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DO HOUSING BUBBLES GENERATE FISCAL BUBBLES? EVIDENCE FROM CALIFORNIA CITIES

ABSTRACT

This paper examines the effects of the most recent U.S. housing bubble on the fiscal policy of California cities. We use an instrumental variables approach that helps isolate the fiscal consequences of house price appreciation by taking advantage of the influence of local topological constraints on the elasticity of house prices with respect to interest rates. Our analysis generates three main findings. First, despite Prop 13 fiscal constraints, rapid house price appreciation has a strong effect on property tax revenue. Second, the resulting increase in property tax revenue was largely offset by a reduction in other local tax revenue. This offsetting response leaves total city expenditure unrelated to local house prices. In that sense the housing bubble did not produce local fiscal bubbles. Third, we find that fiscal adjustments to house price appreciation depend on local political institutions.

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