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Reducing Development Costs with Impact Fee Deferral

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Key Findings and Policy Implications

- >> The City of Los Angeles charges developers over \$140 million per year in fees to offset the service and infrastructure impacts of new residential development. Many fees are collected early in the development process, when developers' financing costs are highest.
- >> As a result, the true cost paid by developers can greatly exceed the value of fees paid to the city. This added cost provides no benefit to the public, but it does limit the production of new housing by reducing the number of parcels available for redevelopment.
- >> A fee deferral program would bring the cost to developers in better alignment with the value to the city by requiring fee payment at a later date, when financing costs are lower. This would modestly boost housing production and improve housing affordability at no cost to the public.

Reducing Development Costs with Impact Fee Deferral

Motivation

Southern California cities increasingly rely on development impact fees — charges levied on new housing — to fund many important investments including parks, schools, transportation, and affordable housing. Impact fees are intended to offset the cost of providing infrastructure that serves new homes and businesses, but if they are high they can also make it harder to build housing and exacerbate local housing shortages and affordability problems. Local governments, therefore, have the difficult task of balancing the need for revenue against the indirect costs of insufficient housing production.

While research on development impact fees has mostly focused on their cost and fee structure, the timing of fee collection also affects development feasibility and merits greater attention. Cities generally want to collect fees at earlier stages in the development process, allowing them to invest in public services and capital improvements promptly. Developers prefer to pay later, which reduces their costs through cheaper borrowing with shorter timelines.

In this brief I recommend a fee deferral program that would preserve the quantity — and depending on policy design, also the timing — of public fee revenues, while reducing private carrying costs. Enacting this policy would better align the interests of local governments and builders and improve the financial viability of housing development, without asking the public to forfeit any revenue.

Background

Development impact fees are collected from developers when they build new residential or commercial properties. These fees are typically assessed based on the number of dwelling units, bedrooms, or square footage. In the City of Los Angeles, impact fees are collected to fund school and park construction and affordable housing, adding approximately \$14,000 per unit to the cost of multifamily housing and \$11,000 per single-family home. Other jurisdictions charge less, such as Imperial County where fees for a prototypical multifamily development are roughly \$5,000 per unit, or they can charge much more, such as in Irvine, Fremont, and Oakland, which each charge over \$20,000 per unit (Raetz et al., 2019).

The Turner Center for Housing Innovation at UC Berkeley has extensively researched impact fee practices in California, finding that the fees can be difficult to estimate, vary widely between cities, and are often poorly coordinated between departments in the same jurisdiction. How the fees are assessed can affect project design. For example, basing fees on the number of dwelling units, rather than square footage or number of bedrooms, can inadvertently discourage smaller, more affordable unit sizes (Mawhorter et al., 2018; Raetz et al., 2019). Higher impact fees can also negatively impact housing production by increasing the cost of development, reducing land values (thereby limiting the amount of land on the market for redevelopment), reducing returns on investment, or all of the above.

The total cost of development impact fees isn't the only thing that determines their effect on housing production and affordability, however. The timing of fee collection also matters. When impact fees are collected during the early stages of development, such as when building permits are issued, the actual cost to the developer can exceed the sticker price. This can lead planners and policymakers to underestimate the extent to which fees limit housing production.

Major Fees and Payment Timing

Impact fees are usually collected at one of three main stages of development:

- **Application:** This stage occurs when the developer first takes their project application to the city for review, typically two to five years before construction is completed and residents begin moving in. Few impact fees are collected at this stage, though other types of fees, such as those used to reimburse the city for staff review time, are commonly paid at application.
- **Building Permit:** A building permit is required before construction can begin. Building permits are issued roughly 12 to 24 months after application and 18 to 36 months before residents move in, depending on the size and complexity of the project. Most impact fees are paid at this stage (Raetz et al., 2019).
- **Certificate of Occupancy:** A certificate of occupancy must be issued before residents can move in, occurring at roughly the same time as the building's opening date. In Los Angeles, the average time from building permit to certificate of occupancy is nearly 800 days for projects between two and 49 units, and even longer for larger projects.¹

A fourth option, though rarely exercised, is to collect fees after the certificate of occupancy is issued, such as at sale or refinance of the completed project. This idea will be discussed in the Fee Deferral Program Options section.

In the City of Los Angeles, three of the largest developer impact fees are: Los Angeles Unified School District (LAUSD) developer fees used to pay for school construction; Department of Recreation and Parks park fees, which pay for adding and expanding city parks; and Housing and Community Investment Department (HCID) affordable housing linkage fees, which support various affordable housing programs. Fee revenues and timing are summarized in **Table 1**.

LAUSD developer fees are assessed on each square foot of new residential and commercial development, and in FY 2017–18 raised \$104 million in the city (Office of the Inspector General, 2019). These fees must be paid before the city will issue a building permit.

Park fees are assessed on each dwelling unit. As of July 1, 2020, residential subdivision projects (mostly condominiums) pay a fee of \$13,609 per unit and are collected prior to final subdivision map approval, before the building permit is issued. Non-subdivision developments (mostly apartments) pay a fee of \$6,671 per unit collected before issuance of the certificate of occupancy, considerably later than for subdivision projects. Park

¹ Author calculations using City of Los Angeles open data on new building permits and certificates of occupancy issued 2013 to early 2020.

fees raised \$24.2 million in revenues in FY 2018–19, roughly three-quarters of which came from residential subdivision developments (Shull, 2019).

HCID linkage fees weren’t fully phased in until mid-2019. From July 1, 2019 through April 20, 2020, the fees raised \$15.8 million in revenue (Affordable Housing Linkage Fee Oversight Committee, 2020). Projected revenues for the entire fiscal year are approximately \$20 million.

Table 1. Major Development Impact Fees in the City of Los Angeles

Fee Type	Annual Revenue	Fiscal Year of Revenue Data	Development Stage Fee is Collected
LAUSD Developer Fee	\$104 million	2017-18	Building permit
Park Fee (subdivision)	\$18.2 million	2018-19	Final subdivision map approval (pre-building permit)
Park Fee (non-subdivision)	\$5.9 million	2018-19	Certificate of occupancy
Affordable Housing Linkage Fee	\$20 million (approx.)	2019-20	Building permit

Developers pay many other fees at building permit issuance or earlier, including building permit fees, plan check fees, planning fees, a development services center surcharge, dwelling unit construction tax, and residential development tax, among others. These additional fees amount to roughly 1% of total project costs (Department of Building and Safety).

Local governments prefer to be paid at earlier stages while developers prefer to pay later. Both parties are justified in their preference. From the government’s perspective, the earlier payments are made, the sooner the funds can be spent. For developers, later payments mean a larger share can be paid with low-cost debt rather than high-cost equity, and interest accrues for a shorter time before the debt or equity is repaid. This is why a fee paid at application or building permit will effectively “cost” more than the same fee paid at certificate of occupancy or later. See **call-out box** for further explanation of the roles of debt and equity in real estate development.

Equity and debt in development finance

Developers finance their projects with a mix of equity and debt. Equity comes from developers themselves and investors such as pension funds and high net worth individuals, and it pays for early development activities like land acquisition and project entitlements, and usually, though not always, at least 30 percent of total project costs. Because equity bears greater risk than debt — if a project doesn’t meet its financial targets, the losses are taken from equity — equity investors expect a relatively high return on investment, perhaps 10% per year or more. Debt comes in later, usually once a project has secured city approval and is ready to be built, and once 100% of the equity has been funded. Because debt is lower risk, it commands a lower interest rate, today often 6% or less. Within reasonable limits, developers can reduce financing costs (“carrying costs”) by minimizing the equity share of project funding and maximizing the debt share.

Once a project has building permits and all equity has funded, fees can be paid with debt sourced as a construction loan. Developers typically can’t use construction loans to pay for fees due at application because banks won’t lend to them at this stage — the project is still too risky for debt. A portion of fees due at building permit must be paid with equity because banks won’t always lend enough to cover the full cost. While the exact split between debt and equity varies from project to project, we will use the following as an approximate breakdown of the funding sources for fees due at each of the three major stages:

Table 2. Approximate Breakdown of Funding Sources by Timing of Fee Collection

Fee Timing	Share Paid With Equity	Share Paid With Debt
Application	100%	0%
Building Permit	30%	70%
Certificate of Occupancy	0%	100%

Impact of Fee Payment Timing

In total, the City of Los Angeles collects over \$140 million dollars in development impact fees each year. Adjusting the timing of fee payment can improve the financial feasibility of development without undermining the public purpose of fee revenues.

The consequences of different fee timing scenarios can be illustrated by a hypothetical 50-unit residential development, shown in **Table 3**. The development cost is \$20 million (\$400,000 per unit) before accounting for impact fees, which total \$20,000 per unit — \$1 million for the entire project. Three possible fee scenarios are described, with 100% of fees collected at a different stage in each scenario: submission of the development application, issuance of the building permit, or issuance of the certificate of occupancy. In the real world, different

fees are usually collected at each of these stages, but to make the point simply we can assume they are all collected simultaneously.

In the first scenario, all development impact fees are paid when the project application is submitted (i.e., at the earliest possible time). The project is assumed to take four years from start to finish: 18 months from application to building permit issuance, another 18 months to construct the building and receive a certificate of occupancy, then 12 months for the building to be fully leased up and sold or refinanced.² At this time both lenders (debt) and investors (equity) are paid back, with interest and profit respectively. It is assumed that construction loans are taken at a 6% interest rate and investors seek a minimum return on their equity investment of 10% per year.

If fees are collected when the developer submits their project application, the full \$1 million will be paid with equity, none with debt. Investors will be repaid four years later, with a minimum 10% return compounded annually. The total amount due to their investors, therefore, will be \$1.464 million — 46% above the nominal fee amount. This is the true cost of the fee to the developer (before adjusting for inflation). If the project takes longer to be approved or built, or both, the true cost will be even greater.

If the fees are due at building permit, 30% will be paid with equity and the remaining 70% will be paid with interest-bearing debt. In this scenario the developer carries these costs for approximately 2.5 years, at which point they repay their investors and lender a total of \$1.19 million — 19% higher.

If the fees are paid when the certificate of occupancy is issued, 100% will be paid with debt and the total carrying period will be just one year. The total amount due at that time will be \$1.06 million — just 6% above the nominal \$1 million fee.

The assumptions and values for each of these scenarios are summarized in **Table 3**.

² Analyzing a sample of over 200 multifamily building permits issued 2017 or later, primarily for projects between 35 and 75 units in size, the average time from application to building permit issuance was 26.2 months and the median time was 19.8 months, so 18 months is a conservative estimate for typical project approval. Similarly, among a sample of over 200 multifamily building permits with linked certificates of occupancy, the average time from permit to certificate of occupancy was 28.1 months and the median time was 25.4 months.

Table 3. Cost of Impact Fees by Timing of Fee Payment for 50-Unit Development

	Time of Fee Payment		
	Application	Building Permit	Certificate of Occupancy
Fee Amount	\$1 million	\$1 million	\$1 million
Share Paid With Equity (10% interest)	100%	30%	0%
Share Paid With Debt (6% interest)	0%	70%	100%
Carrying Period	4 years	2.5 years	1 year
Carrying Costs	\$464,000	\$190,000	\$60,000
Total Repayment	\$1.464 million	\$1.19 million	\$1.06 million
Nominal Cost Above Fee Amount	46%	19%	6%

As noted above, the local government benefits from receiving fees earlier because inflation erodes the value of payments made later. Even accounting for this, however, cannot fully justify having fees paid earlier. The additional cost to the developer dwarfs the amount needed to account for the government's cost inflation. Fee deferral is worth doing because it helps the developer, and makes building housing easier, without harming the government.

Assuming a generous inflation rate of 3% per year (the actual U.S. inflation rate from 2010 to 2019 averaged 1.77%), the government should be essentially indifferent between receiving a \$1 million payment today, a \$1.077 million payment in 2.5 years, or \$1.126 million in four years — each amount will purchase the same amount of goods or services at the time it's received, assuming the cost of goods and services purchased by the government tracks with inflation rates.

If a \$1 million fee currently collected at application (at a cost to the developer of \$1.464 million) is deferred until certificate of occupancy, four years later, any payment greater than \$1.126 million but less than \$1.464 million would be mutually beneficial to both parties. A payment of \$1.2 million, for example, would both buy more government services than a \$1 million payment made four years earlier, and cost the developer less. Similarly, for a \$1 million fee currently due at building permit issuance but deferred until certificate of occupancy, any amount between \$1.077 million and \$1.19 million would benefit both parties. Housing could be built at lower cost and the local government would receive the same or more revenue after adjusting for inflation.

It's reasonable to ask: Won't developers just capture the savings from fee deferral for themselves? In the short term some probably will, but not in the medium and long term.

Many developers with projects in the development pipeline have already purchased land with the current fee structure in place. The current structure involves high carrying costs, and those costs reduce how much developers can pay for the land and still expect a profit. (The maximum price that developers are willing to pay for

land, based on their projected costs and revenues, is known as the “residual land value.”) If a fee deferral program is implemented, the lucky few who’ve bought land at a reduced price — but not yet been charged impact fees — could pad their profits with the savings. For all other projects, present and future, the savings would be incorporated into the residual land value. With developers able to offer a higher price for land, more property owners would become willing sellers. This increase in potential redevelopment sites would lead to increased housing production. By deferring fees at no public cost, local governments can secure additional public benefits in the form of increased housing investment and affordability.

Fee Deferral Program Options

In cities that adopt a fee deferral program, deferral should primarily apply to fees due at or around building permit issuance. Fees due earlier tend to reimburse staff review expenses which are incurred immediately. Many projects that submit applications also never end up reaching the building permit stage, so deferring such fees could result in nonpayment in some cases. In contrast, projects that receive a building permit almost always complete construction and receive a certificate of occupancy (more on that later).

A fee deferral program could be structured in at least three ways. The first two would allow deferral until the certificate of occupancy is issued, and the third would allow deferral until after the development begins generating revenue.

Deferral to Certificate of Occupancy with inflation adjustment

The simpler of the first two options, deferral plus inflation, would delay fee collection, with an inflation adjustment, until certificate of occupancy. Use of an inflation adjustment places the risk of higher-than-expected cost inflation on the developer. Furthermore, impact fees are often collected but not spent until months or years later, held in an interest-bearing account until a use is found for them. The deferral-plus-inflation structure would preserve this interest-bearing feature without imposing higher carrying costs on the developer, as earlier payment requirements do today.

Consumer Price Index figures aggregate price inflation across a wide variety of goods and services, and those goods and services may not perfectly reflect the purchases made by local governments, so an additional 1% added to the base inflation rate may be warranted. Thus, if a \$1 million fee due at building permit was deferred for two years and inflation averaged 1.5% during each of those years, the developer would pay the fee with 2.5% interest compounded annually, or \$1.051 million in total. This would save the developer approximately \$100,000 in carrying costs.

A program of this type is found in Anaheim, where participants in the fee deferral program pay interest equal to the City Treasurer’s return on investment for pooled funds in the previous year. Interest is only charged on impact fee deferrals of \$1 million or more (Anaheim Municipal Code, n.d.). Returns on investment for pooled funds vary much more than inflation and increase risk for both parties, so using inflation is recommended. San Diego uses the Los Angeles area Construction Cost Index, published monthly in the Engineering News-Record, to calculate automatic inflation adjustments (San Diego Municipal Code, n.d.), which may be preferable for fees invested in the development of affordable housing or other infrastructure.

Deferral to Certificate of Occupancy with inflation adjustment and bonding

If a local government approves significant amounts of new housing on an ongoing basis, as Los Angeles does, deferring fees (with an inflation adjustment) until the certificate of occupancy should pose no burden — revenues will flow in consistently even if they lag behind project applications and building permits. If a city insists on receiving and spending fee revenues at the earliest possible date, however, it may consider a “deferral plus bonding” approach.

With this approach, a jurisdiction may issue a bond or draw from an open line of credit against future impact fee payments. Los Angeles International Airport has recently borrowed funds at interest rates under 1% (Albright, 2020), making this a low-cost option for accessing funds immediately without imposing significant and unnecessary carrying costs on developers. While more complicated than the “deferral plus inflation” program described above, cities would not need to wait until projects open their doors to spend fee revenues. And local governments could charge developers interest equal to (or slightly above) the bond rate.

Spending fee revenues in advance of receipt, if done in moderation, should not be risky for cities. An analysis of building permits issued from 2013 to 2015 for developments of 10 or more units in the City of Los Angeles found that at least 96.2% of units received a certificate of occupancy by October 2020, and at least another 2.3% were currently under construction.³ Once a project is issued a building permit it is extremely likely to be completed. And because developers require a certificate of occupancy before they can open their doors to tenants and begin collecting rents, governments maintain leverage to ensure the fees are paid in full.

Deferral to transfer, refinance, or specific date

Deferring fees until the certificate of occupancy would reduce financing costs; deferring them until a later date would eliminate financing costs altogether. Using this option, developers would pay impact fees with project revenues rather than equity or debt. Project revenues could take the form of apartment rents or condo sales, or sale or refinance of the leased-up building.

Municipalities could ensure collection of these fees in several different ways, with the ultimate purpose being to guarantee payment by the developer. One option would be to use the same mechanisms used to collect other fees not tied to permit issuance — annual Fire Department weed-abatement fees and annual housing-inspection fees, for example. Another would be property covenants signed as a precondition for issuing a building permit or certificate of occupancy, granting rights for the city to collect fees at a later date. Finally, they could structure the fees either as transfer taxes or recordation fees for deeds and financing documents, which would allow the fees to be collected when a property is refinanced or transferred to a new owner. All options would include an inflation adjustment based on the length of the deferral period.

³ Author’s analysis of City of Los Angeles building permit and certificate of occupancy data. Permits for approximately 29,000 units with 10 or more units were issued during this period.

Conclusion

Between LAUSD developer fees, residential subdivision park fees, and affordable housing linkage fees, a minimum of \$140 million in impact fees are paid at or around building permit issuance each year in the City of Los Angeles. Other fees, such as the Warner Center Mobility Fee, bring the total higher.

Assuming a conservative 18-month construction period for the average multifamily development and a 3% inflation rate on deferred payments, a fee deferral program could cut approximately \$9.1 million from the cost of development each year while earning a small profit for the city and boosting the production of housing at all income levels. Assuming an average of two years from building permit to certificate of occupancy, the savings increase to \$12.4 million.

This may not sound like much money in Los Angeles, where development costs frequently exceed \$400,000 or \$500,000 per unit for multifamily housing. Compared to the total amount spent on development each year, it's not. But these savings are still important for several reasons.

First, although these savings only amount to roughly \$1,000 or \$1,500 per unit, these are averages. Projects that take longer to complete construction are impacted much more as interest rates compound year after year.

Second, assessing fees at earlier stages can do real harm by deterring housing production. Development is an inherently risky endeavor, with each additional risk factor increasing costs and limiting financial viability. On the margins, fewer projects will “pencil out” and less housing — including both market-rate and affordable units — will be built.

Third, and finally, the additional costs borne by developers don't serve any purpose. There is nothing to gain from imposing fees at such an early date when reasonable alternatives are available.

By itself, increased housing production will not be sufficient to end the housing crisis in Southern California — but it is an essential part of the solution. Fee deferral programs can efficiently reduce costs and increase the viability of housing production, and they can do so without asking local governments to forfeit any revenue. Cities like Los Angeles should consider adopting fee deferral as part of their comprehensive pro-housing efforts.

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