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## **Kelo, Cuno, and the Broken Window**

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November 26, 2006

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### **Kelo**

In June 2005, the Supreme Court made one of its least popular decisions in recent history in *Susette Kelo v. The City of New London Connecticut* (125 S. Ct. 2655). The 5-4 majority ruled that 15 properties in the Fort Trumbull area of New London could be condemned as part of an economic development plan under the provisions of the Fifth Amendment, even though the properties would be used to support the private investment activities of Pfizer and other commercial concerns.

Justice O'Connor wrote a scathing dissent. "Today the Court abandons this long-held, basic limitation on government power. Under the banner of economic development, all private property is now vulnerable to being taken and transferred to another private owner, so long as it might be upgraded..." She added that the court has effectively "delete[d] the words "for public use" from the Takings Clause of the Fifth Amendment."

The majority focused on three primary issues in their opinion. First, is economic development a "public use" according to the Fifth Amendment? Second, when private property is transferred to other private persons, when is the public use merely incidental? Third, should the Court concern itself with evaluating the empirical validity of the public use? In short, the answers were *Yes*, *We don't know*, and *No*. Only on the last question did the minority agree. O'Connor wrote, "the judiciary cannot get bogged down in predictive judgments about whether the public will actually be better off after a property transfer."

Justice Stevens, writing for the majority, pointed out that Federalism requires deference to state and local legislatures, and that states have the right to enact more restrictive legislation if they so choose. O'Connor replied, "States play many important functions in our system of dual sovereignty, but compensating for our refusal to enforce properly the Federal Constitution... is not among them."

As if on cue, 34 states enacted statutes or passed constitutional amendments restricting eminent domain during the 2005 and 2006 sessions. In June 2006, President Bush signed an executive order preventing federal agencies from seizing private property except for purposes benefiting the general public.

We believe there is deeper issue than the ones that occupied the bulk of the Court's time and the ensuing legislation. The Court focused on the visible: observed economic development. This fixation neglects the real cost—an invisible cost that may be felt a thousand miles away.

In short, the Court forgot the Broken Window.

### **The Parable of the Broken Window**

To understand the implications of *Kelo*, we turn to Henry Hazlitt's story about the baker and the broken window, inspired by Frederic Bastiat.

A young hoodlum, say, heaves a brick through the window of a baker's shop. The shopkeeper runs out furious, but the boy is gone. A crowd gathers... After a while the crowd feels the need for philosophic reflection. And several of its members are almost certain to remind each other of the

baker that, after all, the misfortune has its bright side. It will make business for some glazier. ... The glazier will have \$250 more to spend with other merchants, and these in turn will have \$250 more to spend with still other merchants, and so ad infinitum. The smashed window will go on providing money and employment in ever-widening circles.

Hazlitt points out the fallacy in the crowd's thinking. What is the alternative against which we should compare the stream of economic activity that begins with the repair of the broken window?

[B]ut the shopkeeper will be out \$250 that he was planning to spend for a new suit. Because he has had to replace a window, he will have to go without the suit (or some equivalent need or luxury). Instead of having a window and \$250 he now has merely a window... If we think of him as a part of the community, the community has lost a new suit that might otherwise have come into being, and is just that much poorer.

The glazier gains what the tailor loses, but the broken window means that the shopkeeper has no suit.

### The Parable Applied

What is the alternative against which we should compare the economic activity that derives from the taking in *Kelo*? Implicitly, the Court assumes that the relevant comparison is between Pfizer investing at New London, and Pfizer not investing at all. It falls into the same trap as the crowd in Hazlitt's parable. The tailor's profit was never considered by the crowd, because it was never seen. It was an invisible counter-factual—a "but for."

In *Kelo*, what would have happened had the stubborn property owners prevailed? Would Pfizer have forgone the investment entirely? Would it have invested in New London anyway? Or, would it have invested elsewhere, say nearby Fairfield? The Court never considers these questions, and in fact it comes to the opposite conclusion. Citing *Hawaii Housing Authority v. Midkiff* (104 S. Ct. 2321):

When the legislature's purpose is legitimate and its means are not irrational, our cases make clear that empirical debates over the wisdom of takings--no less than debates over the wisdom of other kinds of socioeconomic legislation--are not to be carried out in the federal courts.

In its deference to local decision makers, the Court ignores a simple point: local decision makers make local decisions.

Numerical examples illustrate the point. Suppose that by investing in New London, Pfizer expects a private benefit (profit) of eight. Similarly, New London expects some "public" benefit of three. The public benefit may be direct in the form of increased tax revenue, or indirect in the form of "spillovers" to local residents: more employment opportunities, more shopping opportunities, a more attractive city. If a taking is required to complete the project, the city concludes that it is justified if its public benefit exceeds the market value compensation required for the taking.

However, suppose that an alternative location for the investment exists: *but for* the opportunity in New London, Pfizer would have invested in a similar facility in Fairfield. The values are given in the following table:

	New London	Fairfield
Private Benefit	8	7
Public Benefit	3	2
Total Benefit	11	9

What is the benefit of the taking? It is most accurate to make this calculation with the alternative of Fairfield in mind. The *incremental* public benefit is one, and the incremental total

benefit—the benefit of the taking—is two. Further, because Pfizer’s private benefit is greater in New London than in Fairfield, *there is no need to subsidize Pfizer*.

Let us consider another case, where Pfizer needs to be induced to invest in New London:

	New London	Fairfield
Private Benefit	6	7
Public Benefit	3	1
Total Benefit	9	8

In this example, an incentive is necessary to convince Pfizer to invest in New London. The incremental public benefit is only two, but the city must give one to Pfizer, making the incremental benefit only one.

Will the benefit to New London exceed that to wealthier Fairfield? Perhaps, if investment in economically depressed cities has greater public spillovers. Further, it is possible that an incentive may be required to induce firms to locate in a depressed area, because they give up the private benefit of locating near other firms and other complementary infrastructure. But, importantly, the benefit is properly measured as the *incremental* benefit relative to the next best alternative.

In many contexts, the benefits will be identical between two localities. The *incidence* of the benefit differs depending upon who can attract the investment, just as the broken window differentially impacts the glazier vis-à-vis the tailor. Without at least counting the cost, it is short sighted to allocate investment based on which locality is more politically willing or able to effect transfers to investors.

We will see a lot of broken windows that way. And, a broken window is an important loss.

Taken property generates a loss because market value generally under-compensates property owners who have chosen to keep their property rather than sell at going prices; there is an additional non-pecuniary cost in the form of a deprivation of property rights. The cost should be weighed against the benefit. And, importantly, the public benefit should be defined by the *incremental* benefit, rather than the myopic calculation that a particular locality may put forward.

## Cuno

In *Kelo*, the Court explicitly deferred to local decision makers to determine the value of public use. But in the end, whether a taking is in the public interest is based in part on how locally one wants to make that determination. If we consider the state of Connecticut, the public benefit will be much smaller than it is locally. Will local courts have the right incentive to consider other localities’ lost opportunities? Will state courts? Will Connecticut courts take into account public interests outside the state?

Justice Stevens’ Federalist appeal is satisfying only if the invisible cost of investment diversion is borne within the boundaries of the jurisdiction. Theoretically, state regulation can account for invisible costs in the case of intra-state, inter-city competition. But, it will fail to account for inter-state competition.

In the arena of state tax incentives, explicit recognition of inter-state costs occurred in *Cuno v. Daimler Chrysler* (126 S. Ct. 1854, 2006). In *Cuno*, Ohio residents brought suit alleging that tax credits given to Daimler to expand its Toledo facility violated the commerce clause. Michigan residents joined the suit alleging that *but for* the tax credit in Ohio, they would have been the beneficiaries of Daimler’s investment. Although the Supreme Court did not consider the claims on the merits, there was an acknowledgement of the lost opportunity embedded in the Ohio tax credit. Michigan residents were the not-so-invisible cost.

The parallels between tax competition and eminent domain are unmistakable. In tax competition, the local government effects a transfer from tax-payers to the investor and—because of positive spillovers—to property owners. In eminent domain, the locality effects a transfer from property owners to the investor and—because of increased tax revenue—to tax payers or tax expenditure recipients.

### **State Responses**

Post-*Kelo* state statutes contain two primary provisions. First, most statutes prohibit taking for economic development purposes (with a blight exception) or narrow the definition of ‘public use’ and ‘blight.’ Two states allow the state legislature to temporarily lift restrictions by approval of a majority or super-majority, and several put the burden of proof squarely on the condemning authority.

Second, several states have clarified or expanded the meaning of ‘just compensation.’ Four states (Kansas, Michigan, Missouri and Indiana) require compensation at a *multiple* of market value. Several statutes provide for relocation costs, a replacement dwelling, or attorney fees.

Blanket prohibitions imply that invisible costs always exceed or meet the visible benefits. If public and private returns to a particular investment are similar across locations, then prohibition is appropriate. However, this assumption is as extreme as its opposite. The broken window is unlikely to be fixed with a sledgehammer.

Only a statute with some empirical teeth will have the potential to address the broken window problem. By changing the burden of proof, a locality is no longer accorded deference and the feasibility of a taking becomes an empirical question. It is incumbent upon the courts to properly administer any empirical test. It is not sufficient for the locality to show that some public benefit will locally accrue. Rather, the test should require a positive incremental public use.

Giving state legislatures the power to waive restrictions for particular takings effectively necessitates an act of the legislature to approve certain types of local takings. These provisions serve to ban most destructive takings, while allowing for inter-city bargaining. Of course, state-level statutes still provide no incentive for inter-state cooperation.

Without accounting for the broken window, even well-intentioned policies will be wrong-headed. Without recognizing the invisible loss to other localities, prohibitions, compensation schemes, and even empirical tests will be arbitrary, and will still favor taking from the tailor to give to the glazier.

The entire discussion in this article presupposes that taking is necessary for the locality to obtain the property in question. The majority of legal scholars agree that taking should be relied upon only when private negotiation is impossible or economically infeasible.

### **References and Further Reading**

Hazlitt, Henry (1946) “Economics in One Lesson,” Harper and Brothers (New York), pp. 11-12. (Online at [www.mises.org/books/onelesson.pdf](http://www.mises.org/books/onelesson.pdf).)

Institute for Justice, [www.castlecoalition.org](http://www.castlecoalition.org) (opposing eminent domain).

National Conference of State Legislatures, [www.ncsl.org/programs/natres/EMINDOMAIN.htm](http://www.ncsl.org/programs/natres/EMINDOMAIN.htm) (information on state statutes).