

WEBSITE READING

#2

WILLIAM FISCHER, THE HOMEVOTER HYPOTHESIS 4-12 (2001)

1.2 Homeowners' Big Asset Grabs Their Attention

The reason that local governments perform better is that the benefits and costs of local decision making are reflected in the value of property in the jurisdiction. The homevoter hypothesis holds that homeowners, who are the most numerous and politically influential group within most localities, are guided by their concern for the value of their homes to make political decisions that are more efficient than those that would be made at a higher level of government. Homeowners are acutely aware that local amenities, public services, and taxes affect ("are capitalized in") the value of the largest single asset they own. As a result, they pay much closer attention to such policies at the local level than they would at the state or national level. They balance the benefits of local policies against the costs when the policies affect the value of their home, and they will tend to choose those policies that preserve or increase the value of their homes.

The importance of a home for the typical owner can hardly be overstated. Two-thirds of all homes are owner occupied. For the great majority of these homeowners, the equity in their home is the most important savings they have. Data from 1990 surveys show that "median housing equity is more than 11 times as large as median liquid assets among all homeowners; even for homeowners over 65, that ratio was still more than 3 to 1" (Engelhardt and Mayer 1998, p. 136).

It was reported that the 1990s bull market for corporate stocks has made the aggregate value of these stocks exceed the aggregate value of homes in the United States. But the 1990s increase in stock-market wealth was not widely shared. Examining the *Survey of Consumer Finances*, Joseph Tracy, Henry Schneider, and Sewin Chan (1999, p. 3) found "that the typical household in 1995 had 66 percent of its total assets in real estate and *no* portion of its assets in corporate equity." I point this out to emphasize why most residents have always been acutely concerned about public events that affect their homes' value. They do not really own much else.

I am arguing both positive and normative positions in this book. I think that, subject to some important qualifications, local governments perform localized services more efficiently than the state or national government would. But readers do not have to accept my normative contentions to find something useful here. The approach that yields the best understanding of local government behavior, and hence the best predictions about what happens when institutional arrangements are changed, is to see that behavior through the eyes of a homeowner.

1.3 Homevoters Think Holistically about Local Government

It is important to think of my thesis—that concern for home values is the central motivator of local government behavior—as being tied up in a package in which financing, regulation, and expenditure are all done by the locality. Local officials and voters are assumed to be capable of seeing the whole picture. The story makes little sense if each component—taxes, spending, and regulation—is examined by itself. Considered in isolation, the payment of \$3,000 in property taxes to the locality to fund schools is just as painful to the taxpayer as the payment of \$3,000 in income taxes to the state government to fund schools. (Actually, the property tax is probably more painful, since most income tax is withheld from paychecks.)

The same is true for expenditure: Parents of schoolchildren care as much about the quality of education when it is funded by the state as by the locality. And a regulatory change to accommodate a new dump excites as much neighborhood interest when it is proposed by an agency of the U.S. government as by the local waste authority. My hypothesis does not deny that a dollar is a dollar, a schoolbook is a schoolbook, or that a dump is a dump is not a rose.

But at the local level, none of these events can usefully be considered in isolation by those who make the decisions. An increase in local property taxes to add teachers for schools may make the community more attractive to homebuyers. This will, if the program is cost effective, add to the value of all homes in the community, not just of homes currently containing school-age children. The prospect of a capital gain (or the anxiety about a loss if the schools are left to deteriorate) makes the policy more palatable to the majority of voters, even those who do not have children in school. The added value to homes from an efficient program in turn increases the property-tax base.

My claim is not simply that everything goes round and round, however. There is a prime mover at the local level. In the foregoing scenario, both the costs and the benefits of the action—a tax increase, an extra teacher—are reflected in home values in the community when done at the local level, but not if they are part of a uniform state or national policy. Because of this particularized effect on all homes in their community, homevoters will, at the local level, want to adopt the mix of policies that maximizes the value of their primary assets.

Attention to home values will also guide regulatory policies. A town that is asked to rezone property for a low-level nuclear-waste dump in exchange for \$2 million a year in cash and benefits has to consider not just the value of the cash (which could be used to cut property taxes or to augment local services), but also the effect that harboring the dump will have on the community's reputation and health and hence the value of the voters' homes. This probably accounts for why the actual

proffer of such a deal in New Jersey found no takers among that state's 567 municipalities (*New York Times*, December 9, 1995). The existence of the dump and its risk of spillover effects would be reflected in home values, and it apparently takes more than \$2 million a year to offset that. The state commission formed to persuade localities to accept the fifty-acre facility was disbanded in 1998 after failing to persuade any municipality even to consider the details of the deal (*Bergen County Record*, February 15, 1998).

An example of the error that my approach avoids is much of the economics profession's analysis of "impact fees." These fees are levied on new development by local governments, and economists have typically analyzed them as if they were taxes. The taxes, it is said, add to the cost of the house in the same way that sales taxes add to the cost of consumer goods. Yet this analogy overlooks that impact fees are levied by a municipality that can withhold something that developers value if the fees are not forthcoming. If a court strikes down a sales tax, the state legislature that adopted it is unlikely to do anything that will affect the buyers or sellers of commodities. But if a court strikes down an impact fee, the municipal legislature is likely to respond by making it more difficult for developers to get their projects done. Impact fees cannot be thought of in the traditional tax framework because they are not taxes in the traditional sense. They are payments for permissions that can be withheld.

1.4 Terminology: Capitalization and Property-Tax Base

When I say that proximity to a dump is "reflected in home values," it is the same as saying that proximity to a dump "is capitalized in home values." Noneconomists are usually put off by the term "capitalization," but it is not a difficult concept. The term is borrowed from asset markets. It means nothing more than that the expected future flow of benefits or costs that accrue to something you own—a share of stock in Microsoft, a Russian government bond, your home—is systematically reflected in the present value of your asset. The present value is the price you could sell it for right now. Good news about Microsoft's expected earnings raises the price of that asset; bad news about Russia's economic reforms reduces the price of Russian bonds; reductions in local taxes, unaccompanied by reductions in local services, raise the value of your home.

The term "capitalization" puts people off because it evokes the messy algebra of discounting. The \$10,000 benefit expected to be received twenty years from now is worth much less than \$10,000 received right now, and the way to calculate that benefit is to apply a discount formula to the future benefit. But for the most part, it is not necessary to understand how this is done to use the concept of capitalization intelligently. (A step-by-step trip through the algebra can be found in

Fischel 1991a.) People to whom I explain the concept for the first time usually respond with something like, "Of course the value of any asset is affected by anticipated events. Why would anyone think any differently?"

Because the property tax plays a large role in local government, it is important to understand its mechanics. The property tax is collected as a percentage of the tax base, which is the value of land and buildings located within the community. A local official called an assessor estimates the value of each taxable parcel to arrive at its assessed value, which in most states is supposed to be a uniform fraction of the estimated market value of the property. (It does not matter what fraction of market value is used as long as it stays the same from year to year, so examples in this book assume that property is assessed at 100 percent of market value.) Assessments thus determine the share of local taxes that each property owner must pay.

The amount of taxes to be collected is determined annually by the local governing bodies such as city councils and school boards. Property taxes pay for spending that is not financed by other means, such as (to mention the other two largest sources of local revenue) higher-government grants and local fees and user charges. The total amount to be collected divided by the tax base gives the property tax rate. A typical tax rate might be on the order of 2 percent, so that an owner of a home assessed at a market value of \$200,000 would pay \$4,000 annually in taxes. (Section 6.5 explains the difference between the tax rate and the "tax price," the latter being what the average voter has to pay for an increase in public services.)

For most local governments, the property tax is their largest single source of discretionary funds. As a result, public officials pay close attention to the tax base. The tax base of the average community is composed of, in the usual order of value, residential property (about 65 percent of the total), commercial and industrial property (25 percent), and "undeveloped" land such as farms, woodlots, and vacant lots (10 percent). The proportions vary considerably among communities. Some small suburbs are almost exclusively residential, and a few cities will have a large fraction of commercial and industrial property. Furthermore, several states allow communities to tax nonresidential properties at a higher rate, so that the residential share of taxes may be overstated by assessed value figures. As a result, there is considerable variation in property tax rates among local governments.

1.5 Risk Is the Key to Homevoter Participation

The idea behind the homevoter hypothesis was first advanced in a paper by Jon Sonstelie and Paul Portney (1978), "Profit Maximizing Communities and the Theory of Local Public Expenditures." That there is a financial motive for local political behavior now seems obvious. But it also presented a puzzle. We take care of our own

homes because the benefit redounds to ourselves. Fixing the furnace makes sense, even if you are selling your home next year, because a nonfunctioning heating system would devalue your major asset. Prospective buyers would lower the price you would receive when you sold it.

But what special motivation would make people take care of the collective community benefits and costs that affect home values? Why wouldn't homeowners "free ride" on the efforts of others at zoning hearings, school board meetings, and city elections, with the result that only special-interest groups would be organized well enough to affect local politics? Here is how I discovered the special motivation.

I was chairing a meeting of the Hanover, New Hampshire, zoning board in 1997. A developer, who was a well-known native, was making a request for a routine special exception. (Unlike variances, which are hard to get, "special exceptions" are presumed to be granted if the applicant meets specific criteria set out in the ordinance.) He had purchased undeveloped land in a lightly populated residential district and subdivided it into lots larger than required by the zoning ordinance to build about a dozen single-family homes. The proposed homes would be nicer than those already in the neighborhood, and all of them would be out of sight of adjacent homeowners. All the developer needed from the board was permission to build his driveways across some intermittent streams that qualified as wetlands. He bent over backward to conform with the rules in that his proposed driveways exceeded the recommended drainage specifications at every crossing.

The opposition came from neighbors, particularly two who lived closest to the proposed driveway entrance. They raised "not in my backyard" (NIMBY) issues about flood control and character of the area, both of which I thought were likely to be improved by the development. It was an all-too-familiar litany for me after nine years on the board, and my mind started to go on autopilot.

As one opponent went on and on about the supposed ill effects of this project, I found myself brought up short: "Wait a minute," I thought. "I know this guy (the NIMBY). His son and mine are friends. I've seen him at school functions and talked with him. He's a sensible guy, salt-of-the-earth type. He's not crazy; he can't believe that this project is likely to harm him. So what's he worried about?"

Light bulb turns on in my head: He's not worried about the likely, *expected* effect of the development, which was benign. He's worried about the *variance* (statistical, not legal) in the outcome. He, like almost everyone else in town who appears at these hearings, owns his home. It constitutes nearly all of his nonretirement assets. He can insure it against fire and theft, but he cannot insure it against adverse neighborhood effects. So Tom (the NIMBY) was doing his best in the absence of insurance to reduce the possibility that some unlikely event would adversely affect the value of his home.

NIMBYism is weird only if you think solely about the rationally expected outcome from development. NIMBYism makes perfectly good sense if you think about the variance in expected outcomes, and the fact that there is no way to insure against neighborhood or community-wide decline.

As often happens with my great ideas, I soon found that someone else had thought of it earlier. In an obscurely published paper that I nonetheless had in my files (and so maybe my zoning-board epiphany was just my subconscious at work), Albert Breton (1973) invoked economic theory to explain the existence of zoning and the difficulties it posed for developers. He identified the cause of residents' aversion to development as an incomplete insurance market. Since residents cannot insure against neighborhood change, zoning offers a kind of second-best institution. If homeowners were insured against neighborhood decline, they wouldn't worry so much about unlikely scenarios and behave like NIMBYs.

If homeownership is such a risky portfolio choice, why is it so common? Pride of ownership is one factor, and tax advantages are another. The imputed income (the amount you would have to pay to rent your own home) from owning a house and the capital gains realized from ownership are now completely untaxed at the federal and state level. No other widely available asset has both advantages. And in one sense, owning a home rather than renting does reduce risk. As a housing consumer, having a predictable stream of cash payments in the future is valuable, even if the value of the underlying asset fluctuates. So the risk I am concerned with is asset risk, not cash-flow risk.

1.6 Why Homeowners Are Different from Others

In further support of the idea that the risks of homeownership are the key factor, I would point out that both apartment owners and apartment dwellers are rarely NIMBYs, even after accounting for their lower numbers. I do not have numbers on this, but in my experience on a zoning board and my frequent attention to other disputes, it appears that the opposition to land-use change is usually by homeowners. The only systematic exception is opposition by existing businesses to potential competitors, and even then they usually try to clothe their naked protectionism with appeals to environmental issues that primarily affect homeowners.

Lack of NIMBYism by apartment owners seems strange only if we attribute NIMBYism simply to expected effects of the proposed development rather than the variance of those effects. In absolute dollars, owners of multifamily housing have even more to lose from adverse neighborhood effects than most homeowners. And apartment-building owners could be effective NIMBYs if they cared to, since they could round up tenants and business allies to oppose the land-use change.

But such opposition is rare. The reason is that owners of multifamily homes can spread their risks of ownership much more easily than homeowners. They cannot insure against devaluation of their assets from neighborhood change, but they can divide ownership of rental housing among many owners much more easily by forming a REIT (real estate investment trust) or some other multi-investor form of ownership.

Homeowners cannot similarly divide their assets among locations. A proposal to divide home equity between owner-occupants and distant investors is described in Andrew Caplin et al. (1997). This arrangement, which would be similar in many respects to REITs, would reduce homeowner exposure, though not the risk of ownership. The authors of the proposal concede, however, that dividing ownership is considerably more difficult for owner-occupied homes than for apartment houses and office buildings. A more direct way to assuage NIMBYism is home equity insurance, which has been advocated by Karl Case, Robert Shiller, and Allan Weiss (1993). Their scheme, however, would cover only swings in metropolitan-wide values, not individual communities or neighborhoods. Shiller and Weiss (1998) conceded that even this coarser insurance market would be dauntingly difficult to establish. Zoning may be the best insurance for now.

Another method of diversification, suggested to me by a rueful California real-estate investor, might be for homeowners to get a second mortgage and use the proceeds to invest in safer assets. If the home's value goes down too much, the homeowner can just walk away from the mortgage. Many states, however, allow the lender to haul a defaulting homeowner into court to obtain a "deficiency judgment" (Michael Schill 1991, p. 494). the lender obtains the difference between the home's foreclosed value and the unpaid debt, which puts the homeowner's supposedly safer assets at risk. Some states disallow this remedy—though usually only for first, not second mortgages—but even then the homeowner suffers relocation costs and a much poorer credit rating from a default. Second mortgages are a risky way to spread asset risk.

After a while, it occurred to me that my zoning-board insight applies to more than just land-use regulation. Concern about the vulnerability of their largest asset also explains why homeowners are more likely to participate in school board meetings, vote in local elections, and otherwise participate in community affairs. There is hard evidence that they do so. Denise DiPasquale and Edward Glaeser (1999) analyzed a national survey of citizen participation in local affairs. Even after controlling for other economic and demographic differences between homeowners and renters, they found that homeowners were more conscientious citizens and were more effective in providing community amenities.

The importance and vulnerability of their asset are not the only reasons that homeowners are more likely to be the major local political actors. Living in a home for a long time creates a personal attachment for which changes in the neighborhood and community are upsetting. Surveys indicate that long-term residence by both renters and homeowners is an important factor in community participation (Verba, Schlozman, and Brady 1995, p. 452). But length of residence does not always mean more protectiveness. Kent Portney (1991, p. 94) found that long-time residents were *less* opposed than newcomers to the establishment of proposed waste-disposal sites in Massachusetts. Less systematically, I have observed that people who have just moved into the neighborhood are often most concerned about proposed land-use changes. Maybe noneconomic attachments to neighborhoods and community are formed that quickly, but I suspect that the size of the down payment and the newly acquired mortgage make new homeowners especially watchful of local activity. The uninsurable-asset aspect of homeownership still seems like the key factor.