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A Ph.D. Land Economist Looks at Capital Recovery Fees

The following article is by Dr. Tom McPeak, Ph.D., regarding the economics of capital recovery fees.

AUSTIN, TEXAS, UNITED STATES, December 31, 2018 /EINPresswire.com/ -- As a Land Economist, I have always been fascinated by the allocation of land resources. One emerging area in this field is the use of capital recovery fees to allocate development costs and fund infrastructure.

I believe capital recovery fees balance needs of the buyer, the developer, and the community in a Pareto-efficient way by more efficiently restructuring the economics of the real estate transaction."

Dr. Tom McPeak, Ph.D.

A capital recovery fee is created when a real estate developer files a legal instrument in the deed records, which imposes an obligation on future sellers to pay a percentage of the sales price (e.g. one percent of the sales price), for a given period of time, [usually] ninety-nine years, which equates to an estimated 10 sales).

From the perspective of the real estate developer a capital recovery fee represents an alternative to putting 100% of development costs onto the shoulders of first-time buyers, which allows the developer to gain a competitive advantage from a reduced sales price. In addition, by selling the future income stream to investors looking for long-term income that correlates well with inflation, developers can generate liquidity for their development project, much like the issuance of public improvement district bonds, tax increment financing bonds, and similar financial instruments.

Since a capital recovery fee instrument is filed in the deed records it will appear on the title commitment delivered to a buyer prior to being legally obligated to close. As such, capital recovery fees will only be paid by parties who willingly assume the obligation, and who presumably negotiate their price and terms accordingly.

From the buyer's perspective, the willingness to pay a capital recovery fee in the future in return for a lower initial price will result in lower acquisition costs and carrying costs, and possible reallocation of the savings (i.e. does the buyer pay down high interest credit card debt with the savings). In addition, a buyer may consider intangible issues such as the portion of the transfer fee that goes to non-profits, and whether the buyer can qualify for the lower priced home (with a capital recovery fee) but would be unable to qualify for the higher priced home (without a capital recovery fee). All of these variables go into the decision-making process, and both buyer and seller make an economic decision based upon their respective perceptions of the market value of the trade. If these perceptions match, a bargain is struck and the transaction is Pareto-efficient.

The assumption is that since each seller paid less, they can and will lower the sales price. This assumption is well-founded because economic theory suggests that buyers armed with the facts will not pay the same for a home with a capital recovery fee as they will pay for the same home without a capital recovery fee. It would be illogical to argue otherwise.

The community benefits because a portion of the income from capital recovery fees is virtually always allocated to a non-profit operating within the community. This provides long-term

sustainable revenue for clean air, clean water, youth programs and other benefits to the community while reducing reliance on government funding. This builds stronger property values, which in turn protects and enhances the fee stream.

From a public policy perspective, since the future fee stream depends on long-term sustainable value, it is in the developer's economic interest to take a long-term view of the project. In lieu of accepting a lump sum up front and then having no further economic interest in the project developers imposing a capital recovery fee have a vested interest in ensuring that property values remains as high as possible for as long as possible. This mutuality of interest benefits home buyers, taxing authorities, and the community in general.

When the parties to a transaction come away satisfied with the bargain they have made, it is referred to as a Pareto-efficient transaction. An economic system that is Pareto-efficient is an important metric for evaluating economic efficiencies and public policies. For the reasons discussed above, I believe that capital recovery fees balance the needs of the buyer, the developer, and the community in a Pareto-efficient way by more efficiently restructuring the economics of the real estate transaction.

About Dr. Tom McPeak, Ph.D.: In 2000 I began teaching at one of the nation's top business schools, the Terry College of Business at the University of Georgia. I received my Ph.D. in Resource Development (Land Economics) from Michigan State University.

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