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When money is tight and financing development projects gets tough, the tough get creative. More and more municipalities are partnering with private entities to address local development needs using tax increment financing (TIF). Established by state law in 48 states, TIF provides a taxing process that benefits both its public and private partners. It has grown increasingly popular because of its flexibility, local control and freedom from debt caps.

As of March 2003, the Texas Comptroller of Public Accounts reported 37 Texas cities with at least one Tax Increment Reinvestment Zone (TIRZ). Cities and counties create these special districts to encourage new investment in areas that otherwise might not attract development. When developers make improvements, property values increase. In a TIRZ, the taxes on the increase in property values are set aside to finance public improvements in the zone. For example, the City of Houston has created zones to address inner city deterioration, to develop raw land in suburban fringe areas and to address the decline of major activity centers.

Defining the zone's geographical boundaries is the first step in creating a TIRZ. To establish a baseline, the assessed value of properties in the TIRZ are frozen, and any taxes on the increased or incremental value during the zone's term are captured as TIRZ revenue (see figure).

TIF Fundamentals

Tax increment financing is both a financing and an economic development tool. It was first used in California in response to federal funding cuts for inner urban infrastructure improvements and taxpayer protests over property tax increases. TIF allowed the state to increase tax revenues without raising taxes.

Under the first TIF-enabling statutes, cities sold bonds secured by the incremental tax revenues to obtain funds necessary for redeveloping blighted areas. Funds generated from sale of the bonds were used to pay for infrastructure (streets, sidewalks, lighting, sewers), and bondholders were repaid from the incremental tax revenues as further value was added to the development, primarily by private developer partners.

Texas TIF Laws

Three features distinguish Texas' legislation from that of other states. Usually, only cities or governmental entities can designate an area as a TIRZ. In Texas, however, owners of properties constituting at least 50 percent of the appraised property value in the proposed district may petition for the creation of a TIRZ. This allows private owners-developers to initiate creation of a district rather than depending on a city to do so.

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Second, the law allows taxing units within the zone, such as water districts, to negotiate on a case-by-case basis with the city the percentage (0 percent to 100 percent) of incremental tax revenue they will contribute to the fund. Nationally, one of the most significant criticisms of TIF has been that overlying districts are required to give up part of their tax revenue without having any say in how the money is spent. Texas law addresses this criticism.

Third, in Texas, there are no onerous minimum requirements for finding blight within the zone and few other restrictions on what types of property can be incorporated. The board of a TIRZ may expend TIF funds to pay the costs of replacement housing in or out of the zone, but if the project is city-initiated only 10 percent of the zone may be residential. Zones initiated by petition have to dedicate at least one-third of their areas to residential uses and one-third of their tax revenues to low-income housing in cities of 2.1 million people or more.

Texas property tax code does not require a blight finding, but it does apply a variation of the "but for" test (see TIF-Enabling Statute Elements). To be properly constituted, the code requires that the area's condition must "substantially impair the city's growth, retard the provision of housing or constitute an economic or social liability" because of dilapidated structures, unsafe conditions, a delinquency that exceeds the value of the land or because obsolete platting or other factors have kept the land "open."

The city must affirm that the TIRZ will significantly enhance the value of all taxable real property in the zone. Further, the city must certify that development will not occur solely through private investment in the foreseeable future.

In Texas, the city or petitioner need only submit a preliminary development plan and a preliminary finance plan before the TIRZ is established. Copies of these plans are sent to the local taxing units with notice of a hearing on the proposed zone and a request that representatives meet with the city. The city then makes formal presentations to other city and county taxing units in the zone to educate them on all aspects of the plan.

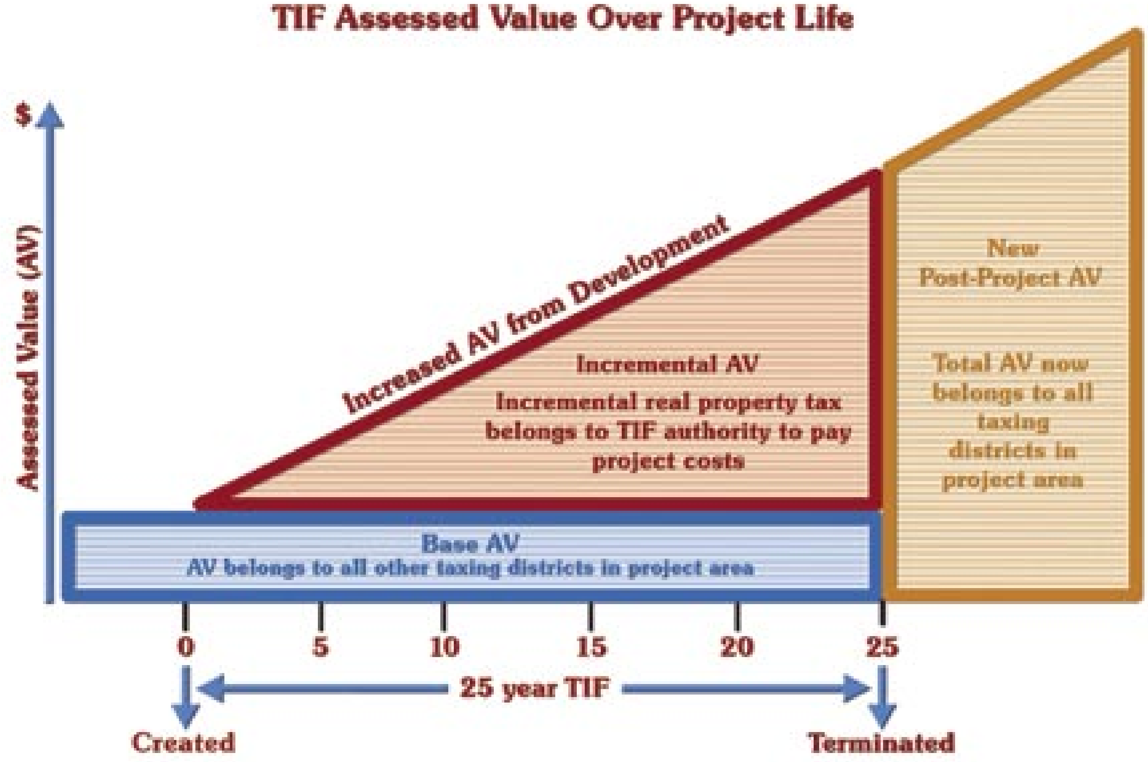
At the public hearing, the governing body evaluates the proposed zone benefits, and interested persons are allowed to speak. Once these preconditions have occurred, regardless of the support of the other taxing units, the city can pass an ordinance establishing the zone and its governing board.

One of the board's most important functions is to execute a formal financing plan that includes:

- a detailed list of estimated project costs;
- a list of all proposed public works or improvements within the zone;
- an economic feasibility study;
- the estimated amount of bonded indebtedness to be incurred;
- the timing for incurring costs or monetary obligations;
- the methods for incurring all the estimated project costs and the expected sources of revenues, including the percentage of tax increment to be derived from the property tax of each taxing unit;
- the current total appraised value of taxable real property in the zone;
- the estimated captured appraised value of the zone during each year of its existence; and
- the duration of the zone.

Once the board approves the plan, it is passed as an ordinance by the city. The overlying taxing units then decide what percentage of their tax increment they will dedicate to the fund, or they can elect to retain all of it for themselves.

Houston has 20 TIRZs. The city participates at 100 percent of its incremental base in each of these and is the sole participant in one. Other taxing units, such as the Houston ISD, Harris County, Houston Ship Channel, and Houston Water District have opted in at percentages ranging from 50 percent to 100 percent of their incremental base or have opted out completely.



Source: Craig L. Johnson, Indiana University

Public-Private Collaboration

Texas' TIRZ creation process facilitates collaboration between public and private partners. Development of the TIF plan requires the public and private partners to define their roles and the scope of the project and determine whether the development would occur solely through private investment, without need for TIF. The mandatory meeting between the city and the various taxing entities fosters goodwill and awareness, as does the law allowing them to determine their level of participation in the zone. They also provide an avenue for mediating potential disputes before the plan is formalized.

School districts in particular have been vocal critics of TIF zones, charging that they deprive districts of substantial operating funds as growth occurs while simultaneously requiring them to furnish more services. Texas law originally allowed school districts to reduce the value of taxable property reported to the state to reflect any increase in appraised value that was diverted to a TIRZ.

In some cases, this created a loophole for school districts to avoid their payments under the "Robin Hood" school financing laws. That possibility has been eliminated now by the law allowing school districts to contribute from zero to 100 percent of the tax increment revenue, just like other taxing units. Although school districts have elected to participate in many TIFs, this change in the law may affect the number of new TIF zones created.

Voter approval is not required to implement TIF, a fact most cities consider one of TIF's greatest advantages. However, many criticize reallocation of tax dollars without taxpayer approval.

Public hearings offer citizens an opportunity to present their input and allow city officials to gauge public opinion on the proposed TIF.

Financing Revitalization Projects

The forming of public-private partnerships is crucial to urban revitalization in this era of constrained federal funding. In such partnerships, the predominant share of the total investment would typically come from the private sector. The public sector would provide a smaller, although critical, share for the infrastructure improvements needed to make the TIRZ profitable for investment.

Studies have shown that in Texas, on average, the public sector participates at a rate of less than eight to one. One notable exception is a $40 million El Paso project funded entirely by the public sector. Conventional wisdom holds that the range of near-term private to public investment leverage a TIF authority should seek is from eight to one to 12 to one.

States' enabling laws generally authorize the taxing entity to issue bonds secured by tax increment revenue so that large amounts can be generated quickly to fund infrastructure. This does not increase taxes but reallocates them to a fund targeting a specific geographic project.

The first Texas TIRZs were financed by bonds, with 75 percent of the projects adopted before 1990 initiated by and built within small cities. This dispels the expectation that only large cities would take advantage of TIF. However, the Texas comptroller, citing annual reporting data submitted by TIF districts, concludes that of the 39 reporting districts, only ten (five of which are in Houston) have any level of debt financing. The remaining districts are using "pay-as-you-go" or developer reimbursement methods.

"Pay-as-you-go" allows tax increment revenues to accumulate with the authority before a project is begun. The City of Arlington, for example, had more than $600,000 in its TIF fund prior to signing an initial redevelopment agreement that called for $90,000 in infrastructure. This option allows the infrastructure to be tailored to specific businesses. Developers of most larger projects in Texas provide up-front funding and are reimbursed for defined infrastructure costs over the TIF term.

Relying solely on TIF revenue to repay the bonds can be risky. Revenue shortfalls can occur when development does not progress on a timely basis, or the projected level of development does not occur. Private developers and their financing sources may weaken over the term of the TIF, thus failing to produce the projected development activity.

The single most significant risk is a decline in assessed value. The TIF property's assessed value may decline because of recession or natural disaster. Property can be acquired by tax-exempt entities, or a state may redirect accumulated TIF revenues. Assessment appeals made by major landowners may negatively affect the assessed value.

To buoy the reliability of TIF bonds, various forms of security are sometimes offered. These may include a guaranty from a developer or a secondary revenue stream — incremental sales tax revenues derived from the new businesses — and, in rare cases, a full faith and credit guaranty of the city. Although a city has no legal obligation to repay the bonds, some have argued that allowing default would affect the municipality's bond rating.

Determining Success

The traditional measure of a successful development is whether it is profitable. However, a project also is a success if it accomplishes what city leaders wanted it to accomplish, such as removing a health or safety concern.

Political risk must be considered when predicting the success of a development project. The more controversial the project, the less likely it is to succeed.

A healthy economy may be a strong predictor of success, although an undertaking can be successful in a weak economy if it has wide-based support. Cities going through economic downturns generally should not undertake projects unless those projects have broad support, are routine in nature and have a purpose apart from revenue generation.

Some observers maintain that to be both viable and efficient, a TIRZ must not only fully repay its borrowing and administrative costs but must generate tangible or intangible incremental benefits (such as enhanced tourism) that exceed the basic revenue growth that would have occurred without the TIF. Desirable spillover effects to adjacent non-TIF areas contribute to the efficiency of the TIRZ and to the public good.

Ultimately, a TIF project needs to be a win-win situation for the public and private sectors. Texas boasts several developer-initiated projects that have resulted in sweeping revitalization efforts. In an era of strained municipal budgets, public investment is not always feasible. Using TIF to allow the private sector to undertake community redevelopment projects is often the best alternative.

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TIF–ENABLING STATUTE ELEMENTS

Establish Authority — Authority to manage the TIF district is normally delegated to a municipality or county and can be further delegated to a commission or an authority.

Assess Needs — Most states require a "qualitative" or a "quantitative" blight finding. Additionally, states often require that applicants show the redevelopment would not occur "but for" TIF, with some also requiring some form of cost-benefit analysis.

Draft a Plan — Most statutes require a formal development plan that tells the community the purposes for which TIF may be used. These can include costs of land assembly and building demolition, rehabilitation and repair of buildings, costs of relocation of persons and businesses, and the costs of infrastructure.

Adopt a Redevelopment Plan — Notice and a public hearing are generally required.

Draft a Finance Plan — The plan must detail exactly what form the financing will take. Traditionally, it has been either TIF bonds, which are like revenue bonds, or developer up-front funding repaid with the incremental revenues as they accrue.

Set Monitor Function — Statutes often require some form of accountability, such as an annual report to the state, to assure that the TIRZ is following plan objectives and that those objectives are still viable.

Plan for Termination — The statutes provide that a TIRZ is in existence only as long as necessary to accomplish its purpose.

Source: Johnson, Craig L., Cole and Thompson Law Firm, "Report to the National Association of Realtors," *Realtor*, November 2000.

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