A PRIMER ON RESIDENTIAL IMPACT FEES

Michael L. Walden

Residential impact fees are in use, or being considered for use, in many communities in North Carolina. However, since impact fees are a public charge - some call them a tax - they have sparked controversy. This publication looks at the impacts of impact fees as well as practical and philosophic issues surrounding their use.

What Are Impact Fees?

Impact fees are one-time public charges applied to new residential construction. Impact fees are usually levied by local governments, such as counties and municipalities. The stated purpose of impact fees is to pay for the off-site costs associated with the new residences, particularly capital costs like new schools and roads, which are not covered by the property taxes assessed on those residences. Supporters of impact fees say they are needed to make residential development pay for the full public costs the development imposes on communities.

Are Impact Fees Justified?

Supporters of impact fees point to several studies showing the local public sector costs of residential development exceed the local tax revenues derived from the development.[1] These studies are typically conducted in the following way. New local public costs associated with the development are calculated based on school space and teachers required to educate the additional children, roads required to carry the increased traffic, and possibly other publicly provided services, like police and fire protection, needed for the residential development. The sum of these costs is then compared to the local tax revenues generated from the new residential development. Sometimes only property tax revenues are considered. If the costs exceed the revenues, then a shortfall occurs and impact fees are justified to close the gap.

However, other analyses dispute the justification for impact fees by taking a broader view of development.[2] The argument is that commercial development, such as stores, restaurants, and shopping centers, will typically follow residential development. Local taxes will be collected from these businesses, and when they are added to the taxes collected from the residences, these studies show the total revenue will be sufficient to fund the required additional public services and facilities needed by the residential project.

While supporters of impact fees may concede that commercial development follows residential development, they say there may be a lag of several years before this occurs. Critics of impact fees counter that, while such lags may occur, the additional local revenues from commercial activity will eventually be collected, and these revenues can be used to offset a portion of the new local public costs.

Impacts of Impact Fees

However the debate over the justification for impact fees is settled, a very important issue is their effect on housing prices. Will impact fees be added to the cost of a new house and passed along to the buyer through a higher price. Or will builders accept a lower profit and absorb the impact fees?

There has been considerable research examining this question, and the majority of the work finds a consistent result.[3] *When impact fees are imposed, prices of new homes rise, sometimes by more than the dollar amount of the fee.* How much home prices rise depends on how homebuyers value the local public services funded by the fees. The more that homebuyers value those services, the more that home prices rise.

Some studies have also found that impact fees affect existing home prices and land values. Specifically, impact fees may cause existing home prices to also rise.[4] This could occur if owners of existing homes valued the public services financed by the impact fees, and this value was incorporated into the price of their homes. In addition, there's some evidence that land values may fall as a result impact fees if builders bid less for land to maintain their profit margins.[5]

Issues in Implementing Impact Fees

If local communities do decide to enact impact fees on new residential construction, there are several practical questions to address. If the fee is designed to pay for added public education and transportation services, should it vary by the size of the family purchasing the home and also by their numbers of children and vehicles? If the answers are yes, then should the fee be different for homes of different square footages and garage sizes, or should the fee be assessed only after seeing the size and type of the purchasing household?

There's also the sticky question of what happens when a family in an existing home adds a child or vehicle. To be consistent with the theory of impact fees, this household should pay an additional fee. Are impact fees to be applied in these cases?

These are issues that communities considering impact fees should address and debate before adopting the fees. They are crucial in allowing citizens to gain an understanding of the logic of the fees.

Issues in the Philosophy of Impact Fees

Last, there's a philosophical issue regarding impact fees. For the most part, local governments have for a long time funded public services, like roads, schools, and public safety, through general taxes that everyone pays. The tax support is not dependent on how much the household directly uses the services.

So, an individual driver pays gas taxes to fund road construction even if that individual will never drive on the new road. Likewise, households with no children still pay taxes to fund public schools, and families who haven't called the police or fire departments still financially support these local public services. The reason roads, schools, and public safety is funded in this way is that all households benefit indirectly from a transportation system that moves products and workers, a school system that produces an educated workforce, and police and fire departments that create a safe community.

Impact fees represent a different approach to funding local public services. Impact fees try to more directly establish a link between use of a public service and payment for that service. So rather than the community paying for new schools or roads required by new residential development, the development directly pays for them.

Therefore, the philosophy behind impact fees is in contrast to the philosophy behind the way in which local public services have traditionally been funded, and a discussion of these two philosophies should be part of any debate about impact fees.

Summing Up

There is more than initially meets the eye regarding impact fees. This primer on impact fees has revealed four major points:

(1) There is debate over the empirical evidence addressing the justification for impact fees. Studies that narrowly measure local tax revenues only from the new residential development generally find that impact fees are justified, whereas studies that take a wider view and include associated commercial and other development come to the opposite conclusion.

(2) A very consistent finding in the studies of impact fees is that new home prices will increase as a result of imposition of the fees. Some studies find that existing home prices also increase when impact fees are adopted. Thus, the use of impact fees raises questions about housing affordability, especially for first-time homebuyers, and economic effects from a possible slowdown in residential construction.

(3) If impact fees are used, there are practical questions about how they should be implemented. Should they vary with size of the household, number of children, and number of vehicles? Also, should they be applied when a household in an existing home adds children or vehicles?

(4) There are philosophical differences between the traditional way local public services have been funded and impact fees. Traditional local public financing assumes all taxpayers benefit from local public services, even if they don't directly use them. Impact fees are based on the idea that direct beneficiaries of a public service should pay for those services.

References

[1] For a national review of these studies, see Robert W. Burchell, Naveed, A. Shad, David Listokin, Hilary Phillips, Anthony Downs, Samuel Seskin, Judy S. Davis, Terry Moore, David Helton, and Michelle Gall, *The Costs of Sprawl - Revisited*, Transportation Research Board, National Research Council, Washington, D.C.: National Academy Press, 1998. For a North Carolina study, see Mitch Renkow, *The Cost of Community Services in Wake County*, A Report to Wake County and the Triangle J Council of Governments, Department of Agricultural and Resource Economics, North Carolina State University, June 2001.

[2] Some examples of these studies are James Dewey and David A. Denslow, *Growth and Infrastructure in Alachua County: Does Conventional Development Pay Its Share of Public Costs?*, Bureau of Economic and Business Research, University of Florida, August 2001; Impact DataSource, *The Fiscal Impact of Five Residential Subdivisions in the Greater St.Louis Area*, Austin, Texas, 2004; and Michael L. Walden, *Economic Impact of Residential Construction of Owner-Occupied Units in the Triangle, North Carolina*, Department of Agricultural and Resource Economics, North Carolina State University, January 2005.

[3] Brett Baden and Don L. Coursey, "An Examination of the Effects of Impact Fees on Chicago Suburbs, Harris Graduate School of Public Policy Studies Working Paper 99.20, University of Chicago, 2002; Charles J. Delaney and Marc T. Smith, "Impact Fees and the Price of New Housing: An Empirical Study", *American Real Estate and Urban Economics Association Journal*, 17: 41-54; Charles J. Delaney and Marc T. Smith, "Pricing Implications of Development Extractions on Existing Housing Stock", *Growth and Change*, 20: 1-12; Marla Dresch and Steven M. Sheffrin, *Who Pays for Development Fees and* Exactions, San Francisco, California: Public Policy Insitute of California, 1997; Keith R. Ihlanfeldt and Timothy M. Shaughnessy, "An Empirical Investigation of the Effects of Impact Fees on Housing and Land Markets", Lincoln Institute of Land Conference Paper, July 2002; Larry D. Singell and Jane H. Lillydahl, "An Empirical Examination of the Effect of Impact Fees on the Housing Market", *Land Economics*, 66: 82-92.

[4] See Ihlanfeldt and Shaughnessy and also Dresch and Sheffrin.

[5] See Ihlanfeldt and Shaughnessy.