Takings, Givings and Bargains

Multiple Challenges to Limited Government

Richard A Epstein

NEW ZEALAND BUSINESS ROUNDTABLE

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He has been a member of the American Academy of Arts and Sciences since 1985 and a Senior Fellow of the Center for Clinical Medical Ethics at the University of Chicago Medical School. He served as editor of the *Journal of Legal Studies* from 1981 to 1991, and as editor of the *Journal of Law and Economics* from 1991 to 2001.

His books include *Skepticism and Freedom: A Modern Case for Classical Liberalism* (University of Chicago, 2003), *Cases and Materials on Torts* (Aspen Law and Business, 7th edition 2000), *Torts* (Aspen Law and Business, 1999), *Principles for a Free Society: Reconciling Individual Liberty with the Common Good* (Perseus Books, 1998), *Mortal Peril: Our Inalienable Right to Health Care* (Addison Wesley, 1997), *Simple Rules for a Complex World* (Harvard, 1995), *Bargaining with the State* (Princeton, 1993), *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Harvard, 1992), *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985) and *Modern Products Liability Law* (Greenwood Press, 1980).

Professor Epstein has written numerous articles on a wide range of legal and interdisciplinary subjects. He has taught courses in civil procedure, communications, constitutional law, contracts, corporations, patents, individual, estate and corporate taxation, Roman law, criminal law, health law and policy, legal history, labour law, property, real estate development and finance, jurisprudence, land use planning, torts and workers' compensation.

Introduction

Bryce Wilkinson, president,
Law and Economics Association of New Zealand

Professor Epstein is on his fourth visit to New Zealand. He has been enormously generous in helping people in this country with the many topics he has worked on. In the late 1980s he made a big contribution to the work of Penelope Brook, one of New Zealand's top economists, on labour law. More recently I greatly benefited from his advice on liability and the accident compensation scheme, which dealt with whether there should be a restoration of the right to sue.

On this trip to New Zealand he's travelling like a tornado. Having torn through Golden Bay in the weekend, Richard descended on Wellington today and spoke to one group on employment law and then to another of 200 people at Victoria University on the foreshore and seabed issue. Tonight's subject is quite different: it is an extension of previous talks in New Zealand on takings and compensation. Richard is speaking on 13 different topics in the course of this week. I do not know anyone else in the world who could take on such an assignment.

Tonight's seminar relates to issues of compensation when governments regulate to take private property rights, but it also overlaps with mandatory user charges for government-provided goods and services, imposed without the consent of the so-called beneficiaries.

Let me give a practical example of the kind of issue that arises. Following the terrorist attacks of September 11 2001, the US government decided to be more stringent about the control of goods coming into the country in containers. New Zealand's government, in response, has incurred considerable costs in upgrading to more sophisticated X-ray screening equipment. The annual

ongoing cost is about $20 million a year. The government argued that this was a private good for the benefit of exporters and importers and that 100 percent of the cost should be recovered from the private sector – port and airport authorities and the like. Private sector parties consulted economists like myself who showed that there was a substantial public good component to the service, indicating that there should be a correspondingly substantial element of taxpayer funding.

One of Richard's books that I drew on in this work was *Bargaining with the State*, because this was a case where the state was seeking to impose a charge for a service without the consent of the parties involved.

Richard has also done a substantial amount of work on the restitution principle. This operates as follows. Suppose I have a charming house with a dilapidated brick driveway and someone rips up the driveway without my consent, installs a modern concrete path, and then sends me an invoice for their costs. In terms of the restitution principle, should I be required to pay the invoice?

Richard has continued to expand on these issues. There is more discussion of them in his latest book, *Skepticism and Freedom.*

Before calling on him to speak to you, I want to stress that, in exploring these themes, there is no implicit criticism of particular government policies. These are generic issues. They have arisen with all manner of governments and jurisdictions. They are important and troubling. The benefit principle, without a proper definition of property rights, is floating around in free space and it is something people need to understand better in order to avoid mistakes and traps.

To that end, it is with great pleasure that I invite Professor Richard Epstein to throw light on these issues and address this seminar.

Takings, Givings and Bargains: Multiple Challenges to Limited Government

Introduction

This topic has the relative virtue of being *sub specie aeternitatis* – covering issues that constantly arise, no matter how a government proceeds in any individual transaction.

I have organised this lecture in three parts. I shall talk first about takings. Then I plan to discuss the inverse of takings, a topic that one might call 'givings'; this relates to the restitution principle. Finally, I will speak about bargaining with the state, which involves forced exchanges, and under American law bears the title of unconstitutional conditions. In each of these cases, a government agency is on one side of the transaction and a private party on the other. One basic assumption of the analysis presupposes that the state has a monopoly of power within the jurisdiction but nonetheless must respect the entitlements to liberty and property of the private individuals within the state. A second basic assumption is that we want government actions to be socially responsible in that they seek to get the most from the available resources that are located in both public and private hands. The challenge here is to cabin in the monopoly power that is necessary for the preservation of ordered liberty.

In attacking this problem, it would be unwise to start from the presumption that everything associated with private property is sacred while

everything associated with government activity is profane. Rather, I want to take a more moderate view of the subject and argue that there is a need for government and that a government can do certain things well. However, if allowed, it will misbehave – just as any private monopolist would if given half a chance.

If we think of the government as a kind of necessary evil it makes it possible to examine how it fits in with private transactions, and leads to a more comprehensive view of the whole system. In virtually every case we should not think of individual rights as somehow fully specified because of natural or divine intuition. Instead, they function as a way to set up institutions so that when individuals engage in actions for their own self-interest, they will do so in a way that is not systematically perverse with respect to everyone else. The effort, quite simply, is to align the incentives of government actors with overall social welfare.

Simple rules revisited

Before considering the distinctive role of takings, givings or bargains in dealings with the government, it is important to set out the background framework of individual rights and duties. One way to do so is to divide the universe into two halves. The first half comprises all situations that arise when autonomous individuals engage in voluntary transactions. In these the role of the government is not to force exchanges between individuals but rather to define and clarify rights that will allow and facilitate cooperative behaviour, either with spot transactions (for example, an isolated sale) or ongoing social relations (for example, partnerships and associations). The second half brings in the role of government.

The first rule is a rather simple one having to do with individual autonomy. There is no precise metric that points to some discrete act that allows you to acquire rights in your own person. In effect, we say: you had these rights when you started out in life. This simple declaration is the strongest basis for resisting slavery. The importance of having individuals controlling their own lives and labour is that it makes it easier to organise voluntary transactions. Everybody knows the limits of their own body and

can enter into voluntary exchanges with trading partners off this baseline of individual rights.

I will not go further down this path because, for the most part, cases in which we are willing to use coercion against individual autonomy are examples of dire necessity – matters involving the draft and national survival, for example. Taxation also comes into the equation in figuring out how a system of takings, givings and bargaining actually operates.

The second set of rules includes those that allow individuals to acquire property. I will not defend these in particular, except to note that we systematically rely on the rule of capture to provide the initial assignment of rights for diverse and critical resources such as land, animals and chattels – to get them out of the state of nature and give them determinate owners. A great advantage of this set of rules is that it uses simple priority to identify the correct owner. First come, first served is the principle used to establish who owns what. Having a single owner, as with labour, opens up a universe of voluntary transactions.

The third set of rules, deriving from the first two, includes those that involve a voluntary exchange of labour or property among individuals. The basic theme of all liberal societies can be summarised in two propositions that we ought never to forget. First: the gain between the two parties in such voluntary exchanges will be mutual and shared, so there is no need for any kind of legal intervention (beyond the recognition and enforcement of contracts) to bring about positive sum games. Second: any increment in the wealth of two individuals increases the trading possibilities of third parties, so that, for the most, part voluntary exchanges generate positive externalities. This happy circumstance obviates the need for government restrictions on trade to protect third-party interests. There are exceptions – the case of monopoly, for example. However, since we are talking in very broad terms I will not belabour the exceptions but stress the rules.

If there is one set of rules that tells us how to achieve positive sum games, there is another that indicates how to avoid negative sum games. The latter set is known as the law of tort. Again, the basic intuition is simple: if somebody uses coercion against another individual, the chances are that the

person cannot pay enough to obtain what the other owns. The thief compares the costs to the benefits of executing the theft. Even when that result is positive for the wrongdoer it is likely to be negative for society, given the loss to the owner and the implicit loss that everyone incurs when property rights are destabilised. So the rules against aggression or misrepresentation are essentially those that steer individuals away from negative into positive transactions. The protection of strangers is the first office of the tort system.

It is amazing how much power can be generated from the successive and repetitive application of these principles. In fact, if you are very careful with the initial definition of property rights, and develop rules to ensure the security of exchange, you can actually structure large and complicated transactions by successive application of the rules of labour, of property and of exchange, all the while using the tort rules as a side-constraint against coercive transactions.

Takings

The inevitable question is: with such a system in place, why do we worry about government at all? We have, as it were, an engine that seems to run of its own accord. Unfortunately, no system is ever so fortunate. Some individuals are going to defect. Somebody needs consciously to create a robust platform on which voluntary transactions can take place. This is the second half of the universe I mentioned earlier.

The sad truth about the world is that there are many cases in which the cooperation between two individuals will not be sufficient to realise gains from trade because the cooperation of everybody in society is necessary to allow these transactions to occur. Think of this in the crudest possible form: a single person, acting alone, who is allowed to use force against anybody, will wreck everyone else's voluntary transactions. Therefore, a collective means must be found to restrain that person, which brings in forms of government coercion against those who do not play by the rules of the game.

This prompts the question of how to raise revenue to enable a government to function. One option is taxation. Taxation and takings are closely related. If coercion is to be used when voluntary transactions do not obtain the desired outcome (social order), the first general rule is to search for a system

in which the impositions, when imposed on all individuals, cost less by way of the sacrifice of liberty and property than the benefits everyone will receive from increased security provided by the government. This is the basic Lockean view of the world, with, however, serious complications to the relationship between coercion and consent.

More concretely, the Lockean model broke down because of a conflict between two statements in the Second Treatise on Government. The first said, in effect, that no individual ought to be required to sacrifice *his* property without his consent. Then Locke immediately goes on to say, " ... [by] the consent of a majority, giving it either by themselves, or their representatives chosen by them ...".[1] The difference between these statements is essentially the major source of difficulty of all political theory. Individual consent cannot serve as a basis for solving all collective problems.

To improve matters one need only change the phrase 'without his consent' to 'without just compensation'. In Locke's model everything is either a matter of voluntary consent (which will not work) or of majority will (which introduces the risk of exploitation and faction). However, the theory of just compensation is different. It says the state can take property from individuals, by way of coercion if necessary, so long as it produces a result that leaves the individuals so coerced at least as well off as they were in the initial position. That is how a just compensation rule works.

In what situations will the state want to use the power to take? In a reasonably well-operating political system, the following rule is appropriate: every resource reallocation will not simply move a physical asset from one location to another but, instead, may place it in a collective use where it is worth more than it was in private use. The theory of the takings clause is this: the state can force an individual to surrender property, yet since the individual is given proper compensation (in itself an enormous issue) the surplus will be kept by the state for collective purposes. Because a classic public good is created, everybody will share the gain including the individual who has been forced to surrender property.

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[1] John Locke (1632–1704) *An Essay Concerning the True Original, Extent and End of Civil Government*, § 140.

The theory, which is optimistic rather than perfect, says coercive institutions can be organised in a way that creates general Pareto improvements. Everybody will be at least as well off as they were before. Some people – in this particular case, almost everybody – will be somewhat better off. The calculation of compensation is critical. If it is underestimated, or if elements of value that are sacrificed are ignored, there will be too much government activity. Then, when it comes to taxes, political institutions are required that ensure that all individuals get back in the form of public goods something at least equal in value to that which they have surrendered in taxes.

In some cases, such as national defence, taxation will be pro rata across all individuals according to income. In others, such as a road that benefits only a small portion of the community, localised exactions against the direct beneficiaries may supply a better match.

The general case for a system of takings is that if we can constrain the type of property that is taken, the purposes for which it is used, and the way it is funded, the social outcome will be superior to that achieved in a purely libertarian world with no coercion. To put it differently: there are times when the risk of government misconduct is worth running if the alternative is abysmal coordination or a hold-out problem that would result in a complete impasse.

The cases I have dealt with thus far have been very simple. All of them concern something the government wanted for public use in the creation of social infrastructure: a particular plot of land needed for a road, for example. The great debate starts when we ask the following, apparently simple, but ultimately hugely difficult, question: to what extent can we apply to the general system of social and economic regulations the same sort of analysis that we apply to the outright confiscation, upon payment of compensation, of individual properties for public use? The standard American and theoretical analyses of this particular question, to my mind, always get it wrong. What is said, in effect, is that all takings – that is, physical dispossessions – fall into one category and must be compensated, while regulations of the power to use the disposed property fall into another. To use the famous, if empty, expression of Justice Holmes: unless regulation goes 'too far', you don't have

to compensate anybody for the loss of rights associated with the diminution in use value on the one hand or disposition value on the other.

To make this scheme work, it is necessary to figure out how far is too far. From a structural point of view this is difficult. You cannot have a situation where if you go only 'so far' you pay nothing and if you go further you pay top dollar for the land, because the discontinuity creates massive incentives for the government to inch up to the line but no further. The political machinations this rule invites make lawyers jump for joy and ordinary individuals weep with sadness.

What is a sounder way to think about the treatment of regulation? I have long supported what may be termed the 'salami' theory of private property that, once understood, puts the entire problem in a very different perspective. Think about the property in question – say, land or a chattel – as a salami. You can slice or dice it as thin as you want. No matter how thin you slice it or dice it, every discrete component remains salami. By comparison, no matter how you subdivide property, every small fraction remains property as well. There is no clever ploy to escape the force of a general prohibition on takings without compensation by redefining and reclassifying various fractional interests of property in an effort to avoid this particular rule.

What does this principle entail in its concrete application? Just this: if you cannot take somebody's property outright you cannot take the life estate and leave the remainder interest, take an easement and encumber the fee simple, or take a restrictive covenant and leave somebody a restricted set of uses. The rules of property that bind an individual against a neighbour are the same rules that bind the individual against the state. The moment state power abridges those rights, in whole or in part, you are not just engaged in 'mere regulation'. Rather, you have slipped into a system of partial condemnation of any of the many interests at hand protected under the private law. Leaving aside the issue of compensation for the moment, the point here is that regulation creates a takings problem.

This threshold proposition has immediate and important social consequences because it denies that there is any free good in private property

that a government could exploit on its own whim. If advantages are obtained without anyone having to pay compensation, it creates a political dynamic in which everybody will try to take without paying. That situation would be intolerable in ordinary product or labour markets; it is intolerable in respect of property.

Our first modest proposition, then, is that private property can be divided into ever smaller pieces. What happens when the number of property owners in the crosshairs of government action increases? If two people are dispossessed it is a double taking, three people a triple taking. No matter how far you move down this path, the number of takings increases. Large-number takings are not some new and unexplained beast.

When these things are put together, it becomes clear that every form of regulation is simply a combination of two manoeuvres. When regulating, we first abandon the idea that we take all of anybody's property – we only take a part. Second, we abandon the notion that we isolate only one individual – the number of people subject to government action could vary anywhere from two to *n*. In each and every case, therefore, everything that purports to be a regulation turns out to be a large number of takings of partial interests in property from a group of affected individuals.

The nub of the problem is this. If each of 1,000 people surrenders a thousandth portion of their property under some form of government regulation, it would be madness to insist that each receives small amounts of compensation that can only be raised by heavy taxation of the same group. If everything turns out to be a taking, the last thing you want to do is to regulate, then tax, then tax again, because our entire income will be dissipated in the valuation and transfer processes associated with the administration of a takings law. Does such an absurd situation ever occur? I believe not. We know from our knowledge of how self-interest drives the political process that things do not get taken unless somebody benefits. In each and every case, the trick to understanding large-number takings is always to ask two questions. The first is who has been hurt by the regulation; the second is who has thereby benefited. If, in fact, the government is well organised, the kind of large-

number takings we are talking about will generate benefits to all members of society that are equal to or greater than the actual harms imposed.

A simple example illustrates the point. A community has a distinctive series of façades and imposes a restriction that nobody can change their façade because it would destroy an important neighbourhood public good – its harmonious appearance. Provided the regulation is properly framed, one can be reasonably confident that the exterior restrictions will result in an increase in the value of each home. The like restrictions imposed on neighbours are worth more to members of this particular community than the losses those same restrictions impose on them.

In some cases, the intended beneficiaries are those within a community along with those nearby, and prices might well go down. If the situation is to create both external and internal benefits then the appropriate response is to provide a tax rebate so that the capital value of the property is increased. If, in fact, all the other property owners receive a halo effect from this particular strategy, they will share in the benefits as well. A combination of mutual restrictions and tax supports will create the general kind of Pareto improvement wanted without the need for an endless regress of piecemeal compensation provided in cash to individual property owners.

When thinking of the whole property system, one should constantly question whether or not large-scale regulation does in fact create these Pareto improvements, and how any hypothesis might be tested.

Let me give an extreme case to show this is not a hopeless proposition. In this example properties are laid out on a tic-tac-toe board. A regulation is created that says nobody is allowed to build any addition to the current plot beyond what already exists. On its face, this neutral regulation could function exactly like the restriction on façades. But add one fact: the person in the middle has built nothing and everybody else has already built their ideal home. This particular regulation operates as an enormous transfer. There is an easily identifiable, disparate impact because one person loses the option to do anything and everybody else essentially loses nothing when all plusses and minuses are totalled. If we look at the regulation alone, there are eight

winners and one loser. Accordingly, the appropriate response, even though only a 'mere' regulation is involved, is compensation to the ninth person paid for by the other eight in equal shares. What will happen? Typically, the winners will discover they do not want to pay the price of compensating the loser. Compensation introduces a price system of sorts that, like all price systems, offers signals that alter the behaviour of individual actors. The function of the clause is not just compensatory; it is also allocative.

An actual illustration of this case was *Lucas v The South Carolina Coastal Commission* (505 US 1003 (1992)). An individual's house was blown down in a storm. The question was whether the individual was allowed to rebuild. The community announced: 'Absolutely not. We're better off without a house on this plot of land.' The owner went to court and said: 'If I can't build, it's tantamount to taking my property. The land is useless to me.' The court decided the owner had a point but went further than just declaring this a taking. It ordered the landowner to convey the title deed to the city for which the South Carolina Coastal Commission had to pay fair market value. The commission duly paid US$500,000 for the empty plot of land. It then put the plot up for sale to recoup expenses but discovered empty land with no building rights was worth almost nothing. Faced with the price constraint, the commission did the only honourable thing: it sold the property *with* building rights. The commission did not want a useless piece of land – it preferred the cash. That is the function of a takings clause: to make a government put its money where its mouth is when it claims an action is for the public benefit.

This basic proposition does not imply, however, the government must pay every time it regulates a landowner. The 'police power' is an important element of the overall picture. If the sole reason for a regulation is to prevent an individual from committing an actionable harm – a nuisance, typically performed against a neighbour – compensation is unnecessary. If the neighbours had stopped the individual themselves, they would not have had to pay compensation. Under these circumstances the state is acting as an agent for people with legitimate claims who unfortunately could not coordinate their activities. To claim 'police power' the government must

intend to act to prevent a private wrong rather than simply claim a social benefit. An example where the government might claim the latter as justification would be the condemnation of land for a highway. This distinction is very important and shows the close connection between private and public law. In effect, the takings law has a nice symmetry in that the only way state power can be used is to generate Pareto improvements. That is about as good an outcome as an economist can achieve in the world as we know it.

Givings

Let me now turn to the givings side of the topic.

The givings issue can appear in many contexts. Whenever a land use regulation is imposed, for example, it will benefit various individuals who could be taxed pro rata for their gain. If you analyse the takings problem correctly you can see where the benefit problem is likely to arise.

Let me focus on a variation on this question: not where an indirect benefit from government behaviour is shared by all individuals subject to tax, but the more limited situation where a single individual gets a sweet deal from the government by being handed property owned outright by the state. When I first thought about this problem in connection with the public trust doctrine – which is at the heart of the foreshore and the seabed case – I invented the inverse of the takings clause. This proposition says: 'nor shall public property be given for private use without just compensation'.

If a government is sufficiently strong, self-interested or faction-ridden to ignore constitutional prohibitions against taking from individuals, it will be just as wily in giving things away. A situation where everybody pays pro rata to create a public improvement that is sold to a private party for a tenth of its value is as much of a perversion of sound government as an illegitimate taking.

It is necessary to find ways to constrain opportunities for such givings. One of the simplest constraints is to require a government wanting to dispose of property to put it up for competitive bidding so that nobody can get a cosy deal. Unfortunately, there are often complicated situations where only a single person can benefit from the property transfer. That makes it very difficult to know how to value the required compensation.

A concrete illustration occurred when the city leaders of Chicago decided a few years ago to take a landmark building on public property – Soldier Field – and construct a stadium. They made a sweetheart deal with the Chicago Bears, involving large state subsidies. This resulted in an increase in the net value of the Chicago Bears' shares of US$300 million. To finance this particular albatross, the city leaders imposed a bewildering array of US$600 million of taxes on the citizens of Chicago, most of who would never go near the stadium.

I was involved in the subsequent litigation. We tried to use the public trust principle to stop the transaction. An ally was a group called the Friends of the Park. This group believed that the appropriate principle was: 'nor shall public property be given away, with no exceptions, even for gainful exchanges with the private sector'.

I told them: 'You are killing all sorts of gains from trade that might otherwise take place. You ought to focus on the level of compensation that should be paid and argue that the city cannot entertain an arrangement where, by any economic estimation, the private benefit to a favoured party exceeds the public cost.'

This case reached the Illinois Supreme Court where we lost unanimously. The reason we lost relates to the way the courts think about the political process. There are two ways of viewing government. If you take the romantic view that everybody elected to public office has only the public welfare at heart, you will conclude that politicians sitting in their legislative capacity know more than you do. Because they are pure of heart, let them decide. Any time outsiders get involved they are likely to make a mistake. But if you take the more sombre view – as I do – that many politicians are every bit as greedy and ill-disciplined in public life as they are in private, you then realise the rule of law has to apply to politicians in their public capacity in the same way that it applies to all of us in our private capacity. The upshot is you start to scrutinise things more closely.

Within an American-style constitutional system, as opposed to a legislative one like New Zealand's, the higher the level of scrutiny that a court brings to government action, the greater the chances of striking something down. In some

cases, a misnamed 'rational basis' test is called into operation. This means that any good reason will result in the statute surviving. Because somebody always benefits from the worst legislation, under this generous test the statute is always constitutional. Conversely, if there is a high degree of scrutiny where you have to show net public gain, the decision always goes the other way.

This principle has recently been tested in another context. In 1998, the Copyright Term Extension Act was passed in the United States, under the influence of the Gershwin estate and Disney Studios. They were able to persuade the Congress to pass a statute that gave every current copyright holder a free 20-year extension of existing copyrights. Nothing was asked for in exchange. I strongly opposed this legislation – again without any success – on the grounds that it violated the givings principle, 'nor shall public property be given for private use without just compensation'. The justification for giving property rights to intellectual property and ideas is to provide the recipients of the property right the incentive to produce. In this case, the owners of the patent had long since produced all that they could, yet they were now given 20 more years with absolutely nothing in exchange. Although it is a future interest that will not vest immediately as it did in Soldier Field, this system is clearly crazy. Tacking 20 years on to copyrights with only two years before they expire increases their value six- or seven-fold, whereas adding 20 years to copyrights with 80 years left has, at most, negligible impact. What sound system of public administration could produce such a crazy-quilt outcome?

When we tried to push this argument, the court said: 'Who are we to second-guess the legislature?'. There is exactly the same problem with judicial review. This is important to understand: as one toughens up on the takings side, the forces of redistribution (many with unsavoury motives and powerful connections) will switch to the givings side. If you were trying to design an ideal constitution, you would want to make sure you had comparable levels of scrutiny on both sides.

Bargains

If this game can be played with takings and givings, it can also be played with bargaining. Somebody said when I wrote *Bargaining with the State*: 'This book

must have been a true intellectual nightmare. You have spent your entire working life extolling the virtues of voluntary exchanges and now you are trying to explain why the government cannot enter into voluntary transactions with its citizens.' In fact, there are good reasons why some limitations on bargaining with the state are imposed. One just has to work through a variety of transactions to see the way bargains operate.

Remember that bargaining is an attractive concept in the competitive situation that naturally emerges in markets for labour or for parcels of property because there is no real concentration of market power. But the government is always a monopolist. If you look at private parties with monopoly powers – common carriers in the Middle Ages, for example – you find that the rule has always been that such parties could not simply bargain for whatever they wanted. Instead, because of the absence of a reasonable alternative, there was a requirement that they provide services on reasonable terms, and the quid pro quo was an entitlement to rates that gave them just compensation for their investment.

In time, this simple intuition for facilities like inns became the basis for an elaborate system of rate regulation for public utilities, which sprang up in large numbers in the last half of the nineteenth century. The design of that system required a sober view to be taken of two opposite risks: one has the monopolist ripping off the public, the other has the regulators ripping off the monopolists. To this day we do not have a perfect way of deciding which of these two risks is the greater. And we know that it is not possible to create any system that gives ironclad protection against both risks simultaneously. Yet here it is possible to avoid some major pitfalls along the way, distinguishing those particular bargains that look to be felicitous and those that sport a rather insidious appearance. Let me give you an illustration of both.

Highways tend to be government owned. The state of Massachusetts has many outsiders travelling on its roads. If a driver from Miami collides with one from Sacramento on a Massachusetts road, we face the possibility that the Miami driver will have to take another trip to California to vindicate their rights. To obviate this inconvenience, Massachusetts has passed a statute that says that anybody using its highways thereby agrees to litigate accidents arising on its

roads within the state. Therefore, a driver cannot say, 'I'm not from the state, so you can't sue me.' Most people would see this as a perfectly sensible regulation. Viewed from the *ex ante* perspective, it seems to be a social improvement to create secure tort rights for all individuals: after all, people entering the state do not know whether misfortune will make them a plaintiff or a defendant. The overall soundness of the rule thus improves the utility of all persons, regardless of their ultimate position. There is an easy way to think of this statutory regime. It is a bargain: if you want to use the highways of Massachusetts, this is the condition that is imposed. It looks as though the statute can be defended by a simple appeal to that old standby, freedom of contract.

But that analysis is too facile. To see why, consider a second case: suppose that anyone who wants to use the highways of Massachusetts must agree to have any suit against them *at any time* and *for any purpose* litigated inside Massachusetts. Perhaps you happen to live in Arizona and you face litigation over a divorce going on with your spouse. Can spouses use this statute to sue in Massachusetts if they decide to move there?

Most people would look at the second case and ask: how does this exercise of monopoly power possibly result in more efficient use of public highways? This behaviour is insidious because individuals are left with very little choice: when driving toward Massachusetts, the probability of being sued is very low and the need to use the highways is very high. Who, therefore, will avoid the state because of this remote possibility? The immediate gains outweigh the long-term losses, so that people will take the bitter with the sweet. Yet the overall situation does not look like a simple bargain with favourable system consequences. Here is one way to test the result. If every state in the nation imitated Massachusetts in requiring local automobile accidents to be resolved locally, no one would think that this were untoward. A successful experiment in one state would be imitated in another. The good results would just be multiplied. But that is not the response to the jurisdictional war that would break out if every state followed Massachusetts's lead by requiring anyone who ever used the public roads to litigate all disputes within the state. Here, the consequences look disruptive in the single case, so that the multiple jurisdictional cascade only compounds the difficulty. The culprit is the use

of monopoly power to lever control over transactions that are better handled somewhere else. If all states could get together by agreement, they would not choose to adopt a uniform rule of open jurisdiction. But they would keep the rule on highway accidents. We have to take a critical look at the consequences of these bargains to see the difference.

This line of analysis turns out to have very profound implications for the overall structure of federalism. Let me illustrate the point. Before 1937, the United States had an ingenious and extremely sensible system in which all local production activities, like manufacturing, were regulated by each state, so there was a nice (if not fully intended) element of competitive federalism. State regulation of interstate communication and transportation was not allowed, however, because of the hold-out risk that one state would prevent through-trade, and thus disrupt the entire national market. Those activities were subject to regulation by the federal government. It was a very elegant solution and is perfectly consistent with modern economic principles that preach the importance of keeping networks open for all users.

As is often the case, the political climate varied in different states on the key issues of the day, including the explosive issue of child labour laws. On these matters, some states did not like competition from other states. But no amount of local regulation could undo the comparative advantage that other states held. The natural move was to appeal to federal assistance to ensure a uniform set of rules. At this point, the role of the federal government was no longer to use its power over commerce to keep open the arteries of trade. Rather, the government said, in effect: any time a party wants to send its goods interstate, it has to agree to uniform federal rules that undo any local advantage. For example, it must use labourers over the age of 14 in all its activities, including purely local production activities that do not enter into interstate commerce. The legislation was put in the form of a bargain: if you wanted to ship your goods interstate you had to accept this regulation. Otherwise, you had to stay out of the interstate markets.

Does such a bargain allow freedom of choice? In a sense it does: after all, bargains are cast in a take-it-or-leave-it form. Why not this one? Again, the answer lies in the systematic consequences of the rule. The lifeblood of

the nation depends upon the ability to trade in a large common market. Very few firms would find compliance with the federal statute less onerous than the loss of the ability to take part in interstate commerce, so everybody would accede. By this very adroit statute the system of competitive federalism was broken down and replaced with national regulation. To be sure, the Supreme Court, when faced with this question in *Hammer v Dagenhart* (1918), did not fully grasp the economics of the situation and said this was an illegitimate use of the commerce power. It declared that where regulation was not confined to protecting the instrumentalities of interstate commerce – for example, to prevent spillage on the railway tracks – it was unconstitutional. But, in so doing, it meant that everyone could now see which state system of regulation was superior. The decision thus preserved decentralised decision making in those cases where no network interest was at stake. It was only with the rise of the New Deal view that distrusted decentralised decision making that the case for federal power was asserted, inverting the original constitutional design of enumerated and limited federal powers.

Let me offer another illustration of how monopoly power exerted by the state can lead to abuse, this time dealing with local matters. A council might say, 'We will let you build your new beachfront house, but only on condition that you give us an easement so that everybody can walk back and forth across your front lawn'. Time and again the puzzle has been how to sort out the benevolent conditions that produce social improvements from the redistributive conditions that are designed to say to individuals: 'we're going to hold you hostage'.

In closing, let me explain why there are real resource arguments for insisting on proper principles for bargaining with the state. In the beach house example, the question is whether the benefit to the community at large is greater than the cost to the owner subjected to the imposition. That is the point of an eminent domain rule. If just compensation equal to the landowners' loss of value is required, you have a pretty good test as to whether the easement is worth more or less than the property interest that has been surrendered. The moment indiscriminate bundling is allowed, the ability to make the proper social calculations is lost.

The state should not have the power to stop individuals from doing things unless those actions are likely to be a nuisance. In this case, the landowner will always capitulate and agree to the required condition because building the new house will be worth more than giving up the easement. But that choice means that we adopt the wrong measure of social benefit. The right measure is whether the easement is worth more to the public than it is to the private parties. Hence, we can easily reach a poor allocative result. The easement is worth $10,000 to the state, but costs the private landowner $25,000. But the ability to build the new house is worth $50,000. The owner will capitulate even if the public easement results in a $15,000 loss in social value. And note that if the numbers were reversed so that the easement were worth $25,000, but cost the private owner only $10,000, then the usual principles of paying for a taking still lead to the right social result: the easement will be condemned.

There is a larger moral here. Once you start thinking seriously about bargaining with the state, you discover not only the kind of cases that I have talked about but also a much broader range of activities. I have already discussed jurisdictional reach, interstate transportation, and land use regulation. The same framework also applies to the full range of government licences and permits about which too little is generally said today. Let us return to our first premise. Every licence can be understood as a bargain: you get the licence to do something only if you agree to do something else in return. Given the monopoly power behind licensing there should be powerful restrictions on the way licences are administered. The basic assumption should be that people should only be denied a licence for reasons that would justify a sanction against them by way of a fine or punishment with respect to the completed act. Thus, if the state could punish you for polluting the public waters, it should then be able to require you to get a licence if your activities pose some threat of pollution. But if the state could not require you to provide free medical care to indigent teenagers, it should then not be able to condition your medical licence on your willingness to so provide. The class of objects for which state power can be exercised is sharply limited.

Indeed, the set of constraints goes still further. As I noted earlier, the state in exercising its coercive powers does so on behalf of the citizens whom it is

duty-bound to protect. However, that protection is not against competition from others, but only against the wrongful sorts of conduct – force and fraud – governed by the tort law. Even then the use of a private injunction is limited to cover those cases where there is a threat of imminent peril. The danger of shutting down legitimate activities cautions courts to go slow on issuing injunctions for behaviour that has a high likelihood of resulting in legal conduct. That balance of advantage does not shift when we use licences or permits because there is no single individual who is willing to step forward to seek injunctive relief when the possible victim of an untoward act cannot be identified. The state too should not just be able to assert a legitimate end and get its injunction. Most houses will be soundly built even without a building permit. Why then allow for endless delays in the process? It should be sufficient to allow the government to halt operations when there is some tangible sign of misconduct, which will occur in only a few cases.

To be sure, there are other instances where more latitude is allowed. Driver licences are easy to acquire and pose little risk of abuse of discretion. Requiring them on a routine basis poses little risk of factional intrigue. But for most occupational regimes, the situation can easily become intolerable. Hence, any belief in limited government means that our institutions should not assume that licences should be granted at the free will and pleasure of the state. The entire system of state activity, which covers taxation, takings, givings, bargains and permits, is of a piece. The sad truth in this area is that every technique that can be put to good use by a government can also be put to bad use. Whether you look at takings, givings, or bargains, each has to be subject to the same degree of scrutiny. In a system of limited government the objective is always the same: to restrict the kind of impositions that the government can make in the course of taking action in respect of hold-out problems or other situations where the grounds for intervention are very strong.

If the game is played correctly, the result will be that private property and its protection is not seen as possessive individualism designed to hurt the public at large. In fact, it will be seen as the only way to secure general prosperity for all citizens.

Questions

Take your beach house example. There might be just 100 people in the front row of houses at the beach. In rows behind them there may be 1,000 people. I understand the philosophical justification for protection of private property rights and I agree with it. But many people will say: 'less than 10 percent of people are being affected'. Is it realistic to expect the rules that you've been promoting to be applied?

If you are dealing with the New Zealand parliamentary system, it will not be realistic unless you can get rules put in place on a universal basis because everybody senses that in their absence there will be negative sum games in individual situations. That is why the American tradition always has constitutional protections designed to protect liberty and property against a transient majority.

The case of obstructed views is a good illustration. The general rule with respect to a view is that it is a private matter between two individuals. If you wish to stop somebody from building because it obscures your view, you must get a restrictive covenant for which you have to pay. You can pay in one of two ways. In a minority of cases, you simply buy a covenant from your neighbour. In most cases, covenants arise out of planned unit developments in which the developer imposes restrictions on everybody as part of a common deed. The developer has the incentive to make sure that the net positives and negatives from these covenants maximise the total receipt on sale, which, in this case, would be a very reliable proxy for total social value.

If you are dealing with unorganised individuals with no way to get them together voluntarily, what ought you to do? A starting point is to envisage

two communities, one of which could build skyward as high as it wants. Then you should figure out whether the increase in use value at the front is going to more than offset the loss of view at the back, or whether it is the other way around. It turns out that for many communities having lower-tiered houses in front so as to preserve the views at the back is worth more than the additional air rights that are sacrificed by not building up, because you can build out or under. How do we know this is the case? If you look at any planned unit development with a single owner in a voluntary situation, typically the buildings at the front are kept low and we can see that the owner is making that judgment.

If that is the case then the situation ought to be that everybody in the front gets compensated by everybody in the back for the restrictions. Imagine 10 layers of houses going up the mountainside, each one in a perfectly symmetrical position with the others. Layers two through nine will cancel each other out – they will be compensated by one and pay to the next, so that what really happens is that number 10 has to pay number one. This means, in effect, that there has to be a cash transfer because there's a disparate impact. The layer at the bottom is a sure loser from this regulation and the one at the top is a pure winner, so they are not, as it were, neutrally impacted. Everybody else both benefited and lost but, since we know the dynamics, the total benefits exceed the total cost. The application of this particular model will give the right result.

Let us look at the argument about the takings clause another way. You want government action in circumstances where it has to impose land use restrictions in order to replicate the patterns of benefit, cost and outcome that would be found in a unified development if transaction costs did not prevent voluntary agreements. If you use these rules you will not get a solution that is 100 percent efficient but at least you will get a better outcome relative to no intervention.

This has immensely important political implications because everybody has an incentive to reveal honestly what value they put on amenities such as views. The moment you say: 'we could impose height restrictions or remove them without compensation in either direction', everybody has the

unfortunate incentive to posture. And, once you say that restrictions can be imposed without compensation, it will be reversible: they can then be removed without compensation. So instead of getting two situations governed by sensible price accommodations reflected in compensation, you will get two situations that are governed by conflict and political intrigue.

Following on from your last point, what about the government's use of its contracting power in its 'private' capacity, that is to say, in bargaining on its own account?

Where the government is simply acting as a buyer and seller in a market I would simply ask: is it the only buyer and seller? If so, you are back to the problem of monopoly power. If, instead, the government is dealing in a competitive market, let it impose whatever conditions it wants. If it gets the wrong mix of conditions and prices it will get no takers in the market and will have to change its plans.

When the government performs dual roles the danger is that the moment something goes wrong, the wall of separation between its regulatory role and the financial side of its operation starts to become porous. The government will demand some kind of special favour that private parties will not be able to get, or its operation might be subjected to some kind of restriction that private parties do not face. Whether it is an extra favour or an extra burden, the result is a distortion. It is better for the government to keep out of things it does not need to undertake. Becoming involved as an operator compromises its role as a neutral arbiter and regulator.

An important area in which this problem comes up is government procurement. The US government buys several hundred billion dollars worth of defence equipment every year from a variety of suppliers. It has to impose conditions upon these purchases that have the appearance of a voluntary exchange market. But the situation is problematical because there is no other buyer of defence equipment. This necessitates various requirements to ensure bids are kept open and honest. An added difficulty is that whenever you are trying to buy services rather than goods, you cannot buy them from somebody who lacks the technical expertise, so low prices do not invariably win and you have to evaluate elaborate proposals. There is no simple solution.

Manuals on government purchasing of goods like defence equipment are very thick. There is no way to avoid the problem by a simple market solution. That works for sellers – if you are getting rid of something, accepting the highest bid is normally fine. It does not work for buyers because you have to worry not only about price but also about quality and service among other things.

A classical liberal order can readily solve the easy problems. It has to struggle with the hard questions and will do a tolerably good job so long as it is aware of the trade-offs and assesses them in an empirical fashion.

What is your position on the regulation of natural monopolies?

Regulation of natural monopoly is hard. The first case I am aware of was English, called *Allnut v Inglis*, dating from 1810. It concerned a warehouse that received a monopoly from the Crown to store goods free of customs duty before they were shipped overseas. What the court said was that the warehouse could charge no more than a warehouse charges in a competitive market. The legal monopoly was relatively easy to identify and the case easy to figure out because there was an easy and reliable reference point.

In a similar vein, consider the case of a single port at which ships could dock and that only has room for a single firm to operate the pier. Without any hesitation, another court took the position that the natural monopoly should be subject to exactly the same kind of regulation. If a single port has these natural barriers then, at least in the short term, it is hard to figure out how the monopoly might be broken. It will require the introduction of air services or railroads or trans-shipment to some distant location to introduce a level of competition. With a monopoly that has that degree of robustness, I think there is probably a case for the same form of rate and access regulation.

Once you get beyond those kind of cases it gets rather trickier. The really difficult cases are network industries like telecommunications and railroads where you have an elaborate lattice of interconnection obligations on the one hand and blockade potentials on the other. Having spent the better part of 10 years working through the telecommunications problem, the conclusion I have reached is that it is probably efficient to have interconnection

obligations that call for reciprocal service as a way of overcoming the monopoly problem with the network. However, it is a terrible mistake to require sales of individual network elements at state-determined prices as a means of dealing with any problem of limited competition. The risk is that underpriced elements will lead to excessive entry into the field and deter new investments by the incumbents. Just that result happened in the American context until recently, when a Court of Appeals decision in the District of Columbia appears to have brought the practice to a halt.

Overall, I think the best answer is regulation with a light touch. The additional caveat – and it would apply in cases with a lot of industry dynamism – is that it is important to recognise that every time you introduce a form of regulation to deal with a static problem of monopoly you create a dynamic inefficiency problem by preventing some innovation that might completely erode it. For the most part I would favour a little bit of intervention but not much. The real problems in the United States and elsewhere are not with the regulation of natural monopoly industries but with the risks of turning perfectly competitive industries into monopolies through government regulation. Those are the cases where further intervention makes no sense at all. The proper response is to deregulate, which was the general strategy followed in New Zealand. The basic rule is that when the external conditions that surround a natural monopoly are less easy to overcome, the case for some form of regulation is stronger.