

The Problem with the Holdout Problem

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Abstract: Recent theoretical work has demonstrated that holdout is the appropriate efficiency justification for eminent domain. In parallel, recent empirical work has demonstrated that state legislatures either grant discretion to local authorities, or constrain them from using eminent domain. This paper extends Miceli's (2011) strategic holdout model to incorporate the efficiency effects of granting discretionary powers. Because discretion can be used for non-efficiency-enhancing purposes it attracts rent seeking by developers. Therefore, the efficiency justification for eminent domain is conditional. It depends on the relative magnitudes of the holdout and rent-seeking sources of inefficiency.

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1. Introduction

Recent theoretical work has demonstrated that holdout is the appropriate efficiency justification for eminent domain. In parallel, recent empirical work has demonstrated that state legislatures either grant discretion to local authorities, or constrain them from using eminent domain. This paper extends the strategic holdout in Miceli (2011) to incorporate the efficiency effects of granting discretionary powers. Because discretion can be used for non-efficiency-enhancing purposes, it attracts rent seeking by developers. Therefore, the efficiency justification for eminent domain is conditional. It depends on the relative magnitudes of the holdout and rent-seeking sources of inefficiency.

2. Institutional Context: Either Restricted or Discretionary Powers

Governments' taking powers have become stronger over time in the United States. Traditionally, the most familiar form of taking is when the government acquires title to real property for public use such as common carriage rights of way (roads, rail, power lines) or public buildings (courthouses, schools, post offices). Doctrine for these types of takings is evident in early U.S. jurisprudence, which institutionalized the principle that the government's chief function is to protect private property.¹ Therefore, the courts interpreted the takings power to be limited in several key respects. Most importantly, the Supreme Court of the nineteenth century prohibited takings that transferred property from one private owner to another. This prohibition almost certainly promotes economic efficiency because it resists the substitution of takings for voluntary exchange between private parties, which is always a Pareto improvement. The nineteenth century Supreme Court also upheld the fundamental fairness doctrine that no

individual property owner should bear excessive burden of supplying public uses. This doctrine promotes efficiency by spreading the costs of takings on a broader set of property owners, similar to the effect of broadening a tax base to decrease deadweight loss of taxation.

It was not until late in the nineteenth century when limitations on the takings power were gradually eroded. Beginning in the Progressive Era, and accelerating in the New Deal, the Court increasingly deferred to legislative bodies as to what constitutes “public use.” On cue, governments in many parts of the country began to advance an ever-expanding notion of public use. By the middle of the twentieth century, the stage was set for the Court to advance the public purpose doctrine, under which it has allowed takings for such purposes as the elimination of blight by urban renewal (*Berman v. Parker*, 1954), enhanced competition in real estate (*Hawaii Housing v. Midkiff*, 1984), expansion of the tax base, and economic development broadly conceived (*Kelo v. New London*, 2005). By the time of the *Kelo* case, the Court’s deference to majority rule was complete. Citing *Berman* heavily, the *Kelo* majority opinion reasoned that a carefully considered development plan that is generated by an open, democratic process, such as the one in New London, “unquestionably serves a public purpose.”² Therefore, so long as there is a rational basis connecting the development plan with some notion of the public purpose or benefit, the Court will not preclude a property taking pursuant to the plan. In short, the public use requirement had been effectively gutted to mean whatever a government says it means. By the final decade of the twentieth century, one prominent legal scholar described the public use clause as being of “nearly complete insignificance” (Rubinfeld 1993, 1078). As expected, economic development takings became very common across many, but not all, states in the country. In some areas, the practice became routine.

The federal court's history with development takings is useful here because it sets up, both historically and logically, our analysis of the states. Writing for the *Kelo* majority, Justice Kennedy found it worthwhile to mention that "nothing in our opinion precludes any State from placing further restrictions on its exercise of the takings power."³ After the *Kelo* ruling on June 23, 2005, nearly all the American states considered changing their eminent domain statutes. As of February 2010, forty-one states had enacted new legislation, passed a referendum, or amended its constitution to restrict takings for economic development. And the high courts in a few states have heard cases, including Ohio, Oklahoma, and Michigan, which overturned precedents that had previously allowed economic development takings. New York has repeatedly upheld its own version of that same precedent.

The activity in the states sparked a flurry of papers by economists, political scientists, and legal scholars to explain the causes and consequences of these new laws. One can easily glean from this literature that there is great variation in how the states responded.⁴ For example, some of the new laws are rather strict and essentially remove eminent domain entirely from the menu of economic development policy instruments. Other laws are looser, with generous exemptions and loopholes that can easily be navigated by an earnest regulator. In short, some states are opting to restrict economic development takings while other states are adopting the federal baseline protections established by *Kelo*. Thus, to benefit this paper we can consider a simple institutional choice environment: the state legislature chooses either to restrict the powers of eminent domain or to grant discretionary powers. If the legislature restricts, then takings can be used for traditional purposes such as rights of way for common carriage, public buildings, and so forth, but regulators cannot use eminent domain for transfer to developers or as part of economic

development plans. On the other hand, if the legislature chooses to grant discretion then governments can use takings for both traditional and economic development purposes.

3. The Model of Restricted Powers⁵

By removing eminent domain from the menu of policy options, the legislature effectively leaves the developer and homeowners as the only players in the game. Miceli (2011) provides a non-cooperative bargaining model of holdout under restricted powers. In Miceli's model, there is one developer and two homeowners on adjacent properties, "each worth v to its owner" (Miceli 2011, 109). The developer seeks to acquire both properties in order to build a development worth $2v + \varepsilon$. In other words, the developer perceives ε as a scale effect of using the two parcels together. The model is symmetric and covers two time periods, "now" and "later." Each homeowner can choose either to "sell now" or "wait." The project is economically viable if both homeowners sell now, or if one sells now and one sells later. However, if neither sells after the second period, then the project is no longer economically viable and the game vanishes. If both homeowners sell later then the developer incurs delay costs of δ . Finally, it is assumed that $\varepsilon > \delta$ so that the project is still profitable if both properties are acquired in period 2.

Miceli's paper implicitly assumes that the bargaining surplus goes to the homeowners. As a consequence, each homeowner perceives ε as a potential external benefit that could be imparted on the other homeowner. For instance, if homeowner 1 sells now he will receive payment of v , which allows homeowner 2 to sell and receive payment of $v + \varepsilon$. The game is non-cooperative and it is assumed that the homeowners cannot coordinate behavior, for example, by merging.

[Figure 1 goes here.]

Figure 1 presents the extensive form of the game. As mentioned, if the homeowners sell in different periods then one receives v and the other receives $v + \varepsilon$. Assume further that if the homeowners sell in the same period that they split the bargaining surplus evenly. Given this payoff structure, backward induction can be used to show that each homeowner's dominant strategy is to "wait." In subgame perfect Nash equilibrium, both sellers holdout and the developer proceeds with the project after period 2, but incurs delay cost of δ . The outcome is suboptimal because the joint payoffs are greater if both homeowners "sell now" instead. As Miceli (2011, 109) concludes: "Thus, the appropriate remedy is to allow 'forced sales' (or eminent domain), which requires that each owner be paid the fair market value for his or her land but does not allow them to refuse the transfer." In short, Miceli specifies that holdout is the appropriate economic justification for granting the regulator with discretionary powers of eminent domain.

4. The Model of Discretionary Powers

In this section of the paper, we extend Miceli's model by discussing the effect of discretionary powers on the incentives of the regulator and the developer. We next model the associated efficiency effects of equilibrium behavior under these incentives. For sake of simplicity, we hold constant any effect on homeowners' incentives—for example, potentially diminished incentives to invest in property under the threat of eminent domain.

4.1 Regulator's Incentives

The regulator with discretion can choose to use eminent domain on holdouts only or on non-holdouts too. Assume the regulator is instrumentally rational. In the rational choice theory of bureaucracy, regulatory agencies seek to maximize discretionary revenue; that is, revenue net of the agency's discretionary costs (Niskanen 2008). Traditionally the regulatory agency is treated

as having a single source of revenue, the legislature. However, in the present institutional context, it is reasonable to include a second source of revenue in the form of lobbying payments from developers. Assume that all lobbying payments are received in the form of cash payments plus the monetized value of non-pecuniary benefits (for example, steak dinners, travel to conferences in exotic locations, and so on) which sum to κ . Denoting revenues from the legislature as ρ , the regulator maximizes the sum of $(\rho+\kappa)$. We specify the magnitude of κ in the discussion of the developer's incentives below. When the regulator uses eminent domain, the homeowner receives fair market value of v , and the developer pays v to acquire the property. In effect, the use of eminent domain transfers all of the bargaining surplus ε from homeowners to the developer.

4.2 Developer's Incentives

Assume the developer is also instrumentally rational. Under discretionary powers, eminent domain is a potential substitute for market exchange to acquire properties. Substitutability in this sense depends on whether the regulator chooses "holdouts only" or "non-holdouts too." If the developer knows the regulator will choose holdouts only, then there is no substitutability and it is rational not to lobby the regulator. That is, when sellers are holdouts the developer knows he will acquire the properties through eminent domain, but when sellers are not holdouts the developer knows he must acquire the properties through market exchange or not at all. On the other hand, if the regulator chooses "non-holdouts too" then it may be rational for the developer to lobby the regulator in order to acquire properties at price v , thus capturing the bargaining surplus ε for a net gain of $(\varepsilon - \kappa)$. To determine the magnitude of lobbying expenditures, we turn to the literature on rent seeking games.

A well-known result in the rent seeking literature suggests that the amount of rent seeking expenditures will equal $\frac{1}{2}\varepsilon$. To see this, consider a typical rent seeking game in which a policymaker offers a prize worth ε to the highest bidder among two players competing for the political rights to the prize. Each player's probability of winning is a function of relative rent seeking expenditures; namely, for expenditures κ_1 and κ_2 the success probabilities are $P_1 = \kappa_1 / (\kappa_1 + \kappa_2)$ and $P_2 = \kappa_2 / (\kappa_1 + \kappa_2)$. Therefore, each i^{th} player's objective is $\max_k U_i = \left[\frac{\kappa_i}{\kappa_i + \kappa_j} \right] \varepsilon - \kappa_i$. It is well known in the rent seeking literature that the one-shot simultaneous move pure strategy Nash equilibrium for this game is $\kappa_1^* = \kappa_2^* = \varepsilon/4$ (denoting optimal choice values with asterisks), so the combined equilibrium rent-seeking expenditures sum to $\varepsilon/2$.⁶ By construction in the present paper, we have only one developer, not two. However, given one developer and one regulator, we may also consider the developer-regulator dynamic as a bargaining game over ε , and assume at least initially that the bargaining surplus is evenly split. Whether drawing indirectly on the rent seeking literature, or assuming even bargaining power between the regulator and developer, the magnitude of lobbying expenditures would be $\kappa^* = \varepsilon/2$. Recent extensions of this basic rent seeking game suggest that political transaction costs can create a form of price wedge between what the developer pays and what the regulator receives. Define γ as the rate of political transaction costs, so that the rent-seeking price received by the regulator is $(1 - \gamma)(\kappa^*) = (1 - \gamma)(\varepsilon/2)$. Note that the regulator bears the full burden of the political transaction costs. In this light, following Godwin et al. (2006), it is helpful to think of γ as the policymaker's cost of supplying the rent. Finally, in order to define the developer's payoff structure, assume the developer earns economic profit of π if the development goes through. Therefore, if the regulator chooses "holdouts only" then the developer's payoff is $(\pi + \varepsilon/2)$, but if the regulator chooses "non-holdouts too" then developer's payoff is $[(\pi + \varepsilon - \kappa^*) = (\pi + \varepsilon/2)]$.

4.3 Social Costs of "Non-Holdouts Too"

Empowering the regulator to use eminent domain against strategic holdouts also lets the regulator use this power for other purposes, which could include purposes that diminish economic efficiency. For example, local development authorities may become involved with routine transactions of property where no strategic holdout is present. Anecdotal evidence suggests that some economic development authorities across the country essentially function as real estate companies, buying and selling properties, leasing to commercial and retail tenants, taking referrals, and so forth.⁷ Because voluntary exchange is Pareto optimal, and because eminent domain typically taxes homeowner subjective value, some unknown portion of which is not offset by gains elsewhere, substituting regulator discretion for market allocation creates inefficiencies. Eminent domain may also reduce equity. For example, available evidence shows the burden of development takings (and urban renewal programs of an earlier vintage) falls disproportionately on areas that are poor, that feature high degrees of racial heterogeneity and high income inequality. The poor are also less able to mount political resistance to takings. Many critics of the *Kelo* decision, including Justice Clarence Thomas in his dissenting opinion, point out these income and racial effects. These inefficiencies and inequities interact with each other. For example, when choosing sites for economic development plans, regulators may systematically prefer poor areas because they are where the public-interest need for development is greatest. However, buyouts in minority and poor areas are prone to escalate to condemnation proceedings because property values are lower, so subjective value is relatively high and just compensation is relatively low. Define λ as the monetized value of the social costs of the regulator using eminent domain on non-holdouts too.

[Figure 2 goes here.]

Figure 2 presents the game tree for the case of discretionary powers. In order to substantiate the payoff structure, we next discuss the interpretations of the available strategies. It bears recalling that the game in Figure 2 exists only if the state legislature grants discretionary powers to local authorities. In the wake of the *Kelo* ruling, many local governments announced commitments not to use eminent domain unless absolutely necessary. For example, in April 2006 the city of San Jose, California, issued a press release assuring residents that the San Jose Redevelopment Agency would not condemn single-family homes (Roberts 2006). Similarly, in August 2005, Los Angeles promised not to invoke eminent domain except as a last resort (Welch 2005). These commitments are signals to developers as well as homeowners. Essentially the regulator says he will not entertain any efforts to be persuaded to invoke eminent domain on non-holdouts. This “closed door” policy alerts developers that there is no use attempting to lobby, and even if the developer chooses to expend κ dollars in rent-seeking efforts, the regulator will not accept. In a colloquial sense, the developer could bring a take-out steak dinner to the regulator’s office, but the regulator will decline. Therefore, if the regulator chooses “holdouts only,” then his only source of revenue is from the legislature, ρ .

By similar construction, the developer’s “profit seek” strategy may be interpreted as a principled stance against acquiring properties through eminent domain. In January 2006, BB&T Bank said it will not provide financing for projects on land that was acquired through eminent domain (BB&T Bank 2006). Construction firms in areas around the country made similar statements. In other words, even though a bargaining surplus of ε may be available to the developer, by choosing “profit seek” he refuses to receive ε . Thus, the payoff to profit seek consists solely of economic profit, π . Notice the payoff to the regulator is ρ for {non-holdouts too, profit-seek} since the developer refuses to rent-see even if the regulator is prepared to

transfer properties in the absence of a holdout. On the other hand, if the developer chooses “rent seek,” he essentially decides to avail himself of the transfer of bargaining surplus, ε , but incurs rent-seeking costs for a total payoff of $(\pi+\varepsilon-\kappa^*)$, regardless of what the regulator chooses.

If, on the other hand, the regulator chooses “non-holdouts too” and the developer chooses “rent seek” the payoffs are different for both players. Under outcome {non-holdouts-too, rent-see}, the regulator receives revenues from the legislature plus the rent-seeking price received, which sum to $\rho+(1-\gamma)\kappa^*$. The developer, in this outcome, receives economic profit from the project and the bargaining surplus from the homeowners, but incurs rent-seeking costs for a payoff of $\pi+\varepsilon-\kappa^*$.

Given this payoff structure, the developer’s dominant strategy is to rent seek because $\varepsilon-\kappa^* > 0$ by the assumption that the critical value $\kappa^* = \varepsilon/2$. For the regulator, “non-holdouts too” weakly dominates “holdouts only.” Specifically, if the developer chooses “profit seek” then the regulator is indifferent between his choice of strategies, but if the developer chooses “rent seek” then the regulator’s rational strategy is “non-holdouts too” because $(1-\gamma)\kappa^* > 0$. Given that the developer will choose “rent seek,” it is clear that the game in Figure 2 has equilibrium outcome of {non-holdouts too, rent-see}.

The outcome {holdouts-only, profit-see} is uniquely allocatively efficient. To see this, we report the calculations for the two players’ joint payoffs as well as the resulting social surplus. The calculations on the line marked “Social” in Figure 2 include external costs—specifically the social costs of λ —while netting out any pure transfer of bargaining surplus ε and substituting $\varepsilon/2$ for κ^* . As can be seen, the equilibrium outcome features a deadweight loss of $\gamma(\varepsilon/2)+\lambda$. The sources of this deadweight loss are twofold: rent seeking by the developer, and social externalities by the regulator.

5. The Comparative Approach

Assume the legislature is welfare-maximizing and must choose whether to restrict the regulator or instead grant discretionary powers. Figure 3 presents the legislature's choice environment. Under the "restrict powers" branch of the legislature's game tree is the restricted powers game from Figure 1, and likewise under "grant discretion" appears the regulatory discretion game from Figure 2. For sake of clarity, only the social surplus and deadweight loss values are repeated from the previous figures.

[Figure 3 goes here.]

The legislature's optimal choice is conditional and is made according to the following *policy rule*:

if $\delta > \gamma(\varepsilon/2) + \lambda$ then restrict powers
if $\delta < \gamma(\varepsilon/2) + \lambda$ then grant regulatory discretion.

In other words, eminent domain is justified on efficiency grounds if and only if the social costs of holdout exceed the combined social costs of rent seeking by the developer and social externalities by the regulator.

6. Conclusion

The problem with the holdout problem is this: it is strictly a *prima facie* argument for justifying eminent domain, ignoring the potential for inefficiencies that may emerge through political institutions. This is an old argument, articulated as early as Arthur Pigou in 1920.

In any [market failure], there is a *prima facie* case for public intervention. The case, however, cannot become more than a *prima facie* one, until we have considered the qualifications, which governmental agencies may be expected to possess for intervening advantageously. It is not sufficient to contrast the imperfect adjustments of unfettered private enterprise with the best adjustment that economists in their studies can imagine. For we cannot expect that any public

authority will attain, or will even whole-heartedly seek, that ideal. Such authorities are liable alike to ignorance, to sectional pressure and to personal corruption by private interest. (Pigou 1920, Pt.II, Ch.XX, Sec.4)

Or, as Ronald Coase (1960) and Harold Demsetz (1969) later noted, Nirvana is not an option. In order to explain the efficiency properties of actual policies, and to offer more meaningful input to policy making processes, future empirical and experimental work on the relative magnitudes of market and political inefficiencies would add much value.

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¹ “The country that became the United States was unique in world history in that it was founded by individuals in quest of private property.... [T]he conviction that the protection of property was the main function of government, and its corollary that a government that did not fulfill this obligation forfeited its mandate, acquired the status of a self-evident truth in the minds of the American colonists.” Pipes (1999, 240).

² *Kelo et al. v. City of New London, Connecticut*, 545 U.S. 469 (2005) at 13.

³ *Kelo et al. v. City of New London, Connecticut*, 545 U.S. 469 (2005) at 12-16.

⁴ Somin (2008), Morriss (2008) or Lopez, Jewell and Campbell (2009).

⁵ This entire section draws directly from Miceli (2011).

⁶ See Godwin, López, and Seldon (2006) for a review.

⁷ For example, the Charleston (W.Va.) Urban Renewal Authority (CURA) has a history of frequent and large-scale use of the takings power for economic development. From the 1960s through the middle of 2006, CURA condemned 523 properties for 47 development projects, 28 of which were private development projects (Anderson 2006). Although CURA’s condemnation rate has slowed in the past two decades, West Virginia is still a relatively aggressive user compared to other states. Since 1998, West Virginia ranks 19th in per capita properties condemned for private use (López, Jewell, and Campbell 2009). CURA’s property acquisitions have become so routine, the authority now performs many of the quotidian functions of a real estate company. “We do buy land that is blighted, if you will, and we also have property available for redevelopment. We usually put signs on our property. We get direct calls, referrals from the [Charleston Area] Alliance as well as the city, and we all work together” (Ali 2008).