Chapter 5: 
Addendum

D. Takings

According to the Constitution, government taking of private property is permitted when
i. the private property is taken for a public use, and
ii. the owner is compensated.

1. Compensation: One argument for the compensation requirement is that it encourages
government to rely on taxes, rather than takings, to fund its activities. A second
argument is that taxes create less distortions in incentives to own property than do
takings. This is because the threat of an uncompensated taking reduces the incentive to
acquire property, which in turn reduces the likelihood resources will go to their most
highly valued uses.

2. Public use: This requirement is intended to prevent the state from acting as a third party
that facilitates the transfer of property from one private individual to another private
individual. Note that the state’s ability to act in this capacity creates the potential for
significant abuse of individual property rights, because compensation is based on market
values rather than individual owners’ subjective values. When an owner’s subjective
value exceeds the “fair market value” there is the potential for the government to benefit
certain private individuals by moving property to where it is less highly valued, thus
destroying existing wealth.

3. Holdouts: This consideration distinguishes between the government purchasing property
and taking property. When the government purchases property it pays a price established
through negotiation with the owner. When the government takes a property it is required
to pay fair market value, which may or may not equal the subjective value the owner
attaches to the property. In situations in which the government must acquire several
parcels of land for a public good, holdouts are possible. Holdouts increase the
transactions costs incurred in the process of acquisition. The government should only
resort to taking private property (with compensation) when transactions costs (created by
holdouts) preclude purchasing the property. Why?

4. Insurance: In effect, the requirement of compensation forces the state to insure private
property owners against takings. In doing so, the state internalizes the cost of a taking
and, as such, is more likely to engage in this activity only when it is efficient to do so.

5. Regulations: Regulation, by the state, of certain activities of private property owners
provides an alternative means to address the problem of nuisances. However, unlike a
taking, a regulation that results in a reduction in the value of the owner’s property does
not require compensation by the state. Think of takings as compensated restrictions and
regulations as uncompensated restrictions.

The problem here is that takings and regulations create different incentives effects for
private individuals and governments. In particular, if a private individual is ensured of
compensation, because a government restriction is treated as a taking, the individual will
overinvest in improvements to private property. In a similar manner, because regulation
is costless (relative to a taking) from the government’s perspective, the government will
have an incentive to over-regulate. These outcomes result because, in each case, the party in question does not fully internalize the costs of its actions.

E. Bargaining with the state: *Skip this section*

F. Zoning and the regulation of development
Zoning ordinances are frequently used to control development in a particular area. For example, areas of a city are frequently zoned such that only single-family homes are allowed. Multi-family dwellings, e.g., apartment buildings are not allowed. An economic case for such regulations can be made when there are nonconvexities in production. Nonconvexities, which are the product of, among other things, externalities, result in corner solutions. This is inefficient because nonconvexities prevent relative prices from sending the proper signals regarding production. (Relative prices are distorted because the presence of the externality reduces the price of the adversely affected good.) The use of a zoning ordinance can, in theory, correct the inefficiency in resource use that would otherwise result.