Eminent Domain for Private Use: Is it Justified by Market Failure or an Example of Government Failure?*

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I. Introduction

The alleged market-failure "justification" for using eminent domain to obtain property for a private development is that compulsory transfers are necessary in order to overcome holdout problems. After all, this argument continues, only the state has such power, so the private sector would be unable to supply the efficient amount of land-extensive developments. This market-failure justification is examined from two different perspectives in order to demonstrate that it is not efficacious. Section II provides a direct examination of the alleged holdout problem to demonstrate that, while government entities may face significant holdouts, the magnitude of any market failure that might actually exist with a private development is much less significant than this argument assumes. Section III follows with an examination of the actual historical evolution of eminent domain powers and its accompanying requirement for compensation to illustrate that the actual development reflects repeated efforts to constrain government rather than to solve market failures. Section IV illustrates that, as with earlier efforts to constrain government, the United States' constitutional requirements of public use and just compensation have gradually broken down. As a consequence, eminent domain powers actually result in substantial government failure. Therefore, even if there is a potential market-failure, the high likelihood of government failure undermines the claim that eminent domain is an appropriate solution to the market failure. The concluding comments in Section V point out, however, that eminent domain is only one type of government takings. Takings also occur through the regulatory process (police powers), for instance. Thus, potential limitations on eminent domain should be considered in the broader context of government failure and takings. If local governments' abilities to

transfer wealth through eminent domain condemnation with compensation are limited, it could lead to a substitution of uncompensated takings.

II. The Alleged Market Failure Justification for Eminent Domain: Holdouts[1]

Suppose one person, individual A, wants to obtain possession of a tract of land that is currently legally controlled by another person, individual B, perhaps to combine with other parcels currently owned by still other people. There are two ways for A to obtain the property. One is through bargaining in an effort to achieve a mutually advantageous exchange. The other is through coercion if the person desiring the land has the power to force a transfer or the ability to call on someone (e.g., a government official) who has. Suppose that A values the land at $X and B values it at $Y, X>Y. A and B are therefore likely to find mutually advantageous terms to make the exchange, i.e., A will pay price $P to B where X>P>Y. In general, successful voluntary exchange is likely to be Pareto efficient,[2] but such exchange is not costless. If transactions costs prevent some valuable exchanges from occurring then, in theory, a substitute for bargaining, such as regulation or compulsory sale, may increase social welfare.[3] The primary source of transactions costs that allegedly justify eminent domain powers is the so-called "holdout problem" (Posner 1977, 40-41; Fischel 1995, 68; Miceli and Segerson 2000, 330). This problem is explained quite succinctly by Posner (1977, 40-41):

> An economic reason for eminent domain, although one applicable to its use by railroads and other right-of-way companies rather than by government, is that it is necessary to prevent monopoly. Once the railroad or pipeline has begun to build its line, the cost of abandoning it for an alternative route becomes very high. Knowing this, people owning land in the path of the advancing line will be tempted to hold out for a very high price - a price in excess of the actual opportunity cost of the land. The high

[1] This section draws from and expands on Benson (2005b, 2006).
[2] A fundamental fact is that *voluntary* exchange takes place only when *both parties expect to be better off* as a consequence. And of course, if those expectations are met, the *voluntary exchange increases "wealth"* (subjective well-being) in what economists refer to as a *Pareto efficient* way. Use of Pareto efficiency as a criterion indicates that an action is desirable if it makes someone better off without making anyone else worse off. Naturally, fraud can lead to non-Pareto improving exchanges, so trust or recourse (e.g., to a legal system) may be required to alleviate this problem when there are significant asymmetries in information (Benson 2001). Pareto inefficiency may also arise in voluntary exchange if significant externalities arise through the exchange.
[3] See discussion of the Kaldor-Hicks welfare concept below.

> cost of acquiring land will, by increasing the costs of right-of-way companies, induce them to raise the prices of their services; the higher prices will induce some consumers to shift to substitute services; the companies will therefore have a smaller output; and a result the companies will need, and will purchase, less land than they would have purchased at prices equal to (or slightly above) the opportunity costs of the land. Furthermore, higher land prices will give the companies an incentive to substitute other inputs for some of the land that they would ordinarily purchase. As a result of these factors land that would have been more valuable to the right-of-way company than to its present owners remain in its existing, less valuable uses, and this is inefficient.

Indeed, a holdout problem presumably could be so severe that it prevents the transfers of any property. This may be particularly likely when a buyer is trying to purchase several contiguous pieces of land in order to create a private (or public) development. If a large number of land owners know about the intended purchase ahead of time, they will all want to be the last individual to sell in order to be in a monopoly position and extract the highest possible price. Such strategic behavior on the part of sellers would result in expected transactions costs for the buyer being so high that she gives up the effort and the potentially welfare enhancing development is never undertaken. Thus, Fischel (1995, 68) suggests that "Preventing time-consuming strategic bargaining is an important justification for eminent domain."

Holdout incentives for sellers actually may be weaker than they are often assumed to be, however, particularly if an individual sells only part of his land for the development. After all, the increase in the rental value of his remaining land due to proximity and access to the development easily can be substantially more than the price of the land that is sold for the development. Thus, there clearly are strong incentives for many landowners to sell part of their land, offsetting the incentives to hold out [e.g., see Engel, Fischer, and Galetovic (2002)].

Further note that Posner's description of the holdout problem explicitly assumes that there is only one combination of property that can be used for the project and that the project is begun before all of the land for the project is purchased. These two assumptions lead to the potential for a single seller to act like a monopolist because the buyer has no substitute to consider. If this is not the case then, once again, holdouts may not be a serious concern, as Posner (1977, 43-43) observes. In this regard, for instance, Miceli and Segerson (2000, 330) note that the land could,

in theory, be acquired prior to construction. They recognize that when projects are publicly funded plans are not likely to be kept secret until after the land is obtained because of the need to appropriate the funds. There often are many other requirements associated with government projects, such as mandated public hearings, environmental review, and so on, that preclude secrecy (and, we might add, the prevalence of corruption as public officials sell information to speculators). On the other hand, Miceli and Segerson (2000) also note that private developers who want to assemble large tracts of land generally do not have the power of eminent domain (except through manipulation of the political process), perhaps because it is "easier for them to acquire the property while disguising their ultimate intent, for example, through the use of 'dummy' buyers" (Miceli and Segerson 2000, 330).

Private buyers of multiple parcels can also make their deals much more quickly than public buyers. They do not have to get budgets approved by legislatures, deal with time-delaying statutory procedures, or operate under rules that limit the amount that they can pay on each piece of land (e.g., rules that constrain bureaucrats to paying assessed values, for instance). Therefore, the likelihood that a private firm's plans are discovered is much lower than the similar plans by a government agency. Not surprisingly, private developers frequently consolidate large parcels of land without being held up (Starkie 1990).

A private buyer's secret efforts to obtain multiple parcels of land may be discovered, of course,[4] and if this happens, holdout incentives can arise. Can such transactions costs be avoided? Landsburg (1993, 29) provides an interesting solution to what might appear initially to be an intractable problem analogous to the holdout problem by citing a situation from Joseph Conrad's novel, *Typhoon*. A number of sailors stored their gold coins in personal boxes in the ship's safe, but a severe storm caused the boxes to break open and all of the coins were mixed together. Everyone knew how many coins he had placed in the safe but no one knew how many

[4] One reason for this could be that government approval of the development is required. Changes in zoning classification may be needed, for instance.

that others had placed there. Therefore, everyone's incentives were to claim that they had more coins in the safe than they actually had and the problem for the captain was to determine how to divide the coins to give each sailor his actual savings. Landsburg's (1993, 29) proposed solution: "Have each sailor write down the number of coins he is entitled to. Collect the papers and distribute the coins. [But] Announce in advance that if the numbers on the papers don't add up to the correct total, you will throw all of the coins overboard." This clearly reduces, and perhaps eliminates the incentives to holdout for more coins than had actually been contributed.

A similar strategy might be used by the private buyer of a number of contiguous parcels of land, even if it is known that a development of some sort is going to be constructed. Suppose, for example, that the developer chooses more than one potential site for development. She then informs the land owners within the two or more sites that she would like to purchase specified parcels from each of them, and that each should submit the price at which they are willing to sell (alternatively she might make initial bids that can be accepted, but indicate that each seller has an opportunity to make one take-it-or-leave-it counter offer). In addition, potential sellers are informed that the buyer will only purchase the parcel that has the lowest total cost associated with it (a maximum might also be specified, and/or information provided about the total acreage required at each site). The precise nature of the strategy may be quite different than this, but the fact is that pipeline builders, for instance, "routinely consider alternative routes, negotiate with different groups of owners, and settle with the first group that comes up with an acceptable arrangement. Where buyers compete with competing groups of sellers, there is extra pressure on the sellers to agree to reasonable deals" (Roth 1996, 199). When a private buyer structures the bargain appropriately (e.g., by secretly buying land or by simultaneously considering alternative sites and buying the parcels only after every seller has agreed and before the project starts, by

choosing sites where landowners only give up part of their land so they can collect rents on the rest, etc.),[5] holdouts are not likely to prevent acquisition.

Fischel (1995, 70), in criticizing arguments against the use of eminent domain, notes that the literature has not indicated how the holdout problem is to be dealt with, and suggests that the theoretical progress made regarding methods to induce people to reveal their preferences involve complicated voting rules. These arguments either presume that the purchase is being made by the government or that private entities face the same holdout problems that government does. However, if private developers do not have the option of asking government to consolidate land for them, the incentives to find solutions to potential holdout problems would be very strong, and methods for doing so might be forthcoming quite quickly. For instance, several large firms (e.g., Sears, Walmart, Kmart, Ford Motor Company) use combinatorial auctions to select transportation carriers in order to construct routes that avoid empty back hauls and other unnecessary costs.[6] The fact is that actual market participants have discovered many ways to induce people to reveal their relative preferences in situations similar to those that would characterize purchases of contiguous parcels of land from multiple owners by private firms. This really is the relevant issue, even if theorists do not fully understand how these processes work, or might work if local governments' eminent domain powers were not available for private developers with political influence.[7] Indeed, the growing literature on combinatorial auctions is developing as theorists are attempting to understand the actual processes that are already being implemented. Of course, incentives to develop methods to avoid holdout problems are diminished when developers know that they can call upon local governments to use eminent domain powers to condemn the desired property and transfer it to the private developer. Thus, as long as this option remains open,

[5] In a given project, private developers may also acquire options to purchase on speculation—something that public officials generally cannot do.
[6] See De Vries and Vohra (2001) for a review of combinatorial auctions.
[7] Tabarrok (1998, 345) offers a theoretical mechanism for a private profit-seeking entrepreneur to provide a public good using a "modified form of an assurance contract, called a dominant assurance contract", for instance, and similar contracts could be used to purchase multiple contiguous parcels of land.

holdout problems are likely to appear to be more severe than they actually would be in the absence of the eminent domain option. In other words, while Posner (1977, 41) explicitly recognizes that the economic justification for eminent domain based on the holdout problem actually is "applicable" to private purchasers of multiple contiguous properties "rather than the government", private sector purchasers are actually much more likely than government to be able to avoid the problem.

The final point to note in this context is that the holdout justification for eminent domain powers does not actually explain why government has those powers. That is, the holdout justification is an ex post rationalization of the existing government power, not an ex ante explanation for why the power exists. If it is assumed that government is simply a benevolent mechanism for solving market failure problems, then it follows that there must be some market failure reason for an existing government power. If, on the other hand, it is assumed that those with power are likely to use that power in pursuit of their own preferred objectives, then the possibility of other explanations for eminent domain powers should be considered. In order to "test" these alternative theories of government, let us consider the historical evolution of eminent domain powers.

III. The Evolution of Eminent Domain: Market Failure or an Effort to Limit Government Failure[8]

The roots of the law of eminent domain trace to England (Stoebuck 1977, 7-9), as much of American property law does (Eagle 2002). Indeed, eminent domain clearly reflects the feudal underpinnings of English property law (Paul 1988, 8-9). Early Norman Kings retained absolute authority over the allocation of land: landholders controlled land only as long as they performed their required duties and paid their required fees. This tenurial system, whereby a landholder simply held the land of those

[8] For more details on the evolution of the roots of eminent domain, see Benson (2008), from which this section draws.

higher in the feudal pyramid, was designed for military and political purposes. Land use decisions were clearly not central to the process, but the implication was that landholders were "stewards" for the feudal lord and king, rather than being free to determine how land should be used or disposed of. Landholders wanted more secure property rights, of course, and some felt that they were powerful enough to obtain them. Increasingly tenants were regarded as having ownership rights rather than simply possessionary rights, and they expected to hold the land as long as they fulfilled their various feudal obligations. The effort to establish such rights is one reason for the long series of Baronial revolts to limit royal power. The most famous of these revolts occurred in 1215, when powerful barons renounced their homage to John; as a result, on June 19 *Magna Carta* was issued with both John and the barons swearing to abide by its provisions. The struggle for power between the King and the barons (as well as the church, and other groups that became influential, such as the growing merchant class) continued for centuries, however, with some Kings ignoring *Magna Carta* and others forced to recognize it. Gradually the King's powers were reduced and feudal relationships were broken down. In the process, a right to compensation was extracted from the Crown in the event that property was condemned (seized).

The practices of condemnation and compensation were transplanted from England into the American colonies. Condemnation was regularly used to obtain highway right-of-ways (compensation was not always paid, however, as in at least some colonies no payments were made if the land was unimproved, partly due to the fact that such land was abundant so property owners could easily obtain replacements at very low costs), for example. Many of the roads of the period were privately financed, built, and maintained,

often by charging tolls (Gunderson 1989; Klein 1990). Nonetheless, government condemnation was used at times to obtain right-of-ways (Paul 1988, 73). Land was condemned for other private purposes too, such as the drainage of lowlands and the erection of private mills run by water power that required dams and flooding of land up river from a mill. As Paul (1988, 73) suggests, "The various mill acts enacted by the New England and several southern colonies are interesting because they afford an early example of the delegation of sovereign "taking" authority to private businesses."

The power of government to take property was clearly well established by the American Revolution, a remnant of sovereign powers established under feudalism in England. It was also customary for the government to pay compensation, however, a result of the long struggle to limit the power of the King in England, so such payments were clearly expected. The culmination of that struggle in North America was the revolution and the establishment of a new set governments (13 states under the *Articles of Confederation*, and then the stronger federal government under the U.S. Constitution). Yet, just as parliament retained the power to take property when they wrestled control of the government of England away from the kings, the new governments in North America did not explicitly give up that power either. Note, however, that the United States Constitution does not explicitly grant condemnation powers to the federal government. Today it is generally assumed that this power is implied by such clauses as 7 and 17 of Article 1, Section 8, and especially, the taking clause of the Fifth Amendment. In fact, however, the clauses in Article 1 appear to limit federal takings by requiring the "Consent of the Legislature of the State" In this context, one of the arguments against including the Bill of Rights raised by Alexander Hamilton (1788 [1961], 513) was that "it would

contain various exceptions to power which are not granted." The takings clause of the Fifth Amendment may well fit this concern given the limits on federal takings implied by Article 1.

Some of the founding fathers actually argued for an explicit recognition of private property rights that could not be taken by the government. For instance, Thomas Jefferson contended that all remnants of feudalism in regard to property should be eliminated. He vigorously pushed for allodial ownership wherein land owners would hold absolute dominion over their property. In other words, he contended that land holders should not be treated as stewards, with property ultimately controlled by the prerogative of the state (Paul 1988, 9). He felt that if the state was considered to be the ultimate owner of land, freedom could not be secure, as the state would be in a position to reduce men to poverty or even serfdom. Others obviously had a different view, of course. One reason may well have been that the former colonies had been actively confiscating property to benefit powerful business interests, and their leaders did not want to repudiate their actions. Similarly, the property of loyalists had been seized during the Revolution, debts owed to British subjects by the tobacco producing states were cancelled, and a number of other takings had been made (Paul 1988, 74), so if the new governments did not have similar powers, claims by former owners might have had legal standing.

IV. Government Failure Through Eminent Domain Powers[9]

In light of the preceding discussion, recall individual A introduced earlier who valued a parcel of land at $X. In the earlier hypothetical, A obtained control of the land through voluntary bargaining, and paid $P where X>P>Y, but this is not his only choice.

[9] This section draws from and expands on material in Benson (2005b. 2006).

Assume that by spending $T, a small fraction of $X (e.g., on a lobbyist, a bribe, or some other method of influencing the city council), he is quite sure that he can get local government officials to decide that the business he is going to establish on the land is in the "public interest" because it will generate employment in the community and increase the tax base (see the discussion of the actual purposes of eminent domain condemnations below where it becomes clear that this would be an adequate justification for such political action). He negotiates with the local officials who decide to condemn the land and sell it to him for $Z where T+Z<P - i.e., below market value, because they are convinced (or claim to be convinced) that the project will benefit the community. The city's land appraiser determines that the "fair compensation" for the parcel is $W and this is paid to B (note that the assessor cannot determine B's actual subjective value; furthermore, as explained below, there is an under-valuation bias in such assessment processes in that it is likely that W<Y) which is paid to B. The land, in this case, is still transferred to a higher valued use, but the transfer is not Pareto optimal. Even if B is fully compensated (an unlikely outcome), the taxpayers who pay any difference between the compensation payment and the sales price (W<Z is clearly possible, and probably likely, as explained below), are worse off. A is clearly much better off, of course. Indeed, he could fully compensate B and the taxpayers for their losses if he wanted to (his decision to choose condemnation rather than bargaining suggests that he is not willing to, however). Thus, the "net" gain in social welfare is as large as it was under voluntary exchange but the gain is now distributed so unequally that the "transaction" makes some people worse off. In this light, note that some economists suggest that the Pareto criterion is too constraining in the public policy arena and that an alternative,

called Kaldor-Hicks efficiency (a transfer is said to be efficient if the gainers gain enough to compensate the losers, even if no compensation is paid), is preferable. Recognize, however, that if full compensation is not required when a "Kaldor-Hicks efficient" transfer is made through the government, then the incentives to bargain in the first place are weakened, as a subsidized political transfer is a more attractive option for the "buyer". Why bargain and pay for a property that can be obtained without full payment through the use of political influence (unless the political influence is more expensive than the property would be)? Furthermore, and importantly, under voluntary exchange both parties are likely to be made better off by the exchange, but there is no guarantee that land under compulsory purchase is actually moved to its highest valued use. The example just given would work just as well if B valued the land at $Y > X$, in which case any forced exchange would fail even the Kaldor-Hicks test and lower net welfare.

Can inefficient transfers be avoided by constraining the use of compulsory purchase powers to a limited set of circumstances? Suppose such purchases can only be made if the benefits to the "public" are clearly very large, for instance and where sufficient compensation is paid to avoid making the individual worse off when her property is condemned (i.e., meeting the Pareto criterion). The United States Constitutions' Fifth Amendment states, for instance, "nor shall private property be taken for *public use*, without *just compensation*" (emphasis added). Thus, it appears that the framers wanted government's takings powers to be constrained to "public use" purposes (presumably, uses with substantial benefits for many members of the public at large, as opposed to narrowly focused private uses, perhaps with some public purpose such as higher tax revenues as a secondary goal), and they expected such takings to involve "just

compensation." Let us consider the effectiveness of these constraints on transfer activity. First, consider the way that "public use" has been interpreted by U.S. courts to see if it might prevent compulsory purchase for purposes that produce relatively small concentrated benefits, and after that, the "justness" of compensation will be examined.

IV.1. The deterioration of the "public use" constraint; or Why *Kelo* was not a surprise.[10] James Madison, who wrote the Fifth Amendment, and those who supported him, clearly hoped to restrict the takings behavior that had been going on in the colonies under British rule. Therefore, along with *just* compensation, the amendment explicitly requires that takings be for "public use" rather than public purpose, interest, benefit, or some other term. "Public use" was recognized at the time as a narrower and more objective requirement that such alternative terms might imply (Jones 2000, 290). Indeed, this wording was, at the time, conceived of as a strong constraint, since the Framers did not recognize a non-public authority in government; "an express prohibition on 'private' taking would [therefore] have been superfluous" (Jones 2000, 289, note 23).

Before 1875 all eminent domain condemnations in the United States were performed by state or local governments, and therefore, most early litigation over the constitutional limits implied by "public use" in the United States took place in state courts.[11] Evidence from this litigation illustrates that even though state constitutions had takings clauses similar to the U.S. Constitution's Fifth Amendment, there were two interpretations of public use across the states. The narrow interpretation required that the project for which the condemned property was used had to be open to the public (Jones

[10] This subsection draws heavily from Paul (1988), Jones (2000) and Kulick (2000). For similar analysis and conclusions regarding the public-use issue and police powers, see Epstein (1985, 161-181) and Eagle (2005, 153-188).

[11] See the discussion relating to *Kohl v United States* (91 U.S. 367 (1875)) in the concluding section of this paper for an indication of why this was the practice even for properties to be used for federal purposes.

2000, 293) while the broader interpretation "equated *public use* with more nebulous terms such as *public advantage, public purpose, public benefit,* or *public welfare*" (Paul 1988, 93). States adopting this broader interpretation allowed transfers of condemned land to private commercial activities under the assumption that "the public" benefited from economic development (Jones 2000, 292). Thus, many states used eminent domain powers to transfer property from one private entity to another for a variety of private purposes. In other states, however, public use was interpreted by courts to mean "use by the public" (Paul 1988, 93). State treatment of the concept of public use still varies, both across states and within states over time,[12] although for the most part, state court treatment of public use has closely mirrored federal court views (Kulick 2000, 654).[13] The focus here will be on the effectiveness of the Federal Constitution as a constraint on eminent domain practices, however.

When the United States Supreme Court began considering compulsory purchase issues, it adopted the narrow view of public use (Jones 2000, 292). In *Kohl v. United States* (91 U.S. 367 (1875)), for instance, the Court explicitly stated that this power could be used by "a sovereign to take private property for its own public use, and not for those of another" (at 373-374). Furthermore, in *Missouri Pacific Railway Co. v Nebraska* (164 U.S. 403 (1896)), ruling on a condemnation of railroad property by the state of Nebraska

[12] See *Poletown Neighborhood Council v. City of Detroit* (304 N.W. 2d 455 (1981)), for instance and compare it with *County of Wayne v. Hathcock* (684 N.W. 2d 765 (Mich. 2004)).

[13] *County of Wayne v. Hathcock* (2004) is one example of recent state court departures from this pattern. Also see, for example, *99 Cents Only Stores v. Lancaster Redevelopment Agency*, 237 F. Supp. 2d 1123 (C.D. Cal. 2001).). Indeed, while the focus below is primarily on federal court decisions, it must be noted that most of the takings for private developments are done under state law. Furthermore, state treatment of the public use concept clearly varies considerably, both across states and within states over time (see Eagle 2005, 175-187). Therefore, in one sense, this discussion is illustrative of changes in constitutional constraints rather than a direct discussion of all constraints relevant to the use of eminent domain for private development. Over the last 130 years, however, many states courts have made similar changes in the interpretation of public use to those that have occurred in federal courts.

in order to transfer it to a private grain elevator, the court concluded that the taking was an unconstitutional violation of the Due Process Clause of the Fourteenth Amendment, as well as being "in essence and effect, a taking of private property [for a] private use".[14] Two decades later, however, the court reversed itself. The opinion in *Mount Vernon-Woodberry Cotton Duck C. v Alabama Interstate Power Co.* (240 U.S. 30 (1916)) explained that the Court would exercise great deference when reviewing a state court's findings regarding public use, and in *Old Dominion Land Co. v. United States* (269 U.S. 55 (1929)) the court began to suggest that it would exercise similar deference with regard to legislative decisions about public use. Indeed, a relatively broad definition was explicitly adopted in *Rindge C. v. Los Angeles County* (262 U.S. 700, 707 (1923)): "It is not essential that the entire community, nor even any considerable portion, should directly enjoy or participate in any improvement in order to constitute a public use."

United States ex. re. TVA v Welch (327 U.S. 546 (1946)) came close to withdrawing the federal court from even considering the question of public use when Justice Black wrote "We think it is the function of Congress to decide what type of taking is for a public use and that the agency authorized to do the taking may do so to the full extent of its statutory authority" (at 551-552). Whatever limitation might have remained was severely undermined by Justice Douglas's decision in *Berman v. Parker* (348 U.S. 26 (1954)). The case involved a District of Columbia condemnation of land in areas of the city that were apparently dominated by slums, with the land subsequently transferred to

[14] Such rulings were consistent with earlier Supreme Court views of Constitutional constraints. For instance, in *Calder v. Bull* (3 U.S. 386, 388 (1798)) the court stated that there "are acts which the Federal or State Legislature cannot do, without exceeding their authority. There are certain vital principles in our free Republican Governments, which will determine and overrule an apparent and flagrant abuse of legislative power... [For example, a] law that punishes a citizen for innocent action... a law that destroys, or impairs, the lawful private contracts of citizens,... ***or a law that takes property from A and Gives it to B***: it is against all reason and justice, for people to entrust a Legislature with such powers" (emphasis added).

private developers. The petitioner was the executor of the estate of the deceased owner of a department store in one of the areas, and among other things, he objected to the fact that the seized property could be transferred to another private party who would then redevelop it and sell it for private gain. Douglas wrote, "The concept of the public welfare is broad and inclusive. .... It is within the power of the legislature to determine that the community should be beautiful as well as healthy, spacious as well as clean, well balanced as well as carefully patrolled.... there is nothing in the Fifth Amendment that stands in the way" (at 33). Paul (1988, 94) describes the implications of *Berman v. Parker* as follows:

> In a decision remarkable for its confusion of the central issues, Douglas and his colleagues concluded that the appellants' "innocuous and unoffending" property could be taken for the larger "public purpose" of remediating urban blight.... traditionally the limitation on the exercise of the police power, the power of the states to regulate property, has been something called the "public purpose." This broad phase allows quite a wide range of state regulatory behavior ... so long as they serve some loosely defined notion of the public purpose.... What Douglas accomplished by his confusion of the more permissive criterion of the police power's public purpose with eminent domain in *Berman v. Parker* was the application of the more permissive criterion of the police power's public purpose to eminent domain. Public use as a constraint on governmental seizures suffered a crippling blow as the result of Douglas's confusion.
>
> .... If the legislature is "well nigh" the final arbiter of "public needs," then what is the purpose of the Bill of Rights or the Constitution? The Court apparently lost sight of the purposes behind the Fifth Amendment's property clauses: to limit congressional seizures of property; to place conditions on those seizures that are necessary for a "public use," and to protect individual property rights.

Similarly, Epstein (1985, 161) suggests that the public use constraint was given "a mortal blow in *Berman v. Parker* when [the Court] noted that 'the concept of the public welfare is broad and inclusive' enough to allow the use of the eminent domain power to achieve any end otherwise within the authority of Congress." The decision essentially implies that whatever the legislature says is a public purpose (which now is the meaning of public

use) is a public purpose and this "opened a Pandora's Box of state interference with individual property rights" (Jones 2000, 294). If this decision did not completely eliminate the public use constraint, then subsequent decisions have.

Jones (2000, 296-297) notes that "In *Hawaii Housing Authority v. Midkiff*, the United States Supreme Court dealt the public use requirement a final mortal wound." Hawaii passed a Land Reform Act which transferred property from private-land owners to the lessees of that land. While the Ninth Circuit Court of Appeals [*Hawaii Housing Authority v. Midkiff* (702 F.2d. at 798)] declared the Act to be "a naked attempt on the part of the state to take land from A and give it to B solely for B's private use and benefit," the Supreme Court declared the Act to be Constitutional [*Hawaii Housing Authority v. Midkiff* (476 U.S. 229 (1984))]. The Court ruled, once again, that if a legislature has determined that an eminent domain takings involves "a conceivable public purpose" then the public use requirement has been met. As Kulick (2000, 653) explains, "a legislature, under the Supreme Court's guidance from *Midkiff*, can legitimately effectuate public-private takings by merely making some legislative pronouncement that the taking will serve some public purpose or goal."[15] Clearly, this ruling "effectively [rendered that [the public use] requirement nugatory" (Eagle 1005, 164).

This non-constraint was reaffirmed in the 2005 U.S. Supreme Court case, *Kelo et al. v. City of New London*, 545 U.S. 469 (2005). This case involves the New London Development Corporation, a public corporation created in the City of New London, Connecticut, condemnation of privately owned real property in order to lease it to Pfizer Corporation for economic redevelopment. In a ruling consistent with *Berman v. Parker*

[15] Since *Midkiff* the Supreme Court has reconfirmed the same public use standard (or perhaps non-standard would be more appropriate). See *National R..R. Passenger Corp. v. Boston & Maine Corp.* 503 U.S. 407, 422 (1992).

(1954), the majority held that a more broadly defined "public purpose," such as proposed economic development, was consistent with the takings clause. This decision is not surprising, given past rulings, although two dissenting opinions contend, in different ways, that the decision was contrary to earlier precedents.[16]

The changes in the constitutional public-use constraint has been criticized from a number of perspectives [efficiency, liberty, equity - e.g., Epstein (1985, 2001); Paul (1988); Jones (2000); Kulick (2000)].[17] The focus here is on economic efficiency, however. One efficiency implication is that the lack of a public use constraint increases the chance that the benefits of an involuntary transfer will be less than the losses, implying inefficiency even with the weak Kaldor-Hicks standard, and clearly from a Pareto perspective, particularly if the individuals who lose their property are under compensated.

IV.2. The systematic under-valuation bias for eminent domain condemnaitons. The Fifth Amendment to the U.S. Constitution requires "just"

[16] Justice O'Connor's decent contended that a narrower interpretation of public use was appropriate, along the lines taken by the Michigan Court in its 2004 *Hathcock* decision. Justice Thomas was more direct in that he essentially contended that *Kelo* was simply one in a series of rulings which are misguided, as they ignore the original meaning of the public use concept.

[17] This conclusion is far from universally accepted of course. For instance, Fischel (1995, 74) contends that the broad interpretation of public use is desirable, in part because he sees two other constraints on the use of compulsory purchase. One is that the transactions costs of using it are high, so the "budget-preserving instincts of government agencies may usually be depended upon to limit eminent domain", and the other is that the use of compulsory purchase to transfer property for private uses "are also limited by popular revulsion at the government's action." The Constitution is suppose to protect people even when there is not a "popular revulsion" however (i.e., even when the majority supports some action that harms a minority) so it is presumably suppose to be a stronger constraint than popular beliefs. Moreover, the budget preserving tendency are not a relevant constraint when powerful political interests are seeking benefits through the political process, particularly if the "fair compensation" constraint is also relatively weak (in addition, revenues matter, for instance, where a condemnation of one business to help another was motivated, at least in part, by fear of losing sales tax revenues). Finally, some bureaucracies have found ways to actually enhance their budgets through compulsory purchase. When the Southwestern Illinois Development Authority's seizure property to transfer it to Gateway International Raceway, for instance, Gateway used the Development Authority's standard "application form" for seeking a condemnation for "private use" and paid the $2,500 application fee. The authority also charged a percentage commission for the land: $56,500, a sum greater than the Authority's appropriated budget (officials from the Authority also got free tickets to Gateway events) (Berliner 2002, 3).

compensation for takings by the federal government. The federal courts actually did not constrain state or local compensation awards in eminent domain situations at all, however, until the Fourteenth Amendment and its due process clause, applicable to the States, was adopted. Prior to that, the Supreme court ruled that the Fifth Amendment's taking clause only applied to the federal government [*Baron v. Baltimore* 7 Pet. 243, 247 (U.S. 1833)].[18] The Fourteenth Amendment states: "nor shall any state deprive any person of life, liberty, or property without due process of law; nor deny any person within its jurisdiction the equal protection of the law", however, and this suggests that at least some subsequent legislative actions and bureaucratic applications may not meet constitutional standards. Therefore, in *Chicago Burlington and Quincy Railroad Company v. Chicago* (166 U. S. 226 (1897)) the Supreme Court considered a claim that payment of a just compensation for a takings was an essential ownership right, implying that any takings without such compensation was a violation of due process. The fact that the Supreme Court decided to consider this issue could have been important since it implied that state court decisions regarding compensation in eminent domain takings could be appealed to the federal level on due process grounds, suggesting a potential constraint on compensation assessments. However, the potential constraint did not materialize. The court ruled that it was improper for it to review state court rulings on

[18] The only other eminent domain case to reach the Supreme Court during the first several decades of the country's existence was *West River Bridge v. Dix* (6 How. 507 (U.S. 1848)), but that case was based on Article 1, Section 10 of the Constitution where the states are barred from impairing the obligation of contracts. Vermont had granted an exclusive franchise to operate a bridge for 100 years. The private firm was clearly willing to operate the bridge, but the state decided to take it over anyway. West River Bridge sued, contending that the franchise charter was a contract, and while the Supreme Court agreed that the charter was a contract, it ruled that the state's breach and seizure of the bridge did not violate Article I, Section 10. Instead, the court stated that the state's eminent domain powers were "paramount to all private rights vested under the government, and these last are by necessary implication, held in subordination to this power, and must yield in every instance to its proper exercise." In other words, contracts, including contracts entered into by a state legislature, can be taken through compulsory purchase, "a rather odd conclusion, one among many that served to eviscerate the contract clause, while strengthening the states' power to take all kinds of interests in property" (Paul 1988, 78).

matters of fact (under the Seventh Amendment), and that the Illinois court's conclusion that no significant property had been taken was an issue of fact, not law. The City of Chicago had opened a public street on the railroad's land and compensated it with a payment of one dollar. The contention was that no significant property had been taken because the land's railroad purposes were not impaired (ignoring the fact that the railroad erected a gateway to make the street crossing safe - the court ruled that "Such expenses must be regarded as incidental to the exercise of the police powers of the state").

The Supreme Court has considered federal, state and local eminent domain compensation cases since *Chicago Burlington and Quincy Railroad Company v. Chicago* in 1897. First recognize that the concept of significant property (i.e. what really constitutes a takings) and just compensation are intertwined. Compensation could be generous, for instance, but if the view of what constitutes a significant property taking is extremely narrow so most government actions that affect property uses and values are not considered to be a takings worthy of compensation (e.g., as in *Chicago Burlington and Quincy Railroad Company v. Chicago;* the courts phrase this as a two-part inquiry: does the plaintiff possess a property interest, and if so, was it taken). In this regard, the U.S. Supreme Court's view of property appears to have broadened since 1897. Indeed, the Court has been quite explicit in some instances, stating for example, that the meaning of property is not interpreted in the "vulgar and untechnical sense of the physical thing with respect to which citizens exercise rights recognized by law... [Property refers to] the group of rights inhering in the citizen's relation to the physical thing... The constitutional

provision is addressed to every sort of interest the citizen may possess" (*United States v. General Motors* 323 U.S. 373, 377-78 (1945)).[19]

In *Olson v. United States* (292 U.S. 246 (1934)), the Court explained that compensation should put an owner "in as good a position pecuniarily as if his property had not been taken. He must be made whole but is not entitled to more. It is the property and not the cost of it that is safeguarded by the state and federal constitutions." Epstein (1985, 182) notes that this is an appropriate standard from an economic perspective, as the Pareto criterion is met. If compensation really comes close to making the loser whole, however, then one must wonder why so many people who have property taken continue to protest and even sue? One obvious conclusion is that the compensation is actually less than what a willing seller would accept, as Epstein (1985) observes, because in reality courts do not follow this standard.[20] Indeed, they have chosen to ignore

[19] *General Motors* has proven largely aspirational, although some relatively recent Supreme Court decisions appear to be broadening the concept of property rights takings that require at least some compensation (e.g., *Lucas v. South Carolina Coastal Council*). The overall trend in such requirements is far from clear, however, particularly given the decision in *Tahoe-Sierra Preservation Council v. Tahoe Regional Planning Agency Planning Agency* (2002). See Greenhouse (2002) for discussion. Also see Paul (1988, 82-91).

[20] Another conclusion addressed above is that the incentives that motivate holdout also motivate political action and litigation, but the answer suggested here clearly is relevant in many cases. After all, "abuses in practice are legion" (Paul 1988, 81). Furthermore, many loses are still considered to be "incidental," as in *Chicago Burlington and Quincy Railroad Company v. Chicago*. For instance, in *United States v. General Motors* the court ruled that the loss of business goodwill or other injury to a business is not recoverable. Other losses that the court considers to be unrecoverable included future loss of profits and the expenses associated with removing fixtures or person property from the condemned property (even though expenses for moving are supposedly recoverable). As Paul (1988, 165) explains, "the Court reasoning that such losses would be the same as might ensue upon the sale of property to a private buyer ... because when business persons sell their buildings... they have presumably factored in these ancillary costs and found the deals satisfactory despite such costs. No such assumption, of course, can be made where the government forcibly takes property ... over the owner's objection... and, indeed, the opposite assumption is far more likely." The Court actually recognized this, however, when it stated that "No doubt all those elements would be considered by an owner in determining whether, and at what price, to sell. No doubt, therefore, if the owner is to be made whole for the loss consequent of the sovereigns' seizure of his property, these elements should properly be considered. But the courts have generally held that they are not to be reckoned as part of the compensation for the fee taken by the government" (at 379). In other words, in the past such property takings have not been compensated for so compensation is not required. As a result, loses arising in many condemnations are considered to be incidental due to the interpretation of "property," and therefore, not warranting compensation.

subjective value in most cases. This stems from *Monongahela Navigation Co. v. Untied State* (148 U.S. 312 (1893), at 325-326) wherein the Supreme Court recognized that one of the important reasons for awarding "just compensation" is that "it prevents the public from loading upon one individual more than his just share of the burdens of government, and says that when he surrenders to the public something more and different from that which is exacted from other members of the public, a full and just equivalent shall be returned to him." Yet, the Court went on to hedge this statement by stressing that "this just compensation, it will be noticed, is for the property, and not the owner" (Id. at 326). This qualification has been interpreted to mean that the compensation is for the property taken, and not for losses to the owner that are a consequence of that taking (Epstein 2001, 12). In other words, any losses that are collateral to or a result of the taking of property are born by the landowner.

While the *Monongahela* standard might still imply that the person whose property is taken is entitled to be compensated for losses in subjective value, subsequent interpretation has denied such an interpretation. For instance, in *United States v. 564.54 Acres of Land* (442 U.S. 506, 511 (1979)) the Court stated that "the owner is entitled to receive 'what a willing buyer would pay in cash to a willing seller' at the time of the taking."[21] However, as Epstein (2001, 12-13) explains,

> There is a good reason why 'for sale' signs do not sprout from every front lawn in the Untied States. In a well ordered society most individuals are content with their personal living or business situation. They do not put their property up for sale because they do not think that there is any other person out there who is likely to value it for a sum greater than they do. In the normal case, use value is greater than exchange value. so the property is kept off the market. The use of the market value standard therefore results in a situation in which the party who owns the property, even if he shares in the social gain generated by the project, is still

[21] The opinion quotes an earlier ruling, *United States v. Miller* (317 U.S. 369, 374 (1943)), which stated this market value rule.

> left worse off than his peers. He is forced to sacrifice the subjective values associated with his property, values which almost by definition he could not recreate through his next best use for the funds received.

After all, an owner purchases property because she values it at more than the purchase price and/or holds onto the property because she places more valuable on it than the market price she could get for it. Thus, even an accurate assessment of market value "does not leave the owner indifferent between sale and condemnation" (Epstein 1985, 183). Indeed, the court has explicitly recognized that compensations are lower than the level that would actually restore the landowner. In *Kimball Laundry v. United States* (338 U.S. 1 (1949)) Justice Frankfurter noted that "the value of property springs from subjective needs and attitudes; its value to the owner may therefore differ widely from its value to the taker.... In view, however, of the liability of all property to condemnation for the common good, loss to the owner if nontransferable values deriving form his unique need for property or idiosyncratic attachment to it, like loss due to an exercise of the police power, is properly treated as part of the burden of common citizenship." Thus, for instance, the laundry owner in *Kimball* could not recover for the dissipation of the "good will" that he had built up at his location because it was not transferred to the State (it was simply destroyed). More recently, Judge Richard Posner, in *Coniston Corp. v. Village of Hoffman Estates*, 844 F.2d 461, 464 (7th Cir. 1988) explained:

> Compensation in the constitutional sense is therefore not full compensation, for market value is not the value that every owner of property attaches to his property but merely the value that the marginal owner attaches to his property. Many owners are “intramarginal,” meaning that because of relocation costs, sentimental attachments, or the special suitability of the property for their particular (perhaps idiosyncratic) needs, they value their property at more than its market value (i.e., it is not “for sale”). Such owners are hurt when the government takes their property and gives them just its market value in return. The taking in effect confiscates the additional (call it “personal”) value that they obtain from the

property, but this limited confiscation is permitted provided the taking is for a public use.

Clearly, "The disregard for non-market values ... creates a systematic downward bias in the priced paid in eminent domain proceedings" (Posner 1977, 43). Beyond that, the Supreme Court has frequently stated that the fair-market-value standard is not "absolute".[22] In fact, a number of doctrines have been developed by the courts that allow compensation substantially below market value, and even lower than the owner actually paid for the property, thereby guaranteeing that compensation must be below the value that the owner places on the condemned property [e.g., *United State v Commodities Trading Corp.* 339 U.S. 121 (1950), and *United States v. Fuller* 409 U.S. 488 (1973)]. As a result, “the fact is that ‘just’ compensation hardly ever is ‘full’ compensation. The landowner almost invariably loses more than the government takes” (Eagle 2005, 189).

The under-compensation bias creates significant incentives for under-valuation by condemning agencies, and this is a common practice (Starkman 2001). In fact, "initial compensation offers by the government often pale in comparison to the market value of the land" (Kulick 2000, 665, note 159) and compared to the value that the victim might ultimately receive through litigation. Consider Vera Coking's situation, for instance. She had lived in her ocean-front home in Atlantic City for almost four decades when, in May of 1996, she received notice that her property had been condemned by the Casino Redevelopment Authority. She had 90 days to move so her land could be used by the Trump Plaza Hotel and Casino to build a parking area and put in a lawn. The "fair market value" of her home was appraised to be $251,250. However, she had actually

[22] There is another source of systematic under compensation as well: “the expense in finding, obtaining, and relocating to other premises” (Eagle 2005, 154). Some of these costs may be compensated under state or federal laws, under some circumstances, but many are not.

turned down a $1,000,000 offer by another casino operator in 1983, suggesting that the actual market value was much higher than the assessed value, but still lower than Coking's personal subjective evaluation. This appraisal was quite consistent with other condemnation assessments done in the same community, however. For instance, a pawn shop that had recently been purchased by the owners for $500,000 (an obvious indicator of actual market value) was assessed at $174,000, and a neighboring restaurant was assessed at $700,000, a value that would not even cover the legal fees and start up costs for the restaurant owners to relocate. Of course, the victims of an under-compensated takings can sue in an effort to overturn the condemnation or increase the compensation (and the victims of the Atlantic City condemnations just mentioned have done so), but this is clearly a costly and time consuming process, with considerable risks involved. A land owner who sues for just compensation is likely to have to pay his lawyer around 30 to 40 percent of the award, so the actual gain from litigating may be very small.

The power of eminent domain combined with an under-compensation bias and the high cost of litigation gives substantial bargaining power to government entities. Not surprisingly, "institutionally, government behavior will take advantage of the background legal rules. The eminent domain power thus allows the state to push hard so that the landowner will take a price which is ... lower than he would have taken in any voluntary exchange" (Epstein 2001, 7). Indeed, as a result of this bargaining power, "government officials are becoming increasingly brazen in invoking eminent domain" to transfer land to private for-profit organizations (NCPA 2002, 1), in part because "many owners cave in to the pressure and settle" (Berliner 2002, 1). The fact is that the prospect (and expected costs) of fighting a threatened eminent domain condemnation through the courts in an

effort to get more money than was offered by a government official can be sufficiently frightening for many individuals to induce people to accept substantially lower prices than they would otherwise be willing to take. Thus, there is an under-evaluation bias even for so-called "voluntary" sales of property to the government, at least for individuals who do not have sufficient political influence to counter such a bargaining power advantage. Note that even if a holdout problem arises in the absence of eminent domain powers, because sellers have “excessive” bargaining power, the ability for buyers to use eminent domain provides excessive bargaining power to these buyers, creating the opposite and potentially equally inefficient result. Holdouts may mean that some potentially desirable property transfers may never occur through bargaining, but eminent domain powers mean that some undesirable property transfers may occur through bargaining in the shadow of eminent domain, as well as through actual takings.

IV.3. Inefficient transfers through eminent domain. As the public use constraint on eminent domain powers has been undermined, it has become easier for government to use this power to transfer land to other private entities, thus encouraging the use of the process by those with political power to gain wealth transfers for substantially less than they would have to pay through a voluntary purchase. This political transfer seeking activity, often called "rent seeking" (Kulick 2000, 673-675),[23] can involve government condemnation of property for subsidized transfer to other private entities, after all. In one widely cited example (the condemnation that lead to the *Poletown* case in Michigan), the City of Detroit displaced 3,438 residents of Poletown so General Motors could have the land for a Cadillac assembly plant, paid the residents $62 million in compensation for their condemned homes, spent another $138 million in other

[23]This rent-seeking process and its consequences are discussed in more detail below.

costs including improvements to the land required by General Motors, and then resold the property to General Motors for $8 million. Or consider the more recent use of compulsory purchase to attract a Nissan plant to Mississippi (see *Percy Lee Bouldin and Minnie Pearl Bouldin, et al. v. Mississippi Major Economic Impact Authority*, Case No. 2001-CA-01296 (Mississippi Supreme Court)), which included more than $300 million in subsidies and tax breaks along with condemnation of the property in question (*Wall Street Journal*: *WSJ.com - From the Archives*, January 4, 2002). This clearly creates excess demand for condemnations relative to what would be necessary with a strong public use constraint. Subsidies also give the private recipient of the transfer a competitive advantage over others who have not obtained similar subsidies, creating incentives for everyone who may want to obtain property for a new, expanded, or relocated business to look seriously at the political process to obtain the transfer rather than directly bargaining.

Subsidies are often explicit, as in the *Poletown* example, but even if the recipient of a condemned property repays the full amount that the government pays as compensation, there is an implicit subsidy if the victims of the condemnation (or condemnation threat) are not fully compensated for their losses, as suggested above. In this regard, what apparently is the only empirical study of the use of compulsory purchase found that low valued parcels (note that these are the parcels most likely to belong to individuals with little political influence, in part because litigation costs are likely to limit the chances that such owners will challenge the payment) systematically received less than estimated market prices through compulsory purchase in Chicago's

urban renewal program (Munch 1976, 473).[24] Clearly, such transfers are not efficient in a Pareto sense, and there is no way of knowing whether they are efficient in a Kaldor-Hicks sense. Indeed, as Epstein (2001, 6) notes, the under-compensation bias "has the unfortunate effect of inviting government initiatives that do not even meet the hypothetical compensation [Kaldor-Hicks] requirement." But inefficiencies from such transfers go well beyond those implied by under-compensation (Pareto inefficiency) or possible a net reduction in "social welfare" (Kaldor-Hicks inefficiency) arising from the specific transfers of resources through eminent domain. "The inequitable treatment, of course, leads to profound allocative distortions: the lower prices stipulated by government lead to an excessive level of takings, and thereby alters for the worse the balance between public and private control" (Epstein 2001, 15).

IV.4. Government failure: the costs of involuntary transfers. Political wealth transfers reduce wealth (i.e., are inefficient) for at least five reasons. First, involuntary transfers (e.g., through regulations under the police powers, through condemnation and reallocation of property as in *Poletown*) generally produce deadweight losses (e.g., a net reduction in wealth). For instance, when explicit subsidies such as those in Detroit (*Poletown*) or implicit subsidies due to under-valuation are implemented, they "encourage economic markets to operate in an economically inefficient state by lowering the cost for firms to purchase property for corporate activities" (Kulick 2000, 662). Standard neoclassical production theory suggests that a subsidy to a producer in obtaining

[24] Individuals who have political connections are less likely to suffer such losses, however, or at least, less likely to suffer large losses. In the empirical study of eminent domain practices in Chicago's urban renewal program, high valued parcels (e.g., those owned by individuals who probably had political clout, in part at least, because of their financial capacity and incentives to challenge payments through litigation) were systematically paid more than estimated market prices (Munch 1976, 473). This problem of discriminatory pricing based on political influence is inevitable given the flexibility of the assessment standards and the ease with which some (but not all) individuals and groups are able to influence political decisions.

a particular input (e.g., land) leads to inefficient over use of the subsidized input relative to other inputs (e.g., in the Mississippi-Nissan arrangement mentioned above, for instance, the Mississippi Supreme Court actually ruled *Percy Lee Bouldin and Minnie Pearl Bouldin, et al. v. Mississippi Major Economic Impact Authority* that the state may have taken more land than it needed to in order to meet the alleged public use), and therefore, to inefficient input combinations. These inefficient methods of production mean that less is produced given the true opportunity cost of production than could be if the prices paid for resources reflected full opportunity costs - there is a "deadweight loss" to society because resources are allocated inefficiently.

Second, Tullock (1967) explains that the resources consumed in the process of seeking such transfers also have opportunity costs. He emphasizes the striking analogy between monopoly achieved through regulation, tariffs achieved through legislation, and theft. Thieves use resources, particularly their time, in order to steal, and potential victims employ resources (e.g., locks, alarms, private security, public police) in an effort to deter or prevent theft. Tullock then points out that precisely the same analysis applies to the political transfer process, or what has come to be known as "rent seeking" (Krueger 1974). Some individuals and groups expend resources (e.g., time to organize interest groups, lobbyists, investments in political campaigns to exchange support for those who have the discretionary power to create transfers) in an effort to gain wealth in the form of subsidies or artificial rents created by government actions (e.g., monopoly franchises, licenses, quotas, tariffs, subsidized purchase of property),[25] and others expend resources in an effort to defend against such transfers. These rent-avoidance costs, arising through

[25] Note that rents are not necessarily all captured by firms like General Motors. Many of the rents will be diverted to politicians who are in a position to create them, and to other parties such as labor unions (Benson 2002, 2005a).

investments in political information and influence by potential losers in the political transfer process, can be considered as a third source of costs arising in the involuntary transfer process. Because resources used in both rent seeking and rent avoidance have opportunity costs (they could be used to produce new wealth rather than to transfer existing wealth), they are "wasted" (Tullock 1967, Krueger 1974). Yet, individuals and groups have incentives to invest time and resources in an effort to gain wealth through the political process if the net gains are expected to be greater for them (but not to "society") than they can obtain through investments of the resources they control in actual wealth creation alternatives. Clearly, the use of condemnation powers to provide subsidized transfers of property from one private entity to another is part of this rent-seeking process.

Exit is another option for potential victims, perhaps by moving to an alternative political jurisdiction or by hiding economic activity and wealth (e.g., moving transactions underground into black markets). While immobile resources like land cannot be hidden in a gross sense, many attributes of land can be hidden (or destroyed) in order to make it less attractive for taking. Rapid development or exploitation of land might be attractive, for instance, if an under-compensated transfer (or regulatory taking) is anticipated, perhaps because such development at least raises the cost of pursuing the project through a takings. The rapid development also can eliminate alternative potentially more valuable future uses that make the land attractive for seizure. Essentially, the incentives are to capture whatever benefits from the property can be extracted relatively quickly before the property it is taken away (or before police powers are exercised through zoning or some other regulatory process that attenuates use rights). Therefore, for

instance, a landholder might develop (e.g., create a residential or commercial development) or exploit the property (e.g., plant crops that consume the soils nutrients, harvest its trees and/or minerals) much more quickly than she otherwise would, even though greater benefits potentially exist from later development or exploitation.

In order to reduce such "exit" actions and induce compliance with discriminatory transfer rules, other rules are likely to develop, and furthermore the rule makers will generally have to rely on courts and bureaucracies to implement and enforce the myriad of rules that are produced. Governments all over the United States have or are creating development authorities, zoning commissions, growth-management commissions, environmental authorities, and other agencies in order to implement controls on land use, for instance. Furthermore, lawyers representing land owners, developers, and government authorities are involved in millions of hours of negotiation and litigation, experts (e.g., assessors), land owners, and many other parties devote many more hours in control and compliance costs, and so on. These implementation, enforcement, and compliance costs are a fourth source of opportunity costs that accompany an involuntary wealth transfer process.[26]

The fifth source of costs may be the most significant. The takings power (including police powers and eminent domain) undermines the security of private property rights (Kulick 2000, 663), and importantly, insecure private property rights result in the same kinds of "tragedies" as those which arise in a common pool: rapid use (as suggested above) along with under maintenance of resources relative to the efficient

[26] Rules that facilitate voluntary production and exchange (e.g., private property rights, enforceable contracts) also require some enforcement costs, of course, but the level of these costs (e.g., litigation costs, assessment costs, policing costs that arise when individuals attempt to hide their wealth, etc.) increases dramatically when laws are also imposed in order to generate involuntary wealth transfers.

level of conservation. The more frequent and arbitrary transfers are expected to be, the more significant these costs become. The trends in the use or threatened use of eminent domain discussed above suggest that this power is being used increasingly frequently and arbitrarily. Perhaps these actions may not have a tremendous impact on property rights security, at least by themselves, but when they are put into the context of overall trends in government takings (e.g., through regulatory actions under the police powers), it is clear that property rights to land in the United States are becoming less secure.[27]

Clearly, government taking powers have substantial costs. Indeed, as Epstein (2001, 18) concludes, "The consequences are quite sobering. Whatever the theoretical promise of taking property only with compensation, that gain has been nullified in large measure [if not entirely] by the troubling circumstances of its application." Therefore, any justification for such powers (e.g., the holdout problem that may prevent obtaining a beneficial transfer), that does not also recognize the potential government-failure consequences when such powers, exist should be questioned.

V. Conclusions

The rhetoric of market failure used to justify government takings assumes that the starting point in the analysis is private property rights, since this assumption underlies the

[27] When property rights are relatively insecure, bargaining is also less likely (Coase 1960). When the insecurity arises because of governments power to take, however, there is an additional reason for expecting bargaining to decline. People who can effectively operate in the political arena essentially have potential claims on other people's property. Seeking control of the desired land through political channels is costly, of course, but if it is expected to be less costly than direct bargaining and voluntary exchange, incentives to seek involuntary transfers are strong. Thus, individuals who are active in and familiar with the political process are likely to choose that arena (i.e., the marginal cost of seeking condemnation is very low once someone has invested in building political connections and influence), while individuals who are not politically connected are relatively likely to choose direct bargaining. Furthermore, as the level of state transfer activity increases, more people will be forced to learn about the political process, so over time, political takings will tend to replace voluntary exchange. On the other hand, increasing the constraints on the state and reducing the ease of transfers would lead to the substitution of voluntary exchange for political actions. Indeed, the fact that compulsory purchase may appear to be necessary to obtain property rights under the existing property regime does not mean that it would be necessary with very secure allodial rights.

models of perfect competition and general equilibrium against which market failures are compared. Then, given the potential for holdout problems that can prevent beneficial (efficient) transfers of property through voluntary agreements, it follows that private property rights should be modified to the degree that government can take property under certain limited circumstances. The limited circumstances specified by the constitution are that the property is for "public use" and "just compensation" is paid. As explained above, the strength of these limitations have been substantially undermined by the U.S. Supreme Court, but an entirely different point is also made above. The assumptions underlying the market failure rhetoric in support of eminent domain powers actually have the story about the evolution of eminent domain powers backwards. The starting point was government ownership of property. Kings in England granted stewardship to individuals, but maintained the "right" (or more accurately, power) to take the property back. Gradually, over a long history of struggle to limit the power of government, property rights evolved in the direction of private property by placing various constraints on government. Government in England and then in the United States never fully relinquished its power to take property, but efforts continued to limit such power through revolts and efforts to constrain the feudal powers of the subsequent government through contracts (*Magna Carta*, The United States Constitution). The U.S. Constitution therefore included the Fifth Amendment's requirements of just compensation and public use, which have since been undermined to a substantial degree. It also successfully limited the federal government's power to condemn for almost a century while not constraining state governments. The federal government was not allowed to condemn property directly (it had to ask a state government to use its eminent domain powers)

until *Kohl v United States* (91 U.S. 367 (1875)). In *Kohl,* however, the court declared that the takings power is an attribute of sovereignty, and that (*Kohl,* 91 U.S. at 372) the federal

> government is as sovereign within its sphere as the States are within theirs. True, its sphere is limited. Certain subjects only are committed to it; but its power over those subjects is as full and complete as is the power of the States over the subjects to which their sovereignty extends. The power is not changed by its transfer to another holder.
> But, if the right of eminent domain exists in the Federal government, it is a right which may be exercised within the States, so far as is necessary to the enjoyment of the powers conferred upon it by the Constitution.

As Paul (1988, 73) explains "Justice Strong deduced a federal power to condemn in its own name both from the very nature of sovereignty and, more concretely, from the Fifth Amendment's taking clause ... The latter inference was, undoubtedly, inventive. The requirement that the government must pay compensation when it takes was construed to imply a power to take in the first place. This clause, as virtually all commentators agree, is a restriction on government's powers, not a concession."

Whether the U.S. constitution constrains the federal government's takings powers or not is not directly relevant to the issue of takings for retransfer for development, of course, since these actions are virtually all undertaken by local governments pursuant to State law. It is relevant to the point that constitutional constraints on governments are not binding, however. As governments find ways around such constraints, or simply reinterpret them, property rights are increasingly threatened. The backlash against the *Kelo* decision that is playing out in state legislatures all over the country (López and Totah 2007; Somin, this volume) actually is another in a long chain of backlashes against the ever-present incentive that those in government have to expand the scope and strength

of the claim that the state is the actual property owner and that the population simply serve as stewards for the state.

Criticism of uses of eminent domain powers are once again widespread and growing.[28] Much like the barons who demanded *Magna Carta*, the critics tend to demand reestablishment of constraints on the power of the state that have been eroding. The evidence and analysis presented above clearly support reestablishing the constitutional constraints. Indeed, they suggest that much stronger constraints on government takings are justified (perhaps to the degree that the sovereign authority that underlies eminent domain and police powers is not justifiable at all?). The government-failure perspective taken here also should suggest some caution in this regard, however.

The evolution of eminent domain powers and compensation requirements reflect an ongoing effort to constrain government powers to transfer wealth rather than to resolve market failure. Eminent domain is just one of many ways for government to take property and transfer rents, however, and it may be the most desirable method of transfer from an efficiency (and equity) perspective. After all, takings through eminent domain do require some compensation, even though it is likely to be inefficiently (and unfairly) low. Other methods of transferring property that are available to government do not even require compensation.

Regulatory takings involve similar government failure problems (Eagle 2005, 21-28; Benson 2002, 2004, 2005a) and do not require compensation. Thus, potential limitations on eminent domain should be considered in the broader context of takings. If

[28] For instance, the Castle Coalition has been developed by the Institute for Justice as a nationwide network of property owners and community activists dedicated to the prevention of the use of eminent domain powers in the United States for transfers to private parties for private uses. See www.castecoalition.org. Note that this anti-eminent domain movement is just one of the "property rights" movements in the U.S. See Eagle (2002), for instance.

local governments' abilities to transfer wealth through eminent domain condemnation with compensation are limited, it could lead to a substitution of uncompensated regulatory takings. Suppose a local government wants to encourage construction of a large power plant (or a low income housing development, manufacturing plant, retail store, etc.) in a particular area, for instance. It could encourage a private firm to build the plant (or developer to provide the desired housing, etc.) by using eminent domain to take the desired land, and transferring it to a private firm at a relatively low price. If the local government' use of eminent domain is effectively constrained by a true "public use" requirement that prevents a transfer to a private firm, however, it has alternatives. It could establish sufficiently strong regulatory requirements instead, which zone the land for industrial use, require lot size restrictions that dictate a plant of the size desired, and require sufficient regulatory approvals and oversight that would lead to the land being used as desired (or require any developer to provide a substantial number of low income housing units, etc.), without compensating for the reduced land value that results. Thus, for the public use constraint to prevent the transfer, it should be accompanied by restrictions on the use of police powers (e.g., a requirement of compensation for regulatory takings).

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