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Fred Jacobsen

Jeff Redding

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# IMPACT TAXES: MAKING DEVELOPMENT PAY ITS WAY\*

FRED JACOBSEN†  
JEFF REDDING‡

## I. INTRODUCTION

When a local government grants a landowner permission to develop, two things ordinarily occur. First, the landowner's property increases in value because development permission allows market demand to come into play. Second, development usually creates a need for additional public works and services.

"Impact taxes" have evolved in some states primarily to cope with the public facilities and services costs caused by new development. Subdivision exactions, which normally take the form of required dedication or reservation of land for public improvements and facilities, the provision of these improvements and facilities and the payment of fees in lieu of dedication, reservation or provision, have traditionally been the means for imposing the cost of new development on the development itself. There are statutory limits, however, on the types of facilities and services that subdivision exactions can provide. Some states might not allow a local government to exact land for parks; other states might allow park exactions, but not allow exactions for fire station sites or school sites. Exactions could never be used to finance operating as distinguished from capital costs.

Communities that wanted to allocate more costs to new development than subdivision exaction law allowed circumvented these limits

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† Member, Los Angeles, California Bar. B.A., University of California, Santa Cruz; J.D., University of California, Los Angeles.

‡ B.A., University of California, Santa Cruz; M.A. in Urban Planning, University of California, Los Angeles.

in two ways. First, they ignored the limits. Developers either accepted illegal exactions or risked the obstacles a local government could create throughout the development process. Second, additional exactions being illegal but not necessarily immoral, local governments sought to invent a new tool to raise additional revenues for capital improvements and municipal services.

We call this new tool an impact tax, although it is also known as a bedroom or new construction tax. In most cases, the tax takes the form of a fixed levy imposed on a given unit—*e.g.*, \$100 per bedroom or \$.05 per square foot. Local governments frequently collect the entire tax before construction begins; often the tax will be payable when final subdivision maps are approved or when a building permit is issued.

Impact taxes are innovative because they commonly fund the types of facilities and services needed by new development that could not be funded by way of subdivision exactions. Impact taxes can fund municipal services such as fire protection and libraries, capital improvements such as the expansion of sewage treatment facilities, or operating costs of capital improvements. In California, impact taxes can even be treated as general revenue; local governments need not spend the taxes to benefit the development from which the taxes were collected.<sup>1</sup>

## II. IMPACT TAXES AS A WINDFALL RECAPTURE DEVICE

### A. Introduction

There are two types of windfalls associated with development.<sup>2</sup> First, by allowing market forces to act fully on a given parcel of land, governmental development permission can trigger an unearned increase in land value. We label this increase "Windfall I." New development also necessitates the installation of infrastructure and the provision of municipal services; if the community at large finances these development generated costs, the development enjoys a windfall that we label "Windfall II."

Unearned increases in land value (Windfall I) are generally not recaptured by impact taxes. Historically, Windfall I gains have not been recaptured by any device in the United States. Additionally,

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1. See text accompanying notes 34-38 *infra*.

2. See generally AMERICAN SOCIETY OF PLANNING OFFICIALS, WINDFALLS FOR WIPEOUTS ch. 15 (D. Hagman ed. 1977) (tentative title) [hereinafter cited as Hagman].

since impact taxes grew out of subdivision exactions, they tend to be used more to recapture public facilities and services-costs (Windfall II).

How well do impact taxes recapture Windfall II gains? The answer depends on how the impact tax is calculated. Two methods of calculating impact taxes are currently used in the United States.

### *B. Revenue-Raising Impact Taxes*

Impact taxes designed to raise general revenues may or may not recapture Windfall II gain. The answer depends on the local government's budgetary position when the impact tax rate is calculated. For example, a revenue-raising impact tax may recapture less than the whole Windfall II gain. Suppose a city collects an abundance of tax dollars from several manufacturing plants in its taxing jurisdiction. The city then decides to encourage residential development. The city is willing to provide a partial "subsidy" to residential development by using general revenues to finance the water and sewer needs of the residential development. The city also imposes an impact tax of fifty dollars per bedroom. The proceeds from the impact tax will go into the general fund and help defray the cost of acquiring parks for all the new residents. Here the impact tax raises general revenues, but it offsets only a portion of the public costs generated by the new development.

Revenue-raising impact taxes can also recapture the exact amount of the Windfall II gain. In the example above, the city's impact tax could have been calculated on the basis of the total needs of new development, including water, sewage, and parks. This approach would probably substantially increase the rate.

A third possibility is that revenue-raising impact taxes can collect more than the Windfall II gain enjoyed by a given development. Suppose the city in our example does not enjoy an abundance of tax revenue but is instead hard-pressed. If the city is an attractive site for development, it might be able to impose high impact taxes without discouraging new development. The tax for a given development could be set well above the public costs generated by that development, yet low enough to leave the developer an acceptable profit. The city thereby obtains enough revenue to meet its budgetary obligations and the developer is left with enough profit to stay in business.

The last situation, where impact taxes exceed the public costs generated by new development, gives rise to an equal protection problem.

Assuming that a developer passes the cost of the impact tax to the purchasers of his product,<sup>3</sup> is it fair that these new residents finance projects that benefit the community at large? In states where the issue has arisen, the answer has been "no"; new residents can only be required to foot the bill for the costs that they create, and community costs must be financed by a tax levied uniformly throughout the community.<sup>4</sup> California is the sole exception to this rule. In California, impact taxes can basically be set as high as the market will bear, and can finance facilities that benefit the whole community.<sup>5</sup>

### C. *Impact Taxes Keyed to Public Costs*

An impact tax directly connected with the cost of all public facilities and services that a local government provides to a new development is a pure Windfall II recapture device.

In states (other than California) that allow impact taxes, the taxes are so connected with development-generated costs. In most states, however, impact taxes are currently used to offset only a portion of these costs. Nevada, for example, only permits local governments to impose impact taxes for park acquisition.<sup>6</sup>

If an impact tax is limited to offsetting the cost of parks, or, as is commonly the case, to sewer costs, then the impact tax works as an imperfect Windfall II recapture device. In this situation, the community is subsidizing development-generated costs other than parks or sewage, and a Windfall II gain would still exist. One state, Virginia, has recognized this problem; Virginia's impact tax is based on a concept of "net public cost," a concept that is broad enough to include most development-generated costs.<sup>7</sup>

An impact tax keyed to development-generated costs will, of course, vary inversely with any applicable development permission exactions. For example, if a developer must install street lighting (or pay a fee in lieu thereof) as a condition for obtaining subdivision approval, then no impact tax will be imposed for that purpose.

### D. *Impact Taxes Versus Development Permission Exactions*

Impact taxes and development permission exactions<sup>8</sup> usually serve

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3. See *id.*, ch. 7, for a discussion of this assumption.

4. See, e.g., text accompanying notes 16-19 *infra*.

5. See text accompanying notes 40-44 *infra*.

6. See text accompanying note 30 *infra*.

7. See text accompanying notes 32-33 *infra*.

8. See generally Hagman, *supra* note 2, ch. 15.

the same purpose; both attempt to allocate the public costs of new development to the development itself. Impact taxes, however, have several characteristics that better suit them for this purpose.

First, impact taxes provide an immediate source of revenue to help ease the burden of new residents on existing community facilities and services. Second, the need to extend services to new residents begins when they arrive. There may be a time lag before the new tax base provided by new residents can be utilized. The immediate revenue source provided by impact taxes resolves this problem. Third, impact taxes may well provide more certainty to a developer. The exaction system has grown up under a practice involving a highly elastic ruler; the process is often quite informal and open to negotiation. Some developers may consider this flexibility as tantamount to extortion. An advantage of impact taxation is that fees may be more readily determined before the decision to develop. Consequently, developers are in a better position to calculate the cost of development. Fourth, impact taxes are easily administered if they take the form of a flat rate per given unit. Finally, there may even be advantages for the developer if the impact tax is assessed late in the development process—*e.g.*, when a building permit is approved. At such a late stage, the fees need not be financed and carried over a long period of time. The impact tax, as opposed to exactions, is paid at a time much closer to the cash flow that begins when the units are sold.

### III. UNSUCCESSFUL IMPACT TAXES

#### A. *Lack of Statutory Authority*

##### 1. Michigan

The City of St. Clair Shores, a suburb of Detroit, had a population of 19,000 in 1950. By 1959, its population had almost tripled to between 50,000 and 60,000 people. The city sought to charge a substantial part of the associated increased expenses of city government to these new residents in the form of increased building permit fees.

The Michigan Supreme Court held that increased expenses of city government arising from the growth of a city

are the public problems of the community and the expenses incurred in their solution are to be defrayed (absent valid legislation otherwise providing) from the general revenues of the city, not

on a fee basis under the guise of regulating such matters as plumbing and wiring in the new houses.<sup>9</sup>

Evidence established that the revenue derived from the increased building permit fee was entirely disproportionate to the cost of issuing such a permit and the direct and indirect costs of administration. Although the court lauded the purpose for which the revenues were collected, it held that a *regulation* designed to raise *revenue* was invalid; in effect, the city had impermissibly sought to raise revenues under its regulatory powers.

This result is similar to early California decisions. There was no discussion in the *St. Clair* case, however, of the legality of basing impact taxes on a city's power to tax, a ground California courts used to uphold impact taxes.

## 2. New Jersey

On February 17, 1956, the Borough of Point Pleasant increased the fees charged for the issuance of building permits to five cents per square foot for business and manufacturing construction, to ten cents per square foot for additions to existing dwellings, and to twenty-five cents per square foot with a two hundred dollar minimum charge for new dwellings.

A building contractor whose fees increased from an average of \$18 to \$262 brought suit and established that, although the building fees had increased dramatically, the cost of regulating new construction had increased very little if at all.<sup>10</sup> The Supreme Court of New Jersey held the impact tax invalid as an ordinance enacted under authority of the police power. The court indicated that the state legislature could authorize revenue-raising impact taxes. On the facts before it, however, the court did not find such an authorization.<sup>11</sup>

## 3. Arizona

In September, 1971, the City of Tempe, Arizona enacted a "Parks and Recreation Facility Tax" ordinance whereby a fee of \$50 on each new apartment unit and \$100 on each new housing unit was required. The Arizona Supreme Court held this ordinance unconstitutional.<sup>12</sup>

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9. *Merrelli v. City of St. Clair Shores*, 355 Mich. 575, 586, 96 N.W.2d 144, 149 (1959).

10. *Daniels v. Borough of Point Pleasant*, 23 N.J. 357, 129 A.2d 265 (1957).

11. *Id.* at 362, 129 A.2d at 267.

12. *Homebuilders Ass'n v. Riddel*, 109 Ariz. 404, 510 P.2d 376 (1973).

The court found that "the power of taxation is to be exercised by the State Legislature and not by municipalities, unless the power is conferred *specifically* by charter or delegated by statute."<sup>13</sup> Tempe had no charter provision permitting such a fee, and the constitutional provision on which the City relied did not confer this power.

The court next rejected the argument that the impact tax was valid as a special assessment.<sup>14</sup> Tempe's impact tax could be spent anywhere in the city, whereas a special assessment had to be "used for neighborhood park land at a location so as to specially enhance the value of the taxpayers' property as opposed to benefits diffused throughout the City."<sup>15</sup>

#### 4. Maryland

State Senate Bill SB731, introduced in Maryland in February, 1973, would have required that all charter counties charge a fee when issuing a building permit. That fee would include an amount equal to the capital costs needed to provide the additional county services. The bill was not enacted.

#### B. *Discrimination Against New Residents: Utah*

Perhaps even the legislature could not authorize impact taxes in Utah. A state statute authorizes cities to raise revenues by imposing business license taxes, but the taxes must be "uniform in respect to the class upon which they are imposed."<sup>16</sup> The Utah Supreme Court found this uniformity requirement violated by an impact tax in the form of a \$100 building permit fee.<sup>17</sup> The court believed that the impact tax placed "a disproportionate and unfair burden [of the cost of city government] on the class of new households."<sup>18</sup> Uniformity was held to be required by constitutional guarantees of equal protection as well as by Utah statute.<sup>19</sup>

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13. *Id.* at 406, 510 P.2d at 378 (emphasis added).

14. For a detailed discussion of special assessments, see Hagman, *supra* note 2, ch. 13.

15. 109 Ariz. at 407, 510 P.2d at 379.

16. UTAH CODE ANN. § 10-8-80 (1953).

17. Weber Basin Home Builders Ass'n v. Roy City, 26 Utah 2d 215, 487 P.2d 866 (1971).

18. *Id.* at 219, 487 P.2d at 869.

19. *Id.*

#### IV. IMPACT TAXES OFFSETTING DEVELOPMENT-GENERATED COSTS

##### A. *Municipal Service Expansion: Florida*

The controversy over impact taxes has been hottest in Florida. In the first reported decision, a Florida trial court struck down an impact tax funding the acquisition and development of parks and open space for the benefit of the general public.<sup>20</sup> The court found that the tax lacked statutory authority and subjected new residents to double taxation because of a property tax also assessed.

Lack of statutory authority was the ground used by a Florida appellate court to invalidate a different impact tax.<sup>21</sup> The court concluded that the fee did not have to be spent to benefit the development from which it was collected.<sup>22</sup> The absence of a direct connection between the area of collection and the area of expenditure made the fee a "tax." The tax was invalid because there was no state statute "permitting such fees for impact to create funds for heightened county costs."<sup>23</sup>

An impact tax for the privilege of connecting to a city's water and sewage systems has been upheld in Florida. In *City of Dunedin v. Contractors & Builders Association*,<sup>24</sup> the court treated a \$325 water connection fee and a \$375 sewage connection fee as a user charge, not a tax. Unlike the taxes imposed in the two other cases, user charges were authorized by state statute and city charter.<sup>25</sup>

Under the court's holding,

a municipality may properly charge for the privilege of connecting to the system a fee which is in excess of the physical cost of connection, if this fee does not exceed a proportionate part of the amount reasonably necessary to finance the [system] expansion and is earmarked for that purpose.<sup>26</sup>

Thus, Florida has limited impact taxes to offsetting the cost of municipal service expansion. Further, new development may only be

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20. *Venditti-Sivaro, Inc. v. City of Hollywood*, 39 Fla. Supp. 121 (Cir. Ct. 1973).

21. *Broward County v. Janis Dev. Corp.*, 311 So. 2d 371 (Fla. Dist. Ct. App. 1975).

22. *Id.* at 375.

23. *Id.* at 376.

24. 312 So. 2d 763 (Fla. Dist. Ct. App. 1975).

25. *Id.* at 766.

26. *Id.*

taxed for the proportionate share of service expansion cost that is "specially and uniquely attributable"<sup>27</sup> to the new development.

*B. Park and Recreation Costs: Nevada*

On April 30, 1973, the Nevada State Legislature approved legislation that provided for exactions and fees in lieu thereof.<sup>28</sup> In addition to these subdivision exactions, the city council of any city or the board of county commissioners of any county having adopted a master plan may impose a "residential construction tax."<sup>29</sup> The purpose of the tax is to raise revenue *only* for "the acquisition, improvement, and expansion of public park, playground, and recreational facilities in the city or county. Moneys in the fund shall be expended, insofar as it is practical and feasible to do so, for the benefit of the immediate area from which it was collected."<sup>30</sup>

The statute also specifies that the requirements for dedication of land and the imposition of the residential construction tax are mutually exclusive: if parks are dedicated by the developer, no impact taxes can be assessed.<sup>31</sup>

*C. "Net Public Costs": Virginia*

Loudoun County, Virginia is the site of a hybrid form of impact taxation. Located just outside the Washington, D.C. metropolitan area, Loudoun County has long been ripe for development. Levitt, one of the nation's largest homebuilders, wanted to build a \$112 million, 13,000 resident planned community there. However, in early 1971 the Loudoun County Board of Supervisors denied Levitt's rezoning application. The board's rationale was basically that the development would cost the county more in increased service demands than it would provide in new revenue. Levitt challenged the county's denial of its rezoning application. To Levitt's dismay, however, the circuit court upheld the board's denial of the rezoning application, stating that "facilities essential to the public health, safety, and general welfare are

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27. See Rhodes, *Impact Fees: The Cost-Benefit Dilemma in Florida*, 27 LAND USE L. & ZONING DIG., No. 10, 1975, at 7.

28. NEV. REV. STAT. § 278.4979 (1975). See generally Hagman, *supra* note 2, ch. 15.

29. *Id.* § 278.4983(1).

30. *Id.* § 278.4983(5).

31. *Id.* § 278.4987.

not cost-free and a governing body may consider the economic effect of providing such incidentals to a proposed rezoning . . . ."<sup>32</sup>

In June, 1972, a new zoning ordinance was passed by the county board of supervisors. Article 12 of that ordinance has been the subject of controversy since its inception. In general, article 12 provides for the method by which amendments to the county zoning ordinance may be pursued. The prospective developer may follow one or two options as a precondition to rezoning. One option for the developer is to show that his proposed development requires no enlargement or extension of any public facility that would involve a "net public cost" to the county. A "net public cost" is defined as the difference in capital costs between the capital outlay attributable to the proposed development and the public cost that would have occurred were the property developed under existing zoning. The second option open to the developer recognizes that the development will generate "net public costs" and requires that the developer compensate the county for those capital improvement costs that his development will generate or, where appropriate, construct the public facilities according to county specifications and donate the facilities to the appropriate public agency. If a development is non-residential, then the developer is usually responsible for the enlargement or extension of the county road system and various utility systems. If the development is a residential one, however, then the developer may be required to provide park sites, open space areas, and school facilities.<sup>33</sup>

Article 12 thus attempts to assess the developer for the impact that his rezoning application will have on the county service facilities. The ordinance does not expressly address the impact of developments that do not require a rezoning.

## V. THE IMPACT TAX AS GENERAL REVENUE: CALIFORNIA

### A. *Legal Development*

Like other states, California has a state statute, the Subdivision Map Act,<sup>34</sup> authorizing local governments to regulate the subdivision

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32. Quoted in Ducker, *Loudoun County's Pay-as-You Grow Plan*, 26 LAND-USE L. & ZONING DIG., No. 1, 1974, at 3.

33. *Id.* at 4.

34. CAL. GOV'T CODE §§ 66,410-66,499.37 (West Cum. Supp. 1975).

of land. Early attempts to enact modest impact taxes as a building "fee" were uniformly invalidated by California courts.

The City of Santa Ana, for example, under the "authority" of the Subdivision Map Act enacted an ordinance in 1956 imposing a "per lot" business license fee of fifty dollars. The revenue was to be used for capital improvements and fire protection. In an action challenging this fee, a court held that a revenue-raising fee could not be imposed as a condition for subdivision map approval:

[While] a charter city has broad powers in the imposition of taxes for revenue purposes and . . . a license tax may be levied for the privilege of carrying on a business, [there are limitations on these powers] . . . . [A]n ordinance attempting to impose another regulation, unrelated to design and improvement, as a prerequisite to the filing of a [final subdivision] map . . . conflicts with the whole plan of the Subdivision Map Act.<sup>35</sup>

The significance of the distinction between regulatory and revenue taxes was observed by Modesto, California, which asked the State Attorney General's opinion regarding the validity of a proposed ordinance.<sup>36</sup> The ordinance would provide authority to raise revenue for the planning, acquisition, improvement, and expansion of public parks, playgrounds, and recreation facilities. Every person constructing a dwelling unit within the city would pay a minimum of fifteen dollars for each unit of not more than one bedroom, plus five dollars for each additional bedroom, with a maximum imposition of thirty dollars. Most important, the taxes were payable when a building permit was issued. The Attorney General opined that the Modesto "per unit constructed" tax ordinance was valid insofar as the tax was *not* precedent to approval of a final subdivision map.

Santa Clara (a charter city) next adopted both a modified subdivision ordinance and a business license tax on the construction of new residential units. The business license tax was similar to that approved for Modesto by the Attorney General. The subdivision ordinance provided that as a condition precedent to issuance of any building permit and approval of a final subdivision map, the builder or developer was to pay a sum into a "Capital Outlay Recreational Fund" that was to be used throughout the city.<sup>37</sup> In light of the *Santa Ana* decision, it came

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35. *Newport Bldg. Corp. v. City of Santa Ana*, 210 Cal. App. 2d 771, 776-77, 26 Cal. Rptr. 797, 800 (Ct. App. 1962).

36. 45 CAL. OP. ATT'Y GEN. 23 (1965).

37. See *Santa Clara County Contractors & Homebuilders Ass'n v. City of Santa Clara*, 232 Cal. App. 2d 564, 571-72, 43 Cal. Rptr. 86, 90-91 (Ct. App. 1965). The amount payable was at most \$25 for each dwelling or apartment unit. *Id.*

as no surprise that the court held the ordinance unauthorized. Quoting the reasoning of an earlier case, the court stated: "The purpose and intent of the Subdivision Map Act is to provide for the regulation and control of the design and improvement of a subdivision with proper consideration of its relation to adjoining areas, *not to provide funds for the benefit of an entire city.*"<sup>38</sup> The court went on to indicate that as a subdivision condition only fees authorized by the statute could be imposed and further, that "the state has pre-empted the field in all respects concerning subdivisions, except as to design and improvement . . . ."<sup>39</sup>

Four of the first seven cities to adopt impact taxation for revenue purposes were charter cities. The power of California charter cities to levy taxes for revenue purposes is well established in California law. The other three cities—Fairfield, Rohnert Park, and Newark—were general law cities. Their power to tax for revenue purposes was less certain.

Newark's ordinance became the test case.<sup>40</sup> Since Newark did not condition approval of a final subdivision map on payment of the license "fee," the ordinance did not run afoul of the *Santa Ana*<sup>41</sup> and *Santa Clara*<sup>42</sup> decisions. Plaintiff Homebuilders Association contended that the Newark ordinance violated guarantees of equal protection by taxing residential construction at a substantially higher rate than the building of commercial and industrial structures.<sup>43</sup> The court upheld the power of cities to make reasonable classifications for taxing purposes.<sup>44</sup> Impact taxes levied by a general city law were held to be authorized by state law because the court treated the tax as a business license tax; the ordinance did not seek to regulate the issuance of building permits but sought to raise revenues for the city.<sup>45</sup>

The *Newark* decision was also significant for what it did not say. The case did not place limits on how business license taxes on new con-

38. *Id.* at 572, 43 Cal. Rptr. at 93 (quoting *Kelber v. City of Upland*, 155 Cal. App. 2d 631, 638, 318 P.2d 561, 565-66 (Ct. App. 1957)) (emphasis added).

39. *Id.* at 580, 43 Cal. Rptr. at 96.

40. *Associated Homebuilders v. City of Newark*, 18 Cal. App. 3d 107, 95 Cal. Rptr. 648 (Ct. App. 1971).

41. *Newport Bldg. Corp. v. City of Santa Ana*, 210 Cal. App. 2d 771, 36 Cal. Rptr. 797 (Ct. App. 1962).

42. *Santa Clara County Contractors & Homebuilders Ass'n v. City of Santa Clara*, 232 Cal. App. 2d 564, 43 Cal. Rptr. 86 (Ct. App. 1965).

43. 18 Cal. App. 3d at 109, 95 Cal. Rptr. at 649.

44. *Id.* at 110, 95 Cal. Rptr. at 649.

45. *Id.* at 110-11, 95 Cal. Rptr. at 649-50.

struction had to be spent. As distinguished from subdivision exactions, which must be spent primarily to benefit the subdivision from which exacted, business license taxes are general revenues.

### *B. Present Use of Impact Taxes*

When impact taxes were first enacted in California and their legality was still doubtful, local governments had an understandable tendency to write conservative ordinances. Taxes were often earmarked for use in the development from which they were collected, much like subdivision fees. Once the courts upheld the use of impact taxes for raising revenue, however, local governments could fund a much greater variety of improvements and services than was possible by means of subdivision exactions.

For example, California local governments cannot as a condition for subdivision approval require a developer to dedicate land for a school site or pay fees for school construction. Impact taxes are not so limited. The city of Oakland enacted an impact tax in October, 1972, the proceeds from which are placed in a school construction fund.<sup>46</sup>

California law also requires that exactions from a given subdivision be spent primarily to benefit that subdivision. Local governments can spend impact taxes wherever they desire. For example, the cities of Hermosa Beach<sup>47</sup> and Rancho Palos Verdes<sup>48</sup> presently use impact taxes to acquire park sites, purchase park equipment and construct recreational facilities throughout the cities.

## VI. CONCLUSION

The impact tax is a device to impose the full cost of new development on the new development itself. Such a tax seems fair because it is hard to say that existing communities have an obligation to subsidize new development, particularly if some or all of the subsidy ends up in the hands of the landowner who sells off the land for development or the developer who builds.

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46. OAKLAND MUNICIPAL CODE ch. 5, art. 26.

47. Interview by Jeff Redding with H.R. Merl, Hermosa Beach Planner, in Hermosa Beach, Cal. (March 1975).

48. Interview by Jeff Redding with J. Johnson, Rancho Palos Verdes Planner, in Rancho Palos Verdes, Cal. (March 1975).

Whether the impact tax is too high depends on where it is spent. If it is spent in the area from which it is collected, and redounds to the benefit of the land there, it can hardly ever be said to be too high in the sense of being confiscatory or prohibitory. One pays more because one receives more.