Why Howard County is Facing Record Budget Deficits

April 5, 2019

Hiruy Hadgu

"What we have found is that new development tends to more than pay for itself and disproportionately finances the growth in government…"

This was a quote by economist Anirban Basu from a 2005 Baltimore Sun article [3] citing a study his firm Sage Policy Group conducted for the Maryland Builders Association, in response to a slew of impact fee legislation adopted by several Maryland Counties.

The view Mr. Basu stated is an orthodoxy shared by most municipal leaders in Maryland if not the entire U.S. To them, more residential development means, more tax revenue for the county's coffers.

There were dissenters at the time who cast doubt on the assertion. A Baltimore County councilman at the time, Vincent J. Gardina, said the following: "… houses are selling for an arm and a leg, but if you look at one house with two children in school, that [cost per pupil] approaches $20,000 a year. No way we get that kind of revenue from a property tax." [3]

Fourteen years have passed since Howard County enacted legislation that allowed the collection of surcharge fees to provide infrastructure needed for new development. Who was right?

First lets clear up some terminology...

Impact Fees vs. Surcharge Fees

The technical terms used to define the fees differ based on how the fees are assessed and spent. Howard County collects *surcharge fees*, while others collect *impact fees*. Impact fees are required to provide direct benefit in the geographical region of those who purchase the new homes, while surcharge fees have no geographical restriction. Impact fees are also supposed to be spent within a prescribed period of time, after which they are returned to the Developer.

The TL;DR...New Development does not Pay for itself

Looking back, the evidence suggests Mr. Basu and others who pushed that orthodoxy were wrong. In fact, new development does not pay for itself. Each home has associated costs:

schools, roads, police, fire, hospital, water, sewer, environmental, bike paths, public transportation etc...

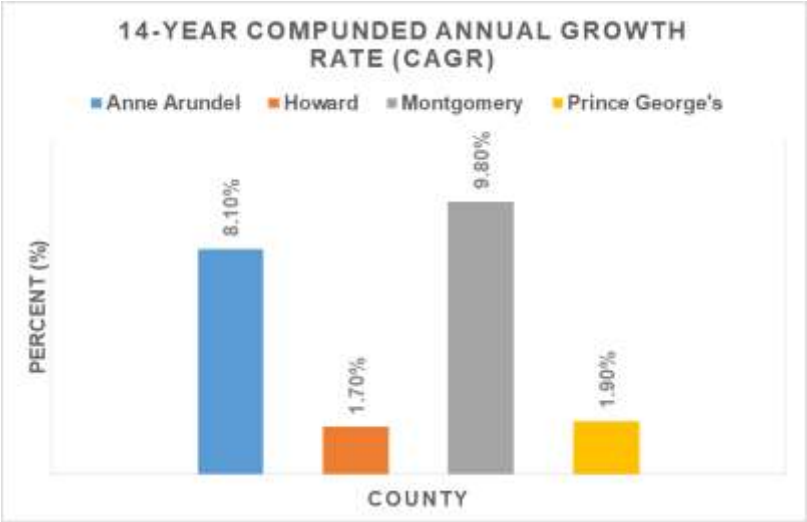
For example, the construction of High School #13 will cost nearly $78,000 per new student. Furthermore, at the rate of 0.5 kids per home in Howard County, it costs $15,000 per student to run the public school system.

The marginal revenue and cost of each additional new residential home is further complicated because “where the last units of service are more expensive to provide than the first- the cost of providing services to new residents may be higher than the cost of providing such services to existing residents.” [1]

Developer Corporate Subsidy

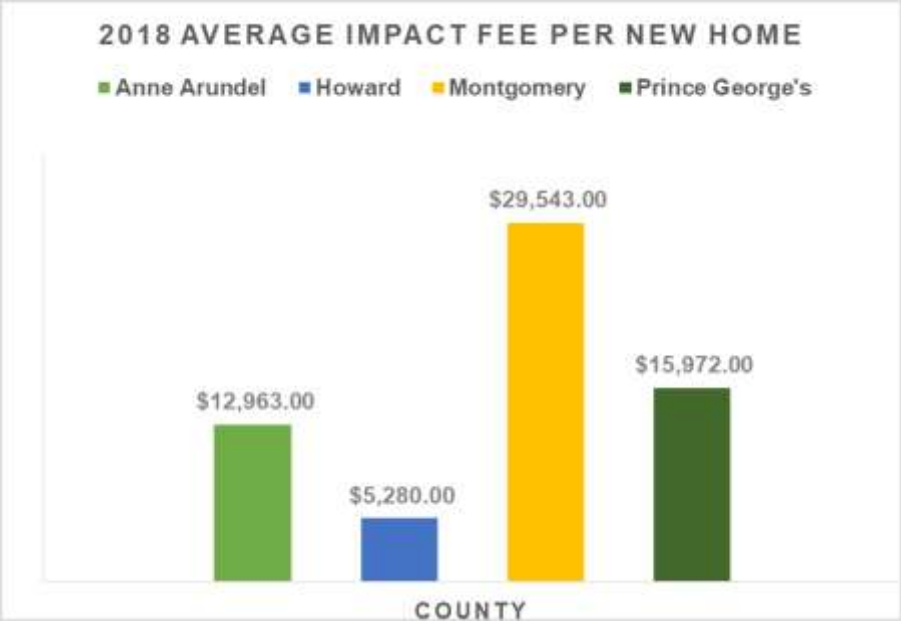
Radio personality Marc Steiner once said "Developers are the defense industry of local governments".

In 2004, the Maryland State Legislature enacted a law that enabled Howard County to charge Developers surcharge fees. The fee was set at an arbitrary value of $1 per square foot, without any analysis to demonstrate the fee was market rate.



The 2004 bill also tied the County's hands by preventing it from adjusting the fee in the future. Consequently, since 2004, the fee has increased only at the rate of inflation to an annual rate of 1.7%.

In 2018, the average impact fee per new home was $5,280. By comparison, Montgomery County charges nearly $30,000, increasing at an annual rate of 9.8% over 14 years.



Since 2004, Howard County has approved a minimum of 1,700 homes per year, or nearly 24,000 new homes in 14 years. If Howard County's impact fees kept up in pace with Montgomery County, it would have received an additional $500 million in fees. The county subsidized developer profits to the tune of $500 million.

The Public School System's Record Deferred Maintenance

For perspective, as of October 2018, the school system's deferred maintenance has exceeded $500 million. Furthermore, the county's trailer classrooms have increased annually to over 200 over those years.

	Total Deferred Maintenance as of October 2018			
SHOP/Project Mgr	Count of SHOP/Proj Mgr	Sum of Total Deferred Operating Cost	Sum of Total Deferred Capital Cost	Sum of Total Deferred IEQ Cost
Building Envelope	62	$6,901,475	$13,812,260	$825,000
Carpentry	6	$467,250	$13,350	$0
Custodial	1	$40,000	$0	$0
Electrical	24	$1,675,000	$4,451,300	$0
Elevator	1	$0	$100,000	$0
Energy	2	$160,000	$0	$0
Flooring	47	$1,375,145	$19,842,310	$0
HVAC	74	$10,162,000	$433,875,365	$0
Paint	66	$7,715,000	$0	$0
Plumbing	30	$6,761,000	$10,714,471	$0
Roofing	23	$163,000	$22,927,000	$0
Construction	16	$0	$3,805,368	$0
Total	352	$35,419,870	$509,541,424	$825,000
		Grand Total Deferred		**$545,786,294**

Howard County issues bonds backed by the collected surcharge fees. Since 2004, the county issued $101 million in bonds based on $84 million in surcharge fees. Assuming it can realize 20% more in funds through bond financing, how much would the county have raised based on market-rate surcharge fees? That is to say, if the county charged market-rate surcharge fees instead of subsidizing developer profits?

If the county had collected the additional $500 million, it could have raised nearly $720 million in bonds for schools.

Specific Example of Developer Subsidy

Every year, the county appropriates funds for various capital projects. Between 2011 and 2017, an average of 5% of the county's capital budget was appropriated for road construction and resurfacing. As of 2017 an all-time total appropriation 8.7% of the county's capital budget was set aside for these two programs.

Many of the county's roads are operating at a very low level of service. Not by accident, but by design. For example the level of service for the intersection of Snowden River Parkway and Broken Land Parkway is 'F' because the mitigation process through the adequate public facilities ordinance (APFO) requires a low level of service standard. Furthermore, the county collects very little money from the main beneficiaries of the road improvements- developers of the various businesses along the road.

The county approved construction of a Royal Farms gas station on Snowden River Parkway and Minstrel Way. Over the years, the approval of many such businesses led to significant congestion on the Parkway.

To relieve this congestion, a road widening project will begin in mid-2019. A portion of the project - to add a third westbound left turn lane - in that section of Snowden River road will cost taxpayer $750,000. [7]

The Traffic Group.

April 7, 2014

Mr. Chad Edmondson, Chief
Howard County
Department of Planning & Zoning
Development Engineering Division
3430 Courthouse Drive
Ellicott City, Maryland 21043

Based upon the potential improvement, a preliminary cost estimate has been developed and that estimate is also attached. The total identified cost for this improvement is $123,815.50.

With a total cost of $123,815.50, the pro-rata share for this development at 10.8% would be $13,372 (10.8% of $123.815.50)

HOWARD COUNTY
MARYLAND

J4222 Snowden River Parkway Widening

Widening of Snowden River Parkway between Oakland Mills Road and Broken Land Parkway.

Project will be phased with new third left turn lane to be constructed in Summer of 2018

Estimated Cost of 3rd left turn lane: $750,000

Estimated Cost of Overall Project: $30M

Overall project anticipated completion: 2023

But, the price-tag diverges significantly from the amount estimated by the Developer-financed study of $123,815.50.

The traffic study group provided the following estimate as the developer's share:

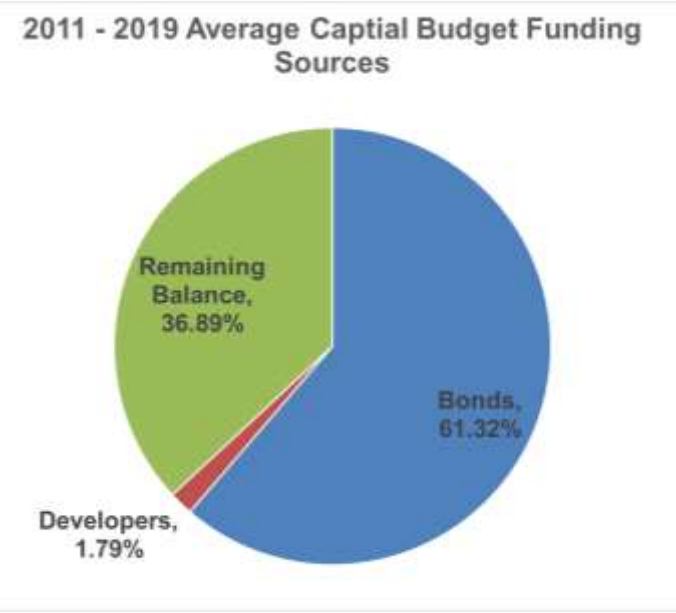
"With a total cost of $123,815.50, the pro-rata share [Royal Farm's cost] for this development at 10.8% would be $13,372 (10.8% of $123,815.50)".

So not only is the basis for the traffic study a weak APFO mitigation standard requiring low quality of service, the estimated cost impact is 83.5% less than the actual price tag. Furthermore, the Developer will pay only 1.78% of the actual price-tag. Not 10.8%.

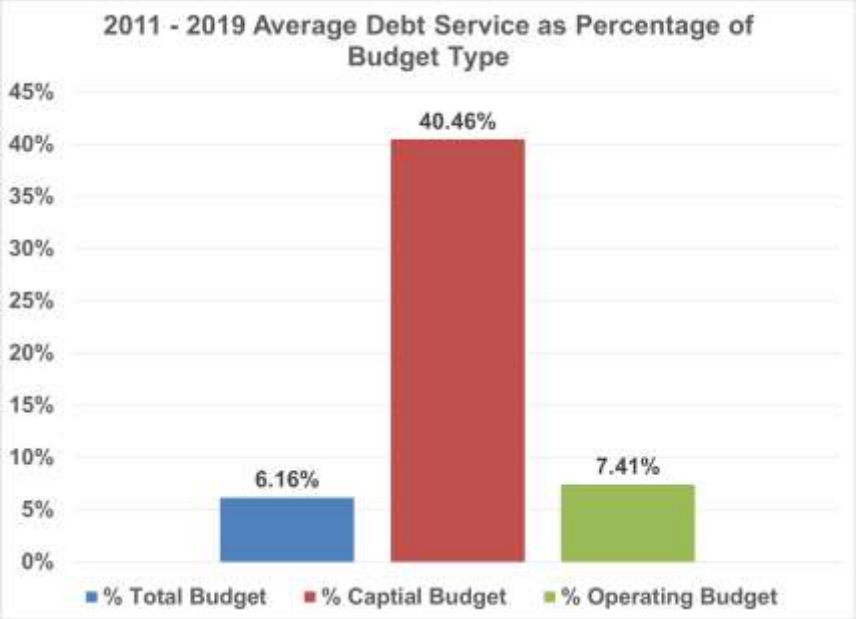
Here again is an illustration of how poorly the county does a poor job of accounting for all externalities in assessing the impacts of a project. In this case the job is to mitigate road congestion.

Record Deficits due to an Orthodoxy

Over the years, the “new development more than pays for itself” orthodoxy has led to record deficit. Recent news reports state, Howard County's “...deficit will reach $108 million in fiscal year 2020 and will likely grow to about $275 million by fiscal year 2025 unless officials take corrective action.”[6]



Since 2011, the average annual contribution to the capital budget by Developers is equivalent in percentage to the road example presented earlier.



More than 61% of the capital budget is financed through bonds, while developers pay less than 1.8% of the cost as shown by the road construction example. The average annual developer contribution is 1.79%.

Howard County has spent an average of $100 million per year since 2011 to service these bonds, which amount to nearly 41% of the capital budget, 7.5% of the operating budget, and 6% of the total budget.

Little doubt exists as to the root cause of the deficits. Exorbitant bonds to finance capital projects primarily cause by unmitigated development.

County leaders have not used the benefit of hind-sight to change course. In fact they continue to push for policies based on the orthodoxies and economic approaches championed by Mr. Basu and many others in 2004.

The Traditional View of Development

Why is their approach wrong? Let's get back to impact fees (or surcharge fees in Howard County).

The approach is based on the traditional view [2] on impact fees that looks at the supply-side effect on housing. Broadly speaking, their orthodoxy says "more housing means more revenue".

According to the traditional view, impact fees are like excise taxes, which shift the short-run supply of housing up by the amount of the fee in a competitive market. The traditional view predicts, higher house prices, lower developer profits, and reduction in new home construction. In addition, the traditional view predicts impact fee increases would reduce prices paid to land owners and would hurt the availability of affordable housing.

What to do if an Impact Fee Seems Inevitable

- Suggest alternative mechanisms for the financing of public infrastructure (Chapter 6).
- Provide economic data to demonstrate the influence that impact fees have on housing affordability in an effort to lower the impact fee and/or transfer the timing of the payment of the impact fee further in the development and building process.

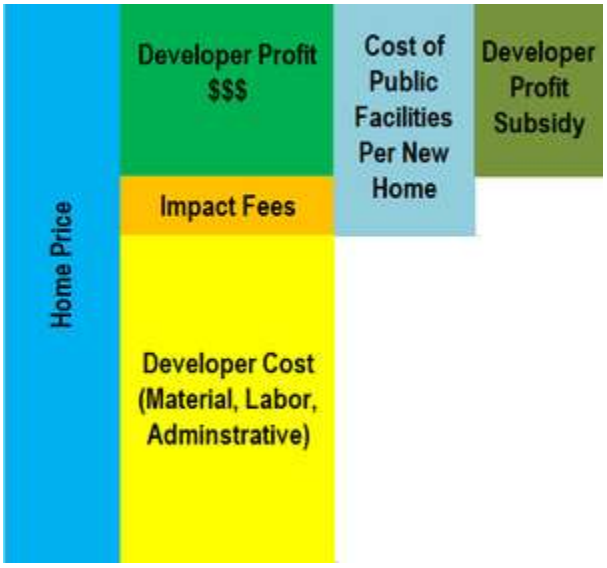
Developers would then be forced to leave the jurisdiction to avoid paying the fee. Consequently, the Developer flight combined with a reduction in tax base would lead to a decline in overall economic activity.

The Development Industry published a playbook [5] to reinforce the orthodoxy and traditional view of development. A snapshot of this playbook is shown. In addition to the predicted economic calamity, they also suggest the use of transfer taxes as an alternative means to raise infrastructure fees.

The Traditional View's Fatal Flaw

The traditional view has a fatal flaw, but it has the advantage of being intuitive to any consumer who has purchased any kind of goods. The concept of an excise tax getting passed on to the consumer is easy to understand since it happens every day. Alcohol and cigarette tax, gas tax, electricity tax, etc…This fatal flaw is reflected in the figure provided by the developers impact fee playbook.

This is not to say the model is not applicable to other jurisdictions, albeit with some heavy caveats. In Howard County, the traditional model has led to an increase in county debt, decrease in quality of infrastructure, and massive developer profits.



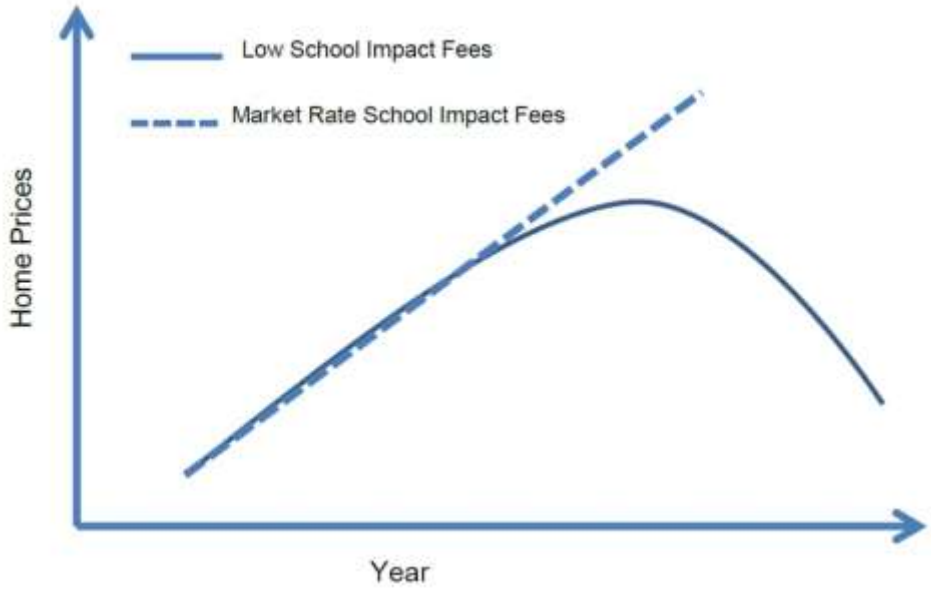
What happens in jurisdictions with low or no impact fees? Developer profits are subsidized because the taxpayer funds <u>all</u> infrastructure.

“When a development reduces the commons available to others, such as open space, clean air, or natural habitat, the developer will tend to provide too much of the housing or other product if

the developer and its home buyers are not asked to internalize the full costs of the development's use of commons." [1]

Furthermore, growth is delayed through lengthy planning review processes and a moratorium may be put in effect [by the taxpayer who becomes sick of subsidizing those profits] [2].

"Because residential development does not generate enough additional tax revenue to cover the cost of providing new public services, the community may adopt exclusionary barriers to the construction of residential property." [2]



Finally, developers move to other jurisdiction because of the inadequate public facilities and low quality of life they activities created.

In the long term, home prices decline because consumers look for jurisdictions with better infrastructure and the remaining tax-base is saddled with all the costs of maintaining existing infrastructure. Since the remaining tax base is poorer it won't be able to sustain the burdens, which leads to higher debt, resulting in a municipal financial crisis.

"In a competitive market, if a jurisdiction increases its property taxes but does not increase the quality or quantity of services it provides with property tax revenue, consumers will purchase housing in jurisdictions with lower property tax rates. Decreased demand will reduce the price of housing in the taxing jurisdiction so that the total housing price/property tax/service package will remain competitive with other jurisdictions." [1]

That is to say, it is the low quality of infrastructure that leads to decrease in demand, not increase in impact fees to keep up with infrastructure needs.

There is an approach to development that more accurately reflects its impacts.

The "New" View on Development

This "new" view, discussed in great detail in [2] says, impact fees are nothing more than the cost of providing valuable facilities to new development. They offset property taxes that would otherwise have been assessed, leading to a savings in these costs that will be capitalized into home values. They improve the timeliness of availability of infrastructure, which increases the supply of developable land by adding capacity to public infrastructure.

Empirical studies on effects of impact fees indicate future property tax increases are averted when the cost of public infrastructure is paid by the Developer at the time new homes are built. Studies also show that impact fees have at best a boosting effect on job and economic growth and at worst a non-discernible effect.

Furthermore, impact fees have an insignificant effect on construction rates, while positive effect on demand for homes in inner and outer suburban and rural areas. The study demonstrates that very little relationship exists between the Developer claims that impact fees reduce affordable housing. The mechanism to provide affordable housing in a jurisdiction with high home prices is not through low impact fees.

So, What is the Solution? Use Level of Service as a Metric

The framework used to assess the effects of new development needs to change. Not only is it grossly inaccurate and misleading, it does not take into account a key metric in the analysis.

For example an economic and fiscal impact study of the update to the county's adequate public facilities ordinance (APFO) prepared for the Howard County Economic Development Authority [4] predicted a decline in "residential construction and employment activity" and a broader decline on "residential income and spending impact".

The predictions like those made by Mr. Basu in 2004 are not accurate because they have no consideration for the impact on the **level of service**. For developers, the level of service is an afterthought.

"For the market for housing (or other forms of development) to be efficient- to maximize overall social utility – standard economic theory holds that the price of housing must include all the benefits and costs that the development brings to or imposes on society." [1]

A socially, economically, and fiscally optimal rate of growth can only be achieved only when the impacts of growth on each of these factors are internalized.

Level of service of public infrastructure must be the main driver of new development. In a spectrum with extremes of moratorium at one end and unregulated development on the other, impact fees actually represent a happy medium.

References

1. Been, V. (2005). Impact Fees and Housing Affordability. *Cityscape,8*, 139-185. Retrieved from https://www.huduser.gov/periodicals/cityscpe/vol8num1/ch4.pdf.
2. Burge, G. (20106, May 03). Impact Fees in Relation to Housing Prices and Affordable ... Retrieved from https://www.researchgate.net/publication/265228760_Impact_Fees_in_Relation_to_Housing_Prices_and_Affordable_Housing_Supply
3. Carson, L. (2005, March 28). Md. counties, builders at odds over who pays for the costs of growth. Retrieved from https://www.baltimoresun.com/news/bs-xpm-2005-03-29-0503290027-story.html
4. Clinch, R. P., & Steere, E. M. (2018, January 16). The Economic and Fiscal Impacts of the Proposed Adequate ... Retrieved from http://www.hceda.org/wp-content/uploads/HCEDA-APFO-Impact-Report-1-16-18.pdf
5. IMPACT FEE HANDBOOK - NAHB. (2008). Retrieved from https://www.nahb.org/en/research/~/media/8B12E2AABAE549F49CDC751B378C737A

6. Wilen, H. (2019, March 1). Howard County could raise taxes following panel recommendation. Retrieved from https://www.bizjournals.com/baltimore/news/2019/03/01/howard-county-could-raise-taxes-following-panel.html

7. Snowden River Parkway Lane Addition Project to Begin. (2019, March 26). Retrieved from https://www.howardcountymd.gov/Departments/Public-Works/Bureau-Of-Engineering/Transportation-and-Special-Projects/Current-T-SP-Design-Project-Information