

Eminent Domain: Acquisition of Property

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Eminent Domain I

Read Miceli (2004; Ch 7) and Singh (2012).

Eminent Domain is power given by the law to by the State/Government, to

- Compulsorily Acquire/Purchase Property
- The power is to be used for 'pubic purpose'
- The acquisition affected owners are entitled to 'just compensation'

Most Constitutions have clause

No private property shall be taken, save for public use and with just compensation.

Question

What is the meaning of public use?

Eminent Domain II

Purpose/use can be called public purpose, if it serves the community at large. For example, a project for a public good, like school, hospital, road, etc

Question

What is the meaning of just compensation?

A compensation can be called just if it is at least equal to

- the 'market value' of the property.
- the value of the property in the opinion of the owner.

Eminent Domain: Justification I

Public use is neither necessary nor sufficient condition for justifying ED:

- Public use could mean provision for 'Public Good'
- 'Public Good' demands that the good should be owned and provided collectively/by govt
- But it does not mean that the land or the resources needed for the project should be acquired by force. For example, the following goods/services are public goods
 - Defense - yet, several inputs, i.e., officers, trucks, jeeps, etc., are not forced to join
 - Hospital - yet several factors of production needed, i.e., doctors, medicines, are not acquired by force

Eminent Domain: Justification II

Question

Is there economic justification for compulsory acquisition of private property?

Land Assembly: Land Assembly problem is there if

- the good/service to be provided requires several parcels of land
- all land parcels have to be contiguous; e.g., road, railways, port projects
- the parcels are owned by different individuals

Land Assembly problem can be serious for two reasons

- Transaction Costs: Since many sellers are involved so transaction cost of voluntary transactions can be very high - so Coase theorem can fail
- Hold-out: some sellers will behave strategically/opportunistically and threaten to refuse to sell their land - in order to extract huge price from the buyer

Hold-out: Illustration I

Consider a project such that

- The project developer who is Buyer B of land, wants two identical parcels of land
- B values two parcels together at V
- B values any one parcel at v ; you can consider v to be the resale value of the acre for B
- Each seller values the land at R ; so, total valuation of sellers is $2R$
- Assume

$$V > 2R > 2v$$

- You can easily extend the argument to the case where $v \in \{v_1, v_2\}$
 $R \in \{R_1, R_2\}$, such that

$$V > R_1 + R_2 > v_1 + v_2$$

Hold-out: Illustration II

With the above assumption, we want to capture the idea that the land is valuable to B only if he has access to both the acres.

Question

Suppose, B want to buy land through voluntary transactions with the two owners. What is the price B will have to pay to each owner/seller?

To the see the answers, for a moment suppose

- B has purchased first parcel at price P_1 .
- Now, he is contemplating as to what price he should pay for the second parcel
- if B cannot buy the second parcel, his payoff is v ; the resell value of the first parcel (ignore the price he has paid for it)
- If B can buy second parcel at price P_2 , his payoff due the second parcel will be $V - P_2$

Hold-out: Illustration III

- So, for B, the net *additional* gains from the transaction over the second parcel is

$$(V - P_2) - v = V - v - P_2$$

- For the second seller S_2 , the net gains from the deal is $P_2 - R$
- So, the total net social gains from the second deal is

$$(V - v - P_2) + (P_2 - R) = V - v - R$$

Suppose, seller S_2 insists on receiving half of the total gains.

So, he will insist on a price that makes his **profit** equal to half of the above social gains, i.e., P_2 should be such that

$$P_2 - R = \frac{V - v - R}{2}$$

Hold-out: Illustration IV

That is,

$$P_2 = \frac{V - v + R}{2} \quad (1)$$

Next, let's find P_1 . As to the first parcel,

- if B does not buy the first parcel, there is no way the project will take-off
- So, if B does not buy the first parcel, his payoff is 0
- If B can buy first parcel at price P_1 , his payoff will be

$$V - P_2 - P_1,$$

since B knows that he will have to pay P_2 to S_2

- For S_1 , the net gains from the deal is $P_1 - R$
- So, between B and S_1 , the net total gains from the **first** deal is

$$(V - P_2 - P_1) + (P_1 - R) = V - P_2 - R$$

Hold-out: Illustration V

- Suppose, S_1 would want (half) share of these gains from the first-deal. That is,
- S_1 would want P_1 to be such that is

$$P_1 - R = \frac{V - P_2 - R}{2}, i.e.,$$

$$P_1 = \frac{V + R - P_2}{2}, i.e.,$$

$$P_1 = \frac{V + v + R}{4}$$

Hold-out: Illustration VI

Remark

You can verify that the second seller is able to Hold-up, i.e., extract a higher price, from B since

$$P_2 - P_1 = \frac{V - 3v + R}{4} > 0$$

Moreover, B will go for the project only if

$$\begin{aligned} V - P_1 - P_2 &> 0, \text{ i.e.,} \\ V &\geq 2R + (R - v) \end{aligned} \quad (2)$$

However, from efficiency point of view, the project should be implemented when

$$V \geq 2R \quad (3)$$

So, if

$$2R + (R - v) > V \geq 2R$$

Hold-out: Illustration VII

the project should be implemented, will not be undertaken
So, due to hold up

- Some efficient projects will not be taken up
- land transfer will be inefficiently low

Eminent Domain: Justification Issue I

Question

Is requirement of land assembly sufficient condition for economic justification for the use of ED?

- Land assembly is not a sufficient condition for an efficient use of Eminent Domain
- Land assembly is only a necessary condition for an efficient use of Eminent Domain
- The issue of compensation is relevant for an efficient use of Eminent Domain

In practice, under Eminent Domain

- the compensation is determined with reference to the 'market value' of the property

Eminent Domain: Justification Issue II

- suppose, v above denotes the market-rate of the property
- market value is generally less than the owner's valuation; recall $R > v$

Use of Eminent Domain will be inefficient if compensation is equal to market value.

- In the above example, suppose each owner is paid v
- so the project will be implemented as long as $2v < V$
- govt will acquire land even if $V < 2R$
- V is such that $2v < V < 2R$ the acquisition is clearly inefficient
- that is, under ED there will be excessive acquisition and too many projects will be implemented

Eminent Domain: Justification Issue III

Remark

Even in the presence of land assemble, the case for ED is not obvious. One has to trade inefficiency on account of too few projects (due to hold up) with the inefficiency of ED (due to too many projects).

Moreover

- market value is determined on the basis of the sale-price of 'similar' properties
- So, compensation is subject to errors

As a result,

- there is excessive litigation over eminent domain compensation
- litigation is costly for the society
- moreover, litigation is pro-rich