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## TAX INCREMENTAL FINANCING: LEARNING FROM RESEARCH AND MUNICIPAL “BEST PRACTICE”

*This issue brief describes some of the notable research on tax increment financing and reviews challenges associated with the use of this technique. It also presents an example of how a local community has adapted to changing economic conditions in the wake of the Great Recession to restore momentum behind a large-scale TIF project. This brief also illustrates some of the notable research generated by student-faculty collaborations at our state’s teaching-oriented universities.<sup>1</sup>*

### INTRODUCTION

Tax Increment Financing (TIF) provides an innovative and flexible way for local governments to redevelop communities or to stimulate local economic development. An early adopter of this strategy, the state of California touted it as a “catalyst for redevelopment” in 1952. By the 1970’s, state and local governments nationwide had gradually increased their use of this tool. Today, every state except Arizona uses this technique in some manner, as it is regarded as a potentially beneficial both for new businesses, developers, and residents, and for existing businesses in the created districts.

This issue brief reviews of the notable research on this form of financing and provides a practical example of how a community has responded to the changing investment climate in the wake of the Great Recession. It illustrates how communities must constantly adjust their strategies and expectations when using this financial technique.

### PERPECTIVE

The central idea behind TIF is that it can foster economic development in an area that might otherwise not have such development. Were it not for the creation of the district, property would remain vacant or underutilized, to the detriment of local taxing bodies, the infrastructure, and development goals (Mikesell, 2014).

When a TIF is established, local taxing bodies continue to collect the base amount of property tax that they currently receive from within the district’s boundaries. When additional (incremental) taxes are generated, the associated “increment” goes into a special fund, which can be used to reimburse the developer’s qualified costs, make additional improvements, or reduce the outstanding economic developmental costs of the municipality (see Figure 1 below). The public agency that established the district can also use the funds to repay the tax-exempt debt used to finance the redevelopment project. When the TIF is abolished – often after 23 years – the tax base is returned to the original jurisdiction. If the project is successful, however, the new tax base will be considerably larger than before the redevelopment activities began.

To use this financial tool, however, the sponsoring local government needs to prepare a detailed proposal for a specified area. Although the requirements vary from state to state, they often can include “blight”

and “but for” tests: the “blight” test measures the area’s degree of deterioration and economic decline, while the “but for” test measures the possibility of future development of the TIF district without a TIF program implementation. Passing these tests requires demonstrating that without TIF assistance, growth or development at the proposed level would not otherwise occur.

The Government Finance Officers Association’s *An Elected Official’s Guide to Tax Increment Financing*, a standard reference tool, notes that the State of Illinois stipulates that an area is blighted if it meets a specified number of factors that include dilapidation, deterioration, obsolescence, having structures below minimum building code, and declining assessed value (Greifer, 2007, pp.14-15). Other analysis shows, however, that carefully adhering to such requirements does not eliminate the tension associated with trying to achieve the dual goals of eliminating blight *and* stimulating development at the same time (Chapman et al., 1998; CivicLab, 2013).

Since the 1990s, the evidence suggests that this tool has been much more widely used for economic development than for the elimination of blight, though the requisite use of the term “blight” is still often found in the reasoning behind the establishment of districts. Furthermore, many scholars have found that TIFs tend to be concentrated in areas with rapidly growing property value, which violates the spirit of the “but for” criteria (Dye & Sundberg, 1998; Brueckner, 2001; Gordon, 2003; Briffault, 2010). One study shows, for example, that the use of this financing technique is less pervasive in communities with household incomes less than \$25,000 than in communities with higher incomes (Felix and Hines, 2013).

Dye and Merriman (2000) found that cities with larger populations, higher municipal tax rates, and larger proportions of non-residential property are more likely to use this form of financing than others. According to Pacewicz (2013), the use of this technique is also skewed by the fact that development professionals sometimes have “incentives to use the TIF in ways that are not aligned with the city’s fiscal outlook and lock them into ever-higher rates of TIF spending.” On a more positive note, TIFs can play a strategic role in securing these relationships necessary to foster successful public-private partnerships.<sup>2</sup>

All these issues point to the need for municipalities to follow “best practices” that include reporting requirements, formal feasibility studies, and an annual audit of project revenue and expenses. California and Minnesota require municipalities to clearly articulate why the TIF is needed to ensure efficient use of public funds (and avoiding paying too much to developers), and to justify public subsidies for private development (Lefcoe, 2011). These requirements, of course, need to be rigorously enforced, which is often challenging. In California, for example, approximately 25% of cities do not file the required reports (Lefcoe, 2011).

## **DECIDING WHETHER TO ESTABLISH A TIF**

The legal basis for tax increment financing in our state can be found in the Illinois’ Tax Increment Allocation Redevelopment Act, which was passed in 1977. Through 2016, 514 municipalities had created 1,397 TIFs in the state (Comptroller Illinois, 2016). A survey of municipalities showed that the average TIF project in Illinois produced four dollars of private investment for every dollar of tax increment investment. The investment of the \$225 million of property tax increment induced \$900 million of private investment, for a total of \$1.125 billion (Illinois Tax Increment Association, 2016).

Local governments use TIF for many different purposes including: attracting new business, promoting downtown redevelopment, aiding blighted areas, relieving fiscal distress, providing off-budget financing to avoid political opposition, capturing tax revenues from overlapping jurisdictions, and retaining or expanding existing businesses. Due to the inherent unpredictability of economic cycles, however, outcomes are often subject to considerable uncertainty, particularly when TIF have a full 23-year lifespan. According to Haider and Donaldson (2016, p.14), for example, TIF projects “launched during or at the onset of an economic recession are unlikely to experience a strong increase in property values.” Similarly, Das, Larson, and Zhao (2010) find that TIF districts created in *positive* economies tend to perform better than ones created during (or near) recessionary periods.

The success of TIF also varies in accordance with the types of land uses involved. Haider and Donaldson (2016, p.16) find that single-purpose land use developments tend not to foster significant appreciation of property values or higher rates of growth. Other research shows that *mixed-use* developments that provide for new residential developments in combination with other land uses are more likely to be successful (Bhatta, Merriman, & Weber, 2003; Carroll & Sachse, 2005). Wang (2009, p.8) argues that it is important to carefully specify “the goal of each TIF before adoption” to assure that policies are aligned with expectations.

The politics associated with this tool can also be complex. Lefcoe (2011) suggests that, when TIF is used in blighted areas, existing residents often do not benefit, due to the elimination of residential housing in favor of commercial projects and gentrification in low-income areas. Moreover, using this tool can worsen the fragmentation of local governments by creating competition between neighborhoods and neighboring governments (Briffault, 2010; Ferkenhoff, 2014; Smith, 2009). In addition, residents can suffer when incremental revenues from these taxing districts fail to meet expectations, forcing the municipality to turn to other sources to meet bond obligations. In short, TIF is a powerful tool, but the research shows that it is fraught with political, economic, and financial uncertainty.

Chicago has been particularly aggressive in using this tool. Gibson (2003) found that TIF districts in the city were generally located in neighborhoods with higher vacancy rates, older structures, higher unemployment rates, lower percentage of white residents, and lower income. This same research nonetheless shows that these districts tend *not* to be located in the most blighted areas. Gibson suggests that these areas tend to be “disadvantaged, but not too disadvantaged” due to the difficulty of making TIF projects successful and financially sustainable in the most blighted parts of the city. This tool has played a particularly large role in regenerating downtown Chicago. The school system, however, is often regarded as a net loser, due to the fact that, when a city uses this technique, it does not see the incremental revenue until the district expires. In Illinois, this can exacerbate the mistrust that already exists between school districts and municipalities. Nevertheless, there are also many success stories that point to the enormous benefits that can result from well-managed projects.

## CHANGING EXPECTATIONS AFTER THE GREAT RECESSION

Virtually all communities with TIF districts have had to reassess their expectations in the wake of the Great Recession. The changing economic climate has been particularly difficult for projects relying on retail and manufacturing jobs. The Village of Elwood is among the many communities that have substantially

modified a TIF project due to these changing conditions. While its example is instructive, the views presented here should not be interpreted as representing the views of the Village of Elwood; the following conclusions were developed independently.

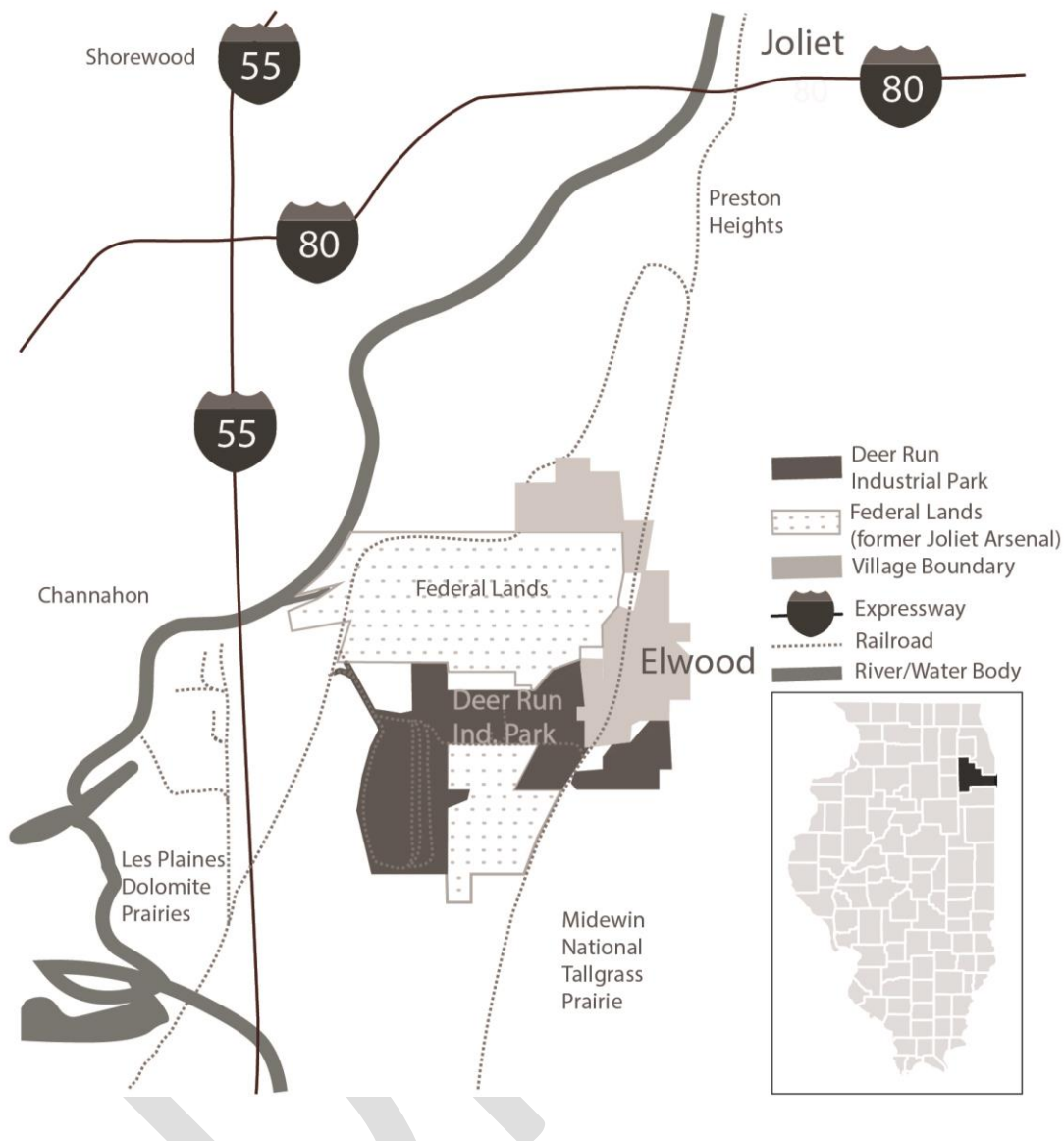
Elwood is a small community with approximately 2,300 residents in Will County approximately ten miles from Joliet, the county seat. For generations, this crossroads remained a farming community, but in the 1930s, it became home to growing number of workers from the rapidly expanding Joliet Army Ammunition Plant, formerly known as the Joliet Arsenal. By the 1980s, the Arsenal was in a severe state of decline, and the property became a Superfund site that suffered from a range of problems, including runoff from a cold-fired power point that had contaminated a river. This created extreme planning challenges that could not be resolved within the budget constraints of the village government. The environmental problems associated with the site were expected to worsen as the aging facilities deteriorated.

Working with prominent consultants and financial institutions, Elwood created Deer Creek Industrial District on 1,820 acres of the former Arsenal land, which was annexed and rezoned by the village in 2000. [The State of Illinois provided loans and grants for local water, sewer, and transportation improvements.](#) [Industrial real-estate company CenterPoint began construction in 2000 and the facility opened in 2002.](#) This TIF district was situated in an area with extensive rail service by both BNSF and Union Pacific railroads, and near the busy interchange of I-55 and I-80 (Figure 1), which is regarded as holding considerable strategic importance for the logistics sector. The district was envisioned to host a large intermodal rail yard, businesses, and warehouses, and once fully built, it would encompass more than 2,500 acres. Situated on the dividing line of eastern and western railroad systems, Elwood sought to leverage its strategic location for logistics and warehousing.

Furthermore, the project was expected to create as many as 8,000-12,500 industrial, manufacturing, commercial and retail jobs (O'Brien, 2000). The industrial park was planned to include manufacturing, retail stores, restaurants, and hotels (Monson, 2013). The Economic Development Plan for the industrial park illustrates the goal of dividing the property in parts for intermodal, commercial, services, power plant and industrial development.

## FIGURE 1

## Elwood, Illinois and its Surroundings



Such ambitious mixed-use development, however, was obviously not feasible during and after the Great Recession. As in many, if not most, of the TIF districts in the country established in the years leading up to the Recession, a gap emerged between *planned* acreage and *actual* acreage in most land-use categories. Although the acreage for intermodal exceeded expectations, other sought-after aspects of the projects did not materialize. Conditions were made worse by the well-publicized challenges facing our state, which experienced an average annual GDP growth that lagged behind the national average. Illinois' real estate crisis was particularly severe, which likely made meeting many types of development targets impossible. (See "Retail Construction in Illinois: Why The Slump", on page 123 of Issue 1 of this journal for a summary of the fall in retail development). Although its economy has been improving, in 2017 Illinois ranked 11<sup>th</sup> worst among U.S. states in unemployment while also experiencing gradual population losses.

Through 2014, the number of jobs generated at the industrial park totaled about 3,800, with employment almost entirely concentrated in the intermodal category. Tax proceeds lagged behind expectations, and concerns over the debt associated with the project grew. In response, the village took the innovative step of constructing *two* balance sheets: one with net position *including* the Deer Run Industrial Park TIF, and another with net position *excluding* Deer Run Industrial Park TIF. This helped stakeholders appreciate the scale of the debt in the district against the background of the village's general assets and liabilities.

Through a series of strategic steps, legal actions, and, eventually, a financial restructuring – which included working closely with the project developer, Centerpoint – the village gradually adjusted the goals for the industrial park. It conducted extensive research on its options and emerged with a plan to pursue new set of industrial and intermodal opportunities. Supported by consultants and gaining the full cooperation of Centerpoint, Elwood collaborated on an expansion that is anticipated to increase its intermodal and manufacturing development. This expansion will push the industrial park further west, closer to I-55, and encompass additional acres of land. Much of this land, too, suffers from contamination and other problems attributable to its industrial past. Through 2017, the TIF has generated about 7,000 jobs, but the village hopes that the next phase of expansion will result in significantly higher employment.

The village is also working with Centerpoint on a variety of projects to enhance safety and promote other goals in the community. Efforts are being made to address the rise in truck traffic, including movements and from the nearby Centerpoint facility in Joliet. Elwood's bond rating now stands at AA and anticipates that its population will grow appreciably over the next 10 years. A sense of optimism has returned.

## CONCLUSION

There are several takeaways from the above analysis that warrant attention by municipal leaders. First, the literature suggests that TIF is an enormously powerful tool that can generate large benefits. However, it also shows that navigating the politics surrounding this tool often become more difficult during rates of slow economic growth. Such conditions add to the challenges facing the taxing bodies affected by the creation of these districts, particularly when they receive “pushback” from local residents. In the relatively slow-growth conditions that characterize many parts of our state – in which taxing bodies face the prospect of gradually declining revenue – the apprehension over the use of this tool can manifest itself in accusations that the benefits of TIF are not spread equitably. This problem is compounded by the fact that many residents often do not fully understand the tool's complexity or timeline.

Secondly, current academic research is mixed regarding whether this form of financing can be highly effective in some of the most blighted neighborhoods. Some research suggests that this TIF districts have been most effective in areas that already had a least some momentum for development. As a result, local governments may need to consider other tools when trying to abet a turnaround in some of their most distressed areas.

Finally, the case study example from Elwood demonstrates how strategies for promoting development can and should be regularly re-evaluated in light of changing economic conditions. This community shows how planners can respond to the changing realities of a marketplace by modifying the goals of a TIF district to capitalize on emerging opportunities; in Elwood's case, such re-evaluation involved making

plans to expand the district that hold the promise of generating more intermodal and industrial jobs. At the same time, the community deemphasized other forms of development, such as retail and hotel uses.

In a similar vein, TIF plans should be developed cautiously and used in combination with other incentives or as part of more comprehensive public-private partnership efforts. Local governments should also work with legal counsel and financial experts throughout the planning process to mitigate the risks, as was done in case-study example described above.

Overall, this financial tool is expected to remain a central component of planning and financial strategies at a time when municipal budgets throughout Illinois are extremely tight. This research shows that communities must retain a “hands on” role that involves constantly reevaluating and repositioning TIF districts in response to emerging challenges and opportunities. In the Reference section below, readers will find a listing of some of the notable literature on this powerful development tool.

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<sup>1</sup> Substantial editorial and substantive contributions to this article were provided by Joseph P. Schwieterman, professor of Public Service Management at DePaul University.