UCF Dr. P. Phillips School of Real Estate

Dr. P. Phillips Institute
for Research and Education in Real Estate

'Just Compensation' in Eminent Domain: Too Much, Too Little, or Just Right?

Real Estate Notes, No. 8, June 2013.
http://www.bus.ucf.edu/realestate/notes.aspx?y=2013

Geoffrey K. Turnbull, Professor and the Jim Heistand-NAIOP Eminent Scholar Chair in Real Estate, University of Central Florida

Economic efficiency means that resources are being put to their highest valued uses. It is widely believed that eminent domain promotes efficiency when properly applied. A government can take land out of private use and put it into a higher valued public use without having to rely upon voluntary sale by the owner, thereby sidestepping potentially costly holdout problems associated with assembling contiguous parcels for roads, parks, government buildings, or other public uses. But law and economics scholars have long recognized that eminent domain creates distortions in markets that reduce the social gains from putting a property into a higher valued public use even when the owner is compensated at market value. More troubling, a growing body of research identifies a range of situations in which the reduction in efficiency is likely to exceed the social benefits of the land in public use. One lesson arising from this line of study is that when efficient policy calls for the taking of property by eminent domain, it also calls for compensating owners with more than the market value of their property. The practical question is: how much more?

The Fifth Amendment of the US Constitution requires that governments provide "just compensation" for property taken for public use. Courts have long interpreted just compensation as market value. On the one hand, requiring market value compensation promotes efficient government behavior to the extent it forces governments (and their constituents) to weigh the benefits of public use against the property's foregone value in private use. On the other hand, compensation at market value also shortchanges owners who are unwilling to voluntarily sell their property at that price. In such cases—the archetypical eminent domain scenario—owners value their property by an amount greater than the prevailing market price (otherwise they would be willing sellers at the market price). But an owner's idiosyncratic value of the property is not independently observable and hence provides no objective basis for compensation. Compensation at market value is therefore not really full compensation in the sense of making the private owner economically whole. It is, at best, an approximation—a conclusion widely known to economists and legal scholars.

Other arguments for above-market compensation do not hinge on the owner's unverifiable idiosyncratic value of the property but on the potential value of the property in public use. Eminent domain compensation, like all taxes, subsidies, and land use regulations, affects investment incentives and therefore influences economic decisions. The threat of eminent domain introduces an incentive to develop or redevelop real estate sooner than is economically efficient when takings are compensated at market value.[1] This pattern holds whether or not the government prefers to take vacant land over developed land. At least in part the problem is that because capital improvements typically must be removed from the land in order to ready it for its eventual public use, more rapid development increases the social cost of taking land for public use by increasing both the necessary demolition costs and the foregone benefits of the still-useful structures and other improvements that are destroyed to clear the land. But even for land not ultimately taken by the government, more rapid development induced by the threat of eminent domain distorts resource allocation and by itself reduces efficiency. Basing compensation on the value of the taken property in public use rather than the lower market value in private use eliminates this distortion.

A study recently published in the *Journal of Housing Economics* finds that the situation is more complicated when the exercise of eminent domain affects the market price of remaining vacant land, but the case for above-market compensation is even more compelling.[2] When eminent domain removes a significant portion of a particular type of vacant land in the market, as is sometimes the case in interior metropolitan counties, the market price of the remaining similarly situated parcels rises. But there are less obvious intertemporal effects as well. Constraining the future supply of developed real estate puts upward pressure on future rents and increases the *current* value of both existing and new development. As a consequence, the threat of future eminent domain increases the value of current development relative to retaining vacant land and promotes more rapid development. Once again it turns out that it is more efficient to compensate owners for the greater value of their land in public use since it creates stronger incentives to leave land vacant longer, incentives that balance the unavoidable increase in the private return to current development arising from the constraint on the future development supply induced by eminent domain.

---

1. R. Innes, "Takings, Compensation, and Equal Treatment for Owners of Developed and Undeveloped Property," *Journal of Law and Economics* 1997, 40: 403-432.
2. G.K. Turnbull, "Irreversible Development and Eminent Domain: Compensation Rules, Land Use, and Efficiency," *Journal of Housing Economics* 2010, 19: 243-254.

The lesson drawn from these and related studies is simple, if not palatable to state and local governments and taxpayers. If eminent domain must be used, then compensation should be based on the value of the taken property in public use rather than market value. While state and local government officials engaged in taking land may be understandably reluctant to open themselves to the charge of "raiding" their taxpayers' wallets to support above-market compensation to nonresident landowners or developers, their reluctance bears no more weight than does the reluctance of the owners to lose their property in the first place. The justification for taking the land is that it has higher value in public use. The flip side is that it is also more efficient to always follow the rule that the owner's compensation be based more heavily on the higher social value rather than on the lower market value in private use. The arguments justifying both eminent domain and higher compensation rest on the same notion of economic efficiency, and in that sense are inseparable.

Finally, if policy makers advocating the taking of a particular parcel of land believe compensation above market value cannot be justified by standard cost-benefit analysis or if they claim to be unable to accurately calculate the value of the land in public use, then they are simply acknowledging that the proposed public project cannot be justified as economically efficient in the first place—in which case it is appropriate to leave the targeted property in private hands and questions about appropriate compensation become moot.

About the author: *Geoffrey K. Turnbull* is Professor and the Jim Heistand-NAIOP Eminent Scholar Chair in Real Estate at UCF. Previous academic appointments include Professor of Economics at Georgia State University and Professor of Economics and the C. J. Brown Distinguished Professor of Real Estate at Louisiana State University. His current research on real property markets focuses on housing and real estate brokerage, property rights issues in developed and developing countries, and the effects of taxation and regulation on urban land use and real estate markets. He has published extensively in scholarly journals on these and related topics and is Co-Editor of the *Journal of Housing Research.* Dr. Turnbull also advises local governments and firms in the business services, energy, and hospitality industries on a variety of issues.

Real Estate Notes is a publication of the Dr. P. Phillips Institute of Research and Education in Real Estate at the University of Central Florida. The purpose of this publication is to present timely summaries of current relevant research in the fields of real estate, finance, and urban land economics to the professional and academic communities to aid decision making and understanding the marketplace. The conclusions and opinions expressed in *Real Estate Notes* are the authors' and not necessarily those of the Dr. P. Phillips Institute of Research and Education in Real Estate, the Dr. P. Phillips School of Real Estate, or the University of Central Florida.