Proceedings of the 2008 Land Policy Conference

PROPERTY RIGHTS AND LAND POLICIES

Edited by Gregory K. Ingram and Yu-Hung Hong

Property Rights and Land Policies

Edited by

Gregory K. Ingram and Yu-Hung Hong

LINCOLN INSTITUTE OF LAND POLICY
CAMBRIDGE, MASSACHUSETTS

Library of Congress Cataloging-in-Publication Data

Property rights and land policies /
edited by Gregory K. Ingram and Yu-Hung Hong.
p. cm.
Includes index.
ISBN 978-1-55844-188-0
1. Land tenure. 2. Land use. 3. Real property. 4. Eminent domain.
I. Ingram, Gregory K. II. Hong, Yu-Hung. III. Lincoln Institute of Land Policy.
HD1251.P77 2008
333.3—dc22 2009002563

Designed by Vern Associates

Composed in Sabon by Achorn International in Bolton, Massachusetts.
Printed and bound by Puritan Press Inc., in Hollis, New Hampshire.
♻ The paper is Rolland Enviro100, an acid-free, 100 percent PCW recycled sheet.

MANUFACTURED IN THE UNITED STATES OF AMERICA

CONTENTS

10

Should Decreases in Property Value Caused by Regulations Be Compensated?

Abraham Bell

For nearly a century now, land use controls have been the domain of regulation rather than private law. Nuisance and other private lawsuits are still available to neighbors quarrelling over land use. But most of their land use questions—from construction materials to building size and shape, and even to the types of use (number of residences, permissibility of commercial activity, and so on) are resolved by the municipal and state regulatory system called land use law.

Since the dawn of the modern land use era, American law has struggled to deal with what came to be known as the regulatory takings question: whether the state would have to recompense landowners whose property values declined as a result of the regulatory scheme. Three legal analogies suggested themselves to courts as the key to resolving the compensation question. First, eminent domain—or government takings of title to property—is subject to the takings clause of the Fifth Amendment to the U.S. Constitution; consequently, all takings under the power of eminent domain must be accompanied by payment of just compensation to the owner (see Epstein 1985). Second, judicial applications of the common law rule of nuisance can eliminate valuable land uses, but are not generally seen as requiring compensation to the party whose use is found to be a nuisance. (For an interesting exception, see *Spur Industries, Inc. v. Del E. Webb Development Co*., 494 P.2d 701 [Ariz. 1972].) Third, a number of government powers, ranging from taxation to criminal forfeiture to welfare legislation, are never seen as requiring compensation; indeed, the very purpose of the power is often inimical to compensation (cf. Penalver 2004). Over the years, all three analogies have been used and recycled in the jurisprudence of regulatory takings in service of inconsistent results. (For descriptions of the inconsistencies of the doctrine, see Epstein 1985; Farber 1992a; Kanner 1998; Krier 1997; Rose 1984.)

Whatever one might think of the value of the analogies for legal doctrine, they should have little appeal for consequentialists. Whether a regulation that diminishes property value looks doctrinally more like a tax or like an exercise of eminent domain does not seem to provide any independent reason to favor or oppose compensation. One irrationally drawn line should not command another—or so it would seem.

However, upon closer examination, the doctrinal background is important even for the consequentialist. The consequentialist arguments for and against regulatory takings compensation ultimately cannot be uprooted from their doctrinal backgrounds. Whether and when regulatory takings compensation should be paid is a question that cannot be answered solely by reference to the question of whether payment for regulatory harm is optimal in the abstract; it must be answered in reference to a world that offers certain kinds of compensation for certain kinds of government action and that does not extract charges for many benefits.

This chapter attempts to determine the correct regulatory takings compensation policy given the general doctrinal framework in other bodies of American law. In particular, it addresses the following questions: First, given a compensation requirement for eminent domain, is it sensible to interpret the government's regulatory authority as permitting the elimination of property value without compensation? Second, since regulations often produce benefit as well as harm, how can a regulatory givings be incorporated into a consequentialist analysis of regulatory takings compensation? Should the right of property owners to benefit from capital appreciation caused by regulations without returning the windfalls to the government be interpreted as implying a denial of the right to receive compensation where the regulations produce adverse effects? Third, given the likelihood that overlapping regulations will produce both benefit and harm for property owners over time, should land use regulations remain uncompensated in light of the probability of a future or past beneficial land use regulation? Fourth, in light of the ubiquity of ad valorem property taxes, should regulations that adversely affect property be seen as implicitly accompanied by compensation, given that a reduction in housing values will lead to lower tax payments just as an increase in property prices caused by a public action will increase tax liabilities for property owners?

The findings of the chapter may be summarized as follows: The case for takings compensation is far from perfect, and serious arguments can and have been made against it. However, once compensation is a required accompaniment to eminent domain takings, it is extremely difficult to draft a cogent argument for ruling out compensation for regulatory takings in general. Adding consideration of givings and taxes to the picture further demonstrates the problematic nature of much of the law of takings, but does not make a compelling case against compensating for regulatory takings.

The first part of the chapter explores the concept of takings compensation and briefly sketches the consequentialist case for compensation. The second part asks how regulatory takings may be distinguished from other takings and asks whether they ought to be. The third part introduces the concept of regulatory givings and questions whether a givings analysis ought to change the conclusions of a takings analysis. The fourth part briefly addresses the issues concerning interplay with other doctrinal bodies, especially tax, to determine whether tax capitalization effects are the equivalent of compensation.

Takings Compensation

The Fifth Amendment to the U.S. Constitution guarantees just compensation to property owners whenever "private property [is] taken for public use." The compensation guarantee goes back in Anglo-American legal history to the Magna Carta and, though ambiguous in scope, is thoroughly uncontroversial as a matter of law.

While beyond the scope of this chapter, fairness concerns appear to animate many popular understandings of the compensation requirement. The most familiar formulation of these concerns is found in the U.S. Supreme Court's announcement in *Armstrong v. United States*, 364 U.S. 40 (1960), that, per Justice Blackmun, fairness in the takings context requires that "Government [not force] some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole." Drawing heavily on the work of John Rawls (1958, 1971), Frank Michelman (1967) argued that the fair compensation requirement represents the legal regime that the citizenry would have chosen behind a veil of ignorance. Specifically, Michelman argued that the scope of the just compensation requirement is that which the citizenry would choose if it knew of a governmental power of eminent domain in the abstract but did not know how the burden of exercising that power would be distributed among the general public.

Essentially, Michelman assumed that if people had no knowledge of what their future property holdings would be, they would nevertheless have a shared notion of an acceptable risk of exposure to eminent domain. In this understanding, people would accept some takings only with compensation, to be identified by situations in which the demoralization costs of having one's property taken exceeded the settlement costs of arranging for payment of compensation. More precisely, Michelman suggested that compensation should be paid when settlement costs are low, the gains from the government action are dubious, and "the harm concentrated on one individual is unusually great." On the other hand, compensation may be denied when property owners who are burdened by the government action also benefit from it or when the burden falls on the shoulders of many people.

The Michelman formulation has greatly influenced the development of takings doctrine. It played an important role in the majority opinion in *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978), the Supreme Court's 1978 reentry into the field of regulatory takings. But it is difficult to translate into economic terms. In particular, demoralization costs, the key utilitarian term in

Michelman's analysis, are difficult to translate into workable terms. This chapter focuses instead on economic justifications for takings compensation: (1) fiscal illusion; (2) counteracting the interest group power of property owners; and (3) reducing the ability for profiting from corrupt use of political power.

Before exploring these explanations, I must add an important caveat regarding the dual nature of compensation. Takings compensation, like any other compensation required by law—such as compensation for torts and breaches of contract—creates incentives for both the actor who pays the compensation and the actor who receives it. Often, the rule that properly incentivizes one party creates the wrong incentives for the other. Consider, for example, bilateral accidents—accidents whose likelihood or scope of damages may be limited both by the party that causes the accident and by the accident's likely victims. A tort standard of strict liability, which requires the tortfeasor to pay for all damages caused by the accident irrespective of fault, will properly incentivize the would-be tortfeasor to engage in optimal levels of care to prevent the accident as well as optimal levels of activity in carrying out the accident-prone pursuit. However, the strict liability standard provides complete insurance for all victims irrespective of whether the victim herself might have reduced or eliminated the damage by being more careful or refraining from the activity in which she was harmed. Thus, the strict liability rule may encourage potential victims to engage in supra-optimal levels of activity and suboptimal levels of care (Shavell 1987). Where both the tortfeasor and the victim may take measures to prevent social harm, optimal deterrence may be achieved only by imposing a standard that creates "double responsibility at the margin" (Cooter 1985). Thus, economic analysis dictates that where the victim must be induced to optimize a level of care, either the tortfeasor must be given the opportunity to avail herself of a defense of contributory negligence or the tortfeasor must be subject to a standard of negligence. In this way, both tortfeasor and victim will be induced to take responsibility for reducing the incidence of tort harms (Shavell 1987).

An optimal rule of compensation must not only address incentives to the potential taker (the government). It must also concern itself with the incentive effects created by the compensation rule on property owners. I therefore examine the incentive effects on each party—first the government and then the property owner—and finally attempt to combine the rules into one creating optimal incentives for both parties.

COMPENSATION AND GOVERNMENT BEHAVIOR

Fiscal Illusion Fiscal illusion is perhaps the most common economic justification of the constitutional mandate of just compensation (Blume, Rubinfeld, and Shapiro 1984; Blume and Shapiro 1984; Fischel 1995). Proponents of this explanation of the utility of compensation argue that government decision makers overlook costs that do not directly affect government revenues and expenditures. When operating under fiscal illusion, decision makers are blind to costs (and benefits) their actions impose (and bestow) on private property owners, save those that appear on the budget. As a consequence of their limited vision, decision makers subject to fiscal illusion take insufficient heed of costs they impose on private property owners and potentially will take too much if unconstrained by a compensation requirement, because uncompensated takings enrich the government by adding property holdings while imposing relatively small costs, such as administrative costs.

The requirement of compensation remedies the problem by forcing the government that takes property to place the costs incurred by the private property owners on the budget. Once the government must pay compensation (and if social benefits are properly accounted for), the cost of takings appears in the decision-making process, and fiscal illusion no longer distorts it.

To be sure, there are some significant gaps between the requirements of the fiscal illusion justification and current compensation doctrine and practice. First, it is at odds with the legally mandated compensation standard of compensation at market value. Taken to its logical conclusion, the fiscal illusion justification calls for a more generous compensation measure than that currently employed, namely compensation at subjective value—at the value the owner attaches to the property rather than the value attached by the marketplace. As Judge Posner wrote in *Coniston Corp. v. Village of Hoffman Estates*, 844 F.2d 461 (7th Cir., 1988), "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 'inframarginal,' 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." Since the fiscal illusion theory is concerned with full accounting for costs and benefits, the only measure that reflects the full cost of government projects is not payment of market value to the aggrieved owners but rather the payment of compensation at the owners' subjective value, which reflects the true loss as a result of the coercive transfer (Bell and Parchomovsky 2007; Krier and Serkin 2004; Merrill 2002; Serkin 2005). Second, the theory of fiscal illusion implies that decision makers ought to be just as blind to the effect of benefits bestowed on others as to the costs imposed on them. Thus, the fiscal illusion justification calls for assessing charges for givings just as much as it demands compensation for takings. Yet, while a handful of doctrines—such as the doctrine of average reciprocity of advantage and local exactions or levies—account for givings, they generally do so only partially and as offsets, leaving an expected situation of too few givings (Bell and Parchomovsky 2001a).

Additionally, as an empirical matter, the fiscal illusion justification appears to overstate decision makers' adherence to the requirements of government budgets. However, political actors are independent agents whose interests are not entirely identical to the state's (see, for example, Niskanen 1971; Peters 1978; Posner 1974; Stigler 1971; Tullock 1989). They take account of nonbudgetary concerns and clearly do not exclusively maximize budget surplus. For instance, political actors will invariably care about the effect of their actions and decisions on their personal utility functions and, especially, on the probability of being reelected. Hence, decision makers might pay compensation for political reasons without being required to do so.

Property Owners as an Interest Group A different explanation focuses on property owners' political grievances created by uncompensated takings. This explanation operates on the assumption that government makes benign decisions for the benefit of society, but may be foiled by well-organized compact interest groups. When it comes to takings, this model envisions that an initially efficient proposal to take property for the benefit of society may not be implemented on account of opposition from politically powerful property owners who can and will stop the government initiative by exercising their political clout unless paid enough money to remove their opposition. As a result, efficient takings would be likely blocked absent the payment of compensation (Farber 1992b). The touchstone for this explanation is Mancur Olson's (1965) theory of the superior political power of minority interest groups.

While maintaining some surface appeal, the explanation comes apart upon further examination. In fact, the theory provides no explanation for why it is necessary to mandate compensation by law. If the theory is right, the government will always choose to pay compensation of its own accord in order to carry out efficient projects. At best, the compensation requirement can be seen as a precommitment mechanism under which the government concedes the inevitable to the politically powerful. Additionally, there is no need to compensate owners at the full value of their property (whether measured by market price or subjective value). On one hand, politically powerful homeowners have no reason to be appeased at the payment of market value or even the full subjective value they attach to the property. Once they understand their power to hold out and block the project, such owners will require the payment of the largest amount they can extract from the government commensurate with the group's political power; this can range from zero up to the full value of the project to society. On the other hand, if the owners are not sufficiently powerful to block the project, there is no need to offer them any compensation. Indeed, in such cases the payment of compensation is not only unnecessary, but also a waste of resources (Bell and Parchomovsky 2009).

Compensating Against Corruption A third and final explanation for takings compensation is that it helps reduce the incentives for corruption by limiting the ability of politicians to profit from takings. The touchstone for this theory is rent-seeking accounts of government behavior. In such theories, actors attempt to harness the powers of government to transfer to themselves market power or other benefits in order to earn rents—the socially undesirable extra profit earned by the use of the regulatory powers in a socially suboptimal manner. Government powers, in this view, are auctioned off to the highest bidder and are employed toward that bidder's desired end. Aside from the costs of auctioning, avoiding detection, and the like, government activity divides rents between interested bidders and politicians. Given the rent seeking that attends all public decision-making processes in this model, the best way to improve the quality of public decision making is to reduce the profitability of rent-seeking activity by minimizing available rents. Takings compensation does just that. It reduces the profitability of rent seeking, in this account, by reducing the pool of funds available for extracting rents. If government could take property by eminent domain without paying compensation, the full value of the property would be available for rent-seeking activity. Once compensation is paid, however, the value of rent-seeking activity is reduced to the value of the property less the compensation paid (Bell and Parchomovsky 2009).

This explanation of the purpose of takings compensation avoids many of the difficulties of the fiscal illusion and interest group explanations of takings compensation. However, it relies on a limiting assumption: Specifically, in order to extract funds from owners in exchange for not taking properties, decision makers must have some means of credibly assuring owners that their property will not be at further risk from takings. This means not only that politicians must be able reliably to assure owners that the politician will not threaten a taking a second time after receiving payment; it also means that owners must be reasonably assured that other decision makers will not threaten the same taking.

COMPENSATION AND OWNER BEHAVIOR

The imperfect case for takings compensation becomes more complicated once the effects on owner incentives are included. The problem here is that compensation for property owners grants each a de facto government insurance policy against takings. A reasonable case can be made in favor of the benefits of such social insurance. However, like all cases of insurance, the granting of an insurance policy creates moral hazard in the insured, the risk that the insured will recklessly expose herself to risk given the lack of financial consequences (Arrow 1971).

The social insurance case for takings compensation is straightforward. Property owners, like others, are risk averse. Insurance against the loss of takings improves social utility by partially eliminating disutility engendered by uncertainty. For the risk averse, insurance provides a benefit beyond the actuarial value determined by the magnitude and likelihood of expected loss. That is to say, for the risk averse, even if the premiums paid are worth enough to fully cover the probabilistic likelihood of loss, the insured will come out with greater utility. Of course, in order to justify mandatory takings compensation, it is not enough to point to likely social gains from insurance. One must further explain why—if insurance provides such utility—private markets do not provide such policies and why the government ought to provide that insurance rather than the private market. Rent-seeking accounts of government might explain the lack of private insurance as impossible under a rent-seeking regime or, at the very least, explain why such private insurance might lead to social loss. This is because rent-seeking actors would take advantage of government decision makers' knowledge about future takings decisions by purchasing this information about future takings. Insurance companies could then use the information both to deny coverage to the parties imperiled by future takings and to bribe government decision makers to change their takings decisions and impose takings on the uninsured rather than on insured parties. Given these possible corruptions of the system, the likely losses created by the combined effect of inefficient takings, unnecessary insurance policies, and bribes would outweigh social gains created by private insurance (Bell and Parchomovsky 2009). Additionally, private insurance might be plagued by problems of adverse selection, thin markets due to the rarity of eminent domain takings, and monitoring of moral hazard (Blume, Rubinfeld, and Shapiro 1984).

Yet, even if there are social gains to be realized by public provision of the social insurance of takings compensation in the form of greater security for the risk averse, it is far from clear that takings compensation is socially optimal when all gains and losses are taken into account. After all, irrespective of insurance's positive effects in increasing security, it necessarily creates risk of moral hazard. In the context of takings insurance, as Louis Kaplow (1986), Lawrence Blume, Daniel Rubinfeld, and Perry Shapiro (1984), and others have identified, the risk is that owners will overdevelop their properties. Knowing that takings compensation will insure them for the value of any development that ends up being rendered worthless by a taking, and knowing they will enjoy a full benefit if there is no taking, owners will naturally overspend on developments that should never have been built had the risk of takings been accounted for.

In legal schemes that provide compensation, there are a number of standard remedies for moral hazard. For instance, to prevent moral hazard created by tort compensation in bilateral accidents, the law may impose a contributory negligence defense (Shavell 1987). In contract cases, the law may require victims to mitigate their damages. Insurance companies may privately impose various duties upon insured parties to ensure due care, and they may require the insured to accept a policy with a deductible—an agreement that the insurance company will deduct a fixed amount from any compensation for the loss in order to ensure that insured parties are properly motivated to take care. The takings literature has offered a number of such remedies in order to resolve the moral hazard problem. But while there are elements of such remedies to be found in existing takings compensation law, as a general rule takings compensation does little to discourage overdevelopment (Bell 2003; Miceli and Segerson 1994).

As a consequence of the adverse incentive effects on property owners, a number of scholars have proposed that takings compensation is inefficient altogether if viewed from the perspective of property owners only, and only partially justifiable if the government is considered subject to fiscal illusion or other decision-making frameworks that would be adversely affected by immunity from takings compensation (Blume, Rubinfeld, and Shapiro 1984). This may be correct. Indeed, without a clearer picture of the degree of risk aversion of the general public to takings, it may be unknowable whether the losses created by moral hazard exceed the gains produced by social insurance and discouragement of inefficient takings or bribe extraction. Unfortunately, as there is no market for private takings insurance, the value of this service is difficult to determine.

In summary, various economic cases may be made for takings compensation, but none is free from controversy.

Regulatory Takings Compensation

In contrast to the difficulty of making a case for general takings compensation, making a case for regulatory takings compensation is easy once the appropriateness of takings compensation in general is conceded. This is not to say that the law of regulatory takings has found it easy to determine when compensation ought to be paid. On the contrary, finding the line between regulations that are considered constitutional takings (which must therefore be paid for by just compensation) and those that are not (which may remain uncompensated) has proved one of the most difficult tasks in modern law (see Kanner 1998). Regulatory takings questions have remained on the Supreme Court's docket for several decades now, and the numerous cases have created as much confusion as they have resolved.

The formalist case law for differentiating between regulatory takings and ordinary takings is both textual and functional. Traditionally, the state has been required to pay compensation to property owners only when it has used its power of eminent domain, but not when it has used the other regulatory powers encompassed within its police powers. This reflects the fact that the Constitution extends its guarantee of compensation for takings only to the use of the eminent domain power and not to the use of any other government power.

However, this formalistic treatment does not resolve very much. In the seminal *Pennsylvania Coal v. Mahon*, 260 U.S. 393 (1922), the Supreme Court acknowledged that regulations may sometimes go too far in reducing property value such that they must be considered takings, although not formally acts of eminent domain. Thus, ruled Justice Holmes in the name of the Court, a Pennsylvania regulation forbidding mining that would cause subsidence damage to buildings on the surface above the mine was a taking because it unduly diminished the value of the subsurface owned by the mining company.

Unfortunately, Justice Holmes refrained from clearly explaining when and how a regulation was to be identified as a taking, and in the four decades since regulatory takings returned to the Supreme Court docket in *Penn Central Transportation Co. v. New York City*, the judiciary has failed to craft a coherent doctrinal approach. In *Penn Central*, the Court established an ad hoc inquiry comprising three factors for identifying takings in actions that purport to be exercises of the police power: the owner's reasonable investment-backed expectations, the nature of the government action, and the degree of diminution in property value. At the same time, the Court refused to let go of traditional identification schemes characteristic of the pre–New Deal era. Notwithstanding the *Penn Central* test, permanent physical invasions alone are takings (*Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 [1982]); prevention of noxious uses may block the finding of a taking (*Hadacheck v. Sebastian*, 239 U.S. 394 [1915]), and a complete wipeout of property value not ascribable to nuisance prevention is a per se taking (*Lucas v. South Carolina Coastal Council*, 505 U.S. 1003 [1992]).

From an economic perspective, all this is meaningless. Indeed, in the view of property rights economists, the takings versus regulatory takings distinction is even more meaningless than might at first appear. To economists like Yoram Barzel (1997), valuable entitlements are property rights, whether so defined by law or not. They may be defined as property rights by law, or as administrative or contract rights. They may be *in rem* or *in personam*. They may even be illegal. For the property rights economists, these distinctions are little more than curiosities.

For property rights economists, then, there is no difference between a government action that takes away all value in extracting rights from a mine by means of eminent domain and one that takes away the same value extracting rights by means of what the law calls a regulation. For the property rights economists, in both cases, the rights taken are property rights, and there is no reason to treat any of them as different in kind than the other.

This is not to say that economists have nothing to say about the regulatory takings debate. Several economic explanations have been offered for why some regulatory takings remain outside the realm of compensation. In the main, these explanations have focused on a parallel between mandated takings compensation and other mandated compensation. For example, Saul Levmore (1991) suggested that the kind of acts that would be considered noncompensable under private tort law ought not to be compensable under takings compensation law. Similarly, William Fischel (1995) suggested that regulatory takings lines should track the local development norms and that compensation should be paid only where government compels the use of land in a more restrictive manner than local norms would indicate.

Ultimately, however, these explanations appear to do little more than describe a set of cases where takings compensation of any kind would be inefficient, because, properly understood, the property right claimed to be taken by the owner never, in fact, existed. These explanations do not describe an approach that justifies treating regulations generally as distinct from eminent domain in compensation policy.

And, indeed, on the other side of the regulatory takings divide, one can find an economic argument that regulatory takings present a better candidate for compensation than other kinds of takings. Again, this is not due to a difference in the nature of the power or property rights involved. Rather, argue Thomas Miceli and Kathleen Segerson (1996), because regulatory takings are more frequent than eminent domain takings, they may present better candidates for efficient compensation under an unusual theory involving preemptive development. According to their theory, where governments make efficient decisions regarding takings and owners properly anticipate takings and the government's reluctance to destroy valuable developments by takings, uncompensated owners will attempt to reduce the likelihood of their property being taken by overdeveloping it. This is particularly true when takings involve a number of candidate properties and owners need only slightly overdevelop to make it efficient to seize another slightly less-developed property. Miceli and Segerson (1996) conclude that takings compensation eliminates this risk by eliminating the incentive to invest inefficiently to alter the takings risk.

Finally, the practice of requiring compensation for some kinds of takings of property rights (by eminent domain) and not requiring compensation for other kinds of takings of property rights (by regulation) can create its own set of distortions. Since the government may, in many cases, accomplish the same result of taking and transferring property rights by either regulation or eminent domain, requiring compensation in one of these cases but not the other would push the government toward using the regulatory tool, even where it would be less efficient. Whether the government was subject to fiscal illusion or corruption (as in standard rent-seeking models), it would be ready to use a less-efficient regulatory tool in order to avoid the mandated budgetary expenditure on compensation.

Thus, from an economic perspective, it is difficult to justify a broader rule against compensation for regulatory takings than against compensation for ordinary takings. For the economist, property rights are property rights, whether described as title or as regulatory permissions.

Regulatory Givings and Compensation

There is one readily observable difference between regulatory powers of the state and naked eminent domain. In an act of eminent domain, the state appropriates title to a property. Generally, that property will subsequently be put to some use that benefits at least one person, but the act of eminent domain itself involves only the taking, not the subsequent benefit. Regulations, by contrast, generally combine both giving a benefit and taking property value. Land use regulations, in particular, almost invariably involve some losses and some gains for a number of property owners.

Bell and Parchomovsky (2001a) labeled the distribution of such benefits "givings" in an attempt to tie the rules of conferring benefits more explicitly to the law of takings. (An earlier work, Hagman and Misczynski [1978], referred to such benefits as "windfalls.") The issue of givings is not unique to regulation; it is merely highlighted by the combination of givings and takings in the same act. Givings are ubiquitous. They exist not only when government grants licenses or regulatory favors, but also when government directly grants money and properties to private actors. In a sense, granting givings is the major business of government, and takings or taxes are simply means to the end of givings.

How should takings compensation policy deal with the fact that regulations generally involve both givings and takings? One possibility might be to exempt regulations altogether from the general obligation to pay takings compensation, on the assumption that the givings and takings in regulations will generally cancel one another out. Second, one might urge dealing with the combination of givings and takings that is usually found in regulations in the same way as the law deals with ordinary takings that are not directly accompanied by givings. Today, this means paying compensation for takings while neglecting to assess charges for givings. In this part, I endeavor to show that the optimal means of dealing with givings, in both regulatory and ordinary takings, is to assess charges for them. I also argue that even in the absence of givings charges, it is preferable to pay compensation for regulatory takings on the same terms as ordinary takings than to exclude regulatory takings from compensation altogether.

Since the dawn of modern regulatory takings jurisprudence, regulatory takings law has included a doctrine called the average reciprocity of advantage. This doctrine was first introduced in *Pennsylvania Coal v. Mahon*. As Justice Holmes explained it, it excluded some regulations that would otherwise be thought to be regulatory takings from the compensation requirement. The specific case to which Justice Holmes was referring was a regulation requiring mining companies to leave pillars of coal in place along adjoining mines. These pillars were necessary to prevent flooding mine collapses, but, naturally, they also required mining companies to leave substantial amounts of coal in the ground. Justice Holmes insinuated that without average reciprocity of advantage, a regulation requiring that coal companies leave as much as one-third of their coal behind in pillars in the mine would constitute a taking. However, Justice Holmes argued that the pillars rescued the mining companies' own miners. Thus, while on one hand, the regulation destroyed valuable property rights by preventing the company from taking up large portions of coal, on the other hand, the regulation also rescued another valuable resource of the company, namely, the health and safety of its workers. The reciprocity was to be found in examining the whole scheme: while the pillars in X's mine might be more valuable than the safety benefit to X's workers from the pillars, X's workers also benefited from Y's pillars, and, together, X's and Y's workers benefited more from leaving the pillars in place than X and Y would earn together had they mined the pillars.

Unfortunately, neither *Pennsylvania Coal v. Mahon* nor any subsequent decision spelled out precisely what is meant by average reciprocity of advantage. One possible meaning is that where those affected by the regulation as a whole are benefited more than they are harmed, the regulatory action is not a taking. The important contribution of the doctrine is that the harm and benefit need not be measured at the same time, but rather over the entire effects of the regulatory scheme. In one period of time, a mining company may lose more as a result of leaving coal in place than it saves as a result of better worker safety. In other periods, the reverse may be true. Over time, however, for all affected parties, the regulation should produce benefits.

Yet, this is not the only possible meaning of the doctrine. While applying the term in his dissent in *Penn Central Transportation Co. v. New York City*, Justice Rehnquist asserted that average reciprocity of advantage could only be utilized to save a regulation from mandatory compensation where the regulation's effects were widely felt, rather than applied to a small number of singled-out properties. This condition was apparently meant to supplement rather than replace the requirement that all ultimately benefit. Others have highlighted what appears to be an ironic aside in Justice Brandeis's dissent in *Pennsylvania Coal v. Mahon*, arguing that where a regulation produces more good than harm overall, it meets the conditions of average reciprocity of advantage because it is part of the larger web of regulations that affect businesses in society (Coletta 1990). Some scholars have suggested that average reciprocity of advantage presents the best explanation of why the government need not compensate landowners for permitting airplanes to fly over their land, notwithstanding the traditional *ad coelum* role, which grants landowners title to all air space up to the heavens (Epstein 1985). In this instance, it is unlikely that all affected parties will benefit as much as they are harmed, and vice versa. Some landowners doubtless fly little while residing close to airports and therefore suffering greatly from overflights. Other landowners suffer trivial losses from overflights while benefiting greatly from air travel. This concept of average reciprocity of advantage appears to refer to balance of benefits and harms not for individual parties, but rather over the entire affected populace. This latter concept of average reciprocity of advantage is difficult to justify from an economic standpoint.

To see why universal offsetting takings might not be the best approach, consider a regulation limiting or forbidding building within wetlands. In preserving the wetlands, the regulation doubtless alleviates drainage problems and therefore flooding of many properties. However, the benefits and harms are almost certainly not evenly distributed. To take the most extreme example, those who own properties within the wetlands that must remain undeveloped lose a huge portion—perhaps all—of the value of their lands. By contrast, those whose properties are upland of the wetlands, at the edge of where the floodwaters would reach were the wetlands developed, almost exclusively enjoy benefits from the regulation. They earn the entire value of the reduction in flooding risk to their property. When aggregating these costs and benefits over the entire society, it may well be that the benefits outstrip the harms. But this is true of any taking. Depending upon one's understanding of the reason for takings compensation, compensation should still be mandated for the regulation.

Consider first a corruption-blocking explanation of takings compensation. Because a regulation of this kind predictably helps certain types of owners and harms others, it represents an excellent opportunity for decision makers to extract payment from potentially aggrieved owners in order to sidetrack the regulation, or to extract payment from beneficiary owners in order to push it forward. Mandatory takings compensation for aggrieved owners reduces the pool of valuable regulatory favors that can be sold off by those decision makers. To be sure, the absence of mandatory givings charges still leaves decision makers with the ability to benefit from the sale of regulatory favors. They may still withhold beneficial regulation until adequately paid, and they may support socially harmful legislation because owners who benefit are willing to offer payment for the favor. This might seem to indicate that symmetry in not paying compensation and not assessing charges would lead to auctions for regulatory favors clearing the market at efficient prices. However, somewhat ironically, the imperfections of the corrupt market for political favors block this happy outcome. Specifically, because the benefits and harms are not symmetrically distributed, harmed owners will not be able to act collectively at the same cost as benefited owners. While this will not be true of every potential regulation, would-be beneficiaries will naturally seek out regulations where harmed owners cannot respond adequately, leading to adverse selection and the likelihood of inefficient regulations alongside efficient ones.

Next, consider a fiscal illusion explanation of takings compensation. If one assumes that a regulation is social welfare enhancing, there is no need to require payment as compensation for the taking; after all, the government has independently arrived at the decision to which takings compensation was to have led it. However, it is not clear why the overall utility of the regulation may not be assumed. This seizure of land by eminent domain and its subsequent transfer to a private developer may well enhance social utility. However, the fiscal illusion explanation of takings compensation is based on the idea that the best way to ensure that, in fact, such takings are social welfare enhancing is to mandate compensation. The same is true of a regulation. Indeed, if we were to assume that government always mandates welfare-enhancing regulations and is unaffected by fiscal illusion, there is little reason to worry about compensation. Compensation, in this view, would have no effect on the social welfare calculation other than administrative costs of compensating and social gains in reduction of uncertainty for the risk averse. Thus, absent extreme effects in one direction or the other due to administrative costs and insurance gains, regulatory decisions should be unchanged by compensation requirements for a benevolent government.

It is doubtless true that a fiscal illusion explanation would expect too few beneficial wetlands regulations, because decision makers would not take full account of the benefits to properties within the floodplain and outside the wetlands. However, this would be just as true of any taking carried out by eminent domain. The giving problem is ubiquitous and not restricted to regulatory takings. If it does not justify eliminating compensation for eminent domain, it cannot justify eliminating compensation for regulatory takings.

Finally, the interest group explanation would strongly indicate the value of compensation to wetlands property owners, lest there be too little wetlands regulation. Politically powerful owners of wetlands properties would use their concentrated political power to block beneficial wetlands regulation unless paid off. Guaranteed compensation sidelines them and permits the beneficial regulation to go forward.

It is worth noting that a handful of methods are used at the local level to recapture givings. These include transferable development rights, in-kind or monetary exactions, and betterment levies (see Bell and Parchomovsky 2001b; Hagman and Misczynski 1978). While none of these techniques is comprehensive—and none generally aims at recapturing the full value of the giving—each partially ameliorates the givings problem. To the extent that such techniques exist, they undermine the argument that givings can be seen as implicit compensation for regulatory takings. In any event, givings require separate analysis.

Regulatory Takings and Taxation

Taxation is the central means by which government raises revenues and naturally greatly affects property values. Surprisingly, however, few models have attempted to deal with taxation and takings in an integrated fashion. This is particularly surprising for believers in fiscal illusion explanations of takings compensation. If the government truly suffered from fiscal illusion, it would doubtless tax too much. Yet, there is no legal requirement of compensation for tax, and, indeed, such a requirement would be impossible, as it would involve returning the same revenue sought to be raised.

If we accept that taxation must remain uncompensated and that takings should remain compensated, the existence of taxation remains important for takings compensation analysis when the taxation is assessed on the basis of ownership of an asset. For land use, this type of taxation is an important part of the analysis, as ad valorem taxation is used almost universally throughout the United States as a means of raising local revenues. The use of ad valorem taxation thus opens up two possible amendments to the takings compensation analysis thus far. First, taxation and land use regulation might be viewed as explicitly linked in a manner that allows Tiebout competition. In other words, we might view the decision to live in a given municipality as essentially a question of accepting a given package of local property taxes and land use regulations, with the result that land use regulations could be viewed as accurately reflecting the preference of residents who have chosen to take up residence in the municipality. Second, the changes in tax revenues resulting from regulatory givings and takings could be seen as partial takings compensation and givings charges that might alter compensation policy.

Charles Tiebout created an entire branch of economic analysis of municipal competition in a pathbreaking article in which he challenged the traditional view (see Musgrave 1939; Samuelson 1954) that the absence of an effective preference revelation mechanism prevents efficient provision of public goods. Tiebout observed that at the local level, however, multiple localities with different revenue and expenditure patterns compete to attract residents, and residents choose among them by "voting with their feet"—by moving to the locality that best fits their preferences (Tiebout 1956). The greater the number of communities and the larger the variance among them, the closer individuals will come to satisfying their preferences. This analysis led Tiebout to conclude that, under certain conditions, it is possible to achieve efficient provision of local public goods. At least to some extent, the Tiebout hypothesis has found support in empirical studies that appear to suggest that migration patterns between city and suburbs are significantly affected by tax levels and investment in education (see Poindexter 1997).

If Tiebout is right and municipalities compete among one another for residents on the basis of property tax and land use policies, there is no need to mandate compensation for any land use regulation. This is because a municipality that takes too much property by land use regulation will find itself losing residents. The municipality will therefore reach the optimal amount of regulatory takings and taxation to fit the preference of the market niche of residents to which it caters. Indeed, William Fischel has argued in his homevoter hypothesis that homeowners dominate local politics because, as a group, homeowners' most valuable asset is generally their homes, and that asset's value is dramatically affected by local political decisions (Fischel 2001). However, Fischel also noted that the dominant local good that determines homevoter sorting is local school expenditures, rather than land use law. At the same time, local property controls enhance local property owners' voice at the expense of other interest groups that might compete for control of local property law. The result, Fischel argues, is that land use controls are more likely to resemble monopoly production and pricing by the local political controllers of land use law than efficient competitive results (Fischel 1985). Thus, a Tiebout analysis provides no reason to assume efficient regulation and therefore provides no reason to eliminate the compensation requirement.

I turn to viewing taxation as partial takings compensation and givings charge. Any reduction of property value reduces tax revenues that may be realized from that property, and vice versa. Even without a requirement of takings compensation or givings charge, government will already be partially incentivized not to take too much or give too little.

Tax policies also interact explicitly with regulatory takings and givings. First, tax policy is often explicitly tied to regulatory favors or restrictions. Extra taxes may be levied against areas that have received zoning benefits (betterment levies), and development areas may receive favorable tax treatment as part of a plan to encourage the full exploitation of regulatory benefits (Bell and Parchomovsky 2001b). Second, expected tax burdens are known to the marketplace and are therefore capitalized into the price of realty. Specifically, the price of a piece of real estate in a given area reflects the tax-adjusted stream of benefits and costs that would be realized by anticipated owners (Fischel 2001).

However, once again, this does not provide good reason for treating regulatory takings differently. Since property taxes are generally assessed at a very small percentage of the value of the asset, taxation changes will reflect only a small percentage of the value of the taking or giving. Blume, Rubinfeld, and Shapiro (1984) have made a case that partial compensation is the best result that may be obtained given the restraints of fiscal illusion and moral hazard, and one might anticipate that relying on property taxation would be appealing in their model. However, the model offers no reason to treat regulation differently than any other taking of properties subject to ad valorem taxation. Indeed, if it is optimal to rely upon the partial compensation effect created by property taxation to produce the correct amount of land use regulation, it is optimal to rely upon the same to produce the correct amount of eminent domain takings of land. Thus, if the small changes in tax burden resulting from regulatory changes constitute adequate compensation for regulatory takings, the elimination of taxes that result from having property taken by eminent domain should be sufficient compensation for the ordinary taking. Of course, that is not an argument that holds sway under current law.

Conclusions

In this chapter, I have explored the economic understandings of takings compensation in order to determine the proper regulatory takings compensation policy. The case for takings compensation is far from perfect, and serious arguments can and have been made against it. In addition, a case can be made that property regulation and takings are made inefficient by the failure to properly account for givings and the incentives created by the interaction of ad valorem taxation and takings compensation. However, once compensation is a required accompaniment to eminent domain takings, it is extremely difficult to draft a cogent argument for ruling out regulatory takings in general.

REFERENCES

Arrow, Kenneth. 1971. *Essays in the theory of risk-bearing*. Chicago: Markham Publishing.

Barzel, Yoram. 1997. *Economic analysis of property rights*. New York: Cambridge University Press.

Bell, Abraham. 2003. Not just compensation. *Journal of Contemporary Legal Issues* 13(1):29ff.

Bell, Abraham, and Gideon Parchomovsky. 2001a. Givings. *Yale Law Journal* 111: 547–618.

———. 2001b. Takings reassessed. *Virginia Law Review* 87(2):277–318.

———. 2007. Taking compensation private. *Stanford Law Review* 59:871–906.

———. 2009. Compensating against corruption. Unpublished manuscript.

Blume, Lawrence E., Daniel L. Rubinfeld, and Perry Shapiro. 1984. The taking of land: When should compensation be paid? *Quarterly Journal of Economics* 99(1):71–92.

Blume, Lawrence E., and Perry Shapiro. 1984. Compensation for takings: An economic analysis. *California Law Review* 72:569–628.

Coletta, Raymond R. 1990. Reciprocity of advantage and regulatory takings: Toward a new theory of takings jurisprudence. *American University Law Review* 40:297ff.

Cooter, Robert. 1985. Unity in tort, contract, and property: The model of precaution. *California Law Review* 73:1–51.

Epstein, Richard A. 1985. *Takings: Private property and the power of eminent domain*. Cambridge, MA: Harvard University Press.

Farber, Daniel A. 1992a. Public choice and just compensation. *Constitutional Commentary* 9:279–308.

———. 1992b. Economic analysis and just compensation. *International Review of Law and Economics* 12:125–138.
Fischel, William A. 1985. *The economics of zoning laws*. Baltimore: Johns Hopkins University Press.
———. 1995. *Regulatory takings: Law, economics, and politics*. Cambridge, MA: Harvard University Press.
———. 2001. *The homevoter hypothesis: How home values influence local government taxation, school finance, and land-use policies*. Cambridge, MA: Harvard University Press.
Hagman, Donald, and Dean Misczynski, eds. 1978. *Windfalls for wipeouts: Land value recapture and compensation*. Washington, DC: Planning Press, American Planning Association.
Kanner, Gideon. 1998. Hunting the snark, not the quark: Has the Supreme Court been competent in its effort to formulate coherent regulatory takings law? *Urban Lawyer* 30:307–308.
Kaplow, Louis. 1986. An economic analysis of legal transitions. *Harvard Law Review* 99:509–617.
Krier, James. 1997. The takings-puzzle puzzle. *William and Mary Law Review* 38(1): 1143ff.
Krier, James E., and Christopher Serkin. 2004. Public ruses. *Michigan State Law Review* 2004:859–875.
Levmore, Saul. 1991. Takings, torts, and special interests. *Virginia Law Review* 77:1333–1368.
Merrill, Thomas W. 2002. Incomplete compensation for takings. *New York University Environmental Law Journal* 11:110–135.
Miceli, Thomas J., and Kathleen Segerson. 1994. Regulatory takings: When should compensation be paid? *Journal of Legal Studies* 23(2):749–776.
———. 1996. *Compensation for regulatory takings: An economic analysis with applications*. Stamford, CT: JAI Press.
Michelman, Frank I. 1967. Property, utility, and fairness: Comments on the ethical foundations of "just compensation" law. *Harvard Law Review* 80:1165ff.
Musgrave, Richard A. 1939. The voluntary exchange theory of public economy. *Quarterly Journal of Economics* 53:213–237.
Niskanen, William A. 1971. *Bureaucracy and representative government*. Chicago: Aldine, Atherton.
Olson, Mancur, Jr. 1965. *The logic of collective action: Public goods and the theory of groups*. Cambridge, MA: Harvard University Press.
Penalver, Eduardo. 2004. Regulatory taxings. *Columbia Law Review* 105:2182–2254.
Peters, Guy. 1978. *Politics of bureaucracy: A comparative perspective*. Essex, UK: Longman Group.
Poindexter, Georgette C. 1997. Collective individualism: Deconstructing the legal city. *University of Pennsylvania Law Review* 145:607ff.
Posner, Richard A. 1974. Theories of regulation. *Bell Journal of Economics and Management Science* 5(2):335–358.
Rawls, John. 1958. Justice as fairness. *Philosophical Review* 67:164–194.
———. 1971. *A theory of justice*. Cambridge, MA: Harvard University Press.
Rose, Carol M. 1984. Mahon reconstructed: Why the takings issue is still a muddle. *Southern California Law Review* 57:561ff.

Samuelson, Paul A. 1954. The pure theory of public expenditure. *Review of Economic Statistics* 36:387–389.
Serkin, Christopher. 2005. The meaning of value: Assessing just compensation for regulatory takings. *Northwestern University Law Review* 99(2):677–742.
Shavell, Steven. 1987. *Economic analysis of accident law*. Cambridge, MA: Harvard University Press.
Stigler, George J. 1971. The theory of economic regulation. *Bell Journal of Economics and Management Science* 2(1):3–21.
Tiebout, Charles M. 1956. A pure theory of legal expenditures. *Journal of Political Economy* 64:416–424.
Tullock, Gordon. 1989. *The economics of special privilege and rent seeking*. Norwell, MA: Kluwer Academic Publishers.