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Publication Date

2005-09-26

3 October 2005

Local Public Good Provision: Voting, Peer Effects, and Mobility

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Few empirical strategies have been developed that investigate public provision under majority rule while taking explicit account of the constraints implied by mobility of households. The goal of this paper is to improve our understanding of voting in local communities when neighborhood quality depends on peer or neighborhood effects. We develop a new empirical approach which allows us to impose all restrictions that arise from locational equilibrium models with myopic voting simultaneously on the data generating process. We can then analyze how close myopic models come in replicating the main regularities about expenditures, taxes, sorting by income and housing observed in the data. We find that a myopic voting model that incorporates peer effects fits all dimensions of the data reasonably well.

JEL classification: C51, H31, R12

Keywords: Local Jurisdictions, Tiebout Competition, Empirical Analysis.

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1 Introduction

Models of interjurisdictional equilibrium take as their starting point the idea that households are at least potentially mobile. Communities differ according to their levels of public good provision, tax rates, and local housing market conditions. Each household takes these factors into account in choosing a community. If local public good provision is decentralized via local majority rule then the level of public goods will depend on characteristics of the community's residents. Households will sort among communities according to tastes and income, so that households with similar preferences for local public goods will tend to live in the same community. Since the population of each community is endogenous, the set of households who live in the community and the decisive voters in the community are jointly determined in equilibrium. We would like to know whether, when voting and thereby collectively determining the level of public good provision within a community, voters take into consideration the interaction among housing market equilibrium, mobility and public good provision. Almost all models of locational equilibrium rest on the assumption that voters are myopic: voters in each community ignore all effects of migration. Under this assumption, voters treat the populations of the communities as fixed and believe that the distribution of households across communities is not affected by a change in public good provision.

While local public good provision is an important component of neighborhood quality, there is a growing recognition in urban economics that the composition of neighborhoods itself may be valued by some of its residents. Thus the quality of life in a given community

may depend on peer or neighborhood effects.¹ Recent empirical research suggests that peer effects may also be quantitatively important.² If peer effects are important in explaining residential sorting, then they will alter the nature of the political equilibrium within communities. We, therefore, need to incorporate peer effects into the specification of our locational equilibrium model if we want to explain the patterns of local public good provision observed in the data. Thus far, almost no empirical strategies have been developed that test models of majority rule while taking explicit account of the constraints implied by neighborhood effects.³

The objective of this paper is, therefore, to provide an empirical test of majority rule in the presence of peer interactions controlling for the mobility of households. The approach taken in this paper differs from previous research in four important aspects. First, we extend the baseline locational equilibrium model to incorporate peer or neighborhood effects. Second, we show that there is at most one equilibrium of the model that is consistent with the observed sorting of households by income. Third, we develop a new estimation algorithm that is based on solving for equilibria for different parameter values. Almost all previous work has primarily looked at demand side issues using partial solution estimation methods.⁴ We impose all relevant restrictions that arise from the model in estimation and

¹For theoretical studies see, for example, deBartolome (1990), Benabou (1993), Durlauf (1996), Epple and Romano (1998), Nechyba (2000), and Sethi and Somanathan (2004).

²The empirical literature incorporating peer and neighborhood effects in local public good provision includes early research by Henderson, Mieszkowski, and Sauvageau (1978), and Summers and Wolfe (1977), and the more recent resurgence reflected, for example, in work of Cutler, Glaeser, and Vigdor (1999), Hanushek, Kain, Markman, and Rivkin (2000), Hoxby (2000), and Rothstein (2004).

³Epple, Romer, and Sieg (2001) found little empirical support for the hypothesis that myopic voting behavior is consistent with the data. But they largely ignored peer effects.

⁴Examples of this strategy include Bergstrom, Rubinfeld, and Shapiro (1982), Rubinfeld, Shapiro, and Roberts (1987), Epple and Sieg (1999), Sieg, Smith, Banzhaf, and Walsh (2004), Bajari and Kahn (2004), Bayer, McMillan, and Reuben (2004), Bayer and Timmins (2005), and Ferreira (2005). The only exception is

provide a comprehensive analysis of how well each specification of the model fits the outcomes observed in the data. This approach is feasible if we can easily compute equilibria for models with large numbers of communities. There are, for example, 92 communities in our data set. Thus, a fourth contribution of this paper is that it provides a method for computing the equilibrium of a model with a large number of communities in the choice set. Previous research with endogenous local public provision has typically not solved for equilibrium with anything near a choice set of this magnitude.

The data set we use in this paper includes the communities that constitute the Boston Metropolitan Area. Massachusetts is convenient to study because cities and school districts are coterminous. Hence a single residential tax rate applies within a community's boundary. We therefore avoid problems that may arise due to overlapping jurisdictions. Property taxes are also the primary source of local revenues in Massachusetts, which avoids the need to model other revenue sources. Our data set is from the 1980 US Census. This time period predates a Massachusetts law that restricts property taxation (usually referred to as Proposition 2 $\frac{1}{2}$). This law, which was passed in 1981, limited property tax rates to two-and-a-half percent (after some adjustment period). Since many jurisdictions had property taxes in the period leading up to 1981 that were higher than the limits set in Proposition 2 $\frac{1}{2}$, the law imposed for all practical purposes a binding constraint on these communities. We model the political process within each community as unconstrained choices determined by majority rule, and we estimate the parameters of the model using data prior to Proposition

Ferreira (2005) who also estimates demand and supply side parameters of a fully specified general equilibrium model.

$2\frac{1}{2}$.

Our main findings indicate that the simple myopic model can generate a distribution of local expenditures that fits the data well. Nonetheless, the model does not fit the observed tax rates and hence does not explain the pattern of local political choices. We find that a generalization of the myopic voting model, that also allows for peer effects in the production of educational quality, fits the data much better. Thus, our model adds support to the increasing emphasis placed on neighborhood effects and peer effects in theoretical research on locally provided public goods and in related empirical research. We emphasize, however, that our empirical analysis does not pin down the channel through which peers affect outcomes. Our findings are consistent, for example, with peers directly influencing educational attainment of fellow students, or with households having preferences with respect to peers even if peers have no impact on educational achievement.

The rest of the paper is organized as follows. Section 2 introduces the theoretical model on which the analysis is based and discusses existence and uniqueness of equilibrium. Section 3 introduces a parameterization of the model and discusses the estimation strategy. Section 4 discusses the data. Section 5 reports the main empirical findings. Section 6 discusses the main findings. Section 7 concludes the paper.

2 The Model

The economy consists of a continuum of households, C , living in a metropolitan area. Throughout the paper we will refer to a household as the decision-making unit, though for

variety we will sometimes also use the terms “individual”, “voter”, and “agent” to mean the same thing. The homogeneous land in the metropolitan area is divided among J communities, each of which has fixed boundaries.⁵ Jurisdictions may differ in the amount of land contained within their boundaries. In the development that follows, we suppress the jurisdiction subscript, j , where this is obvious from context. We assume that households behave as price-takers. A household has preferences defined over local public good quality, q , housing good, h , and a composite private good, b . Households differ in their endowed income, y , and in a taste parameter, α , which reflects the household’s valuation of public good quality. The continuum of households, C , is implicitly described by the joint distribution of y and α . We assume that this distribution has a continuous density, $f(\alpha, y)$, with respect to Lebesgue measure. We refer to a household with taste parameter α and income y as (α, y) . The preferences of a household are represented by a utility function, $U(\alpha, q, h, b)$, which is strictly quasi-concave and twice differentiable in its arguments.

The quality of this local public good in a jurisdiction is determined by per capita government expenditure, g , and by a measure of peer “quality,” \bar{y} ; $q = q(g, \bar{y})$. We assume that peer quality can be measured by the mean income in a community, which is given by:

$$\bar{y}_j = \int_{C_j} y f(\alpha, y) dy d\alpha / n_j \quad (1)$$

where C_j is the set of households choosing community j and n_j is the population of community j . Higher income neighbors may generate positive “production” externalities such

⁵In our empirical application, we consider the Boston metropolitan area. Municipal boundaries in Massachusetts were set in the 1930’s and have remain unchanged since.

as interactions among achievement-motivated children that facilitate learning, or parental engagement in neighborhood and school activities that enhance learning by children. Alternatively, \bar{y} may reflect preferences for neighbors due to "consumption" externalities, such as desire by each household for social contact and interactions with higher income households.⁶

Let p denote the relative gross-of-tax price of a unit of housing services in a community, p^h the net-of-tax price, and let y be the household's endowment of the composite private good. Households pay taxes that are levied on the consumption of housing services. Let t be an *ad valorem* tax on housing. Households maximize their utility with respect to the budget constraint, which is given by:

$$(1 + t) p^h h = y - b \quad (2)$$

and choose their preferred location of residence by comparing maximum attainable utility levels among communities. We can represent the preferences of a household by specifying the indirect utility function. Let $h(p, y, \alpha)$ denote the housing demand function⁷ and let

$$V(\alpha, q(g, \bar{y}), p, y) = U(\alpha, q(g, \bar{y}), h(p, y, \alpha), y - p h(p, y, \alpha)) \quad (3)$$

⁶Combining the utility function and quality function from the "production" formulation of peer effects, we obtain an induced utility function that has g , h , \bar{y} , and b as arguments: $U(\alpha, q(g, \bar{y}), h, b)$. The allocative effects of this formulation of preferences and quality are equivalent to those from the "consumption" formulation in which public good quality depends only on g , $q = q(g)$, and peer quality enters the utility function as a separate argument: $U(\alpha, q(g), \bar{y}, h, b)$. We have presented the production interpretation in the text for ease of exposition, but emphasize that our empirical analysis does not distinguish these two channels for peer influence. Nechyba (2000) and Ferreyra (2005) likewise use mean income as a peer measure to capture potential production and/or consumption externalities. Were a measure of student ability available in our data, it would be of interest to investigate a more general formulation of peer effects, along the lines of Epple, Romano, and Sieg (2004), in which mean student ability affects peer quality.

⁷Here we anticipate a simplification adopted in our empirical analysis. Preferences are assumed separable in q and (h, b) so that housing demand does not depend on q .

denote the indirect utility function of a household, where $p = (1 + t) p^h$. We assume that the indirect utility function satisfies standard single-crossing properties. In particular, indifference curves in the (q, p) plane have slopes increasing in y for given α and increasing in α for given y .

Let $C_j \subset C$ denote the population living in community j . The set of border households between communities j and $j + 1$ is characterized by the following expression:

$$V(\alpha, q(g_j, \bar{y}_j), p_j, y) = V(\alpha, q(g_{j+1}, \bar{y}_{j+1}), p_{j+1}, y) \quad (4)$$

This boundary indifference condition defines loci $y_j(\alpha)$. The single crossing properties imply that the population, C_j , living in community j is thus given by

$$C_j = \{(\alpha, y) \mid y_{j-1}(\alpha) \leq y \leq y_j(\alpha)\} \quad (5)$$

Total housing demand in community j is then given by:

$$H_j^d(g_j, p_j, t_j) = \int_{C_j} h(p_j, y, \alpha) f(\alpha, y) dy d\alpha \quad (6)$$

We also assume that the budget of community j must be balanced.⁸ This implies that:

$$t p^h \int_{C_j} h(p, y, \alpha) f(\alpha, y) dy d\alpha / n_j = c(g) \quad (7)$$

⁸The analysis can be extended to incorporate lump sum transfers, for example, from the state government to the local governments.

where $c(g)$ is the cost per household of providing g and

$$n_j = \int_{C_j} f(\alpha, y) dy d\alpha \quad (8)$$

is the size of community j .

Furthermore, we assume that housing is produced from land and non-land factors with constant returns to scale, so that housing per household is given by:

$$H_j = h(A_j, Z_j) \quad (9)$$

where A_j is the fixed amount of land area in community j and Z_j is a mobile factor used in production. Assume that p_z is the same in all communities. Profit maximization by price-taking producers implies that the total housing supply function is given by:

$$H_j^s = H_j^s(p_j, t_j) \quad (10)$$

Following most previous positive studies in the literature, we assume that the pair (t, q) in each community is chosen by majority rule. In each community, voters take the (t, q) pairs in all other communities as given when making their decisions. One can make a variety of assumptions about voter sophistication regarding anticipation of the way changes in the community's own (t, q) pair affect the community's housing prices and migration into or out of the community. For example, voters might take the community's net-of-tax price, population, and the community tax base as given, and then deduce from the budget

constraint the link between gross-of-tax price and the quality of the local public good. The myopic model is the simplest and most commonly adopted approach (Epple, Filimon, and Romer, 1984).⁹ Alternatively, voters in a community might take the (t, g) pairs in other communities as given and then predict how changes in their community's tax rate will affect community population, public good quality, and the price of housing in their community. The myopic model is used extensively both in theoretical models and in empirical analysis. Our focus in this paper is on investigating in our equilibrium framework whether the myopic voting assumption provides a good fit of the data.

The community budget constraint, housing market clearing, and perceived migration effects define a locus of (g, p) pairs that determines the government-services possibility frontier, i.e. $\text{GPF} = \{g(t), p(t) \mid t \in R^+\}$. For given tax and expenditure policies in other communities, a point on the GPF that cannot be beaten in a majority vote is a majority equilibrium. Let $y_j(\alpha)$ be the implicit function defined by equation (4). Consider a point (g_j^*, p_j^*) on community j 's GPF, and let $\tilde{y}_j(\alpha)$ define a set of voters who weakly prefer (g_j^*, p_j^*) to any other (g_j, p_j) on the GPF. It follows from the assumption that the utility function satisfies the standard single-crossing properties that (g_j^*, p_j^*) is a majority voting equilibrium for the given GPF if

$$\int_0^\infty \int_{y_{j-1}(\alpha)}^{\tilde{y}_j(\alpha)} f(\alpha, y) dy d\alpha = \frac{1}{2} \int_0^\infty \int_{y_{j-1}(\alpha)}^{y_j(\alpha)} f(\alpha, y) dy d\alpha \quad (11)$$

⁹Fernandez and Rogerson (1996) provide a formalization of the timing of moving and voting that rationalizes this assumption on the part of the voters.

Note that $\tilde{y}_j(\alpha)$ defines a locus of pivotal voters.¹⁰

In order to characterize pivotal voters in a community, we need to derive an expression for the slope of the GPF. Recall that the GPF is defined as the locus of (g_j, p_j) such that housing markets are in equilibrium:

$$F_j(g_j, p_j, t_j) = H_j^d(g_j, p_j, t_j) - H_j^s(p_j, t_j) = 0 \quad (12)$$

and the community budget is balanced:

$$G_j(g_j, p_j, t_j) = c(g_j) - p_j \frac{t_j}{1+t_j} \frac{H_j^d(g_j, p_j, t_j)}{n_j} = 0 \quad (13)$$

given the perceived migration effects. Totally differentiating (12) and (13) and solving for dp_j/dg_j yields:

$$\left. \frac{dp_j}{dg_j} \right|_{GPF} = - \frac{\frac{G_{jg}}{G_{jt}} - \frac{F_{jg}}{F_{jt}}}{\frac{G_{jp}}{G_{jt}} - \frac{F_{jp}}{F_{jt}}} \quad (14)$$

The right-hand side of (14) does not have a simple closed form solution in general.

If voters are myopic, they ignore all effects of migration; i.e., voters treat the population boundaries of the communities as fixed. Hence, voters believe that the distribution of households across communities is not affected by a change in public good provision. Furthermore, if voters also treat housing demand and net-of-tax price of housing as fixed when

¹⁰A formal proof of a similar result is in Epple and Platt (1998) and the same argument applies in this model.

voting, then we obtain the simple myopic voting model:

$$\left. \frac{dp_j}{dg_j} \right|_{MV} = \frac{c'(g_j)}{H_j^d/n_j} \quad (15)$$

The right hand side of equation (15) gives the slope of the GPF as perceived by a myopic voter. The main technical advantage of the myopic voting model is that the slope of the GPF is basically a function of only two variables: the marginal cost of providing the public good and per capita housing demand. This formulation is implicit in all prior empirical work estimating demand functions for local public goods and traces to the pioneering work by Barr and Davis (1966) and Bergstrom and Goodman (1973).

To summarize, voters in each community decide about the level of provision of the public good, g , and the tax level, t . Mobility among communities is costless, and in equilibrium every household lives in his or her preferred community. Having specified all components of a (generic) equilibrium model, we define an intercommunity equilibrium as follows

Definition 1 *An intercommunity equilibrium consists of a set of communities, $\{1, \dots, J\}$; a continuum of households, C ; a distribution, P , of household characteristics α and y ; and a partition of C across communities $\{C_1, \dots, C_J\}$, such that every community has a positive population, i.e. $0 < n_j^* < 1$; a vector of prices and taxes, $(p_1^*, t_1^*, \dots, p_J^*, t_J^*)$; an allocation of public good expenditures, (g_1^*, \dots, g_J^*) ; a vector of public good qualities, (q_1^*, \dots, q_J^*) ; and an allocation, (h^*, b^*) , for every household (α, y) , such that:*

1. *Every household (α, y) , living in community j maximizes its utility subject to the*

*budget constraint:*¹¹

$$\begin{aligned} (h^*, b^*) &= \arg \max_{(h,b)} U(\alpha, q_j^*, h, b) \\ &s.t. \quad p_j^* h = y - b \end{aligned}$$

2. *Each household lives in one community and no household wants to move to a different community, i.e. for a household living in community j , the following holds:*

$$V(\alpha, q_j^*, p_j^*, y) \geq \max_{i \neq j} V(\alpha, q_i^*, p_i^*, y) \quad (16)$$

3. *The housing market clears in every community:*

$$\int_{C_j} h^*(p_j^*, y, \alpha) f(\alpha, y) dy d\alpha = H_j^s \left(\frac{p_j^*}{1 + t_j^*} \right) \quad (17)$$

4. *The population of each community, j , is given by:*

$$n_j^* = \int_{C_j} f(\alpha, y) dy d\alpha \quad (18)$$

¹¹Strictly speaking, all statements only have to hold for almost every household; deviations of behavior of sets of households with measure zero are possible.

5. *Public good qualities are determined in each community, j , by:*

$$q_j^* = q \left(g_j^*, \frac{\int_{C_j} y f(\alpha, y) dy d\alpha}{n_j^*} \right) \quad (19)$$

6. *The budget of every community is balanced:*

$$\frac{t_j^*}{1 + t_j^*} p_j^* \int_{C_j} h^*(p_j^*, y, \alpha) f(\alpha, y) dy d\alpha / n_j = c(g_j^*) \quad (20)$$

7. *There is a myopic voting equilibrium in each community: Over all levels of (g_j, t_j) that are perceived to be feasible allocations by the voters in community j , at least half of the voters prefer (g_j^*, t_j^*) over any other feasible (g_j, t_j) .*

If household preferences satisfy single-crossing properties, the existence of an intercommunity equilibrium has been shown in simpler versions of this model, *e.g.* models without taste variation and peer effects considered in Epple, Filimon, and Romer (1993).

Equilibria cannot be computed analytically. Instead we rely on numerical algorithms to find them. Computing an equilibrium requires us to solve a system of $3J$ nonlinear equations: J housing market equations, J budget-balance equations, and J equations characterizing pivotal voters. Thus computation of equilibria only exploits necessary conditions

that equilibria must satisfy. Once the algorithm has found such an allocation, one still needs to make sure that all second order conditions are satisfied.¹²

From the perspective of empirical analysis, housing supply in each community is not easily measured. By contrast, community populations are measured with a relatively high degree of accuracy. Hence our approach in this paper is to take observed community populations as equilibrium outcomes from the model that we have described. We take these populations as measured without error. This permits us to focus on household location and voting in our empirical analysis. More formally, we focus on allocations that satisfy the J budget equalities, the J equations characterizing pivotal voters, and $J - 1$ equations that constrain the observed populations to equal the predicted population sizes. These allocations are equilibria in the following sense. For any allocation that satisfies the $3J - 1$ equations above, there exist housing supply functions for each community such that housing markets are in equilibrium.¹³ An interesting extension, which we do not pursue in this paper, is to investigate the housing supply implied by the model.

The algorithm to compute equilibria takes observed community populations and the hierarchy of communities (ordered by mean income) as known (i.e. observed in the data). One advantage of this approach is that, for the parameterization we use for estimation (see Section 3), we can prove uniqueness of the equilibrium that gives rise to a given set of community populations and ordering of communities, taking voters to be myopic. For that

¹²An appendix that explains how to compute equilibria numerically is available from the authors.

¹³Since we are going from a system with $3J$ equations in $3J$ unknowns to a system with $3J - 1$ equations in $3J$ unknowns, one equilibrium variable is not determined. We solve this problem by normalizing the price of housing in the lowest community to be equal to 1. The appendix details how to compute these types of equilibria numerically for the parametrization introduced in Section 3.

parameterization, we have the following result:¹⁴

Proposition 1 *Given a set of equilibrium community populations, the associated equilibrium ordering of communities, and myopic voters, the equilibrium is unique.*

Our estimation approach takes observed community populations and the hierarchy of communities as known. We presume that the observed allocation is an equilibrium allocation. The result above shows uniqueness of the equilibrium that gives rise to a given set of community populations and ordering of communities, taking voters to be myopic. This uniqueness result is useful in justifying our estimation approach. Estimation is based on a full solution approach, i.e. at each parameter vector we compute the equilibrium of the model and match the predicted equilibrium to the one observed in the data. If the equilibrium were not unique, we would need to compute all equilibria at each parameter vector and find the one that matches the data the best. Proposition 1 establishes that at each parameter vector, there is only one equilibrium that is consistent with the observed community sizes and the observed hierarchy.

3 Estimation

Since we are interested in empirical analysis, it is necessary to parameterize the model. Let the joint distribution of $\ln(\alpha)$ and $\ln(y)$ be bivariate normal. The means of the distribution are denoted by $\mu_{\ln(y)}$ and $\mu_{\ln(\alpha)}$. The variances are $\sigma_{\ln(y)}^2$ and $\sigma_{\ln(\alpha)}^2$, and the correlation is

¹⁴A proof of Proposition 1 for the parametrization of the model used for the econometric analysis is given in the appendix.

denoted by λ . Furthermore, assume that the indirect utility function is given by:

$$V(q, p, y, \alpha) = \left\{ \alpha q^\rho + \left[e^{\frac{y^{1-\nu}-1}{1-\nu}} e^{-\frac{Bp^{\eta+1}-1}{1+\eta}} \right]^\rho \right\}^{\frac{1}{\rho}} \quad (21)$$

where the quality index q is given by:

$$q_j = g_j \left(\frac{\bar{y}_j}{\bar{y}} \right)^\phi \quad (22)$$

and $\rho < 0$, $\alpha > 0$, $\eta < 0$, $\nu > 0$, $\phi \geq 0$ and $B > 0$. We assume that while α can vary across households, ν , η , ρ , B and ϕ are the same for all agents. Roy's Identity applied to equation (21) implies that the individual housing demand function can be written as $h(p_j, y) = Bp^\eta y^\nu$. Given the utility function above, the locus of households indifferent between communities j and $j + 1$ can be written as:

$$\ln(\alpha) - \rho \left(\frac{y^{1-\nu} - 1}{1 - \nu} \right) = \ln \left(\frac{Q_{j+1} - Q_j}{q_j^\rho - q_{j+1}^\rho} \right) \equiv K_j \quad (23)$$

where

$$Q_j = e^{-\rho \frac{Bp_j^{\eta+1}-1}{1+\eta}} \quad (24)$$

The first-order condition of the voting problem can be expressed as:

$$\ln(\alpha) - \rho \left(\frac{y^{1-\nu} - 1}{1 - \nu} \right) = L_j \quad (25)$$

where the intercept, L_j , is given by

$$L_j = \ln \left[\frac{B e^{-\rho} \frac{B p_j^{\eta+1} - 1}{1+\eta} p_j^\eta \frac{dp_j}{dg_j}}{q_j^{\rho-1} \frac{\partial q_j}{\partial g_j}} \right] \quad (26)$$

The cost function is linear:

$$c(g_j) = g_j \quad (27)$$

Thus the 10 parameters of the model are $\mu_{\ln(y)}$, $\mu_{\ln(\alpha)}$, $\sigma_{\ln(y)}$, $\sigma_{\ln(\alpha)}$, λ , ρ , η , ν , B , and ϕ .¹⁵

The estimation procedure can be implemented in two stages. The first stage uses the model's implications regarding locational equilibrium, while the second stage incorporates voting equilibrium. We will briefly describe the first stage of the estimation procedure implemented in Epple and Sieg (1999), which we apply in this paper. We have made parametric assumptions on the joint distribution of income and tastes for the population of the metropolitan area and the indirect utility function of the households. With these assumptions, the model determines a joint distribution of income and taste parameters for every community. If the model is evaluated at the correct parameter values, the difference between the empirical quantiles of the income distributions observed in the data and the quantiles predicted by the model should be small. This provides the rationale for the first stage of the estimation.

¹⁵Note that the approach developed in this paper does not require us to specify a functional form for the housing supply function.

Equation (23) implies that quantiles of the income distribution of community j depend on (q_j, p_j) only through the community-specific intercepts K_j . We can, therefore, solve equation (8) recursively to obtain the community-specific intercepts, K_j , as a function of the parameters of the bivariate distribution of income and tastes, $(\mu_{\ln(y)}, \mu_{\ln(\alpha)}, \lambda, \sigma_{\ln(y)}, \sigma_{\ln(\alpha)})$, the parameters (ν, ρ) , and the community sizes, n_1, \dots, n_J . These community size restrictions in the estimation procedure pin down the values for the community-specific intercepts. We then estimate the parameters that are identified from community populations and income distributions by matching the quantiles of the income distributions subject to the constraint that community-specific intercepts are chosen to replicate observed community sizes.

Heterogeneity in tastes and income in the metropolitan population, together with self-selection of households into municipalities, means that income distributions will differ across municipalities in the metropolitan area. In equilibrium, the self-selection of the metropolitan population into municipalities results in boundary loci in the (α, y) plane that divide the metropolitan population into the various municipalities in the metropolitan area. The within-community income distributions that result thus depend on the shape and position of the boundary loci and on the parameters of the joint distribution of (α, y) . The empirical differences in the within-community distributions of income across municipalities prove to be sufficient to identify the parameters that determine the slope and shape of the boundary loci $(\rho/\sigma_{\ln(\alpha)}, \nu)$ and the correlation between tastes and income (λ) . The mean and variance of tastes are not identified in this stage because we do not exploit information on public good provision. The parameter ρ determines the slope of the indifference curve and hence affects sorting in equilibrium. Less obviously, the lack of identification of $\sigma_{\ln(\alpha)}$ also implies that

we can identify only the ratio $\rho/\sigma_{\ln(\alpha)}$ in the first stage. Finally, ν determines the curvature of the boundary indifference curves and hence the composition of populations within and among communities. Identification of ν thus rests on functional form assumptions of the indirect utility function since we do not exploit housing expenditure data at this stage of the analysis.

To summarize, in the first stage of the estimation procedure the following parameters, denoted by θ_1 , are identified: the mean and the standard deviation of the income distribution $(\mu_{\ln(y)}, \sigma_{\ln(y)})$, the correlation between income and tastes (λ), the income elasticity of demand for housing (ν), and the ratio of ρ to the standard deviation of the taste for public goods ($\sigma_{\ln(\alpha)}$). The estimates from this stage typically have a relatively high degree of precision because the relevant sample size is not the number of communities (J) but rather the number of households (N) sampled by the U.S. Census; i.e., the asymptotics of the first stage estimator only require N to go to infinity, for any given value of J .

That leaves us with five parameters to be estimated: the two remaining parameters of the housing demand equation η and B , as well as the mean and the standard deviation of the distribution of α and ϕ . In the absence of housing price data, it is hard to estimate η . We, therefore, set $\eta = -0.3$ and conduct some sensitivity analysis to demonstrate that our main results do not depend on the choice of η . Thus, in the second stage, we need to estimate the following parameters $\theta_2 = (\mu_{\ln(\alpha)}, \sigma_{\ln(\alpha)}, B, \phi)$. The rest of this section focuses on the second stage of the estimator, which differs from our previous work. Epple et al. (2001) derived necessary conditions that local public expenditures, housing prices, and tax rates had to satisfy in equilibrium. Here we follow a different approach. We compute equilibria,

thus forcing our predicted outcomes to satisfy all restrictions implied by theory. We then investigate how closely our model can predict the observed outcomes.

In the estimation, we incorporate the implications of the myopic voter assumptions. These are embodied in equations (15), (25), and (26). Together they imply that the first-order condition determining the level of expenditures in community j depends on (g_j, p_j) but not directly on the property tax rate t_j . Using the parameters and $J - 1$ boundary loci estimated in the first stage of the estimation and given values for $\theta = (\theta_1, \theta_2)$, we can calculate the implied equilibrium (g_j, p_j) for $j = 1, \dots, J$, up to an arbitrary normalization. (We adopt the normalization $p_1 = 1$.) Note that the equilibrium (g_j, p_j) pairs can be calculated without using any information about community land areas or parameters of the housing supply function. These are the key consequences of the property of myopic voting noted above. Having calculated the (g_j, p_j) pairs for all communities, the community budget constraints can be solved to obtain tax rates. In particular, the budget constraint for community j is

$$t_j p_j^h \bar{h}_j(p_j) = g_j \quad (28)$$

where

$$\bar{h}_j(p_j) = \int_{-\infty}^{\infty} \int_{y_{j-1}(\alpha)}^{y_j(\alpha)} h(p_j, y) f(\alpha, y) dy d\alpha / n_j \quad (29)$$

is per-household housing consumption in j . This and the identity $p_j = p_j^h(1 + t_j)$ imply:

$$t_j p_j \bar{h}_j(p_j) / (1 + t_j) = g_j \quad (30)$$

Given (g_j, p_j) and the community boundary loci, equation (30) can be solved for each j to obtain t_j . We do not observe the price per unit of housing services, p_j^h . Hence, we calculate the per capita annualized rental value of housing consumed in each community:

$$R_j = p_j^h \bar{h}_j(p_j).^{16}$$

Let $t_j(\theta_2|\hat{\theta}_1)$, $g_j(\theta_2|\hat{\theta}_1)$, $R_j(\theta_2|\hat{\theta}_1)$ denote, respectively, the tax rate, public expenditure level, and mean housing expenditures predicted by the model as a function of the parameters that have been estimated in the first round $\hat{\theta}_1$ and the parameters that need to be estimated in the second round θ_2 . We assume that the observed levels of these three variables differ from the ones predicted by our model because of measurement error:

$$\begin{aligned} t_j &= t_j(\theta_2|\hat{\theta}_1) + \epsilon_j^t \\ g_j &= g_j(\theta_2|\hat{\theta}_1) + \epsilon_j^g \\ R_j &= R_j(\theta_2|\hat{\theta}_1) + \epsilon_j^R \end{aligned} \quad (31)$$

We assume that the measurement errors, $(\epsilon_j^t, \epsilon_j^g, \epsilon_j^R)$, are jointly normally distributed. For each set of trial values of θ_2 , and given the first stage estimator $\hat{\theta}_1$, we solve for (g_j, t_j, R_j) in each community. We can then estimate the remaining parameters of the model using a

¹⁶The algorithm used to compute equilibria is discussed in the appendix.

maximum likelihood estimator.¹⁷ Obtaining these maximum likelihood estimates is the second stage of our estimation procedure.

We view the above estimation procedure as appealing for two reasons. First, it does not require estimates of the amount of land in each community that is available for residential development. Such measures are likely to be subject to substantial measurement error. Instead, we use community populations and income distributions. While these are also subject to measurement error, such measurement errors are likely to be small relative to errors in measuring land areas. Second, the two-stage approach permits us to exploit, in the first stage, the large sample (five percent of the metropolitan population) that is available for estimating community income boundaries and parameters of the distribution of income. The second stage then exploits the implications of household location and voting in determining community property values and local government expenditures and tax rates.

4 The Data Set

The data set used in this paper is based on the Boston Metropolitan area in 1980. Table 1 reports some descriptive statistics of the most important variables in the sample. The sample size of 92 equals the number of cities and townships in the Boston Metropolitan

¹⁷Our model may be misspecified. One of the main objectives of the analysis is to determine and evaluate the fit of the model. This exercise is well-defined even if our model is misspecified. In that case, it makes more sense to interpret the MLE as a quasi-maximum-likelihood estimator. Basic asymptotic theory suggests that the quasi-maximum-likelihood estimator is still well defined and converges almost surely to the parameter vector that minimizes the Kullback-Leibler discrepancy which measures the distance between our class of models and the true data generating process. Moreover, the limiting distribution of the quasi MLE is still asymptotically normal. Of course, the standard formula that we use for estimating asymptotic standard errors would need to be modified in this case to account for misspecification problems. For an introduction to the theory of misspecified MLE see, for example, Gallant (1997).

Area.¹⁸

TABLE 1

It is interesting to consider the relationship of the community budget constraint to residential property tax revenue. We have arrayed communities in order of increasing median household income and plotted residential property tax revenue and educational expenditure per household in Figure 1. As the lower two lines of the plot below show, residential property tax revenue and education expenditures per household track relatively well across the communities. The correlation coefficient is 0.73. This is striking given that the data come from different sources. The expenditure data are from the U.S. Census of Governments while data for tax rates and assessed residential property tax bases are from state government sources. Thus, we will view the residential property tax as earmarked for education and property tax as the only source of revenue for education.

FIGURE 1

Recall that housing consumption in our model is framed in terms of the flow of housing services. We consider the conversion of property values to annualized implicit rental values for the 1980 Boston data. Let R be annualized implicit rent and V be the housing value. These are related by the following identity:

$$R = k_p V \tag{32}$$

¹⁸Since a detailed discussion of the data is published in Epple et al. (2001), we provide details here only on issues that have not been previously discussed.

where, k_p is the user-cost factor (Poterba, 1992) given by the following expression:

$$k_p = (1 - t_y)(i + t_v) + \zeta \quad (33)$$

where t_y is the income tax rate, t_v is the tax rate on property value, i is the nominal interest rate, and $\zeta = \beta + m + \delta - \pi$ where β is the risk premium for housing investments, m and δ are maintenance and depreciation costs, and π is the inflation rate. We wish to calculate implicit rents net of the property tax, so we remove t_v from the previous expression. Following Poterba, let $\zeta = -.02$ and $i = .1286$. We set $t_y = .15$. Then,

$$k_p = .85 * (.1286) - .02. \quad (34)$$

Thus, the average user-cost factor for these communities is then:

$$k_p = .85 * (.1286) - .02. = .0893. \quad (35)$$

It is natural to question whether the assessed values ("equalized residential values" or ERV) provide an adequate measure of actual property values in communities. While this cannot be answered definitely, we can check the consistency between these values and values that community residents report to the U.S. Census. We converted rents into housing values using Poterba's formula, as discussed above. We then regressed equalized residential property value per household on aggregate owner-occupied property values (Census) and

the imputed values from aggregate rents (Census).¹⁹ The overall fit is high, with $R^2 = .94$. The coefficients on each of the right-hand side variables should be 1. For owner-occupied housing, we find that the estimated coefficient is 1.039 with an estimated standard error of 0.031. Thus we fail to reject the null hypothesis that the coefficient is equal to 1. Indeed, for owner-occupied housing, the correspondence between property tax assessments made by local and state government officials and the Census values obtained from individual owners' estimates of the values of their properties is remarkable. For rental housing, we find that the coefficient is equal to 0.7117 with an estimated standard error of 0.147. The null hypothesis that the coefficient equals 1 has p -value = .058.

We thus find that the user-cost factor seems to understate the extent to which rentals are converted to property values. If we add .05 to the user-cost factor (i.e., let $\zeta = .03$ instead of -.02), then we get a coefficient on the rental variable very close to 1 in our regression. Such an increase could be motivated by greater depreciation and maintenance costs than Poterba assumed or greater risk factor in housing investments. Alternatively, it may be that rental properties are under-assessed relative to owner-occupied properties. All in all, these regressions are overall relatively reassuring about the alternative house value measures that we have. In the empirical analysis of this paper, we use ERV as our measure of value.

FIGURE 2

Finally, we also need to convert tax rates on property values to rates on annualized implicit rental values to get a tax rate on the flow of housing services. The property tax

¹⁹The regression results are available upon request from the authors.

rate on implicit rental, R , is related to the property tax rate on value, V by the following identity:

$$t_r R = t_v V \quad (36)$$

Thus,

$$\begin{aligned} t_r &= t_v V/R = t_v/k_p = t_v/[(1 - t_y)i + \zeta] \\ &= t_v/ [.85 * .1286 - .02] \end{aligned} \quad (37)$$

Figure 2 plots the implied rates on imputed rental values.

5 Empirical Results

In the first stage of the estimation procedure, we match selected quantiles of the empirical income distributions of the communities with their predicted counterparts. The mean of log income, $\mu_{\ln(y)}$, is 9.790 with an estimated standard error of 0.002. The estimate of the standard deviation of log income, $\sigma_{\ln(y)}$, is 0.755 (0.004). The correlation between income and tastes for local public goods is -0.019 (0.031). The ratio $\rho/\sigma_{\ln(\alpha)}$ is -0.283 (0.013). Finally, the income elasticity of housing demand is estimated to be 0.938 (0.026).²⁰

TABLE 2

In this paper, we estimate the remaining parameters by matching the observed distri-

²⁰This part of the estimation procedure is identical to the one in Epple and Sieg (1999). These estimates are reproduced from Table 1 in that paper.

bution of tax rates, expenditures, and imputed rents as discussed in section 3. To provide a baseline, we first estimate the model without peer effects, i.e., setting $\phi = 0$. Column I of Table 2 reports the estimates for this baseline model. We find that the estimate for $\sigma_{\ln(\alpha)}$ reaches the lower boundary of 0.1, which is set in the estimation algorithm to keep $\sigma_{\ln(\alpha)}$ positive. With $\sigma_{\ln(\alpha)} = .1$, the implied value of ρ is given by the first-stage coefficient restriction that $\rho = -.283 * \sigma_{\ln(\alpha)} = -.0283$. Our estimate for $\mu_{\ln(\alpha)}$ is -2.623. Our estimate for B is 0.325. These estimates are not of great intrinsic interest, but they are needed to calculate the predicted equilibrium quantities of interest.²¹

FIGURE 3

Next we focus on the goodness of fit of the baseline model. First, Figure 3 plots observed and predicted expenditures, rents, and tax rates. We find that the model fits the observed expenditure patterns reasonably well, though with some overstatement of expenditures in the poorer communities and some understatement in the higher-income communities.²² The correlation between observed and predicted expenditures is 0.727. Imputed rents serve as both equilibrium housing consumption and the tax base in our model. The model somewhat over-predicts rents for poor communities and under-predicts rents for high income communities. The correlation coefficient is 0.94. Finally, we consider observed and predicted tax rates. Here the results are not favorable and point to a serious lack of fit. The over-prediction of housing values in the poorer communities and under-prediction of expenditures combine to create a severe under-prediction of tax rates in the poorer communities.

²¹We have verified that the second-order conditions are satisfied for these estimates.

²²The term “expenditures” refers to local spending on education.

Similarly, in the wealthier communities, the under-prediction of housing values and over-prediction of expenditures create an over-prediction of tax rates. Thus, while observed tax rates decrease in community rank, the model predicts tax rates increasing in community rank. The correlation between observed and predicted tax rates is $-.67$. This failure to fit tax rates is a serious shortcoming of the baseline model. We also conducted some sensitivity analysis. Changing the price elasticity, η , from $-.3$ to $-.5$ has negligible effect on the likelihood function.

FIGURE 4

We next turn to results obtained when peer effects are included. The parameter estimates are shown in Column II of Table 2. We find that the estimate of ϕ is large and statistically significant. Expressing the exponent of the quality function in relative terms, our estimates imply that the peer effects are 2.5 times as important as spending. Introducing peer effects into the model specification also markedly improves the fit of the model, as documented in Figure 4. We find that the model with peer effects can not only explain expenditures, but also tax rates and tax bases (rents) reasonably well. In particular, we find that the correlation between actual and predicted tax rates is 0.747 . We thus conclude that the extended myopic voting model that allows for peer effects in public good provision fits our data very well.

In the estimation, we treat housing prices as latent. Our model predicts that housing prices (per unit of housing consumption) vary from 1.0 in the lowest community to 5.14

in the most expensive community.²³ These price differences are similar compared to those found by quite different methods in empirical work such as Sieg, Smith, Banzhaf, and Walsh (2002).

6 Discussion

Epple et al. (2001), working with a model without peer effects, found that the parameter estimates from the locational equilibrium and voting equilibrium components of the model led to different results that were difficult to reconcile. Our results provide a resolution of this puzzle: generalizing the model to incorporate peer effects eliminates the apparent inconsistency. It is natural to ask whether explanations other than peer effects might be responsible for the unsatisfactory results found when peer effects are not included. In addition, if peer effects are operative, it is appropriate to ask whether it is possible to provide evidence about the channels through which peer effects operate. We address both of these questions below.

Our model presumes that the marginal source of funds for increasing a community's educational expenditures is the community's residential property tax. It is natural to wonder whether the poor fit of the baseline model (i.e., the model without peer effects) may be due to failure to incorporate factors that affect incentives for local property taxation.

We explored whether intergovernmental aid formulas might have embodied features that significantly affected marginal incentives for local taxation. After extensive investigation,

²³In the model without peer effects prices ranged from 1 to 1.6.

we concluded that this is not the case. The state aid formula applicable during the period from which our data are drawn specified aid as a function of the local property tax base and school enrollment.²⁴ The school enrollment variable in the formula gave higher weight to disadvantaged students. In addition, greater aid went to districts with lower property tax base per capita. Thus, both components of the aid formula had the effect of directing greater aid to lower-income municipalities. A key aspect of the formula is that, beyond a threshold, aid was not conditioned on the local tax rate or local expenditures. Thus, because it was not tied to local taxation or expenditure, the aid provided by the state would tend to induce localities to respond by lowering their tax rates. Moreover, since aid was higher to lower-income communities, the associated tax rate reduction would tend to be higher in poorer communities. Recall that a major shortcoming of the fit of the model without peer effects is that it substantially underpredicts tax rates in poorer communities. If anything, incorporating state aid into the model would worsen the fit of the model to the data by inducing even lower predicted tax rates in poorer communities.²⁵

We explored a second possibility, related to taxation of non-residential property. Suppose poorer municipalities have proportionately more non-residential property than wealthier municipalities. If localities were required to impose the same tax rate on both residential and non-residential property, then poorer municipalities might have an incentive to raise the property tax rate in order to extract additional revenue from non-residential

²⁴The relevant statute is *Acts and Resolves of Massachusetts*, 1978, ch. 367, amending ch. 70, "School Funds and State Aid for Public Schools."

²⁵There is one potentially important caveat to the preceding discussion. In order to receive the full amount of aid specified by the formula, a municipality was required to meet a threshold spending level from own sources. Unfortunately, the data are not sufficient to permit us to determine whether that condition was binding on any municipalities.

sources.²⁶ During the time period from which our data are drawn, Massachusetts state law did require that the same property tax rate be imposed on both types of property. However, municipalities routinely circumvented this requirement by assessing residential and non-residential properties at different rates (Bradbury, 1988). The poorest municipalities all imposed higher effective rates on non-residential than on residential property. Thus, presence of non-residential property does not appear to have created incentives for poor communities to increase tax rates on residential property.

A third potential issue relates to the possibility that our peer measure (mean income) is proxying for some other factor unrelated to peer influences. Dunz (1989) and Nechyba (1997) appeal to heterogeneity of the housing stock, and the high degree of durability of the stock, as an important factor generating income sorting within and across jurisdictions.²⁷ It is undoubtedly the case that a household's location is influenced by the character of available housing. In our model, the role of housing in sorting is captured by the price per unit of housing services. Thus, cross-community variation in mean housing quality is captured by cross-community variation in this price variable. Might this representation be an oversimplification, with the consequence that mean income serves as proxy for variation across communities in the average quality of the housing stock? To provide some evidence regarding this possibility, we investigated the cross-community relationship between mean community income and the age distribution of the housing stock. In particular, we estimated a regression of mean income against variables that reflect the proportion of houses built prior

²⁶The extent of any such incentive would depend on the relative "exportability" of taxes on residential and non-residential activities.

²⁷It is quite possible, of course, that both housing stock and peer effects drive sorting. In Nechyba's model, for example, sorting across communities in his analysis is presumed to be driven in part by such peer effects.

to 1940 and the proportions built in each subsequent decade. The results of this regression are reported in Table 3. We see from this regression that mean community income bears a non-monotonic relationship to age of the housing stock. The coefficient on fraction built in the 1950's is significantly higher than either the coefficient on fraction built before 1940 or the coefficient on the fraction built in the 1970's. While age is an imperfect measure of housing quality, these findings suggest that mean income is playing a role beyond serving as a proxy for community housing stock.

TABLE 3

While the evidence we have provided cannot conclusively rule out alternative interpretations, viewing our findings as evidence for peer effects is a natural interpretation, and this interpretation is very much in accord with most current models of inter-community choice. Indeed, we see our approach, contrasting the fit of general equilibrium models with and without peer effects, as an appealing strategy for investigating the importance of peer effects. If one provisionally accepts our findings as evidence of peer effects, it is then natural to ask what mechanism gives rise to these peer effects. As is now well known, identification in models with peer effects is exceedingly challenging.²⁸ While we cannot resolve these identification problems with the data available to us, we can provide some suggestive evidence.²⁹

²⁸See the discussion in Manski (1993), Moffitt (2001), Brock and Durlauf (2001).

²⁹Ideally, we would like to have measures of student aptitude and achievement, with students matched to the households in which they reside. We could then augment our model, treating α as a vector, with student ability as a component of that vector. Estimating the model to account for the effects of ability on sorting, and the effects of school quality, including peers, on educational achievement, would then provide value evidence for identifying peer effects.

As we emphasized earlier, the peer effects that we find may be due either to "production" or "consumption" externalities. Peer effects that have received particular emphasis are those operating through schools.³⁰ If that is the primary mechanism for peer effects, then one would expect that households without children would locate where peer quality is low, avoiding the housing price premium for externalities that are not of value to them. Thus, we would expect that families with school-age children would tend to locate where the peer variable is higher, and households without children would locate where the peer variable is relatively low. To provide some evidence in this regard, we calculated the correlations of the logarithm of mean household income with fraction of households that are families (.57), school enrollment per household (.32), and fraction of the population over age 65 (-.38). To the extent that peer effects operate through education of children, the education of the adult population may provide a measure of both the value attached to education and the resources available to facilitate student learning. To investigate this, we regressed the logarithm of mean household income on a constant, the fraction of the population with high school education, and the fraction with more than high school education. The estimated coefficients were 8.3, 1.4, and 2.4 respectively, all highly significant, and the $R^2 = .83$. Thus, the peer variable that we use, mean community income, is strongly related to the education of the community population. While the evidence summarized in this paragraph is only suggestive, it is consistent with the peer effects interpretation of the results from our structural estimation.

³⁰Recent empirical studies include Arcidiacono and Nickolson (2005), Betts and Morell (1999), Dale and Krueger (1998), Sacerdote (2001), and Zimmerman (2000). Rothstein (2004) considers the determinants of school choice and the possible role of peer effects in a setting where sorting among communities may be important.

7 Conclusions

Few empirical strategies have been developed that investigate public provision under majority rule while taking explicit account of the constraints implied by mobility of households. In this paper, we have explored the implications of the myopic voter model when peer effects are important aspects of neighborhood quality. We have specified a locational equilibrium model with peer effects, characterized its equilibrium properties, and derived a new algorithm to compute equilibria. Moreover, we have developed a new empirical approach that imposes all restrictions that arise from these equilibrium models on the data generating process. This allows us to study the goodness of fit of the model and helps us determine which dimensions of the data can or cannot be explained by our model.

While the myopic voting model without peer effects can replicate many important stylized features of the data, including the observed expenditure patterns, it yields distributions of property tax rates that differ significantly from the ones observed in the data. Our model predicts that tax rates are higher in high income communities than in low income communities. In the data, we observe the opposite: high income communities have on average lower property tax rates than poor communities. We also find that the implied mean housing expenditures are too low in the predicted equilibrium for rich communities and too high for poor communities. This shortcoming is not present in a generalization of the model that incorporates peer effects. Our findings are encouraging in demonstrating that a relatively simple equilibrium model of sorting and public good provision fits all aspects of the data well—community income distributions, housing expenditures, public good provision

levels, and property tax rates. The results also suggest that peer effects may be important components in determining the quality of local public good provision.

A natural generalization in future research is to express α as a vector, and to exploit data on the distribution of household demographic variables such as age, education, race/ethnicity, and family size in estimating the model. Of course, this adds to the challenge of estimation, since solving for equilibrium is more computationally demanding in such an extended framework. However, the computationally efficient strategy we have developed in this paper extends quite naturally to such more general settings, opening the door to a much broader range of applications of the framework. It is also useful to note that the communities in our model need not be separate municipalities. Neighborhoods within jurisdictions that have distinct local amenities can be treated as separate communities, with the locally provided good having both a governmentally provided and an endowed component.³¹

In closing, it is important to return to an issue raised earlier in this paper, namely the observational equivalence of alternative channels through which peer effects may operate. In particular, our estimated peer effect may reflect both consumption externalities (rubbing elbows with wealthy neighbors or enjoyment of proximity to attractive houses of wealthy neighbors) and production externalities (enhanced learning of children due to peer interactions in schools or the influence of positive role models in the neighborhoods). The peer effect that we find may well reflect a combination of such factors. The policy implications of these alternative mechanisms are clearly quite different. Thus, an important continuing agenda for research on local communities is development of data and identification strategies

³¹See, for example, Sieg et al. (2004).

that can separate these alternative interpretations.

Acknowledgments

This is a revised version of a paper that was prepared for the TAPES Conference on Fiscal Federalism in Munich, May 2004. We thank Tim Besley, Soren Blomquist, Roger Gordon, Antonio Merlo, James Poterba, Richard Rogerson, and Jesse Rothstein for comments and suggestions. We also thank participants at TAPES and a PIER conference on political economy at the University of Pennsylvania, and workshops at Arizona State, the University of Florida, and UCLA for their comments. Frederico Gil Sander and Fernando Botelho provided research assistance. We would also like to thank the National Science Foundation and the MacArthur Foundation for financial support.

Appendix: Existence, Uniqueness, and Computation of Equilibrium

We first draw together key results that will be used in our proof. Let (p_j, q_j) , $j = 1, \dots, J$ be arrayed in ascending order. For each adjacent pair of communities in this ordering, there is a locus of household types in the $(\ln y, \ln \alpha)$ plane that is indifferent between those communities. Our utility function is:

$$V = \left\{ \alpha q^\rho + e^{\rho \frac{y^{1-\nu}-1}{1-\nu}} e^{-\rho \frac{Bp^{\eta+1}-1}{1+\eta}} \right\}^{\frac{1}{\rho}} \quad (38)$$

Hence, the condition determining the locus of households indifferent between adjacent communities is:

$$\left\{ \alpha q_j^\rho + e^{\rho \frac{y^{1-\nu}-1}{1-\nu}} e^{-\rho \frac{Bp_j^{\eta+1}-1}{1+\eta}} \right\}^{\frac{1}{\rho}} = \left\{ \alpha q_{j+1}^\rho + e^{\rho \frac{y^{1-\nu}-1}{1-\nu}} e^{-\rho \frac{Bp_{j+1}^{\eta+1}-1}{1+\eta}} \right\}^{\frac{1}{\rho}} \quad \text{for } j = 1, \dots, J-1 \quad (39)$$

Solving the above boundary-indifference condition for $\ln \alpha$ and evaluating at the point where $\ln y = 0$ (i.e., $y = 1$), we obtain the vertical intercept of the boundary locus in the $(\ln y, \ln \alpha)$ plane. We denote the intercept of the locus between communities j and $j+1$ as K_j . From equation (39) we obtain:

$$K_j = \ln \left(\frac{e^{-\rho \frac{Bp_{j+1}^{\eta+1}-1}{1+\eta}} - e^{-\rho \frac{Bp_j^{\eta+1}-1}{1+\eta}}}{g_j^\rho \left(\frac{\bar{y}_j}{y}\right)^{\rho\phi} - g_{j+1}^\rho \left(\frac{\bar{y}_{j+1}}{y}\right)^{\rho\phi}} \right) \quad j = 1, \dots, J-1 \quad (40)$$

The K_j are estimated in the first stage of Epple and Sieg (1999) (ES, 1999) and are taken as given for our analysis in this paper. As a shorthand below, we will refer to equation (40) as the condition for mobility equilibrium.

Within each community, voting equilibrium is characterized by the requirement that there be a locus of households all sharing the same most-preferred local public goods bundle, such that half of the community population lies on either side of the locus. The first-order condition for g_j for a household on that locus is:

$$\alpha \rho q_j^{\rho-1} \frac{dq_j}{dg_j} - e^{\rho \frac{y^{1-\nu}-1}{1-\nu}} e^{-\rho \frac{B p_j^{\eta+1}-1}{1+\eta}} \rho B p_j^\eta \frac{dp_j}{dg_j} = 0 \quad (41)$$

The identity relating gross- and net-of-tax housing prices combined with the community budget constraint yields:

$$p = p_h + t p_h = p_h + \frac{g}{H^d/n} \quad (42)$$

The preceding and the myopic voting assumption yield:

$$\frac{dp}{dg} = \frac{1}{H^d/n} = \frac{1}{B p^\eta Y^\nu / n} = \frac{1}{B p^\eta \overline{Y}^\nu} \quad (43)$$

where

$$\overline{Y}_j^\nu = \int_{c_j} y^\nu f(\alpha, y) d\alpha dy / n_j \quad (44)$$

The production function for quality of the local public good is:

$$q_j = g_j \left(\frac{\bar{y}_j}{\bar{y}} \right)^\phi \quad (45)$$

This in turn implies:

$$\frac{dq_j}{dg_j} = \left(\frac{\bar{y}_j}{\bar{y}} \right)^\phi \quad (46)$$

Hence, the first-order condition for a voter on the pivotal locus is:

$$\alpha e^{-\rho \frac{y^{1-\nu}-1}{1-\nu}} = \frac{e^{-\rho \frac{Bp_j^{\eta+1}-1}{1+\eta}} Bp_j^\eta \frac{1}{Bp_j^\eta \bar{Y}_j^\nu}}{\left(g_j \left(\frac{\bar{y}_j}{\bar{y}} \right)^\phi \right)^{\rho-1} \left(\frac{\bar{y}_j}{\bar{y}} \right)^\phi} = \frac{e^{-\rho \frac{Bp_j^{\eta+1}-1}{1+\eta}}}{g_j^{\rho-1} \left(\frac{\bar{y}_j}{\bar{y}} \right)^{\phi\rho} \bar{Y}_j^\nu} \quad (47)$$

The vertical intercept of the preceding locus in the $(\ln y, \ln \alpha)$ plane is the value of $\ln \alpha$ when $\ln y = 0$. We denote this intercept L_j . From the preceding:

$$L_j = \ln \left(\frac{e^{-\rho \frac{Bp_j^{\eta+1}-1}{1+\eta}}}{g_j^{\rho-1} \left(\frac{\bar{y}_j}{\bar{y}} \right)^{\phi\rho} \bar{Y}_j^\nu} \right) \quad j = 1, \dots, J \quad (48)$$

The L_j are thus determined from the stage-one estimates. As a shorthand, we denote equation (48) as the voting equilibrium condition.

Finally, within each community, budget balance requires:

$$t_j \frac{p_j}{1+t_j} Bp_j^\eta \bar{Y}_j^\nu = g_j \quad j = 1, \dots, J \quad (49)$$

A necessary condition for equilibrium is that q_j , p_j , and K_j ascend across communities in the same order. The loci defined by equation (39) do not cross. Thus, ascension of the K_j impounds the property of income stratification. That is, all individuals of type α in community j have higher incomes than the wealthiest individual of type α in community $j - 1$. In light of this income stratification property, it is natural to expect that the \bar{y}_j and \bar{Y}_j^p will ascend across communities in the same order as the K_j . We find this to be the case in the first-stage estimates in ES (1999). However, it is possible to contrive distributions of (y, α) such that this is not the case. The following assumption rules out such distributions.

Assumption 1 (A1) \bar{y}_j and \bar{Y}_j^p ascend across communities in the same order as K_j .

We also assume:

Assumption 2 (A2) *The price elasticity of housing demand satisfies $-1 < \eta < 0$.*

Proposition 1: *Given community populations and the ordering of mean incomes, \bar{y}_j , across communities, equilibrium exists and is unique.*

Proof: In light of A1, the K_j ascend across communities in the same order as the \bar{y}_j . Given community populations and the ordering of communities, the K_j are uniquely determined by the recursion described in detail in ES, 1999, Equation (14). Given the community-specific intercepts, the boundary loci delineating communities are as given by equation (39). This in turn implies that the distribution of (α, y) types in each community is known. The community-specific voting intercepts are then uniquely determined by the requirement that half the population of each community lie on either side of the locus of pivotal voters.

It remains to show that, given the preceding, the internal equilibrium in each community is unique. Thus, we must show existence and uniqueness of the solution to equations (40), (48), and (49). We denote this solution $(\widehat{p}_j, \widehat{g}_j, \widehat{t}_j)$, $j = 1, \dots, J$. We first show existence and uniqueness of $(\widehat{p}_j, \widehat{g}_j)$, $j = 1, \dots, J$ in equations (40) and (48).

Given the normalization $p_1 = 1$, equation (48) can be solved to yield a unique closed-form solution for g_1 . The remainder of the proof is by induction. Given $(\widehat{p}_1, \widehat{g}_1)$, the following conditions determine (g_2, p_2) .

$$K_2 = \ln \left(\frac{e^{-\rho \frac{Bp_2^{\eta+1}-1}{1+\eta}} - e^{-\rho \frac{B\widehat{p}_1^{\eta+1}-1}{1+\eta}}}{\widehat{g}_1^\rho \left(\frac{\bar{y}_1}{y}\right)^{\rho\phi} - g_2^\rho \left(\frac{\bar{y}_2}{y}\right)^{\rho\phi}} \right) \quad (50)$$

$$L_2 = \ln \left(\frac{e^{-\rho \frac{Bp_2^{\eta+1}-1}{1+\eta}}}{g_2^{\rho-1} \left(\frac{\bar{y}_2}{y}\right)^{\rho\phi} Y_2^\nu} \right) \quad (51)$$

Solve equation (48) for g_j :

$$g_j = \left(\frac{e^{-\rho \frac{Bp_j^{\eta+1}-1}{1+\eta}}}{\left(\frac{\bar{y}_j}{y}\right)^{\rho\phi} Y_j^\nu e^{L_j}} \right)^{1/(\rho-1)} \quad (52)$$

Using the preceding equation for $j = 1$ and $j = 2$, we substitute for \widehat{g}_1 and g_2 in equation

(50) to obtain:

$$K_2 = \ln \frac{e^{-\rho \frac{Bp_2^{\eta+1}-1}{1+\eta}} - e^{-\rho \frac{B\hat{p}_1^{\eta+1}-1}{1+\eta}}}{\left(\frac{e^{-\rho \frac{B\hat{p}_1^{\eta+1}-1}{1+\eta}}}{\left(\frac{\bar{y}_1}{y}\right)^{\rho\phi} \bar{Y}_1^\nu e^{L_1}} \right)^{\rho/(\rho-1)} \left(\frac{\bar{y}_1}{y}\right)^{\rho\phi} - \left(\frac{e^{-\rho \frac{Bp_2^{\eta+1}-1}{1+\eta}}}{\left(\frac{\bar{y}_2}{y}\right)^{\rho\phi} \bar{Y}_2^\nu e^{L_2}} \right)^{\rho/(\rho-1)} \left(\frac{\bar{y}_2}{y}\right)^{\rho\phi}} \quad (53)$$

Simplifying and exponentiating:

$$e^{K_2} = \frac{e^{-\rho \frac{Bp_2^{\eta+1}-1}{1+\eta}} - e^{-\rho \frac{B\hat{p}_1^{\eta+1}-1}{1+\eta}}}{\left(e^{-\rho \frac{B\hat{p}_1^{\eta+1}-1}{1+\eta}} \right)^{\rho/(\rho-1)} \left[\bar{Y}_1^\nu e^{L_1} \left(\frac{\bar{y}_1}{y}\right)^\phi \right]^{-\frac{\rho}{\rho-1}} - \left(e^{-\rho \frac{Bp_2^{\eta+1}-1}{1+\eta}} \right)^{\rho/(\rho-1)} \left[\bar{Y}_2^\nu e^{L_2} \left(\frac{\bar{y}_2}{y}\right)^\phi \right]^{-\frac{\rho}{\rho-1}}} \quad (54)$$

Candidate solutions to equation (54) must satisfy the requirement that prices ascend in the same order as the K_j , implying $p_2 > \hat{p}_1$. In addition, since the LHS of (54) is positive, candidate values of p_2 must yield a positive expression for the RHS. Denote the RHS by $R_2(p_2)$. The numerator of $R_2(p_2)$ is positive for all $p_2 > \hat{p}_1$. Thus, for admissible values of p_2 , the denominator must be positive. This in turn requires:

$$p_2^{\eta+1} < B\hat{p}_1^{\eta+1} - \frac{1+\eta}{\rho} \ln \left(\frac{\bar{Y}_2^\nu e^{L_2} \left(\frac{\bar{y}_2}{y}\right)^\phi}{\bar{Y}_1^\nu e^{L_1} \left(\frac{\bar{y}_1}{y}\right)^\phi} \right) \quad (55)$$

The L_j ascend in the same order as the \bar{Y}_j^ν and the \bar{y}_j . Thus, $\bar{Y}_2^\nu e^{L_2} \left(\frac{\bar{y}_2}{y}\right)^\phi > \bar{Y}_1^\nu e^{L_1} \left(\frac{\bar{y}_1}{y}\right)^\phi$.

In addition, by Assumption 2, $-\frac{1+\eta}{\rho} > 0$. Thus the right-hand side of equation (55) is

greater than $B\widehat{p}_1^{\eta+1}$. Let p_2^x solve:

$$p_2^x = \left[B\widehat{p}_1^{\eta+1} - \frac{1+\eta}{\rho} \ln \left(\frac{\overline{Y}_2^\nu e^{L_2 \left(\frac{\overline{y}_2}{\overline{y}} \right)^\phi}}{\overline{Y}_1^\nu e^{L_1 \left(\frac{\overline{y}_1}{\overline{y}} \right)^\phi}} \right) \right]^{\frac{1}{\eta+1}} \quad (56)$$

The range of potential solutions of equation (54) must satisfy $p_2 \in (p_1, p_2^x)$. Note that $R_2(p_2)$ is continuous on (p_1, p_2^x) , $\lim_{p_2 \rightarrow \widehat{p}_1} R_2(p_2) = 0$, and $\lim_{p_2 \rightarrow p_2^x} R_2(p_2) = \infty$. This establishes existence of a solution to equation (54).

Let $R_2^n(p_2)$ and $R_2^d(p_2)$ be respectively the numerator and denominator of $R_2(p_2)$. Differentiating $R_2(p_2)$ we obtain:

$$\frac{dR_2(p_2)}{dp_2} = \frac{R_2^d(p_2) \frac{dR_2^n(p_2)}{dp_2} - R_2^n(p_2) \frac{dR_2^d(p_2)}{dp_2}}{(R_2^d(p_2))^2} \quad (57)$$

where

$$\frac{dR_2^n(p_2)}{dp_2} = -\rho B p_2^\eta e^{-\rho \frac{B p_2^{\eta+1} - 1}{1+\eta}} > 0 \quad (58)$$

$$\frac{dR_2^d(p_2)}{dp_2} = \frac{\rho^2}{\rho-1} B p_2^\eta \left(e^{-\rho \frac{B p_2^{\eta+1} - 1}{1+\eta}} \right)^{\rho/(\rho-1)} \left[\overline{Y}_2^\nu e^{L_2 \left(\frac{\overline{y}_2}{\overline{y}} \right)^\phi} \right]^{-\frac{\rho}{\rho-1}} < 0 \quad (59)$$

The above conditions coupled with $R_2^n(p_2) > 0$ and $R_2^d(p_2) > 0$ imply that $\frac{dR_2(p_2)}{dp_2} > 0$.

This establishes uniqueness of the solution to equation (54).

Completing the induction argument, suppose there is a unique $(\widehat{p}_j, \widehat{g}_j)$. Repeating the preceding argument replacing subscripts 1 and 2 with j and $j+1$ respectively then serves

to demonstrate that there exists a unique $(\hat{p}_{j+1}, \hat{g}_{j+1})$.

Given existence of unique (\hat{p}_j, \hat{g}_j) , $j = 1, \dots, J$, tax rates are uniquely determined by equation (49). QED

Computation of equilibrium: Our proof of equilibrium leads to a simple strategy for computation of equilibrium. Given $\hat{p}_1 = 1$, the following univariate nonlinear equation is solved recursively for $\hat{p}_2, \hat{p}_3, \dots, \hat{p}_J$.

$$e^{K_j} = \frac{e^{-\rho \frac{Bp_{j+1}^{\eta+1} - 1}{1+\eta}} - e^{-\rho \frac{B\hat{p}_j^{\eta+1} - 1}{1+\eta}}}{\left(e^{-\rho \frac{B\hat{p}_j^{\eta+1} - 1}{1+\eta}} \right)^{\frac{\rho}{\rho-1}} \left[\bar{Y}_j^\nu e^{L_j} \left(\frac{\bar{y}_j}{\bar{y}} \right)^\phi \right]^{-\frac{\rho}{\rho-1}} - \left(e^{-\rho \frac{Bp_{j+1}^{\eta+1} - 1}{1+\eta}} \right)^{\frac{\rho}{\rho-1}} \left[\bar{Y}_{j+1}^\nu e^{L_{j+1}} \left(\frac{\bar{y}_{j+1}}{\bar{y}} \right)^\phi \right]^{-\frac{\rho}{\rho-1}}} \quad (60)$$

Given the \hat{p}_j , $j = 1, \dots, J$, equation (52) yields unique values of \hat{g}_j , $j = 1, \dots, J$.

Given the (\hat{p}_j, \hat{g}_j) , $j = 1, \dots, J$, tax rates, t_j , $j = 1, \dots, J$, are obtained from the community budget balance equation (49) above.

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Table 1: Descriptive Statistics of the Sample

Variable	Mean	Std. Deviation
Population size	30036	59719
Number of households	10769	23335
Mean income ^a	27402	8024
Median income ^a	24108	6481
Education expenditure ^a	1479	435
Property tax rate ^b	0.031	0.009
Median property value ^a	64923	21515
Median gross rent ^a	314.35	58.22
Fraction of renters	0.28	0.16

Table 1 provides summary statistics for the 92 communities in the Boston Metropolitan Area in 1980. The notation ^a indicates that the value is per household. The notation ^b indicates that the variable is measured per dollar of value.

Table 2: Estimation Results

	I	II
parameters	baseline model	extended model
$\mu_{\ln(\alpha)}$	-2.622 (0.021)	-2.643 (0.017)
$\sigma_{\ln(\alpha)}$	0.1 —	0.1 —
B	0.325 (0.006)	0.175 (0.007)
ϕ	0.0 —	2.623 (0.147)
likelihood function	-1360.92	-996.51
R^2 expenditures	0.680	0.739
R^2 rents	0.786	0.930
R^2 taxes	- 0.301	0.728

Column I reports the estimates for the model without peer effects.

Column II reports the estimates for this model with peer effects.

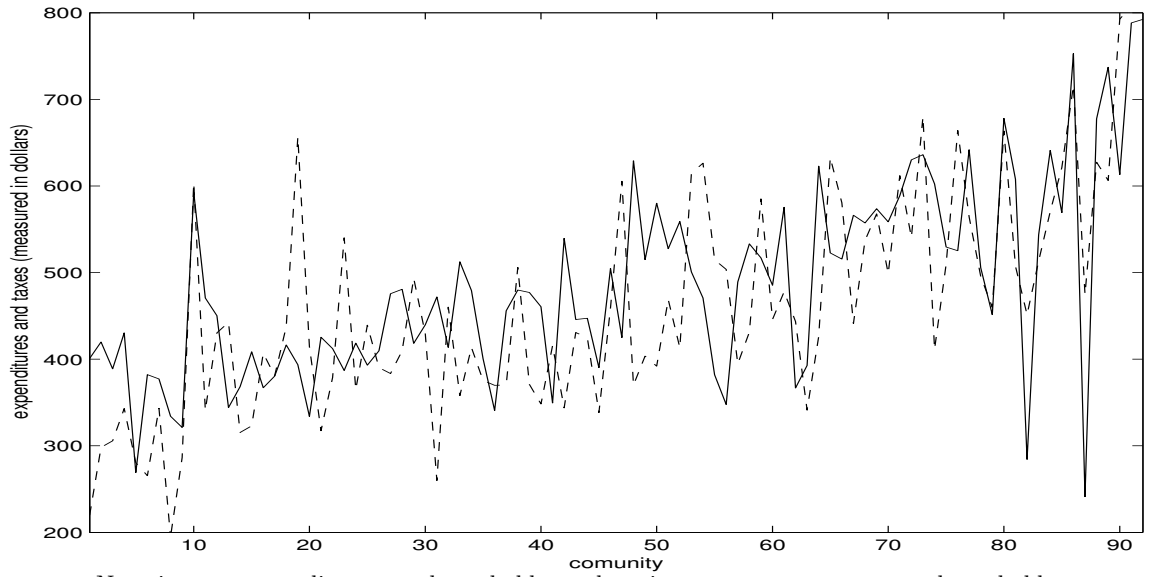
Estimated standard errors are given in parentheses.

Table 3: Mean Income and Age of Housing

	Coefficient	t-statistic
Before 1939	17186.66	4.016
1940-49	6892.59	0.270
1950-59	56489.98	4.716
1960-69	37179.83	3.058
1970-80	18513.01	1.779
$R^2 = .26, J = 92.$		

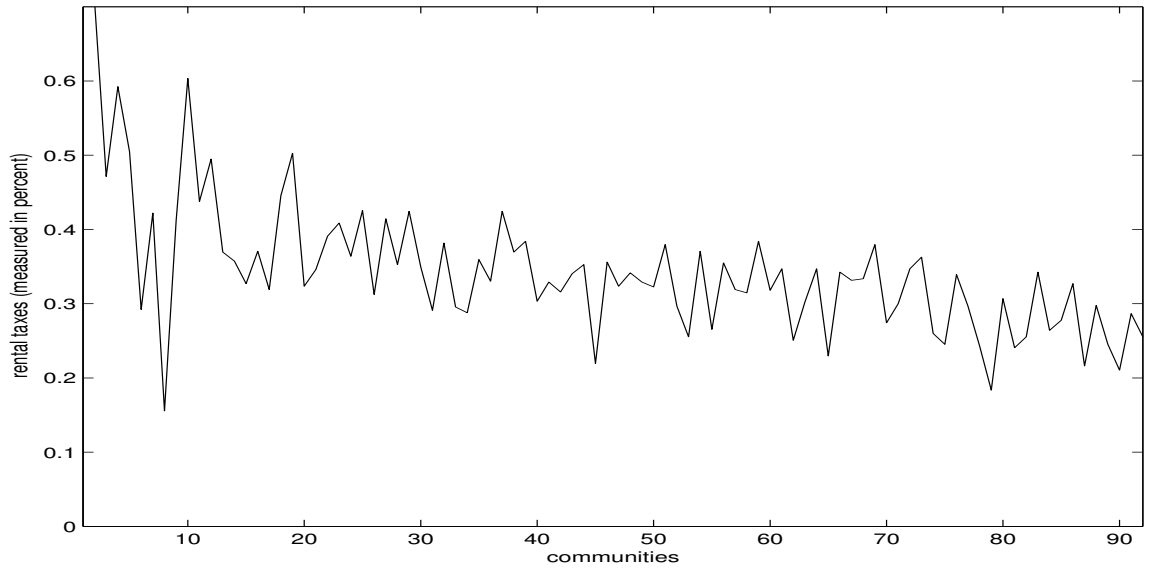
This table reports the parameter estimates from a regression of mean income against variables that reflect the proportion of houses built prior to 1940 and the proportions built in each subsequent decade

Figure 1: Residential Property Tax Revenue and Educational Expenditure per Household



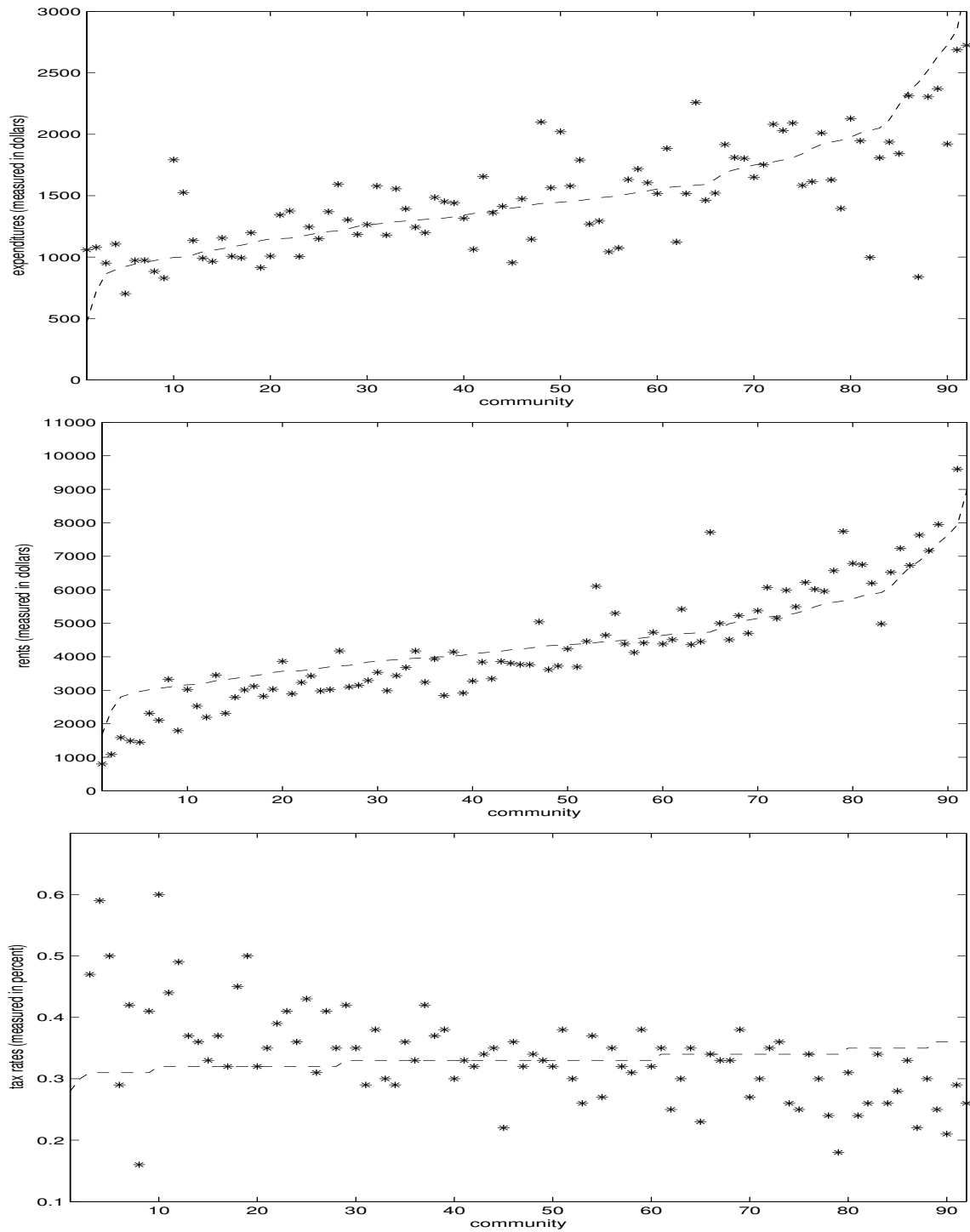
Notation: — expenditures per household on education, - - property taxes per household
Communities are arrayed in order of increasing median household income.

Figure 2: Equalized Residential Tax on Imputed Rental Values



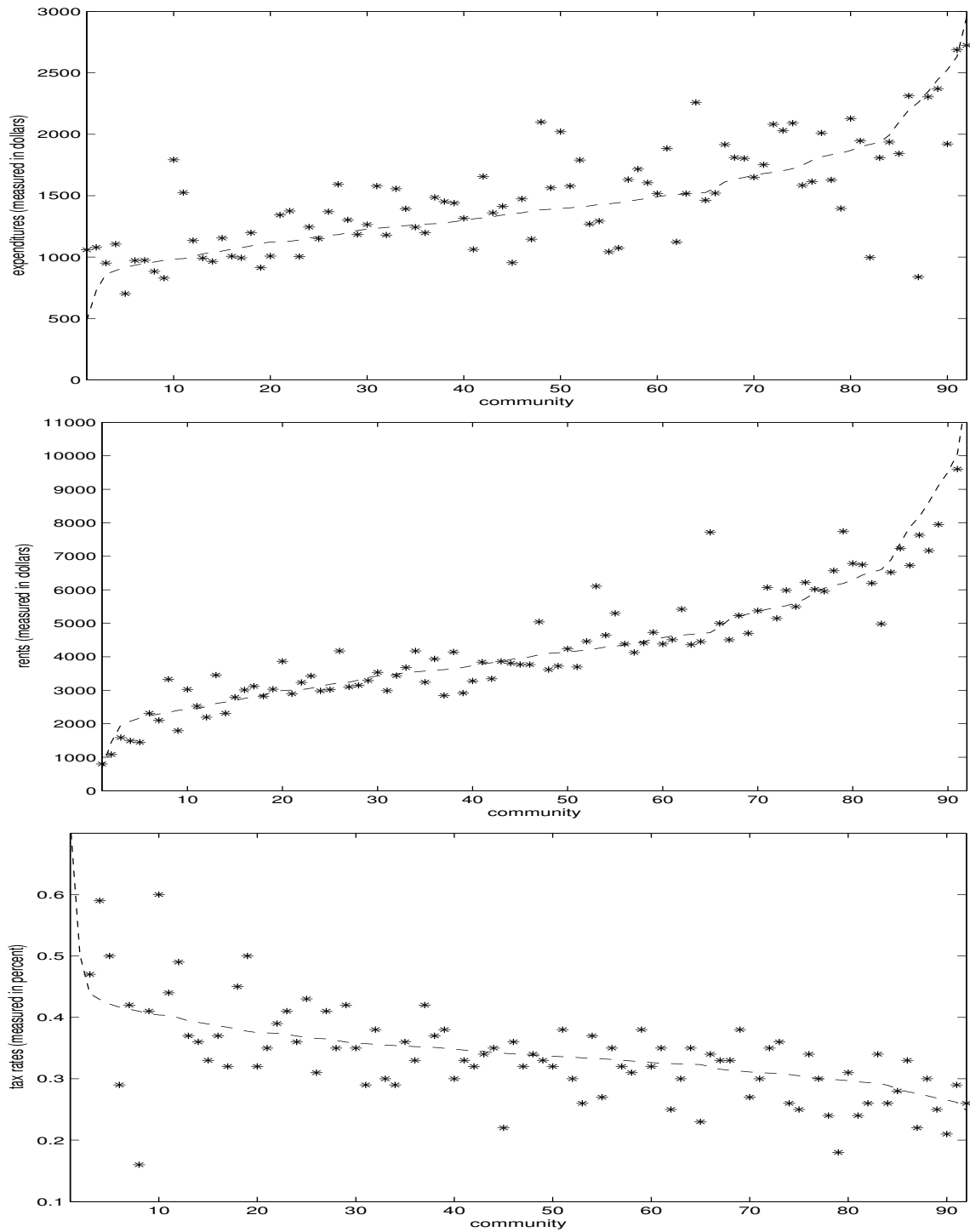
Communities are arrayed in order of increasing median household income.

Figure 3: Observed versus predicted Expenditures, Rents, and Taxes: Baseline Model



Notation: * actual, - predicted. Communities are arrayed in order of increasing median household income.

Figure 4: Observed versus predicted Expenditures, Rents, and Taxes: Extended Model



Notation: * actual, - predicted. Communities are arrayed in order of increasing median household income.