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The Renter Effect Part 3: Policy Implications

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It's Elementary

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The Renter Effect
Part 3: Policy Implications

This column is part three of my examination of a phenomenon called the "rental effect," which was first identified by Wallace Oates.[1] This effect exists whenever renters have a higher demand for local public services than do owners with the same income and preferences because renters do not pay the property tax directly and hence face a lower actual or perceived price for local public services. My first column explained this effect and how it arises. My second column explored the evidence on this effect's existence. This column discusses the policy implications of the renter effect if it actually exists.

The article by Oates makes a striking claim about the policy implications of the renter effect. To be specific, he says (p. 420): "If renters believe that they don't have to pay for local public services, they will tend to support excessively large public budgets; as a result, we might expect overspending in the local public sector." This argument is endorsed by Eric Brunner, Stephen Ross, and Becky Simonson, henceforth BRS, who write (p. 38) that "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 among others that fiscal illusion resulting from non-salient taxation may result in an excessively large public sector."[2]

The logic here seems straightforward. If landlords cannot shift the entire property tax onto renters, which seems likely, or even if tenants believe that landlords cannot do this, then the price tenants expect for an increase in local public services falls far below the actual costs. As a result, the argument goes, tenants will vote for public service increases that cost more than they are willing to pay, which represents inefficiency and leads to the conclusion that there is "overspending in the local public sector."

Although this argument appears straightforward, it is seriously incomplete because it makes the implicit assumption that the level of local public services in a heterogeneous community would be efficient if the renter effect did not exist. A large literature shows that this

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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.

[2] Eric J. Brunner, Stephen L. Ross, and Becky K. Simonsen, "Homeowners, Renters and the Political Economy of Property Taxation," *Regional Science and Urban Economics*, July 2015, pp. 38–49.

is not the case.[3] Indeed, the most likely outcome without the renter effect in a heterogeneous community, which includes any community with both owners and renters, is underspending on local public services. Adding the renter effect may therefore boost efficiency, not undermine it.

The argument here is fairly technical because it depends on the difference between a median and a mean.[4] Voting outcomes are driven by the median voter. After all, the median voter is the one who always has at least 50 percent of other voters on her side. Efficiency, on the other hand, is determined by the mean outcome. Suppose MC is the marginal cost of local public services per household. As shown by Paul Samuelson, the efficient level of public services is the level at which the mean marginal benefit, that is, the benefit to the average household, equals MC. Because benefits decline as the level of services increases, any increase beyond this efficient level will have a mean marginal benefit below MC.

The marginal benefit from public services is a demand concept. It is equivalent to the amount someone is willing to pay for a public service increment. Demand is, of course, linked to income, so, all else equal, someone with a higher income has a higher marginal benefit. As a result, the distribution of marginal benefits is linked to the distribution of income. Moreover, the mean and median marginal benefits are linked to the mean and median income.

As shown in Figure 1, the distribution of income usually has a long tail, which means that it has a few people with very high incomes. This type of distribution results in a mean income (and hence a mean marginal benefit from local public services) that is above the median income (and the median marginal benefit). Thus, voting outcomes, which are based on the median, will generally fall short of efficient outcomes, which are based on the mean. Let's call this the income-distribution effect.

The surprising conclusion of this analysis is that if the renter effect exists, it is likely to move local public services toward the efficient level—not away from it. Of course, the level of local public service could still be above or below the efficient level even after the renter effect and the income-distribution effect are combined. After all, the two effects are totally independent and we have no reason to believe that they add up to zero. Nevertheless, the possibility of the income-distribution effect implies that the statements made by Oates and BRS are simply not correct. The renter effect, if it exists, is more likely to boost efficiency than to undermine it.

So far this analysis has assumed that the renter effect exists. The evidence presented in my previous column suggests that it does not. Moreover, the case for inefficiency caused by the renter effect has a built-in contradiction. The argument by Oates and BRS assumes that renters recognize the benefits they receive from local public services but do not pay their share of the

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[3] This literature is reviewed on pages 2047-2049 of 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.

[4] The discussion here is simplified because it does not consider the distribution of tax shares. This issue, which does not alter the basic point, is discussed in the Ross and Yinger survey.

costs because landlords are not able (or are perceived by tenants to be unable) to shift their property tax payments on to their tenants. If tenants can recognize their benefits from local public services in the voting booth, however, it makes no sense to assume that they do not perceive these benefits when they bid on an apartment. Thus, tenants realize that the benefits of local public services show up in rents and they have little or nothing to gain from a public service improvement. As discussed in my July 2015 column, it is difficult to see how a renter effect could arise under these circumstances.

Overall, therefore, the argument that the renter effect leads to overspending in the local public sector is internally inconsistent and makes the erroneous assumption that the level of local public services would be efficient if the renter effect did not exist. Nobody should lose any sleep over the possibility that the presence of renters leads to bloated local governments.