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Strategic interaction and the adoption of tax increment financing

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Abstract

This paper examines municipalities' Tax Increment Financing (TIF) adoption decision. In particular, the paper examines if municipalities engage in strategic interaction when making the adoption decision and if municipalities use TIF to capture tax revenue from overlapping jurisdictions. The underlying motivation for testing the strategic interaction hypothesis is to determine whether the popularity of TIF is partly the result of competition among neighboring municipalities for private development. The results show that municipalities do engage in strategic interaction in their TIF adoption decision, but municipalities do not use TIF to capture revenue from overlapping jurisdictions.

JEL classification: R00; R51; R58; H71
Keywords: Tax Increment Financing; Strategic interaction; Economic development; Tax capture

1. Introduction

Tax Increment Financing (TIF) districts have become a popular economic development tool in the United States. The genesis of TIF began in California in 1952. As is the case with most state laws authorizing TIF, the purpose of the California legislation was to encourage investment in blighted urban areas. Although TIF was used extensively in California following the passage of TIF legislation, widespread expansion of TIF to other states did not occur until the late 1970s and mid-1980s. Today, almost all US states have

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passed or are attempting to pass TIF legislation. When a municipality creates a TIF district, part of the process is to specify the geographical area that encompasses the district. Though property within the TIF district continues to be taxed, the assessed value of the properties that is taxable by the overlapping jurisdictions is capped at the base year amount. Any additional tax revenues generated by increases in property value within the TIF district are captured by the TIF administrator. This incremental revenue can then be used to finance public improvements within the TIF district, an outcome that is achieved without raising anyone's tax rate. Once the TIF has expired, the entire assessed value is again taxable by the overlapping jurisdictions, which then experience increased tax revenue.

This paper examines municipalities' TIF adoption decision and takes into account that municipalities may engage in strategic interaction when making the adoption decision. Although the modeling of strategic interaction is well established in public economics (e.g. Wilson, 1986; Wildasin, 1988), past research on TIF adoption has focused on municipalities' own characteristics in analyzing TIF adoption. Allowing municipalities to take into account the adoption decision of nearby cities leads to a more realistic model of the decision making process. This paper uses spatial econometrics to accurately measure whether or not municipalities in the Chicago metropolitan area engage in strategic interaction in their decision to adopt TIF. An underlying motivation for testing the strategic interaction hypothesis is to determine whether or not TIF is purely a financing mechanism for infrastructure investment or if its popularity, at least partly, is a result of competition among neighboring municipalities for private development.

This paper further contributes to the literature on TIF by shedding light on whether or not TIF is used to capture tax revenue from overlapping jurisdictions without proper justification, a common criticism of TIF. To test this revenue-capture hypothesis, past studies have included past property value growth in their TIF adoption regressions, their assumption being that a municipality's incentive to capture revenue through TIF is greater when it is experiencing a rapid growth in property values. However, this test of the revenue-capture hypothesis ignores the fact that each dollar of captured revenue means a dollar less spent by the overlapping jurisdictions, reducing the provision of valued public services below the level that might have been achieved otherwise. The model here includes the adopting municipality's percentage share of its school district's land area, to test whether the service-reduction aspect of TIF limits its adoption. If this share is low, then the capture of school district tax revenue mainly affects residents in other municipalities, increasing the given city's incentive to adopt TIF.

The results show that municipalities do engage in strategic interaction in their TIF adoption decisions, suggesting that TIF is used as a way to compete for private development. Additional evidence suggests that municipalities do not use TIF to capture revenue from overlapping jurisdictions. Instead, municipalities are more likely to adopt when a city's boundaries encompass a larger percentage of its school district. Additional factors influencing TIF adoption are the municipal tax rate, the proportion of the tax base made up of non-residential property, the share of owner occupied housing, and the existence of an influx of new residents.