A Primer on TIF: What It Is, Why It's Controversial November, 2006

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Tax increment financing, universally referred to as TIF, is a means to provide government financing to private investment projects. While it is used in over 40 states, this primer will focus on the use of TIF in Missouri. Briefly stated, TIF is a mechanism whereby a government dedicates future tax revenues to finance a project that is expected to increase those revenues. TIF projects are financed with either long-term debt (bonds), short-term debt (notes), or on a pay-as-you-go-basis. When notes or bonds are issued, they are repaid by setting aside a portion of the increased tax revenues (the "tax increment") for that purpose. The tax increment is used to directly reimburse some of the developer's initial costs or associated public infrastructure such as wider roads, new interchanges, sidewalks, etc.

Why is TIF important?

1. Because many local governments are bumping up against their constitutionally-mandated maximum tax rates, a successful TIF project provides a source of increased tax revenue for a jurisdiction, though it may reduce tax revenue in other jurisdictions.
2. TIF represents an increase in the value of government subsidy compared to other methods commonly used, such as tax abatement, for a given nominal value of the subsidy. That is, a $10 million TIF can be more valuable to a recipient firm than a $10 million tax abatement, because if the TIF is structured to float bonds, The developer receives more of the money sooner with TIF than with tax abatement. In technical terms, the present value of the TIF is higher. (See Glossary #16.)
3. The actual geographic pattern of use of TIFs suggests that it may contribute to urban sprawl, by stimulating or speeding development in suburbs that would not have occurred without the TIF. (See footnote #1.) While it was originally designed for economically deprived areas, TIFs are at present more commonly used for suburban development, often in quite prosperous communities.
4. As with any investment subsidy, there are potential efficiency, equity, and even environmental drawbacks to the use of TIF.
5. Controversies over adoption have occurred as citizens of some municipalities have attempted to force referenda on TIF adoption, sometimes successfully, sometimes not.
6. There are debates about what criteria should be used for the designation of TIF redevelopment areas.

What is TIF?

The use of the term TIF, which focuses on financing, often hides the more important fact of *what* a government is financing with TIF: a subsidy to a private company**.** While TIF funds are used in part for general-purpose infrastructure, it is much more common for the funds to be used for site-specific infrastructure and non-infrastructure costs such as land acquisition. Subsidies can be good or bad tools of public policy depending on the circumstances, but it is important to recognize that when we discuss TIF, what we are really discussing is subsidy policy. TIF, then, should be seen in the broader context of economic development policy, as one of a number of subsidy tools at a government's disposal. When TIF bonds are used, the funds benefit the recipient firm as soon as eligible expenditures are made and the project is completed. Thus TIF subsidies are a type of direct grant, although they do not show up as part of a municipality's budget. In general, the larger the project, the more likely it is that such borrowing, using TIF bonds, will be used.

We can define TIF as an off-budget direct grant to a private firm that is paid from future increases in tax revenues.

What TIF isn't:

Although the repayment of TIF bonds is based on future tax revenues, TIF is not considered a type of tax abatement. This is true for quite different legal and economic reasons. From a legal point of view, the TIF beneficiary is considered to have paid the full amount of taxes that are due (see footnote #2.), even though the TIF recipient may get back a significant amount of those taxes. The government providing the TIF may use some of that revenue to repay TIF bonds or to reimburse the developer for certain other types of expenditures.

From an economic standpoint, a TIF project that floats bonds and repays them with future tax revenues differs from a tax-abated project because the bond proceeds are immediately made available to reimburse for eligible expenditures as soon as expenses are incurred and once the project is completed, rather than paid over a number of years as taxes become due. Thus, the present value of a bond-using TIF is substantially higher than that of a tax abatement with the same nominal value.

TIF Nuts and Bolts

TIF is legally enabled by the Real Property Tax Increment Allocation Redevelopment Act (Chapter 99, Revised Statutes of Missouri). It authorizes governments to fund redevelopment projects in geographically defined areas that meet certain tests of economic distress. Redevelopment areas can be designated "blighted," "conservation areas," or "economic development areas," with respectively less stringent tests of economic need. Indeed, for an economic development area, a municipality need only find that redevelopment is in the public interest, without any evidence of economic distress. Any of these three can be used for the creation of a TIF project, but TIF based in an economic development area can only be used to fund public infrastructure projects. While not technically correct, in common parlance all three designations are often referred to as "blighted." According to the Missouri Department of Economic Development's 2004 Annual Report on TIF, the most common designation used was "blighted," with 123 projects, followed by 48 conservation area projects and 16 economic development area projects. In 16 projects, more than one designation was used.

A local jurisdiction (county or municipality) wishing to use TIF establishes a TIF Commission, with members appointed by the County, the municipality, the school district and other local taxing districts (fire, library, sewer, etc). (See footnote #3.) The sponsoring jurisdiction will then conduct a study (or hire a consultant for this purpose) to establish whether a redevelopment area might be eligible for TIF and, if so, issue a Request for Proposals or RFP. The TIF Commission is required to hold a public hearing prior to voting on approval. Decisions of the TIF commission are advisory only. Adoption of a TIF is ultimately the sole decision of the city or county council, and is done via an ordinance. Such ordinance must include "findings" that the redevelopment area meets the criteria for one of the three designations above, that it has not received private investment and would not do so without the TIF (the so-called "but-for" test), that it conforms with the city's comprehensive plan, that a relocation plan has been drawn up, and that the TIF will not fund a gambling establishment. However, the 2001 lawsuit over West County Center showed that all a city has to do is say these things are so, without outside proof. Thus, the criteria for making these findings are not very restrictive.

Once a TIF ordinance is adopted, it is common practice for the city to issue short-term notes to finance the project (normally bought by the developer as an incentive to bring the project to fruition, though arguably this is a further subsidy). When the project generates incremental tax revenue, long-term bonds are then sold to refinance the TIF and pay off the notes. While this is a common pattern, especially with larger TIFs, cities will often use a pay-as-you-go approach to financing the TIF, or some mixture of borrowing and pay-as-you-go.

Distribution of TIF funds:

A base year is established during the planning process. Half of sales tax revenue (and other economic activity taxes or EATs) and all of property tax revenue above the base year (all of which are designated as Payments in Lieu of Tax or PILOTs) is available for reimbursing eligible project costs and/or repaying the bonds. Because these revenues normally are distributed to a number of governmental entities such as the school district, county, etc., all of the taxing districts are affected by TIF decisions. Since these costs are paid for only by the incremental taxes collected into a Special Allocation Fund, they are not considered to be a general obligation of the municipality and are not subject to the requirements of the Hancock Amendment. PILOTs can be paid into the Special Allocation Fund -- and TIF bonds can be issued -- for as long as 23 years, although many bonds are repaid sooner.

An Example of How TIF Works:

This example is based on revenue projections for the Crestwood Point TIF project prepared by the City of Crestwood's consultant, PGAV. It has been simplified by including only real property tax and sales tax, while excluding such smaller “economic activity taxes” such as utility tax, the real property commercial surcharge, and personal property tax.

Real Property Tax:

equalized assessed value (EAV) of property prior to development	$934,330
equalized assessed value (EAV) of property after first year of development	$2,246,400
Change (i.e. increment) in assessed value between pre and post development :	$1,312,070
PILOT in first year after development = Tax rate of 4.987% x $1,312,070 =	$65,433

The entire real property PILOT is applied to reimburse expenses or repay TIF bonds.

Economic Activity Taxes (EATs):

Pre-development sales tax revenue:	$143,719
Post-development sales tax revenue:	$461,655
Incremental EATs:	$317,936

Half of incremental EATs is applied to reimburse project costs and/or repay TIF bonds. The other half is available to the taxing districts. The city’s share can sometimes be used to pay off the bonds sooner, or transferred to other taxing districts (usually the school district) to buy their agreement.

Part 2: Good and Bad Uses of TIF

As mentioned above, TIF is only one tool available to economic development officials. TIF, tax abatements, loans, on-budget grants, and free infrastructure all aim to attract investment by reducing the cost to the investor. This results in a competitive dynamic that takes place internationally, between states, and within states.

By using present or future tax revenue to attract investment, governments may have to resort to three alternatives to offset the funds committed thereby: 1) Raise taxes on individuals (personal income, sales, property tax, etc.); 2) Borrow money by floating bonds; 3) Cut spending on existing programs. (In the case of TIF, this dilemma is often handed off to the schools and other affected district(s).) Government revenue can also be reduced by the activities of other governments: the building of Mills Mall in Hazelwood likely has reduced the sales, and hence sales tax revenues, from Northwest Plaza in St. Ann. If governments react by building subsidized projects that draw tax revenue away from other jurisdictions, then both governments will have given away some of their tax base while doing little to affect the location of investment. Moreover, there are general problems caused by subsidy use that need to be addressed.

First, location subsidies are often inefficient. If a subsidy induces a company to locate somewhere other than its most efficient location for production or distribution (in the case of retail), the economy is less productive than it would be without the subsidy. If the subsidy goes to a firm for locating in the most efficient location, it was not needed to begin with. A study by economists Richard F. Dye and David F. Merriman (Journal of Urban Economics, 2000) found that northeastern Illinois municipalities adopting TIF actually reduced their economic growth rates (measured by property EAV), as faster economic growth within the TIF district was more than offset by slower growth outside the TIF district. In other words, TIFs had directed capital to less efficient locations.

Second, investment subsidies are given to owners of capital, but paid for by all taxpayers in proportion to their existing tax contributions. This will tend to make income distributions less equal than without the subsidy. From this standpoint, the use of TIF is unfair to average taxpayers who pay for benefits to richer investors.

Third, a number of subsidies are given to activities that are environmentally harmful. Subsidies to projects in wetlands (such as Mills Mall or the proposed Lakeside 370 project in St. Peters) are a clear example, but subsidies encouraging sprawl also harm the environment by increasing automobile and other forms of pollution even if the project itself is not directly polluting.

Given these potential problems, it is important to look at potential good and bad uses of TIF.

One important function of governments is to promote the economic well-being of its poorer citizens. A TIF can be one way of doing this. One good example would be Stout Industries in Jennings. This project maintained good jobs in a community whose income was only 69% of the regional average and had unemployment more than twice the regional average.

By contrast, using TIF to subsidize retail opportunities in a high-income area like Des Peres (West County Center) is clearly inefficient and had no compensating redistributive effects. The mall's owner had more than sufficient economic incentive to renovate it without subsidy, given its location in a high-income suburban area (according to the 2000 Census, median family income in Des Peres was $106,195 compared to a $61,680 county average, and a $53,844 regional average.

An example of an environmentally harmful TIF is the Mills Mall TIF in Hazelwood. This project displaced a number of residents who had not wanted to be annexed by the city (leading to a bitter fight, including two lawsuits), and was built in a wetland area near the Missouri River. In addition, much of the area had been farmland. (See footnote #4.) Finally, Hazelwood, while no Des Peres, had median family income of $52,656, according to the 2000 Census.

Part 3: Ways to Reform Current TIF practices

The key to reforming TIF abuses is to require objective measures of economic deprivation and need. This would return the law to its original purpose of helping poorer areas of the state. A number of proposals have been made along these lines. The East-West Gateway Council of Governments has offered proposals for comprehensive reform of TIF. It proposed that a redevelopment area would have to qualify for TIF in one of three ways: 1) Median income below 80% of that of the region; 2) Unemployment rate at least one and a half times the regional average; 3) Assessed value per capita of 60% or less of the county in which it is located.

There are other important aspects of TIF practice that require reform, several of which are covered in the East-West Gateway proposals. As the West County Center lawsuit decision showed, judges consider a municipality's required findings to be unchallengeable except in extreme cases. Yet the factual basis for findings of blight -- lack of private investment, and lack of prospects for private investment "but for" TIF -- often appear to outsiders to be quite weak. In

West County Center, for example, it is hard to believe that a shopping center in one of the wealthiest communities in the county does not have the economic incentive to renovate without subsidy. Thus, the East-West Gateway proposal would change the TIF law to make such findings specifically challengeable in court, and require governments to document findings with objective measures such as business licenses, etc.

Other potential reforms of the TIF statute would be (1) to require reimbursement of subsidies (clawback) if developers do not fulfill their promises under redevelopment agreements, (2) to require the cost-benefit analysis to take into account the effect of a TIF on other taxing districts outside the sponsoring jurisdiction, (3) to provide a financial disincentive to use TIF for retail purposes or convert farmland or open space to development, (4) to disallow TIF for developing in floodplains regardless of levee protection, (5) to allow citizens to vote on TIF projects, and (6) to establish minimum wage and job creation guidelines for TIF projects.

Appendix A: Footnotes

1. Studies in Minnesota and Wisconsin have both shown the contribution of TIF to sprawl.
2. Missouri case law has established that the company is considered to have paid its taxes in full.
3. There are twelve persons on TIF commissions in St. Louis County. When St. Louis County proposes a TIF, the commission consists of six county representatives, three representatives of municipalities in the county that have their own TIF projects, two school district representatives, and one representative of all other affected taxing districts. When a municipality within St. Louis County proposes a TIF, it appoints six members, the county appoints three, the school district appoints two, and one person represents all other taxing bodies for a total of twelve members. The City of St. Louis has a nine-member commission. The City of Kansas City has eleven members: six appointed by the City, two by the County, two by the affected school district(s), and one representing all other affected taxing districts All other counties have eleven-member commissions.
4. Loss of wetlands harms wildlife and reduces bio-diversity. Loss of prime farmland can lead to farming less fertile land and requiring greater irrigation.

Appendix B: Glossary of Major Terms

1. Tax Increment Financing (TIF): An off-budget direct grant to a private firm. It can be financed by revenue bonds (see below) or on a pay-as-you-go basis.

2. Economic Activity Taxes (EATs): Taxes which are based on the activity taking place at a particular location, in contrast to property taxes, which are unrelated to economic activity. The most common EATs are sales tax, utility tax and business license fees. Half of incremental EATs are deposited into the Special Allocation Fund.

3. Payments in Lieu of Tax (PILOTs): Funds paid by real property owners in a redevelopment area based on the increased equalized assessed value of the property resulting from the TIF project. These are deposited into the Special Allocation Fund.

4. Redevelopment plan: A city's plan to remove the problems causing an area to be eligible for designation as blighted, a conservation area, or an economic development area.

5. Redevelopment area: An area of a city in which conditions eligible for designation as blighted, a conservation area, or an economic development area exist, and which will be redeveloped using a TIF. It cannot occupy more than 10% of the entire area of a city.

6. Blighted area: An area in which a predominance of unsatisfactory conditions "retards the provision of housing accommodations or constitutes an economic or social liability or a menace

to the public health, safety, morals, or welfare in its present condition and use." (Chapter 99, Revised Statutes of Missouri, 1994)

7. Conservation area: A developed area in which at least half of the buildings are 35 years of age or greater and which may become blighted due to the existence of at least three unsatisfactory conditions such as abandonment, obsolescence, inadequate utilities, etc. (See Statute for the complete list.)

8. Economic development area: An area not meeting either of the previous tests but which is one in which a city determines that redevelopment is in the public interest to maintain or increase tax revenue, create jobs, or prevent an enterprise from moving to another state.

9. "But-for" test: The requirement that a redevelopment area has not received private investment and would not receive private investment in the absence of the TIF.

10. Equalized Assessed Value (EAV): The valuation given to property for purposes of determining the property taxes payable every year.

11. Special Allocation Fund: The fund used to repay TIF bonds or to reimburse the developer for eligible costs. It includes all incremental PILOTs and half of the incremental EATs generated by a TIF project.

12. Request for Proposals (RFP): An official notice by a government soliciting bids from the private sector to enter into a contract to provide goods or services to the government.

13. Bonds: Debt instruments issued by corporations, governments, etc. A bond with a maturity of less than one year is normally referred to as a “note,” whereas the term “bond” is reserved for debt with a maturity of over a year.

14. General obligation bonds: Bonds backed by the general revenues of the issuer.

15. Revenue bonds: Bonds backed by the revenue expected from a particular project. If the project does not generate enough to pay off the bonds, the bondholders lose money, and are not entitled to seek payment from the general revenue of the issuer.

16. Nominal value vs. present value: Ways of calculating the value of a stream of funds over time. The nominal value adds up the actual amount that will be paid each year without considering that receiving a dollar ten years from now will be less valuable than a dollar today. The nominal value of $1 million dollars a year for 10 years is simply $10 million dollars. Present value calculations discount future payments to account for the time value of money. For example, if one estimates that receiving a dollar a year from now is only as good as receiving 95 cents today, we would reduce the value of each payment by 5% per year. Thus, the present value of $1 million a year for 10 years would be $1 million + $950,000 + $902,500, etc., or $8,025,265.13.