

spotlight

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DEBT IS DEBT

Taxpayers on hook for TIFs despite rhetoric

KEY FACTS:

- Tax increment financing (TIF) hides the diversion of funds from government services inherent in borrowing.
- It still puts taxpayers at risk for repayment and is more expensive than general obligation bonds or certificates of participation (COPs).
- The City of Kannapolis plans to borrow \$168 million through TIFs for \$132 million in projects more or less related to the North Carolina Research Campus (NCRC).
- Just as lenders and borrowers underestimated risks from subprime mortgages, there is great potential for negative surprises with TIFs
- Higher tax revenues will go to debt repayment, not government services.
- City and county taxpayers could also pay directly for the NCRC because Kannapolis is unlikely to default on the debt even if revenue falls short, and may ask Cabarrus County for assistance.
- The amounts differ, but these principles also apply to the Randy Parton Theatre in Roanoke Rapids and a proposed parking garage in Raleigh.

North Carolina voters in 2004 approved Amendment One, which allowed local governments to issue debt for capital projects paid from the new tax revenues collected in special districts tied to the projects. This form of debt is usually called tax increment financing (TIF), but Amendment One proponents often euphemistically called it Self-Financing Bonds. Nearly every other state uses TIF with mixed results.

Tax increment financed bonds (TIFs) have three disadvantages for taxpayers. It is no surprise that these disadvantages for taxpayers make TIFs extremely valuable to some government officials. First, like certificates of participation (COPs), TIFs do not require voter approval. Once the town council or county commission determines how much to borrow and what to do with the proceeds, it just needs the approval of the Local Government Commission. Second, TIFs divert tax revenue before it reaches the general fund, so the fiscal effect is hidden and the TIF's role as a subsidy is left begging. Third, the lack of voter approval and transparency, combined with the transfer of risk to lenders, make TIFs far more expensive than other forms of debt.

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Local governments have been slow to use this new form of debt, which the state Local Government Commission (LGC) must also approve. Only two projects have passed a government body – one for the Randy Parton Theatre in Roanoke Rapids received approval from the LGC in February 2007; one for the North Carolina Research Campus (NCRC) in Kannapolis passed the Cabarrus County Commission in June. On November 26, the Kannapolis city council will set the final list of projects to be financed and the LGC will act in December. Whatever the value of these projects, and contrary to the claims of advocates, TIFs are an expensive form of debt that burdens taxpayers from the start.

This paper will compare TIFs with certificates of participation (COPs) and general obligation bonds, illustrate the premium local governments pay to use TIFs, and provide an example of how the City of Kannapolis and Cabarrus County could have accomplished the same result as a TIF using other methods.

General Obligation Bonds

After a vote of the people, governments can pledge their full faith and credit to issue general obligation (GO) bonds. Because they must be approved in a referendum, bonds do not provide funds as surely or as quickly as debt instruments that only need approval from elected officials. The responsible government’s full financial commitment to finance the project gives more assurance to investors who are then willing to charge lower interest. Like the interest you pay on a car loan or home mortgage, a government’s interest rate also varies based on its credit rating and the life of the bond. A higher-rated county would have a lower interest rate than a lower-rated county; a 25-year bond would have a higher interest rate than a 20-year bond. Funds to repay a general obligation bond come directly from the General Fund budget or from a special fund for the project.

COPs

Certificates of participation (COPs) have become a more common form of debt because they allow governments to borrow money without getting voter approval. These instruments pledge property as collateral for the loan. The final state budget for Fiscal year 2008 included more than \$500 million in COPs and COPs have been used by local governments to pay for stadiums and convention centers. The government offers as collateral a building that has been built or renovated using some of the proceeds. A lender has to do more to convert a fixed asset into liquidity, and the asset could fall in value, so lenders face greater risk that the loan will not be fully repaid if the project is not completed. More risk for the lender means higher cost for the borrower. Before Amendment One passed, COPs were sometimes structured so the government could put off repayment until the financed project produced new tax revenue for the issuing government, much like happens with tax-increment financing. These specially structured COPs are called synthetic TIFs and commanded a premium above a standard COP because of the delay, though still below the premium for a standard TIF. Funds to repay a certificate of participation come either directly from the General Fund or from a special fund for the project.

Table 1: Features of Debt Instruments

General Obligation Bonds (GO Bonds)
Lowest cost, straightforward accounting; Voter approval needed, clearly paid from General Fund; repayment schedule not tied to revenues
Certificates of Participation (COPs)
Higher cost than GO bonds, do not require voter approval, can be structured so repayment depends on revenue availability; clearly paid from General Fund, assets provide collateral
Tax Increment Financing (TIFs)
No voter approval needed, payment tied to new tax revenues – no pledge of taxing authority; Highest cost, hidden obligation, rely on growth for repayment

TIFs

Tax increment financing is the newest option for local governments. The idea is that new tax revenue from a specially designated district tied to a capital project will go to pay back the debt on the project. For example, incremental property taxes from new hotels, restaurants, retail centers, and even other theatres that locate in the Carolina Crossroads entertainment district near the Randy Parton Theatre in Roanoke Rapids will pay off the debt incurred to build and operate the Theatre. New incremental tax revenue in a district provides the revenue for a TIF, instead of the value of a specific asset such as a stadium or office building as in a certificate of participation. This makes it easier for TIFs than COPs to pay for parks, sidewalk improvements, water, sewer, or other capital projects that would not provide a return on their own. In some cases, such as the Randy Parton Theatre in Roanoke Rapids and a retail center in downtown Pittsburgh, Pennsylvania, the capital project is itself a private enterprise that anchors other investment to the district. Because incremental tax revenues pay the TIF debt instead of general revenues as in a COP or general obligation bond, TIFs do not affect a government's credit rating. This also makes repayment less assured, so lenders charge higher fees and interest, making TIFs the most expensive way to borrow money.

Cost of borrowing

Different methods of borrowing have higher or lower fees and other costs in addition to higher or lower interest rates. To account for these variations, governments and lenders compare the “all-in true interest cost,” which incorporates all of the fees and other costs. Making comparisons of debt instruments even more complicated, the length of the loan can raise or lower the amount of interest paid. Present value calculations equalize time-based differences by showing what it would cost the government in cash today to pay for the project and all interest costs.

North Carolina Research Campus – In Cabarrus County, the all-in true interest cost for a 20-year general obligation bond that would generate \$67 million for NCRC would be 4.26 percent. Total interest cost if Cabarrus County used a standard 20-year COP would be 4.45 percent, a premium of 19 basis points (a basis point is 0.01 percent). Total interest cost for a COP structured like a TIF (a synthetic TIF) would be 4.65 percent, a 39-basis-point premium over the GO bond. A 25-year TIF would have total interest cost of 4.81 percent, 55 basis points higher than the bond.

Over the life of the debt, the lower interest cost of the GO bond would save Kannapolis \$1.3 million compared to a 20-year COP, \$32.3 million compared to a synthetic TIF, and \$38.5 million compared to the 25-year TIF.

With a discount rate of about 4.3 percent, the 20-year general obligation bond would save \$1.8 million in present value terms compared to the 20-year COP, \$3.6 million compared to the synthetic TIF, and \$6.8 million compared to the 25-year TIF. Table 2 summarizes these figures.

Flexibility and taxpayer risk

Advocates say TIFs do not impose a burden on taxpayers. This is simply not true, and those who say it have confused costs with budget items. It is true the government does not pay debt service for a TIF from the general fund, but that is only because the revenue never makes it to the general fund in the first place. This has no cost in the same way that having taxes deducted from your paycheck has no cost. The money used to pay the debt service is not available for other needed services, even in the TIF district itself. A private development without tax-increment financing would pay the same amount of taxes, with all of it going to pay for city services instead of new debt.

For example, if the TIF district needs upgrades to the road, water, or sewer systems, those are new costs that would not have occurred if the land remained in its prior state, but there is no new tax revenue available to pay for these projects because it is dedicated to debt service. The budgetary effect of a TIF is no different in kind than that of other

Table 2: Premium versus General Obligation Bond

	Present Value (\$, millions)	All-in Total Interest Cost (Basis Points)
TIF	\$6.8	55
Synthetic TIF	\$3.6	39
20-yr COP	\$1.8	19
20-yr GO Bond	—	—

Source: Cabarrus County estimates for \$67 million capital

forms of debt. Taxpayers are just as exposed to the costs, which are higher than with other forms of debt.

If the TIF-supported project fails, however, the investors will be unlikely to have enough revenue on their own to finance the project and will rely on government help. The expectation of government assistance is one reason why TIFs have lower borrowing costs than standard corporate debt instruments.

In Kannapolis as a result, the net effect of the TIF is to provide an incentive of \$111 million in interest savings (present value of \$63 million) to the NCRC's developer, Castle & Cooke.¹ Kannapolis City Manager Mike Legg argued that the higher cost of TIFs is justified because the investor bears more risk for repayment. The city would pledge nothing other than the incremental tax revenue. Legg also implied that a TIF would not affect the issuing government's ability to borrow. He further argued that a separate debt issue from the county used to finance some projects would limit the ability to redirect funds if certain projects fell through after work began. Combining everything in a single debt issue leaves the money available for any other project in the overall scheme.² Legg acknowledged, however, that flexibility in projects can be made fairly broad even with separate debt issues.

Different paths to the same goal

Financial instruments are terrifically flexible. Financial engineering provides a number of ways to do the same thing.³ Municipalities and counties can achieve similar goals in a variety of ways. The comparison above showing the present value cost of TIFs compared to other methods of borrowing gives some indication. Consider, too, some other aspects of tax increment financing related to the NCRC.

If it made sense to subsidize the NCRC, citizens would be willing to take on the additional debt, as voters have been willing to pass bonds and higher taxes for schools, roads, open space, and even light rail. In choosing TIFs over COPs or bonds, the city has chosen the most expensive form of borrowing to hide the fact that it is borrowing and the subsidy inherent in its borrowing. The City of Kannapolis and Cabarrus County could offer the same subsidy at less cost by issuing a general obligation bond or certificates of participation and dedicating the proceeds to the North Carolina Research Center. Either move would save more than \$60 million over the life of the loan. The governments could then give NCRC developer Castle & Cooke a \$60 million incentive, equal to the difference in interest costs. Either would achieve the same fiscal effect as issuing TIFs.

The city and county paying for these projects is itself an incentive. If Castle & Cooke borrowed the money on its own, as mentioned above, it would pay another \$111 million more just in interest over the life of the loan. The governments could acknowledge the nature of this incentive and request Castle & Cooke to pay a portion of the interest cost it saved by not borrowing on its own, the developer would still pay less and have an incentive, but it would offset some of the cost to taxpayers. If the governments wanted to be completely open about the nature of their incentive, they could also leave Castle & Cooke to borrow the money and offer to pay the \$111 million in higher interest costs as an incentive.

All of these options shift some amount of risk, just as the TIF does, but none completely eliminate it, because risk is inherent in any capital project. The Kannapolis City Council and Cabarrus County Commissioners decided that the risk mitigation of TIFs justified their higher cost. Just as likely, they chose to hide the nature of their subsidy to Castle & Cooke for the NCRC. This calls into question whether the NCRC will really meet the economic development goals its proponents claim.

Tax breaks for individual developers and similarly targeted economic development incentives are never a good idea. Hiding the incentives behind the veil of a TIF may keep people from recognizing the risks of a project, which is even worse. Local governments need to be honest with taxpayers about the costs and risks involved in TIFs and also about their use as targeted economic incentives. The Local Government Commission should also provide more scrupulous due diligence before approving any future TIFs given the poor record of the Randy Parton Theatre.

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Notes

1. The interest rate for a AAA-rated corporation issuing a 25-year \$160 million bond, similar to the amount of financing in the Kannapolis TIF, would be around 6.89 percent based on a June 20, 2007 Bank of America estimate, 165 basis points higher than the TIF.
2. Mike Legg, Memo to Bob Carruth regarding Tax Increment Financing (“TIFs”) and Certificates of Participation (“COPs”), May 30, 2007
3. Sometimes the results of using these tools can be disastrous as the investors in Long Term Credit Management found in 1998. See Roger Lowenstein, *When Genius Failed*, Random House: New York, 2000.