

Takings and Public Choice: The Persuasion of Price

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accepted for publication in The Encyclopedia of Public Choice
(Charles Rowley, editor), June 2002

The Fifth Amendment of the United States Constitution concludes, “nor shall private property be taken for public use without just compensation.” What is known as the “just compensation” or “eminent domain” or “takings” clause is also present (or judicially construed to be present) in every state constitution and in the officially-proclaimed practice of most governments around the world. Yet the takings issue remains controversial, as is suggested by the many treatments of it by scholars who reflect the public-choice tradition (Ellickson 1977; Epstein 1985; Farber 1992; Fischel 1995; Levmore 1991; Miceli and Segerson 1996; Siegan 1980; Wyeth 1996). This essay will illustrate how a public choice approach can illuminate some of the important issues. The plan is to explain how the present distinction between physical takings and regulatory takings causes governments to choose too much regulation.

The idea that owners of property should be compensated is relatively uncontroversial when applied to actions in which the government takes physical possession of the property in question, as when it seeks to build a road, a dam, or a public building on private land. Compensable “physical invasion” includes instances in which the government itself takes title (even if it does not occupy the property), entitles private parties to trespass without taking title, or causes a detrimental physical occupation by water or foreign material. In most physical invasion cases, the government attempts first to buy the land (or an easement) on the open market. Unlike most other market participants, however, the government’s right of eminent domain entitles it to force reluctant landowners to give up title in return for a court’s determination of just compensation. Just how much compensation is “just” is often a

matter of controversy (Goldberg, Merrill and Unumb 1987; Kanner 1973), but that something is owed by the government is usually not disputed in these instances.

The more controversial aspects of takings arise when the government establishes or changes a regulation that causes some properties to decline in value. Examples include rezoning formerly residential (but undeveloped) land for open space, restricting economic activity in certain areas because of the presence of wetlands or endangered species, and requiring that underground mining be curtailed to protect surface owners. In these instances, the government usually declines to offer just compensation even though the loss to the owner may be almost as great as if the government had taken the property for a roadway. This dichotomy in compensation practice — almost always pay for physical invasion, almost never pay for regulation — is the focus of this essay.

In the public choice view, government is not a neutral, third-party referee in matters concerning regulations and eminent domain. The scope and content of regulations will depend crucially on how the costs are distributed. This is in contrast to the black-letter law on the subject, which does little to inquire about the political process and usually takes the government's justifications for its actions at face value. The epitome of this deference is the U.S. Supreme Court's view of the "public use" clause, which many commentators regard as prohibiting the government from taking private property (with compensation) and giving it to another party for his private use (Epstein 1985; Merrill 1986; Paul 1987). The Court agrees that takings must be for public use, but it accepts without inquiry almost any legislative declaration that, say, a private shopping center or an automobile assembly plant is a "public use." The possibility that private parties may be operating through the legislative process to further their private interests is largely disregarded.

The public choice approach regards the government as responding to the economic interests of those involved in the process. The obligation to pay will shape the behavior of the government's actions; they are not "exogenous" to the model. In this respect, a government agency's behavior is analogous to that of a private firm. The agency possesses a budget constraint, and officials have to decide whether purchase of certain inputs exceeds the priority of other items in its budget, or whether it is worth requesting

the legislature to raise taxes to obtain additional funds to purchase them. In weighing these considerations, the government undertakes the same sort of benefit-cost analysis that private individuals must do when making a purchase: Would the money spent on purchasing the land possibly be better spent on some other project or left in the hands of taxpayers?

In introductory microeconomics, a private firm's decisions about how to produce something depends not just on technology and resources, but the relative prices of those resources. Farmers can produce raw food and fiber, for example, with inputs of land, labor, and capital. If labor is inexpensive, farm owners will hire many workers to plant, cultivate, and harvest their crops. They will substitute towards labor and away from expensive machinery and other forms of capital. If labor becomes relatively costly, however, farm owners will find it worth their while to purchase and employ sophisticated machinery to plant, cultivate, and harvest. The relative prices of inputs will also affect what crops they raise. Those that require intensive husbanding by hand will be planted where labor is less costly, while those that can be tended largely by machinery will be planted where labor is expensive.

The "inputs" for the government must be characterized differently than they would for a private firm. The government often has a choice between accomplishing its goals by acquiring title to land or by regulating it while leaving it in the hands of the private owners. The alternative inputs, in other words, are not labor and capital, but regulation and acquisition.

To provide a concrete example of a trade-off, consider government efforts to protect an urban area along a major river from flooding. The government could build flood-control dams upstream in order to prevent the floods from occurring. This would obviously involve acquisition of land for the dam and of the area subject to periodic inundation. (As one can see, what the dam does is shift the flood damage upstream to presumably cheaper land in rural areas.) Another way to reduce flood damage in urban areas, though, is to regulate development in flood-prone areas downstream (White 1986). Such regulation is not entirely paternalistic, in the sense that property owners are prevented from accepting risks of flooding to themselves. In major floods, buildings that

become unmoored by the torrent become additional agents of destruction as they hit other buildings and bridges downstream, and personal liability for such damage is nearly impossible to establish after the fact.

As the reader can easily surmise, cost-minimizing flood control programs would most likely involve a combination of regulation of downstream land and acquisition of upstream land to build dams and levies. The difficulty arises from the fact that one input to flood control, regulation, can seem much cheaper than the other, acquisition, if regulation does not require compensation. For example, an optimal amount of flood control might involve a dam that costs \$50 million and regulations that reduce downstream floodplain owner's property value by \$30 million (net of the gain to property value from less flood damage). To be scrupulous in this comparison, it should be noted that the \$50 million for the dam must include, besides the opportunity cost of the resources taken, the costs of condemnation and the excess burden of additional taxes needed to finance the compensation.

Assume now that the same degree of flood control could be had by building no dam at all but adopting more widespread and stringent land-use regulations that impose a net cost of \$100 million. Clearly the former method (dam and moderate regulation) is less costly by \$20 million. But if the government agency charged with flood control does not have to compensate landowners for regulation, it may be tempted to undertake the latter strategy (regulation only), even though it is more costly to society. Moreover, it may be tempted to use its regulatory powers to extend flood "protection" to areas where the costs of such protection exceed the benefits to those protected.

In general, underpricing regulatory activity relative to acquisition in most circumstances induces overregulation and excessive expansion of government activities. The agency responds rationally to the price schedule it faces, just as a firm would expand its labor-intensive activities if it did not have to pay for labor. One exception arises when those burdened by the regulation are politically influential and thus can constrain the agency's choices. Indeed, some historical accounts of the development of just compensation for landowners in England point to the political influence of land-owning barons (Stoebuck 1972). But the political defense often fails for

regulation, since those victimized by the regulation may be a small minority who are not even resident in the jurisdiction, which is commonly the case for suburban landowners (Ellickson 1977). Moreover, the government agency may be captured by interest groups who receive the benefits of its regulatory activities but do not bear its costs. Such agencies may be sufficiently independent — indeed, may have been deliberately made independent — that they can resist political pressure from those who bear the costs.

The objection voiced by many scholars who are not influenced by public choice is that the government simply does not make such calculations. Defenders of the status-quo (no compensation for regulation) argue that the government is different from a private actor. Government agencies are supposed to promote the public welfare, not make a profit for shareholders. Because the agency is charged with maximizing well-being, it actually does take account of the value of economic opportunities that are foregone as a result of regulation.

There is a situation in which a regulator might actually behave this way. Private developers sometimes acquire large amounts of contiguous land on which to build houses. Prior to selling the houses (or the prepared lots), the developer often imposes covenants that bind the purchasers to observe a list of regulations. These regulations look much like those of a typical government-imposed zoning ordinance, except that the private regulations are often much more detailed and intrusive. They go beyond saying where the houses must be placed and what they can be used for. These private regulations often dictate what kinds of vehicles may be placed in driveways, what color the homes may be painted, and what sort of furniture may be put on the front porch.

Yet the private developer does not pay anyone to accept these regulations. To the contrary, he expects buyers of homes to pay a premium for their existence. He does not have to price his regulations explicitly because he feels the full opportunity cost of them. If he adopts regulations that repel most buyers, it will lower the value of his assets. If he adopts too lenient a set of regulations, buyers will likewise be shy of living in a densely-developed community in which their neighbors may be able to do things that lower their property's value.

It is arguable that sometimes governments behave the same way as private developers do. A small municipality consisting entirely of homeowners and whose land is used only for housing is apt to be governed by members of their own group. If they propose a general regulation that prohibits renting homes to students from a nearby university, they are apt to feel both the benefit and cost of such a decision. The benefit would be a more peaceable neighborhood and hence higher home values, while the cost would be the foregone revenue that each owner might have gotten had she decided to rent her property to students. In this situation, a decision to adopt such a regulation is not much different from that which a private developer would do.

The situation changes greatly, however, when the government agency can subject to regulation the property of people who are not members of the governing faction. Here a more explicit cost in the form of just compensation can be helpful to prevent the excessive use of regulation. I will describe a famous example that came to light in *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003 (1992).

The South Carolina Coastal Council had in 1988 altered the land-use regulations pertaining to building on private property along the oceanfront beaches of the state. Seaward of a Council-drawn line in the sand, no development of any kind was permitted. The Council was complying with a recently passed state legislation. The legislature cast its rationale for the prohibition on development as a matter of preventing public harms such as beach erosion, storm damage to homes, and destruction of wildlife habitat. In order to insulate the Council's land use decisions from political influence, the legislature decreed that the decisions of the Council were not subject to landowner requests for variances or other exceptions.

David Lucas owned two beachfront lots, each about one-third acre in area, that were within the new zone on which no permanent structures could be built. He had purchased the two parcels prior to the adoption of the new regulations for about one million dollars. The effect of the new regulations was to leave his investment nearly worthless. Having no means of appealing his classification, Mr. Lucas sought in court to compel the state to pay him for the denial of economic use of his land.

The trial judge held the Council's new regulation to be a taking, given that no economic use for Lucas's land remained. The state supreme court reversed. Accepting the state legislature's determination that building along the beach was a "harmful" activity, the state court held that no compensation was due despite the complete wipeout of economic use. Faced with Lucas's Fifth Amendment claim that this amounted to a regulatory taking, the South Carolina Supreme Court declared that regulations meant to prevent "harms," as declared by the legislature, were not compensable.

The U.S. Supreme Court reversed the South Carolina Supreme Court. Justice Scalia's opinion expressed a public-choice insight. He worried that if the Court always deferred to regulatory legislation that prevented "harms," the legislature would go about recasting the language of its regulations to avoid the obligation to compensate. A highway, to use an example not used by Justice Scalia, could be built much more cheaply if existing homes and businesses in a projected right of way could be said to be "harmful" to the public.

And from the road-builder's point of view, such buildings are harmful to his mission. It is not difficult to see how people who specialize in a single activity can persuade themselves that activities inconsistent with their enterprise can be so perverse as to be labeled "harmful." Environmental and planning agencies would seem no different from highway departments in this respect.

Yet if government agencies were given this license, they could obtain property rights of great value that the government would otherwise be unwilling to pay for. Wildlife preserves, scenic views, and open space could be established without the need to compensate owners whose activities were curtailed. They could even leverage regulation into acquisition at low cost by downzoning (under the harm-prevention rubric) the desired land and then purchasing it at the now-diminished price. To forestall this opportunism in cases of complete economic wipeout, Scalia's opinion held that such regulations were compensable under the takings clause unless grounded in "background principles" of state law. While the provenance of such principles remains

unclear, the thrust of Scalia's idea is that they should sufficiently remote in time as to be removed from verbal manipulation by the present legislature.

The *Lucas* decision is subject to the criticism that its holding can be invoked only against regulations that are so extreme as to leave owners with no viable economic use whatsoever. Few regulators are so dull as to be unable to meet this criterion by, say, allowing a few tents on land best suited for homes, thereby keeping it from being developed. The property owner who can get some economic use by pitching tents but not houses on her land gets nothing under the *Lucas* criterion.

Lucas is not invoked here to explicate Constitutional principles, though. It is to show how perceptions of cost affect government behavior. The eventual outcome in *Lucas* exquisitely illustrates how government agencies respond to changes in relative prices. The evidence emerged not in the court opinion but in the subsequent settlement of the case. After the U.S. Supreme Court's decision, the state of South Carolina decided to settle the case by purchasing Mr. Lucas's two lots. What did it do with the lots whose development it had argued was irreparably harmful to the environment? Well, it had just paid almost a million dollars for them. It decided to recoup its money by selling them to a developer to build houses upon (Fischel 1995, chap 1; Lucas 1995). The state even declined an offer by an inland neighbor who sought to purchase one of the lots (for about eighty percent of the asking price) and keep it undeveloped in order to preserve his seaward view. When I revisited the site with Mr. Lucas and his attorney, Jerry Finkel, in March of 2000, there was a large house on one of the lots, and the other was still on the market.

Some see this story as an example of government hypocrisy — professing one thing but doing another. Public choice tends to make one less judgmental even of this remarkable about-face. The *Lucas* outcome is an example of how the price one has to pay affects behavior. Prior to the *Lucas* decision, South Carolina perceived the price of Lucas's lot (and others like it) as being low, since it did not expect to have to pay for them. At that price — zero dollars and zero cents — even the least environmentally-sensitive legislator would have to concede that environmental values surely should prevail. No highways or hospitals or airports — that is, alternative uses for the state's

money — needed to be given up to preserve the coast. The legislature did not have to risk the wrath of voters by raising taxes to pay for the lots. All it had to do was pass a regulation, whose burden fell upon a small number of landowners.

Once the state came into possession of the land, however, it had reason to pay attention to its market price relative to its environmental value. Agents of the new owner (the state) now surely noticed that the properties in question were among the few lots along several hundred yards of this beach that did not already have large homes upon them. They are packed side-by-side, so that Lucas's vacant lots look like two missing pickets in a long fence. The state's agents then surely noticed that developers were willing to pay nearly half a million dollars for each of the lots, and the state's agents did what rational and faithful public servants should do: They sold the lots to developers.

The state had not changed its intrinsic values. It valued the environment no less after the case than before. The state simply responded to the higher price of preserving this tiny (less than one acre) stretch of the beach and did the sensible thing. It is no more hypocritical for them to have done so than it would be for an owner of a farm to switch from human pickers to mechanical pickers once the wages of farm laborers went up.

The just compensation clause can be viewed as a device that keeps government officials from excessive enthusiasm. Having to pay money out of scarce budgetary resources makes officials calculate whether it is worthwhile to undertake a particular project. By applying methods of analyzing individual choice to the public sector, public choice offers insights into an important constitutional question that other approaches might not.

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