

Reverse That TIF: An Analysis of Alternative Tax Incremental Finance Measures in Wisconsin

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Abstract

Tax increment financing, or TIF, has become a hot topic in the world of public economic development for professionals, politicians, and academics. TIF occurs when a municipality offers what is essentially a loan to a private developer to increase the property value on a blighted property, thus creating economic development. When the property value increases, the property tax revenue increases. This future tax revenue will then repay the loan. Since TIF is considered a subsidy, researchers and policymakers disagree over the methods that should be used, and, sometimes, whether TIF should be used at all. An alternative method, reverse TIF, has been studied little (if at all) but could save a municipality from financial destitution in the event of a failed TIF district since the developer takes out a private loan that is repaid through the future increased tax revenue. This study will analyze the success and failure rates of Wisconsin municipalities utilizing reverse TIF and compare them to those using “regular” TIF. Data will be collected through use of an email survey to each of the 431 municipalities in Wisconsin that currently utilize any type of TIF (since the State of Wisconsin Department of Revenue does not differentiate between “regular” and reverse TIF). A Chi-Squared test will be used to analyze the data. The hypothesis for this study is that there is a lower failure rate when reverse TIF methods are used because developers have more at risk and a higher incentive for a successful tax incremental district. No matter the results of this study, Wisconsin municipalities—and possible those from other states, too—can use the findings as a tool to more successfully implement TIF in the future.

Keywords: Tax Increment Finance, Economic Development, Wisconsin

1. Introduction

Tax incremental finance, or TIF, has, relatively recently, become trendy in the public economic development circles. If a municipality (city, village, town, or occasional county) has within it a blighted property, such as a decrepit factory, it may turn its lot and/or the areas around it into a TIF district. TIF works essentially as a loan. For example, consider a blighted property in downtown La Crosse, Wisconsin to be worth \$100,000. A private party owns it so the 5% property tax will be paid in the amount of \$5,000 in its current condition. A developer enters the picture, however, and eventually works out a deal with the property owner to purchase the property for what it is worth: \$100,000. The developer plans to build a hotel on the site and make many improvements, thus increasing the property value. As the value of the property increases, so do the taxes. A short while later, the property is worth \$500,000, so the taxes increase to \$25,000. By the time development is finished the hotel is worth \$1,000,000, causing the property taxes to be \$50,000.

This is where TIF comes into play. Since it is not good for a municipality, especially a downtown area, to have blighted properties, local governments can use economic development methods to help revive the area. When a

municipality uses TIF, it is taking on debt and then either passing the funds along to the developer or investing in infrastructure costs within the district. In this example, assume that the municipality had given the developer a \$400,000 loan to renovate and improve the structure and lot. Because it is in a TIF district, however, this loan will be repaid through the new property taxes collected by the municipality. The municipality will keep receiving its “base” tax (the only part that will be usable this year) of \$5,000, or the amount of taxes the property owner was paying at the time of TIF implementation. However, the “increment,” or the amount the property tax has increased thanks to the improvements and the increased property value, will start paying off the loan (so it will not be considered usable to the municipality). This will happen each year until the debt is paid off. Once the debt is repaid, the increment turns into pure property tax revenue for the municipality; it will generate \$50,000 annually from that single property even though it only collected \$5,000 in usable “base” funds the previous year.

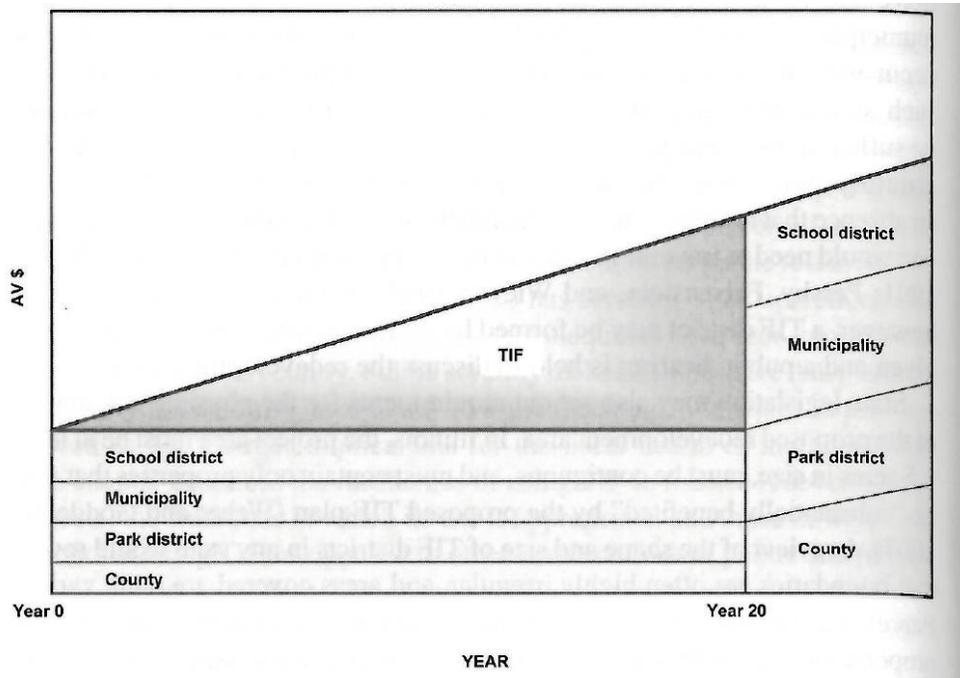


Figure 1: Diagram of Tax Incremental Finance
Source: Weber (2013)

This diagram shows the division of tax revenue at the beginning of a healthy TIF district, Year 0, and throughout the TIF district’s lifespan. At the retirement of the TIF district, Year 20, there is a jump in revenue for each department since revenue is no longer needed to repay the TIF loan.

This sounds wonderful—if TIF works the way it should and produces a flourishing TIF district like the example above. Sometimes, however, it fails and becomes what is legally designated as “distressed.” Distressed TIF districts simply do not receive revenue at the speed or scale necessary to repay the debt issued for them. Specifically, according to the Wisconsin Department of Revenue, a district is designated as distressed when its projected increments will not cover the project’s costs¹. Who is responsible for repaying the loan that the municipality took on? The municipality. Specifically, the municipality will have to increase property taxes, decrease spending on services, or take money from a successful TIF district’s increment (though it should then be put back into the general fund after its debt is repaid).

How can this be prevented, even if a TIF district fails? Reverse TIF. Reverse TIF is a relatively new and unstudied method of economic development used by local governments. There are two main types that were considered for this study. The first is called developer financed TIF. The only difference between TIF and developer financed TIF is that the developer is taking out the loan instead of the municipality. The municipality still receives the base tax, and the increment still pays off part of the loan every year (via the developer); the only difference is who takes out the loan². Also, if the TIF district fails, the municipality only loses, or does not gain, the expected increase in property tax

revenue (which it would have never seen anyway if TIF had not been attempted); the developer is still responsible for repaying the loan, not the taxpayers.

The second main type of reverse TIF is called pay-as-you-go TIF. This method allows the city and developers to only spend the increment as it is received. For example, in a TIF situation, if TIF debt were to finance a new façade on a building, the municipality would take on debt, give the funds to the developer, who would then use the funds to pay for the façade. In a pay-as-you-go situation, however, both the city and developer would have to wait until the increment provided enough revenue. The funds would come from already-designated tax revenue and go right to the developer, who would use it to pay for the façade directly. In a pure and theoretical pay-as-you-go situation there would be no debt ever taken on and the bank would never have to see a payment. It should be noted, however, that often this method is combined either with developer financed TIF or regular TIF, or some other method, for an initial investment; the size of this investment, however, varies. Pay-as-you-go is also typically used for developer incentives rather than for infrastructure improvements.

At first glance, this is attractive to municipalities because they would reap the tax revenue benefits in the same amount of time while taking on little of the risk. Therefore, because municipalities greatly reduce their risk and because developers have heightened responsibility when reverse TIF methods are used, theoretically there should be a lower distressed rate among districts that utilize reverse TIF measures than those that do not.

2. Review of Related Literature

“If the past quarter of a century is any indication, tax increment financing (TIF) is likely to remain one of the most popular forms of finance for local economic development in the United States.”³ Though TIF use is widespread today, it was controversial and doubted when it was first introduced in California in 1952⁴. Today, however, the majority opinion is that it can be beneficial—if it works. For example, home values have been shown to increase when there is a TIF investment⁵, with the investment also decreasing the effects of crime and brownfields in a given area⁶.

Keeping TIF’s reputation in mind, Greenbaum and Landers assess previous literature and find all mixed reviews⁷. For example, some literature touted that TIF increased local property values while others bemoaned that it increased competition for other local business that were there and flourishing first⁸. Weber goes so far as to liken this competition to gentrification, meaning that existing businesses, especially small businesses, may be forced out when unable to pay increasing rent costs⁹. Greenbaum and Landers list seven recommendations going forward to improve the chances for success of TIF¹⁰. Some examples of their recommendations include involving all overlapping tax jurisdictions in TIF district approval (such as school districts, utility districts, etc.); applying an inflation factor to the base tax value so that it can account for inflation over long periods of time; and limiting TIF use to blighted areas. The one that sticks out regarding this research, however, is the sixth recommendation, which is to use a reverse TIF method, though they did not call it by this name¹¹.

This recommendation to utilize reverse TIF is similar to what Hall and Bartels also conclude. They start their article by saying what should be fairly obvious: people disagree over types, amounts, and the virtues of economic development tax incentives. They also state that, all too often, economic development methods can be politically driven and that this causes good management practices to be thrown aside¹². It has also been suggested that not only will the existence of a TIF district depend on the political atmosphere of the municipality, but the method or process of approval will, too¹³. Hall and Bartels empirically study two things: pre-implementation risk assessment methods and post-implementation performance measurement methods. They conclude that better managed TIF districts, especially regarding pre- and post-implementation assessments, typically show better performance¹⁴. While this does make sense, Weber argues that “municipalities also need to migrate more of the fiscal risks back to the developers and big-box tenants receiving generous TIF subsidies.” She uses the example of Chicago, in which, except for the largest and safest TIF projects, they have “opted for [promissory] notes or pay-as-you-go arrangements”¹⁵. I argue that unless a proposed TIF district is determined through pre-implementation assessments to be extremely low risk, a reverse TIF method would be safest for a municipality. If traditional TIF is considered the inherently riskiest method, good management would try to balance this risk by applying it to only low risk projects.

It is encouraging that using reverse TIF has been recently and repeatedly recommended to make TIF more successful overall. Despite this advice from researchers, however, there are no published studies (at least no accessible ones) analyzing the success rates and distressed rates of TIF districts relative to finance methods. I will be collecting data on both reverse TIF usage and promissory note usage, as well as bond usage, to analyze the success and distress rates of Wisconsin TIF districts.

3. Data and Methods

I have chosen for this study to follow a cross-sectional observational research design because I am observing many units at a particular point in time. My unit of analysis is individual active TIF districts, or TID's, in Wisconsin. Over 40% of municipalities have only one TID, many have several TID's, and some have many TID's; for example, Milwaukee had nearly fifty, though it is a high outlier. The sample size of TID's in this study is 315. At the beginning of the study there were 1239 total active TID's in Wisconsin.

To begin my study, I had to first obtain contact information of the Municipal Clerks of each Wisconsin municipality that utilizes TIF; this was provided by the Wisconsin Department of Revenue. Next, I designed and created a survey using Qualtrics and sent it to all of the municipalities that the DOR reported as having active TID's (further discussed below)¹⁶. I used the distressed status of each TID as my dependent variable. Whether or not a Wisconsin TID is distressed is a legal designation which is determined by the Wisconsin Department of Revenue when projected increments will not cover the project's costs¹⁷. If a district is distressed it is allowed to continue several years past its original termination date so it can make adjustments and attempt to recoup its costs. There are also certain restrictions that are put in place once a district is designated as distressed¹⁸. I chose to measure my dependent variable in this way for several reasons. First, this legal definition is well known among the local economic development community. Second, since the DOR determines distressed status, it reduces ambiguity and arbitrariness in TID "health" levels either on my part or municipalities' parts. Third, this information was readily available from the Wisconsin Department of Revenue. Of the 1239 active TID's statewide at the time of study, 76 (or 6.1%) were legally distressed. Of my 315 observations, 18 (or 5.7%) were legally distressed, which is comparable to the proportion of the population that was distressed. The standard deviation was .232.

My independent variable is the method used to finance a TID. There are several possible ways to finance a TID, but they all fit under one of two basic methods. I will refer to them as "traditional" and "reverse." Traditional financing methods include general obligation bonds, other bonds, promissory notes, and bank loans, or any combination of these. Pay-as-you-go methods or developer financing indicated a reverse method. A financing method was considered reverse any time pay-as-you-go and/or developer financing occurred, even if they occurred in conjunction with each other and/or a traditional method. Simply put, reverse can be (but does not have to be) partly traditional, but traditional cannot be reverse in any way.

The survey requested that respondents, for each of their TID's, choose the appropriate finance method among "Promissory Note or Bank Loan," "General Obligation (or other) Bonds," "Developer Financing or Pay-As-You-Go Financing," or "Other". I then recoded my responses to form a binary independent variable: a "traditional" funding category formed from "Promissory Note or Bank Loan" and "General Obligation (or other) Bonds" while "Developer Financing or Pay-As-You-Go Financing" created the "reverse" funding category. If "Other" was chosen respondents were taken to a page to further explain their methods. Of the 315 sample districts, 223 of them (or 71%) used only traditional TIF methods, while 92 of 315 (or 29%) used reverse methods to finance at least part of the district. The standard deviation was .455.

4. Analysis

I used a cross tab analysis. A cross tab analysis is especially appropriate since both my independent variable and my dependent variable are categorical and this shows a comparison between two groups. I also used row frequency to show how often TID's utilizing reverse financing are distressed and how often distressed TID's use reverse financing. I continued on to use a Chi Squared statistic to compare the actual values obtained by my survey and the values I could expect to get if there were no relationship.

Looking at just the 297 TID's that are not legally distressed from my data, 92 (or 31%) used reverse TIF methods in some capacity, while 205 (or 69%) used only traditional TIF methods. Comparing this to the 18 TID's from my data that are legally distressed, zero (or 0%) utilized reverse TIF methods. Therefore, I found zero data points that are both reverse and distressed TID's. Since both my Independent and Dependent Variables were categorical, I was also able to run a Pearson Chi-squared test for significance. I found a significant p-value of .005.

Table 1: Crosstab analysis of survey results

	Traditional TIF	Reverse TIF	Total
Not Distressed	69.02%	30.98%	100.00%
Distressed	100.00%	0.00%	100.00%
Total	70.79%	29.21%	100.00%

5. Conclusion and Discussion

In this research I chose to explore the possibility that using reverse TIF methods could lead to a lower rate of distressed TID's in Wisconsin. This is a good theory for two reasons. First, it means there is less risk for the municipalities. Second, since a developer has more to lose with a failed district, it will be less likely to push ahead with a risky project or it will be more willing to make sure the increment increases at least as much as was initially projected.

I found that of the 315 observed TID's, 205 neither used reverse TIF methods nor were distressed, 92 used reverse TIF methods and also were not distressed, 18 did not use reverse TIF methods but were distressed, and zero used reverse TIF methods and were distressed. This means that there were no findings that refute my hypothesis. I also did a Pearson Chi-Squared test and got a p-value of .005, which is significant.

What does this mean for Wisconsin's TID's? With a high amount of reservation, at least at this point in my research, I would recommend that most municipalities strongly consider using reverse TIF methods. So far, to my knowledge, this is the only data that has been collected regarding reverse TIF specifically, even though it has been recommended more than once to lower distressed TIF rates. I would go forth with the recommendation to consider reverse TIF methods because there were zero points that went against my hypothesis, but I would remain reserved because there are simply too many other possible intervening variables that must be considered in future research.

A common question has been whether the population size of a municipality (or, related, their total budget and therefore total debt payment allowance) is possibly correlated with distressed TIF rates. While I did not see an obvious pattern, I am unsure if this may be a statistically significant intervening variable.

I predict a major intervening variable to be the bond rating of the municipality. For example, the City of Madison has the best bond rating possible and has never had (and likely will never have) distressed TID's. They also, however, choose not to use reverse TIF methods because it would actually cost their taxpayers more since they can get a lower interest rate, and therefore a shorter payback period, than private developers. Bond rating could also be used as a proxy for the amount of fiscal responsibility a municipality has and may, therefore, greatly affect the probability that a municipality has distressed TID's.

Related to bond rating and fiscal responsibility is internal management practices. Since there are no obvious state standards in Wisconsin regarding neither TIF approval and implementation nor follow-up assessments, internal management quality would be critical in TID success. For example, if one municipality has very high scrutiny levels when approving their districts and it only chooses to approve TID's that are low risk, it is less likely to have distressed districts than a municipality that approves them quickly and with little prior analysis. In some cases, however, there could be a correlation between internal management practices and the amount of TID's with reverse financing methods; municipalities may designate higher risk districts as needing to use reverse methods so their risk is reduced. Extrapolating this idea to my data would still encourage the use of reverse TIF methods since there were no reverse TID's that were also distressed. The biggest problem with analyzing internal management practices, however, is the practicality of gathering the data—how would they be measured, on what type of scale, et cetera.

There are many other potential intervening variables as well, such as whether or not there was coordination with a developer before TIF implementation; the trends of property values in the community; possible effects of the Recession; if there were any changes in TIF law, either at the state level or the local level; use of financial recovery tools called clawbacks; and the TIF type, among others. Like any good research, however, it will never be over because more questions will always arise.

6. References

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- 9 Weber
- 10 Greenbaum and Landers
- 11 Greenbaum and Landers
- 12 Hall, Jeremy L., & Christopher E. Bartels. 2014. "Management Practice Variation in Tax Increment Financing Districts: An Empirical Examination of the Administrative Theory of Performance." *Economic Development Quarterly* 28 (3): 270-282.
- 13 Weber
- 14 Hall and Bartels
- 15 Weber
- 16 There were five municipalities to which I did not send the survey: Milwaukee, Madison, Waukesha, Oshkosh, and Janesville, WI. These municipalities each have so many districts that I opted to contact them via phone to ensure clarity and understanding.
- 17 Wisconsin Department of Revenue
- 18 Wisconsin Department of Revenue