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FISCAL DECENTRALIZATION AND LAND POLICIES

Edited by Gregory K. Ingram and Yu-Hung Hong

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Community Associations: Decentralizing Local Government Privately

Robert H. Nelson

Not often in U.S. history does a major new social institution appear,[1] but the rise of the private community association since the 1960s represents just such an event. In 1970 about 1 percent of all people in the United States lived in a community association, a category that includes homeowners associations, condominiums, and cooperatives. Today, amazingly enough, that figure is approaching 20 percent, or 60 million people (Community Associations Institute 2007). This growth partly reflects that, from 1980 to 2000, about half the new housing built in the United States was subject to the private governance of a community association (Nelson 2005b). In many rapidly growing parts of the United States today, almost all new housing, other than small-scale infill development in older areas, is being built within the legal framework of a community association.

The majority, about 55 percent of community association housing units, are found in homeowners associations that typically provide services and regulate land use within a neighborhood of single-family homes (Community Associations Institute 2007). About 40 percent of housing units are in condominiums that can range from a single multifamily building to a full neighborhood encompassing diverse housing types. Cooperatives are the third type of community

1. Private community associations are not exclusively a U.S. phenomenon. In fact, the condominium form of housing ownership was imported to the United States from Latin America in the early 1960s. Worldwide, community associations are now rapidly spreading.

association, having about 5 percent of total association housing units, and are most likely to consist of a single building in a large city with multiple occupants. In both homeowners associations and condominiums, the housing units are individually owned, but common areas are subject to the collective private governance. In cooperatives the entire facility is collectively owned, but individuals hold legal rights to occupy their units.

The rise of the private community association in the United States can be compared in social scope and significance with the rise of the private business corporation in the late nineteenth century. Both transformed an existing U.S. property system, one that had long been based on individual ownership, into a new system of collective private rights. Both established new forms of private governance as means of collective decision making: the rise of systems of business and residential "private politics" to add to the traditional "public politics" in U.S. collective life. Within the U.S. federal system, state governments have assumed the responsibility for chartering and overseeing both business corporations and community associations. Finally, partly because of the resulting increased private economic and political power, the rise of the business corporation years ago and the rise of the private community association in recent decades have both proven to be socially and politically controversial and contentious.

Recognition of the full social importance of private community associations has been slow in developing in the United States. Several valuable studies have been done (Dilger 1992; Foldvary 1994; Gordon 2004; McKenzie 1994; U.S. Advisory Commission on Intergovernmental Relations 1989), but, other than the law journals, the academic literature is relatively scant. Part of the problem is that community associations have been most visible in the most rapidly developing parts of the United States (which happen to be distant from many leading U.S. centers of learning). Another significant problem is a shortage of data. The U.S. Census of Governments, for example, regards a community association as a form of private activity outside its scope and collects essentially no information on the rapidly growing place of community associations in the U.S. system of local governance. The Census of Housing collects a bit more, but it is still minimal. It is no exaggeration, however, to say that private community associations are transforming the basic organization of local governance in the United States, achieving a major decentralization of local government privately (Nelson 2005b).

In the nineteenth century, good government at the local level in the United States was considered to mean consolidated government. In 1898, for example, the current City of New York was created by combining five separate boroughs into one much larger, centralized political unit. Chicago, Baltimore, and many other U.S. central cities were the result of wide annexations (Jackson 1985). In the first half of the twentieth century, however, the tide began to turn. Small suburban governments increasingly resisted being swallowed up by larger central cities. By the mid-twentieth century, the familiar northeastern and midwestern pattern of today was well established: a large central city surrounded by numerous small suburban municipalities, many with no more than a few thousand

people. Today, reflecting this decentralized model of suburban local governance in the public sector, the Chicago metropolitan area includes 569 general-purpose local governments; the Detroit, St. Louis, and Cleveland areas, exhibiting the same basic pattern of public-sector suburban decentralization, have 335, 314, and 243 local governments, respectively.

Today, the basic manner of organizing local governance in the United States is once again changing. In California, Florida, Texas, Arizona, Nevada, and other rapidly growing areas, the rise of the private community association is central to the new urban models. In such places where private community associations have proliferated, the small suburban municipality of the Northeast and Midwest is an endangered species. Local government in the public sector is not disappearing altogether, but it is taking new forms. On a neighborhood scale, the regulation of land use and the provision of "micro" common services such as garbage collection, street cleaning, and private security patrols are being undertaken privately by community associations (McCabe and Tao 2006). Local governments in the public sector are then increasingly left to focus on wider responsibilities of a regional scope such as water and sewer systems, arterial highways, rapid transit, courts of law, and other responsibilities that involve significant economies of scale or otherwise are best provided at a regional and, even, a full metropolitan scale.[2]

In the newly evolving U.S. system of local governance, the two key players in the public sector are powerful county governments and large suburban municipalities. Strong county governments have become the principal instrument of local public governance in unincorporated areas, sometimes covering much of a metropolitan area. In those areas that have been incorporated, counties share these responsibilities with large municipalities, what Lang and LeFurgy (2007, 129–130) have labeled the new municipal "boomburgs" of the South and West. These large, new suburban municipalities typically have nonpartisan elections and part-time mayors, leaving daily oversight of municipal affairs to a professional city manager. The scope of responsibilities is less than those of the old central city and suburban municipalities of the Northeast and Midwest, and the municipal administrative staff is correspondingly reduced. In one extreme case, given a smaller number of service responsibilities, the municipality of Weston, Florida—home to 70,000 residents—has contracted out almost all the municipal functions, leaving the local city government in the hands of a total of three employees. All these changes are further accompanied by a sharp decentralization of the microfunctions of local government to the individual neighborhood level, now carried out by private community associations and financed by association assessments. Thus, the new urban

2. In terms of physical and administrative character, schools could be provided locally in a highly decentralized manner, but in much of the United States they have nevertheless long been consolidated into larger regional systems of public education in counties and special school districts.

local governance model is a novel blend of public government on the larger scale and private government on the smaller scale.

Because of the long lifetime of urban housing and infrastructure, the specific character of any metropolitan area is highly path-dependent. Moreover, community associations are created at the time of development and are seldom found in areas—typically built before the 1960s—with separate ownership of each unit. In such areas, the retroactive establishment of a community association would require the unanimous consent of every property owner, which is almost always a practical impossibility. As a result, the new metropolitan trends are most visible in newly developing and rapidly growing metropolitan areas such as Las Vegas, which had a population of 139,126 in 1960, but which grew to 1.9 million in 2007.

As a particularly fast-growing part of the most rapidly growing state in the nation, and thus a place where the weight of the past is minimal, Las Vegas offers a prototype of the evolving new U.S. patterns of local governance. In contrast to the many hundreds of public municipalities typically surrounding central cities in the Northeast and Midwest, there are only 13 general-purpose local governments in the public sector in the Las Vegas metropolitan area. Almost all metropolitan Las Vegas falls within one county, Clark County. The county includes large, unincorporated sections (including most of the famous "Vegas strip"), where the county is the principal instrument of local governance. In three large, incorporated municipalities—the City of Las Vegas (population of 575,000), Henderson (256,000), and North Las Vegas (202,000)—governing responsibilities are shared with Clark County.

At the same time, much of the traditional role of local government is now private. Although there are some older Las Vegas neighborhoods where local land use controls were established as a municipal function many years ago, in almost all newer developments the regulatory protection of neighborhood quality has now been taken over by private community associations. They also provide many services and perform other neighborhood-level tasks. As Lang and LeFurgy (2007, 129–130) note, "The bottom line . . . is that every new North Las Vegas development now has some form of common-interest development," and these community associations have become "critical . . . to the basic functioning" of the system of local government throughout much of the metropolitan area.

In Phoenix, another rapidly growing metropolitan area that has largely taken shape in recent decades, similar governing patterns are on display. Despite having a total population of 3.3 million, there are only 34 general-purpose local governments in the public sector, compared with 318 in an older metropolitan area of almost the same population, Minneapolis–St. Paul. Much of the governing responsibility in the Phoenix area is exercised by two large and powerful counties, Maricopa County and Pinal County. The Phoenix metropolitan area also includes the incorporated City of Phoenix and seven other large, incorporated suburban boomburgs. These eight municipalities are home to fully 80 percent of the total Phoenix metropolitan population, a much higher percentage than a

similar number of the largest municipalities surrounding a typical central city in the Northeast or Midwest. As in Las Vegas, private community associations have proliferated in the Phoenix metropolitan area, assuming land use regulation and common service responsibilities at a neighborhood scale that in the Northeast and Midwest have remained largely in the public sector.[3]

A Private Tiebout World

This transformation in the system of local government is a matter of large changes both in substance and in form. The formal privatization of local government is discussed later. The decentralization and privatization of metropolitan governance began at least informally, however, well prior to the rise of the private community association. The numerous suburban municipalities surrounding the central cities of the Northeast and Midwest, although nominally public, might also be described as de facto private governments.[4] As Lang and LeFurgy (2007, 124, 127) comment, traditional suburban governance, as they examined it recently in Bergen County in the northern New Jersey suburbs of New York City, is characterized by "strong municipal and weak county governance," including separate provision by each municipality of its own schools, amounting to a system of "de facto private" education encompassing Bergen County. The best Bergen County public schools, found in upper-middle- and upper-income suburbs where entry is strictly limited by zoning, are comparable to higher-quality private schools in the nation.

Not only the schools, but the entire system of local government—including dozens of municipalities in Bergen County, none larger than 50,000 in population—are, for most practical purposes, largely private. Thus, as Lang and LeFurgy (2007, 127) observe, most municipalities in Bergen County, often containing 5,000 or fewer residents, "are essentially run as private clubs," whatever the formal appearances of being "public" might be. They are, in fact, similar to the private community associations in the more newly developing parts of the United States. Or, as Lang and LeFurgy (2007, 127) comment, many Bergen County municipalities "could easily be accommodated in just one phase of a master-planned community in the West." Las Vegas and Phoenix today are witnessing a newly explicit and official legal recognition of the past informal privatization of local governance that occurred earlier in the twentieth century in the Northeast and Midwest.

3. Even in the Northeast and Midwest, private community associations are now also widespread in the farthest outer suburbs, the newest and most rapidly growing parts of these older metropolitan areas.

4. For example, University of Virginia law professor Richard Schragger (2003, 1835, 1852) states that U.S. suburban municipalities in the twentieth century had "essentially become privatized," resulting in a new "political economy of privatized local government."

A number of urban scholars—often with training in economics—have recognized the essentially private character of the small suburban municipality. One of the earliest and most famous depictions of this metropolitan governance pattern was that of Charles Tiebout (1956). Tiebout noted that the traditional problems of organizing the production of public goods at a national level did not apply in the case of the system of local government in the United States, at least not as it was evolving in mid-twentieth-century America, with hundreds of suburban governments surrounding the typical central city. Given such large numbers of small municipalities and a metropolitan area of any significant size, purchasers of housing had a wide range of individual choices. They could select a particular municipality that provided the set of public services they wanted in light of the level of property and other taxes that would be required to pay the costs. It was, in fact, similar to buying other ordinary consumer goods and services in the marketplace: a housing purchaser would act to maximize his or her overall consumptive benefits subject to an income constraint.

Housing was a bit complicated in that a single choice involved a range of housing features, neighborhood amenities, and location characteristics, but this aspect did not distinguish housing in principle from other forms of consumption. An automobile, for example, represents a practical means of transportation, a statement of personal image, a level of safety, and other relevant features of consumption. If all transaction costs were assumed to be zero—an assumption made in most economic analyses in the 1950s when Tiebout was writing—the system of local government would, in fact, reach a perfect equilibrium equivalent to a competitive market outcome for other ordinary goods and services, as described in the conventional economic theory.

In such a perfect metropolitan equilibrium, as Tiebout (1956, 420–421) thus explained, "the allocation of resources [by local municipal governments] will be the same as it would be if normal market forces operated" to determine municipal service and taxing levels. Even allowing for some imperfections in the workings of the suburban market for municipal service provision, "the solution will approximate the ideal 'market' solution." In establishing the market equilibrium, "the act of moving or failing to move [from a given municipality] is critical." In the suburban "market" for municipal services, instead of visiting a store or other location away from home to make a purchase, the decision to stay or leave "replaces the usual market test of willingness to buy a good and reveals the consumer-voter's demand for public goods. Thus each locality has a revenue and expenditure pattern that reflects the [private] desires of its residents." In fact, it reflects them as accurately as individual consumer purchases made in a grocery store or other conventional market setting.

As an economist, Tiebout applauded the resulting effective privatization of the local governance system as it could be found in the U.S. metropolitan areas of the 1950s. In effect, even though it was an approximation, this implicit privatization of local government allowed the market methods of a capitalist economic system to be extended into yet another area of American life, something that

previously had been thought to be impossible because of the intrinsically "public" character of all governmental service provision. Other observers, however, were less sanguine. Around the same time Tiebout was writing, Charles Haar, a Harvard law professor, addressed critically the workings of the same system of privatized local governance as he found it in New Jersey (and as Lang and LeFurgy still find it little altered today in Bergen County). Haar (1953, 1036, 1063), criticizing a decision of the New Jersey Supreme Court upholding the exercise of strong municipal zoning powers, wrote that "the preservation of expensive homes . . . apparently becomes a proper function if suitably dressed up as a zoning ordinance." Even as the workings of the land use system were harmful to the poor, "the New Jersey Court substituted shibboleths for reasoning and used liberal shibboleths to attain an illiberal result," according to Haar.

Committed to greater income equality in American life, progressive critics such as Haar were, in essence, deploring the distributional consequences of the country's evolving de facto private system of suburban municipal governance, the very same result that Tiebout was so enthusiastic about. In effect, neighborhood environmental quality, neighborhood common service provision, and other local collective amenities were being socially allocated in much the same manner as ordinary private goods and services in the market. Just as the rich can drive a Mercedes-Benz and go to French restaurants, the poor drive used Chevrolets (or now Toyotas) and eat at McDonald's. With the workings of zoning and other elements of the evolving system of local suburban governance, the rich could also live in a Scarsdale, leaving the poor to live in the Bronx. It was the American way, and the private market system now extended to encompass the collective use of neighborhood land. Indeed, that was why zoning and the other elements of this decentralized suburban system have, since they emerged in the first half of the twentieth century, proven so popular with the public.

Another concern of progressives such as Haar was that a privatized system of local governance would obstruct the wider metropolitan planning and land use control they had long advocated. If it was a question of use of market methods or public planning and control in organizing the metropolitan land system, most urban planners and lawyers of the 1950s and 1960s—and many still today—assumed that the wide range and the complexity of physical and economic interactions among land uses in a large metropolitan land system would defy market resolution. The private land market, they believed, would be hopelessly inadequate as the basic organizational device for the metropolitan economy.

As capitalism generally proved unexpectedly vital in the last decades of the twentieth century at the national economic level, however, in urban economies it was, in practice, the visions of the economists such as Tiebout that mostly prevailed. For the most part, the zoning and other powers of small autonomous municipalities in the suburbs withstood the many progressive challenges. The resulting privatization of local government is now being extended—on an even smaller geographic scale, in many cases—to the newly developing neighborhoods of the U.S. South and West. The difference is that there is no longer an informal

and partially disguised privatization; it is now up front and official, the result of the rise of the private community association since the 1960s.

Reconciling "Public" and "Private"

Tiebout spawned a successor group of economists—and of legal theorists inspired by the teachings of the law and economics movement—who in the 1970s and 1980s cleaned up some of the details of his theoretical model and recommended a set of zoning and other reforms to reflect a more explicit recognition of the actual private character of suburban governance. In 1975 economist Bruce Hamilton clarified the crucial role that zoning regulations played in keeping out unwanted land uses, acting informally in the exclusionary capacity of a conventional private property right (a collective private right in this case). Since the late 1970s, another economist, William Fischel (1978, 1985, 2001), has carried this line of analysis much further, exploring comprehensively in his many writings the workings of zoning as a de facto collective private property right and other aspects of the effectively privatized system of suburban municipal governance in the United States (see also Nelson 1977). Within the legal profession, law professors Dan Tarlock (1972) and Robert Ellickson (1977) characterized zoning in the 1970s with new accuracy as an internal redistribution of neighborhood property rights and suggested making these rights transferable with monetary payments—in effect, buying and selling zoning and nuisance protection rights—as a step toward enhanced metropolitan land efficiency (and, to some extent, equity).

On the whole, these efforts have had more scholarly influence than practical consequences. The legal mills grind slowly, and the task of transforming the official law of zoning and municipal governance to the evolving Tiebout–Ellickson–Fischel reality was daunting. Significant changes in local governance were occurring, but the most important public-sector ones had to be legally camouflaged. To acknowledge formally the de facto private realities, a virtual revolution in the public forms of the law in these areas was required. Perhaps equally difficult, an explicit acknowledgment of the practical failures of the progressive urban governing vision—at least as this vision had been applied in matters of zoning and local government—was also required. In the academy, moreover, this progressive vision still generally held sway in urban planning schools, in law schools, among students of urban politics, and elsewhere, even at the end of the twentieth century.

In the legal community, instead of facing the evolving private realities, widespread obfuscation prevailed, sustained in the courts by the ritual recitation of a set of legal myths and fictions. A particular characteristic of land law is that the outward forms tend to depart significantly from the accepted common practice. Indeed, such disparities have long attracted notice and commentary among legal scholars; in Great Britain, for example, altogether outmoded feudal elements of the land laws survived as a matter of form until well into the nineteenth century and even, in some cases, into the twentieth century (Pollock 1979 [1896]). When

change does come to land law, it is commonly by means of brand-new institutions that do not as much challenge directly as supplant the old practices. Such has been the case with the rise of the private community association in the late-twentieth-century United States. Now, in the newly developing areas of the South and West, these associations have officially acknowledged the long-standing private character of neighborhood-level suburban governance.[5]

A Coasian Analysis

Unlike Tiebout, Ronald Coase, a leading figure of twentieth-century economics and winner of the Nobel Prize in 1991, has written little about the system of local government. Nevertheless, his 1937 article, "The Nature of the Firm"—a main reason he received his Nobel—raised issues that are also relevant to understanding the nature of local government in the United States today. In the article, Coase (1937) explored the reasons for the growing role of the private business corporation in the U.S. economy, a role that had become widely evident by the 1930s. As Coase noted, large parts of the U.S. economy were found outside the marketplace and instead were governed by the internal private planning and management of the business corporation. In some ways, this reality seemed at odds with the core message of mainstream economics that the market is the most efficient method of economic organization.

Coase explained, however, that all economic activity—whether in the market or in a single, large organization—involves transaction costs. Evidently, based on the evidence of the U.S. economy, the private business corporation—at least up to some large size that often encompassed many thousands of employees spread among many plants and other manufacturing operations across the country—was an efficient way of economizing on transaction costs. It would simply have been too cumbersome, and otherwise costly, to organize such complex production and distribution systems through individual sales and price agreements in the market, among potentially hundreds, or even thousands, of independently owned economic agents. Together with other writings, Coase's insights in this regard eventually led to the rise of the "new institutional economics" in the 1970s. This movement has since radically altered the understanding of the basic workings of markets among American economists (Furubotn and Richter 1997).

5. As a student of urban affairs who received his professional economic training in the late 1960s at Princeton University (where Bruce Hamilton and William Fischel were fellow economics graduate students at the time), my own economic contribution in the spirit of Tiebout—with less attention to the theory and a greater emphasis on legal and other institutional details of the zoning system—is Nelson (1977). I concluded by recommending the substitution of collective private rights for a gravely flawed zoning system, which is not too far from what has since happened in newly developing areas of the United States (not to suggest that there was any causal connection).

If local government in the United States, at least at the neighborhood level in the suburbs, has now become a private good, it is subject to a similar analysis. The same kinds of questions Coase asked arise in the "market" for private neighborhoods today. Why have collective forms of housing ownership largely replaced the traditional individual home ownership of the past? Among forms of collective ownership, why is the small suburban municipality of the mid-twentieth century now losing out? How large should a collectively owned and managed private neighborhood be, and what factors limit the size of such neighborhood governing units? Why not simply have a single, large government that could closely plan for and thus better coordinate land uses throughout every part of a full metropolitan area, including all its neighborhoods?

A system of strictly individual housing ownership would not, in itself, preclude actions to maintain overall neighborhood quality. Bargaining could still take place among individual homeowners within a neighborhood, including monetary transfers from one neighbor to another as compensation for desired actions and to limit negative neighborhood externalities. Or, a developer could establish covenants on all individually owned neighborhood properties in advance, thus limiting the future actions of the homeowners. Such covenants were, in fact, widely employed to protect neighborhood quality in the early 1900s. By the second half of the twentieth century, however, the collective instrument of the community association was rapidly replacing those older, private covenant regimes.

In a Coasian framework, this success of private governance will be understood as a way to minimize transaction costs when providing neighborhood services and neighborhood environmental amenities. Enforcement of covenants, for example, was burdensome and unreliable because it depended on individual owners to bring legal actions against any neighborhood parties who might be violating the covenants. Large expenses might also be imposed on the legal system if the resolution of every covenant dispute among property owners had to rely on the courts.

Another land tenure based on individual ownership is the rental model, whereby a developer, in the pursuit of private business profits, might rent individual housing units to tenants. This governing system is one of "private neighborhood dictatorship" by landlords who have received voluntary renter consent (at least for the term of the lease).[6] The renters are then not burdened with the potentially significant responsibilities to participate in democratic neighborhood governance. Day-to-day, the lowest transaction costs of neighborhood management are likely to be found under such a landlord/renter tenure. Indeed, emphasizing the savings in political time and effort of residents—and the efficiencies of having a single, responsible decision maker—some observers have argued that

6. Although usually the case, this tenure arrangement is not necessarily a for-profit venture. For example, public housing projects lease apartments to renters.

large rental projects will be the economically optimal ownership form for organizing a neighborhood environment (MacCallum 2002).

There were, in fact, many such large rental projects in the past, but, as collective ownership with private neighborhood democracy has come to dominate the housing market, fewer are being built today. There has, however, been little economic research thus far to explore the relative total transaction costs of the various individual and collective systems of housing ownership and why rental housing is losing out. As such investigations are undertaken, important factors in explaining the preference for ownership versus rental tenures should be the role of home ownership within a person's investment portfolio and the prospect of achieving home equity gains as part of a broader investment strategy (Fischel 2001).

Transaction Costs: Small Municipalities Versus Community Associations

As noted, the small suburban municipality is, for most practical purposes, an alternative form of "private" land tenure, one that will involve its own forms of transaction costs. The municipal form of privatization, though, has also been losing out to the private community association. Following a Coasian line of analysis, it would seem that a private community association lowers the transaction costs of neighborhood organization and management. Although no precise calculations can be offered here (and few are available in the literature), it is possible, at least, to identify the qualitative factors that will influence relative transaction costs of small municipalities in comparison to community associations.[7]

In municipalities, there are two main governance models: the town council/mayor and the town council/city manager. (Numerically, the latter type is most common.) In a community association, by comparison, legal authority lies with an association board of directors elected by the property owners, which may choose to delegate the operational responsibilities to a private management firm. With some important differences, this arrangement resembles the council/town manager system of a municipality. (One difference, for example, is that the dismissal of the private manager and administrative staff of the community association—firing the management firm—would likely involve considerably fewer transaction costs than the dismissal of a municipal city manager and all the civil service.)

Compared with a small suburban municipality, a community association—officially a private entity—will usually have more flexibility of organizational structure and operation, and thus wider ability to act to minimize transaction costs. A community association, for example, has wider discretion in assigning voting rights; most associations assign the rights to unit owners, but a private association can (and some do) also give renters the right to vote. Associations

7. One attempt to address such matters is found in Fennell (2004).

can search for the "optimal" voting scheme among many private constitutional possibilities. Municipalities, however, are tightly bound by the one person/one vote requirement imposed by the United States Supreme Court (*Avery v. Midland County*, 390 U.S. 474 [1968]). This requirement creates the possibility that renters, if they become numerous enough in a municipality, might alter the neighborhood initial contract to impose rent controls or take other steps adverse to owner interests. As a result, property owners relying on municipal protections could be faced with large transaction costs in enforcing the neighborhood contract, perhaps leading them to organize politically to protect their private ownership interests, including in some cases "political bribes" to buy off renter votes. Alternatively, property owners may simply direct more of their investments outside the housing area.[8]

The level of "social capital" might be higher, and transaction costs therefore lower, in neighborhoods that are able to gather together a more homogeneous group of homeowners. A strong neighborhood culture, based on a powerful set of shared norms that help to reduce internal transaction costs, is more likely in the private setting of a community association (Ellickson 1991). Although municipalities can achieve substantial homogeneity of owner incomes through the exercise of their zoning powers, in other respects they have less authority than a private community association to set personal entry requirements. For example, community associations of senior citizens (one unit owner must be 55 years old or older) have proliferated across the United States. It would be difficult—and perhaps legally impossible—for a public municipality to maintain a similar age restriction, though. In general, although the Fair Housing Act (the federal law prohibiting racial and other forms of discrimination in the buying and selling of housing) applies to private community associations, private governments will have a greater legal flexibility to work to establish a neighborhood common culture that minimizes transaction costs.[9]

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8. The differences between a small suburban municipality and a private community association are not necessarily an intrinsic—and thus fixed—characteristic of the law. Indeed, to a large extent, they are the product of past court decisions. In the future, courts could, in concept, modify the legal status of suburban municipalities to loosen current municipal restrictions and grant greater freedom of operation, more resembling the flexibility of today's private community association. It seems that it has been easier and faster, however, simply to transfer local government from the official "public" status to "private" status. From this perspective, the rise of private community associations can be seen as a legal device that has made possible a rapid and efficient increase in the flexibility and freedom of operation of local governments in the United States.

9. Admittedly, this new and evolving area of the law is subject to considerable future legal uncertainty. It can at least be argued that, in the case of a community association established for religious purposes (a "residential church"), the courts should interpret freedom of religion to prohibit the interference of public governments with discriminatory actions that reflect the pursuit of genuine neighborhood religious purposes. See Nelson (2005a).

A private neighborhood can typically regulate free speech, including the posting of signs, in ways that would be constitutionally impermissible in a public municipality. If most private neighborhood residents object to such signs, the transaction costs that would otherwise be incurred in buying out (through formal or informal means) those who want to put up the signs would be reduced. It might be suggested that basic constitutional rights should not be surrendered under any circumstances. In small enough social units, however, a right to discriminate is widely accepted in American society. Is there anything objectionable in a small neighborhood limited to Italians, or Baptists, or unmarried residents, or people under age 30? As neighborhoods become smaller and more intimate in size, the private legal status of a community association will give courts wider flexibility to make appropriate judgments on such matters.

The different legal statuses of a small municipality and a private community association will produce different transaction costs when it comes to the initial organization of a neighborhood collective governance regime. A suburban municipality in the public sector is established through each state's legal procedures for municipal incorporation, usually based on a simple majority vote of the residents. Hence, in the public sector, it is typically impossible for a developer to establish a particular system of neighborhood governance in advance as part of the overall development "sales package." If the incoming neighborhood residents subsequently wish to have an incorporated municipality, they will have to work through the procedures for municipal incorporation on their own, normally involving major uncertainties and large internal organizing costs among the residents. Of course, it is also possible that an existing municipality already encompasses the boundaries of the development. In that case, though, another transaction cost problem arises: usually, the municipal boundaries will not correspond to the new development boundaries. Thus, neighborhood collective decision making could end up outside the hands of the owners and other residents themselves, potentially requiring complex political negotiations with many other neighborhoods in the same municipality.

A private community association, by contrast, can tailor the boundaries of the neighborhood government precisely to fit the geographic requirements of a new development. As part of the development process, the developer prepares the declaration of a community association—the neighborhood "private constitution"—that becomes part of the marketing plan for the entire neighborhood project. In this way, the specific form of neighborhood government becomes a private market item itself, subject to developer calculations designed to maximize profits (Barzel and Sass 1990; Boudreaux and Holcombe 1989). The transaction costs for a neighborhood establishing its own distinct system of governance can thereby be substantially reduced privately.

Municipal incorporation, however, will enjoy a decisive transaction cost advantage in at least one circumstance: organizing a new regime of collective governance in an existing neighborhood of individually owned homes. Municipal incorporation in such circumstances will usually be possible with a favorable

simple majority vote of the neighborhood's resident voters.[10] By comparison, after the fact of development, the private establishment of a new community association in an existing neighborhood would require the unanimous consent of the property owners, which is likely to be a practical impossibility.[11] This issue, of course, does not arise with brand-new housing developments that establish a private government in advance and then require every incoming buyer, as an initial condition of purchase, to agree to the terms of the community association declaration in the usual manner of establishing a community association.

Long-Term Neighborhood Contracting

Following Coase's seminal contributions, the new institutional economics has explored the important organizational consequences of the frequent need for long-term contracting in the business world (Williamson 1975). If one business party must make a large investment now and the benefits depend on the actions of a second party well in the future, there may be a strong incentive to integrate the two parties into a single firm. Otherwise, if the two were operating as independent agents in the market, the second might end up with the future bargaining power to capture most of the total investment value. This problem could, in concept, be solved by a long-term market contract, but it might be difficult to foresee all future contingencies and incorporate them formally in an enforceable legal contract.[12] Instead, such issues may be best resolved with a minimum of transaction costs by keeping all current and future activity within one business unit.

Similar issues arise in the residential housing market, partly because, compared with most other forms of consumption, a housing purchase has long-term economic consequences. Many people buy a home with the expectation of

10. In many cases, of course, multiple neighborhoods may be included in the same municipality. In this case, a particular neighborhood can obtain collective controls through the simple majority vote of the wider municipal legislature (normally reflecting the expressed wishes of the neighborhood residents). When zoning was first widely employed in the United States in the 1920s, it was often established in this manner in older neighborhoods that had previously been under systems of individual home ownership. Without the exercise of zoning coercive powers, it would have been impossible to establish any system of collective controls in such neighborhoods.

11. State legislatures, admittedly, could enact new laws to make it easier to retrofit a private community association in an existing neighborhood of individually owned homes with less than unanimous consent. In that case, it might then be possible to create a community association with a favorable vote of, say, 75 percent of the property owners (and the remaining 25 percent would be legally required to join as well). I make such a proposal in Nelson (2005b, part IV).

12. Even if the large number of possible future contractual issues can be accurately foreseen, the costs of spelling out so many future contingencies in adequate detail for legal purposes may itself be prohibitive.

remaining there for many years, perhaps even decades. As a result, it is usually impossible to foresee every neighborhood situation that might come up. Without a well-specified contract, it may be necessary to leave considerable discretion to a future neighborhood decision-making process, however it may be structured. This process may have to be put in place, and the decision-making rights of future unit occupants well established, in the initial neighborhood contract.

Specifying and maintaining this decision-making process can be a particular problem in the landlord/rental form of land tenure. Incoming occupants of new homes who expect to live in a neighborhood for many years may want contracts that spell out the outcomes of many future long-term contingencies. That specificity may not be possible with the traditional serial renegotiation of short-term rental agreements. Renters can always move out at the end of the lease, but each turnover has potentially high transaction costs. Landlords, for their part, may be unwilling to commit to very long-term leases whose full contractual consequences are unclear and whose terms may be difficult to change. In short, the particularly high transaction costs of long-term contracting in this legal setting may discourage wider use of the landlord/renter form of land tenure.

Under the collective land tenure of the small suburban municipality, the municipal legislature will have the authority to revise neighborhood land use regulations, common service levels, and other terms of neighborhood governance by simple majority vote of the residents. Hence, even leaving aside the complication that potentially multiple neighborhoods may be politically involved within the same municipality, many neighborhood property owners may be exposed to newly revised neighborhood contracts that may be opposed by as many as 49 percent of fellow property owners. A private community association could, in concept, follow the same municipal voting rule, but it has greater institutional flexibility to fine-tune its neighborhood recontracting procedures. Indeed, rather than a simple majority vote as in municipalities, most community associations require high supermajority votes—typically 66 or 75 percent—to change the land use regulations or otherwise amend the declaration. Many also require still higher approval percentages for "foundational" changes.

The exact voting requirement chosen will reflect two types of costs. One, the transaction costs of renegotiating a neighborhood contract, will be higher as the approval percentage is increased above 51 percent. Another form of transaction cost can be described as the "losing side" cost, whereby the burdens are borne by those who oppose a particular change but whose preferences are overridden by the collective decision and thus who end up in an inferior position. This latter cost will decline as the voting requirement increases toward unanimity. In 1962 Buchanan and Tullock famously analyzed this issue in a general way in *The Calculus of Consent*. They showed that there will be an optimal voting rule, normally lying somewhere between a simple majority (minimum negotiation costs) and unanimous consent (minimum "losing side" costs).

Unlike the circumstances analyzed by Buchanan and Tullock (in which the losers had no choice but to accept the final collective decision), it is possible for a

losing homeowner to exit a neighborhood. Despite the resulting upper bound this sets on individual "losing side" costs, though, the option of moving somewhere else may not be much comfort for many homeowners. For those who have made large commitments to an existing circle of friends and otherwise have strong connections to their existing neighborhood, the greater constitutional flexibility of a private community association in setting an optimal neighborhood rule for recontracting may be a significant advantage. Probabilistically, the freedom to select their own supermajority voting rule may reduce their expected long-run transaction costs.

Community association rules commonly regulate exterior paint colors, shrubbery placement, driveway use, fences, and, in fact, almost any detail of a property's exterior. That few public municipalities have such all-encompassing neighborhood controls is an indication that the overall transaction costs of collective decision making may be lower in the private community association. Having less confidence in the future reliability and predictability of their own neighborhood regulatory regimes—or, as one might say, facing higher transaction costs to obtain greater contractual security—municipal residents may choose to put less at risk in terms of the extent of future neighborhood controls.

Payment of Compensation

Although many community associations have taken advantage of this wider flexibility of constitutional design and practice—a consequence of their official private legal status—further gains of this kind may be realized. Admittedly, developers of community associations would need to show greater creativity in the future, rather than simply adopting the boilerplate declarations of previous associations. Community associations are a fairly new development in American life, however, and further progress along a learning curve is to be expected.[13]

One example of a potentially valuable private innovation is the greater use of monetary compensation in resolving neighborhood disputes and in negotiating neighborhood agreements in general. This practice would again follow the thinking of Coase (1960), who argued many years ago that market incentives could resolve private externality issues without the direct involvement of government, as long as the private legal rights were well defined and the rights were freely transferable according to the wishes of the holders. Thus, if I wish to plant a tree that diminishes the sunlight reaching my neighbor's property, the two of us in a Coasian setting can be expected to strike a bargain. If I have the initial right to plant the tree and my neighbor wants to block it, he or she will have to offer a large enough payment to dissuade me from going forward. Conversely, if

13. I explore a wide variety of possible improvements in the private governance systems of community associations in Nelson (2005b, part V).

the neighbor legally must agree to the tree, I will then have to offer a sufficient payment to compensate for any negative externalities the neighbor experiences. Either way, as long as the legal rights are clearly specified, free private bargaining between me and my neighbor will achieve an efficient result.

At present, however, few community associations recognize in their declarations the possibility of any such forms of Coasian bargaining. A unit owner who wants to paint his or her property green, against the current rules of the association, has no option, say, to offer $10,000 to the association in exchange for a waiver of the house-color rules. Ellickson (1973), among others, argues that greater legal flexibility in this regard—both in community associations and in other private settings—might yield more flexible and satisfactory internal neighborhood outcomes, significantly enhancing overall economic efficiency in the land market.

In one particularly important case, a land developer might offer to buy out an entire community association (the entire package of neighborhood rights) and transform the use of land at the entire neighborhood site.[14] Owing to changed economic circumstances, the site might have become much more valuable than in its current use. Few community associations, however, anticipate in their declarations the possible full buyout of the entire neighborhood even if it could be a large win-win proposition all around, creating large profits for the developer and large financial gains for unit owners. This defect should be remedied in future new declarations of community associations, and states may have to address the matter legislatively for older associations that now lack such provisions.

State Oversight

Although community associations have wider private flexibility of operation than small municipalities, they are also subject to significant state oversight. Like a business corporation, a community association is chartered under a state law that may include various requirements relating to the structure of association governance and other internal matters. Other state laws typically include significant further requirements. Many states, for example, require as a matter of consumer right that developers must make relevant information about the financial status of community associations available to prospective unit owners. In Florida a community association and unit owner are required to enter into nonbinding

14. A recent example involving a trailer park in Palm Beach County attracted considerable media attention. Although not a conventional community association, the residents of Briny Breezes had many years ago established a collective ownership. With land values rising rapidly in that part of Florida, a developer offered more than $500 million for the full park area. Eighty-two percent of the residents voted to accept (66 percent was required for approval), yielding around $1 million per household. Under the agreement, the owners had up to two years to vacate the park. See *South Florida Sun-Sentinel* (2007).

arbitration prior to initiating any court action. In one widely noted 2006 case (*Committee for a Better Twin Rivers v. Twin Rivers Homeowners Association*, 383 N.J. Super 22 [App. Div.]), a New Jersey appeals court, departing from the precedents in most states, limited the rights of community associations to control the placement of political signs within the common areas. In 2007, however, the New Jersey Supreme Court overturned that decision, thus illustrating the many uncertainties with respect to the future legal rules for community associations. In California, after a long debate, brand-new community associations were denied the right to exclude pets (older associations with such rules already in place were grandfathered).

A particularly complicated transaction for many community associations is the transition from developer control to unit owner management. To protect the developer's rights, unit owners do not normally take full control of community association management until a significant share—most often 75 percent—of the units have been sold and occupied. Early in the history of community associations, however, there were problems with developers locking in management contracts and taking other measures that unit owners subsequently found objectionable. After turning over the project, litigation alleging developer defects in construction often followed. In hopes of reducing these types of transaction costs, states have established rules to define developer and association rights.

In addition, states increasingly oversee many aspects of the routine internal decision making of community associations (separate state laws may apply to homeowners associations and to condominiums). Community associations are required to hold annual meetings for the election of board members and the conduct of other business. Access to board meetings, as well as access to information relating to the operations of the community association, is generally guaranteed under state law as a matter of unit owner right. Florida condominium law requires that annual budget increases greater than 15 percent must be approved by a vote of all unit owners, if 10 percent of owners sign a petition requesting such a vote. Some states are now moving to limit the foreclosure options of community associations in dealing with unit owners delinquent on payment of their assessments or otherwise in violation of association rules.

In 1982 the National Conference on Uniform State Laws published a model law for common-interest developments, recommending that states oversee various details of community association operation. For example, the model law suggested that states establish a quorum requirement of 20 percent for meetings of all the unit owners and of 50 percent for meetings of the board of directors. In general, a community association's private status is relative. State governments are increasingly involved with overseeing community association affairs. State oversight should reflect, among other things, a balance of transaction cost considerations. With clear state rules, developers can operate according to a well-established standard and need not commit unnecessary resources to creating individualized rights regimes for each community association. A common statewide standard will reduce the information burdens and monitoring costs of prospective and

current unit owners as well. The negative side, however, is that such state limitations may impede developers and individual neighborhood groups that wish to tailor collective property rights to particular circumstances and preferences. Ill-conceived state regulations may force all community associations to adopt inefficient rules that impose unduly high transaction costs on neighborhood residents and otherwise frustrate their collective wishes.[15]

Indeed, the greater danger at present may be an excess of state oversight of community association workings. States increasingly seem inclined to micromanage even the small details of community association life. Small vocal minorities within community associations may be willing to incur significant costs trying to influence state legislatures, whereas larger silent majorities of unit owners may be deterred from political involvement by the usual free-rider disincentives to collective action.

One option is to make more state requirements a default option for community associations. Certain core developer and unit owner rights would be established for all community associations uniformly. Beyond that, an association might be granted wide latitude to establish its own private governance regime as long as the collective rights are clearly defined in the initial declaration. If the declaration is silent on a crucial matter, however, a uniform state rule would then come into play. A backup rule is needed because the transaction costs to restructure a collective property rights regime that initially failed to address an important governance issue may be high.

Since the late 1960s, a large law and economics literature has addressed in a general way the definition and oversight of property rights in society. A main goal in specifying rights is to minimize transaction costs as well as meeting equity and other social aims. To date, however, this literature has not given much attention to private community associations.[16] Future research might contribute to this area valuably, including giving attention to the proper oversight role of state government.

Taxation of Community Association Property

Under federal tax law, the profits of a business corporation are taxed as corporate income, whether they are later distributed as dividends or not. Then, any dividends received by shareholders are taxed again as individual income, resulting in double taxation. Economically, the rationale for taxation of both business profits

15. In Florida, where state oversight is particularly detailed, one provision of state law had the effect of requiring variable cable television charges within many condominiums based on the square footage of each unit. Florida unit owners complained that hookup charges should instead be the same for each condominium unit. To make this simple change, the state legislature in 1998 had to revise the law.

16. A few authors have begun such explorations. See Fennell (2006).

and distributed dividend income has long been doubtful.[17] In the face of strong economic criticisms, the political durability of corporate double taxation may reflect that many Americans are ambivalent about the prominent role of large business corporations in American life. They are willing to tolerate these corporations because of the major contributions the companies make to the U.S. economy. In return, however, Americans want corporations to pay some form of penance—higher taxes—to compensate for their special legal privileges (limited liability, for example) and the wide private powers in society they are allowed to possess.

In a much different way, private community associations are also subject to double taxation, conceivably for similar implicit reasons. Many community associations deliver common services that are also provided by a municipality (or local county) in other areas of the same jurisdiction (where there are no community associations). The association unit owners end up paying twice, first in the form of private assessments to cover the costs of their own services and second through property taxes to pay service delivery costs elsewhere in the public sector.[18] Like double taxation of corporate dividends, this situation creates a potentially inefficient set of incentives, artificially discouraging private provision and encouraging public provision of local services. In jurisdictions of mixed public and private governance, for example, double taxation creates a strong incentive for service provision in the public sector, even if community association provision may be more efficient.

Equally important is that double taxation of community associations creates a strong incentive for local public jurisdictions in rapidly growing areas to require that all new development must occur within the legal framework of a private community association. If all housing in the jurisdiction is located within a community association, there need be little or no public service delivery at all (at least of the micro kinds of services associations typically provide); there will also be no cross transfers of funds from private to public service recipients and thus no double taxation. Indeed, in areas such as Las Vegas and Phoenix, large county and municipal governments are doing precisely that: requiring, formally or informally, all new housing developments to have a community association.

Some people, however, may object to the tight collective land use controls of a community association. Other people will have other reasons for not wanting to live in a community association. It would be preferable to allow the two main forms of collective land tenure—the small suburban municipality and the private

17. If the capital gains tax is less than the dividend tax, as has often been the case in the United States, there will be a strong financial incentive for corporations to retain earnings for reinvestment, stimulating the further concentration of the U.S. business sector. This situation is virtually the reverse of antitrust goals.

18. Adding to the private disadvantage, municipal taxes are deductible under the federal income tax, but community association assessments are not.

community association—to compete on an even playing field. They might even coexist within the same large county jurisdiction as alternative forms of neighborhood collective governance. Some people would then choose to live in a small municipality and others in a private community association, according to their specific preferences. As described above, these two tenure forms each have their own levels of transaction costs along with other advantages and disadvantages. If double taxation were eliminated, the resolution could simply be left to a competitive process.[19]

One way to eliminate double taxation is for local governments in the public sector to provide compensation if a community association provides privately a service that is provided publicly in other areas of the same jurisdiction. At least a few public jurisdictions do provide such compensating payments. In New Jersey, state law requires them for some types of local services. As in other aspects of community association life, however, there has been little research on this subject, including the issue of the difficulty—the likely level of transaction costs incurred—in calculating appropriate compensation payments.

In connection with the writing of this chapter, the Community Associations Institute distributed a questionnaire to its membership seeking greater knowledge of the extent of double taxation and any compensating payments from local public governments being received by associations. Unfortunately, given several constraints, there was no assurance that the sample collected was representative, and the response rate was low (further research may be possible).[20] Nevertheless, the information obtained from 127 respondents may be of some interest. If only suggestive, the main findings were that only a few associations (about 10 percent of the respondents) are receiving compensation, many more would like to receive compensation, some associations are not concerned (they may provide few services or be located in areas where associations already dominate the landscape), and double taxation is an important political issue for about half of all associations.[21] About one-quarter of the associations surveyed paid property taxes on the common elements, in addition to the personal tax payments for the individually owned units within the association.

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19. Admittedly, to achieve a level playing field for resolving the efficient form of land tenure competitively, some additional tax issues may have to be addressed. Individual home ownership, for example, receives significant tax advantages, especially the deductibility of mortgage interest payments. A result is a bias against rental forms of land tenure, although it is partially compensated for by business tax advantages available to real estate investments.

20. Part of the problem reflected the membership system of the Community Associations Institute (members are individuals) and the difficulty of distributing questionnaires to community associations rather than to individual members. Further survey efforts will be needed to establish a more reliable information base.

21. Additional survey details are available from the author.

Conclusions

The system of local government in the United States is being transformed by the rise of the private community association. Local government in the public sector is increasingly limited to large county and municipal governments—and also sometimes large special districts—that assume responsibilities of a regional and metropolitan scope. The regulation of land use to protect neighborhood environmental quality, and the delivery of small-scale neighborhood services, is increasingly the responsibility of a private government. In the most rapidly growing parts of the United States in the South and West, the small suburban municipality in the public sector, historically the dominant collective ownership mode for Northeast and Midwest neighborhoods, is disappearing.

Previous studies have described these new patterns of governance, but little literature is available to understand the full reasons for such changes. This chapter has offered several hypotheses relating to the magnitude of transaction costs under alternative forms of land tenure. Table 13.1 summarizes expected key transaction cost advantages and disadvantages of private community associations relative to municipal governments in the public sector. The analysis here, however, is conceptual. A large research agenda remains; the specific levels of transaction costs associated with rental housing, small suburban municipalities, private community associations, and potentially other individual and collective instruments of neighborhood governance need to be studied in greater detail. It may also be possible to reduce the transactions costs associated with each tenure form by appropriate institutional redesign of the precise legal status of that tenure.

Table 13.1
Relative Transaction Costs

Transaction costs of . . .	Private Community Association	Small Municipality
Establishing new collective controls in existing neighborhoods	Higher	Lower
Fine-tuning voting rules for special neighborhoods	Lower	Higher
Using monetary compensation in neighborhood disputes	Lower	Higher
Tight controls over aesthetics	Lower	Higher
Changing use rules	Higher	Lower
Changing community management	Lower	Higher
Collecting taxes/assessments	Higher	Lower
Installing gates	Lower	Higher
Defining social environment (e.g., senior citizen community)	Lower	Higher
Avoiding double taxation	Higher	Lower

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