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The Completely Decentralized City

The Case for Benefits Based Public Finance

By FRED E. FOLDVARY*

ABSTRACT. An alternative to centralized top-down city governance is a multi-level bottom-up structure based on small neighborhood contractual communities. This paper analyzes the voting rules and public finances of decentralized, contractual urban governance and the likely outcome of such a constitutional structure, substantially reduced transfer seeking or rent seeking. Tax and service substitution, with lower-level funding and services substituting for higher-level public finance, is the general process by which the governance would devolve. Land rent is the most feasible source of such decentralized public finance, and local communities could also engage in local currency and credit services. Some empirical examples demonstrate the implementation of some of these governance structures.

I

Governance

THIS PAPER PRESENTS AN ANALYSIS of a decentralized and voluntary contractual city governance.

Gordon Tullock (1994) theorizes that many urban services can be delegated to the neighborhood level, which could become a predominant level of government. Bryan and McClaughry (1989) also propose devolving much of government to a more local level, between the level of a village and a county. Tullock (1985) also proposes "associations with quasi-governmental power" which, like churches, would not necessarily have a unique geographical jurisdiction.

This paper carries the decentralist concept further, exploring the concept of a purely voluntary city based on neighborhood associations, in which all governance is voluntary and contractual. It exam-

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ines a voting structure, based on this governance, that would reduce the capability of special interests to capture the democratic process and shift funds to their special privileged benefits. The public finances suitable to voluntary territorial associations is then analyzed and the provision of local financial services is noted. A few brief case studies show how some of these principles have been implemented.

Ultimate power in a purely voluntary city would be completely decentralized, down to the individual household and family. Its governance structure would be bottom-up, power ultimately based on sovereign individuals. The distinction between the government and private sectors would disappear, as voluntary governance would be based on contracts among private members and property owners.

The dynamics of voluntary association can proceed in two ways, via evolution or devolution. The evolutionary method consists of the joining together of individual households into an association to provide services for the members. If there are more than a few households, it is efficient to create a governing body, a board or council elected by the members, who delegate some authority to the board. The financing of the services can come from equal dues or payments by the members, as done by some of the private communities in St. Louis, or by assessments based on the value of the real estate or land owned by the owners, or on some other basis such as income or wealth. Financing is discussed in Section II.

Devolution is the transfer of political authority, property, and programs from a higher level to a lower level of governance. The devolutionary method recognizes that any path to a voluntary city would start with the status quo of imposed government. Devolution would therefore consist of various degrees of secession and substitution of lower-level for higher-level governance, and the legal ability to create lower-level governance. We thus begin with a neighborhood which is part of a city and its government. Households as well as the owners of commercial property would be able to form a neighborhood association, which would then be recognized by the city as a lower-level governing agency, or even as a new separate jurisdiction. Authority, property, and programs would then be transferred to the association and the taxes that were imposed to fund these would be eliminated or reduced, to be replaced by the association financing.

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Devolution can be partial, with residents of an association withdrawing only from some services such as schooling, and then not paying taxes for the state schools. Generally, "tax substitution" would allow residents to replace those services provided by the city with local services, with an equivalent reduction in tax liabilities. Some cities now do this for garbage collection; condominiums may contract with a private service and receive a tax rebate.

In the evolutionary model, the neighborhood associations would themselves federate into higher-level associations to facilitate the coordination of programs such as security and to provide services with economies of scale that make them more efficient to produce for a larger population or territory. The higher-level association would have a council or board which could either be directly elected by the households or by the neighborhood councils.

The election of representatives by a large number of voters, termed here "mass democracy," leads to the governance disease that economists have called "rent seeking" or "transfer seeking." Public choice, the branch of economics that studies choices made by voters and government officials, theorizes that when the benefits of transfer seeking are concentrated in a few recipients while the costs are spread thinly among consumers and voters, the incentives to organize are high for the beneficiaries and low for the payers. Also, since with mass democracy the voters are so numerous that they do not personally know their representatives, candidates rely on the mass media for their campaigns. Special interests can profit from providing much of the campaign financing in return for programs that transfer wealth to them. Mass democracy thus leads to the capture of the governance process by special interests. Besides the wealth lost by the consumers and taxpayers that is transferred to these interests, there is a social cost from the resources spent to obtain the transfers and from the disincentives created by taxes that pay for the transfers.

Mancur Olson (1971, p. 63) theorizes that while in large groups the incentive is lacking to provide collective goods, the voluntary incentives could be present in a federal group. This makes the problem of providing the good to a large area a small-numbers matter. The contrasting voting structure to mass democracy is small-group democracy, where all voting is done by small groups. The higher-level council or board is elected by the members of the neighborhood councils. For

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example, each lower-level council can elect one of its members to the higher-level council. To avoid being short a board member, the neighborhood voters can elect alternates who vote when the regular representative is absent. With this communitarian and cellular small-group voting, there is no need for media campaigns, hence little or no demand for campaign funds, since the voters personally know and have easy access to their next-level representatives.

The practice of government today is to have mass democracy for all levels of government, and thus a voter faces a long ballot with candidates for city council, mayor, county supervisors, state legislators, Congressional representatives, a Senator, and the President. Most voters do not bother to spend much time investigating all the candidates and vote either by a rule of thumb such as political party, or are swayed by campaign advertising that presents an image and a biased, superficial treatment of the issues. The practice by voluntary associations would more likely be small-group multi-level voting, avoiding the dysfunction of transfer seeking. (See the Columbia Association case study, described in Section V.) The voters at the lowest level would only vote for a few representatives to their neighborhood council. Those associations practicing mass democracy would be costlier and less effective than smaller groups, and competition with the more communitarian small-group associations would tend to favor them over mass democracy.

The association level above that of the neighborhood would in turn elect an association above it to federate the second-level associations for services with even greater economies of scale, and for coordination among the second-level associations. The associations would form a bottom-up small-group multi-level voting structure, the polity based on neighborhood cells, hence a "cellular democracy" as contrasted with mass democracy. The highest-level council could be that of a city, county, state, up to a continent and the entire planet. Spencer Heath (1957, p. 96), among others, envisioned such a structure, although he provided few details.

Since the lower-level associations voluntarily form the next higher-level association, they may also withdraw from it when the members no longer wish to be part of that association. The governance structure is thus entirely voluntary from the bottom to the top

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levels. Another feature that would reduce transfer seeking even more is to make the representatives recallable at any time. The absence of a guaranteed fixed term would reduce the potential to exploit the powers of the office, and the fact that each level is elected by a small number of electors would make it more feasible for the voters to monitor their representatives.

II

Finance and Public Goods

THE UNANIMITY IMPLIED BY PURELY voluntary governance poses two challenges to the associations: 1) funding their programs by voluntary means by those who benefit and 2) spending in ways that avoid major spillovers to non-members. This first challenge is due to the nature of public or collective goods, which are used by many persons at the same time. With a so-called "private" good, the amounts used by individuals are severable, each individual consuming a separate quantity. For collective goods, each individual uses or is impacted by the entire quantity of the item and once the good is provided, an individual may benefit without having to pay, unless he or she can be excluded from the domain of the good. Some economists have thus concluded that collective goods have a "market failure" in that firms will not provide the amounts wanted by the public if some individuals can refuse to pay.

The "market failure" argument sounds plausible only because it is presented in a way abstracted from realities such as space. The public goods typically alleged to be subject to market failure are civic goods typically provided by government, such as streets, parks, sewerage, street and traffic lights, public transportation, security, fire protection, the enforcement of contracts, and education. These services are basically territorial, serving the residents and visitors of a particular territory. To benefit from them, one must for the most part be located in that specific area.

In order to be located to benefit from civic goods, a person must pay rent for the use of space. If one buys the rights to some space, the site value is the capitalized value of the rents, so one is really buying the future benefits which have the rent as their market value. For owner-occupants, the economic rent of the space gets paid either as a

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mortgage or as the opportunity cost, what the space could have been rented out for, hence the foregone opportunity of having rented it out.

The presence of these civic works makes sites more desirable, increasing the demand and therefore the site rent. This marginal or extra rent makes the civic works self-financing. The civic goods generate rent, which then pays for the costs. The rent also provides a measure of whether the civic goods are worth providing. If they generate at least as much rent as they cost, then it is economical to provide them. The optimal rent is the quantity at which the marginal rent equals the marginal cost.

The rent enables the collective goods to be provided by the market process (Foldvary 1994). When developers, REITS (real-estate investment trusts), corporations, or civic associations own the land and provide the goods, they can collect the rent to pay for the cost. There are no free riders, since the users pay rent, or if they are guests, then their hosts pay the rent. The first challenge of collective goods is solved: those who benefit pay rent. Rent would be supplemented by user fees and profits from enterprises operated by the associations.

The second challenge, providing services in ways that avoid major spillovers to non-members, is solved by the multi-level association structure described in Section I. The civic goods are provided by the lowest level of association in which the spillovers to non-members is minimal. In practice, many civic goods do not have many economies of scale and can be provided locally, or local associations can cooperate for mutual benefit, such as by helping one another with law enforcement when criminals escape a jurisdiction. As noted by Hamilton (1991, p. 675), the evidence from several studies suggests that "we have no particular reason to believe that scale economies are an impediment to wide community choice." An analysis of economies of scale among St. Louis jurisdictions, which are among the most polycentric in the United States, has shown no significant evidence of diseconomy effects of size on per-capita expenditures, consistent with other findings (Parks and Oakerson 1988, p. 122).

To avoid free riding, a higher-level association contract can specify that if a lower-level association secedes from the higher-level association, some compensation or continuing payment be made for those services from which the lower-level still benefits. When only some house-

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holds in a block wish to form a territorial association and maintain the local street or park and provide better security, the other services remaining directly under the city, then the city and the neighborhood can form a partnership, delegating some tasks to the association and sharing the costs. In this way, neither side is privileged. If the association members wish to adopt some rule or change (such as blocking off one end of the street) that the non-members do not favor, an arbitration board can assign compensation for the disfavored party. This then shares the social cost among the whole neighborhood rather than the majority imposing it on a minority. The association might decide that the compensation cost is not worth the benefit of the new rule. Either way, as Ronald Coase (1960) points out, economics suggests either win-win solutions or at least some sharing of costs rather than the win-lose method typical with imposed centralized government. Another option, as noted by Heath (1957, p. 136), if some owners can hold out, is that "they and their unincluded properties will naturally receive second consideration in all matters of public benefit or preferment. Unfranchised as owners, their influence and advantages all will be of second rate."

With multi-level associations, the financing is bottom-up, although the assessments can be top-down. A lower level is assessed by the higher level and pays assessments or fees only to the next higher level. The higher level may assess the payments according to the land value of the sites in the area, but the funds are collected and sent up starting with the lowest level. There could be special boards set up to assess rent and land value with representatives from several association levels, but the assessments performed by professional appraisers.

With freedom of association, there would be a great variety of association themes and services. Over time, people would move to the communities that are best suited to their interests and finances. Competition among communities, as described by Charles Tiebout (1956), would also induce efficiency in the provision of services.

III

Local Money and Banking

IN A WORLD WITH NO TRANSACTION COSTS and perfect knowledge, local-association money and banking would be redundant. Commercial firms

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and standard currency would be adequate for community needs. But in the real world, there can be cash and credit constraints that are overcome by voluntary civic institutions. Some communities have had success with local currencies, sometimes issued by local firms, which lend notes at a discount. The notes circulate and are later redeemed for goods. In Ithaca, New York, "Ithaca Hour Notes" circulate widely and are based on a labor hour (those providing more expensive labor can charge multiples of the base hour). Great Barrington, Massachusetts, has used "Deli Dollars" redeemable in food (Greco 1994).

Communities in several countries have also organized indirect exchange systems, most notably using the Local Exchange Trading System (LETS), which began in Canada in 1983. LETS is similar to a credit union, but members begin their account balances at zero and exchange with other members. Those who purchase goods incur a debit, while those who sell obtain a credit; debits and credits are denominated in the national currency. LETS enables a local economy lacking in cash and credit to provide mutual employment by creating a means for mutual credit and transactions without cash. As LETS expands, a wider market linking local systems can become feasible.

There can be multi-level LETS systems serving wider areas. Thus neighborhood associations can provide financial as well as civic services to their members (Greco 1994).

IV

Urban Problems

We can now analyze some urban problems to see how associations would compare with central city governments in handling them.

A) Crime

Security and criminal justice can be divided into two aspects, the front and the back ends. The front end is the prevention of crime by guards and equipment, as well as catching criminals. The back end consists of trials and punishment. Different agencies can handle the two ends. Already, much of crime prevention is done privately by households and businesses with guards, locks, alarms, and other security services.

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Private neighborhoods in St. Louis often block off one end of a block, making it more difficult for criminals to escape. Associations provide for more control, more monitoring and involvement by the community, and a more difficult target. Judge Richard Neely (1990) has described how neighborhood associations are being set up for protection against crime, supplementing government policing.

On the back end, a devolution to local governance would retain constitutional protections for both criminals and victims, while emphasizing restitution where feasible. Arbitration as well as private courts already supplement the clogged civil courts. Bottom up governance would be supplemented by top-down higher-level constitutional requirements for justice and due process, but with local and private options such as contracting out prisons.

Crime itself is divided into two types, crimes with victims and victimless crimes. Decentralized governance would let the local voluntary association determine how it deals with victimless crimes. Some associations might wish to outlaw nudity, gambling, intoxicating and narcotic drugs, pornographic literature and performances, and prostitution, while others may wish to have some of these legal. Competitive communities would thus provide choice in law along with other collective goods. Communities which decriminalize victimless acts would have lower law enforcement costs as well as possibly less violent crime. The private provision of police services would in many instances be more focused on the protection of property and personal safety and less on the enforcement of cultural standards such as what people read or whether they spend money in gambling.

B) Slums and Poverty

Poverty, which is basically a low wage level, can be remedied by increasing labor productivity and reducing the cost of employment. Ways to do this include removing legal barriers to employment and enterprise, increasing skills and improving work habits, and eliminating taxes and other imposed costs on wages. By seceding from government with its restrictions and taxes, civic associations also withdraw from restrictions on enterprise and labor, such as not allowing jitneys or vans to provide for local transit (Klein et al. 1997). Devolu-

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tion would also substitute local assessments and fees for income and sales taxes, a shift that would reduce the social burden of public revenues. This would include reducing the high tax rates for those escaping the welfare system, which adds the loss of benefits to the taxes on wages.

The property tax, as practiced in most of the world, imposes a burden on real-estate improvements. Whenever owners put up buildings or improve property, they get slapped with a tax increase, as though being punished for doing something bad. This is one reason why poor neighborhoods deteriorate. With control over their finances, a low-income community that chose to attract enterprise and development could exempt all buildings and other improvements from an assessment based on real estate.

As noted, increased productivity also comes from better human capital. If the city school system is costly or ineffective, families would be able to substitute private and home schooling, with tax substitution for the tuition. Some associations could provide schooling as well.

C) Sprawl

Urban sprawl consists of a wasteful use of land for urban expansion due to a greater amount of land usage than would exist in a pure free market. As defined here, sprawl is a function of interventionist policy which subsidizes land holding, rather than the result of purely voluntary choices to live in a low density environment.

Rather than develop compactly with gradually decreasing density, sprawl leapfrogs over developable land to further locations. Cities then build more costly infrastructure, and commuting times get longer and longer. With a low density, public transit is not economical, and there is more automobile congestion.

By definition, such sprawl is not a pure market outcome. Zoning contributes to sprawl, especially when it mandates a low density and precludes multiple-use real estate (Nelson 1977). Property taxes and government funding for public works also induce sprawl by creating dysfunctional land speculation. Speculation can serve a useful function in allocating goods over time and providing more buyers and sellers. But in cities today, government policy leads to inefficient and tur-

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bulent speculation. Government provides public works such as transit, streets, police and fire services, and schools. These services increase land rent and land values since the landowners pay only a small fraction of the cost. This constitutes a transfer of income from taxed workers to the landowners; developers thus become rent seekers. Speculators anticipate where the growth will be, accompanied or led by government-financed infrastructure. Lots held for speculation await higher prices, and so development leapfrogs over them to less expensive, further-away sites. Speculation can also induce malinvestments in real estate, buildings which turn out to be unprofitable. This especially occurs when monetary policy artificially makes interest rates low, leading to excessive investment in higher-order capital goods such as real-estate construction. Developers also expect a large part of their profits to come from increased land values. But those who build at the end of a real estate boom are left with vacancies, low rental income, and large loans to pay back (Foldvary 1997).

Cellular democracy and contractual communities would induce a more economical, since competition would induce a more rational system of financing public works and covenants would replace zoning. Association finance would follow the benefit principle, where those who benefit pay the costs. This would lead to a more compact development, since the profits from development would come from producing buildings and streets rather than from land values created by government works. Public utilities such as water would have a higher cost for users at the fringes who require longer piping and larger volumes from the source than do central-city users (Gaffney 1964).

D) Congestion

Since the streets and freeways in a city are free to the user, they tend to get overused during rush hour. A more compact development would ease the congestion with shorter distances and more urban transit, due to greater density. But also, privately provided thoroughfares would charge tolls which could vary according to congestion. Such peak-load pricing would reduce congestion. Some city associations might also provide public transit such as street cars, without ex-

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cluding private alternatives such as vans and jitneys. The associations could fund the fixed cost from the rent assessments, since the transit increases rent, and users could pay the marginal costs.

While private streets are provided by many private communities and some firms run private toll roads, major avenues are typically operated at the city level. In St. Louis, however, some boulevards have been privately owned. An advantage of such ownership is the ability to control the utilities along the route (Beito and Smith 1990, p. 288).

V

Case Studies

COLUMBIA, MARYLAND IS AN EXAMPLE OF A large contractual community with both residential and commercial members, and which has decentralized its governance. It was developed during the 1960s. The population is about 100,000, with about 34,000 dwelling units. The Columbia Association runs an internal bus system, ColumBus, connecting the villages and the town center. The board is made up of one director from each of the ten villages. Each village has a governing board in charge of the local roads and grounds. Each resident, whether renter or owner, has a vote, as do non-resident owners. The Columbia villages are in turn divided into neighborhoods of between 600 and 800 dwelling units (see Foldvary 1994 for more details on Columbia and the cases below).

While Columbia is an example of successful multi-level organization, the model presented in this section would carry the concept further, to lowest-level neighborhoods of about 500 persons. Two examples of communities this size are the village of Arden in Delaware and the Fort Ellsworth condominium in Alexandria, Virginia.

Arden is an example of a land trust; in this case the land is owned by a nonprofit trust. The trust leases plots to households, who own the structures on the land. The lease rents pay for the expenses of the trust and the property tax as well as the village's budget. Unlike most residential associations, there are no restrictive covenants on the architecture in Arden, and it does not need them, since the houses are pleasantly different from one another, and very well maintained. There is no tax penalty for improving one's building, since the lease

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payment is only for the land and the property tax on the building is paid for by the trust. Indeed, Arden was deliberately founded on this principle in 1900 by followers of Henry George, as a model of a community funded from its site rents. The founders were also influenced by Ebenezer Howard (1965), who proposed "garden cities" which combine urban and rural features. Some 43 percent of Arden consists of greens, forests, and roads.

Arden is governed by town meetings and committees, with four regular town meetings per year. The village also elects a board of assessors to assess the lease rent. There are also many social, charitable, and recreational clubs. The Arden model was so successful that two similar communities were started nearby, Ardentown and Ardencroft. Arden demonstrates that a population of approximately 500 is sufficient to have community spirit, much activity, volunteers, and local civic goods. The village even had its own school until the state government forced it to give up local control in 1969. If it were much larger, town meetings would become unwieldy and the residents would be less well acquainted with one another.

The Fort Ellsworth Condominium Apartments in Alexandria, Virginia is an example of a private community within a city. Its 169 units were constructed in the early 1970s. There are five buildings, each four stories high, the buildings divided into sections with a stairwell, mail boxes, and a bulletin board. There is a Stairwell Captain for each section.

The governance at Fort Ellsworth consists of a board of directors and various committees, as well as an annual association meeting. The association also hires professional management. Though most residents do not take part in the association functions, there are about 50 volunteers, including renters, sufficient to run the committees and serve on the board, all without pay. If a community is too small, it might have trouble finding volunteers. Given some percentage of the population predisposed to community activism, a size of about 500 seems typically sufficient to provide members for the governing board and committees.

In the cases of Arden and Fort Ellsworth, the size of the land trust and the condominium land set the boundaries for the community. For neighborhood associations that devolve from city governments, the

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boundaries can be flexible so that the associations are just large enough to generate sufficient volunteers for the board or council as well as for committees, yet small enough so that candidates and board/council members still have close personal contacts with the members. But even associations of a few households would be feasible if the members are motivated enough to form their own community.

The "private places" of St. Louis are the best case studies of single-family housing in private associations in the midst of a city, integrated within the city of St. Louis and the towns of St. Louis County. In St. Louis, "street ownership [has] represented the means to control the 'commanding heights' of the local economy" (Beito 1989, p. 35). The fact that private neighborhoods persist despite a lack of tax substitution (there is no tax rebate or credit and, unlike property taxes, the association fees are not deductible from income taxes) demonstrates their value to the residents. Despite such handicaps, some streets that were not private have become so since World War II (Savage 1987, p. xi).

VI

Conclusion

THE PURELY VOLUNTARY CITY involves an integration of several political and economic concepts. Multi-level small-group governance would permit economies of scale while minimizing privilege seeking and keeping the power base centered on neighborhoods and households. Benefits-based public finance, based on user fees and site rents, is feasible in the local level and avoids the disincentives and burdens of taxes on productive effort. Tax substitution and degrees of secession and devolution from city government would provide an orderly way towards civic associations, respecting the right both of those who form associations and those who do not wish to join. Associations could also facilitate local exchange and credit operations that overcome institutional constraints.

Many urban problems could be confronted and remedied by civic associations which replace dysfunctional taxation and regulation with benefit-based financing and association covenants. Finally, the case studies point to actual successful implementations of some of these concepts. The conclusion seems to be warranted that a purely volun-

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tary city is feasible and has the potential of replacing urban blight, congestion, and sprawl with the grandeur of free, prosperous, handsome, and well-governed centers of civilization.

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