Introduction

In the summer of 2005, the U.S. Supreme Court handed down *Kelo v. City of New London*, 545 U.S. 469 (2005), which prompted the most extensive legislative response to a Supreme Court decision in recent decades (Somin 2008: 1190). The newly enacted or amended federal and state laws, however, seem to have little impact in constraining the economic development takings (Lopez, Jewell, and Campbell 2009; Somin 2010). Although the issue of *Kelo* is economic development as public use, not just compensation, some legislatures have viewed increasing takings compensation as one way to deter undesirable takings, or at least to better protect property rights. For instance, Michigan State has amended its constitution to require payment of 'not less than 125% of that property's fair market value, in addition to any other reimbursement allowed by law,' if the condemned properties are their owners' principal residence (Michigan Constitution Article X, Section 2 (amended 2006)). Indiana, Kansas, and Missouri also have passed laws to require at least 125 percent of fair market value as compensation in certain cases (Salkin 2006: 10870–71; Wyman 2007: 257 fn. 61).

This book focuses on compensation for physical takings, leaving issues of public use or regulatory takings untouched. Indeed, as this book will demonstrate, the problem of physical takings compensation itself is complicated enough, and how much compensation should be paid when condemnation occurs poses a well-documented dilemma (see, e.g., Miceli and Segerson 1996: 7). When full compensation (that is, economic value compensation[1]) is paid, government officials who condemn properties (the condemnors) are perceived to have incentives to take into account the social costs of condemnation. Unfortunately, compensation, especially full compensation, is said to create a moral hazard problem. Owners of condemned property (the condemnees) ignore the possibility of physical takings and overinvest (Blume and Rubinfeld 1984: 618; Blume, Rubinfeld, and Shapiro 1984: 71–2, 81). On the other hand, if

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[1]   This book uses 'full compensation' and 'economic value compensation' interchangeably. Note that in the prior literature, full compensation is sometimes used to connote full compensation of the current value of the condemned properties.

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zero compensation were paid, although condemnees would have the right investment incentives, condemnors would ignore the social costs of physical takings and condemn too many properties (Miceli and Segerson 1994: 754).

The dilemma is similar to the one faced in tort law when balancing the incentives of tortfeasors and victims (Kaplow 2003: 193; Miceli 2011: 106). Full compensation for the injury creates moral hazard for the victims (not taking enough care), whereas zero compensation induces potential tortfeasors to be reckless. The negligence rule, giving both sides incentives to act optimally, is the most prominent solution to the problem (Cooter and Ulen 2012: 205–8). There is nothing similar to negligence in takings law, although some scholars propose a partial compensation rule that it is thought might serve an analogous function (Blume and Rubinfeld 1984: 620; Fischel and Shapiro 1989).[2]

This book, however, argues that this dilemma exists if we fail to recognize what the actual takings laws require and how the compensation mechanism works. In the past several decades, most articles on takings compensation focus on one dimension of the issue. To concentrate on the issue at hand, many prior works have to make (sometimes unrealistic) explicit or implicit assumptions about condemnors' incentives, condemnees' incentives, the accuracy of assessing property value, and the cost of such appraisals. Standing on the shoulders of giants, this book wishes to synthesize the prior works and lift as many unrealistic assumptions as possible, making some contributions of its own along the way. Moreover, certain aspects of the takings compensation problem have been undertheorized, and this book plans to fill the void. Finally, although there is an increasing amount of empirical scholarship, works related to eminent domain are still scant. Using econometric methods and unique data sets from New York City and Taiwan, this book adds empirical evidence to support its theoretical claim, hoping to put the policy suggestions at the end on a more solid ground.

The plan of this book is as follows:

Chapter 1 lays down the theoretical framework. I observe that five forms

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[2] Compare Dana and Merrill (2003: 178) who argue that '[i]ncomplete compensation . . . works something like a rule of comparative negligence in tort'; Kaplow (1986: 603) who analogizes partial compensation to partial insurance; Cooter (2000: 295) who proposes a 'second-best theory of takings' in which 'one party will have efficient incentives and the other party will have distorted incentives'; and Heller and Krier (1999: 997) who propose to detach 'payments by the government' from 'compensation to the condemnees,' which is another, more radical proposed solution.

of takings compensation have been advocated or at least discussed in the prior literature; they are zero compensation, current value compensation, fair market value compensation, economic value compensation, and project value compensation. This whole book is devoted to the ultimate question of which form is the most economically efficient.[3] Chapter 1 also argues that four factors determine the economic efficiency of these forms of takings compensation. They are condemnors' incentives, condemnees' incentives, assessment accuracy, and assessment costs. The former two have been the center of debate for decades, whereas the latter two have been systematically analyzed—to do so, Chapter 1 proposes a typology of four assessment methods, each of which varies in assessment accuracy and assessment costs. Based on the identity of the party who appraises the value of condemned properties and the timing of such appraisals, Chapter 1 categorizes assessment methods into ex ante assessment by landowners, ex ante assessment by non-landowners, ex post assessment by landowners, and ex post assessment by non-landowners. The five forms of takings compensation, four critical factors, and four assessment methods are the critical theoretical concepts used throughout the book.

Chapter 2 reviews and critiques the three theories regarding condemnors' incentives, which is one of the four critical factors. Chapter 2 argues that the political interest theory is theoretically sounder than the simpler but unrealistic benevolent theory and the fiscal illusion theory. In terms of condemnors' incentives, in order to minimize wasteful rent-seeking activities and inefficient use of the eminent domain power, economic value compensation is the most efficient.

Chapter 3 re-evaluates the three theories regarding condemnees' investment decisions and their incentives to undertake rent-seeking activities. This chapter claims that, contrary to what the prior works have claimed or implicitly assumed, the fair market value of condemned properties is in fact largely independent of the investment made by their owners—it is the current value that is not independent. Moreover, this chapter argues that, assuming that subjective value cannot be changed through investment, compensation of fair market value, economic value or project value generally induces efficient investment incentives from landowners. Nevertheless, if compensation is less or more than full, wasteful rent-seeking activities

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[3]   The efficiency standard I use in this book is the Kaldor-Hicks efficiency (Posner 2011: 17–20). Under the Kaldor-Hicks standard, a legal policy is more efficient than the status quo or another policy choice if those that are made better off under the legal policy in question could in theory compensate those that are made worse off. In other words, the new legal policy creates net benefits.

emerge. Thus, once again, in terms of condemnees' incentives, economic value compensation is the most efficient.

Chapter 4 turns to assessment accuracy and assessment costs, the rest of the four critical factors. This chapter first analyzes these issues when property owners themselves assess their property value ex ante or ex post. Two major strands of scholarship are reviewed and critiqued, concluding that the models that claim to induce an honest revelation of landowner's economic value all fall short, because the self-assessments will be inaccurate, high cost, or impractical. That is, no self-assessment mechanism can produce accurate and low-cost assessment of economic value. This chapter then deals with the accuracy and costs of assessments when third parties assess the value of condemned properties ex ante or ex post. It is a pipe dream to expect that government officials will produce accurate assessments of the fair market value of condemned properties, even when the same value is used to levy property tax. Outsourcing is not a panacea, either, as independent real estate appraisers have their own self-interests and their appraisal methods are more art than science. Chapter 4 ends by arguing that hedonic regression models are the most accurate and (in the long run) cheapest way to appraise the fair market value of condemned properties, whereas the best way to assess economic value is probably by a simple and unmanipulated ex ante self-assessment regime.

Then enters Part II, which empirically examines the takings compensation awarded under three prototypical assessment methods and one mixed type. Chapter 5 conducts an empirical study of contemporary Taiwan's takings compensation system, which implements the 'ex ante assessment by non-landowner method.' I find that the majority of landowners since 2000 have been undercompensated. In other words, this assessment method does not produce accurate assessment. The reason is that in the minoritarian local politics in Taiwan, big landowners who have much more political clout than condemnees oppose the rise of official land value, because it will increase their tax payments. The official land value is also used to calculate takings compensation. Landowners have received undercompensation as a side effect. This chapter also demonstrates that the fiscal illusion theory is not borne out by data from Taiwan. Instead, the empirical findings lend support to the political interest theory, which is also favored by Chapter 2.

Chapter 6 empirically examines Taiwan's takings compensation system in 1954–77, which is an example of the 'ex ante assessment by landowner method.' Under this system, landowners report the property value of their land, to be used by the government in both levying taxes and awarding takings compensation. As predicted by my theory in Chapter 4, landowners underassess and are thus undercompensated, because the tax rate is

much higher than the probability of takings. This case study shows that the self-assessment method is not always a success, and landowners' self-assessments are indeed affected by the external legal regime.

Chapters 7 and 8 investigate the takings compensation practice in New York City in 1990–2003. The court-adjudicated takings compensation (discussed in Chapter 8) fits the 'ex post assessment by non-landowner method,' whereas the settled takings compensation (discussed in Chapter 7) is determined by a mixed type of assessment method, as it incorporates inputs from both landowners and non-landowners. Using hedonic regression models and hundreds of thousands of data, these two chapters find that inaccurate assessment and deviant takings compensation are the norm, not the exception. The empirical analysis also shows the danger of relying solely on appraisers to assess property value in eminent domain procedures. Echoing Chapter 4, these two chapters demonstrate that hedonic regression models can much more accurately assess the fair market value of condemned properties than the appraisers' method generally can do.

The Conclusion sums up the findings of this book and provides policy suggestions. First of all the Conclusion returns to the ultimate question: which form of takings compensation is the most efficient? When all four critical factors for efficiency are taken into account, the 'ex post assessment by non-landowner method' appears to be better than other assessment methods at approximating real economic value. This method can accurately assess the fair market value of condemned properties at low costs. Then, the assessed value should be complemented with bonus compensation, so that total compensation is more likely to attain full economic value compensation. The bonus compensation rate, however, should not be flat, as has been advocated in the past.[4] Rather, a schedule of bonus rates that, for example, gives long-term owner-occupants higher bonus rates is more likely to reflect the amount of their subjective value. As for owners of non-residential property or investment residential properties, fair market value compensation should be the norm, because these properties hold low, if any, subjective value for their owners. Finally, the Conclusion proposes that hedonic regression models should be more frequently employed in eminent domain procedures, to ensure that landowners receive (at least) fair market value as compensation.

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4   See the discussion and literature cited in Wyman (2007: 256–7).