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# The Puzzle of Local Double Taxation

## *Why Do Private Community Associations Exist?*

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**T**he most important change in local government in the United States in the last quarter of the twentieth century was the rise of the private community association (Dilger 1992; Foldvary 1994; McKenzie 1994; Nelson 2005). From 1980 to 2000, about half the new housing built in the United States was subject to the private governance of a community association. At present, in California, 60 percent of all new housing is being built in a community association (Lyon 2004, iii). Indeed, in many areas of the South and the West today, essentially all development—other than small infill projects—is being built in conjunction with the creation of such a form of private government. As a result, 20 percent of all Americans now live in community associations, up from 1 percent in 1970. However, urban scholars have given only limited attention to this major development in urban governance, which represents the widest extent of privatization in any area of American life since the Homestead Act of 1862 sought to privatize the public lands.

One important neglected issue is why community associations exist at all, given that they are subject to a large financial disincentive in the form of double taxation. Much as business profits are taxed both as corporate income and as individually received dividends, private community associations are also subject, if in a different

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way, to double taxation. Many community associations deliver common services privately that are also provided publicly in other parts of the same jurisdiction in which the community association is located. The association unit owners, however, pay twice, first in the form of private assessments to cover the costs of their own privately provided association services and second through property and other local taxes to cover the costs of the same publicly provided services elsewhere in the same jurisdiction.

Just as double taxation of corporate dividends distorts business investment, the double taxation of community associations creates incentives for inefficient local service delivery. Recipients of publicly provided services receive a “subsidy,” paid by the residents of the private communities, to obtain higher levels of services than they would be willing to pay for themselves. Residents of the private communities have a strong financial incentive to seek service provision in the public sector, even if private community provision is more efficient. Adding to the incentives working against private-sector provision, municipal taxes are deductible for the federal income tax, whereas community association assessments are not.

Moreover, the fiscal disadvantages of private community status extend to other matters. Local municipal governments, in part because they are regarded legally as appendages or extensions of state government, often receive large intergovernmental transfers of revenues. Overall, almost 40 percent of local government revenue in 2005 came from the states and the federal government. Although much local spending is for education and social services that community associations typically do not provide, local governments did spend \$27 billion in 2005 for parks and recreation and \$18 billion for garbage collection, areas of significant overlapping responsibility. Federal and state funds generally are not available to a community association, in part because the communities are regarded as a form of private activity not eligible for such public support. In one recent example, federal disaster assistance was available to municipal governments in the aftermath of Hurricane Katrina but was largely denied to nearby private community associations in similar circumstances.

So why do private community associations exist at all when significant financial advantages favor municipal public organization? One possible answer is that a private government has other advantages that compensate for the negative fiscal elements. Another possible answer is that county and other wider public governments may prefer private governments at the neighborhood level and may insist on their creation as a condition of development approval. I maintain that both answers have merit.

### **Private “Tax” Levels**

The significance of local double taxation depends on the magnitudes of the additional financial burdens imposed. Unfortunately, systematic data on community associations is difficult to obtain, which is one reason why this important new social phenomenon has received less scholarly attention than it deserves. The U.S. Census collects few data

on community associations. The Census of Governments collects none at all, reflecting the Census Bureau's view that a private community association is not a governmental body, but instead a form of private business activity. The American Housing Survey collects data on the number of owner occupants who pay community association fees and the magnitudes of these fees (see U.S. Bureau of the Census 2006). The purpose is not to illuminate the circumstances of community associations in the United States, but to enable the Census Bureau to estimate levels of total housing costs by categories of owner occupants. Thus, the survey is a partial sample of American housing units in community associations, limited to owner occupants and excluding the significant number of association units that are rented. Nevertheless, it is the best that the Census Bureau has to offer.

According to the American Housing Survey, the median assessment in 2005 per owner-occupied unit in a condominium or cooperative was \$196 per month, or \$2,352 per year—hardly a trivial amount (U.S. Census Bureau 2006, 9). By comparison, the median real-estate tax paid in 2005 by an owner occupant of a housing unit in the United States was \$127 per month, or \$1,524 per year (of course, the geographic distribution of all housing units in the United States differs greatly from that of condominium and cooperative units alone). According to the Community Associations Institute (CAI), condominiums represent about 40 percent and cooperatives about 5 percent of all private community associations in the United States. The largest category, about 55 percent, is homeowners associations. (Although these three forms of collective ownership of housing have many similarities in their day-to-day operation, each rests on a different legal basis.)

Unfortunately, the census data on homeowners associations is even more compromised. In asking questions of owner occupants, the Census Bureau does not distinguish between voluntary associations of neighbors that have few powers and collect little revenue (typically organized after the neighborhood has been developed) and mandatory homeowner associations in which the home buyers are required to agree to the terms of a powerful private government as an initial condition of purchase. The latter sort is the one spreading rapidly across the United States today, and it typically involves much higher private assessments. Perhaps the best indicator of such mandatory homeowner association “taxes” is the average assessment for townhouses (or owner-occupied “attached housing” in the Census Bureau's language), which typically consists of newer housing that is more likely to be part of a mandatory homeowners association. In 2005, according to the American Housing Survey, the median private assessment for a townhouse unit in a homeowners association was \$105 per month, or \$1,260 per year.<sup>1</sup>

Because the census data are so flawed, most researchers have relied heavily on estimates developed by the CAI, which is an unusual combination of a trade associa-

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1. This figure is derived from the *American Housing Survey for the United States: 2005* (U.S. Census Bureau 2006), based on a special run of public-access data done by U.S. Census Bureau staff at my request.

tion and a research and educational institute. According to the 1999 *Community Associations Factbook* (the most recent such general compilation available from the CAI), the average homeowners association assessment was \$90 per month per unit, the average condominium assessment was \$152, and the average cooperative assessment was \$440 per month (Treese 1999, 19). Weighted by the shares of each type of community association, the average assessment per housing unit for all community associations in the United States in 1999 was \$132 per month, or \$1,584 per year. The CAI estimated more recently that the 300,800 private community associations in the United States in 2008 will have a total annual operating revenue of \$41 billion. Spread over the 24.1 million housing units in these current community associations, this total comes to a nationwide annual average of \$1,701 in association service costs per unit owner—an amount that must be covered in one way or another by assessments (CAI 2008).

Further confirmation of the significant magnitude of assessments appears in the available data (again rather limited) on the actual services community associations provide, overlapping in many cases with public services provided to other people in the same jurisdiction. According to the 1999 CAI *Factbook*, 77 percent of all community associations provided snow removal, 64 percent garbage collection, 54 percent street cleaning and lighting, and 12 percent supplemental police patrols of the streets (Treese 1999, 13). A survey by Barbara McCabe and Jill Tao in 2006 focused on “large scale HOA [homeowner association] communities,” those with at least 1,200 housing units, 1,000 acres, and \$1.5 million per year in service expenditures (2006, 1144–45). Among these larger homeowner associations, more than 95 percent cut the grass and otherwise provided landscaping services in their common areas, 82 percent operated a swimming pool, 62 percent undertook street repairs, 48 percent had a security guard, 41 percent collected the trash, and 33 percent had their own golf course, among other service responsibilities (1154–55).

Thus, the added financial burdens of paying both for their own private services through community association assessments and at the same time for public services through local public taxes are significant for many associations. As noted previously, this additional burden raises the question: Why do these community associations exist in the face of such negative financial disincentives? To examine this issue, it is helpful to revisit the Tiebout model, the leading intellectual construct for analysis of urban governmental forms. I also consider how the rise of the private community association fits into the framework of and might require modification of the basic Tiebout model analysis.

### **Charles Tiebout’s Perfect World**

In the early history of the United States, most people lived on farms or in small towns and villages. By the second half of the nineteenth century, however, cities were bringing together increasingly large agglomerations of people and business. As new

areas outside a city were developed, the central city government would often annex them. Chicago, Baltimore, and many other eastern and northeastern cities acquired their current boundaries by such a process (Jackson 1985). Reflecting the wider American trend toward consolidation, the present City of New York was formed in 1898 by combining five separate boroughs.

In the first half of the twentieth century, however, growing numbers of people in suburban areas began to resist consolidation. A standard tactic was to incorporate as a suburban municipality, thus blocking annexation by other municipalities. By the mid-twentieth century, today's prevailing system of local governance in the Northeast and Midwest had emerged. An older central city would be surrounded by a large number of mostly much smaller suburban municipalities. The metropolitan areas of Chicago, Cleveland, and Detroit, for example, today include 569, 243, and 335 general purpose local governments, respectively. As a result of this new form of organization of local governance in metropolitan areas, the purchaser of a home began to face a much wider choice in local government services and taxes, which resembled other consumer choices among a wide range of available goods and services in ordinary markets.

Economist Charles Tiebout famously analyzed these new realities of American local governance in a 1956 article, "A Pure Theory of Local Expenditures." He assumed a manifestly impossible set of circumstances. Let us assume, he said (in part implicitly), that home buyers have perfect information, economies of scale in local services are small, land developers know the home purchasers' preferences perfectly, people can move from one place of residence to another without cost, and local governments can be formed easily and their boundaries modified to compete actively to win home buyers. In such highly stylized circumstances, Tiebout went on to argue, the equivalent of a perfect market solution for local government services would emerge. Consumers would make marketlike choices in choosing to live in one local jurisdiction or another, and each jurisdiction would provide the precise level of services, paid for by local taxes, that corresponded to the private preferences of its homogeneous group of homeowners. As Wallace Oates has commented recently, Tiebout's "purpose is . . . to establish a kind of equivalence between the local public sector and a competitive market" (2006, 23). In this respect, Tiebout was challenging the conventional wisdom of the time that the social allocation of publicly provided goods and services necessarily had to be determined politically outside a market framework. Local public goods and services, he argued, were a large exception.

Indeed, as Tiebout himself put the matter, in a perfect metropolitan equilibrium "the allocation of resources [by local municipal or other public governments] will be the same as it would be if normal market forces operated" to determine local services and taxing levels (1956, 421). Even allowing for the significant imperfections in the actual workings of the suburban market for local service provision, "the solution will approximate the ideal 'market' solution" (421). In establishing the market equilibrium, "the act of moving or failing to move [from a given municipality] is crucial"

(420). In the suburban market for municipal services, the decision to stay or move “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” (420)—in fact, reflects them as accurately as do individual consumer purchases of other goods and services made in conventional markets.

Since at least the time of David Ricardo, economic reasoning has often proceeded by heroic abstraction. The abstraction is not necessarily meant to convey an accurate picture of reality. When such methods of abstraction are employed insightfully, however—their employment being as much an art as a science—the results may shed a powerful light on important aspects of the real world. Since the 1960s, Tiebout’s framework of analysis has in fact had a powerful impact on the way analysts understand the workings of the metropolitan system of local governance (Fischel 2006).

As an economist, Tiebout applauded the resulting effective privatization of local governance that he saw emerging, if less than perfectly in practice, even in the nominally public governance system of American metropolitan areas. Other observers, however, were less enthusiastic about the extension of market workings—and their distributional consequences—to yet another area of American life. The quality of the surrounding neighborhood environment would closely reflect the economic status of the home buyers there. Thus, just as the rich buy Mercedes and the poor buy used Toyotas in the automobile market, the rich would live together in the most attractive neighborhood environments, and the poor would live together elsewhere in their own lower-quality neighborhoods.

At about the same time that Tiebout was writing, Harvard law professor Charles Haar objected to this less-than-egalitarian outcome and criticized a New Jersey Supreme Court decision that upheld the exercise of strong municipal zoning powers: “the preservation of expensive homes . . . apparently becomes a proper function if suitably dressed up as a zoning ordinance” (1953, 1036). Even as the workings of the land-use system were leaving the poor to live among themselves, Haar argued, “the New Jersey Court substituted shibboleths for reasoning and used liberal shibboleths to attain an illiberal result” (1063).

## **From Zoning to Community Associations: The Evolution of a Collective Property Right**

For a market system to work, a system of property rights must defend the owners’ authority to exclude others and otherwise to assert control over their property’s use. As was implicit in Tiebout’s analysis, and as I argued explicitly in *Zoning and Property Rights* (Nelson 1977), the system of suburban zoning in effect solved this problem. All the many public-planning illusions and other conventional urban “progressive”

mythology of government scientific management aside, the reality of zoning was that it provided a de facto collective property right to a common neighborhood environment.<sup>2</sup> Bruce Hamilton (1975) had already pointed to the essential role of zoning powers of exclusion in the Tiebout model's theoretical workings. Without the city's power to exclude the poor, they would perpetually chase the rich in seeking to share a residential jurisdiction.

William Fischel (1978, 1985, 1995, 2001) subsequently elaborated and refined a property-rights perspective on zoning in books and articles that have continued to the present day. As he observes in *The Homevoter Hypothesis*, local "city governance," even though nominally a public activity, "is more like that of business corporations" (2001, 23). Local governments thus cut private deals with private land developers much in the manner of one private business negotiating and reaching an agreement with another. When a local government grants entry to a new development, it does so because sufficient "compensation" in one form or another has been paid to win the voluntary "consent of the community" (180); in other words, a mutually beneficial deal has been cut. Voters in local elections, like stockholders in ordinary business corporations, seek primarily to maximize their private gains as members of the local community. Extending the Tiebout framework of analysis, Fischel states that the suburban "fragmentation of local government causes property owners, who are mainly homeowners, to seek a mix of local services that maximizes the value of their holdings. . . . They will avoid living in jurisdictions in which their property taxes are used to finance things they do not want" (223).

Fischel does not deal with the issue raised here—namely, the fiscal and other consequences of the newly emerging system of dual, overlapping, suburban governments that leaves many people subject at a given location to both the private governance of their community association and the public governance of their municipality (or other public jurisdiction). With the rise of private community associations, however, a new system of local governance is rapidly emerging in the United States. The traditional public sector is still important in providing arterial highways, water supply and sewerage, basic fire and police protection, and other public services on a regional scale, which state governments, large county governments, or metropolitan special districts usually provide. However, small private governments are increasingly providing garbage collection, street maintenance, neighborhood parks, swimming pools, supplemental security patrols, and many other neighborhood-level services. Community associations are also increasingly undertaking the task of regulating the small-scale interactions among nearby and adjacent land uses, previously assigned to county and municipal zoning.

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2. This understanding of zoning applied in the most widespread setting of an existing neighborhood with homes. When zoning was applied to undeveloped land, however, it worked much differently, amounting to an expropriation of land-development rights by the municipality (which might prove to be only temporary if development permission were eventually granted in later years). See Nelson 1977, chaps. 2, 3, 4.

In many newer areas of the United States, a fairly clear separation of these responsibilities exists between the private sector and the public sector, with the private governments providing the neighborhood-level “micro” services and the public governments providing the regional-level “macro” services.” In older areas, however, the private and the public governments overlap to a significant degree, resulting in double taxation and other novel policy issues, such as the existence of dual public and private regulatory systems for neighborhood land use.

### **Minimizing Transaction Costs Privately**

Despite the significant negative financial disincentives of double taxation, private community associations may have spread so rapidly because they work to minimize key transaction costs, thus compensating for the fiscal disadvantages (Nelson 2008). Indeed, the community association actually brings the real world of local government closer to the heroic abstractions of the Tiebout model. In the model’s original conception, the formation of a local government is treated in effect as having zero costs, as are essentially all other metropolitan transactions. In the case of a community association, this assumption is perhaps not hopelessly unrealistic. It may be possible to create a community association at small expense because it is legally established as part of the initial development process. A land developer files a declaration for a fully conceived project that includes a political process—a “private constitution”—to establish the rules for collective decision making and a private government to implement these rules. Each home buyer must agree to the terms of this private constitution and government as an initial condition of purchase.

As a result, the residents of community associations need not engage in any costly negotiations with respect to the future political arrangements of a local government. Moreover, in a community association, the political boundaries of the new private government are initially set to match the boundaries of a fully planned, soon-to-be-developed community. Once again, the developer produces this setup as part of the larger development project; the private government is part of the new home buyer’s overall private consumption package. Tiebout’s heroic assumption of perfect foreknowledge of home-buyer preferences is more closely approximated when the developer plans the new community for a specific set of targeted future buyers well in advance of their arrival.

In the case of a municipal government in the public sector, the situation differs greatly, and a new government’s creation is less compatible with a strict set of Tiebout assumptions. Under the typical state law of incorporation, a new municipal unit of government may be created only after a group of residents has already moved into an area. The residents can then organize themselves to work out the details of an incorporation proposal and submit it to an appropriate unit at a higher level of government. In many cases, the new municipal incorporation can be blocked at the higher level if the government there objects. Assuming this hurdle can be overcome, however, a

referendum vote among the residents typically must be held to approve or reject the proposed incorporation (usually decided by a simple majority vote).

Forming a new municipal government in this manner is likely to involve significant transaction costs. Contentious debate may occur among the residents concerning issues such as the precise political structure of the local government and its exact boundaries (which may include some local residents but exclude others from the proposed area of incorporation). The usual free-rider problems and other difficulties of organizing collective action among any group of separate individuals will surface. Achieving a homogeneous municipality of residents who share the same common service demands is also likely to be more complicated under an incremental process of gradual municipal development and subsequent incorporation than in a developer-led process of planning and building a single large project of many homes and establishing a community association in advance to serve them.

In incorporating a new municipal government in the public sector, various rent-seeking possibilities arise that are less likely to arise in the creation of a new private community association. A group of more densely settled residents may propose the incorporation of a wider municipal area that includes other residents, such as farmers, who are few in number but own large areas of land. Then, needing only a simple majority vote, the residents might win incorporation of the municipality over the objections of this minority of landowners (who may nevertheless own the greater part of municipal land). Applying new zoning powers obtained through a successful incorporation, municipal residents may then zone farm land and other unoccupied areas for “open space” or an “agricultural preserve” or something else to serve their own purposes.

Such rent-seeking local opportunism, in which one group of residents of a newly incorporated municipality effectively confiscates another group’s development rights, would be more difficult or even impossible in a private community association. At the beginning, the developer controls the process and has a strong incentive to block the exercise of any such political strategy by early-arriving home purchasers. Moreover, in a private community association, as in an ordinary private business corporation, voting shares of unit owners are distributed in proportion to the magnitude of ownership of the land and property rather than according to the one person/one vote rule in the public sector, thus inhibiting *de facto* confiscations of landowners’ development rights.

The local governments of the Tiebout model are expected to exhibit a privately entrepreneurial behavior. In principal, nothing prevents a government in the public sector from acting in a businesslike manner, but in practice municipal governments’ political incentives are less certain to encourage maximization of total land and property values. Besides the one person/one vote issue, including the potentially large voting impact of renters in municipalities, the management goals set for municipal officials are vaguer, as compared with those set for the officers of a private community association. According to longstanding planning and zoning legal theory, in matters

of zoning and some other community responsibilities, municipal officials' actions are supposed to serve a wider interest than those of the municipal residents alone (for zoning, municipal decisions should be "in accordance with a comprehensive plan" prepared by land-use experts) (Haar 1955, 1154). The resulting ambiguity with respect to a "public" municipality's legitimate "objective function" is likely to impede at least to some (admittedly, perhaps rather limited) extent the municipality's quasi-private pursuit of Tiebout maximization. Even if municipal officials want to maximize the welfare of local residents alone, final decisions in many cases rest in the hands of judges who may act to protect a wider social interest.

The theoretical workings of the Tiebout model also require the ability to re-contract the metropolitan governance outcome in the long run. As economic circumstances change, the optimal Tiebout configuration of local government boundaries and of public-service levels and taxes also changes. In the real world, such change is bound to pose a major obstacle for municipal governments. Once municipal boundaries have been set, they are typically difficult to alter, and municipalities almost never dissolve themselves to allow a new set of municipal boundaries and governments to emerge to suit new demographic and economic circumstances. Changing the boundaries of a community association or voting a private community association out of existence also involves high transaction costs. For private legal entities, however, the transaction costs are considerably less than the costs of reconfiguring the metropolitan organization of a local municipal government (and they might be reduced even further if state legislatures clarified the private legal status of community associations, establishing a private collective right to sell the entire association in one package or to dissolve it as a simple market transaction).<sup>3</sup>

## **Community Associations' Greater Constitutional Flexibility**

The very existence of large numbers of private community associations, despite double taxation and other added financial liabilities connected with them, may also indicate their superiority as an instrument for local governance. Because the public and the courts regard community associations as legally "private" entities, these associations have wider legal flexibility, giving them governance options unavailable to local governments in the public sector. These potentially valuable private political options include:

1. Greater flexibility in the assignment of voting rights, which do not have to follow the mandatory public-sector rule of one person/one vote, but may do so if the association chooses.
2. Flexibility to allow foreign nationals, people legally registered to vote in other political jurisdictions, nonresident property owners, and other types of unit

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3. Nelson 2005, chaps. 9–11, explores this possibility.

owners the right to vote in the community association, a right they are denied in a public setting, where voting is considered a right of public citizenship assigned to a person in a single official place of residence.

3. Wider private flexibility to define a social environment by discriminating against and thus excluding others who do not meet the entry qualifications, as in a community association of senior citizens that is legally entitled to exclude younger adults or children.
4. Wider flexibility to regulate even the fine details of neighborhood land use, such as house color, placement of shrubbery, parking of vehicles, building of fences, and other small alterations in property that public zoning has not traditionally controlled.
5. Greater private flexibility to regulate the entry of nonresidents into the neighborhood by the placement of gates and other barriers on streets and at other entrances to a community association, creating, so to speak, a virtual private “visa” system.
6. Wider flexibility to control the placement of political signs, the holding of meetings, and other activities within the association boundaries that would be constitutionally protected in an officially public setting as necessary to the protection of free speech and assembly.
7. Greater flexibility to control the hiring and firing of local governmental employees than exists with respect to the hiring and firing of public-sector employees—in the case of a community association requiring only a change in the private management firm.
8. Greater flexibility in contracting out local government functions to private suppliers.
9. Greater flexibility to terminate the local government, as when a community association votes to sell all the units as a single package for comprehensive redevelopment of the neighborhood in an entirely new use (a potential step that community associations have not often taken thus far, but one they might increasingly take in the future as total land-use transitions accelerate in many rapidly changing urban neighborhoods).
10. Greater constitutional and other political latitude than public governance has, the latter often reflecting a past history of legislative and court decisions that have severely constrained local governments’ flexibility in the public sector.

Many of these forms of greater private flexibility at present may not be intrinsic to the character of a “public” or a “private” government. With a new legal framework, public governments might be able to act in a similarly flexible quasi-private fashion, but in practice they cannot do so today. Instead, American federal and state legislatures and the courts over the years have increasingly imposed a tight set of procedural and substantive legal rules on local public governments. Admittedly, it might be possible, as Harvard law professor Gerald Frug (1980) has advocated, to loosen the

rigid legal rules that bind local public governments by revisiting and overturning fully or partially these past legislative and judicial decisions. However, it has been more practical—the transaction costs have been lower—simply to redefine new local governments at the neighborhood scale as “private” and thus as substantially less legally and constitutionally constrained (Nelson 2003).

Although the issue has not been widely studied, some limited empirical research has been conducted on the value added to a home as a result of its being located in a private community association. Jeffrey Pompe (2008) estimates that for coastal areas in South Carolina, a home in a community association (in this case all having a gate) commands a price 18.6 percent higher than a comparable home commands in an area lacking such an association (other things equal). In northern Virginia, Amanda Agan and Alexander Tabarrok (2005) find that a home in a neighborhood with a private government is worth 5.4 percent more. Other researchers also find that the presence of a private neighborhood government has a positive effect on property values (Bible and Hsieh 2001; LaCour-Little and Malpezzi 2001). Such incremental values admittedly may decline in the future as developers respond to positive financial incentives by increasing the supply of available housing that is privately governed at the neighborhood level. Given differences in tastes for neighborhood collective governance—some people like the greater control, whereas others find the tight rules oppressive—home buyers will gradually sort themselves out by moving to areas with or without private community associations, thus tending to shift the existing housing-price differentials among these areas.

### **Moving beyond Tiebout**

Since Tiebout wrote in the mid-1950s, mainstream economics has increasingly questioned the general usefulness of abstract models of a perfectly competitive world of perfectly knowledgeable economic agents who incur zero transactions costs. Inspired first by the writings of Ronald Coase and then by those of Oliver Williamson and other economists, a new institutional school of economics has taken shape since the 1970s to explore the workings of a much different economic world—one of opportunism, asymmetric information, high search costs, lock-in effects, dynamic disequilibrium, and frequently significant information and other transaction costs (Furubotn and Richter 1997). As Wallace Oates comments, in the 1990s analysts of urban governance were increasingly applying this “expansive literature on problems of information” in economic systems (2005, 356). Moving beyond Tiebout, the creators of a new “second generation theory of fiscal federalism” took explicitly into account that “optimal ‘procedures’ or institutions are likely to be quite different from those in a setting of perfect information. The SGT [second generation theory] is thus drawing heavily on much of the work in industrial organization and microeconomic theory that has explored these information issues” more broadly throughout the economic system (Oates 2005, 356; see also Fennell 2006).

Even more so than in a typical private market, an assumption of zero transaction costs is likely to be inappropriate in an urban setting with all of its fixed past investments and other historical rigidities. Hence, it may be helpful to explore a metropolitan system of governance under assumptions almost diametrically opposed to Tiebout's assumption of a continuously maintained perfect urban equilibrium. Let us suppose that once housing has been built and local government boundaries have been set, these decisions are fixed permanently. The evolution of urban governance will then be left to reflect a limited range of dynamic elements that remain in the system. In these circumstances, it will exhibit a high degree of path dependence.

Most homeowners who want change will have to work politically to change their local government's policies or have to move their place of residence. Only in the few newly developing areas (usually in the outer suburbs) will everything be in flux, as developers are free there to decide what types of housing to build and what private government structures to provide. Under these assumptions, the overall pattern of land use and local government in a metropolitan area will depart greatly from the Tieboutesque, perfectly maintained equilibrium of a world of zero transaction costs.

As a starting point in exploring the workings of such a model, we might note that when the American states were created, each state was generally divided into counties, and the initial county boundaries have seldom been changed. Thus, a new urban model might begin with a fixed set of county boundaries inherited from the distant past. Then, at least if the counties are large relative to the metropolitan area, no new governmental equilibria of Tiebout counties can arise. Furthermore, if counties are the only form of local government in the public sector, as in many rapidly growing parts of the South and West that remain unincorporated, the metropolitan public sector will be characterized by a uniformity of service levels and taxation in each of the few large county jurisdictions.

Now, for analytical purposes, let us assume that intensive land development has not yet reached a single county that lies at the outer edge of the metropolitan area, so the county's residents at present are, for the most part, farmers. Suppose now that the economic circumstances begin to change, and new urban residents start to move in. If the county is the only form of government, the public sector will remain the same throughout the metropolitan area. The newer residents of the county, however, may desire and be willing to pay for higher levels of common services. If these services are best accomplished through collective provision within neighborhoods or other limited geographic areas, they will require new forms of subcounty government. Historically, the alternatives were publicly incorporated municipal governments or, since the 1960s, private community associations.

Assume further that, owing to zoning and other necessary public county approvals, the new (and probably richer) residents must persuade their fellow county residents to allow them to "secede" governmentally in this manner. The choice between a municipal government and a private community government involves at least two aspects: which form of government is preferred in terms of its general

effectiveness and which form is more likely to obtain the county's approval of such a "secession of the successful"—to borrow Robert Reich's (1991) phrase.

In this light, in the county's perspective the municipal form of government may appear to have significant disadvantages depending on the state laws of incorporation and other laws that control the relationship between new municipalities and the counties in which they are located. Because the municipalities belong to the public sector, the counties will often be required to transfer revenues to the new municipalities and otherwise act to accommodate their needs. In Maryland, for example, under state law any newly created municipality automatically receives a direct transfer of 17 percent of the total stream of county income-tax revenue already being paid by the new municipality's residents. In Montgomery County, as in some other Maryland counties, newly created municipalities are also entitled to compensating payments from the county for any existing service responsibilities they assume.

### **Double Taxation as the Price of Entry to a Private Community**

By contrast, if the richer, urbanizing residents of the county propose to meet their service demands by creating a new private community association, the county is likely to benefit financially. Forming a private entity, members of the community association will pay for their own neighborhood services *and* pay the full county income, property, and other taxes. Owing to double taxation, a new private community association for senior citizens (which imposes minimal educational costs) has fiscal consequences for an existing public jurisdiction similar to the building of a new shopping center, office park, or other commercial facility. Even when education costs are factored in for children living in a community association, some developers at present—and potentially more in the future—are building an elementary school, leaving the public sector with only the operating costs. In short, given the current system of double taxation of private community associations, our hypothetical county is more likely to agree to a private governmental secession (a new community association) than to a public secession (a new municipality).

Moreover, once a few private community associations have been approved in this manner, the political forces opposed to new public municipalities will intensify. Because of double taxation, the existing private associations will contribute to the financing of any new public-sector services. The community associations may be concerned that new municipal residents will seek to raise public-service levels and taxes still further in the county, thus increasing the burdens of double taxation on the existing private associations. In a path-dependent world, as described in this simplified model, a county may therefore come to have few if any municipalities and instead be dominated by a host of private community associations. Indeed, this outcome, as noted earlier, characterizes many of the rapidly growing counties of the United States today. If municipalities are present at all, they are likely to be either historical legacies

of entities created many years ago, well before suburban development and private community associations arrived in the area, or large municipalities that function almost like counties—or “boomburbs,” as Robert Lang and Jennifer B. LeFurgy (2007) call them.

### Double Taxation as a Local Exaction

I assumed earlier that the county would be willing to accept either a municipality or a community association and that it would choose the most advantageous form of neighborhood governance for the county. Another possibility exists, however. The county might simply deny entry to new developments in a large part of its area. Consider how this denial might occur. As new development begins in the county (or other larger political jurisdiction) on the suburban fringe, the farmers who have previously been the main county residents will at first still control the political process. As more urban residents arrive, however, political control will gradually shift. Because the newer urbanizing residents will live in their homes at much higher densities, political control may shift well before the newer residents own the greater part of the county’s land area.

Moreover, the new residents will have different incentives than the farmers with regard to accommodating new development in the remaining undeveloped parts of the county. Indeed, given potential problems from new development, such as heavy traffic and loss of open space, they may prefer to limit or to prevent altogether further county development (they might zone the remaining undeveloped areas of the county for “open space” or an “agricultural preserve”). Even though housing prices rose and other large costs were incurred throughout the metropolitan area as a whole, the urban newcomers (the “door slammers”) might stand to benefit significantly by using zoning powers to block further residential development of their own jurisdiction.

A state government or a court (historically more likely) might intervene to assert a wider metropolitan interest. Short of that action or an unlikely burst of social altruism on the part of the county newcomers, the only way to open the remaining areas of undeveloped land in the county will be to pay for this outcome. Indeed, as long ago as 1966, economist Marion Clawson proposed such a policy solution. He did not mince words in advocating the open legal sale of zoning by county (or other local public) governments. Many others have made similar proposals since then, although they have often used more restrained language, stopping short of advocating the explicit public sale of zoning, hoping perhaps that less-direct language will camouflage the market character of the transaction and thereby increase the likelihood of judicial acceptance. Most of this literature has conceived of the necessary payoff from the developer to the county (or other public) government as taking place either as an in-kind payment or as money transferred to the public government. In the latter case, the payment may be made in different ways, but the generic term for the resulting impact fees and other forms of direct cash transfers is *exaction* (Saxer 2000).

The rise of private community associations suggests a new payoff possibility, however. As discussed previously, the double taxation of a private community association offers a potentially large financial gain to the local public jurisdiction. The community association pays for many of its own services, yet it also transfers significant new property taxes—and potentially other tax payments—to the public jurisdiction to pay for similar services elsewhere. Indeed, the financial gains of double taxation may significantly exceed the amounts a court would allow a public jurisdiction to extract from a developer in the form of an exaction. Further empirical studies are needed, but it may turn out that this transfer is an important element—conceivably even the most important factor—in resolving the puzzle of local double taxation. If a public jurisdiction wants to sell its zoning, it can get the highest price (at least the highest price the courts are likely to approve) by requiring new developments to be subject to the governance of a community association and thus to double taxation.

New Jersey is alone among the states at present in legally limiting such double taxation. Instead, in many other parts of the United States, local county and other public jurisdictions now formally or informally require that a community association be created as part of any large new development project. A community association is thus increasingly no longer a voluntary developer's choice, but a necessary condition for obtaining public zoning approval. As Steven Spiegel reports on this nationwide trend:

Local governments, on a broad scale and independent of market forces, effectively have *required* developers of new subdivisions to create community associations to operate and maintain the subdivision in lieu of the municipality providing traditionally municipal services to the subdivision, including such services as street maintenance, sewer service, water supply, drainage, curbside refuse collection, parks, and even traditional police patrols of public streets. Local governments have been able to achieve this purpose—with virtually unfettered discretion and in the absence of judicial review—through a robust application of their traditional land use powers: i.e., the power to zone and the power to approve the establishment of new subdivisions. (2006, 859–60, emphasis in original)

## The Case for Selling Zoning

The buying and selling of zoning changes, whether by direct payment of monetary exactions or by a community association's voluntary agreement to double taxation, yield a socially desirable outcome, at least in a second-best world in which state legislatures and courts have given local governments wide latitude to use their regulatory powers to block almost any kind of private development (Fennell 2000). By means of the various forms of zoning sale and purchase, developers are allowed to

build new housing to serve more people in places where public regulations would otherwise block development; home buyers therefore have more options and, with an expanded supply of metropolitan housing, pay lower prices; and the residents of the county or other public jurisdiction receive a large payment for granting zoning approval. It is win-win-win all around. The only fly in the ointment might be a punctilious judge offended by the sale of a nominally “public” regulation, who might then refuse to allow a rezoning transfer of development rights, regarding it as an illegal “bribe,” despite the substantial benefits to all parties involved.

If judges can be persuaded not to intervene, a direct payment for the zoning by means of a monetary exaction would be preferable. The exaction would resemble the monetary side of an ordinary transaction between two private parties, the zoning change (a transfer of property rights) being granted in exchange for an amount of money (the price of obtaining the property rights) paid to the local zoning jurisdiction. Double taxation, by contrast, is a clumsier form of payment. Given the requirement that the tax level must be uniform throughout a public jurisdiction, it would be difficult to fine-tune the full payment amount. If the public jurisdiction wants a larger zoning payoff from the private community, it must require the development of more expensive housing that pays more in property taxes, thus distorting the workings of the housing market.

There is considerable evidence that at least some part of the population does not want the tight controls and other characteristic management features of today’s typical community associations. This aversion can and probably will change in the future as a wider range of association types is created and more experimentation in the forms of collective governance takes place, but the learning process will occur slowly. Many people experience significant tensions in living under current community associations’ tight rules and often contentious administration. Many residents complain of power-hungry, oppressive boards of directors. Under the current system of zoning sale by double taxation, however, it is often necessary to have a private community association, whether the incoming home buyers want one or not.

Judges frequently cast a skeptical eye on large exactions, raising questions such as whether the exaction is genuinely related to financial burdens actually imposed by new development. By contrast, given the long history of double taxation and its more indirect, disguised way of making payments for zoning changes, it is unlikely that a judge will decree that the current local government practice of double taxation is illegal. Like other aspects of local urban governance, the rise of private community associations is an evolutionary response developed in part to get around regulatory rigidities and other undesirable features of the current legal regime as it applies to local public jurisdictions. In the long run, either the significant curbing of local regulation or the fully legal buying and selling of zoning would be preferable (Nelson 1977), but a large educational task must be carried out before such reforms will have any chance of acceptance.

## Conclusion

Owing to double taxation, private community associations face significant financial disadvantages relative to small public municipalities of a similar size and with a similar scope of governing responsibilities. Yet private community associations are spreading rapidly in the United States, displacing the traditional governing role of the small suburban municipality and thus transforming the character of local government. Community associations therefore must have significant compensating advantages. I have identified three: (1) in newly developing areas, they have lower transaction costs in initially forming neighborhood-level governments; (2) they have more legal flexibility to tailor their private constitutional arrangements to meet the collective governance needs of the homeowners in a neighborhood; and (3) a new development accompanied by a community association can legally offer a higher entry price to win approval of public zoning changes necessary to accommodate the development (zoning “bribes” paid in the form of double taxation are less likely to be judicially overturned).

Although suburban municipalities are nominally public entities, as the widespread *de facto* sale of zoning indicates, in practice they act more like private entities. A small suburban municipality and a private community association may be viewed as alternative tenure forms for collective private ownership of American housing at a neighborhood scale. They arose in different historical circumstances with different local collective governance needs. Each has distinct features that reflect its historical origins, some of which might be discarded today. Each might be given a new legal charter in recognition of the changing needs and circumstances of the present time (Nelson 2005, parts IV and V, describes various options).

If the tenure forms were allowed to compete, this process might converge to one form of private collective housing tenure in the urban areas of the United States, presumably within the framework of private community association law, thus abolishing neighborhood-level municipal zoning (Nelson 2004). Alternatively, and perhaps preferably, multiple forms of tenure might remain available for collective housing ownership, all of them private in practice, but some still perhaps officially labeled as “municipal,” whereas others might be more explicitly private in being a category of “community association.” The process of metropolitan land settlement would then include choices not only among different locations and housing types and qualities, but also among different local collective governance tenures (Nelson 2008).

To put this local collective tenure competition on a more even basis, steps to curb double taxation are necessary. If a private community association provides neighborhood services that duplicate corresponding “micro” services provided publicly in other parts of the local jurisdiction, the community association should receive a partial tax rebate in compensation. Given financial parity, urban residents might then choose the forms of collective land tenure and local neighborhood governance that best meet their overall needs.

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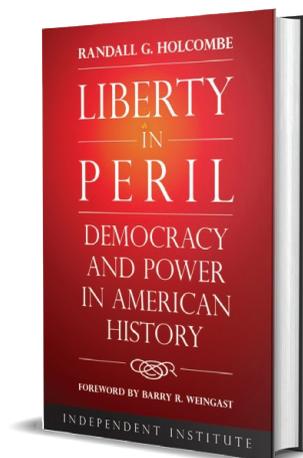
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