

Property Takings in Developed versus Developing Countries: Economics, Politics, and the Limits of the Holdout Problem

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1. Introduction

Property takings are common in the developing world. For example, despite Chinese reforms in 2003 to protect property rights, Chinese governments forced thousands of families to relocate during the buildup to the Beijing Olympics. In recent years, governments in Peru, Venezuela, Bolivia, Zimbabwe, Russia, and others have nationalized heavy industry as well as specific firms. Large-scale land takings also have occurred in some of these same countries through reallocation of commercial farmland across economic and ethnic lines to preferred constituencies. Because they are occurring in underdeveloped economies, these takings share the feature that they occur under weaker political and legal institutions and, generally speaking, under a poor rule of law; that is, they occur in countries whose governments are at least partially unconstrained from violating individual rights to private property.

Perhaps surprisingly, similar cases of takings occur in developed countries where the rule of law is generally strong. We need look no farther than the United States to draw this point. In 1978, for example, the State of Hawaii compelled the transfer of land ownership from a small number of traditional family owners to a large number of their lessees. Most home dwellers on the island owned their homes but leased the land that the houses were on from one of these traditional families. The State argued that the concentration of land ownership created undesirable, oligopolistic outcomes

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in the housing market. Their policy would achieve a wider disbursement of fee simple titles, which, it was argued, would bring about more competitive circumstances. The Supreme Court ruled in *Hawaii Housing Authority v. Midkiff* (1984) that the State's plan fulfilled the Fifth Amendment's public use requirement.² The Court applied the relatively weak "rational basis" level of scrutiny, ruling that the taking must be rationally related to a legitimate public purpose—in this instance, a more competitive real estate market. The Hawaii case is not an isolated incident. *Midkiff* was anticipated by an earlier case in Washington DC, in which an urban renewal plan called for razing an entire neighborhood. In the landmark case *Berman v. Parker* (1954), the Supreme Court upheld this use of the takings power and thereby ushered in an era of urban renewal programs across many cities in the United States.³ As the failures of urban renewal became widely known, plans for localized economic development became more targeted in their use of eminent domain. In particular, removing entire neighborhoods grew out of fashion in favor of condemning a few properties whose owners stood in the way of assembling a tract for development. The issue of "holdout" properties came to a head in the *Kelo v. City of New London* (2005) Supreme Court case, which authorized the government to take residential properties from a small number of unwilling sellers to make way for a new commercial development.⁴ These are only the most famous cases. In any given year, thousands of properties across the United States are taken or threatened by eminent domain pursuant to economic development plans (Berliner 2003, 2006). In total for the post-World War II era, Somin (2008) estimates that a combined one million properties and 3.6 million people have been reallocated for economic development purposes.⁵

There are many interesting margins of contrast between takings in developed and developing countries. For example, as suggested above, the rule of law is one contrast. Furthermore, poor countries are more likely to have a history of political instability, so takings can be a means of settling political scores between a new regime and its opponents. Similarly, takings are a way for socialist leaders to denounce and expel the ideology of capitalism. For example, on May 1, 2010, Bolivian President Evo Morales nationalized four major electricity firms, telling the media that the expropriation was needed to combat injustices created by capitalist imperialists. This continues several years of expropriation in various industries, such as mining. "Basic services cannot be a private business," he said about the May Day takings. "We're recovering the energy, the light, for all Bolivians."⁶ Recently he told the international media, "capitalism

² *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229 (1984).

³ *Berman et al. v. Parker et al.*, 348 U.S. 26 (1954).

⁴ *Kelo et al. v. City of New London, Connecticut*, 545 U.S. 469 (2005)

⁵ (Garvin 1995) provides an earlier estimate for urban renewal programs only: one million people, two-thirds of whom were black.

⁶ Ore, Diego and Eduardo Garcia, "Bolivia Nationalizes Four Power Companies," Reuters,

must die, or it is Mother Earth.”⁷ Third, and for related reasons, agricultural takings in developing countries usually redistribute land from relatively wealthy (and white) minorities to relatively poor (and indigenous) majorities. In contrast, the costs of takings in the United States fall disproportionately on the poor and ethnic/racial minorities.⁸

Yet, on economic margins, takings in these respective settings lead to remarkably similar consequences because property rights are the foundation of economic development, regardless of the broader institutional and ideological context. Sound property rights support the division of labor, which increases productivity while necessitating exchange and promoting the discovery of ever more extensive exchange opportunities. Wealth and living standards increase, in no small part because people can securely exchange property rights over valuable resources, which pushes resources toward increasingly valued ends. This is the general process by which entrepreneurship and exchange of property rights create wealth. This role of property is among the deepest lessons in the history of economic thought. The ancient Greek, Xenophon, for example, drew a causal link between ownership of distant property and people’s specialization in navigation skills. He described the resulting variety of specializations of labor among sea crew. Some would specialize in navigating small craft, others in larger merchant vessels, still others in larger warships, and so on.⁹ Much later, among

May 1, 2010, (accessed at http://news.yahoo.com/s/nm/20100501/bs_nm/us_bolivia_power_nationalization May 1, 2010). The article reads further: “Morales, the country’s first indigenous president and a self-declared anti-capitalist, took office for a second term in January pledging to diversify the economy from its dependence on natural gas and mining exports and to launch state-run paper, cement, iron and lithium companies.

“His efforts to give the state more control over the economy are very popular with Bolivia’s indigenous majority, who say foreign companies have ransacked the country’s natural resources and invested little to help the poor.

“Critics say Morales [...] has scared away crucial foreign investment with nationalizations of companies and is not acting on behalf of all Bolivians but primarily for Aymara and Quechua Indians and other indigenous groups.”

⁷ Andres Shipani, “Evo Morales’ message to grassroots climate talks—planet or death,” *The Guardian U.K.*, April 21, 2010. <http://www.guardian.co.uk/environment/2010/apr/21/evo-morales-grassroots-climate-talks>

⁸ For debate on the racial/ethnic/socio-economic incidence of economic development takings, see Somin (2007) versus Dana (2007). In earlier seminal work, Munch (1978) details the particular history of takings pursuant to Chicago’s urban renewal programs, finding that low-value properties tend to be undercompensated while high-value properties tend to be overcompensated. Furthermore, in American states with greater percentages of poor and minority population, governments are less constrained from using the takings power for economic development purposes (López, Jewell, and Campbell 2009).

⁹ In *The Polity of the Athenians and Lacedaemonians*, Xenophon writes: “Furthermore, owing to the possession of property beyond the limits of Attica, and the exercise of magistracies which take them into regions beyond the frontier, they and their attendants

political philosophers of the Scottish Enlightenment, the division of labor was seen to necessitate exchange opportunities that in turn serve as the channels through which Adam Smith's invisible hand would function. More recently, modern economics has studied deeply and widely the fundamental role of property rights in growth and development. For instance, in *The Mystery of Capital* Hernando de Soto explains how a regime of formalized property rights allows people to integrate dispersed information in value-creating ways, to make accountable capital investments through collateralization and to make assets more fungible by protecting a wide nexus of exchange transactions (de Soto 2000). De Soto's work unfolds within a wider corpus of economic theory on property rights, including their evolutionary origins (Demsetz 1967; North and Weingast 1989), their causal role in the development of economies in Western countries (North and Thomas 1973; Rosenberg and Birdzell 1986), and the robust statistical relationship between secure (though not necessarily formal) property rights and spillover benefits like economic growth and measures of well-being.¹⁰ The essential lesson to this wide range of work is captured by de Soto's own theme, which is that property rights promote the division of labor and the extent of exchange and thereby promote economic growth and development. Takings, especially when applied with uncertain constraints, reverse the social benefits imparted by property rights—namely, their role as a fundamental building block of economic development.

In the spirit of the Upton Forum, I will take this opportunity to compare and contrast takings in developing versus developed countries (specifically the United States). I will argue that takings differ in the two realms by the political processes through which they pass, which reflects the different institutional and ideological contexts through which they are enacted. These political differences help explain the fact that the distributional effects operate in opposing directions in the two settings: from rich to poor in developing countries but from poor to rich in the United States. Yet there is an important similarity as well. Takings in both developed and developing countries alter people's incentives for maintaining and investing in their property. This paper explores these margins of contrast between takings in the developed versus developing world, and then discusses implications for the primary economic

have insensibly acquired the art of navigation. A man who is perpetually voyaging is forced to handle the oar, he and his domestics alike, and to learn the terms familiar in seamanship. Hence a stock of skilful mariners is produced, bred upon a wide experience of voyaging and practice. They have learnt their business, some in piloting a small craft, others a merchant vessel, whilst others have been drafted off from these for service on a ship-of-war." Quoted without footnotes from <http://www.fullbooks.com/The-Polity-of-the-Athenians-and-the-Lacedaemo.html> (Accessed May 1, 2010).

¹⁰ A small sample of relevant papers is Gwartney, Lawson, and Hall (2009); Kerekes and Williamson (2008); Acemoglu, Johnson, and Robinson (2002); Besley (1995); Mauro (1995); and Scully (1988).

justification of the takings power, known as the holdout problem. The holdout problem is an argument based on economic efficiency, but it does not account for two sources of inefficiency that I highlight here.

In the following section, I discuss the main similarity between takings in developed versus developing countries, the adverse incentive effects to property owners. Section 3 discusses their primary differences, which are political, ideological, and directional in terms of the way they redistribute wealth. Section 4 deploys the arguments of Sections 2 and 3 to provide a fuller account of the holdout problem as the basic economic justification for takings.

2. *Incentives to Property Owners*

In de Soto's *The Other Path*, private property is defined as a bundle of rights "which confer on their holders inalienable and exclusive entitlement to them" (de Soto 1989, 159). Compulsory sale infringes on the alienability and exclusivity aspects of this definition of private property. More generally, the takings power creates uncertainty among property owners and distorts their incentives for maintenance and investment in their property. In that event, the accounting of the social costs of eminent domain would need to include misallocation of resources under the threat of eminent domain. This section explains how the law in the United States has widened the meaning of "public use" so as to effectively remove all formal legal constraints on the majoritarian use of eminent domain for economic development. This relatively unconstrained power creates uncertainty as to the defined circumstances under which a property may be taken. This uncertainty, in turn, perturbs the economic plans of property owners and places the market process onto adverse paths of dynamic inefficiency. Some of the most thorough uses of takings for economic development in the United States illustrate the argument.

Under U.S. law, the government's taking power has become stronger over time. The evolution of cases and politics that explains this process is covered well in recent literature.¹¹ For our present purposes, I will emphasize a few of the economic implications of the changes in legal doctrine. Early courts interpreted the takings clause of the Fifth Amendment, which reads "nor shall private property be taken for public use, without just compensation," to mean the government acquires title to real property for *use by the public* such as common carriage rights of way (roads, rail, power lines) or public buildings (courthouses, schools, post offices). Doctrine for these traditional types of takings is evident in early U.S. jurisprudence, which institutionalized a legal principle that entails important economic implications: public

¹¹ The erosion of the public use requirement has been documented in greater detail by Somin (2008); Sandefur (2006); Ely (2005); Staley and Blair (2005); Rubinfeld (1993); and Epstein (1985, see chapter 12).

use does not authorize transfers of property from one person to another person. This prohibition on private transfers promotes economic efficiency because if the transfer from person A to person B were truly an improvement in the allocation of resources, it would be reached through voluntary exchange. Thus, constraining the takings power with this particular bright line imparts beneficial economic incentives by strengthening property rights. Similarly, the compensation requirement promotes efficiency by preventing the government from treating the takings authority as an indirect source of tax revenue. If the state were not required to compensate the property owner, it would begin to finance its land requirements through eminent domain and would over utilize property takings to finance its operations. Like a levy on a narrow tax base, the deadweight loss would be large because property owners would do much to try to avoid bearing the tax burden, such as not investing in property. The nineteenth century Supreme Court reflected this in upholding the fundamental fairness doctrine, under which no individual property owner should bear excessive burden of supplying public uses.

It was not until late in the nineteenth century that limitations on the takings power were gradually eroded. Beginning in the Progressive Era, and accelerating in the New Deal, the Court increasingly deferred to legislative bodies as to what constitutes “public use.” On cue, governments in many parts of the country began to advance an ever-expanding notion of public use. By the middle of the twentieth century, the stage was set for the Court to advance the public purpose doctrine, under which it has allowed takings for such purposes as the elimination of blight by urban renewal (*Berman v. Parker*, 1954), enhanced competition in real estate (*Hawaii Housing v. Midkiff*, 1984), expansion of the tax base, and economic development broadly conceived (*Kelo v. New London*, 2005). By the time of the *Kelo* case, the Court’s deference to majority rule was complete. Citing *Berman* heavily, the *Kelo* majority opinion reasoned that a carefully considered development plan that is generated by an open, democratic process, such as the one in New London, “unquestionably serves a public purpose.”¹² Therefore, so long as there is a rational basis connecting the development plan with some notion of the public purpose or benefit, the Court will not preclude a property taking pursuant to the plan. In short, the public use requirement had been defined to mean whatever a government majority says it means. By the final decade of the twentieth century, one legal scholar described the public use clause as being of “nearly complete insignificance” (Rubinfeld 1993, 1078). As expected, economic development takings and urban renewal programs became very common across many, but not all, states in the country. In some areas of the country, the practice became routine.

As the public use requirement has been weakened over time, the takings power has become a more uncertain policy instrument. Majorities are effectively unconstrained by the Court, which it demonstrated in *Berman v. Parker* as follows. “The concept

¹² *Kelo et al. v. City of New London, Connecticut*, 545 U.S. 469 (2005) at 13.

of the public welfare is broad and inclusive ... If those who govern the District of Columbia decide that the nation's capital should be beautiful as well as sanitary, there is nothing in the Fifth Amendment that stands in the way."¹³ Under such broad latitude to legislatures, properties are vulnerable to takings for effectively any reason agreed to by a majority of a city council or other relevant governing body. As Justice O'Connor's dissenting opinion in the *Kelo* case remarked, "this [public use] constraint has no realistic import ... The specter of condemnation hangs over all property. Nothing is to prevent the State from replacing any Motel 6 with a Ritz-Carlton, any home with a shopping mall, or any farm with a factory."¹⁴ Furthermore, granting the takings power for economic development purposes enables governments to use it for other purposes as well. Because the court defers to legislatures with such broad latitude under the rational basis level of scrutiny, there is no effective limit to the takings (Somin 2010). The mantra among the grassroots backlash after the *Kelo* case seemed to be, "If they can take Susette Kelo's house, they can take mine."

Furthermore, there is additional variation depending on the rules established by state and local governments. After the *Kelo* ruling in June 2005, a wave of legislation brought reforms to a majority of the states. In a few states, the laws have also changed through court cases. High courts have ruled in recent cases in Illinois, Michigan, Ohio, Oklahoma, and South Carolina, making illegal takings for economic development. In New York, however, lower courts have recently ruled in opposite directions on two prominent cases, making people even more uncertain of the security of their property rights.

When the institutional rules provide little constraint on the threat of property expropriation, economic incentives lead property owners to make less efficient use of resources. First, people plan their maintenance, investment, and other development decisions over a shorter time horizon. Spot exchanges and short-term investments are relatively secure because the takings process is a deliberative one that features advance public notices and other purposefully instilled lags. But over longer planning horizons, it is uncertain how to factor in some probability that investments will be lost to expropriation. The effect is equivalent to an increase in the discount rate of time preference. It changes the quantity and composition of property investments, resulting in foregone long-term developments and greater allocation of resources according to short-term contracts than would otherwise occur under more secure rights. In addition, people may exchange over less extensive margins more generally; for example, across shorter distances, over shorter time spans, under more limited access to credit, and so forth. With enough substantial uncertainty due to threat of expropriation, economic activity can be pushed into the shadow economy where people feel less extensive and less secure in their exchange opportunities. De Soto

¹³ Berman et al. v. Parker et al., 348 U.S. 26 (1954)

¹⁴ Kelo et al. v. City of New London, Connecticut, 545 U.S. 469 (2005) at 11.

explains this process in *The Other Path* (de Soto 1989).

Market process theory provides the most effective basis for understanding the distortive impacts of unconstrained takings power. Boettke, Leeson, and Coyne (2010) present the argument in terms of Israel Kirzner's theory of entrepreneurship (Kirzner 1973) and Robert Higgs's theory of regime uncertainty (Higgs 1997). Two fundamental conditions motivate the analysis. First, entrepreneurship is a ubiquitous trait—it is a mode of activity that all individuals practice in order to make the most of their available knowledge and opportunities. For instance, people are entrepreneurs in making their decisions about real estate if for no other reason than that, for most people, real estate is the largest good in their household budget. Second, the incentives of the market are a function of the institutional environment, which is affected by political rules such as constraints on the takings power. Changes to the institutional environment will entail a new incentive structure, which in turn results in different outcomes. When uncertainty is built into the rules of the game—as when relying on policymaker discretion to decide when properties may be taken—this, in turn, increases uncertainty in entrepreneurship, and the market process will generate adverse consequences. So, for example, where the takings power is meaningfully constrained, economic incentives are shaped by a well-functioning system of exchange with secure rights to property and contract, and entrepreneurship will exploit arbitrage opportunities to the point that resources become used in ever greater-valued uses. On the other hand, if the soundness of property rights were compromised, as with the uncertain threat of eminent domain, then so will be the social function of Kirznerian entrepreneurship in propelling the market onto a path of dynamic efficiency. When governments possess effectively unconstrained use of eminent domain, as under the rational basis test to satisfy public use, this perturbs the institutional structure and creates altered entrepreneurial incentives that direct the market process onto a different path. Evidence across the American states is consistent with this argument. In states that expressly authorize governments to use takings for economic purposes, the government sector occupies a greater share of economic activity. As Turnbull and Salvino (2009) demonstrate, tax revenues as a share of personal income are significantly greater at both the state and local levels when takings for economic purposes are expressly authorized. Strong takings powers, then, correlate significantly with incentives to engage in unproductive entrepreneurship, rent seeking, tax avoidance, and other inefficient activities.

The distortive effects can be seen also in many urban areas where eminent domain has been used extensively. In New York City, for example, the threat of eminent domain contributed to the decline of Times Square in the 1970s. When the city's development authority announced its ambitious, large-scale plans with the assurance of using eminent domain to assemble the necessary land, property owners adopted a shorter planning horizon. The area became filled with tenants who welcomed

short-term leases and whose clientele were not dissuaded by the poor neighborhood conditions, such as sex shops (Stern 2009). The promise of eminent domain altered property owners' incentives, and the results mattered. In New Haven and other Connecticut cities, where urban renewal programs in the 1950s and 1960s were used more than in any other place in America, entire cities failed. Already in 1967, *Time* wrote of New Haven's many woes and dashed hopes of grandeur, quoting long-time Mayor Richard Lee: "For everything we've done, there are five things we haven't done, or five things we've failed at. If New Haven is a model city, then God help urban America."¹⁵ By 1980, the population had dropped by 30 percent in thirty years, and New Haven ranked among America's poorest cities, as it still does today.¹⁶ Nearby in New London, the site has been cleared where Susette Kelo's house formerly sat, and an empty terrain sits undeveloped, after the city spent some \$80 million purchasing the properties. *Midkiff* also failed on utilitarian grounds. In the years after transferring title from leasers to lessees, the island became a more active real estate market, and prices increased substantially (Stark 2007). The same overall trend characterizes most of the major takings cases that have reached the courts: Where eminent domain has been used for economic development projects, peoples' incentives have become distorted, and the economic outcomes suffer as a consequence.

3. *Politicized Takings Power*

It is in the political realm where focus turns more toward the differences between takings in developed versus developing countries. Takings in developing countries tend to occur for ideological reasons within political systems that have weak rules of law, concentrated executive powers, weak judiciaries, and a dependent or state-run media. Even though compensation requirements are ubiquitous, officials in these situations are relatively unconstrained from taking properties to fulfill political objectives. They often offer minimal compensation as well. By contrast, takings in developed countries occur mostly for social utilitarian reasons within a strong rule of law system of shared and federal powers under the watch of an independent media. Perhaps the economic effects of the takings in both situations are similar, as detailed above. But these political differences appear to be substantial. They also fix our attention on certain neglected aspects of the economics of eminent domain.

¹⁵ "Washington has rewarded the city's imaginative urban-renewal administration with a greatly disproportionate share of federal renewal money—\$852 per capita (given or pledged), or six times as much as Philadelphia, in terms of population, seventeen times as much as Chicago, twenty times as much as New York." *Time* editorial, "Cities: No Haven," Friday September 1, 1967, <http://www.time.com/time/magazine/article/0,9171,837213,00.html>.

¹⁶ By 2005 more than a quarter of its residents were living in subsidized housing (Gelinis 2005).

Consider initially the ideological context. The system of property rights selected by a people is generally informed by the society's culture, its systems of shared beliefs, and other salient values (North 2005). As a consequence, institutional arrangements including property rights are ingrained within the prevailing ideological profile of a society. In certain developing country situations—for example, Bolshevik Russia and Castrovian Latin America—socialist revolutions have taken hold such that abolishing private property becomes the central change that will bring about the transition from capitalism toward the egalitarian utopia. The question of whether property rights promote economic development and lead to better outcomes for one's society becomes secondary. As Bolivian president Evo Morales told the socialist publication *Monthly Review*, the ultimate goal is:

“To live in community and equality ... It is an economic model based on solidarity, reciprocity, community, and consensus. Because, for us, democracy is a consensus ... And within this framework we are seeking a communitarian socialism based on the community. A socialism, let's say, based on reciprocity and solidarity. And beyond that, respecting Mother Earth, the Pacha Mama. It is not possible within that model to convert Mother Earth to merchandise.”¹⁷

Under this rationale, Bolivia's government has seized and redistributed commercial farmland to indigenous poor peoples and has nationalized energy and other industries. These patterns resemble the clear path to Marxist socialism that has been charted in Venezuela and an increasing number of neighboring countries (Haber 2009). In other countries where there is a history of expropriations, the operative ideology has taken on slightly different appearances. In Zimbabwe, for example, after decolonization, the prevailing ideologies supported a solution based on black self-rule, as in other postcolonial African countries. This gave rise to Zimbabwe's first president, Canaan Banana, and his successor, Robert Mugabe, who eventually corrupted the spending of foreign aid dollars and expropriated enormous swaths of land en route to destroying the economy. Mugabe was more of a kleptocrat than a socialist demagogue. Elsewhere in Putin's Russia, the Yukos affair illustrates that there is ideology in play, but it is an ideology of oligarchy and control over energy supplies.¹⁸

¹⁷ Dieterich, Heinz. 2006. “Evo Morales, Communitarian Socialism, and the Regional Power Block,” *Monthly Review*, Saturday January 14. Original in Spanish: <http://mrzine.monthlyreview.org/2006/dieterich070106.html>. Translation to English: http://www.axisoflogic.com/artman/publish/article_20656.shtm

¹⁸ In an influential paper, Martha Brill Olcott (2004, p.30) explains: “Putin's priorities with regard to natural resource development...[provide that] state interests must take precedent over those of individuals or private enterprise. Free markets will not direct foreign policy under a Putin administration. He believes that private property should exist and that the state has to grant property owners legal protection, but the rights of property are not absolute and do not take priority.”

The ideology surrounding the takings power in the United States is, relatively speaking, more pragmatic. On the one hand, property rights are held very dearly in people's beliefs. This can be seen from the time of the American founding¹⁹ to the substantial public backlash after the *Kelo* ruling, which evidently struck a chord with the American polity (López and Totah 2007). On the other hand, Americans do value progress, and they especially desire economic progress for the opportunities it provides, its innovations, employment and rising living standards. There is relatively little sympathy for property owners who merely hold out for more money and thereby block beneficial investment projects. By comparison, the *Kelo* backlash suggests that there is significant sympathy for principled holdouts like Susette Kelo and others. The default position is secure private property. Yet people may be willing to empower government to infringe on property rights if it means being able to pursue a project for the greater good, or if unreasonable and isolated nodes of greed are holding it up.

As a result, takings in the United States are usually carried out for more pragmatic purposes. The typical property taking is at least nominally intended to promote the public good rather than nakedly to instill preferred social institutions or to settle political scores. Quite often, takings are justified by alluring promises of utilitarian gains under centrally planned economic development projects—by notions of the public interest that Americans have come to associate with economic development, such as high incomes, good jobs, steady tax bases, and rising living standards. In this public interest view, takings are viewed as a rare but necessary tool for promoting commerce and capitalism in the face of strategic holdouts. Individual property rights take priority, but, in certain situations and on relatively rare occasions, these rights can be compromised for the greater good of the society.

To be prepared for such circumstances when they emerge, a democratic people may occasionally want to avail itself of the option to use eminent domain to move development along. To wit, electorates in many American states and localities have chosen to entrust their governments to use discretion in determining when those particular circumstances justify takings. In these areas, it is common for officials to make public comments to assure property owners that their use of eminent domain will be limited—"only when absolutely necessary" and "only as a last resort" are two common refrains (Lopez and Totah 2007).

Efficient implementation is another matter, of course, and rigidities in political and legal institutions often confound public interest rationales. For example, contrary to the efficiency-restoring justification for the use of eminent domain, U.S. law does

¹⁹ "The country that became the United States was unique in world history in that it was founded by individuals in quest of private property.... [T]he conviction that the protection of property was the main function of government, and its corollary that a government that did not fulfill this obligation forfeited its mandate, acquired the status of a self-evident truth in the minds of the American colonists." Pipes (1999, p. 240).

not decide takings based on economic measures of the public interest. Rather, the *Kelo* Court expressly rejected the argument that governments should demonstrate to a “reasonable certainty” that the promised economic benefits are likely to materialize in order to justify the taking. Citing *Midkiff*, the *Kelo* Court reinforces that “our cases make clear that empirical debates over the wisdom of takings—no less than debates over the wisdom of other kinds of socioeconomic legislation—are not to be carried out in the federal courts.”²⁰ Lower courts have gone as far as to rule that developers cannot be required to proceed at all with the development plan, much less proceed in such a way that the promised economic benefits are realized.²¹ Instead, the relevant test is whether the crafting of the development plan adhered to deliberative, democratic procedures. Thus, under current federal law, a planned development could ultimately accrue no benefits whatsoever in the form of promised jobs, tax revenues, and general economic vitality, yet the taking would be legal as long as the process that created the plan was a deliberative, open, democratic one. While inconvenient for the utilitarian public interest rationale, the Court’s rejection of “reasonable certainty” is pragmatic for at least two reasons. First, there is no practical way to impose binding legal obligations on the new property owners to provide the promised benefits (Somin 2010). Second, the Court may want to avoid substituting rational basis with a stricter form of scrutiny in order to not burden the lower courts with having to decide piecemeal which takings will be likely to generate utilitarian gains.²² In short, the courts lack effective means to limit development takings only to circumstances in which the promised gains have a good chance of materializing—to argue otherwise would be to place the Court in the role of entrepreneur.

Statutory rigidities also confound the implementation of public interest takings. For example, while most of the American states prohibit or curtail the use of eminent domain for economic development purposes, many of these laws include generous loopholes and exemptions that serve to nullify their restrictiveness.²³ The most

²⁰ *Kelo et al. v. City of New London, Connecticut*, 545 U.S. at 488, citing *Hawaii Housing Authority v. Midkiff*, 467 U.S., at 242–243. The *Kelo* opinion further reads: “A constitutional rule that required postponement of the judicial approval of every condemnation until the likelihood of success of the plan had been assured would unquestionably impose a significant impediment to the successful consummation of many such plans.”

²¹ *City of Detroit v. Vavro* 177 Mich. App. 682 (1989). For detailed discussion see Somin (2010).

²² This point was argued by Richard Posner on the Becker-Posner blog at the time of the *Kelo* ruling. See “The *Kelo* Ruling,” Becker-Posner Blog, June 24, 2005. Cf. Justice Stevens for the *Kelo* majority: “A constitutional rule that required postponement of the judicial approval of every condemnation until the likelihood of success of the plan had been assured would unquestionably impose a significant impediment to the successful consummation of many such plans.” *Kelo et al. v. City of New London, Connecticut*, 545 U.S. at 488.

²³ In the four years after the *Kelo* ruling, a total of forty-one states revised their eminent

common and important type of exemption allows takings for the removal of blight. Since the condemning authorities are often the same or very close to the personnel who write the statutory definitions of “blight,” it is common to see expansive and vague definitions. In New York, for example, a property may be blighted if the government deems it to be “underutilized” (Gelinis 2010). In California, the statute applies to structures of “obsolete design,” properties with “adjacent or nearby incompatible land uses,” and “lots that are in multiple ownership.”²⁴ In Lakewood, Ohio, the redevelopment agency attempted to blight a residential area, citing homes that lacked a two-car attached garage, had less than two full bathrooms or three bedrooms, and for being too small.²⁵ A lawsuit later found that under these standards, most of the City Council members’ homes would be blighted. Similarly expansive definitions of blight are still on the books in many states as holdovers from the post-*Berman* urban renewal era.

Nebulous blight rules play to the strengths and strategies of people who aim to use the takings power beyond its narrow, public interest justification. Policymakers may want to use eminent domain as an expedient rather than as a last resort. With such expansive definitions of blight, this becomes an easy task—as Justice Antonin Scalia has famously remarked, in “practically every case,” only a policymaker with a “stupid staff” would fail to muster a rational basis.²⁶ Case studies have revealed that in many instances, authorities have used eminent domain as a first resort and have initiated condemnation proceedings prior to making any private offers (Staley and Blair 2005; Gelinis 2010). Certain instances are particularly revealing when eminent domain is introduced, then removed under popular backlash, only to then have the parties negotiate a voluntary sale.²⁷ Eager to see their proposals constructed, urban planners have also advised opportunistically, suggesting that cities use a “quick take by eminent domain” to “reduce the time and cost required to ready a site” and to “allow immediate public possession” (Strategic Planning Group 2002). Adopting such a

domain statutes. Qualitative analyses have estimated that about 40 percent of the post-Kelo laws are effectively nullified by loopholes and exemptions. See Lopez, Jewell, and Campbell (2009), Somin (2008), and Morris (2009) for details.

²⁴ California Health and Safety Code Sections 33030–33039, <http://law.justia.com/california/codes/hsc/33030-33039.html>.

²⁵ In the four years after the Kelo ruling, a total of forty-one states revised their eminent domain statutes. Qualitative analyses have estimated that about 40 percent of the post-Kelo laws are effectively nullified by loopholes and exemptions. See Lopez, Jewell, and Campbell (2009), Somin (2008), and Morris (2009) for details.

²⁶ California Health and Safety Code Sections 33030–33039, <http://law.justia.com/california/codes/hsc/33030-33039.html>

²⁷ Institute for Justice. “Ohio’s ‘City of Homes’ Faces Wrecking Ball of Eminent Domain Abuse,” Litigation Backgrounder, http://www.ij.org/index.php?option=com_content&task=view&id=1053&Itemid=165.

routine stance toward takings has turned development authorities into commercial real estate firms, regularly purchasing properties, maintaining a portfolio of properties, advertising for tenants, and taking losses for lack of occupancy.²⁸ These patterns give pause to the idea that eminent domain is a tool of last resort meant for rare use only when necessary to solve a strategic holdout problem.

Nebulous blight rules also interact with public interest intentions to create distributional effects along race and income lines. As mentioned, the burden of takings in the United States has been disproportionately borne by poor and nonwhite populations (*supra* note 9). Concentrating takings in poor areas is consistent with the public interest rationale because these are the areas where development is most needed. However, the compensation requirement also gives policymakers an instrumental, budgetary incentive to target properties where property values are low. And furthermore, since subjective value is high relative to market value in poor areas, property owners are more likely to resist initial offers, which in turn makes it more likely that the negotiations escalate to condemnation proceedings.

Finally, combining the above institutional realities with well-defined and organized interests enables rent seeking dynamics to displace public interest intentions. Organized interests align in predictable ways on this issue. Opposing takings for economic development are homebuilders, realtors, owners of large land holdings (such as the King Ranch in Texas), and public interest groups such as the NAACP and the libertarian Cato Institute. Groups that support takings for economic development include municipal governments, urban planners, and some developers. These groups of concentrated interest have lobbied legislatures and filed briefs with courts to influence the outcomes of specific takings as well as the institutional rules that define government's powers. Campaign contributions are also a factor that may persuade these decisions. As a result, rent seeking tends to divert the decision process from serving the public interest as intended, and instead winds up serving the interests of those groups that can most successfully influence the condemnation authority and its legislative overseers.

In summary, takings for economic development fail to serve the public interest in either developing or developed countries. In the former settings, the effect is by design of ideology and concentration of power in the executive. In the United States, the effect is a byproduct of upholding a public interest rationale for government regulation while institutional rigidities in the legal and political systems cause implementation of policies to follow private interests instead.

²⁸ Lucas v. South Carolina Coastal Council, 505 U.S. 1003, at 1025–06, note 12 (1992).

4. *The Limits of the Holdout Problem*

Just as there is strong ideological and political support for economic development takings, there is also strong intellectual support. The primary justification for takings in economic theory is known as the holdout problem, which is a form of market-failure argument as follows. Large-scale developments and rights of way require land assembly. When the developer begins buying up properties, the stakes may become known to existing property owners, who now have the incentive to refuse to sell in order to hold out for higher prices. This creates a position of increased bargaining power, which puts the property owner in a position of monopoly power. If the development fails or incurs delay costs under significant holdout pressure, then the result is a market failure in the sense that voluntary exchange fails to efficiently transfer resources to higher-valued uses.

An equivalent way to understand the holdout problem is as a situation of prohibitively high transaction costs. While defined and secure property rights impart the benefits discussed above, property rights are no free lunch. Private property entails costs of definition, search, enforcement, and transfer—in short, transaction costs. When the transaction costs of private property exceed its economic gains, economic efficiency calls for alternative institutional arrangements such as communal rights, state control, or even commons. The holdout problem is a particular mode of transaction costs, which, in situations of land assembly, can become dominant. The remedy is to infringe upon voluntary exchange through the use of eminent domain to acquire the properties of holdout owners. This argument is the primary economic justification for the policy under *Kelo*. When governments promise to use eminent domain “only as a last resort,” they are implicitly suggesting that the only circumstance in which using eminent domain would be justified is in the presence of a holdout. In other words, the holdout problem represents the theory underlying the public interest rationale discussed above.

At issue is whether economic efficiency is improved by granting governments the power to forcibly transfer property so that it will be used in more socially valuable ways. The general response is “no” because voluntary exchange is Pareto optimal. However, under strategic holdout conditions, the market-failure response is “yes,” which means that eminent domain can be used to recover monopoly deadweight loss of strategic holdout. The holdout argument justifies takings for economic development on the basis of economic efficiency. Yet granting that power, especially in an unconstrained way, creates new incentives for all the decision makers involved—property owner, policymaker, developer, and planning consultant. New sources of economic inefficiency arise from these new incentives. Thus, the holdout argument itself is incomplete. The political economy view advanced here provides a fuller account of the institutional choice whether to empower governments to take

properties for economic development. This fuller view concludes that economic efficiency provides only a weak, perhaps even nonexistent, justification for economic development takings.

5. Conclusion

Property takings are common in both the developing and developed world, and Hernando de Soto's work attracts us to the task of comparing the causes and consequences of takings in these two alternative settings. This paper compares the two within the framework of economic theory, including the economic efficiency argument that is used to justify eminent domain under conditions of strategic holdout. By comparing takings in developed versus developing countries, we come to see the limitations of the holdout problem justification for the takings power.

In developing countries, property takings tend to occur for ideological reasons under weak rule of law by regimes with little regard for conditions of Pareto optimality. In the United States, meanwhile, takings occur mostly on the basis of social utilitarianism in a relatively constrained democratic system of shared powers. This helps explain the different directions of distributional effects between the two settings—from rich to poor in developing countries and from poor to rich in the United States. This paper also draws attention to the main similarity between takings in the two settings, which is the adverse effect on economic incentives. The takings power increases regime uncertainty—in the developing world because governments are not constrained by a strong rule of law, and in the United States because “public use” has become a nearly completely ineffective check on takings for economic development. This creates uncertainty in the market, which shortens time horizons and reduces the extent of exchange, thus reversing the benefits that secure property rights would have imparted. Takings for economic development serve the public interest in neither setting, the fault of intention in developing countries and in the United States of rigidities in legal and political institutions.

The holdout problem is a form of market-failure argument. It implicates the principle of voluntary exchange as imposing unnecessary costs on the free transfer of property to increasingly higher-valued uses. Markets are inefficient under this condition, which in turn justifies the use of eminent domain in order to correct market failure and restore an efficient outcome. While the logic of the holdout problem is sound as far as it goes, the efficiency implications of the takings power go well beyond correcting the inefficiencies of strategic holdouts. As I have discussed, when governments possess effectively unlimited takings powers, this creates economic costs from mal-investment while also creating the scope for counterproductive activities such as rent seeking. If economics is to offer sound policy analysis on grounds of economic efficiency, it must account for the full range of efficiency effects of empowering governments to use eminent domain for economic development purposes.

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