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# The Renter Effect Part 1: Explanation

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# *It's Elementary*

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**The Renter Effect**
**Part 1: Explanation**

This is the first of three columns on an interesting, hypothesized phenomenon called the renter effect. This column explains what this effect is and why it might arise. The second column explores the empirical evidence concerning the renter effect, and the third column explores the policy implications of this effect, should it prove to exist.

The term "renter effect" was coined by Wallace Oates. His definition of this effect has two parts. For the first part he writes "other things equal, the larger the fraction of renters in a community, the higher the level of local public spending per capita. This is the phenomenon that I am calling 'the renter effect.'"[1] The second part concerns the cause of this outcome. As Oates put it, the renter effect "is the propensity of renters to think *for whatever reasons* that they pay a very low (perhaps zero) tax-price for local public services." These two parts are connected because voters respond to a tax-price (to be defined below) the same way they respond to any other price; a lower tax price implies a higher demand for public services, all else equal. Putting these two parts together, therefore, the renter effect is the impact of renters' low tax prices (real or imagined) on their demand for public services, holding everything except tax price constant.

Thus, the renter effect as the term is used here (and by Oates) has nothing to do with differences between owners and renters in incomes or in preferences for public services. Instead, it only has to do with the possibility that renters may perceive that they have low tax prices compared to owners so that they demand a higher level of public services than owners with the same income and preferences.

A voter's tax price for a particular public services is the amount she must pay through the local tax system (which, for the purposes of this column means through the property tax) for a one-unit increase in the level of this service in her community. As shown by many scholars, a tax price has two components.[2] The first, which is called the tax share, is the increase in a household's property tax payment when the property tax rate increases enough to raise $1 per

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[1] Wallace E. Oates, "Property Taxation and Local Public Spending: The Renter Effect," *Journal of Urban Economics*, May 2005, pp. 419–431. The quotes are from page 421; the emphasis in the second quote is in the original.

[2] For a formal derivation of the tax price (and a discussion of the other technical issues in this column), see Tae Ho Eom, William Duncombe, Phuong Nguyen-Hoang, and John Yinger, "The Unintended Consequences of Property Tax Relief: New York State's STAR Program," *Education Finance and Policy*, Fall 2014, pp. 446-480.

household. If all households in a community are alike, the tax share is $1 for everyone. More realistically, however, households with relatively expensive houses have a higher tax share than those whose houses have below-average values. The marginal cost of a public service depends on the characteristics of a community. The marginal cost of services is the same for everyone in the same community, but it differs widely across communities. As many of my previous columns have discussed, for example, the cost of public education in much higher in a community with a high poverty rate than in a community where poverty is rare.[3]

The tax share is different for owners and renters because owners must write a check to the local government, whereas renters face no such requirement. If renters do pay any of the property tax, it is because landlords, who are the ones writing property tax checks, are able to pass some of the burden on to their tenants in the form of higher rents.

Even with full shifting of the property tax onto tenants, the renter effect could arise because individual apartments tend to have smaller assessed values, and hence smaller property tax shares, than houses.[4] According to standard incidence theory, however, full shifting of the property tax onto tenants is unlikely, at least in an area with many different local governments. So long as a reasonable share of tenants have alternative locations from which to choose, a landlord cannot fully shift property taxes onto tenants without driving them away.[5] Thus, the renter effect could arise because of the relatively low market values of apartments, partial shifting of property taxes into rents, or renters' belief in either of these possibilities.

Further analysis of the renter effect must address two issues. The first issue is that one can observe community level demands but not, in general, the demands of individual voters. As a result, the demand for public services is usually analyzed using what is called a "median voter model." The basic idea behind this type of model is that the household in the middle of the distribution of demands for a public service, who is the median voter, always votes on the winning side, so their demand determines the outcome. Scholars have shown that, under some conditions, the voter with the median income and the median tax share is the median voter. So a standard demand analysis looks at the outcome for a public service at the community level as a function of the community's median income and tax share.

Unfortunately, however, this approach runs into difficulty when a community contains both owners and renters. The median tax share for owners is relatively easy to observe. In the case of education, for example, it can be shown to equal the median house value in a community divided by the community's property value per pupil. The median tax share for renters cannot be

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[3] See, for example, my November 2013 column. The distinction between within-community and across-community variation in marginal cost will prove to be important in my next column.

[4] Apartments are not, of course, individually assessed, but they have an implicit assessed value based on the assessed value of the building in which they are located.

[5] As pointed out by Robert J. Carroll and John Yinger ("Is the Property Tax a Benefit Tax? The Case of Rental Housing," *National Tax Journal*, June 1994, pp. 295-316), mobile tenants are willing to pay more for an apartment in a community with better public services but are not willing to pay more simply because property taxes are higher, holding public services constant.

observed, however, because it depends on the extent of tax shifting, which is unknown. Moreover, even if the median renter tax share could be observed, the overall median tax share in the community could not be calculated, because it depends on the extent to which the owner and renter tax-share distributions overlap.

One way to handle this situation, which was introduced by Oates, is to assume that the perceived tax share of every renter household falls below the median tax share for owners. In this case, the use of the median owner tax share in a demand regression overstates the median tax share in the community, and the degree of overstatement increases with the community's renter share. Including the percentage of households who are renters in an estimated demand equation can therefore be seen as a rough correction for this overstatement—and as a test of the renter effect. Like any price variable, the owner tax-share variable is expected to have a negative sign, so the renter effect predicts a positive sign for the percent-renter variable.

The second issue is that renters differ from owners in another important way that works in the opposite direction from the renter effect, namely, that increases in the rents for their apartments represent a cost to them, not a capital gain. As many scholars have shown, an increase in the quality of local public services results in higher house values, so people who own a home receive a capital gain when the increase takes place.[6] They can either stay in their house and receive the higher public services or sell their house and receive the present value of the increase in services as a capital gain. Service quality increases also lead to rent increases. Renters benefit from an improvement in local public services, but the value of this benefit is cancelled out by an increase in their rent. Indeed, one might argue that renters do not care about the public service level because of this link to rents.[7]

The impact of public service quality on rents has not been studied as much as the impact of public service quality on house values. Nevertheless, several studies, including one by Oates, have found that rents do reflect public service quality.[8] If these studies are correct, it is difficult to see how the renter effect could arise. After all, renters are the ones who bid more for apartments in places where public services are higher (all else equal), so it is implausible to assume that renters are unaware of this relationship when they vote for local public services. With full reflection of service quality in rents and no renter illusion, renters will be indifferent to service quality increases, and their voting behavior will not be influenced by their tax share, real or perceived. In this case, the median tax share for owners is the appropriate variable in a

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[6] See, for example, Phuong Nguyen-Hoang and John Yinger, "The Capitalization of School Quality into House Values: A Review," *Journal of Housing Economics*, March 2011, pp. 30-48.

[7] This is not a new point. See the discussion on page 2020 in Stephen Ross and John Yinger, "Sorting and Voting: A Review of the Literature on Urban Public Finance," in *Handbook of Urban and Regional Economics, Volume 3, Applied Urban Economics,* P. Cheshire and E. S. Mills, eds. (Amsterdam: North-Holland, 1999), pp. 2001-2060.

[8] J.D. Heinberg and Wallace E. Oates, "The Incidence of Differential Property Taxes on Urban Housing: A Comment and Some Further Evidence," *National Tax Journal*, March 1970, pp. 92-98.

demand regression—with no need for a correction. Under these conditions, the renter effect will not exist.

One theoretical possibility is that renters have long, fixed-rent leases so that they do not have to worry about rent increases offsetting the benefits they would receive from improvements in local public service quality. In fact, however, renters tend to be quite mobile; one-quarter of renters have moved within the last year. Moreover, my impression is that most leases are either month-to-month or one year in duration.[9] Even if the benefits from service improvements are only partially offset by rent increases, however, the positive impact of low renter tax shares on renter demand might be smaller than the negative impact of the rent increases tenants expect to occur.

In summary, the renter effect arises when a relatively low tax share perceived by renters, all else equal, induces them to demand more public services. The case for a renter effect relies on the likely incomplete shifting of property taxes onto tenants. What is not so widely recognized, however, is that arguments for the renter effect implicitly assume either that renters do not bid more for otherwise-equivalent apartments in communities with higher-quality public services or that they forget about these higher bids when they go into the voting booth.

[9] I do not know of any data on lease lengths. Renter mobility is documented at http://sasweb.ssd.census.gov/ahs/ahstablecreator.html.