Michigan House of Representatives Commerce Committee – Testimony on House Bill 5856*

David S. Bieri†[1,2]

[1] *Urban & Regional Planning, University of Michigan, Ann Arbor, MI 48109, USA*
[2] *Political Space Economy Lab, Ann Arbor, MI 48103, USA*

1 October 2014

Good morning, Chairman Foster and Members of the House Standing Committee on Commerce.

I wanted to thank you and the members of the committee for the opportunity to comment on House Bill 5856 ("HB-5856", "the Bill") and on the long-running and important issue of tax increment financing ("TIF") as a popular tool to raise revenue for local governments. While I welcome the much needed reform efforts that this proposed legislation attempts to address – and indeed, I am grateful for Rep. Kowall's leadership in this matter –, allow me to highlight important areas, where the Bill falls short in terms of sound public policy, both with regard to public finance and regulatory oversight. Overall, I see the following shortcomings in HB-5856 that I urge the Michigan Legislature to take seriously:

1. HB-5856 introduces a sweeping array of changes to just one type of TIF-enabled entity, namely Downtown Development Authorities ("DDAs", PA 197), without systematically engaging with the legislation that governs a large number of other authorities that are eligible to use TIF, including Brownfield Redevelopment Authorities ("BRAs"; PA 381), Corri-

*The views offered are mine alone and not necessarily those of my colleagues at the University of Michigan.

†Corresponding author: A. Alfred Taubman College of Architecture and Urban Planning, University of Michigan, 2000 Bonisteel Boulevard, Ann Arbor, MI 48109-2069, USA. Web: circular-flows.org. Email: bieri@umich.edu (David Bieri)

dor Improvement Authorities ("CIAs"; PA 280) and Local Development Financing Authority ("LDFAs"; PA 281). Such a partial TIF reform could lead to a number of unintended policy distortions, including regulatory arbitrage. In fact, it is not at all inconceivable that such a unilateral "regulatory tax" would simply lead to a shift of TIF activities from DDAs to the other, lesser regulated TIF authorities instead.[1]

2. At present, a regulatory cost-benefit assessment of the changes proposed in the Bill is not possible because lax compliance with current reporting requirements on TIF activities means that the necessary data on the collective TIF activities of local governments in Michigan – a prerequisite for objective policy analysis – are simply not available. Given the material broadening of the regulatory aspects of HB-5856, an economic cost-benefit analysis of the new legislation might not only allay the concerns of entrenched stakeholders over of regulatory accountability, but also over the (direct and indirect) economic burden that the Bill might entail.[2]

3. My own research identifies a number of governance concerns with current TIF practice. Most importantly perhaps, we show that there is a fundamental lack of transparency and accountability across all TIF entities in Michigan (Bieri and Kayanan, 2014). Unfortunately, by focusing on DDAs alone, the Bill only addresses these issues in part.[3]

4. Instead of simply increasing the reporting burden for some TIF entities as is proposed in HB-5856, the Legislature should mandate and enforce more effective, streamlined reporting for all local tax expenditures that is funded via TIF. At a minimum, the reporting require-

[1] In addition to CIAs and LDFAs, the current enabling legislation for Historic Neighborhood Financing Authorities ("HNFAs"; PA 530) and Neighborhood Improvement Authorities, ("NIAs"; PA 61) certainly appears to permit enough legal flexibility to accommodate a significant portion of TIF activities currently conducted by DDAs.

[2] A common argument for the introduction such analysis is that it would bring much-needed transparency and accountability to the rule-writing process in the U.S. regulatory complex (Copeland, 2013).

[3] Specifically, some of the additional findings in Bieri and Kayanan (2014) include: *a*) Municipal compliance with current reporting requirements on TIF activities is inconsistent/patchy and has become more so after the financial crisis. State oversight and regulatory enforcement is weak (with reporting coverage as low as 20%). In combination, this leads to an unacceptably low level of transparency and accountability on TIF activities across the state. *b*) Official figures grossly underestimate the true magnitude of revenue capture because of the lack of reporting. Our best range estimate is closer to $500 million, possibly as much as $1.2 billion – nearly 10% of total property tax revenues.

ment on such activities should be consistent with the intent of the disclosure principles for local governments as set out by the Government Accountability Standards Board in Statement No. 34: "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments" (GASB, 1999).

Before I address these issues in more detail, I would like to provide some context about the nature of TIF as a municipal financing mechanism in a system of fiscal federalism. As such, I beg your indulgence if the tone of much of what follows appears to be overly academic or theoretical. However, I firmly believe that these are important points that ought to be considered as the Legislature embarks on this important policy reform process.

1 The delicate Hamiltonian balance

In a theoretical sense, TIF as a financing mechanism falls under the purview of "fiscal federalism" which deals with the division of labor between federal, state and local government *a*) in terms of which public finance functions and instruments are best centralized, and *b*) which ones are best placed in the sphere of decentralized levels of government.[4] In many ways, the Holy Grail of Fiscal Federalism thus lies in the policy process' ability to maintain the delicately calibrated "Hamiltonian balance" of relative local "fiscal autonomy", while enforcing sufficient "fiscal responsibility". I will come back to the autonomy-responsibility nexus later.[5]

It is against this backdrop that the reform proposals of HB-5856 need to be considered as part of broader set of economic development efforts conducted via federal, state and local tax policy. In other words, TIF reform ought to be evaluated not only on its own, but also in terms of its interaction with other place-based tax policy, including the state's Neighborhood Enterprize Zones ("NEZ"; PA 147) and a variety of corresponding federal tax incentive programs (e.g.

[4]In this sense, fiscal federalism is the study of how competencies (expenditure side) and fiscal instruments (revenue side) are allocated across different (vertical) layers of the administration.

[5]See Rodden (2002, 2006) for a discussion of the promise and peril of fiscal federalism in terms of long-term balanced budgets among subnational governments either through borrowing restrictions imposed by the federal government or through wide-ranging taxing and borrowing autonomy by subnational governments.

Empowerment Zones, Renewal Communities, Enterprize Zones). More so than ever, the fiscal challenge at hand – both at the state and at the local level – consists of three elements: *a*) to raise sufficient revenue to deal with long-run budget challenges, *b*) the challenge of promoting long-run economic growth, and *c*) the challenge of providing re-distributive progressivity of the tax code in the face of increasing inequality.

2 TIF as a local finance mechanism in the age of austerity

Many of the testimonies that the Committee heard in this matter when the HB-5856 was first introduced last week emphasize the importance of TIF as a financing mechanism for local communities up and down the State. There is no doubt that municipal budgets have come under a tremendous amount of pressure from a range of factors, including interlocal competition for business investment and a general post-crisis climate of increased fiscal restraint. While the crisis has certainly accentuated local budgetary imbalances, these fiscal pressures have started to build up long before the recent recession, reaching back several decades and arising from the twin challenges of the "property tax revolts" and shrinking intergovernmental transfers under the programmes of New Federalism during the 1980s and 1990s.

As a direct consequence of this fiscal stress, municipalities have shifted away from using TIF as a last-resort financing strategy to a practice of using TIF as a central mechanism to finance development. In this process, the budgetary procedures of local governments have been transformed, often creating opportunities for economic development professionals to exercise jurisdiction over local budgets. But the anecdotal evidence provided to the Committee last week is no substitute for a scientific evaluation of TIF-related legislative reform.

3 Specific concerns about TIF practice in Michigan

In the context of HB-5856, I would like to highlight a number of elements that ought to be considered in light of current TIF practice in Michigan:

1. TIF is neither intrinsically good nor bad local tax policy, but – as with all policy – implementation is key and there is good or bad policy implementation. At present, the TIF system in Michigan is highly fragmented, complex and intransparent. TIFs are an earmarking revenue-side mechanism, and it is not a forgone conclusion that shifting from general-fund financing to earmarking leads to more optimal economic outcomes on the expenditure side. Good economic analysis calls for a joint consideration of all expenditure and revenue at the local level that preserves the sanctity of the "unified budget" – an age-old principle of public finance that is fundamentally undermined by current TIF practice.[6] Indeed, without the appropriate checks and balances, TIF earmarking leads to a fragmented and inefficient tax system, and tying expenditure amounts to specified tax revenues might cause inefficient resource allocation decisions.

2. The lack of TIF transparency leads to a specific form of what economists refer to as "fiscal illusion", whereby there persists a systematic public misperception of key fiscal parameters that may significantly distort the fiscal choices by the electorate. Indeed, there is strong empirical evidence that the institutional manner in which citizens are required to pay for government can affect taxpayer perceptions of the price of government, and, hence, the size of the public sector. Largely because of the fragmentary nature of TIF-related activities, there are various elements of the local tax structure in Michigan that are hidden, not permitting a comprehensive picture of the cost of provision of public services. In other words, the true cost of paying for local government and the perceived price of local government are currently misaligned.[7]

3. TIF gives rise to local "shadow budgets" that are outside of the control of local elected local officials. In the absence of sufficient regulatory enforcement of consolidated unified local

[6] See Musgrave (1939) for a classic exposition of the principle of budgetary unity – i.e., the requirement that the budget should not be divided into independent parts, but that all items should be included in one total revenue and expenditure balance.

[7] See Oates (1988) for an overview on the nature and measurement of fiscal illusion. Wagner (1976) and Banzhaf and Oates (2013) provide an overview of the evidence for fiscal illusion in the context of local public finance in the U.S.

fiscal reporting, TIF undermines the budgetary process – one of the key fiscal accountability mechanisms in a democratic system. Further more, sound public policy treats taxes are "prices" for public goods which mandates that – in addition to being as little distortionary as possible – TIF should be both transparent and administratively feasible! TIF capture exemptions, while rational, are technically "messy" and administratively complex/wasteful and ultimately not welfare enhancing, creating "shadow government structures" outside the purview of regular budgetary scrutiny.

4. TIF also appear to create the conditions for an "overfishing" of the fiscal common-pool as multiple territorially overlapping governments and special purpose districts provide services and levy taxes in a common geographic area. Indeed, contrary to the traditional Tiebout model in which increasing the number of competing governments improves efficiency, recent research on the fiscal behaviour of local governments in the United States identifies a strong positive relationship between the number of overlapping jurisdictions and the size of the local public sector (Berry, 2008). Substantively, the "overlap effect" might amount to as much as 10% of local revenue.[8]

5. From an analytical perspective, the observation that TIF districts grow faster than other areas is unremarkable on its own and does not permit any causal inference! In fact, an increasing body of statistical evidence indicates that property values of TIF-adopting municipalities grow at same rate as or even less than in non-adopting localities. From a scientific perspective, ex-ante growth projections and ex-post growth attribution to TIF-related development activity are very complex and notoriously case specific, in part because development spillovers do not stick to boundaries. In reality, the flow of causality might even be reversed in that TIF might cause growth, but anticipated growth could cause TIF formation in the presence of municipal revenue capture.[9]

[8] See also Foster (1997); Berry (2009) for a detailed discussion of the subnational autonomy and overlap of tax-enabled special purpose governments in the U.S.

[9] There is fairly sizable literature on the empirical of TIF effectiveness of TIFs. In addition to the ambiguity of TIF effectiveness, this research indicated that land use matters: Commercial TIF districts can have a tendency to reduce

4 Conclusion

Michigan needs a reform of TIF legislation. Such reform is particularly pressing in light of the fact that Michigan's "Hamiltonian fiscal balance" is seriously tilted in favor of too much "fiscal autonomy" without any corresponding "fiscal (reporting) responsibility". The future of TIF should be tied to more comprehensive TIF reform that covers all TIF-enabled special purpose governments in Michigan, not just ad-hoc legislative "patches" for some entities along the lines of HB-5856.

Regulatory cost-benefit analysis is not possible without reliable factual data (e.g. key performance indicators) on consolidated TIF activities at the state level. Such analysis would permit systematic fiscal comparison across all TIF-enabled entities. At this juncture, however, we simply to not have any reliable numbers on the full extent of TIF activities to engage in objective policy discussions! I would therefore urge the Legislature not to engage in sweeping regulatory reform before the factual conditions are created upon which policy changes can be deliberated.

I really appreciate your consideration of the important issue of public finance and fiscal governance in the State of Michigan.

References

BANZHAF, H. S., AND W. E. OATES (2013): "On Fiscal Illusion in Local Public Finance: Re-Evaluating the Ricardian Equivalence and the Renter Effect," *National Tax Journal*, 66(3), 511–540.

BERRY, C. R. (2008): "Piling on: Multilevel Government and the Fiscal Common-Pool," *American Journal of Political Science*, 52(4), 802–820.

——— (2009): *Imperfect Union: Representation and Taxation in Multilevel Governments*. Cambridge University Press, New York, NY.

BIERI, D. S., AND C. M. KAYANAN (2014): "Improving TIF Transparency and Accountability: Towards a Consolidated View of TIF Activities in Michigan," Discussion paper, University of Michigan and MSU-EDA University Center for Regional Economic Innovation, available at http://ssrn.com/abstract=2476143.

COPELAND, C. W. (2013): "Economic Analysis and Independent Regulatory Agencies," White paper, Administrative Conference of the United States, Washington, DC.

property value growth in non-TIF part of same municipality (cf. industrial land use). Furthermore, TIF adopters might also be fundamentally different from non-adopters which highlight the importance of a careful definition of the policy counterfactual. See Bieri and Kayanan (2014) for an overview of this literature.

Foster, K. A. (1997): *The Political Economy of Special-Purpose Government*, American Governance and Public Policy. Georgetown University Press, Washington, DC.

GASB (1999): “Statement No. 34: Basic Financial Statements and Management’s Discussion and Analysis for State and Local Governments,” Executive summary, Government Accounting Standards Board, Washington, DC.

Musgrave, R. A. (1939): “The Nature of Budgetary Balance and the Case for the Capital Budget,” *American Economic Review*, 29(2), 260–271.

Oates, W. E. (1988): *Taxation and Fiscal Federalism: Essays in Honour of Russell Mathews* chap. On the Nature and Measurement of Fiscal Illusion: A Survey, pp. 65–82. Australian National University Press, Sydney.

Rodden, J. A. (2002): “The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the World,” *American Journal of Political Science*, 46(3), 670–687.

——— (2006): *Hamilton’s Paradox: The Promise and Peril of Fiscal Federalism*, Cambridge Studies in Comparative Politics. Cambridge University Press, Cambridge, UK.

Wagner, R. E. (1976): “Revenue Structure, Fiscal Illusion, and Budgetary Choice,” *Public Choice*, 25(6), 45–61.