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HOW DEVELOPMENT IMPACT FEES AFFECT RESIDENTIAL DEVELOPMENT

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You asked how development impact fees (DIFs) affect residential development.

SUMMARY

DIFs are one-time fees towns impose on proposed development projects to defray some of the costs of constructing or improving sewers, roads, parks, schools, and other infrastructure needed to service them. Theoretical and empirical studies show that DIFs increase housing production costs, and that developers usually pass the increase along to their customers. They also cautiously suggest that DIFs may increase the sale prices of existing homes, cause developers to concentrate on building higher priced homes, and reinforce racial and economic segregation. The caution stems from a lack of data needed to test DIFs' potential effects and the difficulty of identifying, isolating, and controlling the other factors that influence the way developers and homebuyers behave.

Theoretical studies present theories or models about how landowners, developers, and homebuyers react to DIFs under different market conditions and land use policies. Some use mathematical formulas to predict how DIFs, in combination with other land use policies, affect these parties' behaviors under different market conditions. While theoretical studies systematically explain the different ways DIFs could affect housing markets, they do not use empirical data, such as home sale prices, to test their predictions.

Empirical studies, on the other hand, use this type of data to test theories about how DIFs affect housing markets. Many reflect theories about how taxes and fees generally affect housing markets and use data to test their validity. For example, a study that compares the rate at which developers build homes before and after a town adopts impact fees probably assumes that DIFs will cause developers to cut production. But in presenting its findings, the study may also show how other factors besides DIFs affect production. For this reason, empirical studies stop short of finding a cause and effect relationship.

ISOLATING FEES' EFFECTS

Most studies show that DIFs generally increase housing construction costs, but they are cautious about attributing other outcomes to this fact. DIFs are one-time fees towns impose on proposed development projects to defray some of the costs constructing or improving sewers, roads, parks, schools, and other infrastructure needed to service them. In doing so, towns shift the cost from the current taxpayers to the developer, who initially pays the fee but may subsequently add it to sales price.

Researchers have studied how the shift directly affects landowners, developers, and homebuyers and how it indirectly affects existing residential values, affordable housing stock, and demographic profiles. But their findings are often tentative because they cannot adequately isolate and assess the way other unrelated factors influence the way developers behave. This is true for both theoretical and empirical studies.

THEORETICAL STUDIES

Theoretical studies postulate how landowners, developers, and homebuyers will react to fees under different situations, such as markets where demand outstrips supply. The studies often express these reactions as mathematical equations, as the authors attempt to predict how each player will react to each situation. Some researchers use empirical data to check the accuracy of their predictions. For example, they test whether DIFs discourage developers from building units by comparing the number of units built in a town before and after it imposed fees.

Attachment 1 presents a theoretical analysis of three scenarios depicting how DIFs affect residential development. In doing so, it shows how DIFs interact with market conditions and land use policies to affect the way landowners, developers, and homebuyers behave and how that behavior affects future home construction, the value of existing homes, and the supply of housing low- and moderate-income people can afford. It theorizes that location and market factors cause certain parties to pay the fees, which in turn affect future residential development.

As the analysis shows, developers are more likely to absorb the fees and not pass them along to homebuyers in suburbs surrounding larger central cities. Here, developers are more likely to compete against each other and sellers of existing comparable homes. Since the fees cut into their profit margins, developers may concentrate on building higher priced homes, reduce home quality and size, or build only in those towns that impose no fees. Consequently, the supply of affordable housing could shrink, homebuyers could pay more for less housing, and residential development could accelerate in other towns.

New homebuyers are more likely to pay fees in desirable communities in isolate regions or large metropolitan areas. Since their choices are fewer, new homebuyers are more likely to ignore small or modest price increases. But the fee amount, in combination with land prices and zoning regulations, could cause developers to shift construction to higher priced homes. In this case, affordable housing production could shift to other communities with no or lower fees and relatively less restrictive zoning, which in turn could lead to greater racial and economic segregation.

DIFs could lead to sprawl if developers rush to develop land in outlying areas where zoning regulations are less restrictive. But a 1995 study suggested that DIFs lead to efficient growth patterns because they force new development to pay for the infrastructure it needs. The traditional cost-sharing approach, it postulated, leads to

excessive growth rates because the infrastructure costs fall on all taxpayers (Brueckner (1995), cited in Skidmore and Peddle, "Do Development Impact Fees Reduce the Rate of Residential Development?" *Growth & Change*, Fall 1998).

The analysis also suggests that DIFs could benefit existing homeowners. Roads, parks, libraries, and similar infrastructure benefit everyone, not just the new residents who paid the fees. And, since DIFs financed this infrastructure, the jurisdiction does not have to increase existing homeowners' taxes. Large DIFs, which drive up the price of new homes, make existing homes more attractive to new homebuyers, thus increasing the homes' market value. Existing homeowners indirectly benefit from the new, higher priced DIF-paying homes because those homes generate enough property taxes by themselves to pay for the services their occupants require.

But the results of other theoretical studies, when viewed as a whole, are not as clear-cut as the attachment suggests. While logic dictates that DIFs reduce residential development, they "increase the development value of land. To the extent that these infrastructure and public services would not be provided in the absence of an impact fee system (or be provided in a lesser quantity or lower quality), the net effect may be to increase the value of land for development purposes and therefore the rate of agricultural land conversion. " DIFs may also "reduce the growth in property tax burdens which may serve to encourage residential development" (Skidmore and Peddle).

EMPIRICAL STUDIES

Attachment 2 summarizes the results of several empirical studies examining how DIFs affect residential development. As the summary shows, researchers have collected and studied empirical data to see how DIFs affect construction costs, home sale prices, residential construction rates, and affordable housing supply. All showed that DIFs increase construction costs and that most developers pass the difference along to homebuyers. Some presented market conditions under which land sellers might absorb the DIFs by reducing lot prices, but presented no empirical evidence of this effect.

Countywide studies in Florida (1992), California (1997), and Illinois (1999) show that developers, in most cases, tack the DIFs onto the sales price and thus pass them along to homebuyers. But in an economically distressed section of California's Contra Costa County developers absorbed about 75% of the fees. This fact, the study speculated, could discourage developers from undertaking future projects. The Illinois study found that the increment in new home sale prices more than exceeded the DIFs, a fact the researchers attributed to the fees and regulatory delays.

A 1999 study found that DIFs significantly increased sale prices for new and existing homes in eight Du Page County, Illinois suburbs. These findings seem to confirm theoretical speculation that DIFs can indirectly drive up the sales price of existing homes if more buyers see them as comparable substitutes for new homes.

This study also postulated that the overall price increases could price some long-term residents out of the area and could deter lower-income families from becoming first-time homebuyers. The latter are more likely to feel the DIFs regressive effects, which stem from the fact that the fee amounts are often based on the number of people in a household, not their income or the home sale price. The study also speculated that

DIFs, along with other factors that drive up housing costs, can lead to or reinforce racial and economic segregation along geographic lines.

A 1998 countywide study found that home building decreased in those areas that imposed the fees, but did not find a corresponding increase in those areas that did not. The study also found that property taxes were lowered where the fees were imposed, but did not increase housing demand to the point where it stimulated more home construction.

Attachment 1: Theoretical Analysis of How Development Impact Fees (DIFs) Affect Residential Development

<i>Location Characteristics and Market Conditions</i>	<i>Party Paying Fee</i>	<i>Parties' Reactions to Fees</i>			<i>Potential Unintended Effects</i>
		<i>Land Owner</i>	<i>Developer</i>	<i>New Home Buyer</i>	
<p>Suburban areas in larger metro markets:</p> <ul style="list-style-type: none"> · Broad range of housing choices · Buyers shop around for comparable, lower-priced homes · Land use controls and DIFs vary by community 	<p>Initial home buyers and developer split fee when first imposed</p> <p>Later, home buyers will pay most of fee</p>	<p>In the long run, owners may have to reduce prices (and absorb some of the fees) if buyers are price conscious and developers compete for their dollars</p>	<p>Initially absorb some of the fees, but then shifts toward building higher priced homes or moves to other geographic markets</p> <p>Developers who remain will be able to add more of the fee amount to the sales price if drop in production subsequently intensifies demand</p> <p>Those who left may return if demand goes up, allowing them to shift the fees forward (to the land owners) or backward (to the buyers)</p>	<p>Buyers and developers initially share the fee costs, but proportions vary from community to community; in long-run, buyers will pay the largest share unless landowners reduce their prices, but difference in fee amounts for comparable lots could make it difficult for owners and developers to accurately discount land value to offset fees</p>	<p>Construction could stop in DIF communities if developers get financing to build in other markets</p> <p>Developers who remain in the market may absorb the fees by reducing lot or unit size or cut back on amenities, causing buyers to pay more for less housing</p> <p>If production drops and demand increases, the price of comparable, existing homes and their tax assessment could go up</p>
<p>Small, isolated desirable communities or large metro area suburbs offering unique attractions:</p> <ul style="list-style-type: none"> · New home buyers ignore small or modest price increases · Relatively unrestrictive land use controls (e. g. , higher permitted densities, smaller minimum lot sizes) · Low DIFs · Relatively low land prices 	<p>New home buyer</p>	<p>Offers land for sale without having to reduce sales price (since developer will pass fee forward to home buyer)</p>	<p>Tacks most of the fee amount to the home sale price</p>	<p>Pays the biggest share of the fee</p>	<p>Existing residents may benefit from certain types of fee-funded infrastructure, such as parks and road improvements</p>

<p>Very desirable locations in larger metro areas:</p> <ul style="list-style-type: none"> · Limited range of housing choices · New home buyers ignore small or modest price changes · Restrictive land use controls · High DIFs · Relatively high land prices 	<p>New home buyer</p>	<p>Offers land for sale without having to reduce sales price (since developer will absorb some of the fees by reducing the sales price and his profit margin)</p>	<p>Shifts toward building mainly higher priced homes</p>	<p>Depends on income: upper income home buyers can afford the higher priced homes, but the lower income ones will look for homes in other areas</p>	<p>Production of starter home drops and demand for affordable housing shifts to surrounding neighborhoods</p> <p>Economic segregation could increase if low- and moderate-income housing units become concentrated in those neighborhoods</p> <p>Higher priced property yield more property taxes while requiring fewer municipal services</p>
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Source: Huffman, Nelson, Smith, and Stegman; "Who Bears the Burden of Development Impact Fees," in *Development Impact Fees: Policy Rational, Practice, Theory, and Issues (1988)*

Attachment 2: Summary of Selected Studies Examining How Development Impact Fees (DIFs) Affect Residential Development

Authors	Time Period	Location	Effects Studied	Study Design	Findings
Nelson, Frank, and Nicholas (1992), cited in Baden and Coursey	1981-1987	Sarasota County, FL	DIFs effect on new home sales prices	Empirical: How fees interact with sale price, location, lot size, and sale dates to affect housing prices in a presumably competitive market where fees are clear and predictable and guarantee adequate services to new housing	DIFs increased sales price and value of new homes
Dresch and Sheffrin (1997)	1992-1996	Contra Costa County, CA	DIFs effect on new home construction costs and sales prices	Empirical: DIFs' effect on housing prices (after controlling for quality, market changes, and community characteristics) and conditions under which developers pass DIF costs onto home buyers	DIFs increased construction costs by \$ 20,000 to \$ 30,000 per unit Developers absorbed about 75% of fee costs in economically distressed areas and passed most of them onto to buyers in more prosperous areas
Skidmore and Peddle (1998)	1977-1992	DuPage County, Ill.	DIFs effect on rate of residential development	Empirical: Isolate DIFs' effects on residential growth rate from those of taxes, property values, and material and labor costs	29% or 31% rate reduction, depending on econometric model Fees seem to lower property taxes, but not enough to offset their effect on growth rate
Baden and Coursey (1999)	1995-1997	Eight Chicago Suburbs	DIFs effect on housing prices, moderate-income housing supply, existing	Mostly empirical: town by town comparison of fee amount for new four-bedroom single-family homes	DIFs significantly increase sales prices for new and existing homes,

			<p>home sale prices, and business development</p>	<p>on ¼ acre lot, economic model showing how DIFs interact with housing quality and location factors to affect housing prices</p>	<p>with increases ranging between 70% to 210% of fee amount</p> <p>DIFs cause more than dollar-for-dollar increase due to costly regulatory process delays</p> <p>Possible unintended consequences:</p> <ul style="list-style-type: none"> · Lower-income home buyers forced out of local market · Developers encouraged to build higher priced homes · Business have harder time attracting workers due to shrinking affordable housing supply · Towns set unnecessarily higher fee amounts
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