EFFICIENT COMPENSATION RULES FOR EMINENT DOMAIN

***Research Notes*, September 2003, Number 1.**

Economic efficiency requires that resources be put to their highest valued uses. The economic rationale for eminent domain is that it promotes efficiency when properly applied. A government can take land out of private use and put it into a higher valued public use without having to rely upon voluntary sale by the owner, thereby sidestepping the costly holdout problem and related issues tied to trying to purchase property in the open market to assemble contiguous parcels of land for roads, parks, government buildings, or other social uses.[1] Recent economic research, however, provides a caveat to this sanguine view of eminent domain; eminent domain creates distortions in markets that reduce efficiency even with full compensation at market value (Innes, 1997; Turnbull, 2003). More troubling, this hidden cost to society can exceed the social benefits of the land in public use. One lesson from these studies is that when efficient policy calls for taking property by eminent domain, it also calls for compensating the owners at above private market values.

The Fifth Amendment of the US Constitution requires that governments provide "fair" compensation for property taken for public use. Courts tend to interpret fair compensation as full compensation at market value. Aside from equity concerns, economists generally argue that requiring compensation at market value promotes efficient takings decisions to the extent it forces the government (and its constituents) to weigh the benefits of public use for the property against its foregone value in private use as measured by the required compensation at the market value of the property. But it is also widely recognized that compensation at market value shortchanges owners who refuse to voluntarily sell their property at that price. In such cases—the archetypical eminent domain scenario—the owners of property taken by the government often value their property by an amount greater than the prevailing market price. While economists and legal scholars studying eminent domain recognize this, they also recognize that the additional owner surplus (or even if it exists in a particular case) is not independently observable and hence provides no objective basis for measuring appropriate compensation. Compensation at market value is therefore not true full compensation in the sense of making all of the affected parties economically whole. Instead, it serves as a functional approximation.

Nonetheless, there remains another argument for above market compensation. Eminent domain compensation, like all taxes, subsidies, and land use regulations, affects investment incentives and therefore economic decisions. The threat of eminent domain introduces an incentive to develop or redevelop real estate sooner than is socially efficient when takings are compensated at market value (Innes, 1997). Since capital improvements must typically be removed from the land in order to ready it for its

[1] The practice of using eminent domain to acquire private property that is to be used for private purposes, e.g., for economic development or enhancing the tax base, is justifiable by economic efficiency criteria only in special cases, so the discussion in this note focuses solely on the exercise of eminent domain for government use.

eventual public use, the more rapid development identified by Innes increases the social cost of taking land for public use by increasing both the necessary demolition costs and the foregone benefits of the still-useful structures and other improvements that must be destroyed to clear the land. Compensating owners for taken property at its social value rather than its lower private market value eliminates this distortion.

The situation is more complicated when real estate development is irreversible, but the policy lessons are remarkably similar (Turnbull, 2002; 2003). Consider, for example, the eminent domain problem for green space preservation.[2] Development irreversibility arises in this case when constructing buildings and infrastructure remove flora and fauna or otherwise change natural topographical features, therefore permanently destroying the potential social value of the parcel of land as a green space or ecological enclave. When the amount of vacant land to be taken by the government for green space is a very small part of the remaining vacant land in the market, the takings will have little effect on the market price of the remaining vacant land. In this case, which is relevant to exurban or peripheral metropolitan counties, compensation at market value for vacant land taken by eminent domain will increase efficiency—but not as much as over-compensation would. In other situations, though, even the basic proposition of whether or not eminent domain can lead to a more efficient land use remains in doubt. For example, when the green space or ecological enclave removes enough vacant land from the market, exercising eminent domain will increase the market price of the remaining parcels of comparably situated land. In this case, which is relevant to interior metropolitan counties with little remaining undeveloped land, exercising eminent domain with compensation at the original market value can actually reduce overall economic efficiency despite the fact that the land taken by the government is put to the highly valued social use. So it turns out that the over-compensation rule also pertains when development has an irreversible component; compensating owners for the social value of their taken land is efficient, since it aligns private investors' incentives with the higher social benefits of vacant land rather than the lower private benefits of vacant land.

The market distortion arises only in the case of threatened eminent domain because the transaction is not voluntary. Since outright purchases of land or development easements in the market are voluntary transactions, the owner will agree to relinquish the property or development rights only when compensated for the value he or she attaches to the particular parcel of land, including any owner surplus value. Of course, the entire rationale for eminent domain is that the holdout problem and associated difficulties may preclude voluntary transactions in the first place. Thus, there may be a legitimate efficiency argument for allowing governments eminent domain powers for green space preservation to augment open market purchase policies.

The lesson drawn from these and related economic studies is simple, if not palatable to local governments and taxpayers. Property owners should be compensated with the social

[2] While the explanations offered here focus solely on vacant land within and near urban areas, the relationships described in this paragraph also apply to land well outside developed areas. For example, the irreversibility characteristic might apply when harvesting timber; once harvested, the land loses its green space or ecological features that are the sources of its alternative social value.

value of the property rather than the private market value in order to eliminate the inefficient wedge introduced into investors' incentives by the threat of taking. While local government officials engaged in taking land may be understandably reluctant to open themselves to the charge of "raiding" their taxpayers' wallets to support above-market compensation to nonresident landowners or developers, their reluctance bears no more weight in the efficiency calculations than does the reluctance of the owner of the taken land to lose his property in the first place. The justification for taking the land is that it has higher value in public use. The flip side is that it is also more efficient to always follow the rule that the owner's compensation be based more heavily on the higher social value rather than on the lower market value in private use. The arguments justifying both eminent domain and higher compensation rest on the notion of efficiency, and in that sense are inseparable.

Requiring compensation at social value rather than private value has the added benefit of reinforcing the public use doctrine, a doctrine that has been stretched by local governments' successful application of eminent domain to acquire land for other than governmental uses. Finally, if the government taking the property finds that compensating above its value in private use cannot be justified by standard cost-benefit analysis or if it claims to be unable to accurately calculate the social value of the land, then the public use project cannot be justified as economically efficient in the first place and it is appropriate to leave the targeted property in private hands.

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