Tax Increment Financing in North Carolina: Great Expectations, Limited Use

By

D. Shawn Purvis

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Executive Summary

In July 2003, the North Carolina General Assembly overwhelmingly passed the Project Development Financing Act. The purpose of the act is to encourage local governments to be "actively engaged in economic development efforts to attract and stimulate private sector job creation and capital investors." Project development financing, commonly known as tax increment financing (TIF), is one of the most widely used tools for economic development in other states. Local governments typically use TIF to stimulate economic development in blighted, depressed, or underdeveloped areas by financing public improvements. Despite the great expectations that accompanied TIF, only three municipalities in North Carolina have taken advantage of the legislation. This paper presents deterrents to municipal TIF adoption for local and state officials to consider when evaluating the limited TIF adoption by North Carolina municipalities.

Introduction

On July 19, 2003, The North Carolina Senate passed Senate Bill 725 by a vote of 42 to 2. North Carolina voters then approved the bill on November 2, 2004. Several groups supported the bill including the League of Municipalities in response to its members, the Association of County Commissioners, and the Economic Developers Association.[1] The name of the bill was the Project Development Financing Act. Project development financing is more commonly known as tax increment financing (TIF). The General Assembly passed TIF legislation on two previous occasions in 1982 and 1993, but the legislation failed to gain voter approval in a referendum.[2] The purpose of the bill was to encourage local governments to be "actively engaged in economic development efforts to attract and stimulate private sector job creations and capital investors."[3] In the bill, the General Assembly acknowledges the success of TIF in other states and its ability to make North Carolina more competitive in attracting private jobs and investment.[4] With the passing of the Project Development Financing Act, North Carolina became the 49th state to permit the use of TIF.[5]

Tax increment financing is one of the most widely used tools for economic development in other states.[6] Local governments typically use TIF to stimulate economic development in blighted, depressed, or underdeveloped areas by financing public investment or infrastructure improvements.[7] A TIF project begins by designating an area as a TIF district and determining a base property value. The base valuation is set for a specific number of years, during which time public and private investments should improve the property. The increase in value over the base valuation is the increment. Local governments continue to accrue taxes levied on the base valuation for normal operations. Additional taxes levied on the increment are for the repayment of debt service or other qualifying needs associated with the TIF. At the end of the specified time, all debt associated with the TIF is amortized and all tax revenues can be used at the discretion of the local government (Appendix A). A successful TIF project is dependent upon an increase in the property value of the designated district. The inherent risk in TIF is the assumption that property values will increase enough to repay the associated debt. Despite the risk, many local governments in other states have used TIF for a variety of projects including parking decks, conventions centers, and mixed-use developments.[8]

The beginnings of TIF trace back to 1952 in California. Local governments in California developed TIF as a way to offset dwindling federal and state funding.[9] By the 1970s, TIF had become a popular tool throughout the country. For many cities, TIF is the primary source of financing. The city of Chicago, which has over 150 TIF districts, has used TIF so frequently that Mayor Richard Daley has called it "the only game in town."[10] Despite its frequent use nationally and initial support in North Carolina, few local governments in North Carolina have used TIF. To date, the Local Government Commission (LGC) has approved only the following three TIF projects: Roanoke Rapids, Woodfin[11], and Kannapolis.[12] The purpose of this paper is to identify reasons why more municipalities are not pursuing the use of TIF. Municipal leaders can consider these reasons as they evaluate the possibility of using TIF in their municipality. The findings also are relevant for state legislators to consider as they evaluate the possibility of amending current TIF legislation to facilitate future TIF projects.

Literature on Tax Increment Financing

Academic literature on TIF tends to focus on the following topics: fiscal feasibility, effects on economic development, effects on multiple jurisdictions, and adoption indicators. It also is clear from the literature that a lag effect exists between the adoption of TIF legislation and frequent municipal use.[13] Once municipalities begin adopting TIF, however, they use it regularly and nearby municipalities tend to adopt TIF as well.[14]

The previous research on municipal adoption indicators is most relevant to this study. Some of the earliest research on TIF attempted to identify reasons for municipal adoption. Despite the amount of literature devoted to adoption indicators, inconsistencies exist for some variables. There is a consensus that increasing populations,[15] low residential tax share,[16] and reduced state funding per capita[17] encourage TIF adoption. Joyce Man suggests that political attractiveness is a determinant of municipal adoption because the self-financing nature of TIF does not warrant an increase in tax rates.[18] Separate studies have identified property tax rate[19] and per capita income[20] as having both significant and insignificant influences on TIF adoption. Ironically, existing studies have not revealed blight as a significant influence on municipal adoption despite the fact literature commonly identifies TIF as a tool to combat blight.[21]

Currently, a gap exists between identifying TIF adoption indicators and factors that deter the use of TIF. This study begins to fill that gap in North Carolina by building off an earlier study conducted by the University of North Carolina at Charlotte Urban Institute (UNC-Charlotte). The study attempted to evaluate factors that influence TIF feasibility to prepare the Charlotte region to use TIF.[22] A survey conducted in March 2006 identified several potential barriers to TIF including the public perception of TIF, the TIF creation process, and the availability of other financing alternatives. Only twenty-nine percent of respondents identified public perception as a serious barrier and twenty-five percent identified alternative financing options as a serious barrier. Thirty-seven percent of respondents considered the TIF creation process a serious barrier. Other barriers respondents considered serious were lack of TIF knowledge (30 percent), lack of large projects (31 percent), and working with other governments (11 percent). It is important to note that out of 107 respondents only forty-four were municipalities. The percentages include municipalities, counties, and councils of government. Municipalities were not the sole focus of the UNC-Charlotte study. The focus of this study is municipal use of TIF throughout the state of North Carolina and, therefore, some findings differed from the UNC-Charlotte study.

Research Design

This study focuses on municipal TIF use because much of the existing literature also tends to focus on municipal TIF use. This may be because TIF commonly addresses typical urban problems and many states only permit municipalities to use TIF.[23]

Research for this capstone consisted of two phases. The initial phase was an online survey conducted through the North Carolina League of Municipalities (NCLM) (Appendix B). The survey was a selection tool used to create an interview pool by identifying municipalities considering the use of TIF. The study is based on the notion that these municipalities would have more experience with TIF and would have encountered potential deterrents to implementing TIF. Twenty municipalities reported they were considering using TIF. Although the survey was a selection tool, the respondents were representative of North Carolina municipalities in terms of population and geography. Of the ninety-two responding municipalities, seventy-one percent had populations under ten thousand, thirteen percent had populations between ten thousand and twenty-five thousand, and sixteen percent had over twenty-five thousand. Geographically, twenty-four percent were from eastern North Carolina, fifty-six percent were from the piedmont, and twenty percent were from the western part of the state.

The second phase of the research was semi-structured interviews with eighteen municipalities considering TIF and four not currently considering TIF, but who had started TIF research or had internal discussions about TIF (Appendix C). Each municipality identified the most appropriate person to discuss TIF in the interviews. Fourteen managers or administrators, two finance directors, three economic development directors, two assistant managers, and one senior management analyst participated in the interviews. The interview sample also included municipalities varying in size and geography. Thirteen of the municipalities had populations over twenty-five thousand, while four had populations between ten thousand and twenty-five thousand, and five had populations under ten thousand. Geographically, six were from eastern North Carolina, fourteen were from the piedmont, and two were from the western part of the state. The interviews were used for deductive and inductive analyses to identify common deterrents to municipal TIF adoption.

Findings

Process Complexity. Of all the deterrents to TIF use, municipalities most frequently cited the complexity of the TIF process. The UNC-Charlotte survey also identified "the complicated and lengthy qualification process required for TIF" as the most serious barrier to TIF adoption. The North Carolina statutes require municipalities to1) define a development financing district, 2) establish a development financing plan, 3) complete an LGC application for approval, 4) determine the base valuation of the district, and 5) establish a revenue increment fund.[24] The first three steps include other steps and complex calculations required by the LGC to ensure the feasibility of the proposed TIF project. Municipalities admitted they do not have the staffing capacity to commit the necessary time and staff needed to prepare a TIF proposal. Only four other states require municipalities to receive approval from a state agency or commission.[25] TIF is not as prevalent in these states, except Illinois, as it is in those without the requirement for higher approval.

Project Scale. The second most frequently mentioned deterrent of TIF was identifying an appropriate project. Municipalities typically defined appropriate as meaning a large enough project to make TIF a feasible option. Three municipalities initiated conversations with the LGC about potential projects. In each instance, the LGC responded that the projects were not large enough to support TIF. Two smaller municipalities mentioned that although they would like to use TIF and had identified potential projects, they would not be able to move forward with TIF because the projects were too small. Several larger municipalities also responded that project size was an obstacle because they currently did not have any large projects the LGC considered suitable for TIF. The UNC-Charlotte study from 2006 also identified lack of appropriate projects as a deterrent. Municipalities may have an easier time identifying appropriate projects if TIF use becomes more frequent in North Carolina.

Negative Perception. Municipalities identified two negative perceptions of TIF as deterrents to its use. First, a popular view of TIF is simply as another incentive for business. Several municipalities indicated that anti-incentive cultures exist in their communities. Managers commented that trying to persuade elected officials to consider TIF is difficult if the municipality is not accustomed to providing incentives for economic development. Both small and large municipalities identified a negative public perception of tax incentives as a deterrent to using TIF. Second, the mixed-success of TIF in North Carolina has created a negative perception of TIF capability. Despite TIF success in other states, North Carolina municipalities are hesitant to use TIF until projects that are more successful exist in the state. One manager commented, "I want to see TIF work before we use it." Several municipalities indicated that proposing TIF to elected boards currently is not feasible because elected officials are hesitant to use TIF due to negative publicity. This negative perception of TIF could diminish its political attractiveness, an identified incentive for adopting TIF.

County Notification. Existing literature cites the need for approval from an affected taxing district as the most restrictive law regarding TIF.[26] In North Carolina, however, a municipal TIF district does not affect the ability of counties to levy taxes in the district unless the county pledges its tax levy to the project. Despite the fact that municipalities can create TIF districts without affecting county tax revenues, municipalities must still notify counties of their intent to establish a TIF district. The county then has twenty-eight days to deny the project. If the county does not respond in the allotted time, the municipality may proceed with the TIF project.[27] The UNC-Charlotte survey did not identify having to give counties the option to deny the project as a barrier to adoption. This study, however, found county collaboration as a primary deterrent to TIF. Seven municipalities expressed concern about needing county approval. One municipality commented, "We would have a hard time getting the county to approve a TIF if we wanted to do one." There appears to be doubt, especially among large municipalities, that counties will be willing to allow municipalities to create a TIF district.

County Collaboration. Small municipalities also expressed concern about county collaboration, but for a different reason. Several small municipalities commented that to use TIF, the county would have to participate in order to provide enough financing. A joint TIF would involve an inter-local agreement in which the county and municipality would pledge their respective tax levies on the expected increment to secure debt. The concern the small municipalities have is convincing the counties to participate in TIF projects. One municipality commented that persuading a county to participate would require them to educate the county commissioners about the TIF project, something that would "take some time and be hard to do."

Education. The fact that education remains a major deterrent to TIF after nearly five years demonstrates the complexity of TIF and replicates the learning curve experienced in other states. The NCLM survey indicated only fifty-five percent of the responding municipalities have at least a basic familiarity with TIF, and the UNC-Charlotte study from 2006 indicated education as a major concern among local governments. Although other states have used TIF regularly for decades and North Carolina has permitted TIF since 2004, municipalities still identify education as a barrier to TIF. "Helping elected officials understand how TIF works is one of the hardest things to do," was one of several comments made regarding TIF familiarity during interviews. One manager identified education as the most difficult obstacle to overcome in implementing TIF. He said trying to educate staff, elected officials, and citizens about a TIF project was extremely time consuming and difficult. Other municipalities commented that educating staff was difficult, but the education component became even more challenging when the city had to educate the county as well. All but three municipalities indicated they would need to hire a consultant to use TIF because they did not have adequate knowledge of TIF among their own staff.

The limited understanding of TIF in North Carolina is understandable. TIF has not yet become a common tool in North Carolina. The adoption lag experienced in other states predicts that familiarity with TIF may not increase until more municipalities begin adopting TIF regularly. Although lack of education is a deterrent to TIF use, municipalities are attempting to overcome this obstacle. Every municipality interviewed responded that there had been some TIF research or discussion among staff. To help educate elected officials, some municipalities have invited consultants to speak at council meetings while others have taken elected officials and staff to other states to view TIF projects.

Public-Private Partnership. Advocates of TIF claim that it encourages public-private partnerships.[28] For a TIF project to be successful, it needs adequate private investment to promote development and increase property values. Municipalities of all sizes acknowledged the need for public-private partnerships for an effective TIF project, but they also reported that identifying and developing these partnerships is something they have difficulty accomplishing. Smaller municipalities indicated that they did not have adequate staff or time to seek out and develop the necessary private interests. One small municipality remarked, "We are a small town. We have an abandoned mill downtown that would be perfect for redevelopment with TIF, but what private investor is going to come here for economic development?" Other small municipalities shared this same concern. The few large municipalities that identified this deterrent claimed developing such partnerships is difficult because their municipalities are not economically attractive compared to other large cities in the state.

Because of the public-private partnership deterrent, several of the same municipalities remarked that if they could establish a district and issue debt to make improvements without the initial private commitment, they could increase private interest. The LGC requires municipalities to submit a development financing plan, which includes proposed public and private development, before it will approve a TIF project. Although several municipalities mentioned wanting to use TIF with a "build it and they will come" mindset, it is unlikely the requirements will change. The risk involved in TIF is already greater than other financing options. This would only increase the risk.

Financial. The risk involved with TIF increases the rates for TIF bonds. North Carolina municipalities have some of the strongest bond ratings in the country.[29] High bond ratings allow North Carolina municipalities to receive lower interest rates on other types of financing. For this reason, TIF is not a primary option for most municipalities. This is consistent with the findings of the UNC-Charlotte study. One municipality said there was no reason to go through the "headache" of the TIF process when cheaper financing options exist. Interestingly, the larger cities acknowledged the benefit of the self-financing theory of TIF by using synthetic TIF. Instead of issuing debt based on an expected property value increase, the cities have borrowed through Certificates of Participation (COP) to receive a lower interest rate. They then use the revenues generated from the project, including the increase in property value, to repay the COP without affecting the tax rate. In theory, these cities are using TIF but not issuing the debt with the traditional tax increment security.

"But for." Many states require a "but for" test before municipalities can use TIF. A "but for" test means the municipality must prove that economic development would not occur in an area unless the municipality uses TIF. The "but for" clause in the North Carolina statutes requires that "the proposed project development financing … is necessary to secure significant new economic development" in the proposed TIF district.[30] The "but for" can often be difficult for municipalities to prove and only is required in seventeen other states.[31] Existing research finds that TIF can be an effective leveraging tool to accelerate development in an already growing area.[32] This finding can deter municipalities from adopting TIF if a "but for" test compromises the project's chance for success. Many municipalities did not mention this deterrent but its prevalence in literature suggests that as TIF becomes more common, more municipalities may identify it as a deterrent to adoption. Interestingly, several of the states where municipalities frequently use TIF, including California, Illinois, and Minnesota, all have "but for" test requirements. This may indicate that "but for" requirements do not necessarily inhibit TIF use.

Land Area. North Carolina TIF statutes limit the total area of TIF districts to no more than five percent of municipal land.[33] Two municipalities mentioned the land area restrictions as a deterrent. This is surprising considering previous research suggests that area limits can hinder the potential for greater financial gains.[34] Much like the "but for" deterrent, the land area restriction could reduce the number of municipalities adopting TIF by reducing the chance for success. In addition, a land area limit could potentially reduce the size of potential projects, which would compound the project scale deterrent. The land area limit has a stronger impact on small municipalities. For some of the smallest municipalities, a five percent area may not be big enough for a project large enough to make TIF a feasible option.

Conclusion

Great expectations accompanied North Carolina TIF legislation in 2003. Although municipalities in other states frequently use TIF, only three in North Carolina have taken advantage of the legislation. This study has attempted to identify deterrents to municipal TIF adoption in North Carolina. Among the deterrents most commonly mentioned by municipalities are the complexity of the TIF adoption process, the lack of large and appropriate projects, the current negative perceptions of TIF, the lack of familiarity with TIF, and the need for county collaboration for TIF adoption. Each deterrent presents an opportunity for state and local officials to consider when evaluating the limited use of TIF in North Carolina.

This study recommends future research to develop potential strategies to facilitate municipal TIF adoption in North Carolina. In developing potential strategies, it is important to remember TIF is only one of several tools available to municipalities for economic development. Municipalities should evaluate if TIF is an appropriate tool for their community before committing to it. Additionally, several deterrents exist because of safeguards in the state statutes intended to counter potential abuses of TIF. State legislators should thoroughly evaluate the implications of policy changes before amending existing legislation.

[1] Hankins, Ellis, NCLM Executive Director. Personal interview. 18 January 2008.
[2] TIF legislation required voter approval of a constitutional amendment in North Carolina because TIF involves local governments pledging tax revenues to secure debt.
[3] North Carolina Project Development Financing Act, 2003
[4] North Carolina Project Development Financing Act, 2003
[5] Arizona is the only state without TIF legislation. The state repealed its TIF enabling legislation in 1999.
[6] Man from Johnson and Man 2001
[7] Man from Johnson and Man 2001
[8] Council of Development Finance Agencies. Online TIF resource library found at www.cdfa.net/cdfa/cdfaweb.nsf/pages/tifcbuildingresources.html
[9] Huddleston 1984
[10] Nolan and Berlin 2002
[11] The TIF project in Woodfin is a collaborative project with Buncombe County.
[12] There is no clear connection between the early adopters of TIF in North Carolina. The municipalities are in different geographic regions, vary in population, and have implemented distinct projects.
[13] Calia 1997; Cox, Mundell, and Johnson 2001; LaPlante 2001; Man 1999
[14] Mann 1999
[15] Dye and Merriman 1999; Man and Rosentraub 1998
[16] Dye and Merriman 1999; LaPlante 2001; Man 1999;
[17] Man 1999; Man and Rosentraub 1998
[18] Man from Johnson and Man 2001
[19] Dye and Merriman 1999; LaPlante 2001; Man and Rosentraub 1998
[20] Dye and Merriman 1999; Man 1999
[21] Dye and Merriman 1999; Man and Rosentraub 1998
[22] Ott, Bott, and Rassel 2006
[23] Weber and Goddeeris 2007
[24] "Amendment One: Project Development Financing." NC Department of the State Treasurer online found at www.nctreasurer.com/NR/rdonlyres/26DF90C8-DF73-4AAF-9832-3830EA07B089/0/AmendmentOnedraftrevised9205docrevised307.pdf
[25] Johnson and Kriz from Johnson and Man 2001, Connecticut, Illinois, Massachusetts, and New Jersey require approval from a state agency or commission.
[26] Johnson and Kriz from Johnson and Man 2001
[27] N.C. G.S. 160A-515.1(e)
[28] Man from Johnson and Man 2001
[29] Coe 2007
[30] N.C. G.S. 159-105(b) (1)
[31] Johnson and Kriz from Johnson and Man 2001
[32] Dye and Sundberg 1998; Kriz 2001
[33] N.C. G.S. 160A-515.1(b)
[34] Kriz 2001

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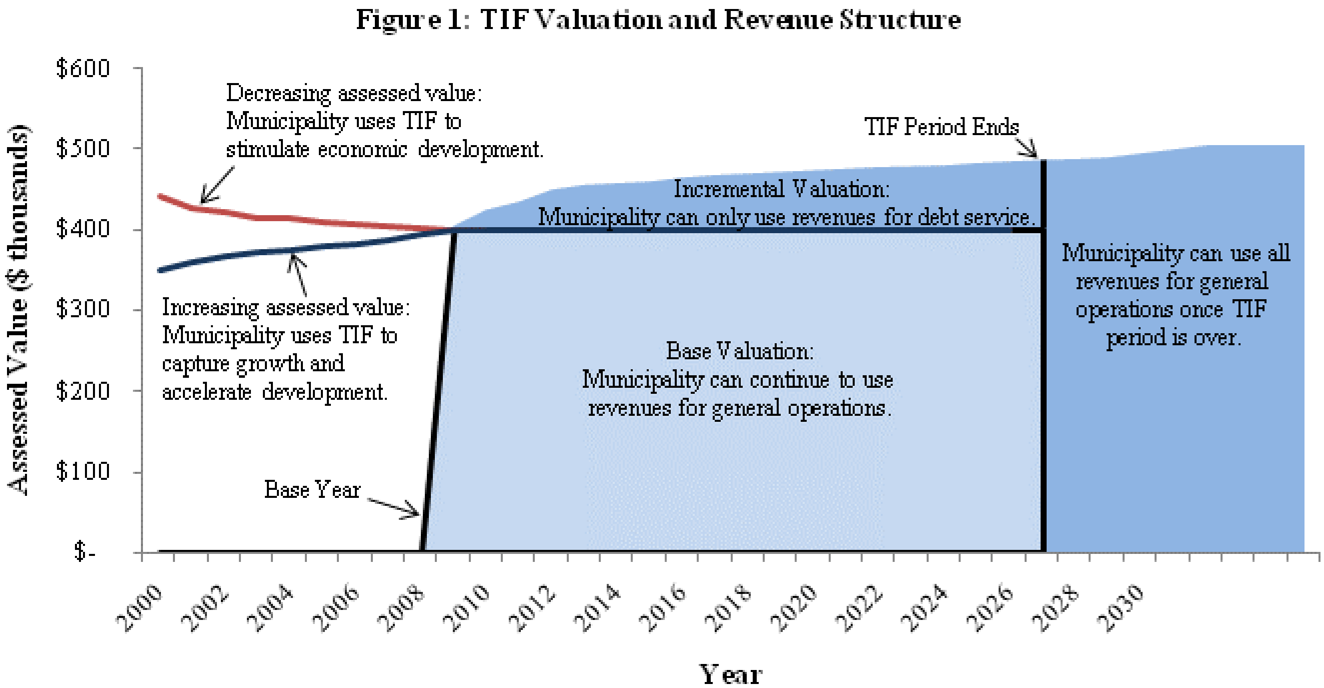
Appendix A



Adapted from Johnson and Man, 2001, pg. 21

Appendix B
Tax Increment Financing Interest Survey

This short survey will be used to gather preliminary information about municipal interest in and familiarity of tax increment financing (TIF). The research is intended to investigate where North Carolina municipalities stand in pursuing TIF as a tool to promote economic development or combat blighted areas. It also will include strategies to increase the utilization rate of tax increment financing in North Carolina. Results from this study are intended to inform government officials at both the local and state levels. Municipal leaders may find this study relevant as they determine what financing methods are best for their jurisdiction. Elected officials, managers, budget and finance officers, economic development professionals, and policy analysts considering TIF will be able to use findings to determine if TIF is a viable financing tool for their jurisdiction. In addition, the findings should provide insight into obstacles other jurisdictions encountered while implementing TIF or reasons for not pursuing TIF. Likewise, the findings will include reasons for using TIF and possible suggestions for overcoming anticipated obstacles.

Thank you for your time and participation in this study. Results of this study will be available to you once the data has been collected and reviewed.

Municipality Name: ______________________

Name: _________________________________ Position/Title: ____________________________

Phone: _________________________________ E-mail: _________________________________

1. What is your level of familiarity of tax increment financing (TIF)?

   a. No familiarity b. Slight familiarity c. Basic familiarity d. Full familiarity

2. Has your municipality considered using TIF?

   a. Yes b. No

3. What best describes your municipality's current interest in TIF?

   a. Not interested b. Not interested, but would like to learn more c. Interested d. Very interested

   3a) If not interested, which of the following is the best reason for why not?

   a. Lack of information b. Lack of financing expertise in house to use TIF

   c. Lack of planning expertise in house to use TIF d. Lack of interest by elected officials

   e. Lack of need for this type of financing f. Other better or more appropriate financing tools

   g. Other _____________

4. How active has your municipality been in considering TIF? Select ALL that apply.

   a. Staff discussions b. Staff research c. Administration discussions with elected officials

   d. Elected official discussions in council e. Conversations initiated *by* business owners about TIF

   f. Municipal initiated conversations with business owners about TIF g. Municipal initiated

   conversation with the LGC h. Other _____________

5. May we contact you or your staff to discuss TIF further?

Appendix C
Tax Increment Financing Deterrents & Obstacles: Interview Questions

- Why did your municipality first consider using TIF?
    - What reasons did people give for using TIF in your municipality?
    - What reasons did people give for opposing TIF in your municipality?
- Who initiated the first discussion about TIF? (Administration, Council, businesses?)
- Has your municipality researched TIF?
- How did your municipality go about gathering information concerning TIF?
    - Who did you contact for information about TIF?
    - Where were you able to get information?
- Did your municipality have the technical expertise needed "in house" to complete the TIF process?
- What other financing options were considered?
    - What financing option has been most used by the municipality?
- Does your municipality have a policy for using TIF?
- Is your municipality actively pursuing the use of TIF?
  This question will lead to one of two directions:
  1) Stopped pursuing- Why?
  2) Actively pursuing- Deterrents or strategies?

1) Stopped pursuing TIF:

- Why is your municipality no longer pursuing TIF? (The answer may or may not be deterrents)
- How did "deterrent" prohibit the further consideration of TIF?
    - How would your municipality overcome those obstacles in the future?

2) Actively pursuing TIF:

- What steps has your municipality taken in pursuing TIF? (Walk through process)
    - Which of these steps has been the most difficult? Easiest?
    - What obstacles were encountered while pursuing TIF?
        - What was the greatest obstacle?
    - How did your municipality overcome any obstacles?
        - Who/what helped your municipality overcome these obstacles?
- Has your municipality established a process for pursuing TIF projects in the future?

General Comments, Notes, Inductive Questions