Richard A. Epstein

Zoning: deliberative democracy at zero prices

Perhaps the most intractable problem of political theory turns on setting the right interaction of market and political institutions.[1] Markets rest upon the twin institutions of private property and freedom of contract. The former allows all individuals the exclusive possession, use, and disposition of particular resources, such as land or chattels; the latter structures the transfer of human and tangible resources by hire, sale, lease, or partnership. Property rights both separate neighbors and allow individuals to plan over time. Contract permits them to coordinate their activities for mutual gain. It is this one-two punch that facilitates the economic growth that satisfies human wants.

If that were all there was to it, then political theory would be easy because government would be irrelevant. Market systems, however, do not rest on thin air. They depend critically upon the use of state monopoly power, first to protect the holders of property from depredations of strangers, and next to enforce the contracts that facilitate the transfer and recombination of human and physical assets. Try as one might, it is hard – make that impossible – to think of any just and reliable system for supplying that infrastructure that does *not* rely upon the sound operation of democratic politics, with its own distinctive deliberative and voting procedures.

And that is where the difficulties begin. The simmering tension between market and political institutions arises in a multitude of contexts. But it becomes perhaps most vivid in connection with the steamy local controversies over the mundane matters of the ownership and use of land: what should be done if some political majority votes to take the home or business of one person for some

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1 My thanks to David Strandness, Stanford Law School, Class of 2007, for his valuable research assistance.

public use without paying any compensation for the privilege?[2]

It won't do to fight the hypothetical by saying that such untoward results never happen because they do: It is easy to recount numerous situations throughout the world where ethnic majorities use their political power to plunder their rivals. Nor do these issues play out only on the grand scale of outright confiscation. As will become painfully clear, a miniaturized version of this struggle, often with unspoken racial overtones, takes place daily in the ubiquitous planning commissions and zoning boards in the United States and everywhere else in the developed world.

The underlying structural weakness of majority rule, moreover, cannot be easily corrected by adopting a constitutional requirement for unanimous (or even just owner's) consent for any surrender or alteration of property rights. Now a new risk emerges, for that device leaves the state vulnerable to serious holdouts at the instance of a landowner whose property is vital to siting a military facility or completing a public highway.

Yet rescue is close at hand. The Fifth Amendment to the United States Constitution states: "Nor shall private property be taken for public use, without just compensation." Now that "just compensation" is substituted for "the consent of the owner," the state may take the private property of its citizens for public use, so long as it compensates them for the property so taken. This clever intermediate practice nicely cuts between the horns of a real dilemma. The power to take prevents any property owner from demanding a king's ransom before surrendering the property. But the need to pay just compensation prevents the majority from oppressing isolated individuals for its own political advantage. Rightly calculated, the just compensation requirement ensures that owners can be no worse off after the taking than they were before.

The basic protection offered to property rights does not undermine the ideals of deliberative democracy. Quite the opposite: strong property rights work well in tandem with that system of governance. Here's why. The pattern of deliberation within any collective body does not depend solely on its members' opinions and attitudes, which active interchange reveals and refines. Politics is not just about expression, sentiment, and education. It also depends on the practical problems that give rise to the need to deliberate in the first place. Let it be known that any individual is fair game for expropriation, and the grandest deliberative body in the world, when composed of self-interested individuals, may well solemnly conclude that the public welfare requires the confiscation of particular resources from politically vulnerable parties. The adroit deliberator can point out to members of the majority faction – without having to make peace with the rest – that the gains from confiscation will far exceed its costs to members of the winning coalition. Duly persuaded, the majority could vote to ratify the proposed confiscation and rest content that they have been generous toward friends. Or, for strategic reasons, that same majority could limit the power of those same vulnerable groups to use or dispose of their property in various productive or market transactions.

2 I note in passing that a veritable firestorm of protest arose when the Supreme Court held in *Kelo v. New London*, 125 S. Ct. 2655 (2005), that the public use requirement of the takings clause allowed the state to condemn property for private development purposes, even with payment of just compensation. I put aside any systematic discussion of that issue in this paper.

The objections to these confiscatory practices customarily fall into two classes. The first raises the fairness objection, that no majority should be able to 'single out' by legislation or administrative rule a small group of vulnerable individuals to bear some unique burden for which they receive in exchange no unique benefit. The second is the related efficiency objection, that confiscation reduces the overall stock of goods and services available in the economy. But as long as the political majority stands to benefit from, without having to pay full value for, the property taken, it will be quite content to reduce the property's value. Thus, if left free to do so, the state may expropriate land worth $100,000 to its owner even if it is worth only $40,000 in public hands. The $60,000 loss is concentrated on one person, while the political majorities profit by their share of the $40,000 that the same asset has in public hands.

Those well-organized majorities would not, however, attempt this peculiar maneuver if they had to compensate the owner for his losses, for even with political intrigue it is highly unlikely that they could raise the $100,000 in taxes needed to buy off the property owner. Once constrained by the constitutional requirement of just compensation, the political deliberations will raise the pointed question of why the majority is asked to pay so much for so little. When no answer is forthcoming, the misguided project will fail. The fairness and the efficiency objections work in tandem in most situations, which is why property protection through a just compensation rule is a necessary precondition for stable political governance.

Of course, no one can claim that this one feature offers ironclad protection against all abuse through democratic political processes. Notable difficulties arise in calculating the proper level of compensation, to take into account the subjective value that an owner has in his or her property. But better that we suffer from some errors in calculation than pretend that no compensation is the ideal result.

Nor is it easy to identify the goods that the state should provide. It is commonly supposed, for example, that streetlights or national defense are public goods that can be financed only through public taxation. The happy story arises only when all individuals within the system equally value the state-provided goods. At that point, the taxation system prevents free riding by those individuals who would be happy to let others pay for installations from which they will then derive a large benefit. In fact, however, the term 'public good' often misleads as well as informs, because we have no reason to think that all the individuals who pay taxes for a product or service value it equally. The streetlight that supplies illumination to some people may not protect others further down the block, or it may blind the homeowner who lives next to it. Likewise, states will spend military appropriations on wars that many citizens strongly oppose.

The just compensation principle, then, does *not* solve the question of what public projects should be undertaken when their perceived benefits and burdens differ widely across various groups, even if the actual costs of the projects are evenly distributed through the society. At this unhappy juncture, democratic rule following debate is, for all its flaws, about as good as any society can do.

Yet just because political perfection is unattainable gives no reason to abandon sensible safeguards that tend to reduce the overall level of political intrigue. Having to pay for land used as a military facility or a road does *not* eliminate the need for deliberating on whether the fort

or road is called for at all. But it does offer one useful check against a systematic form of abuse that, if left unchecked, is highly likely to produce an excess of condemnations initiated by parties who suffer no financial consequences from their own behavior. Demand is always high for property that can be forcibly acquired at no cost. Churchill was wrong when he said democracy was the worst of all forms of government, except the rest. Constitutional democracy will work better.

In dealing with the relationship between private property and democratic institutions, much attention, especially in the United States, is placed on institutions that operate at the national level. But with land-use condemnation and regulation, most of the action is at the state and local level. One useful way to check whether private-property protection is compatible with democratic institutions is to look at state and local zoning laws, whereby the state and local governments announce in advance that only certain types of uses – manufacturing, commercial, and residential, for example – are permitted in certain specified zones. The hallmark of the state and local systems is that the law provides constitutional protection against forcible dispossession, but much less, or no, protection against restrictions on particular types of land uses.

Everyone thinks that just compensation makes sense when the government expropriates land for public use, but that proposition is sharply contested in those cases where the state forswears occupation in favor of *restrictions*, found in zoning or environmental laws, on how a landowner *uses* his property. Those who are opposed to strong protection of property-use rights often champion legislation at the national and state level that is intended to promote community deliberation over proper land use. The grand constitutional trade of the modern welfare state substitutes a right to participate in administrative procedures for strong property rights. For example, the National Environmental Policy Act of 1969 (NEPA) and the various state acts based on it – the so-called SEPAs – allow various projects that affect the built environment to go forward only after the owner prepares for the public an Environmental Impact Statement (EIS) that examines the environmental impact of the proposed action, the adverse effects it could generate, and alternative measures that might be taken to avoid these consequences.

The conventional defense of this combination of weak property rights and strong notification and disclosure requirements starts from the premise that intelligent planning of complex land-use allocation decisions must avoid two perils. The first perceived risk is that developers will pressure local government officials into making hasty decisions to allow new projects to go forward. The second perceived risk is that a weak information base impairs informed public participation in land-use decisions. The effort typically backfires, as these endless deliberative arrangements produce much mischief in land-use matters.

To see why, start with this simple question: should we treat restrictions on land use as fundamentally different from the occupation of land? This question was brought to a head eighty years ago in *Village of Euclid v. Ambler Realty Co.*,[3] which has defined judicial attitudes toward zoning from that date forward.

The Ambler Realty Company held title to a 68-acre parcel of land located be-

3 272 U.S. 365 (1926).

tween the Nickel Plate Railroad to the north and Euclid Avenue to the south, and bounded by a single-family zone to the west and a two-family zone to the east. As an integrated plot, it was worth about $680,000 when devoted to its highest and best use as a site for a new plant for the Fisher Body Company. When zoned, it was divided into three separate areas that were slated, from north to south, for industrial use, apartment use, and single-family homes.

To Justice Sutherland, the second division was as important as the first, for with ill-concealed racial overtones he described apartment houses as "parasites" in neighborhoods with single-family homes. No racial issue was directly before the Court in *Euclid*. Still, the bottom line was that this zoning scheme stripped about 75 percent of value from the site. Was that loss in value, driven by the regulation, compensable? The Supreme Court said no, by a six-to-three vote.

In one abstract sense, the *Euclid* scheme had a perverse internal logic. If the Village *had* to divide the property into zones, better that the area next to the railroad tracks be zoned industrial, and the area near residential neighborhoods be zoned residential. But why zone at all? The one obvious consequence of the Village's zoning decision was a loss of roughly $510,000 in land value, because the divided parcel was much less attractive to develop than the integrated parcel, which Ambler Realty could develop, taking care to limit the negative spillovers from one portion of its parcel to another. In other words, if that parcel had been kept intact after development, Ambler would have borne the loss from any noxious use directly. But since the parcel was divided, buyers paid less for land that was encumbered with unwanted noises or smells. The welfare of the owner therefore tracks the overall social welfare, whether he holds or subdivides. Ironically, enforced division within the middle of the tract increased the likelihood of boundary conflicts on the one hand and reduced the use value of the plot on the other.

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So where was the social gain that offset the $510,000 hit? The short answer is nowhere, at least at that magnitude. The project in question would probably not have had any adverse physical effects on neighbors: sixty-eight acres allowed for setbacks to avoid conflicts. And the public could have attacked any remaining noxious use that survived without the zoning law through the law of nuisance, which awards both damages for the hurt and an injunction against continuation of the harm. Some indirect costs could have come from siting the new project in the neighborhood. But even the direction of those effects was uncertain at best, for (some) housing values could have swung upward if the new industrial plant had provided jobs for the people who live nearby. In addition, the proposed industrial use was in fact more consistent with the overall patterns of industrial land use in immediate environs adjacent to the Village of Euclid. So the decision by a provincial local government probably caused more external dislocation, not less.

The resolution of the relevant legal issue now quickly follows. Why should these formal restrictions on use *not* be treated as though they were a taking of property? The perverse public-choice dynamic – excessive government activity at no price – works as powerfully for any restrictions on use as it does for the outright confiscation of property. In a world without just compensation, the political forces that constitute the dominant coalition will impose these restrictions so long as the benefits they receive

are greater than the costs that *they*, *not society*, have to incur to achieve those gains.

The values lost in zoning cases can be worth literally tens of millions of dollars (as with downzoning of developable agriculture land). But in all cases the *private* losses to the owner are part of the *social* calculus. They cannot be ignored. Nor can we overlook the gratuitous loss of property value stemming from the uncertainty created by the instability that hangs over these use rights, like a regulatory sword of Damocles. Yet the moment that compensation for these losses in value has to come out of government coffers, the political calculus changes: the forces in favor of zoning have to persuade the neighbors through democratic politics to tax themselves $510,000, and for what? The proposal will fail because no one can identify the net positive benefits that make this social venture worth undertaking.

At this point, a skeptic might ask me whether this means that, without cash on the barrelhead, all zoning ordinances are categorically off-limits. The answer to that question is a cautious but principled no: certain focused zoning ordinances may generate packages of burdens and benefits that make sense socially. In certain cases, for example, restrictions on exterior design imposed on a given region (similar to the restrictive covenants in a private planned development) allow a benevolent kind of canceling-out to take place: the restriction on each party is a negative to each owner, but it is more than offset by the indirect gains obtained from the parallel restrictions imposed on others. The compensation formula thus has an internal gyroscope that tends to weed out regulations that cause negative-sum games from those that generate positive-sum games. But this will only work if the logic that we use for outright confiscation covers all forms of government-mandated property transactions.

This entire issue of compensation is often clouded by a distinction that economists like to draw between two kinds of externalities, which they (misleadingly) describe as 'real' and 'pecuniary.' The former covers cases in which the restrictions in question impose overall allocative losses on the system. In contrast, pecuniary externalities cover changes, positive or negative, which do not have any 'real allocative effect.' For example, a change in housing prices because of an influx of new buyers is a pecuniary externality, but pollution is a real externality.[4]

These two opposing examples help explain the conventional, if puzzling, verbal distinction. A pecuniary externality covers the losses suffered by disappointed participants in a competitive market. Those ubiquitous losses are 'real' to the party who sustains them, but if they were compensable, then any technological improvement that results in lower prices would be the target of nonstop litigation from disappointed competitors. Every competitive loss is offset by some greater gains, so that behind a Rawlsian veil of ignorance *all* people would prefer to bear those losses rather than the greater systemwide losses from private monopolies or state regulation. In contrast, real externalities, like pollution, result in private losses to the aggrieved party that accurately reflect some overall systemwide losses. Hence it is sensible to protect persons against real losses but not against pecuniary ones.

The traditional law on takings and just compensation was alert to that distinc-

4 http://en.wikipedia.org/wiki/Pecuniary_externality.

tion: it rightly treated nuisances as real externalities for which it provided legal remedies. Competitive losses, on the other hand, were considered pecuniary externalities that traveled under the rubric *damnum absque injuria* ("harms without legal injury") and were thus not compensable.

That distinction should guide our assessment of the political activities of local governments. Once the current rules allow local governments (through their deliberative processes) to impose real losses without paying just compensation, persons who suffer only pecuniary externalities (that is, competitive losses) will have a field day trying to get political relief. Nothing is as common as an effort by one competitor to 'zone out' a rival from the central business district, by persuading local government to designate suitable sites for rivals as noncommercial. Yet just as in *Euclid*, the huge losses to the downzoned landowner are not offset by external social gains, and the zoning restrictions create a geographical monopoly that harms consumers.

What is true with respect to commercial developments is also true with respect to residential ones, which take on cockeyed form once the compensation requirement is absent. The severe zoning and building restrictions on *new* construction around Lake Tahoe, for example, unwisely sustained in *Tahoe-Sierra Preservation Council, Inc. v. Tahoe Regional Planning Agency*,[5] show how insiders who impose these neighborhood losses on others purport to act with high environmental purpose. In this case, the runoff into Lake Tahoe, which has destroyed its matchless deep blue, stems from the excessive paving over of bare land by early landowners of the nearby lands.

5 535 U.S. 302 (2002).

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The correct solution is to pull up chunks of asphalt devoted to low-value uses. But the entrenched homeowners have found political ways to force the costs of their own excesses on the nonvoting landowners of vacant lots. Having contributed nothing toward the pollution of Lake Tahoe, the nonvoters are saddled with the full costs of harm prevention. Only the rich on huge lots can now afford to build at all. Yet the hard ground covering already in place just remains.

Requiring compensation to the outsiders who cannot build would lead to more (and more intelligent) environmental protection. If the just compensation requirement were in place, the current owners would probably prefer to rip out their own expensive asphalt than pay owners of vacant land huge amounts of money in order to prohibit all new construction on lakeside lots. And the same policy works well for wholly undeveloped areas. The last thing we want to do is foster a 'race' mentality that induces landowners to rush construction on vacant land because they cannot otherwise protect their future rights to build!

In international trade, it is well recognized that phony health and safety claims often conceal anticompetitive entry restrictions. The same social danger is at work in the zoning cases, which falls prey to the pettiness of local protectionist politics. The just compensation requirement fights that ugly form of localism, by seamlessly taking into account the interests and desires of outsiders to the (voting) community, including future buyers from developers, *without* compromising local protection against real externalities like pollution.

In contrast, ignoring the difference between pecuniary and real externalities undermines the mechanisms of social choice when political participation,

without financial accountability, is made the centerpiece of land-use policy. Here is one telltale sign of how it works. The New York's SEPA statute was at issue in *Chinese Staff & Workers Association v. City of New York*.[6] The case held that the construction of a luxury condominium on a vacant lot in Chinatown had enough of an adverse effect on the "physical environment" – defined to cover historical and aesthetic changes as well as population shifts within the community – to trigger a full-scale environmental impact statement, which delayed the project and galvanized political opposition. Just look at who was suing: Chinese groups (which had themselves moved into what was once Little Italy) that feared their displacement owing to new competitive entry. Invariably overlooked in this process were the gains to the new owners, their employees, and customers. *Chinese Staff* thus illustrates the unwise territorialism of deliberative processes, which silences all outsiders to 'the' community.

The alert reader might at this point rightly ask: aren't the real negative externalities more complicated because of traffic, parking, and the like? And so they are. But don't let the tail wag the dog. To see how to attack this issue, it is necessary to have some understanding of a central issue in land-use law – the problem of exactions.

Go back to *Euclid*, where the zoning law generated few external benefits and large owner losses, and ask what maneuvers are likely to take place once the zoning ordinance is put in place. If it produced some net benefit, then no one would have an incentive to buy their way out of the status quo. But that is not what happened in *Euclid*. Rather, in a depressingly familiar pattern, the land was eventually rezoned for industrial use, allowing the construction of GM's Fisher Body plant. Both the local government and the landowner looked for ways to undo the original zoning move.[7]

Suppose that the reduction in the Ambler Realty site was $510,000, while the gain to the rest of the township was only $100,000. Now the parties are in a position to make a bargain that allows Ambler to build its plant in exchange for providing the community, say, $205,000 in side benefits. Town and landowner each gain $205,000 by a deal that calls for building anything from new roads to new schools, or indeed, as in one case, a contribution to community artwork.

At this point, we have this odd inversion. The defenders of broad state power see in the exaction game a useful application of the principle of freedom of contract, since both sides are better from the transaction than they were before. Yet the defenders of markets are suspicious of these gains, and for good reason. Note that the bargain would have been unproblematic if the Village of Euclid had *purchased* its initial downzone for cold hard cash. As owner of those development rights, it could sell them off to anyone, including Ambler, at a price. But of course, the Village did not buy these rights. It just took them. The danger is that the prospect of a free bargaining chip for resale will provide a greater incentive to take property rights in the first place. Allow exactions and no one has any idea which initial land-use restrictions make sense, for it is not credible to believe that the Village would have paid $350,000 to acquire the benefits that it exacted, if it never had the power to downzone the property at all.

6 502 N.E. 2d 176 (N.Y. 1986).

7 See Nicolas M. Kublicki, "Land Use By, For, and of the People," *Pepperdine Law Review* 19 (1991): 112.

Sensing both the use and the dangers of these exactions, the Supreme Court has tried with only middling success to place some limits on the exaction game. In *Nollan v. California Coastal Commission*,[8] the Court narrowly held that the Commission could not tell a landowner that he could rip down a shack and build a beachfront house, like his neighbors, only if he first donated a lateral easement to the public that would allow everyone to walk to and fro in front of his house. In one sense that deal makes perfect sense because Nollan's right to build a new home is probably worth ten times the cost of that lateral easement. But this analysis leaves unexplained why the Commission has the right to single him out for permit denial when an enlarged house will pose no threat to the health or safety of any other individual.

Unfortunately, Justice Scalia muddled the analysis, by holding only that the easement in front of the house was not "germane" or "tightly connected" with the Commission's legitimate interest in preserving a "viewspot" from the Pacific Coast Highway, which ran behind the houses, parallel to the beach. The right result is to recognize that the viewspot has to be purchased just like the easement, for it does not make a particle of difference that the easement can be termed 'possessory' while the restriction on use is a mere 'restrictive covenant.' Both are property interests that private parties must buy. Both are still property interests when the state wants to acquire them for the public at large. We will get better social results if government agencies are not able to bundle the two interests together, but are instead forced to condemn each separately at a price that reflects the losses they impose on owners.

8 483 U.S. 825 (1987).

All of this does not mean that new construction never creates additional harms. Revert back to the Tahoe example, and now any new owner who paves over his land should be held responsible for his share of the runoff damage caused to the lake, just like the other owners are. In some cases, that could mean requiring that owner to pay his fair share for the construction of a conduit or a well to control dangerous runoff. But it hardly follows that he has the sole burden of paying for the removal of all water generated by his neighbors. And once the right metric is found, then the political process will no longer give rise to the corrupt exaction deals that followed in the wake of *Euclid*. Instead, the disputes will focus on the principled and narrow liability question of just how much harm to a common pool resource (the clear lake) this landowner contributed.

Nollan was an easy case not because of any lack of "tight" relationship between the lateral easement and the public views over the land. It was easy because the construction of an ordinary beachfront home created no dangerous runoff in the first place.

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Zoning has been advertised as a way in which local democratic politics can improve land-use decisions relative to those of the simpler common law, which used nuisance law to control harmful externalities and contracts to organize voluntary efforts among neighbors. Like so much of Progressive rhetoric of the first third of the twentieth century, this foray into democratic politics has been widely oversold. The huge losses that zoning and similar land-use restrictions incur *do* count as part of the losses of the community. And the political process that allows for their exercise brings in its wake a set of undesirable social practices

that reveal the dangers that lurk when political majorities are able to impose extensive regulation on others at no cost to themselves. We desperately need to broaden the application of the just compensation requirement. For, ultimately, stronger property rights will lead to better deliberative processes.