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Taking Compensation Private

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TAKING COMPENSATION PRIVATE

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In light of the expansive interpretation of the "public use" requirement, the payment of "just compensation" remains the only meaningful limit on the government's eminent domain power and, correspondingly, the only safeguard of private property owners' rights against abusive takings. Yet, the current compensation regime is suboptimal. While both efficiency and fairness require paying full compensation for seizures by eminent domain, current law limits the compensation to market value. Despite the virtual consensus about the inadequacy of market compensation, courts adhere to it for a purely practical reason: there is no way to measure the true subjective value of property to its owner. Subjective value is neither observable nor verifiable to third parties and courts cannot rely upon owners' reports of the value they attach to their properties. To date, the challenge of screening truthful from exaggerated evaluation has proven insurmountable.

This Article solves the undercompensation conundrum. It offers a novel self-assessment mechanism that enables the payment of full compensation at subjective value when private property is taken by eminent domain. Under the proposed mechanism, property owners would get to set the price of the property designated for condemnation. The government could then either take the property at the designated price or abstain, leaving the property subject to two new proposed restrictions. First, for the life of the owner, the property could not be sold for less than the self-assessed price, adjusted on the basis of the local housing price index. Second, the self-assessed price—discounted to take account of the peculiarities of property tax assessments—would become the new benchmark for the owner's property tax liability.

This Article shows that under most conditions, these restrictions will induce honest reporting by owners while reducing the transaction costs created by the

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compensation process. The result is a dramatically more efficient law of eminent domain that is also far more respectful of private property rights.

INTRODUCTION

Eminent domain is a controversial prerogative, and an obvious challenge to vital private property rights. It is not surprising, therefore, that this power has sparked a great deal of public interest and scholarly debate. The Takings Clause of the Fifth Amendment places two restrictions on the power of the government to take private property. First, taken property must be put to public use. Second, just compensation must be paid to aggrieved property owners. The public use requirement has gradually been rendered virtually non-existent in light of the Supreme Court's rulings in *Hawaii Housing Authority v. Midkiff* and then in *Kelo v. City of New London* that the public use clause is conterminous with the government police powers.[1] Consequently, "just compensation" remains the only meaningful safeguard of private property rights and the only check on government abuse of its eminent domain power.

It is curious, therefore, that while public use continues to attract scholarly interest, very little attention has been paid as of late to the arguably more important requirement of "just compensation."[2] As it currently stands, the law of eminent domain compensation suffers from two principal flaws. First,

1. Kelo v. City of New London, 545 U.S. 469 (2005); Haw. Hous. Auth. v. Midkiff, 467 U.S. 229 (1984).

2. *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).

although the Takings Clause requires, in principle, the payment of compensation for the full loss occasioned on property owners,[3] in practice, current law settles for the payment of the market value of the property taken—a benchmark that often falls far short of the reserve price of the aggrieved owner.[4] Thus, takings law permits undercompensation whenever the reserve value of the property owner exceeds market price. Second, many important compensation doctrines require courts specifically to ignore different kinds of value lost to owners of taken property, such as goodwill.[5]

The problem of inadequate compensation has not gone unnoticed by courts.[6] Judge Posner wrote in *Coniston Corp. v. Village of Hoffman Estates*:

> 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 their particular (perhaps idiosyncratic) needs, they value their property at more than its market value . . . .[7]

Undercompensation is both unfair and inefficient. It is unfair because it deprives property owners of part of the value of the property taken. As Justice Black famously stated in *Armstrong v. United States*, "The 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."[8] An award that falls short of full compensation potentially wrongs the condemnee.[9] As for efficiency, undercompensation may induce excessive takings because it allows the government to ignore part of the cost it imposes on private property owners through its land use policies. Theorists have pointed out that government decision making is subject to fiscal illusion, which prompts the government to believe that actions that do not affect the budget are, in fact, costless.[10] On this

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3. For discussion generally, see *infra* Part I.

4. *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 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").

5. *See infra* Part II.A.

6. *See also* Curtis J. Berger & Patrick J. Rohan, *The Nassau County Study: An Empirical Look into the Practices of Condemnation*, 67 COLUM. L. REV. 430 (1967).

7. 844 F.2d 461, 464 (7th Cir. 1988).

8. 364 U.S. 40, 49 (1960).

9. *See infra* Part I.A.

10. *See infra* Part I.B.

theory, partial compensation will lead the government to take too much.[11] Additionally, by failing to pay full compensation for its takings, the government incentivizes property owners to oppose potentially societally beneficial projects.[12]

It bears emphasis that eminent domain law has adopted fair market value as the compensation benchmark despite its tension with the goal of full compensation for purely practical reasons—that is, "[b]ecause of serious practical difficulties in assessing the worth an individual places on particular property at a given time . . . ."[13] Subjective value is neither observable nor readily ascertainable by third parties; only the aggrieved property owners know the true value of their property. Yet, courts cannot rely on the testimonies of aggrieved property owners for fear that they would exaggerate the value they place on property in order to increase the compensation they receive. And courts have no reasonable means at their disposal for reviewing the accuracy of owners' self-serving reports.[14]

Moreover, more accurate compensation mechanisms would likely exacerbate the already considerable problems of high litigation and other transaction costs. Aggrieved owners often invest considerable resources in legal battles with the government in an effort to raise compensation awards. Regardless of the ultimate outcome, the negotiations and litigation that attend eminent domain exercises cost time and money both to private property owners and the government. Thus, the current compensation mechanism generates considerable efficiency losses without yielding meaningful offsetting benefits.[15]

Recognizing the inherent inefficiencies of the existing compensation regime, some scholars have proposed that compensation be withheld for certain small takings.[16] Others have doubted the wisdom of eminent domain power altogether.[17]

Indeed, it is difficult to devise a compensation mechanism that would lower transaction costs while simultaneously enhancing accuracy and ending undercompensation. 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

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11. *See infra* Part I.B.
12. *See infra* Part I.C.
13. United States v. 564.54 Acres of Land, 441 U.S. 506, 511 (1979).
14. *See* Lee Anne Fennell, *Revealing Options*, 118 HARV. L. REV. 1399, 1404 (2005) (noting the problem of false valuation statements).
15. *See* Michael A. Heller & James E. Krier, *Deterrence and Distribution in the Law of Takings*, 112 HARV. L. REV. 997 (1999); Patricia Munch, *An Economic Analysis of Eminent Domain*, 84 J. POL. ECON. 473 (1976).
16. *See, e.g.*, Heller & Krier, *supra* note 15.
17. *See, e.g.*, Munch, *supra* note 15.

payment for such items as goodwill lowers the cost of the process but only at the price of greater undercompensation of subjective value.[18]

In this Article, we introduce an innovative bargaining mechanism that can dramatically reduce the scope of both problems, and importantly, does so at a very small cost. At the core of our model lies a self-assessment apparatus that is designed to induce potential condemnees to accurately report the subjective value they place on the property to be taken. The basic version of the mechanism works as follows: at stage I, the government announces its intention to take property by eminent domain. Thereafter, at stage II, affected property owners name the price they want for their properties. Finally, at stage III, the government either proceeds with its plan and seizes the properties at the named price or abandons the proposed taking. If the government decides not to take property at the self-assessed price, the owner will retain title to the properties, but will become subject to two restrictions. First, for the life of the owner, 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 will show, the combined effect of partial inalienability and enhanced tax liability should suffice to keep the owner honest in reporting her subjective value.

To see how the proposed mechanism would work, consider the following example. Imagine that the city of Chicago declares its desire to use its power of eminent domain to seize Blackacre, a property owned by the Epstein family. The property has an assessed value of $200,000 on the city property tax rolls and a market value of $300,000.[20] Assume, however, that the Epstein family values the property at $400,000 and names this amount as the price of realty for the purpose of the taking. If the City of Chicago decides to take the property, it will have to pay the Epsteins $400,000 in compensation. If, however, the city decides to forego the taking, the Epsteins will not be able to sell Blackacre for less than $400,000, and the property tax they have to pay will be based on the same figure.[21]

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18. By contrast to market value, special subjective value is presumed to be zero absent evidence indicating otherwise.

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.

20. 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 1% of assessed value and limited reassessment rates to 2% per year. *See* Arthur O'Sullivan, *Limits on Local Property Taxation: The United States Experience*, *in* PROPERTY TAXATION AND LOCAL GOVERNMENT FINANCE 177, 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).

21. As we explain in Part III.A., *infra*, the model would permit sale of the property if the Epsteins paid the difference between this amount and the eventual sale price. For

The virtues of the self-assessment mechanism are significant. It 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.[22] 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.

The basic model gives rise to one potential peril, however. The government may announce its intent to take properties by eminent domain simply to boost its tax revenues. To keep the government from strategically abusing its power, we complement the basic model with a "decoupling" mechanism that severs the amount paid by the owner for high self-assessed valuations and for redeeming a property's inalienability restriction from the amount collected by the government. We show that with this adjustment and several other refinements to account for the effects of inflation, shocks to the housing markets, and other price changes,[23] our mechanism can be employed in almost all eminent domain cases and furthermore, may be easily extended to cases of regulatory takings.

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 and discusses the parameters that affect owners' reports. Part III explores potential drawbacks and limitations and compares our proposal to alternatives. A brief conclusion follows.

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simplicity's sake, we assume at this point that the taxes will be paid on nominal values.

22. As we discuss in Part III.B., *infra*, we do not claim that our model precisely calibrates incentives nor that it produces first-best results.

23. 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.

I. THEORETIC JUSTIFICATIONS FOR JUST COMPENSATION

Eminent domain has long been accepted as an indispensable feature of the sovereign powers of government. However, the immense scope of this government power is not limitless. The Fifth Amendment of the Constitution provides that government may only take private property for "public use" and must always pay "just compensation" for the taken property.

Over time, the just compensation requirement has proven to be far more important than the public use limitation. As the Supreme Court reaffirmed most recently in *Kelo v. City of New London*,[24] under federal constitutional law, virtually any governmental action that is otherwise permitted by constitutional law will satisfy the public use requirement. Notwithstanding a handful of notable exceptions,[25] federal constitutional law recognizes the states' plenary powers to act in the interests of "the public health, safety, morals, or general welfare."[26] The states' powers in this regard—generally labeled "police powers"[27]—permit the undertaking of such diverse actions as the confiscation and redistribution of private land holdings,[28] and the imposition of comprehensive zoning plans that severely limit the ability to build upon and develop real estate holdings.[29] 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.[30] Federal constitutional law has effectively eliminated the public use limitation on eminent domain.[31]

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24. 545 U.S. 469 (2005).

25. Perhaps the most prominent exception is the dormant commerce clause, which prevents states from regulating interstate commercial activities. *See, e.g.*, Cooley v. Bd. of Wardens, 53 U.S. 299, 319 (1851) ("Now the power to regulate commerce[] embraces a vast field, containing not only many, but exceedingly various subjects, quite unlike in their nature[,] some imperatively demanding a single uniform rule, operating equally on the commerce of the United States in every port . . . . Whatever subjects of this power are in their nature national, or admit only of one uniform system, or plan of regulation, may justly be said to be of such a nature as to require exclusive legislation by Congress.").

26. Vill. of Euclid v. Ambler Realty Co., 272 U.S. 365, 395 (1926) (citations omitted).

27. *See generally* Randy E. Barnett, *The Proper Scope of the Police Power*, 79 NOTRE DAME L. REV. 429 (2004).

28. Haw. Hous. Auth. v. Midkiff, 467 U.S. 229 (1984).

29. *See Euclid*, 272 U.S. at 379-80.

30. The police power is the state's regulatory power. D. Benjamin Barros, *The Police Power and the Takings Clause*, 58 U. MIAMI L. REV. 471, 473 (2004). The courts grant nearly unlimited discretion to the state's regulation of economic affairs. RONALD D. ROTUNDA & JOHN E. NOWAK, TREATISE ON CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE § 15.4 (3d ed. 1999). In the arena of takings, the Supreme Court has ruled that "[t]he 'public use' requirement [of the Fifth Amendment's Takings Clause] is . . . coterminous with the scope of a sovereign's police powers." *Midkiff*, 467 U.S. at 240.

31. In state law, public use requirements continue to have some significance. For example, in *County of Wayne v. Hathcock*, 684 N.W.2d 765 (Mich. 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" (e.g., highways, railroads, etc.); (2) the public retains continuing oversight

Given the decline in importance of the "public use" requirement, the just compensation requirement remains the only meaningful constitutional safeguard against unlimited use of the eminent domain power.[32] 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 three major groupings: fairness-based justifications, efficiency-based justifications, and public choice justifications.

A. *Fairness-Based Justifications*

The Supreme Court announced a fairness-based justification for the compensation requirement in *Armstrong v. United States*.[33] Per Justice Black, fairness in the takings context requires that the cost of takings not be shouldered by a small group of property owners.[34] Unfortunately, the Court refrained from elaborating the means by which such fairness could be determined.

Into this void stepped Frank Michelman.[35] 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.[36]

Essentially, Michelman assumed that if people had no knowledge of what their future property holdings would be, they would 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 Transportation Co. v. City of New York*,[37] it is difficult precisely to map his view onto current doctrine.[38] However, it is clear that Michelman believed that citizens would be willing to accept *some* risk of eminent

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authority over the use of the land; or (3) the property is selected based on "facts of independent public significance," *id.* at 783 (internal quotation marks omitted). *See also* Thomas W. Merrill, *The Economics of Public Use*, 72 CORNELL L. REV. 61 (1986).

32. *See* James Geoffrey Durham, *Efficient Just Compensation as a Limit on Eminent Domain*, 69 MINN. L. REV. 1277, 1278 (1985).

33. 364 U.S. 40 (1960).

34. *Id.* at 49.

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

36. *Id.* at 1221-22.

37. 438 U.S. 104 (1978).

38. Some of Michelman's analysis appears to have been incorporated in part by the *Penn Central* court. *See id.* at 128.

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.[39]

Michelman's framework heavily relies on John Rawls's *Justice as Fairness*.[40] 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."[41] 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.[42] 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.[43] 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.[44]

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 payments) are employed to equalize impacts."[45] 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."[46] 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.[47] 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

39. *Id.* at 1214-24.

40. John Rawls, *Justice as Fairness*, 67 PHIL. REV. 164 (1958). John Rawls further elaborates his theory at book length. *See* JOHN RAWLS, A THEORY OF JUSTICE (1971).

41. RAWLS, *supra* note 40, at 136-42.

42. *Id.* at 136-37.

43. *Id.* at 60.

44. *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*.

45. Michelman, *supra* note 35, at 1221.

46. *Id.*

47. *Id.* at 1214.

stems from the fear of undercompensatory takings.[48] In the background lurk presumed "efficiency gains"—net social gains explored more fully in Michelman's parallel utilitarian analysis.[49]

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 advantaged members of our society. A lax compensation regime, by contrast, will allow efficient development 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."[50] 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.[51]

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 the competing interests 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.[52]

An alternative framework for evaluating the fairness of takings compensation was advanced by Margaret Radin.[53] 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

48. *Id.*

49. *Id.* at 1214-18.

50. *Id.* at 1223.

51. *Id.* Although Michelman does not explicitly say this, subsequent commentators interpreted his analysis as suggesting that government pay compensation when demoralization costs exceed settlement costs but not otherwise. *See* DAVID A. DANA & THOMAS W. MERRILL, PROPERTY TAKINGS 36 (2002).

52. 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 as a means of wealth redistribution. Specifically, he argues that compensation amounts should be adjusted to the recipient's wealth. Under Dagan's proposal, poor condemnees would likely receive greater compensation than richer condemnees. *See* Hanoch Dagan, *Takings and Distributive Justice*, 85 VA. L. REV. 741, 783-95 (1999). For criticism, see Glynn S. Lunney, Jr., *Takings, Efficiency, and Distributive Justice: A Response to Professor Dagan*, 99 MICH. L. REV. 157 (2000).

53. Margaret Jane Radin, *Property and Personhood*, 34 STAN. L. REV. 957 (1982).

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.[54] Building on Hegel's theory, Radin introduced an important distinction between kinds of property.[55] She divided the world of objects into two categories: nonfungible (or "personal") and fungible.[56] Nonfungible goods, such as wedding rings or a family home, are constitutive of their owner's personality and hence create special value for the owner above and beyond market value.[57] Fungible objects, by contrast, lack uniqueness and serve little purpose in constituting the self.[58] Radin argued that property law should respect the distinction between fungible and nonfungible goods and treat the two differently.[59]

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, or liability rule protection, would be applied to all other cases.[60] Radin explicitly noted that the personality theory would support extending property rule protection to "a special class of property like a family home."[61] 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[;]"[62] in such cases paying market value would be insufficient. Hence, the personality theory also rejects compensation at fair market value 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*

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

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54. GEORG WILHELM FRIEDRICH HEGEL, PHILOSOPHY OF RIGHT §§ 39-45 (T.M. Knox trans., Oxford Univ. Press 1967) (1821).

55. Radin, *supra* note 53.

56. *Id.* at 960.

57. *Id.*

58. *See id.* at 986-88.

59. *See id.*

60. *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.").

61. *Id.* at 1005-06. She also observed that such a limitation has not developed. *Id.* at 1006.

62. MARGARET JANE RADIN, REINTERPRETING PROPERTY 154 (1993). Radin further notes, "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.*

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 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.[63] 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 decision making process. 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 surplus subjective value, the theory of fiscal illusion posits that the government will take too much, since it will ignore surplus subjective and idiosyncratic value destroyed by the taking.

The fiscal illusion justification has been challenged by theorists who point out that the payment of full compensation creates a moral hazard problem on the side of property owners. In the context of takings compensation, theories of moral hazard suggest that full recompense distorts property owners' incentives. Property owners may overdevelop 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.[64] A similar result was reached by Lawrence Blume, Daniel L. Rubinfeld, and Perry Shapiro in circumstances where the decision to take is independent of the use to which the property is put.[65] Both

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63. The important costs for uncompensated takings are administrative costs and the lost tax revenue from the now-public property.

64. *See* Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 602 (1986) ("The basic economic framework suggests that, as a matter of economic efficiency, compensation is unwise.").

65. Lawrence Blume et al., *The Taking of Land: When Should Compensation Be Paid?*, 99 Q.J. ECON. 71 (1984). Thomas Miceli emphasized the flip side of this

studies assumed that government policies are made efficiently and are not affected by fiscal illusion.[66]

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.[67] 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.

Elsewhere, one of us has suggested that the tension between providing optimal incentives to the government, on the one hand, and property owners, on the other, may be diffused by introducing a contributory negligence standard for takings compensation that would bar recovery for reckless overdevelopment of property and thereby achieve double responsibility at the margin.[68] A different solution is associated with Blume, Rubenfeld, and Shapiro, who 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.[69] Either way, full compensation leads to the most efficient results, so long as compensation is not paid for excessive development.

In cases where the government may choose from a variety of alternative properties for achieving the same goal or where the government value is very close to the market value, moral hazard is particularly unlikely. As Thomas Miceli noted, in such cases, overinvestment by the owner runs the risk of foiling the taking, leaving the owner with a wasted investment.[70] As Gideon Kanner has noted, the announcement of a pending government taking often

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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. INSTITUTIONAL & THEORETICAL ECON. 354 (1991).

66. Blume et al., *supra* note 65, at 81, 88; Kaplow, *supra* note 64, at 521.

67. Blume et al., *supra* note 65, at 88. Kaplow expressed greater skepticism about the argument but acknowledged that fiscal illusion could change the results of his model. Kaplow, *supra* note 64, at 604-06.

68. Abraham Bell, *Not Just Compensation*, 13 J. CONTEMP. LEGAL ISSUES 29, 48 (2003).

69. Blume, Rubinfeld, and Shapiro provocatively wrote 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 65, 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. Lawrence Blume & Perry Shapiro, *Compensation for Takings: An Economic Analysis*, 72 CAL. L. REV. 569, 619 (1984).

70. Miceli, *supra* note 65, at 362.

results in takings blight, i.e., the precipitous decline of property values in the targeted neighborhood. Thus, while current law does not bar recovery for excessive development, the existence of takings blight strongly suggests that this is not a serious problem.[71] Thus, it is difficult to argue that moral hazard presents a strong argument for less-than-full compensation.

C. *Public Choice and Interest Group Payoffs*

A different justification for compensation, focusing on the arena of politics, was advanced by Daniel Farber.[72] 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 that efficient takings would likely be blocked absent the payment of compensation. This is due to the probable way government actions based on 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 small and well-motivated 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).[73]

Implicitly relying upon Mancur Olson's theory of the superior political power of minority interest groups,[74] 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.[75] Once targeted property owners are mollified by compensation payments, they will remove their objections to socially beneficial projects and permit them to move forward.

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71. *See* Robert H. Freilich, *Planning Blight: The Anglo-American Experience*, 29 URB. LAW. vii, xi-xv (1997).

72. 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); *see also* Timothy J. Brennan & James Boyd, *Political Economy and the Efficiency of Compensation for Takings*, 24 CONTEMP. ECON. POL'Y 188 (2005).

73. Farber, *supra* note 72, at 133-38. Kaplow briefly alludes to this possibility as well. Kaplow, *supra* note 64, at 604-05.

74. MANCUR OLSON, JR., THE LOGIC OF COLLECTIVE ACTION AND THE THEORY OF GROUPS (1965).

75. Farber, *supra* note 72, 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.'").

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 have a strong incentive to lobby against beneficial government projects. The lobby will only be neutralized when it is indifferent to the taking because it has been fully compensated for the loss occasioned by the taking.[76]

II. THE FLAWS IN MARKET COMPENSATION

Thus far, we have discussed the theoretic case for full compensation. In this Part, we shift our attention to the real world and discuss how compensation works in practice. We show that the current compensation regime leads to undercompensation and highlight the types of value excluded from compensation under current doctrine: surplus subjective value, goodwill, and "community premiums." In addition, we look at the adverse effects of transaction costs, particularly litigation costs.

A. *Surplus 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.[77] Location, construction, and layouts naturally differ from home to home. In addition, owners often derive additional enjoyment from unique experiences and memories associated with the homestead.[78] 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.[79] 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.[80]

76. *Cf.* Nicole Stelle Garnett, *The Neglected Political Economy of Eminent Domain*, 105 MICH. L. REV. 101, 110-15 (2006) (noting that uncompensated surplus subjective value probably derailed some proposed Chicago takings, and arguing that too-high compensation will undermine efficient takings).

77. 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.

78. 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).

79. *See, e.g.*, 4 NICHOLS ON EMINENT DOMAIN § 12.01 (3d ed. 2006); Durham, *supra* note 32, at 1292; Lee Anne Fennell, *Taking Eminent Domain Apart*, 2004 MICH. ST. L. REV. 957, 958-59; Garnett, *supra* note 76, 107-110; Merrill, *supra* note 31, at 82-85.

80. James E. Krier & Christopher Serkin, *Public Ruses*, 2004 MICH. ST. L. REV. 859,

Granted, not every taking of property results in a significant loss of surplus 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.[81] However, many takings of property are of nonfungible assets that hold value to the owner in excess of the property's market value and of its nearest market substitutes.

Finally, even putting aside the loss of idiosyncratic sentimental value, 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.[82] Many states do not compensate for lost goodwill,[83] and, as interpreted by the courts, the constitutional standard of "just compensation" does not require compensation for this head of damages.[84]

B. *Community Premiums*

Large-scale projects add an additional dimension of lost subjective value to takings.

Consider the notorious case of *Poletown Neighborhood Council v. City of Detroit*.[85] General Motors sought to build a new automobile manufacturing facility in the residential neighborhood of Poletown in Detroit. At General Motors's behest, Detroit seized over one thousand residential properties, several churches, a hospital, and more than one hundred businesses, destroying the neighborhood in order to make way for the automobile plant.[86] Poletown residents lost not only the value of their residential properties as individual units, but also the attendant community premium that stemmed from the existence of the neighborhood as a whole.[87]

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

82. 26 AM. JUR. 2D *Eminent Domain* § 306 (2005).

83. *See, e.g.*, City of Dunkirk v. Conti, 588 N.Y.S.2d 465 (N.Y. App. Div. 1992); State v. Rogers, 772 S.W.2d 559 (Tex. App. 1989); Mich. State Highway Comm'n v. Gaffield, 310 N.W.2d 281 (Mich. Ct. App. 1981).

84. *See, e.g.*, United States v. 0.88 Acres of Land, 670 F. Supp. 210 (W.D. Mich. 1987); State v. Ensley, 164 N.E.2d 342 (Ind. 1960); Williams v. State Highway Comm'n, 113 S.E.2d 263 (N.C. 1960).

85. 304 N.W.2d 455 (Mich. 1981).

86. *See* Ilya Somin, *Overcoming* Poletown*:* County of Wayne v. Hathcock*, Economic Development Takings, and the Future of Public Use*, 2004 MICH. ST. L. REV. 1005; Ilya Somin, *Michigan Should Alter Property Grab Rules*, DETROIT NEWS, Jan. 8, 2004, at 11A.

87. *Cf.* Garnett, *supra* note 76; Gideon Parchomovsky & Peter Siegelman, *Selling Mayberry: Communities and Individuals in Law and Economics*, 92 CAL. L. REV. 75, 139-41 (2004).

The property owner's enjoyment of part of the community premium is a potentially important component of subjective value not reflected in the market value of an individual property. However, current takings doctrine does not offer any compensation for the loss of the community premium.

C. *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.[88] 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 pretakings 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 in Virginia, the local board of commissioners awarded a farmer approximately 2000% of the initial government appraisal for his land ($2.4 million instead of $112,000).[89] Similarly, a jury awarded the owner of one of the properties that was condemned for the construction of General Motors's Poletown plant in Detroit almost 1500% of the initial government offer ($5.1 million instead of $357,000).[90] According to another report, "For years, the Minnesota Department of Transportation has taken private land for road projects and offered the owners substantially less than the land was worth."[91] 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. 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."[92] For example, one family rejected a $175,000 offer it had received from the agency, hired an attorney, and eventually won an

88. *See* Berger & Rohan, *supra* note 6, at 440-42.

89. *See* Press Release, Va. Farm Bureau Fed'n, Farmer Wins Compensation in Eminent Domain Case (Apr. 21, 2005), *available at* http://www.vafb.com/news/2005/april/042105_1.htm.

90. *See* Ackerman Ackerman & Dynkowski, Case Study: General Motors Poletown Plant, http://www.ackerman-ackerman.com/case.php?case=poletown.

91. Dan Browning, *MnDOT's Tactics Squeeze Landowners*, MINNEAPOLIS STAR TRIB., Sept. 21, 2003, at 1A.

92. *Id.*

award of $420,000; but the legal battle cost $53,000 in appraisal and attorney fees.[93] Other Minnesotans whose land was condemned complained that the "high cost of fighting has forced many of them to settle for less than they deserve" and that even those who ultimately received fair market value "c[a]me out behind, financially."[94] Other 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? One of the few empirical studies on the subject found widespread and intentional undercompensation in takings settlements. The Nassau County Study,[95] a 1967 examination of takings compensation in Nassau County, New York, provides an in-depth look at the compensation practices of that county from 1960 to 1964. Organized by Curtis J. Berger and Patrick J. Rohan, the study covers over 2409 parcels of land which were subject to either total or partial takings over that five-year span.[96] Berger and Rohan noted that the County would hire "fixed-fee" appraisers to measure the value of the condemned land, and the appraisers were paid a flat fee for the amount of land to be taken, regardless of the complexity of the appraisal. The result was a surfeit of appraisals based on a "single, unsubstantiated opinion as to value" and high likelihood of error in assessing the value of land.[97] In some more complicated cases, a second, higher-paid appraiser would be contracted. Only about half of these second appraisals came within ten percent of the value of the first appraisal, further undercutting confidence in the fixed-fee appraiser's declaration.[98]

Risk-averse owners would therefore prefer to settle for sub-market compensation in order to avoid the risk of adverse errors in the appraisal process. And, indeed, Berger and Rohan showed that 85.7% of completed takings in their study were finalized by a settlement agreement,[99] 88.3% of the settlements resulted in the claimants receiving less than the County's mean appraisal for their land, and 29.3% of claimants received less than 70% of the mean appraised value.[100]

However, another empirical study depicts a far more complicated picture. In her study of eminent domain compensation in Chicago, Patricia Munch Danzon 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 get

93. *Id.*
94. *Id.*
95. Berger & Rohan, *supra* note 6.
96. *Id.* at 435.
97. *Id.* at 439.
98. *Id.* at 439-40.
99. *Id.* at 440.
100. *Id.* at 442.

undercompensated.[101] Danzon theorized that what accounts for this result is the presence of *symmetric* litigation costs and the inadvertent cross-subsidies of government legal costs.[102]

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 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 underqualified, 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.

Danzon found that "[a]s 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."[103] Thus, she characterized eminent domain as "a tax on low-valued and a subsidy on high-valued properties."[104] This distributive result is, to say the least, unattractive.

Although Danzon's work fails to support the belief that the government pays submarket prices due to a superior bargaining position, the inexactness of market appraisal almost certainly does lead to suboptimal compensation. There can be little doubt that, as Thomas Merrill has written, "the concept of fair market value is essentially a fiction in the context of takings of property," given the absence of thick markets in which to measure value accurately.[105]

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101. Munch, *supra* note 15. Throughout this Article, we refer to Munch by her current last name, Danzon, rather than her maiden name.

102. *Id.* at 482-84.

103. *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.

104. *Id.* at 488.

105. Thomas W. Merrill, *Incomplete Compensation for Takings*, 11 N.Y.U. ENVTL. L.J. 110, 116 (2002). Merrill adds that "value is fixed based on an opinion or educated guess about what the negotiated price of the property would have been if, contrary to fact, the owner had sought to sell it and a willing buyer had sought to buy it on the day of the taking . . . using various valuation techniques similar to those used in appraising property in other

Many states have enacted legislation designed to "restore" the balance between property owners and government. As Nicole Garnett has noted, nearly twenty states offer some kind of subsidy for condemnees' litigation expenses.[106] Some states leave the subsidies to the courts' discretion, and some allow only the payment of certain kinds of expenses, such as expert witness fees.[107] Others, moreover, require the payment of litigation expenses where the final compensation award substantially exceeds the government's initial offer.[108] No state specifically addresses the distributive problems identified by Danzon.

III. A SELF-ASSESSMENT MODEL OF EMINENT DOMAIN 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.[109] 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

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non-market contexts . . . ." *Id.* at 116-17.

106. Garnett, *supra* note 76, 129 & n.175.

107. The laws of at least three other states—Colorado, Minnesota, and New Hampshire—allow condemnees to recover expert fees. *See* MINN. STAT. § 117.175(2) (2007); N.H. REV. STAT. ANN. § 498-A:27 (2007); *In re* Ribblesdale, Inc., 513 A.2d 360, 360 (N.H. 1986); Keller v. Miller, 63 Colo. 304, 313-14 (1917).

108. Sixteen 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. Generally speaking, Alaska, California, Florida, Iowa, Michigan, Montana, Oregon, South Dakota, Washington, and Wisconsin mandate such awards when the litigation results in a greater award to the condemnee. *See* ALASKA R. CIV. PRO. 72(k)(3) (2007); CAL. CIV. PROC. CODE §§ 1268.710, 1268.720 (2007); FLA. STAT. ANN. § 73.092(1) (2007); IOWA CODE § 6B.33 (2007); MICH. COMP. LAWS ANN. § 213.66(3) (2007); MONT. CODE ANN. § 70-30-305(2) (2007); OR. REV. STAT. § 35.346(7)(a) (2007); S.D. CODIFIED LAWS § 21-35-23 (2007); WASH. REV. CODE § 8.25.070(1)(b) (2007); WIS. STAT. § 32.28(3)(d) (2007). It should be noted that most of these states require the compensation awarded at trial to be greater than the relevant government offer by a margin of 10% to 30%. 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* DEL. CODE ANN. tit. 10, § 6111(3) (2007); IDAHO CODE ANN. § 7-711A(8) (2007); KAN. STAT. ANN. § 26-509 (2007); LA. REV. STAT. ANN. §§ 19:8 & 19:109 (2007) (attorney's fees only); NEB. REV. STAT. § 76-720 (2007); N.Y. EM. DOM. PROC. LAW § 701 (2007); OKLA. STAT. tit. 27, § 11(3) (2007); S.C. CODE ANN. § 28-2-510(b) (2007). Some states in this group also require the final award to exceed the relevant government offer by a certain margin.

109. 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.

inverse condemnation actions, including those asserting the existence of a regulatory taking.

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 unverifiable information supplied by owners. Herein lies the rub. Where the owner's testimony serves as the basis for determining compensation awards, the owner has every incentive to exaggerate.[110] It is for this reason that compensation doctrine systematically disregards those components of surplus value that cannot be readily verified, such as surplus subjective value. In short, 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.[111] 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' tendencies to underreport 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 under-reporting. 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.[112] In other words, if the owner of Blackacre reported its value as $100 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.[113]

A handful of other scholars have also examined the possibility of using self-assessment to discover subjective value and have proposed other mechanisms for ensuring truthfulness. Peter Colwell suggested a scheme similar to Levmore's.[114] Lee Anne Fennell, by contrast, recommended permitting owners to declare a subjective value of up to 200% of market value; however, once the declarations were made, owners could no longer challenge a

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110. Fennell, *supra* note 14, at 1419.

111. Saul Levmore, *Self-Assessed Valuation Systems for Tort and Other Law*, 68 VA. L. REV. 771 (1982).

112. *Id.* at 779.

113. *Id.* at 789.

114. Peter F. Colwell, *Privatization of Assessment, Zoning, and Eminent Domain*, ORER LETTER (Office of Real Estate Research at the Univ. of Ill. at Urbana-Champaign, Urbana-Champaign, Ill.), Spring 1990, at 1.

proposed taking for lack of "public use."[115] Economists have proposed a number of additional reserve price-revelation mechanisms of general application.[116]

Our proposal is closest to Levmore's, though it is in many ways the obverse. 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, in contrast to Levmore, the foremost challenge we face is over- (rather than under-) reporting. As we will explain later, 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.

Our mechanism tracks the eminent domain process and hence may be divided into three time periods. In the first time period, the government declares its intent to condemn a certain lot or set of lots.[117] Once such a declaration is made, the owner is 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 set the strike price for the government option to take.[118] The third time period follows the government decision. If the government declines to take the property, two restrictions will be imposed on the property owners. First, the owners will not be able to transfer the property for less than the self-reported value. Second, 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

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115. *See* Fennell, *supra* note 79, at 995-1002. Fennell would add a tax rebate to encourage owners to voluntarily declare a value and expose their property to taking.

116. The economic literature on mechanisms for revealing reserve prices for public goods is extensive and important, albeit little applied in the real world and of surprisingly little impact in the legal academy. *See, e.g.*, Edward H. Clarke, *Multipart Pricing of Public Goods*, 11 PUB. CHOICE 17 (1971); Theodore Groves & Martin Loeb, *Incentives and Public Inputs*, 4 J. PUB. ECON. 211 (1975); Theodore Groves & John Ledyard, *Optimal Allocation of Public Goods: A Solution to the "Free Rider" Problem*, 45 ECONOMETRICA 783 (1977); T. Nicolaus Tideman & Gordon Tullock, *A New and Superior Process for Making Social Choices*, 84 J. POL. ECON. 1145 (1976); Peter J. Hammond, *Symposium on Incentive Compatibility*, 46 REV. ECON. STUD. 181 (1979). The Nobel Prize-winning work of William Vickrey, which discussed general reserve price revelation in auctions, laid the foundation for Groves's and Clarke's advances, and deserves particular note. *See* William Vickrey, *Counterspeculation, Auctions, and Competitive Sealed Tenders*, 16 J. FIN. 8 (1961).

117. To reduce the possibility of strategic overreporting, the government should register its intent to take all plots for any given project simultaneously.

118. For a discussion of eminent domain as a call option, see IAN AYRES, OPTIONAL LAW: THE STRUCTURE OF LEGAL ENTITLEMENTS 4 (2005).

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 the life of the owner,[119] unless the owner transfers the property, in which event the restraint will expire. If the owner wants to transfer the property at less than the self-assessed amount, she may overcome the inalienability restraint 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 the government a fee equal to the difference between the sale price and the self-reported value.

The tax restraint is 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.[120] We do not propose changing this basic fact. Only when the government indicates its intent to seize a particular parcel will our proposal come 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, that is, 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.

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's tax liability will be $3000.

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

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119. 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 lifetime restraint will often not be significantly less costly to owners than an infinite restraint. We discuss the particular problems raised by elderly owners in *infra* Part IV.B.

120. *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) ("Modern 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.").

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 $1000 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 the second option, the taxpayer would pay a total property tax bill of $2400.

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 Professor Richard Epstein 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. Professor Epstein values Blackacre at $300,000, and he so reports. If the city takes the property, it will have to pay Epstein the full $300,000. If not, Epstein will retain the property subject to the inalienability and property tax restraints. He will only be able to sell Blackacre for less than $300,000 if he pays the City of Chicago the difference between this amount and the eventual sale price. Second, Epstein will receive a tax bill adjusted for his self-assessed value of $300,000 rather than the former tax roll assessment of $200,000. Professor Epstein's taxable property value will be $240,000, and five-sixths of his tax bill will be paid to the municipality, and the other sixth to Professor Epstein's charity of choice—naturally, the Federalist Society.[121]

If Professor Epstein sells Blackacre to Professor Cass Sunstein for $210,000 two years later, he 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.

Additionally, the inalienability restraint will need to take a broad view of what is considered a "transfer" in order to prevent circumvention of the restraint through creative assignment of rights without full transfer of ownership (as in, for example, the creation of a long-term lease). Restricted

121. As we explain in Part IV.A, *infra*, the surplus tax assessment should go to charity rather than to the government.

transfers should include subsets of ownership rights and even some financing mechanisms such as mortgaging.

Finally, it bears emphasis 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.[122] Unfortunately, however, it is not possible to extend our self-assessment proposal to takings of personal property (or real property owned by tax-exempt organizations) 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, by contrast, relies on expensive judicial determination of compensation awards when private negotiations break down.

In this Subpart, 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[123]—it brings us much closer to accurate compensation at a reasonable administrative cost.[124] Due to the lack of a mechanism that perfectly matches the penalties on overreporting with its rewards, it is very difficult to design a legal apparatus that eliminates altogether

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122. There are limits to the ability to implement our system of self-assessment in cases of implied takings. If there is no ability to exclude individual properties from a regulatory system or from the spillover effects of a physical or regulatory taking, the government cannot rely on self-assessment to create an accurate benchmark for determining subjective value. Thus, compensation for some kinds of regulatory takings and most derivative takings would have to be determined by market values or some other system. *See* Abraham Bell & Gideon Parchomovsky, *Takings Reassessed*, 87 VA. L. REV. 277 (2001).

123. This is a first-best result if not inclusive of excessive development. *See supra* Part I.B.

124. *Cf.* Benjamin E. Hermalin, *An Economic Analysis of Takings*, 11 J.L. ECON. & ORG. 64, 70-71 (1995) (arguing that first-best results can be reached by paying compensation equal to the value of the property to the taking authority); Robert Innes, *Takings, Compensation, and Equal Treatment for Owners of Developed and Undeveloped Property*, 40 J.L. & ECON. 403, 413-14 (1997) (noting the same point).

undercompensation, on the one hand, and the blocking of efficient takings, on the other.

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, no inefficient taking will occur because the owner has no reason to report a value lower than her reserve price; but certain efficient takings will be thwarted. Since the owner faces no penalty for exaggerating, her 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.[125] 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 surplus 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.[126] This process is prone to errors and has no stable equilibrium solution, leading to the well-known holdout problem that justifies eminent domain.[127]

The real barrier to efficient outcomes under 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.[128]

Enter the two penalties we propose. The introduction of penalties greatly increases the chance that efficient takings will be carried out by changing the reporting incentives of property owners. Self-reporting potentially imposes two additional costs—a higher tax burden and a partial inalienability restraint which

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125. While this might have undesirable distributive effects, it will lead to the optimal number of takings.

126. This is due to the fact that if the total self-reported amount exceeds the government's expected value, the government will forgo the project.

127. *See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 62 (6th ed. 2003) (justifying eminent domain as a mechanism for overcoming holdouts); STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 124 (2004) (arguing the same point).

128. If the owner reports a price in excess of the true reserve price but less than the value to the government, the government will still choose to take, leading to an efficient assignment of the property. The owner will, however, successfully appropriate a share of the government surplus.

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 lower 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.

Issues of timing at the outset of the takings process will be important to the accuracy of the incentives. The government must issue all proposals for takings for a given project simultaneously, with simultaneous deadlines for self-reported values. If the government staggers the reports, owners will be able to report strategically, based on other owner reports, in order to try to capture all of the government surplus.

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 making the property more illiquid, thereby reducing the ability of the owner to enjoy the full subjective value. Specifically, owners will not be able to translate the surplus 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. However, since owners would generally not sell their property for less than the reserve price, the inalienability restraint does not create a substantial risk of reporting a price lower than reserve value. Unfortunately, the inalienability restraint, on its own, does not provide a sufficient check on owner's predisposition to overreport. First, not all owners wish to transfer title to their property in the foreseeable future. Some 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 carrying 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 their estimation of the government's expected value. Naturally, however, owners are unlikely to have very good information about the likelihood of a taking and the government's value.

Alas, 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 Table 1.

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 projects. We refer to this as Type II inefficiency.[129]

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129. It should be noted that Type II inefficiencies can also occur from

Table 1. Efficiency of Eminent Domain Under Different Compensation Regimes

	Current Policy	Self-Reporting Without Penalty	Self-Reporting with Penalties (Our Proposal)
Type I: Inefficient Project Implemented	Possible[130]	Impossible[131]	Possible but rare[132]
Type II: Efficient Project *Not* Implemented	Possible but rare[133]	Common[134]	Possible but rare[135]

Because the 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 above 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 Type

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undercompensation if those to be undercompensated are politically powerful enough to block an efficient project. *See supra* Part I.C. In this Part, and in Table 1, we limit our analysis to inefficiencies caused by the direct financial costs of projects percieved by government actors.

130. Under the current regime, Type I inefficiency will occur when the government's value is higher than the market value but lower than the owner's reserve price.

131. Under a regime of self-reporting without penalty, no Type I inefficiencies will occur because the owner's report will never fall below her reserve price.

132. Our proposal admits of Type I inefficiency because property taxes are ordinarily not based on reserve prices. Consequently, the tax penalty may cause owners to report values lower than their reserve price, leaving open the possibility that the value to the government will exceed the reported price but be lower than the reserve price.

133. Under the current regime, Type II inefficiencies may occur if courts overcompensate condemnees, i.e., when courts award damages that—together with the market price—exceed the value of the property for the government.

134. A regime of self-reporting without penalty may often give rise to Type II inefficiencies since property owners operating under this regime will try to appropriate as much of the government surplus as possible. Type II inefficiencies will occur whenever the owners who operate under conditions of imperfect information overestimate the government surplus from the project or overestimate their ability to extract shares of that surplus relative to other owners.

135. Our proposal admits of Type II inefficiency only in the case where the reported price is greater than both the owner's reserve price and the government value. Such cases will be rare but may nevertheless happen if the owner believes that the government project will be implemented irrespective of the price she reports.

II inefficiencies. Owners may exaggerate their estimation of the government value and block execution of the project altogether.

With a small refinement, we introduce below, self-reporting with penalties can eliminate all Type I inefficiencies, while dramatically reducing Type II inefficiencies. To eliminate all Type I inefficiency, our proposed system of self-reporting should incorporate one small refinement: as far as tax liability is concerned, self-reporting owners will not be able to reduce their liability below what they paid prior to the self-assessment. In other words, the tax amount paid by owners prior to the self-assessment will serve as a floor for their new tax liability. This means that under no circumstances, will self-reporting owners be able to lower their property tax payments—relative to the preexisting situation—by submitting excessively low reports. This simple refinement prevents owners who do not plan to part company with their properties from taking advantage of our proposed mechanism to minimize their property taxes. With this refinement, our proposal only admits of Type II inefficiencies. As far as Type II inefficiencies are concerned, 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.

At the end of the day, the magnitude of the gap between the reported value and the owner's subjective value will depend on the owner's subjective estimate of the probability that the government will take her property. If the owner believes that the government taking is a certainty, then she has an incentive to report a value in excess of her subjective value: the value she estimates the government places on the property. If, on the other hand, the owner believes that there is no chance that the government will carry out the taking, then the reported value should coincide with market value. In between these extreme cases, where the owner's reported value significantly affects the likelihood of a taking, the owner's subjective value will be the important touchstone for owner self-assessments. Since the government usually has several options to advance its plan and in some instances may choose to forego the taking altogether, these intermediate cases should constitute the overwhelming majority

IV. POTENTIAL OBJECTIONS

In this Part, we address potential objections to our proposal. We focus on potential abuses of our model both by the government and by property owners and explain how they can be remedied.

A. *Government Abuse*

A seemingly serious concern raised by our proposal is that the government may abuse it to boost its property tax base. The introduction of heightened tax liability may spur the government to declare multiple eminent domain projects (without intending to carry them out), force the affected owners to reveal their true valuations, and then forego the takings and enjoy the increased tax revenues.[136]

This concern may be remedied by "decoupling" the amount owners will pay from the amount the government will collect.[137] While the owner's tax liability will, indeed, be based on her report, the government will not be entitled to this entire amount. The additional increment of property tax (based on the self-assessment) will not be paid to the government; instead, the property owner will be free to donate it to a charity of her choice. For example, if the owner's property tax liability prior to the self-assessment was $3000 per year and after the self-assessment is $3500 per year, the government will continue to collect $3000 and the additional $500 will be paid to one of the owner's favorite charities. This can be implemented by simple methods such as a check-off box in the property tax bill.[138] Like the inalienability restraint, the surplus tax liability should end once the property is transferred.

The diversion of surplus tax revenues to a charity of the owner's choice, rather than the government itself, should dramatically reduce the incentive of the government to exercise its eminent domain power excessively[139] and provides both sides with an incentive to act efficiently.

B. *Corner Cases*

A different challenge to our proposal is presented by owners who have no realistic expectation of sale during their lives, such as elderly owners. Elderly

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136. It should be noted at the outset that this concern does not arise in all takings cases. This is because all the different levels of government—local, state, and federal—may exercise the power of eminent domain while property taxes are generally collected only at the local level. Accordingly, it is unlikely that most state and federal takings decisions will be driven by the desire to raise property tax assessments. Moreover, even at the local level, decisions to take property may be made by government bodies that are funded by dedicated funds or excise taxes and therefore do not directly benefit from property tax hikes.

137. The decoupling strategy is most prominently associated with Mitchell Polinsky and Yeon-Koo Che. *See* A. Mitchell Polinsky & Yeon-Koo Che, *Decoupling Liability: Optimal Incentives for Care and Litigation*, 22 RAND J. ECON. 562 (1991).

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

139. There remains a residual concern that the government may declare its intent to take properties simply in order to raise revenues to charitable organizations. While this concern is not baseless, 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 believe that the government would rely on our mechanism as a means for funding charitable activities.

owners will expect to transfer title only upon their death, through bequest or inheritance. The result is that the value of the expected sanction imposed by the inalienability restraint will be limited. 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, bear 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, although 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 they 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 them 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 and, hence, may eliminate their special motivation to hold out.

To the degree that there is still a concern about overreporting by the elderly, our proposal may be modified by extending the period of the penalties beyond the lifetime of the owners. For example, the inalienability period could be extended to lifetime plus twenty years rather than just lifetime.[140]

C. *Changed Circumstances*

Extreme changes in circumstances may dramatically alter subjective value without connection to prevailing property market prices in the area. For example, the owners of a residential lot may divorce, leaving them unable to enjoy the property together and without their former ability to extract high surplus value from the property. Additionally, even if subjective value remains in the same proportion to market value, an owner might encounter such extreme liquidity problems as to be ready to part with substantial surplus subjective value simply in order to be able to translate the asset into a more liquid form. This may happen, for example, when an owner wishes to send her daughter to college.

There is a degree to which, irrespective of the ex ante assessment, an owner will be exposed to the possibility of ex post inefficiencies. Specifically, the owner may be exposed to circumstances where the ex post subjective value

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140. Even here, there will still be a potential problem with reporting as elderly owners may discount some effects of the restraints because they apply only indirectly, i.e., to their successors. This difference, however, is one of degree rather than kind.

of the property has descended below the price to be offered by a potential purchaser, but the owner continues inefficiently to hold on to the property because the gains from sale are insufficient to justify paying the transfer redemption fee.

We believe, however, that most owners will be able to take account of likely changes in circumstances in calculating their self-assessed values. Additionally, it must be borne in mind that the adverse effects of changed circumstances are limited to a very small domain. Owners will only have to absorb liquidity losses or subjective value losses to the extent of the expected redemption fee. If the liquidity or subjective value loss exceeds this amount, the owner will pay the fee and transfer the property.

D. *Gaming the System*

As in other situations in which penalties or rewards are triggered by events, parties may try to game the system by dressing up non-events as trigger events in order to collect rewards or hiding trigger events as something else in order to avoid penalty. In other fields of law such maneuvers can be seen, for example, in collusive transfers of property in order to shield assets from creditors or characterizations of loans as sales in order to protect security interests.

Our proposal for self-assessment too is vulnerable to collusive transfer between closely related persons. An owner might declare a high self-assessed value and then seek to avoid the associated penalties by collusively transferring the property to a close associate, allegedly at the self-assessed price but actually for a lower amount. To a degree, this strategy may be thwarted by existing tax liabilities. A collusive transfer may, for instance, expose the transferor to a high capital gains tax. More generally, we propose granting the government the power to petition courts to set aside fraudulent transactions, or, at least, to recharacterize them for purposes of the penalties. While this power may seem drastic, it is commonly used to deal with the problems of collusive transfers in many other fields of law,[141] such as bankruptcy.[142]

E. *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.[143] We openly admit that our proposal

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141. Fraudulent conveyance law dates back to the Statute of Elizabeth, (1570) 13 Eliz., c. 5 (Eng.). *See also* Twyne's Case, (1601) 76 Eng. Rep. 809 (Star Chamber). *See generally* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

142. *See, e.g.*, 11 U.S.C. § 548 (2007).

143. *See* Abraham Bell & Gideon Parchomovsky, *Pliability Rules*, 101 MICH. L. REV.

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.[144] 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.[145]

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 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 to the state exceeds the self-assessed price; otherwise, the planned taking is inefficient.

We acknowledge that ours is not a first-best solution and that as a result, in some cases, exaggerated self-reports may thwart efficient development projects. 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

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1, 59-64 (2002); Fennell, *supra* note 14; Merrill, *supra* note 31, at 64.

144. *See, e.g.*, POSNER, *supra* note 127, at 62.

145. Bell & Parchomovsky, *supra* note 143.

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 overassessed the price of the asset.[146]

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.[147] 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,[148] Nobel laureate Gary Becker

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146. This exception might be broadened to include all cases where there is serious risk of the moral hazard of compensation causing substantial overdevelopment of property. This would appear to be the case when such overdevelopment is available and cost-efficient for the owner whose property is to be seized, and where substitutes are absent and the substantial gap between government value and owner value is apparent to the owner. *Cf.* Miceli, *supra* note 65.

147. Daniel Farber issued one of the milder summaries of the state of takings law: "[T]here 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, 279 (1992). Jed Rubenfeld 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. 307, 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.").

148. 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 [sic] 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 [sic] 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.

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).

wrote, "To me, the only reasonable interpretation of 'fair compensation' is the worth of property to the *present owners*."[149]

Becker is not alone. There is little doubt that the current compensation practice, which many perceive as neither fair nor efficient, is a 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 be 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."[150] In light of this fact, it becomes all the more important to ensure that affected property owners receive full compensation for their losses.

149. *Id.* (emphasis added).
150. *Id.*