OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Recommended Changes to Housing Impact Fees

OVERVIEW

On July 11, 2011 the City Council will consider a number of changes to the Housing Impact Fees that are being proposed by the San Diego Housing Commission (SDHC). Principally, SDHC is proposing that:

1. The Housing Impact Fee be maintained at current levels for two years, through June 30, 2013;
2. Beginning on July 1, 2013 the Housing Impact Fee be increased by 20% per year for five years until the Fee reaches the levels originally established in 1990;
3. Beginning July 1, 2018 the Housing Impact Fee be automatically adjusted based on the change in the Building Cost Index for 20 Cities.

In July 2009 the City Auditor released a performance audit of the San Diego Housing Commission (SDHC). Among the audit finding were that the commercial linkage fees were outdated, substantially lower than comparable cities, and had not been adjusted as required by the Municipal Code. The audit report recommended, among other things, that the Housing Impact Fee schedule be reviewed and updated, and that procedures be developed so that Housing Impact Fee updates are recalculated each year and presented to the City Council for approval.

Following the City Auditor's report, SDHC contracted with Keyser Marston Associates (KMA) to perform a Jobs Housing Nexus Study as part of an effort to review and update the Housing Impact Fees. In addition, a separate consultant was retained to conduct an Affordable Housing Best Practices and Funding Study. These studies were presented to the Land Use and Housing (LU&H) Committee in November 2010. In March 2011, following several months of stakeholder meetings, SDHC presented their recommended changes to the Housing Impact Fees to the LU&H Committee. At that meeting, the IBA presented verbal comments regarding several elements of the fee proposal. This report expands upon those comments by providing an overview of the Nexus Study conducted by KMA, and outlining potential alternatives with respect to three key elements of the fee proposal: the basis for setting fees, the index used for making annual adjustments, and the possibility of implementing a trigger mechanism to account for current economic conditions.

FISCAL/POLICY DISCUSSION

This section begins by providing an overview of the Nexus Study conducted by KMA, followed by a discussion of three key elements of the Housing Commission's proposed changes to the Housing Impact Fees: the basis for setting fees, applying an index for annual adjustments, and the possibility of implementing a trigger mechanism.

Nexus Analysis
To assist in updating the Housing Impact Fee schedule, the San Diego Housing Commission contracted with Keyser Marston Associates (KMA) to conduct a Jobs Housing Nexus Study, which was completed in October 2010. The purpose of the Jobs Housing Nexus Study was to quantify the nexus or relationship between new commercial development and the need for affordable housing that is created by such development.

The basic premise of the Nexus Study is that new jobs create a need for additional affordable housing. In this context, commercial development is used as a proxy for job growth. Using factors such as average employment density, occupational composition, average income, and workers per household, the Nexus Study quantifies the number of new households created at various income levels for each type of development. These results are then combined with the estimated cost of developing new affordable housing units to arrive at the total linkage or nexus costs for each type of commercial development. The total nexus costs represent the maximum fee levels that could be supported by the Nexus Study.

Total Nexus Cost per Square Foot

Building Type	Nexus Cost
Office	$78.08
Hotel	$81.16
Retail	$115.55
Medical	$72.01
Manufacturing/Industrial	$41.94
Warehouse/Storage	$13.32
Education	$40.91

Source: KMA Jobs Housing Nexus Study

The total nexus costs could also be interpreted as the fees per square foot that would be necessary to meet the additional demand for affordable housing created by each type of new development. It should be noted that the total nexus costs do not factor in existing demand for affordable housing, but rather only the net new demand that is created by new development. In addition, the Nexus Study makes several assumptions that result in lower total nexus costs, such as a downward adjustment to account for changing industries and long-term declines in employment, not factoring in demand for affordable housing by students and the elderly, and only factoring in workers that live in the City of San Diego.

Basis for Establishing Fee

While the total nexus costs quantify the relationship between new commercial development and new demand for affordable housing, they are not recommended fee levels. Rather, they represent the maximum fee levels that can be supported by the Nexus Study; fees may be set at any level below the total nexus cost.

As a policy matter, the Nexus Study highlights two basic approaches to setting Housing Impact Fees. The first approach is setting fees as a percentage of estimated development costs. This approach would result in a consistent fee burden across different building types, and is more equitable with respect to development costs. Because each type of development would pay a fee based on a percentage of estimated development costs, this approach allows for a fee structure that minimizes the impact to development. However, this approach would also result in fee levels that are unrelated to the affordable housing needs created by different types of development.

The second approach is setting Housing Impact Fees as a percentage of the total nexus cost for each building type. Under this approach, fee levels would be set in proportion to the affordable housing needs created by different types of development, as reflected by the total nexus costs. For example, a retail development would pay a larger fee per square foot than an office building development because retail development creates a greater need for new affordable housing. This approach allows for a fee structure that is more focused on addressing the affordable housing needs created by different types of development. However, it would also result in a disproportionate fee burden for certain types of development.

While these two approaches are specifically highlighted in the Nexus Study, there are other valid approaches to setting Housing Impact Fees. The Nexus Study even notes that other policy considerations may be brought to bear in establishing the appropriate fee structure. The only requirement is that fees are equal to or less than the total nexus costs. The Housing Commission's proposal does not use either of the approaches described above, but rather, seeks to restore Housing Impact Fees to the levels that were originally adopted in 1990. While this is an equally valid approach, it would result in fee levels that are somewhat arbitrary with respect to the current Nexus Study, and unrelated to either estimated development costs or the affordable housing needs created by different types of development.

For purposes of comparison, the table below shows the Housing Commission's proposed Housing Impact Fees with the estimated development costs and total nexus costs for each building type, as reflected in the Nexus Study.

Proposed Housing Impact Fee as % of Development and Nexus Costs

Building Type	Estimated Dev. Cost (per sq.ft.)	Total Nexus Costs (per sq. ft.)	Proposed Impact Fee (2017)	Proposed Fee as % of Dev. Cost	Proposed Fee as % of Nexus Costs
Retail	$340	$115.55	$1.28	0.4%	1.1%
Office	$375	$78.08	$2.12	0.6%	2.7%
Warehouse	$150	$13.32	$0.54	0.4%	4.1%
Manufacturing	$240	$41.94	$1.28	0.5%	3.1%
R&D[1]	$276	$41.94	$1.60	0.6%	3.8%
Hotel	$325	$81.16	$1.28	0.4%	1.6%
Education[2]	$310	$40.91	$1.60	0.5%	3.9%
Medical[3]	$310	$72.01	$2.12	0.7%	2.9%

1. Recommended by KMA to be combined with Manufacturing.
2. No separate fee proposed for Education - R&D fee applied.
3. No separate fee proposed for Medical - Office fee applied.

As the table above shows, the Housing Impact Fees proposed by the Housing Commission are fairly consistent as a percentage of estimated development costs, generally ranging from 0.4% to 0.7%. However, the proposed fees vary considerably as a percentage of total nexus costs, ranging from 1.1% for retail to 4.1% for warehouse.

<u>Indexing Fees for Annual Adjustment</u>

The Housing Commission is also recommending that Housing Impact Fees be adjusted annually, beginning July 1, 2018, based on the Building Cost Index for 20 cities. This annual adjustment is proposed to be applied automatically instead of being subject to Council approval each year, which is consistent with the recommendation made by KMA in the Nexus Study.

The IBA supports the concept of applying an annual index to the Housing Impact Fees. This will ensure that fees keep pace with cost increases (or decreases) and maintain a constant level of mitigation over time. In addition, there is precedent for applying annual adjustments to fees based on specific indices. The Inclusionary Housing In-Lieu Fee is adjusted annually based on a housing affordability index maintained by the Housing Commission. Developer Impact Fees and Facilities Benefit Assessments are also subject to an annual adjustment based on either the Construction Cost Index or the Consumer Price Index (CPI). Finally, the City's User Fee Policy contemplates annual adjustments to maintain cost recovery levels based on indices such as the CPI, Local Implicit Price Deflator, or Municipal Cost Index.

The Nexus Study offers a number of potential options for indexing the Housing Impact Fees. The Building Cost Index, which is recommended by the Nexus Study, is a well established index published by Engineering News-Record (ENR) that tracks general construction costs. One of the benefits of using the BCI is that it would provide for a consistent fee burden with respect to development costs over time. However, it would not necessarily trend with changes in the demand for affordable housing.

Other options for indexing the Housing Impact Fees include a Housing Affordability Index, which is maintained by the Housing Commission, or the CPI. The Housing Affordability Index measures the difference between the median home price and the value of a home that could be purchased with the median household income. As previously mentioned, this index is currently used for annual adjustments to the Inclusionary Housing In-Lieu Fee. One of the advantages of using the Housing Affordability Index is that it would provide for a more constant level of mitigation over time. However, it would not necessarily provide for a constant fee burden. Finally, the CPI is a standard measure of general price changes, and has the advantage of being widely known and accepted. However, it is also very broad in scope, and does not have a direct relation to either construction costs or housing affordability.

Ultimately, the differences between the various options for indexing the Housing Impact Fees are nuanced and not very significant. While any of these options could be employed, we believe that the BCI is a very suitable index, and concur with the recommendations of both the Housing Commission and the Nexus Study that the BCI be used for annual adjustments to the Housing Impact Fees.

Trigger Mechanism

In recognition of the prolonged economic downturn, the Nexus Study recommends that Housing Impact Fees be maintained at their current level until the economy improves. This may be accomplished by implementing an economic indicator or trigger mechanism that would need to be met before any increase would become effective. Several economic indicators are provided in the Nexus Study that could be used as possible triggers, including non-residential building permits, employment, or vacancy rates.

The primary challenge with implementing a trigger mechanism is in determining the appropriate trigger point, which would likely be contentious and difficult to agree upon. For example, if the countywide unemployment rate was selected as the relevant economic indicator, it would be difficult to determine the rate that should be reached, or how long that rate should be sustained, before an increase in the Housing Impact Fee was triggered. If the “trigger rate” is set too high, then fees could be increased before a sustained economic recovery is established. However, if the trigger rate is set too low, then fees would not increase until much of the economic recovery had already passed.

Optimally, a trigger mechanism would be set at the point where there is evidence of a sustained economic recovery. However, such a point is difficult to determine, and economic data is subject to interpretation. For example, based on data through May, San Diego County has seen positive year-over-year job growth for the past 11 months. This might suggest that the region is experiencing a sustained job recovery. However, the unemployment rate of 9.6% remains significantly higher than historical averages, suggesting that the economic recovery is still weak.

As an alternative to using an economic indicator as a trigger mechanism, the Nexus Study also suggests the option of using a phased approach for implementing a fee increase, possibly combined with holding fees constant for one or more years. This is the approach that is being recommended by the Housing Commission. While this approach does not link the fee increase to any particular economic condition or threshold, it does provide time for further improvement in economic conditions. In addition, it has the advantage of being more predictable and avoids a potentially complex and contentious trigger mechanism. In light of the probable challenges associated with establishing a trigger mechanism, we believe that the recommended approach is a suitable alternative.

CONCLUSION

The San Diego Housing Commission is proposing that the City's Housing Impact Fees be increased by 20% per year for five years, beginning in July 2013, until fees are restored to the levels originally adopted in 1990. In addition, the Housing Commission is recommending that beginning in July 2018 the Housing Impact Fees be adjusted annually based on changes in the Building Cost Index for 20 Cities.

This report provides an overview of the Jobs Housing Nexus Study prepared by KMA, and examines several key elements of the Housing Commission's fee proposal, including the basis for setting the fee structure, applying an index for annual fee adjustments, and the possibility of implementing a trigger mechanism in light of current economic conditions. Overall, we believe that the Housing Commission's proposal to restore the Housing Impact Fees to the levels originally adopted in 1990 is an acceptable approach to setting a fee structure, and will provide additional resources to address affordable housing needs. However, other approaches to setting fees, such as a percentage of development costs or as a percentage of nexus costs, could produce a fee structure that is more closely aligned to the results of the Nexus Study.

In addition, we support the recommendation to adjust the Housing Impact Fees annually based on the change in the Building Cost Index for 20 Cities, which will ensure that fees keep pace with costs adjustments and maintain a constant level of mitigation over time. Finally, due to the challenges associated with establishing a trigger mechanism, we believe that the Housing Commission's proposal to maintain the current fee structure for two years, combined with a phased in fee increase, is a suitable approach to accommodating further improvement in local economic conditions.

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