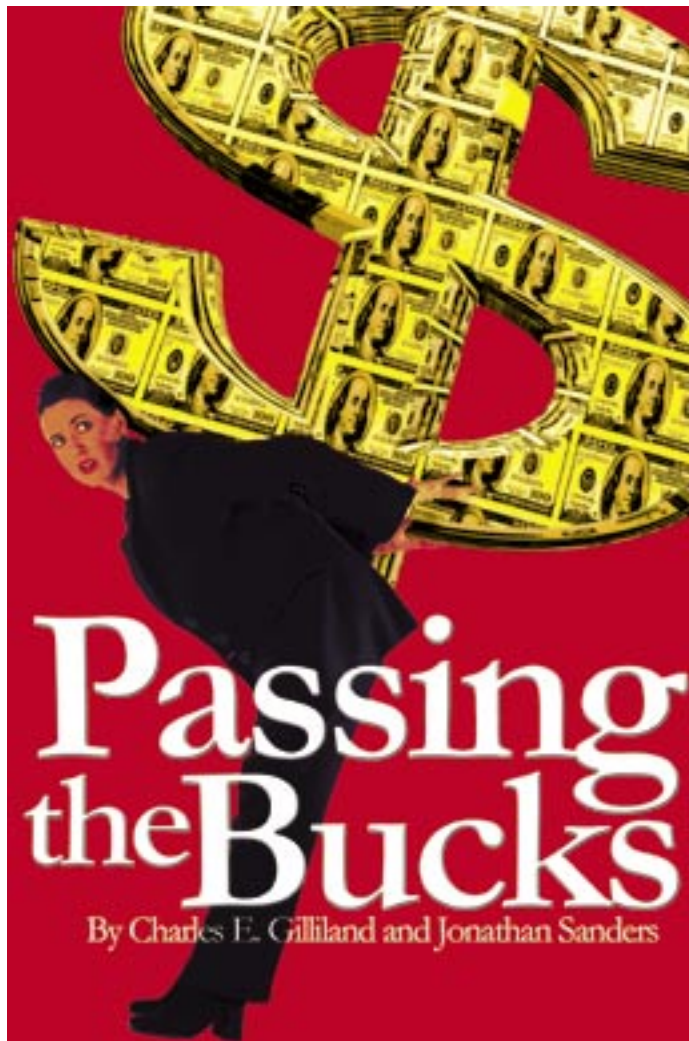


A Reprint from *Tierra Grande*

Who really pays development fees? These fees typically are imposed to make up for perceived negative effects of development and are sometimes called mitigation or impact fees. They are generally charged to developers in the early stages of a project.

Advocates of development fees say this is only fair. Developers profit from subdividing land, so they should incur the cost. And they do, initially.

But it isn't that simple. In reality, market forces and competition shift this added development cost away from the developer, passing it to the owner of the raw land or the end user of the developed property. Here's how.

First, the tier of marginal developers, those who are just covering their costs before paying the fee, are forced out. This results in a reduced supply of lots, which allows the remaining developers to increase their lot prices. This increase in effect passes development fees on to builders, who ultimately pass the cost to homebuyers.

If developers cannot shift the entire expense to end users, they begin to factor the fee into projected costs when planning new projects. The added cost reduces the amount they can afford to pay for raw land and still achieve their required rate of return. Because developers pay less for land, owners of raw

land indirectly incur the fee through a reduction in the market value of their property.

In markets with competitive developments, developers may not be able to increase prices, especially if competing subdivisions are not subject to development fees. By contrast, developments with highly marketable features like waterfront lots generally face little or no competition, so developers can increase the prices charged to the end users. These developers can afford to pay higher prices for raw land because they pass the development fees on to buyers of the developed lots.

Real Cost of Fees

Transforming a tract of raw land into a finished subdivision requires capital, labor and time. Although the process varies from one locale to another, small developers frequently purchase raw land with financing provided by the landowner. This arrangement allows developers to use available cash for development activities and allows landowners to earn interest on the financed amount.

Larger developers commonly borrow funds to complete improvements. Because development fees require cash at the inception of development, developers incur carrying costs by borrowing money to pay the fees. The cost to developers thus exceeds the face value of fees.

Subdivision Analysis, an Appraisal Institute publication, provides an analytical framework for determining the real cost of a fee imposed at the beginning of development. The model forecasts revenues and costs for a hypothetical development, with lot sales occurring over two years. The analysis includes both direct costs for infrastructure and indirect capital costs of development.

Applying Model to Texas

The following example applies the model to a hypothetical Texas development described in Table 1. The simulated subdivision involves one loan for purchase of raw land and one to cover development costs. Because mortgage lenders require

Table 1. Hypothetical Texas Development

13.75 acres	55 lots
Construction period	6 months
Developer's target investment return	18 percent
Expenses	
Development fee imposed by government*	\$41,250
Indirect costs (insurance, etc.)	\$25,000
Engineering fees	\$25,000
Development cost	\$500,000
Loan Information	
Raw land loan interest rate	7.5 percent
Raw land loan-to-value ratio	75 percent
Raw land loan repayment rate	125 percent
Development loan interest rate	8.5 percent
Development loan repayment	125 percent

*\$3,000 per acre. Dollar amounts taken from a development in the golden cheeked warbler zone 1 habitat in western Travis County. In that area, developers can take advantage of the regional incidental take permit held and administered by the City of Austin and Travis County. Mitigation fees collected support the Balcones Canyonlands Conservation Project.

Source: Real Estate Center at Texas A&M University

Table 2. Effect of Development Fees on Lot Prices and Housing Costs

	Typical Tract Homes	Resort Homes ¹	Upscale Homes ²
	Homebuyers pay 0 percent of fees	Homebuyers pay 100 percent of fees	Homebuyers pay 50 percent of fees
Original raw land value, no development fees (Maximum price developers can pay and still achieve 18 percent return)	\$527,667	\$527,667	\$527,667
New raw land value, with development fees	\$482,268	\$527,667	\$504,968
Landowner loss (Reduction in sales price of raw land)	\$45,399	–	\$22,699
Homebuyer loss			
Added lot cost (alone)	–	\$69,335	\$34,665
Added lot cost plus “upscaled” development costs	–	\$173,338	\$138,662
Total loss (landowner + homebuyer)	\$45,399 (110 percent of fee)	\$173,338 (420 percent of fee)	\$161,361 (391 percent of fee)
Added cost per home		\$3,152	\$2,521

¹Lot represents 40 percent of home value

²Lot represents 25 percent of home value

Source: Real Estate Center at Texas A&M University

clear title before they make a mortgage loan on a home, the developer’s land loan agreement allows for title releases for individual lots as they are sold to homebuilders.

The developer accelerates principal retirement by making payments equal to 125 percent of the proportion of the debt applying to a specific lot when a builder buys it. For example, if the lot represents 10 percent of the acreage in the development, it also represents 10 percent of the land loan principal. But the developer pays 12.5 percent of the principal to obtain title for that lot. This practice ensures that the land mortgage is retired before the development completely sells out.

The developer also borrows capital to install infrastructure and prepare the land for homebuilding. That loan provides for accelerated debt retirement based on the same 125 percent convention.

This analysis includes the effects of development fees on raw land values and the cost of finished homes. Table 2 shows land values calculated using different scenarios.

Typical Tract Homes Scenario

The *Typical Tract Homes* column represents an extremely competitive housing market in which developers cannot pass fees on to homebuyers. In this scenario, developers who are subject to the fee must compete with others who are not. For example, one city might impose high fees while neighboring cities do not. Owners of raw land bear the burden of development fees through reduced raw land values in these cases.

If land prices were not reduced, development would halt in the affected area because developers could not achieve an adequate return at current prices. Developers would shift to projects in other locales. Eventually, general price increases and a shortage of lots would likely make development profitable once again at the raw land prices landowners were originally asking. It might look as though land prices had remained stable; however,

they would actually be lower than they would have been absent the fees’ negative impact on development.

Resort Homes Scenario

The *Resort Homes* column represents the opposite end of the spectrum — high-end homes in a luxury or resort setting that has no competition. In this scenario, 100 percent of the fees are passed through to the homebuyer.

This scenario also applies to regions where virtually all developers are subject to development fees. In these areas, developers can

pass the full fee on to homebuyers. Owners of raw land incur no loss. However, the magnifying effect of carrying costs would impact the lot prices homebuilders pay. Developers would have to collect an added \$69,335 to shift fees and carrying costs to homebuilders.

Like developers, homebuilders pass increased land costs on to homebuyers through higher home prices. Higher land costs prompt builders to create higher-end developments with larger, more expensive houses. Development fees thus affect the prices homebuyers pay in two ways. First, the lot price increase is added to the price of the home. And second, they encourage the “upscaling” of developments, resulting in higher-priced homes than would have been built if homebuilders did not have to try to recoup higher lot costs.

Upscaling has a two-pronged effect on local economies. First, higher home prices increase closing costs, including down payments, loan origination fees and insurance premiums. This makes houses less affordable by pricing marginal buyers out of the market.

Second, because higher mortgage payments use more of homeowners’ housing budgets, upscaling limits

expenditures on other items. This budget effect tends to limit the number of homes that can be cost effectively provided in an area’s housing market. This supply effect could potentially result in a net reduction in a community’s housing inventory.

These combined effects could affect the local government’s tax base. Upscaling should result in higher taxable values per home. However, the reduced numbers of homes resulting from the supply effect could translate to a net loss of added value.

Factoring in the value of the public service provided by the fee further obscures the issue. The public expenditure may enhance property values by improving community marketability. If funds are diverted to activities not affecting homes,

Ultimately, market forces and competition shift fees from developers to owners of raw land and to homebuyers.

fees are an economic drain on development. Thus, the ultimate economic impact on the community remains unclear.

Upscale Homes Scenario

Between the extremes of the tract homes and resort homes scenarios, developers and homebuilders likely encounter markets that allow limited fee shifting to homebuyers. In these markets, the portions of development fees not shifted stifle development or reduce raw land values. The *Upscale Homes* column in Table 2 shows the effects of development fees in markets where the fee is split equally between landowners and homebuyers.

Analysis confirms that the actual cost of development fees always exceeds the face amount of the fees when developers are required to pay at the outset of the development process. In addition, this shifting of fees to homebuyers increases housing costs and reduces home affordability. Ultimately, landowners and homebuyers pay development fees, not the developers who were initially targeted. ➡

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