

## **The Benefit View and the New View: Where do we stand 25 years into the debate?**

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Consider the following quotes from recent papers by experts in local public finance:

(1) “The evidence against the benefit view is overwhelming” (Ross and Yinger, forthcoming).  
(2) “Several recent studies provide some limited support for the new view. However, much further empirical investigation must be done” (Zodrow, 2000). (3) “As things stand, it is impossible to reject either the new view or the benefit view in favor of the other” (Oates, 1994).  
And finally (4) “The local property tax is a benefit tax” (Fischel, 2000). How, one might ask, after 25 years of debate, can it be that such prominent and highly respected scholars in local public finance can still be found in such total disagreement regarding the relative merits of the new view and the benefit view of the property tax.

No two scholars better represent the two sides than George Zodrow on the side of the new view and Bill Fischel on the side of the benefit view, and the two papers they have written for this conference are wonderful introductions to the debate. In addition, they provide us with insights as to why it is that the disagreements persist, and where the future of this debate might be heading. Finally, they give us the background to consider whether this issue is important and where it may matter. I will begin by giving a brief caricature of the debate before proceeding to these other issues.

*The Benefit View: Mobility of Households and Immobility of Housing*

Bill Fischel reminds us eloquently that home values represent the bulk of most households' net worth, that it is difficult for homeowners to diversify or insure against the risks associated with such an undiversified portfolio, that homeowners are keenly aware of the connection between the value of residential property and local fiscal decisions, and that homeowners each get one vote in local elections. As a result, democratically elected local governments hold the key to the net worth of most Americans, and the local median voter who is typically a homeowner will elect a local government that seeks to maximize property values. Finally, the primary tools through which the local government can accomplish this is through tax and spending policies and through zoning.

It is important to note how Fischel changes the standard argument away from Tiebout's emphasis on "voting with feet" to a more realistic emphasis on who controls the local political process and why. It is not, he cautions us, the threat of exit which causes cities to engage in efficient local policies – it is rather capitalization of local decisions into housing values that causes homeowners to become vigilant and thus force efficient policies at the local level. Even though the shift is away from emphasizing the disciplining power of "voting with feet", such capitalization of course still requires the assumption that households are potentially mobile. Under this assumption, positive capitalization – i.e. the effect of local policies raising property values – can happen only if (i) local governments choose their tax/spending packages wisely relative to other jurisdictions and, just as importantly, if (ii) supply of communities and housing

services is restricted through zoning. If the latter is not the case, then housing would be built in desirable jurisdictions to accommodate increased demand thus bidding *down* house prices, or new communities that offer similar services would form. By restricting supply of housing, local governments can insure that the rents their homeowners are receiving from positive features of the community are protected from outsiders. With such strict zoning laws, local governments then simply decide on local tax and spending programs on the basis of whether these would result in positive capitalization.

Two key assumptions underlying the benefit view of the property tax are therefore that first, households are potentially mobile across jurisdictions (thus giving rise to the potential of capitalization) and, second, that local governments employ strict zoning in order to produce the capitalization that is desired by local homeowners. Put differently, the benefit view requires *mobility of households* and *immobility of the housing stock* through zoning regulations that lock in current houses and limit the building of new ones. Furthermore, while the property tax itself is efficient under this view (because of the immobility of housing), the overall outcome for the whole economy is generally not efficient (as supply is artificially restricted in order to keep rents to homeowners high). Full efficiency would in fact demand no capitalization in equilibrium as new communities would form or housing would be added to existing communities to satisfy the demand for desirable local features that is expressed through capitalization.<sup>1</sup>

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<sup>1</sup> Fishel reminds us, however, that he is not arguing for the global efficiency of a local property tax system – he is simply attempting to point out the positive features of such a decentralized system as compared to more centralized methods of governance.

*The New View: The Mobility of Housing and a Fixed National Capital Stock*

The new view of the property tax builds on the general equilibrium insights earlier tax theorists had derived for corporate income taxes and relies critically on the assumption that housing, however strange that might sound, is mobile. More precisely, the assumption is that housing capital is mobile and can, at least in the long run, be converted to other uses. Thus, when the local property tax is increased, housing capital is moved to other uses thus causing more capital to flow into the non-housing sector and, because of that flow, reducing the rate of return on all forms of capital. A property tax, on average, is therefore shifted to all owners of capital if the national capital stock is fixed. If the national capital stock is not fixed, however, this result does not hold as cleanly because the burden would be spread internationally to all forms of capital (or it would be borne domestically by savers). In the extreme case of a “small open economy” (which the U.S. is surely not), the exit of capital from the housing sector would in fact cause no decline in the rate of return on capital.<sup>2</sup>

While this conclusion holds on average, differentials in local property taxes across jurisdictions must be thought about separately. If my jurisdiction provides the same level of services as other jurisdictions but charges a higher property tax rate, that differential will be passed to whatever it is that cannot escape the tax by moving away from the jurisdiction. The “whatever” that cannot escape can be renters if they are assumed not to be mobile, or workers, or consumers, etc. If all these are mobile, then the only immobile factor that remains is land. Thus, in the presence of full mobility of all households and factors, local property tax differentials will

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<sup>2</sup> It would still be the case, though, that a local tax on housing is inefficient as communities consider the cost to them of capital leaving the jurisdiction without considering the benefit to others of capital arriving elsewhere.

simply be capitalized into land values.

It is important to note that, as Zodrow points out, we can find here a “benefit view within the new view”: Differentials in property taxes are indeed felt locally - by consumers, renters, factors of production or land owners – and to that extent, we would expect the locally affected parties to pressure local governments to do what is efficient just as Fischel argues under the benefit view. Capitalization, just as in the benefit view, would affect home values and thus the net worth of the median voter, who would then have an incentive to discipline the local government and keep it from squandering his wealth. The mechanism, however, is different because of the assumption of mobile housing in the new view. Here, local governments are forced to think about the fact that their taxes cause capital to leave the jurisdiction, while under Fischel’s model local governments think about using zoning to keep new housing capital from entering and thus bidding away the positive capitalization to current homeowners. Under the new view, the local property tax therefore becomes distortionary because the thing that is taxed - housing capital - is mobile and will respond to the tax rate. Under the benefit view, on the other hand, housing is fixed (inelastically supplied), and the property tax becomes much like a land tax that is efficient. Under either view, however, capitalization may arise and cause voters to be vigilant.

One final but often overlooked caveat is in order. Under the new view, capital will move when local property taxes are raised *if and only if* the increase in taxes is not accompanied by a corresponding increase in services relevant to that form of capital. Thus, mobility of capital enters only to the extent that local property taxation is redistributive in some way. If it is not,

there is no reason for capital to move in response to property tax changes as these changes are simply payments for services rendered by the local government.

### *Differentiating Between These Views*

There are several approaches we can take to evaluating which of these views is the more appropriate to guide our thinking about the property tax. First, we could check the realism of the assumptions required to make each view work. Second, we could ask more fundamentally if economic theory has some additional insights to give us. And third, we can try to get empirical implications of the two views and see which ones hold up in the data.

### Realism of the Assumptions

The crucial assumptions behind the benefit view are the mobility (or potential mobility) of households and the immobility of housing due to zoning regulations. The critical assumptions behind the new view, on the other hand are the mobility of housing capital and the fixed national capital stock. Which of these strike us as more realistic?

I have several reactions. First, I have trouble with the notion of housing capital being perfectly mobile. Houses are quite durable, and while they are easy to build on to, it is difficult to turn bricks from an existing house into machines or other forms of capital. Movement of capital *out of* a jurisdiction therefore happens through gradual depreciation of the housing stock – houses may simply not be as well maintained when property taxes are too high. While there are anecdotes of housing stocks deteriorating rapidly in some neighborhoods, it seems to me that the process of moving housing capital through depreciation is a slow one at best, and the

inefficiencies arising in the new view might be quite long run. Second, Fischel is right in challenging us to think more carefully about zoning and the role it plays in local public finance. He provides many compelling anecdotes<sup>3</sup> throughout his writings – anecdotes that suggest zoning to be an extremely prized power at the local level, and one that is exercised with an eye toward excluding some in order to benefit current homeowners. Zoning, I suspect, does in many circumstances make housing even less mobile than it already is. Finally, at least Americans are incredibly mobile, and the assumption of household mobility that is central to the benefit view seems confirmed by personal experience as well as systematic empirical evidence. On the residential property tax, therefore, I find the assumptions behind the benefit view plausible, although no one believes they are ever completely satisfied.

I have different reactions, however, when I think of business capital and the portion of the property tax that applies to businesses. The benefit view does not address this part of the property tax, and the “mobility of capital” assumption required for the new view seems to ring true more easily here. Business property is different from residential property in many ways – less durable, more easily adapted to other uses, etc.; and the evidence seems to increasingly point to fairly substantial responses by businesses to local tax environments. Similarly, while the national capital stock is clearly not fixed, the U.S. is far from a small open economy that simply takes the world rate of return on capital as fixed. While we clearly need to modify our thinking about capital taxes as the U.S. capital stock becomes more internationally mobile and the U.S. becomes a relatively smaller player in the world economy, the evidence at this point seems to

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<sup>3</sup> I do not mean the term “anecdotes” to be pejorative in any way. The institutional detail that we can gain from anecdotal evidence is often quite powerful, as it is in my judgement in the case of zoning.

suggest that the national capital stock is relatively (though not completely) inelastic. Business capital, therefore, seems more mobile and the fixed national stock assumption is not entirely unreasonable as a starting point. This would then lead us in the direction of the new view when thinking about business property taxes.

### Insights from Economic Theory

For the past three decades, there have been many attempts to construct coherent models of spatial economies with many jurisdictions. These attempts were motivated by Tiebout's initial insight that mobile households are likely to sort based on incomes and preferences into different jurisdictions. Furthermore, there is increasing evidence that sorting of this kind is real and shows up in the data. What kinds of models, then, exist that can support such sorting as an equilibrium outcome, and what assumptions do they require? My suggestion here is that something can be learned from these models – something beyond the technical details that often seem tedious and hair-splitting.

The basic problem that researchers have to overcome in constructing such models is that there tends to be an incentive for poor households to locate near rich households in order to free-ride on the large property tax payments those households are making to support the high level of local amenities desired by them. If I am poor but would like to send my child to a good public school in a rich district, I can buy a tiny condominium in the rich district, pay relatively little in property taxes and enjoy the good school quality for my child. This tendency of the “poor to chase the rich” brings with it a tendency for local public finance models to be unstable and not to be able to support equilibria in which sorting occurs. In other words, it is quite difficult to write



down an internally consistent and general model of the world in which sorting of the type we observe is actually an equilibrium outcome.

Two alternative paths out of this theoretical maze have been developed: First, some have found conditions on preferences and local production functions that would guarantee that, even though the desire for the better public goods in rich communities is there, the poor will choose not to live in those communities because housing is just too expensive – even small condominiums.<sup>4</sup> A second strand in the literature has focused on modeling the housing stock as something that is quite fixed in any local community. This could be due to some history leading up to the present day, or it could be due to explicit zoning policies by local governments.<sup>5</sup> In either case, housing stocks are fixed, public goods and local tax rates are capitalized and the distribution of households across communities is determined by the types of houses available in different communities. Thus, in this second strand of the literature, the poor will not chase the rich because there are either no low income houses available in rich communities or those that are available are quite expensive due to the capitalization effect. Theorists who are attempting to construct workable models of the local sector therefore typically choose between two alternatives: either assume specific conditions on preferences and production processes in a model which otherwise would not yield a sorting equilibrium, or assume that housing is fixed and pre-determined while being flexible in regard to the kinds of preferences and technologies that may be out there in the economy.

While I am clearly biased since much of my work has been placed squarely in the second

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<sup>4</sup> For examples of this approach, see Epple, Filimon and Romer (1993).

<sup>5</sup> For examples of this approach, see Hamilton (1976) and Nechyba (1997).

strand of the literature described above, I nevertheless would like to suggest that what theorists have learned about the conditions under which an equilibrium with sorting can be supported can inform the debate on the new and the benefit view. In particular, if we believe the models of the first strand of the literature, we have to believe that preferences and production processes happen to have the form that would allow there to be an equilibrium with sorting. If this assumption strikes us as unreasonable, then we are forced to the other strand of the literature – a strand in which housing, at least residential housing, is relatively fixed. On balance, the latter approach seems to ring truer, and my reading of the theoretical literature is therefore on the side of the benefit view assumption of fixed housing capital rather than the new view assumption of perfectly mobile housing capital.

#### Testable Implications and Data

The kind of evidence that is ultimately most compelling, however, is empirical in nature. Bill Fischel presents us with a series of testable empirical implications of the benefit view and argues that the literature is broadly supportive of the empirical validity of these implications. He points out, for example, that the median voter model on which his version of the benefit view is built performs well at the local level, that it works better when jurisdictions are smaller, that homeowners are more involved than renters, that “capitalization is everywhere”, and so on. While all these observations are indeed consistent with the benefit view that he has outlined, they are also (as pointed out by Zodrow) consistent with some versions of the new view. There is, for example, a role for capitalization in either view, and the new view is not inconsistent with zoning regulations for purposes other than those assumed under the benefit view. Similarly, the other

implications are not inconsistent with the new view. Therefore, empirical findings of this kind do not make it any easier for us to *distinguish* between the two views, with both views remaining un-rejected.

Both papers therefore struggle to point to papers in the literature that can truly separate the implications of the two views and come out in favor of one or the other. The best empirical evidence for the benefit view, in my opinion, is the anecdotal evidence presented in much of Fischel's work – evidence that tries to get at the heart of how zoning is actually practiced in the real world and whether this is consistent with the view of zoning required for the benefit view to be valid. Zodrow, on the other hand, cites two papers from the 1990's that tend to support the new view. One, however, deals with rental properties (to which, at least the version of the benefit view expounded by Fischel, does not apply all that well), and the other paper is unsatisfactory for other reasons. Neither of the two sides can therefore demonstrate a history of empirical work that rejects one view in favor of the other.

*Where do we go from here, and does it really matter?*

We can now return to the question I began my comments with: Why, after so many years, is there still a debate as to which of the views put forth in these papers is the correct one? I think the papers we have read lead us to at least four possible explanations: First, reasonable people can disagree on which assumptions in the different models are more reasonable. While I have argued that some assumptions are more appropriate in certain contexts than in others, a mere focus on the assumptions of the models is unlikely to be fruitful. Second, the main piece of empirical evidence in favor of the benefit view is anecdotal – and however persuasive that may

be in individual cases, the economics profession in general tends to be unpersuaded by anecdotes. Third, too little attention has been paid to identifying testable implications that distinguish the two views. Thus, few of the empirical tests that are typically persuasive to economists have been conducted. Finally, the whole question may be quite wrong-headed: maybe there is no one *right* model. The different assumptions underlying the two different views are likely to hold to varying degrees from one setting to another, and one view may therefore be more appropriate in one case than in another. We may in fact gather another 25 years from now and have a whole series of empirical papers – some purporting to prove the benefit view and others to prove to new view. It may be that we will then conclude that these papers are all correct – that different data arise in different contexts, and sometimes one view will be more applicable than other times. I suspect there is truth in each of these four explanations.

One fact that has become clear to me in reading these two papers is that, if we are to shed more light on this old debate, we need better models with crisper distinguishing testable implications. Ultimately, empirical evidence is needed to resolve the debate, but empirical evidence cannot be persuasive without a better understanding of the differences in implications of the two views. While the new view is relatively well developed formally, the benefit view has not been modeled as carefully. More attention to the modeling of these views may therefore be helpful.

Does It Matter?

Before getting carried away, however, we might ask whether it really matters which of the two views is correct? In the end, I think the answer is yes. If the benefit view is correct, then

the wave of anti-property-tax movements that has swept the country would be quite destructive. In particular, Fischel's account of the property tax makes that tax an integral component of an efficient local public finance sector. On the other hand, to the extent that the benefit view continues to be relevant, one must at some point seriously address the equity rather than the efficiency concerns it raises. Specifically, the benefit view suggests that zoning is a tool used by local governments to exclude households that are "fiscally undesirable" (which typically means poor). This implies that, if Fischel is right, the local property tax combined with exclusionary zoning is responsible for much of the disparity in public amenities between districts. While this may not concern us when we are thinking of amenities like parks and recreation, it does raise serious concerns when the public good of interest is education. If exclusionary zoning is used as described in Fischel's paper, it may create desirable efficiency properties for the property tax by converting it into a land tax, but in the process the least advantaged among us are systematically excluded from the opportunity to gain a worthwhile education.

If, on the other hand, the new view is closer to the truth, then local property taxation is not necessarily such a good idea and the wave of anti-property tax measures may be justified on efficiency grounds. Furthermore, if the crucial element of the property tax is the mobility of capital, then increasing capital mobility may cause the efficiency problem of local property taxation to get worse with time. Finally, the new view suggests that, far from being an efficient lump sum tax (as claimed by the benefit view), the local property tax is largely a tax on all forms of capital. If so, we may wonder whether the property tax is adversely affecting savings and investment, and whether the local property tax is therefore a drag on national economic growth.

### *Concluding Remarks*

In conclusion, I want to reiterate that I highly recommend these two papers to those readers who would like to get a better understanding not only of the debate over which view of the property tax is more correct but also for those who want to acquire better intuitive tools to think about policy questions related to the local public finance sector. Young researchers (like myself) can take heart - not all research has been done quite yet, and more work is out there. In this case, this future work is likely to have dramatic implications for how we think of the property tax and its appropriateness for local government finance.

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