

Tax Increment Financing

A new tool for funding
regeneration in the UK?

The purpose of this paper

This paper looks at the concept of tax increment financing (TIF), a mechanism for funding regeneration pioneered in the US. TIF is sometimes referred to in the UK as local tax re-investment programmes.

Drawing on the US experience, we look at the advantages and disadvantages of the TIF approach and examine the case for introducing tax increment financing districts (TIFs) within the UK. We hope to stimulate a debate within the UK about the merits of introducing a regeneration tool that has proved both popular and effective in the US.

Finding the appropriate mechanisms for funding the infrastructure needed to support regeneration has been a longstanding concern. However, the combined effects of the credit crunch, the downturn in the property market and the constraints on public spending (including the impact of empty rates in England and Wales) are having a particularly severe impact on regeneration activity which, by its very nature, is often on the margin of viability. This has helped to reignite interest in new ways of funding infrastructure requirements – as exemplified by the recent report, *Unlocking City Growth: Interim Findings on New Funding Mechanisms*, commissioned by the Core Cities Group (a network of England's major regional cities).

Although some new funding mechanisms are emerging in England and Wales – most notably the community infrastructure levy (CIL) and the business rate supplement – these will not be sufficient to fund the infrastructure that is needed in those areas that most urgently require regeneration. In Scotland, the new Scottish Government is pushing the concept of a Scottish Futures Trust, though this is mainly intended to avoid the standard private finance initiative (PFI) contracts for major infrastructure projects.

The inadequacy of current infrastructure funding arrangements has prompted us to examine other options and to identify TIF as offering one of the most promising avenues. We are encouraged that, in its recent report, the Core Cities Group advocated the introduction of accelerated development zones (ADZs), a concept similar to that of TIFs.

We are also aware of interest in the TIF concept among Government circles in Scotland. Most notably, Edinburgh City Council is considering under its Single Outcome Agreement with the Scottish Government whether it might attract investment via a TIF.

What is TIF?

TIF is a mechanism for using anticipated future increases in tax revenues to finance the current improvements (such as new or improved infrastructure) that are expected to generate those increased revenues. In simple terms, it enables a local authority to trade anticipated future tax income for a present benefit.

Typically, those who invest in municipal debt which is funded using TIF are incentivized to do so by a tax exemption for interest they receive.

TIF schemes have been favoured by local leaders in the US and elsewhere because of the prospects they offer for attracting investment to sites that might not otherwise receive it. Sometimes the remediation and infrastructure related costs of brownfield sites can be so large that property developers are reluctant to get involved. In these circumstances, the only way to proceed may be for the public sector to help prepare land for development through up-front investments. In the US, TIF is the mechanism by which this is usually funded.

TIF works on the principle that the supply of new or improved infrastructure usually leads both to new development and to an increase in the value of surrounding property, both of which serve to increase the level of property taxation in the area. Within a designated TIF district, this anticipated increased taxation (the 'tax increment') is captured and used to fund the infrastructure that has been provided. Financing debt issued to pay for the project by utilising increased tax revenues can take up to 20-25 years, but in some cases the timeframe can be much shorter.

In the US, TIF has traditionally been used to fund:

- urban renewal
- affordable housing
- cleaning up pollution
- public infrastructure projects such as roads, sewers, pavements and similar improvements.

TIFs are now such an important part of the regeneration agenda in the US that in some areas TIF and regeneration are virtually synonymous terms.

What is the history of TIF?

First introduced in California in the 1950s, TIFs were intended to be another tool, like tax abatement and enterprise zones, which could be used to promote urban renewal. While some states, such as California and Illinois, have used TIF for decades, many others have only recently introduced state laws that allow them to use this tool. Of the US's fifty states, almost all now have enabling legislation that allows tax increment financing.

The use of TIFs in the US has grown dramatically since the 1970s. It is hard to calculate precisely how many TIFs operate there since not every state requires their registration, but the number has expanded exponentially, especially over the past decade. Illinois, which had one TIF district in 1970, now has over 900 (including many in Chicago, but also including one in the town of Wilmington, population 129 – an indicator of how TIF has spread). A moderate sized city like Janesville, Wisconsin – a town of 60,000 – has accumulated twenty-six TIFs.

The rapid expansion of TIFs has been driven by a number of factors. These include a reduction in Federal funding available for redevelopment activities and an administrative transference of urban policy to lower level government. State-imposed caps on property tax collections and limits on the amounts and types of city expenditures have also caused local governments to adopt funding strategies like this.

Until the 1990s, most states reserved TIFs for areas that could be described as 'blighted', based on criteria set out in statute. But, as with eminent domain (compulsory purchase), the definition of blight for TIF purposes has been dramatically expanded. In 1999, for example, Baraboo, Wisconsin, created a TIF for an industrial park and a Wal-Mart supercenter that were built on farmland. The blight label was based on a single house in the district that was uninhabited. In recent years, sixteen states have relaxed their TIF criteria to cover affluent areas, 'conservation areas' where blight might occur someday, or 'economic development areas', loosely defined as commercial or industrial properties.

The reasons for loosening the criteria for establishing TIFs appear to include competition between states and neighborhoods for development, and the fact that municipal bodies have realized that areas with higher property values can generate more tax revenue to pay off development bonds.

How do you set up and operate a TIF?

A pre-requisite for creating TIF is the passage of enabling legislation which provides the necessary powers, and defines the criteria, under which TIFs can operate. In the US, this is a matter for individual states and, as a result, the enabling powers can vary significantly from across state lines. If TIF were introduced in the UK, the task of enacting enabling legislation would presumably fall to Parliament, and/or the devolved administrations in Scotland, Wales and Northern Ireland.

In the US, while TIF arrangements vary between states, once enabling legislation is in place the establishment of a TIF district usually involves the following steps:

- Interest in establishing a TIF might come either from a business or from the redevelopment arm of the municipal authority. The initiator of the proposal makes a case for the need to stem blight, and sets out redevelopment plans together with an estimate of the impact of the project on property values and tax revenues.
- A detailed study is undertaken to demonstrate that the district meets the criteria for setting up a TIF contained in the enabling legislation. The criteria generally spell out that the purpose of the TIF must be 'regeneration', and that the development envisaged within the proposed TIF would not be viable without the benefit of TIF status. The study also defines the boundaries of the TIF district.
- The next step is the creation of a redevelopment agency by the governing body of the municipality. The key initial task of the agency is to prepare a development plan for the proposed TIF area. A tax increment financing district is created by the adoption of plans both for redevelopment and for TIF. Redevelopment in a TIF district is usually required by statute to follow a comprehensive plan so as to avoid the emergence of a patchwork quilt of unrelated developments.

- Following designation of a TIF district, property taxes (and, in the US, sometimes sales taxes) within that district are divided into two streams. The first tax stream is based on the original assessed value of the property before any redevelopment, with the city or other taxing body receiving that money. The second stream is the additional tax money generated after development takes place and, as a result, property values have risen. Typically that revenue is used to pay off municipal bonds that raise money for infrastructure improvements in the TIF district, for land acquisition through eminent domain or for direct payments to a private developer for site preparation and construction.
- There has to be clarity about what happens if the second income stream is insufficient to meet the cost already incurred in connection with the infrastructure improvements. Existing TIF schemes offer different approaches towards the allocation of risk, some of which are discussed below.
- TIFs generally capture the increase in value within the district, including increases attributable to:
 - new development
 - overall inflation in property values unrelated to development
 - market effects that are attributable to the TIF development (proximity to a new development, in many cases, will increase the value of surrounding properties).
 - market effects that are unrelated to the TIF development (market values may increase through shifts in locational values, or for other reasons unrelated to the TIF development).
- Once the TIF district has been designated, the TIF and/or municipality need to start the task of marketing the area to potential developers.
- The revenues funding the proposed improvements can be generated in one of two ways:
 - Most commonly by selling bonds and incurring debt based on anticipated revenue streams. In this arrangement, the bonds financing the project are guaranteed by the anticipated revenues of the project (in which case, the investment is a speculative one for those buying bonds), or the general obligation of the city (in which case, the municipality and its taxpayers take the risk of insufficient tax increment to fund repayment of the bonds). Investing in the bonds is rendered more attractive because of their exemption from federal taxation. A bank plays the role of trustee in this arrangement; for the duration of the TIF, taxpayers may be directed to send all, or part of, their rising tax payments to the trustee rather than the usual taxing bodies. The trustee then forwards the payments to the bondholders.
 - In a 'pay-as-you-go' arrangement in which the revenues are spent as they are received without incurring debt. The practice in Minnesota, for instance, now is not to use bonds, but instead expect developers to pay the costs, and to be reimbursed as increments become available. This approach shifts the 'capitalized interest' costs to the developers. In some cases, the city or development authority absorbs the cost by advancing its money (e.g. from another city or authority fund) until it can be reimbursed with the increments. If the city accepts lower or no interest on these advances, it is using these funds to assist or subsidize the development.

- The extra property tax revenue generated within a designated area is usually deposited in a special fund which is then used to pay for public improvements within that area. Once the cost of the redevelopment is met and associated debt repaid, the 'ring fencing' of the additional property taxes is removed and the property taxes can be spent anywhere in the local authority's area. The length of time the taxes are diverted to pay for the bonds can be anywhere from seven to 30 years.
- Typically, a locality issues bonds to purchase or acquire by eminent domain several parcels of blighted property, clears the land, prepares it for sale by installing water and sewer improvements as needed, and sells or gives it to a developer at less than the locality's cost. This is known as a 'land writedown'. The bonds' principal and interest are paid by the tax increments, which are dedicated to that purpose.
- Many of the above processes are subject to extensive public consultation. It is vital that the proponents of a TIF obtain political buy in as well as that of neighborhood groups and local business leaders.

Dealing with risk

Risks arise with TIFs when the expected revenues from property taxes, or other revenues, do not materialize within the timescale envisaged, and so there is insufficient money to pay bondholders. The way in which those risks can be allocated between bondholders, municipality and developers have been touched on above. Ways of limiting or mitigating risk, therefore, are important considerations within TIF schemes. Some of the ways that this can be done include:

Rigorous feasibility studies

A rigorous feasibility study by an independent consultant of the revenue stream is needed to support the bonds is essential. This needs to address all issues that might impact on the timely receipt of TIF payments.

Issuing a bond as close to the completion date as possible

Bonds may be issued up to three years ahead of the completion of a project and the flow of tax increment revenue. The issue of a bond at such an early stage means that the risk factors are greater (assuming that bondholders are taking risk on insufficiency of tax increment) and hence the bond will accordingly carry a higher rate of interest than say, a normal municipal bond. A portion of the proceeds from the bond will also typically have to be applied to finance the interest cost during construction. Issuing a bond closer to the completion date is therefore advantageous as it may significantly reduce both the perceived risk of insufficient tax increment and the financing of the interest cost during construction.

The use of complementary special assessments

When TIF revenues are used to support a bond issue, bondholders are at risk of not receiving a bond payment if a delay occurs.

The increasingly common practice in the US is for this risk to be mitigated by what are known as 'special assessments', which can be imposed by a vote of residents or property owners within a district, and in some cases

can cover all of the project costs. The cost of the improvements needed is distributed among all the properties in the district according to each property's share of project costs. Unlike TIFs, special assessments do not rely on assessed value growth. To the extent that if construction occurs and TIF revenues are generated, then TIF revenues can be used to reduce the amount of special assessment a property owner pays that year. An example of how this works is given in the *Tax Increment Finance Best Practice Guide*, published by the Council of Development Finance Agencies and the International Council of Shopping Centres:

"A TIF district and a special assessment district are created with coterminous boundaries to support the development of a new mixed use project.

TIF improvements in the amount of \$10,000,000 are to be financed via bonds. It is anticipated that the project will begin generating incremental property tax of \$1,250,000 per year beginning in 2010, and that a bond payment of \$1,000,000 per year will be made using those revenues. A special assessment district is imposed which sets up special assessments for the same improvements in the amount of \$1,000,000 per year, divided among the property owners within the district.

Construction delays result in TIF increment in 2010 of \$625,000, not \$1,250,000. In this year the special assessment contributes \$375,000 and the TIF contributes \$625,000 towards the bond payment. In 2011, when the project is complete and the full \$1,250,000 in increment is generated, no contribution of special assessment payment is needed to pay bondholders."

As the example illustrates, the special assessment is used to effectively guarantee the payment of principal and interest to bondholders. By putting the special assessment district in place at the outset, that guarantee should enable bondholders to take a view on the risk of delayed or insufficient tax increment.

Developer financing

The use of pay as you go arrangements has been discussed above. However, the way that this operates can take many different forms.

In those cases where it is feasible, developer financing can be an alternative to TIF-backed bonds, and an effective way of reducing or eliminating risk on the part of local government. Such financing works on the basis that a developer takes a 'promise to pay' note from the relevant local government body or TIF district, and is reimbursed for the project costs over the life of the note. The note is tied to the amount of tax increment generated on an annual basis. Where this approach is used, risk associated with the delivery of tax increment is passed on to the developer (who may, in turn, recognize that additional risk in his pricing).

What are the advantages and disadvantages of TIFs?

Advantages

Those involved in a TIF may see a range of benefits depending on their particular perspective:

- Elected officials may see it as a way to raise money for redevelopment painlessly, without having to deplete general revenues or accept funding from central or higher level government with strings attached. They will also take into account the fact that they will enjoy higher property tax revenues when the bonds are retired.
- Developers may see it as a way for the city to make a commitment to redevelopment through public improvements or through write-down of the cost of land; they have some of their infrastructure needs paid for, which in some circumstances could be the equivalent of a tax reduction.
- Private investors have a tax-exempt bond that generates tax-free returns.
- Residents and homeowners may see it as a way of funding redevelopment from taxes collected in the redevelopment district itself, without raising their taxes (although those in the TIF could be liable in some cases for a special assessment).
- Property owners in the district may see their property values rise after the development occurs.

The general benefits of TIF include:

- Analysis of those localities using TIF programs indicate it is a successful method for generating revenues for blighted areas.
- Public improvements can be created without increasing the burden of property taxes on existing tax payers, as TIF enables local authorities to use funds that would not have been generated without the TIF district.
- As well as stimulating economic activity within the TIF district itself, a TIF might increase economic activity in surrounding areas, which will be taxed at full value.
- As TIF is a locally administered programme that has relative autonomy from central government intervention, it fits in well with the principle of devolving more power to the local level. It can provide a local solution for funding economic development in an environment in which funding from central or regional government may be diminishing. In short, TIFs can be an effective way of empowering local communities.
- The redevelopment agency usually provides a comprehensive plan for the TIF district.
- There is little evidence of dead weight: without TIF, some good projects may have gone ahead, but the scope of the development and scale of impact would not have been as comprehensive. TIF is widely acknowledged as being a prime reason, for instance, for substantial investment coming back into Chicago (though displacement effects can occur, as seen in Chicago's North Loop).

Disadvantages

Possible disadvantages with TIFs include:

- TIFs may not necessarily create new jobs, but simply move existing jobs into new facilities. This criticism does, of course, apply to almost any type of area based regeneration vehicle, such as enterprise zones.
- Borrowing against projected TIF revenues may be overly optimistic, and may lead to financial problems if growth does not match projections. Although not a big problem in most cases, the legal and financial uncertainties resulting from a default could create serious problems for a community. Clearly, the potential impact of insufficient TIF revenues depends on how the risk is allocated as between investors, the municipality and the developer.
- Residents in the city who are not included in or are not near the TIF district could be perceived as losing out under the system. Since the increased tax receipts do not go to the city, any increased service needs in the targeted area may have to be financed by non-district residents and businesses through increased taxes.
- The TIF district creates another level of local bureaucracy. TIF financing also limits the power of local elected officials to make decisions about use of public funds.
- Originally used to help revive blighted or depressed areas, TIFs now appear in affluent neighborhoods, subsidizing high end housing developments, big box retailers and shopping malls.
- Since most US cities are using TIFs, businesses can play them off against each other to boost the handouts they receive simply to operate profit-making enterprises. Now that TIFs are so widespread, cities find it hard to attract new development without tax breaks.

Could TIFs work in the UK?

The rapid spread of the TIF approach in the US and the fact that other countries are experimenting with TIFs demonstrates that it is widely seen as an effective tool with a proven track record. Overall, TIF schemes in the US have generated billions of dollars of investment – creating more jobs, more affordable housing and better public spaces.

So could TIFs work in the UK? If properly regulated, TIF could potentially empower local communities and help them attract the private sector resources that can deliver change.

Some important lessons for the UK include the following:

- A key attribute of the use of TIFs in the US has been the adaptation of the concept to suit particular local needs. There does not have to be a one size fits all approach, although certain basic requirements must be present to give TIFs credibility. If TIFs were to be set up in the UK the retention of a good degree of flexibility

in their operation would seem to be desirable but there would be a need to avoid the introduction of TIFs in scenarios which are clearly inappropriate.

- Getting the enabling legislation right is essential. TIF works best when it observes two key factors: that there must be a regeneration need sufficient to justify a TIF, and that regeneration would not be feasible without the kind of help that a TIF can provide. The latter requirement is often described as the 'but for' rule - in other words, it has to be demonstrated that private funds are insufficient and development could not be realized without TIF. The main criticism of TIFs in the US usually arises as a result of departures from these rules. It is important not to dilute the value and brand by applying TIF to mainstream development that would happen anyway. Any scheme in the UK would have to guard against abuse by having a transparent assessment of the viability of development without a TIF.
- The initial viability analysis is crucial in establishing whether there is a case for a TIF, and that expectations of development and resulting tax increment are realistic. It is essential, therefore, that the right expertise is deployed at this stage. This might involve a role for public audit.
- A TIF needs to have a comprehensive development plan so that piecemeal and uncoordinated development does not take place. In particular there needs to be clarity about what infrastructure is going to be provided.
- The relationship between the TIF and the local authority must be harmonious. TIFs must be established with the full backing of the relevant local authority. As a TIF is a long term project it would also be advantageous to seek cross-party support.
- TIF relies on strong economic conditions and is predicated on borrowing - typically via a bond issue - against assumed future economic growth. TIFs do better when the economy is buoyant and development can be attracted more readily. Although we are currently in an economic downturn it could be a good time to put enabling legislation in place so that local authorities were in a position to use TIF to stimulate regeneration (and support the wider recovery) when conditions begin to improve.
- TIF money needs to be spent on infrastructure investment that is most likely to encourage greater private sector investment. This is likely to include public transport links, roads, flood defences, utilities and other essential infrastructure.
- A TIF could simply collect property tax revenue generated by new construction in a designated area. Alternatively, it could capture both revenue from new construction and additional revenue generated by the enhanced value of existing development (whether attributable or not to the improvements undertaken) within the TIF district. The latter approach would usually be more appropriate as more revenue would be generated and it would also underpin the concept of regenerating the whole district. It may also have the virtue of greater administrative simplicity.

- As TIF is intended to capture the additional tax revenue flowing from enhanced property values it would be an advantage if the practice in the UK was to have annual valuations for local taxation purposes. In the absence of such annual valuations, other arrangements would need to be made to record increases in value.
- A further problem in the UK is the current inflation cap on rate increases. The continued operation of this cap might prevent increases in property values within a TIF from being fully translated into additional revenue and this could, therefore be an impediment to creating TIFs. This is an issue that would have to be addressed in any proposal for introducing TIFs in the UK.
- As the tax bases of local authorities in the UK are currently very narrow, the Treasury would have to devolve greater financial powers to them unless, of course, it was willing to underwrite any loans that local leaders were to take out. The issue of bonds is usually a key part of a TIF scheme. Whilst HM Treasury has raised objections in the past to proposed bond issues by local authorities, there is already experience in the UK of local authorities issuing bonds. In April 2005, Birmingham City Council proceeded with a £215 million bond issue to refinance old NEC debt and replace it with new City Council bonds. The new bonds were listed on the London Stock Exchange and the deal provided funds to redevelop and refurbish the National Exhibition Centre, one of the UK's leading exhibition and conference venues.
- There needs to be clarity about the allocation of risk so that it is clear where the liability falls if the expected additional revenues do not materialize, and so the cost of improvements carried out cannot be met in the way intended. The UK could take a prescriptive approach or a more flexible approach that would permit deals to be done with risk being carved up in different ways.
- However, 'pay-as-you-go' schemes appear to work successfully in many American cities and the application of this approach should also be explored.
- TIF may not be the sole means of supporting incurred debt. Other funding sources from central and local government (as well as revenue raised from CIL, etc) may also need to be utilized.

Do TIFs offer more than other area based regeneration vehicles?

The UK has seen a number of vehicles with area based regeneration objectives similar to those of TIFs. Some of these have been concerned simply with improved co-ordination of sources of funding, and the better joining up of regeneration and economic activity. Others, notably Enterprise Zones (which operated between 1981 to 2006), have offered tax breaks (freedom from development land tax, exemption from rates, 100% allowances for corporation and income tax purposes for capital expenditure on industrial and commercial buildings), and simplified or speeded up planning arrangements.

Enterprise zones were generally seen as effective vehicles, stimulating activity in many areas suffering from long-term decline. TIFs share some similarities with Enterprise Zones, but they offer a different and more direct means of enabling the upfront provision of infrastructure.

Many different kinds of area based regeneration strategies have been pioneered in the US. The longevity, popularity and continuing spread of the TIF concept, however, suggest that it is seen as the most valuable and productive approach. However, even in a city such as Chicago – which with its 130 TIFs is often seen as a prime exponent of the TIF approach – TIFs are not seen as the only legitimate approach.

Other area based approaches used in Chicago include:

- Special Service Areas, which allow a group of taxpayers to agree to a small increase in their tax rate in exchange for control over the funds for purposes such as joint marketing efforts, security and small-scale capital improvements.
- Empowerment Zones, which provide incentives for businesses to expand within a number of designated 'clusters', including wage credits, tax deductions on property owned within the Zone and tax exempt bond financing to help pay for expansion projects.
- Enterprise Zones Areas, which are designated by the city and certified by the state to receive tax incentives and other benefits, including sales tax exemptions, property tax reduction, financing assistance, real estate tax exemption, investment tax credit, state jobs creation tax credit and utility tax exemption. There are currently six Enterprise Zones in Chicago.

The message, therefore, is that TIFs do not offer the only approach to area based regeneration but can be an effective part of a suite of measures aimed at achieving this objective.

Conclusion

In their report, *Urban Renewal in Oregon* (2002), Johnson and Tashman summed up TIF as a “fabulous tool that must be used carefully.”

One of the best recent studies of TIFs was carried out by the City of Calgary, which focused on the TIF experience in three American cities: Portland, Chicago and Denver. Its conclusion accurately sums up the strengths and weaknesses of TIFs, but broadly concludes that, if used in the right way, TIF can be a powerful tool:

“There are varying opinions on the effectiveness of TIF and viewpoints on how it should be used.

To some, TIF is seen as a flexible, self-financing tool that allows communities to finance long-range urban renewal projects and leverage other funding (Johnson and Tashman 2002). Others feel that TIF has been overused, or inappropriately used, which has led to diminishing returns to taxpayers in cases where private funding should be used (Haulk and Montarti 1999). Even TIF critics, however, generally support the use of this tool in circumstances where the elimination of blight is truly the goal, and where development would not happen but for the use of TIF.

The challenge and opportunities offered by TIF appear to rest in the details of how it is implemented. Cities such as Portland, Denver and Chicago have developed and adapted TIF over the last fifty years and the City of Calgary can learn much from this US experience.”

The message for the UK is that, if used appropriately, TIF has the potential to be a powerful tool for achieving regeneration.

Introducing TIFs in the UK would involve overcoming some difficult hurdles, but none which are insurmountable. Moreover, TIF would also appear to fit well with current political agendas that emphasize the need for greater local empowerment.

The British Property Federation feels that it is time that this approach was tried in the UK, and that the most appropriate starting point would be to set up a small number of pilot schemes.

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