<UOS-ANU Seminar>

# Tax Increment Financing: Applicability to Australian Tax System as a New Financing Method for Infrastructure

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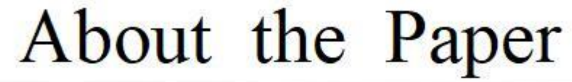



□ worked as a part of a project

- ○ “Trends of Infrastructure Investment Policies in Australia, and Implications from them” of the Korean Development Institute
- ○ not finished, in its opening stage
- ○ may not be completed and satisfactory yet

□ All your kind comments and suggestions are welcome.

# Background

□ Backward infrastructure of Australia

○ Emerging evidence that Australia's infrastructure is struggling to match growing population and expanding economy
  - General recognition that there is scope to improve the current approach to infrastructure funding and provision

○ Land itself is in plentiful supply in Australia.
  - However, land well serviced by infrastructure is in relative short supply
  - High residential and non-residential property prices in established, well serviced areas within capital cities, and high costs of development in new release areas

## ☐ Funding of public infrastructure

○ Capital goods like roads, public transport systems, education and health facilities, recreational areas, and utility services that are essential for prosperity, quality of life and for community to function properly.

- ‘External’ to the immediate consumer or ‘non-excludable’ by nature.
- Strong community expectation that some public infrastructure services, such as education and health, will be available to all citizens, at least at a basic level, regardless of their capacity to pay.
- Rather than leaving it to the ‘market’ to provide this infrastructure, there is often a strong case for the government to be involved in its funding and provision.
- Governments’ sources to fund public infrastructure include:
  - * Budget appropriations or capital grants using consolidated revenue (in turn, consolidated revenue is derived primarily from taxes)
  - * Borrowings - usually in the form of bonds
  - * Public-Private Partnerships (PPPs) in various forms
  - * User charges - charges for the use of services provided by infrastructure facilities
  - * Special Purpose Vehicles (SPVs), ‘off-budget’ agencies or companies established to operate infrastructure, often involving a mixture of funding approaches including user charges, debt finance and subsidies from government
  - * Development charges or levies - which require developers to provide infrastructure or make payment commensurate with infrastructure needs associated with new development

## ☐ Shortcomings of the current systems

○ The economic and social benefits of public infrastructure can provide strong justification for funding it from general government revenue and debt.

- However, since the 1970s, budgetary pressures have seen public capital expenditure fall, with governments more reluctant to use public debt to fund infrastructure.
- Furthermore, a problem that has emerged with financing infrastructure from general government revenue or budget appropriations is that infrastructure funds effectively have to compete with a range of short-term distractions and competing interests.
- In recent years, some states have increasingly relied on development charges to fund investment in new infrastructure.
- However, this focus on funding infrastructure via development charges is not delivering infrastructure of a sufficient scale or in an adequate time period.
- This is also impeding new development, and ultimately contributing to worsening housing supply and affordability and higher costs to business.
- Arguments against the current use of development charges include:
  - * Development charges that are passed onto new home buyers have equity effects that are generally regressive, and work against a more even distribution of wealth, and also generally increase the cost of housing for first home buyers.
  - * Property owners arguably pay twice, once as a consequence of the development levy being absorbed into the purchase price of their property, and a second time as a result of property taxes being tied to the value of the property.

# Background

☐ Shortcomings of the current systems (continued)

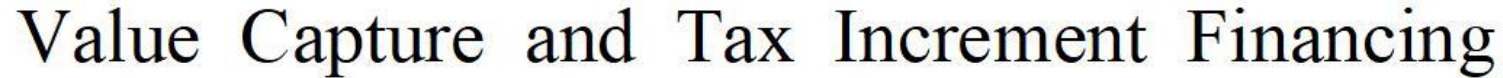
○ It is worth noting that where population growth in established areas necessitates additional public infrastructure, much of this is usually funded from tax revenue or other sources.
- The basis behind this is sound, as it would be inequitable for only new development in an established area to fund infrastructure upgrades that are required as a result of general population growth − particularly, when all residents in the area would benefit from such upgrades.

○ Development charges essentially 'drip feed' income for infrastructure investment.
- However, to be provided on a sufficient scale, and in a timely and coordinated manner, much of this infrastructure requires large upfront investment (prior to the collection of development charges).
- Under current arrangements, developers provide capital without guarantee of timely service delivery, which does not provide efficient incentives to suppliers or adequate levels of certainty to developers.
- The different application and levels of development charges within and between states can distort investment decisions.
- Difficulty in identifying and accurately quantifying costs and benefits associated with infrastructure provision can make development charges arbitrary and not truly cost-reflective, which in turn can distort the efficient allocation of resources.
- Lack of transparency and uncertainty in the current process of development charges.

# Background

- Shortcomings of the current systems (continued)

  - Developers have an incentive to fund facilities that may be less than optimal in terms of durability or scale, whereas authorities may have an interest in seeking to 'over-build' infrastructure to avoid future augmentation costs.
    - These concerns show that there is considerable merit in investigating alternative infrastructure funding mechanisms.
    - One such mechanism that has the potential to avoid many of the abovementioned weaknesses is Tax Increment Financing (TIF).



# Value Capture and Tax Increment Financing

☐ Value Capture

- Value capture is a type of public financing that recovers some or all of the value that public infrastructure generates for private landowners.

- Public investments can increase adjacent land values, generating an unearned profit for private landowners.
  - The unearned value (increases in land value which otherwise profit private landowners cost-free) may be "captured" directly by converting them into public revenue.
  - Thus, value capture internalizes the positive externalities of public investments, allowing public agencies to tax the direct beneficiaries of their investments.

- Urban planners and finance officials are often interested in value capture mechanisms, for at least two reasons: 1) because they offer a targeted method to finance infrastructure benefiting specific land, and 2) because some such investments can generate private investment in the area, which will more widely benefit the city.
  - It can be politically useful to capture for the city treasury a share of the positive externalities of city-financed investment.
  - This can help address public concern about the fact or perception of unfair windfalls when specific owners' land values increase after urban infrastructure investment is paid from general city revenues.

# Value Capture and Tax Increment Financing

## ☐ Value Capture

- Although it is not always talked about as such, the most common value capture mechanism is the general real property tax, with no special features other than regular assessment of market value.
  - The value of any given land is determined by its proximity to various amenities
  - Investment in capital improvements to land can synergistically generate capital investment in other nearby locations, which further increases land value.
  - Thus, even if the rate of taxation does not change, the tax revenue generated from properties of which benefit goes up by way of higher land values and increased development.
  - The effectiveness of value capture depends, of course, on a smoothly functioning ad valorem property or land value tax system, with regularly updated assessments.

- Value capture strategies can be applied to developers or landowners, and they can be applied before or after a public improvement is built.

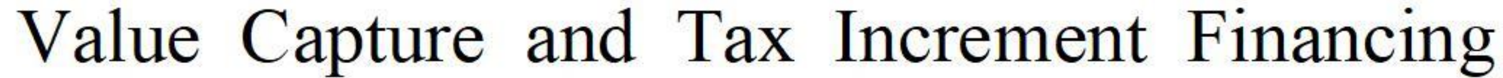
- Types of value capture include the following:
  - Land value tax (LVT)
  - Tax-increment financing (TIF)
  - Special assessment districts or improvement districts
  - Joint development
  - Infrastructure impact fees (such as traffic or utility fees)
  - Air rights
  - Exactions, public easements, or other nonpossessory interests

# Value Capture and Tax Increment Financing

## □ Tax Increment Financing

○ Tax increment financing (TIF) is a public financing method that is used as a subsidy for redevelopment, infrastructure, and other community-improvement projects in many countries, including the United States.

- Through the use of TIF, municipalities typically divert future property tax revenue increases from a defined area or district toward an economic development project or public improvement project in the community.
- The first TIF was used in California in 1952, and by 2004, all 50 American States had authorized the use of TIF, while the first TIF in Canada was used in 2007.

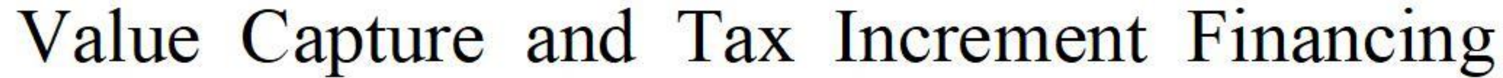


# Value Capture and Tax Increment Financing

## TIF-Use and Common Downsides

- TIF subsidies, which are used for both publicly subsidized economic development and municipal projects, have provided the means for cities and counties to gain approval of redevelopment of blighted properties or public projects such as city halls, parks, libraries etc.
  - To provide the needed subsidy, the urban renewal district, or TIF district, is essentially always drawn around hundreds or thousands of acres of additional real estate (beyond the project site) to provide the needed borrowing capacity for the project or projects.
  - The borrowing capacity is established by committing all normal yearly future real estate tax increases from every parcel in the TIF district (for 20-25 years, or more) along with the anticipated new tax revenue eventually coming from the project or projects themselves.
  - If the projects are public improvements paying no real estate taxes, all of the repayment will come from the adjacent properties within the TIF district.

- Although questioned, it is often presumed that even public improvements trigger gains in taxes above what occurs, or would have occurred in the district without the investment.
  - In many jurisdictions yearly property tax increases are restricted and cannot exceed what would otherwise have occurred.

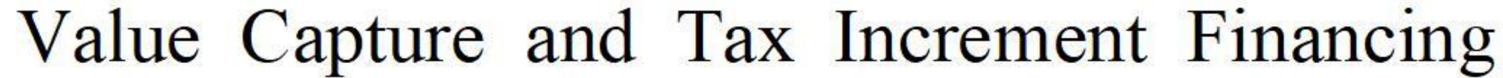


# Value Capture and Tax Increment Financing

## TIF-Use and Common Downsides (continued)

- The completion of a public or private project can at times result in an increase in the value of surrounding real estate, which generates additional tax revenue.
  - Sales-tax revenue may also increase, and jobs may be added, although these factors and their multipliers usually do not influence the structure of TIF.

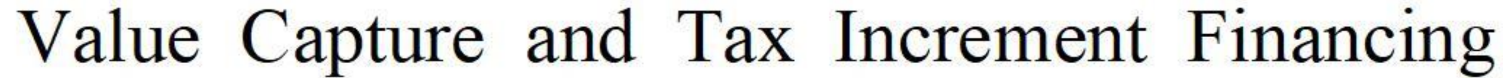
- The routine yearly increases district-wide, along with any increase in site value from the public and private investment, generate an increase in tax revenues.
  - This is the "tax increment."
  - Tax increment financing dedicates tax increments within a certain defined district to finance the debt that is issued to pay for the project.
  - TIF was designed to channel funding toward improvements in distressed, underdeveloped, or underutilized parts of a jurisdiction where development might otherwise not occur.
  - TIF creates funding for public or private projects by borrowing against the future increase in these property-tax revenues.



# Value Capture and Tax Increment Financing

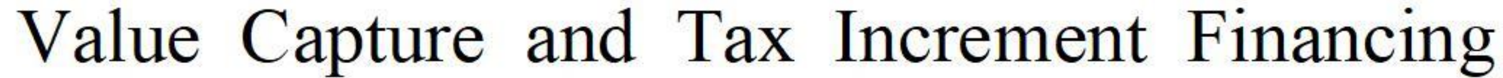
## □ TIF-History

- Thousands of TIF districts currently operate nationwide in the US, from small and mid-sized cities.
  - Since the 1970s, the following factors have led local governments (cities, townships, etc.) to consider tax increment financing: lobbying by developers, a reduction in federal funding for redevelopment-related activities (including spending increases), restrictions on municipal bonds (which are tax-exempt bonds), the transfer of urban policy to local governments, state-imposed caps on municipal property tax collections, and State-imposed limits on the amounts and types of city expenditures.
  - Considering these factors, many local governments have chosen TIF as a way to strengthen their tax bases, attract private investment, and increase economic activity.




## TIF-Applicability and Administration

- Cities use TIF to finance public infrastructure, land acquisition, demolition, utilities and planning costs, and other improvements including sewer expansion and repair, curb and sidewalk work, storm drainage, traffic control, street construction and expansion, street lighting, water supply, landscaping, park improvements, environmental remediation, bridge construction and repair, and parking structures.
  - State enabling legislation gives local governments the authority to designate tax increment financing districts.
  - The district usually lasts 20 years, or enough time to pay back the bonds issued to fund the improvements.
  - While arrangements vary, it is common to have a city government assuming the administrative role, making decisions about how and where the tool is applied.
  - Most jurisdictions only allow bonds to be floated based upon a portion (usually capped at 50%) of the assumed increase in tax revenues.



# Value Capture and Tax Increment Financing

## ☐ TIF-Unintended Consequences of TIF Subsidies

○ TIF districts have attracted much criticism.

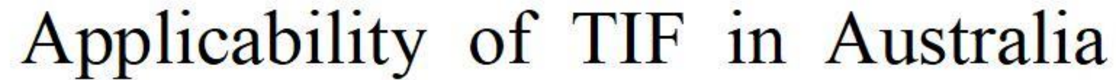
- Some question whether TIF districts actually serve their resident populations.
- Here are further claims made by TIF opponents:
  * As investment in an area increases, it is not uncommon for real estate values to rise and for gentrification to occur.
  * Although generally sold to legislatures as a tool to redevelop blighted areas, some districts are drawn up where development would happen anyway, such as ideal development areas at the edges of cities.
  * The TIF process arguably leads to favoritism for politically connected developers, implementing attorneys, economic development officials, and others involved in the processes.
  * Normal inflationary increases in property values can be captured with districts in poorly written TIFs, representing money that would have gone into the public coffers even without the financed improvements.
  * Districts can be drawn excessively large thus capturing revenue from areas that would have appreciated in value regardless of TIF designation.
  * Capturing the full tax increment and directing it to repay the development bonds ignores the fact that the incremental increase in property value likely requires an increase in the provision of public services, which will now have to be funded from elsewhere (often from subsidies from less economically thriving areas).

# Applicability of TIF in Australia

□ Potential Application of TIF in Australia

○ Based on U.S. experience, there is an opportunity for Australia to develop the necessary TIF criteria and governance arrangements to facilitate efficient and effective use of TIF to fund public infrastructure in suitable areas.

- As is the case in the US, TIF should not be the only mechanism of funding infrastructure, and it may not be suited to all circumstances.
- Furthermore, there is no one strict definition or application of TIF.
- Rather, application of the concept can be tailored to suit local development needs and governance arrangements.
- As has occurred in the US, TIF has the potential to ensure the timely delivery of much needed public infrastructure to areas where it is most needed and promote economic development. The potential application of TIF in Australia is discussed below.

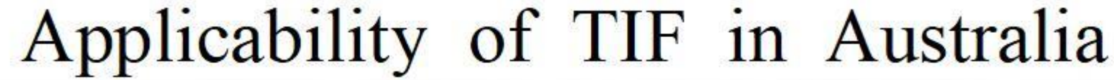


# Applicability of TIF in Australia

☐ Governance Arrangements

- The first step in implementing TIF arrangements would be for state governments - as agents primarily responsible for infrastructure funding and delivery - to establish enabling legislation and supporting regulation to:
  - provide for the establishment of TIF development bodies, their composition, rights and responsibilities
  - outline appropriate provisions/requirements of TIF arrangements - including steps for establishing TIF districts/projects and criteria for TIF designation and approval, the development and publication of TIF Development Plans, reporting/consultation arrangements, and definitions/measurement of TIF districts, tax revenue 'base' and tax revenue 'increment'.

- Such enabling legislation could provide for TIFs to be applied to 'districts' or specific infrastructure projects.
  - It is expected that one Act would be created in each state to cover TIF arrangements - rather than a separate Act for each TIF scheme within a particular state (and that, where possible, differences in TIF legislation between states should be kept to a minimum).
  - Consideration could be given to establishing TIF development authorities under this Act, or it could be referred to as a starting point in drafting specific TIF legislation, to minimize the time taken to get TIF arrangements up and running.

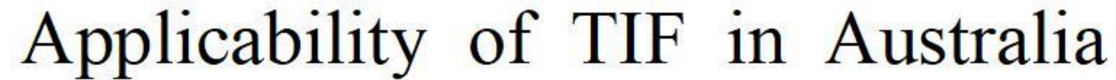


# Applicability of TIF in Australia

☐ Governance Arrangements (continued)

○ In the US, local municipalities are primarily the sponsoring agents and administrators of TIF programs.

- However, while a significant role for local councils is expected in TIF arrangements, it is generally proposed that:
  - * State taxes, rather than local government rates, be subject to TIF; and
  - * TIF arrangements in Australia involve some coordination and oversight at the state level (primarily via the approval and establishment of TIF development authorities and TIF districts)
  - * at least for the foreseeable future.
- Likewise, while TIF arrangements in some states in the U.S. are confined only to ‘blighted’ areas (although this definition of ‘blighted’ can be very broad – e.g. to include districts that aren’t growing as fast as the rest of an urban area), broader application of TIF in Australia is expected - albeit a suitably selective application, supported by an appropriate governance framework.



# Applicability of TIF in Australia

- Governance Arrangements-Aligning Tax Revenues with Infrastructure Funding Responsibility

  - Australia is relatively well placed to implement TIF as it does not have the complication of overlapping taxing bodies or jurisdictions drawing on common tax revenues in a particular area, as occurs in the US.

  - However, it does have the layers of local and state government, with revenue collected (development charges, state taxes and local council rates) and infrastructure services provided in a given area at both the state and local government level.
    - To avoid any potential fiscal imbalance and confusion about infrastructure provision responsibility between the two levels of government and ensure that TIF can be implemented as simply as possible, it is important to align revenues received under a TIF arrangement with infrastructure funding responsibility.
    - That is, if incremental state tax revenue is collected under TIF, these funds should predominantly be used to fund infrastructure that would otherwise be funded by the state Government in the TIF district, rather than local government infrastructure.
    - Likewise, if incremental local government rates or levies were to be collected under TIF, this revenue should be used to fund 'local government infrastructure'.

# Applicability of TIF in Australia

☐ Governance Arrangements-Aligning Tax Revenues with Infrastructure Funding Responsibility (continued)

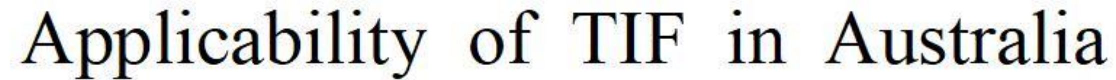
- However, it is also noted that there should be scope for some flexibility to be built into TIF arrangements.
  - For example, where there are synergies in the provision of state and local infrastructure, or these types of infrastructure overlap or are even difficult to distinguish, local councils and the relevant TIF development authority could enter into a funding and infrastructure delivery and maintenance arrangement.
  - For instance, a local council could contribute funding to the TIF development authority, in return for the TIF authority providing 'local' infrastructure (e.g. parks, upgrades to local roads and pedestrian facilities, etc) around (or to complement) 'state' infrastructure (e.g. a rail or metro station).
  - In any case, it is expected that local councils would have a close working relationship with TIF authorities operating within their jurisdiction.

# Applicability of TIF in Australia

- Governance Arrangements-State Tax Revenues and State Infrastructure

  - TIF arrangements in a state would be well placed to use incremental increases in state property tax revenue (land tax, transfer duty, premium property duty) to fund state infrastructure that is currently largely financed through state development charges.
    - These development charges currently primarily apply to new release areas - although it is also expected that significant infrastructure upgrades will be required in established areas in coming years.
    - Applying TIF at this level should ensure that TIF is used in a coordinated and strategic way to deliver infrastructure that is of benefit to the state and consistent with broader land use and development objectives.
    - It would avoid the potential for misuse of TIF, which has sometimes occurred in the U.S. when local districts seek to 'compete' with each other for development and revenue base.

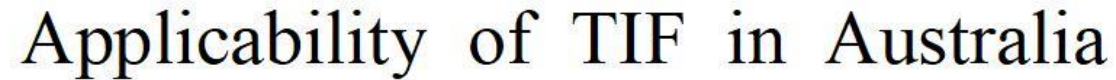
  - Using TIF to finance state infrastructure would also avoid some concerns in the U.S. that TIF is sometimes used to inappropriately subsidize private infrastructure/development with questionable public benefit.
    - State infrastructure - such as that currently covered by state infrastructure levies in the new release areas - has clear public benefit, with much of it needed as a result of general population growth.



# Applicability of TIF in Australia

## Financing Arrangements

- The U.S. experience shows that there are a range of potential sources, or combinations of sources, to finance TIF infrastructure.
  - However, bonds issued by municipalities have been the primary method of TIF funding.
  - This has comprised general obligation (GO) bonds (backed by general government revenue) and revenue bonds (secured only by the specific TIF revenues promised to investors in the bond documents).
  - In practice, it is expected that exact finance arrangements could vary from TIF to TIF, depending on their characteristics - including level of private sector involvement, type of infrastructure and tax base and property characteristics of the TIF district.

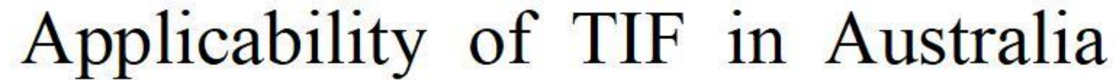


# Applicability of TIF in Australia

- Financing Arrangements-Tax Incentive for Investment in TIF

○ At various times, governments in Australia have encouraged investment in infrastructure through tax incentives, which is a feature of TIF in the U.S.

- These incentives recognize the significant social benefit that infrastructure provision can deliver, as well as the fact that, due to the large, upfront costs of infrastructure, revenues can often lag costs for some years.
- For example, in 1992 the Federal Government introduced the Infrastructure Borrowing Scheme (IBS).
- Under this legislation, interest paid on infrastructure bonds was tax exempt in the hand of the lender and not tax deductible in the hands of the borrower.
- The intention of the scheme was for lenders to pass back the benefit of tax exempt interest in the form of lower lending rates.
- However, the Federal Government soon became concerned that:
  - * schemes being proposed were "exploiting the concession for tax minimization schemes"; and
  - * these additional taxation benefits were "principally being accessed by financial packagers and high marginal tax investors."
- It was found that "The transfer of tax benefits as originally intended under legislation is not working, while most of the benefits are being captured by financiers and tax planners."



# Applicability of TIF in Australia

## □ Financing Arrangements-Tax Incentive for Investment in TIF (continued)

- Consequently, in 1997 this scheme was replaced by the Infrastructure Borrowings Tax Offset Scheme (IBTOS).
  - Like, the IBS, the purpose of IBTOS is to encourage private sector investment in the provision of infrastructure by reducing finance costs.
  - It allows infrastructure financiers to apply for a tax rebate on interest received from infrastructure providers, in return for the infrastructure providers foregoing a tax deduction on that interest.
  - However, unlike the IBS, which could be used to finance construction of a wide range of infrastructure facilities, IBTOS is limited to approved road and rail projects (although non-land projects that applied under the previous scheme are eligible to apply for a tax rebate).
    - * There is also a cap on overall cost to the scheme of $75 million per annum.
  - IBTOS is a selection (rather than entitlement) scheme, based on eligibility requirements and the merits of each project.
  - it was reported that only a small number of proponents had availed themselves of the IBTOS rebate.
  - This was believed to be because commercial decisions were made not to proceed with the project or the tax regime of the applicant was such that greater or commensurate benefits to the IBTOS rebate could be obtained elsewhere.

# Applicability of TIF in Australia

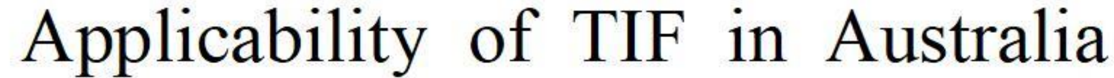
## Financing Arrangements-Tax Incentive for Investment in TIF (continued)

- In the 2004 Federal Budget, the Treasurer announced that the IBTOS is being phased out and that no further applications will be called for.
  - This is mainly because of concern that such tax benefits are still being primarily accessed by financial packagers and high marginal tax rate investors.
  - However, given the strong governance and eligibility requirements that would be imposed on TIF infrastructure and Australia's need for investment in such infrastructure, there may be merit in considering tax incentives for investors (e.g. TIF bond purchasers) to support TIF programs.
  - In developing these tax arrangements, State and Federal Government cooperation would be required.
  - Governments could also draw on the experience (and any perceived weaknesses or flaws) of previous infrastructure incentive schemes, as well as arrangements in the U.S.

# Applicability of TIF in Australia

- Financing Arrangements-Measurement and Collection of Incremental Tax Revenue

  - Key items for consideration are the definitions of the tax ‘base’ and the tax ‘increment’.
    - Apart from ‘freezing’ the tax base at pre-TIF nominal levels, as occurs in some states in the U.S., options include indexing the tax base by the rate of inflation (to ensure that it is maintained in real terms) or indexing it by a forecast ‘business as usual’ growth factor.
    - The latter approach may generate less incremental tax revenue, and hence may require some additional ‘top-up’ funding from Government or other sources.
    - However, it would ensure that TIF incremental tax revenue is additional tax revenue that is genuinely generated from the provision of the TIF infrastructure.



# Applicability of TIF in Australia

☐ Financing Arrangements-A Rate to Supplement TIF

- Closely related to TIF is the concept of Special Assessment Districts (SAD).
  - In the U.S., state enabling legislation allows a public agency to construct and maintain public infrastructure improvements, and to levy a charge against parcels of property in a defined area that have benefited from this infrastructure.
  - The Special Assessment Levy can only be levied against parcels of real estate that have been identified as obtaining a direct and unique benefit from the public infrastructure project.

- These levies are based on the principle of beneficiary pays.
  - Drawing on this principle, and to assist funding TIF infrastructure for a limited period of time, consideration could also be given to levying a supplementary charge or levy on property owners within the TIF district.
  - The merits and necessity of this could be assessed on a case-by-case basis, depending on factors such as the nature of the TIF infrastructure, forecasts costs relative to revenue and the timing of these, and the socio-economic characteristics of the TIF district.
  - It may be that it is not warranted, or is even an unwanted distraction from the core TIF arrangement.
  - Alternatively, it may prove a valuable supplement to TIF incremental tax revenue - particularly in the first few years of a TIF development term, before the tax revenue 'increment' has had a chance to gain momentum and take full effect.

# Applicability of TIF in Australia

- Financing Arrangements-A Rate to Supplement TIF (continued)

- Where this rate is applied, it must be set at an appropriate/reasonable level, and for a specified period of time.
  - There should also be a direct and obvious link between the charge and the benefits to the levied property (in the form of property/asset value appreciation).
  - It is foreseeable that it could be levied annually on households and non-residential properties on a dollar per dwelling type or dollar per $m^2$ basis, for example.
  - And that it could be collected by Local Councils (to be redistributed to the TIF development authority) via its rates collection system (i.e. it would be a clearly identified separate charge on each property's rates bill).

- TIF is a proven financing model for urban infrastructure, being employed in all U.S. States.
  - Indications are that its targeted application in Australia could be an effective means of delivering much needed infrastructure, while also assisting in improving housing affordability.
  - TIF should not be viewed as the only infrastructure funding mechanism, nor may it be suitable in all circumstances.
  - Rather, it should be considered as a potentially valuable component of a suite of infrastructure funding options.

# THANK YOU