Tax Increment Finance: A Success-Driven Tool for Catalyzing Economic Development and Social Transformation

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In the wake of an economic downturn, many cities are left with sites, projects, districts, or entire urban cores requiring redevelopment. The need for social improvements such as community centers, school rehabs, and parks has also become a critical development challenge. However, the ongoing risks of the development market require communities to be even more diligent and aware when entering into the use of public financing mechanisms such as Pay for Success (PFS) financing. One such mechanism, tax increment finance (TIF), has the potential to forge a new path for communities to fund development projects on the basis of their success.

What Is Tax Increment Finance?

TIF is a targeted development finance tool that captures the future value of an improved property to pay for the current costs of those improvements. This mechanism can be used to finance costs typically pertaining to public infrastructure, land acquisition, demolition, utilities, planning, and more. TIF funds have also been used to help support community amenities such as parks, recreational facilities, schools, and network infrastructure.

TIF can focus attention on a problematic area and catalyze development that addresses both the economic needs of a community and the quality-of-life advancements that improve cities. Dozens of TIF projects have been introduced throughout the country, including the University North Park project, which adds both mixed-use development and a beautiful park to Norman, Oklahoma, and the "Green Corridor" project, which aims to create a business park as well as to clean and connect waterfront public spaces in Baltimore, Maryland.

The TIF process begins when the community establishes the TIF district's geographic boundaries. Next, the initial value of all land within the district is assessed, and the current value of property (or other) tax revenue is established as a baseline. As development occurs and revenue from property taxes rises, the increase–or increment–above the baseline is used to pay debt service for the improvements made to the district. In this way, municipalities are able to build infrastructure and incentivize development without raising taxes. In fact, only the new tax revenue generated by the development is used to finance the improvements, thus creating a sustainable pool of resources for the project.

The benefits of this model have made TIF a popular development finance tool, particularly for addressing blight and promoting district-oriented development. TIF is currently authorized in forty-eight states and the District of Columbia and is employed by cities of all sizes. In the most creative places, like Chicago, Illinois, and Columbus, Ohio, TIF is being used to develop both private enterprise and community assets.

TIF is designed to effect both physical and social changes in a community. In fact, the best TIF projects are public-private partnerships in the truest sense, where developers and investors receive incentive payments only if the project is successful. This model is called "pay-go" and implies that as the project moves forward successfully, the community pays for its share of the related and financed infrastructure. The "pay-go" model is used throughout the country and allows communities to continue to invest in infrastructure while limiting potential risk from project challenges.

An example of this financing model is the Shops at Worthington Place in Worthington, Ohio. This nontraditional redevelopment of an obsolete mall is being financed using the "pay-go" model over the course of the next twenty years. As the developer makes improvements to the mall, the city reimburses the developer for qualified infrastructure improvements. The city only pays as estimated tax revenue projections are achieved, making this arrangement a true win-win project for the city and the developer. The project has achieved early success and has spurred a second, new project adjacent to the mall, catalyzed by the initial investments from the developer and the city.

What Makes Tax Increment Financing Successful?

TIF can be effective for addressing blight and promoting development, but this is not a given. The nation's newspapers are filled with stories of both successful and unsuccessful uses of TIF. Unfortunately, these articles rarely indicate (at least, not explicitly) what separates the good TIF districts from the bad.

Much of the time, unsuccessful TIF districts are the result of insufficient awareness or transparency. In other cases, the project needed additional support or planning on the financial side of the equation. Successful operation of TIF districts requires attention to both project financing and best practices. TIF districts also need to be rational and entail a commitment from both the public and private partners to the transaction.

Best Practices in Tax Increment Financing

Best practices are important in the use of any development finance tool, but this may be particularly true for TIF. Once property (or other) taxes have been frozen and any TIF bonds (revenue bonds issued and supported through debt service payments by the future tax increment generated by the new development) have been issued, revenue collected from the TIF district has the potential to become a sore point among community stakeholders, including area residents, school districts, and others. Following best practices in creating and operating the TIF district can help ensure that the community remains committed to the project.

The first area of TIF best practices is related to public policy and statutes. For example, a TIF project should be clearly eligible according to the state's authorizing statute. In most cases, in order to ensure appropriate use of tax revenue, the project should remain viable even if it did not receive any TIF assistance. The project should yield a positive net gain for the community.

The second area of TIF best practices is focused on the mechanics of the project. Identifying the experience and financial history of the developer is a crucial early step. The municipality and developer should determine up front when TIF funds will be needed and whether the project will require TIF bonds. In assessing the financial viability of the project, consideration should be given to whether the development or redevelopment has a high likelihood of maintaining an enduring presence in the community.

The third–and often forgotten–area of TIF best practices is community support and buy-in. The municipality should identify the project's broader stakeholders, which include neighborhood groups, business leaders, school districts, and elected officials. A plan for communicating the importance of the project, as well as information on how the project will be financed, should be developed and executed.[1]

Pairing Tax Increment Financing and Other Development Finance Tools

Unfortunately, strict adherence to best practices does not always determine the financial viability of a project, and TIF alone may be insufficient or inappropriate for some or all of a project. This may be the case when some particular problem with the area–such as environmental damage or acute poverty–causes a project to have particularly high initial costs or long-term risk. In such a case, an additional development finance tool may be necessary to attract investors, complete a project, or lower the cost of TIF bonds.

For example, consider a property blighted by environmental damage caused by a previous owner. The high initial costs and risks of redeveloping this property may make TIF bonds less than ideal for at least the first phase of redevelopment. Brownfield finance programs may finance the site's cleanup costs to a sufficient level to make a later bond issuance on the property viable.

Brownfield programs, which are another targeted development finance tool, often pair well with TIF districts and projects. The US Environmental Protection Agency offers several brownfield programs, including a tax incentive and assessment grants. State and local development agencies also frequently offer support for brownfield cleanup. Payment-in-lieu-of-taxes (PILOT) programs, tax abatements, and grants are common forms of brownfield cleanup financing.

Regardless of the program type, brownfield programs help reduce the costs and risks of redeveloping properties blighted by environmental damage. Depending on the needs and wants of the community, the TIF district can be put in place before the cleanup or after it. This decision will have a significant effect on the district's frozen value–and therefore on the district's potential to generate TIF revenues. In either case, issuing TIF bonds after the cleanup risks have been borne out will likely result in a more favorable financing structure.

1 The Council of Development Finance Agencies (CDFA) works openly with community stakeholders and municipalities to position TIF projects for success.

Other TIF projects that may require additional financing are those that take place in districts encompassing low-income census tracks. These projects may be considered particularly risky, as a financial analysis could well indicate that businesses will be reluctant to invest in such areas. In these cases, an investment tool such as the New Markets Tax Credit (NMTC) Program could be paired with TIF redevelopment to make low-income areas attractive to stakeholders, including investors, businesses, developers, and nonprofits.

The NMTC Program is designed to incentivize investment in businesses located in low-income census tracts. Receiving financing for a qualified project also requires working with a community development entity that has received a tax credit allocation. A TIF district covering a blighted area may well meet NMTC requirements.

The benefit of the NMTC Program for a TIF district is that the tax credits can provide an additional source of equity for a project that costs more than TIF bonds alone can bear. TIF revenue can be put toward the related public costs of infrastructure, while developer and tax credit equity can go into the bricks-and-mortar development to be located within the district. These two programs may work particularly well in states that strictly limit the use of TIF revenue to infrastructure costs alone.

Getting the Most out of Tax Increment Financing

Although complicated and occasionally challenging to implement, TIF has much to offer communities and businesses looking to redevelop sites that are neglected or otherwise blighted. Atlanta has used TIF to redevelop the entire BeltLine transportation corridor surrounding the city; Washington, DC, has used the tool to facilitate redevelopment and establish a popular new museum; and communities throughout the country have used TIF to add business parks, repair blighted properties, and improve parks. These communities have all incorporated a variation of the "pay-go" model, paying for success as the projects prove successful.

Economic development finance agencies should utilize TIF as part of their development finance toolbox and promote the benefits of this tool to their constituents. By following best practices and creatively pairing district revenue with other financing tools, communities can employ TIF to effectively provide targeted redevelopment. And ensuring that developers adhere to PFS principles will allow communities to reward positive development and protect against challenging economics.

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