

ARTICLES

THE ILLUSION OF FISCAL ILLUSION IN REGULATORY TAKINGS

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The main economic justification for compensating owners for losses from land use restrictions is based on a surprising mistake. Compensation is said to make governments internalize the costs of their actions and therefore enact more efficient regulations. Without compensation, the argument goes, governments operate under a fiscal illusion because, from their perspective, their actions are costless. The problem is that this argument makes no sense as a description of the actual costs to governments.

Taxation is the main way governments get revenue, and most taxes depend on the value of property and its permissible uses. If a government restricts land use so as to reduce the value of a parcel or the income produced by it, its residents, or its patrons, tax revenues should go down. If, however, the restriction creates benefits, tax revenues should go up. While there are limitations to the accuracy and efficacy of the tax revenue signal, efficient regulations should have a net positive effect on governmental revenues, while inefficient ones should have a net negative effect. Fully compensating owners, in contrast, does not lead the government to accurately internalize societal

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costs—it rather adds a new and much larger cost. Because this cost usually far exceeds revenue gains, governments may rationally forgo even efficient regulations. Owner compensation, in other words, does not correct fiscal illusion, it creates it.

Revealing the illusion of fiscal illusion leaves standing much older arguments that compensation is required as a matter of fairness. But clearing away the main efficiency justification for one-to-one compensation permits clearer-eyed assessment of whether and to what extent fairness may require compensation and reveals that compensation measures in the name of efficiency may, in fact, undermine it.

TABLE OF CONTENTS

Introduction.....	2
I. Fiscal Illusion Arguments and Their Flaws	7
A. Fiscal Illusion in Takings Scholarship	7
B. The Illusion of Fiscal Illusion in Brief.....	12
C. Conclusion	15
II. The Tax/Land Use Feedback Loop and Its Limitations.....	16
A. Real Property Taxes.....	17
B. Income Taxes.....	22
C. Sales Taxes	26
D. Conclusion	27
III. Do Governments Care About Revenue Impacts?	28
A. Governments Often Won't Care Much About Tax Revenues	28
B. Sometimes Governments Do Care About Tax Revenues—But That's Not Always a Good Thing.....	31
C. Governments Do React to Full Compensation for Regulatory Restrictions—And That's Usually a Bad Thing.....	34
D. Conclusion	37
IV. So What?—or, Focus on Fairness.....	37
A. The Fairness Justification for Compensation.....	37
B. What Compensation Does Fairness Require?	40
C. Regulatory Takings and <i>Murr v. Wisconsin</i>	46
Conclusion	48

INTRODUCTION

For the first time in decades, the constitutional standard for requiring compensation for land use restrictions that leave title in the

original owner may be facing revision. In the last half century, the United States Supreme Court has affirmed a regulatory takings claim only once, in a 1992 case where the courts below found the restriction rendered the property at issue “valueless.”¹ In January 2016, however, the Supreme Court granted certiorari in *Murr v. Wisconsin*,² the first regulatory takings case to be decided by the Roberts Court.³

Because regulatory takings doctrine has little direct support in constitutional text or history, and earlier cases mostly rule against regulatory takings, the push to expand regulatory takings often rests on policy arguments.⁴ This Article argues that the central efficiency

1. *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1007 (1992). The regulation there prohibited any building at all on the owner’s two beachfront lots for erosion control purposes, although all the neighboring lots already had homes on them. *Id.* at 1007–08. Even there the Court remanded to determine whether the economic wipe-out was permitted under “background principles of nuisance and property law.” *Id.* at 1031–32. Although the South Carolina Supreme Court found no such background principle on remand in *Lucas v. South Carolina Coastal Council*, 424 S.E.2d 484, 486 (S.C. 1992), other state courts have exploited the loophole. See Michael C. Blumm & Lucas Ritchie, *Lucas’s Unlikely Legacy: The Rise of Background Principles as Categorical Takings Defenses*, 29 HARV. ENVT. L. REV. 321, 321, 323 (2005) (examining the use of background principles as categorical defenses to takings claims).

2. 136 S. Ct. 890 (2016), *granting cert. in Murr v. State*, No. 2013AP2828, 2014 WL 7271581 (Wis. Ct. App. Dec. 23, 2014) (per curiam). In the case below, the Wisconsin Court of Appeals held that a restriction on building on one of two neighboring lots owned by the same owners was not a *per se* taking of the owner’s property. *Murr*, 2014 WL 7271581, at *8.

3. Several Roberts Court decisions have expanded the potential for takings claims when governments acquire or claim ownership of property. See *Horne v. Dep’t of Agric.*, 135 S. Ct. 2419, 2426 (2015) (finding a taking in federal demand for personal property); *Koontz v. St. Johns River Water Mgmt. Dist.*, 133 S. Ct. 2586, 2599, 2603 (2013) (holding that demands for money in exchange for a permit must be considered under the exactions analysis); *Stop the Beach Renourishment, Inc. v. Fla. Dep’t. of Envtl. Prot.*, 560 U.S. 702, 715 (plurality opinion) (2010) (opining that a legislative or judicial disposition transferring land ownership could be considered a taking). These decisions might be applied to future regulatory takings cases. The last case to directly consider a regulatory takings claim, however, was *Lingle v. Chevron U.S.A. Inc.*, decided on the eve of Roberts’ ascension to the Court. 544 U.S. 528 (2005), *abrogating Agins v. City of Tiburon*, 447 U.S. 255 (1980). The Court in *Lingle* unanimously narrowed the grounds for finding a regulatory taking, overruling a previous suggestion that regulatory restrictions must “substantially advance” their stated purpose. *Id.* at 531, 548.

4. See William Michael Treanor, *The Original Understanding of the Takings Clause and the Political Process*, 95 COLUM. L. REV. 782, 783 (1995) (arguing that the original understanding of just compensation did not include regulatory takings).

argument for expansion—often dubbed “fiscal illusion”⁵—is without foundation. Understanding the illusion at the heart of fiscal illusion arguments for compensation places a sharper focus on the other arguments for and against broader compensation requirements.

The efficiency argument goes like this. If governments need not compensate owners for the loss in value caused by restricting land use, they need not internalize the costs of their actions.⁶ As a result, governments will enact inefficient restrictions because they experience only the benefits of the land use restrictions.⁷ Governments operate under a fiscal illusion, in other words, because—from their perspective—their actions are costless.

The argument seems at first glance a common-sense extension of the cost-internalization argument often applied in analyses of private uses of land.⁸ But it ignores fundamental differences with respect to governmental income streams that make the cost-internalization argument inapplicable. In fact, the assertion of fiscal illusion in regulatory restrictions is itself based on the illusion that governments do not already experience the costs of reductions in property value.

Governmental revenue is intimately tied to property value—quite directly for property taxes, and indirectly for most sales and income taxes.⁹ Governments thus already feel the costs of actions that reduce the value or productivity of property but leave title in the hands of the owner. These costs will be balanced against any economic benefits the action creates in the jurisdiction, whether by increasing tax revenue or decreasing the costs of taxpayer-funded services associated with the property. Directly compensating owners for losses due to use restrictions, in contrast, will not lead the government to accurately internalize this loss. Rather, it will add a new and much larger cost to the action. If this additional cost is greater than the expected benefits of the land use measure, the government will

5. See Lawrence Blume & Daniel L. Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 CALIF. L. REV. 569, 572–73, 621 (1984) (discussing “fiscal illusion” in takings).

6. ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 186–87 (5th ed. 2009).

7. *Id.*

8. Nuisance laws, for example, are justified in part by the need to ensure that parties whose land uses impinge on each other’s take into account the social costs they create, so that the resulting combination of land uses maximizes the overall benefits from the use. *See id.* at 180–81; *see also* Boomer v. Atl. Cement Co., 257 N.E.2d 870, 873 (N.Y. 1970) (reasoning that the risk of permanent damages would “be a reasonable[,] effective spur to research for improved techniques to minimize nuisance”).

9. *See* discussion *infra* Part II.

rationally decide to forgo the measure, even though the sum of the costs and benefits to the community would be positive. Requiring owner compensation does not correct the assumed fiscal illusion. It simply creates a new one.

The surprising mistake at the heart of many arguments about takings is the result of a broader phenomenon. As others have noted, law and economics scholarship too often analyzes problems as isolated transactions between parties, overlooking both the interdependence of multiple actors and the importance of their social and legal context.¹⁰ In this case, by treating land use restrictions as bilateral transactions in which some property owners lose and others (or perhaps governments themselves) win, scholars have ignored the tax structure that results in governments experiencing these losses as well.

There are, of course, limitations to the accuracy and impact of the tax cost signal.¹¹ The myriad qualifications, exceptions, and deductions in the tax system mean that there will almost never be a one-to-one correspondence between the tax received and the underlying value taxed. Nevertheless, the goal of the system is to achieve this correspondence, regardless of the extent to which the system actually realizes this goal. Practically, moreover, there is a rough relationship between tax returns and fluctuations in underlying value taxed, something lacking with respect to direct compensation to owners for claimed losses.

In addition, different levels of government will feel the impact of loss in property value more or less keenly.¹² Local governments, which rely heavily on property taxes, will be most sensitive to land use restrictions that reduce the assessed value of the property; state governments will be less sensitive; and federal governments, even less. While state and federal governments will be more sensitive to effects on sales and income taxes, the relationship between land use regulation and such taxes is less readily calculated. Similarly, expenses associated with property use—such as funding costs of

10. See, e.g., Gideon Parchomovsky & Peter Siegelman, *Selling Mayberry: Communities and Individuals in Law and Economics*, 92 CALIF. L. REV. 75, 77–78 (2004) (“[L]aw and economics scholars see victims in pollution disputes as acting independently of each other, with no interdependencies and no sense of social embeddedness. . . . [This] is a highly incomplete description of human behavior, one that can be misleading in some important settings.”).

11. See discussion *infra* Part II.

12. See discussion *infra* Part II.

policing, providing public education, or remediating environmental degradation—are borne by different levels of government.¹³

There is also a robust debate on whether and to what extent governments change their behavior in response to financial losses.¹⁴ Some argue that revenue generation does not motivate political actors in the same way that it motivates private individuals or firms.¹⁵ The central currency for politicians is votes, not dollars; while revenue losses—with resulting tax increases or service reductions—may affect political goals, they do not necessarily do so. In addition, the structure of government decision making often means that while one entity may be responsible for making land use decisions, another entity will be responsible for paying for them. But the premise of the fiscal illusion argument is that governments and their constituents need to feel both the costs and the benefits of governmental action in order to make efficient decisions. The point of this Article is that through the tax system, they already do.¹⁶

Establishing that governments already feel the costs of land use restrictions does not mean that compensation is never necessary. Owners may still be entitled to compensation for their losses as a matter of fairness.¹⁷ But revealing the mistake on which many efficiency arguments for compensation are based facilitates clear-eyed assessments of fairness arguments for and against compensation. Mirroring the way that, on a societal level, tax revenues may both rise and fall as a result of land use restrictions, values of individual parcels may be both enhanced and depressed by land use laws. Demanding compensation when the same infrastructure restricts realization of

13. See DAVID BRUNORI, LOCAL TAX POLICY: A FEDERALIST PERSPECTIVE 46–47 (2d ed. 2007) (chronicling the stability of property tax and its use in financing public services).

14. See discussion *infra* Part III. Compare Daryl J. Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. CHI. L. REV. 345, 345 (2000) (arguing that governments do not respond to compensation requirements), with WILLIAM A. FISCHEL, THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES 39–40 (2001) (arguing that municipal governments are sensitive to compensation requirements).

15. Levinson, *supra* note 14, at 347.

16. Indeed, while some scholars challenge direct compensation as an effective prod for inefficient regulation, there is overwhelming evidence that zoning, the primary form of land use restriction, seeks to maximize tax revenue and limit demands on that revenue. See, e.g., ANN O'M. BOWMAN & MICHAEL A. PAGANO, TERRA INCognITA: VACANT LAND AND URBAN STRATEGIES 55–59 (2004) (describing ways municipalities shift land use strategies to maximize different forms of tax revenue).

17. See discussion *infra* Part IV.

those opportunities is sometimes, to borrow a phrase, a demand to socialize costs but privatize benefits.

Part I of this Article outlines the takings debate, how the concept of fiscal illusion has been employed in that debate, and how the link between tax revenues and land value undermines the concept. Part II provides more detail on the taxes impacted by land use regulation and discusses limitations to the link between taxation and land value. Part III discusses whether, and to what extent, political decision making is actually sensitive to these revenue impacts. Part IV suggests ways that exposing the illusion of fiscal illusion adjusts the focus on arguments for and against compensation as a matter of fairness and briefly shows how this analysis applies to *Murr v. Wisconsin*.

I. FISCAL ILLUSION ARGUMENTS AND THEIR FLAWS

Increasing efficiency is one of the core arguments for expanding the category of “takings,” governmental impacts on property for which compensation is required.¹⁸ The central economic justification for compensation is that it will ensure that governments take into account the societal costs of their actions, a phenomenon often described as counteracting fiscal illusion. This justification is based on the premise that governments do not already experience the losses caused by actions that reduce property value. Because governments already lose revenue whenever their actions reduce the value of property or the activities associated with it, requiring direct compensation to the owner does not mitigate fiscal illusion. Rather, it creates new distortions that may deter efficient decision making. This Section briefly outlines the takings debate, the role of fiscal illusion arguments in this debate, and the fallacy of those arguments.

A. *Fiscal Illusion in Takings Scholarship*

Whether property has been “taken,” so as to demand compensation, is the most palpable site of interaction between public and private definitions of property and is a fertile battleground for debates over the role of each. Since at least 1967, when Frank Michelman wrote his masterful exploration of the reasons for the compensation requirement, debates about takings have revolved around two policy goals: fairness, or respect for the rights of those affected by governmental action, and utility or efficiency, or

18. U.S. CONST. amend. V (“[N]or shall private property be taken for public use, without just compensation.”).

incentives for uses of property that will maximize public welfare.¹⁹ The sweeping nature of these goals, perhaps, explains why takings jurisprudence offers as many questions as answers. When and why the government must pay compensation for actions that affect property has been described as a “muddle,”²⁰ “a secret code that only a momentary majority of the Court is able to understand,”²¹ a candidate for the “doctrine-in-most-desperate-need-of-a-principle prize,”²² and “like finding shapes in the clouds,” a process that says “more about the observer than the clouds themselves.”²³

Despite this muddle, the broad contours of takings doctrine are easy to outline. When the government takes title to property or orders its permanent occupation by a stranger, there is almost always a taking, and the government must pay the owner the fair market value of the property acquired.²⁴ Similarly, when the government renders real property valueless, there will generally be a taking.²⁵ But where the government simply restricts the uses of property, even if the restriction significantly reduces the property’s value, compensation will very rarely be required.²⁶

19. Frank I. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of “Just Compensation” Law*, 80 HARV. L. REV. 1165, 1214, 1219 (1967).

20. Carol M. Rose, *Mahon Reconstructed: Why the Takings Issue Is Still a Muddle*, 57 S. CAL. L. REV. 561, 561 (1984).

21. Michael A. Heller & James E. Krier, *Commentary, Deterrence and Distribution in the Law of Takings*, 112 HARV. L. REV. 997, 997 (1999).

22. Jed Rubenfeld, *Usings*, 102 YALE L.J. 1077, 1081 (1993).

23. Christopher Serkin, *The Meaning of Value: Assessing Just Compensation for Regulatory Takings*, 99 NW. U. L. REV. 677, 741 (2005).

24. *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 441 (1982) (holding that permanent physical occupations, no matter how small, require compensation). The Supreme Court has recently held that this principle usually applies to personal as well as real property. *Horne v. Dep’t of Agric.*, 135 S. Ct. 2419, 2426 (2015).

25. See *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1031–32 (1992) (holding that economic wipe-outs are per se compensable unless the regulations merely implemented “background principles of nuisance and property law”).

26. William A. Fischel, *Why Are Judges So Wary of Regulatory Takings?*, in PRIVATE PROPERTY IN THE 21ST CENTURY: THE FUTURE OF AN AMERICAN IDEAL 50, 55 (Harvey M. Jacobs ed., 2004) (stating that under the Penn Central test, the “bottom line is that the complaining property owner almost always loses”); see, e.g., *Tahoe-Sierra Pres. Council, Inc. v. Tahoe Reg’l Planning Agency*, 535 U.S. 302, 306, 319–20 (2002) (finding no taking when temporary moratoria prevented any development of property for more than two years); *Penn Cent. Transp. Co. v. City of New York*, 438 U.S. 104, 116–17, 138 (1978) (finding no taking in the implementation of a landmark protection law preventing Grand Central Station from selling its air rights for millions of dollars).

It is this last thread of the doctrine that has come under attack as furthering fiscal illusion. The argument goes like this: if governments do not have to pay owners for the costs of actions that reduce the value of property, they will act as though those actions are costless. The result will be overregulation or restrictions on uses of property whose net effect is to detract from public welfare. If, however, governments compensate owners for their losses, they will internalize the costs of their actions and make more efficient decisions.²⁷

Although scholars made this argument in earlier articles,²⁸ Lawrence Blume and Daniel Rubinfeld dubbed it “fiscal illusion” in 1984, and the title has stuck.²⁹ This use of the phrase is somewhat different from its use in the public choice literature that coined it, where fiscal illusion primarily describes the failure of voters to understand the cost of government services that they are *already* in fact paying for through taxes or other means.³⁰ In takings literature, in contrast, “fiscal illusion” seems instead to mean that the government does not take into account the societal costs of governmental actions unless the government itself pays for them:

[A] governmental regulatory body will over- or under-regulate if it does not consider all budgetary and social costs. The actual result depends upon the distribution of individual tastes and political influence within the community. As applied to the land market, if the governmental body responsible for zoning decisions does not pay compensation, it cannot make socially beneficial decisions. In other words, the governmental body is subject to “fiscal

27. Throughout the literature, and in this Article as well, “efficiency” generally refers to Kaldor-Hicks efficiency, meaning that the regulation generates benefits to society as a whole that outweigh its costs, not that the action makes all those affected by it better off. See COOTER & ULEN, *supra* note 6, at 43–44; Jules Coleman, *The Normative Basis of Economic Analysis: A Critical Review of Richard Posner’s The Economics of Justice*, 34 STAN. L. REV. 1105, 1106–07 (1982) (book review) (discussing Kaldor-Hicks and Pareto superiority definitions of efficiency); Thomas S. Ulen, Commentary, *Professor Crespi on Chicago*, 22 L. & SOC. INQUIRY 191, 193 (1997) (noting that law and economics scholars have made Kaldor-Hicks the “default” criterion for efficiency).

28. See Robert C. Ellickson, *Suburban Growth Controls: An Economic and Legal Analysis*, 86 YALE L.J. 385, 420 (1977) (arguing that compensation will lead municipal officials to conduct more thorough cost-benefit analyses of alternate measures); Michelman, *supra* note 19, at 1218 (arguing that compensation may provide assurance that “society deems the measure . . . efficient”).

29. Blume & Rubinfeld, *supra* note 5, at 621.

30. See JAMES M. BUCHANAN & RICHARD E. WAGNER, *DEMOCRACY IN DEFICIT: THE POLITICAL LEGACY OF LORD KEYNES* 128–30 (1977) (arguing that voters make fiscal choices in response to the perceived cost of public services rather than their actual costs).

illusion.” Fiscal illusion arises because the costs of governmental actions are generally discounted by the decisionmaking body unless they explicitly appear as a budgetary expense.³¹

Whether called fiscal illusion or cost internalization, the concept is a polestar of economic analysis of takings. The leading law and economics textbook, for example, summarizes it as follows:

Obviously, the noncompensability of regulations gives government officials an incentive to overregulate, whereas the compensability of takings makes governmental officials internalize the full cost of expropriating private property. If the state need not compensate for restrictions, then it will impose too many of them. If there are too many restrictions, then resources will not be put to their highest-valued use. Thus, uncompensated restrictions result in inefficient uses.³²

Compensation, in contrast, provides a check to ensure that governments will enact only efficient actions. Richard Epstein puts it bluntly: “If by chance, the diffuse social gains do outweigh the localized costs, then the ‘winners’ should be able to push the condemnation measure through, *with compensation.*”³³ Richard Posner, one of the founding figures in law and economics, summarizes the argument as follows: “The simplest economic

31. Blume & Rubinfeld, *supra* note 5, at 621 (footnotes omitted). Although those who argue that compensation will lead to more efficient results do sometimes argue that the efficiency-generating impact of the results stems from voter pressure, they generally do not incorporate the public choice insight that the form—rather than amount—of public expenditures is crucial. See *Pennell v. City of San Jose*, 485 U.S. 1, 22 (1988) (Scalia, J., dissenting) (arguing that uncompensated regulation permits wealth transfer “to be achieved ‘off budget,’ with relative invisibility and thus relative immunity from normal democratic processes”). In public choice literature, however, full compensation may be consistent with fiscal illusion depending on whether the connection between compensation and voter tax bills is sufficiently salient. See Wallace E. Oates, *On the Nature and Measurement of Fiscal Illusion: A Survey*, in *TAXATION AND FISCAL FEDERALISM: ESSAYS IN HONOUR OF RUSSELL MATHEWS* 65, 65–67 (Geoffrey Brennan et al. eds., 1988) (summarizing the fiscal illusion thesis).

32. COOTER &ULEN, *supra* note 6, at 186–88. Cooter and Ulen then go on to state moral hazard problems with across-the-board compensation. See DAVID A. DANA & THOMAS W. MERRILL, *PROPERTY: TAKINGS* 41–46 (2002) (calling “fiscal illusion,” along with fairness and process concerns, one of three central arguments for compensation); WILLIAM A. FISCHEL, *ZONING RULES! THE ECONOMICS OF LAND USE REGULATION* 105 (2015) (“[T]he appeal of regulatory takings to economists is that it makes regulators pay close attention to the economic consequences of their actions”); STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 127–29 (2004) (summarizing and critiquing the cost internalization argument).

33. RICHARD A. EPSTEIN, *SUPREME NEGLECT: HOW TO REVIVE CONSTITUTIONAL PROTECTION FOR PRIVATE PROPERTY* 119 (2008).

explanation for the requirement of just compensation is that it prevents the government from overusing the taking power.”³⁴

Scholars have raised important qualifications of the efficiency-generating results of compensation standing alone. In some cases, high transaction costs undermine the efficiency benefits of compensation.³⁵ Compensation may also create a moral hazard by effectively insuring those engaging in potentially harmful behavior, leading them to invest without regard to the risk of government prohibition.³⁶ Further, cost internalization does not require—and is sometimes undermined by requiring—governments to pay owners, rather than putting the money into some other worthy fund.³⁷

Scholars have also raised more fundamental challenges to the efficiency argument for compensation. One such challenge is that governmental actors are far more concerned with getting and maintaining political power—a goal that needs not have a direct connection with revenue going out and has an even more tenuous connection with revenue coming in.³⁸ Another challenge is that measuring the impact of government actions by their monetary costs and benefits may miss less monetizable impacts, such as the harms of racism or pollution, the benefits of an old growth forest, or the importance of preserving existing communities.³⁹

34. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 58 (4th ed. 1992).

35. See Michelman, *supra* note 19, at 1214–15 (discussing “settlement costs” for paying compensation).

36. Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 537–40 (1986).

37. See Heller & Krier, *supra* note 21, at 1000 (arguing that at times efficiency would be better served if governments “pay deterrence damages into a special fund, or even into general revenues”).

38. See Daniel A. Farber, *Public Choice and Just Compensation*, 9 CONST. COMMENT. 279, 280 (1992) (asserting that compensation may sometimes decrease public opposition, thereby reducing incentives for officials to enact only efficient measures); Levinson, *supra* note 14, at 345 (arguing that government actors are less responsive to financial factors than political ones); see also FISCHEL, *HOMEOWNER HYPOTHESIS*, *supra* note 14, at 39–40 (discussing the different political considerations of local versus larger governments). For a recent empirical study showing that increasing compensation requirements did not deter eminent domain in Israel, see Ronit Levine-Schnur & Gideon Parchomovsky, *Is the Government Fiscally Blind? An Empirical Examination of the Effect of the Compensation Requirement on Eminent Domain Exercises*, 45 J. LEGAL STUD. (forthcoming 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2621778.

39. See generally Joseph William Singer, *Democratic Estates: Property Law in a Free and Democratic Society*, 94 CORNELL L. REV. 1009, 1035–38 (2009) (discussing limitations of the efficiency approach).

These arguments, however, have largely led economics-minded authors to develop proposals tinkering with when and how much compensation should be required rather than to discard reliance on the concept.⁴⁰ Despite decades of critique, therefore, fiscal illusion remains “perhaps the most common economic explanation of the constitutional mandate of just compensation.”⁴¹

B. *The Illusion of Fiscal Illusion in Brief*

Missed in all the writing on fiscal illusion in regulatory takings is that the concept makes no sense as a description of the actual costs to governments. Taxation is the main way governments get revenue, and most taxes depend on the value of property and its permissible uses. If governments restrict property use so as to reduce the value of the property or the income produced by it, its residents, or its patrons, they already feel the loss in their budgets. If the restriction enhances the value of property or limits the taxpayer-funded services associated with it, the government will experience those benefits as well. Efficient regulations, therefore, should have a net positive effect on governmental revenues, while inefficient ones should have a net negative effect. Compensation will only undermine accurate internalization of the societal cost of regulation.

This argument has less force with regard to physical takings. When the government physically acquires the property of another, it actually gets the property itself. Therefore, the government has gained an asset with an easily identifiable market value and will roughly break even if it compensates the owner for the same amount.⁴² Conversely, if the government need not pay

40. See Timothy J. Brennan & James Boyd, *Political Economy and the Efficiency of Compensation for Takings*, 24 CONTEMP. ECON. POL'Y 188, 200 (2006) (arguing that whether compensation is paid should depend on the relative political power of beneficiaries and land owners); Thomas J. Miceli & Kathleen Segerson, *Regulatory Takings: When Should Compensation Be Paid?*, 23 J. LEGAL STUD. 749, 750–51 (1994) (proposing that compensation should be owed only if the land was used efficiently before regulation or if the government passed the regulation inefficiently); Paul Pecorino, *Optimal Compensation for Regulatory Takings*, 13 AM. L. & ECON. REV. 269, 271, 274 (2011) (positing that compensation should depend in part on the distortionary impact of taxes and the level of governmental bias).

41. Abraham Bell & Gideon Parchomovsky, *The Hidden Function of Takings Compensation*, 96 VA. L. REV. 1673, 1682 (2010).

42. The government will only “roughly break even” because some additional costs are not included here, such as the cost of finding the owner and setting compensation, and the loss of tax revenue on the property. But except for very minuscule governmental invasions—see, for example, *Loretto v. Teleprompter*

compensation, it collects a windfall and may have an economic incentive to overtake.⁴³ Compensation thus makes more sense as a measure to discourage inefficiency in physical takings—but those are the actions for which compensation is already clearly required anyway.

In contrast, where the owner retains title to the property, taxation means that the government already feels her pain. This concept is clearest for property taxes, which are based on a property's assessed value. Because property is assessed at its highest and best legal use, if a regulation prohibits its most lucrative use, then its assessed value should decrease, which should reduce taxes from the property.⁴⁴ But

Manhattan CATV Corp., 458 U.S. 419 (1982) (property occupied had almost no value)—the value of the property itself should be so much larger that transaction costs and lost tax revenues are relatively insignificant in the overall transaction.

43. One could make a similar argument with respect to land use restrictions. Covenants are private agreements for land use restrictions and include some of the same things—commercial use restrictions, single family home requirements, etc.—included in land use laws. Why, when the government enacts such a restriction, aren't they acquiring the value of the equivalent private covenant? There are practical and theoretical objections to this argument. The practical objection is that placing a dollar value on such restrictions is far more difficult than valuing physical property. Covenants are usually created as part of an exchange of land or as a voluntary exchange for tax benefits, so there are few comparable market sales of such restrictions. Indeed, recent investigations suggest donations of such restrictions are routinely overvalued. See Josh Eagle, *Notional Generosity: Explaining Charitable Donors' High Willingness to Part with Conservation Easements*, 35 HARV. ENVTL. L. REV. 47, 70 & n.122 (2011) (arguing that tax deductions for conservation easements overvalue the easements); Wendy C. Gerzog, *Alms to the Rich: The Façade Easement Deduction*, 34 VA. TAX REV. 229, 229 (2014) (contending that the façade easement tax deduction overvalues the easements); see also JOAN YOUNGMAN, A GOOD TAX: LEGAL AND POLICY ISSUES FOR THE PROPERTY TAX IN THE UNITED STATES 131 (2016) (discussing the difficulty of valuing conservation easements). The theoretical objection is that physical property, once taken, belongs to the government in a way that a regulatory restriction simply does not. Land, if not valuable for the use for which the government took it, may be sold or put to another use. A land use restriction simply cannot be repurposed in this way—if the restriction turns out not to be worth the costs it imposes, the government's only option is to repeal it, retaining no future value to enjoy. Moreover, the benefit of the use is generally not experienced by the government itself, but by owners of other property. Situations in which the restriction is the equivalent of an easement for the government's own use are far more likely to be held to be takings. See Joseph L. Sax, *Takings and the Police Power*, 74 YALE L.J. 36, 47 (1964) (positing that “state courts have quite uniformly rejected” appropriations in the guise of restrictions “and required the payment of compensation”).

44. The municipality might make up the difference by increasing the local tax rate, but such increases would be uniform across properties, so that the yield from the restricted property would still be proportionately lower.

land use restrictions also affect income and sales taxes.⁴⁵ If residential purposes are restricted or the property becomes less desirable for them, fewer or less wealthy people, who will pay lower income taxes, will live there. If lucrative industrial or commercial purposes are prohibited, corporate and employee income taxes will go down. Finally, if retail purposes are restricted or become less profitable on the property, sales taxes will drop accordingly. As discussed in the next Section, a number of factors distort the cost signals of these taxes and whether the same government that enacts the land use restriction is the one that feels the restriction's effects. Despite this, some government always and already feels the cost of restrictions on property.

The cost experienced by the government is, of course, not the same as that experienced by the property owner. But neither is the benefit. Both the cost and the benefit reflect the percentage of value reached by taxation, and (assuming that tax rates accurately capture value and income, an assumption discussed further below) the sum should reflect the overall economic impact of the action on social welfare. Requiring governments to compensate owners directly for the loss, in contrast, adds an extraneous cost that is usually significantly larger than, and has little to do with, the social welfare impact of the restriction and may therefore deter otherwise efficient regulations.

Consider this extremely simplified example: assume that residents of Anytown are taxed at 1% of the value of their properties annually, and that a new zoning restriction lowers the fair market value of Blackacre by 20%, from \$100,000 to \$80,000. The owner of Blackacre immediately loses \$20,000 in value, while the government will only lose \$200 in revenue in the first year reflecting this change. If the zoning restriction raises the value of surrounding properties, taxation will also only capture that value at a rate of 1% a year. Say the zoning restriction raises the value of twenty surrounding properties by \$5000 each, for a total of \$100,000, or a net gain of \$80,000 in property value. The government will recoup \$1000 per year of this benefit, for a net gain of \$800. Thus, although the net impact of the property restriction on social welfare is not the same as the impact on governmental revenue, the coefficient will be the same for each. An overall efficient change will have an overall positive impact on governmental budgets, while an overall inefficient change will have a negative impact.

45. See BOWMAN & PAGANO, *supra* note 16, at 55 (discussing land use strategies to maximize particular kinds of taxes).

Now imagine the impact if Anytown is forced, as advocates of expansion of regulatory takings urge, to pay the owner of Blackacre for the reduction in value to the property. In the first year after the restriction, the government loses both the reduction in taxable value (\$200) and the cost of compensation (\$20,000), but only gains \$1000, for a net loss of \$19,200. Although the overall benefit will still be \$800 for future years, it will be twenty-five years before the government breaks even on this restriction, by which point the positive impact on governmental revenue may well be wiped out by the cost of financing the initial \$20,000 compensation.

Across the range of cases, the length of time necessary for a government to reap the benefits of an efficient restriction will depend on multiple factors: the tax rate, the amount of compensation necessary, the cost of generating the initial lump sum award to the property owner, any independent change in property value, and the relative gains and losses from the restriction.⁴⁶ But, except in extreme cases, the governmental incentives are very different in a regime that requires compensation for land use restrictions. A restriction that is efficient as a matter of overall social welfare no longer makes as much sense as a matter of governmental revenue. A government motivated by its budget might well choose to forgo the restriction in order to avoid paying compensation, and property regulation would be less efficient as a result.

This hypothetical example does not take into account the transaction costs in finding those experiencing loss as a result of the restriction, determining the amount of the loss, and paying the compensation. All of these additional costs will make restricting land use with a compensation requirement an even less attractive proposition.⁴⁷ In contrast, there are no additional transaction costs involved in taxation. Although setting and collecting taxes is costly and cumbersome, both cost and cumber exist whether or not compensation is required for regulatory restrictions.

C. Conclusion

Requiring compensation for regulatory restrictions does not dispel fiscal illusion—it creates it. Fully compensating the owners whose property loses value as a result of land use restrictions has nothing to

46. See Pecorino, *supra* note 40, at 274 (showing the costs of fulfilling compensation requirements).

47. Cf. Michelman, *supra* note 19, at 1214–15, 1214 n.99 (discussing ways that finding and settling claims for compensation affect a measure’s gains).

do with accurate balancing of costs and benefits. Governments do not receive the value that is lost by the owner directly; instead, they receive only a fraction of that value through the amount recouped in increased tax revenues or saved in taxpayer-funded services. But governments also experience a decrease in revenues proportionate to any losses property owners experience. In a nondiscriminatory and accurate system of taxation, actions that have a positive economic impact will increase governmental revenue while those that have a negative impact will decrease revenue. To the extent governments react to these revenue changes, they do not need compensation requirements to dispel the illusion that land use restrictions are costless. Adding a compensation requirement, in contrast, distorts the cost signal that taxation already provides.

Will this realization make governments enact only measures that maximize economic welfare? Not necessarily. Sadly, governmental actors, like the rest of us, lack crystal balls foretelling which measures will produce wealth and prosperity. All they can do is guess, and their guesses are sometimes very bad. Also, governmental actors, perhaps even more than the rest of us, are motivated by many things beyond maximizing revenues.⁴⁸ They may support measures that are bad economics because they are good politics and will win votes even if they lose money. They may also support measures that serve policy goals without regard to their ultimate economic impact. Economic arguments are helpful in environmental protection or affordable housing debates, for example, but are less important in securing their passage than other convictions. But the fiscal illusion argument is built on the assumption that policymakers should and do care about maximizing fiscal returns. Taken on its own terms, the argument makes no sense.

II. THE TAX/LAND USE FEEDBACK LOOP AND ITS LIMITATIONS

Governments raise revenue in many ways, and property use affects most of them. Property taxes are affected by the value of the property, sales taxes by the sales connected with the property, and income taxes by how attractive the property is for profitable businesses and higher-income employees and residents. As legal changes affect the importance of any one of these forms of taxation, governments turn to others to make up lost revenue. Limits on municipal property taxation, for example, lead local governments to

48. See discussion *infra* Part III.

compete for local sales or income taxes and other fees, or to rely on state revenues, themselves derived from sales and income taxes, to make up shortfalls.⁴⁹

Changes in property value have different impacts on different taxes and governments. Municipal governments, which enact most land use restrictions, are most sensitive to changes in property taxes, while federal and state governments are most sensitive to changes in income taxation. By contrast, state and, to a lesser extent, municipal governments are most sensitive to changes in sales taxes. Features of various tax systems may also distort the accuracy with which assessment value reflects property value. Nevertheless, this section shows that various taxes should ultimately communicate much of the economic impact of land use restrictions to each of the jurisdictions in which the property is located.

A. *Real Property Taxes*

The impact of land use restrictions has the most direct and transparent effect on real property taxes. Real property taxes are levied in every state and are a tremendously important source of revenue.⁵⁰ Property taxes range from over 40% of all revenue in many northeastern states to only 11% of revenue in Alaska, which relies heavily on mineral extraction fees and royalties.⁵¹ Property taxes are particularly important for local governments: property taxes make up over 70% of local tax revenue.⁵² Although both states and municipalities rely more heavily on other sources of revenue than they did before the property tax revolts of the 1970s, property taxes remain the most significant source of tax revenue for state and local governments.⁵³

Property taxes are a function of the assessed value of the property at issue, multiplied by the assessment rate, multiplied by the rate at

49. See *infra* notes 77–83 and accompanying text.

50. YOUNGMAN, *supra* note 43, at ix (stating that “[t]he property tax is a mainstay of independent local revenue in this country,” whose annual totals far exceed the corporate income tax); Ryan Forster & Kail Padgett, *Where Do State and Local Governments Get Their Tax Revenue?*, 242 FISCAL FACT 1, 4–5 (2010), <http://taxfoundation.org/sites/taxfoundation.org/files/docs/ff242.pdf>.

51. *Id.*

52. See JEFFREY L. BARNETT ET AL., 2012 CENSUS OF GOVERNMENTS: FINANCE—STATE AND LOCAL GOVERNMENT SUMMARY REPORT 3 (2014), http://www2.census.gov/govs/local/summary_report.pdf (reporting that property taxes made up 73.5% of local tax revenue in 2012).

53. See BRUNORI, *supra* note 13, at 55, 58 (discussing the decline in reliance on property taxes).

which the value is taxed, called the millage rate.⁵⁴ Assessment is most often conducted by municipalities, although states have varying levels of control and involvement in assessment.⁵⁵ Assessment itself is based on the sales prices of comparable properties, replacement cost, or income stream of the property, or some combination of the three.⁵⁶ With the exception of replacement cost, each of these factors is directly affected by restrictions on the use of the property. Indeed, claims for takings compensation for regulatory restrictions generally rest on either the reduced expected sales price or income stream from the property.⁵⁷

A number of factors affect the extent to which assessed value accurately reflects the impact of land use restrictions. Some factors are the result of various exemptions and limitations on property taxes imposed as a result of widespread protests against property taxes in the 1970s.⁵⁸ Many of these measures draw differences between business and residential, particularly owner-occupied, properties.⁵⁹ More than half of states have homestead exemptions reducing the taxes on properties occupied as the owner's primary residence.⁶⁰ Many other states prevent property taxes from exceeding a certain percentage of the owner's annual income.⁶¹ A number of other states

54. *E.g.*, MANDY RAFOOL, *A GUIDE TO PROPERTY TAXES: AN OVERVIEW* 8–9 (2002).

55. *Id.* at 7–8 (breaking down the assessment responsibility in each state).

56. Jennifer J.S. Brooks & Ronald J. Schultz, *Market Theory: An Approach to Real Property Valuation for State and Local Tax Purposes*, 45 TAX LAW. 339, 339–40 (1992).

57. *See, e.g.*, *Palazzolo v. Rhode Island*, 533 U.S. 606, 616 (2001) (alleging takings based on different in value if he could fill in and develop his wetland property versus its value with the restriction); *Vill. of Euclid v. Ambler Realty Co.*, 272 U.S. 365, 384 (1926) (arguing that regulation amounted to a taking because property was worth \$10,000 per acre if it could be used for industrial purposes versus \$2500 per acre if restricted to residential purposes).

58. Property taxes are extremely visible to taxpayers. Unlike most income taxes, property taxes are not deducted from an income stream or calculated as a portion of an overall tax bill. Rather, owners receive a separate bill for property taxes, often twice a year. If individuals choose not to pay, governments may foreclose on their homes. Property taxes also need not reflect ability to pay; those who own property as a residence receive no additional income when the value of their property increases. Particularly for those on a fixed income, increased taxes as a result of increased assessed value impose a serious hardship. In response to such inequities and other protests, states have enacted a number of measures that distort the relationship between taxation and assessed value. *See BRUNORI, supra* note 13, at 56–58; Edward A. Zelinsky, *The Once and Future Property Tax: A Dialogue with My Younger Self*, 23 CARDOZO L. REV. 2199, 2201–03, 2216 (2002) (discussing changes to property tax).

59. BRUNORI, *supra* note 13, at 58, 63–64.

60. *Id.* at 63–64.

61. *Id.* at 64.

grant deferrals of property taxes for elderly or disabled owners until the property is sold, although few of those eligible take advantage of the deferrals.⁶² Many states also create different assessment rates for different kinds of properties, often taxing homeowners and farmers on a smaller percentage of the assessed value than that on which businesses are taxed.⁶³

Each of these measures might be expected to make governments less sensitive to measures that affect the assessed value of residential, as opposed to business, properties. Nevertheless, governmental reliance on residential property taxes has only grown since the 1970s.⁶⁴ Factors behind this trend may include greater difficulty in assessing business property, greater reliance by businesses on equipment rather than real property, and negotiated tax reductions for new businesses expected to contribute to economic development.⁶⁵ So although changes in value may affect the tax levy on different kinds of property in different ways, restrictions that affect the value of different kinds of properties will in most cases also affect property taxes.

An additional limitation lies in the accuracy of assessed value. Because assessments rely on the assessor's estimate of what the property will sell for, and because individual properties may differ in many ways even from neighboring properties, there is much room for error. Inconsistencies in assessed values are notorious.⁶⁶ Some of these differences are random. Others are the result of systemic differences. Studies have found systemic undervaluation of high value residences and overvaluation of low cost properties; lower valuation of owner-occupied versus rental properties; and even overvaluation of properties in majority-minority versus majority-white neighborhoods.⁶⁷

If there were truly no relationship between assessed value and true value, there would be no reason for property taxes to reflect the impact of land use restrictions. But, of course, there is a significant

62. *Id.* at 64–65.

63. RAFOOL, *supra* note 54, at 8.

64. BRUNORI, *supra* note 13, at 58; see also Byron Lutz et al., *The Housing Crisis and State and Local Government Tax Revenue: Five Channels*, 41 REGIONAL SCI. & URB. ECON. 306, 308 (2011) (reporting that residential property makes up about 60% of assessed value).

65. BRUNORI, *supra* note 13, at 58.

66. *Id.* at 57; see also Lee Harris, ‘Assessing’ Discrimination: The Influence of Race in Residential Property Tax Assessments, 20 J. LAND USE & ENVT. L. 1, 2 (2004) (discussing the systematic differences in property valuation across racial lines).

67. See Harris, *supra* note 66, at 12 (examining the racial dynamics underlying the disparities in property tax assessments).

relationship, even if the relationship is not perfect.⁶⁸ The kind of differences caused by land use restrictions are also relatively easy to assess. Unlike the different feel and attractiveness from one block to another, prohibitions on building more than one home per acre, for example, or on industrial use, have clear and comparatively easy to monetize impacts.⁶⁹ Land use restrictions also do not fall within the known categories of systemic overassessment, such as low value, commercial, renter-occupied properties.⁷⁰

Another potential limit on the sensitivity of governmental decision makers to changes in property value comes from lag times between assessments. If property need not be reassessed regularly, governments may enjoy long periods without experiencing revenue changes from reductions in property value. Although eventually the change will affect tax revenues, in the interim the situation might appear to be closer to the something-for-nothing that advocates of the fiscal illusion construct posit. If the cost is delayed, however, so is the benefit; the government will not experience any tax gains from increased value of other properties until reassessment is complete either.⁷¹ Widespread decreases in assessment times over recent decades also mitigate this problem.⁷² Today, reassessment is mandated every year in twenty-five states; in most others, reassessment is required between every two and four years.⁷³ There are outliers—Rhode Island requires reassessment every ten years; North Carolina, every eight years; and California, under Proposition 13, requires reassessment only when property is sold.⁷⁴ But in most states owners are entitled to regular reassessments.

The availability of appeals provides another safeguard to ensure that assessments reflect the impact of restrictions that decrease

68. See Justin M. Ross & Wenli Yan, *Fiscal Illusion from Property Reassessment? An Empirical Test of the Residual View*, 66 NAT'L TAX J. 7, 9 (2013) (noting high correlation between property tax revenues and housing prices).

69. In fact, state and local governments regularly do monetize such impacts by reducing property taxes on land dedicated to open space, wilderness, or farming purposes. Because such easements are only exchanged with governments or charities, however, and not on the open market, there is concern that such easements are overvalued. Eagle, *supra* note 43, at 69–70.

70. If anything, downzoning, restrictions on commercial uses, and environmental protections are more likely in the high value, owner-occupied areas that are more likely to be underassessed already. Harris, *supra* note 66, at 12.

71. RAFOOL, *supra* note 54, at 6.

72. *Id.*

73. *Id.* at 6–7.

74. *Id.*

property value. Assessment appeals are rare—occurring in just 2% of assessments according to one early study⁷⁵—but are low cost and readily available to the disgruntled property owner.⁷⁶ For the owner significantly aggrieved by a land use restriction, the assessment appeal presents an easy partial remedy.

The most important limitation of the impact of land use restrictions on property taxes is that they are primarily municipal taxes. Many states collect taxes on particular kinds of property, such as railroad rights-of-way;⁷⁷ a number commandeer some municipal taxes to fund school revenue equalization schemes; and a few collect and distribute most property tax revenues directly.⁷⁸ In general, however, property taxes fund municipal budgets, not state ones, and certainly not federal ones. Municipal governments will, therefore, be most sensitive to the impact any land use restrictions have on property taxes, state governments less so, and federal governments hardly at all.

But what one level of government loses, other governments and other tax sources must make up.⁷⁹ In particular, when local revenues decrease, state support increases. The limitations on property taxes in recent decades have been accompanied by sharply increased state support for local governments.⁸⁰ States, in turn, have increased their reliance on other forms of revenue, particularly individual and corporate income taxes.⁸¹ Still, property taxes compete with sales taxes

75. THEODORE REYNOLDS SMITH, *REAL PROPERTY TAXATION AND THE URBAN CENTER: A CASE STUDY OF HARTFORD, CONNECTICUT* 46 (1972).

76. See RAFOOL, *supra* note 54, at 11 (describing the elements of the appeals process common to most states, including that property owners generally may simply call the assessor's office).

77. *Id.* at 13.

78. *Id.* at 4–5.

79. See generally John Joseph Wallis, *A History of the Property Tax in America*, in PROPERTY TAXATION AND LOCAL GOVERNMENT FINANCE: ESSAYS IN HONOR OF C. LOWELL HARRISS 123, 127–28 (Wallace E. Oates ed., 2001) (describing a shift between different types and levels of taxation over U.S. history).

80. See BRUNORI, *supra* note 13, at 65–66 (discussing the significant increase in state funding for local schools over the past quarter century).

81. Between 1948 and 2010, sales taxes as a percentage of state and local revenues have remained almost the same. See Liz Malm & Ellen Kant, *The Sources of State and Local Tax Revenues*, TAX FOUND. tbl.2 (Jan. 28, 2013), <http://taxfoundation.org/article/sources-state-and-local-tax-revenues> (showing that individual and corporate income taxes increased from 8.5% of state and local revenues to 23.9% between 1948 and 2010).

as the single largest source of state and local tax revenue⁸² and have increased in importance as state sales taxes decreased in recent years.⁸³

In short, both state and local governments will experience real budgetary effects from land use restrictions that affect property values. While these are not precisely proportional to or simultaneous with those felt by property owners, they are significant enough to undercut any false impression that the actions are costless, and accurate enough to signal what those costs and benefits actually are.

B. Income Taxes

Land use restrictions also frequently affect income taxes. In contrast to property taxes, federal and, to a lesser extent, state governments will be most sensitive to these impacts. The impact of property restrictions on income taxes is neither as direct nor as transparent as the effect on property taxes, but is particularly clear for the kinds of land use measures likely to be imposed by non-municipal governments.

Land use measures affect income taxes in many ways. Changing the value of the property obviously changes the income produced on sale of the property, but the effects are much more pervasive. Restricting property to residential uses prevents the property itself from generating income except as rental property. Increasing minimum lot sizes generally leads to higher-income property owners.⁸⁴ Prohibiting development of a property to achieve environmental goals may undermine almost all of its income-producing potential.

The impact of such measures on income taxes is more difficult to calculate than the impact on property taxes. Income taxes, after all, are not based on property value.⁸⁵ In addition, because many local

82. *Id.*

83. See *id.* (showing property taxes outpacing sales taxes in 2010); NATIONAL TOTALS OF STATE AND LOCAL GOVERNMENT TAX REVENUE, BY TYPE OF TAX, U.S. CENSUS BUREAU tbl.1 (June 21, 2016) [hereinafter STATE & LOCAL GOVERNMENT TAX REVENUE], <http://www2.census.gov/govs/qtax/2016/q1t1.xls> (showing property taxes were significantly larger than sales or income taxes in 2013 and 2014).

84. Fencing out low-income residents may even be the purpose of such restrictions. See REC'L PLANNING ASS'N & LINCOLN LAND INST., FUNDAMENTAL PROPERTY TAX REFORM: LAND USE IMPLICATIONS OF NEW JERSEY'S TAX DEBATE 7–8 (2005) [hereinafter FUNDAMENTAL PROPERTY TAX REFORM] (finding that municipalities use their zoning and taxing power to restrict affordable housing).

85. The income of a wealthy person residing in a hovel, for example, will be taxed at the same rate as that same person residing in a mansion. A fabulously successful restaurant in a hole-in-the-wall on Manhattan's Avenue C is taxed at the

governments lack the ability to levy income taxes, they will generally not be sensitive to the effects on income except as a proxy for other qualities.

Quite a number of local governments, however, particularly larger ones, do levy a small income tax.⁸⁶ All Indiana and Maryland counties, for example; over six hundred Iowa school districts; hundreds of Ohio school districts and cities; twenty-three Michigan cities; plus a number of major cities, like New York, San Francisco, and Philadelphia, levy an income tax.⁸⁷ One comprehensive study shows that cities with the ability to levy employee or corporate income taxes aggressively tailor land use strategies to maximize such taxes, particularly because they often fall on non-residents (and therefore non-voters).⁸⁸ But these jurisdictions still represent a minority,⁸⁹ and local governments get most of their revenue from property taxes and state transfers.

This is not to say that municipalities do not care about the income of their residents and businesses—successful businesses and wealthy residents generally raise property values and, with them, property taxes. Poorer residents and those with children often require more government services, demanding more governmental outlay.⁹⁰ Therefore, municipalities often try to exclude low-income residents⁹¹ and solicit successful businesses.⁹² But in general, concern about income taxes per se does not generate these desires; in fact,

same rate as an equally successful restaurant on Fifth Avenue. In fact, the effective income tax rate for taxpayers with less valuable property might be even higher because they will have lower deductions for mortgage interest, business expenses, and the like.

86. Joseph Henchman, *County and City Income Taxes Clustered in States with Poor Tax Climates*, TAX FOUND. (July 11, 2008), <http://taxfoundation.org/article/county-and-city-income-taxes-clustered-states-poor-tax-climates>.

87. *Id.*

88. See BOWMAN & PAGANO, *supra* note 16, at 70–78 (discussing land use strategies of cities with income taxes).

89. *See id.* at 50 (reporting that out of 555 cities with populations over 50,000, only 8% had the ability to levy an income tax).

90. See FUNDAMENTAL PROPERTY TAX REFORM, *supra* note 84, at 8 (reporting that over half of New Jersey's expenditures are on educating school-age children).

91. See, e.g., S. Burlington Cty. NAACP v. Twp. of Mount Laurel, 336 A.2d 713, 718 (N.J. 1975) (noting the municipality's concession that "its land use regulation was intended to result and has resulted in economic discrimination and exclusion" and argument that "its policies and practices are in the best present and future fiscal interest of the municipality").

92. See Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 378 (1996) (discussing the unproductive battle to lure businesses with subsidies).

municipalities often give up part of the property, sales, and income taxes they would otherwise receive to lure businesses to relocate there.⁹³

The reverse is true for the federal government. Between personal income taxes (47%), corporate income taxes (11%), and payroll taxes (33%), in 2015, 91% of federal government tax revenue came from income.⁹⁴ The multiplicity of exceptions and deductions in the federal tax code makes it difficult to calculate a one-to-one relationship between income and taxation. Nevertheless, federal policymakers are extremely concerned (though not in agreement) about the impact of various measures on income taxes.⁹⁵

What is more, federal land use measures are more likely to have foreseeable impacts on income than the classic use and area restrictions enacted by local governments. One might (overstating it quite a bit) even say this is a constitutional requirement. Under the main provision authorizing federal land use restrictions, the activity restricted must impact interstate commerce.⁹⁶ And even though Commerce Clause jurisprudence defines both “interstate” and “commerce” broadly,⁹⁷ the federal government is unlikely for political reasons to intervene regarding land uses that do not have significant monetary impacts. Consider some of the main federal land use restrictions—New Deal Era agricultural adjustment programs; Endangered Species Act habitat protections; Clean Water Act restrictions on filling wetlands; Coastal Management Act regulation of building on coastlines; and standards governing siting of airports,

93. See *id.* at 384–85 (reviewing tax incentives for businesses); Mark Taylor, Note, *A Proposal to Prohibit Industrial Relocation Subsidies*, 72 TEX. L. REV. 669, 675–77 (1994) (describing tax incentives to induce businesses to relocate).

94. *Policy Basics: Where Do Federal Tax Revenues Come from?*, CTR. ON BUDGET & POLICY PRIORITIES (Mar. 4, 2016), <http://www.cbpp.org/research/policy-basics-where-do-federal-tax-revenues-come-from>.

95. See MOLLY F. SHERLOCK & MARK P. KEIGHTLEY, CONG. RESEARCH SERV., TAX REFORM IN THE 114TH CONGRESS: AN OVERVIEW OF PROPOSALS 2 (2016), <https://www.fas.org/sgp/crs/misc/R43060.pdf> (characterizing the ongoing income tax debate as centered around reforming or repealing various tax expenditures).

96. U.S. CONST. art. I, § 8, cl. 3.

97. See Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2578 (2012) (discussing the “expansive” power over interstate commerce activities under the Commerce Clause); Mandeville Island Farms, Inc. v. Am. Crystal Sugar Co., 334 U.S. 219, 236 (1948) (“[I]t is enough that the individual activity when multiplied into a general practice . . . contains a threat to the interstate economy that requires preventative regulation.”); Gibbons v. Ogden, 22 U.S. 1, 196 (1824) (stating that the commerce power “is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations, other than are prescribed in the [C]onstitution”).

telecommunications towers, and nuclear power facilities.⁹⁸ All have clear impacts on income, even if their magnitude and whether the overall impact is positive or negative is subject to debate.

States will fall somewhere in between local and federal governments in their sensitivity to income tax impacts. Individual and corporate income taxes rose to make up about 28% of state and local revenues in 2000.⁹⁹ Greater reliance on property taxes in the face of first rising housing prices, and then plummeting income,¹⁰⁰ has reduced tax's impact on revenue. However, income taxes still comprise a significant portion of state revenues.¹⁰¹

Similarly, state planning measures fall somewhere between federal and local ones with respect to the clarity of their impact on income. In general, states have delegated their authority regarding land use to municipal governments rather than exercising it directly.¹⁰² Many of the state measures that do exist intervene to prevent local land use restrictions that have undesirable statewide impacts, such as zoning laws that exclude affordable housing¹⁰³ or restrictions that prevent construction of solar panels and other alternative energy sources.¹⁰⁴ But others resemble federal measures that prohibit or encourage broad changes to land use in ways that predictably affect income.¹⁰⁵ Many of these are through programs mandated by or coordinated with federal law, such as the Coastal Zone Management Act and

98. See generally Patricia E. Salkin, *The Quiet Revolution and Federalism: Into the Future*, 45 J. MARSHALL L. REV. 253, 268–90 (2012) (summarizing federal measures affecting land use); Todd A. Wildermuth, *National Land Use Planning in America, Briefly*, 26 J. LAND RESOURCES & ENVT'L. L. 73, 73–79 (2005) (same).

99. Malm & Kant, *supra* note 81, tbl.2.

100. See Lutz et al., *supra* note 64, at 306 (discussing why property taxes remain relatively stable in times of economic decline).

101. See Malm & Kant, *supra* note 81, tbl.2 (showing income taxes comprising 24% of state and local tax revenue in 2010); STATE & LOCAL GOVERNMENT TAX REVENUE, *supra* note 83, tbl.1 (showing income taxes as the same share of state and local tax revenue in 2014 and 2015).

102. Salkin, *supra* note 98, at 257.

103. See, e.g., CONN. GEN. STAT. § 8-30g (2016) (permitting override of local decisions barring affordable housing); MASS. ANN. LAWS ch. 40B, §§ 20–23 (LexisNexis 2016) (same).

104. See Sara C. Bronin, *Solar Rights*, 89 B.U. L. REV. 1217, 1242–44 (2009) (discussing state laws that address land use restrictions that pose obstacles to alternative energy).

105. See Ashira Pelman Ostrow, *Land Law Federalism*, 61 EMORY L.J. 1397, 1424 (2012) (discussing federal requirements that restrict the development of private property).

Clean Water Act.¹⁰⁶ Other programs with significant impacts on land use, including regulations regarding fracking or public transportation investments, are in part driven by their impact on income and other tax revenue.¹⁰⁷

C. Sales Taxes

Sales taxes are a very significant source of revenue for state governments and sometimes a significant source of revenue for local governments. Reliance on state and local sales taxation varies inversely with other taxes. Restrictions on non-residential uses, big box stores, shopping plazas, and the like obviously affect state and local sales taxes, while restrictions on population density do so less directly.

Sales taxes comprise about a third of combined state and local revenues.¹⁰⁸ As the role of property taxes shrank over the course of the twentieth century, the role of sales taxes grew, until sales taxes comprised a slightly larger portion of state tax revenue.¹⁰⁹ Since the 2008 recession, the importance of sales and property taxes has flipped; in 2014 sales tax revenue was about 75% of property tax revenue.¹¹⁰ Reliance on sales and income taxes are also often inversely related—for example, Washington, which has no state income tax, has one of the highest sales tax rates, while neighboring Oregon has no general sales tax,¹¹¹ but one of the highest income tax rates in the nation.¹¹²

Local governments in thirty-eight states collect sales taxes.¹¹³ Such taxes are particularly important in states with low property tax

106. *Id.* at 1424–34 (discussing various federal laws influencing state land use decisions).

107. See, e.g., Press Release, State of Conn., Gov. Malloy: Funding for Transformative Transportation Plan Now Underway (July 28, 2015), http://portal.ct.gov/Departments_and_Agencies/Office_of_the_Governor/Press_Room/Press_Releases/2015/07-2015/Gov_Malloy_Funding_for_Transformative_Transportation_Plan_Now_Underway/ (“Improving transportation is fundamental to strong economic and market growth.” (quoting Lieutenant Governor Nancy Wyman)).

108. Malm & Kant, *supra* note 81, fig.1.

109. *Id.* tbl.2.

110. STATE & LOCAL GOVERNMENT TAX REVENUE, *supra* note 83, tbl.1.

111. Scott Drenkard & Jared Walczak, *State and Local Sales Tax Rates in 2015*, TAX FOUND. (Apr. 8, 2015), <http://taxfoundation.org/article/state-and-local-sales-tax-rates-2015>.

112. Jared Walczak, *State Individual Income Tax Rates and Brackets for 2015*, TAX FOUND. (Apr. 15, 2015), <http://taxfoundation.org/article/state-individual-income-tax-rates-and-brackets-2015>.

113. Drenkard & Walczak, *supra* note 111.

collections. Alabama, for example, with some of the lowest property tax collections,¹¹⁴ also has the highest average local sales taxes, and one of the highest combined state-local sales tax rates.¹¹⁵ Similarly, after California passed Proposition 13, which significantly limited local property taxes, local officials shifted their development planning toward attracting businesses that generated sales taxes.¹¹⁶ A 1999 survey of government officials in California found that they ranked sales taxes as either the first or second most important factor in considering new developments.¹¹⁷ Impacts on sales taxes are thus an important land use factor for the large number of municipalities with sales tax authority.

D. Conclusion

In general, governments will feel the positive or negative impact of land use measures through tax revenues. Localities experience these impacts significantly through property and often sales taxes and, less frequently, through income taxes. Federal governments experience them directly only through income tax revenues, but most federal land restrictions raise obvious potential income effects. States will feel the effects of land use restrictions on all three forms of taxation, although states have delegated much of their land use authority to municipalities.

The tax feedback loop is not perfect. Tax deductions and exemptions mean taxes often fail to capture the value of the asset taxed, limit the accuracy of the signal, and add complexity to the system, making it more difficult to perceive the relationship between impacts on value and impacts on revenue. In addition, some measures may increase the value taxed by one government but decrease the value taxed by another. Imagine, for example, a local government measure that prohibits commercial uses, which increases property values and therefore local property taxes, but decreases sales and therefore state sales taxes. However, this example is a failing of compensation requirements as well because compensation is paid only by one level of government, but the negative or positive impact of that property restriction may be felt by another government

114. Malm & Kant, *supra* note 81, tbl.2 (showing Alabama as one of the five states with the lowest reliance on property tax revenues).

115. Drenkard & Walczak, *supra* note 111 (listing Alabama with the highest local sales tax rate in the country, and one of five highest combined local-state sales tax rates).

116. Jonathan Schwartz, Note, *Prisoners of Proposition 13: Sales Taxes, Property Taxes, and the Fiscalization of Municipal Land Use Decisions*, 71 S. CAL. L. REV. 183, 199–200 (1997).

117. Robert W. Wassmer, *Fiscalisation of Land Use, Urban Growth Boundaries and Non-Central Retail Sprawl in the Western United States*, 39 URB. STUD. 1307, 1317 (2002).

entirely. If the goal is to use fiscal incentives to get the government to maximize wealth within a jurisdiction, the tax system is as close to an accurate means to internalize costs and benefits as that jurisdiction is going to get.

III. DO GOVERNMENTS CARE ABOUT REVENUE IMPACTS?

The preceding Section takes the cost-internalization argument on its own terms, accepting its premises that policymakers actually care about, and are motivated by, governmental revenues. As others have written, there is good reason to believe that these premises are false.¹¹⁸ Maximizing governmental revenue is only tangentially related to most political goals, and the structure of political decision making often divorces those who make land use decisions from those who have to pay for them. Nevertheless, enhancing revenues is a basic planning goal, one that state and particularly local governments actively pursue. Understanding the tax feedback loop also helps to explain why the compensation requirements for regulatory restrictions enacted in some jurisdictions have so effectively blocked such restrictions: even when the action will produce more economic gains than losses, one-to-one compensation is usually so much higher than the government's share of those gains that withdrawing the restriction is the only rational choice. This Section discusses the extent of, and limitations on, governmental sensitivity to financial incentives.

A. *Governments Often Won't Care Much About Tax Revenues*

The fiscal illusionists' assumption—that revenue impacts will significantly impact political behavior—ignores both the theory and reality of government decision making. A number of scholars have examined these shortfalls.¹¹⁹ This Section briefly reviews the reasons that governments often do not care about the revenue impacts of land use restrictions.

First, it is a mistake to attribute the private actor's desire to maximize revenues to the self-interested political actor.

118. *E.g.*, DANIEL A. FARBER & PHILIP P. FRICKEY, LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION 31 (1991).

119. *See, e.g.*, Farber, *supra* note 38, at 279–80 (examining the political impact of compensation); Nicole Stelle Garnett, *The Neglected Political Economy of Eminent Domain*, 105 MICH. L. REV. 101, 101 (2006) (discussing the ways that politics influence eminent domain practice); Levinson, *supra* note 14, at 345–47 (arguing that compensation requirements do not impact governments in the same way they impact private firms).

Governmental representatives are not like pure economic actors, whose interests are neatly aligned with the profits of their firms. Public choice theory, the primary economic theory regarding political decision making, posits that governmental actors are less interested in maximizing governmental budgets than in maximizing political power and securing reelection.¹²⁰ Although beliefs about the public interest clearly play a role as well,¹²¹ those who can most powerfully express their sense of the public interest will have the greatest influence on such beliefs. The most politically effective actions in this light are not those that maximize benefit across a broad group, but rather those that significantly affect a smaller group of actors that is more highly motivated and can more easily coordinate to act on its concerns, and which can therefore more effectively command public attention.¹²² Daniel Farber has even argued that, in some cases, failing to compensate may result in more political pressure than will compensating because failure to compensate will make owners more active in decrying their perceived wrongs and make their cries more sympathetic to the public.¹²³

In addition, policy-setting, implementation, and budget management responsibilities are often divided among different entities: sometimes within the same government, sometimes by the same entity at different periods of time, and sometimes by different entities—municipal, state, federal, or regional—altogether.¹²⁴ The people that cause revenue changes, in other words, may not be the same people that experience the impact of those changes, limiting the effect of such impacts on political behavior.¹²⁵ Zoning and planning decisions, for example, are made in the first instance by a planning commission, then ratified by the general government, and then may be implemented by a separate zoning board or board of adjustment.¹²⁶ Neither the

120. FARBER & FRICKEY, *supra* note 118, at 20–22, 31; Levinson, *supra* note 14, at 374.

121. FARBER & FRICKEY, *supra* note 118, at 29–33 (arguing that politicians' ideologies influence their actions).

122. Farber, *supra* note 38, at 289–90 (analyzing reasons that “small groups with high stakes have a disproportionately great influence on the political process”).

123. *Id.* at 299; see also Brennan & Boyd, *supra* note 40, at 190 (calculating compensation necessary to produce efficiency—generating political action).

124. See, e.g., Garnett, *supra* note 119, at 141–42 (noting that local economic development projects are often funded by state and federal governments).

125. Levinson, *supra* note 14, at 380 (explaining that the decision makers are often bureaucrats rather than elected officials).

126. See JOSEPH WILLIAM SINGER, BETHANY R. BERGER, NESTOR M. DAVIDSON & EDUARDO MOISÉS PEÑALVER, PROPERTY LAW: RULES, POLICIES, AND PRACTICES 429 (6th

planning commission nor the board of adjustment, responsible respectively for determining the rules and whether individual owners comply with them, will be responsible for distributing funds between schools, police, garbage collection, or the many other demands on municipal revenues. A similar division of responsibility affects other levels of government. Congress may enact a broad mandate, the relevant agency will implement it, and a wholly different agency may feel the revenue impact of the action.¹²⁷ Revenue shortfalls, moreover, need not block governmental action to the extent another government will finance its operation at an own-revenue deficit.¹²⁸

Even when the entities making, implementing, and paying for a land use measure are closely aligned, the individual actors may not be because there may be a lag time in realizing the costs and benefits of a certain land use decision. A government official may leave office, or face an election in which the official has to explain the decision, long before the community or government realizes the tax benefits of the decision. Nor will costs and benefits necessarily be realized on the same schedule. A measure preventing development of wetlands, for example, will immediately and significantly reduce the market value of a parcel but only slowly produce economic benefits by avoiding impacts on drinking water and avoiding costly protection and remediation of areas subject to flooding. A decision maker's calculus, therefore, will rationally depend far more on the voices of aggrieved homeowners and environmental advocates than the promise of far off increased revenues. Indeed, that is perhaps how it should be: as high as the economy is on the list of public concerns, bean-counter kings are unlikely to create the kind of society in which most of us want to live.

Again, all of these challenges may be levied equally powerfully at the fiscal illusionists. Their arguments depend on the assumption that making governments pay will cause governments to internalize costs and make efficient decisions. This Section summarizes some of the many reasons to doubt this assumption. The questions about whether requiring

ed. 2014) (describing the institutions involved in zoning code enactment and implementation).

127. The National Environmental Policy Act of 1969, 42 U.S.C. § 4231 et seq., for example, is implemented by the Environmental Protection Agency, but revenue effects of compensation would be shared with those agencies, like Health and Human Services or the Department of Defense, with large budgets that are frequently subject to appropriations battles.

128. See Levinson, *supra* note 14, at 382 (stating that compensation may be paid from a general fund rather than the budget of the agency deciding to take the action).

compensation for land use decisions will lead to more efficient decisions are thus another reason to question the fiscal illusion argument.

B. Sometimes Governments Do Care About Tax Revenues—But That's Not Always a Good Thing

While impacts on tax revenues are unlikely to be the primary determinant of land use decisions, these impacts are an important motivator, particularly for local governments. This Section discusses both governmental sensitivity to revenue and its potential negative consequences.

Local governments, which are most likely to make decisions affecting land use, are also the most sensitive to the tax impacts of their decisions. Part II suggested that because the connection between taxes and land use measures is the most direct and transparent for property taxes, local governments will be most sensitive to the cost-internalization mechanism that taxes provide. The political economy factors discussed above will work differently for smaller local governments. Because municipal decisions are readily capitalized into property values and property taxes,¹²⁹ homeowners are far more aware and involved than either renters or voters in federal, state, or large city governments.¹³⁰ Officials in these communities, therefore, are extremely responsive to “homevoter” interests in maintaining overall community property values and property tax burdens, and their decisions reflect this fact.¹³¹ Land use plans from across the country cite increasing tax revenue and reducing tax burden among their planning concerns,¹³² and

129. FISCHEL, HOMEOWNER HYPOTHESIS, *supra* note 14, at 39–40.

130. *Id.* at 4.

131. *Id.* at 89; cf. Vicki Been et al., *Urban Land-Use Regulation: Are Homevoters Overtaking the Growth Machine?*, 11 J. EMPIRICAL LEGAL STUD. 227, 229, 231–32 (2014) (providing evidence that these values even impact land use decisions in New York City, perhaps the polar opposite of the small municipalities Fischel focuses on).

132. See, e.g., HOKE COUNTY LAND USE PLAN, at I.3–4, A-32 (2005), <http://www.hokecounty.net/DocumentCenter/View/63> (noting that “land uses that typically generate high tax values and collections but demand little in public services are industrial and commercial activities” and that “[c]apturing sales tax revenue is essential for guaranteeing a growing revenue stream for local government budgets”); LAND USE PLAN: PLATTE COUNTY, MISSOURI, at 3–5 (2010), https://static1.squarespace.com/static/564a1160e4b082647c602a40/t/566867f4df40f3a42f45b175/1449682932498/2010_land_use_plan.pdf (discussing tax opportunities of increased retail sales); LAND USE PLAN: ROCK ISLAND COUNTY, ILLINOIS, at 6, 16, 24 (1998), <http://www.rockislandcounty.org/uploadedFiles/landuse98.pdf> (discussing the discrepancy between tax revenue and additional costs of new housing as impetus for plan); MONTCO 2040: A SHARED VISION, THE COMPREHENSIVE PLAN FOR MONTGOMERY

numerous studies demonstrate the connection between land use patterns and hoped-for tax consequences.¹³³

Sensitivity to revenue impacts does not necessarily lead to better land use decisions. In fact, the small size that creates this sensitivity also makes local governments less likely to fully internalize the costs of their decisions because there is more spillover across municipal borders.¹³⁴ At times, spillover is deliberate. Governments may seek to off-load a greater portion of the costs of their activity by, for example, locating big box stores (with resultant traffic, aesthetic, and other costs) or industrial activities (with environmental and stigmatic costs) on municipal borders.¹³⁵ At times, the spillover effects are unintentional. By downzoning or preventing new housing developments, for example, municipalities may unintentionally

COUNTY, at 68 (2015), <http://www.montcopa.org/DocumentCenter/View/7719> (discussing the need to “attract and retain businesses and vital community assets” to provide “a strong tax base”).

133. See, e.g., JEFFREY I. CHAPMAN, PUB. POLICY INSTITUTE OF CAL., PROPOSITION 13: SOME UNINTENDED CONSEQUENCES 11–12 (1998) (stating that Proposition 13 led municipalities to compete for new big box stores and car dealerships); FUNDAMENTAL PROPERTY TAX REFORM, *supra* note 84, at 8 (claiming that increasing property taxes without new revenues led New Jersey to overzone for commercial development and underzone for housing); Wallace E. Oates & Robert M. Schwab, *The Simple Analytics of Land Value Taxation*, in LAND VALUE TAXATION: THEORY, EVIDENCE, AND PRACTICE 51, 67–68 (Richard F. Dye & Richard W. England eds., 2009) (finding that while property taxes theoretically might increase or decrease sprawl, in practice the taxes’ effect is to increase sprawl); Robert D. Cheren, *Fracking Bans, Taxation, and Environmental Policy*, 64 CASE W. RES. L. REV. 1483 (2014) (showing that states without the authority to tax fracking activity were far more likely to enact fracking bans); Wassmer, *supra* note 117, at 1324 (showing the impact of sales tax reliance on non-urban retail sprawl); BENNOY JACOB & MICHAEL A. PAGANO, BORDER WARS: DO TAXES INFLUENCE LAND USE DECISIONS ACROSS STATE BOUNDARIES? 17 (2009) (unpublished paper on file with author) (demonstrating effects of property, sales, and income tax reliance on approval of developments); see also Kurt Paulsen, *The Effects of Land Development on Municipal Finance*, 29 J. PLAN. LITERATURE 20, 20–21 (2014) (stating that revenue and cost modeling has become much more common in planning in recent years).

134. See ALAN A. ALTSHULER & JOSÉ A. GÓMEZ-IBÁÑEZ, REGULATION FOR REVENUE: THE POLITICAL ECONOMY OF LAND USE EXACTIONS vii (1993) (discussing the importance of spillover effects); Paulsen, *supra* note 133, at 26 (“Projections of likely fiscal impacts for one community almost never consider the fiscal, land use, and other indirect impacts on neighboring jurisdictions”).

135. See JACOB & PAGANO, *supra* note 133, at 10–11, 16, 30–31 (discussing the spillover effect and noting its presence in retail development in Tempe, Arizona and Kansas City, Kansas); Franco Ordonez, *Neighbors Prefer Sweets to Power Plant: Doughnuts Warehouse Considered*, BOS. GLOBE, Nov. 30, 2003, http://archive.boston.com/news/local/articles/2003/11/30/neighbors_prefer_sweets_to_power_plant (discussing a decision to approve a power plant in a neighborhood near the Charles River).

increase sprawl and undermine availability of affordable housing across the region.¹³⁶ Similarly, as multiple municipalities in a region chase retail tax dollars, they may increase retail sprawl and decrease open space for all.¹³⁷

Of course, overall revenue is not the only goal motivating land use decisions. The homevoter hypothesis means that homevoter wishes, such as those for open space or against industrial uses, may hold sway over revenue-maximizing land uses. Splashy but costly projects, such as sports stadiums, may appear more attractive to politicians. Municipal governments may also fail to accurately calculate either the costs or revenues from new developments.¹³⁸ For example, municipalities across the country provide property tax rebates to lure job-producing businesses even though, in the absence of local income taxes, these businesses are unlikely to produce compensating revenue for the municipality.¹³⁹ As governments all use the same techniques to lure businesses, moreover, the likelihood that the business will be lured away before it creates surplus revenue increases.¹⁴⁰ Municipalities may also fail to account for competitive effects within their own borders, such as the impact of big box developments on the edge of town draining business and vitality from the center of town.¹⁴¹

In short, although governments do at times take tax revenues into account, this consideration often fails to result in land use decisions that benefit either the local residents or the governments themselves.

136. See *FUNDAMENTAL PROPERTY TAX REFORM*, *supra* note 84, at 1 (discussing the ways that increased commercial zoning inadvertently decreases affordable housing).

137. See *id.* (finding that commercial zoning has led to a decrease in the availability of green spaces).

138. See JACK R. HUDDLESTON, LINCOLN INST. OF LAND POLICY, THE INTERSECTION BETWEEN PLANNING AND THE MUNICIPAL BUDGET 1–2 (2005) (discussing a town that pursued intensive downtown redevelopment to compensate for big box development at the city’s edge, but found that the costs of maintaining the development overwhelmed the city budget).

139. DAPHNE A. KENYON, ADAM H. LANGLEY & BETHANY P. PAQUIN, LINCOLN INST. OF LAND POLICY, RETHINKING PROPERTY TAX INCENTIVES FOR BUSINESS 2 (2012) (noting that governments lose \$5 to 10 billion dollars per year on property tax exemptions despite a lack of evidence that they generate economic development).

140. *Id.*

141. Paulsen, *supra* note 133, at 33–34.

C. Governments Do React to Full Compensation for Regulatory Restrictions—And That's Usually a Bad Thing

Although the tax feedback loop will not necessarily motivate governments to enact fiscally and socially advantageous land use measures, the full compensation response actually deters governments from enacting such measures. Because, as discussed above, full compensation to the owner is so different from and usually so much greater than the benefits experienced by the government, one-to-one compensation may deter even efficient decisions. Evidence from states that have required broad compensation for losses caused by land use restrictions confirms this. Full compensation requirements do not lead to more efficient regulations; they simply shut regulation down.

The most extreme example comes from Oregon's short-lived Measure 37, which required governments to compensate owners retroactively for losses in value due to land use restrictions enacted after the owners acquired their land.¹⁴² In the three years before Measure 37 was substantially modified in a second voter initiative, owners filed over 7000 claims for compensation.¹⁴³ In all but one case, the responsible government simply waived the regulation rather than compensate.¹⁴⁴ The dominant explanation municipalities gave for these decisions was that they lacked funds to pay compensation.¹⁴⁵ For example, the Lincoln County Board of Commissioners repeatedly justified its decisions by saying, “[T]he Board finds it is in the public interest, due to the lack of resources to pay compensation, to modify, remove or choose not to apply the challenged land use regulation to the subject property and issue the ‘waiver’ to claimants.”¹⁴⁶

The waivers, if not largely repealed by Measure 49, would have had predictable negative consequences.¹⁴⁷ Many of the building rights

142. See Bethany R. Berger, *What Owners Want and Governments Do: Evidence from the Oregon Experiment*, 78 FORDHAM L. REV. 1281, 1287 (2009) (asserting that Measure 37 “fundamentally reworked governmental compensation requirements”).

143. *Id.* at 1284.

144. *Id.* at 1303.

145. *Id.* at 1307.

146. *In re* Ballot Measure 37 Claim of Walter and Sara Maguire, No. 06-LURCC-06, Order No. 11-06-380, at 1, 2 (Bd. of Comm'r's for Lincoln Cty., Or., Nov. 8, 2006) (approving a claim to divide property into up to eighty one-acre parcels); see also *In re* Ballot Measure 37 Claim of Robert and Janice Foley, No. 147-LURCC-06, Order No. 9-07-708, at 1, 3 (Bd. of Comm'r's for Lincoln Cty., Or., Sept. 12, 2007) (approving a claim to divide property into up to nine one-acre parcels).

147. Berger, *supra* note 142, at 1305.

would have undermined state groundwater protections.¹⁴⁸ Lane County officials, for example, opined that the planned developments could “imperil the quality of customers’ drinking water” in the county by increasing levels of fecal bacteria and other contaminants.¹⁴⁹ The Oregon Department of Agriculture also found that Measure 37 development would have “major implications” for Oregon’s multibillion dollar agricultural industry.¹⁵⁰ But faced with the disproportionate costs of paying the owners for the entire reduced value of the owners’ land, from funds that the governments did not have then and would likely not recoup, if at all, for many years, the governments waived the restrictions.

Measure 37 was particularly extreme because it required compensation for the effects of regulations enacted long before the initiative came into effect.¹⁵¹ But laws with solely prospective effects in Florida and Arizona also chill land use regulations. Florida’s Bert J. Harris Jr. Private Property Rights Protection Act (“Bert-Harris”), enacted in 1995, requires compensation for land use restrictions that “inordinately burden[]” property owners.¹⁵² Most of the planners and government attorneys interviewed for a 2005 study reported that Bert-Harris “fundamentally restricted their ability to do the[ir] job” by giving individual owners power to freeze land use laws in place.¹⁵³ As in Oregon, few governments chose to litigate under Bert-Harris. Instead, most chose not to enact or to waive land use rules in the face of Bert-Harris claims.¹⁵⁴ For developers, meanwhile, threatening a claim under the act became an easy way to circumvent legal obstacles to their plans.¹⁵⁵ By 2006, even Senator Harris, the sponsor who gave

148. *Id.* at 1306.

149. *Id.* (quoting Jeff Wright, *Claims Spur Watershed Warning*, REGISTER-GUARD (Or.), Feb. 8, 2007, at A1).

150. *Id.* (quoting Oregon Dept. of Agriculture Develops Maps to Show Impact of Measure 37 Claims: Willamette Valley Farmland Faces Measure 37 Impact, OR. ASS’N OF NURSERIES (Feb. 21, 2007), <http://www.oan.org/?500#>).

151. *Id.* at 1310.

152. Bert J. Harris, Jr., Private Property Rights Protection Act, FLA. STAT. § 70.001 (2016).

153. George Charles Homsy, *The Land Use Planning Impacts of Moving “Partial Takings” from Political Theory to Legal Reality*, 37 URB. LAW. 269, 288 (2005).

154. John D. Echeverria & Thekla Hansen-Young, *The Track Record on Takings Legislation: Lessons from Democracy’s Laboratories*, 28 STAN. ENVTL. L.J. 439, 459, 460–69 (2009).

155. *Id.* at 464.

his name to the act, worried that the law may have become a “development shelter.”¹⁵⁶

Studies report a similar effect for Arizona’s Proposition 207 (“Prop 207”),¹⁵⁷ enacted in 2006.¹⁵⁸ In the wake of the act, municipalities waived or failed to enact historic preservation, infill, and urban form restrictions rather than expose residents to potentially ruinous suits for damages.¹⁵⁹ The law came too late to contribute much to the massive sprawling construction before the Great Recession. Between 2005 and 2006 alone, 60,000 houses were built surrounding Phoenix—and in the years afterward, those developments went empty and new ones were not built.¹⁶⁰ Today, however, massive new leapfrog-style suburban developments are being planned in areas that would be water-challenged even without current drought conditions.¹⁶¹ Prop 207, however, “effectively eviscerated land-use laws” that could slow growth.¹⁶²

Whether the overall benefits of the unenacted or waived regulations would have outweighed the costs is not clear. Most likely, some would have and others would not. But requiring full

156. *Id.* at 459.

157. ARIZ. REV. STAT. § 12-1134 (2016).

158. See, e.g., Echeverria & Hansen-Young, *supra* note 154, at 522–24 (discussing the way Proposition 207 undermined historic preservation); Jeffrey L. Sparks, *Land Use Regulation in Arizona After the Private Property Rights Protection Act*, 51 ARIZ. L. REV. 211, 219–22 (2009) (reporting that Prop 207 had already chilled land use regulation in Arizona); see also Kristena Hansen, *Phoenix Grapples with Building Preservation amid Legal Threats*, PHX. BUS. J. (Dec. 7, 2012), <http://www.bizjournals.com/phoenix/print-edition/2012/12/07/phoenix-grapples-with-building.html> (quoting Mesa Mayor Mark Smith’s statement that “there’s no doubt Prop. 207 has changed cities’ approach” to Phoenix’s 2012 attempt to protect a Frank Lloyd Wright home).

159. See Echeverria & Hansen-Young, *supra* note 154, at 522–23; see also Sparks, *supra* note 158, at 220–21; *Infill Development: Completing the Community Fabric*, MUN. RES. & SERVS. CTR., <http://mrscc.org/Home/Explore-Topics/Planning/Development-Types-and-Land-Uses/Infill-Development-Completing-the-Community-Fabric.aspx> (last updated Aug. 16, 2016).

160. Jonathan Thompson, *Huge New “Communities” Planned for Tucson, Albuquerque: Sprawl Rises from Its Slumber, but Urban Renaissance Is Still Thriving*, HIGH COUNTRY NEWS (Apr. 27, 2015), <http://www.hcn.org/articles/huge-new-communities-planned-for-tucson-and-albuquerque-fringes>.

161. See *id.* (describing the development within a “sizable swath of open desert between Tucson’s urban fringe and the planned development”).

162. Jonathan Thompson, *Light Rail Enters the West’s Most Sprawling Metropolis: New Transportation Sparked a Renaissance in Denver. Can It Do the Same for Phoenix?*, HIGH COUNTRY NEWS (Nov. 24, 2014), <https://www.hcn.org/issues/46.20/two-cities-develop-public-transportation>; see also City of Flagstaff, Student Housing Symposium (Oct. 27, 2014) (describing Prop 207 as “the largest impediment to local land-use regulation to control student housing” because it makes down-zoning very expensive).

compensation for the owners' losses does not appear to lead to the hoped-for careful balancing of potential costs and benefits. Instead, it simply shuts it down. As discussed in Part I, this only makes sense: the governmental revenue benefits, even of efficient regulations, are almost always less than the cost of full compensation.¹⁶³

D. Conclusion

Given the motivations and structure of governmental decision making, balancing costs and benefits through the tax structure will not necessarily affect land use decisions. When it does affect decision making, moreover, the result may not be more efficient regulation of land use. But lack of governmental responsiveness to fiscal incentives presents a challenge not simply to the effectiveness of the tax feedback loop; rather, it undermines the argument that cost-internalization plays a helpful role in land use decisions at all. Full compensation, moreover, distorts all consideration of costs and benefits by imposing costs on the government that are so far beyond what the government will likely realize, even for efficient regulations.

IV. SO WHAT?—OR, FOCUS ON FAIRNESS

Increasing overall efficiency in governmental land use decisions is not the only, or even the most, important argument in favor of compensation requirements. The dominant justification for compensation remains that it is required as a matter of fairness to the individual owner. The argument that compensation is necessary to align government costs and benefits, however, undermines careful examination of the fairness justification. The apparent symmetry between the compensation required to achieve efficiency and fairness clouds separate interrogation of these objectives and the most effective ways to achieve them. By showing that accurate cost internalization does not require compensation, this Article allows closer analysis of what compensation fairness does in fact require.

A. The Fairness Justification for Compensation

Fairness is a far older justification for compensation than efficiency and remains judicially more influential. Justice Holmes distinguished the fairness justification from the utilitarian justification in his 1922

163. See *supra* Part I (discussing the efficiency argument and explaining why governments enact inefficient land-use regulations).

opinion creating the regulatory taking.¹⁶⁴ Regardless of the public interest in the restriction, he stated, “the question at bottom is upon whom the loss of the changes desired should fall.”¹⁶⁵ The Court formulated the problem more starkly in *Armstrong v. United States*,¹⁶⁶ stating that the takings guarantee “was designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole.”¹⁶⁷

The efficiency argument is far less prominent in takings jurisprudence. A search of Supreme Court takings decisions turns up none that use the term “fiscal illusion.” Only one Supreme Court opinion uses the term “efficiency” to analyze a takings rule, and that reference is in a dissent arguing against compensation for a regulatory restriction.¹⁶⁸ Justice Alito’s 2013 opinion in *Koontz v. St. Johns River Water Management District*¹⁶⁹ invokes the insistence that “landowners internalize the negative externalities of their conduct” but only as a justification for the general rule upholding land use restrictions against regulatory takings claims.¹⁷⁰

It is of course true that the Court has long debated the effect of a compensation requirement as a “check to the exercise of . . . discretion by the legislature” and an incentive for investment in property.¹⁷¹ But these debates have always been closely tied to arguments about fairness to the individuals whose rights are claimed to be lost.¹⁷² The fairness-efficiency link also appears in one of the most explicit modern discussions of the efficiency justification for compensation, Justice Scalia’s dissent in *Pennell v. City of San Jose*.¹⁷³

164. *Pa. Coal Co. v. Mahon*, 260 U.S. 393, 416 (1922) (stating that the public need for the action does not itself justify not paying compensation).

165. *Id.* at 416.

166. 364 U.S. 40 (1960).

167. *Id.* at 49. Since its drafting, this pithy phrase has been cited at least twenty-seven times by the Supreme Court alone.

168. See *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1070 n.5 (1992) (Stevens, J., dissenting) (arguing that finding a taking in that case would have undermined efficiency by creating a “moral hazard”).

169. 133 S. Ct. 2586 (2013).

170. *Id.* at 2595.

171. See *Charles River Bridge v. Warren Bridge*, 36 U.S. 420, 564 (1837) (McLean, J., concurring) (stating that property owners would not invest to improve property if they were likely to lose it to the government without compensation).

172. See *id.* at 566 (stating that the rights of “associations of men to accomplish enterprises of importance to the public, and who have vested their funds on the public faith, . . . do not become the sport of popular excitement, any more than the rights of other citizens”).

173. 485 U.S. 1 (1988).

The Court there rejected as unripe a challenge that a limitation on rent increases unconstitutionally took the property of the landlords.¹⁷⁴ Justice Scalia dissented, arguing that the provision was facially unconstitutional.¹⁷⁵

One of Justice Scalia's arguments was that if implemented, the provision would permit the public to accomplish its goal of providing housing for low-income people without having to acknowledge their costs.¹⁷⁶ This would result in both inefficient decisions and unfairness to landlords:

The politically attractive feature of regulation is not that it permits wealth transfers to be achieved that could not be achieved otherwise; but rather that it permits them to be achieved "off budget," with relative invisibility and thus relative immunity from normal democratic processes. . . . Subsidies for these groups may well be a good idea, but because of the operation of the Takings Clause our governmental system has required them to be applied, in general, through the process of taxing and spending, where both economic effects and competing priorities are more evident.

That fostering of an intelligent democratic process is one of the happy effects of the constitutional prescription—perhaps accidental, perhaps not. Its essence, however, is simply the unfairness of making one citizen pay, in some fashion other than taxes, to remedy a social problem that is none of his creation.¹⁷⁷

If one equates the government's fiscal gain to the owner's loss from land use restrictions, such links between fairness and efficiency seem only logical. By revealing that the fiscal check on inefficient regulations of land use exists independent of compensation to the owner, however, we can more carefully interrogate what losses property owners may demand as a matter of fairness alone.

174. *Id.* at 9–10.

175. *Id.* at 15 (Scalia, J., concurring in part and dissenting in part).

176. *Id.* at 22.

177. *Id.* at 22–23. Justice Scalia's dissent inspired one state supreme court and one Federal Court of Appeals opinion, although the first was a dissent and the second was later vacated. *Cf.* Santa Monica Beach, Ltd. v. Sup. Ct. of L.A., 968 P.2d 993, 1045 (Cal. 1999) (Brown, J., dissenting) ("As Justice Scalia's dissent in *Pennell* suggests, [when the costs of rent control] are paid by rental property owners through government compulsion, however, it is impossible to measure the intensity of public support for rent subsidies."); Guggenheim v. City of Goleta, 582 F.3d 996, 1022 (9th Cir. 2009) (Rent control takes "from A to give to B, both for the benefit of B (the incumbent tenants) and for a larger group, who does not wish to support affordable housing through more politic means"), *vacated*, 638 F.3d 1111, 1123 (9th Cir. 2010) (en banc) ("[T]he Due Process Clause does not empower courts to impose sound economic principles on political bodies.").

B. What Compensation Does Fairness Require?

Previous Sections discussed why compensation, even if potentially useful to prevent over-taking of physical property, is not necessary to prevent over-regulation: the government does not acquire the property at all and loses tax revenue, revenue that will only be made up by gains in taxation or decreases in services in other areas.¹⁷⁸ Similarly, basic fairness would seem to demand compensation when the government directly acquires the property or transfers it to another, but this calculus shifts when the government simply regulates how the owner uses the land.¹⁷⁹

The reasons are already reflected in the case law. First, when an owner is prevented from engaging in a use that is broadly agreed to be harmful, justice does not usually demand that the owner be paid to stop such use.¹⁸⁰ There may be compelling justice claims when the government, rather than preventing exploitation of a new use of property, makes the owner stop a current use of the property.¹⁸¹ Even

178. See *supra* Section I.B.

179. Like the efficiency calculation discussed in note 27, *supra*, the justice calculation is different in cases in which the regulatory restriction is the equivalent of an easement for the government's own use. This is evident in cases involving height restrictions imposed on buildings in the flight path of airports, which are more frequently found to be takings. *See Griggs v. Allegheny Cty.*, 369 U.S. 84, 90 (1962) (finding the seizure of an air easement over the petitioner's property was a taking). In fact, the papers of Justice Oliver Wendell Holmes suggest that *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922), the first Supreme Court case to find that a regulatory restriction was a taking, was motivated by the sense that the restriction on digging coal so as to cause subsidence was designed to protect the government's own streets and roads located above the coal mines. William Michael Treanor, *Jam for Justice Holmes: Reassessing the Significance of Mahon*, 86 GEO. L.J. 813, 859–60 (1998).

180. *See Koontz v. St. Johns River Water Mgmt. Dist.*, 133 S. Ct. 2586, 2595 (2013) (“Insisting that landowners internalize the negative externalities of their conduct is a hallmark of responsible land-use policy, and we have long sustained such regulations against constitutional attack.”); *Penn Cent. Transp. Co. v. City of New York*, 438 U.S. 104, 125 (1978) (stating that land-use regulations that promote the “health, safety, morals, or general welfare” are typically upheld). *Lucas v. South Carolina Coastal Council* appeared to reject the harm/benefit distinction but quickly resurrected it by saying that individuals could not claim compensation if the action was prohibited by “background principles of nuisance and property law.” 505 U.S. 1003, 1030–31 (1992).

181. The classic example is *Hadacheck v. Sebastian*, 239 U.S. 394 (1915), in which the Court rejected a takings claim by the owner of a brickyard whose operations were prevented because a residential neighborhood had grown up around his existing operation. *See Michael A. Heller & James E. Krier, Deterrence and Distribution in the Law of Takings*, 112 HARV. L. REV. 997, 1009–11 (1999) (arguing that compensation should be provided in cases such as *Hadacheck* even though stopping operations was the efficiency-producing result).

here, compensation is often not required. As nuisance law has recognized since candlemakers wafted their stench over Cotswold cottages, in some cases the law must make a choice between one owner's use and another's,¹⁸² and it usually need not pay the loser when it does.¹⁸³

Second, property only has value within a particular context, and much of that context is created by governmental infrastructure and surrounding properties that emerge from it. Regulatory takings analysis therefore looks not just to the value an owner could realize if the property could be used without a particular governmental regulation but also to the owner's "distinct investment-backed expectations."¹⁸⁴ This inquiry requires attention to both whether the opportunity the owner seeks to exploit is itself the product of governmental regulation and the extent to which the owner has already reasonably recouped the investment in the property.

Demands for compensation generally hold constant all governmental inputs other than the impact of the restriction on the property itself.¹⁸⁵ But of course, governmental inputs into property value are pervasive.¹⁸⁶ Restrictions that apply to a range of properties create a "scarcity effect[]" by limiting the properties that can violate the restriction, thereby increasing the value of lifting the restriction on any one property.¹⁸⁷ Second, governmental actions—whether by preventing the harm the restriction is intended to avoid, or by independent provision of infrastructure or other "amenity effect[s]"—

182. See SIR JAMES FITZJAMES STEPHEN, A GENERAL VIEW OF THE CRIMINAL LAW OF ENGLAND 106 (2d ed. 1890) (stating that medieval nuisance case against a candlemaking factory was dismissed because, "Le utility del chose excusera le noisomeness del stink"). Or, in Anglo-Norman legal "French," the utility of the thing excuses its noisome stink.

183. Whether the plaintiff came to the nuisance remains a factor in the analysis but is no longer an absolute defense. See RESTATEMENT (SECOND) OF TORTS § 840D (AM. LAW INST. 1979) (stating that the fact that the plaintiff came to the nuisance is a factor but "is not in itself sufficient to bar his action"). Despite the academic celebration of the purchased injunction of *Spur Industries v. Webb*, 494 P.2d 700 (Ariz. 1972), the ruling seems to have been a one-time remedy, tailored to the egregious action of the developer. No other opinions use the phrase "purchased injunction," and I have been unable to find any references to such cases in the literature.

184. *Penn Cent.*, 438 U.S. at 124.

185. See Berger, *supra* note 142, at 1316.

186. For a fuller discussion, see Berger, *supra* note 142, at 1316–18 (discussing the governmental inputs that often have an effect on property value).

187. William K. Jaeger, *The Effects of Land-Use Regulations on Property Values*, 36 ENVTL. L. 105, 106 (2006).

increase the value of the location for all uses.¹⁸⁸ Just as the government does not claim precise payback for all incidental benefits to individual property value, fairness rarely demands compensation when the individual is the loser in the governmental action calculus.

Take, for example, the infamous office tower Penn Central proposed to balance on Grand Central Station. With more than fifty additional floors of office space in a midtown transportation hub, Penn Central hoped eventually to net between 2 and 2.3 million dollars per year on the addition.¹⁸⁹ But this value was, even more than for other New York real estate, inextricable from governmental support and regulation.¹⁹⁰

First, imagine that same piece of real estate on Manhattan Island without the rest of New York City around it. The land would be worth something, but not enough to justify building a fifty-story office tower, or even a five-story one. For New York City to exist requires the vast governmental resources that permit millions of people to live and work together. Of course it would be wholly unjust to compensate New York owners for property losses at the rate similar properties would command in an undeveloped wilderness. But imagine now, not Manhattan undeveloped, but Manhattan as it in fact was in the 1970s when Penn Central was litigating its claim, with the Bronx burning, garbage workers on strike,¹⁹¹ and New York City itself preparing to file for bankruptcy.¹⁹² The office tower, had it been built, would surely have suffered from the commercial real

188. *Id.*

189. *Penn Cent.*, 438 U.S. at 116.

190. See *Penn Cent. Transp. Co. v. City of New York*, 366 N.E.2d 1271, 1275 (N.Y. 1977) (“It may be true that no property has economic value in the absence of the society around it, but how much more true it is of a railroad terminal, set amid a metropolitan population, and entirely dependent on a heavy traffic of travelers to make it an economically feasible operation. Without people Grand Central would never have been a successful railroad terminal, and without the terminal, a major transportation center, the proposed building site would be much less desirable for an office building.”), *aff’d*, 438 U.S. 104 (1978).

191. Kevin Baker, “*Welcome to Fear City* – The Inside Story of New York’s Civil War, 40 Years on”, GUARDIAN (May 18, 2015), <http://www.theguardian.com/cities/2015/may/18/welcome-to-fear-city-the-inside-story-of-new-yorks-civil-war-40-years-on>.

192. Ralph Blumenthal, *Recalling New York at the Brink of Bankruptcy*, N.Y. TIMES (Dec. 5, 2002), <http://www.nytimes.com/2002/12/05/nyregion/recalling-new-york-at-the-brink-of-bankruptcy.html>.

estate glut and bust at the beginning of the 1970s¹⁹³ and benefitted from government subsidization of the recovery.¹⁹⁴

Even setting aside governmental contributions to these and other developments, the value of the proposed office tower was always in part a government creation. Grand Central was, after all, the New York terminus of the interstate railroad system, which—from its inception—was the product of government subsidies, eminent domain, rights-of-way, and monopolies.¹⁹⁵ New York City added to these federal and state inputs by placing stations for multiple subway lines under the terminal and bus lines beside it.¹⁹⁶ The city further subsidized the station by exempting it from most property taxes, a benefit to Penn Central of over eleven million dollars in the previous decade.¹⁹⁷ In fact, the landmark preservation policy Penn Central challenged was itself in service of something that Penn Central depended on more than most businesses—keeping New York an attractive destination for those from out-of-town.¹⁹⁸ In sum, it was almost entirely governmental action that made Grand Central Terminal one of the most desirable commercial addresses in New York. It was the height of chutzpah for Penn Central to claim that the government had to pay because the company could not exploit all of the economic potential that resulted from this government action.¹⁹⁹

193. See Vincent Mosco, *The Empire at Ground Zero*, in URBAN COMMUNICATION: PRODUCTION, TEXT, CONTEXT 209 (Timothy A. Gibson & Mark Lowes eds., 2007) (discussing New York's office space glut and recovery).

194. See GEORGE J. LANKEVICH, NEW YORK CITY: A SHORT HISTORY 214–20 (2002) (describing New York's dire financial state in the 1970s and the programs implemented for rehabilitation).

195. *Penn Cent.*, 366 N.E.2d at 1276–77.

196. *Id.* at 1276.

197. Findings of Fact and Declarations of the Law of New York, *Penn Central Transportation Co. v. New York*, Supreme Court, Trial Term (May 29, 1974), reprinted in Appendix to Jurisdictional Statement, *Penn Central Transportation Co. v. New York*, 438 U.S. 104 (1978) at 53a.

198. See, e.g., *Penn Cent.*, 366 N.E.2d at 1275 (describing Grand Central's reliance on out-of-town traffic). At that point, of course, the newly merged Penn Central Company was no longer as interested in the declining railway business. The company had sold off its air development rights in 1968—the same year it merged with New York Central—which was one of several poor business decisions leading to the company's bankruptcy in 1970.

199. See *id.* at 1276 (“Plaintiffs may not now frustrate legitimate and important social objectives by complaining, in essence, that government regulation deprives them of a return on so much of the investment made not by private interests but by the people of the city and State through their government.”).

Delinking the cost internalization and justice aspects of a regulatory takings claim may also permit more careful attention to the investment in the specific opportunity the owner seeks to exploit. Although return on investment is a well-established aspect of the regulatory takings inquiry,²⁰⁰ demands for compensation rarely mention the owner's original investment in the property.²⁰¹ To the extent this information is available, often even with the restriction, the owner will still profit after adjusting for inflation.²⁰² Where the owner's use now undermines public interest, even in cases where the conflict was totally unforeseeable, it is not clear that fairness demands more.

Take as an example the much-litigated wetlands and coastal development restrictions. In many such cases, the restricted portion of land was originally part of a larger purchase, but the owners had developed and sold the upland portion long before the restriction's enactment.²⁰³ By the time the owners finally sought to develop the

200. See *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 426 (1982) ("[T]he degree of interference with investment-backed expectations, is of particular significance"); *Penn Cent. Transp. Co. v. City of New York*, 438 U.S. 104, 136 (1978) (analyzing the regulation's fiscal impact on the property); *United States v. Lynah*, 188 U.S. 445, 470 (1903) (considering the property's value in the Court's takings evaluation).

201. See, e.g., *Palazzolo v. Rhode Island*, 533 U.S. 606, 616 (2001) (not discussing original investment); *Vill. of Euclid v. Ambler Realty Co.*, 272 U.S. 365, 384 (1926) (not providing original investment).

202. The Measure 37 campaign in Oregon, for example, was driven by ads featuring Dorothy English, a grandmotherly woman, complaining that Oregon's land use laws prevented her from subdividing the land she had purchased with her husband fifty years earlier. English and her husband, however, had already sold off half of the original purchase decades before, netting about ten times the original price for the land. At the time she made the ads, moreover, her remaining property was worth 150 times what she and her husband had paid for the whole parcel, or twenty-one times in time-adjusted dollars. Berger, *supra* note 142, at 1321. This is a considerably better return than she would have gotten had the same investment received a compounding 10% interest rate for a similar time. See *Compound Interest Calculator*, U.S. SEC. & EXCH. COMM'N, <http://investor.gov/tools/calculators/compound-interest-calculator> (last visited Oct. 19, 2016). *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003 (1992), is a notorious exception. David Lucas allegedly purchased his two lots for almost one million dollars before South Carolina established that he could not build on the lots. *Id.* at 1006–07. However, Lucas' purchase at top-of-the-market prices for two parcels from the partnership he had recently left seems to require more explanation. See Vicki Been, *Lucas v. the Green Machine: Using the Takings Clause to Promote More Efficient Regulation?*, in *PROPERTY STORIES* 299, 304–06 (Gerald Korngold & Andrew P. Morrise eds., 2d ed. 2009) (speculating that the purchase price may have been set to reap tax benefits).

203. See, e.g., *Lost Tree Vill. Corp. v. United States*, 707 F.3d 1286, 1288–90 (Fed. Cir. 2013) (setting forth that the plaintiff bought 2750 acres of coastal property, sold

wetlands portion, intervening legislation prevented the change.²⁰⁴ It seems likely that at the inception of the purchases, draining and filling the land would not have been economically worthwhile, but the value of the easy-to-develop parcels made the investment profitable even without doing so. Only after other nearby land had been developed—often with government-financed water, sewer, and transportation infrastructure; subsidized flood insurance; and emergency assistance after natural disasters—would it be sufficiently profitable to develop the last remaining land. At this point, even the restrictions on wetlands development would enhance the property's value to the plaintiffs, effectively creating a monopoly in the area. Only a very peculiar sense of fairness would decree compensation for owners because they could not profit from this monopoly.²⁰⁵

This Section is obviously not a comprehensive or conclusive examination of whether and what degree of compensation is fair for regulatory restrictions. Rather, this Section argues that the linkage of fairness-based compensation and efficiency-based compensation may have distorted the analysis of each, individually. Understanding that economic costs are already balanced—at least as well as they can be—through the tax system may allow more thoroughgoing examination of the fairness question. This examination should place less emphasis on an isolated analysis of the value of the land with and without the restriction, and more on what other factors created that value as well as on whether the owner has already recouped any investment justice demands the owner reap from the land.

or developed the vast majority, and did not consider developing the 4.99 acres at issue until 2002); *Palm Beach Isles Assocs. v. United States*, 208 F.3d 1374, 1377–78 (Fed. Cir. 2000) (setting forth that the plaintiffs originally purchased 311 acres, sold the 260 upland acres, received permits to fill the remaining acres in 1961, but allowed the permits to expire and did not again seek to develop the area until 1988); *Loveladies Harbor, Inc. v. United States*, 28 F.3d 1171, 1174 (Fed. Cir. 1994) (involving plaintiffs who purchased a 250-acre tract in 1956, developed upland 199 acres, and did not seek to develop the remainder until 1970s); *Palazzolo v. State*, 746 A.2d 707, 709–10 (R.I. 2000) (concerning a plaintiff and partner who originally developed only the small upland portion of the land, and only much later sought to develop the portion that would need dredging and fill).

204. See *Loveladies Harbor, Inc.*, 28 F.3d at 1173–74 (referencing the impact of the Clean Water Act legislation, passed in 1972, which regulated development near bodies of water).

205. Despite this, the Federal Circuit recently found that only the impact on the undeveloped fraction of land should be considered in such a claim. *Lost Tree*, 707 F.3d at 1294–95.

C. Regulatory Takings and Murr v. Wisconsin

All of these considerations are relevant to *Murr v. Wisconsin*, the regulatory takings case pending in the Supreme Court.²⁰⁶

The case involves two neighboring lots on the St. Croix River, purchased by the petitioners' parents in 1960 and 1963.²⁰⁷ The parents built a vacation cabin on the first lot and left the second undeveloped.²⁰⁸ In 1994 and 1995 they transferred the first and then the second lot to their children, both times without compensation.²⁰⁹ In 2004, over four decades after the original purchases, the children became interested in selling the undeveloped lot.²¹⁰ They then were allegedly "flabbergasted" to learn that they could not build on the lot.²¹¹ In 1975, the County amended its zoning ordinances to comply with federal and state laws designating the St. Croix River as a "part of the National Wild and Scenic River System,"²¹² as well as to prevent erosion, water contamination and flooding, and to protect property values.²¹³ The ordinances required that a lot include at least one acre of buildable area before construction on the bluffs would be permitted.²¹⁴ Because the lots are located on an extreme slope and also subject to wetlands and right-of-way restrictions, the buildable area of the undeveloped parcel is only 0.5 acres, and the buildable area of the developed parcel is 0.48 acres.²¹⁵ The 1975 restriction, however, has an exception that permits building a single family residence on lots of less than one acre created before 1976.²¹⁶ Because, however, the Murrs own both lots, and there is already a residence on the combined lots, their property does not qualify for

206. 136 S. Ct. 890 (2016), *granting cert. in* Murr v. State, No. 2013AP2828, 2014 WL 7271581 (Wis. Ct. App. Dec. 23, 2014) (per curiam).

207. *Murr*, 2014 WL 7271581, at *1.

208. *Id.*

209. Petition for Writ of Certiorari, *Murr v. Wisconsin*, No. 15-214, 2015 WL 4932231, at *4 (2015).

210. *Id.* at *4.

211. Petitioners' Brief on the Merits at 5, *Murr v. Wisconsin*, No. 15-214, 2016 WL 1459199, at 1, 5 (2016).

212. Brief for Respondent St. Croix County at 4, *Murr v. Wisconsin*, No. 15-214, 2016 WL 3254214, at 1, 5 (2016).

213. *Id.* at 7–8.

214. *Id.* at 8; St. Croix Cty., Wis., Land Use & Dev. Ord. § 17.36.G.1.b (July 1, 2005).

215. Petition for Writ of Certiorari, *supra* note 209, at *5 n.1.

216. See *id.* at *5 (explaining that landowners may build on "any lot created prior to January 1, 1976 . . . but only if the lot 'is in separate ownership from abutting lands'").

the exception.²¹⁷ The Murrs petitioned the Supreme Court to determine that the undeveloped parcel should be considered separately for regulatory takings analysis.²¹⁸

Compensation should not have been needed to make the municipality internalize the economic costs of the restriction. Because Wisconsin is among one of the most property-tax dependent states in the union,²¹⁹ St. Croix County should already have internalized the effects of its restricting more extensive development in this vacation community through lost tax revenue. The Murrs' case, however, reveals the flaws in tax assessments as a reflection of value. Until the dispute began, the assessment did not reflect the zoning restriction, and the lots were assessed as individual buildable lots.²²⁰ Once the dispute began, however, the Murrs challenged the assessment, and the lots are now being taxed as a single buildable lot.²²¹ The County is now (albeit belatedly) internalizing the economic cost of the restriction.

The fairness considerations discussed above also weigh against compensation. First, the value the Murrs hope to exploit is at least in part the result of governmental action. By prohibiting building on lots with less than one buildable acre of land, the County limited the supply of buildable land in St. Croix and surely raised the price of land that could still be developed.²²² By restricting the number of new residents to the community, moreover, the restriction likely prevented growth in demand for taxpayer funded services and thereby reduced the tax burden on existing residents. And the wetlands and slope preservation restrictions that limited the buildable portion of existing parcels likely helped to preserve St. Croix River County as a peaceful community on the water.

Even if the value the Murrs claim to have lost could be separated from their gains from the governmental action, they have no investment-backed expectations that must be compensated to achieve

217. *Id.*

218. *Id.* at *9, *22.

219. Forster & Padgett, *supra* note 50, at 2 (listing Wisconsin as one of the ten most property-dependent states).

220. Brief for Respondent St. Croix County, *supra* note 212, at 32 n.13.

221. *Id.*

222. See Brief of Carlisle Ford Runge et al. as Amici Curiae Supporting Respondent, *Murr v. Wisconsin*, No. 15-214, 2016 WL 3398639, at 1, 2–3 (2016) (explaining how property value may be increased “by restricting the amount of development that can occur in an area”).

justice. First, the petitioners themselves obtained both lots for free.²²³ While the ability to give property to one's children is precious, and one should not diminish property rights simply because they came as a gift, the lots here still have substantial value.²²⁴ There hardly seems to be a compelling justice claim because the gift is not worth quite as much as the recipients hoped.

Most importantly, for more than forty years, the petitioners and their parents were happy to use the property in exactly the way in which they can still use it, as land surrounding their vacation residence. The Murrs treated the lot as part of their larger property, using it for swimming, camping, and parking, even building a volleyball court there.²²⁵ Indeed, the additional buildable area and river frontage secured by combining the two lots enhances their value to such a degree that they would only be worth 10% more if developed separately.²²⁶ Fairness does not demand payment simply because the Murrs cannot now exploit part of their property in violation of the public calculation about the needs of their community.

CONCLUSION

The assertion that compensation will correct fiscal illusion in governmental land restrictions rests on mistaken premises. The argument treats the revenue gained by governments the same as the loss to owners that results from the restrictions. This assumption is wrong. Governments generally only experience revenue increases through tax benefits, which are by design a small fraction of the value experienced by society as a whole. What is more, governments also experience lost revenue, again through the tax system, from restrictions that reduce the value of land and the income it produces.

Revealing this mistake leads to three important conclusions. First, requiring full compensation for regulatory restrictions is not necessary to cause governments to internalize the costs of their actions. The tax system already does this. Inefficient land use measures—those whose costs outweigh their benefits—will lead to a decrease in government revenues, and efficient ones—those whose

223. Petition for Writ of Certiorari, *supra* note 209, at *4.

224. See Brief for Respondent St. Croix County, *supra* note 212, at 18–19 (noting that the property was worth \$698,000 sold as a single lot).

225. *Id.* at 13.

226. See *id.* at 18–19 n.12 (noting that the trial court found that the combined lots with a single home would be worth \$698,000, while the two lots sold separately each with a home would be worth \$771,000).

benefits outweigh their costs—will lead to an increase in government revenues or at least reduced demands on such revenues. The qualifications to this equation are discussed above, but overall, the tax system already is a far more accurate way to ensure that governments feel the economic impact of their actions than is full compensation.

Second, full compensation will only distort government efforts to enact efficient land use policies. Because the cost of full compensation far outweighs the revenue benefits even of efficient regulations, governments will rationally choose not to enact regulations that would be socially beneficial. Evidence from states that require full compensation for losses due to land use restrictions bears this out.

Third, revealing that full compensation is not necessary to achieve—and in fact undermines—efficiency allows more careful analysis of the fairness justification for compensation. In particular, full compensation shifts attention from the reduction in dollar value due to the restriction in isolation, to the portion of that value the owner should be able to demand from the government. Under this analysis, compensation will often not be required because the governmental restrictions are in fact what makes property valuable to begin with, and because the value remaining with the owner is more than sufficient to satisfy justice.

Determining when regulatory restrictions should result in owner compensation is a wilderness of competing ideological concerns and real world effects. This Article is not the magic path out of that wilderness. It seeks only to clear some of the underbrush obscuring the way. Doing so, it is hoped, will facilitate progress toward just and beneficial regulation of land.