The Economics of Eminent Domain: Private Property, Public Use, and Just Compensation

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The Economics of Eminent Domain: Private Property, Public Use, and Just Compensation

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Abstract

The eminent domain clause of the U.S. Constitution concerns the limits of the government's right to take private property for public use. The economic literature on this issue has examined (1) the proper scope of this power as embodied by the "public use" requirement, (2) the appropriate definition, and implications, of "just compensation," and (3) the impact of eminent domain on land use incentives of owners whose land is subject to a taking risk. This essay reviews this literature and draws implications for our understanding of eminent domain law.

Keywords: Eminent domain; just compensation; land use incentives; public use.

JEL codes: K11, R52

Contents

1

Introduction

The Fifth Amendment of the U.S. Constitution says that the government shall not take private property for public use without paying just compensation.[1] This provision, referred to as the eminent domain, or takings, clause, has generated an enormous amount of case law and scholarly literature aimed at determining exactly what sort of government actions constitute a compensable taking, and what amount of compensation should be paid when they do. Economists have made a substantial contribution to this debate regarding both the proper scope of takings and the conditions under which compensation should be paid.

The takings clause has two key components: (1) the public use requirement, and (2) the just compensation requirement. These components serve to restrict the conditions under which the government can take private property. The public use requirement restricts when the taking of private property is justified. In terms of efficiency, government intervention in the market is justified for providing public goods and regulating externalities. In its role as a public good provider, the

[1] The actual clause reads: "nor shall private property be taken for public use, without just compensation."

government often seeks to use eminent domain to acquire the necessary land, an action that seems acceptable based on the plain meaning of the eminent domain clause, given that the land is being put to "public use." However, economists have argued that the proper justification for takings is to overcome the holdout problem associated with land assembly, which suggests that eminent domain should not be used for all public projects, only those involving assembly. More controversially, it implies that eminent domain should also be available for private projects requiring assembly, as in the case of urban renewal. The recent Supreme Court decision in *Kelo v. New London*[2] reflects this logic.

The second component of the takings clause, that users of eminent domain must pay "just compensation," specifies the terms under which private property can be taken. These terms can affect both the distribution of the benefits and costs associated with the taking, and the incentives parties face. Courts have defined just compensation to be the fair market value of the taken property. Although it might appear that this requirement protects the interests of private property owners, many have argued that this measure under-compensates owners because it does not reflect the amount they would accept in a consensual sale. It therefore creates the risk of excessive transfer of private property to public use, as well as raising questions of fairness. The difficulty with using the owner's true reservation price as the measure of compensation, however, is that it is unobservable, which creates the countervailing risk of opportunism by sellers. Thus, the market-value measure represents a practical compromise.

Eminent domain is typically couched in terms of physical acquisitions of property, for which compensation is universally required by courts. Much more pervasive, however, are government regulations that restrict the use of private property without physically acquiring it. Examples include zoning, environmental and safety regulations, historic landmark designation, and laws promoting equal opportunity for disabled or other disadvantaged groups. Historically, courts have granted governments broad police power to enact such regulations in the public interest without triggering the need for compensation. Occasionally,

[2] 125 S.Ct. 2655, 545 U.S. 469 (2005).

however, a regulation goes so far in reducing the value of a regulated property that the owner seeks to have the regulation declared a "regulatory taking" for which compensation is due.[3]

From an economic perspective, there is no substantive difference between a government action that involves an outright seizure of property for purposes of providing a public good, and one that merely regulates that property for purposes of preventing an external harm (Kaplow 1986; Hermalin 1995). In both cases, the government imposes a cost on the landowner in order to provide a social benefit, where the action is justified on efficiency grounds only if the gain (whether in the form of a benefit conferred or a harm prevented) exceeds the cost. From a legal perspective, however, the question of whether compensation is due is treated quite differently in the two types of cases — it is virtually always required for physical acquisitions (however slight), but is rarely required for regulations.

While much of the discussion of just compensation for takings has addressed its "justness," most recent economic analyses have focused on a different aspect of the compensation question — namely, whether the payment of compensation creates a moral hazard problem that causes landowners to overinvest in land that may be suitable for public use. (This literature does not distinguish between physical and regulatory takings.) The key result in this area, due originally to Blume et al. (1984), says that compensation must be lump sum in order to prevent moral hazard. A corollary of this conclusion is that zero compensation is efficient.

While the economic logic of this "no compensation result" is unassailable — it represents a direct application of standard results from the economics of insurance — it has understandably generated considerable controversy because of the perceived unfairness of the proposal, as well as its apparent inconsistency with the constitutional requirement of just compensation (at least in the case of seizure). As a result, several counterarguments have emerged to justify compensation, including the need to restrain excessive government takings, the perverse incentives that a no-compensation rule creates for the timing of development, the

[3] Such claims take the form of so-called "inverse condemnation suits."

insurance benefits that compensation provides to risk-averse landowners, and the "demoralization costs" that arise when compensation is not paid. The conclusions from these studies shed considerable light on takings law, particularly in the area of regulatory takings.

In this essay, we present an overview of the economics of eminent domain. We begin in Section 2 with a brief review of the relevant case law, both for physical acquisitions and for regulatory takings. We then survey the academic literature that examines eminent domain from an economic perspective. Section 3 considers the economic justification for eminent domain, focusing on the public use requirement and the land assembly problem. Section 4 examines the just compensation requirement, focusing primarily on its distributional implications. Section 5 then surveys the literature on the impact of compensation on the incentives of landowners to invest in property subject to a taking or regulatory risk, and also of the government to exercise its taking or regulatory powers. Finally, Section 6 summarizes our conclusions. Throughout the essay, we draw on a simple modeling framework that can be readily adapted to address various issues that have been discussed in the literature. This allows us to examine these issues within a common paradigm.

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