Chapter 7

The Economics of Property Law II: Involuntary Transfer and Regulation of Property

This chapter examines various justifications for government intervention to restrict the ways in which people can use their property, such as the presence of externalities. It also examines limitations on consensual transfers of property, and coercive transfers to higher valuing users.

Key Points

- The traditional economic remedy for externalities is a Pigovian tax, which imposes the costs of the externality on the party imposing it.

- The Coasian perspective on externalities challenges two assumptions underlying the Pigovian approach: namely, that there is a single, identifiable cause of the externality, and that government intervention is needed to internalize it.

- The Coase Theorem says that the initial assignment of property rights is irrelevant to the final allocation of resources, which will be efficient, provided that the parties can bargain at low cost.

- When applicable, the Coase Theorem implies that the law is irrelevant with regard to efficiency. This result mirrors the Invisible Hand Theorem from welfare economics, which says that the competitive market will lead to the efficient allocation of resources regardless of the initial distribution of wealth.

- The final distribution of wealth, however, does depend on how property rights are initially assigned. This mirrors the Second Fundamental Theorem of Welfare Economics, which says that any efficient allocation can be achieved by a suitable redistribution of the initial assignment of rights.

- When transaction costs are high, the initial assignment of property rights matters for efficiency. This is true because not all value-enhancing trades will occur. In this case, legal rules replace markets as the primary means of allocating resources.

- The assignment of rights can be protected by property rules or liability rules. Property rules give owners the right to refuse any unacceptable offers to buy their rights, while liability rules only entitle them to seek compensation after the fact for seizures of their rights.

- Property rules should be used when transaction costs are low, and liability rules should be used when transaction costs are high. Property rules promote voluntary (market) exchange, while liability rules permit forced (legal) exchange. This distinction portrays the choice between markets and law in allocating resources.

- For many types of externalities, common law remedies, like trespass and nuisance, have been superseded by government-imposed remedies, like zoning and regulation.

- Government regulation is preferred to common law control when harm is dispersed, given the cost of collective action by victims. The disadvantage of regulation is that it generally imposes a single standard applicable to all injurers, resulting in too little care by some and too much by others.

- Adverse possession allows the occupier of a piece of property to acquire legal title if he or she occupies it continuously for a set number of years without objection by the true owner. It thus represents a statute of limitation on the owner's right to enforce a property rule.

- The economic theory of adverse possession justifies the doctrine as a way of balancing offsetting risks of ownership. These risks arise, on the one hand, from past claims by legitimate owners and, on the other, from the possibility that an absentee owner will lose title to a squatter.

- Owners of land that has been mistakenly improved by another can either pay for the improvements or require the improver to buy the land at its unimproved value. This rule gives would-be improvers the correct economic incentives regarding whether or not to conduct a survey prior to commencing the improvement.

- Inheritance rules give testators considerable freedom to pass their property on to heirs. Formerly, primogeniture required all land to be passed on to the eldest son. The decline of primogeniture reflects several factors, including the development of land markets that facilitate the transfer and consolidation of land.

- The rule against perpetuities puts a time limit on the ability of testators to control bequests to the lifetime of anyone alive at the time of the bequest plus twenty-one years. The economic purpose of the rule is to limit a testator's control of resources into the uncertain future.

- The *eminent domain* (or takings) clause of the Constitution allows the government to take private property for *public use* as long as just compensation is paid.

- The proper economic justification for eminent domain is to overcome the holdout problem, which impedes the efficient assembly of land. Importantly, this justification does not necessarily limit the use of eminent domain to public projects.

- Courts have defined just compensation to mean the *fair market value* of a taken parcel. Economists have noted, however, that this measure undercompensates owners by failing to account for the subjective value to their land.

- Recent economic models of eminent domain have shown that compensation must be lump-sum in order to avoid a moral hazard problem that would cause landowners to overinvest in land subject to a takings risk. A special case of lump-sum compensation is zero compensation.

- Scholars have raised several objections to the *no-compensation result*, including the need to prevent the government from taking too much land (*fiscal illusion*), the benefits of insuring landowners against the risk of a taking, and the *demoralization* costs of not paying compensation.

- The takings question often arises in the context of government regulations that substantially reduce the value of the regulated property. Courts have developed several tests to determine when a regulation crosses the boundary between a non-compensable police power action and a compensable taking (referred to as a *regulatory taking*).

- Economic theory shows that both efficient land use incentives and efficient takings decisions can be achieved by a threshold compensation rule that only requires compensation to be paid if the regulation was enacted inefficiently. The result is reminiscent of the efficiency of negligence rules in tort law.

- In terms of explaining actual takings law, the efficient threshold rule resembles the famous diminution value test, as well as other legal tests for compensation.

- Capitalization of the compensation rule into the market price for land does not make the compensation rule irrelevant because the owner of the land at the time at which the threat of a regulation is first announced suffers a capital loss.

- Zero compensation for land use regulation creates a risk that landowners will develop prematurely in an effort to pre-empt the regulation.

- The General Transaction Structure describes the legal and economic framework within which exchange occurs. It involves an assignment of rights coupled with an enforcement rule.

- This framework represents the foundation of the economic approach to law, and can be shown to encompass the basic structure of tort, contract, and property law as special cases. It also depicts the relationship between markets and law.