Last week I had the chance to give a TIF 101 presentation to the city's Economic Development Committee. I had given a similar talk to city staff and business representatives from the Chamber of Commerce back in February.

Tax increment financing (TIF) is a tool to encourage development. For local governments in Wisconsin, it is the main (if not the only) tool for development. In Evansville we have a few other tools in our economic development toolbox: matching grants for building façades, a revolving loan fund, access to the federal Rural Economic Development Loan and Grant program, a shared savings program through WPPI Energy, and we have assisted businesses with state grant applications and administration.

Understanding TIF

Three of the key ideas to understanding TIF are the but-for test, that TIF is not a tax break, and that TIF always involves debt.

TIF is based on the following premise: "but for" the use of TIF, this development would not happen. It would not happen at this location, maybe instead locating in a neighboring community. It would not happen at this scale, maybe instead building smaller or hiring fewer. Or, it would not happen at this time, maybe instead occurring a year or more in the future. Obviously, the but-for test has some flexibility. But the key is that TIF is necessary for that particular development to occur.

TIF is not a tax break. The mechanics of TIF (in very simple terms) are that when the TIF district is created, the value of the properties in the district is frozen. The owners still pay property taxes, at the same tax rate and just like every other property in the city. And the taxes on the "frozen" value still go to the city, school, county, and other taxing jurisdictions.

But any increased value to the property, say a new or improved building (after all, TIF is meant to encourage development), would have its value designated for TIF. The property owner would still pay property taxes on the increased TIF value at the same tax rate; this portion of the property taxes is called the increment. However, instead of going to the city, school, county, and other taxing jurisdictions, the increment goes into a special TIF account to pay for eligible expenses unique to the TIF district.

And here is where the but-for test is essential. This particular development would not have occurred but for the use of TIF. If the project would not have occurred, there would not have been an increase in the property value, and thus no additional property taxes for the city, school, county, or other taxing jurisdiction. If there would have been no additional taxes without TIF, then these taxing jurisdictions are not losing any taxes.

Granted some other development might have occurred at some smaller scale or some time in the future, but the particular development in question would not have occurred but for the use of TIF.

The third key point to understanding TIF is that it always involves debt. There is some sort of assistance to encourage the development to occur. Typically, that assistance is either a capital improvement (site preparation, infrastructure, or building construction) or a cash grant to the developer. In either case, up-front money is needed.

Typically the city pays the up-front costs; although, there can be arrangements whereby the developer pays up-front. Whoever pays is essentially making a loan to the development. The TIF will repay the loan as the development generates increment each year.

At times, it can be tempting to think of TIF as a source of money, I have too often heard city councils say, “The TIF will pay for that.” True, but TIF is not a money tree. The TIF will pay only as long as the project and assistance are right-sized. If not, the city is making a loan which the TIF can’t repay.

Uses of TIF
The cold reality that TIF always involves debt should not be seen as a reason against utilizing it. TIF remains the main tool we have to encourage development. And there are benefits to development: added tax base, new jobs, improved infrastructure, new businesses or services in the community, and reinvestment in historic properties.

The point to understanding the debt mechanics of TIF is to make sure the tool is used conservatively and right-sized for the project.

By law, TIF can be used only for eligible expenses. These include capital costs such as site preparation, infrastructure, or building construction. We used TIF to finance the utility and street projects on Highway 14 and downtown in 2005-2007. These infrastructure improvements are meant to benefit the entire business district and increase property values throughout.

Eligible expenses also include cash grants. We have paid incentives directly to individual projects such as the Heights at Evansville Manor, Cobblestone Inn, Eager-Economy Building, and several smaller downtown renovations. In every case that we provide a cash grant, we also have a contractual development agreement. The agreement lays out the expectations of the developer and provides security for the city.

Eligible expenses also include various financing costs. TIF can be used to pay interest; this is particularly important since TIF always involves debt, often literally with a bond issue or bank loan. TIF can also be used for professional fees and administrative costs; these are important because there are laws for creating a TIF district, regular reporting requirements, financial audits, and similar costs necessary to the district. It is only right that the district be able to pay its own way.

There are ineligible costs. TIF cannot be used to pay for public buildings. And it cannot be used to pay for the city’s general operations.

TIF Security

I've mentioned right-sizing of the project and also development agreements. These are vital aspects in providing TIF assistance, especially since TIF always involves debt.

It may be convenient to make a blanket statement that a project can expect 10-12% in assistance. As a general rule of thumb, that may be okay. But the actual amount of assistance really should consider the specifics of the project. Due diligence is needed to consider the but-for test, to look at a project's financial feasibility, to check assumptions, and to plan ahead.

We actually forecast the increment an individual project can be expected to generate. This helps us from over committing the amount of assistance. It can also help to build in some safeguards. For example, a project may reasonably be expected to generate $50,000 in increment each year, but we may base the loan instead on $40,000 each year. Or, although there may be 20 years in the life of the district, we may instead use 12 years in calculating the payback of the loan.

The development agreement itself also provides security for the city. At minimum, it lays out the expectations of the developer. For example, the developer will build a 5,000 square foot building by next year. Often the agreement will require the developer to have some skin in the game; it is harder for the developer to walk away if it has a financial stake in the project. The agreement may also include traditional securities such as a mortgage, personal guarantee, letter of credit, or surety bond.

One safeguard that we have used with each and every cash grant incentive the last six years is a requirement for the developer to cover any shortfalls. This has proven valuable with the downturn in the economy. For example, the assistance may have been based on $30,000 in increment each year. But instead the development is generating only $25,000 in increment. In such a situation, the developer is required to pay the shortfall.

Tax increment financing is a tool, and one that we have used quite successfully in Evansville, to encourage development. Because TIF always involves debt, it is important that the city use due diligence to right-size any assistance to the district or individual project. And with any assistance directly to an individual project, it is important to have a development agreement to provide additional security for the city.