities area. In 1984 Minneapolis and Saint Paul issued about 20 percent of the total amount of IRBs issued by metropolitan area jurisdictions. With the exception of 1983, more use was made of IRBs in the rapidly growing suburbs of the Twin Cities than in the two central cities. Of the $962 million of IRBs approved in the metropolitan region during 1983, half was approved by the suburbs and half by the central cities.

How much money is involved? Minnesota is a leading user of IRBs: According to Mark Dayton, commissioner of the Minnesota Department of Energy and Economic Development, in 1981 (the last year for which comparative data are available) Minnesota ranked fifth highest in the nation in IRB dollars authorized for sale. During that year Minnesota local governments approved $949 million of IRBs to finance 82 projects. In 1982, Minnesota cities approved just under $670 million of IRB bonds, and in 1983, local governments approved a record $1.3 billion of IRB issues. After the federal government imposed a limit on the amount of private activity bonds to be issued, Minnesota issued about $1.1 billion of total IRBs in 1984.

Interest income from IRBs is tax free and represents a loss to the U. S. and state treasuries. The state Department of Revenue has estimated the fiscal impact of the lost interest income on state and locally issued bonds; included in these estimates is interest on bonds issued for private purposes, mass transit, energy facilities, pollution control equipment, student loans, hospitals, both rental and owner-occupied housing, and other miscellaneous bonds.

Interest on Nonguaranteed State and Municipal Debt

Fiscal Year	Fiscal Impact
1984	$71 million
1985	$77 million
1986	$92 million
1987	$104 million

According to the U.S. Joint Committee on Taxation, the federal revenue loss from IRBs is significant and growing:

Fiscal Year	Federal Revenue Loss
1984	$ 8.1 billion
1985	$ 9.3 billion
1986	$10.7 billion

B) Tax Increment Financing (TIF)

What it is.--TIF is a financing tool that allows the public costs of a development project to be paid off with the taxes generated by the increased value of the developed property. Once a parcel is approved as a tax increment district, the assessed value of the property is essentially frozen. Any increase in the district's assessed valuation (the 'captured' value), resulting from the development determines the tax increment available to pay off the public costs of the development.

Minnesota has three distinct types of tax increment districts. First, redevelopment districts may be established when areas are found to be blighted or have deteriorated properties. Second, housing districts are defined by the need to develop some residential units for low and moderate income households. The third type of TIF district is called the economic development district, for which a finding of blight is not required. The public purpose is satisfied through increased tax base and increased employment. TIF districts must meet the definitions of one of these three types of districts. Creating the TIF district must also be justified with a finding that 'but for' public intervention, private development would not occur in the forseeable future.

No tax increment may be collected in a redevelopment or housing district after 25 years from receipt of the first tax increment, or after eight years from receipt of the first increment from an economic development district. This limitation does not relate to the term of the bonds.

How much money is involved?—Cities are turning more frequently to TIFs. Cities captured over $516 million of the statewide tax base for taxes payable in 1984, which is 3.55 percent of the total assessed value in those cities and which generated $56.3 million in net taxes to pay off the bonds. (As compared to $437.2 million captured in 1983, representing 3.45 percent of total assessed value for $46 million of tax increment to repay TIF expenses).

Where is TIF being used?—In the seven county metropolitan area over $431 million of the tax base for taxes payable in 1984 is in TIF districts, which is 3.7 percent of the total assessed value of the cities using TIF, bringing in $46.3 million in net tax increment to pay off public costs of TIF development. Thus over 82 percent of the tax increment generated in the state occured in the metropolitan region; of that tax increment generated in the metro area, 72 percent came from Hennepin County; and 67 percent of the tax increment generated in Hennepin County came from Minneapolis.

Tax Increment Property Tax Data
Metropolitan Counties 1984

County	% Assessed Value in TIF	% of Total State Captured Increment	Net TIF Taxes Payable in '84
Anoka	1.83	2.7	$ 1,445,247
Carver	6.31	1.6	$ 946,527
Dakota	4.5	4.1	$ 2,342,429
Hennepin	4.14	60.4	$33,396,465
Ramsey	2.77	12.4	$ 6,963,219
Scott	7.2	2	$ 1,175,543
Washington	.42	.08	$ 40,076

Source: MN Dept. of Revenue

Minneapolis and Saint Paul remain the two cities with the largest amount of assessed value in TIF.

1984 Tax Increment Financing Data
For Selected Metropolitan Cities

City	% Assessed Value in TIF	Net TIF Taxes Payable in 1984
Bloomington	.24	$ 194,514
Chanhassen	13.6	$ 951,916
Eden Prairie	7.2	$ 2,078,531
Edina	1.9	$ 1,043,621
Fridley	1.2	$ 294,012
Hopkins	7.2	$ 928,720
Minneapolis	7.3	$22,425,652
Robbinsdale	6.9	$ 559,513
St. Louis Park	2.9	$ 1,169,270
Saint Paul	3.6	$ 6,799,859
Shakopee	7.9	$ 848,680
South Saint Paul	9.3	$ 977,870

Source: MN Dept. of Revenue

Cities that had more than 10 percent of their total tax base tied up in TIFs for 1984 include: Annandale, Appleton, Benson, Buffalo, Chanhassen, Cottonwood, Marshall, Princeton, Rushford, Waconia and Watkins.

How is the TIF money being used?—A quick look at the tax increment financed projects around the state reveals that about 70 percent of the tax increment districts are for redeveloping central business districts. The types of CBD redevelopment activities financed with TIFs include site clearance, rehab and construction of housing, office, retail and commercial space, landscaping, public improvements, and parking.

Besides CBD redevelopment, TIF districts have been used for redeveloping industrial areas and commercial areas in neighborhoods, and for developing essentially raw vacant land zoned for industry. In many of the TIF districts designated as economic development districts, soil corrections, highway, sewer and other public improvements are financed with the tax increment.

Refinancing tax increment units. As cities see the tax increment revenues far exceeding the amount needed to repay the tax increment bonds, some are planning to restructure their TIF indebtedness. Coon Rapids instituted a master project concept in which it expanded the project area to encompass virtually any part of the city. In this way 'excess' revenues from TIF districts can be used anywhere in the city and not just in the TIF district.

Minneapolis is pooling the debt service of the separate tax increment districts so that funds raised in one district can be spent in another. It would return all property in TIF districts to the tax rolls by 2003 and generate about $427 million in additional revenue beyond the amount needed to pay off the bonds. Of the $427 million about one quarter would be distributed in cash payments to Hennepin County, the Minneapolis Public Schools and the Minneapolis City Council. Thus about $100 million in annual payments would be shared by the county, schools, and city in proportion to their mill rates; 32 percent of the total would go to the city, 43 percent to the schools and 25 percent to the county.

TIF tax deferral.--Cities may defer the property taxes of developers involved with residential, commercial or industrial improvements in any development district for the duration of the construction period.

After construction, the amount of tax due is computed by the amount of tax due the year in which the developer applied for the deferral, multiplied by the number of years the property was exempt. This formula constitutes tax abatement. However, the city may opt to charge the amount of taxes that would have been due and payable each year during the deferral, which constitutes pure tax deferral.

Proposed changes.--The 1985 Minnesota Legislature modified TIF in two ways. This legislation requires the state auditor to develop a system of accounting and financial reporting on all TIF districts, to ensure full disclosure of the sources and uses of public funds in the districts.

The second change limits the use of tax increment for interest rate reduction programs. No tax increment can be collected after 12 years from the date of the first interest reduction payment. No tax increment can be used for interest rate reduction if bonds were issued for the same project. Up to 50 percent of of the tax increment may be used to finance an interest reduction program for owner-occupied, single-family dwellings.

Assistance Initiated by the Federal Government

A) Community Development Block Grant (CDBG)

What it is.--CDBGs are a form of federal assistance to cities for housing, urban renewal and public improvements that: 1) primarily benefit low and moderate income persons, 2) prevent blight, and 3) deal with urgent community development needs. Since 1981 CDBG dollars may also be loaned or granted to finance private development costs related to building construction and equipment acquisition that benefits low income persons or prevents blight.

Where is it being used and how much money is involved?—Congress designed CDBG in 1974 to replace several ineffectual urban renewal programs whose funding had primarily gone to large cities. These cities became 'entitled' to receive specific amounts of CDBG. The nine entitlement cities and counties in Minnesota have received $356,600,257 from 1974 to 1983. According to HUD, in 1984 the following entitlement cities and counties received $31,789,450 in CDBG funds (Dakota County became an 'entitlement' county in 1984):

Local Unit	CDBG Grant
Anoka County	$ 2,450
Bloomington	$ 475,000
Duluth	$ 2,890,000
Hennepin County	$ 2,981,000
Minneapolis	$14,867,000
Moorhead	$ 298,000
Rochester	$ 493,000
St. Cloud	$ 500,000
Saint Paul	$ 7,945,000
Dakota County	$ 1,338,000

Some smaller cities which had been major recipients of urban renewal funds prior to CDBG were 'held harmless' for the first five years of the CDBG grants and therefore also automatically received some of the CDBG allocation ($26,519,000 from 1975 to 1979). The rest of the allocation, approximately 30 percent of the total funds distributed in Minnesota, has been distributed to small cities who apply and compete for the funds.

A pool of $21,689,000 in CDBG money (about 40 percent of the total block grant to Minnesota in 1984) was available for small cities on a competitive basis last year. The state awarded grants to about 26 outstate local governments. Of the total granted to small cities, about $5.4 million of the money was used in downtown revitalization projects, about $4.3 million for housing rehab, and about $4.6 million for sewer and water improvements.

Proposed changes.—The Reagan administration proposes $3.1 billion for the 1986 CDBG program, a 10 percent reduction from the 1985 level. It would also change the distribution of CDBG funds, giving a larger share of the money to the small city program, and correspondingly less to the large city/urban county program.

B) Urban Development Action Grant (UDAG)

What it is.—Congress designed UDAGs to encourage private real estate investment in cities experiencing economic distress. Eligible cities apply to HUD for a UDAG grant which they then loan to the developer. The federal government requires that UDAG money be a loan of last resort; private financing for the project must exceed the UDAG amount by a factor of at least two and a half. The money can be used for clearance, site improvements, provision of infrastructure, rehab and construction of commercial, industrial, and mixed-use developments.

Money that cities acquire from the repayment of the loans may be used for future development loans or in other ways consistent with UDAG objectives.

Currently Saint Paul receives $2-3 million in pay-back each year. In a few years Minneapolis will begin receiving over $2 million annually.

Where is it being used?—Cities must qualify annually as 'distressed cities' before being considered for a UDAG. To determine a city's level of physical distress HUD sets minimum standards that cities must meet. Cities over 50,000 in population must meet minimum standards in three of the following six areas: 1) percentage of housing constructed before 1940; 2) per capita income; 3) percentage of people below poverty; 4) population growth or decline; 5) unemployment; 6) decline in jobs. Eligible smaller cities have slightly different criteria. Any city not deemed physically distressed may apply for UDAG money by documenting the existence of a 'Pocket of Poverty' within its boundaries.

In this metropolitan area the only eligible cities of any size are Minneapolis and Saint Paul. Some other very small cities, Mendota, Coats, Randolph, New Germany, Hampton, Bethel and New Trier, are also eligible this year, although none of these cities applied for UDAG money.

How much money is involved?—Between 1977 and 1983 Minnesota cities received $109,404,723, in UDAG grants, of which over 88 percent went to Minneapolis and Saint Paul.

UDAG grants to Minnesota cities in 1984 included the following:

City	Grant	Purpose
Minneapolis	$ 836,807	Assist financing of St. Anthony Main Phase IV development
	$3.4 million	Construction loan to renovate Standard Mill, Ceresota Mill and Smokehouse building, including public plaza and underground parking
Saint Paul	$ 700,000	Rehab old Donaldson's store into office facility
Two Harbors	$1.4 million	Assist Louisiana-Pacific Corp. construct waferboard siding production facility
Virginia	$ 386,000	Assist construction of medical office
Total	$6,785,807	

Almost any activity can be funded with UDAG money, provided it supports a project that stimulates economic recovery. Some activities are specifically prohibited: a) the cost of planning the development (except in small cities); b) costs of relocating commercial or industrial facilities from one metrpolitan area to another; and c) costs of public services like day care or social services; d) refunding debt service; e) use as operating capital.

Proposed changes.—The Reagan administration's budget would eliminate UDAGs in 1986 on the basis that they do not add to national investment or job creation. According to the administration, this program, along with other federal economic development subsidies, does not expand the national economic base. The administration believes UDAGs may provide the funds to support jobs in new subsidized commercial facilities, but at the expense of existing jobs in established, unsubsidized businesses. The $522 million projected in Reagan's budget for UDAG in 1986 reflects the continued spendout of funds for projects approved in prior years.

Some other federal officials believe UDAGs will be refunded, but distributed differently, to provide help to the cities most in need.

Assistance Initiated by the State

A) Enterprise Zones

What the program is.—In Minnesota an enterprise zone is a development tool that provides tax reductions over a five year period for businesses locating in an economically distressed area. The zones are intended to expand business in these areas to a) create jobs and b) increase the value of the area through building construction or improvements.

Where is the tool being used?—After cities or counties applied for designation as an enterprise zone, DEED designated enterprise zones based on the level of distress in the area. Distress is signified by the number of people below poverty, the amount of substandard housing, and unemployment rates.

Two sets of enterprise zones exist in Minnesota: Border zones, in which economically distressed areas share borders with other states; and competitive zones. There are six border zones and ten competitive enterprise zones in the state.

In the metropolitan area only Minneapolis and Saint Paul have designations as enterprise zones.

How much money is involved?—Throughout the state more than $35.6 million of tax relief is currently available for the enterprise zones. The tax relief available for each of Minneapolis and Saint Paul is $4.5 million. For the competitive zone cities besides the Twin Cities, $10 million in tax relief is available. In the border zones $16,609,900 of total tax relief is available.

Four tax credits are available to companies locating in enterprise zones: 1) Exemption from sales tax on any equipment purchases; 2) Up to $3,000 credit against the employer's income tax for every new employee hired; 3) Income tax credit for a percentage of the debt financing for facility construction or expansion; 4) State-paid property tax credit for the newly-built facility.

By law the cost of the enterprise zone program cannot exceed $40 million over the eight years of the project.

Proposed changes:—1. The 1985 Legislature passed legislation establishing an enterprise zone to attract the GM Saturn automobile manufacturing plant to Minnesota. If GM selects Minnesota for the plant, this enterprise zone will provide specific benefits to the facility: a) None of the property in the zone may be taxed by the state or local units of government; b) All corporate income and excise taxes would be abated, as would all sales and use taxes on the purchase of construction materials or equipment.

The zone must be designated before September 30, 1985; its benefits would remain in effect for 30 years. The state will reimburse the local unit of government for revenues foregone from the abated property taxes for any net financial burdens resulting from the zone.

Appropriations from the general fund for this enterprise zone: a) $5 million for foregone property tax revenues; b) $30 million in grants to the city for purchasing and conveying the site, and public improvements such as sewer, water and other utilities; c) $4 million for a relocation expense fund; d) $2 million to the Higher Education Coordinating Board to create education and training transition teams; e) $2.2 million for administrative support to the job training center (to be built by the state board of AVTIs with $20.6 million from the state building fund.)

2. The 1985 Legislature passed legislation offering special assistance to new or expanding manufacturing businesses in the state. Businesses that qualify as economic "diversification projects" would be eligible for loans, property and sales tax reimbursements, or interest subsidy payments. Businesses locating inside a distressed county as defined in the legislation, must meet several conditions to be eligible: they must be primarily engaged in manufacturing or mail order sales; the total capital investment in the business must be at least $3 million and it must create at least 25 new jobs, or the investment must be at least $1 million with 50 new jobs; it must be shown the business would not have located in the distressed county without the assistance.

Manufacturing businesses locating outside a distressed county must have a national or international market for their products, a total capital investment in the project of at least $3 million, and must create at least 50 new jobs. The project must result in diversifying the state's economy and establishing new markets for Minnesota products. The Department of Energy and Economic Development must determine the business would not locate in Minnesota without the assistance.

The special assistance may not exceed 20 percent of the total capital investment in the project, nor exceed $20,000 for each permanent job created.

3. The federal government is advocating a program similar to Minnesota's enterprise zones. The Reagan administration supports an enterprise zone program with tax incentives to attract redevelopment of distressed areas. With the administration's proposal, up to 25 areas per year would be designated enterprise zones for three years. Businesses in the zones would be exempt from tax for certain gains, and entitled to tax credits for capital investment, increases in employment, and hiring disadvantaged employees. Tax credits would also go to employees in the zones. The tax expenditure for the 25 zones would be $305 million in 1986.

B) The Economic Recovery Grant

What it is.—A $6 million grant program from the state, allowing cities to offer below-market, fixed rate loans to new or expanding businesses. Cities may apply for up to $250,000 in development grants to make loans to businesses or to create infrastructure improvements that are in direct support of the development project. Businesses may use the low-rate loan for buying or improving fixed assets, purchasing machinery and equipment, or for working capital. The state-funded grants are not actually grants because $100,000 must be paid back to the state for future development grants. These grants supplement the federally funded Small Cities Development Program, $3 million of which is set aside as economic development grants.

Where is it being used? In 1984 nineteen local governments received grants from the state-funded economic development grants, and fourteen received grants from the federal small cities block grant. All are located outside the metropolitan area.

The grants from the state are available to all local units of government. However, only cities and counties under 50,000 population are eligible for grants from the federal funds.

How much money is involved? Through November of 1984 the state awarded a total of $6,830,870 to 32 cities around the state.

Tax Expenditures for Individuals

A) Depreciation

What it is.—To compensate for the loss in a building's value as a result of age, usage, etc., the federal and state government allow building owners a depreciation tax allowance. When depreciation for tax purposes exceeds the rate at which buildings actually depreciate, business tax liabilities are deferred. Depreciation allows building owners to significantly reduce the amount of their taxable income over the useful lifespan of the building, which is about 40 years. Changes in the tax law have allowed building owners to accelerate the depreciation of the building by shortening the useful life of the building to 18 years; as a result building owners receive the equivalent amount of tax benefits over a shorter period of time.

Depreciation is allowed on buildings in addition to any other subsidy the building may have received. Depreciation is a tax expenditure and represents a loss to the U.S. and state treauries.

How much money is involved?—The Reagan Administration's Budget for Fiscal Year 1986 estimated the outlay equivalent of the tax expenditure for accelerated depreciation of buildings other than rental housing:

1984	1985	1986
$6.490 billion	$8.555 billion	$9.725 billion

The Minnesota Department of Revenue estimated the fiscal impact of depreciation allowances as measured by 35 year straight line depreciation for real property and class life asset depreciation ranges for personal property:

	Corporate Income Tax	Individual Income Tax
FY84	$21 million	$ 8.3 million
FY85	$20 million	$11 million
FY86	$19 million	$21 million
FY87	$19 million	$29 million

Of course, the value of all buildings usually does not actually decrease to the extent and within the time period allowed by the depreciation law. For instance, even thought the Foshay Tower was built back in the 1920s we certainly would not say it has lost its value.

B) Historic Preservation Credit

The federal government provides tax incentives for preservation of historic structures. The U.S. Joint Committee on Taxation estimates the revenues lost for historic preservation.

Fiscal Year	Tax Expenditure for Historic Preservation	
	Corporations	Individuals
84	$115 million	$205 million
85	$130 million	$250 million
86	$150 million	$290 million
87	$170 million	$330 million
88	$195 million	$380 million

The state of Minnesota does not offer historic preservation tax incentives.

C) Investment Tax Credits

With the investment tax credit, the federal government provides incentives for investment in capital equipment and rehabilitation of structures. The U.S. Joint Committee on Taxation estimated the revenues lost from investment credits for rehabilitation of structures other than historic structures.

Federal Revenues Lost from Investment Tax Credits
on Rehabilitation of Structures

Fiscal Year	Tax Expenditure for Investment Credits	
	Corporations	Individuals
84	$200 million	$165 million
85	$185 million	$160 million
86	$220 million	$190 million
87	$265 million	$230 million
88	$320 million	$275 million

The state of Minnesota does not offer similar investment tax credits. For tax years 1984 and 1985 Minnesotans were allowed to claim a credit for equity investments in a small business. The Revenue department estimated the fiscal impact of this credit for individuals and corporations at about $1.4 million in each year.

III. Organizational Structures

Cities use different organizational structures in their real estate development efforts. Cities' planning and/or development staffs range in size from one to more than 200. Their expertise and emphases vary. Minnesota's land planning act of 1976 directed each municipality in the metropolitan area to develop a comprehensive plan for the city's growth. Even before this act many cities utilized planning staff to zone the city and direct the development of its infrastructure and its growth. In addition to their traditional functions, city planning departments are sometimes used to seek out grants and aids, market the city, and attract businesses to locate there.

Although for years Saint Paul and Duluth were the only port authorities in the state, Minneapolis, Winona, Bloomington, South Saint Paul, St. Cloud, Plymouth and Granite Falls now have port authorities to assist development within their borders. (Some of the enabling legislation granted port authority powers to the city councils in the city, not to separate port authorities.) About six cities including Red Wing, Austin and Albert Lea, have requested port authority powers from the 1985 Legislature.

With authority granted specifically by the State Legislature, port authorities act as land developers and financiers for selected real estate projects. Before amendments to the port authority laws in 1957, port authorities had the function of promoting the general commercial use of waterway ports for freight and passengers as alternatives to railroads. Now port authorities have additional powers:

*Development of industrial development districts and marginal land.

*Authority to issue industrial revenue bonds.

*The ability to pool the excess revenues generated by its projects and use that pool as security for the revenue bonds it issues.

*Port authorities have the same powers an HRA has with its housing and redevelopment activities, which provide a much broader definition of projects for which port authorities may issue revenue bonds.

*Port authorities may enter into limited partnerships in which the port authority has an equity position in the project.

*Port authorities may acquire, develop, improve and lease lands in an industrial development district.

*On land they own, port authorities may construct buildings or furnish capital equipment in the buildings for the purpose of selling them to private persons.

*Eminent domain with approval from the city council.

*Operation of parking facilities or other public facilities to promote economic development.

*Port authorities may apply for powers of a foreign trade zone which allows exports and imports to be handled and stored without payment of custom duties.

*The power to construct, own and manage district heating systems.

Port authorities have a number of financial mechanisms available to them:

*They may issue industrial revenue bonds payable from revenues generated by the port authority's facilities.

*They may issue general obligation bonds secured by the full faith and credit of the city to purchase land or construct buildings; city councils must approve the G. O. issues; port authorities may then levy a tax in an amount not less than five percent more than the total needed to retire the bonds.

*Port authorities may use tax increment financing for projects in industrial development districts.

*After a bond issue, port authorities may borrow money on a short term basis of up to 12 months.

*The proceeds from issuing revenue bonds and from temporary loans can be used to make or purchase loans to finance facilities in the port authority's district.

*Cities may at the authority's request, levy up to .75 mill annually (beyond levy limits) for use by the authority.

*The city may levy an additional ad valorem tax of up to 7/60th mill on the dollar for the port authority's use in industrial development districts.

*Cities may issue bonds and give the proceeds to the port authority, and may transfer property to it.

*Counties may appropriate general fund money to port authorities.

Perhaps one of the best known is the Saint Paul Port Authority, with over $548 million in 1984 assets. The mayor appoints the seven member board of directors, subject to approval by the city council. Saint Paul's Port Authority claims to be the fifth largest financial institution in Minnesota.

The Legislature granted specific powers and duties to the Saint Paul Port Authority. It may provide venture capital to small businesses, limited to the lesser of ten percent of the authority's annual net income or $400,000. The port authority's participation is limited to 25 percent of the total venture capital provided for the business. It also has the authority to finance parking facilities for the Saint Paul Civic Center.

All revenue bonds authorized by the Saint Paul Port Authority must be approved by the city council. The Port Authority has a reserve fund which serves as security from defaults on the individual projects for which it issues revenue bonds. The reserve fund consists of money from land sales, leases, and interest on its investments.

A 1980 law gave port authority powers to the Minneapolis Community Development Agency.