



Competitive Enterprise Institute

1899 L Street, NW • 12<sup>th</sup> Floor • Washington, DC 20036

202.331.1010 • www.cei.org

*Advancing Liberty – From the Economy to Ecology*

March 3, 2010

No. 164

## **This Land Ain't your Land; this Land Is my Land A Primer on Eminent Domain, Redevelopment, and Entrepreneurship**

By Marc Scribner \*

Eminent domain jumped to the fore of America's political consciousness on June 23, 2005, when the U.S. Supreme Court upheld the City of New London, Connecticut's decision to condemn several parcels of privately held property using eminent domain.<sup>1</sup> At issue in *Kelo v. City of New London* was a comprehensive redevelopment plan designed to support a new research facility of pharmaceutical giant Pfizer.

Homeowners of the affected parcels attempted to save their homes from the wrecking ball. But in a 5-4 decision, the Court held that the Fifth Amendment's Takings Clause—"nor shall private property be taken for public use, without just compensation"<sup>2</sup>—sanctioned local governments' condemnations of private property solely for the purposes of economic redevelopment. Most of the *Kelo* petitioners' homes were soon demolished.

Since the *Kelo* decision, the debate over eminent domain has only grown more heated. Proponents of eminent domain claim that its use for economic redevelopment is a valuable tool for local policy makers and that a blanket ban on using eminent domain to foster economic growth would tie the hands of government officials in their ongoing battle against blight.

Opponents argue that economic redevelopment does not constitute "public use," which the Constitution requires governments to show in order to justify takings. They argue that increased takings weaken private property rights due in part to the lack of a bright-line standard on what specifically constitutes "public use." They also note that eminent domain takings are inherently politicized, so local governments may be biased in favor of larger, politically connected property owners and interests, at the expense of small business owners, entrepreneurs, and homeowners—particularly those at the lower end of the income scale. Moreover, use of eminent domain circumvents market processes that could better promote economic development.

---

\* Marc Scribner is Assistant Editor and a Policy Analyst at the Competitive Enterprise Institute.

This paper examines the economic relationship between eminent domain and entrepreneurship. It discusses the economics of eminent domain and property law; analyzes the relationship between eminent domain, entrepreneurship, and public-financed redevelopment; and warns local policy makers of the negative effects that eminent domain abuse has upon entrepreneurs, especially lower-income ones.

**Property Law and Eminent Domain.** To fully grasp the relationship between eminent domain and entrepreneurship, it is first necessary to establish a foundational understanding of the economics of property law and eminent domain. To illustrate the fundamental economic importance of legally protected property rights, imagine a hypothetical society *without* property rights. In this society, an owner of, say, a factory would have no legal recourse—and thus no potential for redress—if a roving band of thugs were to seize control of the factory.<sup>3</sup> Helpless under the law, the owner has little to no incentive to remain in the market.<sup>4</sup>

The law defines property as a “bundle of rights,” with rights defining what people can and cannot do with the property to which they hold title.<sup>5</sup> Generally, owners may exercise these rights freely under the law, provided their actions do not interfere with the rights of another property holder. These legal rights fall into two categories: rights of possession and rights of transfer.<sup>6</sup> Rights of possession, or possessory rights, define legally permissible uses of property. Rights of transfer define legally permissible transfers of possessory rights from one owner to another.

Within legal rights of transfer, there are two common approaches to achieving an efficient allocation of property. The first, known as the Normative Coase Theorem, holds that the law should seek to minimize barriers to reaching private agreements over property rights.<sup>7</sup> The second, known as the Normative Hobbes Theorem, holds that the law should seek to minimize the harm caused by non-cooperation when negotiating private agreements by assigning the property right to the party who values it most.<sup>8</sup>

When information costs—the costs associated with discovering which party values the property the most—are high, but transaction costs are low, applying Coase will theoretically result in a more efficient outcome. In an inverse case where transaction costs—the costs associated with the bargaining process—are high, but information costs are low, an efficient outcome is achieved by applying Hobbes. Both of these approaches seek to define property rights clearly in a way that facilitates economic exchange and development. However, an important distinction between the Coasian and Hobbesian principles must be noted. Coase functions well within a dynamic market framework, whereas Hobbes assumes a static framework where government can set prices and allocate property perfectly by decree. Simply put, Coase allows for *many* efficient property allocations, while Hobbes permits *one*.

Conversely, *unclear* property rights act as barriers to economic exchange and development. This second assumption is implied in the Fifth Amendment’s Takings Clause, which grants the state the power to seize private property under certain circumstances. The state is constitutionally permitted to condemn private property, but only if: 1) the property is being taken for “public use,” and 2) the property owner is given “just compensation,” which is generally taken to mean

“market value.” Both of these conditions are meant to restrain the state’s appetite for private property takings.

The economic rationale behind these two conditions is simple. To discourage the state from financing itself through takings, it must compensate the owner at market value. This compensation must be financed through taxation, and people are far more willing to incur high costs to protect their property than to avoid paying a broad-based tax.<sup>9</sup>

The public use condition of the takings clause is designed to prevent the politicization of state condemnations of private property—public takings cannot be for private benefit. Projects generally conceived as public goods, such as roads, defense installations, and municipal sanitation, satisfy the requirement, but a state transfer of property from Owner A to Owner B, even when Owner A is compensated at “market value,” is prohibited.

To illustrate the common economic argument in favor of state takings when the above requirements are met, imagine the following example involving holdouts. A state is constructing a highway over a tract of land that is divided into five parcels valued at \$10,000 each. Taxpayers are willing to pay \$100,000 in excess of construction costs to acquire the property necessary to complete the highway, creating a total economic benefit of \$50,000. Now suppose that the state purchases three of the parcels at \$10,000 each, allowing it to spend up to \$70,000 on the remaining two parcels. Upon hearing of the state’s recent acquisitions, the owners of the two remaining parcels set their selling prices at \$50,000 for each parcel. If the state were required to purchase the remaining parcels at the owners’ newly desired prices, the result would be a total economic loss of \$30,000. In this instance, applying the Normative Hobbes Theorem would result in a better outcome, although this example assumes that state planners got the prices right in the first place.

This rationale for takings also holds for right-of-way companies, such as railroads or oil companies building pipelines. Holdouts in these cases can impose very high costs if the constructing firms are forced to abandon projects before completion. This, say proponents of government intervention, would have a chilling effect on future construction projects. The holdout property owners can set selling prices much higher than market value, meaning that these above-optimal costs will be passed on to consumers in the form of higher prices, thus eroding the economic benefit of such projects.<sup>10</sup>

However, this analysis—while representative of the mainstream textbook orthodoxy—is in many ways far too simplistic to paint an accurate picture of the dynamic, complex interaction of property, the law, and society. In reality, there are private bargaining solutions to the holdout problem. A famous example of a private party overcoming the holdout problem is Walt Disney’s purchase of land in central Florida to construct Walt Disney World. Learning from mistakes from the building of Disneyland in southern California, Disney assembled a large tract of land for his future park near Orlando in secret, utilizing a third-party purchasing strategy.<sup>11</sup> Any potential holdout problems were effectively neutralized without eminent domain takings.

Furthermore, there is reason to believe the costs of government failure in takings condemnations far outweigh the costs of non-cooperation in a holdout scenario. As Florida State University

economist Bruce Benson notes, “the holdout problem does not provide [an economic] justification ... even for eminent-domain power in order to obtain right-of-way properties.”<sup>12</sup> Likely failures of government are numerous, although the most distortionary relate to land valuation. Government officials have a strong incentive to undervalue the parcels targeted by eminent domain, and there is significant evidence that governments engage in systematic undervaluation in the compensation process.<sup>13</sup>

**Eminent Domain and Entrepreneurial Activity.** Entrepreneurship is an important economic activity, accounting for nearly \$1 trillion in U.S. business receipts annually.<sup>14</sup> Entrepreneurs’ “outside the box” thinking can drive innovation, as they are relatively free from the managerial concerns that most typical firms must deal with.<sup>15</sup> However, entrepreneurs typically lack the advantages of established firms<sup>16</sup>—such as economies of scale and established client relationships—so institutional changes can affect them to a much greater degree.

To develop a theoretical framework for the relationship between eminent domain and entrepreneurship, a key assumption is that preferences are fixed in the short run. In the long run, preferences can be shaped by changes in the economic environment and social landscape. Government policy and institutions play a major role in influencing individuals’ attitudes and preferences over time.<sup>17</sup>

State institutions that foster networking and support for entrepreneurs can increase the desirability of entrepreneurial work, pushing supply out.<sup>18</sup> On the other hand, excessive taxation, a burdensome regulatory regime, laws that restrict competition or incentivize rent-seeking behavior, and an inconsistent treatment of property rights all serve to push demand for entrepreneurial activity down.<sup>19</sup>

Two facts define the interaction between eminent domain and entrepreneurship. First, an environment with consistent, well-defined private property rights appears to do the most to increase demand for entrepreneurship.<sup>20</sup> Second, the state’s power of eminent domain is one of the most significant legal distortions of absolute private property rights.

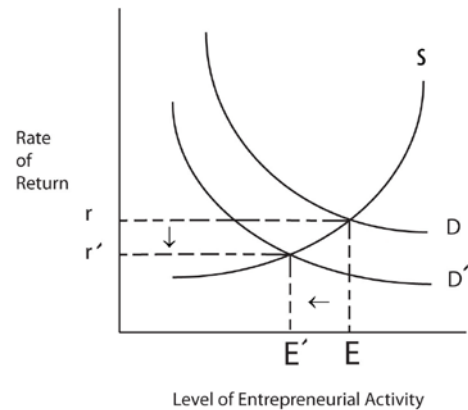
As stated earlier, governments traditionally have used eminent domain to develop so-called public goods like roads and sewers or to protect right-of-way firms like railroads from monopoly power holders in the form of holdouts. Thus, while an optimal level of eminent domain could *theoretically* provide additional incentive for potential entrepreneurs to enter the market, thereby shifting the supply curve out,<sup>21</sup> governments generally face incentives to overuse eminent domain power.<sup>22</sup>

**Entrepreneurship and Redevelopment.** Municipal private property condemnation for the purpose of economic redevelopment has increased in recent years.<sup>23</sup> The two primary motivations for these types of takings are increasing the tax base and creating jobs. These are questionable justifications, on both legal and economic grounds.<sup>24</sup>

Entrepreneurs’ concerns about their eroded property rights could incentivize them to move to other municipalities or states. On the other hand, an increase in jobs and the tax base could

benefit entrepreneurs indirectly by increasing wealth and capital investment in the area, thus stimulating more demand for their products and services.

Unfortunately, local takings are often financed in part by state and federal funds, obscuring the real costs to local residents and from society at large.<sup>25</sup> Pretextual takings—in which a property transfer deal between a private developer and a local development authority is reached before acquiring the affected property—worsen the problem by forgoing the normal contract bidding process.<sup>26</sup>



The market for entrepreneurship can be portrayed as a simple supply-and-demand model (see graph). An increase in the desirability of entrepreneurial work relative to normal employment will push the supply curve out.<sup>27</sup> Stronger domestic and international economies create a greater demand for entrepreneurship, pushing the demand curve out.<sup>28</sup> The vertical axis represents the rate of return to entrepreneurial work versus normal employment, and the horizontal axis represents the level of entrepreneurial activity in the marketplace. The point at which demand (D) equals supply (S) determines the equilibrium rate of return to entrepreneurial activity ( $r$ ) and the equilibrium level of active entrepreneurs in the marketplace (E).

If takings fail to improve local economic conditions while at the same time they corrode private property rights, then demand for entrepreneurship will fall as institutional risk increases. A decrease in demand for entrepreneurial activity ( $D'$ ) reduces the number of entrepreneurs in the market ( $E'$ ) and results in a falling rate of return to said activity ( $r'$ ). As noted, the hypothetical takings could indirectly benefit entrepreneurs, but a scenario in which institutional uncertainty restricts potential entrepreneurs from entering the market should worry local policy makers.

Takings generally target lower-income areas, which are more likely to be targeted for economic rehabilitation. Property values in these areas are lower, so takings compensation settlements there tend to be significantly lower than in higher-income areas.<sup>29</sup> As a result, eminent domain takings decrease profitable opportunities for low-income entrepreneurs disproportionately. It is worth noting that compensation for takings typically considers only the value of the land seized, *not the value of whatever would have been produced*. Remember that land is a factor of production. That is a poor policy to promote wealth creation for those who most need it.

Advocates of the liberal use of eminent domain argue that its use for targeted economic redevelopment can prove beneficial for local economies, especially in low-income areas. If an area is truly blighted, their argument goes, then takings condemnations and subsequent redevelopment of the locale could produce positive effects, because current conditions severely restrict or prevent development investment. For example, many impoverished inner-city neighborhoods have entire blocks that are largely abandoned. These areas are often crime-ridden and supported by dilapidated infrastructure, keeping wealthier potential residents and businesses from relocating to the neighborhood. A targeted redevelopment plan that rehabilitates public

infrastructure and provides modern commercial and residential space could potentially provide entrepreneurs with promising economic opportunities.

However, as University of Chicago legal scholar Richard Epstein has noted, the blight argument for takings is extremely tenuous.<sup>30</sup> If a parcel is truly “blighted,” it is no different than any other public nuisance. Thus, the property could be handled through traditional police authority granted to government without invoking the public use doctrine. In fact, the property could be seized without compensating the owners at all, thus rendering eminent domain irrelevant.

Finally, municipal policy makers face the fundamental challenge of trying to figure out *when* and *where* to optimally implement redevelopment plans using eminent domain. In fact, information costs are likely extremely high with respect to policy makers knowing the *whens* and *wheres*. For example, a case study of a redevelopment plan in Lakewood, Ohio, found that policy makers failed to take into account key economic variables when finalizing the public financing mechanism for the project, such as the benefits of the existing affordable housing stock.<sup>31</sup> If municipal officials are unable to accurately assess the short-run fiscal implications of economic redevelopment, they are even less likely to make the right decisions to promote long-run regional economic growth.

State intervention may theoretically benefit areas suffering from blight, by helping to attract potential entrepreneurs to the area. But opportunities for harmful economic distortions are numerous, and defining what exactly constitutes blight is a contentious issue. Worse, officials carry out takings as if transaction costs were so prohibitively high so as to justify forgoing the normal bargaining process for an acquisition of property. As lower-income persons are more sensitive to changes in price, it follows that transaction costs should be comparatively lower. The Normative Coase Theorem suggests that an efficient allocation of property could occur without government picking favorites. Therefore, state intervention will create harmful distortions—with much of the burden falling on persons and households at the lower end of the income scale.

**Conclusion.** The consequences of eminent domain abuse are extremely dire for the low-income potential entrepreneur. An increase in the discretionary use of eminent domain for economic development would lead to a decrease in entrepreneurship. As local officials lack the knowledge and expertise to effectively promote private development, their political missteps can keep their localities in poverty by undermining entrepreneurship, and forgo the wealth it would have created. Moreover, entrepreneurs in the marketplace benefit when their economic decisions are correct and pay when their decisions are incorrect. This acts as a powerful incentive to make the right choices. Government does not face this incentive structure. For that reason, claims by government officials that they possess a more accurate picture of the economic landscape than actual market players should be met with extreme skepticism.

Government planning is no substitute for market incentives in promoting economic development, including resolving property allocation issues. As Thomas A. Garrett and Paul Rothstein, of the Federal Reserve Bank of St. Louis, rightly note, local governments should focus on securing the environment for economic growth, rather than attempt to jumpstart it through bold corporatist schemes:

Rather than use eminent domain or other tools to target individual economic development projects, local governments should ask the fundamental question as to why the desired level of economic growth is not occurring in the local area without significant economic development incentives. For example, are taxes too high, thus creating a disincentive for business to locate to the local area? Do current regulations stifle business creation and expansion? All of the targeted economic development in the world will not compensate for a poor business environment. From a regional perspective, local governments should focus on creating a business environment conducive to risk-taking, entry and expansion rather than attempting targeted economic development through eminent domain or other means.<sup>32</sup>

Had the officials in New London, Connecticut, taken this to heart, much pain and suffering could have been avoided—and residents' property rights would not have been undermined. In November 2009, Pfizer announced it was shuttering the research facility at the center of the redevelopment plan that led to the *Kelo* decision.<sup>33</sup> The increased tax revenue and revitalized river district promoted by city officials have yet to materialize, and the land previously occupied by the petitioners' homes is now a large vacant lot occupied by waist-high weeds and feral cats.<sup>34</sup> Remember that scenario the next time you hear promises of benefits from a “public-private development project.”

## Notes

---

<sup>1</sup> *Kelo v. City of New London* 545 U.S. 469 (2005).

<sup>2</sup> U.S. Const. am. 5.

<sup>3</sup> On the institutional level, Economics Nobel laureate Douglass North notes that “an essential part of development policy is the creation of polities that will create and enforce efficient property rights.” Douglass C. North, “Economic Performance Through Time,” *American Economic Review* Vol. 84 No. 3, June 1994, p. 366.

<sup>4</sup> As Judge Richard Posner notes, the “legal protection of property rights creates incentives to exploit resources efficiently.” Richard A. Posner, *Economic Analysis of Law*, New York: Aspen Publishers, 2003, p. 32.

<sup>5</sup> Robert Cooter and Thomas Ulen, *Law and Economics*, 4<sup>th</sup> ed., New York: Pearson Addison Wesley, 2004, p. 77.

<sup>6</sup> Steven Shavell, *Foundations of Economic Analysis of Law*, Cambridge, Mass.: Harvard University Press, 2004, p. 9.

<sup>7</sup> Ronald H. Coase, “The Problem of Social Cost,” *Journal of Law and Economics* Vol. 3, October 1960, p. 19.

<sup>8</sup> Guido Calabresi and Douglas A. Melamed, “Property Rules, Liability Rules, and Inalienability: One View of the Cathedral,” *Harvard Law Review* Vol. 85 No. 6, April 1972, p. 1095.

<sup>9</sup> Cooter and Ulen, p. 175: “Indeed, the possibility of uncompensated takings would divert efforts and resources away from production and toward the politics of redistribution.”

<sup>10</sup> Posner, p. 55.

<sup>11</sup> Stella Tarnay, “Barriers and Solutions to Land Assembly for Infill Development,” *ULI Land Use Policy Forum Report*, Washington, D.C.: Urban Land Institute, February 19, 2004, p. 24.

<sup>12</sup> Bruce L. Benson, “The Mythology of Holdout as a Justification for Eminent Domain and Public Provision of Roads,” *The Independent Review* Vol. X No. 2, Oakland, Calif.: Independent Institute, Fall 2005, p. 191, [http://www.independent.org/pdf/tir/tir\\_10\\_2\\_1\\_benson.pdf](http://www.independent.org/pdf/tir/tir_10_2_1_benson.pdf).

<sup>13</sup> *Ibid*, pp. 184-5.

<sup>14</sup> Vincy Fon and Ying L. Lowrey, “Entrepreneurial Activities: A Microeconomic Analysis,” *Working Paper*, July 10, 2008, p. 2, <http://ssrn.com/abstract=1158147>.

<sup>15</sup> Lowrey, “The Entrepreneur and Entrepreneurship: A Neoclassical Approach,” *U.S. Small Business Administration Economic Research Working Paper*, Washington, D.C.: USSBA Office of Advocacy, January 2003, p. 8, <http://ssrn.com/abstract=744785>.

<sup>16</sup> Coase, “The Nature of the Firm,” *Economica* Vol. 4 No. 16, November 1937, p. 390.

<sup>17</sup> Fon and Lowrey, p. 2.

---

<sup>18</sup> *Ibid*, p. 18.

<sup>19</sup> *Ibid*, p. 19. *See also*, *Ibid*, p. 21: “[C]onsistency and predictability of regulatory control” is critically important for increasing entrepreneurial activity.

<sup>20</sup> Robin Douhan and Magnus Henrekson, “The Political Economy of Entrepreneurship: An Introduction,” *Research Institute of Industrial Economics: Working Papers*, January 2, 2007, p. 10. *See also*, Lowrey, p. 14: “A well-defined entrepreneurship must include *the social constitution*, of which each economic man must be granted the basic rights: the right of free enterprise *and the property right*.” [Emphasis added]

<sup>21</sup> Amnon Lehavi and Amir N. Licht, “Eminent Domain, Inc.,” *Columbia Law Review* Vol. 107, 2007, p. 1706.

<sup>22</sup> William A. Fischel, “The Political Economy of Public Use in *Poletown*: How Federal Grants Encourage Excessive Use of Eminent Domain,” *Working Paper*, February 2007, p. 27, <http://ssrn.com/abstract=645402>.

<sup>23</sup> Carla T. Main, “How Eminent Domain Ran Amok,” *Policy Review* No. 133, October & November 2005, Stanford, Calif.: Hoover Institution, <http://www.hoover.org/publications/policyreview/2920831.html>.

<sup>24</sup> Thomas A. Garrett and Paul Rothstein, “The Taking of Prosperity,” *The Regional Economist*, St. Louis: Federal Reserve Bank of St. Louis, January 2007, p. 4: “[T]ax motivated takings are defined to be takings aimed purely at increasing the local tax base, as opposed to assembling land for public use.”

<sup>25</sup> Fischel, p. 14. *See also*, Phil Davies, “Condemned Prosperity,” *Fedgazette*, Minneapolis: Federal Reserve Bank of Minneapolis, March 2006: “In practice, condemnation often results in a net economic loss, because eminent domain is routinely used in conjunction with TIF, tax abatements and other tax incentives designed to entice developers and major employers to build in a particular community.”

<sup>26</sup> Daniel B. Kelly, “Pretextual Takings: Of Private Developers, Local Governments, and Impermissible Favoritism,” *Supreme Court Economic Review* Vol. 17, Chicago: University of Chicago Press, 2009, p. 180.

<sup>27</sup> Fon and Lowrey, p. 18.

<sup>28</sup> *Ibid*, p. 19.

<sup>29</sup> Yun-Chien Chang, “An Empirical Study of Compensation Paid in Eminent Domain Settlements: New York City 1990-2002,” *3<sup>rd</sup> Annual Conference on Empirical Legal Studies Paper*, September 6, 2008, p. 5.

<sup>30</sup> Richard A. Epstein, “Public Use in a Post-*Kelo* World,” *Supreme Court Economic Review* Vol. 17, p. 168.

<sup>31</sup> Samuel R. Staley and John P. Blair, “Eminent Domain, Private Property, and Redevelopment: An Economic Analysis,” *Policy Study* No. 331, Los Angeles: Reason Foundation, February 2005, p. 29.

<sup>32</sup> Garrett and Rothstein, p. 4.

<sup>33</sup> Pfizer Inc. press release, “Pfizer Announces Global Research Network: Five Main Research Centers Will Drive Scientific Innovation,” *Business Wire*, November 9, 2009, [http://www.businesswire.com/portal/site/pfizer/index.jsp?ndmViewId=news\\_view&newsId=20091109006047&newsLang=en](http://www.businesswire.com/portal/site/pfizer/index.jsp?ndmViewId=news_view&newsId=20091109006047&newsLang=en).

<sup>34</sup> Castle Coalition press release, “The End of an Eminent Domain Error: Pfizer Closes in New London,” November 9, 2009, [http://www.castlecoalition.com/index.php?option=com\\_content&task=view&id=2422&Itemid=129](http://www.castlecoalition.com/index.php?option=com_content&task=view&id=2422&Itemid=129).