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SENATE COMMITTEE ON GOVERNANCE & FINANCE

SENATE COMMITTEE ON HOUSING

ASSEMBLY COMMITTEE ON LOCAL GOVERNMENT

ASSEMBLY COMMITTEE ON HOUSING & COMMUNITY DEVELOPMENT

February 26th, 2020

Committee Background

This background paper prepares the members of the Senate Governance & Finance and Housing Committees and the Assembly Local Government and Housing Committees for the February 26, 2020, informational hearing titled "The Price of Civilization: Benefits and Costs of Impact Fees on Housing in California." Through this hearing, the Committees will explore the balance between the need for public services supported by impact fees and the effects that higher fees have on developers and ultimately home prices.

At the hearing, the Committees will first receive an overview of local fiscal constraints that drive the need for local governments to impose impact fees, as well as a description of the legal requirements that guide how local governments establish impact fees, the amounts they may charge, and the manner of collection. Second, the Committees will hear from local government service providers on their uses of impact fees and the importance of these fees to their ability to provide service to new residents and mitigate effects on existing residents. The third panel will highlight several cities and counties that have adopted innovative strategies for setting impact fees to address the unique circumstances within their jurisdictions. Finally, the Committee will hear from developers—both for-profit and non-profit—as well as the Terner Center for Housing Innovation on the effect of impact fees on supply, and ultimately, housing prices.

This background paper:

- Previews the legal framework governing local government revenue sources, including impact fees;
- Identifies common uses of impact fees and distinguishes impact fees from other costs imposed on developments;
- Reviews some impact fee practices that local governments use to achieve local policy goals; and
- Provides an overview of recent research on the effects of impact fee effects on the building industry.

Impact Fees and Other Local Government Revenue Sources

Local governments pay for services using a variety of mechanisms, including fees for the cost of facilities needed to provide services to new residents—known as impact fees, mitigation fees, or developer fees.

Constitutional Limits on Local Government Revenues. Local governments have seen their tax revenues decline on a per-capita basis since Proposition 13 (1978) capped property tax rates at 1% of assessed value, which only changes when ownership changes, capped the growth in assessed value to 2% per year, and required 2/3 vOter approval for special taxes. As a result, local governments turned to general' taxes to avoid the higher voter threshold. When Proposition 62 (1986) required majority voter approval of general taxes, local governments turned to assessments that were more closely tied to the benefit that an individual property owner receives. Subsequently, Proposition 218 (1996) required voter approval of parcel taxes and created a landowner-voter process for approving assessments and property-related fees.

As a result Of these limitations, the revenue that local governments in California receive from taxes has declined on a per-capita basis. A 2018 report on Proposition 13 by the Legislative Analyst's Office notes that, "adjusted for inflation, cities and counties received roughly $790 per person in 1977-78, but only about $640 per person in 2014-1-5." Local governmelåts made up for this shortfall by imposing other types of fees and assessments, so overall local revenues per capita have increased in California since the passage of Proposition 13, but less so than has occurred for local governments in other parts of the United States.

Dissolution ofRedevelopment Agencies Eliminated Another Source ofLocal Funds to Build Affordable Housing. In 2011, as a result of serious budget shortfalls, the Governor proposed eliminating California's redevelopment agencies (RDAs). The Legislature subsequently adopted legislation to dissolve RDAs, however RDAs were required to set aside 20% of funding generated in a project area to increase the supply of low and moderate-income housing. RDAs used housing funds in a variety of ways to support and assist the development, improvement, and preservation of affordable housing. They used funds to acquire housing development sites, structures that could be converted to housing, and to develop or rehabilitate housing. RDAs also used these funds for long-term project financing, to provide down payment assistance for individual home buyers, or for grants. At the time RDAs were dissolved, the State Controller estimated that statewide, RDAs were obligated to spend $1 billion on affordable housing. The dissolution of RDAs eliminated one of the most significant, dedicated revenue sources for local agencies to invest in affordable housing projects.

Because Proposition 13 reduced per-capita local tax revenues, which was compounded by the loss of redevelopment funds, local governments increasingly rely on other sources of funding in order to mitigate the impacts created by new development and provide the facilities necessary for the services that new residents expect.

Legal Frameworkfor Impact Fees. When approving development projects, counties and cities can require the developers to mitigate the project's effects by paying impact fees. Impact fees stem from a straightforward principle: new developments should pay for the impacts that they have the community and the burden they impose on public services.

When establishing, increasing, or imposing a fee as a condition of approving a development project, the Mitigation Fee Act requires local officials to:

- Identify the fee's purpose;
- Identify the fee's use, including the public facilities to be financed;
- Determine a reasonable relationship between the fee's use and the development; and
- Determine a reasonable relationship between the public facility's need and the development.

In its 1987 Nollan decision, the U.S. Supreme Court said that there must be an "essential nexus" between a project's impacts and the conditions for approval, which is similar to the "reasonable relationship" requirement under the Mitigation Fee Act. In the 1994 Dolan decision, the U.S. Supreme Court said that conditions on development must have a "rough proportionality" to a project's impacts.

In the 1996 Ehrlich decision, the California Supreme Court distinguished between "legislatively enacted" conditions that apply to all projects and 't ad hoc" conditions imposed on a project-byproject basis. Ehrlich applied the "essential nexus" test from Nollan and the "rough proportionality" test from Dolan to "ad hoc" conditions. The Court did not apply the Nollan and Dolan tests to the conditions that were "legislatively enacted." In other words, local officials face greater scrutiny when they impose conditions on a project-by-project basis, but local officials have more leeway when setting fees that apply broadly to all projects in a given category.

Other requirements in the Mitigation Fee Act ensure that development fees are appropriately levied and spent, including that a local agency must:

- Hold at least one open and public meeting prior to levying a new fee or increasing an existing one;
- Deposit and spend the fees within five years of collecting them; and • Refund fees or make specific findings on when and how the fees will be spent for construction, if the fees are not spent within five years of collection.

What Do Impact Fees Fund, and How Are They Levied?

Uses ofImpact Fees. To ensure that any proposed impact fees meet all legal requirements, including the essential nexus test and the reasonable relationship test, local governments must conduct a nexus study prior to imposing a new impact fee or increasing a fee above the level of fees allowed by the previous nexus study. These nexus studies often identify the new demand for services from development, usually on a per-unit or per-capita basis, an expected level of service provision, and a maximum level of impact fees needed to fund the facilities to meet that level of service provision. Some nexus studies also consider the feasibility of different levels of fees and their effects on local housing production. Local governments must spend the revenues generated by impact fees on capital projects and cannot use them to support ongoing operations and maintenance. These fees can be used to improve existing facilities, but can't be spent to remedy existing service deficiencies.

Impact fees support a wide range of community services and benefits, including:

- Public safety infrastructure, including fire stations, police stations, and correctional facilities;
- Transportation infrastructure, including roads, traffic improvements, public transportation systems, and sidewalks; • Affordable housing;
- Environmental mitigation (such as habitat conservation);
- Libraries;
- Parks and open space; • Flood control; and
- Public art requirements.

In addition, local agencies that provide public utility services, including water, wastewater, and electricity, impose fees on new developments for any needed infrastructure and capacity increases, and school districts impose fees to construct school facilities needed to serve new students. While these are broadly defined as impact fees, they are governed by different statutory rules than apply to other types of impact fees, which contain more specific limitations on rates that can be charged.

Not all local governments impose fees on new developments for all of the above purposes—instead, they reflect the jurisdiction's priorities for service delivery.

Other Development Costs. Local governments also impose other costs on developers that are not strictly impact fees. These include:

- Fees to recover the costs of processing permits, reviewing plans, or performing inspections;
- Dedications of parkland or fees charged in lieu of this dedication imposed pursuant to the Quimby Act (these dedications may be combined with other park impact fees);
- Dedications of property for public infrastructure, such as streets and roads, and utility easements;
- Conditions that a developer and a city or county agree to in a development agreement;
- Mello-Roos Taxes, in which a special tax is assessed on properties that benefit from the construction of public facilities;
- Mitigation requirements under other statutes, such as the Subdivision Map Act or the California Environmental Quality Act;
- Construction excise taxes; and
- Inclusionary housing requirements that mandate a percentage of units in a development be rented or sold at a price that is affordable to lower-income households.

Development Fee Practices. Impact fees apply to many type of developments, not just housing. New commercial and industrial developments also pay development fees, but in general these fees are lower because the demand for services generated by these types of development is lower than residential development.

Local governments have flexibility in how they structure these fees. Importantly, local governments can lower fees below the maximum authorized by a nexus study, and many local governments do so to achieve varied policy goals. Some local governments charge lower fees for certain classes of projects to reduce barriers to their development, such as affordable housing, higher density housing, or accessory dwelling units. For example, the City of Sacramento does, not impose impact fees for developments that contain certain proportions of affordable housing units and does not charge its affordable housing impact fee to certain high-density developments. Local governments can also lower fees based on other considerations, such as project feasibility under given market conditions, or desire to channel development to certain areas. For example, the City of Santa Rosa only imposes impact fees on the first three stories of a development in its downtown core, and the City of Oakland lowers fees in particular zones of the city based on estimates of project feasibility in those areas.

Local governments also vary the basis for imposing a charge, such as charging fees on a persquare-foot basis or per-bedroom basis, rather than on a per-unit basis. For example, a city that wants to encourage multifamily development might charge fees on a per square foot basis so that a multifamily project with multiple units on a parcel pays lower per-unit fees than a single family home on the same parcel.

For additional information on impact fee practices across California, please see the 2019 report "Residential Impact Fees in California," published by the Terner Center for Housing Innovation. [1]

How Do Impact Fees Affect Builders?

Impact fees are one component of the costs that builders must pay to develop new housing, which can affect housing production decisions. Housing construction is influenced by the following cost drivers:

- Land cost, which can make up 5-15% of a project's cost;
- Hard costs, such as labor and materials, which can make up 60-70% of a project's cost; and
- Soft costs, such as design, process, financing, and fees, which can make up 20-30% of a project's costs. [2]

These percentages fluctuate by project and housing market, as do the total costs. For example, construction costs in the East Bay are over $570,000 per unit, whereas the same unit in Sacramento would cost $380,000 to build.[3] Across the nation, homebuilding costs have substantially outpaced inflation in recent years. This phenomenon is particularly true in California, and acutely so in its coastal areas [4] These increased costs are a major reason that housing demand in California greatly exceeds actual production, further exacerbating our existing housing crisis.

Impact fees can represent a substantial portion of overall soft costs. They are also a portion of the overall cost that can fluctuate the most from jurisdiction to jurisdiction within the same

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[1] http://ternercenter.berkeley.edu/uploads/Residential Impact Fees in California August 2019.pdf

[2] http://ternercenter.berkeley.edu/uploads/Making It Pencil The Math Behind Housing Development.pdf, page 6

[3] Ibid

[4] https://ternercenter.berkeley.edu/construction-costs-series

housing market. For example, a single family home in Fremont would be charged up to $145,000 in impact fees while a similar home in Sacramento would be charged under $20,000. A multi-family development in Fremont would be charged over $70,000 per unit in impact fees, while a similar development in Los Angeles would be charged about $10,000 per unit. [5] The result is that in some jurisdictions, impact fees can reflect around two percent of total construction costs, whereas elsewhere they can exceed 15%.

In addition to direct costs, impact fees can add two additional layers of costs to development — carrying costs and costs associated with higher risk. Carrying costs are the financing costs associated with paying the fees in advance of the project making revenue. The timing of fee payment varies substantially between jurisdictions; but often payments are due at the time a building permit is issued, which can be multiple years before completion of construction and generation of revenue. [6] The risk factor is due to the uncertainty of the total fees. AB 1483 (Grayson, 2019) for the first time requires cities and other jurisdictions to post their fee schedules • online. However, current law still enables cities to change the amount of fees charged during the development process — in some instances up to the time of building occupancy. This uncertainty increases risk for the underwriters of development, requiring them to seek higher returns, which further drives up the cost of housing.

Recent Legislation Affecting Impact Fees

The Legislature has considered several bills related to impact fees in the past fewyears. Concerned that mitigation fees may be increasing the cost of hoüsing, in 2017 the Legislature passed AB 879 (Grayson), which required the California Department of Housing and Community Development (HCD) to complete a study to evaluate the reasonableness of local fees charged to new developments. On August 7th, 2019, HCD released the study, performed by the Terner Center for Housing Innovation. The findings from the study on fees were split into three categories: Fee Transparency; Fee Structure; and Fee Design. Among other conclusions, the study argued that fees can be a barrier to development and raise prices of both new and existing homes. However, the study also noted that local governments face substantial fiscal constraints and thus have turned to fees as a source of revenue to fund public services for new developments.

Consistent with previous studies by the Temer Center and others, the report found that fee transparency could be substantially improved. According to the study, many jurisdictions do not post their fee schedules or their nexus studies online, making it hard for developers to know their costs ahead of time. Meanwhile, other jurisdictions have adopted best practices, such as offering

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[5] Excluding service fees. http://ternercenter.berkeley.edu/uploads/DeveIopment Fees Report Final 2.pdf, page 19

[6] http://ternercenter.berkeley.edu/uploads/Residential Impact Fees in California August 2019.pdf, page 35

an estimate of the fees that a project would pay. The study recommended requiring local governments to post fees and nexus studies online, as well as annual reports on fee collections, and requiring jurisdictions to provide fee estimates.

Following the release of the Terner Center report, the Legislature enacted AB 1483 (Grayson, 2019), which requires local agencies to post a current schedule of fees, exactions, and affordability requirements applicable to a proposed housing development project, as well as annual fee reports required under the Mitigation Fee Act.

In addition, AB 1484 (Grayson, 2019) would have imposed a wide variety of limits on impact fees, including to prohibit local governments from requiring increased levels of service or from improving existing facilities and changing the legal standards that mitigation fees must meet in order to be valid. AB 1484 is currently in the Senate Rules Committee,

Questions

As members. hear from experts on the subject of mitigation fees, the Committees may wish to consider the following questions:

- Are the costs that impact fees impose on builders (and resulting impacts on housing prices) outsized relative to the benefits that the fees fund?
- Should the state enact legislation to change the fees that local governments can charge to new development? What options are available and what are the tradeoffs associated with them?
- Are there best practices that should be required of local governments statewide?
- How would changes to impact fees affect local government finances and service provision?