A Taxing Journey

Progress and challenges on implementing Tax Increment Financing

Zach Wilcox & Kieran Larkin
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Summary

When the Government introduces Tax Increment Financing (TIF), it should be based on "Option 2" – a ringfenced TIF which is best suited for local investment finance within the proposed business rate retention system. Ringfenced TIFs protect the revenue streams of business rates uplift within an area and provide the necessary clarity and certainty. In doing so, the Government will face difficult choices on how to ration TIF in a way that keeps national debt at a reasonable level while not preventing worthy projects. At the same time, the Government must recognise that TIF is not a viable option for every city, and it should provide the necessary tools and guidance for cities to determine if TIF is right for them as soon as possible so preparations can move ahead.

TIF is not *the* answer to local development challenges, but, if designed the right way, it can provide new opportunities for the UK's cities to invest in their growth.

Introduction

Tax Increment Financing (TIF) is seen by many as the big answer to the challenges facing cities and the regeneration sector in the UK today. When announcing the Government's intention to introduce TIF in his speech to Conference last year, Nick Clegg, Deputy Prime Minister, asserted:

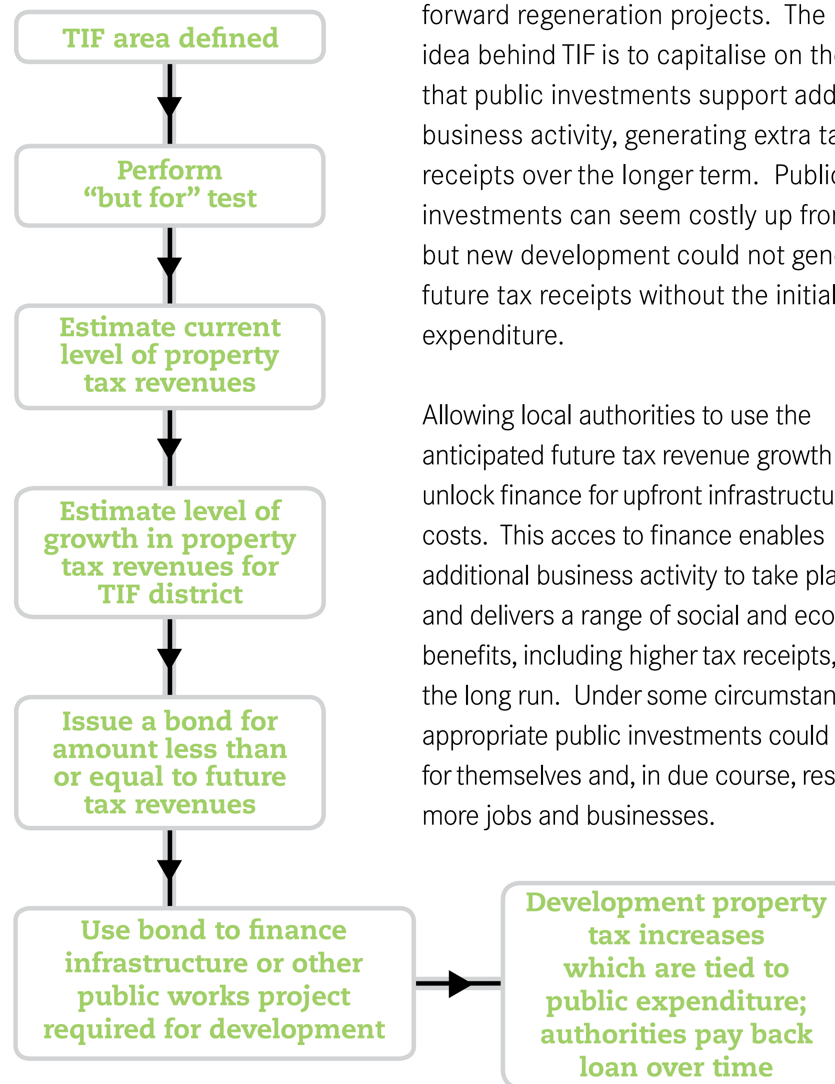
"I assure you it is the first step to breathing life back into our greatest cities."

Despite this demonstration of support, over the past 12 months only a few details have emerged as to what TIF will look like in a UK context.

This research note seeks to update thinking on TIF in light of recent developments, such as Enterprise Zones (EZs) and the Local Government Resource Review (LGRR). It argues that, while TIF is an important tool, it won't be the answer to local finance needs for every city. Accordingly, local authorities' expectations need to be realistic. At the same time, more can be done to ensure local authorities are ready for TIF once it is implemented and make sure that it is as effective a mechanism as possible.

1. What is Tax Increment Financing?

Figure 1: The TIF Investment & Development Process



Tax Increment Financing (TIF) is a funding mechanism, developed in the US, for financing new infrastructure and bringing forward regeneration projects. The key idea behind TIF is to capitalise on the fact that public investments support additional business activity, generating extra tax receipts over the longer term. Public investments can seem costly up front, but new development could not generate future tax receipts without the initial expenditure.

Allowing local authorities to use the anticipated future tax revenue growth can unlock finance for upfront infrastructure costs. This acces to finance enables additional business activity to take place and delivers a range of social and economic benefits, including higher tax receipts, in the long run. Under some circumstances, appropriate public investments could pay for themselves and, in due course, result in more jobs and businesses.

Tax Increment Financing in the US

TIF has been used in the US for more than 50 years. While the model varies between states, a TIF zone is usually a small site. The current property tax receipts (and in some cases sales taxes) from the site are considered fixed, with the additional growth in these taxes for a period of up to 30 years taken as an increment. The municipality then issues a bond, sometimes via a development corporation, to be repaid on receipt of the future tax revenues.

The funding raised from the bond issue is used to make new development in an area viable, either through infrastructure or public realm improvements. As part of the agreement the developer often accepts some of the risk, for example, by guaranteeing the property tax receipts even in the absence of tenants.

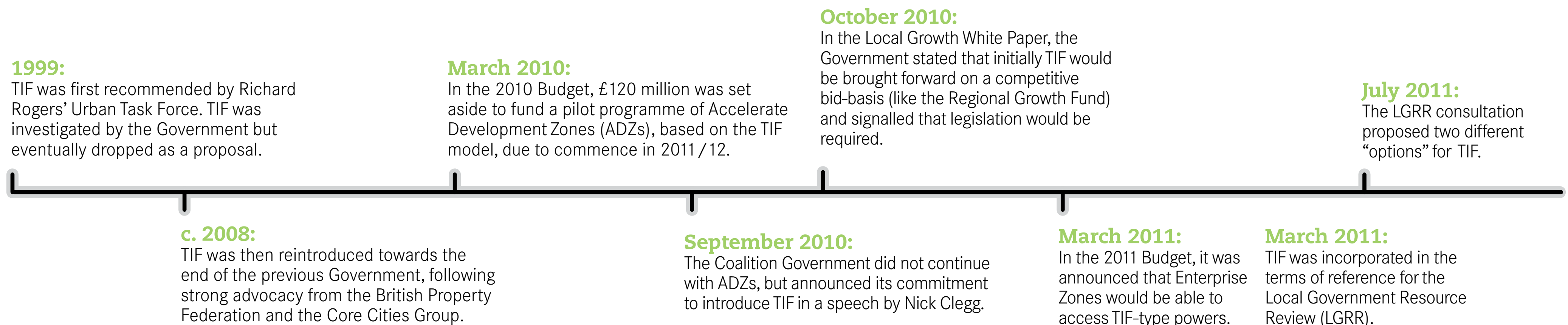
In order to secure TIF designation, a business case usually has to be put forward to demonstrate that without the TIF investment, the development would not go ahead. This requirement is known as the "but for" test.

Progress in England to date

The introduction of TIF in England has been a long time coming, as detailed in Figure 2. TIF's development has now been integrated into the wider LGRR, a package of reforms that will potentially make radical changes to the way local government funding is allocated. The scale of these changes means that inevitably they will take longer to finalise and introduce.

Many cities are frustrated with the time that it has taken to introduce TIF. Cities are looking to implement TIF as soon as possible to unleash development potential in a time when every opportunity can make a difference to slowed economic growth. The uncertainty around the design of the policy has also led to some confusion, with cities and regeneration professionals unsure how to develop their proposals. Additionally, this type of local government borrowing is new to authorities and may require investment in training or outside expertise to support implementation. The Government could do more to provide certainty towards TIF's introduction by being clearer on the details and providing guidance to local authorities on how TIF might or might not be implemented appropriately in their area.

Figure 2: Timeline to TIF



Box 1: TIF in Scotland

Scotland has already implemented Tax Increment Financing and offers some early lessons learned for implementing it in England. Though the system in Scotland may be less "light touch" than we would advocate for England, there are aspects of the TIF system from which England should borrow.

- **Rigorous vetting of TIF business cases.** Before a TIF programme can move forward, the business case must be scrutinized and approved by three groups: the local council, the Scottish Futures Trust and the Scottish Government. At each level, these groups are ensuring that the business case is sound, that the TIF passes the "but for" test, and there is a good projection of true additionality in the plan.

  Lesson: *The same sentiment can be used in England; LEPs could act as independent reviewers of TIF schemes to ensure they are viable and will provide significant public benefit.*

- **Long-term and involved process.** TIF programmes are not easy to develop. In fact, they are much more difficult than gaining planning permission alone or using the prudential borrowing powers of an authority. The experience in Scotland has shown that TIF requires the use of outside intelligence and expertise. Authorities have utilised property and economic consultancies to provide the skills base and man power needed to deliver a TIF plan.

  Lesson: *Demonstrating additionality, anticipating legal challenges and showing how the plan will unlock economic potential are all tasks which require expertise from which local councils will likely need to draw on outside resources.*

- **Well positioned TIF schemes may be in challenging positions.** Those TIF projects which are the least speculative may find it the most difficult to prove additionality and significant public benefits. The TIF scheme in Glasgow was well positioned to unlock local economic potential, focused more in an economically marginal area rather than a derelict space in the city. However, it was the viability of this scheme that caused it to be contested by a nearby shopping centre on the basis of competition law and a lack of public benefit.

  Lesson: *Those schemes which are most viable in England may also find it difficult to prove their "but for" case and to demonstrate a significant public benefit (because they are in less deprived areas to begin with).*

Ultimately, it is the local councils which must make the decision to bring TIF forward, and risk of repayment lies with them. Developing a TIF plan is a long-term process, and it will face much scrutiny throughout its planning and design. This means that authorities must take special care in deciding which TIF project to bring forward, especially during these uncertain financial times.

2. TIF won't be the right solution for all cities

TIF certainly represents an important development for the financing of new infrastructure in UK cities. However, there are a number of reasons to believe that TIF is unlikely to be appropriate for the economic challenges facing all cities. For TIF to work, it requires clear demand from the private sector and a reasonably buoyant local tax base. Moreover, in some cities, TIF may not be needed because a lack of infrastructure is not the primary barrier to growth.

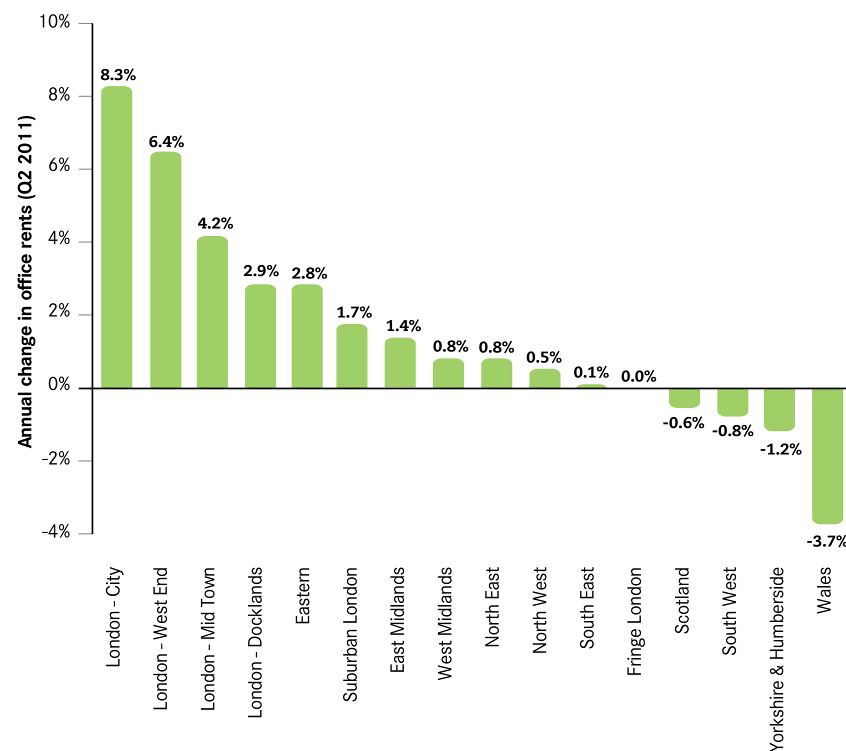
Tax Increment Financing requires private sector demand and the potential for tax growth

TIF will only be appropriate in those cities with sufficiently robust private sector demand and cities with real scope to grow their business rates tax base. Following the recession, demand for new commercial property remains subdued in many regions. Office rents in four of the UK's regional markets underwent negative growth in the year June 2010 to June 2011, and weak or zero growth was observed in four others (Figure 3). The only markets to see robust growth were in East and Central London (City of London, West End, Mid Town and Docklands). Yorkshire and Humberside and the South West are still experiencing very weak demand as are peripheral office locations in the Greater South East – for example, fringe London.

The picture is more complex at the city level. In the same period, Manchester (+5.3 percent), Birmingham (+3.6 percent) and Bristol (+5.8 percent), have all seen annual increases in prime office rents. However, prime rents have fallen in Leeds (-3.8 percent) and have not moved in Newcastle.[1]

While a recovery in demand is expected in all regions in the medium term, it seems unlikely that demand will return to the levels experienced prior to the recession in every location. In some cities, increased demand cannot be stimulated by further infrastructure provision alone. It is likely that, in such locations, developers will be unable or reluctant to bring forward new developments even when underpinned by supporting public investment. In these cases, TIF will not be a viable option.

Figure 3: Many regions currently have a lack of demand – annual growth in office rents (June 2010 to June 2011)



Source: CBRE

Similarly, TIF models based on a more general uplift in business rates across a local authority area (the two models are discussed in the next section) will only be applicable for authorities which are convinced that interventions will result in increased business rates revenues. While the majority of cities experience real

1. Cushman & Wakefield (2011) *Market Beat: An overview of the UK property market* Cushman & Wakefield Research Publications: London

terms increases in business rates revenues in the long term, the level of growth experienced is fairly low for a number of cities and likely to be insufficient to fund significant borrowing.

Table 1 lists the cities that saw the lowest growth in business rates revenues in two periods, between 2001/01 to 2005/06 and 2005/06 to 2010/11. Two main points can be demonstrated with this data. Firstly, over these shorter periods, a number of cities experienced real declines in their business rates revenues. Secondly, some cities were consistently present at the lower end of the growth table. For example, 20 of the cities in the bottom half of the growth distribution (the bottom 28 cities) between 2000/01 and 2005/06, were also in the bottom half between 2005/06 and 2010/11. Middlesbrough and Chatham came in the bottom 10 in both of these periods.

Table 1: Business rates receipts may be an insufficient revenue stream in some cities (2000/01 to 2010/11)[2]

Rank	City	Business rates growth 2000/01 - 2005/06	City	Business rates growth 2005/06 - 2010/11
47	Middlesbrough	-3%	Nottingham	-1%
48	Bristol	-4%	Crawley	-1%
49	Hastings	-5%	Birkenhead	-1%
50	Aldershot	-5%	Worthing	-2%
51	Ipswich	-6%	Middlesbrough	-2%
52	Grimsby	-6%	Chatham	-2%
53	Southend	-8%	Warrington	-3%
54	Blackpool	-8%	Wakefield	-3%
55	Bradford	-9%	Northampton	-5%
56	Chatham	-15%	Reading	-6%

Source: DCLG

2. These time periods are used because they are the dates in which revaluations are implemented. So, this makes the data more comparable. The first also represents a period of growth, while the second covers pre-post recession information.

Under the business rates retention incentives proposed in the LGRR, these cities may have been able to make investments that would have increased their revenues. However, given the low growth previously experienced in a period when publicly funded activity was often taking place, it also seems plausible that they still would not see a significant uplift in tax receipts. Again, in these cases, TIF may not be a suitable mechanism for driving economic growth. In addition to their capability for raising funds to support a TIF project, cities must also evaluate whether they have an infrastructure need that requires TIF.

Is a lack of transport infrastructure the main barrier to growth for all UK cities?

TIF has been used in the US to fund both infrastructure and services. While the UK Government has not defined what types of projects TIF may fund, the most common TIF projects are infrastructure-based, often for transportation.

It is probable that many UK cities suffer from underinvestment in the infrastructure required to support economic growth, having spent a smaller proportion of GDP on public investment over the past decade than many comparable European competitors.[3] This situation is unlikely to change in the foreseeable future; the Government's spending plans indicate that public sector net investment will fall to 1.3 percent of GDP in 2014/15 (a decrease of 48 percent from 2010/11).[4]

While a number of cities – and areas within cities – face an infrastructure deficit, others face what could be called an infrastructure "surplus". In some cities, declining populations imply that they may actually have more infrastructure than they require. Further infrastructure investments in these locations are less likely to unlock growth.

3. Larkin K, Wilcox Z & Gailey C (2011) *Room for improvement: Creating the financial incentives needed for economic growth* London: Centre for Cities
4. Larkin K (2010) *The Impact of the Spending Review for Cities* London: Centre for Cities

Congestion is an important indicator of infrastructure deficits. Only 25 percent of people across the UK surveyed by the Department for Transport think traffic or congestion is a problem, but almost 40 percent believe it is a very serious or serious problem in the UK's cities.[5] Of businesses surveyed by BCC, almost 75 percent say that road transport is essential, and 80 percent say congestion locally, regionally and nationally is a problem.[6]

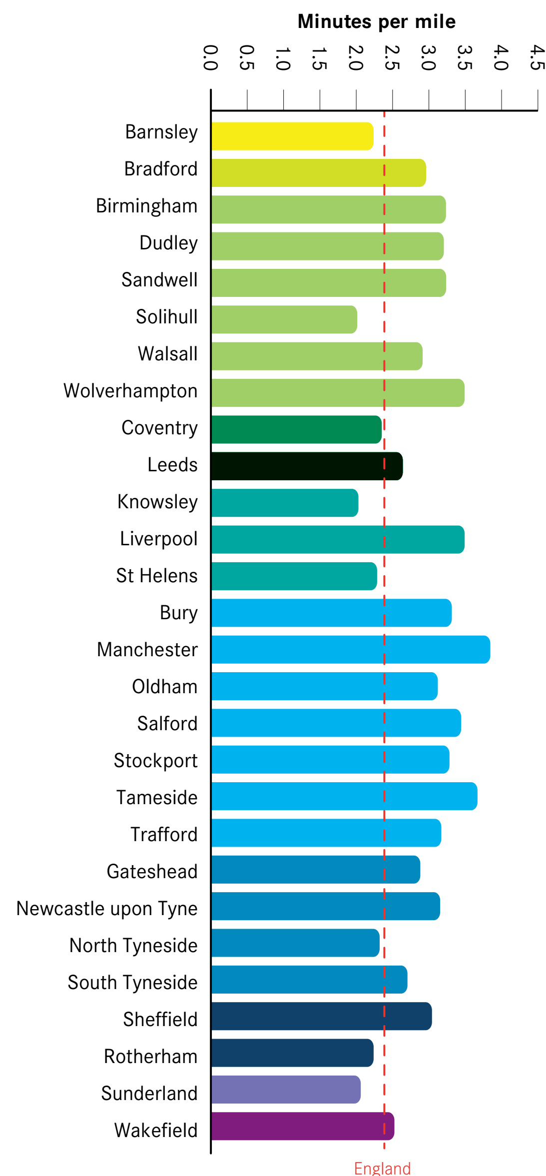
Congestion varies across the UK's cities and within them. Figure 4 shows the time it takes to travel one mile during peak morning travel time on "A" roads for local authorities within selected cities. While cities like Burnley and Sunderland have lower minutes per mile during rush hour than the English average, local authorities in Manchester and Birmingham are more congested. Within cities, though, infrastructure bottlenecks can occur in certain areas with dense housing or businesses. Within Liverpool PUA, for example, Liverpool LA has longer travel times while Knowsley and St. Helens are faster than average.

This paper does not suggest a causal relationship between having an infrastructure surplus or deficit and future economic performance. The correlation between road kilometres per person and a variety of economic indicators is weak; there are economically strong cities with road surpluses and economically weak cities with road deficits. Additionally, larger cities would also be expected to benefit from economies of scale.

However, the likelihood of a lack of infrastructure being a major barrier to growth in an economically weak city with an infrastructure surplus is small. For many cities with weaker economies, further infrastructure investments unlocked by TIF are not necessarily the answer for boosting economic performance.

5. DfT (2011) *British Social Attitudes survey: attitudes to transport 2010* London: DfT
6. British Chambers of Commerce (2008) *The Congestion Question: A business transport survey* London: British Chambers of Commerce

Figure 4: Congestion varies across cities and within cities



Source: DfT
Note: Average vehicle journey times (flow-weighted) during the weekday morning peak on locally managed "A" roads: by local authority, 2009/10

Analysis of spending by the European Structural Fund highlights the weak contribution of transport infrastructure stocks to growth in European regions, concluding that too great a proportion of this fund has been allocated towards regional infrastructure projects at the expense of other policy areas, such as human capital and innovation.[7]

The most important factor for TIF is to consider whether infrastructure investment is necessary to unlock the economic potential of new development. For tightly-bound development schemes, new infrastructure is necessitated by new development and supports wider infrastructure within the local authority as a secondary purpose. Therefore, TIF is less about the total infrastructure capacity within a city than the specific needs for new infrastructure within the transportation network to support the flow of people and goods into and out of a new development.

Summary

Any new financing model is always likely to generate considerable interest from local authorities, and expectations for TIF are understandably high. For example, 124 bids were submitted to the previous Government's invitations for expression of interest in TIF.[8] While TIF will certainly be an important part of the future of city infrastructure funding, current assumptions are likely to exceed the ability of the model to deliver. Central government may need to manage expectations to ensure that plans being developed fit with reality.

7. Crescenzi R & Rodriguez-Pose A (2008) 'Infrastructure Endowment and Investment as Determinants of Regional Growth in the European Union' EIB Papers Vol 13 (2)
8. John Healey's May 2009 invitations for expressions of interest in TIF

3. A lack of clarity is creating uncertainty and confusion

Since the Government announced its intention to introduce TIF, a variety of models have begun to emerge. Some of these bear a greater resemblance to TIF as it operates in the US than others. The lack of clarity around TIF has led to a degree of uncertainty and confusion. In the LGRR, the Government introduced two options for TIF. In addition to these options, Enterprise Zones have also been given TIF-type powers. However, beyond this very little further detail has been offered around how TIF will actually work once implemented.

In this section, we concentrate on the features of these two models and look at the challenges they might face, particularly in EZs We then look at the methods for financing TIFs.

Local Government Resource Review

Option 1: Borrowing against local authority-wide growth

The first option proposed by the Government in the LGRR is for local authorities to make use of their existing prudential borrowing powers, taking advantage of the new local business rates retention scheme, and to treat any uplift in business rates over the baseline as an additional revenue stream against which to borrow. We refer to this version as "**generalised TIF**" as the revenues from the TIF are not ringfenced and are subject to the same resetting principles as a Local Authority's general revenues. Local authorities will be able to make use of business rates growth across the whole of their administrative area to fund infrastructure improvements, rather than growth from a specific site. It is expected that funding will primarily come from the Public Works Loan Board (PWLB).

Within a system of genuinely long-term business rates retention, the option to borrow against general uplift offers a number of benefits. Firstly, as the borrowing falls within the parameters of the prudential borrowing framework, central government will not restrict its use. Secondly, the larger tax base at the local authority or LEP level, as opposed to the individual site level, means that risk can be reduced. If revenues from a specific project fail to materialise, the authority's general tax base can always be used to meet the cost of a loan.[9] Across an LEP area, the size of this tax base would be significant.

However, within the new business rates retention system proposed by the Government, generalised TIF may prove to be a fairly weak tool. In the short-term, the Government intends to restrict the business rates growth authorities can accrue with a levy and by excluding growth from revaluations. Resets to the system, even if they occur reasonably far apart – for example, every 10 years - will limit the long-term uplift and business rates revenues that areas can benefit from. Future revenues will also be uncertain as the level of the levy, top up and tariffs may be changed, or the system may be revised substantially. Since the TIF is not ringfenced in this option, local authorities can be left with TIF debt to repay after resetting periods. Overall, many local authorities may only be able to generate a relatively small short-term revenue stream subject to considerable uncertainty which will limit the potential for TIF borrowing.

Option 2: Borrowing against growth in a defined area

Option 2 proposed in the LGRR consultation is more like the traditional model of TIF as implemented in the US. We refer to this option as a "**ringfenced TIF**." Specific projects would be identified, and the business rates growth resulting from them for a set period of time would be ringfenced. The ringfenced funds would be used to service the debt associated with the upfront infrastructure costs. This is an important distinction from the generalised TIF option in which the non-ringfenced revenues are subject to complicated rules and may be sent to the Government pool. Ringfencing, in this option, better aligns the costs with the revenue streams associated with a specific TIF project; it also provides more certainty to investors.

Under the Government's proposals, within the defined area, the business rates revenues would not be subject to a levy or included in the reassessment of top ups and tariffs.[10] Excluding the TIF area from these features will mean a larger, more certain revenue stream would be available and local authorities would be able to access the uplift in rental values from the five-yearly revaluations. In fact, it is the complexity and non-ringfencing of local authoirty business rates as a whole which makes Option 2 TIF necessary. Ringfencing means that the business rates revenues and TIF area are less succeptable to shocks from the property cycle, reducing risk in repayment by the local authority. The direct link between the site and business rates growth and, most importantly, the ringfencing of TIF increment from the wider world of local government finance, means that this is the model favoured by the development community.[11]

Using TIF in Enterprise Zones

TIF, as implemented in EZs presents a different context and changes the rules of the game. EZs give businesses located in them a number of benefits, including business rates discounts, simplified planning and access to superfast broadband. They will also allow the LEPs in which they are located to capture future business rates revenues generated in the zone for 25 years or more, with the intention of enabling LEPs to borrow against this revenue stream and introduce a TIF scheme.

9. However, risk in the TIF is then associated with the local authority's financial strength rather than the specific project. This can weaken the financial discipline which should be exercised in a TIF project and lead to sub-optimal investment.

10. Under the LGRR proposals the tariff will result in a proportion of an authority's tax base being reallocated to meet the funding shortfall in top up authorities, while the levy will limit the "disproportionate growth" in business rates an authority captures.

11. Centre for Cities interviews, 2011

EZs have a number of similarities to the ringfenced TIFs set out in the LGRR consultation. As they cover small geographies – the Government anticipates the size of zones to fall between 50 and 150 hectares – the areas represent a small initial tax base.[12] The zones will also provide groups of local authorities with a long-term, ringfenced revenue steam; the 25 year period for the revenues to be captured is similar to that used in many American TIF programmes. However, TIF may have the opportunity to operate a bit differently in EZs, as they do not necessarily have to invest in infrastructure (spending is up to the LEP) and do not have to pass a "but for" test. This means that TIF in EZs bears many similarities and advantages of a ringfenced TIF, but it also allows more freedom for the borrowers.

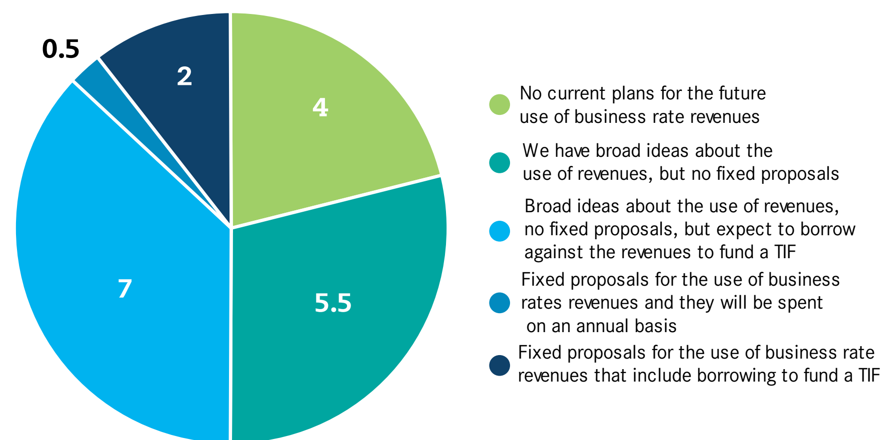
Over the 25 year period of business rate retention in the EZs, the revenue stream will also be reasonably certain. It will not be subject to the levy or tariffs which form part of the new local government finance system. EZs will be set a baseline for the amount of rates collected in their area in December 2011. From April 2013, any growth over this baseline will go to the LEP. For this reason the EZs will also be excluded from the total available national business rates pool.[13]

There are also significant differences between Enterprise Zone TIFs and the ringfenced model. Unlike TIF projects, the business rates revenues generated by EZs are not set aside for any specific use. They can be used for general revenue purposes, for example, LEP economic development programmes, rather than capital expenditure. Similarly, EZs that intend to borrow against the business rates revenues to fund infrastructure improvements are under no obligation for the improvements to be linked to infrastructure that supports the EZ site. In general, site identification of the EZs has not been linked to the need for a TIF, but it may be driven by other considerations such as the need to regenerate a certain area.

12. DCLG (2011) *Enterprise Zones: Application form and guidance* London: DCLG
13. If Enterprise Zones displace businesses from one area to another, they will reallocate tax revenues from one local authority to an LEP, of which that local authority may or may not be a member.

Given these initial conditions, it is not surprising that few EZ areas have fully worked up plans for the use of the business rates revenues and their TIF borrowing powers. Our survey of the Zones found that the vast majority of EZs have no fixed plans for how they will use their business rates revenues – although almost half intend to fund a TIF. For most LEPs, the details of the schemes or even the process by which the schemes will be selected have yet to be worked out. Even those cities with the most developed plans are still at a relatively early stage in their analysis, business planning and investment decisions.

Figure 5: Most Enterprise Zones proposals for TIF are at an early stage



Source: Centre for Cities

The lack of fixed plans for the use of TIFs in Enterprise Zones raises some important questions. Has the association of TIF with EZs introduced confusion into the likely working of a future TIF model? For example, the "but for" test – a test which is meant to guarantee that the development would not have happened without a TIF - has clearly not been an important factor in determining the location of the EZs. Does this mean that the Government is stepping away from requiring a "but for" test in determining whether TIF is an appropriate tool, and is this decision correct?

Box 2: Ready for take off? Manchester's Enterprise Zone TIF plans

Greater Manchester was selected as one of the 10 LEPs to automatically receive an EZ in the 2011 Budget. Airport City, the preferred location in Greater Manchester was announced as one of four vanguard areas. The location was chosen based on the site's potential for jobs creation and business rates growth. The proposed EZ incorporates a number of linked sites within an Enterprise Area. The proposed Zone is 116 hectares and is expected to generate 7,500 jobs by 2015.

Initial calculations have estimated that business rates revenues of £8 to 14 million will be generated by the zone by 2020. This revenue stream would provide a Net Present Value (NPV) figure of around £200 million. This implies that - allowing for some caution - a loan of perhaps £100-150 million could be secured using a TIF-type proposal.

While the Enterprise Zone itself may need some infrastructure investment, the cost of these requirements is thought to be reasonably small. TIF may be used to finance these investments or funding could be secured from other public sources.

The remainder of the revenues generated through increases to business rates will be used to support further economic priorities across Greater Manchester. This is expected to be through the Greater Manchester Investment Fund which, when combined with other revenue sources such as the New Homes Bonus, will be able to secure a greater amount of upfront capital funding. Investment priorities will then be selected from across Greater Manchester, based on the city region's project pipeline that has been developed to create jobs and growth.

4. Capturing the growth from revaluation

As well as the confusion that exists over the development of the various TIF models and the length of time it has taken to introduce their proposals, a more fundamental problem has been created at the heart of the LGRR. In the current proposals, growth from revaluation – the growth attributable to a change in the relative values of existing properties - is likely to be excluded from the uplift in business rates revenues retained by local authorities.[14] It has been suggested that authorities might be able to retain an element of the locally-specific rental growth in excess of the wider regional uplift, although the exact proposals remain unclear.

Excluding the business rates growth retained from rental uplift will reduce the size of the revenue stream available to local authorities, restricting the strength of the incentive for growth and making TIF less viable in some cases.

Property values and business rates

Business rates are paid as a percentage of the value of a commercial property. Growth in the business rates tax base comes from two sources, new revenue from additional properties or more revenue from existing properties as property values increase over time. Equally, property values can fall. Property values are driven by the demand for space relative to its supply, and thus, amongst other things, reflect the strength of the local economy.

Under the current revaluation system - carried out by the Valuation Office Agency (VOA) - changes in property values are only recorded every five years. Between revaluations the amount of the tax paid by a business

14. "This has the effect of ensuring that the incentive linked to physical growth can remain over the long run. It does, however, remove the financial gain (or loss) from wider economic uplift reflected in rental values" (DCLG Consultation, p27)

basically rises by the Retail Price Index (RPI), while the notional value of the property remains fixed. As they only take place intermittently, when revaluations do take place, large changes in property values are often recorded.

Rental value uplift is an important source of business rates growth

Rental value uplift is an important source for the growth in business rates revenues. Though it cannot be sufficiently quantified with public data, the VOA does publish historical valuation data on business properties which demonstrates on a site-by-site basis the increase in property values from one valuation to the next. This shows how increases in property values will raise the total tax intake for a local authority.

Increases in connectivity, public realm, security and local amenities can all raise the value of business premises as well as densification or constraints on supply. There are a variety of factors which the local government can influence or control to increase the quality and benefits, and thus the price, of commercial premises. However, historical factors and general economic trends can increase property values as well, without effort from the local authority.

Why does the Government only want to allow revenues from new development to be retained?

The Government's decision to restrict the uplift to business rates from new developments does have some rationale. Firstly, the Government is concerned that authorities could seek to boost their revenues by restricting commercial space leading to price rises, rather than accepting new development. While this is a valid concern, there are probably only a limited number of local authorities of sufficient size and attractiveness as a business location to engage in this type of activity.

Secondly, the Government is cautious that, because of the way revaluations are carried out, allowing local authorities to capture the rental value uplift would expose them to "significant volatility in their budgets as a result of revaluation changes which are out their control".[15]

Thirdly, the Government may not want to reward local authorities for growth which they have not supported or incentivised. Some authorities experience high growth in property values because of activities outside of their control – for instance, proximity to a new rail line extension in a neighbouring authority.

Authorities are vulnerable because, at the same time as revaluation takes place, the Government changes the Universal Business Rate (UBR), or multiplier, so that the growth in the national yield from business rates is capped at RPI growth. As property values increase at a different rate in different places, authorities that see below average increases in their local property values would actually experience a decline in their local business rates yields. At the 2010 revaluation, over 200 billing authorities saw a decline in their business rates yields.

Rental uplift is an important part of the TIF model

Traditionally, the uplift in the value of existing properties is often an important part of revenues used to finance TIF projects. New infrastructure, which improves the business environment, is known to increase local property values. For example, the Jubilee Line extension in London has shown to have a large impact on both commercial and residential property values around Southwark and Canary Wharf.[16] Improvements to a city's local economy and business environment should lead to higher property values.

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15. DCLG (2011) *Local Government Resource Review: Proposals for Business Rate Retention Consultation* London: DCLG
16. Bannister D (2007) 'Quantification of the non-transport benefits resulting from rail investment' *Transport Studies Unit* Working paper No 1029 Oxford University Centre for Environment

The decision to exclude rental uplift from the business rates revenues that local authorities accrue will make generalised TIFs, based on revenues from across the whole local authority area, far more difficult to introduce. Ringfenced TIFs (if they are given the go ahead) and EZs are expected to be able to capture the increases in local property values. The Government's concerns about the impact of rental growth on the volatility of local authorities' budgets are relevant, but these are largely generated by the design of the existing revaluation regime rather than because it is undesirable for an area's local tax base to reflect the actual value of local properties.

Rather than restricting the growth retained to that from new development, the Government should move to a system of more frequent revaluations with the fixed (nationally set) UBR. This would reduce the volatility in individual authorities making business rates more like any other tax, and would mean mean that areas are able to benefit from improvement in local property values more quickly. This would benefit both generalised TIFs which would be able to access revaluation growth, and Option 2 or ringfenced TIFs, which would capture the uplift in property values more rapidly.

Neither of these changes should have significant implications for the amount of taxation paid by individual businesses, although it would have an impact on the total yield, which would no longer be held constant. In addition, the change would not transfer tax setting powers to local authorities - the UBR would continue to be set nationally. The practicality of this option may not be as far out as many think, as states across the US undertake more regular revaluations. However, many businesses prefer the stability in values that longer revaluation periods create. The Government should consider how to mitigate those issues while increasing revaluation frequency.

5. A localised approach to rationing TIF

Because TIF sits within the overall public sector finance system, the Government will need to ration the amount of business rates revenues used for TIF for two reasons. First, they will need to limit the amount of money retained locally to ensure the shared business rates pool is large enough to pay for local government services across the country. Secondly, the national debt must be considered, and unhindered borrowing in TIF projects could raise debt to unacceptable levels. Currently, the Government is trying to reduce public sector debt as a part of its macroeconomic strategy.[17] In the consultation document, the Government specifies that it intends to impose a limit on the total amount of TIF schemes.[18]

While we agree with these two points, the Government could adopt a light touch approach to rationing. This approach should focus on ensuring that the Government maintains an acceptable debt level and sufficient funds for local government services, rather than implementing an arbitrary cap on the number of TIF schemes initiated per year.

It is important to recognise the financial implications of TIF are likely to be small in comparison to total Government spending aggregates. For example, Edinburgh's TIF plans envisage an £84 million loan serviced by annual revenues of around £7.8 million per annum. If each of England's 56 cities were to launch a TIF project of a similar size – an unrealistic prospect – it would imply a total liability of £4.7 billion, serviced by an annual revenue commitment of £440 million. This would increase public sector debt by less than 0.5 percent and represent just two percent of England's current annual business rates revenues (£20 billion).

17. In the 2010 Budget, the Government set a target for public sector net debt as a percentage of GDP to be falling at a fixed date of 2015/16
18. DCLG (2011) *Local Government Resource Review: Proposals for Business Rate Retention Consultation* London: DCLG

A localised approach to rationing might focus on some key considerations: risks to individual local authorities; the suitability of the expenditure; stability of the public finances; the level of decision makers; and, the amount authorities may borrow. With these many factors to judge, some guidelines for how TIF projects could be light touch rationed follow:

- To ensure that the amount of centrally-retained TIF is sufficient for Government to disburse to authorities, Government could limit the amount of ringfenced TIF borrowing to a proportion of business rates revenues within a LEP. For example, two percent of LEP revenues would be £100 million per annum in the Pan London LEP and £3 million in Black Country.[19]
  - Tying TIF revenues to a proportion of business rates revenues ensure the proportion is in line with the central pooling budgets.
  - Setting this at the LEP-level allows authorities to pool resources that can unlock the potential of cross-boundary projects.
  - Setting the overall limit for borrowing within a LEP will allow for larger-scale borrowing for major projects and strategic inter-authority investment, which setting the limit at the authority level may not allow.
- The LEP could determine which authorities' TIF proposals go forward based on a business plan from the local authority or authorities.[20] LEPs can build on their experience working with EZ business rates revenues and TIF as a template for working with authorities' TIF proposals.
  - Business plans should ensure that the TIF proposals are sound in structure and will offer net economic returns to the TIF area.
  - Business plans should include proof for the "but for" case of the project as well as demonstrate a rate of return to pay off the debt.
  - Having the LEP approve the business case will provide a "checks-and-balances" measure to ensure the TIF has been properly evaluated and is not simply a local "pet" project.

The approach outlined above meets the two criteria for rationing: maintaining a sizeable central pool and limiting national debt levels. The amount available to each LEP to ensure both criteria are met should be agreed for each Spending Review period. This will ensure that borrowing is not kept low in stronger economic times (if TIF limits were set as a percentage of national debt) and that the proportion of TIF revenues are kept in line with the on-going devolution of local government responsibilities and finance.

At the LEP level, some authorities may not use TIF at all, while others may want to borrow for big projects. This means that some LEPs may want to use less than or none of their TIF limit and some may want to exceed their limit. Government could choose to use a LEP's TIF monies not borrowed as a buffer against over-borrowing at the national level. Another option would allow one LEP to purchase TIF rights from another (similar to a cap-and-trade system) to make the most of financing opportunities available under the limit.

Such a light touch approach would ensure that local authorities had significant autonomy to develop their TIF schemes, while at the same time ensuring that national Government is able to maintain control over its key areas of interests. A light touch approach to rationing would also ensure that the LEPs could rapidly approve potential TIFs and avoid the creation of a bureaucratic and centralised appraisal process.

19. DCLG Council Tax and Non-Domestic Rates statistics. Analysis by Centre for Cities.
20. We recgonise that not all LEPs are at the same stage in development. Their role in facilitating TIF is contingent upon having the sufficient resources and skills in place.

Box 3: Rationing tools to avoid

- **Making local investment decisions at the national level.** In line with Government's localism agenda, decisions for TIF should be made at the local area in conjunction with the functional economic area. National-level decision making will create bureaucracy, take too long to evaluate and weigh different TIF proposals, and may undermine local knowledge of what will unlock growth.
- **Setting a national limit on the number of TIF proposals.** This hard rationing approach would set an arbitrary limit on proposals and exclude projects which could create growth.
- **Allowing free use of TIF under a certain national debt limit.** While this does reduce risk to national debt, it does not pay due respect to the need to retain a sizeable central pooling system.
- **Limiting TIF to a proportion of local asset values or national GDP.** While these are important measures of economic potential in an area, they are not directly tied to the two measures of importance in rationing: national debt and business rates revenues.
- **Allocating TIF proposals on a first come, first served basis.** This system would incentivise authorities to put forward proposals as soon as possible and could reduce the due-diligence required. Also, this may cause selection bias of less valuable TIF proposals being accepted over more valuable ones based solely on timing.
- **Prioritising regeneration areas as TIF areas.** TIF is meant to unlock the potential of an area and bring value to the economy. While some regeneration areas may do just that, opportunities in successful TIF areas may create more relative value for the national economy.

6. How will TIFs be financed?

Alongside having a development-funded revenue stream – enabled by business rates retention or hypothecation – the other necessary aspect of TIF is the ability to borrow against that revenue stream to finance the upfront investment. The method chosen to finance a TIF will have important implications for the cost of borrowing and allocation of risk.

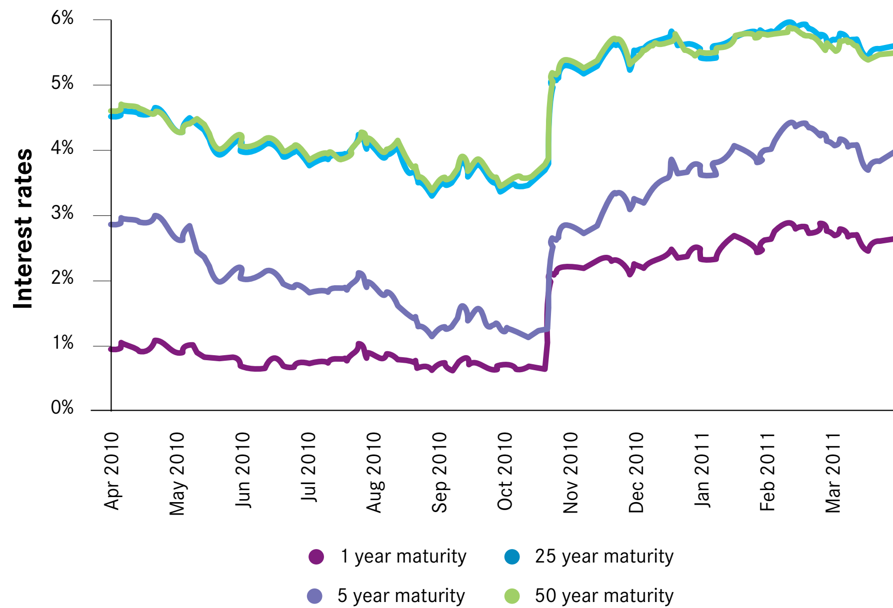
Initially, it is likely that most TIF projects will seek to access finance from the Public Works Loan Board (PWLB). It is relatively straightforward for local authorities to borrow from the PWLB, funding can be raised quickly and at a relatively low cost.

However, the PWLB is not the only option for public sector borrowing for TIF, and other options may become increasingly attractive. In the Spending Review, the Government raised the cost of borrowing from the PWLB to one percent over central government's borrowing cost, a decision which it believes will reduce total borrowing from this source by 17 percent over four years (Figure 6).

The increase in the cost of borrowing from the PWLB has led many authorities to reconsider the use of municipal bonds, accessing finance from the capital markets (see Box 4). While for most local authorities the PWLB will continue to be the cheapest form of finance, some areas, particularly those looking to secure larger amounts of money, may find municipal bonds a cost effective alternative.

It is also possible that some TIF projects could be financed directly from private sector sources. Models - such as the Local Tax Reinvestment Programme (LTRiP) - have been proposed, in which the developer pays the upfront infrastructure costs and is reimbursed through receipts of the tax increment over time. This approach offers the flexibility of transferring all the risk to the private sector and can avoid the need for any project-specific

Figure 6: Cost of borrowing from the Public Works Loan Board has risen



Source: PWLB

borrowing. Other suggestions include "sliced bonds" where bonds are issued jointly by the private and public sector, perhaps via a Special Purpose Vehicle (SPV). However, one would expect that this transfer would be offset by a corresponding increase in the cost of funding.[21]

Therefore, the most valuable application of private sector funding mechanisms may be to align interests and ensure that developers face strong incentives to deliver the required infrastructure on time. The Government should commit to allowing a range of finance forms to develop, so that cities are able to use the funding mechanism (and risk allocation) most appropriate to their particular TIF needs.

21. Based on the US experience it would also probably be the case that any bond would still need to be secured at least in part against the local authority's asset base.

Box 4: Bond Street: A new approach to funding Crossrail

In July 2011, the Greater London Authority (GLA) issued a bond worth £600 million to raise money for Crossrail, the £16.8 billion cross-London rail link. The bond issuance was the first time that a local authority had accessed the capital markets for 17 years.[22]

The main reason for the GLA choosing to go down the bond route was the increased cost of accessing finance from the Public Works Loan Board (PWLB). The GLA bond will be 0.17 percent cheaper than finance from the PWLB.[23]

Another interesting feature of the arrangements is that the bond has been issued via an SPV with favourable tax arrangements, rather than directly by the GLA. This vehicle will potentially offer local authorities, whose funding requirements are typically too small to access the capital markets directly, the ability to seek funding from this source by packaging their funding needs with those of other local authorities.[24]

22. Sherwood B (2011) 'Bond Issue to Raise Crossrail Funds' published in *Financial Times*, 3 July 2011
23. However, HMT announced that the PWLB is lowering interest rates for borrowing Housing Revenue Account reform loans. This will increase the credit available to local authorities for housing projects.
24. Hilton A (2011) 'GLA Bond Solves Local Funding Crisis' published in Evening Standard, 5 July 2011

7. Recommendations

The Government has set out two different options of TIF which have various implications for the risk, borrowing potential and their utilisation. The first version, a generalised TIF, is more of an extension of local authorities' prudential borrowing measures and it may be used to cover smaller development within an authority. The second variation, a ringfenced TIF, is most like the US version and is best suited for large scale developments. TIF projects within Enterprise Zones gives LEPs more freedom to exercise usage of the TIF and do not have to pass a "but for" test. However, it is the lengthy debate and loose definitions of these models which causes confusion and holds back the development of new proposals in the UK's cities. Accordingly, this report makes the following recommendations:

- **Tax Increment Financing is not an appropriate or feasible solution for all cities.** The Government needs to manage expectations for TIF as it is unlikely to be an appropriate model for all areas and will probably be more relevant for growing city economies.
- **Ringfenced Tax Increment Financing should be introduced** if the proposed retention system remains as complicated as it appears. The Government has developed two options for TIF, neither of which has detailed plans. This has led to some confusion, particularly as one of the models is more an extension of current local government borrowing powers. It is vital that ringfenced TIFs (or Option 2 TIFs) are introduced as a model available to local government. Below, the three reasons why a generalised version of TIF will produce a small, uncertain revenue stream that will not have the impact local governments would want from a TIF are given.
  - **Generalised TIFs are limited in time frame.** With the prospect of full government resets, the maximum life of a non-ringfenced TIF is from the time developed until the next reset (maybe 10 years). This inherently limits the life of the TIF and, thus, the amount that can be borrowed. Ringfencing, on the other hand, protects TIFs from resets and promotes full-term borrowing periods (upwards of 25 years).
  - **Generalised TIFs are subject to a levy, which reduces their revenue stream.** This limits the amount non-ringfenced TIF programmes may borrow and, thus, their effectiveness.
  - **Ringfenced TIFs provide certainty from the Government changing the system.** The system of business rate collection and retention as well as overall local government finance has changed dramatically within the past 30 years. Without ringfencing, TIF projects not protected from government changes to the system, and there is not enough certainty for lenders or a long enough time frame for borrowing.
- **Ensure that local authorities are prepared for TIF once it is introduced.** The 2013/14 financial year is a long time to wait for TIF's introduction. In order to make the most of TIF as soon as possible, local authorities should be prepared for the introduction of TIF once it is available to them. This involves providing details, supplying guidelines and training, and setting up the technical and personnel infrastructure to support TIFs within local and national government.
- **The Government should adopt a light touch approach to rationing.** While the Government is right to ration TIF, a light touch approach would probably meet its aims. Such a framework based around limiting risks to individual local authorities, the suitability of the expenditure and stability of the public finances would suffice.
- **Government should allow local authorities to capture the uplift from revaluations and introduce more regular revaluations to make TIF a more powerful mechanism.** For some TIF projects, revaluation will be an important part of the value uplift achieved. This should be accessible by all local authorities, regardless of the TIF option they choose. Moving to annual or bi-annual revaluations would minimise the unattractive volatility in rates, while increasing the viability of other TIF schemes.

Authors

Zach Wilcox, Economic Researcher at the Centre for Cities
z.wilcox@centreforcities.org / 020 7803 4323

Kieran Larkin was formerly an Analyst at the Centre for Cities

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All views expressed in this report are those of the Centre for Cities and do not necessarily represent the views of those we interviewed.

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