Can Tax Increment Financing (TIF) Reverse Urban Decline?

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Abstract

To counteract physical decline, local governments have increasingly relied on a redevelopment tool called Tax Increment Financing (TIF). TIF allows municipalities to designate an area for improvement and then earmark any future growth in tax revenues from the area to pay for any economic development expenditures made there. The use of TIF is controversial primarily because of differing perceptions about its impact on property values. If TIF is responsible for property value increases, this tool may be a relatively inexpensive way to increase local wealth and grow the tax base, reduce property abandonment, and make inner city areas more attractive to private investors. If it is not, then this mechanism becomes a way of channeling resources away from the other functions of local government (such as public education) to subsidize development that might have taken place without its use. After describing the mechanics of TIF, the author explains why municipal use of incentives like TIF would or would not raise property values independent of other changes taking place within local land markets. She discusses research that provides empirical evidence to support both sides of the debate and suggests policy reforms that could encourage its more effective use in practice.

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Introduction

Persistently vacant land, failing commercial strips, and abandoned buildings are a source of both embarrassment and concern for local governments. They reflect a complex relationship between poverty and private disinvestment, which results in physical environments that may threaten safety and lack aesthetic appeal. These environments also tend to be fiscally unproductive, i.e., they do not generate enough sales and property tax revenues to pay for the municipal services consumed there.

To counteract physical decline, local governments rely on an arsenal of programs and policies. They use eminent domain to assemble land for private firms, issue tax-exempt bonds to fund below-market rate loans to developers, and install new infrastructure to enhance sites for development. Such interventions are often grouped together as place-based "economic development" strategies, and in the United States, they have been used at the state and local level since the early nineteenth century. These strategies are intended to encourage private investment in particular locales, setting in motion a cycle of new jobs, wealth creation, and the enhancement of the local tax base.

Given all of the responsibilities of local governments, economic development strategies can be very expensive to implement. Over the past three decades, federal support for such activities has contracted, and property tax revolts, resulting in tax and expenditure limits, have restricted the amount of revenue that local governments can raise from their property bases and through the bond market.

Increasingly municipalities have turned to a previously obscure mechanism to finance their redevelopment efforts. This mechanism, known as Tax Increment Financing or TIF, allows a municipality to designate an area for improvement and then earmark any future growth in property tax revenues to pay for the initial and ongoing economic development expenditures. TIF, which is known by different names in different states (for example, Redevelopment Areas or RDAs in California), is neither a new tax nor tax abatement; rather it is a way of using today the new tax revenues generated tomorrow from redevelopment activities. Developed in California in 1952 as a creative way to provide matching funds for federal grant programs, TIF is now used in 49 states and over one thousand cities. Seen as manna for cash-starved cities, this financing mechanism has become one of the most popular and powerful tools that municipal governments have for facilitating market-driven urban revitalization.

The more cities rely on TIF, the more the tool has come under scrutiny. Is TIF an important innovation that harnesses the power of property tax-based incentives to stimulate redevelopment that otherwise would not have occurred? Can TIF be used to turn declining neighborhoods into economically vibrant areas that create benefits which spillover onto surrounding areas? Or, is TIF simply another example of corporate welfare and the destructive inter-jurisdictional competition for tax revenue and private investment that jeopardizes the fiscal health of municipalities?

Most of the controversy hinges on the impact or lack of impact of TIF on property values. Local officials assume that lowering the private cost of development will automatically increase the attractiveness of these previously ignored areas, but sometimes these incentives are not effective. Moreover, many factors other than new development, such as inflation, cause property values to increase. If TIF does not raise property values, then this policy intervention may be a wasteful use of scarce tax dollars. Worse yet, TIF may not create new value but simply capture normal growth and divert it away from other public functions, such as education and safety, to economic development.

Although the stakes are high, TIF is poorly understood and often subject to misrepresentation. The following brief lays out the key issues so that readers can gain an understanding of the mechanics of TIF and the factors that may lead its success or failure as a redevelopment tool.

How TIF Works

Although the precise details of TIF legislation differ in each state, the underlying design is similar. In a typical state, the process is set in motion when a city designates an area for improvement (see also Weber 2003 for a detailed description of the mechanics of TIF). This area must be “blighted” – a term that has a long and controversial history given its association with urban renewal programs of the 1960s. In the local renewal ordinances and state statutes of this period, the definition of blight is vague; it is framed as both a cause of physical deterioration and a state of being in which the physical environment is deteriorated or impaired beyond normal use.

To prevent the indiscriminate use of TIF, state authorizing legislation sets out standards that define a "blighted area." These appear as checklists of features that impair values or prevent a normal use or development of property, including the presence of structures that do not meet building codes, obsolete platting of the land, and excessive vacancies or land coverage. The municipality, together with developers and consultants, must draft a study to demonstrate that the proposed area meets the state’s definition of blight, documenting the deterioration, the age of the building stock, zoning and land use designations, vacancies, and declining property values. In some states, non-blighted areas may be designated as TIF districts so long as they serve other legislated goals, such as industrial job creation.

States also require the municipality to demonstrate that the area in question cannot be redeveloped “but for” the use of TIF. This provision requires municipal officials to attest to the fact that (a) the redevelopment would not occur without public assistance; and (b) other available sources of incentives, such as a combination of bonds, abatements, and tax revenues, would not be sufficient to attract private investment. If the blight and but for conditions are met, a TIF district may be formed by municipal ordinance after notice is given and a public hearing is held to discuss the municipality's plan for redeveloping the bounded area.

TIF legislation grants very broad powers to municipalities that have approved redevelopment plans, designated project areas, and adopted TIF. Essentially, municipalities are given the power to engage in almost any kind of activity that they believe would encourage private investment and restore and enhance the property tax base of the blighted area. This includes using eminent domain to acquire property and combine small or oddly shaped parcels into larger lots that may be more marketable. They can relocate streets, install utilities, and construct buildings to improve the district and make it more attractive to business. They can provide below-market rate financing and other kinds of financial incentives to potential developers.

How will the city pay for such activities? As soon as an area becomes designated as a TIF district, the sum of the initial assessed values of the properties in the district forms "the base" against which growth will be measured. As private investment is attracted to the area, the assessed value of property and the taxes on it are expected to rise. The difference between the base value and new assessed value is the "tax increment" (see Figure 1 on page 13).

Instead of going to the municipality's general fund and to other taxing bodies with jurisdiction over the area (such as school and park districts), the tax increments are used by the municipality or TIF authority to finance any debt accumulated when making improvements. In most states, the lifetime of a TIF district is around 20 years. Therefore, the increase in the property values of the district over the subsequent 20-plus years will pay for the initial and ongoing economic development activities, while taxes on the base value of the properties will remain the same and will continue to be paid to the local taxing bodies. Although TIF district property is assessed and taxed at the same rate as property in the rest of the municipality, the district contributes less than its proportionate share to the municipality and other overlapping taxing jurisdictions since all incremental revenues generated there stay in the district. After the TIF district is dissolved, the property values revert back to all of the overlapping jurisdictions.

With TIF, tax revenues are committed as project expenditures *before* they are actually generated. Therefore, the municipality must find ways of paying for the up-front costs of those improvements that will make the TIF district attractive to new development. Municipalities rely on two primary methods of "front funding" expenditures from the expected increments. Under the first method, the municipality floats bonds for the total amount of the redevelopment, dedicating the expected tax increments to pay the debt service. The second method of front funding–commonly known as "pay-as-you-go"–requires the private developer to pay initially for the costs of the project. The municipality then reimburses the developer annually as it receives the incremental property taxes.

Because of its flexibility, this tool has enabled municipalities to channel funds to infrastructure improvement, industrial expansion, downtown redevelopment, historic preservation, and military base conversion. The city of Dallas, for example, used TIF to create the American Airline sports arena, while Washington D.C. is using TIF to revitalize its Gallery Place metro stop with a movie theater, residences, offices, restaurants, and shops. The city of Jackson, Michigan plans to use the proceeds of TIF bonds to pay for two public parking lots, environmental cleanup, and infrastructure work related to a site where the state's largest public utility is building a new headquarters. Smaller towns regularly use TIF to jumpstart aging main streets and finance industrial expansions. Unlike federally funded programs, TIF can be used for the wide range of projects that demonstrate financial feasibility and promise an increase in property values.

TIF as a Self-Financing Incentive

Good development projects should be able to find the land and financing they need at reasonable terms. Why, then, should local governments subsidize development, either by providing below-market interest rates or absorbing land preparation costs that would otherwise be borne by private developers?

Proponents of economic development argue that incentives like TIF will increase the wealth of metropolitan area by providing direct assistance to business. Such market interventions are necessary because the private market often fails to recognize the benefits of developing these blighted areas, benefits that may include net fiscal growth and reductions in unemployment for the entire city. In other words, economic development incentives are intended to compensate for the presence of market failures.

TIF often avoids the stigma of "corporate welfare" because of its self-financing design. TIF is designed so that subsidized development will pay for itself through taxes on the increased property values. TIF can only be considered self-financing, however, if the increases in property values within the district are attributable to TIF, i.e., they would not have occurred "but for" the incentive. If property value increases within a district are solely due to the municipality's public assistance, the cost to taxpayers is zero. They are simply foregoing tax revenues that they would not have had access to otherwise. In such a case, TIF appears to be a no-cost proposition because additional revenues generated by the new development would not have existed otherwise. TIF would therefore obviate the need for unpopular tax increases.

If, on the other hand, TIF has no effect on the value of property within the district and property taxes would have increased without its use (because of inflation or the attractiveness of the particular location), then this mechanism is not really creating new value. When TIF is used in areas that need no stimulus, it becomes a device for capturing revenues in areas rich in appreciating property and redistributing them from overlapping taxing jurisdictions. The potential for redistribution exists because taxes on any increase in the assessed property values of the TIF district go into a separate fund to pay for TIF activities while taxes on the base value of the properties remain the same for the designated lifespan of the TIF. In other words, much of the tax revenue foregone by freezing the value of properties in TIF districts would have been paid to county governments or to the school, library, or other special districts with jurisdiction over property in the TIF.

TIF and Property Values

Can market interventions like TIF really increase property values above what they would have been without public assistance?

There are many reasons, most of them supported by basic tenets of microeconomics, which lead one to believe that municipal use of incentives like TIF would raise property values. Creating new value requires developers to make risky investments, and they will only do so if prospective rents are sufficient or the cost of initial investment low enough to justify the risk. What TIF and other incentives do is lower the cost of the initial investments by providing things like land at reduced prices and free site preparation. This should increase the perceived profitability of a specific area and, therefore, increase demand for property within a designated area. If the incentives succeed in making an area more attractive for new investment, demand for property there will continue to increase and the price of land inside the district will be bid up – particularly if there is a relatively fixed building stock. Over the long term, the prices of wages, goods and services may be positively affected by increases in the price of land.

Increased demand for real estate should eventually lead to new construction that might not have been built in the absence of TIF. Vacant land and abandoned structures may be converted to productive use, and nearby properties may be favorably influenced by the "spillover" effects of the new development. Even if there are few opportunities for new construction, the density of existing buildings may increase through subdivision, upgrading, and renovation. Indeed, TIF districts across the country have experienced a tremendous amount of new construction. Shopping centers, hotels, office buildings, and residential complexes have all been built with the help of TIF-financed improvements. When TIF designation is tied to a particular development project, properties in the district often experience a strong, initial surge of demand due to the specific growth "shock," and property values may spike in the first few years of the TIF district's lifespan.

In the short term, property values are determined primarily by demand because of the time and regulatory constraints involved in constructing new supply. But as supply grows to meet demand, the rates of increase may taper off. To avoid flooding the market and depressing sales prices, developers gradually introduce different phases of their projects. In depressed areas, however, there is typically an abundance of underutilized land and abandoned property, i.e., there are few constraints on bringing new supply into the market. This is why, in truly blighted neighborhoods, increased demand may not lead to huge increases in property values. New developments in areas awash with vacancies may only result in small increases in purchase price, if they increase at all. In other words, the market response to TIF-induced demand will vary with the tightness of the housing market.

The magnitude of impact will also depend on how TIF dollars are actually used within the district. TIF is a catalyst for several different kinds of economic development strategies. Although TIF is the underlying financing mechanism, municipalities may use a combination of demolition, infrastructure improvements, low-interest loans, land write-downs, and site assembly in the actual TIF districts. Each of these strategies will vary in cost and, possibly, induce separate observed effects. For example, building demolition may have an initially negative impact on an individual parcel's value. The renovation of an existing structure deemed historically significant or the addition of new infrastructure may not create as large of a spike in property values as converting a parking lot into 100 units of new housing.

High-density industrial and commercial uses may induce quicker, steeper increases in property values than the development of a few new single-family homes. Moreover, the cost of the public services commercial and manufacturing projects consume typically pales in comparison to the amount of state and local tax revenues these uses generate. This is why, in many states, TIF was originally intended for use only in blighted commercial and industrial areas. Chicago, for example, began using TIF in the 1980s in those parts of the city that were negatively affected by deindustrialization and the relocation of business to regional malls. During the 1990s, however, many TIF districts were designated in predominantly residential neighborhoods. Even where cities invest in only industrial and commercial projects, there is a generally positive relationship between local business growth and housing prices. If TIF districts are successful at attracting commercial and industrial users, the residential market should reflect the enhanced desirability of these districts for living and working. Such a demand shock should raise the market value of housing, increase rents, and decrease vacancies.

The diverse uses of TIF would explain why it occasionally has a negligible impact on property values. Some TIF districts are not tied to specific projects. Without a development catalyst, it may take several years before property values increase. Or they may not increase at all – perhaps because the condition of land and building stock are too distressed to appeal to developers. It is important to remember that simply designating a TIF district does not imply that any public or private investment will actually take place there. In most cities, there are TIF districts have remained dormant for decades, generating no or very little increment.

Even if no new development actually occurs, the simple designation of a TIF district may increase property values because such an act signals to the private development community that investment is likely in the near future. In other words, developers and owners may be willing to pay higher prices for TIF property if there is a high probability that they will be eligible for subsidies and/or experience rapid appreciation because the area has been targeted for additional development and infrastructure. Land development is a generally speculative endeavor, and information about possible public investment in an area where there may have been little may be enough to pique market interest. Indeed, in many instances, property values in TIF districts have increased without any significant redevelopment activity or public investment.

Would Development Take Place Without TIF?

For these reasons, TIF has the potential to cause property values to rise. Nonetheless, other factors that have nothing to do with TIF may result in the same effect. Proponents of TIF tend to view the relationship between incentives and property values as one of "pure attribution. Municipal officials, for example, are quick to attribute all increases in value to economic development policies like TIF. Case studies conducted and commissioned by cities simply add up the increases in property value since the TIF designation and either state or imply that the TIF *caused* the increases. They point to TIF-funded parking garages and office buildings, public improvements, and demolitions as evidence of the tool's success.

Others interpret the relationship between incentives and property values as one of "pure capture." In other words, it is possible to view TIF as a device designed to capture tax revenues that would have occurred without this policy intervention. If property taxes would have increased without the use of this tool, then TIF becomes a device for appropriating revenues in areas rich in appreciating property. Municipalities and developers have an incentive to arrange TIF designation for areas that are expected to grow in the future. They may be tempted to designated areas with fast-growing property tax bases as TIF districts in order to capture incremental revenues from the other taxing jurisdictions. In many cases, properties within TIF districts were growing at or beyond the municipality's average annual growth rate *before* they were designated as TIF districts.

Moreover, it is likely that the tax increment reflects not just combination of new private investment and public subsidy but also the normal rate of inflation as well as potential spillover from projects that were finance without TIF. But municipalities will not to discriminate unless required to by law; they appropriate *all* tax revenues that exceed the base value.

Most previous research on TIF are case studies, which can not provide insight into what would have happened in the absence of TIF. They do not say much about how comparable districts that have not been affected by TIF have fared. Determining the causal effect of TIF, therefore, is complicated because of the need to "control," by reasonable assumption or appropriate statistical technique, for what would happen *without* TIF.

Those studies that do use appropriate methodology have found evidence to support both the "pure attribution" and the "pure capture" hypotheses. One study found TIF had a positive effect on median housing values in Indiana municipalities (Man and Rosentraub 1998). In contrast, another study compared TIF-adopting and non-adopting municipalities around metropolitan Chicago and found a negative impact of TIF adoption on the growth in municipal-wide property values (Dye and Merriman 2000). Where there was a positive effect on growth in property values within the TIF district, it was more than offset by a negative impact on the non-TIF portion of the same city. These findings imply that within one municipality, it is possible that TIF causes a transfer of business activity from one part of the city to a TIF district. Growth in property values within the TIF boundaries may not necessarily be new growth and could be cancelled out on a city-wide basis by decreases elsewhere. Such findings raise the issue of whether TIF should be judged by how well it improves the blighted project area alone or its impact on the entire municipality.

TIF could also have negative economic consequences *within* the district. TIF helps some businesses to the detriment of others, and picking winners and losers like this may not only be unfair but inefficient from a market perspective. TIF may reward those businesses and developers that are weaker by nature, and such businesses may "crowd out" those that would be competitive without any form of government assistance. Incentives can also distort business decision-making, attracting firms to locations where they are less productive than they would be in a more suitable site. One study found evidence that industrial TIF designation suppressed property values within these districts (Weber, Bhatta, and Merriman forthcoming). The authors suggest that such results can be explained by the fact that parcel owners in industrial TIF districts are constrained in their ability to convert their holdings to non-industrial uses. Moreover, it is possible that TIF stigmatizes a blighted area, making it harder to overcome a bad reputation for crime or environmental contamination.

Policy Implications and Suggestions

Under what circumstances is TIF likely to be a catalyst for revitalization? What kinds of policy measures could encourage its effective use in practice?

Place-based economic development appears to be most effective when the area in question conforms to the letter of the law and meets the "but for" and "blight" requirements to the greatest extent possible. Neighborhoods that have experienced little development due to specific site conditions (e.g., abandoned rail lines) are good candidates. Government-owned (i.e., tax exempt) property, abandoned buildings, or derelict sites in appreciating neighborhoods are especially ripe for TIF-financed in-fill development. TIF was originally intended for pockets of blight in otherwise thriving municipalities, but some municipalities have created so many districts that the majority of their tax base is covered by TIF. City-wide TIF districts and large, unusually shaped scattered site redevelopment areas are less effective than their use in specific cases where targeted public assistance can remove the impediment responsible for no or slow growth.

Even though the “but for” requirement is difficult to meet with certainty, this requirement can be strengthened, instead of ignored. Legislation can require municipalities to demonstrate specific impediments related to cost (unusual circumstances, such as historic preservation, make the project too expensive without public assistance) and location (site is handicapped by conditions such as poor soil quality). It can require developers to disclose competing offers of relocation assistance from other municipalities as well as financial statements documenting proposed project costs and expected financial returns.

Some states have tried to insure that only TIF-induced value increases are counted toward the tax increment the municipality receives. Minnesota requires that the base value of the property in the TIF district be adjusted by the inflation rate. This allows school districts and other jurisdictions to recapture some of the increment that is not attributable to the new development. Minnesota also requires municipalities to make real investments in the district before any increment can be attributed to the TIF. If building permits were not issued in the 18 months before the assessment, if parcels were not redeveloped within 4 years of the district designation, or if the municipality never issued bonds or acquired property, then it cannot lay claim to the full amount of the increment. In this way, the legislation requires municipalities to demonstrate responsibility for creating the value that is appropriated for economic development.

Because of its design, TIF operates well in areas where property values are initially low relative to other parts of the municipality or are growing at a slower pace. Fringe neighborhoods on the periphery of a commercial center may have weak market conditions but, with a small amount of planning assistance, could to begin to attract private interest. TIF is also a useful tool in instances where land uses are up-zoned; i.e. when property moves from less-intensive use to more-intensive use.

It is important to note, however, that not all large-scale development strategies will provide long-term economic benefits for community residents. Who benefits from increased property values? If an area is targeted for large and rapid increases in property taxes as a result of the appreciation, some residential and business tenants may not be prepared for the higher rents that will likely be passed on to them. They may be forced out of their neighborhoods and end up worse off.

This is why some states have taken measures to ensure that residents keep their homes or find replacement housing. Set-aside provisions require the city to use a portion of the tax increment gathered to directly benefit lower income residents, either through the construction of affordable housing or by funding programs used by lower income residents. For instance, California law requires that redevelopment commissions use at least 20 percent of the tax increment funds collected to increase, improve, and preserve the supply of affordable housing. In Illinois, state legislation allows TIF funds to be spent on training for those jobs located within the boundaries of the TIF district. A successful program initiated by the City of Chicago created a revolving loan pool to fund façade improvements for homeowners and small business owners in TIF districts. By implementing these kinds of statutory safeguards and programs, municipalities can distribute the positive benefits of TIF more equitably.

Other measures meant to widen the group of beneficiaries include those that provide community members and representatives of overlapping jurisdictions with a voice in the TIF adoption and increment allocation decisions. Municipalities are under no obligation to recognize when TIF would seriously harm a school district's financial condition or encourage gentrification. Some states require review boards but their recommendations are often non-binding. In Wisconsin and New Mexico, however, state law requires that a majority of representatives of overlying districts approve the TIF district. In Kansas, a county or school board can veto the designation. If the municipality can convince other jurisdictions that their projects are legitimate use of tax dollars, there is a greater likelihood that they will end up funding worthwhile development that would not have taken place but for the incentive.

In contrast, using TIF to finance the development of high-end housing, luxury car dealerships, and golf courses calls into question the meaning of blight and the use of public dollars. Moreover, TIF simply does not work as well in high rent areas because property values are already inflated. If the municipality is unable to lock in a low base value (the value in the year of the TIF designation), it is unlikely that property values will grow substantially in subsequent years and very little increment may be generated. In such areas, the cost of land acquisition is already too high for the public sector to absorb. Despite city efforts to encourage landowners to develop or sell their property, sellers' expectations of the true worth of their property may exceed that which buyers are willing to pay. In such cases, land prices will be remain high while landowners sit on their land in expectation of future appreciation. Little property will come on the market, thwarting the city's redevelopment plans. Tightening the blight requirement can reduce the tendency to use TIF for purposes other than rehabilitating parts of the city that can stand to benefit from this tool.

At the other end of the spectrum, public dollars spent in neighborhoods where rents and market occupancy levels are fundamentally weak may also be wasted. The most disadvantaged places are not likely to generate much increment because they will require more than a few new "bricks and mortar" development projects to nudge property values upwards. Self-financing is least feasible for poor communities since high borrowing costs and market forces do not favor development there. Nonetheless, areas that are unlikely to develop are often designated as TIF districts since municipalities are risking little revenue in these cases. Such efforts may be more symbolic than effective; overcoming years of disinvestment is a longer-term project, one that cannot simply focus on the physical shell of a neighborhood.

Conclusion

This brief has explored the use of Tax Increment Financing, assessing the claim that TIF can increase property values and reverse urban decline. TIF allows municipalities to selectively lower the development costs of private businesses and developers. This tool, therefore, has the potential to increase demand for property in otherwise blighted neighborhoods.

The controversy surrounding TIF stems from the claim that TIF alone causes any increases in property values that may occur subsequent to its designation. If TIF is responsible for property value increases, this tool may be a relatively inexpensive way to increase local wealth and grow the tax base, reduce property abandonment, and make inner city areas more attractive to private investors.

If it is not, then this mechanism becomes a way of channeling resources away from the other functions of local government to subsidize development that might have taken place without the use. It is also possible that property values will not increase despite the use of TIF. Subsidies may not be sufficient to overcome more intractable market barriers like environmental contamination and racial discrimination.

Given the ambiguity of their impact, it would be easy to recommend that municipalities stop using incentives like TIF. A more constructive approach would seek to improve the practice of economic development and prevent the misuse of these financing tools. Unfortunately, when direct federal funding for urban renewal disappeared, so too did much of the oversight associated with federal grants. Local governments now have the power to use TIF funds for pet development projects and to expand project area boundaries indefinitely. But in many cases, municipal powers have been used responsibly – to remove specific development impediments in fringe neighborhoods. Performance now needs to replace expansion as a city goal, and cities can use TIF in conjunction with other programs that can distribute the benefits of property value growth more widely.

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Figure 1: The Allocation of Assessed Value in a TIF District