The Limits of Tax-Increment Financing of Economic Development in Saint Louis and Kansas City

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In the second half of the 20th century, American cities suffered economically as residents moved to the suburbs. Such movements altered investment incentives for private businesses that shifted away from central cities and other distressed parts of metropolitan areas. In response, policymakers developed a broad set of tools meant to lure economic activity back to urban areas.

Tax-increment financing is among the most popular and widespread forms of local public subsidy. With this kind of financing, local governments agree to underwrite certain costs in order to attract new private investment in an area planned for redevelopment. The new tax revenue generated by private investment is then used to retire notes or bonds that were issued to pay for the government's initial redevelopment project costs.

How does the process work? In general, local governments accomplish tax-increment financing by freezing real estate taxes at the beginning of the project in districts within the area being redeveloped. Once redevelopment is complete and real estate taxes resume, the area's increased assessed value adds to the real estate tax base and this "tax increment" is then used to pay for project costs or retire any debt that was issued to pay for the project upfront. Different from most other states, Missouri has a tax-increment financing statute that also allows for up to 50 percent of economic activity taxes collected in the project area – that is, taxes on sales, earnings, and payrolls – to be diverted for financing the plan. Tax-increment financing remains highly controversial because it can tie up property tax revenue for decades and divert resources from overlapping jurisdictions such as school districts.

Developers love the subsidies associated with tax-increment financing, but the economic benefits to the municipalities are less clear. How effective is this kind of financing for attracting new businesses and increasing employment and sales in a given area? A "but-for" test is at the heart of justifications for tax-increment financing. This test required by law is supposed to show that the area planned for redevelopment has not grown and development cannot reasonably be anticipated *but for* the adoption of tax-increment financing. Our research examines the impact of tax-increment financing schemes on economic development in Saint Louis and Kansas City.

A Rigorous New Study

The most obvious starting point for measuring the impact of tax-increment financing is simply to compare indicators of economic activity such employment, sales, creation of establishments before and after affected areas are designated for tax-increment financing. Such information is helpful, but it does not prove a causal relationship between the financing scheme and economic development. To pinpoint effects from tax-increment financing, we need to know how much growth occurred during the same time period in areas that were not designated for the policy. Comparing the before and after data in areas with and without tax-increment financing forms the basis of our study. Specifically, our research assesses the usefulness of the "but-for" test in determining the need for tax-increment financing. Because satisfaction of the "but-for" test requirement is made via an affidavit by the proposed developer – the one who stands to benefit if tax-increment financing is awarded – it is reasonable to be skeptical about the rigor with which the test is normally applied.

Our research faced challenges. Ideally, economically distressed areas would be more likely to receive tax-increment financing than areas that are thriving – which complicates comparisons between areas with and without the tax incentives. To deal with this, we selected areas to compare based on the similarity of their economic conditions before one was designated for tax-increment financing and the other was not. In other words, the study compared areas that did receive tax-increment financing with areas that were, economically speaking, similarly likely candidates that did not win such financing. Economic development in the control areas offers an approximation of how the tax-increment financing areas might have fared "but-for" the awarding of the incentive. Working from a data from 1990 through 2012 about employment levels, establishment counts, and sales at the census block group level, our study tracked and compared the control and treatment groups to measure the effects of tax increment financing at the local level in Kansas City and Saint Louis.

Key Findings – and Reform Recommendations

Overall, our analysis finds the level of economic activity in tax-increment financing areas was not discernably greater than the levels in initially similar areas where the policy was not used. In other words, the development in tax-increment financing areas unfolded as we would have expected even if the program was absent. In Kansas City, specifically, the estimated impact of this financing scheme across all instances was very close to zero, which suggests that this city's program has been ineffective in promoting incremental business development. In Saint Louis, the results are slightly negative and, for the most part, statistically significant, suggesting that tax increment financing might actually have hurt development. We cannot be sure because there may be differences among the St. Louis areas compared in our study that we could not fully measure.

Although we find that the use of tax-increment financing has not stimulated investment or increased economic activity beyond what we would have expected if the scheme was not used, it is important to acknowledge that this refers to the average effects of the use of this program in these cities. Our analysis does not enable us to make any claims about individual tax-increment financing projects. Possibly, tax-increment financing was economically justifiable and effective in certain cases. Or this use of this tool might have made sense for other reasons, such as for the sake of equity. The bottom line is that the tax-increment financing approval process should be modified to promote transparency and accountability, so that this kind of public financial subsidy is awarded only for those areas and projects where it really is needed.

Specifically, reforms could require project proposals to include cost-benefit analyses that clearly articulate the expected job creation outcomes. Once in process, local or state government bodies could be empowered to disband tax-increment financing for projects that are underperforming, restoring the public tax rolls. What is more, reforms could allow stakeholders like schools from whom funds are diverted to weigh in during the approval process, and even grant them rights to veto diversions of tax funds they would otherwise have received.

Read more in Thomas William Lester and Ahmed Rachid El-Khattabi "Does Tax Increment Financing Pass the 'But-For' Test in Missouri?" (Show Me Institute Online, 2017).