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Homevoters, Municipal Corporate Governance, and the Benefit View of the Property Tax

Abstract *- Tiebout's "vote with your feet" model dispensed with political behavior in local government. The present article offers a political model borrowed from corporate finance. Local governments are viewed as municipal corporations whose shareholders are homeowners and whose collective property rights are protected by zoning. Homeowners are motivated to control local government because its services and taxes affect the value of their largest asset, their homes. The homevoter model implies that local property taxes are benefit taxes, that locally-funded schools are more efficient than state-funded systems, and that home-conscious "NIMBYs" forestall an environmentally destructive "race to the bottom" in tax-base competition.*

INTRODUCTION

The peculiarity of municipal corporations is that their most numerous "shareholders" are owners of homes. Because homeowners cannot diversify their assets adequately, they are motivated to be "homevoters"—homeowners whose voting and other local political activities are guided by their concerns about home values. This essay will outline the homevoter hypothesis and explain why it gives a better account of local government activity than models that view local government as Lilliputian versions of state governments. In particular, I hope to show that adopting the homevoter view strengthens the case for viewing the local property tax as a benefit tax. It is, in my view, not a "tax" at all, but the primary source of revenue of municipal corporations.

TIEBOUT'S MODEL FITS COLLEGES AND LOCAL GOVERNMENTS

The ambition of Charles Tiebout (1956) was to show that local public goods could be provided without resort to politics. Instead of voting for politicians who would then set expenditures and taxes, Tiebout envisioned households as "voting with their feet" (to use his interpreters' term) to select the community that happened to offer the right level of public goods. This shopping trip would be like that which students undertake when they select residential colleges: They get in-

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formation about the curriculum, reputation, amenities, and tuition and fees from a variety of colleges and universities, and then they "vote with their feet" by moving to the institution that, provided it admits the student, meets their demands.

Come to think of it, residential colleges resemble Tiebout's communities better than most local governments. Colleges offer a "mixed" public good, in that it is possible to exclude outsiders who do not pay tuition and fees. Once a student is admitted, he can enjoy amenities and the curricular offerings more or less without further charge, so that they then are provided as if the services were pure public goods. The governance of colleges is, as in Tiebout's local governments, not especially well specified, but, in any case, colleges do not seek to be governed by their resident students. A student dissatisfied with her present college is best advised to "vote with her feet" and transfer to another. The discipline of the market, not the ballot box, keeps college administrators attentive to the demands of students.

Local governments do resemble residential colleges in several ways that make them correspond to Tiebout's model. They are numerous (about 25,000, not counting independent school districts), they are geographically contiguous, people select them for their menu of local services and amenities, and residents have to pay (via local taxes and housing prices) for the privilege of locating there.

Most impressively, the quality of municipal public services affects home values (Yinger et. al., 1988; Dowding et. al., 1994). A good school system, a low crime rate, a low tax rate, and clean streets all increase the value of homes in a community. Bad air quality, congested streets, dangerous land–uses, and corrupt cops all reduce the value of homes. Municipalities are like colleges and universities in that respect: An improved reputation raises the value of the BA, MA, or PhD issued by that institution, and newly–revealed scandals, low academic quality, and losing football teams reduce their value. (I have found that this capitalization effect helps overcome the free–rider problem in alumni fund–raising campaigns. My class agent is shameless: "You wouldn't want us to slip in the U.S. News survey, would you?")

The college–municipality analogy is strained in two important dimensions, however. The formal governance of municipalities is far more responsive to their residents than that of colleges. Elections are held regularly, and elected officials hire and fire municipal managers. Elections and politics, however, are exactly what Tiebout wanted to avoid as a solution. Once we open up communities to electoral politics, we have to inquire about the governance structure and the objectives of the governing body.

Second, potential residents may desire a municipality's local services but not want to pay enough in taxes to finance these services. The means of excluding free riders is fairly transparent at residential colleges. Students who do not pay are not permitted to attend classes and reside on campus, and those who slide past those rules will not be given a transcript to memorialize their accomplishments. Local governments would seem to have a much more difficult time dealing with free riders. Putting up a toll booth at the city limits is impractical and, in most cases, contrary to state law. While municipalities establish user fees for some services, most of their output can be enjoyed equally by all residents, regardless of their willingness to pay.

I propose to enrich the Tiebout model in this essay by pointing out (as Hamilton did) that municipal zoning and related regulatory powers serves the same function as the college registrar, making sure that potential residents pay their expected charges. My contribution has been to argue that zoning is up to the task that Hamilton assigned it.

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Secondly, I will advance my theory of municipal governance, which plants it in another economics literature, that of corporate governance (Easterbrook and Fischel, 1991). Instead of avoiding politics in the name of economics, as Tiebout desired, I embrace politics in the name of economics. The second task of this essay, then, is to explain how a corporate view of local government is analogous to that of business corporations. The primary difference is not their voting arrangements (per capita for municipalities, per share for businesses), but the riskiness of the portfolio of homeowners in local government compared to the portfolio of stockholders.

HOW ZONING SCREENS OUT MUNICIPAL FREE RIDERS

Tiebout did not explain how free riders would be excluded from his municipalities, but the mechanism was already in place. For almost a century, American municipalities have been dividing their territory into "zones" in which certain activities are allowed (or conditionally allowed) and others are prohibited. Nearly every community of any size has zoning. The continuing rejection of zoning by voters in Houston, Texas (McDonald, 1995), is by now probably caused by pride in being different from everywhere else. Elsewhere, zoning vies with public education as the local function of greatest interest to voters. As one index of this, I found that the dominant motive for municipal incorporation in the United States since 1910 has been the desire of residents to control land use (Fischel, 2001, chaps. 7 and 8; Teaford, 1997).

Bruce Hamilton (1975) repaired Tiebout's omission by proposing that municipalities could use zoning to specify the taxable property for each new development. If the average home in the village was worth $200,000, then new homes would have to be worth at least $200,000 it they are to have no adverse fiscal impact on existing residents. (No zoning law can legally specify a minimum dollar value, but the matrix of lot–size, quantity, and quality standards that are legal can come pretty close ([Fischel, 1985, chaps. 2–4.]) Under Hamilton's conditions, new construction "pays its own way" in municipal costs. The property tax has no deadweight loss because homebuyers get the public goods they are willing to pay for (since they have a choice of many communities' service packages, ala Tiebout), but they have to pay for what they get (since local zoning sees to it that they cannot shirk by building a smaller than average house, ala Hamilton).

Critics of this model concede that if zoning did work so perfectly, it would indeed give the result that Hamilton claimed, but they argue that zoning is too crude to make such fine distinctions (Mieszkowski and Zodrow, 1989). I argue that the critics greatly underestimate the creativity of local governments (Fischel, 1992). In the previous example, suppose that the village had average home values of $200,000, as before, but that a large commercial facility had been built, which added $100,000 per household to the tax base. The per household tax base is now $300,000. The developer of a new home would now have to bring with it $300,000 in tax base in order for it to have no adverse fiscal impact. It would seem that it could do this only by demanding that new homes cost $300,000, which could upset the Tiebout sorting mechanism.

In reality, however, developers and municipal governments can find their way around such problems. For example, the developer might propose a "mixed use" development of commerce and homes that worked out to $300,000 per new household so that the fiscal impact would be nil. However, if such a deal could not be worked out and the proposed use was not anticipated to pay its own way from

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property taxes alone, the developer might be asked to provide financial benefits to the community to make up the fiscal deficit. These might be dedicated facilities that benefit the entire community, or they might be side payments called "exactions" (Been, 1991) or, if regularized by a schedule, "impact fees" (Blaesser and Kentopp, 1990).

Such payments are controversial not because they charge too little, but typically because they charge more than the development seems to add to the municipality's fiscal costs. Courts have paid some attention to them by finding that the more imaginative arrangements constitute an unconstitutional "regulatory taking" (Dolan v. Tigard, 512 U.S. 687 [1994]). Wise developers know, however, that it is better to pay reasonable exactions than to litigate them. Community demands for specific side–payments are likely to be struck down in some state courts as illegal "contract zoning." To deal with this, developers offer to "donate" something of value to the community, knowing that if they do not, no rezoning or other regulatory accommodation will be forthcoming (Porter and Marsh, 1989).

Many commentators nonetheless claim that local governments continue to subsidize sprawl because property taxes do not cover the cost of infrastructure development. The Real Estate Research Corporation's study, *The Costs of Sprawl* (1974), was a pioneer in promoting this dubious idea, which continues to be an article of faith among the anti–sprawl set. It overlooks entirely the exactions process, which has been a widely–used tool in American land–use controls for at least half a century (Heyman and Gilhool, 1964). Altshuler and Gómez–Ibáñez (1993), who examine the exactions process and review the literature, conclude that, if anything, exactions extract payments in excess of the social costs of development.

Nor are there any special mysteries about how to do fiscal zoning. For local public officials who want development to pay its own way, how–to manuals such as *The Development Impact Assessment Handbook* (Burchell, Listokin, and Dolphin, 1993) are widely available. Evidence shows that the process works to the advantage of established homeowners. Dresch and Sheffrin (1997) undertook a nuanced study of how market conditions determine who pays for exactions in California: When the housing market is strong, the buyers pay in the form of higher prices, but otherwise the burden is shifted back to developers and landowners. In either case, preexisting homeowners in the community are not adversely affected.

The characteristics of land–use regulation in the United States are sometimes obscured by ideological debates about whether there is a right to develop here that is not present in other countries. American land–use law is unusual in that it is subject to constitutional review by more–or–less independent judges. The effect of the review, however, is highly favorable to municipal authorities. In general, a rezoning that reduces a parcel of land's value will be upheld by the courts if the municipality has followed prescribed procedures and if the new restrictions allow some viable economic use (Fischel, 1985, chap 3). This can be a single home on a ten–acre lot or larger in many states. There is a "right to develop" in most states, but it is not worth much.

Because rezonings and other increments to land–use restrictions are not much constrained in American municipalities, it is largely inappropriate to judge zoning by what is currently on the books. Communities that have loose zoning laws can quickly adopt more stringent regulations if an unwanted project is proposed. Loopholes are easy to close, and multiple layers of regulation by zoning boards,

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environmental councils, planning commissions, and historic–district committees can dissuade all but the most thick–skinned, accommodating, and well–heeled developers. When critics of American land–use decry "sprawl" and other currently disfavored patterns, they are criticizing not the land market (though they say as much), but the product of tens of thousands of land–use boards that have held the reins on development for most of the past century. That sometimes the reins were slack was in most cases a deliberate choice not to stop a particular development.

Finally, I wish to respond to the argument against zoning as a constraint that I hear most often from economists. Most homes and other structures do not extend to the limits of their current land–use constraints. A professor who owns an eight–room home on a half–acre lot can probably add a room or two without having to go to the zoning board for a variance. At this margin, the property tax may weigh on his mind. A new room would be nice, but it would increase his assessment, and the higher taxes may thus deter him from building the addition. The disutility from doing without the addition (net of the utility of using the building funds elsewhere) is the deadweight loss of the property tax.

Zoning thus does not completely constrain development, and traditional inefficiencies of property taxation remain within these constraints. What I insist, however, is that zoning prevents wholesale free riding by initial developers and major redevelopers. Homeowners may be able to add a room without going to the zoning board, but they certainly cannot build a tract of housing or add five stories to their home without a discretionary review by officials who are attentive to the concerns of other homeowners in the community. In conceding this effect, I admit that zoning is not "perfect" in the sense that Mieszkowski and Zodrow (1989, p. 1108) insist is necessary to turn the property tax into a benefit tax. Zoning is only "pretty good," as in Ralph's Pretty Good Grocery of Garison Keillor's mythical Lake Woebegone, Minnesota.

My best critic, George Zodrow (2001), remains unconvinced that all of this does not add up to more than seminar–room anecdotes. I could respond by saying that's what economists actually find convincing, but I will be serious about empirical work. Two strands of evidence convince me that zoning is a constraint at most of the economically important margins. One is that almost all of the studies that ask the question find that a change in public land–use constraints affects the value of property in the jurisdiction. I surveyed a number of these studies a decade ago (Fischel, 1990), so I will mention only one here.

Katz and Rosen (1987) examined San Francisco Bay Area communities that in the 1970s adopted the then–novel zoning of "growth controls." If zoning were just community window dressing, as Zodrow and others suggest, nothing should have happened as result. The effect should have been no greater than a change in the color of the police cars from black and white to white and black. But in fact Rosen and Katz found that home values in the communities rose by between 18 and 35 percent. The scarcity of building sites that the new zoning created bid up the prices of existing homes.

The other support for zoning is based on public choice, which teaches us that public sector activities are as explicable by rational self–interest as are private sector activities. Voting at the local government level is best characterized as majoritarian, so that on economic issues, the median–income or median–home–value model of politics prevails over the bureaucratic and special interest models (Turnbull and Mitias, 1999). In this majority–rule setting,

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it would be peculiar that an institution that gives rise to substantial costs and negligible benefits at the local level would persist and even expand over time. If zoning is the redundant bit of municipal window dressing that its economist–critics say it is, how can it be that local voters regard it as a critical activity of local government? Zoning has plenty of critics, and powerful interest groups such as homebuilder associations have worked against its expansion. (Ironically, homebuilders were largely responsible for zoning's introduction in California as an alternative to covenants [(Weiss 1987, p. 68)].) Zoning's opponents these days get nowhere. As Richard Babcock, the late dean of the American land–use lawyers, used to say at conferences convened to decry zoning's excesses, "Nobody loves zoning but the people."

WHY MUNICIPAL CORPORATIONS DON'T SEPARATE OWNERSHIP FROM CONTROL

The reason homeowners govern municipal corporations is risk. Shareholders of business corporations elect a board of directors, who in turn choose top executives to run the company. The "shareholders" of municipal corporations are owners of property in that municipality. Their assets will rise or fall in value depending on the performance of their elected officials and who those elected officials choose to manage municipal affairs. Both types of shareholders (homeowners and stockholders) trade their assets in a competitive market. The real estate market is not as efficient nationally as the stock market because of high transaction costs. Within metropolitan areas, however, the market for single family homes captures anticipated differences in community characteristics remarkably well.

The true difference between business and municipal corporations is that homeowners—the main municipal shareholders—cannot diversify their assets. Most homeowners do not own other assets of any consequence (Engelhardt and Mayer, 1998, p. 136). They cannot diversify location risk by placing their home in several different jurisdictions. They can insure the physical capital of their homes but not its location value. Read your homeowner insurance policy: It insures the structure, not the land (location) value. In contrast, owners of shares in business corporations can diversify as much as they want by holding a varied portfolio of different companies.

Diversification by business stockholders leads to a serious governance problem, which was first and famously pointed out by Berle and Means (1932). The separation of ownership (by the stockholders) from control (by the managers) in American business firms is the result of stockholder diversification. Because stockholders can diversify, they are rationally indifferent to how any given business is run. It's not that they don't care whether it succeeds; it's that they know their efforts to make an informed vote won't have much effect on the board of directors' behavior, and, anyway, there are too many different companies to keep tabs on managerial performance.

As Henry Manne (1965) first pointed out, the same vehicle of shareholder diversification, the stock market, provides a substitute discipline for wayward managers. If they goof off, the value of the company's stock declines: Managers' stock options become less valuable, and they are exposed to hostile takeovers. Even if they hold on to their jobs, incompetent managers will find it more difficult to raise capital again in the market. While the reduction in the stock's price hurts shareholders as well as managers, the shareholders spend little time worrying about it, because the worriers have already diversified their stock portfolios.

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A similar "stock market"—the market for single–family homes—reflects the failures and successes of municipal managers and their "board of directors," the locally–elected officials. Unlike the stock market, however, the consequences of poor decisions by municipal officials are not inconsequential. When home values fall because of a property–tax increase that is not offset by better schools or better roads, homeowners take a major hit on their net worth. They are not diversified, and their home constitutes, for most of them, nearly all of their nonhuman wealth. The housing market's discipline for bad municipal decisions—declining home values—is excessively harsh and falls on people who cannot easily diversify their risks. (They do some diversification by investing in safer instruments in the financial market [(Fratantoni, 1998)], but this has little effect for the simple reason that most people don't have enough nonhousing wealth to spread around to Treasury bonds [(Tracy et. al., 1999)].)

Precisely because of their exposed position in the housing market, homeowners are more interested in the governance of their municipal corporation than most stockholders are in their business corporation. Voting and related political activity are more important to homeowners. They set up institutional monitoring systems that are more stringent than those for business corporations. For example, they insist that public business be transacted in the open rather than behind closed doors. While this can inhibit some otherwise efficient transactions, open–meeting and sunshine laws reduce the risk of self–dealing by managers.

RISK–AVERSION MAY WARRANT PER CAPITA VOTING

The greater exposure to risk by homeowning "shareholders" may also explain why municipalities have never, as far as my extensive readings of secondary sources can tell, experimented with voting by property value rather than by resident. Investors in early American (pre 1840) business corporations did not typically vote by share, either. The default rule (when no voting rule was specified in the charter) for businesses was one vote per shareholder. Even as strict equality was gradually reduced over the nineteenth century, many corporations put a cap on the number of votes any one shareholder could exercise (Maier, 1993; Dunlavy, 1999). My tentative explanation for their reticence to vote by share is that stockholders before 1840 or so had less opportunity to diversify their holdings because stock markets were not accessible to investors nationwide. Because the risks to owners of business corporations was greater, the principle of one shareholder, one vote was more compelling.

The big advantage of voting by shares is that it is consistent with maximizing the expected value of the corporation (Grossman and Hart, 1988). However, if shareholders are risk averse and cannot otherwise insure, they might prefer to allocate votes by shareholder rather than by share to avoid the risk that owners of large amounts of stock might undertake some self–dealing transactions. Dominant shareholders might, for example, sign sweetheart deals with family members to work for the firm, which may increase the largeholders' net worth at the expense of the smallholders. Without an efficient stock market to discipline such inefficient self–dealing, smallholders might insist on protecting their assets by retaining a per capita voting system. This may explain why municipalities never went to share voting, even when it was an option. Share voting may have been too risky for owners of small amounts of property.

Their inability to diversify their assets makes homeowners into what I have called "homevoters"—homeowners who vote with their homes' values in mind.

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This helps to overcome the free rider problem in local political decisions. Homeowners' participation is not limited to voting. They are more likely to attend local hearings, especially those that affect their neighborhoods. They are more likely to volunteer in schools and government committees. Unlike corporate shareholders, they know their neighbors and network with them more effectively than renters of housing in the same community (DiPasquale and Glaeser, 1999).

Allocating votes by resident rather than by value of ownership gives rise to the other majoritarian anxiety, the one we usually think about. Per–capita voting runs the risk that owners of large amounts of property will be subjected to redistribution schemes by the more numerous owners of less valuable parcels. The owner of a mansion will worry that owners of mobile homes will tax them and use the revenues to enhance their own assets.

Local governments have two means of dealing with this anxiety and its inefficient transfers of wealth. One is to form more homogenous communities, so that the risk of factional voting is reduced. If everyone has a similar amount of wealth, the temptation to redistribute it is less. As several tests of the Tiebout hypothesis have shown, local governments are more homogeneous in their characteristics than the region (metropolitan area or state) at large (Eberts and Gronberg, 1981; Heikkila, 1996). They are also more homogenous than analogous sets of corporate shareholders. Zoning and other devices help accomplish this.

The other largeholder protection is to appeal to state legislatures and constitution makers to bind local voters, preventing them from engaging in activities that would redistribute wealth. For example, a state constitution might prevent municipalities from engaging in activities that are tempting opportunities for redistribution. The constitution may insist that local expenditures be confined to public goods rather than private goods, the latter being easier to redistribute from largeholder to smallholder. Most states insist on uniformity of local taxation, so that the smallholders cannot foist higher rates on the largeholders. And it may offer a rationale for Dillon's Rule, which empowered judges to hold municipalities on a short corporate leash, insisting that they only undertake activities specifically authorized by the legislature. Monkkonen (1988; 1995) found that local governments themselves sought these rules in order to tie down their own redistributive inclinations. The private business corporation has less need for these constraints, since the stock market can provide the needed discipline without being too drastic for any one set of shareholders.

Both of the foregoing mechanisms—community homogeneity and state–imposed constraints—lessen the need for homeowners to use the political process to protect their assets. This may explain why local elections have, on average, lower turnouts than state and national elections. Consistent with this explanation is the empirical finding that cities with more heterogeneous populations have higher voter turnouts (Oliver, 1999). In diverse cities, there are more opportunities for redistribution and thus more reason for both rich and poor to turn out at the polls to protect their assets or to enhance their wealth.

CLOSING THE TIEBOUT MODEL WITH HOLISTIC–MINDED VOTERS

I have attempted to close the Tiebout model by adding a model of politics. The model of politics is inspired not by the political science department, but by the finance department. While I cannot provide solid evidence for all of the conjectures about municipal corporations, there is enough there to begin to explore how Tiebout might be rescued from his critics —and from his own aversion to politics.

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One key to my analysis is that municipal voters are conscious participants in governance, not merely passive receptors of decisions by government officials. Another is that land–use regulation provides municipal voters with the opportunity to establish property–rights in their municipality's location advantages. This does not just internalize external effects; it allows residents to use zoning as a device to maximize the value of their homes. Local voters and their elected officials understand the relationships among zoning, spending, taxation, and property values. They don't just do one and then the other without thinking about the connections (Lenon et. al., 1996).

The possibility that municipal corporations are rational and can be profitably compared to business corporations may strike economists as strange. Business corporations may have managers who are remote from their shareholders, but their accountants provide pretty direct signals about success and failure, and failure is eventually disciplined by the stock market. Municipal activity, in contrast, has no such direct feedback of success and failure, and municipal managers don't get stock options or face hostile takeovers.

The difference, however, is structural, not behavioral, and I am arguing that the structural aspects of local government are there for a good reason. The concentration of homeowners' assets in a single municipality makes them want to have much more hands–on control. They want open meetings, so we can all see the messy process of management that is conveniently hidden away in the business corporations' offices. They want frequent elections and the options provided by recall and referenda and initiatives, all of which help to overcome shirking by elected officials and municipal managers.

I will readily concede that many municipal decisions don't seem to fit the rational mold in which I have cast them. Few municipal officers would say their job is to maximize property values. Close examination of the declared objectives of supposedly profit–maximizing business managers, however, can also uncover a gulf between theory and practice, a fact economists have wrestled with since its revelation by Richard Lester (1946). Business people don't say they want to maximize profits. Nor are their transactions closely governed by the formalities of contract law, as Macaulay (1963) demonstrated. Compared with the messy decision processes that go on in business corporations, municipalities don't look so irrational, especially when we keep in mind that municipalities have to make most of their decisions in full view of the public.

What insights do these two additions (effective zoning and homevoter control of local government) get us that the original Tiebout model does not? I offer in the following sections three examples, which I explore in greater detail in my forthcoming book. They are the paucity of rent control, the falseness of the "race to the bottom" theory of environmental protection, and the superiority of local property–tax funding for public schools. None of these is explained by the bare–bones Tiebout model or by subsequent variations on it.

RENT CONTROL IS SCARCE BECAUSE OF HOMEVOTERS

Rent control is regularly criticized by economists for its tendency to cause tenants to stay too long in their units and to induce landlords to undermaintain their buildings. What is not so commonly remarked on is why rent control is so scarce. Most local governments could enact rent control if they wanted to, yet as of 1990 there were only about 200 jurisdictions in the United States that had any serious rent control (Olsen, 1991). True, one of these jurisdictions is New York City, which has about eight percent of the rental units in the nation (and a supermajority of rent-

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ers as voters), but New York accounts for nearly half of the rent–controlled units in the country, too.

The big question is why rent control is not more common outside of the Big Apple? Renters outnumber landlords everywhere. Any politician could get a net addition to his votes by promising to adopt rent control. It could be that landlords offer campaign finance assistance to forestall this, but what's impressive is that rent control is not an issue even in small towns, where money for campaigning is rarely an issue and the majority of voters tend get what they want. If the majority really rules in the suburbs, at least, why don't they have rent control?

The answer is that the majority of voters are homeowners, and rent control is bad for homeowners in at least two ways. The more obvious is that deterioration of apartment houses by the undermaintenance that rent control fosters has adverse neighborhood effects on the value of owner–occupied homes. The more subtle is that property–tax revenues decline as rent–controlled buildings are devalued, and more of the burden of property taxation is shifted to homeowners.

Evidence for the property tax's protection of landowners comes from California. After Proposition 13 passed in 1978, stringent rent–controls appeared in a number of communities (Chapman, 1981). Proposition 13 limited the *ad valorum* taxes on all property to a maximum of 1 percent of their 1975 assessments. Assessments could rise by no more than 2 percent per year except upon sale, after which the new price formed a base for the 2 percent annual escalator. This system insulated homeowners from the property–tax shift that rent control would otherwise have caused. Rent control did devalue apartment buildings, but this had no effect on homeowners' property taxes, since they were already at the maximum that they could be under Proposition 13. In the new tax regime, homeowners were no longer the allies of apartment owners, and the perennial rent–control advocates were more persuasive. As a result, the number and stringency of rent control ordinances took a noticeable jump right after Proposition 13 passed. (I discount to nearly zero the theory that rent control was passed because Howard Jarvis, the leader of the tax revolt, promised that his initiative would lower rents. Apartment owners publicly disavowed this idea before the vote, and, anyway, Jarvis promised many palpably implausible effects from Proposition 13, such as that school funding would not be harmed.)

HOMEVOTERS FORESTALL THE "RACE TO THE BOTTOM"

No charge against local government is more damning of their merits than the claim that their competition for industrial land–uses devolves into a self–destructive "race to the bottom" of the environmental quality heap. It is so widely believed that it forms the fundamental basis for the nationalization of environmental regulation under the 1970 National Environmental Policy Act (Esty, 1996, p. 593). As Professor Esty goes on to point out, "Fears of a welfare–reducing race to the bottom represent one of the central underpinnings of federal environmental regulation in the United States" (p. 628). The "race to the bottom" theory is also behaviorally similar to the tax–competition models that derive from the Mieszkowski–Zodrow view of the property tax and which are regarded as promoting inefficient locations and suboptimal levels of public services (Wilson, 1999). Both models assume that local governments are irrationally fixated on fiscal gains at the expense of environmental quality, if the model–builders even acknowledge that businesses may detract from the latter.

Yet belief in the race to the bottom is based on almost no systematic evidence. What evidence we have at the state level

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indicates that efforts to attract business seldom give rise to regulatory exceptions that actually harm the environment (List and Gerking, 2000; Revesz, 1992). At the local level, there is no systematic evidence that voters or their local representatives are typically inclined to give away their environmental birthright for a pottage of tax revenue and jobs.

The evidence is much to the contrary. An extensive literature documents how difficult it is to find any locality that will take the necessary nuisances of metropolitan living, such as landfills and power plants (Portney, 1991; Gerrard, 1994). Even generous compensation schemes seem inadequate to bribe local voters to accept such uses these days (Been, 1994). If there is a local "race" along the environmental spectrum, it seems more towards the top than to the bottom.

The homevoter hypothesis suggests a coherent reason for this difficulty. Homeowners are stuck with a large, uninsured asset whose value demonstrably declines when environmentally problematic uses are placed nearby. Homeowners are induced by this and more subjective concerns to become "NIMBYs," the folks who cry "not in my back yard" when even modest land use changes might adversely affect their home values.

The efficiency problem with NIMBYism is not the opposition itself. Some proposed projects have such adverse effects that they ought to be located far from any residences. The true NIMBY problem is that the uninsurability of homes makes homeowners too risk averse. Even proposed projects that are benign or that offer full compensation are still opposed because there is some risk that, as the project unfolds from drawing board to actual construction, things might turn out badly.

The homevoter hypothesis thus offers a reasonable explanation for the NIMBY syndrome. The remaining puzzle is why so many academics and policymakers persist in the belief that local governments will give away the environmental store. It is probably related to the reason that urban economists persist in believing that intermunicipal tax competition is bad: In either case, the conventional analysis assumes that owners of factories can just move wherever they want, without having to satisfy existing residents. Zoning is believed (when it is considered at all) not to be a binding constraint on their activities. Except in unzoned Houston, it is not a reasonable assumption.

WHY LOCAL CONTROL MATTERS FOR SCHOOL FINANCE

The third insight that the homevoter hypothesis offers concerns local financing for education. Funding for public education was traditionally a local activity for much of the twentieth century, and the property tax provided most of the revenue. States supplemented in varying degrees local funding with categorical grants based on average income and taxable property values, but displacement of local funds was usually opposed as a decrement to "local control."

In the 1970s, a number of state courts held on the basis of vaguely–phrased state–constitutional provisions that local property tax financing of education had to be greatly attenuated (Heise, 1998). Virtually all advocates of these decisions thought they would increase funds for public education and improve educational outcomes. The view of the property tax as a capital tax, as advanced in this forum by Zodrow, would seem to suggest that these advocates were on the right track, since the state does not have to contend as much with capital migration as local school districts do.

The first and paradigmatic case arose in California as *Serrano v. Priest*, 96 Cal. Rptr. 601 (1971). As a result of the California Supreme Court's 1976 holding (135 Cal. Rptr. 345), the state legislature

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adopted a funding law that left nearly no room for local school districts to vary their per–pupil expenditures on the basis of their local property–tax base (Henke, 1986). On the eve of its implementation in June 1978, half of the funds for this law were eliminated by Proposition 13.

I believe that *Serrano* caused Proposition 13. The great tax revolt was a logical consequence of the elimination of local fiscal control of schools (Fischel, 1989). If the California Supreme Court insisted that variations in local property–tax bases could not buy better schools, why not have the state assume all of the financing? I found that California legislators were aware of the burgeoning tax revolt but found their hands tied by the need to respond to *Serrano* (Fischel, 1996). I don't claim to have nailed down all of the corners on this argument, which would require examining detailed budget histories of local districts, but I have encountered no other persuasive explanation for Proposition 13. (The most plausible alternative explanation, that rising housing prices and assessments pushed angry voters over the brink, begs the question of why housing inflation in other states did not bring a similar result. I also found that California legislators had a simple solution—differential assessments—but were stymied by the need to use inflated property–tax revenues to fund *Serrano* [Fischel, 1996, pp. 625–28].)

The more general issue that homevoting addresses is why school quality has fallen in California and, apparently, in other states that have traveled down a similar path away from local control of school finances. On the face of it, state control of funds would seem to improve education. State authorities do not need to worry as much about elasticity of the tax base. State education departments have more professional expertise than any local board. Poor districts can be "leveled up" to the spending and quality of the richer locales.

The econometric evidence, however, is largely pessimistic about the effect of the centralization trend. States that have gone farther than others towards the *Serrano* solution (centralization and equalization of funding) have lower average test scores (Husted and Kenny, 2000; Peltzman, 1996). There is some evidence that the variance in test scores between rich and poor has narrowed in these states, but, given the reduced average scores, the reduction in variance seems to come more from dumbing down the high–spending places than improving educational outcomes in the poorer places. This is consistent with the findings by several studies that show that greater state fiscal involvement results in less efficient schooling (Hanushek, 1986; Husted and Kenny, 1997).

The homevoter hypothesis offers two related reasons why centralization of funding along the *Serrano* model seems to have reduced school efficiency. One is that local funding provides a benefit–cost discipline on local voters who own homes in the district (Hoxby, 1999). Consider a local superintendent's proposal to improve schools by adding more teachers. Under local property tax funding, this has a positive and a negative effect on voters. If the additional teachers raise the quality of education, home values will rise, which pleases most homeowners in the same way that capital gains please stockholders. But the additional need for funds will raise property taxes, and it is widely established that higher taxes will reduce home values. Thus local voters have an incentive to adopt cost–effective school measures, which makes their schools more efficient.

Why can't the state legislature do the same thing? There are three reasons. First, state officials cannot rely on the housing market to guide them (Hoxby, 1999). Capitalization of the net benefits of school spending in home values, which guides (at least in part) local officials, does little

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to influence state officials. States are too large for the statewide housing market to give much systematic evidence about school quality compared to other states. Homeowners seldom search for homes among states like they do among the scores of local governments that characterize most metropolitan areas.

Second, adults without kids in school, who constitute a large majority of voters, have less interest in school spending at the state level than at the local level. The previous homeowner calculation of benefit (home value appreciation) and cost (depreciation) did not depend on whether the voter had any children in school. As long as they own homes that they can sell to someone with school–age children, childless voters are interested in the quality of schools and other local public goods. At the state level, this interest is nearly zero.

The third reason that centralization produces poorer results is that teachers' unions displace homeowners as the most influential group at the state level. Unions may be effective in raising average spending per pupil, but at the same time they make that spending less efficient by insisting on work rules that they would not be able to obtain at the local level (Hoxby, 1996). Local boards have to deal with the union, too, but its influence is mitigated in most districts by the fact that local voters, who are mostly homeowners, monitor the board's spending more closely. At the state level, homeowners are far less influential because state spending affects home values much less than local spending. It is not just ideology that has induced the teachers unions to support *Serrano*–style litigation in nearly every state.

HOMEVOTERS, NIMBYS, AND HOME–VALUE INSURANCE

This essay explains the conditions under which the local property tax is a benefit tax. The explanation rests on the idea that local governments behave differently than the state and national brand. My analogy of municipal to business corporate governance seems strange only because the two types have gone their separate ways for more than a century.

The three implications of the model that I described in the previous sections are largely complimentary of local government. The homevoter hypothesis explains why they resist the self–destructive redistributions that rent control entails; why they promote local environments that are, if anything, too good; and why they manage public schools more effectively than the state or national government. But there is a distinct downside to homevoting.

The NIMBY attitude is not confined to potential polluters. It manifests itself in opposition to low–income housing and almost anything that might lead to the higher–density patterns that most economists regard as necessary for an efficient urban economy. The homevoter hypothesis offers an explanation and a potential solution for this problematical side of local behavior. The risks of homeownership make residents too worried about neighborhood change. Low–income housing is often opposed, and even high–priced housing and nonprofit land–use proposals can be the occasion for homeowners to use their land–use powers to pull up the suburban gangplank now that they are aboard.

One way to deal with homeowner anxieties would be to provide home–value insurance. The idea is not to compensate people for things that they should accept, but to assure them that if things do not turn out so well, at least their financial assets will be protected. Such a program was initiated in Oak Park, Illinois (adjacent to Chicago) to prevent panic selling in the face of racial integration (McNamara, 1984). Although it was only part of a larger program to promote stable integration (Yinger, 1995), home equity assurance has been adopted in other

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Chicago–area communities, including parts of the city itself (Mahue, 1991).

My suggestion would be to extend this type of insurance to a wider range of land–use changes. (In fact, the "home equity assurance" program in Chicago does not distinguish among causes of home value decline, and I heard of one developer who used it to persuade neighbors not to oppose his low–income housing project.) Neighborhood opposition to an otherwise worthy project could be quelled with an insurance policy underwritten by the developer. If it were to succeed, a major drawback of homevoter dominance of local government would be removed.

CONCLUSION: THE MODELS ARE DIFFERENT, AND SO IS THE FUTURE

The difference between my view and the "capital tax" view promoted by Mieszkowski and Zodrow is profound. I do not simply argue for the "benefit" view of the property tax. I argue that the property tax is, at the local level, part of a government apparatus that is completely different from most views of government. Local politics is driven by real estate economics, and the most important and sensitive players are homeowners. That is not true at the state or national level.

Zodrow (2001), following mainstream public economics, does not distinguish political behavior by type of government. In the mainstream view, local governments are just tiny versions of state governments, which in turn are small models of the federal government. Thus it is not as if Zodrow and I are arguing about different shades of gray. The gray he sees is on an elephant, and the gray I see is on a battleship. The economic motivation of local government is so different from that of the state and national government that it is comparing elephants to battleships. No amount of tinkering with the parameters of the capital–tax view can reconcile it with the approach I have advocated here.

Ordinary citizens appear to agree that local government is a different enterprise. When they are able to express their will through ballot initiatives, voters resist centralization of tax and expenditure functions at the state level (Matsusaka, 1995). Exceptions like Proposition 13 can be explained by court decisions like *Serrano.* State supreme court judges have responded to the calls of academic lawyers and social scientists to centralize education finance; it is not the *vox populi* that has undermined local fiscal control (Carrington, 1973; Lee and Weisbrod, 1978). In continuing this enterprise as a matter of constitutional law, the judges impose a previous generation's beliefs on a public that no longer subscribes to it. Fiscal centralization reached its worldwide zenith in the 1950s and has been in retreat ever since (Oates, 1999). I predict that, judges and scholars notwithstanding, decentralization will prevail in the new century. Our task as policy analysts and advisors should be to understand its underpinnings, promote its virtues, and correct its faults.

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