



BEST PRACTICE

Tax Increment Financing as a Fiscal Tool (2006) (DEBT and CEDCP)

Background. Tax Increment Financing (TIF) has become an important tool for local governments to attract economic development projects, create jobs, foster infrastructure investment and redevelop blighted areas. TIF is a technique for financing a qualifying capital project, or its related infrastructure, from a stream of revenue generated within the geographic area defined as a TIF district. Primary governments with taxing powers often utilize TIF Districts, but redevelopment agencies may also be party to a TIF project. When a redevelopment agency utilizes TIF, the agency will share in property or other taxes imposed by other taxing entities. TIF districts are currently used in more than 40 states. TIF districts generally rely upon incremental property taxes generated in a specific area, but can also apply to other taxes, including sales taxes. TIF's can include a number of different concepts including tax increment districts, urban renewal districts, general improvement districts, special improvement districts, metro districts, and utility districts. The basic principles outlined herein are applicable to any type of TIF.

Most states have established laws and eligibility requirements to designate an area as a TIF district (i.e., blight, dilapidation or deterioration, age of structures, etc). Once an area is legally designated as a TIF district, the amount of the base valuation is “frozen.”¹ Improvements to vacant or dilapidated properties within the boundaries of the TIF then generate additional real estate valuation or “increment”, which is captured through augmented property taxes and expended solely within the TIF district.² This increment can serve as a source of revenue to pay debt service, up-front development costs, or for individual projects on a “pay-as-you-go” basis. The maximum period of time a TIF may exist is determined by state law; generally speaking, legislation allows time for development efforts and a traditional 20-year financing period.

Recommendation. The Government Finance Officers Association (GFOA) recommends that local governments evaluate whether tax increment financing districts may assist the local government in its economic development plans. A TIF policy should be adopted by the local governing body that includes statements regarding when a TIF district is appropriate, including its relationship to an overall development/redevelopment plan. The policy may be based only on enabling statutes, but should provide flexibility for the local governing body. The policy should also address the following steps to evaluate whether a TIF district should be created.

- Management should identify the blighted area or area identified for potential development or redevelopment to determine whether a proposed district meets the criteria under applicable state law and the priorities established by the governing body. TIF districts may vary in size, depending on the applicable state laws and local government objectives.
- Feasibility studies, which include an evaluation and review to determine whether redevelopment could take place within an acceptable timeframe, without economic assistance from the local government (e.g. “but for” the TIF assistance, the development would not be possible). The feasibility studies should also include an evaluation of debt limits, impact on taxing entity’s credit ratings, ability to meet the proposed

¹ Depending on state and local laws and regulations, the method of determining the base valuation of real estate tax revenue varies. Each jurisdiction should clearly define the methodology for determining the base prior to formation of a TIF.

² Generally, TIFs apply to the capture of the frozen base real estate valuation, but similar methodology can be utilized with other taxes generated within the TIF, such as sales tax revenue.

TIF plan objectives and ability to mitigate potential risks to local agencies, including the inability to repay debt in the event of revenue declines.

- The economic benefit to the local economy, the fiscal impacts to the affected government(s), and overlapping tax entities, such as school districts, and the economic cost of TIF district incentives should be analyzed and subjected to various sensitivity analyses.
- An evaluation should be performed on the risk to the general government operations³ when the TIF related revenue growth is no longer available, including an evaluation of the total impact of all TIF districts to the tax base.
- The risk sharing between local government and the private developer(s) for the TIF project should be documented in a development agreement that clearly states each party's responsibilities.
- An alternative analysis should be prepared to evaluate pay as you go financing and/or debt financing options that the TIF district would support.

If management believes a TIF district is warranted, the following should be done, in addition to compliance with state and local laws:

- A thorough development or redevelopment plan should be prepared with project(s) identified and an estimate of the incremental increase in real estate valuation created by the proposed projects.
- Public input should be obtained on the TIF plan and adjustments made accordingly, including public hearings if required or desired.
- Appropriate approval should be obtained from the legislative/governing body.
- Periodic review of the TIF district should be undertaken to determine if the TIF plan is functioning as intended. This periodic review should include performance measures of actual performance as compared to projected performance. Measurements could include items such as, actual versus projected tax base, jobs created, and the potential impact of shifting economic development from non-TIF areas to TIF areas.
- Steps should be taken to ensure that the TIF would not adversely affect the operations of other taxing entities.
- If TIF bonds are issued, special provisions for coverage, feasibility studies and other legal requirements should be evaluated. In addition, the related debt service structure should be based upon the availability of TIF district revenues or other monetary sources. Consideration should also be given to the use of additional credit support by the local government.
- If tax-increment supported debt is considered to fund projects at the inception of the TIF district, revenue volatility should also be estimated. Conservative assumptions should be used, and reserve funds established, when establishing a debt service structure to protect against future shortfalls. This will allow for the projects to be developed, become operational, and provide sufficient time for the required increment to come on line to pay debt service.

³ General Government operations include those core services performed by the local agency forming TIF, such as public safety, sanitation, recreation and library services.

References

- “Recommended Practices for State and Local Governments,” Economic Development Incentives, 1990.
- “Urban Revitalization and Tax Increment Financing in Chicago,” by Healey and McCormick, *Government Finance Review*, GFOA, Dec, 1999.
- “Tax allocation/Tax Increment Bond Financing Guidelines,” Fitch, October 16, 2000.
- *Elected Official’s Guide to Tax Increment Financings*, GFOA, 2005.

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