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Homeowners, renters and the political economy of property taxation

Eric J. Brunner [a,*], Stephen L. Ross [c], Becky K. Simonsen [b]

[a] Department of Public Policy, University of Connecticut, 1800 Asylum Ave., 4th Floor, West Hartford, CT 06117, United States
[b] Urban Institute, 2100 M Street, NW, Washington, DC 20037, United States
[c] Department of Economics, University of Connecticut, 341 Mansfield Road, Unit 1063, Storrs, CT 06269-1063, United States

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ABSTRACT

Studies find that renters are more supportive of public spending that is financed by the property tax than homeowners, a finding commonly referred to as the "renter effect." The renter effect suggests that, all else equal, renters should prefer property taxation over other forms of taxation. We test that hypothesis using detailed micro-level survey data that contains voter responses to two key questions: their willingness to pay higher property taxes to fund public services and their willingness to pay higher sales taxes to fund those services. Using a difference-in-differences estimation strategy, we find first that renters are approximately 10 to 18 percentage points more likely than homeowners to favor a property tax increase over a sales tax increase, a finding consistent with the presence of a renter effect. However, these results are not driven by the survey responses of renters. Analysis based on separate regressions for renters and homeowners reveals that renters are indifferent between a property tax increase and either a sales tax or state income tax increase, while homeowners strongly oppose a property tax increase relative to either a sales tax or state income tax increase. Further, the strong opposition among homeowners to the property tax is not eroded by including controls for income and other demographics as might be expected if these differences were driven by economic incentives. Finally, an examination of the variation in tax burden created by Proposition 13 in California shows no evidence that homeowner aversion to the property tax increases with the homeowner's relative tax burden. These findings of homeowner aversion to property taxes are consistent with recent work suggesting that salience matters when voters evaluate taxes, but also suggest that increased salience does not necessarily lead to more careful consideration of individual tax burdens.
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1. Introduction

Studies that analyze the demand for local public services consistently find that renters tend to be more supportive of public spending than homeowners. Indeed, the finding is so pervasive that Wallace Oates dubbed it the "renter effect" (Oates, 2005). Perhaps the most common explanation for the renter effect is fiscal illusion. Local public goods are typically financed through the property tax and while the property tax is one of the most salient taxes paid by homeowners it is largely invisible to renters who never receive a property tax bill. Consequently, renters may believe they don't pay property taxes. As noted by Oates (2005) if this is true, the renter effect has important policy implications since it implies that public budgets could be inefficiently large in communities with high concentrations of renters, a point consistent with arguments made by Buchanan (1967) among others that fiscal illusion resulting from non-salient taxation may result in an excessively large public sector.

Studies of the renter effect fall into two main groups. The first and largest group estimates demand functions for local public services by regressing per capita local expenditures on community income, the tax price associated with the property tax, and a set of controls that includes either the fraction of renters or the fraction of homeowners.[1] The second group of studies uses vote outcomes from local property tax or bond referenda to estimate demand functions for public goods using control variables similar to those used in the expenditure studies.[2] These studies tend to find that public spending and the

* Corresponding author.
E-mail addresses: eric.brunner@uconn.edu (E.J. Brunner), Stephen.L.Ross@uconn.edu (S.L. Ross), becky.simonsen8@gmail.com (B.K. Simonsen).

[1] Early studies include Bergstrom and Goodman (1973) and Lovell (1978). More recent studies include Rothstein (1994), Dollery and Worthington (1999) and Corcoran and Evans (2010). See Oates (2005) and Dollery and Worthington (1996) for a review of this literature.

[2] Examples include Martinez-Vazquez (1983), Biegeleisen and Sjoquist (1988), Rothstein (1994) and Brunner and Balsdon (2004). See Oates (2005) and Dollery and Worthington (1996) for a review of this literature.

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fraction of yes votes cast in referenda are positively (negatively) related to the share of renters (homeowners).[3]

Both types of studies rely on aggregate data and so compare average voting or spending outcomes to aggregate ownership shares. As a result, these studies tend to suffer from two significant limitations. First, the comparison of renters to owners creates the potential for bias because households sort into home ownership based both on their own unobservable characteristics and location attributes that may affect the demand for public services. For example, households that choose to rent may have stronger unobserved preferences for public services than homeowners, suggesting that they would prefer higher levels of government spending regardless of whether that spending was financed with property, income or sales taxes. To our knowledge, Banzhaf and Oates (2013) is the only existing study prior to ours that addresses this problem. They exploit the fact that open space referenda differ across the U.S. in terms of whether they are funded by property or sales taxes. They find that jurisdictions with a high share of homeowners are *more* likely to support referenda designed to protect open space, a finding they attribute to the fact that homeowners benefit from the resulting capital gains, but find no evidence that the use of the property tax affects this difference in support relative to the sales tax.

The second major limitation of all renter effect studies is that they provide no evidence on whether the observed renter effect arises because renters prefer property taxation over other forms of taxation or because homeowners dislike property taxation more than other forms of taxation. As noted above, the most commonly cited explanation for the renter effect is renter illusion, but this suggested mechanism is always made in the context of studies that simply show aggregate differences between renters and owners. Therefore, none of these studies have actually attributed the renter effect to the revealed preferences of renters. As noted by Cabral and Hoxby (2012), homeowners appear to hate the property tax more than other taxes as evidenced by survey responses, property tax limits and a general decline in the use of the property tax over time. This raises the possibility that the renter effect identified in previous studies arises not because renters strongly prefer the property tax to other taxes but instead because of homeowners disdain for the property tax.

In this paper we address these limitations by turning to a rich body of micro-level survey data provided by the Public Policy Institute of California (PPIC) and the Field Poll. Each survey asked a representative sample of California voters' two key questions: 1) their willingness to pay higher property taxes to expand funding for public services and 2) their willingness to pay higher sales taxes to expand funding for public services. Because we observe responses to these two questions for each voter we are able to estimate models that condition out individual fixed effects in order to isolate the effects of the funding mechanism: property taxes versus sales taxes. Specifically, we estimate a model where the dependent variable is the difference between a voter's support for a property tax increase and their support for a sales tax increase and the key independent variable is an indicator variable that takes the value of unity if the voter is a renter. This difference-in-differences specification allows us to control for any unobservable individual characteristics, such as tastes and preferences for public services, which might otherwise bias our estimates.

Based on our combined sample of homeowners and renters, we find robust evidence consistent with the presence of a renter effect. Our difference-in-differences estimates suggest that renters are approximately 10 to 18 percentage points more likely than homeowners to favor a property tax increase over a sales tax increase to fund public services. This effect is robust to the inclusion of county fixed effects to control for regional differences in the relative preference for property and sales taxes. The effect is also relatively homogeneous across both college educated and non-college educated renters, high and low income renters, and younger and older renters, suggesting that the renter effect we identify is unrelated to typical proxies for financial sophistication.

Having provided new evidence that the renter effect is not driven by differences in preferences for public service provision, we turn to the second major limitation of the empirical work on the renter effect: the inability to examine the preferences of owners and renters separately. Our estimates based solely on the sample of renters suggest that renters are indifferent between a property tax increase and a sales tax increase to fund public services: a finding that is inconsistent with the common conclusion that renters prefer the property tax because they do not realize that they pay the property tax. On the other hand, homeowners are significantly more likely to support a sales tax increase to fund public services than a property tax increase.

There are several plausible explanations for these findings. First, homeowners may have higher tax shares since they tend to consume more housing than renters with similar incomes (Martinez-Vazquez, 1983) and tend to have higher incomes on average causing a preference for relatively regressive taxes like the sales tax.[4] Second, the lumpiness of property tax payments may impose additional costs on homeowners if individuals find short run consumption smoothing to be difficult or costly. Third, the sales tax may be just as insalient to renters as the property tax, while homeowners may find the property tax to be much more salient than the sales tax (Cabral and Hoxby, 2012). Fourth, homeowners may anticipate that property values will be reduced by an increase in the property tax (Martinez-Vazquez and Sjoquist, 1988; Banzhaf and Oates, 2013). Finally, homeowners may feel more burdened by the property tax because of the high degree of salience that arises from the lumpiness of tax payments.[5]

While we cannot decisively rule out any of these explanations, we carefully consider the relevant evidence concerning each explanation and conduct a series of follow-up analyses. First, our estimates are very robust to including socio-economic controls that capture the effect of economic differences between homeowners and renters that are likely associated with the relative economic burden created by the property tax. The magnitudes of our preferred estimates are relatively unchanged by the inclusion of income and other respondent attributes that correlate with owner-occupancy. Next, it is well established that higher income households tend to have more liquid assets and access to credit, and so are better able to income smooth over time. If our results were driven by either differential economic burden or the effect of the lumpiness of tax payments on current consumption, the inclusion of these controls should have reduced the renter effect in our primary estimates. Our estimates, however, are quite robust to the inclusion of these controls.

Next, we examine whether respondents expect to pay at least part of the sales tax, i.e., the sales tax's salience, by comparing their responses to a question regarding willingness to support a sales tax increase to fund public services to a question regarding willingness to support a state income tax increase to fund those same services. Unlike the federal income tax, the state income tax in California has no standard deduction and the marginal tax rate exceeds the sales tax rate for incomes as low as $40,000. Consequently, the state income tax is a highly visible and salient tax that is paid by most households in California, including renters. We find that both renters and homeowners are indifferent

[3] While the majority of studies that analyze the demand for local public services find evidence of a renter effect, there are a number of notable exceptions. Based on survey data, Schokkaert (1987) finds no evidence that renters are more willing to pay higher taxes than homeowners to support an expansion of local public services. Similarly, Schwab and Zampelli (1987), Reid (1991), Heyndels and Smolders (1994), Gemmell et al. (2002), Blom-Hansen (2005) and Banzhaf and Oates (2013) find no evidence of a renter effect.

[4] There is also some debate on whether property tax increases are fully shifted forward onto renters further raising the fiscal burden of homeowners (Carroll and Yinger, 1994; Tsoodle and Turner, 2008).

[5] In many states, the uncertainty in property tax burden created by errors in the assessment process (Anderson, 2012; McMillen, 2013) could be an additional mechanism for homeowners' dislike of the property tax, but in California homeowners face no such assessment uncertainty because assessments are based on the original sales price.

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