Do homeowners' associations lower property values?

Accountability and Private Governments

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In a pair of recent *Regulation* articles, Robert Nelson and William Fischel discuss the emergence of private residential community associations (RCAs) as suppliers of services that historically have been provided by local government. (See "The Private Neighborhood" and "Revolution or Evolution," Summer 2004.) Nelson argues that state laws should be amended to allow subdivision residents to formally supplant local government (or parts of local government) with RCAs while Fischel responds that, though RCAs are growing in popularity, residents seem to want the services provided by RCAs and local government in combination, rather than having RCAs supplant local governments.

Interestingly, neither author considers whether residents as a group benefit from their homeowners' associations. Instead, they both appear to assume that RCAs provide net benefits; hence their disagreement over whether residents prefer the services of an RCA by itself or in conjunction with a local government. Is that assumption correct? Do RCAs efficiently provide services to residents?

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A BRIEF DESCRIPTION

RCAs are private organizations that display many characteristics of typical local governments. They supply services that are

often provided by municipalities, including maintenance of common areas, roads, utility systems (water and sewer), lighting, refuse removal, and communication systems. They "tax" their residents for services through regular and special assessments, and each association holds periodic elections to choose representatives who, as a board, will make decisions on behalf of their neighborhood. Current estimates are that there are more than 250,000 RCAs in the United States and that one out of every six Americans now lives in some form of homeowners' association.

EFFICIENCY If RCAs provide a level of services with benefits equal to or exceeded by residents' willingness to pay for them, then property values in the community should remain constant or increase. But RCAs may not provide an efficient level of services because of inadequate oversight by community residents. Most residents, if not all of them, have an incentive to let someone else speak for (or against) community services. The consequences of individual inaction may be policies that reflect the preferences of community activists who have higher demands for services than the mean or median resident. In the most likely type of inefficient RCA, an increment in expenses for services reduces property values because the marginal purchaser of property gets less benefit out of the services than their cost. In that case, the excessive fee will be negatively capitalized into RCA property values.

Overprovision of services is particularly likely in RCAs because the elected members of the various association boards spend other peoples' money and residents have insufficient individual incentive to monitor their boards' activities. If the homeowners anticipate that they will each pay the average cost, then each has an incentive to demand a level of services such that the marginal benefit of that level just exceeds their anticipated average cost. The result is oversupply.

Evaluation and oversight of an association's board of directors is a problem in the management of RCAs. Many community residents are apathetic about their governance, unless policy directly affects them negatively. Our study of RCAs in Alexandria, Virginia found that resident activity in the administration of the RCA ranged from 1 percent to 38 percent. One board member explained, "As long as property values are increasing, the pool is open in the summer, and the snow is removed in the winter, residents don't feel a need to come to the meetings."

Those who choose to run for the board are unlikely to represent a random sample of the preferences of RCA residents. Instead, board members are most likely to represent residents who prefer particularly high service levels. The "compensation" from being a board member is that, as an elected representative, the resident-member can directly influence whether the excessive service level that he or she prefers will be provided. Of course, the costs will be shared and borne primarily by those who would prefer lower service levels.

One possible check on the tendency of RCA boards to overspend is professional management. Because the professional manager is not a volunteer, he or she has little incentive to provide any more service than residents demand. Of course, the professional manager could shirk by providing too few services at too high a cost. But, assuming a minimum level of control by RCA residents (including the board), such a contract is unlikely to be renewed.

RESEARCH DESIGN

To evaluate the efficiency of these private governments, we gathered data on six RCA communities in Alexandria, Virginia. We then used regression analysis to examine the impact of RCA fees and the ratio of professional to residential control, along with other variables, on property values of 195 individual units in the six RCAs. The RCAs in our sample are representative of all of the condominium communities in Alexandria, a relatively small urban suburb of Washington, D.C. Its population of 128,000 occupies less than 16 square miles and is about 50 percent white, 20 percent African-American, and 15 percent Hispanic. In terms of its density and heterogeneity, it is typical of other urban suburbs in the Eastern and Midwestern United States. Our data come from the city of Alexandria, a multiple listing service used by realtors, and our own questionnaire.

The dependent variable is the sales price of all properties that sold in 2000–2001. The 1999 assessed property value

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is included as an independent variable to reduce omitted-variable bias. The assessed value is a good proxy for characteristics both of the RCA and the specific unit that affect the sales price but are omitted from the regression. For example, some RCAs are closer to "good" public elementary schools in Alexandria than others; some RCAs are closer to parks and quiet streets than others. We assume that those factors, and many others as well, are capitalized into the 1999 property value, and that the city assessment of that value captures those features without systematic error. Other independent variables include the RCA fee, square footage of the unit, and the number of units in the RCA. Our first expectation is that, controlling for the size of the individual unit, the number of units in the RCA, and previous property value, one consequence of overspending by RCA boards is that higher RCA fees will lead to sales prices lower than they would be otherwise.

Two other important independent variables are indicators of the governance system of each RCA. To measure residential control, we asked a board member from each RCA how involved residents were in the management of the community. The board member answered by using a response scale that ranged from -3, indicating very low involvement, to +3, indicating a very high level of involvement. We also asked the responding board member what percentage of RCA responsibilities is handled by professional managers whom the board hired. Our actual measure is the ratio of professional to residential management. We expect that professional managers mitigate the effect of excessive activity by zealous boards, so that the effect of this proxy on the sales price should be positive.

We also used the survey as the source of data on the number and type of services provided by the RCA. We asked if the RCA provided trash collection, road maintenance, sidewalk maintenance, leaf collection and snow removal in common areas, landscaping, building maintenance, swimming pools, tennis courts, playgrounds, and other services. Our measure was the count of each service provided; it could range from 0 to 11. If RCAs are inefficient and provide excessive services given the fees, the effect of our proxy for services should be significant and negative. We have no direct way to measure the frequency or quality of those services; rather, we assume that some or all of the unmeasured aspects of RCA services are reflected in the 1999 assessed value, one of the control variables.

> Board members' "compensation" is that, as elected representatives, they can directly influence whether the excessive service level they desire will be provided.

TABLE 1

Descriptive Statistics for a Sample of RCAs

VARIABLE	MEAN	STANDARD DEVIATION	MINIMUM VALUE	MAXIMUM VALUE
Property value ($)*	138,321	45,846	21,000	310,000
RCA monthly fee ($)	252	106	115	602
Percent professional mgmt.	86.15	25.3	40	100
Community involvement	-0.07	1.34	-3	2
Number of services	9.38	1.12	5	10
Sq. ft. of unit	933.3	270.8	489	2,178
Number units in RCA	1,059.8	705.9	110	1,684
Assessed value ($)**	89,116	31,206	40,200	202,600

* 2000–2001 sales price **1999 assessed value

FINDINGS

Table 1 reports the descriptive statistics for our data. The mean 2000–2001 sales value was $138,320, but the variation in the sample is considerable, ranging from $21,000 to $310,000. It is interesting that the range in fees is considerably larger than the range in services provided. Association fees average $252 a month, and they range from $115 to $602, a ratio of about 5:1. The average RCA in the sample provides 9.4 services, and the range is from five services provided to 10 services provided, only a 2:1 ratio.

Though all of the RCAs in our sample have some degree of professional management, the average is 86 percent, with a range from relatively little professional involvement (40 percent) to total professional management (100 percent). Community involvement also varies. The mean of the original, ordinal scale (from -3 to +3) is 0, and the range is from -3 to +2. The simple correlation between community involvement and professional management is slightly negative (-0.29), consistent with the implicit expectation that they are substitutes.

The ratio of professional to residential management is of central theoretical importance. We measured the ratio by dividing the percent of management that is professional by a re-scaled measure of community involvement, using a scale of 1 to 7. The mean ratio is 30 in the sample of six RCAs. The minimum ratio is 8, implying 40 percent professional management divided by a community involvement score of 5 (on a 1–7 scale). The maximum ratio is 100, which means min-

TABLE 2

Effects of RCA Fees and Control Variables on Log 2000-2001 Sales Price (N=195)

Variable	MODEL 1 Coef.	Prob.	MODEL 2 Coef.	Prob.	MODEL 3 Coef.	Prob.	MODEL 4 Coef.	Prob.	MODEL 5 Coef.	Prob.
Log RCA fee	-0.26	.001	-0.21	.005	-0.18	.022	-0.13	.101	—	—
Log total services	—	—	—	—	-0.52	.002	-0.40	.007	—	—
Ratio, vertical/horizontal management	0.0025	.000	—	—	0.003	.000	—	—	—	—
Log, ratio of vertical/horizontal management	—	—	0.11	.000	—	—	0.11	.000	—	—
Log square feet	0.67	.000	0.65	.000	0.59	.000	0.55	.000	0.51	.000
Log number units	0.14	.000	0.11	.000	0.19	.000	0.15	.000	0.12	.022
Log 1999 assessed value	0.52	.000	0.50	.000	0.51	.000	0.50	.000	0.51	.000
RCA1	—	—	—	—	—	—	—	—	-0.20	.000
RCA2	—	—	—	—	—	—	—	—	0.12	.263
RCA3	—	—	—	—	—	—	—	—	0.22	.079
RCA4	—	—	—	—	—	—	—	—	-0.21	.040
RCA5	—	—	—	—	—	—	—	—	*	*
Constant	1.66	.000	1.71	.000	2.75	.000	2.59	.000	1.77	.013
GOODNESS OF FIT										
Wald Chi-sq.	574	.000	556	.000	587	.000	583	.000	753	.000
Log likelihood	106		108		109		110		114	

*dropped because of collinearity

imal community involvement and 100 percent professional management.

Consistent with the variation in property values, the square footage of properties in our sample varies from very small units (489 sq. ft.) to very large units (2,178 sq. ft.). The mean is 933 sq. ft. The size of the RCAs also ranges considerably. The smallest RCA in our sample has 110 units and the largest has 1,684 units. The mean is 1,060 units.

Table 2 displays the regression results. The first column omits the proxy for service and measures management (a ratio variable) with no log transformation. The second column reports results when management is measured in log form. The third and fourth columns parallel the first two, but they include the log of the service proxy. The last column reports the results when five dummy variables for each RCA (six of them, minus the reference group) are substituted for the theoretical variables.

In all of the models, for each percentage point increase in 1999 assessed value, the sales price goes up by 0.5 percent ($p<0.001$). For each percentage point increase in the size of a unit, the price increases by about 0.6 percent ($p< 0.000$), with point estimates ranging from about 0.5 percent to 0.7 percent. Larger RCAs (those with more units) also appear to increase somewhat the value of a unit when other variables are held constant. The elasticity is small (ranging from 0.11 to 0.19) but significant and positive in all five estimating equations.

The other coefficients are the ones of central theoretical interest. In the four models that include the theoretical variables, holding the other variables constant, higher RCA fees are associated with significantly lower sales values. A 1 percent increase in the RCA fee reduces average property values by 0.2 percent. (That is the mean of the point estimates in the four models.) At the mean of the variables, this implies that a $2.50 increase in the monthly fee results in a $277 drop in the sales value of the unit.

This result can persist because it is not directly observable by RCA residents. The bivariate correlations among the three variables (fees, services, and sales value) are each clearly positive, in the range of 0.20 to 0.30. (For example, the simple correlation between RCA fees and the property sales value is 0.29.) The political message from the RCA board is clear: higher fees mean more services, and together the result is higher property values. The likelihood that sales values could be even higher if the board charged less (and possibly provided somewhat fewer services) is a politically invisible but economically relevant foregone cost.

Table 2 reveals that adding the proxy for RCA services does not change any of the results for the theoretical or the control variables. In both the third and fourth columns, services have a negative impact on property values, controlling for other variables, including the RCA fee. In the fourth column, including services reduces the significance of the fee variable, but it is still significant at the 0.05 level using a one-tailed test of the hypothesis of overprovision (predicting a negative coefficient) against the null of efficiency (predicting a parameter of zero). The consistently negative estimates of both the service proxy and the RCA fee imply that, independent of each other, additional fees and additional services are negatively capitalized into property values. This conforms to the expectation of overprovision.

However, Table 2 also reveals that management is important. In fact, professional management appears to counteract some of the excesses of horizontal self-management. As the ratio of professional to community management increases, property values increase slightly but significantly. In particular, in the first column, a 100 percent increase in the ratio

of professional to community management (from no professional management to complete professional management) would raise sales values by 0.25 percent, offsetting the effects of excessive fees in the average RCA. However, no RCA in our sample actually has zero professional management. The observed range in the ratio of professional to community involvement is from 8 to 100. For the RCAs in our sample, going from very little professional management relative to community involvement (index score = 8) to 100 percent professional management raises property values by 0.23 percent, or $318.

Measured as a log, the results in the second column imply that a 10 percent increase in the ratio of professional to community management increases property values by 1 percent. Regardless of the point estimate, in all panels, the variable is significant and positive. The implication is that property values would be higher in RCAs with the highest levels of professional management and relatively low levels of community involvement. Professional managers apparently have little incentive to provide excessive quality or quantity levels of service, given the fees that they are paid.

Professional management constrains both fees and services, but it does so in different ways. Assuming that board members consist of high demanders, they (and the RCA residents) have an incentive to monitor the fees they pay to professionals. Because there are many suppliers of property management services, that is easy to do. The board members have less incentive to monitor the level of services because they are high demanders of those services. But professional property managers have some incentive to cap the level of services that they provide, given their fee, because the managers would bear the opportunity costs of excessive service levels. Overall, the regression points to the importance of excessive fees and services as well as a zealous community board in lowering sales prices on units in homeowner associations from what they might otherwise be.

CONCLUSION

Our findings suggest that RCAs appear to act as if they are governed by a high-demand review group, while professional management (i.e., hierarchical control) slightly reduces the tendency of RCAs to produce and charge too much. In our sample of RCAs, higher fees lead to a lower sales value of the average unit. This result, however, is politically invisible; the politically visible simple correlations are all positive.

The story is consistent with that of overprovision by a private government that is more responsive to high demanders than to the median resident. Excessive fees (and possibly excessive services) reduce property values below what they would otherwise be. However, increasing the ratio of professional to community management, perhaps a form of separation of powers, appears to restrain somewhat the tendency to overcharge (and possibly overprovide). Professionally paid managers have an incentive to constrain the provision of excessive service levels.

> RCAs appear to act as if they are governed by a high-demand review group, but professional management slightly reduces that tendency.

Like all collective decision-making organizations, the RCAs that we examined seem to be characterized by problems of free riding. In RCAs, the problem of free riding may be exacerbated by the lack of political parties to frame the dimensions of dispute and hold representatives accountable. R

READINGS

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