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Bargaining for Takings Compensation

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BARGAINING FOR TAKINGS COMPENSATION

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ABSTRACT

Efficiency and fairness require paying full compensation to property owners when their property is taken by eminent domain. Yet, current law requires condemnees to settle for fair market value. Courts and commentators acknowledge the inadequacy of this state of affairs, but defend it on practical grounds — there is no way to measure the full subjective value of property to its owner. Subjective value is neither observable nor verifiable; consequently, courts cannot rely upon owners' reports of the value they attach to their properties, and must rely instead, upon a suboptimal compensation regime. To date, the challenge of screening truthful from exaggerated evaluation has proved insurmountable.

This Article proposes a strikingly simple solution to the undercompensation conundrum. It offers a novel self-assessment mechanism that can make full compensation at subjective value practical by inducing potential condemnees to report accurately. Under our proposal, property owners must be given the opportunity to state the value of the property designated for condemnation. Once property owners name their price, the government can take the

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property only at that price. However, if the government chooses not to take and pay, the property will become subject to two restrictions. First, for seventy years, the property cannot be sold for less than the self-assessed price. If the property is transferred for less than that price, the owner will have to pay the shortfall to the government. Second, the self-assessed price – discounted to take account of the peculiarities of property tax assessments – will become the benchmark for the owner's property tax liability. These dual burdens of partial inalienability and enhanced tax liability will induce honest reporting by owners, while reducing the transaction costs created by the compensation process. The Article sketches several refinements of and limitations on this mechanism in order to improve its accuracy and prevent both the government and property owners from abusing it.

We demonstrate that, properly used, our self-assessment mechanism can dramatically enhance the efficiency and fairness of eminent domain proceedings, and may even be extended to regulatory takings.

JEL classifications: H29, K10, K11, K41

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INTRODUCTION

Eminent domain is a controversial prerogative. The government's power to take property upon payment of "just compensation" undermines property rights that are considered inviolable in other contexts. As a consequence, an increasingly large number of legal controversies and voluminous scholarly literature concern such questions as how much "public use" is necessary to justify a taking,[1] and when government actions bearing the label "regulation" are, in fact, regulatory takings for which compensation must be paid.[2]

Surprisingly, much less attention has been paid lately to the equally important issues of the amount of compensation that should be paid to condemnees and whether current doctrine actually guarantees "just" compensation.[3] Theorists and practitioners have long recognized two flaws in the compensation mechanism under current law. First, although the constitutional requirement of "just compensation" theoretically requires the payment of compensation for the full value of property to the owner,[4] in practice, current law requires payment of compensation at the market value of the property taken, rather than the true reserve price of the aggrieved owner.[5] Thus, takings law provides inadequate compensation to owners whose reserve value exceeds market price. Second, current compensation practices give rise to high litigation and other transaction costs.

Undercompensation is ubiquitous. Indeed, many important compensation doctrines require courts specifically to ignore many kinds of value lost to owners of taken property, such as consequential damages[6] and goodwill.[7] Courts have adopted restrictive rules such

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[1] *See generally* Thomas W. Merrill, The Economics of Public Use, 72 CORNELL L. REV. 61 (1986); James E. Krier & Christopher Serkin, Public Ruses, Symposium: The Death of Poletown: the Future of Eminent Domain and Urban Development After *County of Wayne v. Hathcock*, 2004 MICH. ST. L. REV. 859, 866 (2004); Jed Rubenfeld, Usings, 102 YALE L.J. 1077 (1993); Lee Anne Fennell, Taking Eminent Domain Apart, 2004 MICH. ST. L. REV. 957.

[2] *See* Abraham Bell & Gideon Parchomovsky, Givings, 111 YALE L.J. 547 (2001); Abraham Bell, Not Just Compensation,13 J. CONTEMP. LEGAL ISSUES 29 (2003)

[3] *Cf.* Christopher Serkin, The Meaning of Value: Assessing Just Compensation for Regulatory Takings, 99 NW. U. L. REV. 677 (2005) (identifying valuation mechanisms for just compensation).

[4] For discussion, see Part I.C., *infra.*

[5] *See, e.g.*, Kimball Laundry Co. v. United States, 338 U.S. 1, 5 (1949) ("[L]oss to the owner of nontransferable values deriving from his unique need for property or idiosyncratic attachment to it, like loss due to an exercise of the police power, is properly treated as part of the burden of common citizenship."); United States v. Miller, 317 U.S. 369, 374 (1943) (explaining that, for practical reasons, "courts early adopted, and have retained, the concept of fair market value" in determining takings compensation); Olson v. United States, 292 U.S. 246, 255 (1934) (stating that just compensation "does not exceed market value fairly determined").

[6] *See infra* Part I.C.1.

[7] *See infra* Part I.C.1.

as the fair market value standard "[b]ecause of serious practical difficulties in assessing the worth an individual places on particular property at a given time."[8] Subjective value is neither observable nor readily ascertainable. If the constitutional standard for "just compensation" required payment at full subjective value, property owners would no doubt exaggerate their self-estimations of the value they place on property and courts would have no reasonable means for reviewing the accuracy of these reports.[9]

The problem of inadequate compensation has not gone unnoticed by courts. Judge Posner wrote in *Coniston Corp. v. Village of Hoffman Estates*[10]:

> Compensation in the constitutional sense is [] not full compensation, for market value is not the value that every owner of property attaches to his property but merely the value that the marginal owner attaches to *his* property. Many owners are "intramarginal" meaning that because of relocation costs, sentimental attachments, or the special suitability of the property for those particular (perhaps idiosyncratic) needs, they value their property at more than its market value….

The inefficiency of the current compensation regime is exacerbated by the high litigation and other transaction costs to which it gives rise. Even with the concession to fair market value as the measuring stick, the current compensation mechanism generates high costs, and considerable efficiency losses.[11] Indeed, recognition of this fact has led some scholars to propose that compensation not be paid for certain small takings,[12] and other to doubt the wisdom of eminent domain power altogether.[13] Observers have pointed to multiple cases in which the strategic use of such costs may permit the government taker to "low-ball" compensation offers.[14] According to media reports, property owners who take the government to court routinely receive much higher compensation awards—often by hundreds of

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[8] United States v. 564.43 Acres of Land, 441 U.S. 506, 511 (1979).
[9] *See* Lee Anne Fennell, Revealing Options, 118 HARV. L. REV. 1399, 1404 (2005) (noting the problem of false valuation statements).
[10] 844 F.2d 461, 464 (7th Cir. 1988).
[11] *See* Patricia Munch, An Economic Analysis of Eminent Domain, 84 J. POL. ECON. 473 (1976), Michael A. Heller & James E. Krier, Deterrence and Distribution in the Law of Takings, 112 HARV. L. REV. 997 (1999)
[12] *See* Heller & Krier, *supra* note 11.
[13] *See* Munch, *supra* note 11.
[14] *See, e.g.*, Dan Browning, MnDOT's Tactics Squeeze Landowners, MINNEAPOLIS STAR TRIBUNE, Sept. 21, 2003, *available at* http://www.startribune.com/stories/462/4109734.html.

percent—than their peers who elected to settle for the government's initial offer. Yet, the higher compensation can only be secured after expensive legal battles.

Importantly, it is difficult to devise a compensation mechanism that would address both problems simultaneously. The more we invest in determining the condemnee's subjective value, the costlier the compensation process. Conversely, compromising the accuracy of the compensation mechanism by eschewing payment for such items as goodwill lowers the cost of the process but only at the price of greater undercompensation of subjective value.[15]

Undercompensation raises both fairness and efficiency concerns. First, it deprives property owners of part of the value of the property taken. Because the fairness rationale for takings' compensation posits that it is wrong to force an individual to bear the costs of benefiting society, an award that falls short of full compensation potentially wrongs the condemnee.[16] Second, undercompensation poses the risk of excessive takings. Government decisionmakers are often thought to be subject to fiscal illusion, meaning that they operate under the misapprehension that actions that impose no cost on the government budget are, in fact, costless.[17] Under this theory, when it takes without compensating the owner for the full loss occasioned by the taking, the government takes too much.[18]

In this Article, we introduce a strikingly simple bargaining mechanism that can dramatically reduce the scope of both problems and importantly does it at a very small cost. At the core of our model lies a self-assessment apparatus that is designed to induce potential condemnees to report accurately the subjective value they place on the property to be taken. Once the property owners name their price, the government can take the property only at that price. However, if the government chooses not to take and pay, the property will become subject to two restrictions. First, for seventy years, the property cannot be sold for less than the self-assessed price. If the property is transferred for less than that price, the owner will have to pay the shortfall to the government.[19] Second, the self-assessed price will become the benchmark for the owner's property tax liability. As we

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[15] By contrast to market value, special subjective value is presumed to be zero absent evidence indicating otherwise.
[16] *See infra* Part I.A.
[17] *See infra* Part I.B.
[18] *See infra* Part I.B.
[19] We thank William Fischel for helping us think through this element of our proposed mechanism. Any flaws in the mechanism, of course, are solely our responsibility.

will show, the dual burdens of partial inalienability and enhanced tax liability should suffice to keep the owner honest in reporting her subjective value.

The self-assessment mechanism provides more accurate compensation for subjective value, while dramatically reducing transaction costs created by the compensatory process. Since owners name their price, they will state a value that is no less than their subjective value, as there is no reason for them to voluntarily part with their property for less than the full subjective value. However, owners will not state a price greater than the subjective value, lest they subject themselves to excessive tax liability and limitations on alienation.[20] Moreover, the mechanism is self-policing and therefore should reduce the costs of assessing and litigating property valuations. By relieving both sides of the need to hire expert assessors and legal counsel and to engage in extensive evidence-collection, our proposal significantly lowers the transaction costs associated with compensation.

A potential peril arising under our model is that it may induce the government to exercise its eminent domain power excessively simply to boost its tax revenues. To alleviate this concern, we complement the basic model with a "decoupling" mechanism that severs the amount paid by the owner for high self-assessed valuations from the amount collected by the government. While the owner will pay based upon her self-assessment, the decoupling mechanism will prevent the government from collecting the higher tax. Instead, taxes on the increment between the value of the property based on tax assessment rolls and the self-assessed value will be payable to recognized charities of the owner's choice.

For example, imagine that the city of Chicago declares its desire to use its power of eminent domain to seize realty owned by Joni Olin for the purpose of building a public university. The realty – a plot known as Blackacre – currently has an assessed value of $200,000 on the city property tax rolls, and a market value of $300,000.[21]

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[20] As we discuss at length in Part II, *infra*, we do not propose a first-best mechanism, and cannot precisely calibrate incentives so as to ensure that all self-assessed values will be identical to subjective value. However, for reasons that we explain *infra*, our mechanism should push owners toward a self-assessment of subjective value.

[21] Perhaps the most famous example of the unmooring of assessed value from market value in property tax assessment may be found in California's Proposition 13 passed in 1978. In addition to freezing assessed property values to 1975 levels, Proposition 13 capped property tax rates at one percent of assessed value, and limited reassessment rates to two percent per year. See PROPERTY TAXATION AND

However, Ms. Olin values Blackacre at $400,000, and she so declares its value for the purposes of the taking. If the city of Chicago abandons its plan to seize Blackacre, Ms. Olin's freedoms with respect to the property will be restricted in two significant ways. First, she will not be able to sell Blackacre for less than $400,000 unless she pays the City of Chicago the difference between this amount and the eventual sale price. Hence, if she sells Blackacre at less than $400,000, she will have to make up any shortfall by making a payment to the city of Chicago. For instance, if she sells Blackacre to Frieda Ford for $310,000 one year later, Ms. Olin will have to pay $90,000 to the city of Chicago. Second, Ms. Olin will have to pay higher taxes on Blackacre for so long as she holds the property. For purposes of simplifying this example, we assume that the taxes will be paid on nominal values.[22] Thus, Ms. Olin will receive a tax bill based upon the self-assessed value of $400,000 rather than the former tax roll assessment of $200,000. Half of Ms. Olin's tax bill will be paid to the municipality (in accordance with the $200,000 originally on the tax roll). The other half (representing the difference between the $400,000 declared value and the original $200,000) will be paid to Ms. Olin's charity of choice – naturally, the Federalist Society.

As the example shows, small adjustments to the self-assessment mechanism may be necessary in order for it to remain effective over time. In our example, we have overlooked the effects of inflation, shocks to the housing markets, and other factors that may require updating the self-assessed price. In the main, we suggest that these factors can be dealt with by pegging the self-assessed price to an appropriate local housing price index. The index would adjust prices both upward and downward, so that homeowners would not be unduly punished for downturns in the market, or unduly rewarded for upticks. Thus, in our example, if during the year following the self-assessment, the local housing price index goes up by 6%, the self-assessed value would similarly be increased by 6%, i.e., from $400,000 to $424,000. Naturally, the index would have to be one measuring similar prices for similar assets in similar locations, in order to truly reflect the market changes on the self-assessed value.

LOCAL GOVERNMENT FINANCE 180 ((Wallace E. Oates ed., 2001). For discussion of the mechanisms of tax assessment in Illinois, including Cook County, see Nina H. Tamburo, The Illinois Property Tax System: An Overview*,* 10 LOY. CONSUMER L. REV. 186 (1998).

[22] Our mechanism actually discounts the additional tax burden in order to take account of the gap between assessed and market value. For further discussion, s*ee infra* Part II.

More importantly, in order to reduce possible distortions introduced by the property tax liability, relative, rather than nominal values should be used. We introduce a mechanism that adjusts tax liabilities to government assessment practices later in the text.[23]

Our proposed mechanism constitutes yet another contribution to the burgeoning law and economics literature on self-assessment. This line of inquiry originated in Saul Levmore's classic article on the possibility of using self-assessment as a mechanism for setting property tax rates.[24] Several years ago, we proposed a self-assessment mechanism for measuring the third party effects of governmental takings—a phenomenon we called "derivative takings."[25] Recently, Lee Anne Fennell suggested the utility of self-priced options in a variety of property contexts such as nuisance control and conservation easements.[26] As we discuss later, while Levmore's mechanism was designed to resolve a different problem (undervaluation of properties for property taxes) than ours (undervaluation of properties for takings compensation), our mechanism owes a heavy intellectual debt to Levmore's work, as well as others examining self-assessment. To date, however, no one has attempted to devise a self-assessment mechanism capable of tackling the nettlesome challenge of ordinary eminent domain compensation, which continues to be the classic example of the limits of self-assessment.[27] It is this void that this Article attempts to fill.

The Article unfolds in four parts. In Part I, we review the reigning theories of compensation and demonstrate why they mandate full and "just" compensation for government takings. This Part examines the theoretical and practical flaws with market-based valuation for takings compensation, and pays particular attention to empirical data verifying the phenomenon of systematic undercompensation. Part II presents our proposal for declaring subjective value. Here we explain the mechanism, and compare it to other proposals for correcting undercompensation, as well as similar self-assessed pricing mechanisms. Part III explores potential drawbacks and limitations, and compares our proposal to alternatives. A brief conclusion follows.

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[23] *See infra* Part II.
[24] Saul Levmore, Self-Assessed Valuation Systems for Tort and Other Law, 68 VA. L. REV. 771 (1982).
[25] Abraham Bell & Gideon Parchomovsky, Takings Reassessed, 87 VA. L. REV. 271 (2001).
[26] *See* Fennell, *supra* note 9.
[27] *See* Fennell, *supra* note 9, at 1419 (invoking eminent domain compensation as a case where self-reporting will fail).

I. WHY JUST COMPENSATION

Eminent domain has long been accepted as an indispensable feature of the sovereign powers of government. However, the immense scope of the government's power to take is not without constitutional limits. The Fifth Amendment of the U.S. Constitution enumerates two independent prerequisites to the exercise of eminent domain. First, the government may only take private property for "public use." Second, the government must always pay "just compensation" in exchange for the taken property.

In practice, the just compensation requirement has proved to be far more important than the public use limitation. As the Supreme Court reaffirmed most recently in Kelo v. City of New London,[28] under federal constitutional law, virtually any governmental action that is otherwise permitted by constitution law will satisfy the public use requirement. Notwithstanding a handful of notable exceptions,[29] federal constitutional law recognizes the states' plenary powers to act in the interests of public health, safety, morals or general welfare.[30] The states' powers in this regard – generally labeled "police powers"[31] – permit the undertaking of such diverse actions as the confiscation and redistribution of private land holdings,[32] and the imposition of comprehensive zoning plans that severely limit the ability to build upon and develop real estate holdings.[33] Importantly, in Hawaii v. Midkiff, the Supreme Court held that "[t]he "public use" requirement [of the Fifth Amendment's Takings Clause] is [] coterminous with the scope of a sovereign's police powers."[34] Thus, it is difficult to conceive of a state action against private property that would lack constitutional justification as being in service of a public use.[35] Federal constitutional law has effectively eliminated the public use limitation on eminent domain.[36]

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[28] 125 S. Ct. 2655 (2005).
[29] Perhaps the most prominent exception is the dormant commerce clause, which prevents states from regulating interstate commercial activities. *See, e.g.*, Cooley v. Board of Wardens, 53 U.S. (12 How.) 299 (1851).
[30] Village of Euclid v. Ambler Realty Co., 272 U.S. 365, 395 (1926).
[31] *See* Randy E. Barnett, The Proper Scope of the Police Power, 79 NOTRE DAME L. REV. 429 (2004).
[32] Hawaii v. Midkiff, 467 U.S. 229 (1984).
[33] *See* Euclid, 272 U.S. at 379.
[34] *See* Midkiff, 467 U.S. at 240.
[35] The police power is the state's regulatory power. D. Benjamin Barros, The Police Power and the Takings Clause, 58 U. MIAMA L. REV. 471 (2004). The courts grant nearly unlimited discretion to the state's regulation of economic affairs. RONALD

Given the limited importance of the "public use" clause, the just compensation requirement remains the only meaningful constitutional safeguard against unlimited use of the eminent domain power. Not surprisingly, the duty to pay just compensation has been analyzed by numerous scholars, and a number of competing theories have been proposed to explain its purpose and scope. Following convention, we divide these theories into two major groupings: fairness-based justifications and efficiency-based justifications.

A. Fairness-Based Justifications

The Supreme Court announced a fairness-based justification for the compensation requirement in *Armstrong v. United States*.[37] Per Justice Black, "[t]he Fifth Amendment's [just compensation] guarantee … was designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."[38] Unfortunately, the Court refrained from elaborating the means by which such fairness could be determined.

Into this void stepped Frank Michelman.[39] Drawing heavily on the work of John Rawls, Michelman suggested that the fair compensation requirement represents the legal regime that the citizenry would have chosen behind a veil of ignorance. Specifically, Michelman argued that the scope of the just compensation requirement is that which the citizenry would choose if it knew of a governmental power of eminent domain in the abstract but did not know how the burden of exercising that power would be distributed among the general public.

Essentially, Michelman assumed that if people had no knowledge of what their future property holdings would be, they would

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ROTUNDA AND JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW-SUBSTANCE AND PROCEDURE § 15.4 (3d ed. 1986).

[36] In state law, public use requirements continue to have some significance. For example, in County of Wayne v. Hathcock, 471 Mich. 415, 684 N. W. 2d 765 (2004), the Supreme Court of Michigan ruled that the use of eminent domain when private parties ultimately acquire the property is permissible only when: (1) there exists a "public necessity of the extreme sort" (highways, railroads, etc.); (2) the public retains continuing oversight authority over the use of the land; or (3) the property is selected based on "facts of independent public significance." *See also* Merrill, *supra* note 1.

[37] 364 U.S. 40 (1960).

[38] *Id.* at 49.

[39] Frank I. Michelman, Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law, 80 HARV. L. REV. 1165 (1967).

nevertheless have a shared notion of an acceptable risk of exposure to eminent domain. Since Michelman developed his view before the important Supreme Court decision in *Penn Central v. City of New York*,[40] it is difficult precisely to map his view onto current doctrine.[41] However, it is clear that Michelman believed that citizens would be willing to accept *some* risk of eminent domain – that is, Michelman's citizenry would not require compensation for every taking. Just as clearly, Michelman believed that citizens would not be willing to leave their property fully exposed to government taking.

Michelman's framework heavily relies on John Rawls' *Justice as Fairness*.[42] Rawls sought to uncover the terms of the hypothetical "social contract" at which rational, self-regarding and interdependent individuals would arrive behind "a veil of ignorance."[43] Rawls further assumed that the actors behind the veil of ignorance have information about the basic structure of society but lack knowledge about their personal traits and status in the real world.[44] Rawls postulated that his thought experiment yields two principles for designing social institutions. The first principle entitles each individual to the maximum liberty compatible with the exercise of a like liberty by others.[45] The second principle (widely known as the "difference principle") sanctions deviations from the first principle so long as the positions subject to the differential treatment are open to everyone, and the unequal treatment yields the greatest advantage for the least well off members of the group.[46]

Applying the two principles in the takings context, Michelman posited that the first prohibits "all efficiency-motivated social undertakings, which have the prima facie effect of impairing 'liberties' unequally, unless corrective measures (compensation

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[40] 438 U.S. 104 (1978).
[41] Some of Michelman's analysis appears to have been incorporated in part by the *Penn Central* court. *Id.* at 128.
[42] 67 PHIL. REV. 164 (1958). John Rawls further elaborate his theory at book-length. JOHN RAWLS, A THEORY OF JUSTICE (1971).
[43] *Id*. at 136-42.
[44] *Id.* .
[45] *Id.* at 60-65.
[46] *Id.* George Klosko notes that "[t]here are differences in Rawls's presentation of the principles between 'Justice as Fairness' and later works. In particular, the second principle in 'Justice as Fairness' is stated in terms of the advantage of everyone, rather than the least advantaged." George Klosko, Rawls's Argument From Political Stability*,* 94 COLUM. L. REV. 1882, 1882 n.4 (1994). It bears emphasis that Michelman's article predated the publication of A THEORY OF JUSTICE, and therefore relied on "Justice As Fairness."

payments) are employed to equalize impacts."[47] The second, however, justifies departures from the rule of full compensation "if it could be shown that some other rule should be expected to work out best for each person insofar as his interests are affected by the social undertakings giving rise to occasions of compensation."[48] Under what circumstances, then, would a "less-than-full-compensation" be fair? In answering this question, Michelman first identified the key parameters that affect the analysis. The first parameter – "settlement costs" – denotes the cost of calculating and paying compensation to aggrieved owners.[49] The second – "demoralization costs" – represents the psychological harm incomplete compensation occasions on condemnees and their sympathizers, and the forgone investment in property across the board that stems from the fear of undercompensatory takings.[50]

A stringent compensation regime invariably entails high settlement costs that would occasionally thwart welfare enhancing projects. Hence, such a regime will in some cases leave everyone worse off, including the least advantageous members of our society. A lax compensation regime, by contrast, will allow efficient developments projects to proceed but only at the cost of imposing a disproportionate portion of the cost on certain members of our society. Hence, a lax compensation regime may generate high demoralization costs. Michelman suggested that compensation should be paid when settlement costs are low, the gains from the government action are dubious and "the harm concentrated on one individual is unusually great."[51] On the other hand, compensation may be denied when property owners who are burdened by the government action also benefit from it or when the burden falls on the shoulders of many people.[52] Although it does not explicitly say this, subsequent commentators interpreted Michelman's analysis as suggesting that government pay compensation when demoralization costs exceed settlement costs but not otherwise.[53]

At the end of the day, Michelman's position appears to be that while not all takings (broadly defined) require the payment of compensation, in those cases where compensation ought to be paid, it must be paid in full. Michelman's analysis strikes a balance among

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[47] Michelman, *supra* note 39, at 1221.
[48] *Id*.
[49] *Id.* at 1214.
[50] *Id*.
[51] *Id*. at 1223.
[52] *Id*.
[53] DAVID A. DANA & THOMAS W. MERRILL, PROPERTY TAKINGS 36 (2002).

the competing interest implicated in takings law by exempting the government from the duty to compensate for many acts that adversely affect property value. But in instances when the duty to compensate *does* arise, property owners should be fully compensated for their losses. The payment of less than full compensation in such cases would seem to violate the demands of fairness.[54]

Margaret Radin developed an alternative framework for evaluating the fairness of takings compensation.[55] Radin based her analysis on her understanding of Freidrich Hegel's personhood theory. Hegel's work highlighted the link between property and the self. To Hegel, property constituted the mechanism by which humans achieve self-actualization. He believed that the human will required material objects to manifest itself and that without them individual freedom could not exist.[56] Building on Hegel's theory, Radin introduced an important distinction between personal and fungible property.[57] She divided the world of objects into two categories: nonfungible and fungible.[58] Nonfungible goods, such as a wedding ring or family home are constitutive of their owners' personality and hence create special value for their owners above and beyond market value.[59] Fungible objects, by contrast, lack uniqueness and serve no purpose in constituting the self.[60] Radin argued that property law should respect the distinction between fungible and nonfungible goods and treat the two differentially.[61]

Accordingly, Radin argued that compensation at market value would often not suffice for the needs of justice. She proposed that owners have the right to injunctive relief, or property rule protection, in cases involving nonfungible goods, while compensatory damages,

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[54] It should be noted that Hanoch Dagan advances a different interpretation of Michelman. Working from a distributive justice perspective but relying heavily on Michelman, Dagan proposes that takings compensation be used a means of wealth redistribution. Specifically, he argues that compensation amounts should be adjusted to the recipient's wealth. On Dagan's proposal, poor condemnees will be entitled to a compensation award greater than the market value of their property, whereas affluent condemnees will receive less than market value. *See* Hanoch Dagan, Takings and Distributive Justice, 85 VA. L. REV. 741 (1999). For criticism, see Glynn S. Lunney, Jr., Takings, Efficiency, and Distributive Justice: A Response to Professor Dagan, 99 MICH. L. REV. 157 (2000).

[55] Margaret J. Radin, Property and Personhood, 34 STAN. L. REV. 957 (1982).

[56] GEORG WILHELM FRIEDRICH HEGEL, PHILOSOPHY OF RIGHT ¶¶39-45 (T. M. Knox trans. 1967) (1821).

[57] Radin, *supra* note 55.

[58] *Id*. at 960.

[59] *Id.*

[60] *Id.* at 986.

[61] *Id.*

or liability rule protection, would be applied to all other cases.[62] Radin explicitly noted that the personality theory would support extending property rule protection to "a special class of property like a family home.[63] And elsewhere, she wrote that compensation at market value "seem[s] quite wrong in cases where property interests are apprehended as personal and incommensurate with money";[64] in such cases paying market value would be insufficient. Hence, the personality theory also rejects compensation at fair market for family homes and other personality laden assets and supports substituting the existing compensation measure for a higher award, or in some cases, a complete ban on the taking.

B. Efficiency-Based Justifications

Efficiency-based justifications for takings compensation are both numerous and controversial. All such justifications hold as a premise that governmental decisions to take property cannot be held *ex ante* to be efficient. As Louis Kaplow has argued, if the government is presumed always to act efficiently, takings compensation is counter-productive because it creates moral hazard; i.e., it encourages owners to build too much, without taking account of the likelihood of government takings.[65] However, once the possibility of inefficient governmental decisionmaking is acknowledged, just compensation plays an important role in encouraging efficient takings.

1. Fiscal Illusion

The most prominent efficiency-based explanation for compensation references fiscal illusion. Fiscal illusion is the presumed habit of government decisionmakers of ignoring costs that do not directly affect government inflows and outflows. When operating under fiscal illusion, a state actor ignores any costs of her action to private property owners resulting from takings, aside from

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[62] *See id.* at 988 ("[T]here would be a nice simplicity in hypothesizing that personal property should be protected by property rules and that fungible property should be protected by liability rules.").

[63] *Id*. at 1005-06. In the alternative, she noted that such a limitation has not developed.

[64] MARGARET JANE RADIN, REINTERPRETING PROPERTY 154 (1993). Radin further notes that "In such cases it may be difficult to decide whether compensatory justice requires higher compensation or whether no compensation should be paid because the problem is outside the scope of compensatory justice." *Id.*

[65] Louis Kaplow, An Economic Analysis of Legal Transitions, 99 HARV. L. REV. 509, 614-17 (1986). *See also*, Lawrence Blume & Perry Shapiro, Compensation for Takings: An Economic Analysis, 72 CAL. L. REV. 569 (1984).

those that appear in the budget (such as lower tax yields). Thus, government actors suffering from fiscal illusion see most of the benefits engendered by uncompensated takings, but few of the costs. Takings without compensation enhance the government coffers by adding property holdings without significant cost.[66] However, when compensation is not paid, most costs are borne by the private property owners. Consequently, if government could take without paying compensation, it would take too much.

The constitutional requirement of just compensation fixes the problem by forcing the government to include private costs in government budgets. Once the budget fully reflects social costs and benefits, fiscal illusion no longer distorts the decisionmaking process.

This can be seen by way of example. Imagine that the state is considering condemning land, currently used for various industrial purposes, in order to build a toll road. The road will produce benefits to the public of $10 million, of which the state will recapture the full amount in tolls. Construction costs for the road are $8 million. In private hands, the land produces $9 million for the industrial owners; consequently, the land is worth $9 million on the open market. By efficiency criteria, the state should not build the road. The road produces only $10 million in benefits, but costs $17 million (i.e., $8 million in construction costs, and $9 million in lost industrial output). However, that is not how the transaction is viewed by a state actor that suffers from fiscal illusion. If the state operates under fiscal illusion, and need not pay takings compensation, it will build the road, because the road produces $10 million of benefits for the state budget, at a cost of only $8 million on-budget. Mandating takings compensation overcomes this problem by forcing the state to take account of the full measure of costs engendered by the project. The fiscal illusion-afflicted state that must pay compensation will take account of $10 million in benefits and $17 million in costs, and make the efficient decision not to produce the road.

To fully overcome the distorting effects of fiscal illusion, takings law must mandate full compensation for losses suffered by the owners of the taken property. If the government need pay only for market value, but not for idiosyncratic or subjective value, the theory of fiscal illusion posits that the government will take too much, since it will ignore subjective and idiosyncratic value destroyed by the taking.

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[66] The important costs for uncompensated takings are administrative costs, and the lost tax revenue from the now-public property.

This can be seen by revising our earlier example. Imagine that the road described above is designated to pass through a private residential area, rather than an industrial area. Once again, anticipated benefits from the road are $10 million, all of which will be recovered by the state through tolls. And, again, construction will cost $8 million. Market price of the residential properties is $1.5 million. However, resident families have lived in the area for generations, and have developed such great sentimental attachment to their homes that they would only sell them at twice the market price, i.e., $3 million. If the government need only pay market value compensation, it will make the inefficient decision to build the road, since it will take account of only $9.5 million in costs against $10 million in benefits. However, if the government must pay full compensation at the value of the property to its current owners, it will make the efficient decision not to build the road, since there is only a $10 million from construction, at a total cost of $12 million.

To be sure, fiscal illusion provides only a partial explanation for the current state of compensation law. Taken to its logical conclusion, the fiscal illusion justification calls for a much more vigorous compensation policy than that currently employed. As we noted in a previous essay, many of the costs occasioned by government takings are indirect, falling upon third parties who suffer losses due to government acts even though their property is not taken directly. Thus, the theory of fiscal illusion calls for full compensation for derivative takings.[67] By the same token, there is no reason to suspect that fiscal illusion afflicts only decisions to effectuate the power of eminent domain (i.e., physical takings). While not subscribing to a theory based upon fiscal illusion, Richard Epstein has observed that government actions affecting private property and wealth are ubiquitous, and certainly extend far beyond traditional exercises of eminent domain.[68] To address concerns of fiscal illusion, the compensation requirement for takings would have to extend to many government actions well beyond ordinary physical and regulatory takings. Moreover, as we wrote in a previous article, since many of the benefits of government takings find no expression in the governmental budget, a theory of fiscal illusion calls for the assessment of charges for benefits conferred by government givings.[69]

[67] Bell & Parchomovsky, *supra* note 25.
[68] RICHARD A. EPSTEIN, TAKINGS: PRIVATE PROPERTY AND THE POWER OF EMINENT DOMAIN 10 (1985).
[69] Bell & Parchomovsky, *supra* note 2, at 585.

None of this, however, suggests that full compensation should not be offered. The gaps in treating the effects of fiscal illusion merely suggest that there are many cases in which takings law is deficient in failing to pay compensation or assess charges. None of the gaps suggests that partial compensation is a preferable rule. On the contrary, absent a more cost-effective means for ensuring efficient takings decisions by the government, the best means for combating fiscal illusion is requiring that the government fully internalize the costs of takings.

2. Moral Hazard

The economic case for the payment of compensation in order to combat fiscal illusion has been countered by commentators argue that economic analysis actually requires not paying any compensation in order to avoid creating moral hazard. Theories of moral hazard posit that where the government insures individuals against economic loss resulting from some kinds of harm, the government incentivizes individuals to engage in excessively risky activities. For example, where the government provides disaster relief funds for properties that are destroyed by floods, it incentivizes private homeowners to build too may houses in flood plains, as they need not take full account of the risk that floods will destroy the homes. Moral hazard arises whenever that the insured actor has the ability to prevent or mitigate the harm by any means, including refraining from engaging in the activity altogether.

In the context of takings compensation, theories of moral hazard suggest that full recompense distorts property owners' incentives. Property owners may over-develop property at risk of government taking, knowing that they will receive compensation for any taking. On the one hand, the owners know that they will enjoy the full upside of any increased value resulting from the development if there is no taking. On the other hand, the owners do not have to worry about recouping development costs if the government seizes the property, because the government will have to pay compensation for the value of the property as developed.

To alleviate the moral hazard created by takings compensation, some commentators have argued for either no compensation, or reduced compensation for takings. Louis Kaplow, incorporating an analysis of eminent domain into a larger study of "transitions" – government policy changes that impose gains and losses on private actors – opined that the optimal amount of takings compensation is none.[70] A similar result was reached by Lawrence Blume, Daniel Rubenfeld and Perry Shapiro, in circumstances where the decision to take is independent of the use to which the property is put.[71] Both studies assumed that government policies are made efficiently and are not affected by fiscal illusion.[72]

However, once these unrealistic assumptions are relaxed, the no-compensation recommendation can no longer be sustained. Blume, Rubenfeld and Shapiro explicitly recognized that a government that is susceptible to fiscal illusion would make inefficient decisions unless it paid full compensation.[73] In other words, any policy of less than full compensation at subjective value (except for the value of inefficient development) will fail to incentivize the government properly.

The problem – a familiar one in such fields as torts and contracts – is how the law can simultaneously incentivize opposing parties who can each mitigate harm. In takings cases, full compensation incentivizes the government not to take recklessly, but encourages property owners to develop recklessly. Incomplete compensation may discourage reckless development, but will lead the government to take too much. In torts, this problem is resolved by creating a negligence standard for at least one of the parties. For instance, to assure that both potential tortfeasors and victims take due care to mitigate possible harms, tort law will often adopt a rule of contributory negligence, barring recovery when the victim negligently contributed to the accident.[74] By exposing the tortfeasor to strict liability or liability based on negligence, and simultaneously barring recovery for a contributorily negligent victim, the law achieves what

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[70] See Kaplow, *supra* note 65, at 614-17 (1986).

[71] Lawrence Blume, Daniel L. Rubinfeld & Perry Shapiro, The Taking of Land: When Should Compensation Be Paid? 99 Q. J. ECON. 71 (1984). Thomas Miceli emphasized the flip side of this observation—excessive development may deter takings where full compensation is required. Thus, a full compensation regime can ensure optimal land use. Thomas J. Miceli, Compensation for the Taking of Land Under Eminent Domain, 147 J. INST. & THEOR. ECON. 354 (1991).

[72] Kaplow, *supra* note 65, at 521; Blume, et al., *supra* note 71, at 81.

[73] Blume, et al., *supra* note 71, at 88.

[74] The economic incentive effects of tort law have been widely analyzed. Among the important works are GUIDO CALABRESI, THE COSTS OF ACCIDENTS (1970); Richard A. Posner, A Theory of Negligence, 1 J. LEGAL STUD. 29 (1972); Prather Brown, Toward an Economic Theory of Liability, 2 J. LEGAL STUD. 323 (1973); Steven Shavell, Strict Liability versus Negligence, 9 J. LEGAL STUD. 1 (1980); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW (1987).

Robert Cooter calls "double responsibility at the margin," or optimal incentives for both parties.[75]

Elsewhere, one of us has suggested a contributory negligence standard for takings compensation that would bar recovery for reckless overdevelopment of property and thereby achieve double responsibility at the margin.[76] Blume, Rubenfeld and Shapiro posited that this result could be achieved by requiring lump sum compensation at an amount approximating full value of the property absent excessive development. In substance, these proposals are identical, albeit under different terminology.[77] Either way, full compensation leads to the most efficient results, so long as compensation is not paid for excessive development.

While current law does not bar recovery for excessive development, the existence of takings blight strongly suggests that this is not a serious problem.[78] Thus, it is difficult to argue that moral hazard presents a strong argument for less-than-full compensation.

3. Public Choice and Interest Group Payoffs

A different efficiency justification – based in the arena of political economy – was advanced Daniel Farber.[79] Like Kaplow, Farber proceeded from an assumption of the efficiency of initial government decisions to take property by eminent domain. However, Farber assumed a more complicated political process, modeled on the insights of public choice theory. In Farber's model, an initial efficient proposal to take property for the benefit of society would not be implemented until approved by a political process ruled by interest groups. Here, Farber posited, efficient takings would be likely

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[75] Robert Cooter, Unity in Tort, Contract, and Property: The Model of Precaution, 73 CAL. L. REV. 1, 4 (1985).
[76] Bell, *supra* note 2, at 48.
[77] Blume, Rubinfeld and Shapiro provocatively write that in an environment of fiscal illusion coupled with moral hazard, "no compensation is suboptimal, *but* so is the payment of full compensation." Blume, et al, *supra* note 71, at 88. This statement is somewhat misleading, as it refers to the inefficiency caused by payment of full compensation inclusive of all development, including reckless overdevelopment. In a separate article, Blume and Shapiro more explicitly suggested that moral hazard could be eliminated by adjusting compensation to eliminate rewards for inefficient development. Blume & Shapiro, *supra* note 65, at 619.
[78] *See infra* Part I.C.2.
[79] Farber's article does not rely solely on the public choice/rent-seeking account presented here; indeed, Farber acknowledged the plausibility of other economic explanations for the compensation requirement. Daniel A. Farber, Economic Analysis and Just Compensation, 12 INT'L REV. L. & ECON. 125, 137 (1992).

blocked absent the payment of compensation. This is due to the probable way government actions based upon eminent domain will distribute costs and benefits. In Farber's view, the usual case involves a small number of affected properties to be taken, with widely spread public benefits. Thus, the owners of properties designated for taking will comprise a well-motivated and small interest group, while the benefiting public will be scattered and poorly motivated (as the benefits for any individual member of the public will be small).[80]

Implicitly relying upon Mancur Olson's theory of the superior political power of minority interest groups,[81] Farber suggested that absent compensation for government takings, targeted property owners will systematically foil societally beneficial government actions in order to block personal loss. Farber argued that compensation combats the power of this powerful property owner interest group by paying it off.[82] Once targeted property owners are mollified by compensation payments, they will remove their objections to socially beneficial projects, and permit them to move forward.

While Farber does not address the question of how much compensation must be paid, it seems clear that the anchor should be full compensation. If targeted property owners are systematically undercompensated, they will be left with a high incentive to lobby against beneficial government projects. The lobby will only be safely neutralized when it is indifferent to the taking, because it has been fully compensated for the loss occasioned by the taking.

C. The Flaws In Market Compensation

Thus far, we have seen that, whether based in explanations of fairness or efficiency, theories of takings compensation mandate full recompense for the taken property at its value to the erstwhile owner. Yet, there are a number of ways in which compensation at market value falls short of this goal of full compensation. In this section, we discuss several types of value excluded from compensation under current doctrine: subjective value, goodwill and "takings blight."[83]

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[80] *Id*. at 133-38.

[81] Mancur Olson, Jr., THE LOGIC OF COLLECTIVE ACTION AND THE THEORY OF GROUPS (1965).

[82] Farber, *supra* note 79, at 125 ("Public choice theory suggests that legislators normally offer compensation to landowners whose property is taken for a project, because they would form a powerful lobby against the project if not 'bought off.'").

[83] As we shall explain in greater detail, below…, we use the term "takings blight" to refer to the difference between the property's market value prior to the

In addition, we look at the adverse effects of transaction costs, particularly litigation costs.

1. Subjective Value and Goodwill

For fungible goods with readily available market substitutes there should be no substantial gap between market value and the subjective value of the owner. However, many types of property do not share this characteristic. For example, perfect substitutes for a family home may rarely be found on the market.[84] For one, location, construction and layouts naturally differ from home to home. In addition, owners often enjoy additional enjoy from unique experiences and memories associated with the homestead.[85] Consequently, when government takes residential property it often wipes out substantial subjective value in excess of market value. Many scholars have recognized the gap between subjective and market value, albeit occasionally under different names.[86] James Krier and Christopher Serkin, for example, note that takings law fails to compensate for the gap between subjective and market values, and label it the consumer surplus.[87]

In addition, as Margaret Radin noted, the gap between subjective and market value may be found not only with respect to residential homes but also in the case of other assets. She uses the example of a wedding band as the paradigm of personal property for which market substitute will not do. Of course, takings of personal property such as wedding bands are so rare by comparison to condemnations of residential homes that we elect to focus on the latter. At the same time, it is important to recognize that not every taking of real estate results in a significant loss of subjective value. For instance, the taking of a nondescript warehouse in an area where similar warehouses may be obtained is unlikely to occasion a loss of excess subjective value.[88]

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government's announcement of its intent to take, and the subsequent lower value at the time compensation is actually set. The difference stems is due to the fact that the announcement in and of itself depresses property values.

[84] Many unique variables come together to form a family's home, and it is difficult or even impossible to replicate all of them in another perfect substitute available on the market.

[85] The value of stable ownership should be distinguished from the "endowment effect," which causes individuals to value goods in their possession more than identical goods in someone else's possession. *See, e.g.*, Richard Thaler, Toward a Positive Theory of Consumer Choice, 1 J. ECON. BEHAV. & ORG. 39, 44 (1980).

[86] *See, e.g.*, Merrill, *supra* note 1; 4-12 NICHOLS ON EMINENT DOMAIN § 12.01.

[87] Krier & Serkin, *supra*, note 1, at 866 .

[88] Of course, warehouses can exhibit some of the same personalized characteristics as a family home, and so may also exhibit increased subjective value.

Finally, even without the likelihood of any idiosyncratic value, sentimental businesses may be harmed by the standard rules of market value compensation. Businesses often have values as going concerns above the summed values of their assets. The gap between the value of the business as a whole and the assets comprising the business is called "goodwill" and it represents the unique value of the business as a going concern.[89] Many states do not compensate for lost goodwill,[90] and, as interpreted by the courts, the constitutional standard of "just compensation" does not require compensation for this head of damages.[91]

2. Takings "Blight"

Generally, compensation is paid for the value of property as of the day it is actually taken, rather than the day on which the taking was announced. Not surprisingly, these values may differ greatly. Businesses will not invest in a new property consequent to the announcement of a taking, as any the value of any built-up goodwill will disappear on the day of the taking. Similarly, purchasers of residential properties looking for a stable long-term home will avoid the area. As Gideon Kanner has noted, the announcement of a pending government taking often results in the precipitous decline of property values in the targeted neighborhood. Many sales are "distress sales," while buyers are limited to those interested in short term uses only.[92] This phenomenon, known as "planning blight" or "condemnation blight," is the result of the impairment of marketability caused by the knowledge that any ownership interest in the property is short-lived.[93]

While three doctrines of takings compensation have been proposed to deal with this lost value, none has provided a complete solution. The first of the three doctrines recognizes the rights of

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[89] 26 AM. JUR. 2d *Eminent Domain* § 306 (2005).

[90] *See, e.g.*, Michigan State Highway Commission v. Gaffield, 108 Mich. App. 88, 310 N.W.2d 281 (1981); City of Dunkirk v. Conti, 186 A.D.2d 1012, 588 N.Y.S.2d 465 (4th Dep't 1992); State v. Rogers, 772 S.W.2d 559 (Tex. App. Amarillo 1989).

[91] *See, e.g.*, U.S. v. 0.88 Acres of Land, 670 F. Supp. 210 (W.D. Mich. 1987); State v. Ensley, 240 Ind. 472, 164 N.E.2d 342 (1960); Williams v. State Highway Commission, 252 N.C. 141, 113 S.E.2d 263 (1960).

[92] Gideon Kanner, Hunting the Snark, Not the Quark: Has the Supreme Court Been Competent in Its Effort to Formulate Coherent Regulatory Takings Law?, 30 URB. LAW 307 (1998).

[93] *See* Robert H. Freilich, Planning Blight: The Anglo-American Experience, 29 URB. LAW. vii, xii (1997). Freilich distinguishes between planning and condemnation blight on the grounds that the latter is caused when "condemnation is inevitable—as opposed to the former, where condemnation is merely a possibility."

aggrieved property owners to compensation for "*de facto* takings." A *de facto* taking occurs whenever the state excessively interferes with property rights without carrying out a declared seizure by eminent domain. The category of *de facto* takings is a broad one, and includes regulatory takings, physical invasions and denial of access.[94] Some courts have extended the concept to include particularly egregious instances of condemnation blight.[95] Many cases, however, have refused to find that a takings declaration amounts to a *de facto* taking, even where the declaration itself leads to loss of property value.[96]

Some states utilize a second doctrine permitting the court to roll back the date of measuring market value to the date that the government declared its intention to confiscate the property.[97] This doctrine produces results very similar to the *de facto* takings doctrine—the *de facto* takings doctrine moves back the date of the recognized taking, while the valuation rollback doctrine moves back the date of the *valuation*, while leaving the recognized takings date in place. However, most states agree that the correct valuation date is the date of the taking, leaving compensation blight uncompensated.[98]

The scope of the project doctrine does not focus on compensation dates; instead, it posits that the state does not have to pay compensation for value created by the government project prompting the taking. Thus, if a government project raises the value of land to be taken for it, the government may discount from the compensation award all increases attributable to the project.[99] The scope of the project rule may also be used by property owner-compensation

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[94] *See* 2A-6 NICHOLS ON EMINENT DOMAIN § 6.01 (2005).

[95] *See, e.g.*, Foster v. City of Detroit, 254 F.Supp. 655 (E.D. Mich. 1966), *aff'd*, 405 F.2d 138 (6th Cir. 1968).

[96] *See, e.g.,* Veillon v Lafayette, 467 So 2d 184 (La App 3d Cir 1985) (mayor's and project agent's declaration to homeowners that their home will be taken in order to facilitate transportation project does not constitute a taking).

[97] Lange v. State, 547 P.2d 282 (Wash. 1976) (valuation must be at an earlier time than the date of the trial to achieve just compensation); City of Buffalo v. J.W. Clement Co., 28 N.Y.2d 241, 257, 321 N.Y.S.2d 345, 355, 269 N.E.2d 895, 905, *reh'g denied*, 29 N.Y.2d 640, 324 N.Y.S.2d 315, 273 N.E.2d 315 (1971), *appeal dismissed*, 31 N.Y.2d 958, 341 N.Y.S2d 104, 293 N.E.2d 252 (1972) (property owner may introduce evidence of "affirmative value-depressing acts" by government agency in order to increase valuation).

[98] *See* 8A-18 NICHOLS ON EMINENT DOMAIN § 18.04 (2005).

[99] *See, e.g.* Almota Farmers Elevator & Warehouse Co. v. United States, 409 U.S. 470, 477-78 (1973) ("Government must pay just compensation [only] for those interests 'probably within the scope of the project from the time the Government was committed to it.'"); United States v. Miller, 317 U.S. 369, 63 S. Ct. 276, 87 L. Ed. 336 (1943); City of Cleveland v. Carcione, 118 Ohio App. 525, 26 Ohio Op. 2d 53, 190 N.E.2d 52, 5 A.L.R.3d 891 (1963).

claimants to support the argument that the owner is entitled to payment for the diminution of value caused by the takings announcement. However, this is not the usual application of the rule.

Most importantly, in Monongahela Nav. Co. v. United States, the United States Supreme Court has ruled that the constitutional requirement of just compensation does not include payment for condemnation blight.[100]

3. Bargaining, Litigation and Transaction Costs

Private property rights activists allege that the undercompensation problem is further exacerbated by the government's superior bargaining position in its negotiations with owners. It is often the practice of the government to try to negotiate a voluntary transfer, prior to resorting to eminent domain. A voluntary settlement is advantageous for the government as it saves the government potential litigation costs as well as negative publicity. Private property rights champions and eminent domain practitioners caution, however, that the settlement amount offered by the government in pre-takings negotiations is much lower than the fair market value and owners who agree to accept it receive lower compensation than their neighbors who refuse the offer, and seek instead legal determination of just compensation. Various anecdotal horror stories about government's abuse of its bargaining power are brought to substantiate this claim.

For example, in a recent eminent domain case from Virginia, the local board of commissioners awarded a farmer approximately 2,000% of the initial government appraisal for his land ($2.4 million instead of $112,000).[101] Similarly, a jury awarded the owner of one of the properties that was condemned for the construction of General Motor's Poletown plant in Detroit almost 1,500% of the initial government offer ($5.1 million instead of $357,000).[102] According to another report, "[f]or years, the Minnesota Department of Transportation has taken private land for road projects and offered the owners substantially less than the land was worth."[103] Occasionally, the Department of Transportation commissioned more than one appraisal and chose to negotiate with property owners based on a low appraisal without disclosing the existence of higher estimates.

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100 Monongahela Nav. Co. v. United States, 148 U.S. 312 (1893).

101 *See* http://www.vafb.com/news/2005/april/042105_1.htm. The case is likely to be appealed.

102 *See* http://www.ackerman-ackerman.com/case2.html.

103 Browning, *supra* note 14.

Property owners complained that these "'low-ball' offers have compelled them to spend thousands of dollars to get their own appraisals, hire attorneys and fight for a fair price for land they didn't even want to sell."[104] For example, one family rejected a $175,000 it had received from the agency, hired an attorney and eventually won an award of $420,000 but the legal battle cost $53,000 in appraisal and attorney fees.[105] Other Minnesotans whose land was condemned complained that the "high cost of fighting forced to settle for less than they deserve" and that even those who ultimately received fair market value "c[a]me out behind, financially."[106] Others stories of low-balling abound. Indeed, the conventional wisdom among eminent domain practitioners is that government will always try to get land on the cheap.

But are these stories representative? Or more importantly, do they really prove the existence of widespread undercompensation? The answer is probably no. There is nothing particularly surprising about the fact that government seeks to get land on the cheap. After all, at least on some accounts, the government's motivation is to pay as little as possible. Evidence that the government often makes low initial offers, however, does not prove that the final amount paid is also low. The initial offer is merely the opening salvo in a long legal battle.

The only empirical study on takings compensation depicts a picture far more nuanced and complicated than various private property rights activists would have us believe. In her study of eminent domain compensation in Chicago, Patricia Munch found that current compensation doctrine leads to both undercompensation, and overcompensation: owners of high-value properties tend to get overcompensated while owners of low-value lots often receive undercompensation.[107] Munch theorized that what accounts for this result is the presence of *symmetric* litigation costs and the inadvertent cross-subsidies of government legal costs.

Like private property owners, the government stands to incur litigation costs when its attempt to secure consensual transfer fails. However, the calculus of private property owners is dramatically different than that of the government. Since each owner has only one lot at stake, her decision about how much to invest in legal representation depends directly on the value of the lot. Owners of

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[104] *Id.*
[105] *Id.*
[106] *Id.*
[107] Munch, *supra* note 11.

high value lots who have a lot at stake have an incentive to hire top legal advisors, while owners of low value lots obtain lower quality legal representation. By contrast, the government engages in numerous legal proceedings, and it has a permanent staff of lawyers on standby. These lawyers are paid a steady salary, and do not receive differential compensation based on the value of the condemned property. Rather, the government pays an optimal amount for its legal staff when averaged over the total expected cost of eminent domain cases, meaning that in any individual case, the government will probably pay too much or too little. In low value cases, the government lawyers are probably overqualified, and the government effectively overpays for legal representation. Conversely, for high value cases, the government lawyers are probably under-qualified, and the government receives inadequate representation. Consequently, the government's legal counsel will likely outperform the owner's counsel for low-value property, while being outperformed by the lawyers of high-value property owners.

Munch found that "as a rough approximation, a $7000 parcel receives about $5000, a $13,000 property breaks even, and a $40,000 parcel may get two or three times its market value."[108] Thus, she characterized eminent domain as "a tax on low-valued and a subsidy on high-valued properties."[109] This distributive result is, to say the least, unattractive.

Although Munch's work fails to support the belief that the government pays sub-market prices due to a superior bargaining position, many states have enacted legislation designed to "restore" the balance between property owners and government. Nearly twenty states offer some kinds of subsidy of condemnees' litigation expenses. Some states leave the subsidies to the court's discretion, and some allow only the payment of certain kinds of expenses, such as expert witness fees.[110] Others, however, require the payment of litigation expenses where the final compensation award substantially exceeds the government's initial offer.[111] No state specifically addresses the distributive problems identified by Munch.

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[108] *Id*. at 488. The estimates are based on a study of land acquisitions by the Chicago Department of Urban Renewal from 1962-1970. *Id.* at 485.
[109] *Id.* at 488.
[110] The laws of at least three other states – Colorado, Minnesota, and New Hampshire – allow condemnees to recover expert fees. See Keller v. Miller, 165 P.774, 776 (Colo. 1917); MINN. STAT. § 117.175(2); NH. REV. STAT. ANN. § 498-A:27, Appeal of the Ribblesdale, Inc., 513 A.2d 360 (N.H.1986).
[111] 16 states have enacted statutes that award full or partial reimbursement for court costs and attorney's fees to private property owners in eminent domain litigation.

II. SELF-ASSESSMENTS AND COMPENSATION

Our discussion thus far has demonstrated two central points. First, as a general rule, fairness and efficiency theories require payment of full compensation at the property owner's value in those cases where compensation is warranted.[112] Second, existing compensation doctrine does not ensure property owners full compensation. In this Part, we propose an alternative compensation mechanism that aligns compensation practice with the demands of efficiency and fairness. In explaining our mechanism, we will highlight its advantages relative to existing compensation doctrine. In addition, we will show how it may be used not only for government declared takings but also in inverse condemnation actions, including those asserting the existence of a regulatory taking. Finally, we will place our proposal within the burgeoning literature on self-assessment and information revealing valuation mechanisms.

A. An Alternative Proposal

Obviously, the payment of full compensation to owners requires knowing the value that owners attach to their property. While the market value component is both observable and verifiable by third parties, the additional surplus enjoyed by the particular owner is generally not. Hence, to compensate owners for their additional surplus the legal system must rely on nonverifiable information supplied by owners. Herein lies the rub. Where the owner's testimony serves as the basis for determining compensation awards,

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Generally speaking, Alaska, Florida, Iowa, Michigan, Montana, Oregon, South Dakota, Washington and Wisconsin mandate such award when the litigation results in a greater award to the condemnee. See ALASKA R. CIV. PRO. 72(k)(3); FLA. STAT. ANN. § 73.092; IOWA CODE § 6B.33; MICH. COMP. LAWS § 213.66(3); MONT. CODE ANN. § 70-30-305; ORE. REV. STAT. § 35.346(7)(a); S.D. CODIFIED LAWS § 21-35-23; WASH. REV. CODE § 8.25.070(1)(b); WIS. STAT. § 32.28(3)(d). It should be noted that most of these states require the compensation awarded by trial to be greater than the relevant government offer by a margin of 10% to 30%. California, Delaware, Idaho, Kansas, Louisiana, Nebraska, New York, Oklahoma, and South Carolina give courts discretion to award court costs and attorney fees to successful condemnees, but do not mandate such action. See CAL. CIV. PRO. CODE §§ 1268.710 & 1268.720; DEL. CODE ANN. tit. 10 § 6111; IDAHO CODE § 7-711A(8); KAN. STAT. § 26-509; LA. REV. STAT. §§ 19:8 & 19:109 (attorney fees only); NEB. REV. STAT. § 76-720; N.Y. EM. DOM. PROC. LAW § 701; OKLA. STAT. tit. 27 § 11(3); S.C. CODE ANN. § 28-2-510(3). Some states in this group also require the final award to exceed the relevant government offer by a certain margin.

[112] It should be clear that the question of which acts of government mandate compensation under the Takings Clause is a complicated one beyond the scope of this paper.

owners have every incentive to exaggerate.[113] It is for this reason that compensation doctrine systematically disregards those components of surplus value that cannot be readily verified, such as subjective value. In a word, then, takings law pays less than full compensation for practical, rather than principled, reasons.

In a classic article, Saul Levmore pointed a way out of this dilemma. Drawing upon the experience of an income tax system that has relied on self-reporting for many years, Levmore noted that sufficient penalties can curb parties' tendency to under-report their taxable income. He then suggested importing the same approach to the context of property taxes by allowing owners to assess their own property value subject to penalties designed to deter underreporting. Specifically, to balance the tendency to underreport and reduce tax liability, Levmore suggested that self-reported value would also serve as the property's sale price. In other words, if the owner of Blackacre reported its value at $100 liability for purposes of property tax liability, anyone could force the owner to part with Blackacre in exchange for $100. Importantly, Levmore included the government in the group of potential purchasers who could force a sale.

Our proposal is in many ways the obverse of Levmore's. While Levmore's main goal was to ensure higher tax revenues to the government, our goal is to guarantee full compensation to property owners. As a result, by contrast to Levmore, the foremost challenge we face is over (rather than under-) reporting. As we will explain later,[114] property tax law and compensation law do not treat assessed property value identically. Consequently, the shift in focus from tax law to eminent domain compensation has important policy ramifications.[115]

In the remainder of this part, we lay out a simple mechanism that would allow property owners to recover the full value they place on their property in cases of eminent domain. Once the government declares its intent to condemn a certain lot, the owner will be asked to report the value she attaches to the property. After the owner submits her report, the government may either seize the property at the declared value or forego its plan to condemn that property. To use finance terminology, under our proposal, the property owner gets to

[113] Fennell, *supra* note 9, at 1419.
[114] *See* Part III.C., *infra*.
[115] In Part II.C., *infra*, we discuss Levmore's proposal in greater detail and highlight many important differences between our proposal and his.

set the strike price for the government option to take.[116] To deter over-reporting two restrictions will be imposed on owners of properties that the government chooses not to take. First, the owners will not be able to transfer the property for less than the self-reported value. Secondly, their property tax liability will be based on the self-reported valuation. However, for reasons we explain shortly, the government will not collect the full amount paid by the owners.

The two limitations we propose warrant further explanation. The first limitation is essentially a partial inalienability restraint. It does not fully bar owners from transferring their property. Rather, it only sets a price floor (at the self-assessed amount) for transfer. Inalienability does not only apply to commercial sales but also to gifts and more generally to all fee simple transfers, in order to avoid fraudulent circumventions of the inalienability restriction. The partial inalienability restraint will remain in force for seventy years,[117] unless the owner transfers the property at the self-assessed price (or higher) in which event the restraint will expire. The owner may overcome the inalienability restraint, however, by paying a redemption fee to the government at the time of an otherwise-forbidden transfer. Where an owner seeks to transfer the property for less than the self-reported value, she may do so if she pays to the government a fee equal to the difference between the sale price and the self-reported value.

The tax restraint is significantly more complicated. Ordinarily, property taxes are set according to a value assessed by a government assessor, and have no connection with other values that might be assigned to the property by other government bodies.[118] We do not propose changing this basic fact. Only when the government indicates its intent to seize a particular parcel will our proposal come

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[116] For a discussion of eminent domain as a call option see IAN AYRES, OPTIONAL LAW 4 (2005).

[117] We suggest a period of seventy years in order to approximate a lifetime of ownership, without making the length of the partial inalienability period depend on the actual owner's age. We avoid an infinite partial inalienability period out of respect for property law's general (and justified) dislike of absolute restraints on alienability. *See, e.g.*, JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 54 (5th ed. 2002). Additionally, we note that due to the effects of discounting future value, a seventy-year restraint will not be significantly less costly to owners than an infinite restraint. We discuss the particular problems raised by elderly owners *infra*, in Part III.A.

[118] *See e.g.,* Clifford H. Goodall & Seth A. Goodall, Property Tax: A Primer and a Modest Proposal for Maine*,* 57 ME. L. REV. 585, 597 (2005) (noting that "[m]odern property tax limits use a variety of techniques, including direct limits on revenue growth, levy limits, and property tax caps that indirectly limit tax revenue growth, as well as limiting growth rates for assessed values). .

into play. Once the property owner has submitted her reported value for purposes of eminent domain, the property tax assessor will have to keep track of two values – the government-assessed value and the surplus, i.e., the amount by which the self-reported value exceeds the government-assessed value. The government-assessed value will continue to serve as the basis of the regular property tax bill. However, there will be an additional property tax assessed on the surplus. This additional property tax will not be paid to the government; instead, the property owner will be free to donate it to a charity of her choice. This can be implemented by simple mechanisms such as a check-off box in the property tax bill.[119] Like the inalienability restraint, the surplus tax liability should end once the property is transferred.

The rate at which the surplus will be taxed can best be explained in two stages. Consider first the possibility of taxing the surplus at its nominal value, at the same rate as the government-assessed value. For example, consider a property with a government-assessed value of $200,000, market value of $250,000, and self-reported value of $300,000. Additionally, assume that the property tax rate is 1% of assessed value. Under this option, the owner would have to pay a tax of $2,000 (1% of the government assessed value of $200,000) to the government, and an additional tax of $1,000 (1% of the surplus of $100,000) to a charity of the owner's choice.

We suggest, however, taxing the surplus at an assessment-adjusted rate, rather than at nominal value. Specifically, rather than pay tax on the full amount of the surplus, the owner should pay tax only on the difference between self-reported value and market value, further discounted to reflect the ratio between assessed and market value. This can best be understood by returning to the previous example. As noted above, the nominal value of the surplus is $100,000 (self-reported value minus government-assessed value), and the tax due would therefore be $1,000 under a nominal surplus tax. However, under our proposal, the taxable amount is based only on the discounted value of the owner premium. Specifically, we first calculate the amount by which the self-reported value exceeds market value — here, $50,000. Next, we calculate the ratio at which government-assessed value is discounted relative to market value — here, the assessed value is 80% of the market value. Finally, the owner premium is discounted by the same amount, in order to arrive at the taxable surplus — here, 80% x $50,000 = $40,000. Thus, under

[119] Our model is the check-off box for presidential election financing on federal tax forms.

the second option, the taxpayer would pay a total property tax bill of $2,400. The first $2,000 represents 1% of the government-assessed value of $200,000 and must be paid to the government. The other $400 represents 1% of the taxable surplus of $40,000, and must be paid to a charity of the owner's choice.

Importantly, the market price used here for calculating the discount is not the market price of the specific property. Rather, the discount is calculated by comparing market prices (determined by sales of similar sized properties) to assessed values throughout the neighborhood. Thus, there is no need to engage in complicated assessments of market price of any individual property. Instead, readily available data can be converted into an average ratio, providing the base for determining the tax discount.

To illustrate how the two restrictions operate, we return to the example of the Introduction, modifying the numbers to accord with the previous example. The city of Chicago has declared its desire to use its power of eminent domain to seize realty owned by Joni Olin for the purpose of building a public university. The Cook County Assessor's office has assessed the value of Blackacre at $200,000 for the purpose of property tax rolls, and the actual market value of the property is $250,000. Ms. Olin values Blackacre at $300,000, and she so reports. If the city takes the property, it will have to pay Ms. Olin the full $300,000. If not, Ms. Olin will retain the property subject to the inalienability and property tax restraints. She will only be able to sell Blackacre for less than $300,000 if she pays the City of Chicago the difference between this amount and the eventual sale price. Second, Ms. Olin will receive a tax bill adjusted for her self-assessed value of $300,000 rather than the former tax roll assessment of $200,000. Ms. Olin's taxable property value will be $240,000, and five-sixths of her tax bill will be paid to the municipality, and the other sixth to Ms. Olin's charity of choice – naturally, the Federalist Society.

If Ms. Olin sells Blackacre to Frieda Ford for $210,000 two years later, Ms. Olin will have to pay $90,000 to the city of Chicago as a redemption fee. This transfer will end both the inalienability and tax restraints.

Both the inalienability and tax restraints will require adjustments in order to remain viable over the course of time. They must be updated yearly for the effects of inflation and fluctuations in the real estate market. We suggest that this could best be accomplished by looking to a local housing price index.

Finally, we should note that while our proposal has been based upon a traditional exercise of eminent domain over land, it can be used in other contexts as well. Self-assessment may be used, for example, for determining compensation for state actions deemed regulatory takings. Specifically, where an owner successfully challenges a government action under an inverse taking suit, the court can consider ordering a self-assessment for determining the amount of compensation to be paid in the event that the government elects to carry out the deemed regulatory taking. The self-assessment would be subject to all the rules outlined here in order to ensure its accuracy as a basis for compensation. Unfortunately, however, it is not possible to extend our self-assessment proposal to takings of personal property unless the property is subject to periodic taxes based upon the property's value.

B. Assessing Self-Assessment

Our proposed mechanism represents an improvement over existing takings compensation doctrine in two important ways. First, it ensures the payment of full compensation to condemnees, and hence brings compensation practice into closer alignment with the demands of efficiency and fairness. Second, it represents a reduction in transaction costs relative to the existing regime. The current regime relies on expensive judicial determination of compensation awards when private negotiations break down. We submit that the administrative process entailed in self-reporting will often arrive at a compensation figure at a lower cost than litigation.

In this Section, we will discuss the incentive structure created by our proposal and delineate its limitations. It is important to note at the outset that while our model does not yield a first best result—compensation at precisely the owner's reserve price[120]—it brings us much closer to accurate compensation at a reasonable administrative cost.[121] Due to the lack of a mechanism that precisely matches the penalties on over-reporting with its rewards, it is very difficult to design a legal apparatus that eliminates altogether undercompensation, on the one hand, and the blocking of efficient takings, on the other.

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[120] This is a first best result if not inclusive of excessive development. *See supra* Part I.B.

[121] *Cf.* Robert Innes, Takings, Compensation, and Equal Treatment for Owners of Developed and Undeveloped Property, 40 J.L. & ECON. 403 (1997) (arguing that first-best results can be reached only by paying compensation equal to the value of the property to the taking authority).

To understand the incentive structure generated by our proposal, it is helpful to start with a simpler scenario: takings compensation on the basis of self-reported values without penalties. In this case, the possibility of an inefficient taking is eliminated, because the owner has no reason to report a value of less than her reserve price. Rather, the property owner's self-report will be based on her best estimation of the value of her lot to the government, so long as it is greater than the reserve price.[122] Because claiming too much runs the risk of forgoing a profit, owners will likely report an amount lower than their actual estimation of the value of the lot for the government.

In the case of land assembly, matters become more complicated. Here, owners will have to take account of two additional factors: the value of the entire project to the government, and the likely behavior of other owners. In order to extract the marginal value of the property to the government, owners will base their self-reporting on the total surplus of the project to the government, adjusted to the likely reports of other owners. In other words, property owners will attempt to maximize their personal payoff subject to the limitation that *all* reports must not exceed the total value of the project to the government.[123] This process is prone to errors and has no stable equilibrium solution, leading to the well-known holdout problem that justifies eminent domain.[124]

The real barrier to efficient outcomes in such a self-reporting scheme is that the parties may make mistakes on account of information and incentive constraints. While the self-report eliminates the possibility that the government will seize a property whose reserve price exceeds the true value to the government, the owner may falsely report a reserve price that exceeds the estimated value to the government. Thus, self-reporting without penalties ensures that no inefficient takings will proceed; however, it does not guarantee that efficient takings will go forward.

Our proposal addresses this problems by, on the one hand, tying compensation to the reserve price of the owner (at least, as reported by the owner), and, on the other hand, penalizing the owner for over-reporting. The result is that the barrier to efficient takings is greatly

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[122] While this might have undesirable distributive effects, it will lead to the optimal number of takings. *See, id*.

[123] This is due to the fact that if the total self-reported amount exceed the government's expected value, the government will forgo the project.

[124] *See generally,* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 62 (5th ed. 1998) (justifying eminent domain as a mechanism for overcoming holdouts); STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 124 (2004) (same).

reduced, while the chance of inefficient takings is lowered significantly.

To begin with, we consider the effect of our proposed penalties on over-reporting values. How does the addition of our two restraints change the reporting incentives of the owners? Self-reporting potentially imposes two additional costs—a higher tax burden, and a partial inalienability restraint which makes property less liquid. The inalienability restraint will never induce owners to report a price lower than their reserve price, for reasons we will explain shortly. However, it will not completely eliminate the possibility that owners will report a price greater than reserve price (and, accidentally, in excess of government value) and thereby block efficient takings. The tax restraint produces a blanket incentive to report smaller values. Notably, this effect on incentives applies even if the reported price is *lower* than the reserve price. At any reported value greater than the market price, even where less than the reserve price, the owner will face a higher property tax bill. However, the discounting of the surplus tax significantly reduces the power of this incentive. The result, we submit, is that owners will be driven to reporting values close to their reserve prices.

We now turn to a more precise examination of the incentive structure created by our proposed penalties. As we have seen, in the absence of penalties, all reporting is strategic, and is designed to capture as much of the government surplus as possible. However, the inalienability restraint places a cost on excess reporting by reducing the ability of the owner to enjoy the full subjective value. Specifically, owners will not be able to translate the subjective value into other assets, unless they sell the property at the reported price. For any lower price, owners will lose part of the value they attach to their property. The inalienability restraint is not important at reported prices lower than the reserve price. After all, owners would not sell their property for less than the reserve price in any event.

The inalienability restraint, on its own, does not provide a sufficient check on owner's predisposition to over-report. First, it is important to realize that not all owners wish to transfer title to their property in the foreseeable future. Owners derive value from their properties in ways other than transfer, for example, through self-use or leasing. Moreover, many owners have no realistic expectation of receiving an offer that would exceed their reserve price and consequently have no expectation of parting with their property. Such owners derive value from their property through possession and use. Second, even for owners who consider transfer, the partial inalienability restraint does not impose a penalty on exaggeration commensurate with the benefit. The benchmark for the gain from exaggeration is still the value the government places on the project, whereas the cost is represented by the expected loss in the case of a future sale. Since the two measures—the government value and the future sale price—bear no necessary relationship to one another, there will be cases where owners will expect to gain much more from exaggerated self-reports than they will lose.

The tax restraint depresses the incentive to self-report prices above market price, and thereby further reduces the incentive to exaggerate. Because the tax burden is discounted, the tax restraint only takes effect when self-reported values are higher than market price. For any increment above market price, the owner should expect to pay the penalty of increased taxes if the government forgoes carries out the taking. Because the tax liability is affected not only by the above-market premium reported, but also by the probability of taking, owners will be particularly careful not to exceed the government's expected value. Naturally, however, owners are unlikely to have very good information about the likelihood of taking and the government's value.

Unfortunately, the tax restraint does not bear any direct relationship to the owner's reserve price. For a self-reported price above reserve price, an owner will have to compare the expected gains of taking compensation above reserve (discounted by the possibility that a taking will not take place) with the expected cost of a tax liability for above-market value (discounted by the possibility that a taking will take place). For a self-reported price below reserve, the owner will have to compare two kinds of costs: the expected cost of subjective value not covered by taking compensation (discounted by the possibility that a taking will not take place) and the expected cost of a tax liability for above-market value (discounted by the possibility that a taking will take place). In either case, the owner's reported value will be based upon estimations of government value and the likelihood of taking, rather than reserve price.

Nevertheless, the tax restraint does leave room for reporting values above market price (allowing recapture of some subjective value). And because its effects are discounted, it does not create excessive pressure to report low values.

Together, the inalienability and tax restraints create an imperfect but definite incentive to report values close to the reserve price. There is no incentive whatsoever to report values lower than the market price. For supra-market, sub-reserve prices, only the tax restraint is important. Finally, for supra-reserve prices, both the tax and inalienability restraints play a role in curbing exaggerations.

Our analysis is summarized in the following table:

Table I: Efficiency of Eminent Domain Under Different Compensation Regimes

	Current Policy	**Self-Reporting without Penalty**	**Self-Reporting with Penalties**
Type I: Inefficient Project Implemented	If reserve price > government value > market price	Will not happen	If reserve price > government value > reported price (RARE – depends on gap between reserve price and assessed price, property tax rates)
Type II: Efficient Project Not Implemented	Only if court exaggerates compensation value or high administrative costs	If reported price > government value > reserve price	If reported price > government value > reserve price (RARE – depends on owner information concerning government price)

Per our earlier discussion, eminent domain may give rise to two types of inefficiencies. First, when owners are undercompensated, exercises of eminent domain may lead to the implementation of inefficient projects. We refer to this possibility as Type I inefficiency. Second, when owners are overcompensated, the need to pay excess compensation may lead the government to cancel efficient development project. We refer to this problem at Type II inefficiency.

Because current compensation regime does not compensate owners for the full value they attach to their properties, it may generate a relatively high number of Type I inefficiencies. In addition, the current compensation regime may also generate Type II inefficiencies—i.e., prevent efficient projects from moving forward—

where, due to judicial error about market value, courts require compensation about the reserve price of condemnees (overcompensation) or where the administrative cost of meting out compensation is prohibitively high.

Self-reporting without penalties eliminates the problem of Type I inefficiencies. Under this regime, owners get to set their own price and will naturally refuse to sell for less than the value they place on their property. However, self-reporting without penalties may lead to a high number of incidents of Type II inefficiencies. Owners may exaggerate in their estimation of the government value, and block execution of the project altogether.

Self-reporting with penalties reintroduces a small number of Type I inefficiencies, while dramatically reducing Type II inefficiencies. Because the potential increase in property tax liability due to the gap between reported value and government assessed value is relatively low, owners will rarely report a value under their reserve price, and thereby risk loss of a portion of subjective value. Conversely, owners will rarely overshoot government value, since the price of exaggerated reports of property value includes an alienability restriction as well as greater tax liabilities.

Finally, we should note the importance of the diversion of surplus tax revenues to a charity of the owner's choice, rather than the government itself. The introduction of heightened tax liability might spur the government to abuse its eminent domain power to boost the tax base. If the government were to collect the full tax amount paid by owners, it would have an incentive to declare eminent domain projects, without really intending to execute them, in order to extract higher property taxes from all the supposedly affected owners. To safeguard against such strategic abuse by the government, we propose that the incremental rise in tax revenues be diverted to another source.

C. The Self-Assessment Literature

Recently, scholarly interest in self-assessment has grown;[125] our proposal is consistent with this trend. The legal literature on self-assessment may be traced back to Levmore's seminal piece on property taxes,[126] which we have already discussed at some length[127] and will continue to analyze here. Inspired by Levmore, in a previous

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[125] *See, e.g.,* Fennel, *supra* note 9; Levmore, *supra note* 24, Bell & Parchomovsky, Takings Reassessed, *supra* note 25.
[126] Levmore, *supra* note 24.
[127] *See, supra* Part II.A.

essay, we proposed a self-assessment mechanism to account for the effect of derivative takings — government acts that do *not* amount to physical or regulatory takings on property values.[128] Most recently, Lee Anne Fennell made an important contribution to the self-assessment literature by proposing self-assessment mechanisms for establishing the value of environmental and zoning amenities.[129] To date, eminent domain compensation has eluded systematic analysis in the self-assessment framework, and while Levmore's article briefly looks at eminent domain, he arrives at it from a different direction, treating the matter as an extension of a basic tax-oriented theory.[130] Indeed, in her article, Lee Anne Fennell lists eminent domain as an example of a paradigmatic self-assessment case that has not yet been resolved.[131]

What is the draw of self-assessment and why is it growing? Disclosure of information through the legal system may often be costly and the outcome of the process may be highly inaccurate.[132] This is especially true in cases where one of the parties is in possession of nonobservable and nonverifiable information from which she can derive great benefit. Since judicial and administrative processes are both expensive and error-prone,[133] the modern trend in legal scholarship is to look for private and quasi-private mechanisms for resolving certain kinds of market failures. [134] Thus, for example,

[128] Bell & Parchomovsky, *supra* note 25.
[129] Fennell, *supra* note 9.
[130] Levmore, *supra* note 24, at 789-90.
[131] Fennell, *supra* note 9, at 1419-20 (using eminent domain as an example where "name your own award" and standard bargaining fail)..
[132] *See e.g.*, Ian Ayres & Eric Talley, Solomonic Bargaining: Dividing a Legal Entitlement To Facilitate Coasean Trade*,* 104 YALE L.J. 1027, 1030 (1995) (pointing out that "self-interested bargainers have a strong incentive to misrepresent their private valuations so as to capture a larger share of the bargaining 'pie'"); Richard R.W. Brooks, The Relative Burden of Determining Property Rules and Liability Rules: Broken Elevators in the Cathedral, 97 NW. U. L. REV. 267, 281 (2002) (discussing how parties' strategic incentives may impede a judge's ability to assess valuations accurately); Joseph Farrell, Information and the Coase Theorem, 1 J. ECON. PERSP. 113, 117 (1987) (explaining that private valuations typically induce actors to lie, "[u]nless everyone shares the same goals,").
[133] *See e.g.,* James E. Krier & Stewart J. Schwab, Property Rules and Liability Rules: The Cathedral in Another Light*,* 70 N.Y.U. L. REV. 440, 452 (1995) (arguing that it will be costly and difficult for courts to assess damages accurately precisely in those situations that private bargaining fails); Louis Kaplow & Steven Shavell, Property Rules Versus Liability Rules: An Economic Analysis, 109 HARV. L. REV. 713, 750-751 (1996) (contending that injunctions poses an even greater assessment challenge for courts).
[134] For an elaborate discussion of possible legal solutions to the problem of private information, *see,* AYRES, *supra* note 116.

Fennell focuses on the difficulties faced by courts in evaluating environmental and zoning amenities.[135]

In the remainder of this subsection, we will highlight the differences between our self-assessment mechanism and other similar mechanisms, especially that of Levmore. Both Levmore and Fennell focus on what Fennell dubbed "Entitlement Subject to Self-Made Options" (ESSMO).[136] This options mechanism requires the entitlement holder to create a call or put option on her entitlement, and thereby subject herself to a forced sale at the predetermined strike price.[137] For example, in discussing the problem of yard art in the context of common interest community, Fennell suggested that each unit owner who displays art works in her yard would be required to set a price at which the community could remove the art work from the yard.[138] In the same vein, to introduce flexibility into conservation easements arrangements, Fennell suggested that the easement holder (the government or a qualifying non governmental organization) would set a "running call option" on the easement, allowing future owners of the relevant tract to "reclaim" the easement.[139] Likewise, Levmore's proposed a property tax system that would require owners to self-assess the value of their properties while allowing others to acquire the property at the reported valuation.[140]

Both Fennel's and Levmore's projects are far more ambitious than ours; both seek not a solution to the local problem of inadequate compensation, but, rather, to change the very nature of entitlements in our legal system. They seek to impose on all entitlement holders the duty to create new options exercisable by third parties.[141] We limit our suggestions to the realm of eminent domain. Thus, we seek to intervene in a case where the government already has a call option on all property exercisable at the government's will as long as the exercise is for a public use. For this reason, we anticipate that our

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[135] Fennell, *supra* note 9, at 1444-87.
[136] Fennell, *supra* note 9, at 1406.
[137] *Id*., at 1407-08.
[138] *Id.*, at 1446-50.
[139] *Id.*, at 1446-50.
[140] Levmore, *supra* note 24, at 779 ("[i]n short, the system uses forced sales, in lieu of audits and fines, as a way of encouraging accurate self-assessment ").
[141] Fennell, *supra* note 9, at 1407 ("[an ESSMO] works by requiring a party to package her true subjective valuation in the form of an option—in other words, she must formulate a 'revealing option.'"); Levmore, *supra* note 24, at 779 (requiring property owner to state a price at which third parties may force them to sell their properties).

proposal may be adopted even by those opposed to revolutionary change in the legal approach to entitlements.

A second difference is that Fennel and Levmore seek to achieve accurate self-assessment by blurring the roles of buyer and seller. Their mechanisms attempt to put the entitlement holder in a position where she does not know whether she is buying or selling the relevant entitlement.[142] The better the mechanism "veils" the role of the entitlement holder, the more effective it is in inducing truthful reporting. Moreover, both Fennel and Levmore assign the function of securing honest self-reporting by entitlement owners to the market or a segment thereof. The sanction both scholars employ to deter inaccurate reporting is forced acquisitions by private actors.[143]

Eminent domain is not amenable to a similar mechanism. In the context of eminent domain, the government is always the "buyer."[144] Our legal system grants the government a call option over private property,[145] and we do not seek to add to this a general put option in property owners that would empower them to sell their property to the government under normal circumstances. Nor do we wish to expand the number of parties that may exercise a call option over the property. Hence, we are forced to use a different mechanism design to induce truthful self-assessment. Instead of using forced sales, we employ a partial inalienability and tax constraints to deter owners from exaggerating.

Since Levmore noted that his mechanism may also be used in the takings context, we would like to further elaborate on the differences between his apparatus and ours. First, because Levmore's main focus is self assessment of value for tax purposes,[146] his scheme is designed primarily to overcome is under-evaluation. We, by contrast, focus on eminent domain and hence the main challenge for us is over-valuation. Indeed, we specifically employ a decoupling mechanism intended to block use of self-assesment to raise property tax revenues.

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[142] *See e.g.,* Ayres & Talley*, supra* note 132, at 1030 ("[D]ivided entitlements can facilitate trade by inducing claim holders to reveal more information than they would under an undivided entitlement regime. Owners of divided, or 'Solomonic' entitlements must bargain more forthrightly than owners of undivided entitlements, because the entitlement division obscures the titular boundary between 'buyer' and 'seller.'").

[143] Fennell, *supra* note 9, at 1407-09; Levmore, *supra* note 24, at 779-80.

[144] *Cf.* Abraham Bell & Gideon Parchomovsky, Pliability Rules, 101 MICH. L. REV. 1, 59-64 (2002) (discussing eminent domain).

[145] *See* AYRES, *supra* note 116, at 4. *Cf.* Bell & Parchomovsky, *supra* note 144.

[146] Levmore, *supra* note 24, at 778-791 (discussing self-assessment in the context of property tax).

Second, and relatedly, the scope of Levmore's project and remedies is vastly different than ours. Levmore would apply his self-assessment mechanism to all property owners, and would allow private takings (forced purchases by other private parties).[147] Our mechanism requires self-assessments only from property owners whose property is subject to condemnation, and allows takings only by the government. Third, and finally, because of our different goals, we use two mechanisms to keep property owners honest: increased tax liability and partial inalienability. Levmore uses a different mechanism altogether: the threat of forced purchases by third parties.[148] Note that the real big difference here is that Levmore's goal is our means, and one of our means is his ultimate goal (increased tax revenues (at a lower cost, of course). As a result, Levmore has neither need nor use for the partial inalienability.

III. EXTENSIONS AND POTENTIAL OBJECTIONS

In this Part, we elaborate on some of the implications of our self-assessment proposal and address potential objections. Specifically, we focus on the challenges posed by using inalienability and property tax valuations to induce accurate reporting in the context of eminent domain, and the cases in which self-assessed prices may prevent the government from realizing its plans.

A. Corner Cases

We begin by examining potential problems with our inalienability restraint. As we noted, the restriction deters owners from overreporting their subjective value lest they be prevented from transferring the property at anything less than an exaggerated price.[149] We also noted that the effectiveness of this restraint would depend on the owners' anticipation of a sale or other transfer during the coming seventy years.[150] However, there are a number of cases in which the owner might have no realistic expectation of sale during her life, such as where the owner is elderly, rendering the inalienability restraint less effective.

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[147] *Id.*

[148] *Id.*, at 779 ("[p]eriodically--perhaps every other year in staggered fashion around a locale--the self-assessed amounts are publicized and any buyer who is willing to pay that amount to the owner/self-assessor is entitled to the property).

[149] *See*, *supra* Part II.A.

[150] *See*, *supra* Part II.A.

In many cases, elderly owners will expect to transfer title only upon their death, through bequest or inheritance. While the partial inalienability restraint will apply to the property in the hands of the heirs or devisees, elderly owners may discount the effects of this restraint as it does not apply directly to them. The result is that the value of the expected sanction imposed by the inalienability restraint will be lower. Hence, such owners may have a greater motivation to overstate their self-assessment price.

While we recognize that elderly owners pose a challenge for our scheme, this challenge should not be overstated. First, the difference between elderly owners and other owners is merely a difference in degree, not in kind. Hence, our scheme should also work in the case of elderly owners. It must be borne in mind that the property tax restraint will apply to elderly owners who fail to sell at their self-assessed price. The increased tax liability will naturally curb the incentive of elderly owners to overstate the value they attach to their properties.

Second, while folk wisdom suggests that elderly owners are likely to hold out against efficient development, this perception may be more of a myth than reality. On average, the cost of eminent domain for elderly owners is higher than it is for other owners. This is because the cost of transition is especially high for elderly owners, meaning the elderly owners likely face higher transaction costs in replacing property. Consequently, compensation at market value, as is the case under current doctrine, disproportionately undercompensates elderly owners, leaving elderly owners with a higher incentive for opposing all projects requiring them to surrender property for market price.

Our proposal, by contrast, guarantees elderly owners full compensation at their subjective value in the event of a taking. In other words, our mechanism alleviates the special plight of elderly owners, and eliminates their motivation to hold out. Hence, it is impossible to predict the behavior of elderly owners under our proposal based on their actions under the existing system.

A different type of owners that seem to pose a challenge for our proposal is corporate owners. Corporate owners do not attach emotional value to their properties and thus, one might argue that corporations should be compensated at market value when their properties are taken. This argument misses the mark. While it may be true that corporations have no sentiments, this does not mean that corporations realize only market value from the property they own. Indeed, the large amounts of goodwill found in corporate balance sheets demonstrate that corporations often enjoy value beyond the market value of their assets. It is possible that a corporation's goodwill grows out of its business operations, not from the unique value it derives from its assets, in which case the taking of an asset will not diminish the corporation's goodwill. Yet, even if corporations derive only market value from their assets, this would not undermine our self-assessment scheme. Given the incentive structure of our self-assessment proposal, we predict that our scheme would reduce litigation and administrative costs, making it a superior way of carrying out takings compensation even at market value.

B. What's Left of Eminent Domain

A broader objection would claim that our proposal essentially eliminates eminent domain. The essence of eminent domain is the ability to force an owner to part with title of an asset, substituting the owner's property rule protection for a liability rule protection.[151] We openly admit that our proposal transforms the nature of eminent domain, restoring in the owner many of the traditional benefits of property rule protection. Does this change do away with all the benefits of eminent domain? The power of eminent domain is necessary to enable the state to provide public goods. Standard economic theory maintains that without eminent domain, the state will not be able to procure the assets necessary for the provision of public goods on account of information asymmetries and strategic holdouts.[152] Eminent domain allows the government to sidestep these strategic difficulties by temporarily altering the nature of the owner's protection to that of a liability rule, thereby empowering the state to force a sale.[153]

Although we do away with the power of the state to force a sale *at market price*, we do not divest the state of its coercive powers. While the state can no longer force a sale at market value, owners only have the ability to name their own price, not to issue a blanket refusal to sell. Moreover, the introduction of the tax and inalienability restraints provides owners with a powerful incentive to report accurately the subjective value they attach to their property. Granted, the power we give to owners to set the price of their properties may in some cases result in a government decision to forego a taking at the self-assessed price. But this should only worry us if the self-assessed

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[151] *See* Bell & Parchomovsky, *supra*, note 144; Fennell, *supra* note 9; Merrill, *supra* note 1.
[152] *See, e.g.,* POSNER, *supra* note 124, at 62.
[153] Bell & Parchomovsky, *supra* note 144.

price is exaggerated. So long as the self-assessed price reflects the subjective value to the owner, we do not want the state to take the property unless its value exceeds the self-assessed price; otherwise, the planned taking is inefficient.

We acknowledge that ours is not a first-best solution. Consequently, under our proposal, owners will, in some cases, exaggerate in their self-assessments. Depending on the magnitude of the exaggeration and the government surplus, exaggerated reports may in some cases thwart efficient development projects. While the inalienability and tax restraints should reduce the magnitude of this efficiency loss, they will not eliminate it completely. However, this inefficiency does not signal the failure of our proposal. Current compensation doctrine is also susceptible to efficiency losses such as where courts set compensation too low, and the government proceeds with inefficient projects. While we lack empirical data to demonstrate the relative sizes of these inefficiencies, we suspect that efficiency losses are greater under the current system than they would be under our proposed alternative.

A case of particular concern for us is that of irrational owners of unique assets. While an irrational owner is of little importance when the asset at issue has ready substitutes and is traded in a functioning market, the irrational owner of a unique good without substitutes presents a nettlesome problem. In such cases, the irrational owner may as well name a price that is outrageously high, placing an inefficient (and irrational) block on a worthy project. This concern may be especially acute in times of national emergency.

To alleviate this concern, an additional safety valve may be added to our proposal. In instances of declared national emergency, the government could be granted the power to petition a court to override the self-assessed valuation and substitute a court determination of the owner's subjective value. For example, this special procedure may be invoked in war time in order to seize a precious mineral necessary for the production of weaponry after the owner dramatically over-assessed the price of the asset.

This procedure may also be employed in other cases involving irrational owners, such as holdouts in large land assembly cases. For example, in land assembly cases involving more than twenty parcels, the government could be permitted to seek a court assessment of the value of holdout parcels if the government obtains 95% of the targeted parcels through voluntary sales or by compensation at the self-assessed price.

C. The Mismatch Between Takings Compensation and Property Tax Assessments

As we noted earlier the main barrier for achieving first best solution (precise assessment at the subjective value) is the lack of functionally opposite counterpart to takings compensation. A truly accurate self-assessment requires that the reported price would serve as both a buying and a selling price.[154] For takings, the self-assessed value serves only as a benchmark for the owner's selling price. While property tax assessments take the place of a buying price in our proposal, the match is imperfect. As we noted, property tax assessments are not based upon a property's "true" value, or even its market value. Rather, property tax assessments are determined through a complex formula that incorporates elements such as last sale price, historic value and location.[155] Only rarely do tax appraisals approximate the true value for the owner.

The mismatch between the two opens up the possibility of strategic misuse of our mechanism by the government. Our proposal enhances the ability of the government to collect property taxes, by changing the property tax base from the traditional assessment formulation to traditional assessment plus some percentage of subjective value. We combat the government's incentive to misuse takings declarations by diverting the additional increment of property taxes to a charitable organization of the owner's choice. While doing this dramatically reduces the government's ability to abuse our mechanism, it does not completely eliminate the potential for abuse. The government may declare its intent to take properties simply in order to raise revenues to charitable organizations.

While the concern about strategic misuse of takings declarations is a real one, we do not believe it is a crucial one. We entrust the choice of charities to the affected owner. Given the wide range of charities, it is hard to see how the government can use our mechanism to target donations to charities on an ideological basis. Since the government has no way of knowing how the additional property taxes will affect optional charitable giving, it cannot even know if, as a whole, charities will enjoy greater donations. Even if the government could be certain of greater charitable revenues, the activities of charities are so diverse that the government could not reliably plan on reducing any line-item in the budget. Hence, it is quite far-fetched to

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[154] *See* Fennell, *supra* note 9, at 1432 ("uncertainty over whether one will end up buying or selling fungible portions of an entitlement helps to keep valuations of that entitlement honest").
[155] *See, supra* Part II.A.

believe that the government would rely on our mechanism as a means for funding charitable activities.

CONCLUSION

Eminent domain is one of the most extreme weapons in the government's arsenal of powers that affect private citizenry. Therefore, it is not surprising that eminent domain has been at the center of many heated debates in the legal academy and outside of it.[156] Dissatisfaction with compensation practices has even led, of late, legal scholars and economists to question the need for this controversial power. For example, in explaining why he believes eminent domain to be undesirable in this day and age,[157] Nobel

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[156] Daniel Farber issued one of the milder summaries of the state of takings law: "there is no consensus today about takings law--only a general belief that the takings problem is difficult and that takings doctrine is a mess." Daniel Farber, Public Choice and Just Compensation, 9 CONST. COMMENT. 279 (1992). Jed Rubinfeld was less charitable, opining that "[t]hroughout constitutional jurisprudence, only the right of privacy can compete seriously with takings law for the doctrine-in-most-desperate-need-of-a-principle prize." Jed Rubenfeld, Usings, 102 YALE L.J. 1077, 1081 (1993). There is no shortage of critics of the jurisprudence of takings. See Gideon Kanner, Hunting the Snark, Not the Quark: Has the Supreme Court Been Competent in Its Effort to Formulate Coherent Regulatory Takings Law?, 30 URB. LAW. 302, 308 (1998) ("The incoherence of the U.S. Supreme Court's output in this field has by now been demonstrated time and again by practitioners and academic commentators ad nauseam, and I refuse to add to the ongoing gratuitous slaughter of trees for the paper consumed in this frustrating and increasingly pointless enterprise.").

[157] Becker believes that through time the costs of the eminent domain power have eclipsed the benefits:

> In the 18th, 19th, and early 20th centuries, governments did rather little, so there was not much to fear from great abuse of the eminent domain constitutional clause. In fact, the first real eminent domain case was not decided until 1876. Now, however, government at all levels do so much that the temptation is irresistible to use eminent domain condemnation proceedings to hasten and cheapen their accumulation of property for various projects, regardless of a projects merits.
> … [U]sually a road can take competing paths, a power plant can be built in different locations, and so forth, so that buyers, government or private, can use the leverage from competition among sites to reduce the advantage of holding out. And sometimes they can build around stubborn holdouts, as happened when the property to build the privately accumulated Rockefeller Center was put together… I am not claiming that a system without eminent domain would work perfectly—it would not. But modern governments have more than enough power through the power to tax and regulate.

laureate Gary Becker wrote, "[t]o me, the only reasonable interpretation of "fair compensation" is the worth of property to the *present owners*.[158]

Becker is not alone. There is little doubt that the current compensation practice, which many perceive as neither fair nor efficient is major contributor to the general dissatisfaction with eminent domain and the calls for its abolition. It is quite likely, therefore, that if property owners received full compensation for the loss occasioned on them by eminent domain exercises, the public sentiment toward eminent domain would have been more favorable.

In this Article, we developed a mechanism that allows policymakers to achieve this goal. Our self-assessment proposal, by allowing property owners to name their compensation award, yields a fairer and more efficient eminent domain regime. Even the sharpest opponents of eminent domain recognize that "[e]liminating the eminent domain clause from the Constitution is obviously not feasible in any foreseeable time frame."[159] In light of this fact, it becomes all the more important to ensure that affected property owners receive full compensation for their losses.

Posting of Gary Becker to The Becker-Posner Blog, On Eminent Domain, http://www.becker-posner-blog.com/archives/2005/06/index.html (June 27, 2005, 7:35 EDT).

[158] *Id.* (emphasis added).

[159] *Id.*