Practical Issues in Adopting Local Impact Fees

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As cities grow, infrastructure demand and cost increase. Cities constantly seek innovative ways to fund infrastructure. Until now, infrastructure was funded almost entirely by government because infrastructure generally tends to serve a public purpose and to accelerate private investment (Miles et al. 1991, 121). Examples of key public expenditures that have fueled private investment are the billions of public works dollars spent during the Industrial Recovery period of the 1930s, the dollars spent under Title1 of the 1949 Housing Act, and the Intermodal Surface Transportation Efficiency Act (ISTEA) of 1991.

Today, a weak economy and public opposition to higher taxes have whittled down the public dollars available for infrastructure development. Thus, “ more and more of the burden of constructing capital facilities is being shifted to the private sector…” and the private sector has often been lured to provide infrastructure “either in association with private development or as a profitable enterprise” (Miles et al. 1991, 224-25). Local officials face the challenge of developing creative, equitable, and legal methods of funding infrastructure. Under the concept of public/private partnership, cities have adopted creative funding methods such as exactions or impact fees, special taxing districts, tax increment financing, subdivision improvement, and privatization.

This article focuses on impact fees, the most creative and popular of the existing infrastructure funding methods. To adopt impact fees effectively, local officials must be aware of certain legal, procedural, and equity issues. We first review the concept of impact fees. Then, we examine the pertinent legal, procedural, and equity issues that arise in adopting impact fees. Finally, we discuss the practical implications of adopting impact fees.

An Overview of the Concept of Impact Fees

Impact fees, also known as exactions, extractions, contributions, and proffers, are the financial responsibilities which a municipality places upon a developer to provide some or all of the physical improvements (from sewers and streets to parks and schools) necessitated by development and its impacts. Impact fees are levied as a condition for the approval of plat or building plans and subsequent permission to proceed with development. They are direct contributions by developers and may include dedication of land, construction of facilities, or payment of fees in lieu of these facilities. They can be levied through written provisions in ordinances or, as in many cities, through negotiations (Miles et al. 1991, 229). They are an alternative to the use of debt instruments, they can be legally controversial, especially if they are not clearly related to a public purpose (Miles et al. 1991, 230).

Impact fees, originally called exactions, were first adopted in the 1920s by cities seeking new infrastructure financing alternatives. Subsequent and more complex forms of exactions have emerged, the latest being the linkage fee. Each of these tools is a variant of an exaction, and any conceptual distinction between them is quite subtle. For example, a traditional exaction is on –site, meaning the construction of facilities or donation of land occurs on the actual parcel of land being developed. If there is no land within the parcel suitable for dedication of a facility, off-site land could be donated, or a fee accepted in lieu of a dedication (Delany 1987). When a city examines a proposed development and determines what levels of service would be required, it charges the developer a fee, usually on a per-lot of per-square-foot basis, to cover the cost of the new services.

Impact fees differ slightly from traditional exactions in that they can be used to recover capital costs incurred for both on- and off-site facilities necessitated by development. The fees are calculated under the assumption that the incremental need for infrastructure after construction of the project can be measured, and that the needs of current residents in terms of capital facilities can be isolated and identified from the needs of the new residents of the development. Linkage fees are a relatively new type of exaction and are currently in use in only a few large cities such as San Francisco and Boston. Linkage fees are an emerging technique of off-site development exaction, imposed at the certificate-of-occupancy stage, upon large-scale non-residential development to promote social policies. For example, Boston has a linkage fee requirement on all commercial developments exceeding 100,000 square feet at the rate of $5 per square foot in excess of the 100,000 square foot limit. The developer is required to pay for equal installments for seven years to a neighborhood housing trust which then finances homes for middle- and low-income occupants (Smith 1987). These fees are an attempt to tie together the construction of downtown office space with the housing needs created by the new office developments and the jobs which they create (Delany 1987).

Impact fees are now in the mainstream of local discussions of alternative funding for capital expansion. Basically, development exactions have evolved from land dedication to impact fee through a slow process, tested in the courts and modified and improved along the way. Today, impact fees are popular, yet many legal, procedural, and equity issues should be considered in any impact fee adoption decision.

Legal Dimension of Impact Fees

Impact fees have been tested in court in virtually every state where they have been used. The highest test was the 1987 case of *Nollan v. California Coastal Commission* (107 S. Ct. 3141), which was the first U.S. Supreme Court review of subdivision exactions (Lockhart 1987). In an application to the California Coastal Commission for a permit to demolish and rebuild a beachfront home, the Nollans were asked to dedicate an easement for public passage along the property line between the edge of the seawall and the ocean, laterally across the property (parallel to the shore). The commission argued that the easement furthered public interest by increasing public access to the shore, by decreasing congestion at the public beaches, and by decreasing the psychological barrier to beach use created by a continuous line of developed properties between the street and the ocean. The Court ruled that the requirement was taking of private property for public use, that it was impossible to understand how the easement decreased the psychological barrier mentioned, and that no other valid police power was served. The Court suggested that rather than requiring the dedication of land for parks or other public use purposes, the jurisdiction would do better to implement an impact fee, collect the funds, and then purchase the land itself. The impact fee would stand up to dose scrutiny because the proportional fair share has been calculated, and the courts would have less suspicion that the jurisdiction is simply trying to obtain for free what it should legally pay for (Stroud 1988).

Based on the Nollan case and other legal tests of impact fees, courts generally use a two-part inquiry to determine the legality of the fees. First, according to standard legal practice, the courts attempt to determine if the municipality has the statutory authority to impose such a fee as a condition of plat or construction approval under state law. The authority may be expressly written into state law, such as impact fee enabling legislation, or may be implied from more general grants of authority. It may be inferred from home rule charter statutes in the absence of express or dearly implied limitations. Finally, the authority is based on two basic premises. First, it is contrary to public health, safety, and welfare for development to proceed more rapidly than the public capital stock can be expanded. Second, raising user fees and taxes of current residents to finance projects that primarily benefit new residents is unfair to current residents (Nicholas 1987).

The second legal test of impact fees, once authority is determined to exist, is the application of state and federal constitutional standards, where three constitutional provisions limit the exercise of all police powers: due process of law, equal protection of the law, and the taking of private property for public use without just compensation (Morgan 1988). A court reviewing a case in a state with enabling legislation will simply determine if the municipality has food the substantive and procedural standards set forth in the enabling legislation (Morgan 1988). Enabling statutes help to enforce a standard process for implementing and administering an impact fee.

State enabling statutes enhance the process of adopting and administering impact fees. They can resolve issues of design and administration, and help to prevent many of the objections and court challenges which are not unusual in subdivision exaction proceedings. However, localities should not infer from this that it is absolutely necessary to have state approval before adopting an impact fee. The implied authority to do so is often upheld by the courts, as in, for example, *Home Builders and Contractors Association of Palm Beach v. Palm Beach County* (446 So. 2d 140 (1985)). Also, many communities have not waited for enabling statutes before adopting impact fees. This can be attributed, in large part, to the incremental and sporadic way in which state legislatures have approached impact fees. Most states have no enabling legislation, which is a disservice to planners and administrators in need of guidance in drafting fee programs (Lillydahl et al. 1988). Thus, cities in those states derive their guidelines from legal precedents and the experiences of other jurisdictions.

Concept of Implied Authority

Where no state statutes exist to guide local adoption of impact fees, courts have used the concept of implied authority to uphold the fees. The fees can be seen as a valid regulatory exercise of police powers to regulate development for public health, safety, and welfare (Morgan 1987). They can also be considered the exercise of home rule charter, which grants a locality broad powers to enact the various ordinances and regulations necessary for effective governance. Therefore, lack of a state statute is not necessarily a legal barrier to impact fee adoption. The reasonableness and constitutionality of the fee is a more important test.

Reasonableness of Impact Fees

When determining if an impact fee is reasonable, the courts use one of the three following tests: the *reasonable relationship, the specifically and uniquely attributable* and the *rational nexus.* There is no specific requirement which justices must follow in selecting the appropriate test for any given case. Initially, too few impact fee cases went to court, so no one test was established as preponderant. This situation has now changed, and the rational nexus test has emerged as the prime legal test of impact fee ordinances.

The reasonable relationship test originated in the 1949 case of *Ayres v. City of Los Angeles* (207 P.2d 1) (Rundus 1983). This test requires that a development which increases the need for infrastructure be indirectly related to the extent of the exaction levied (Morgan 1988). This is the loosest of court tests, requiring a municipality to fink the impact fee charged with the need created by the new development. California uses this test more than any other state. Yet, it is losing popularity due to recent developments such as California's Proposition 13.

The specifically and uniquely attributable test originated in 1961 with *Pioneer Trust and Savings Bank v. Village of Mount Prospect* (176 N.E.2d 799) (Rundus 1983). In this case, the Illinois Supreme Court required tying the impact fee uniquely and specifically to the incremental need for infrastructure, and documenting the exact users of the new capital facilities and precisely how the fee paid relates to need. Municipalities found it nearly impossible to document the exact level of infrastructure need generated by each development. They found it even harder to measure and isolate the benefits which would accrue from the fees paid. For this reason, courts which use this test nearly always strike down impact fee ordinances, and cities in those court jurisdictions usually explore other infrastructure revenue sources. This test is the most rarely used due to overwhelming restrictions which make it nearly impossible to charge any sort of impact fee. Illinois has subsequently modified its statutes to comply with a cost accounting approach (Stroud 1988). Between the two extreme tests above is rational nexus, a test introduced in 1968 and preferred by courts for testing the reasonableness of impact fee ordinances.

The rational nexus test originated in *Longridge Builders, Inc. v. Planning Board of the Town of Princeton* (52 NJ. 348, 245 A.2d. 366 [1968]) (Stroud 1988). Currently, it is the most popular test in use. The original ruling asserted that there must be a reasonable connection between infrastructure need and new growth. The fees charged must not exceed a proportionate share of the cost to be incurred in accommodating the development requiring the fee. A reasonable connection is also required between the expenditure of the fee collected and the benefits received by the development (Robinson 1990).

Most courts determine if a rational nexus exists between the impact fee and the infrastructure need by asking questions such as the following:

- Is the fee excessive?
- Are the funds kept in separate special accounts or funds to ensure that they are expended in the appropriate projects?
- Are the funds spent within a specific geographic zone to ensure that the appropriate people benefit, or can they be spent anywhere in the community?
- If the funds are not spent within a reasonable time period, are there provisions for refund? (Bauman and Ethier 1987).

In applying the rational nexus test, the Utah Supreme Court (*Banberry Development Corporation v. South Jordan City* [631 P.2d 899 (1981)]) suggested some practical guides to be considered (Morgan 1987). They include the cost of existing capital facilities; the manner of financing for these existing facilities; the relative extent to which new and existing residents have contributed and will contribute to the construction of these and future facilities; the extent to which new owners are entitled to a credit against the impact fee because developers have already provided facilities which are paid for through increased purchase price and other user fees; extraordinary costs, if any, in servicing the newly developed properties; and the time/ money differential inherent in any comparison of amounts paid at different times.

The rational nexus test is the focus of most discussions of the legal restrictions of impact fee ordinances. The guidelines and restrictions which are a result of the rational nexus test are the benchmark for the legality of such ordinances, and experts typically state that ordinances which follow these guidelines and adhere to the rational nexus principle are ruled legal in court.

Besides the legal considerations, it is important to state that when considering any credits which will be extended to new development, local officials should attempt to refrain from viewing development only in terms of costs, while overlooking the benefits of long-term development such as increases in tax base, sales tax, employment, and other secondary and tertiary benefits. Officials should view credits as an effective method to make the impact fee fair and acceptable to everyone, and a particularly useful bargaining tool to mitigate developers' objections to the fee.

Advantages of Impact Fees

As a creative infrastructure financing method, impact fm have advantages. They can assist localities in synchronizing development with infrastructure need by linking decisions on need to financial decisions in a practical way. Also, they can facilitate a better quality of life for the entire community in that infrastructure will be provided at necessary levels in newly developed areas. In addition, they help to mollify the antigrowth sentiments of some citizens. If citizens are aware that growth is, to some degree, paying its own way, the likelihood of serious objection to growth is lessened (Nelson 1988).

The value of impact fees becomes evident when it is realized that growth automatically increases need for infrastructure and services (Nicholas 1987). The increased general funds to meet these needs often mean increased taxes without a corresponding increase in services. Therefore, an attempt to recover some of the capitalized costs which also result from growth seems politically and economically reasonable (Bauman and Ethier 1987). Besides, due to legal restrictions, impact fees rarely cover all of the costs associated with growth. Thus, most localities view impact fees as a supplement to their financial alternatives (Leithe and Montavon 1990).

Impact fees are a viable means, beyond traditional exactions, to finance the variety of service needs created by growth. Off-site facilities such as fire stations, libraries, parks, and city halls can be financed, in part, by impact fees. Additionally, impact fees, unlike many other exactions, can be levied on land which has previously been platted. This distinction became important in Florida, for example, when a mandatory park dedication ordinance proved ineffective because large tracts of land had been platted for more than 20 years prior to the ordinance. Development proceeded on these tracts without the dedication of parkland, since the plats had been approved earlier.

The value of impact fees is not limited to financing new infrastructure. Several municipalities use impact fees to recoup excess capacity in existing facilities. Under this provision, cities which constructed a facility such as a sewer treatment plant with excess capacity to serve 10,000 more residents than were residing in the city at the time of construction can charge new residents a proportionate share of the excess capacity which is used by new development. Two methods have been approved by courts for calculating the proportionate share (Stroud 1988). One is to estimate the replacement cost of the system and deduct depreciation and remaining debt, divide this number by the number of present users of the system and the resulting figure is the recoupment charge. The other is to estimate sewage flow rates for various users of the system and divide by the total cost of the system to determine the per gallon (or similar measurement) charge for recoupment.

Problems of Impact Fees

In spite of the advantages discussed above, impact fees are not without some problems, many of which can be deduced from the contentions expressed by developers. The most vocal objection ensues from the fear that impact fees have adverse effects on the housing market and/or on profit margins. This fear also has a social dimension in that low- and some middle-income earners may be priced out of the housing market should developers build the cost of impact fees into the net cost of housing (Landis 1986; Connerly 1988). For commercial property, developers assert that consumers of office buildings and commercial space would need to increase their expected rate of return on their rent profits and capital gains as a result of paying an impact fee. In an elastic market, commercial renters may relocate some or all of their operations to cheaper locations. Rents can be raised to cover impact fees, but developers must first determine rates at which higher rents would result in vacancies (Huffinan 1988).

Another problem is the inequity that may result from the difficulty and complexity of adopting uniformly enforceable impact fee formulas and structures. In most cases, the fees are negotiable; therefore, even when municipalities do not intend any inequity in the adopted fee structures, the negotiation abilities and political currencies of developers and their attorneys could result in major differences or inequities in the implementation of the fees. Part of this inequity is that, depending on specific circumstances, developers rarely pay the full cost of the fees levied directly on them (Matzer 1989). The cost is often either pushed back to the land owner by lowering the price paid for land, or pushed forward to the consumer. Finally, the cost or part of it can be absorbed by government through some form of public contribution.

If impact fees do not accrue in the amount expected, then the ability of a municipality to finance infrastructure adequately is limited. This is true particularly where development is slow due to recession, excessive interest rates, conservative lenders, refusal by developers to build and/or willingness to build elsewhere, and an impact fee system which generates little or no revenue because of the ease with which developers can abuse it or secure exemptions from it.

Another issue on which there is hardly any consensus is that of double billing residents who relocate from one part of a city to another and are billed in both places for putting additional pressure on infrastructure (Stegman 1986, 3). While the argument can be made that these movers had, in their former residences, contributed their fair share to the city infrastructure funding in the city, a counterargument can be made that the move adds demand on infrastructure in the new location, justifying the levying of new fees. This issue has had no legal test, so cities are able to justify double billing on the basis of the demand placed on infrastructure by newcomers.

Another problem with impact fees is that they are often adopted and implemented with little or no participation from developers. Developers also argue that there is little or no factual information on the impacts which different types of development have on the development and surrounding areas. Furthermore, developers charge that there is no standardization of impact fees, hence, developers must operate under the different rules and regulations of various communities (Morgan 1988, 3-4). Other developers charge that some funds that accrue from impact fees may be spent on projects which benefit the entire community rather than the specific development paying the fees. Finally, some developers view impact fees as a way by which municipalities shirk their public responsibility to fund growth-induced infrastructure (Nelson 1988, 73-74).

Impact Fees and the Equity Factor

The Nollan decision raised certain equity and fair share issues which impact fees can be used to address. Today, these issues can more easily be resolved in dollar figures than in real property dedication (Juergensmeyer 1981). Expectations are that taxpayers should not subsidize new development. Moreover, new development should not impose a reduction in the current level of benefits or increase taxes or user fees for city services. To the extent that the objective of exactions is to achieve an equitable distribution of costs, an impact fee is designed to ensure that new development pays its pro rata share in a community that is already paying its pro rata share costs (Nicholas and Nelson 1988). In the absence of capital cost shifting devices, the developer reaps windfall profits, since she "sells" her customers the schools, parks, and other city services that are primarily paid for by earlier residents (Juergensmeyer 1981). To shift some newer costs to growth is both equitable and effective in raising the overall level of services available to all.

Practical Guides for Impact Fee Implementation

From the experiences of localities that have adopted impact fees, some basic issues can be identified which should guide other attempts to implement impact fees (Porter 1986; Lynch 1990). Among these issues are

- acceptance of the fees by developers;
- actual design and development of the system;
- determination of levels of demand and costs of construction;
- establishment of accurate rates which , reflect those levels;
- costs apportionment among residential, commercial, and industrial developments;
- method of implementing the system;
- legal restrictions; and
- structure of the impact fee ordinance.

In order to address the listed issues effectively, several writers on the subject suggest that a city adopting impact fees should:

- follow the adoption process slowly and meticulously, (ie., do it right the first time);
- be prepared for a long, complex task that does not end with ordinance adoption;
- give as much thought to the administrative process of collecting and enforcing the fee as to the actual structure;
- develop a central point for tracking and collecting the fee;
- develop several categories for land use as a way of easing the calculation of the fee;
- base estimates of facility usage on the most current and locally sensitive data available;
- design a system with provisions for unusual and unpredictable situations such as demolitions and reconstructions, additions, and adjacent structures;
- not require developers to pay different types of exactions simultaneously (ie., double contributions such as paying a fee and making a donation for the same infrastructure);
- keep funds in segregated accounts;
- issue accounting reports periodically;
- allow developers access to the fee calculation process;
- accept and review data regarding costs and usage for applicability to the situation; and
- update the data used to calculate the fee and decide how often the numbers are to be reexamined in the future (Robinson 1990; Auerhahn 1988; Leithe and Montavon 1990; Taylor and McClendon 1989).

The range of guidelines we have listed can be categorized according to the structure of the impact fee ordinance adopted and the process of implementing the fees. Robinson (1990) suggested that the structure of the ordinance contains elements such as the capital planning process, the identification of zones in which development is predicted, the projection of infrastructure needs within those zones, the formulas for the fees, credits against the fees, the accounting methods for tracking the fees, and criteria for refunding the fees after the designated time period has expired.

In implementing an impact fee system, it is important that each community devise its own system since implementation factors and influences differ so widely from city to city that it is impossible to develop a uniform implementation plan for all cities. In each city's attempt to devise its implementation process, the following general steps are suggested:

- The city should appoint a committee of builders, developers, city staff, and community leaders who are able to undertake a comprehensive review of the subject of impact fees and to develop guidelines and suggestions.
- The city must address infrastructure facility standards within its comprehensive plan. The plan should include geographic impact fee zones for the collection and expenditure of the revenues. It should also include all projected infrastructure needs and the costs associated with meeting those needs. The plan is the source of much of the information regarding needs and demands, as well as the legal justification (where the state has enabling legislation) and proof that the city is engaged in a rational, comprehensive process of managing growth.
- The rules and assumptions by which the city will operate should be clearly spelled out. Concepts of equity and management should be addressed. The city should establish the target percentage of infrastructure costs it wishes to finance through this method, generally 50-75 percent. An additional benefit of targeting a lower percentage of costs is the legal defensibility of such a goal. When the issue of authority is decided, a court would quickly determine that the fee is reasonable because the city is not attempting to recover all, but only a percentage of, costs. The issue of some benefits being enjoyed by the existing community is eliminated because this community is paying for the benefits.
- The method of calculating the fee must be determined. This discussion should include both general considerations and specific formulas. Several possible formulas exist; the city must select one which accomplishes its objective as well as conforms to its guidelines.
- The method of administering the fee must be determined. This is a complex issue which addresses the collection, enforcement, tracking, and expenditure of the fee. A proper administrative framework must be created which allows the fees to be used effectively. The city must also be able to track the funds and provide periodic reports on their collection and use.

There are a few suggestions as to how a city may mitigate some of the negative views of impact fees and generate public support. The city should ensure that its long-range plans adequately project future demands for developable land by providing such land in sufficient amounts to prevent shortage induced price increases. This can be accomplished by rezoning, annexation, and redevelopment of older parts of the city. The city should also give developers adequate warning before adopting impact fees, to provide them with greater leverage to negotiate lower land purchase prices. The city should ensure consistent land-use practices. If landowners perceive that land uses can be easily upgraded, then they will hold out for higher purchase prices, and developers will be forced to pay these higher prices which can only be justified by more intense development. Finally, the city should ensure that planners and attorneys use valid technical and administrative standards and procedures in formulating and drafting reasonable and equitable impact fee ordinances, in order to secure judicial and community approval.

Conclusion

The fiscal barometers of cities across the nation indicate a continuous need for creative new methods of financing infrastructure while existing methods are fine-tuned as they undergo legal and political tests. Impact fees demonstrate haw cities can innovatively fund infrastructure needs created by growth. Impact fees have successfully withstood fiery legal and political tests and have, as a result, become a highly popular method of financing infrastructure.

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