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Forrest Huffman

Marc T. Smith

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*Forrest Huffman**
*Marc Smith***

I. INTRODUCTION

During this decade there has been a significant cutback in federal housing subsidy programs.[1] In the same period, rising mortgage interest rates, land costs, and rapid population growth in states such as Florida have driven the cost of housing for low and moderate income households upwards. As a result, housing advocates and local governments have searched for new approaches to reduce the housing affordability problem. Observing the boom in downtown office construction in cities throughout the country, these officials developed office linkage or exaction programs. These programs require office developers, as a condition of approval for their projects, to either construct low and moderate income housing units or contribute to a city trust fund to be used for such purposes.[2] Cities have developed various formulas

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*Assistant Professor, Department of Legal and Real Estate Studies, School of Business and Management, Temple University. B.S., 1979, Ph.D., 1985, University of South Carolina.

**Assistant Professor, Department of Finance, Insurance, & Real Estate, College of Business Administration, University of Florida. B.A., Denison University, (1974); M.C.P., University of Pennsylvania, (1976); Ph.D., The Ohio State University (1984).

1. *See* NATIONAL ASSOCIATION OF HOMEBUILDERS, LOW AND MODERATE INCOME HOUSING: PROGRESS, PROBLEMS, AND PROSPECTS 35-47 (1986) (historical perspective on federal housing programs).

2. *See* Porter, *The Linkage Issue: Introduction and Summary of Discussion*, in DOWNTOWN LINKAGES 2-22 (Porter, ed., 1985); Keating, *Linking Downtown Development to Broader Community Goals*, 52 J. AM. PLAN. A. 133-41 (1986) for background on linkage programs.

dictating the time and amount of contribution required. In 1981, San Francisco became the first city to develop a linkage program; since then a number of other cities including Boston, Santa Monica, and Miami have adopted similar programs. A number of other cities have considered or are currently considering using housing exactions.[3]

This commentary takes a brief look at some of the major issues confronting the use of linkage fees. The first section addresses the legal issue of whether there is a "rational nexus" between commercial development and a reduction in the supply of affordable housing. The next section discusses two related topics: (1) what market factors made linkage programs in some areas of the country successful; and (2) whether linkage programs are viable in depressed office markets. This section also outlines the market effects of linkage fees. Developers may respond to linkage fees in a number of ways that adversely affect the amount of commercial development and, consequently, the success of the linkage fee program. Finally, the alternatives to linkage fee exactions are considered.

II. THE RATIONAL NEXUS TEST

Fundamental to the adoption of linkage programs has been the legal justification for such an approach. Current debate centers on issues such as what constitutes a "rational nexus" and whether it exists in a particular jurisdiction,[4] whether linkage constitutes a taking for which compensation might be demanded,[5] and the authority of local governments to impose such programs.[6] The nexus question is particularly important because linkage programs are impermissible without some connection between the regulation and the lack of affordable housing. Thus, the nexus requirement addresses whether a link actually exists between office development and housing affordability. One argument supporting a nexus is that office development has both direct and indirect effects on housing affordability. Direct effects arise from the demolition of housing units to clear space for office development. Indirect effects are the result of the increase in demand arising from the new workers brought to the city by the office building and the increase in land values resulting from the more intense office type usage.

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3. *See* Porter, *supra* note 2, at 10-11 for a listing of cities adopting or considering adopting impact fees. *See also* Waldman, *Cities are Pressured to Make Developers Share Their Wealth*, Wall St. J., March 10, 1987, at 1.

4. *See* Quinn, *Inclusionary Zoning and Linkage: Land Use Planning Techniques in an Age of Scarce Public Resources* 1 U. FLA. J.L. & PUB. POL'Y 21 (1987).

5. *Id.* at 33-37.

6. *Id.* at 30-33.

Governmental requirements that new housing units replace those demolished in clearing a development site have ample precedent in such programs as urban renewal and highway construction. Exactions imposed on developers to mitigate off-site impacts to infrastructure such as roads and sewer and water systems are also common in many states.[7] However, relating office development to off-site housing needs and establishing a nexus is more controversial. For instance, San Francisco has made a careful attempt to trace the relationship between office space and off-site housing needs.[8] The City's line of reasoning suggests that the net addition of office space leads to a net addition of employees, a portion of whom will reside in San Francisco. A subset of these employees will be new households that demand housing units. Some of these new households will be unable to afford a housing unit in the city without subsidy assistance. The provision of housing has traditionally been left to the private market. Certain groups that are unable to find adequate housing, however, have relied on governmental subsidy programs to fill the gap. In a similar manner, linkage programs are designed to assist these households find affordable housing units.

Linking development of new non-residential space to residential units implies a responsibility on the part of employers to house their employees. Linkage also ignores the benefits office space already generates by increasing income and expanding the tax base of the city. Casual observation in many cities indicates that a substantial underutilized or vacant housing stock exists in close proximity to downtown. The presence of this housing stock implies that a housing shortage does not exist and that the units are not high valued. Thus, outside of intensely developed cities such as San Francisco and Boston, the nexus argument is problematic.

III. ECONOMIC EFFECTS OF LINKAGE

Lost in the debate over the legal issues are the economic implications of linkage programs. Even if a rational nexus can be established and the other legal questions addressed, under what conditions would a city want to establish a linkage program? If linkage fees have been successfully implemented in San Francisco, does this imply that such a program can be implemented in any city or are certain market conditions necessary for the successful implementation of linkage pro-

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7. *See* Delaney, *Impact Fees, Housing Costs, & Housing Affordability*, 1 U. FLA. J.L. & PUB. POL'Y 87 (1987).

8. *See* RECHT HAUSRATH & ASSOCIATES, SUMMARY OF THE ECONOMIC BASIS FOR AN OFFICE-HOUSING PRODUCTION PROGRAM (July 1984) (discussing the methodology).

grams? In other words, what are the office market effects of linkage fees likely to be in different cities? This paper will address the potential effects on the office market that economic theory suggests would result from the imposition of linkage fees. Some of this analysis parallels that done in housing markets. But it recognizes that office markets differ in some respects such as the scale of operations, length of construction periods, and the predominately rental tenancy.

A. *Are Linkage Fees Attractive Today?*

The economic history of commercial and residential development indicates the impetus behind the development of linkage fees. First, the advent of linkage programs seems to roughly parallel the passage of the Economic Recovery Tax Act of 1981.[9] This tax law more than halved the previous depreciation period for non-residential property such that these properties could now be depreciated over fifteen years.[10] Also during this period, lending institutions had substantial resources they eagerly lent for commercial development projects. This combination of tax advantages and available financing led to the construction of office buildings that may not have been justifiable by purely economic/market criteria. The result is an oversupply of office space in may cities, with an excess capacity that may take five to ten years to absorb in some cities.[11] However, during the early 1980's the federal government made substantial cutbacks in its funding of housing subsidies. Housing advocates and local governmental officials observed the growing construction of new office buildings and felt that such buildings were contributing to neighborhood housing problems. Thus linkage programs were developed to tap the office developers to support low and moderate income housing.

In 1986, federal tax legislation again substantially changed the real estate investment market. The Tax Reform Act instituted a number of major provisions that reduced the financial incentives for constructing new office space.[12] For example, the Act lengthened the depreciation period for office buildings to 31.5 years, allowed only straight

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9. The Economic Recovery Tax Act of 1981 furthered the incentive towards capital formation by generally allowing shorter depreciation recovery periods under a new accelerated cost recovery system. *See generally* HANDBOOK ON THE ECONOMIC RECOVERY TAX ACT OF 1981 (1981) (concise explanations of the Act's provisions).

10. I.R.C. § 168(b) (1985). In addition to straight line depreciation, 175% declining balance was available to investors. *Id.*

11. Dowell, *Planners and Office Overbuilding*, 52 J. AM. PLAN A. 131-32 (1986).

12. *See generally* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (1987) (legislative background and general explanation of the Act).

line depreciation,[13] eliminated lower capital gains tax rates,[14] and placed limitations on the ability to use negative taxable income from real estate investments.[15] Coupled with lower tax brackets and an oversupply of office space which had resulted in the previous five year period, these tax law changes will probably result in little new downtown office space.[16] Thus, under current market conditions, linkage fees appear unlikely to generate many new housing units for low and middle income groups. Even under better market conditions, however, linkage programs have a number of potential pitfalls that limit their effectiveness in solving housing affordability problems. The following section discusses the market effects of linkage fees that determine their practicality under various types of market conditions.

B. *Market Effects of Linkage Fees*

This section demonstrates that the viability of such programs will depend upon the characteristics of the office markets in which the fees are levied. Linkage fees are borne by any of three parties: (1) the developers in the form of reduced profits; (2) the tenants through higher rental rates; and (3) landowners who receive lower prices for land suitable for office development. Office market conditions will dictate the incidence of the fees. However, the net result of imposing impact fees may be a reduction in office construction as no party is willing or able to absorb the fee. The following sections discuss the potential effects of linkage fees on office markets.[17] Alternatives are then discussed for markets in which linkage fees are likely to have adverse effects.

C. *The Developer's Perspective*

The effects of linkage fees on developers' behavior are critical in assessing the fees' usefulness. Developers of new office space are motivated by the expected profit generated by the development. These profits are derived from two sources: (1) the annual after-tax cash

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13. I.R.C. § 167(c) (1987).

14. *See id.* at §§ 1201-88 (1987) (capital gains and losses).

15. *Id.* at § 172(b) (1987) (net operating loss carrybacks and carryovers).

16. Salomon Brothers, Inc., reports that after peaking at a $29 billion annual rate in early 1986, office construction has fallen to $21 billion a year and is expected to fall to $15 billion per year. Celis, *Real Estate*, Wall St. J., July 15, 1987, at 31. This construction is both city and suburban office space. One report states that more than one-half of new office space is being built in suburban locations. Fulton, *Office in the Dell*, PLANNING 13-17 (July 1986).

17. A more detailed discussion is Huffman & Smith, *Market Effects of Office Linkage Fees*, 54 J. AM. PLAN. A. ____ (forthcoming 1988).

flows from rentals, and (2) the after-tax proceeds received upon sale of the building.[18] A developer's rate of return is a function of these cash flows and the equity he has invested.[19] The rate of return required by the developer is primarily a function of the riskiness of the real estate investment as perceived by the developer relative to other possible investment opportunities.[20]

Assuming the developer bears the entire burden of a linkage fee,[21] the fee reduces the cash flows to the developer and consequently lowers the rate of return received. Developers will not accept this decrease unless the loss is very minor or the developer still receives returns high enough to continue to entice development. The magnitude of the decrease in the rate of return will be a function of the amount and nature of the exaction, the size of the investment, the equity contributed, and the length of the investment holding period.

Substantial variation in these parameters over time and across markets and developers make specific or "normal" rates of returns difficult to determine with precision. However, assuming that markets are competitive so that most developers just earn their required rates of return, any decrease in that return would drive development from the market. Developers are more likely to suspend development in an area if other development opportunities are available elsewhere. Because real estate market inefficiencies prohibit cities from fine tuning the impacts of linkage on development, the net result is to discourage development in the area.[22]

An additional effect of linkage fees is they increase the riskiness of the project to the developer. The developer incurs additional risk because in most linkage schemes he must pay the fees up front or in the early years of the project. Relatively slow lease up periods and

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18. *See generally* H. SMITH & J. CORGEL, REAL ESTATE: PERSPECTIVES ch. 17 (1987) (valuation theory and financial analysis).

19. *Id.*

20. *Id.* at 601-616.

21. In other words, the developer does not pass the linkage fee on to another party, such as tenants or land owners. *See* Delaney, *Impact Fees, Housing Costs, & Housing Affordability*, 1 U. FLA. J.L. & PUB. POL'Y 87, 92-99 (1987) (general overview of effects of impact fee). Delaney provides a survey of studies that indicate the burden of impact fees depends upon which parties, the developer, home buyer, or landowner, have the least sensitivity to price changes. *Id.*

22. This result assumes the developer bears the burden of the linkage fee. Even when the developer only bears a portion of the linkage fee, and the rest is passed on to tenants, the quantity of office space demanded decreases as rental prices increase. *See* Delaney, *Impact Fees, Housing Costs, & Housing Affordability*, 1 U. FLA. J.L. & PUB. POL'Y 87, 93-94 (1987). Also, the fee may further discourage development by communicating to developers the local government's negative attitude.

the making of rental lease concessions to attract tenants may combine with the fees to result in negative cash flows and increased probability of default. These factors increase risks and require a corresponding increase in rates of return to compensate developers for accepting such risks.

If the developer cannot pay the fee himself yet still has a viable project, then linkage fee must be passed either to the office space user/tenant or recouped in the form of lower land prices paid to landowners. In the latter case, the developer must be able to anticipate and account for the imposition of the fee by lowering the price he is willing to pay for the land. Because of the long lead time necessary for office development, many potential office sites are already owned by the developer so the linkage fees cannot be passed to the landowner. Further, landowners will accept a lower price only if current or alternative uses of their land are expected to be below the land's value as office space. In these situations, they may hold out for their expected market price rather than sell for a lower price.[23] Assuming some market competitiveness, some sites would not be available for office use at a lower price. If neither landowners nor developers bear these costs, then tenants will bear the financial burden. However, the next section demonstrates that in many markets tenants may not have to accept rent increases because of their flexibility in choosing space and the availability of space elsewhere.

D. *Market Requirements*

The supply of office space developers provide is directly related to the characteristics of the demand for this space. First, strong preference by potential tenants for downtown locations are necessary to pass linkage fees to office space users. However, it has been established that recent transportation and telecommunication advances have led service industries, and office space in particular, to become increasingly footloose.[24] This mobility increases potential tenant's locational alternatives.[25] Consequently, potential tenants are more sensitive to rental rate increases. This sensitivity is heightened by the current

23. *See* A. MALLACH, INCLUSIONARY HOUSING PROGRAMS: POLICIES AND PRACTICES 90-91 (1984).

24. The footloose nature of many office tenants is discussed in Archer, *The Determinants of Location for General Office Firms Within Medium Sized Cities*, 9 J. AM. R. ESTATE & URB. ECON. A. 283-97 (1981); E. Mills, Service Sector Suburbanization (1987) (unpublished manuscript).

25. In particular, potential renters may be more willing to locate in suburban office buildings rather than in downtown areas. E. Mills, *supra* note 24.

oversupply of office space in many urban markets.[26] Thus, in addition to being footloose, many tenants have additional choices available in the urban areas. This combination makes it unlikely that the developers could force these tenants into accepting rental increases. Only the combined interaction of price insensitivity resulting from tenant immobility, strong attraction to downtown locations, and relatively tight markets (an undersupply of office space relative to demand) can make exaction fees workable.[27] These characteristics probably exist in San Francisco and a few other cities, but are not widespread.

E. *Potential Market Effects*

If developers cannot pass through linkage fees, rates of return will decrease and drive developers from the market. If the attempt to pass through fees resulted in the loss of some office type employees, total demand for office space would be less. Assuming an increase in demand for office space, the reduction in new supply leads to higher rents. Higher prices would offset the higher costs of development so that eventually the supply of office space might increase in response to the increase in prices and profits. But these higher rents are the result of changing market forces over time, and only indirectly attributable to linkage fees. Further, the resultant total supply would probably remain lower than in the absence of linkage fees.

IV. LINKAGE FEE ALTERNATIVES

Linkage fees have a potentially adverse impact on real estate markets. Either developers, office space users, or landowners will ultimately bear the burden of these fees. Thus, the supply and/or demand for office space declines making linkage fees less attractive and revenue generation less predictable. Assuming linkage fees create potential market problems, but assuming the rational nexus between office space and housing exists, then what alternatives exist?

One alternative is to revise linkage fees to lessen their possible market effects. Voluntary fees, rather than mandatory fees, might be instituted as was done in Miami. These types of programs provide incentives for participating developers such as density bonuses. The program allows the developer to choose whether to build additional affordable housing or to participate in linkage in return for density bonuses or other incentives. However, these types of incentives call

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26. COLDWELL BANKER, OFFICE VACANCY INDEX OF THE UNITED STATES (1986).

27. Even in the situation the developer bears the fee and the associated risk until the space is leased if the fee is levied up front.

into question the integrity of local zoning ordinances. For example, if density can be increased under a linkage program why does the current zoning code only permit a lower density?

A second alternative is to not require the developer to pay linkage fees until leasing reaches some threshold level. This method reduces the severity of having high initial fee payments.[28] While the city would have to wait longer to receive the linkage funds or housing units, risk would be reduced for the developer. The reduced risk would lead to greater investment in office space development and greater contributions to affordable housing projects.

In situations where the fee can be passed through to tenants, it is likely that owners of existing office space will also raise rents to a level comparable with rents in new buildings. In this manner, owners of existing office space accrue windfall profits. These existing buildings also attract employees and contribute to the problem linkage fees seek to alleviate; however, because they were built prior to linkage fee programs, they avoid having to pay a fee. A transfer tax or other similar method[29] that spreads the incidence of linkage fees to *all* buildings would lessen the likelihood of these types of adverse market effects.

Even a tax on all downtown buildings does not completely address the housing problem. Because of the increased mobility of potential renters, the housing problem has become a regional, rather than a purely local, problem. Thus, a regional transfer tax or other revenue-raising method, levied by a county or multi-county taxing authority,[30] is a broad-based approach to meeting this problem. The more broad-based the approach, the more difficult it becomes for developers, office space users, and landowners to escape the tax. Thus, the regional tax lessens the likelihood of the adverse market effects increased mobility causes.

Finally, local policy-makers need to consider the benefits of downtown office development before instituting linkage policies. These buildings provide a wide range of jobs from construction to clerical to

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28. Currently, payment of linkage fees over a development's first five years is also common.

29. A transfer tax is levied against the sales price of a building when the building is sold. For example, Dade County, Florida, has doubled its surtax on transfers of all real property except single family homes, condominiums, and cooperatives. *See* Appel, *Facing the Urban Housing Crisis*, REAL EST. FIN. J., Winter, 1987, at 40. Other income sources might include a tax on the recording of mortgages, a local capital gains tax on real estate sales, interest on real estate escrow accounts, or taxes on commercial leases.

30. The authority would be charged with providing low and moderate income housing within the entire county or multi-county jurisdiction.

professional. Each of these job categories are needed in many cities. In addition, individuals in these jobs each pay taxes to the city. So, while improving low and moderate housing opportunities is a laudable goal, linkage fees may not be the best way to address the problem in many cities.

V. CONCLUSION

Linkage fees appear to be an attractive means to generate funds for low and moderate income housing. They also appear to be legally viable provided they meet the rational nexus test. In many cities, however, local market conditions are not conducive to such fees. Rather than increasing funds or construction for low-income housing, linkage fees may simply reduce local office construction. Local policy-makers should consider the potential adverse effects in a given market and investigate alternatives to linkage fees.