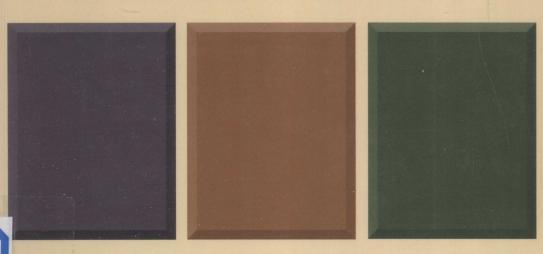


THE ECONOMIC THEORY OF

Eminent Domain

PRIVATE PROPERTY, PUBLIC USE



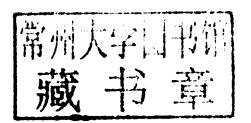
THOMAS J. MICELI

The Economic Theory of Eminent Domain

Private Property, Public Use

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THE ECONOMIC THEORY OF EMINENT DOMAIN

This book surveys the contributions that economic theory has made to the often contentious debate over the government's use of its power of eminent domain, as prescribed by the Fifth Amendment. It addresses such questions as: When should the government be allowed to take private property without the owner's consent? Does it depend on how the land will be used? And what amount of compensation, if any, is the landowner entitled to receive? The recent case of *Kelo v. New London* (2005) revitalized the debate, but it was only the latest skirmish in the ongoing struggle between advocates of strong governmental powers to acquire private property in the public interest and private property rights advocates. Written for a general audience, the book advances a coherent theory that views eminent domain within the context of the government's proper role in an economic system whose primary objective is to achieve efficient land use.

Thomas J. Miceli is Professor of Economics at the University of Connecticut in Storrs, where he has taught since 1987. He is a recognized scholar in the fields of law and economics and urban economics, and he has published widely in such journals as *The Journal of Legal Studies, The Journal of Law and Economics*, and *The Rand Journal of Economics. The Economic Theory of Eminent Domain* is his fifth book. Professor Miceli received his PhD from Brown University in 1988.

To Ana Maria, whom I can never fully compensate

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Preface

The Fifth Amendment of the U.S. Constitution gives the government the power to take private property for public use as long as it pays the owner just compensation. Though never popular, the government's exercise of this power for the purpose of constructing highways, hospitals, or other truly public projects is generally unquestioned. The recent case of *Kelo v. New London* (2005), however, pushed the limits of what constitutes an acceptable public use. In that case, the city sought to use eminent domain to acquire several private residences and small businesses in order to clear the way for a redevelopment project whose primary beneficiary was a large pharmaceutical company. In a 5–4 decision, the U.S. Supreme Court nevertheless upheld the city's right to take the property based on the enhanced tax revenues and new jobs that the project promised. The public outcry against this decision, and its apparent expansion of the government's power over private property, was loud and immediate, and was soon followed by political efforts in many states to curb the perceived abuse of eminent domain.

The *Kelo* case and its aftermath, however, was only the latest skirmish in the ongoing debate about the limits of eminent domain, pitting proponents of strong governmental powers to acquire or regulate property in the public interest on one side against private property rights advocates on the other. The legal terrain is well trod, yet there continues to be a lack of consensus on certain key issues, owing in part to their unavoidable political dimension. The goal of this book is to ask whether economic theory can help provide workable answers that transcend political affiliations. That eminent domain has an economic dimension is undeniable, considering that at its basis it is concerned with the transfer of land or other property interests from one user to another. An economic approach to takings focuses on whether, or under what conditions, a forced transfer (for that is what eminent domain

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allows) is preferred to voluntary (or market) exchange as a means of achieving the maximum value of the property in question.

In adopting this perspective, I do not wish to suggest that economic efficiency is the only criterion by which eminent domain should be evaluated, nor do I wish to minimize the political or philosophical dimensions of the debate over this contentious subject. Rather, I hope to illustrate the power of economic theory to provide both a positive (descriptive) and normative (prescriptive) approach to this issue, thereby clarifying the nature of the legal and political debate, if not entirely resolving it.

Economic analysis of eminent domain has a long history, but research in this area has accelerated in the past quarter century as economists have brought increasingly sophisticated tools to bear on the subject. This book attempts to synthesize that research, but it is more than just a literature review. Rather, it seeks to advance a coherent perspective that embeds eminent domain within a larger economic theory of exchange that draws on insights gained from the wider field of law and economics, which in recent decades has had an increasing influence on the study of nearly all areas of law.

The book is aimed at a broad audience that includes legal scholars, economists, and general readers with an interest in how economics can inform legal debates. To accommodate readers with such diverse backgrounds, I have written the main text in an entirely non-technical way, with limited use of numerical examples to illustrate some of the more formal aspects of the various economic models. For economists interested in technical details, an appendix contains formal proofs of the key results that reflect the state-of-the-art of research in this area. (The appendix reproduces some material that previously appeared in a substantially shorter and more technical survey of the economics of eminent domain; see Miceli and Segerson 2007a.)

From a personal perspective, this book is the culmination of nearly twenty years of my own research on the economics of eminent domain. I was first exposed to the topic as an undergraduate in a law and economics course taught by Richard Adelstein, and my interest was revived by the publication of the seminal article by Blume, Rubinfeld, and Shapiro in 1984 while I was a graduate student. I therefore naturally turned to the subject as a new assistant professor in search of a research agenda, and I have worked on it more or less steadily ever since. Much of my work in this area has been done in collaboration with Kathy Segerson, whose insights are reflected throughout this book, as are the comments of Perry Shapiro and several anonymous reviewers who read and provided valuable feedback on the

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entire manuscript. I also want to thank Scott Parris, who expressed enthusiasm for the project at its early stages and shepherded it through the review and publication process. As usual, my greatest thanks are to Ana, Tommy, and Nick, whose continual support is of incalculable value.

West Hartford, CT Summer 2010

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ONE

Introduction

A Framework for Analysis

When a social decision to redirect economic resources entails painfully obvious opportunity costs, how shall those costs ultimately be distributed among all members of society?

Frank Michelman (1967, p. 1169)

The problem to which the eminent domain clause is directed is that of political obligation and organization. What are the reasons for the formation of the state? What can the state demand of the individual citizens whom it governs and represents?

Richard Epstein (1985, p. 3)

Property rights are fundamental to both law and economics. From the perspective of law, property rights define and protect those things that people can and cannot do with the assets under their control, including, but not limited to, land. From the perspective of economics, property rights provide incentives for people to use their assets in an efficient way. Some reflection, however, should reveal that these are two ways of saying the same thing. The incentive function of property rights ultimately resides in the legal protections that they afford to owners, particularly in terms of their right to exclude others (including the government) from infringing on their chosen use. In this way, property rights ensure that their holders will be able to enjoy the fruits of their efforts. Private property rights therefore represent an important pre-requisite for both efficient exchange and development of land, which are the fundamental sources of economic value. As Robert Ellickson (1993, p. 1327) has observed, private property provides incentives for "people to 'do the right thing' with the earth's surface."

There are cases, however, where one person's unrestricted use of his or her property imposes costs on others. For example, certain uses of property involve the production of smoke, noise, or other forms of pollution that may cause harm to nearby residents or to the environment. These cost spillovers, or externalities (as economists call them), create potential inefficiencies in land use and therefore provide a possible justification for the government to impose limits on what owners can do with their property. And even though such restrictions may reduce the value of the specific properties on which they are imposed, their goal, if properly structured, is to increase overall efficiency.

Inefficiencies in land use can also arise when land that is currently privately owned becomes more valuable for public use. For example, as an economy develops, it becomes desirable for some amount of land to be devoted to the construction of highways, railroads, and airports, which are freely available to all. Or people may desire to set aside some amount of undeveloped land for recreational use or as an undisturbed sanctuary for wildlife. In these cases as well, unrestricted private property may impede the production of such "public goods" on a voluntary basis, so economists have long recognized that there may be a role for the government to step in and ensure that these goods are provided in the efficient quantity.

The government's response to both of the previously mentioned problems - namely, regulating externalities and providing public goods generally involves its asking private property owners to give up some or all of their property rights in the collective interest. That is, owners are either required to limit those things that they can do with their property, or they are compelled to surrender some or all of it to the government for public use. Such acquisitions of rights by the government are justified on efficiency grounds for the reasons just described, but the specific terms under which the acquisition occurs are open to debate. For example, under what circumstances are landowners whose rights are acquired entitled to compensation for the resulting loss in value? And if they are so entitled, how should the amount or form of compensation be determined? Providing answers to these questions is where the issue of eminent domain arises, for this power describes the constitutional limits of the government's ability to take private property without the owner's consent. The problem is that the language of the Fifth Amendment's takings clause is sufficiently vague that courts are left with considerable discretion in applying those limits. Consequently, the government's exercise of its taking power has generated extensive case law and scholarship, both legal and economic, seeking to define its appropriate scope. The purpose of this book is to see what light economic theory can shed on this issue based on the goal of achieving an efficient use of land. (For readers unfamiliar with the idea of economic efficiency, the appendix to this chapter provides a brief overview of the key concepts.)

1.1. The Takings Clause

The concluding clause of the Fifth Amendment to the U.S. Constitution states "nor shall private property be taken for public use, without just compensation." This is referred to as the Eminent Domain, or Takings Clause. Notice that the clause is phrased as a limitation on a power that is inherent to the government, rather than the granting of a new power (Meltz et al., 1999, p. 14). The idea that the sovereign could seize private property for the state's use originated in English common law and was imported by the American colonies. Even after independence, though, uncompensated takings by legislatures were accepted based on the republican notion that individual property rights were secondary to the common good. Only later did the liberal belief in the primacy of private property, and the concomitant need to protect it from legislative infringement, begin to emerge as the predominant viewpoint among the founding fathers, led by James Madison. The Fifth Amendment's Takings Clause was the culmination of this ideological trend (Treanor, 1985).

The specific protections of private property that the clause announced were, first, that the taken property must be put to *public use*, and second, that the owner must be paid *just compensation*. However, no further guidance was provided as to the specific meanings of the phrases "public use" or "just compensation." Thus, it has been left to the courts and legal scholars to define these terms, and much ink has been spilled in that effort. The question of interest here is what economic theory has to say about these limits.

Although the Takings Clause is phrased as a limitation on the government's use of its power to acquire land, a proper inquiry into the nature of those limits necessarily begins by asking why the government should have the power in the first place. This question is especially appropriate in the context of a democratic system where the power of the state emanates from the citizens themselves. Thus, we are prompted to ask why, in such a system, a group of citizens, acting through the government, should have a power that none of them individually has – namely, to force another citizen or group of citizens to surrender or limit the use of their property. This way of framing the question forces us to examine the underlying economic rationale for eminent domain, which, as previously suggested, is based on the goal of achieving an efficient allocation and use of land.

The proper starting point for such an inquiry is the fundamental result from welfare economics, known as the Invisible Hand Theorem, which states that in a competitive market setting, voluntary (or market) exchange will result in an efficient allocation of resources. In other words, when the conditions for perfect competition are in place, property rights will end up in the hands of those parties who value them most, or in those uses where they are most valuable, without the need for government intervention. This is a profound result because it establishes that when individual property owners pursue their own self-interests, the outcome will be socially optimal as regards the efficient use of economic resources. In such an environment, there is no apparent need for the government to intervene in the market for purposes of improving efficiency (though there may be a need or desire for it to intervene to achieve a more equitable distribution of wealth).

The requirement that exchange must take place within a competitive setting is critical, however, because it means that no parties can have market power (that is, neither buyers nor sellers can have an inordinate ability to affect the market price), and other sources of market failure, like externalities and public goods, must be absent. These qualifications are especially important for our purposes because, as suggested earlier, an economic theory of eminent domain (or, for that matter, any departure from voluntary exchange) must be based on its ability to overcome one or more of these market failures. The next section begins to lay the foundation for such a theory of eminent domain by examining the problem of externalities, and the various possible responses to them, in more detail. (I consider the problem of public good provision in Chapter 2.)

1.2. Theoretical Preliminaries: Externalities and the Coase Theorem

The economic theory of eminent domain to be advanced in this book is a component of the broader economic theory of property rights and property law. The distinction between these two is that property rights represent those things that one is entitled do with one's property (thus, they are sometimes referred to as "entitlements"), whereas property law represents the set of legal rules that enforce those rights or entitlements. As previously suggested, the economic theory of property law views these rules as being designed to maximize the value of property.² In most ordinary instances, this involves protecting an owner's right to use his property as he sees fit,

¹ The result is also called the First Fundamental Theorem of Welfare Economics (Feldman, 1980, chapter 3).

For surveys of the economic theory of property law, see Lueck and Miceli (2007) and Miceli (2009a, chapter 6).

allowing him to *exclude* others from using it, and facilitating his ability to *transfer* the right to another user on mutually acceptable terms. As argued earlier, though, when externalities are present, an owner's intended use of his property imposes unintended costs (or benefits) on others. For example, a farmer's use of a certain chemical fertilizer to increase his crop yield may pollute his neighbor's water supply, or a rancher's allowing his cattle to graze freely may result in their straying onto a neighboring farmer's land, destroying his crops. The role of the law in the presence of these incompatible uses is to limit an owner's property rights so as to eliminate or minimize the resulting external cost.

Traditionally, economists viewed externalities as a problem that only the government could solve by coercive means, for example by imposing a tax or other form of regulation on the "cause" of the harm. This so-called Pigovian view of externalities is based on the idea, previously noted, that externalities necessarily lead to market failure and thus require the government to intervene to achieve an efficient outcome. For example, a polluting factory must be taxed; otherwise it will ignore the harm that its pollution causes to nearby residents and will therefore emit too much of it. Another way to say this is that, absent the tax, the factory will view pollution (and the resulting harm) as a free "input" into its production process and will therefore overuse that input. By imposing the tax, the government is in effect saying that pollution victims "own" the right to be free from the harm, and thus the factory has to "purchase" that right (via the tax) if it wants to continue polluting (even though the tax revenue is not necessarily paid to the victims). In this way, a "forced" transaction at a price set by the government replaces the hypothetical market transaction that ideally would have taken place between the factory and residents regarding the exchange of the right to pollute.

Ronald Coase made a fundamental contribution to the economic analysis of externalities when he re-examined this traditional Pigovian response to the problem of incompatible property rights (Coase, 1960). Coase's key insight was not that the Pigovian perspective as just described is wrong; rather, he suggested that it was incomplete. In particular, he argued that it is based on two implicit assumptions, neither of which is necessarily valid. The first assumption is that there is a well-defined "cause" of the external harm; that is, there is a clear injurer, the factory, and a clear victim, the residents. The second assumption is that government intervention is necessary to internalize the harm because the market will fail to do so. The role of these assumptions in the traditional Pigovian view of externalities, and Coase's re-interpretation of the problem, is best illustrated in terms of