TOWARDS A REGULATORY CONSTITUTION

Richard A Epstein

NEW ZEALAND BUSINESS ROUNDTABLE
APRIL 2000

This workshop on the concept of a regulatory constitution was held in Wellington on 24 March 1999.

First published in 2000 by
New Zealand Business Roundtable,
PO Box 10–147, The Terrace,
Wellington, New Zealand
http://www.nzbr.org.nz

ISBN 1–877148–63–6

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Cover illustration by *Jo Tronc, Watermark Ltd, Wellington*
Design and production by *Daphne Brasell Associates Ltd, Wellington*
Typeset by *Chris Judd, Auckland*
Printed by *Astra Print Ltd, Wellington*

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His books include *Torts* (Aspen Law and Business, 1999), *Principles for a Free Society* (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), *Cases and Materials on Torts* (Little, Brown, 5th ed, 1990), *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 and taught courses in contracts, criminal law, health law and policy, legal history, property, real estate development and finance, jurisprudence and taxation, torts, and workers' compensation.

Introduction

Roger Kerr, executive director,
New Zealand Business Roundtable

Let me welcome Richard Epstein and also the Honourable John Luxton, Minister of Food, Fibre, Biosecurity and Border Control, whose participation in this workshop is much appreciated. This is a working session between people who have been interested in developing some type of regulatory constitution in New Zealand. At the New Zealand Business Roundtable (NZBR), work has been underway for around 18 months on a study of this concept which is being undertaken by Bryce Wilkinson, Capital Economics, Susan Begg, Credit Suisse First Boston, and Tyler Cowen, George Mason University. It is pleasing to see this issue also being taken up by other business organisations including the Employers Federation and the Manufacturers Federation, and of course within government. We regard it as a high-stakes exercise.

In thinking about a regulatory constitution, the NZBR considers that there are clear similarities with other constitutional initiatives of recent times. The Reserve Bank of New Zealand Act 1989 introduced new disciplines on government decision making in the area of monetary policy. The Fiscal Responsibility Act 1994 has provided a framework for fiscal policy, particularly in requiring greater transparency. That act places comparatively few restrictions on what governments can do. For instance, governments can favour high spending and taxation so long as they do so openly, specify their objectives, and demonstrate that they are working towards them.

The remaining major area of government activity is regulation. It has an immediate connection with fiscal policy because it is well recognised

that fiscal and regulatory interventions can often be substituted for one another. If fiscal interventions are constrained in some way, there is a danger that the pressures for bad policies, being frustrated at one level, will simply be redirected towards increased regulation. Some developments in New Zealand, such as Accident Compensation Corporation (ACC) levies to fund outstanding claims and proposed charges for border control services, can already be interpreted along these lines.

But there is a much broader reason to be interested in a regulatory constitution – the scope of the modern regulatory state. This regulatory scope continues to grow, often under the impetus of special-interest pressures rather than in the interests of the wider community. The social justification of many regulatory interventions is doubtful. We at the NZBR are seeking a well-constructed regulatory statute that is similar in some ways to the Fiscal Responsibility Act 1994. This statute would not force governments to do specific things, but rather would set up principles for governments to follow and processes to make them accountable for their decisions. There seems to be considerable merit in such an approach.

The idea of a regulatory statute is much more ambitious than other recent attempts to apply greater disciplines to government in the area of regulation. New Zealand has seen a Paperwork Reduction Bill and efforts by various governments to reduce business compliance costs. Cost benefit assessments of regulations have been attempted from time to time. More promisingly, regulatory impact statements have been introduced by the current government. The NZBR strongly supports regulatory impact statements. We are concerned that departments and ministers adhere to their requirements and that they undertake the necessary assessments. But the NZBR seeks to go further in constructing a general framework for regulatory policy.

Recently the Regulatory Responsibility Act exercise underway within government has slowed down somewhat. That is not necessarily a bad thing. There was a risk of a rushed and inadequate outcome. If the conceptual side of the regulatory statute project is properly carried

through, the implementation of any regulatory constitution will raise real challenges for political management. There are many people who will need persuading as to the merits of the idea, because any meaningful framework will challenge various designs of their own. The immediate task for those of us interested in the statute issue at the analytical level is to keep testing approaches and ideas. The NZBR has sought an inclusive dialogue with others working in this area, and the Ministry of Commerce has been helpful in facilitating some group sessions.

As part of this process, we are taking advantage of Professor Epstein's visit to New Zealand to stage this workshop. After a few words from Bryce Wilkinson on the NZBR's regulatory statute research project, Professor Epstein will have the floor and a general discussion will follow.

Regulatory Statute Research Project

Bryce Wilkinson, Capital Economics and NZBR consultant

The NZBR, in its research, is attempting to take the broadest possible view of the concept of a regulatory constitution. We have analysed many attempts at regulatory reform within countries belonging to the Organisation for Economic Cooperation and Development (OECD), starting with the initiatives of various US presidents in the early 1970s. The main countries attempting reform in this area appear to be the United States, Canada, Britain and Australia. The major initiative around the world has been the regulatory impact statement. In Australia, according to the OECD, the regulatory impact statement appears to be slowly changing the culture in the regulatory agencies, by forcing them to undertake some reasonable cost-benefit assessments. But social and environmental regulation continues to grow rapidly. Thus the initiatives of these countries to date appear to have been fairly modest and peripheral in their impact on the overall regulatory problem.

One crucial issue is 'takings', and the need for the payment of compensation when property is taken by government for the public good. That is one reason why Professor Epstein's presence is so welcome here today. To my knowledge Professor Epstein has highlighted the significance of the takings issue more than any other academic working in this field. His first major work in this area was a book entirely devoted to takings entitled *Takings: Private Property and the Power of Eminent Domain*. Three further books by Professor Epstein also include discussions of the same issue, *Bargaining with the State* (1993), *Simple Rules for a Complex World* (1995) and *Principles for a Free Society* (1998).

In New Zealand we have some precedents for a takings section in a regulatory constitution. The Public Works Act 1981 quite powerfully constrains the government in taking land for the common good. That act also covers partial takings, in that if someone loses part of the value of their land, rather than all, they can still be compensated for the loss. Thus the principle of compensation for takings is already well established in New Zealand in the case of land, and the challenge is to take it further. In the series of meetings on the idea of a regulatory statute organised by the Ministry of Commerce, attention was also drawn to the role of the Regulations (Disallowance) Act 1989. That act provides a potentially useful mechanism. Regulations and statutes can be referred back to parliament if they fail to meet a list of quite well-formulated criteria. The one element missing in it is any takings consideration. So the drafting of further provisions in that legislation represents another possible approach to this whole issue.

Tyler Cowen has written a lengthy chapter on cost-benefit analysis for the NZBR study, in which he argues that any such requirement should not be the centrepiece of a regulatory constitution. He sees the assessment of benefits and costs as simply too subjective to take us far. Those groups promoting a regulation will automatically expect benefits to be created along with costs, and almost everything will seem to reduce to a matter of opinion on the important questions. This leads us to suspect that more time and consideration will need to be put into developing disciplines that can be genuinely effective.

Towards a Regulatory Constitution

There is a standard argument about cost-benefit analysis. 'It is extremely difficult to perform', people say. 'We therefore cannot do it in practice, though in theory it makes some sense in welfare terms.' One then inquires about the alternative, and is met with a thundering silence. People end up merely changing their language. They start comparing advantages and disadvantages, and assume verbal gymnastics constitute a conceptual advance when all that has been offered is a low-level terminological redefinition. I share some of Tyler Cowen's concerns with the process, but like him I want to retain a place for cost-benefit calculations. I propose to set out a system for thinking about the takings clause. In doing so I will examine closely the valuation issue, which drives cost-benefit analysis. My hope is to provide cost-benefit analysis with enough discipline to make it a serviceable instrument for social policy, though not a perfect one.

The United States has a strong constitutional tradition. A clause in the Constitution states "nor shall private property be taken for public use, without just compensation". That is a very short clause. It is also coherent enough to have generated a tremendously rich and complex body of law. The full range of fact patterns analysed under the clause is worthy of note: it has covered everything from zoning to environmental regulation to trade secrets to water rights to ship liens. The false turns generated by this analysis have led to unnecessary complexity, which in turn has often given

rise to despair. Sometimes that despair leads to a celebration of sorts: the want of conceptual coherence is taken as a strong argument for those who argue in favour of increased legislative discretion and against compensation to specific property holders. To the extent that advocates for bigger government can successfully argue that no coherent constitutional norms are capable of restricting the activities of legislators, the advocators will win by default the debate over the proper scope of government activities. According to this school of thought, we must perforce trust the politicians who raise and spend money to do so in an equitable and efficient manner, even though we are well aware from public choice theory that most of their laws will be inequitable and inefficient. In public policy one is confronted with this constant source of tension between the desire to restrain government and the paltry means available to achieve that end.

Handling these political realities in a country without constitutional provisions is in a sense more complicated because the defender of small government can appeal to nothing outside the legislative process to restrain legislative excesses. But once again there are ironies in the light of the narrow construction given in the United States to the protection of private property from the ravages of general economic regulation. New Zealand's Public Works Act 1981 probably gives more protection to land owners than the US Constitution as it has come to be interpreted – at least within a limited domain. We must recognise that no constitution is self-enforcing and that a weak interpretation of a constitutional guarantee can easily provide fewer protections than a reasonably honourable interpretation of a legislative protection.

When faced with large-scale government intervention that redistributes massive benefits and costs amongst many individuals, it is best not to begin by addressing the general problem and hoping to make sense of it. One is quickly overwhelmed by the complexity. Rather one should start with cases that seem to make strong claims for compensation under, say, principles of natural justice. A more functional explanation can then be provided as to how these cases are constructed and understood. Once

we understand the basics, we can then branch out and tackle those forms of regulation that have broader scope.

Takings and compensation: the simplest case

Consider the simplest of all possible examples. A plot of vacant land is privately owned by party X, and the government decides to build a public amenity on it. The government forces the transfer of the legal title from that individual to itself. Should it pay compensation? From the point of view of party X, not tendering compensation will have public-choice consequences. Everybody will share in the benefit generated by the public improvement, and, as an initial working assumption, we might assume that the shares will be roughly equal. The dispossessed landowner may face a substantial cost, while other individuals will pay nothing. Could anything justify this apparent fundamental mismatch between the distribution of benefits from a public project and the distribution of costs? On intuitive grounds most people are not prepared to tolerate that form of disparity. Their sense of fairness, often inarticulate, is offended by the thought that some citizens will enjoy benefits from the government that are not shared by others.

The theory of compensation in this case is about equalising the burdens among those who stand to benefit from a project and those who will be harmed. The state pays compensation to the landowner sufficient to leave that person indifferent between owning the land and receiving the money. If the project is a positive sum game for society as a whole, the person who is compensated will benefit overall to the same extent as other members of the community – at least so long as they remain a member of the community, an important caveat with ambitious programmes such as those that expand national parks.

While compensation in this case is often regarded as a straight question of equity, paying it also has strong efficiency justifications. The government wields huge power when deciding which particular parcels of land will be taken for a new road or park. It also has great discretion in deciding

whether a public facility will be built at all. A system with zero compensation will create a political dynamic in which everybody lobbies strenuously for their neighbour's land to be taken rather than their own. Some of the gains from public projects will be dissipated through rent-seeking. Usually rent-seeking involves the attempt by some to acquire assets from others but it can also involve dumping liabilities on to them. In a world without compensation, the dumping will take place at a furious rate.

In the United States, it is widely conceded and understood that the compensation given to landowners when property is taken is typically insufficient to cover their total consequential damages. These losses frequently include appraisal costs, loss of business goodwill, relocation costs and various other costs. When it is announced that a public improvement is planned in a neighbourhood, the 'not in my backyard' contingent immediately springs up. People are not being irrational. They understand that often the compensation will amount to only a small fraction of their losses, which spurs them on to try to push those burdens on to somebody else. There is the usual cycle of intrigue and political resistance, which consumes resources on all sides while creating no discernible social improvement.

A compensation requirement creates a cash transfer that is not itself a resource gain or loss. A valuation survey is needed, but when the relevant asset is land with market value, the expense of the survey is usually trivial by comparison with the wider considerations involved. The other important rationale for the compensation requirement is that some mechanism is needed to filter out those public projects that deserve to be undertaken from those that do not. There is no point building a road if there is no demand for its services, and the same point applies to any other public facility. It is always difficult for public agencies to know precisely which activities they should be undertaking in the service of which constituency. However, one circumstance will sober them up very quickly – the requirement to spend public revenues to provide a given facility.

A just compensation principle essentially introduces a price mechanism in a setting where the government has all the options, and in consequence acts as an effective constraint against excessive intervention. When the compensation principle is operating correctly, public officials will look at the expenditures associated with a project, assess the benefits, and, if the costs exceed the benefits, will simply decline to undertake it. Conceived broadly, the function of the takings clause is not only to make sure the government pays for the projects it undertakes, it is also to ensure that the right projects are chosen. It is the same with a market price, which not only allocates resources for the activities chosen but also gives powerful signals about which activities to undertake. In the intermediate case where compensation is paid but does not fully cover private losses, too many public projects will end up being undertaken and these projects will generate too many private losses – a systematic mismatch. Thus the principle of compensation for takings has two very powerful functions: it prevents negative rent-seeking with respect to liabilities, and it disciplines the way in which the government chooses its projects.

But there are many problems a takings clause does not address. These problems require either a major regulatory constitution or some other means of imposing constitutional restraint on government. We are not dealing here with a typical private transaction between individuals, where buyers possess their own utility functions, assess the land as worth more than the compensation asked, and consider themselves winners on the deal. It is more like a corporate transaction: the land is in effect taken over by a public entity with citizens as stockholders. In attempting to assess whether such a government is handling public resources well or badly we must disaggregate the government sector and examine the benefits that are provided, as it were, citizen by citizen.

Takings within the public sector

One of the great gaps in everybody's regulatory constitution is the case in which publicly held assets are transferred from one use to another. These

shifts can often have pronounced effects on the distribution of benefits and costs amongst individuals, but generally are not covered by a takings clause.

Thus if land is already in public hands, and a decision is taken to allow snowboarders to use it, there is a shift in the distribution of public benefits. If the government then turns around and declares that snowboarders are no longer permitted, there is again an implicit wealth transfer. Simply creating public land does not determine access rights: those rights are determined by the relevant ministry. If land is taken under one pretext, there is one set of beneficiaries. If it is taken under another pretext, a different set of people will benefit. Typically the taxes raised to bring a resource into the public domain depend little on the end use of that resource once it is in public hands. In consequence, essentially the same rent-seeking game takes place within the public sector as outside it. Thus a well-designed constitution attempts to control not only the relationship between the government and the individual but also the relationships amongst all the multiple claimants to an asset inside the government, once that asset comes into public hands.

There is an ideal solution to this problem. If one can make a reasonable judgment as to which individuals will benefit from a project, and can assess levies in proportion to benefits received, there is a strong case for financing the project through special assessments rather than general revenues. The shift to special assessments has extremely valuable consequences. Suppose a local authority is taking land for a local facility. Financing this project from general national taxes would imply powerful redistribution within the public sphere. The benefits are all concentrated while the costs are spread very thinly. The local people might easily be prepared to fund, say, 30 percent of the project if outsiders are funding 70 percent, whereas the locals might not regard it as justified if they had to pay the full cost of a project that had only local benefits. Thus the simple operation of acquiring land, when placed in the context of the public sector, turns out to raise every single important issue associated with corporate governance, where

the question is what steps should the law take to minimise the level of (oft concealed) redistribution within the firm, which if left unchecked reduces shareholder desire to invest in the corporate activities in the first place.

Against this backdrop, a good takings clause or regulatory constitution tries to address the question as to what happens once a resource comes into public hands, even if compensation is paid. Which institutional rules will provide the best set of incentives when a government starts creating property rights that are weaker than fee simple and generally subject to revocation by political action? It is a profound problem – the largest and most important issue in the management of public lands in the United States today. When a road is built, who can use it? Which Indian tribe will find its ceremonial grounds destroyed? These kind of questions come up constantly. The US Constitution essentially kicks for touch on the issue. The judiciary has no willingness to overturn legislative wealth transfers that involve property remaining in public hands. Any comprehensive regulatory constitution, however, would need to address these questions seriously.

Partial takings

More complex varieties of taking will create strategic opportunities for governments, which may call for counter-action. There are the problems of partial takings and takings from multiple individuals, with the two eventually needing to be put together in one analysis. What is a partial taking, how does it matter, and what are the ambiguities? Everybody agrees that if the government takes land in fee simple and occupies it, we go through the social calculus described earlier. We understand why the just compensation principle plays a stabilisation role, even if it cannot solve every problem. Suppose the government now changes the rules. Imagine a wartime situation. Somebody owns a facility that the government wishes to use temporarily. The government tells that person they cannot occupy the land for a certain number of years, or for the

length of the war. Afterwards the government will return the land. Should the government be made to pay for its interim use of the property taken for a limited period of time?

In a private system of property rights, everybody recognises instinctively that property does not take merely one form. There is not just fee simple, with interest of lesser status not counting as property. One can divide land into a leasehold interest and a reversion interest. In this particular case the government has taken a leasehold interest, and should compensate for the taking, even though the original owner will still have the right of reversion. All the same questions arise about loss of goodwill, appraisal remedies, relocation and so on. If they are not fully taken into account, there will be too much government taking, just as in the fee simple case. Indeed it is even more complicated, because sometimes when property is taken for a term of years the pattern of government use causes damage to the reversionary interest in the land. Consequently if a short-term taking has long-term consequences, these must be included in the calculation of the total diminution in value.

Where there is a taking of a partial interest and the residual effects are uncertain, one proposed solution is for the government to purchase the whole property in fee simple. That avoids the need to calculate the value of a partial taking. The government can sell off the reversionary interest at any time. It could dispose of the reversionary interest while the property is in active government service, or it could hold off on sale until the government project is completed, so the land is no longer needed. There will thus be market-like transactions at both stages of the process, reducing the valuation problems coming and going. This is a good illustration of how compensation for takings can be handled given the limitations of cost-benefit analysis. To overcome some of the imponderables of valuation in takings, the government takes (or is even forced to take) composite units that are more easily valued. It takes the whole asset and sells the unwanted portion rather than taking in part and short-changing the owner on the valuation of the retained interest. This is a very important principle, and it can be put into practice.

Easements and restrictive covenants

The great subtlety of the US property law provides us with many other types of partial interest, and hence the possibility of many other forms of partial takings. One is the easement, in which the government simply takes a right of passage over a person's land rather than occupying it exclusively. Compensation should be provided to the landowner in those circumstances. All the same considerations about the need to impose discipline on politicians, limit rent-seeking, and promote the efficient choice of projects require bringing the partial occupation of land by an easement under the takings regime. I suspect easements in New Zealand are covered in the Public Works Act 1981 as an injurious affectation or a partial taking, or in some other way.

But the NZ legislation mirrors the US Constitution in having one fatal omission. In private law there is little real difference between an easement, which gives an outsider limited rights of access to a person's land, and a restrictive covenant imposed for the benefit of a neighbour, which prevents a person from using their own land. Yet the Public Works Act 1981 does not cover land-use restrictions imposed by the government on private parties. The Constitution changes course at exactly the same point, despite the completely different governing structure in the United States. In America, if the government occupies land – no matter how small or sporadic the occupation – an almost automatic obligation for compensation is generated. But if the government merely restricts the use of a person's land, above and beyond the nuisance restrictions of common law, generally no compensation at all is required, unless the restriction leads to a complete loss of all economically viable uses of that resource.

In private law if a landowner's neighbour came up to them with a gun and said, "I am entering your land whether you like it or not", that is regarded as a taking. Suppose the neighbour with the gun also said, "If you build a house on that land I will blow it up. Here is the dynamite I intend to use". Under private law the landowner would still be able to sue that person. Unless the behaviour was in response to a major nuisance

the landowner was intending to create, such a threat to restrict the use of land could never succeed.

Moreover, in private law, if somebody is attempting to use their property in the same way a neighbour has already used theirs, that neighbour's chances of succeeding with a nuisance-like argument are precisely zero. I am not concerned to argue exactly where one draws the line in defining a nuisance. When American case law began taking this question seriously, it instinctively gravitated back to the Restatement of Torts (an overview of American law prepared by experts in the field) that is the standard canonical view of a nuisance. The Restatement was not jerry-built for this situation; rather, it was so useful because it helped avoid legislative nullification of the compensation requirement by artful definition of terms such as 'property' or 'nuisance' – a constant thorn in the side of everybody working with takings law. Land-use restrictions between neighbours are compensable, just as occupation is compensable and restrictive covenants are transferable. The convention called to draw up a regulatory constitution must decide whether these restrictions should be protected by a compensation requirement, or whether they are not covered by the constitution.

Regulation as a substitute for taxation

Roger Kerr is entirely justified in his concern that politicians will begin using regulation as a substitute for taxation, if taxation is subject to heavy scrutiny and political costs. They will do so constantly. An American case about land-use restriction shows the connection between the two far more vividly than any abstract argument. *Lucas v the South Carolina Coastal Commission* was decided in 1992 by the Supreme Court. Mr Lucas owned two plots of land on the waterfront. Each plot was worth around US$500,000 if a single family home could be built on it, as the applicable zoning law then allowed. For the benefit of tourism and the tranquillity of the neighbourhood, the local South Carolina Coastal Commission prohibited Lucas from building on his land a home similar to those of his neighbours. The value of the plots plummeted to either just above or

just below zero, depending on how one treated the residual liabilities and assets associated with owning land. When the case came to the Supreme Court, the Commission argued that no land use restriction should ever be subject to compensation – a comforting thought to planners, because zoning is essentially one huge interlocking set of land-use restrictions.

Five out of the nine judges did not accept that argument. But they did not want to rule that all land-use restrictions should be subject to compensation. Instead they found a rule to the effect that land-use restrictions should be treated like direct occupations when they "deprive the current owner of all viable economic use of his property". That was the test established. And in the eyes of the court, if somebody is subject to a flat prohibition on construction, they have no viable use of their property. Thus the Supreme Court effectively said to the Commission: "You own this land. You have condemned it. You will therefore take a conveyance of the title of the restricted land and pay Mr Lucas the pre-regulation fair market price".

In consequence, the local government needed to find $1 million to acquire the land. It had been announcing to the rest of the world that the restrictions were justified by the benefits they provided – that it had made the decision of a responsible government. But now they said to themselves: "We need to pay $1 million in order that two plots of prime waterfront land be kept vacant. What can we do?" They took the correct course of action and decided to resell the lots. But on what terms? One possibility was to sell the land with a covenant to the effect that it remain vacant. The owner of the neighbouring plots was even willing to buy the land on these terms for around 70 percent of market value, because they did not want neighbours. But that was not enough. In the end there was a complete U-turn: the plots were sold to the highest bidder prepared to build a single family home on them.

In this case the compensation requirement demolished all the pretensions that keeping the land vacant was in the public interest. It was apparent that there was a serious erosion problem along the public beaches in the vicinity. The government was in effect saying, "the best solution is

to destroy $1 million in private land value by preventing construction, instead of spending only $100,000 to restore the beach". Those were somehow its priorities. If anybody really believes that a sensible government might imagine that the way to save a beach is to keep a plot of land idle when all the land around is developed, as opposed to taxing everybody an appropriate share and spending the $100,000 on beach improvement, they are in favour of no compensation under the takings clause. But for those who think otherwise, the case illustrates how a takings clause can be crucial in effectively allocating resources. People who were talking out of one side of their mouth before they were made to pay were talking out of the other side of their mouth afterwards. They were exactly the same people. But once their incentives changed, their behaviour at the time of subsequent sale revealed their earlier misdeeds.

Ambiguous situations: discontinuities and general regulation

There are two ambiguities associated with the principle of compensation. One concerns what happens when a restriction on land permits some building, but not to the extent desired by the landowner. Suppose a landowner is restricted to building a smaller house than everybody else, and their land falls in value from $500,000 to $100,000. In the United States that person must simply bear the loss: a $400,000 fall in value resulting from a partial restriction is non-compensable. Nobody can satisfactorily explain why that discontinuity should be tolerated by the law, any more than they can explain why a government can condemn land worth $500,000 and pay 'bargain' compensation of only $100,000. If the numbers are identical in both cases, why do the legal outcomes differ so dramatically?

Imagine a graph in which the percentage of value lost as a result of a land-use restriction is plotted along the horizontal axis, and the percentage of value paid in compensation is plotted along the vertical axis. We want the compensation to move up in sympathy with the taking, as given by the 45 degree line starting at the origin and ending at the point which

calls for 100 percent compensation for 100 percent taking. We do get 100 percent compensation for a full taking. But with anything short of that, the compensation given is zero. The compensation line does not move up from the horizontal axis. Partial land-use restrictions are not compensated, no matter how large in absolute terms the associated loss, while total losses are fully compensated.

Thus we need to explain why the line should jump at that particular point, but nobody has managed to do so successfully. Once regulators see that completely prohibiting land-use construction will require 100 percent compensation, they might still attempt to obtain the same result by specifying the restriction in such a way that it falls just short of the discontinuity point. They can begin loading on various building requirements and other conditions. They can make land completely impossible to build on by demanding that pylons first be sunk 50 feet into the ground, or that certain road restrictions or setback restrictions be adopted. When parties have been given the right to build only subject to onerous conditions, there is a great deal of litigation in the United States over whether these landowners have been driven to a point on the graph just short of that elusive discontinuity, or whether in fact the conditions are so onerous as to entitle them to compensation. Nobody knows exactly where to find that discontinuous point. The price we pay for the discontinuity is conceptual incoherence, and it is a very high price.

Nobody is arguing of course that taking without compensation can never be justified in the case of nuisance. Major nuisances can be shut down, so long as the actions of the authorities do not themselves constitute a disguised form of confiscation. That is a big issue, but it is not our concern here.

The second question is how one generalises from a case like *Lucas* to regulation applying more widely. Suppose the regulators have grown more ambitious. They not only wish to stop one person. They want to pass a statute prohibiting anybody owning a property along the beach front from building a single family home. Some will argue that the moment regulators shift from preventing Mr Lucas from building to preventing

everybody along the beach from doing the same thing, the nature of the game changes. The picking on an isolated landowner by regulators entitles that landowner to compensation, but 'general regulation that covers an entire class' is seen as perfectly permissible.

That argument conceals a fundamental and fatal ambiguity as to what is meant by general regulation. On one definition, general regulation simply requires that a restriction that is partial in its consequence should apply to multiple users of the land. There need be no discussion of the benefit side of the equation, either in valuing benefits or in identifying the people to whom those benefits apply. Other versions of general regulation can be considered. One version arises when the benefits from a scheme go to all the owners subject to the relevant restrictions. This is very common when land-use restrictions are imposed in a private condominium or subdivision scheme. Everybody must follow the same setback restrictions, and all owners benefit from the increased light and space generated. To the extent that "an average reciprocity of advantage", to use Justice Holmes's felicitous phrase, is possible, this general rule is beneficial. Each member of the association has both a loss and an offsetting benefit. If each individual can only maximise their private position by maximising the overall social position under incentive-compatible voting rules, there is no need to worry about valuation problems. To give a simple example, in a perfectly homogeneous organisation, where everybody agrees to a 10-foot setback, nobody need calculate explicitly how much their own setback costs them, or the value of the return benefit in the form of the like restriction on the neighbours. The mere fact that the policy is decided upon by a majority, is applied even-handedly, and is uniform in impact across the subject population, justifies the restriction. Tyler Cowen's problem with calculation is bypassed by the use of an easily monitorable legal convention.

This framework can be applied to the *Lucas* case, to ask whether the restriction on those two plots of land was designed to benefit Mr Lucas, the beach front owners as a whole, or to serve some wider environmental

purpose. The remainder of the legislation provides the disturbing answer. If somebody owned a house on that beach, and the house was destroyed, it could not be rebuilt. This coastal restriction measure had been passed at central government level at the behest of environmentalists in order to eliminate or curtail beach front development. Even as a general regulation, all the benefits accrued to one group of individuals and all the costs were imposed on another group. Evidently there were no offsetting benefits and costs.

This is not an example of pure benevolence but of pure pathology. In the benevolence scenario, each individual is subject to the same benefits and burdens as every other individual. When somebody optimises their private gain they optimise their social gain. In the other case, one group of individuals votes and only receives net benefits, while the other group votes and only suffers net losses. The group suffering the losses is simply outvoted by the group receiving the benefits – a system for generating wealth transfers on a large scale. If regulators treat both of these patterns of general regulation equally they will completely ignore the different political dynamics involved.

Under the standard analysis one typically cannot draw any of the distinctions people like to draw in these areas. The point made earlier about the easy substitution between government spending and regulation is very important. One can have a series of comprehensive land-use regulations that restrict people from certain building activity. One can impose upon landowners a comprehensive set of special-use taxes, which would also effectively restrict the type of buildings they construct. Or one can give a transfer payment to certain other individuals. Any regulation is a taking of property: it is the government imposition of a restrictive covenant on many individuals. And any tax is a taking of private property, since it is the imposition of a lien with respect to many individuals. The takings law should start from a simple prohibition against taking private property. The government should not escape constitutional scrutiny simply by choosing one form of taking.

The case for proportionality and special assessments

To understand what is going on, one must examine the benefit side of the picture. In writing *Takings: Private Property and the Power of Eminent Domain*, it became clear to me that the principle of proportionality, of average reciprocity of advantage, set out the desired principle for constraining government behaviour that redistributed wealth from one segment of the population to another. With taxation one does not only want transparency, as in the Fiscal Responsibility Act 1994. Whether one is coming from a political, theoretical or constitutional perspective, it is impossible to limit the size of the national budget by allowing the government to follow the path of least resistance. One will simply not succeed, much as one might wish to try. What one can do besides requiring transparency is structure the form of taxation so as to apply indirect constitutional disciplines on government behaviour.

One of the great attractions of a flat tax, levied from first to last dollar over all sources of income and financing all general public expenditure, is that by preventing a tilt in the allocation of burdens, it reduces rent-seeking activity. In *Takings* I argued that one should use general revenues for general expenditures, and that for localised benefits one should use special taxes, betterment taxes, assessments and exactions. One should at least attempt to ensure that the class of beneficiaries is properly identified so that it bears the burden of payment, thereby preventing the destructive cross-subsidy that arises from the shifting of burdens on to others.

In some cases that identification is a very difficult exercise, but that does not mean it should be abandoned. There is also a weaker principle with real force – the consistency requirement. Suppose somebody is building a local road and is faced with the question of how it should be publicly financed. Assume for the sake of argument that the road cannot be funded through user charges. It will either be funded through a property tax levied on adjacent landowners – so-called special assessments – or through general revenues from every citizen in the wider community. Those are the only two choices.

The difficulty of this problem quickly becomes apparent. Residents living on that street will obtain greater benefits than anybody else. But they are not the only people in the city who will benefit: all the business people who supply these individuals will benefit and so on. It is somewhat analogous to a telephone network. The first best solution might be a mixed system in which, say, 60 percent of the costs are financed by special assessments and 40 percent by general revenues, with the general tax only applying if those people paying the special assessment are willing to finance their proportion. But suppose such a proposal is rejected in favour of the road being wholly financed by special assessment of its adjacent neighbours. When the time comes for another road to be built, one treats with enormous scepticism the pleas of people located on the new road who say: "Consider the network externalities. This road should be financed out of general revenues". The people on the first road are already paying localised taxes, and would now be asked to pay more than their fair share. The second group of people benefited when the first road was built, but paid nothing at all, and once again they want to switch the system in their own favour. The consistency requirement is an attempt to discipline government behaviour by ensuring that if the government begins a plan of improvements involving a project to be implemented in stages, it cannot change the method of financing mid-stream. This is extremely important because in local politics the first people coming to a community will often use general revenue for improvements, then tax newcomers on the basis of marginal costs. That is a barrier to entering the community. Thus a takings clause generates many complicated tests on consistency, disparate impact and so on.

If there is any answer to Tyler Cowen's argument that a cost-benefit analysis should not be the centrepiece of a regulatory constitution, it is that one should attempt to identify those areas where some rough proxies suggest that benefits and costs are seriously mismatched, and tackle them first. These cases will always involve resource misallocation. But there comes a point where the provision of certain amenities such as airports, with their distributed benefits and costs, should be subject not to

systematic constitutional restriction but rather to standard procedural regulations. In other words, one pushes cost-benefit evaluation as far as one finds it to be administratively feasible, and then abandons it beyond this point. We can take comfort in the fact that if we can solve some of the local zoning abuses, which are so important in the United States, and some of the abuses concerning mismatched financing, we may have solved 60 percent of the problem at relatively little cost. Those achievements should not be jeopardised simply because not all the problems can be resolved in one global solution.

Questions

The essential idea in the Public Works Act 1981 is that if the government wants to take somebody's land, it must notify the landowner well in advance. That person has an opportunity to object, and the Environment Court then makes a determination. If there is a taking, the landowner can require the government to offer compensation. And although the wording in the statute seems to apply only to land, the coverage is actually broader. When the taking affects the value of a business, there might be compensation for loss of goodwill, if the business must relocate. Partial takings are also covered.

If land is taken for an airport or national defence, thus depriving the owners of the use of that resource, there is the potential problem that 20 years later the use may change again, with somebody else reaping the benefits. According to the Public Works Act 1981, the Commissioner of Works must give prior consideration to returning the land to the original holder. That point is thus implicitly recognised and was not mentioned in your analysis.

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If the government uses land first for one purpose and then another, it may never be returned. This only occurs in the weakest cases where land is surplus. That is not necessarily what we want. In the national park debate in the United States, people grow very passionate over whether mining should be permitted on public lands in preference to various competing recreational uses. Huge values are tied up in these choices, and there is no guidance in the US Constitution.

Whatever service somebody wants from public land will typically be obtained at a price far below its value. For instance, there is a queue literally a mile long for tramping permits in Yellowstone National Park. People will queue in their cars outside the park, waiting to be admitted at below-market prices, and thus create serious environmental damage from their exhaust emissions. This is a very important issue. The tendency in government circles is never to price services on public lands at a market-clearing rate. Government agencies are always giving away benefits to somebody. The most tempting course of action is to charge prices that are positive but low. Nobody wants to be seen as receiving a handout: that is politically indefensible. But if people are charged $20 by the government for a benefit worth $200, they will consider themselves bona fide purchasers for value, fully protected and paying their way, when in fact they are receiving huge implicit subsidies.

Ministries should always be wary about bargain purchases, known and understood to be such, as a real source of abuse. When resources come into government hands, or change from one government use to another, the potential for rent-seeking needs to be reduced by the government's pricing them at market-clearing values. A clear sign that this is not happening is extensive queues lining up for services at below-market prices.

The Public Works Act 1981 does not handle this type of situation. Typically it covers those public facilities where there are relatively few options for alternative uses. Suppose there is condemned land and the government is already building an electricity generating plant on it. At this stage, any shift to a new use will be very difficult to undertake within the legislative framework. But when the government first takes unimproved land, the alternatives can be very significant. It is at that point that one must be concerned about rent-seeking once the property has been taken into public hands. The American constitutional framework is wholly inadequate in addressing that problem.

Putting to one side the problem of changes of use of resources within public ownership, I would like to explore two ideas for generalising the Public Works Act 1981 beyond land to wider takings. Cases in point might be human capital or workplace restrictions. The idea would be that if the government proposed to change a regulation that restricted the ability of employers or employees to use their existing property rights, there would need to be notification. There could be some legal entity analogous to the Environment Court which would hear a complainant's charge that there had been a taking. The definition of a taking would be an action for which there would be a private law remedy in the event of a private party attempting to impose that same restriction on use.

In the American tradition this was a liberty of contract issue, and labour market contracts received constitutional protection in our system for a very long time. If somebody wanted to enter into a wage contract, and the government mandated certain minimum wages, that was struck down as an interference with contract – unless it could be shown that the measure was designed to deal with a genuine externality, which generally speaking could not be done for limitations on wages. The topics of hours of work and safety regulation were more plausible candidates for successful government intervention. In examining the full range of government regulation, the courts distinguished between regulations justified under the police power (which covers health, safety, morals, and even – perhaps – the general welfare) and what they then termed inappropriate exercise of the power to regulate labour markets.

By this standard, the legislation allowing bakeries to require their employees to wash their hands before making bread was regarded as a legitimate use of the police power, because it ensured bread would not be contaminated on reaching consumers. The courts understood that other restrictions on freedom to contract between an employer and an employee were often promoted by competing suppliers of labour attempting to secure some advantage in the wider marketplace. The rent-seeking game was alive and well long before the term was invented. Judges understood

it. This was demonstrated in the most famous of the American labour cases, *Lochner v New York*, decided in 1905 by a five to four vote. The state had legislated that non-union bakers could not work more than 10 hours per day. This prohibition might look to be simply a health statute, but the Court held, rightly in my view, that it was not a health statute at all. Bakers in the immigrant shops were working 12- or 14-hour days, baking the bread in the evening and sleeping on the premises. By contrast, unionised labour worked two shifts – one group of workers in the morning and another in the afternoon. These workers were unaffected by the 10-hour restriction. Thus the legislation had an extremely disparate impact – destroying the mode of production for one type of firm while leaving the other unaffected. The judges instinctively sensed that the law amounted to a transfer between union and non-union firms, and struck it down on those grounds. The public was of course the winner from the increased supply of goods and services that the *Lochner* decision promoted.

A generation of American constitutional scholars, in their ignorance or disregard of public-choice theory, excoriated the decision because they read the statute as protecting Mr Lochner's poor and downtrodden immigrant workers from exploitation. But the legislation was aimed to drive Lochner out of business, and did nothing to advance, and everything to harm, the position of Lochner's employees. The whole story of the case is told by the title. This is Lochner against New York State. It is not Lochner against an employee claiming to have been unconscionably exploited. On this issue the firm and its employees formed a united front. The state was not protecting one from the other, but oppressing both for the benefit of third-party competitors. Anybody with experience of business lobbying over trade policy knows that on the issue of tariffs, unions and management within a given industry typically work together hand in glove. They try to keep out the outsider, which is exactly what occurred in the *Lochner* case. That is why I believe Tyler Cowen to be too pessimistic. Of course, one can find examples where calculating benefits and costs is so difficult as to be not worthwhile. But one can also find many easy cases in which intervention can be very effective.

In the baker example, within the framework I am thinking about, those working a 14-hour day could take a case to, say, a Takings Tribunal, claiming a disproportionate taking. The tribunal would then work through all the considerations you have outlined. If it decided there had been a taking, various compensation requirements would be triggered.

Unlike cases involving land use, liberty of contract cases almost never become a compensation issue. With land, almost everyone can see why a government might sometimes need property for public facilities such as parks. Governments may typically take too much land, but some land needs to be taken. Suppose the restriction in the *Lochner* case makes certain workers unemployed. There is rarely a willingness on the part of the government to give them relocation payments. Almost invariably a restriction is either regarded as valid without compensation or is struck down by the courts. I am not aware of any labour market case that ended with compensation.

Compensation is only given in cases that provide a very bad precedent. Suppose an industry is supplying steel to a domestic market, and is protected by tariffs. The government then lowers tariffs. The industry demands compensation from the government for the displacement of their product by foreign steel. Competitive harm becomes a matter of lawsuits. Unless one can maintain an ironclad distinction between claims for compensation involving genuine restrictions on contractual freedom and claims that simply involve losses due to competition, one could end up entrenching protectionism constitutionally, which would be counter-productive.

In the Lucas *case, the answer is relatively plain. One understands why the dot on your graph is at the point of 100 percent taking and 100 percent compensation. But you say there is no explanation as to why the compensation line does not rise in sympathy with the degree of taking. Have you not given the answer yourself in an article in the* Chicago Law Review? *You talked about the limits of the market, and argued that after a certain point we simply cannot apply market solutions. Alter the* Lucas *facts slightly to make the form of zoning less extreme.*

Suppose it is the imposition of a height limit. Or, to take a recent New Zealand case, if a subdivision proceeded between the Auckland wharf and the former railway station, using old railway land, the noise of round-the-clock wharf activity might be subject to nuisance suits from people coming to live in the new area. If you apply the general takings principle across the board, so that every diminution of a bundle of rights entails compensation, do you not end up with administrative chaos?

The argument is that the administrative costs of trying to superintend a system of compensation for takings are so enormous that the allocative inefficiencies created by the deviation of the compensation line from the 45 degree line are lower than is found in such a system. I believe administrative costs are certainly a consideration, but not powerful enough to drive us back to the point of inaction. There is also a second consideration. In the light of the nuisance created, the state should pay either no compensation or less compensation, depending on circumstances. The basic idea here is that the state acts as an agent for the private neighbours who could, if organised, prevent the activity without paying any compensation at all.

In some cases, however, an understanding of the police power requires an understanding of the fine points of nuisance law. The coming to the nuisance case illustrated by the subdivision on old railway land is a standard American example that has been litigated under the takings clause. That case derives from the English case *Sturges v Bridgman*, and the theme was taken up in *Hadachek v Sebastian* (1915) which constitutionalised the argument in American law. An element generally misunderstood about the coming to the nuisance case is a point Jessell, the judge in *Sturges v Bridgman*, made in his opinion. The case involved a statute of limitations issue. There were two adjacent plots of land with different owners. On one plot, one owner built a factory that created vibrations and noise. On the other plot, 10 years later, the other party built a doctor's surgery that was sensitive to noise from the neighbour. The vibrations from the factory upset the doctor. The great dilemma in this case was whether there should be a system of temporal priority by virtue of the factory being there first so that the person building next door could not recover damages, even

if a remedy would have been available to that second party had the two plots been built upon simultaneously. It is a genuine puzzle.

In analysing this question, it is best to go back one step and assume initially neither party has built upon the land that it owned. That is how Jessell conceived of it. Suppose the first person then starts to build a factory knowing that, once it is built, they will in effect be preventing the other party from establishing their own business. The other party must have the right to enjoin the construction of the factory, even before the other plot is built upon. If not, there would be a clear diminution of rights. Previously the doctor could have built an office and protected it from noise using the law of nuisance. Now that relief is no longer available. Suddenly strategic behaviour becomes very important: the first to build in effect creates a lien or easement over another person's land. Jessell did not want to create a set of legal rules that allowed that to happen. He therefore imposed a judicial deal on the parties that worked to their mutual benefit. One person can build first and create a nuisance-like activity, so long as there is no actual interference with the use of the vacant land next door. But the factory owner must give up the statute of limitations defence when the doctor sues for a nuisance after having opened the new surgery.

This is a good solution because it avoids litigation between the parties in the first period. But there is a price to be paid. Ten years down the road, if an incompatibility exists, the only way to make good on the original allocative gain is to suffer an allocative loss. To claim that it is wrong to allow the doctor to build a surgery next door, and then enjoin the other person, is to treat the problem merely as a one-period game rather than a two-period game. The constitutional argument should follow the nuisance argument. The first party has the choice of relocating the business, buying the second party out, or paying compensation for the nuisance.

The difficulty with saying this is unworkable is that the supposedly unworkable approach has actually worked. And in many cases by postponing the time of actual conflict, the rule allows interim use by the nuisance-creator. And happily, sometimes when the conflict seems

apparent, the overall increase in the value of lands leads the nuisance-creator to alter the use in ways that remove the potential source of incompatibility.

Any regulation is a taking of private property. We can say that the whole democratic process involves those sorts of decisions. Our takings tribunal is essentially our parliament, along with the executive and the courts in our system. It is very hard to find a regulation that does not affect a property right.

You are absolutely right in the general claim, which is why the problem is so difficult. It does not mean that regulations affecting property rights could not be sustained under a regulatory constitution. Consider a complicated taking such as building a new airport. In the United States, there will need to be a ministerial decision at some level over where to locate the airport. What happens to a person right underneath the flight path, whose house becomes intolerably noisy when a plane flies overhead? Such an invasion of air rights is regarded as a complete taking, and the government must buy that person out.

Suppose a house is not directly under the flight path, but foundations are still rattled to the point where they disintegrate. American case law says there is no compensation. Yet the sensible rule is to treat the damage as a common law nuisance created by the government. It is impossible in practice to calculate a payment from each individual plane on the basis of its pro rata share of the harm caused. Instead one places the liability on the airport for introducing the nuisance. A tax can be imposed on the various aircraft in proportion to their noise levels. Since doubling the decibels more than doubles the harm, a sophisticated tax will have some type of exponential form. This provides a compensation system with much better incentives. Identification and compensation by government of the really big losers will influence its decisions over where to locate airports. One does not construct an airport in the heart of a downtown area where it creates major disturbances.

There is a simple answer to the objection that this policy will hurt the poor who may live in a neighbourhood on the outskirts of a city where an airport is built. Poor people like money. The diminishing marginal utility of wealth argument holds that an extra $1000 to a rich person will bring relatively little additional welfare, but to a poor person will bring a great deal. The government should say to the poor person: "We do not wish to pick on you. We are giving you a cash bonus above and beyond the market value of your land. Since rich people have sharply diminishing marginal utility of wealth, it follows that poor people have high marginal utility. Thus we are making you much better off". It is surely better to spend $1000 on one person and give them 500 utiles of benefit than to spend $10,000 on a different person, for which everybody else must be taxed, in order to give that person only 250 utiles of benefit. Thus the poverty issue handles itself.

This is an example of how one can usefully identify a number of restrictions, in addition to direct occupation of land, and treat them as takings. Decision making is improved without having to consider whether compensation should be given to businesses located 20 miles from the airport, which might be hurt relative to businesses only five miles away. That indeed is how ordinary businesses typically are treated. If the government decides to locate its ministry on Street A rather than Street B, it does not need to compensate the restaurant on Street B for business forgone as a result of its decision. We simply rule out of the picture many externalities that are financial and pecuniary, but which ultimately can be expected to roughly net out. Unless we believe some powerful political pressure will skew the outcomes, that is the sensible course of action. My argument is essentially for applying partial cost-benefit analysis where it works, and then giving it up where the benefits of the analysis do not justify its cost. It is, as it were, a cost-benefit analysis of cost-benefit analyses.

I support your argument that we should only go for 60 percent of the gains but there is still a problem. The transactions costs of raising a betterment levy and going from that to a detriment compensation may be too high.

If one takes seriously the potential for misallocation of resources, then one constantly looks for rough proxies that will discipline the government. Here is a real example and a clever solution. New Orleans is a city with districts whose aesthetic and historical values depend on maintaining generally uniform exteriors. Restrictions are imposed on the ability of each landowner to alter those exteriors. The benefit structure has two elements. First, it recognises that there is clearly a reciprocal benefit between individuals in a district. If one ignored any government subsidy and simply looked at the market value of the properties before and after the restrictions, one finds that they fall. But the reduction is less than one might expect, since the preservation of the district operates as a restrictive covenant that is mutual in nature. Secondly, these restrictions also benefit other neighbourhoods: by creating a tourist site, they draw more tourists to New Orleans in general.

New Orleans not only followed a system that took into account both the reciprocal and non-reciprocal portions of the benefit. A rebate on property taxes for landowners covered by the restriction was also given. When account is taken of the lower property values, the tax concession and the reciprocal benefits from the restriction, landowners subject to the restriction were roughly as well off as before. It is a relatively simple system. Indeed it is possible to calculate how large the tax incentive needs to be to make the property units worth as much on average as they were before the restrictions were imposed. Since a surplus is generated by this arrangement, the homeowners should in fact be made better off, and in New Orleans they are. That is what we are seeking – the 60 percent solution.

You talked about replacing tax-funded policies by direct regulations. In the latest edition of its magazine, the New Zealand Historic Places Trust is bewailing the cut in its budget, and saying it intends to increase its efforts to use local authority powers to impose heritage orders.

Landmark designation activity has been a source of great bitterness. Famous cases typically involve a St Bartholomew's Church or a Grand Central Station, both in New York City. When these potential landmarks are located in a downtown area, the air rights over these buildings are worth hundreds of millions of dollars. If a uniform restriction is imposed on some party who cannot build over their land and some party who can, the rent transfers can be enormous. A distinction has to be made about whether the case comes close enough to meeting the average reciprocity of advantage test so that it is not worthwhile becoming involved in administrative corrections, or whether either individuals or the owner of a parcel of land are being made to bear undue costs.

When the older cases successfully made that distinction, they achieved the 60 percent solution. That is all one can do in this business; it is futile to hope for more. But when the new cases no longer make the distinction, one loses not only the 60 percent gain. The frequency of takings also increases, because a zero price has to be paid to effectuate them.

This relates to the point made earlier about administrative costs. In estimating the likely cost of running a compensation system, an assumption of a constant volume of government activity will make the valuation problems seem enormous. But if activity shrinks in response to the price signals received through government budgets, fewer parcels of land will be affected, though costs will be greater for each parcel. The net effect is unclear. In the United States we have never been willing to accept a restriction that results in a total loss of property value. Determining what is, or is not, such a restriction produces immense litigation for no real purpose. Thus the American system does not avoid administrative costs. The costs come in deciding where the discontinuity takes place. I would prefer a fairly unsophisticated valuation system that

determines proportional compensation automatically by proxy instead of spending huge sums in deciding who in a restricted area receives compensation and who does not.

A condition of constructing the new Bank of New Zealand (BNZ) building in Wellington was that the BNZ gave the Council its old building to turn into a park. The Council then sat on that building. There were also problems with the new building: it took around nine years to build. By that stage the Council had said: "We do not want the loss involved in turning this old building into a park. We can sell it to a developer". The building has now been turned into shops.

This is the very same point as in the *Lucas* case. We have talked about how taxation and regulation can substitute for direct takings. But clearly the conditional permit can often become the favoured tactic on the part of the authorities. The government makes it look like an exercise in contractual freedom. "We will give you a permit to build on the land if you give us this other land for public use." In my book *Bargaining with the State* I try to explain why systematic misallocation of resources is likely to occur whenever a government with monopoly power to grant permits is allowed to trade off one development against another. It is like the old common law cases of duress of goods – the tailor will return the garment that they promised to clean for $10 only if the customer pays them $20. The garment is worth $100 so the customer capitulates. Since the customer is entitled to both the garment's return and all cash above $10, they can sue to recover its excess. The customer should not be forced to choose between two entitlements, any more than they should be forced to choose between their money and their life.

That example should be kept in mind in thinking about government. When you write your regulatory constitution, you will need to consider carefully the extent to which the permit power can be conditional upon compliance with land use conditions or sacrifices of property rights. The single most interesting and novel development in American takings law over the last 30 years is *Nollan v the California Coastal Commission* (1987).

The Commission in effect said: "We will give you a permit to build your house in the same fashion as the houses of your neighbours, but only on condition that you give us a lateral easement running across the front of your land for people to walk over". Mr Nollan said to himself: "What is going on here? Giving this easement is a pain in the neck. I would pay $10,000 to avoid it. But if I can build a real house on this land, it is worth another $100,000 to me". In these circumstances people will accept the easement every time as a price for making a much needed improvement.

By making a permit conditional on the surrender of a collateral benefit, the government receives for nothing something worth $10,000 to the landowner. The moment a government can have something for nothing, it is easy to construct scenarios leading to resource misallocations. The easement in the hands of the government might be worth only $5,000 to the public at large, but if the opportunity cost to this one landowner is $10,000, the government may still take it. If the two transactions were unbundled and compensation paid for the partial taking, the building would proceed and the public easement would not. The bundling in effect determines, or misdetermines, the outcomes. It is a classic game of strategy which occurs with bidding in a great variety of contexts.

One of my colleagues at the University of Chicago, Saul Levmore, when he was an economics teacher, liked posing a question to students designed to make them think about this issue. "Imagine there are a number of items on a table", he would say, "each priced at their market values, and totalling $200. You each have $100 to spend on these items. You have a choice: you can either put the goods into two bundles and receive the bundle rejected by the other person, or you can let the other person determine the bundles and have the right to choose between them. No resale is allowed. Which would you prefer – the power to choose or the power to bundle?" If one knows something about the preference schedules of the other person, one will typically prefer to bundle. The values placed on various goods vary greatly amongst individuals. One can come up with a bundle of goods that the other person will choose, even

if the market value of that bundle is less than $100, owing to the subjective values attached to the various goods by that individual. One's own bundle will generally have a subjective value well in excess of $100.

The government has realised that it too can play the bundling game, and any regulatory constitution will need to confront that potential source of abuse. Moreover, as the takings issue has gained prominence, and compensation requirements have become more severe, the willingness of governments to play the bundling and tying game has increased substantially. If somebody wants to construct an office building, it is now perfectly standard to require them in return to give the government land for a public park. In granting a permit for a housing development where ten thousand children are expected to be living, one might understand it if the government demanded land for a school. After all, these very children will be attending the school, and the government is attempting to internalise an externality otherwise imposed on other individuals. But if we simply regard these bundling issues as deals involving arid formulas, without worrying about the public choice dynamic, we will always get them wrong.

This suggests that in addition to the standard rules about when compensation should be paid, an equally important matter is the public choice decision about which institutions should be given the discretion to interpret and apply those rules. This gets us into questions such as whether we should rely on a national legislature or executive, or on judicial institutions, or on local government institutions. What would you do?

This is the standard problem: out of three imperfect solutions, we must choose the one we dislike least. The first point to make is that we must understand that there is a problem before we even start to invoke the answer. Americans who favour big government typically say that so long as we obtain individual consent in a transaction, there is no problem. The irony is that the great new champions of freedom to contract in the government context are exactly those people who despise it in the private sector. Justice Brennan writes a stirring opinion in *Nollan* in which he

says: "This was a bargain in which both sides improved their position compared with the pre-bargain state. Why should we interfere to upset this arrangement?". But ask him about the minimum wage, and suddenly an employment contract is not a bargain between two equal parties that improves their position. It involves exploitation, imperfect information and theft. Justice Brennan simply does not understand that the greater danger lies with government monopoly than with competitive industry.

Thus the first step in solving the problem is to be sensitive to it. Then one follows the same strategy followed with takings. Set up the legislative institutions with requirements for notice, hearings, appeals and so forth. Then bring the most egregious examples of bundling before the courts so that judges have to decide whether a given case of bundling is intrinsic or opportunistic. In *Bargaining with the State* I conclude that this can be done. When local authorities start playing the bundling game in an effort to distort the powers of other governments, such as state and federal, the courts suddenly become very sensitive to this strategy, with the result that they strike down these types of conditions.

Local governments are not necessarily virtuous in these actions, nor are national governments. A local government will respond to those people among its constituency who are politically connected and active, and outsiders will be systematically disadvantaged. When confronted with any development within five miles of their home, even people whose general political stripe is thoroughly free enterprise will put up barriers to new development if they believe that this activity will disturb the tranquillity of the picket fence. Such activity is legitimate if the problem is noise on a public street. But if it is merely the thought that somebody is entering the neighbourhood who may lower the tone, the protesters leave me unmoved. The problem is that these protests fail to distinguish benefits involving private gains but social losses from benefits bringing both private gains and recognisable social gains. Policymakers need to make that distinction.

The first American zoning case, *Euclid v Ambler Realty Co* (1926), reflected the standard view about apartment houses. They are assumed

to be a nuisance in a neighbourhood because all the less respectable types are believed to live in them. Consequently, they give rise to many objections. In this case it meant preventing the use of a 68-acre plot of land where a planned unit development would have taken place. All the externalities would have been internalised, with only a few minor boundary questions to resolve. The case resulted in the decimation of the value of a $4 million parcel of land, reducing it to a tiny fraction of its original worth.

That is the type of case one should have in one's sights. I want to capture the big gains. In my view an incremental approach is best. You should start with the easy cases first, then assess how the system is working. You may perhaps be emboldened to go the next step, while constantly looking for the right point at which to stop. Always seek rules of thumb before applying pure cost-benefit analysis. In the end one recognises that some problems cannot be solved, except by political decision. If we have consensus about that broad approach, we can make progress without immediately determining where the precise transition line lies between regimes.

You said you would do a partial cost-benefit analysis and you would compensate where people's property rights are affected, but you would not compensate people who lose value as a result of competition. Is this simply for the pragmatic reason that the benefits and costs overall can be assumed to roughly even out, or is there a natural, principled reason?

Put aside for the moment the question of a government taking and consider whether a new firm should be required to compensate competitors forced to leave the market as a result of competition from that firm. In a perfect world with zero transactions costs and completely accurate value assessments, there would be nothing wrong with such a compensation system. In welfare terms, all positive-sum-game projects would proceed while negative-sum-game projects would not. But in reality, making these calculations would be such a nightmare that everybody is better off waiving their rights to compensation in exchange

for rights to market entry. As Hume reminds us, we examine social institutions by their general tendencies, not by the consequences that hold solely in individual cases. One will never have competitive markets if disappointed competitors must be compensated.

The same amalgam of practical and theoretical reasons relevant to the case of pure competition is also relevant to cases where externalities result from changes in networks. Everybody is affected one way or another. Compensation is impossible because (a) the precise quantity of business lost through altered traffic patterns is unknown, and (b) it is uncertain to what extent the alleged beneficiaries have really been gainers. The regulator will conclude that even if there is an unfair locational advantage, the administrative costs involved in calculating that advantage are so high that the best option is simply to ignore it. If the claims for compensation for economic losses from competition are difficult to value, and determining the relevant beneficiaries is an almost impossible task, one tells everybody to take their chances with the fortunes of life. That approach has the additional advantage of encouraging well-informed people to mitigate their losses through proactively changing their behaviour rather than attempting to magnify their losses in the hope of gaining judicial compensation.

Thus the rule of non-compensation for competitive losses has no deep mystical rationale. It goes back to the point made earlier that we must constantly trade off transactions costs against allocative efficiencies. In this case, those transactions costs are prohibitive. Where a relatively small number of people can be targeted with nuisance actions, one can achieve something. In other cases where compensation becomes too costly, prohibition of an action may be feasible. It should be a constant aim to minimise transactions costs in ways that do not upset allocative decisions. That is why one begins with the obvious targets first. At some point one concludes that the marginal costs of further resource management are high, and the marginal benefits low. One simply retires like Achilles to one's tent, knowing, or at least hoping, that one will be able to fight another day.