Strategies for Fiscally Sustainable Infill Housing

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Introduction

Passed in 2008, new state legislation (Senate Bill 375) now requires every major region within California to reduce statewide greenhouse gas emissions by accommodating new growth through infill urban development. A growing number of California cities want to comply with this new bill and promote thriving, infill development with multi-family housing affordable to families at a range of incomes.

The benefits of walkable, infill communities are many and well-documented – from greenhouse gas reduction to resource conservation to improved community health. However, in order to achieve the goal of more infill homes, a city’s costs and revenues need to match up. Cities today are faced with a crippling economic recession that is forcing municipalities to drastically cut back on the public services – such as parks, libraries, police, and fire – that make these communities such great places to live. Since property tax rates were capped with the passage of Proposition 13 in 1978, revenues from residential land uses have not increased at pace with the rising costs of both infrastructure needs and public services in California. Cities are reticent to accommodate California’s growing population within their borders without new revenue sources. Simply put, cities need a model for new housing development that is both environmentally sustainable and fiscally sustainable.

This report attempts to help infill housing advocates and city staff better understand the relationship between a city’s fiscal health and infill housing development. It is divided into three parts. Part I provides an introduction to city general revenues and expenses associated with infill housing development. Part II describes strategies that California cities can use to raise additional revenues from housing development. Finally, Part III looks specifically at the city of San Jose as a case study of how a city may promote fiscally sustainable infill housing development.

The primary focus of this report is on strategies that cities can implement to generate net new revenues out of new multifamily infill housing development. Because of this narrow focus, many other important areas of investigation are left out of this report, including: state-level strategies to generate new revenues for cities (such as amending or repealing Proposition 13); cost reduction strategies (such as reducing the health care costs for municipal workers); revenue reallocation strategies (such as tax-increment financing); or new revenue sources from non-residential
development (such as business license fees). All of these topics certainly play an important role in the overall fiscal health of a city, but they are beyond the scope of this report.
Part I: A Primer on Fiscally Sustainable Infill

This section is designed to help infill housing advocates understand the basic mechanics of how cities pay for infrastructure and public services – two essential parts of building a livable community. It’s important to remember that this sort of fiscal analysis of housing only focuses on one aspect of the development. Obviously, other factors such as safety, affordability, and environmental sustainability ought to be considered when determining what sort of housing development is right for a community.

What you should take away from reading this primer is:

- **Infill homes usually costs less per unit than sprawl housing for both infrastructure and most public services.** Most of the recent research shows that on a per unit basis, infill costs less than sprawl.

- **However, revenues from infill homes do not always cover all the costs.** Property taxes are one of the primary revenues that cities receive from housing, but because of California’s highly restrictive property tax laws, residential development generally does not generate enough revenues to offset their costs. So even though infill costs less per unit than sprawl, it generates less property tax revenues per unit, as well.

The City Fiscal Mismatch

Oftentimes, planners and advocates do not fully understand what the costs and revenues are for infill housing development. The common perception in many California cities is that housing will always be a fiscal loss for cities, and doing a full fiscal analysis will only draw opposition. However, it is important that infill housing advocates understand these fiscal issues so that acceptable solutions can be worked out beforehand.

In general, cities have two costs associated with housing: (1) one-time infrastructure and capital costs; and (2) ongoing public services (ie. police, fire, parks, and libraries) and infrastructure maintenance. This report will discuss both, but mostly focuses on a city’s ongoing costs.

Cities also have a range of revenue sources, which can be roughly divided into two groups: (1) unrestricted, or general, revenues, and (2) restricted revenues. Unrestricted revenues go into a city’s general fund and can be spent at the discretion of the city council. Restricted revenues can only be used to pay for specific things.

Not all cities provide the same services, or collect the same revenues. In California, roughly one quarter of cities are full-service cities, meaning that they provide all the common public services to their residents (police, fire, libraries, and parks). Many cities are partial-service cities, with some services such as fire provided through special districts and not by the city itself. Revenues
can also vary widely. For example, if a housing development is in a Redevelopment Area, then a significant portion of property tax revenues get diverted to the Redevelopment Agency. While this grants the Redevelopment Agency the ability to use this money on important things like affordable housing and new infrastructure, it can also mean less money for public services.

To complicate issues further, the costs of most services are usually calculated per capita, while the revenues are generated on a per unit basis. For example, many cities establish a parks requirement based on number of acres per 1,000 residents. However, property taxes are collected based on the assessed value of the property, regardless of the number of residents.

Finally, there is ongoing disagreement about how to divide costs and revenues by land use. For example, sales taxes are an important revenue source for cities, which comes almost exclusively from commercial land uses like stores and shopping malls. However, stores need people living nearby who shop there in order to sell anything – which suggests that at least a portion of sales tax revenues should be attributed to residential uses. Cities will oftentimes hire consultants to determine how much their residents are spending on taxable goods in their city and develop a formula for allocating revenues accordingly.

Even with all this variation between and within cities, it is helpful to understand a city’s basic balance sheet when it comes to housing. Below is a more detailed discussion of both the costs and revenues from infill development.

Costs of Infill Housing

A city’s costs associated with building more housing are twofold. First, there are the initial costs of building or upgrading the infrastructure to serve the new housing; this may include building new roads, upgrading sewage and water capacity in the area, and building new facilities. Second, cities pay for many of the ongoing public services for the residents in the area, including police, fire, parks, and libraries. These ongoing costs also include operations and maintenance for the roads, sewage, and other infrastructure.

*Infrastructure* costs

**Transportation** Road infrastructure per unit is on average much cheaper for infill compared to greenfield; there are simply less roads to be built per unit. Infill can incur significant transportation infrastructure costs if the city requires excessive traffic mitigation measures. See sidebar on “Reducing Infrastructure Costs” for more information.

**Sewage and water** Sewage and water infrastructure per unit are usually cheaper in infill development because the infrastructure in place has excess capacity. The costs of sewage and water both increase rapidly in sprawl development, and particularly where new development
leap-frogs over existing agricultural or undeveloped land. Sewage pipes need either a constant downhill slope to the treatment facility or pumps to move the sewage. A constant slope becomes harder and possibly impossible to achieve over long distances, and pumps can be costly to maintain over time. Providing water over long distances also becomes costly, as pumps are needed to maintain adequate water pressure.

Utility lines Where electrical, phone, and internet lines have excess capacity in urban neighborhoods, the cost of utilities infrastructure for infill development is minimal. For new greenfield development, the cost increases with distance from existing trunk lines, particularly if the cables must be undergrounded.

Capital costs for services The public services listed below have up-front capital costs associated with them, as well. Police and fire need stations and equipment; Parks and libraries require physical space or structures before operations can begin. These costs can vary significantly based on the capacity of existing facilities and how far they are from the new development.

Public services

Police Services As new development is built, police departments must hire additional police officers and patrol cars for new beats. When density increases, hard costs such as patrol cars and gasoline decrease on a per capita level. While some argue that more police officers will be needed because crime rates go up in denser areas, there is more credible evidence that police costs per capita actually decrease with density because a police officer is able to cover more residents in a single beat.

Fire Protection Services With fire protection services, response time is a key factor. Thus, if a sprawl development is built far from existing services, a new station may be required, adding significant costs. By the same logic, if infill developments are particularly tall, firemen may need special equipment to safely and quickly access them in the event of a fire. However, once that equipment has been purchased to service one building in a neighborhood, additional buildings at that height can be built nearby without incurring any additional capital costs.

Parks and Libraries Operations and maintenance of parks and libraries can be a relatively small but significant cost that the city must pay for with scarce general revenues. Maintenance costs for parks are often lower when they are located near the service center, which is often near the city center. Most libraries have excess capacity and benefit from maximizing the number of residents nearby.

General Government and Planning These costs include everything needed to make a city run administratively, from planning and permitting to the City Manager’s office.

Infrastructure Operations and Maintenance The cost of operating and maintaining infrastructure over time varies considerably by neighborhood and by project site. These costs are
often lower for infill development simply because as densities increase, the cost of operations and maintenance per linear foot of infrastructure is spread over more residents.

City Revenues for Infrastructure and Public Services

Cities have two primary sources to pay for new infrastructure and increased demand for public services. First, cities can pay with general (or unrestricted) revenues. These revenue sources include automatic revenues such as property taxes and sales taxes, as well as additional taxes cities can choose to levy, such as Transit Occupancy Taxes (TOTs). For the average California city, general revenues make up 36 percent of a city’s overall revenues.

In addition, cities can pay using targeted revenue sources, such as a traffic mitigation fee to pay for widening roads or a special assessment district to pay for parks maintenance. These additional revenue sources will be discussed in Part II of this report. Finally, it’s important to note that the ongoing costs of many utilities are paid for through service charges, such as water, sewage, waste removal, etc., which will not be discussed here.

This section will discuss the general revenue sources cities can use to pay for infrastructure and public services, and how infill development affects these revenues. For a more general discussion on city revenues, an essential resource is “A Primer on California City Finance” available through the League of California Cities on their website.

Automatic General Revenue Sources

The first three general revenue sources discussed here – property taxes, sales taxes, and vehicle license fee – generate revenues for cities automatically. This means that a certain portion of these state-collected revenues are automatically returned to the city through a pre-established formula.

**Property Tax** Of all the basic general revenue sources, property taxes are the only ones directly generated by residential development. After Proposition 13 was passed in 1978, property tax was locked in at 1 percent of property value, with a maximum increase of 2 percent a year. Property tax gets reassessed whenever a property changes ownership or when major improvements are done on the land. While infill development creates more property tax revenue per acre than sprawl development, it oftentimes generates less property tax revenue per unit or per capita due to the lower assessed value of each individual unit. Property taxes go first to the state, which uses a formula to determine how much of it goes to school districts, the county, and city general revenues. On average, cities receive 21 percent of property tax revenues in non-redevelopment areas. Property tax makes up 11 percent of a city’s general revenues. Even though property taxes are levied on all properties, many commercial and office building owners have found ways to minimize property tax increases on their properties by avoiding changes in ownership. Because of this, the residential share of property tax revenues increased from 50 percent to 64 percent in the last 30 years as the share from commercial properties has declined.
**Sales Tax** Since Proposition 13, sales tax has increasingly become the most important source of revenue for many cities. On average, sales tax revenues are 10 percent of all revenues for cities. This has led to a fiscalization of land use as commercial developments have become a vital source of sales tax revenues for cities. Cities have a financial incentive to prioritize retail or commercial uses over residential or other uses that generate less sales tax revenue. Infill development can have two positive impacts on sales tax revenues: first, infill is often mixed-use, with sales-tax generating ground floor retail. Second, higher density means more residents who are likely to shop at stores in the city, boosting sales. Economic consultants can analyze a city’s demographics and retail profile to determine how much new residents would contribute to this tax base.

**Vehicle License Fee** -- Cities receive the revenues from license fees of vehicles registered in their boundaries. In 2004, the state reduced the rate of the Vehicle License Fee (VLF) from 2 percent to 0.65 percent, and made up for the revenue loss to cities by backfilling it with additional property tax revenues to cities. Because of this, VLFs are now a small sliver of a city’s revenues.

Additional General Revenue Sources

Below are some of the most common additional general revenue sources for cities. These revenues require additional action before they can be collected.

**Utility Users Tax** Cities are allowed to levy a Utility Users Tax (UUT) on a number of utilities, including gas, electric, water, and more. The tax can be approved by a city as either a special tax, or a general tax to pay for city services. The tax is on average about 5 percent of a household’s utility bill, and is included in the utilities bills. Nearly half of all households in California pay a UUT. Infill units often use less resources, and therefore pay less of the UUT than low-density households that consume a greater amount of resources.

**Other Taxes and Fees** Over three quarters of California cities levy a Transit Occupancy Tax on visitors who stay in the city. Because this is a revenue source tied to a specific land use (hotels and other lodging facilities), it has also led to a fiscalization of land use. When infill developments include hotels, significant new revenues for the city may be generated. Business License Taxes and are levied by most of California’s major cities and provide an important source of general revenues, but infill housing development has a minimal impact on this revenue source unless it also includes office space.

Conclusion – Adding it all up

So how well do these costs and revenues add up in an average Californian city? Below is a table that shows a cost/revenue analysis for low-density and higher-density housing in a hypothetical city. Though both growth scenarios show a negative net impact, it’s important to note that the
lower-density scenario costs the city more per unit than a higher-density development. This is explained in part by all the reasons discussed above; higher density infill housing development can take advantage of locational efficiencies to lower costs for cities.

This example does not mean that infill development will never be able to pay for itself; it does mean that in some circumstances, additional revenues are needed in order to make infill housing financially sustainable for cities. In Part II, we’ll talk about what these additional revenues might be. For a more specific analysis, see the case study on San Jose in Part III of this report.
Table 1. Example of Cost and Revenue Analysis for a City

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Single Family</th>
<th>Multi-Family</th>
</tr>
</thead>
<tbody>
<tr>
<td>Density (Gross)</td>
<td>4</td>
<td>20</td>
</tr>
<tr>
<td>Acres</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Total Residential Units</td>
<td>20</td>
<td>100</td>
</tr>
<tr>
<td>Median Cost per Unit</td>
<td>$500,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Property Value</td>
<td>$10,000,000</td>
<td>$25,000,000</td>
</tr>
<tr>
<td>Average Property Tax revenue to cities</td>
<td>0.21%</td>
<td>0.21%</td>
</tr>
</tbody>
</table>
CITY SERVICES COSTS

<table>
<thead>
<tr>
<th>Service</th>
<th>2023</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Police</td>
<td>$15,000</td>
<td>$52,000</td>
</tr>
<tr>
<td>Fire</td>
<td>$8,000</td>
<td>$26,800</td>
</tr>
<tr>
<td>Parks</td>
<td>$4,000</td>
<td>$13,350</td>
</tr>
<tr>
<td>Libraries</td>
<td>$2,250</td>
<td>$7,350</td>
</tr>
<tr>
<td>Planning and General Government</td>
<td>$5,250</td>
<td>$17,500</td>
</tr>
<tr>
<td>Infrastructure Operations and Maintenance</td>
<td>$3,200</td>
<td>$10,700</td>
</tr>
</tbody>
</table>

**Total Ongoing City Costs**
Total Ongoing City Costs per unit

\[\text{Total Revenues} = \$31,700\]

CITY SERVICES REVENUES

Property Tax Revenue

\[\begin{align*}
\text{Property Tax Revenue} & = \$21,000 \\
& \quad + \$52,500 \\
\end{align*}\]

Sales Tax Revenue

\[\begin{align*}
\text{Sales Tax Revenue} & = \$4,600 \\
& \quad + \$23,000 \\
\end{align*}\]

Utility Tax

\[\begin{align*}
\text{Utility Tax} & = \$2,000 \\
& \quad + \$11,200 \\
\end{align*}\]

Other Taxes and revenues

\[\begin{align*}
\text{Other Taxes and revenues} & = \$4,100 \\
& \quad + \$21,000 \\
\end{align*}\]

Total Revenues

\[\text{Total Revenues} = \$31,700\]
Total Revenues per unit

$107,700

$1,585

$1,077

Net Difference

-$6,000

-$20,000

Per unit

-$300

-$200