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Making dollars and sense out of fiscal impact analysis

By Polly Roberts

Fiscal impact studies have held a curious fascination for both opponents and proponents of development. Both groups hail these studies as the new, scientific way to make land-use decisions. But, in fact, fiscal impact studies give incomplete and misleading information about proposed developments. Even worse, fiscal impact criteria strongly bias local governments to exclude moderate- and lower-income persons who need services, notably families with children. In short, the use of fiscal impact criteria for making decisions about development accounts to a major extent for our current land-use problems.

Local officials usually apply some crude measure of fiscal impact in deciding whether to encourage or discourage a particular development. This is done by estimating the cost of the public services the development would require and comparing that cost to the estimated increase in tax revenues. If revenues exceed costs, the development supposedly increases the tax base, and the locals roll out the red carpet. But if costs exceed revenues, the door is barred.

Modern fiscal impact analysis has, however, grown quite sophisticated and expensive (even a modest effort may cost \$40,000 to \$50,000). It sprang to fame with the 1971 report, "Open Space vs. Development: The Foothills Environmental Design Study," by the consulting firm of Livingston and Blayney. This study found that the cost of additional schools and other services for a proposed development in the foothills area of Palo Alto, California, would greatly exceed projected tax revenues. In fact, the city would save money by outright purchase of the land for open space.

The Palo Alto city council, impressed by the study, initially voted \$4 million to buy the lower foothills area, including the proposed development site. When it became apparent the area would cost many times that amount, the council decided not to buy it but zoned it for 10-acre lots, making development economically infeasible. Livingston and Blayney found that even \$80,000 houses would not pay their own way in Palo Alto.

Such studies seem to confirm the feeling of many environmentalists that urban development not only looks worse than open space but also costs more.

Meanwhile, developers have rushed to battle with their own fiscal impact studies. These purport to show that residential development does pay its own way, and handsomely. William Leonard, executive director of Associated Building Industry, the Bay Area homebuilders' association, has edited a whole volume of fiscal impact studies favorable to development. The volume includes a rebuttal to the Livingston and Blayney study.

Conflicting results have not deterred the advocates of fiscal impact analysis. Last year, California Assemblyman Charles Warren introduced legislation requiring the inclusion of an economic impact element in environmental impact statements. The economic impact element is defined as a fiscal impact statement plus an estimate of the number of jobs to be created by a project, its impact on minorities and on various indicators, and a number of other factors.

The AFL-CIO, which helped draft the California bill, apparently hopes that favorable economic impact statements will counteract unfavorable environmental impact statements. However, in support of the bill, Assemblyman Warren argues that "too frequently communities have found they are unable to afford the economic costs of development growth." (The bill passed the legislature but was vetoed by Governor Reagan and will not come up again until the next session.)

Is this widespread faith in fiscal impact analysis really warranted? Or have some important considerations been overlooked? In brief:

- Contrary to widespread impression, a fiscal impact analysis is not a benefit/cost analysis.

- Fiscal impact studies to date have employed an amazing diversity of methods, many of them dubious. There is no established methodology.

- Even competent fiscal impact studies omit many benefits and costs and neglect interdependencies.

- Fiscal impact studies of residential development can only prove something we already know: richer

than average taxpayers, notably owners of commercial and industrial properties, help support services to poorer than average taxpayers: homeowners and renters.

- Local governments have in practice long regulated land use according to fiscal impact criteria and will have strong incentive to continue to do so.

It would be folly to undertake a major public investment, such as a highway or irrigation system, without some idea of the consequences. A benefit/cost analysis attempts to answer these basic questions: If we build this project, what benefits and costs will arise that would not arise if we did not spend the money or spent it on something else? Do the benefits exceed the costs?

The benefits and costs may be either private or public. For example, farmers receive part of the benefits of irrigation in the form of more valuable crops. The public receives part as revenues from water sales and taxes.

Future benefits and costs are not worth as much as present ones. All else being equal, I would not pay as much for a new car to be delivered next year as for one to be delivered tomorrow. So, to permit comparison, future benefits and costs must be discounted to the present, that is, reduced by a certain percentage.

When all costs and benefits have been identified, estimated, and appropriately discounted, a project is justified if and only if the benefits exceed the costs. And that goes not only for the whole project but for any optional components of the project.

Clearly, all sorts of difficulties beset benefit/cost analysis. Perhaps the greatest is that of quantifying privately received nonmonetary benefits and costs like pleasure from recreation or suffering from smog. Analysts also disagree on the proper discount rate for future benefits and costs. Consequently, estimates of benefits and costs may vary widely for the same project.

Nevertheless, it's not true that anything goes. Construction-minded public agencies like the U.S. Bureau of Reclamation notoriously overstate or double-count benefits, understate or omit costs, and use a very low discount rate to magnify future benefits compared to present costs. More im-

partial analysts will offer a range of estimates under different assumptions. Typical Bureau of Reclamation projects fail benefit/cost tests except under relatively implausible assumptions.

Benefit/cost analysis helped environmentalists defeat projects like the Grand Canyon dams and the SST. Impartial analyses showed that these projects not only wreaked environmental havoc, but also wasted taxpayers' money.

Unbiased benefit/cost analysis can help public officials make more intelligent decisions about investments in public works or about certain tax or subsidy policies. However, benefit/cost analysis offers little help in evaluating public services with a large redistributive component, such as free public education, public hospitals, or welfare. No one has yet devised a convincing way to compare the subjective benefits and costs of one group with those of another.

For redistributive services, analysts resort to a cost/effectiveness analysis. Given a decision to provide "X" level of education, for example, how can we do it most inexpensively? Alternatively, given a decision to spend "Y" dollars on education, how can we get the best education for our money?

Cost/effectiveness studies frequently will give the same kinds of results as benefit/cost analysis. For example, a benefit/cost analysis may show it is better to spend money improving city transit than building new freeways in the boondocks. A cost/effectiveness analysis may show it is cheaper to educate children in central areas with existing school capacity than to build new schools in the remote suburbs.

Benefit/cost analysis would be pointless for private development. With two kinds of exceptions, successful private development will always pass a benefit/cost test. The developer's customers receive a benefit at least equal to what they pay, or they wouldn't buy. The developer has a profit left after costs.

There are two exceptions. Whether or not the development is built may depend on a public works project, such as a highway, that fails a benefit/cost test. Or the development—for example, a factory—may cause sub-

stantial harmful side effects, like water pollution. In such cases, if the highway is not built or the pollution controls cost too much, the developer may not want to build.

A fiscal impact analysis tells a local government how much additional money it must spend on services for a new development over a period of years and how much in additional revenue (taxes, fees, and transfer payments) it will derive from the development.

A new residential development will require expenditures for roads, police and fire protection, sewage and water systems, and other services. Schools, typically, require the greatest outlay, which is why local officials chew their nails about the number of children per dwelling unit. Meanwhile, the value of the property rises with development, bringing in more money in property taxes. The local government also may become eligible for grants from other levels of government for roads, sewage treatment plants, or schools.

If the development costs more than it brings in at existing tax rates, then it shows a deficit. It does not pay its own way. The local government must raise tax rates so that other taxpayers in the jurisdiction help pay for services to residents of the new development. The number of children is often the critical factor: wealthier families have more assessed value per family and fewer children, while poorer families have less assessed value and more children.

Fiscal impact studies suffer from most of the same uncertainties as benefit/cost analysis. A cautious analyst will, therefore, present a range of estimates under different assumptions. Yet one might charitably describe the methods of many recent studies, both for and against development, as questionable. The Livingston and Blayney study tried to mix social and environmental impacts with fiscal impact. It gave subcategories of each impact a score weighted by a factor of from two to eight, derived apparently by subjective means, and simply added up the total. Prodevelopment studies often allocate costs of services to people, like education, in proportion to property value. This procedure totally defeats the purpose

of fiscal impact analysis, which is to compare a local government's increased revenues with its increased service costs.

On a regional scale, industry and commerce need housing for workers. To say that housing doesn't pay its own way is a bit like saying women who stay home and raise children don't pay their own way.

Why the poor methodology? For one thing, lawyers, planners, and engineers with little economic expertise have prepared many of the studies. They can hardly be expected to run where better-trained analysts still stumble. In addition, parties with a significant economic or ideological stake in the results have commissioned most of the studies. Consultants seldom prosper by displeasing their clients.

In brief, then, a fiscal impact analysis, unlike a benefit/cost analysis, does not consider all benefits and costs. It considers only those that show up as cash flowing in or out of a particular local government treasury. Thus a fiscal impact analysis omits privately received costs and benefits within the local jurisdiction. It omits all costs and benefits received outside the jurisdiction. Consequently, a project with a good benefit/cost rating may show a deficit on a fiscal impact analysis and vice versa.

A housing development justified by a benefit/cost analysis may show a fiscal deficit because taxes at existing rates collect only a fraction of private benefits. At a higher rate, the same development might show a fiscal surplus.

By focusing on cash, fiscal impact studies also miss interdependencies. Housing diverted to adjoining communities still will contribute to a city's sales tax receipts, for example. Industry and commerce need customers and housing for employees on a regional scale. And residents need jobs and consumer goods. To say housing doesn't pay its own way is a bit like saying women who stay home

and raise children don't pay their own way.

A fiscal impact study of residential development says nothing about its economic desirability. But it does say something about the distribution of costs and benefits of public services—something we already know. Americans long ago decided to provide some social services—free public education, public health care, and welfare—according to need. As an inescapable corollary, richer taxpayers help support such services for poorer citizens.

For example, nonresidential and expensive residential property help support services to low- or middle-income homeowners. Further, newly built family housing is much likelier than older housing to attract families with small children. Thus a fiscal impact analysis naturally shows a deficit for all but the most expensive new housing developments. And—except in central areas with excess school capacity—the deficit normally will require an increased tax rate.

Except in rare instances, middle- or lower-income housing has never paid its own way. Growth-minded city fathers in the past plotted night and day to snare commerce and industry to help finance services to residents. And now, as then, wealthy residents try to keep newcomers from moving in and sharing their surplus. Fiscal impact analyses, misinterpreted as benefit/cost analyses, give them the perfect excuse for doing so.

Furthermore, the bigger a jurisdiction's commercial and industrial tax base relative to housing, the lower the tax rates. But the lower the tax rate, the larger the deficit a new residential development will show. Even an \$80,000 housing development will look bad in Palo Alto, which has a large tax base and low tax rate. The same development may look like a bonanza to less fortunate neighboring cities. Fiscal impact criteria for development fortify economic segregation.

Because they do not include all costs and benefits, and because they are biased against redistribution, fiscal impact studies simply do not provide a valid basis for land-use decisions. Nevertheless, local governments always have made and always

will make land-use decisions based on fiscal impact estimates, however crude. In following their own parochial fiscal incentives, they often manage land use in ways that conflict with the interests of society as a whole.

In regulating land use by fiscal criteria, local governments tend to encourage urban sprawl. Why not change their incentives?

On the one hand, local governments tend to overbuild new infrastructure, such as roads, sewage treatment plants, and industrial parks. Such investment would show up poorly on a benefit/cost analysis. However, state and federal subsidies, such as gasoline tax money, sewage grants, or tax-exempt municipal bonds, give such investment an attractive fiscal impact. Local governments also compete to attract industry and commerce to help pay for services. In the process, they may give a company tax breaks or other special concessions to such a degree that they end up with no fiscal advantage.

On the other hand, local governments strive to exclude factors that create fiscal deficits: poor people and children. Who likes to raise taxes, especially for the benefit of outsiders? In the suburbs, such exclusion may take the form of large-lot zoning, bans on multifamily dwellings, limits on the number of bedrooms per unit, or requirements that developers set aside part of their land for open space. Suburban governments may deny water services to new development. They also may try to make the residential development that does occur pay its way by requiring developers to build and endow schools and parks, install new sewage or water systems, or donate new trucks to the fire department.

In regulating land use by fiscal criteria, local governments play a negative sum game. Since "desirable" industry and commerce depend on "undesirable" residential development, limiting the latter also limits the former. As a net result, both end up sprawled inefficiently across the landscape.

There are some solutions. Instead of trying to force local governments to act against their fiscal interests, why not change their incentives?

First, we should stop paying local governments gas tax money to build more highways. The chief benefits go to local landowners, while the general public pays the bill in higher taxes and smog. The same goes for sewage treatment grants. Far from protecting the environment, these often underwrite otherwise unprofitable development of raw land. Infrastructure development of purely local value should be financed locally.

Second, we should finance schools and other services to people by regional or statewide taxes. The California Supreme Court, in *Serrano v. Priest* in 1971, held it unfair that the quality of a child's education should depend on the wealth of taxpayers in the jurisdiction. The court did not note that this inequity also pushes local governments to compete in grabbing industry and keeping out children.

Consider a possible reform. School money could be collected by a statewide property tax. The state would return the money to each school district in per pupil grants. Or parents of school children would receive educational vouchers to spend at the school of their choice. School districts wishing to spend more than the basic grant could raise the money by local property taxes. The basic state grant could be set at a fraction, perhaps three-fourths, of the average per pupil expenditure, so the grant to local governments would automatically rise as communities increased supplemental spending. This proposal has two advantages. Property owners in low tax jurisdictions could no longer avoid paying their fair share for education. And children would add a plus instead of a minus to local balance sheets.

Similarly, public assistance or free medical care could be made less of a local burden by shifting all financing from the county to the state level. Changes such as these won't cure prejudice and poverty, but they will at least stop reinforcing them. □

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