STATE OF MINNESOTA
IN COURT OF APPEALS
A08-1536

SJC Properties, et al.,

Respondents,

v.

City of Rochester,

Appellant.

AMICUS BRIEF OF BUILDERS ASSOCIATION OF MINNESOTA AND APPENDIX

Gary A. Van Cleve (#156310)
Rob A. Stefonowicz (#297161)
LARKIN HOFFMAN DALY & LINDGREN LTD.
1500 Wells Fargo Plaza
7900 Xerxes Avenue South
Minneapolis, MN 55431-1194
Telephone: (952) 835-3800
Attorneys for Respondents

Thomas J. Radio (#137029)
HINSHAW & CULBERTSON, LLP
333 South Seventh Street
2000 Accenture Tower
Minneapolis, MN 55402
Attorneys for Appellant

Joseph G. Springer (#213251)
FREDRIKSON & BYRON, P.A.
200 South Sixth Street, Suite 4000
Minneapolis, MN 55402-1425
Telephone: (612) 492-7000
Attorneys for Amicus Curiae Builders Association of Minnesota

Steven J. Quam (#250673)
FREDRIKSON & BYRON, P.A.
200 South Sixth Street, Suite 4000
Minneapolis, Minnesota 55402
Attorneys for Amicus Curiae Main Street Development Company of Rochester, LLC and Maine Street Investors of Rochester, LLP

Elizabeth A. Wefel (#251951)
FLAHERTY & HOOD, P.A.
525 Park Street, Suite 470
Saint Paul, MN 55103
651-225-8840
Attorneys for Amicus Curiae The Coalition of Greater Minnesota Cities

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STATEMENT OF INTEREST OF AMICUS

The Builders Association of Minnesota ("BAM") respectfully submits this brief to urge that the district court's holding be affirmed.[1] BAM is a not-for-profit, voluntary trade association established to represent the interests of building contractors, land developers, manufacturers, suppliers, and related business enterprises. BAM was established in 1974 and now serves over 4,500 home building, remodeling and related professionals in affiliation with 15 local associations across the state of Minnesota. It is dedicated to providing the public with a diverse selection of quality and affordable housing. The efforts of BAM focus on development and infrastructure capacity issues, and on the education of association members, policymakers and the public about housing affordability, construction best practices, and land use best practices. BAM's mission is to increase the professionalism of the residential construction and development industries.

The interest of BAM in the present case arises out of the imposition of Transportation Improvement District ("TID") fees by Appellant City of Rochester (the "City"). City-imposed exactions of the nature and extent at issue in this case have a direct and significant impact on the development and housing industries and their ability to produce quality, diverse and affordable housing. This is an issue of importance not only to developers and builders but to all residents of this State.

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[1] In accordance with Minn. R. Civ. App. P. 129.03, BAM certifies that its counsel authored this brief in whole and that no person or entity other than BAM has made a monetary contribution to the preparation or submission of this brief.

BAM is especially concerned with the exactions that the City attempted to impose in this case and the effect that a potential reversal of the trial court's decision would have on the affordability of housing. The City requested that Respondent pay a "voluntary" TID charge of approximately $1.7 million. As the trial court noted, the Rochester City attorney informed the City Council that mandatory TID fees are not permitted in Minnesota and that TID fees are not intended to be a special assessment. Despite this acknowledgment, when Respondent did not pay the "voluntary" TID charge, the City levied the exact same $1.7 million TID charge as a special assessment against the property. The City, however, did not follow the legal requirements for establishing the amount of the special assessment. Developers, builders, and the public all have an interest in the affordability of housing. If cities are allowed to impose illegal fees of the type at issue here, many families will not be able to purchase a home.

ARGUMENT

I. THE CITY CANNOT LEGALLY REQUIRE THE PAYMENT OF TID CHARGES.

A. The Minnesota Supreme Court's Decision in *Country Joe* Establishes that Cities Cannot Require that Developers Pay TID Charges.

In *Country Joe, Inc. v. City of Eagan*, 560 N.W.2d 681 (Minn. 1997), the Minnesota Supreme Court ruled that a city cannot require developers to pay charges similar to Rochester's TID charges. In *Country Joe*, the Eagan City Council adopted a resolution imposing "a road unit connection charge" payable as a condition of issuance of all building permits within the city. *Id.* at 682. The resolution stated that the purpose of the road unit connection charge was to provide: "an equitable source of funding for major county and city street construction . . . in order to accommodate new development and traffic generated from future anticipated residential, commercial and industrial construction . . . ." *Id.* (ellipses in original). Eagan's stated purpose for its road unit connection charge was the same as the purpose stated by Rochester in its Resolution Establishing Traffic Improvement District Program: "The purpose of a TID is to designate a geographic area within the City with existing substandard streets that would need to be improved or replaced if new development were to occur within that area." Exhibit 30, p. 5. The Minnesota Supreme Court concluded that Eagan's "road unit connection charge "[i]s a revenue measure, benefiting the public in general, and is not an authorized exercise of the City's police powers . . . ." *Id.* at 686. Consequently, the Court found that Eagan could not require payment of the fee.

B. The City Has Admitted that It Cannot Require a Developer to Pay TID Charges.

In a memorandum to the Mayor and Common Council, Rochester's City Attorney informed the Mayor and City Council that: "The TID charges and the development agreement are completely voluntary on the part of the City and the developer. Either party can say no. The City cannot impose upon or require the payment of any TID charge from a developer." Exhibit 60 (emphasis added). Accordingly, the City's Resolution Establishing Transportation Improvement District Program, adopted approximately one month after the City Attorney's memo, stated as follows:

> BE IT FURTHER RESOLVED that the City will not involuntarily impose any of the charges, fees, costs or costs allocations described in the TID program. Instead, any reference to or mention of any charge, fee, cost or costs allocation occurs solely for the use by potential developers and City staff in responding to proposed developments involving inadequate public facilities that might be made adequate by way of voluntary development agreements.

Ex. 30, p. 8 (emphasis added). Despite the City's acknowledgment that it "cannot impose" and "will not involuntarily impose" TID charges, that is precisely what the City attempted to do here.

II. THE CITY CANNOT USE THE SPECIAL ASSESSMENT PROCESS TO REQUIRE THAT DEVELOPERS PAY TID CHARGES.

A. The Court in *Country Joe* Specifically Distinguished Between Special Assessments and TID Charges.

In *Country Joe*, the Minnesota Supreme Court acknowledged that special assessments, not TID-type charges, are the method by which cities may finance road construction:

> Although the legislature expressly provided for the sewer and water charges after which the city patterned its road unit connection charge, *see* Minn. Stat. § 444.075, subd. 3, it failed to provide such authorization for a road charge. That this lack of express statutory authorization was not the result of legislative oversight is evidenced by <u>statutory provisions expressly establishing special assessments as the mechanism by which cities are empowered to finance road improvements</u>. *See* Minn. Stat. §§ 429.021, subd. 1(1), 412.221, subd. 6.

Country Joe, 560 N.W.2d at 684.[2] The *Country Joe* court distinguished a Virginia case upholding a city's ability to impose mandatory TID-type charges by stating: "In contrast, the Minnesota legislature has *specifically provided* a funding mechanism for road improvements; therefore, no funding mechanism need be implied to effectuate the legislative grant of authority to undertake road improvements." *Id.* (emphasis in original, citations omitted).

The Court in *Country Joe* also distinguished between special assessments and TIDs as a form of an impact fee as follows:

> Impact fees have also been distinguished from special assessments: "The primary difference is that special assessments represent a measure of the *benefit* of public improvements on new or existing development, whereas impact fees typically measure the *cost* of the demand or need for public facilities as a result of new development only."

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[2] Minn. Stat. § 429.021, subd. 1(1) provides that the council of a municipality has the power to create and improve streets. The process for imposing special assessments for the costs of creating or improving streets is described in Minn. Stat. Ch. 429. Minn. Stat. § 412.221, subd. 6 also provides that a city council has the power to create and improve streets. This subdivision contains a reference to special assessments, but it appears limited to the costs incurred by a city after a property owner fails to remove snow, ice, dirt or rubbish from the sidewalks.

Country Joe, 560 N.W.2d at 685 (emphasis in original, citations omitted). This distinction between cost and benefits of a public improvement is the key difference between TID charges and special assessments respectively.

B. Despite Acknowledging that a TID Charge Cannot Legally be a Special Assessment, the City Imposed the TID Charges as Special Assessments.

The City has admitted that a TID Charge is not intended to be a special assessment charge. In his memo to the mayor and the city council, Rochester's City Attorney acknowledged the legal distinction between impact fees and special assessments drawn in *Country Joe*:

> There is one exception to my "the TID charge is completely voluntary" speech. If the City wishes to involuntarily impose a special assessment on property benefiting from a street improvement, the City can do so. But, the amount of the assessment is limited to the amount of increased market value the property experiences as a result of the improvement. <u>A TID charge is NOT intended to be a special assessment charge.</u> Public Works could ask the Council to collect a TID charge as a special assessment. But, we would have to hire an appraiser to see if the TID charge equals the increase in market value for the property. And the developer would hire a different appraiser to say the TID charge does not equal the increase in market value for the property.

Ex. 60 (emphasis added).

Despite the acknowledgment that the TID charge is not intended to be a special assessment charge, the City imposed the TID charge as a special assessment when the developer objected to the "voluntary" TID charge. In paragraph 38 of its Findings, the trial court found that "property owners either paid the TID fees or the City levied special assessments against them." The trial court drew the same distinction between TID

charges and special assessments that both the court drew in *Country Joe* and that the Rochester City Attorney acknowledged:

> The TID formula is not one that looks at special benefit based upon a market approach but is rather a formula that starts with the projected cost of a project and divides that cost amongst the properties deemed to be benefited based upon projected traffic usage as determined by the size and zoning of the property and the projected trips associated with that size of zoned property.

Trial Court Memorandum, p. 29. Despite this distinction, the trial court further found that "the TID fee that has been proposed for the WCC property is identical to the special assessment amount levied against the property" (Finding 50) and "the City did not secure an appraisal to evaluate special benefit to assess the properties prior to levying the special assessments at issue in this matter." Finding 48.

As the trial court found, the City merely changed the name of its illegal TID fee to a special assessment and sought to force the property owner to pay it. As the Court noted in *Eastern Diversified Properties, Inc. v. Montgomery County*, 319 Md. 45, 53, 570 A.2d 850, 854 (1990) (cited with approval in *Country Joe*, 560 N.W.2d at n.4 and 68), "in evaluating whether a development impact fee is a regulatory charge or a tax, the purpose of the enactment governs rather than the legislative label." (Citations and quotations omitted). Merely changing the name does not turn an illegal fee into a legal fee. The trial court's decision should be affirmed.

III. FEES OF THE TYPE IMPOSED BY THE CITY AFFECT THE ABILITY OF THOUSANDS OF HOUSEHOLDS TO PURCHASE A HOME.

Using the City's own numbers, the TID charges were $804 per single family home. Attachment A to the Resolution Establishing Willow Creek Traffic Improvement

District stated that the TID charge for "R-1" residential property was $2,613 per buildable acre. Ex. 37. The "Trip Generation Ratios for TID Charges" within the same exhibit assumed 3.25 units per acre for single family homes. Dividing the $2,613 per buildable acre by 3.25 units per acre yields $804 as the TID charge per single family home according to the City's own numbers.

A study performed by the National Association of Home Builders ("NAHB") has determined that every $819 increase in fees results in a $1,000 increase in house prices. Special Studies Article, *Building Fee Increases and Reduced Housing Affordability,* National Association of Homebuilders July 18, 2007 (http://www.nahb.org/fileUpload_details.aspx?contentTypeID=3&contentID=79606&subContentID=112544). A courtesy copy of this study is reproduced in BAM's Appendix ("BAM App.") pp. 1-3. This 22 percent increase in the price of housing over the increased fees is due to the cost of financing, brokerage commissions, and normal profit. *Id.* at p. 1.

A companion study performed by NAHB concludes that for every $1,000 increase in a median-priced new home, over 217,000 households can no longer afford to purchase a house. Eisenberg, *Metro Area House Prices and Affordability,* National Association of Homebuilders July 18, 2007 (http://www.nahb.org/fileUpload_details.aspx?contentTypeID=3&contentID=79606&subContentID=112544). A copy of this study is also available at the same website described above and a courtesy copy is reproduced in BAM App. pp. 4-7. The inability of 217,000 households to purchase a home as a result of a $1,000 price increase is due to

the inability to finance the purchase as a result of the $1,000 price increase. Id. The study uses standards established by Fannie Mae and Freddie Mac that total principal, interest, taxes and insurance ("PITI") should not exceed 28 percent of income. BAM App. p. 7. The NAHB study assumed a down payment equal to 10 percent of the purchase price and a 30-year fixed-rate mortgage. Id. NAHB then compared the total PITI payment to the national income distribution and determined that for every $1,000 increase in a median-priced new home, over 217,000 households could no longer obtain conventional financing to purchase a house. BAM App. p. 4.[3]

While one could potentially question the assumptions in this study, there is no question that there are many households at the margin that want to purchase a house. For those fortunate enough to have a good job and salary, an $800 or $1,000 increase in the price of a home may not seem to be much. But for the thousands of households at the margin, this small difference is the difference between owning and not owning a home. City imposed exactions like Rochester's TID charges have a direct effect on the affordability of housing. If cities are allowed to use special assessments as a method to "back-door" illegal charges, many families will not be able to purchase a home.

[3] The study also suggests that because new houses and existing houses all compete for buyers, that an increase in the price of new homes also result in an increase in the price of existing homes. BAM App. p. 4. "As a result, affordability across all price levels is reduced whenever building fees are raised and not just for buyers of new homes." Id.

CONCLUSION

Here the City acknowledged that it could not legally mandate that a property owner pay a TID fee. As a result, the City sought to impose a "voluntary" TID fee. When the property owner failed to pay it, the City imposed the TID fee as a special assessment. Merely calling a TID fee or other exaction a "special assessment" does not legalize an otherwise illegal charge. A city cannot use special assessments, or even the threat of special assessments, to impose a fee that the city cannot legally impose. Allowing cities to do so will increase the cost of housing and prevent many households from being able to afford to purchase a home.

Respectfully submitted,

Dated: December 1, 2008

Joseph G. Springer (#213251)
FREDRIKSON & BYRON, P.A.
200 South Sixth Street, Suite 4000
Minneapolis MN 55402-1425
Telephone: (612) 492-7000
Facsimile: (612) 492-7077

ATTORNEYS FOR BUILDERS
ASSOCIATION OF MINNESOTA

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Building Fee Increases and Reduced Housing Affordability

Special Studies Article, July 18, 2007

Every time a local or regional government raises construction costs by, for example, increasing the price of construction permits, tap fees, proffers or impact fees, the cost of building a house in that area rises. Making maters worse, the rise in the house price will generally be greater than the increase in the government fee. This is because each time construction costs increase other seemingly unrelated costs also rise. The sum of these "other" costs is about 22 percent. Thus, every $819 increase in fees results in a $1,000 increase in house prices. Table 1 give the numeric details, a detailed explanation follows.

Table 1	
Financing Costs	
Hypothetical Construction Fee Increase	$819
Cost of Capital	
Average Annual Interest Rate	10%
Length of Time From:	
Authorizaton to Start (in Months)	0.8
Start to Completion (in Months)	6.2
Completion to Sale (in months)	4.8
Total Time	11.8
Total Increase in Finance Charges	**$80.54**
Brokerage Commissions	
Average Fee as a Percentage of House Price	2.90%
Total Increase in Brokerage Fees	**$23.75**
Compensation and Normal Profit	
Total Compensation and Profit	9.30%
Total Increase in Compensation and Profit	**$76.17**
Sum of all Added Costs	**$180.45**
Sum of all Added Costs as a Percentage	**22.03%**
Total increase in House Price	**$999.45**

Financing

Financing is the first cost to necessarily increase. The dollar amount of the increase is dependent on when the new and or higher fee is paid by the developer or builder to the taxing authority. Building fees, HVAC fees, plumbing fees, electrical fees, platting fees and other similar and related fees are commonly paid at the time the permit is issued. There is strong evidence that park fees, library fees, police and fire fees, school fees, road fees and other infrastructure related fees are also paid when the permit is issued[1]. Therefore, the increase in financing costs is the amount of the fee multiplied by the length of time from payment of the fee until the house is sold.

This time period can conveniently be broken down into three sub-parts; permit to start, start to completion, and completion to sale. The 20-year average period of time from permit issuance to the start of construction for single family detached units based on data from the Survey of Construction (SOC) conducted by the Bureau of the Census is eight-tenths of a month. Interestingly this period of time has been as low as sixth-tenths of a month in 1998 and as long as a full month in 2006, with a full month being about 65 percent longer than the shortest time period. During this several week period of time, land may be cleared, a security fence may be erected, heavy machinery may be brought to the site, a barrier wall may be put up to prevent runoff from the jobsite, and other staging activities may be performed.

Based on the Census Bureau's SOC the 20-year average length of time from the start of construction to completion of the home, is 6.2 months. This period has at times been as short as 5.9 months in 1995 and as long as 6.9 months registered just last year, a difference of just 17 percent. By the end of this period a house is ready for sale. All finishing work has been completed and the house is ready to be shown.

The final phase, or the period from completion to sale also varies over time. Over the past 20 years it has been as short as 3.6 months in 2003 and as long as 6.9 months during the recession of 1991, a difference of over 90 percent. During this time the house sits vacant while the builder and or real estate agent work to find a buyer.

Note that the variation in the duration of the permit-to-start phase and the completion to sales phase is quite large, 65 percent and 90 percent respectively, while the variation of the duration of the construction phase is quite small. Moreover, in all three periods the duration increases when sales fall, and decreases when sales rise. This shows that the amount of the "mark up" actually rises during weak housing markets, when things are stretched out, and contracts when sales are brisk as the sum of all three phases are shortened.

Taken together these three periods of time add up to 11.80 months; almost an entire year. By multiplying the $819 increase in home construction costs by 10 percent (the interest rate currently paid by builders) and then multiplying that amount by almost an entire year results in additional financing costs to builders of $80.54.

Real Estate Agent Fees

The second cost that must rise as a result of a house price increase is the amount of commission paid to a real estate agent or broker. While residential commissions can be as high as six or seven percent, the Census Bureau estimates that the average broker/realtor fee is 2.9 percent of the sales price[2]. Figure 1 shows that every $819 increase in construction costs raises the brokerage fee and thus the final costs of the house by another $23.75.

Compensation and Normal Profit

The final component that must increase because of a new or higher fee is the dollar amount of compensation paid to the builder[3]. This increase is necessary to insure that the rate of return to home building remains competitive with home building in nearby areas and in other similar industries. Otherwise, it would be more profitable for builders to either build houses elsewhere or go into a different business. It is through this process that normal profits are eventually reestablished.

This outcome is assured because homer building is a very competitive industry with very limited barriers to entry. That is, not only are there many home builders in a given community, there are also many more people with the requisite skills to become builders were they so inclined. Thus, if profits become excessively large persons would tend to enter the industry. By contrast, if profits fall there would be a reduction in the number of builders. As a result of this constant ebb and flow of persons into and out of the industry, normal economic profits to those in the industry are the rule.

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[1] Based on a nationwide survey of Executive Officers of local and state home builder associations conducted in June 2007.
[2] Based on a special Census Bureau Survey most recently conducted in 1994.
[3] The amount of compensation and profit are based on *The Cost of Doing Business Study*, 2006 Edition, NAHB.

Metro Area House Prices and Affordability

Special Studies, July 18, 2007
By Elliot F. Eisenberg, PhD.

Report available to the public as a courtesy of HousingEconomics.com

A question frequently posed to economists at the NAHB is "What happens to housing affordability in my city when house prices rise?" One way to answer this is to change the price of a representative home by a fixed amount and observe the impact on affordability. Based on national mortgage underwriting standards, it is possible to estimate how many households that qualified for a mortgage before a house price increase no longer qualify for one afterwards. Those are the households that are "priced out" of the market for a home.

Applying this approach to the U.S. as a whole (detailed results for all 357 metro areas are provided in Table 1) shows that in 2007—using typical assumptions about the mortgage, down payment, property taxes and property insurance, a $1,000 increase in a median-priced new home, more than 217,000 households.

The size of the priced out effect is largely a function of the income distribution. The larger the number of households that have the income necessary to buy a given priced house before the price increase, the more households will be priced out after the price rise. Conversely, the more expensive the house, the fewer the households adversely affected by a price increase.

Building Fees and Affordability

Over time house prices rise for many reasons, including rising household incomes and increases in house size. These are examples of changes in demand. Alternatively it may be that costs have increased. When house costs increase and income stays constant in a market area, affordability declines.

While cost increases can result from forces far beyond the control of government or government officials, frequently it is specific government action that reduces housing affordability. For example, any time a local government raises construction costs by increasing the price of a construction permit, a tap fee, a proffer or an impact fee, the cost of building a house in that area rises and affordability is necessarily reduced.

Moreover, the increase in the price of the home to the home buyer will generally be more than the increase in the governmental fee. This is because when construction costs rise, other costs such as financing costs and broker commissions rise in tandem. To be precise, NAHB estimates that for every $819 rise in fees paid at the beginning of the construction process, the final price of the home to the buyer increases by $1,000, or 22 percent more than the initial fee.

In addition, when the cost of a median-priced new house rises, prices of existing houses rise too. As a result, affordability across all price levels is reduced whenever building fees are raised and not just for buyers of new homes. A detailed breakdown of the final price increase can be found at the end of this article.

Metropolitan Area Results
By adapting the priced-out analysis to local housing market conditions and combining it with house price change information it is possible to estimate quite precisely how housing affordability [2] changes in every metro areas across the country. NAHB has often applied the method to still smaller geographic areas, as many of the crucial decisions that drive up house prices are imposed at the city or county level.

The most recent data source providing household income distributions for Metropolitan Statistical Areas (MSAs) is the 2005 American Community Survey (ACS). Using ACS data, the number of households priced out of the housing market by a $1,000 price increase were calculated for all 357 MSAs. To best perform this analysis it is essential to estimate median new home prices for every MSA as house prices vary considerably from MSA to MSA [3]. For example, the median new home price is almost three times higher in Boston, Massachusetts ($435,403) than in Bismarck, North Dakota ($146,738).

Median new house prices are used as a measure of affordability as opposed to average new house price or average existing house price for two reasons. First, when building fees are raised new units are what are most directly affected. Second, the median is not skewed upwards by the construction of a few multimillion dollar mansions, while the average is. As such the media new house price better captures the typical cost of a new house to a household.

Looking at Table 1, the number of households priced out of the market by a $1,000 increase in the price of a median-priced new home ranges from a low of 10 in both the La Crosse, WI-MN MSA and the Ocean City, NJ MSA, to a high of 4,193 in the Dallas-Forth Worth-Arlington, TX MSA. The MSA with second largest number of priced-out households is the Atlanta-Sandy Springs-Marietta, GA MSA with 4,022 priced-out households.

While there are many reasons why the number of households priced-out because of a $1,000 price increase differs from MSA to MSA, a key determinant is the percentage of households that can initially afford to purchase a median-priced new home before any price increase. Not surprisingly, that number also varies dramatically from location to location. For example in the San Jose-Sunnyvale-Santa Clara, CA MSA, just eight-tenths-of-one-percent of the households can afford to purchase a median-priced new home estimated to cost $849,022. Just behind San Jose, is the Salinas, CA MSA where 3.5 percent of households have the financial ability to purchase a median-priced home that is estimated to cost $669,901.

The three other least affordable MSAs in the nation are the San Luis Obispo-Paso Robles, CA MSA where a mere 4 percent of households have sufficient income to afford a median-priced new house, the La Crosse, WI MSA where only 4.2 percent of households can initially afford to buy a median-priced new home, and the Honolulu, HI MSA, where the percentage of households able to buy a median priced house is just slightly better at 5.9 percent.

While three of the five least affordable MSAs are relatively small (San Luis Obispo, Salinas and La Crosse), there are almost 600,000 households in San Jose and slightly more than 300,000 households in Honolulu. Yet, even in those two larger metropolitan areas few households are priced out due to a price increase because so few households can initially afford a median-priced new home.

By contrast at the other end of the affordability continuum is the Charleston, WV MSA. There, fully 66.9 percent of households can afford to buy a median-priced new home, a home estimated to cost $85,804 before any price increase. Close on the heels of Charleston, WV is the Morristown, TN MSA where 61.2 percent of households currently have sufficient income to purchase a median-priced new house which estimated to cost $97,640.

The other three most affordable MSAs, as determined by the highest percentage of households able to purchase a median-priced new home, are the Lubbock, TX MSA where 59 percent of households can afford a median priced new home, the Trenton-Ewing, NJ MSA where 58.5 percent of households have the financial ability to purchase a median-priced new home, and the Idaho Falls, ID MSA where the number of such households is 56.9 percent.

As for the Dallas-Fort Worth-Arlington, TX MSA and the Atlanta-Sandy Springs-Marietta, GA MSA, mentioned earlier, the reason they rank one and two in terms of the number of households priced out is because those metropolitan areas are very large. Moreover, house prices in both MSAs are relatively affordable at $207,076 in the Dallas-Forth Worth-Arlington, TX MSA and $237,715 in the Atlanta-Sandy Springs-Marietta, GA MSA. As a result of favorable new housing costs, the percentage of households that that can afford a median new house is 40.6 percent in Dallas and 37.6 percent in Atlanta; the highest and third highest affordability percentages in the nation for cities with over 650,000 households.

The priced-out results do not answer questions such as "How many households will not buy a house when they otherwise would have?" or "What will the resulting reduction in home construction be?" To answer those questions requires an economic model that not only incorporates the willingness of households to buy smaller houses, older houses and houses that have fewer amenities, but also the many interrelationships between different segments of the local housing market, as well as the behavioral adjustments of home builders and of surrounding local governments.

By contrast, the priced out effect is relatively easy to understand and justify, straight forward to calculate and available for any housing market in the U.S. However, its limitations must also be kept in mind.

Summary and Conclusion

This article shows that increases in house prices attributable to government action, such as an increase in permit fees, generally raises the final price of the home by 22 percent more than the amount of the initial increase. Thus, every $819 increase in fees paid by builders and developers raises house prices by $1,000. This article also explains that the number of households priced out due to a fee increase varies substantially from MSA to MSA. This is because the number of priced out households itself depends critically on the percentage of households that can afford to initially purchase a median-priced new house and on the size of the MSA.

Footnotes

[1] See below "Determining the Number of Households Priced Out of a Market" for a basic description of current national mortgage underwriting standards.

[2] The measure of affordability is somewhat different than and should not be confused with the NAHB HOI.

[3] For a description of how 2007 house prices were estimated for each MSA see P. Emrath and H. Liu "New Home Prices by State and Metro Area" Housing Economics Online, June 2007.

For more information about this item, please contact Elliot Eisenberg at 800-368-5242 x8398 or via e-mail at eeisenberg@nahb.com.

Determining the Number of Households Priced Out of a Market

For most people, buying a home means taking out a mortgage. According to the U.S. Census Bureau's American Housing Survey, only 19% of recent home buyers purchased their homes for cash. Thus, the ability to buy a home depends, in most cases, on the ability to qualify for a mortgage. For conventional mortgages, qualifying guidelines set by the secondary market lenders play a dominating role.

The major secondary market lenders for conventional mortgages are the Federal National Mortgage Association, or "Fannie Mae", and the Federal Home Loan Mortgage Corporation, or "Freddie Mac". About half of conventional loans are sold in the same year they are originated, so acceptability of these loans to secondary market purchasers is crucial, and institutions making conventional loans tend to follow the guidelines set forth by Fannie Mae and Freddie Mac. Even where these guidelines permit some flexibility, local lenders prefer to follow them strictly -- rather than risk being unable to sell the mortgages, or facing the prospect of selling them and later being forced to buy them back. In fact, most lenders use a standard mortgage application form developed jointly by Fannie Mae and Freddie Mac.

Standards to qualify for a mortgage are typically expressed as a fraction of the household's monthly income. In the jargon of lenders, the "front end ratio" is the percentage of monthly income devoted to "PITI" -- Principal and Interest (the mortgage payment itself), as well as property Taxes and property Insurance. For any particular set of assumptions about the mortgage, the front end ratio can be calculated for a given income. Thus, comparing household income to PITI is a convenient way to analyze the household's ability to buy a home.

Assumptions used in the "priced-out" computations are a downpayment equal to 10 percent of the purchase price and a 30-year fixed rate mortgage. For a loan with this downpayment, lenders would typically require mortgage insurance, so we also assume an annual premium of 45 basis points for private mortgage insurance. Local information about property taxes comes from Census data.[1] Average homeowner insurance rate data were compiled by the National Association of Insurance Commissioners; the data for each state were provided by the Insurance Information Institute. We then say that a particular household can afford a house if it satisfies the front-end requirement set down by Fannie Mae and Freddie Mac: PITI should not exceed 28 percent of income. Given a distribution of household income for the market area in question, this can be used to determine the number of households priced out of the market.

A detailed 2004 income distribution is available for all states and Metropolitan Statistical Areas from the 2005 American Community Survey, but must be adjusted for income and population changes in the intervening years. Income limits are adjusted annually based on the U.S. Department of Housing and Urban Development's list of median family incomes for all states. The number of households in each category is multiplied by a population growth factor -- generally determined by computing the average annual growth rate implied by the change in area population between 2003 and 2005 (available from the Bureau of Economic Analysis, which is part of the U.S. Department of Commerce) and assuming that the number of households in each income group grew at this rate every year since 2005.

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[1] For greater detail, see Paul Emrath, • "Property Taxes in the 2000 Census," *Housing Economics,* December 2002; excerpts reprinted in Nation's Building News June 16, 2003, and Land Development Summer 2003.