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Residential Impact Fees: What are the Impacts?

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Residential 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 that are not covered by the property taxes assessed on those residences – in particular, capital costs associated with new schools and roads.

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 issue of the *NC State Economist* examines the impacts of impact fees, as well as practical and philosophical issues surrounding their use.

Arguments For Impact Fees

Supporters of impact fees say they are needed to make new residential development pay for the full public costs that development imposes on communities. They point to a large number of "Cost of Community Services" studies showing that the local public sector costs of residential land uses exceed the local tax revenues derived from those land uses. These studies are usually conducted in the following way. The local public costs associated with different types of land uses – typically residential, commercial/industrial, and agricultural land uses – are calculated from budget data. These computed costs are then compared with the revenues attributable to those land uses. Cost of Community Services studies almost always suggest that residential land uses do not pay their way, and that commercial and agricultural land uses generally subsidize residential ones. In North Carolina counties, the most important reason for this is that public schools account for a huge fraction of county budgets – anywhere from one-third to over one-half of total county expenditures. While those expenses overwhelmingly benefit residential land uses, the source of revenue streams – particularly property tax revenues – are more evenly balanced between residential and commercial land uses.

Proponents often invoke both fairness and efficiency as rationales for the desirability of impact fees. The fairness rationale maintains that if new residential development tips the balance such that the local government must pay for the construction of a new school, landfill, or road, it is only fair that the new residents should bear the associated costs.

The efficiency rationale holds that impact fees are needed so that the true social costs of residential development, inclusive of the public services supplied to new houses, are more fully reflected in the price of a new house. This point of view takes as given the notion that the public services provided to residents of a community far exceed the value of tax revenues that those residents pay. Because local governments must balance their budgets each year, this means that any increase in the number of residential properties requires the local government to generate increased revenues via increased property or other taxes. Since a large proportion of new taxes will be paid by existing residents, this amounts to the imposition of *externalities* by new residents onto existing ones. In this light, impact fees are seen as a way of "internalizing" those externalities – that is, insuring that a larger fraction of those costs are paid for by the individuals responsible for them.

Arguments Against Impact Fees

As indicated above, proponents of impact fees take as given the notion that the public services provided to residents of a community far exceed the value of tax revenues that those residents pay. However, opponents of impact fees dispute this justification by taking a broader view of the development process. Their argument centers on the fact that commercial development, such as stores, restaurants, and shopping centers, will typically follow residential development. Local taxes will be collected from these follow-on businesses, and when they are added to the taxes collected from the residences, some studies show that 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.

Finally, not all residential developments are the same in terms of their demands on public services. High-value properties contribute more in property taxes than lower-valued ones, and households with multiple children place greater demands on local school systems than households with no children. One can credibly argue that fairness arguments cut both ways if, for example, impact fees are imposed on new expensive housing developments likely to be populated by well-to-do retirees with no children.

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. Are impact fees added to the cost of a new house and passed along to the buyer through a higher price? Or do builders accept a lower profit and absorb the impact fees?

The answer to both of these questions is yes. Whenever a fee or tax is levied on a particular good or service in the marketplace, the economic burden of that tax is shared by participants on both sides of the market – demanders and suppliers of the item in question. The fraction of the total tax burden paid by participants depends on how sensitive they are to changes in the price – the relative *price elasticities* of demand and supply. In general, the more insensitive to price a buyer or seller is, the greater the share of the overall tax burden that individual will pay.

Thus, it is not surprising that a considerable amount of research on this question suggests that when impact fees are imposed, prices of new homes rise. Research also suggests that developers' profits are smaller and less new homes are built than would be the case absent impact fees. Interestingly, some studies have found instances in which the price of new homes rises by *more* than the amount of the impact fee. This would occur if the imposition of impact fees sends a signal to prospective residents that the community in question is serious about providing high quality public goods (like good roads and good schools).

Some studies have also found that impact fees may cause existing home prices to also rise. 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.

Other Issues

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? Taking this line of reasoning one step further, what happens when a family in an existing home adds a child or vehicle? One could argue that to be consistent with the theory of impact fees, such a household should pay an additional fee.

Lastly, there is a philosophical issue regarding impact fees. For the most part, local governments have for a long time funded public services such as roads, schools, and public safety through general taxes that everyone pays. The tax support is not dependent on how much a particular household directly uses the services. 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 rarely call the police or fire departments still financially support these local public services. The reason roads, schools, and public safety are 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, impact fees represent a philosophical contrast to the traditional approaches for the funding of public services. It would seem that a discussion of these philosophical differences ought to be part of any public debate over impact fees.

Conclusions

There is more than initially meets the eye regarding impact fees. This article has suggested four major issues that are relevant to current discussions about impact fees. First, there is debate over the empirical evidence addressing the justification for impact fees. Studies that narrowly measure local tax revenues and expenditures emanating from residential land uses generally find that impact fees are justified, whereas studies that take a wider view and include follow-on commercial and other development come to the opposite conclusion.

Second, 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.

Third, 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?

Finally, 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.

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