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## Property tax limits, local fiscal behavior, and property values: evidence from Massachusetts under Proposition 2 $\frac{1}{2}$

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### Abstract

This paper examines the impact of a specific property tax limit, Proposition 2 $\frac{1}{2}$  in Massachusetts, on the fiscal behavior of cities and towns in Massachusetts and the capitalization of that behavior into property values. Proposition 2 $\frac{1}{2}$  places a cap on the effective property tax rate at 2.5% and limits nominal annual growth in property tax revenues to 2.5%, unless residents pass a referendum allowing a greater increase. The study analyzes the 1990–1994 period, a time when Massachusetts municipalities faced significant fiscal stress because of a 30% cut in real state aid and a demographically driven increase in school enrollments. The findings include the following: (1) Proposition 2 $\frac{1}{2}$  significantly constrained local spending in some communities, with most of its impact on school spending; (2) constrained communities realized gains in property values to the degree that they were able to increase school spending despite the limitation; and (3) changes in non-school spending had little impact on property values. © 2001 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

Beginning with California's passage of Proposition 13 in 1978, an increasing number of states have enacted measures that limit the ability of municipalities to tax their residents to pay for local services. In most cases, the political support for these tax limits comes from voters who are concerned about local officials' lack of responsiveness to the electorate; voters fear that officials will impose taxes to pay for services whose cost exceeds their value to local residents.

This paper looks at the impact of a specific tax limit, Proposition 2½, on the fiscal behavior of cities and towns in Massachusetts and the effects of that behavior on property values.<sup>1</sup> Proposition 2½ places a cap on the effective property tax rate at 2.5% and limits nominal annual growth in property tax revenues to 2.5%, unless residents pass a referendum (an override) allowing a greater increase. The empirical work that follows explores whether towns that face larger barriers to raising additional tax revenue spend less on local services and thereby become less attractive to potential home buyers. Differences across communities in pre-Proposition 2½ tax rates and conditions allow a comparison of the fiscal decisions (expenditure patterns) of more and less constrained communities and the capitalization of that behavior into house prices. If movers in any period find one town more attractive than another, they will bid up the price of housing in the more attractive town. To the extent that cutting local public spending makes a community less desirable, increases in local spending will be associated with rising housing prices.

We begin by estimating the relationship between town spending and constraints imposed by Proposition 2½ between 1990 and 1994, a time when Massachusetts cities and towns faced strong budget pressures because of the coincidence of two factors: a steep decline in real state aid and a sizable increase in school enrollments. The estimates indicate that cities and towns that faced tighter Proposition 2½ budget constraints reduced their expenditures relative to communities that faced fewer constraints. Furthermore, these relative reductions were not proportional across all spending categories; the evidence shows that Proposition 2½ had a more profound impact on local school spending than on the rest of the local budget.

Reductions in spending could represent undesirable service cuts forced by the constraint or exactly the kind of change that backers of Proposition 2½ wanted. The original premise behind Proposition 2½ was that local officials had a tendency to spend 'too much' unless checked by the voters (Ladd and Boatright Wilson,

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<sup>1</sup>See Oates (1969), Edelstein (1974), Rosen and Fullerton (1977), Brueckner (1982), Roback (1982), Rosen (1982), Yinger et al. (1988), Black (1997), Yinger (1982) and a host of other tests of tax capitalization and the Tiebout hypothesis. Ross and Yinger (2000) provide an excellent review.

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