How TIF Works: Basic Mechanics

What is the primary purpose of TIF?

Tax increment financing (TIF) is a method of financing real estate development costs--i.e.:

1. to encourage developers to construct buildings or other private improvements, or
2. to pay for public improvements, such as streets, sidewalks, sewer and water, and similar improvements.

What is the source of the financing?

TIF uses the additional property taxes paid as a result of development in the district to pay for part of the development costs. When a new building is constructed, the market value of the property and its property taxes typically rise. Classic examples would be building a new store on an undeveloped parcel or replacing one or more old buildings with a new, larger building. In both of these instances, the market value of the property will rise because the improvements add value to the parcel.

How do the mechanics of TIF work?

When a TIF district is created, the county auditor certifies the current tax capacity of the properties in the district as the TIF district's "**original tax capacity**." As the property in the district increases in value, these increases above the original tax capacity are "captured." The law refers to this amount as the district's "**captured tax capacity**."

When a TIF district is created, the county auditor also certifies an "**original tax rate**." The original tax rate is total property tax rate that applies in the district, i.e., the tax rates imposed by all of the local governments that levy taxes (the city/town, county, school district, and special taxing districts).

The "**tax increment or increment**" for the district is determined by multiplying the original tax rate by the captured tax capacity. This roughly equals the taxes paid by the captured tax capacity or the increase in taxes that occur as a result of the development.

What are the typical uses of TIF?

TIF traditionally was used as a means of redeveloping urban areas that had old or worn-out buildings in need of replacement or rehabilitation. It was initiated as a tool to help with urban renewal (redeveloping "slums" and "blighted" areas). Its use has spread to other purposes. TIF in Minnesota is generally used to:

- Redevelop areas occupied with substandard buildings
- Build housing for low-income and moderate-income families
- Clean up pollution
- Provide general economic development incentives
- Finance public infrastructure, such as streets, sewer, water, sidewalks, and similar improvements. (This is not an explicit purposes of TIF, but Minnesota cities frequently use it for this purpose.)

What is an example of how TIF is used?

Developer is considering building an office building. The city would like to redevelop a site that consists of three parcels of property (parcels A, B, and C in the figure below). Parcel A is vacant and Parcels B and C contain substandard commercial buildings. Parcel D contains a building in good shape. Construction of the office building will require demolition of the two buildings, new utilities (sewer and water), and closing an alley. The cost of acquiring the property, demolishing the substandard buildings, and putting in the utility and alley improvements is $1.5 million. However, Developer could obtain a comparable site elsewhere in the area for $500,000, including special assessments for utilities. The three parcels have a tax capacity of $24,000 and pay $33,600 a year in property taxes (at a 1.4 rate). But if Developer builds the planned $5 million office building, the tax will rise to $304,000 per year (an increase of $280,000).

To induce Developer to build on the site, the city designates a project area and creates a TIF district that includes the development site. The district consists of parcels A, B, C, and D (the shaded area). (Parcel D must be included to permit the site to qualify as a redevelopment district under state law.) The district is illustrated in the figure. The city agrees with Developer to acquire the site, demolish the substandard buildings, and put in the utility improvements and vacate the alley. The city, in turn, sells the site to Developer for its market value of $500,000. This is commonly called "writing down" the cost of the land. The city's $1.5 million cost is "written down" to $500,000. (The city could write it down to zero–in effect, giving the land to Developer.) The computation of the increment is shown in the table. The "project area" is the area in which increment may be spent (e.g., if some of the sewer and water improvements may actually be outside of the district). The extent to which this may be done is restricted by the rules on "pooling."

Project Area
TIF District

<table>
<tr><td colspan="3">Parcel A
(Vacant land)</td></tr>
<tr><td>Parcel B
(Substandard building)</td><td>Parcel C
(Substandard building)</td><td>Parcel D
(Building in good condition)</td></tr>
</table>

Computation of Tax Increment

Parcel	Original Tax Capacity	Post Development Tax Capacity	Captured Tax Capacity
A	$18,000	$224,000	$200,000
B	$3,000		
C	$3,000		
D	$124,000	$124,000	0
Total	$148,000	$348,000	$200,000
Tax Rate	1.4		
Tax Increment		**$280,000 (tax rate x captured tax capacity)**	

Does the increment equal the full taxes paid by the captured value?

In Minnesota this is frequently not the case. The original tax rate limits increment to the taxes generated by the tax rates in effect when the district was created. Thus, if the local governments increase their tax rates (e.g., to increase revenues or because of changes in the tax base), the increased rates do not yield more increment. Furthermore, in the Twin Cities metropolitan area and in the taconite tax relief area, increment may be reduce by the fiscal disparities contribution for the district's properties, if the city elects that option.

Does TIF capture value increases from inflation or general market effects, as well as those attributable to new improvements?

Yes, the mechanics of TIF capture all of the increase in value of the district. Thus, increments may be attributable to:

- Construction of improvements
- Overall inflation in property values unrelated to development

- Market effects that are attributable to the TIF development, if the properties are in the TIF district. (Proximity to a new development, in many cases, will increase the value of surrounding properties.)
- Market effects that are unrelated to the TIF development, if the properties are in the TIF districts. (Market values in areas around TIF districts may increase and these increases may be caused by factors, such as shifts in locational values or tastes, other than the TIF development. For example, some researchers have observed the tendency of cities to put TIF districts in areas that are already experiencing rising property values.)

What types of developments are not good candidates for TIF assistance?

TIF works because developments frequently increase taxable market values. For developments that do not significantly increase taxable market value, TIF will not generate enough revenues to use to help finance the development. This presents problems for:

- **Developments that do not increase the intensity of land uses or that decrease the intensity of land use**. For example, TIF works if the development replaces an apartment building with a large office building or single family homes with large apartment buildings. But it does not work well if one wishes to replace a deteriorated apartment building with single family homes.
- **Tax-exempt developments (e.g., nonprofits or government buildings)**. Since these properties are exempt from property taxes, they do not generate increments and, thus, cannot be financed with increments, unless increments are taken from other developments.

What are other limitations to using TIF as a financing method?

Development costs must be paid "up-front" or at the very beginning of the development, but the increased property taxes (increments) are not paid until later and, then, only in modest amounts (relative to the development costs) spread over many years. This creates an imbalance or mismatch between costs and revenues. TIF traditionally overcomes this mismatch by issuing bonds. These bonds pay for:

1. Development cost (e.g., site acquisition),
2. Interest on the bonds until increments are received. The need to pay these interest costs on borrowing, pending receipt of increments is commonly referred to as **capitalizing interest**. The need to capitalize interest means that increment flows must be larger to pay off this component of the cost.

Before 1986, municipal bonds were routinely used as part of TIF financing. These bonds were usually tax exempt, providing a lower interest rate to the city and the developers. The 1986 tax reform made it more difficult to issue tax-exempt bonds for this purpose. This took away much of the incentive for the local governments to borrow in anticipation of receipt of tax increments. The practice in Minnesota now often does not use bonds, but instead expects developers to pay the costs and to be reimbursed as increments become available. This approach (called **"pay-as-you go" financing**) shifts the "capitalized interest" costs to the developers. In some cases, the city or development authority absorbs the cost by advancing its money (e.g., from another city or authority fund) until it can be reimbursed with the increments. If the city accepts lower or no interest on these advances, it is using these funds to assist or subsidize the development.

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