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Tax Motivated Takings

Thomas J. Miceli
University of Connecticut

Kathleen Segerson
University of Connecticut

C. F. Sirmans
University of Connecticut

University of Connecticut

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Thomas J. Miceli
University of Connecticut

Kathleen Segerson
University of Connecticut

C. F. Sirmans
University of Connecticut

Abstract

Tax motivated takings are takings by a local government aimed purely at increasing its tax base. Such an action was justified by the Supreme Court's ruling in Kelo v. New London, which allowed the use of eminent domain for a private redevelopment project on the grounds that the project promised spillover public benefits in the form of jobs and taxes. This paper argues that tax motivated takings can lead to inefficient transfers of land for the simple reason that assessed values understate owners' true values. We therefore propose a reassessment scheme that greatly reduces the risk of this sort of inefficiency.

Tax Motivated Takings

1. Introduction

The recent Supreme Court case of *Kelo v. New London* approved the use of eminent domain by a municipality seeking to acquire land primarily aimed at economic redevelopment.[1] The case tested the Constitutional requirement, stated in the Fifth Amendment, that eminent domain can only be used to obtain land for "public use."[2] The requirement is clearly satisfied—and the use of eminent domain is uncontroversial—in cases where the land is intended for a highway or park, but the issue becomes more difficult when, as in *Kelo*, the land is given to a developer for use in a private project. Although the resulting benefits are therefore largely private, there may nevertheless be substantial spillover benefits to the community, "including—but by no means limited to—new jobs and increased taxes" (*Kelo v. New London*, p.   ). The Court argued that existence of these benefits, as part of a comprehensive redevelopment project, satisfies the public use requirement.

Kelo is not the first case to reach this conclusion. In *Berman v. Parker*, the Supreme Court had previously argued that eminent domain could be used for a redevelopment project aimed at eliminating urban blight in Washington, D.C.[3] Similarly, in *Poletown Neighborhood Council v. City of Detroit*, the Michigan Supreme Court allowed the city to use eminent domain to condemn an entire neighborhood in order to

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[1] 125 S.Ct. 2655, 545 U.S. 469 (2005).
[2] The relevant clause reads, "nor shall private property be taken for public use, without just compensation."
[3] 348 U.S. 26 (1954).

clear the way for a new General Motors assembly plant.[4] Again, the Court cited the

economic benefits from the increased jobs and tax revenue as its justification.

Still, courts have not universally accepted the principle that "public use" includes

private uses with some spillover public benefits. For example, in 2004, just a year before

Kelo, the Michigan Supreme Court reversed its earlier decision in *Poletown* when it

disallowed the use of eminent domain for a private development project, despite the fact

that the project created 30,000 new jobs and promised $350 million in tax revenues for

the county.[5] In reaching this conclusion, the Court emphasized the fundamental

protection of private property afforded by the Constitution. Specifically,

> [I]f one's ownership of private property is forever subject to the government's
>
> determination that another private party would put one's land to better use, then
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> the ownership of real property is perpetually threatened by the expansion plans of
>
> any large discount retailer, "megastore," or the like (*Wayne v. Hathcock*, p. 786).

Thus, although the *Kelo* decision represents the law of the land, there is not universal

agreement regarding the proper scope of public use.

The purpose of this paper is not to engage in this debate.[6] Rather, it is to examine

the incentives of local governments, in the wake of *Kelo,* to use eminent domain to

enhance their tax revenues by forcing the transfer of land to higher valued uses. We will

refer to such a use of eminent domain as a "tax motivated taking." Although this type of

action is apparently justified by *Kelo* as a legitimate public purpose, we will argue that it

may often lead to inefficient transfers of land. The simple reason is that assessed values

generally understate true values. Thus, for example, a piece of property assessed at

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[4] 304 N.W.2d 455, 410 Mich. 616 (1981).
[5] *Wayne v. Hathcock*, 684 N.W.2d 765, 471 Mich. 445 (2004).
[6] For interesting economic perspectives on public use, see Merrill (1986) and Kelly (2007).

$10,000 for tax purposes may be worth, say, $25,000 to the owner in the sense that she would not sell for less than that amount in a consensual transaction. Thus, if a would-be buyer offered $20,000, the owner would refuse to sell. In contrast, the local government, seeking to maximize its tax base, would like the sale to occur because it would then be able to extract more taxes from the property. The temptation to use eminent domain in this situation is apparent. Indeed, it is one of the objections raised by the dissenting justices in *Kelo*:

> [W]ithout a bright line rule [preventing the use of eminent domain for private projects] nothing would stop a city from transferring citizen A's property to citizen B for the sole reason that citizen B will put the property to a more productive use and thus pay more taxes… (*Kelo v. New London*, pp. 2666-2667).

At its root, this divergence of interests between the current owner and the government is due to the government's inability to observe the owner's true valuation. In effect, this exempts $15,000 of the owner's valuation (her so-called "subjective value") from taxation (which is why she has no incentive to reveal her true value). Thus, the only way the government can capture at least some of this value is through a sale of the land, whether consensual or forced. The remainder of the paper describes this problem in more detail, focusing on the potential inefficiency arising from it. It then proposes a reassessment scheme aimed at discouraging local governments from resorting to eminent domain purely for tax reasons.

2. Tax Motivated Takings Defined

As noted, tax motivated takings are defined to be takings aimed purely at increasing the local tax base, as opposed to assembling land for public use. Thus, instead of being used for a park or highway, the acquired land is given to a private developer for use in a commercial project whose value exceeds the aggregate assessed values of the taken parcels. The project thus promises greater tax revenues that can be used to increase the provision of public services like education or police protection. In this sense, the taking can be construed as satisfying the public use requirement of the Fifth Amendment, even though the acquired land is not itself being used for the public good.[7] This is essentially the logic underlying *Kelo* and *Poletown*.

Still, the question arises as to why the current owners' land has to be *taken* to achieve this purpose. In other words, if the land has higher value in development (which is the source of the increased tax revenue), then why can't the developer simply acquire the land through the market, without the need for a forced sale? There are two possible reasons. The first is the usual holdout problem. That is, when multiple parcels need to be assembled, the individual owners have an incentive to hold out for prices in excess of their true valuation of the property in hopes of capturing a share of the surplus from the project (Miceli and Segerson, 2007; Strange, 1995). The fact that the project is private rather than public does not alter the nature of this threat: the holdout problem is a consequence of the need for assembly rather than the use to which the land will ultimately be put (Merrill, 1986). Eminent domain is a legitimate response to this form of market failure (a point to which we return in Section 4 below).

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[7] This logic reflects Epstein's (1985) contention that taxes and takings are equivalent in the sense that both involve coercive acquisitions of resources for government use. Also see Fischel (1995, p. 211) on this point.

There is, however, a second reason why the market may fail to bring about the transfer of land to the developer, even in the absence of a holdout problem. This is due to the divergence of the current owners' true valuation, or reservation price, from the assessed value, which is based on market value. As noted above, this difference is sometimes called the owners' "subjective value," and for owners who have occupied their property for a long period of time, this value could be substantial. Remember that market value reflects the amount that comparable properties have recently sold for, not what the particular owner would accept for her property in a consensual sale.[8]

The idea can be illustrated with a simple diagram that describes the allocation of land in a given jurisdiction. In Figure 1, the horizontal axis represents the total amount of land in the jurisdiction, the downward sloping curve (labeled MB_R) represents the marginal benefit of land for residential use, and the upward sloping curve (labeled MB_C) represents the marginal benefit of land for commercial use. The curves may therefore be thought of as demand curves for residential and commercial land, respectively. The intersection determines the equilibrium amount of land devoted to residential use, Q^*, the amount devoted to commercial use (the remaining amount), and the equilibrium price of land, P^*, which can be interpreted as its market value. Focusing on the residential sector,

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[8] One might argue that the assessed value of a property should reflect its highest use, including its possible use for commercial development. This point does not alter our argument, however, because the current owner would sell voluntarily to the highest user, regardless of his intended use, if and only if the offer exceeds her true reservation price. Thus, the fact that a property has not sold implies that the owner's reservation price exceeds the value of the best alternative use, whatever that might be. Of course, the best alternative use is partially determined by existing zoning laws—for example, a parcel in a residential zone presumably could not be assessed at its highest value in commercial use—but the local government always has the option to rezone the property in order to increase its assessed value. Such a strategy, however, is analogous to a tax motivated taking in that it represents another tool at the disposal of the local government for revealing at least a portion of the current owner's subjective value.

the vertical distance between the demand curve, MB_R, and P^* for any given parcel

represents the subjective value of that owner.

[Figure 1 about here]

The problem subjective value creates is that a proposed development project (i.e.,

a project seeking to convert one or more parcels from residential to commercial use) may

have a value above the aggregate *market* value of the targeted properties, but there is no

way to know whether it exceeds the sum of the *true values* (which is the proper

comparison for determining efficient land use). One could argue that the owners' refusal

to sell is evidence that they value the land more than the developer according to the usual

market test for efficiency, but as noted above, this could also represent a holdout

problem. However, even in the absence of a holdout problem (i.e., even in the case of a

single parcel), a government that represents the majority of landowners (as opposed to

maximizing social welfare) would have an incentive to force the sale, irrespective of its

efficiency, in order to increase the tax revenue obtainable from that property.

One might counter that, because the land itself is not needed for the public good,

the desired increase in tax revenue could be obtained without a taking by reassessing the

targeted properties, or by raising the tax rate. The first strategy, however, requires the

government to be able to identify those properties that are "underassessed" in the sense

described above, but the unobservability of subjective value makes this impossible (or

arbitrary). Alternatively, the government could simply raise the property tax rate, but that

just increases everyone's taxes, thereby defeating the initial purpose of extracting more

taxes from a few targeted properties. It also presumably increases the distortionary

effects of taxation and is politically undesirable. For these reasons, tax motivated takings

are an attractive alternative.

3. A Simple Model

The preceding argument, and our proposed response to it, can be illustrated more

formally as follows. Suppose a developer proposes a redevelopment project that requires

acquisition of a single parcel of land currently in residential use. (We initially ignore the

problem of assembly in order to focus on the role of subjective value. Below we examine

the case of assembly.) Let V be the gross-of-tax value of the project, let t be the property

tax rate (which is fixed), and let X be the developer's bid for the land. If the developer

acquires the land, it will be reassessed at X for tax purposes, which makes his net-of-tax

value $V–tX$. Assuming that competition among developers drives their maximum bid to

this level, $X=V–tX$, or

$$X = \frac{V}{1+t} \; .$$
(1)

Now suppose that the targeted parcel is currently assessed at A (=P^* in Figure 1),

and assume that $X>A$, so the expected tax revenue from the proposed project, tX, exceeds

that obtainable from the current owner, tA.[9] Thus, a majoritarian government

(representing "all other" landowners) would like this transaction to take place. Whether

or not the transaction is efficient, however, depends on whether V exceeds the current

owner's true valuation, or reservation price, denoted R (representing the relevant point on

the MB_R curve in Figure 1). If it does, then the transaction will presumably occur through

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[9] Note that, given (1), $X>A$ implies that $V>A$ (although the converse is not necessarily true).

the market, and the question of eminent domain will never arise. However, if $R>A$, reflecting the owner's subjective value, then it is possible that $R>V>X>A$. That is, sale of the parcel to the developer is inefficient (i.e., $R>V$), even though it increases the assessed value of the property (i.e., $X>A$). This sets up a conflict between the government and the developer on one hand, and the current owner on the other, possibly culminating in the government's use of eminent domain to force the sale (a tax motivated taking).

As noted, the conflict would go away if the government could observe R and reassess the property at that amount, for then the incentives of the government and the current owner would be aligned (i.e., the use of the land that maximizes its tax value also maximizes its use value). Fortunately, there exists another rule that accomplishes the same result, thus forestalling the government's temptation to use eminent domain purely for tax purposes: *If a landowner turns down a legitimate offer to buy his or her property, the government reassesses the property at the amount of the offer.*[10]

To examine the impact of this scheme, note that if the owner turns down the developer's offer of X, her property will be reassessed at this amount. In that case, her net value will be $R–tX$. She will therefore accept the offer if and only if $X \geq R–tX$, or if and only if

$$X \geq \frac{R}{1+t}.$$ (2)

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[10] The proposed rule is similar to the self-assessment mechanism proposed by Plassmann and Tideman (2007), which involves all landowners in a jurisdiction stating a price at which they would willingly sell their land if needed for public use. (Essentially, this involves revelation of the MB_R curve in Figure 1.) To prevent strategic overestimation, owners would then be taxed on that announced value. The scheme achieves truthful revelation if the tax rate is set equal to the probability of a taking. The difference between this proposal and our reassessment scheme is that under our rule, the reassessment would only occur after an actual offer has been made and turned down. This avoids the difficulty of having to ensure that the tax rate and probability of a taking are equal.

Substituting (1) into this condition shows that the landowner will accept the developer's offer if and only if $V \geq R$, which is exactly the condition for an efficient sale.

The intuition for this result is that, in the presence of property taxation, the "underassessment" of the current owner's land (owing to the presence of subjective value) gives that owner an implicit subsidy compared to would-be buyers of the property, resulting in "too few" sales. The threatened reassessment takes away that subsidy, thus restoring efficiency.

An important objection to the proposed scheme is that it will potentially put a heavy tax burden on residents who are least able to afford it. Specifically, owners who have a high subjective value of their land and are also "cash poor" may have to sell their property in order to pay the higher taxes. This criticism, however, is not unique to our scheme, but applies to any reassessment. Moreover, owners who are forced to sell at the developer's initial offer in order to afford the taxes are at least no worse off than under the status quo.

4. Assembly and the Holdout Problem

The preceding discussion has perhaps exaggerated the threat of tax motivated takings by focusing on the acquisition of a single parcel. Most likely, courts would not allow the use of eminent domain unless the project in question involved assembly of several contiguous parcels for a large scale project.[11] As noted above, however, assembly raises the complicating possibility of a holdout problem, which many argue justifies the

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[11] In a survey of contested public use cases from 1954-1985, Merrill (1986) in fact found that 60-69% involved assembly. Further, the courts legitimized the use of eminent domain in 90% of these cases.

use of eminent domain, even for redevelopment (Merrill, 1986).[12] The question we ask in this section, therefore, is whether the proposed reassessment scheme can also help to mitigate the holdout problem.

To answer this question, we suppose that the proposed development project in the above model requires the assembly of n identical parcels, each currently assessed at A but valued by their owners at $R>A$. (We initially assume that A and R are the same for all owners.) The aggregate value of the proposed project continues to be V and the developer's offer per parcel is again X, so the condition for the redevelopment to increase tax revenues, as above, is $X>A$, whereas the condition for it to be efficient is now $V>nR$. In this setting, we define a holdout as any seller who turns down an offer greater than her true reservation price. The problem, of course, is that, since R is unobservable, it is impossible to tell whether a seller who refuses an offer is holding out, or truly values the property more than the developer's offer.

Under the proposed reassessment scheme, any owner who turns down the developer's offer of X has her property reassessed at that amount, which again makes the net return from refusing the offer $R-tX$. Thus, as above, the owner will accept any offer that satisfies (1). The developer's maximum offer per parcel in this case is $X=V/n-tX$, which yields

$$X = \frac{V/n}{1+t} \ . \tag{3}$$

Substituting this into (2) shows that a seller accepts the offer if and only if $V/n \geq R$, which is the efficient condition.

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[12] For a counterargument, see Kelly (2007).

Note that this conclusion relies on a couple of assumptions. First, the reassessment threat must be seen as credible by sellers. Otherwise, a seller's initial refusal cannot be interpreted as reliable evidence that the seller values the land more than the developer.[13] (Of course, this same point applies to the model without assembly.)

The second and more important assumption is that all sellers are identical. To examine the implications of relaxing this assumption, suppose sellers differ in their R's (though for simplicity, we continue to assume that they have the same A's). In this case, the condition for the project to be efficient is

$$V \geq \sum_{i=1}^{n} R_i \,,$$

or

$$V/n \geq \frac{1}{n} \sum_{i}^{n} R_i \,. \tag{4}$$

That is, the per-parcel value of the project must exceed the average of the owners' reservation prices. The developer's maximum offer continues to be given by (3), which must be the same for all sellers since they all appear identical.[14]

Now consider seller j. She will accept offer X if and only if $X \geq R_j - tX$, or if and only if $X \geq R_j/(1+t)$. Combining this with (3) yields the condition for owner j to sell:

$$V/n \geq R_j. \tag{5}$$

Clearly, owners with above-average reservation prices will refuse to sell. Thus, since $V/n < R_j$ for any given j is not inconsistent with (4), heterogeneity will potentially prevent

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[13] One might worry that the developer can make use of this threat to underbid on the project. Presumably, this problem can be minimized by allowing competitive bidding by developers so that X is determined by (3).

[14] If sellers differed in their A's, the offers might be made proportional to A, but this would not alter the problem as long as the R's are not perfectly correlated with the A's.

efficient projects from going forward under the reassessment scheme (or at least it will prevent them from attaining the optimal scale). Intuitively, when owners differ in their reservation prices, reassessment based on the developer's best offer will result in under assessment of those owners who value their properties most highly, which takes us back to the original reason for tax motivated takings.

It is important to emphasize that this is not a holdout problem in the sense defined above since the owner truly values the parcel more than the developer's best offer. Still, given the unobservability of the R_j's, it has the same effect of preventing some otherwise efficient projects from going forward.[15] Thus, the proposed reassessment scheme does not provide a complete solution to the problem of land assembly with heterogeneous and unobservable property values.

5. Conclusion

The Supreme Court's decision in *Kelo v. New London* to allow the use of eminent domain for private redevelopment projects that promise economic benefits to the community raises the possibility that local governments will use their condemnation power to raise tax revenue, not just to acquire land. They can do this by forcing the sale of land to users with higher assessed values. We have argued, however, that such tax motivated takings can result in inefficient transactions whenever the assessed value of properties understates the owners' true values. Further, the unobservability of owners' subjective values prevents the government from simply reassessing the properties at their true values, thus leading to the temptation to use eminent domain to extract that value. Because of the potential inefficiency from tax motivated takings, we proposed a

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[15] See Shavell (2007) for an analysis of this justification for the use of eminent domain.

reassessment scheme that accomplishes the same goal for the government while ensuring that only efficient transactions occur. Under the scheme, owners who turn down a legitimate offer have their property reassessed at the amount of that offer.

We emphasize that this scheme is not intended to replace eminent domain when the targeted land would actually be used for a public project, or when a few owners are able to block completion of an otherwise efficient project by refusing to sell (albeit in a legitimate effort to protect their subjective values). Moreover, it may have some undesirable distributional consequences by placing a potentially heavy burden on landowners who are cash poor. Nevertheless, it leaves owners no worse off than the status quo while greatly reducing the temptation of local governments to use eminent domain purely for tax purposes.

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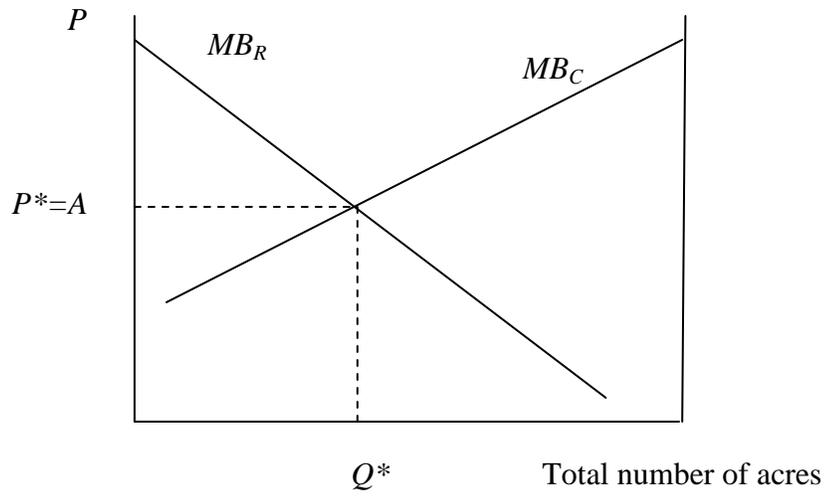
Figure 1: The allocation of land in a jurisdiction and the definition of subjective value.