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TAX INCREMENT FINANCING

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INTRODUCTION

Tax increment financing, or TIF, is a form of “value capture” in which increases in privately owned land values generated by a public investment are captured, in whole or in part, through a land related tax to pay for that investment. Value capture refers to the process by which increases in land value attributed to “community interventions” rather than landowner actions are projected and recouped by the public sector. These “unearned increments” may be captured indirectly through their conversion into public revenues such as taxes, fees or other exactions, or directly through required on-site improvements to benefit the community at large. Value capture refers to a type of public-private “partnership” in which the private sector compensates a public agency for the cost of a facility that generates economic value.

Transportation projects, for example, can increase adjacent land values, and thus generate a windfall for private landowners. With proper planning, public agencies can capture a portion of that windfall with any of several methods including local improvement districts, public-private development of adjacent land, traffic impact fees and TIF. A public agency, for example, could buy on the open market privately held land that is zoned for low density use near a planned transportation hub and increase the designated use density. It could then sell the land back on the open market, capturing the capital gain resulting from both the increase in designated use density and the development of the transportation hub.

Many discussions of TIF focus on the often arcane substantive and procedural requirements of TIF statutes. While the mechanics of TIF are important - particularly to the practitioner - and often reflect policy concerns about its potential excesses, at its best TIF provides a way of thinking about the opportunities afforded by disciplined, strategic investments in public infrastructure. The purpose of this paper is to explore tax increment financing, a method of value capture that has been both popular and controversial in the United States.

THEORY

TIF is a public financing method which has been used in many countries including the United States for more than 50 years. With federal and state resources for redevelopment generally less available, TIF has become a frequently used mechanism to finance public improvements for the purpose of stimulating economic

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development. Fundamentally, TIF uses projected increases in tax revenue to finance current improvements which are anticipated to create the conditions for the future revenues.

When a public project such as a parking facility, a road, or a park is built, there is often an increase in the value of surrounding real estate and investment in newly constructed or rehabilitated buildings. The increases in collected tax revenues are the "tax increment." TIF is a mechanism by which tax increments collected from a certain defined district (the "TIF district") located within a sponsoring jurisdiction are dedicated to pay for the project. In its original conception, TIF was designed to channel funding toward improvements in distressed or underdeveloped areas (often characterized by blight) where development might not otherwise occur. Since it was first introduced in California in 1952, it has been used in thousands of developments, and its application has dramatically expanded.

STAKEHOLDERS

To better understand how TIF works and who it benefits and potentially harms, it is useful to describe the roles of various stakeholders in a TIF project.

(a) The Developer/Entrepreneur. The Developer/entrepreneur is often the instigator of a TIF project, hoping to encourage the sponsoring jurisdiction to make a public investment that will facilitate his business plan. Alternatively he may invest in an area in response to the inducement provided by a sponsoring jurisdiction through its construction of a public improvement. While the developer or large landowner pays taxes derived from the improvement (along with all other taxpayers in the TIF district), he only pays at the rate of taxation of taxpayers throughout the entire sponsoring jurisdiction. He is paying more taxes (though at the same rate) because the value of his land (or the value of transactions subject to excise taxes) has increased. He is generally pleased to pay the anticipated incremental taxes because his land or business is worth more, and particularly if the increased value is a result of increased transactional revenue that provides cash flow for such payments.

Taxes paid pursuant to TIF are distinguishable from assessments levied pursuant to a local improvement district to finance a public improvement. An assessment is generally a predetermined portion of the actual cost of the project and is due and payable regardless if the owner's land value actually increases. If the same improvement is financed through TIF, however, he will only contribute to the cost of the project if the improvement actually increases the value of his property. His contribution, however, will not be limited to a fixed portion of the cost but will simply be his incremental taxes.

Often it is the developer/entrepreneur who requests that the public agency build the public improvement, for example, an off-street parking facility to serve his property. His assessment or tax is a cost that he might otherwise have to absorb entirely to provide on-site parking.

(b) The General Taxpayer. The general taxpayer within the TIF district, as opposed to the developer/entrepreneur, will also only pay additional taxes if the value of his property increases. Like the developer/entrepreneur, if the taxpayer's cash flow does not increase as a result of the improvement while the value of his property does, then he has a higher tax obligation without additional cash-flow to pay it. While he could sell or mortgage his property, he may be perturbed that he has incurred a tax liability without having made a decision that the public infrastructure and resulting values are part of his own business planning. The problem is particularly acute for the homeowner as opposed to the property owner with a marketable business in the TIF district. The homeowner may be opposed to the commercial development of what is, for him, a residential area.

The property of the general taxpayer outside of the TIF district does not benefit from increased economic activity and thus the taxpayer does not have an increased tax burden. However, because the tax increments collected within the TIF are being directed to repay the debt incurred to fund the improvement, the general jurisdiction may not realize benefit to its general fund for some time. In addition, the increased services now needed within the TIF district, e.g. fire and police, may be paid out of the general fund of the jurisdiction, and consequently there may be fewer services available outside the TIF district.

(c) The Sponsoring Jurisdiction. The sponsoring jurisdiction hopes that the public improvement will increase net economic activity within its boundaries, and when the debt for the public improvement is paid, the incremental revenues will be available for new services throughout the jurisdiction. Ideally, a blighted area will be transformed into a prosperous neighborhood due to the public investment and resulting private activity. However, to the extent that the new economic activity only represents a displacement of similar activity in another part of the jurisdiction, there may be no net gain and a diversion of tax revenues away from general services throughout the jurisdiction. Even if there is net economic activity and incremental taxes, unless there are sufficient incremental taxes after paying debt service to meet increased service demands, the sponsoring jurisdiction may be forced to reduce services throughout the jurisdiction until the debt is paid and all incremental revenues reach the general fund.

(d) The Overlapping Jurisdictions. The overlapping jurisdictions forego potential incremental revenues with the hope that this investment in infrastructure will result in net increased taxes when the debt is paid and all taxes are distributed again. However, the overlapping jurisdiction may have projected some increase in taxes due at least to inflation and normal economic growth in the absence of special investments in infrastructure. In those cases it not only expects to continue to receive taxes based on pre-district values (the base level) but some reasonable growth of such value as well. In the absence of required consultation or consent to such diversion, overlapping taxing jurisdictions may be harmed and understandably distressed. In some states, TIF districts have perpetual existence so that all incremental taxes after the formation of the TIF district are diverted from the overlapping taxing jurisdictions.

For overlapping jurisdictions, it is particularly important that “but for” the investment in infrastructure no additional tax revenues would be generated. Otherwise the overlapping jurisdiction would reasonably expect their fair share of such incremental revenues. To protect overlapping jurisdictions from unwanted diversions of such taxes, in some states the formation of TIF districts and the use of incremental taxes for subsequent projects require the approval of the overlapping jurisdictions.

(e) The Urban Planner. An unlikely but potentially important benefactor of TIP is the “urban planner”, the stakeholder who is concerned about future development and attempts to rationalize space and resources to optimize the economic and human potential of urban areas. The urban planner sees

TIF as a way of making strategic investments in infrastructure that results in coordinated development which achieves an urban purpose beyond private economic benefit and the collection of taxes.

TIF requires the sponsoring jurisdiction to think more strategically and more akin to a private developer, assessing where investments are likely to provide a return adequate to pay costs, increase revenues for services and build important and self-sustaining urban centers. Traditionally, cities built a public improvement – a library, courthouse, school or jail – when it needed them and where land was available or could be condemned. Using TIF, cities make investments where it can predict that such investment will be leveraged with private investments to achieve larger public policy goals. The question is not whether the city should build a library, but whether it can build it at a location and in manner that will encourage ancillary private development that will help pay for the library and increase its functionality as an urban amenity. TIF can help finance the public portion of mixed use developments where public assets (e.g. parking, a transit hub or a library) can be collocated with private assets (housing and retail) often in a vertical configuration to reduce land and development costs. TIF is thus a way to plan a physical environment consistent with economic analysis and rigor, a type of strategic planning that cities have not traditionally considered and for which they have not been staffed.

Procedures

Public improvements to be financed through TIF districts are developed and constructed by local jurisdictions or their development authorities. As a prerequisite to establishing a TIF district, a local jurisdiction will determine that the public improvement is likely to induce private investment and economic activity that will result in increased tax revenues sufficient to pay all or a portion of the costs of the improvement. As part of its planning, the local jurisdiction will determine the scope and cost of the improvement, estimate the investment and development that are likely to occur and the incremental revenues to be captured over time, and determine the boundaries of the district from which the incremental taxes will be collected and the term of the debt to finance the improvement. Depending on state law, the proposal may be subject to public hearings, approval by overlapping taxing jurisdictions and other prescribed processes. The estimated cost of the debt will depend on its term and the risk that the marketplace associates with repayment of the debt. When the TIF district is formed and the costs of the project are confirmed, the local jurisdiction will commonly issue the indebtedness to finance construction and pledge the incremental revenues to its repayment.

As states have authorized and reviewed TIF financing over the last fifty years, the core mechanisms and requirements of TIF financing have evolved and some states have amended their original authorizing statutes. For example, while originally limited to the capture of incremental property taxes, some TIF authorizing legislation now permit the capture of incremental excise taxes, such as sales taxes, as a more efficient way to capture value where retail development is central to the redevelopment. In some states each of the overlapping taxing districts must approve the diversion of their taxes often forcing a negotiation regarding the tax allocation. Some states have increased the transparency and frequency of public processes required to approve a TIF district while some have limited the size of districts by geographic area or the amount of indebtedness that can be incurred. In addition states have broadened or narrowed the application of “blight” as a prerequisite to the formation of a TIF district.

Issues

There are a host of policy issues and occasional controversies that have emerged as TIF has been applied throughout the United States.

A. Defining the Goal.

Many of the statutes authorizing TIF require a finding of "blight" by the authorizing legislative body as a precondition to formation of a TIF district. A finding of blight suggests that there is a minimum public policy threshold (apart from increasing tax collections) that must be met before such a diversion of tax receipts may be used. Blight characterizes serious health and safety conditions, so application of this standard suggests extraordinary circumstances. Such a finding also suggests the economic reality that for TIF to be successful there must be a significant potential for increasing economic values. If the base line property values upon formation of the TIF district are so low that they are associated with blight, then there is a likelihood of this upside potential. Furthermore, the existence of blight suggests that in the absence of public intervention, the marketplace itself is unlikely to change the condition of the community. Finally, since political bodies are generally reluctant to make a finding of blight lest it suggest a failure to provide healthy and sanitary conditions, its finding suggests a dire circumstance worthy of extraordinary measures.

Over time many of the statutes authorizing TIF eliminated the requirement of a "blight" finding or watered down the definition to imply that there was underdevelopment and growth potential ("planner's blight") rather than objective health and safety hazards (traditional "blight"). Without any such objective standards, formation of a TIF district is dependent on the finding by the local legislative authority that there would be adequate growth in tax revenues to repay the costs of the improvements. Elimination of the blight threshold has led to some districts without health or safety needs but composed either of undeveloped lands ("green fields") with a clear economic upside or functioning urban areas with the potential of denser, higher yielding development.

While the financial model for TIF financing may work without the existence of blight, the public policy goal justifying such redirection of taxes is less obvious. In the absence of a requirement of blight or comparable objective finding linked to public policy, the only rationale for such public borrowing and risk-taking is general economic development. The only "objective" threshold is a willingness of the marketplace to buy the bonds. Since the marketplace will almost always find a price at which to buy and sell the bonds, this threshold provides little protection to taxpayers who may ultimately be responsible for the repayment of the bonds.

At its best TIF encourages the jurisdiction to think more broadly than whether the investment can pay for itself. It generally requires a business plan and an urban design that identify key private investments that will generate sufficient tax revenues and meet urban goals of livability, vitality, traffic and pedestrian flow and perhaps residential attractiveness. Some uses may provide tax increments but limit design opportunities. For example, a stand alone Wal-Mart with a large parking area may generate tax revenues but little pedestrian traffic and deter small retail development and thus impose limits on the character of the area. The collation of private and public uses, for example, a private retail development atop a public parking garage may achieve synergistic fiscal and urban success though such projects are more challenging to develop. Good planners will see the potential of every public investment dollar to achieve a better urban design; TIF can facilitate that vision by helping to finance the public improvement and thus encourage the resulting private investment.

B. Diverting Anticipated Revenues.

The incremental taxes collected from within the TIF district and used to pay for the public improvement are diverted from the general fund of the authorizing jurisdiction as well as the general funds of overlapping tax jurisdictions. For example, if a redevelopment agency creates a TIF district, incremental taxes that otherwise would have flowed to the city, the county, the port and the state in which the TIF district is located would be diverted to repay the indebtedness. As discussed above, if the incremental taxes would not have been realized "but for" the public improvement and resulting economic activity, then neither the authorizing jurisdiction nor the overlapping tax districts would be harmed since there would have been no incremental taxes to pass on or divert. If, however, a portion of the "incremental" taxes would have been paid due to inflationary increases in land value or development already planned and not as a result of the new public investment, then those overlapping taxing jurisdictions would forego that diverted revenue.

C. Drawing Appropriate Boundaries.

The boundaries of a TIF district need to encompass a large enough area to capture the incremental taxes derived from the public investment but not so large that incremental revenue derived as a result of other causes, e.g. normal inflation or unrelated private activity, are not inappropriately diverted. Authorizing statutes in some states limit the size of a TIF district based on a number of factors including the amount of appraised value within its borders and the acreage or debt than can be incurred as a percentage of the entire jurisdiction's size or value. Any such limitation is somewhat artificial, but each underscores the need to balance the interests of overlapping jurisdictions from excessive tax diversion and the need for the sponsoring jurisdiction to receive adequate revenues to pay debt service. Clearly, the formation of TIF districts requires careful planning and financial modeling that link the public investment and debt to the incremental taxes projected to be available for debt service.

D. Condemning Private Property for Private Ownership.

TIF has been somewhat conflated with condemnation of private land for private use in the United States due to the infamous United State Supreme Court case of Kelo v. City of New London, 545 U.S. 469 (2005). As part of a TIF district, New London, Connecticut condemned private property for use by private landowners to construct a large commercial shopping center in furtherance of economic development. The controversial taking was upheld by the Court as an exercise of state police power authority, but the facts created a firestorm that has led to limitations on condemnation in many states.

Condemnation or eminent domain can be used in conjunction with TIF to amass private land for a public purpose, but it is not inherent within TIF authority and in some states is prohibited for this purpose. In some states condemned private land can only be held in public ownership or used for a purely public purpose; this is distinguishable from a private purpose with some form of ancillary public benefit such as general economic development (even though it may have the effect of increasing tax collections). When statutes permit TIF projects to proceed in the absence of blight or similar important public purposes other than general economic development, legislatures are essentially permitting one private use over another. Condemnation, while common to alleviate blighted conditions, is much less common and more controversial when used to facilitate such general economic development.

E. Inappropriate Private Subsidies.

In a market where land suffers from blight, a public investment may be a prerequisite to spur private investment; it acts as a catalyst to induce private parties to invest in the troubled area. Where blight is absent, however, the public investment may be characterized as a public contribution or "gift" to a private partner who might otherwise be required to provide for the parking, street widening or other public improvements at the developer's expense. In a market where developers are courted to invest in a particular locale independent of blight, TIF is an important from of inducement to private parties. While the resulting investments are arguably of value to both the public and private parties, the policy question is whether the inducement was required or excessive as a form of corporate welfare.

F. Security for Bonds.

Generally a municipality will borrow against a projected future stream of incremental tax revenues by issuing bonds to finance the public improvements and pledge the taxes to repayment of the bonds. If the projected revenues are not realized, then the bond holders face a potential bond default. In order to sell bonds based on projected revenues and thus the risk of default, the bond market will demand measures to mitigate that risk. These may include one or more of the following: that the future revenue stream be materially discounted, that there be binding and enforceable commitments to private investment, that there be third party financial analyses confirming the likelihood of the projected taxes, that there be developer guarantees, or that the sponsoring jurisdiction guarantee the repayment of the debt with its general revenues. These types of credit enhancements and additional security not only assure a market for the bonds, but lower the risk of default and thus the interest rate on the debt.

G. Increasing Taxes for Property Owners.

As mentioned above, not all property owners in the TIF district long for the economic development and increased property values that the sponsoring jurisdiction is encouraging. Furthermore, some uses of the land may not produce the cash-flow necessary to pay the higher taxes resulting from higher valuations. In addition, some property owners, particularly homeowners, may not want the increased economic activity and the changed character of their neighborhood that the renewal promises. The consequence of such unwanted development by certain property owners is the potential for political opposition to a TIF financing. In response to such concerns, some states have required public hearings and the approval of overlapping taxing jurisdictions to which the unhappy property owners can appeal as prerequisites to district formation.

H. Robbing Peter to Pay Paul.

One of the most common criticisms of TIF and the subject of significant research involves the question of whether the increased economic activity within the TIF district resulted simply from a shift of activity within the sponsoring jurisdiction or from one neighboring jurisdiction to the sponsoring jurisdiction. If the public investment simply moved retail investment from one part of a town to another, then there is no net gain for the town and thus no ability to absorb the costs of the improvement or the services it requires. If the economic activity moved from one city within a county to another city within that county, the receiving city gains taxes but the county does not and it loses the incremental taxes which are diverted to the TIF district. The record is mixed on whether for any particular project net economic activity is created. Of course, where the area is blighted to begin with then the issue of economic shift is less of a concern.

Cultural Challenges

TIF generally requires a close working relationship between the sponsoring jurisdiction that will create the TIF district and incur indebtedness to finance the public improvements and the private entity or developer that will reciprocate by making capital investments to increase land values and generate tax revenues. While the idea for a TIF district may originate within either the public or private sector, a successful TIF district requires the cooperation of both sectors. The public sector needs to have confidence that the private investment will follow the public infrastructure so that it can rely on projected tax revenues to repay public debt. The private sector needs to have confidence that the public improvements will be built in a predictable manner with design and quality features appropriate to the private investment. This interdependence and financial intimacy – tested in the first instance during negotiation of a development agreement between the parties - often poses problematic cultural issues that need to be understood and addressed.

The public sector culture, while varying from jurisdiction to jurisdiction, is often characterized by slow, transparent public processes and political pressures. It is often infected with an aversion to financial risk and a general skepticism toward private enterprise. Public sector projects may be vulnerable to political attacks from those unwilling to spend taxes on projects that ultimately benefit private entrepreneurs. The private sector culture, while also varying from developer to developer, is often characterized both by swift and proprietary decision making and an unwillingness to commit to a project prior to receipt of debt and equity financing which turn on unpredictable market forces. The private project may go into default and the single asset entity may declare bankruptcy; its owners who often live elsewhere return home. In contrast, the elected and appointed public officials are left to justify their decision making in public.

TIF projects can be complicated requiring a financial discipline and analysis for which small jurisdictions are often ill prepared. Cities may have to retain high priced financial and legal consultants to effectively negotiate and ultimately partner with experienced developers, an expense which may add another level of skepticism about who is benefitting from the projects. Ultimately in order to succeed with a TIF financing, cities need to leave their comfort zone of daily municipal work and even common infrastructure financings to engage in the competitive and unforgiving marketplace. They need not only the capacity to assess this risk but the discipline to walk away from inappropriately risky transactions. They cannot assume that the marketplace will treat them kindly if they promise to balance future budgets or increase future public services based on projected tax revenues.

These cultural issues, particularly with smaller and less sophisticated jurisdictions, necessitate thoughtful discussion within the public jurisdiction and the development of strategies to mitigate their risks. For example, a local jurisdiction needs to be very deliberate in selecting a partner that shares its goals and values. It would be wise for political leaders to consider local, business advisory groups to help them understand the marketplace and provide political support for these projects. The local jurisdictions need the capacity to develop and understand financial spreadsheets and, to the maximum extent possible, share and confirm their financial assumptions with their private partners. Perhaps most importantly, local jurisdictions need to understand, internalize and be willing to defend the notion that only if their private partner stands to make material profits from the TIF project will the private partner be willing to participate and make the investment that the jurisdiction expects.

CONCLUSION

TIF, as it has evolved, offers overlapping taxing jurisdictions the opportunity to invest projected tax receipts jointly in public infrastructure in order to stimulate private investment and market activity in furtherance of redevelopment plans. If publicly scrutinized and market tested, TIF can be a powerful catalyst for urban renewal. To induce the marketplace to lend against these projected revenues and induce overlapping jurisdictions to pool these resources, the sponsoring jurisdiction needs to have a rigorous plan that meets the objectives of urban planning, withstands rigorous financial scrutiny and takes into consideration unintended consequences such as revenue shifting.

The legislative requirements for TIF vary from state to state and over time individual states have amended their statutes. What may be most important to a practitioner seeking to participate in a TIF on behalf of a client are the particular requirements and procedure that govern TIF district formation. From a policy perspective, however, it is not the mechanism of TIF but the discipline it imposes on public investment that is may be most important. Even in states without workable TIF statutes, jurisdictions should be encouraged to think entrepreneurially but cautiously and project future revenue streams and invest accordingly. Furthermore, overlapping taxing districts can voluntarily agree through inter-local agreement to share the cost of a regional facility that will spur economic development absent a TIF regime. What perhaps is most important about TIF is that it encourages a local jurisdiction to be a careful planner and investor, looking to the future for a return on investment that furthers public policy but is disciplined by market reality.