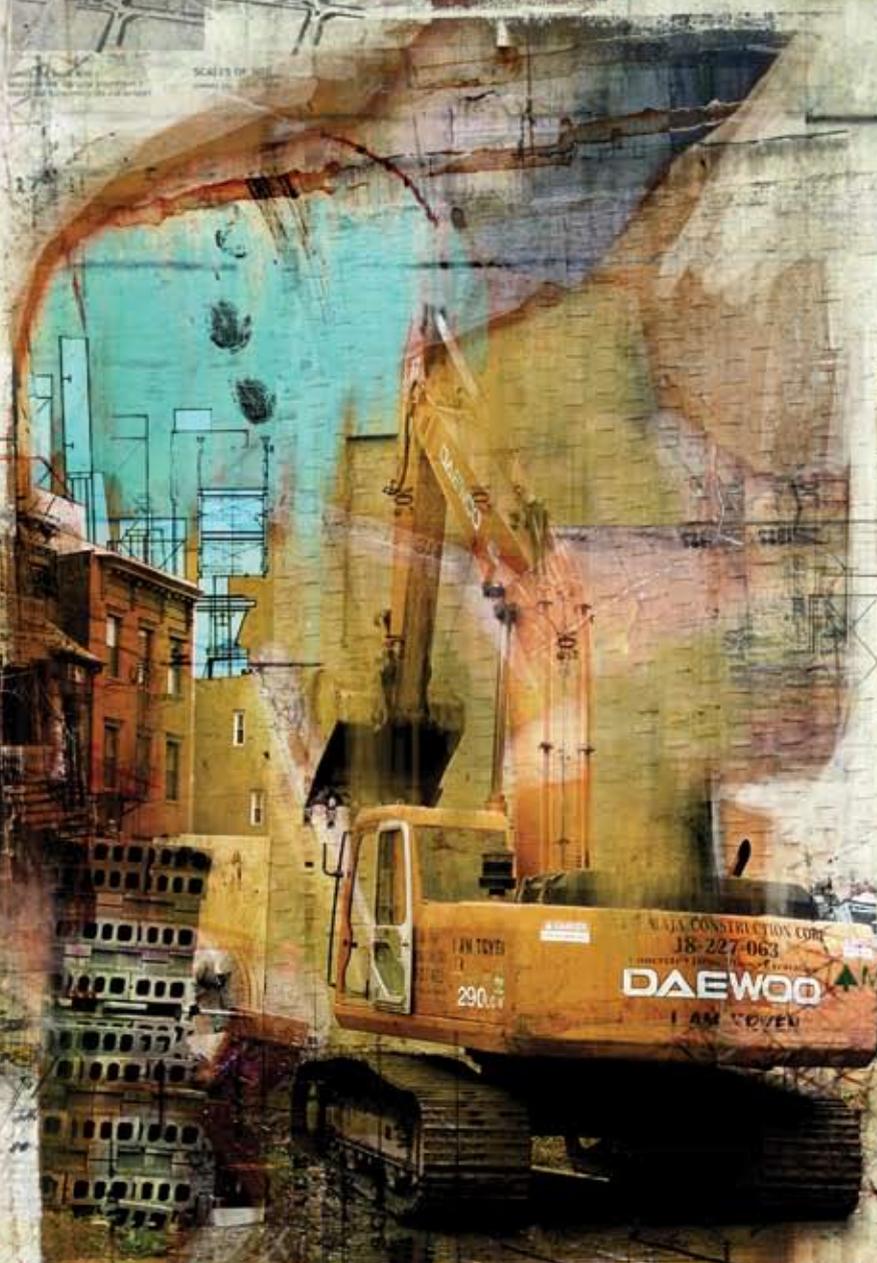


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The Taking of Prosperity?

Kelo vs. New London and the Economics of Eminent Domain

By Thomas A. Garrett and Paul Rothstein

The U.S. Supreme Court's decision in *Kelo vs. New London* was an unlikely source of public outrage. After all, the court didn't overturn anything in its June 2005 ruling; it merely affirmed an earlier decision by the Supreme Court of Connecticut.

That decision allowed the city of New London, which was officially designated as "distressed," to use the power of eminent domain to acquire 15 properties, one of which belonged to homeowner Susette Kelo. Although forcing the sale of homes always raises delicate issues, it is not an unusual event. Furthermore, nothing in the court's decision altered the ability of state legislatures to limit the practice of eminent domain. Viewed in this way, the decision in *Kelo* should have been one of the lower-profile decisions of the Supreme Court that year.

That's not how things went, however. The reaction against both the court and its decision was swift and furious. The U.S. House of Representatives passed a resolution denouncing the court.¹ The

House also passed a bill that would withhold federal development funds from states and political subdivisions that use eminent domain in certain ways.² Since the *Kelo* decision, 34 states have taken action to limit eminent domain: 26 have passed statutes, five have passed constitutional amendments and an additional three have passed both. (Five of the seven states in the Eighth Federal Reserve District have passed statutes.³) President Bush issued an executive order limiting the grounds on which the federal government can take private property.⁴ Finally, the Supreme Court of Ohio handed down a ruling in a case that, by the court's own assessment, raises social and legal issues similar to those in *Kelo*.⁵ Drawing upon the reasoning of several

dissenting judges in the *Kelo* case, the Supreme Court of Ohio gave property owners the protection that was denied to Susette Kelo in Connecticut.

This brief survey of the response to *Kelo* suggests that its shock waves are likely to reverberate for some time. Nevertheless, we are far enough beyond the *Kelo* ruling that we can review the main issues with the knowledge that the most speculative and feared consequences of *Kelo*—free-for-all takings for economic development—have not yet occurred.

A History of Eminent Domain

The U.S. Supreme Court has long recognized in the federal government the power to acquire private property for public use. This is true even though the term “eminent domain” does not appear in the Constitution or the amendments.⁶ The power is limited, however, by two restrictions. First, as with any federal action, the use of eminent domain must be “necessary and proper” in accordance with the congressional powers enumerated in Article 1, Section 8, of the Constitution. Second, the use of eminent domain must obey the final clause of the Fifth Amendment, which states, “Nor shall private property be taken for public use, without just compensation.”

The Fifth Amendment did not apply to state governments prior to the 14th Amendment. By the late 19th century, however, the due process clause of the 14th Amendment came to be regarded as requiring the states’ use of eminent domain to be consistent with federal interpretations of public use and just compensation. A state is free to establish a more-restrictive concept of public use than the U.S. Supreme Court finds in the Fifth Amendment, just as a state could require “more than” just compensation for a taking, but not a less-restrictive concept. Although state governments have the legal ability to establish, to some degree, their own laws regarding eminent domain, local governments like that of the city of New London have only those powers granted to them by state constitutions and statutes.

Although Susette Kelo’s house was in a distressed city, neither her house nor any of the other properties was in poor condition. Rather, the city acted under the authority of a Connecticut statute that (more or less) explicitly declared that the taking of land for purposes of economic development was a taking for public use. The city’s economic development plan designated the parcels for office space, parking and retail services. This scenario highlights the central issues of the *Kelo* case: What is a “public use,” and does the answer to this question given by a state legislature matter?

Public Use, Public Purpose and Judicial Deference

In its majority opinion, the U.S. Supreme Court stated in *Kelo* that the government can never take property from one private party for the sole purpose of giving it to another, even if just compensation is paid. On the other hand, the government can always do so if the general public acquires some actual use of the property. The court has been defining the ground between these extremes since the late 19th century.⁷ From the start, “it embraced the broader and more natural interpretation of public use as ‘public purpose,’” the court said in *Kelo*.⁸ More precisely, the court began to argue in the late 1800s that if property is taken to create a widespread benefit, then it is “put to” a public use and satisfies this requirement.⁹

At the same time, the court developed the language and rationales for deferring to legislative declarations about public use and purpose. The majority wrote in *Kelo*, “For more than a century, our public use jurisprudence has wisely eschewed rigid formulas and intrusive scrutiny in favor of affording legislatures broad latitude in determining what public needs justify the use of the takings power.”¹⁰ In particular, if a state declares that the removal of blight serves a public purpose or land redistribution does the same, then the court would not subject those claims to close scrutiny.¹¹

Thus, following this line of thought, the court essentially declared that it would defer to legislative declarations about public use unless, in a particular application, they were transparently covering up a purely private transfer of property. The court decided this was not the case in *Kelo*.

The Economics of Kelo

Economist Patricia Munch provides an analysis of the economics of eminent domain. In her model, a land developer needs to assemble contiguous parcels of property. All parcels have identical characteristics, and there is nothing special about any particular location. The lowest price a property owner will accept (his “reservation price”) for his property differs across property owners. Munch assumes that each developer offers all owners the same price for their properties and that this price is the (expected) maximum reservation price of all property owners. Munch then argues that the full additional cost of adding a parcel to a development is likely to be larger than just the cost of that parcel. The reason is that, if the developer only needs a few parcels, then he can easily find a cluster in which the maximum reservation price is low. Since the developer (by

assumption) pays the maximum reservation price to each owner, it follows that the cost of each parcel is relatively low. The larger the number of parcels the developer needs to assemble, however, the more difficult it is to find a cluster with a low maximum reservation price. The general result is that, as long as the developer can do a little searching, the per-parcel cost will be strictly increasing with the number of parcels.

It is not hard to see that the result is likely to be inefficiently little land assembly. As in the standard single buyer story (what economists term a monopsony), assembling more parcels requires the developer to offer each homeowner the same (high) price. Assembly stops when the cost to the developer of adding a parcel equals the benefit to him from adding it. In other words, assembly stops when there is no additional profit from adding parcels. The problem, however, is that if the developer could offer different sellers different amounts of money (i.e., he could price discriminate), he could probably offer them prices at which they willingly sell and at which he makes a larger profit. One could argue that the sellers and the buyer should figure this out, but it is expensive for the developer to deal individually with homeowners, and homeowners are reluctant to sell at prices below recent offers. As long as all parcels must sell for the same price, there are likely to be willing sellers whose homes are not purchased.

Now suppose the developer has the power of eminent domain. This makes the reservation prices irrelevant: Every homeowner is paid the market price for his home. Now, land assembly stops when the market price equals the benefit to the developer from adding the parcel. The problem in this case is that the market price is below the reservation price for some of these sellers. In other words, they are unwilling sellers. The result is too much land assembly under eminent domain.

Munch notes that the assumption that the developer is a single buyer is central to the analysis. If there is competition among developers, then some will develop better techniques for determining seller reservation prices. If communities choose these developers, then more-efficient land assembly will result.

Munch also briefly discusses the “hold-out” problem. She notes that there is no inefficiency when the owner of a parcel that has some unique value (perhaps as a location) tries to benefit financially from its uniqueness. The only genuine holdout problem she considers occurs if some sellers believe that other sellers did not capture all the rents that were possible to them in their transactions with the

Select U.S. Eminent Domain Laws and Court Rulings

1) Fifth Amendment to the U.S. Constitution (1791)

“Nor shall private property be taken for public use, without just compensation.”

This statement is commonly referred to as the “takings clause.” Most courts have equated just compensation with a property’s fair market value. Narrowly defined, “public use” requires that the taken property be used by the public at large—what economists call a public good.

2) Fallbrook Irrigation Dist. vs. Bradley, 164 U.S. 112 (1896)

In a case concerning the requirement that a group of property owners pay for the building of an irrigation ditch, the U.S. Supreme Court ruled that the irrigation of arid land served a public purpose and the water used was “put to” a public use. This is an important early case in the development of the public purpose doctrine.

3) Berman vs. Parker, 348 U.S. 26 (1954)

The U.S. Supreme Court ruled that taking private property (and paying just compensation) to remove blight served a public purpose and met the requirements of the Fifth Amendment. This was true even though the seized property was sold to private interests and would not necessarily have a wide use by the public.

4) Hawaii Housing Authority vs. Midkiff, 467 U.S. 229 (1984)

The U.S. Supreme Court ruled that a state could use eminent domain to take land from private landowners and allocate it to others. The case was based on the state of Hawaii’s complaint that a vast majority of the privately held land in Hawaii was in the hands of a few landowners, thus limiting competition in land and property markets. *Berman vs. Parker* served as precedent for the ruling.

5) Kelo vs. New London, 545 U.S. ____ (2005)

The U.S. Supreme Court ruled that eminent domain could be used to take land from one private landowner and give it to another for the sake of economic development. *Berman vs. Parker* and *Hawaii Housing Authority vs. Midkiff* served as precedent for the ruling. Critics of the *Kelo* ruling argue that the court misinterpreted the Fifth Amendment by further broadening “public use” to mean “public purpose.”

More information on these cases can be found at www.findlaw.com/casecode/supreme.html. Other eminent domain cases can be searched at <http://caselaw.lp.findlaw.com/casesummary>.

developer. Misinformation and speculation along these lines could, once again, prevent willing buyers and willing sellers from reaching a transaction.

The Public Good vs. Public Goods

Although the work by Munch suggests eminent domain can improve upon market outcomes under certain conditions, her analysis fails to address several economic issues involving eminent domain that have broader implications for economic development and growth. Specifically, any economic analysis of eminent domain as it relates to the *Kelo* decision must recognize the tradeoffs inherent in giving local governments this kind of power over local economic development. Those who approve of eminent domain as it was used in *Kelo* fail to recognize the difference between what economists call “private goods” and “public goods.” They also fail to see the inefficiencies often generated from government intervention in private markets.

An understanding of the differences between a public good and a private good and the ineffectiveness of governments in providing a private good reveals the incorrect premise behind the *Kelo* decision.¹² Private goods are both “rival in consumption” and excludable. Rival in consumption means that one person’s consumption of a private good denies others the opportunity to enjoy the good. The price of a private good is essentially a result of the good’s scarcity—as additional resources are employed to produce more of the good, the opportunity cost and, thus, the marginal costs, of producing the private good rises. This increasing opportunity cost increases the price and, as a result, some individuals will be excluded from consuming the good because they are not willing to pay the higher price.

Unlike a private good, a public good is both non-rival in consumption and non-excludable. The textbook example of a pure public good is national defense; other examples of similar goods include parks and highways.¹³ One person’s consumption of a public good does not deny others from consuming the good, and people can use the public good without paying for it. As a result, the marginal cost of an additional user of a public good is zero, and this suggests a market price of zero. Economists justify public (government) provision of public goods because too little of the good would be available (given a market price of zero) if production of the good was left to the private market.

Government provision of public goods and, thus, the taking of private property to provide these goods, can be justified under the narrow definition of public use, i.e., used by the community as a whole.

However, the taking of private property from one person and giving it to another for economic development, even if one considers the holdout problem and payment of just compensation, is unlikely to create a net benefit to society. It is more likely to create economic inefficiencies and to reduce economic growth.¹⁴

Historical anecdotal information and formal academic research show that, in general, countries with less government involvement in private markets experience greater levels of economic growth.¹⁵ The only possible exceptions in recent times are the Asian Tigers (e.g., South Korea, Taiwan and now China), but even there, markets are used extensively, and the strategies used by those governments have been difficult to replicate elsewhere. When governments interfere in the private market, whether it be a market for apples, cars or property, the likely result is greater economic inefficiency and less economic growth. The reason is that even the most well-intentioned policymaker cannot comprehend or replicate the complex interactions of buyers and sellers that occur in free markets.

Of course, there will be certain groups that do benefit from the taking of private property, such as developers, property managers and local politicians. Developers and property managers will gain income from developing the property. Many local politicians favor targeted economic development because of what they see as the immediate benefits from development, such as increased employment and tax revenue. These economic benefits also translate into political benefits for those politicians who pledge to improve local economic development. Not realized, however, is that the supposed immediate and tangible benefits from taking private property for economic development are outweighed by the greater economic costs of government intervention in private markets.

Local Governments and Economic Development

The use of eminent domain for economic development as established by *Kelo* complements already existing economic development tools such as TIFs (tax increment financing), tax breaks, local development grants, etc. Local governments use all of these options to target specific projects in their area because of a perception, whether real or imaginary, that the local area suffers from a lack of growth. All of these economic development tools, however, are unlikely to lead to an overall increase in societal welfare because each tool simply involves a transfer of income from one group to another, often resulting in a zero-sum gain.

A simple example can illustrate the point. Suppose a local government takes \$10,000 from Peter and gives it to Paul, who plans to open a business. Paul then uses the \$10,000 to open his business, which creates tax revenue and jobs. From a social welfare point of view, Peter loses \$10,000 and the savings or consumption benefits of his \$10,000, Paul gains \$10,000 to open a business, and jobs are created. By taking the \$10,000 from Peter and giving it to Paul, the local government is essentially saying that Paul can create greater societal wealth with Peter's \$10,000 than Peter can. The same would be true if local governments paid Peter for his house and then gave the property to Paul for development purposes.

Of course, it is impossible for local governments to know if greater wealth would have been created by allowing Peter to keep his \$10,000 rather than giving it to Paul. Economic theory tells us that in the absence of incomplete information or externalities, free markets will result in the most efficient allocation of resources and greater economic growth. By replicating the above scenario across thousands or millions of individuals, the likely result is that the costs and benefits will average out to be the same, thus creating a zero-sum gain. Thus, the same level of economic development would have likely occurred if Peter kept his original \$10,000.

There is reason to believe, however, that a zero-sum gain is not the worst case outcome. In the face of a policy decision like eminent domain, individuals and interest groups on both sides of the issue will expend resources (e.g., campaign contributions, the cost of one's time in campaigning for an issue, etc.) to ensure that the policy decision will favor their respective position. This rent-seeking by opposing groups results in a net economic loss because both groups will expend resources to ensure a particular outcome, but only one outcome will occur. In the above example, even if the transfer of \$10,000 from Peter to Paul created a zero-sum gain, the resources Peter and Paul expended to influence the policy outcome will result in a total economic loss for society rather than a zero-sum gain. Most likely, the policy outcome will be that desired by the interest group that has expended the greatest resources. As Justice Sandra Day O'Connor states in her dissent to *Kelo*, "The beneficiaries (of eminent domain) are likely to be those citizens with disproportionate influence and power in the political process, including large corporations and development firms."¹⁶

What can governments do to promote economic development that yields positive economic growth? 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.¹⁷

Indeed, there is some risk for local communities that use eminent domain for economic development. One requirement for a well-functioning private market is secure property rights. Research has shown that without property rights, individuals will no longer face the incentive to make the best economic use of their property, be it a business or home, and economic growth will be limited.¹⁸ The *Kelo* decision essentially says that individuals can lose their property if the local government believes it needs the property to generate greater economic benefits. Potential residents and businesses may avoid communities that have a record of taking private property for economic development because of a greater uncertainty about losing their property to eminent domain.

Conclusion

The *Kelo* decision by the U.S. Supreme Court was met by great opposition from the public and many local government officials. Numerous public opinion polls taken immediately following the ruling revealed that the vast majority of Americans disagreed with the court's ruling.¹⁹ Supporters of *Kelo* argue that using eminent domain for private development will spur economic growth. Although a lack of sufficient data currently prevents empirically testing the economic effects of eminent domain described in this article, economic theory certainly suggests that eminent domain used for private economic development will likely result in a zero-sum gain and may actually hinder economic development in the local areas, as well as the region, rather than help.

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ENDNOTES

- 1 H.RES 340, 109th Congress.
- 2 HR 4128, 109th Congress.
- 3 Indiana, Illinois, Kentucky, Tennessee, and Missouri have enacted statutes. The National Council of State Legislatures is keeping track of these activities. See www.ncsl.org/programs/natres/EMINDOMAIN.htm.
- 4 "Executive Order: Protecting the Property Rights of the American People," June 23, 2006.
- 5 *Norwood vs. Horney*, Ohio St. 3d, 2006-Ohio-3799, paragraphs 7 and 76.
- 6 In *Kohl vs. United States*, 91 U.S. 367, 372-373 (1876), the Supreme Court wrote, "The Constitution itself contains an implied recognition of it [eminent domain] beyond what may justly be implied from the express grants. The Fifth Amendment contains a provision that private property shall not be taken for public use without just compensation. What is that but an implied assertion, that, on making just compensation, it [private property for public use] may be taken?"
- 7 More detailed citations are available by request.
- 8 *Kelo vs. New London*, 545 U.S. ____ (2005) (Court slip op., at 9).
- 9 *Fallbrook Irrigation Dist. vs. Bradley*, 164 U.S. 112, 164 (1896).
- 10 *Kelo vs. New London*, 545 U.S. ____ (2005) (Court slip op., 12-13).
- 11 *Berman vs. Parker*, 348 U.S. 26 (1954) and *Hawaii Housing Authority vs. Midkiff*, 467 U.S. 229 (1984), respectively.
- 12 Comes and Sandler (1996).
- 13 Highways and parks are called near public goods because they are subject to congestion, which limits consumption.
- 14 Davies (2006) and Rolnick and Davies (2006) discuss the costs of *Kelo*.
- 15 See Gwartney et al. (2004).
- 16 *Kelo vs. New London*, 545 U.S. ____ (2005) (O'Connor slip op., 12-13).
- 17 Bauer (1972).
- 18 Knack and Keefer (1995).
- 19 See www.castlecoalition.org/resources/kelo_polls.html.

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