Eminent Domain: History and Economics

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Abstract

The power of eminent domain is often considered to be the inherent power of the government and it is rarely questioned. There are two possible justifications for eminent domain. Either the government has a superior position to that of private owners, such as a feudal lord, or the power of eminent domain exists to prevent the problem of holdout, i.e. the problem of high transaction costs. This paper examines and contrasts the historical and economic approaches to eminent domain and shows the complementarity of these disciplines.

Keywords: eminent domain, property in land, feudalism, holdout

Introduction

Eminent domain has become a standard way for governments around the world to purchase land. The use of the governmental power to take private property is now generally accepted and rarely questioned. However, the case for eminent domain is far from clear and some questions remain. The most fundamental question concerns the justification for eminent domain.

Property in land is protected by two distinct rules. In most cases it is protected by the property rule. However, when it comes to government purchases, it is protected by the liability rule. This paper aims to examine the justification for such duality in the protection of the same entitlement. One is economic, the other is based on political and legal history.

The purpose of this exercise is to show how different disciplines approach the same problem. There is a well-known diversion in the way in which economists explain the emergence of property rights. One is represented by Harrold Demsetz (1967), the other by Douglass C. North (1981). The former stresses the efficiency approach, the latter accounts for the political process. In the same vein as Demsetz, the traditional economic approach to eminent domain focuses on efficiency issues and ignores the historical development and political processes that have given rise to this institution. There is a lot that history can supplement the economic account with.

This paper is organized in the following way. The nature of property and eminent domain is described in the first part of the paper. Subsequently, the economic theory of eminent domain is presented, followed by an historical account of its emergence in England and the United States. The final part contrasts these approaches and draws conclusions.

Property and Eminent Domain

For lawyers, property is "a legally protected 'expectation' of deriving certain advantages from a 'thing'... [and thus it is] comprised of legal relations between persons with respect to 'things'." (Cunningham, Stoebuck and Whitman, 1989, 3). The term "property" stands for a bundle of rights, each representing a different aspect of ownership. This concept of property rights is useful for further analysis. It is useful to specify these "protected expectations" or the "sticks in the bundle" in more detail.

There are six different aspects of property that are defined in European civil law which are also recognized and protected in Anglo-American law. These are the "legally protected 'expectations': (1) a right of possession (jus possidendi); (2) a right of exclusion (jus prohibendi); (3) a right of disposition (jus disponendi); (4) a right of use (jus utendi); (5) a right to enjoy fruits or profits (jus fruendi); (6) a right of destruction (jus abutendi)." (Cunningham, Stoebuck and Whitman, 1989, 7). The use of eminent domain primarily deprives the owner of jus disponendi, the power to change legal relations with respect to a thing. Consequently, it removes all of the interests (i.e. rights, privileges and powers) in the property.

Eminent domain gives a government the power to acquire property from private individuals by forced rather than by voluntary exchange. Different rules are used to protect private property against the government and against other potential takers. While in most cases property in land is protected by property rules, it is only protected by a liability rule vis-à-vis the government (Calabresi and Melamed, 1972).[2]

The power of eminent domain is usually perceived as an inherent power of a government and a necessary attribute of sovereignty.[3] However, this power is

[2] An entitlement protected by a property rule is fully protected against unwanted taking. As a result, "someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the value of the entitlement is agreed upon by the seller […] Property rules involve a collective decision as to who is to be given an initial entitlement but not as to the value of the entitlement." On the other hand, liability rules do not protect an entitlement against all unwanted taking. An entitlement is protected by a liability rule when "someone may destroy the initial entitlement if he is willing to pay an objectively determined value for it […] This value may be what it is thought the original holder of the entitlement would have sold it for. But the holder's complaint that he would have demanded more will not avail him once the objectively determined value is set." (Calabresi and Melamed, 1972, 1092).

[3] See Cunningham, Stoebuck and Whitman (1989, 510). An argument for regarding the power of eminent domain as a necessary attribute of sovereignty could be made on the basis of the historical development discussed below.
Cunningham, Stoebuck and Whitman further claim that "[c]onstitutional provisions do not create or grant the power of eminent domain to the state and federal governments. Rather both state and federal constitutions limit the power by requiring state and federal governments (and other entities to which the power is properly delegated) to pay for what they 'take'." (Cunningham, Stoebuck and Whitman, 1989, 510). The origin of eminent domain in their legal theory therefore remains unexplained.

frequently delegated to private corporations as well. It is quite obvious, as we will see later, that there is no clear cut rule for the delegation of the power of eminent domain to private parties.

The power of eminent domain cannot be made general. As noted by Murray Rothbard, "[i]f it were, then chaos would truly ensue. For when the government confers a privilege of eminent domain (as it has done on railroads and many other businesses), it has virtually granted a license for theft. [...] The entire system of private property would then be scrapped in favour of a society of mutual plunder." (Rothbard, 2004, 1139). The power to take private property must therefore be either distributed on some discriminatory basis or abolished completely.

There are multiple ways to explain and rationalize the institution of eminent domain. In this paper, two possible lines of reasoning are followed. The first, that there is an economic justification for eminent domain. Eminent domain is said to be the best instrument to overcome the problem of holdout. This therefore makes it an institution that promotes higher efficiency in a world of high transaction costs. The second, is the historical evolution of the law of property which gives a reasonable explanation behind certain powers that governments have in present times. Under this line of reasoning, eminent domain can be explained as a residue of the former feudal system of government.

Economic justification for eminent domain

In economic literature,[4] the taking of land using the power of eminent domain is usually considered to be justified for two reasons.

Firstly, it is said that eminent domain prevents individuals from refusing to sell their property to the government at a "reasonable" price (Miceli and Segerson, 2000). This argument is problematic in that the real value of a property for its owner cannot be discovered if they are not willing to sell it. The concept of "reasonable" price is nonsensical without any contract being drawn up or without the acceptance of the fact that things have some intrinsic value that is independent of their utility.

Secondly, eminent domain is said to be justified by the extremely high transaction costs of land assembly, i.e. by the problem of holdout (Miceli and Segerson, 2000). Although this argument is worth more analysis, "[a] crude examination of the circumstances in which ED is actually used does not leave the impression that their outstanding common characteristic is consolidation of ownership rights, which is nowhere mentioned as a necessary condition of the granting of ED power [...] The outstanding characteristic of situations where ED is used is land acquisition by a government-related body, not consolidation of ownership rights." (Munch 1976, 474-5)[5]. It is quite clear that no

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Benson (2008) states that (in the United States) the power of eminent domain is generally inferred today from Article 1, Section 8 of the U.S. Constitution and the taking clause of the Fifth Amendment.

[4] A comprehensive, although not up to date, overview of economics of eminent domain can be found in Epstein (1985). This paper intentionally ignores a significant portion of the legal and economic literature on eminent domain that deals with just compensation, such as Michelman (1967), Knetsch and Borcherding (1979), Blume and Rubinfeld (1984), or Blume, Rubinfeld, and Shapiro (1984).

[5] Government-related bodies should be interpreted not only as governmental agencies and publicly owned corporations but also any private businesses that are for whatever reason favoured by government. "In practice,

general rule based on transaction costs has been employed to decide who should be eligible to benefit from eminent domain. The power to take private land was rather granted on different bases.

Considering the economic justification for eminent domain, there are two different situations which must be clearly distinguished – monopoly and holdout. The first occurs when a government or private party wants to acquire a unique parcel of land. There are several problems connected with this concept. The most important issue is what constitutes uniqueness. This is similar to the issue of "what is a relevant market" in the standard economic theory of monopoly. It may often be just a government's decision to use a particular parcel of land that makes it unique. Even if the uniqueness is satisfactorily defined, it is not clear how the justification for eminent domain follows from it. The second, the problem of holdout, is connected with the consolidation of many separately owned parcels of land under single ownership. This is truly a problem of high transaction costs. Every owner has the incentive to be the last seller and to extract the rent. Negotiations between the owner and the potential buyer are therefore very costly. This results in a suboptimal amount of land assembly (Munch, 1976).

With regard to the distinction between property rules and liability rules mentioned above, the question it poses is whether a particular entitlement (in our case property rights to land) should be protected by a property rule or by a liability rule. The key to this question is said to be the transaction costs.

According to Posner, "what is fundamental is the distinction between low-transaction-cost setting and high-transaction-cost setting." While in the former situation parties should be required to transact in the market, "in the setting of high transaction costs people must be allowed to use the courts to shift resources to a more valuable use because the market is by definition unable to perform this function in those settings." (Posner, 1986, 49-50).

Calabresi and Melamed (1972) go even further. In their view, "even if holdout and freeloader problems can be met feasibly by the market, an argument may remain for employing a liability rule." (p. 1107). They suggest that it may be possible to eliminate the problem of holdout on the seller´s side; however, at a price. Calabresi and Melamed therefore assume that a forced transaction in return for "the objectively determined value" may be more efficient. They show how a hypothetical park would be efficiently established using eminent domain and that if a market was used instead, "a market which was not worth having would have been paid for." (Calabresi and Melamed, 1972, 1107).

The approach described above is based on the efficiency theory of rights. The aim of the law is said to be an efficient allocation of entitlements whereby transaction costs prevent people from achieving the optimal allocation in the market. Krauss (2000)

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almost all departments of federal, state, and local government, many regulated industries, and government-related educational and medical establishments have some form of ED power in most states, regardless of whether they wish to acquire one parcel for a schoolhouse or campaign headquarters or 1,000 miles of right-of-way for a freeway." On the other hand, "[n]otable examples of industries in the United States which must assemble property, do serve the public, but have not themselves been granted ED are agriculture, private manufacturing, and suburban development." (Munch, 1976, 474-5)

summarizes the conventional answer to the question whether a particular entitlement should be protected by a property rule or by a liability rule as follows:

> "The conventional law and economics answer to this question is that a property rule should be chosen if transaction costs are low (in which case the parties can arguably best establish the relevant values by bargaining after the assignment of the entitlement), while a liability rule should be chosen if transaction costs are high (as might be the case if large numbers of parties are involved either as plaintiffs or defendants, creating risks of free-riding or of holdouts, if the entitlement is incorrectly assigned from an efficiency standpoint)." (Krauss, 2000, 788).

However, the efficiency theory is problematic. As noted by Benson "[o]ne reason for questioning this widely held conclusion is the often implicit assumption that whereas transactions costs are high for private parties, information costs are low for judges or juries who must determine compensation." (Benson, 2005, 169). The assumption is, in fact, that a third party can at low costs "objectively determine value" of a particular entitlement. This can hardly be true, especially if one assumes that the preferences of different people are only revealed in actual transactions.

Richard Posner states that subjective values cannot be used to calculate just compensation. As he admits, "although [it is] illogical in pure theory, it may well be justified by the difficulty (cost) of measuring those values." (Posner, 1986, 51). That is to say, that the cost of determining truly fair value is too high or, more precisely, prohibitive. One must therefore either drop the assumption that a forced transaction with just compensation will lead to the efficient allocation of entitlements or the assumption of determining the just compensation in the courts at low costs. According to Krauss, if "both transaction costs and judicial assessment costs are high, there is little reason to believe that protection of an entitlement with a liability rule will be particularly conducive to efficiency." (Krauss, 2000, 788).

Feudal superiority of government

The law governing property in land originates from feudal systems from the Middle Ages. Even those countries that never experienced feudal rule, such as the United States, have derived the law from pre-existing legal systems.[6] The evolution of English law gives a good illustration of the processes that have shaped the present day rules.[7]

A feudal system is based on the vertical relations of power and property. In England, following the conquest of William the Conqueror, all land was confiscated by the new king and then redistributed to barons and the church. The King, as the ultimate land owner, granted fiefs to tenants in chief (barons, religious bodies and ecclesiastical officials) in exchange for some obligations. These included primarily military service, offices in the royal household and religious duties such as saying mass and praying for the royal family.

[6] American law of land is obviously based on English law. (Cunningham, Stoebuck and Whitman 1989; Benson 2008). Hart (1996) informs about the development of takings in early American history.
[7] See, e.g., Lyon (1980) for further details on the development of English law.

Property rights to land were therefore distributed among several people. "[A]s a consequence of tenurial system, two or more persons had interest of some sort in each parcel of land except for the demesne land of the King." (Cunningham, Stoebuck and Whitman, 1989, 18). Hence nobody had full ownership, with exception to the King with respect to his demesne land.

Throughout the twelfth and thirteenth centuries the rules developed whereby there was a shift in property rights towards tenants and the creation of fuller ownership. Originally, if a tenant died, the land reverted to the lord and the lord could decide whether to grant the land to the tenant's heirs (usually after payment of "incidents") or another tenant. The "common law right of inheritance" that emerged required land to remain with the tenant's heirs. If no heirs existed, the fee would "escheat" to the deceased tenant's lord. Later on, the "fee simple" was established which was transferable inter vivos without the consent of the lord (Cunningham, Stoebuck and Whitman, 1989, 19-24). Although by the seventeenth century most of the property rights were transferred to tenants in fee simple, the institutions of eminent domain and escheat remain to this day.

In the United States, "[t]he American Revolution clearly ended any tenurial relationship between English king and American landholders. Some of the original thirteen states adopted the view that the state had succeeded to the position of the English king as 'lord' and that tenure continue to exist, while other states enacted statutes or constitutional provisions declaring that land ownership should thenceforth be 'allodial,' or otherwise declaring that tenure was abolished." (Cunningham, Stoebuck and Whitman, 1989, 25). Although it is claimed that "[f]or all practical purposes, one who owns land in fee simple anywhere in the United States has 'complete property' in (full ownership of) the land" (ibid.), the institution of eminent domain (and escheat) was adopted in American law.

From the beginning, tenants struggled to limit the King's power with respect to their land. The Kings' attempts to seize the property of barons were met by several revolts. In 1215, King John was forced to adopt the Magna Carta, a charter limiting his powers including the power to take property.[8] However, "[t]he barons did not prevent the seizure of property [...] because they, too, wanted the power to seize property." (Benson, 2008, 426).

The creation and growing power of the parliament also did not eliminate eminent domain. Parliament struggled to acquire powers from the King rather than to limit his power. "The power to seize property, for example, did not disappear as Parliament's power grew at the expense of the king's." (Benson, 2008, 427). Moreover, the parliament also assumed the prerogative to delegate the power to take property. Although, it must be noted that before the voting franchise was expanded, most parliamentarians were also landowners.[9]

In the United States, some of the Founding Fathers argued for absolute ownership. Thomas Jefferson "contended that all remnants of feudalism in regard to property

[8] Chapter 29 of the Magna Carta proclaims: "No Freeman shall be taken, or imprisoned, *or be disseized of his Freehold* … but by lawful Judgment of his Peers, or by the Law of the Land."

[9] This was reflected in a practice whereby compensation for the taking of land included a 10 percent bonus. This bonus was abandoned after the voting franchise was expanded to include many non-landowners. (Benson, 2008, 428).

should be eliminated [and] landowners should not be treated as stewards, with property ultimately controlled by the prerogative of the state." (Benson, 2008, 429). However, some states had already used the power of eminent domain and consensus could only be reached on the limitation thereof. Notably, Jefferson used the term "public use" rather than public purpose, interest, benefit or some other term.[10]

There is good reason to believe that eminent domain is a remnant of feudalism. Despite the fact that there had been no feudal system in the United States, the link to English common law prevailed over the attempts of some Founding Fathers to make property rights absolute. The economic justification for eminent domain clearly only emerged as an *ex post* rationalization of the institution. Today, it provides an acceptable justification for the use of the power of eminent domain in modern market economies.

Conclusion

Economists tend to argue from the perspective of efficiency. To make reality tractable, economic models are necessarily simplified. Simplification is not problematic per se. However, models should not be mistaken for reality. The economic justification for eminent domain makes sense as a solution to the problem of holdout. Nevertheless, it does not provide an explanation for all the situations in which the power of eminent domain is used; nor does it explain how and why the institution of eminent domain emerged.

Historians pay more attention to reality. Typically they do not need to fit into an established model or framework and therefore have more freedom to present details, the details that are so inconvenient for model-building. The case of eminent domain presented in this paper shows how historians can inform economists by supplying facts that would otherwise be left to one side as being redundant. What is more, they can point to these facts as essential elements with which to explain reality.

The role of economists and historians may therefore be complementary. Economists provide general frameworks and models for explaining human behaviour, whilst historians provide information about reality. Historians could benefit from having knowledge of economic theories, whilst economist should listen to historians because otherwise economics cannot be a science that provides meaningful statements about the real world. Economics without history would therefore only be a sophisticated discipline that deals with something else other than reality.

[10] However, the "public use" condition was gradually eliminated by the government and the Supreme Court. In the dissenting opinion to Kelo v. New London, Justice O'Connor states: "To reason, *as the Court does*, that the incidental public benefits resulting from the subsequent ordinary use of private property render economic development takings 'for public use' is to wash out any distinction between private and public use of property – and thereby *effectively to delete the words 'for public use'* from the Takings Clause of the Fifth Amendment." (Kelo v. New London, 545 U.S. 469 (2005), emphasis added).

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