Impact Fees Hit Close to Home

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If a new residential development is built on the outskirts of an urban area, should local governments be allowed to levy extra fees in order to cover the cost of providing public services and building new schools? Or do such fees discriminate against new-home buyers, given that owners of existing homes don't have to pay them?

This is the essence of the debate over "impact fees," the one-time charges designed to defray the perceived extra costs of new developments. Impact fees are intended to support capital improvements for public facilities and services such as schools, roads, water and sewer systems, public safety, and parks.

Usually impact fees are levied on residential developments, but there is nothing in principle to keep them from applying to new industrial or other construction. Of course, the prevalence of economic-development incentives such as tax rebates often points public policy in precisely the opposite direction for industrial development: It gets to pay less, not more.

The debate is very real and it hits close to home. In the most comprehensive study to date of the costs of growth in Guilford County, the consulting firm TischlerBise projected that residential growth between 2004 and 2020 will add an average of $15 million per year to the county's costs of building schools and providing other public services.

And yet impact fees face a tough legal environment. In late June the North Carolina Supreme Court declined to review a lower court's ruling that Durham County's two-year-old program of residential impact fees is illegal. The lower court ruled that local impact fees cannot be put in place without approval by the state.

Reviewing the Research

Before we can assess impact fees as public policy, it's important to understand their effects on housing markets. In other words, what's the economic impact of impact fees? To help me answer that, I'll make use of a paper by Matthew Tarleton, a former economics graduate student at UNCG who researched the existing literature on impact fees.

Until the 1920s, the capital costs of new developments were generally borne by existing home owners. Over the next few decades, as it was increasingly believed that home builders should share the fiscal burden of new development, states began enacting laws that required set-asides for sidewalks, parks, and other public amenities. Eventually, those set-asides evolved into monetary fees assessed on builders and developers.

Impact fees became more prevalent in the 1970s, as federal and state grants to local governments declined and anti-tax movements around the country gained force. By the 1980s impact fees were fairly common, in one form or another, throughout the United States. The use of the fees has fallen somewhat since then, though a 2000 study by the federal government found that 59 percent of all cities and 39 percent of all counties used them. Impact fees measured by various studies range from about $1,000 per home up to $20,000 in some communities in California.

Home Prices Rise

One of the primary claims of those who oppose impact fees is that they get passed on to buyers of new homes. Standard economic theory implies that of course they do, but only partially. The expected response is for the price of new homes to rise by somewhat less than the amount of the impact fee, so that the burden of the fee will be shared by home buyer and home builder. The price buyers pay rises and the price builders receive (net of impact fees) falls.

However, this simple prediction isn't confirmed by real-world evidence. Numerous studies have tried to isolate the price effect of impact fees, and the surprising result is that they generally cause new-home prices to rise by *more* than the amount of the fee itself. Like any result that appears to contradict the tried-and-true model of supply and demand, this is a puzzle to economists.

One possible explanation is that builders are gouging buyers. Under such a scenario, the builder gives the buyer the sad news that one or more impact fees will affect the price of the home, and then the builder quietly raises the price by even more. If true, this explanation would confirm the claims of builders and developers that impact fees are getting passed on to home buyers, but not in the way they'd want it confirmed.

Fortunately for builders and their lobbyists, this is unlikely. It could happen only if builders have consistently better information than buyers. That can happen in some markets such as medicine, where patients rely on their physicians for medical information. But it's probably not the case in the market for new homes.

A more likely explanation is that impact fees serve as a signal to buyers that a given residential development will be equipped with upgraded infrastructure and public services, as the fees make local government more willing to do the upgrades. As a result, buyers' willingness to pay for new homes increases and the improved infrastructure and services get capitalized into a higher price. So even though buyers take a hit on the purchase price, they benefit later when they turn around and sell their homes.

The only problem with this theory is that it can explain why new-home prices would rise by the full amount of the impact fee, but not why they'd rise by more than that. So the puzzle persists.

Another part of the puzzle is that impact fees appear to have different effects on different kinds of neighborhoods. In less affluent areas, impact fees increase new-home prices only modestly. It's in richer areas where impact fees appear to increase prices by more than the size of the fees.

Discrimination?

Much has been made of the potential discriminatory nature of impact fees, because they're levied on buyers of new homes and not on owners or buyers of existing homes. The discrepancy may be even sharper than impact-fee opponents imagine. There is evidence that impact fees actually benefit owners of existing homes, because their prices are also driven up. This is less of a puzzle, because in a typical housing market, new and existing homes compete for many of the same buyers. Something that causes new-home prices to rise tends to bid up prices of existing homes as well. It's also possible that existing neighborhoods are able to capture some of the benefits of the infrastructure improvements.

Impact on Growth Rate

Another important question about impact fees is whether they affect the rate of residential development. If they drive new-home prices up significantly, they should also reduce the pace at which new homes are built. The few studies that have addressed this issue have confirmed this expectation, and they also find that impact fees may shift development to nearby areas that don't levy the fees. Even though local governments generally use impact fees to recoup costs, not to manage growth, it's possible that growth management could be a side effect.

Conclusion

None of this is to say that impact fees should never be used by local governments. However, policy makers need to know the likely effects. They need to know that, for reasons that aren't entirely clear, impact fees may cause new-home prices to rise by more than the fees, at least in higher-end developments. They need to understand that impact fees may raise existing-home values and reduce the rate of home building. They need to think about issues of equity, i.e. who has to pay the impact fees and who benefits.

But having said all that, impact fees could still make sense if the costs of new residential development are large. Impact fees don't get levied in a vacuum. They're levied in an environment of rising public-service costs. To be sure, impact fees shouldn't be set too high. But they can be part of the solution to yet another puzzle: how and whether Guilford County's future growth should be managed.