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The Role of Economics in the Teaching of Land-Use Law

*Robert C. Ellickson**

A land-use law course carries a title that explicitly invites application of economic theory. The title identifies a scarce resource—land—and asserts that the principal question to be studied is how that resource is to be allocated. Because the allocation of scarce resources is the core concern of economics, it is hardly surprising that land-use scholars are increasingly turning to the Dismal Science. Of course, disciplines other than economics might also prove to be powerful lenses for revealing what is at stake in land-use controversies. Urban planning, for example, is an endeavor that focuses primarily on this precise subject matter. However, planning theory has had little impact on legal scholars because it often invokes concepts which don't seem operational (e.g., "orderly, balanced growth"), and because planners, unlike economists, have yet to agree on vocabularies and analytic engines for attacking the puzzles they confront.

The explicit introduction of economics into a law school classroom poses two basic problems. First, there is what might be called the problem of *instructional ethics*. One cannot be absolutely confident that instruction in the economic perspective on land-use problems is worth class time that might otherwise be devoted to additional substantive topics or on other perspectives on the basic material. An even more serious ethical issue is that the economist's lens may so distort reality that it impairs understanding by seducing students to adopt oversimplified views of the world and to being attracted by unreliable policy prescriptions. This risk is particularly acute if the instructor ignores other interdisciplinary perspectives on land-use issues.

Second, even if one assumes that treatment of the economic perspective is ethically justified, there remains the basic problem of *implementation*. Students arrive at law and planning schools

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with highly varied educational backgrounds. Many have had no formal training in economics, perhaps because they are put off, even paralyzed, by graphs and equations. Some students who have been schooled in economics ultimately reject it at a deep emotional level because they perceive economists as adopting overly pessimistic assumptions about human behavior.

To illustrate how these ethical and practical problems might arise in a land-use course, this paper will focus on two concrete topics. The first is landowner remedies against excessive development charges; use of economic analysis should be relatively uncontroversial in this context because the courts themselves often pose some of these legal issues in economic terms. The second example involves more controversial economics—my own positive theory about why local governments might choose to sell the right to develop, and my normative conclusions on the appropriate legal rules to limit that practice. After exploring these two examples, the paper will conclude with some thoughts on the unease many legal scholars currently feel about the law-and-economics enterprise.

I.

UNCONTROVERSIAL ECONOMICS: THE PROBLEM OF REMEDIES AGAINST EXCESSIVE DEVELOPMENT CHARGES

Local governments often exact land, land improvements, and sums of money from developers in return for granting subdivision approvals, rezonings, or other development permissions. In most states there are vague legal ceilings on such local government charges. Suppose, by whatever legal test is in effect, that a local government has gone too far and should be ordered to refund part of what it has exacted. What can economic analysis reveal about the appropriate size of the refund and the identity of the party to whom it should be awarded?

The distinction between compensatory and deterrence goals (one familiar in the tort literature long before the recent ascendance of law and economics) can help determine the appropriate amount to be refunded. If compensation were the sole goal to be pursued, the local government should only be required to give back the excess it took. By contrast, if one important judicial purpose in ordering a refund is to deter local governments from imposing excessive charges in the future, some form of punitive damages should be added as a “kicker.” The economic rationale

for adding a kicker can be traced to Bentham.¹ If monetary penalties are to be the sole deterrent against thefts, and some thieves will not be caught, the monetary penalty must be increased to account for the improbability of apprehension. Because many developers can be expected to be chary of suing municipalities with which they have ongoing dealings, Bentham's analysis supports giving kickers to developers who do litigate successfully.

In the United States, however, courts have typically limited a city's liability to the excessive amounts it collected. This is consistent with the general rule that litigants cannot recover punitive damages from local governments.² To defend this result one would have to believe that deterrence is not an important goal in this context, perhaps because governments arguably would not respond to monetary incentives as would private parties. In any event, evidence from Illinois and New Jersey indicates that the current remedy (a refund without a kicker) does not deter local governments from adopting illegal exaction policies.³ Economics provides a vehicle for explaining this phenomenon and also arms developers' lawyers with potent arguments to support the award of kickers to their clients.

Now to the second legal issue: Who should be entitled to share in the refund, whatever its size? In *Colonial Oaks West, Inc. v. Township of East Brunswick*,⁴ the Supreme Court of New Jersey decided that when an overcharged homebuilder is awarded a refund, he should be entitled to keep only that portion that he did not pass on to those who purchased houses from him, and that the portion that he did pass on should be placed in trust to await claims by house purchasers. In its opinion, that court regarded it as "likely" that developers completely pass on excessive charges to their consumers.

Two aspects of the *Colonial Oaks* opinion warrant discussion. First, did the court correctly predict the incidence of development charges that municipalities impose on subdividers? Are such charges borne by the subdividers themselves or passed forward

1. J. BENTHAM, A FRAGMENT ON GOVERNMENT AND AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION 4 (W. Harrison, ed. 1960).

2. See Annot., 19 A.L.R.2d 903 (1951).

3. See Ellickson, *Suburban Growth Controls: An Economic and Legal Analysis*, 86 YALE L.J. 385, 481 n.288 (1977) [hereinafter cited as *Suburban Growth Controls*].

4. 61 N.J. 560, 296 A.2d 653 (1972).

to consumers? Indeed, this statement of the question is improper because, as the New Jersey Supreme Court failed to recognize, it is possible that such charges are passed *backward* to landowners who sell land to subdividers. (Subdividers might bid less for raw land if they knew of the high charges they would have to pay subsequently to obtain permission to develop.)

The riddle of tax incidence has long troubled economists, who have developed sophisticated tools for analyzing the problem. The initial economic approach would be to treat a subdivision exaction as an excise tax on residential development. To introduce students to this analytic approach, an instructor can draw hypothetical pre-tax supply and demand curves for housing within the taxing jurisdiction. To show the impact of the tax, one then shifts the supply curve upward by a distance equal to the amount of the tax. The intersection of the pre-tax demand curve and the post-tax supply curve is the post-tax equilibrium. This sort of exercise is standard in introductory economics courses, and is hardly the most sophisticated approach to the incidence issue. Nevertheless, the exercise is useful to get across to students two important points: that the incidence of development charges depends on the elasticity (or slopes) of the supply and demand curves for housing in the taxing jurisdiction, and that it is rare for those elasticities to be such that these taxes would be entirely passed on to house purchasers. My own hunch is that when only a few out of many suburbs impose special charges, the demand for housing would be relatively elastic in those suburbs, and consequently these charges would be mostly passed backward to those who owned undeveloped land when the charges were initially enacted.⁵

Use of a partial equilibrium analysis of this sort to teach tax incidence poses several ethical issues. The supply and demand elasticities for housing in specific communities are not well understood; moreover, economists do not regard partial equilibrium analysis as the ultimate tool for analyzing incidence issues. In addition, a land-use-law instructor who wishes to teach this material faces a practical dilemma. If he desires to get across the idea that taxes are not automatically passed on, should he draw graphs that may paralyze a large fraction of his students, or should he instead content himself with an oral, intuitive explanation? My own practice at the three law schools where I have taught has been to draw the graphs and to explain them the way I envision teachers

5. See *Suburban Growth Controls*, *supra* note 3, at 392-401, 425-30.

of economics would explain them to students in an introductory economics course. I have found that student anxiety over the presentation of such graphs seems to have declined as the years have passed. A few students may, of course, come up after class to ask for references to basic economics texts, but this is probably a beneficial fallout from the exercise. Other students may also not comprehend all of what has been presented. This should not be of great concern because the basic point of the exercise is not to teach law students how to draw such graphs but rather to convey to them that there is a social science that one can turn to for systematic discussion of the problem of tax incidence. Professor A. Dan Tarlock and I therefore intend to include an illustrative tax-incidence graph in the fiscal-issues chapter of our forthcoming land-use controls casebook.⁶

The *Colonial Oaks* opinion poses a second question: Was the New Jersey Supreme Court correct in holding that developers should (at least sometimes) share their refunds with homebuyers? Modern legal-economic theory, building on the work of Coase⁷ and Calabresi,⁸ suggests that the New Jersey Supreme Court's rule is mistaken. If homebuyers are entitled to share in developer refunds, and know that they are so entitled, the added benefits that the court has tried to bestow on them will be taken away from them by market forces. Developers will now be selling not just houses, but houses plus claims for refunds. Home prices will rise by an amount equal to the value of the claim for a refund, and homebuyers will have gained nothing.⁹

The underlying question is how parties in a chain of production

6. R. ELLICKSON & A. TARLOCK, *LAND-USE CONTROLS* (Little, Brown forthcoming 1981).

7. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960).

8. See esp. Calabresi & Hirschhoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055 (1972).

9. An example will help demonstrate this point. Suppose a municipality illegally taxed a developer by \$X per house, and that the developer was entitled to recover and keep \$X per house in refunds. The illegal tax would then not affect house prices because a developer would not perceive his production costs to be affected by the tax.

Suppose, by contrast, the developer's purchasers were each entitled to recover the entire \$X from the taxing municipality, but the developer, nothing. The supply curve would then shift upward (to the left) by \$X to account for the developer's added costs of production, *i.e.*, the tax he had to pay. The demand curve would also shift upward (to the right) by \$X because consumers would take into account their entitlements to \$X in refunds for each house purchased. Regardless of the price elasticities of supply and demand, when both curves shift upward by \$X, the market price will rise by \$X.

(*i.e.*, landseller, developer, homebuyers) ultimately share in government benefits bestowed on someone in the chain. The incidence of these benefits does *not* turn on who is legally entitled to them, just as the incidence of sales taxes does not depend on whether buyers or sellers of goods have to pay such taxes. Rather, the incidence of government benefits to an industry turns on the underlying elasticities of supply and demand for that industry's goods. (This incidence can be analyzed with the same sort of tools economists use to analyze the incidence of taxes.) In short, the New Jersey Supreme Court may help housing consumers by ordering refunds to the housing-production chain, but it does not much matter to consumers which member of the chain has the entitlement to refunds.

It might thus appear that the *Colonial Oaks* rule is not mistaken, but merely irrelevant. However, as I have argued elsewhere,¹⁰ all parties in a chain of transfers are better off if the right to a refund from a party outside the chain is vested in the "cheapest right enforcer" within the chain. In the case of subdivision exactions, developers are clearly the cheapest right enforcers. First, developers have more information than either homebuyers or landsellers about what the local government has illegally exacted. Second, homebuyers are too numerous to be able to organize cheaply to pursue claims for refunds; landsellers will also be hard to organize whenever a developer has assembled a tract through several purchases. Third, because incidence of excessive development charges is costly to unravel in any specific case, any rule that invites the sharing of refunds in essence establishes a jobs program for economists at the expense of the parties to the controversy.¹¹

II.

CONTROVERSIAL ECONOMICS: THE PHENOMENON OF GOVERNMENT SALES OF DEVELOPMENT RIGHTS

To illustrate more controversial applications of economic analysis to land-use problems, I will invoke (somewhat presumptuously) my own prior efforts to develop a positive and normative theory of municipal treatment of owners of undeveloped land.¹²

10. See *Suburban Growth Controls*, *supra* note 3, at 479-80.

11. For a similar analysis of the analogous problem of who should be entitled to sue for antitrust damages, see Landes & Posner, *Should Indirect Purchasers Have Standing To Sue Under the Antitrust Laws? An Economic Analysis of the Rule of Illinois Brick*, 46 U. CHI. L. REV. 602 (1979).

12. See *Suburban Growth Controls*, *supra* note 3, *passim*.

Briefly, that prior discussion assumed that all political actors are self-interested, and that the resident homeowners in a small middle-income suburb would dominate the suburb's politics. The analysis then predicted that these homeowners, if unconstrained by law, would choose to adopt policies which would maximize the value of their current real estate holdings, *i.e.*, their houses. In situations where they would be unable to raise housing prices by restricting new development, they would try to capture for themselves the value of development rights in the community. One way to do this would be to place owners of undeveloped land in a straitjacket, and then to agree to free the owners at a price. More concretely, the positive side of the analysis predicted that typical suburbs would place undeveloped land in "holding zones" (for example, agriculture or noncumulative industrial districts), and then release those lands for residential development through rezonings (for PUD's or whatever), with the rezonings conditioned on developer donations of land, land improvements, and money. The developer contributions would enrich homeowners already in residence by improving their relative fiscal positions; these fiscal benefits would be capitalized into higher house prices. A homeowner cartel which carried out such a program to perfection would be able to garner all the producer's surplus that the developer would otherwise have.¹³

Impressionistic data lend credibility to this theory of suburban behavior. Mount Laurel Township, New Jersey, the site of one of the most famous land-use decisions, seems to have been a classic example of such suburbanite profit-maximizing. Mount Laurel placed most of its undeveloped land in holding zones and then sold development rights (via PUD approvals) in return for substantial (and often illegal) developer contributions.¹⁴

My positive theory of suburban behavior is controversial in several respects. It is based on many simplifying assumptions, has never been systematically verified, and, in part for these reasons, is not a perspective on the dynamics of zoning that many other land-use specialists presently share. Despite these shortcomings, I believe that an unverified theory of this sort has an important place in teaching—if no more than to serve as a focus (and foil) for class discussion.¹⁵

13. *Id.* at 425–30.

14. See *Southern Burlington County NAACP v. Township of Mount Laurel*, 67 N.J. 151, 336 A. 2d 713 (1975).

15. The renowned Tiebout Hypothesis that households shop among competing suburbs was also based on many simplifying assumptions, and remains contro-

Commentators on land-use controls have been notably deficient in devising testable hypotheses about how local governments are likely to use the land-use control powers that higher governments bestow on them. Many current writers adopt the optimistic, even utopian, stance of the early advocates of public control of private land development. They view unplanned private development as the harbinger of "housing crises" and "suburban sprawl," and see massive public intervention as the only sure route to the "orderly, balanced development" that is our salvation. My own particular positive theories may not stand the test of time; I am confident, however, that the traditional utopian view of the consequences of public planning is likely to prove to be less tenable than my own. In any event, the point is that a sound understanding of public land-use control devices awaits the formulation and testing of theories of local government behavior. The classroom is a traditional greenhouse for nurturing such theories—even unverified ones.

I have invoked my prior writing on suburban growth controls for a second reason. In discussing whether local governments should be entitled to capture and then sell back development rights in undeveloped land, I used what I now regard to be a potentially inadequate system of normative analysis. Instead of scouring the legal landscape for evidence of values thought to be relevant in this setting, I instead revved up the rather meager normative engines of economics—a discipline that consciously ducks most normative questions. Modern welfare economics provides three criteria for deciding such questions as whether the value of development rights in land should be vested in landowners or in the political faction that controls the local government where the land is situated. The three criteria are (1) efficiency, (2) horizontal equity (the like treatment of like-situated individuals), and (3) vertical equity (the just distribution of wealth between rich and poor). Applying these criteria, I concluded that allowing suburbanites to enhance their welfare by capturing development rights would not enhance efficiency, would not necessarily enhance vertical equity, and would severely threaten horizontal equity among landowners. I therefore concluded that the legal system should require a suburb either (1) to allow landowners to undertake residential

versial. Nevertheless, it has been one of the most important heuristic devices in urban economics. See Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POLITICAL ECON. 416 (1956).

development of a type normal for that suburb, or (2) in cases where the suburb did not allow normal development, to compensate those landowners damaged by its more restrictive policies.¹⁶

I do not wish, in this space, to defend my application of the three normative criteria that modern economics provides. Rather, I would like to report my regret for giving inadequate consideration to whether the three criteria are rich enough to identify all the concerns that the legal system should take into account. Recent scholarly writings advance the proposition that there may be important normative considerations that economics ignores.

III.

RECENT CRITICISM OF THE ECONOMIC PERSPECTIVE ON LEGAL PROBLEMS

Criticism of economics is hardly new. Even beginning students quickly point out that the Pareto superiority criterion for efficiency is impractical in virtually all interesting situations, that many tangential economic consequences (externalities) are extremely difficult to quantify, and that consumers often do not behave as rationally as economists would suggest. These sorts of criticisms, however, are basically within the family and do not cut to the core of the endeavor.

Lately, some of the most esteemed legal scholars have mounted a more fundamental and potentially devastating attack on economic analysis of law. The earliest and wittiest of these skeptics was Professor Arthur Leff,¹⁷ whose basic themes have been elaborated most notably by Professor Frank Michelman.¹⁸ Both Leff and Michelman are occasional, but highly skilled, practitioners of economic analysis of law, and are hardly vulnerable to the criticism that they are vandals who have set out to destroy a culture they do not understand.

The essence of the new criticism is that the world is messy. Those who try to make sense of it must inevitably oversimplify

16. See *Suburban Growth Controls*, *supra* note 3, at 418-24, 438-40.

17. Leff, *Economic Analysis of Law: Some Realism about Nominalism*, 60 VA. L. REV. 451 (1974); see also Leff, *Law and*, 87 YALE L.J. 989 (1978).

18. Michelman, *Norms and Normativity in the Economic Theory of Law*, 62 MINN. L. REV. 1015 (1978); Michelman, *Political Markets and Community Self-Determination: Competing Models of Local Government Legitimacy*, 53 IND. L.J. 145 (1977-78) [hereinafter cited as Michelman, *Political Markets*]. See also Kelman, *Choice and Utility*, 1979 WIS. L. REV. 769; G. Schwartz, *Economics, Wealth Distribution, and Justice*, 1979 WIS. L. REV. 799.

the phenomena they see, and may do so in dangerous ways. Economists, many of whom are instinctively attracted by mathematical models and graphic presentations, may psychologically be particularly prone to oversimplification. (Freud had a somewhat scatological word for this kind of personality.) Economics, these critics would charge, errs when it identifies only efficiency, horizontal equity, and vertical equity as the relevant considerations for policy-makers. "Justice" also comprehends other concerns which may be harder to articulate, and which ultimately may not be translatable into economic language. Beware, say the critics; poets and philosophers may know something that you do not.

Two desiderata not translatable into economic language have won the respect of enough intelligent people to be worthy of special mention. (I should confess at the outset that I usually find both incomprehensible.) First, adherents of "rights-based" conceptions of law regard the proper method for defining rights to be philosophical speculation on the place of individuals in society, not some utilitarian calculus that assigns rights in order to achieve broader social goals.¹⁹

A second non-economic normative perspective — one perhaps more relevant to land-use specialists — is the notion that a group of persons can have objective values and interests that are not necessarily discernible through an aggregation of the individual values and interests of the group's members. Among legal writers, Professor Michelman has made the boldest attempt to flesh out this basic challenge to the fundamental economic conception that the only relevant players are individuals seeking atomistically to maximize their welfares.²⁰ In effect, Michelman argues that there may be reasons for permitting "community self-determination" which are not picked up by the normative apparatus that economists conventionally use. An individual's self-fulfillment may turn in large measure on the achievements of groups to which he or she belongs. Moreover, a person's tastes are not entirely self-engendered, but arise to a great degree from peer influence and from perceptions of the collectivity's norms. This collectivist view is of course unsettling to persons steeped in the libertarian and individualistic notions which underlie Western institutions. There are good reasons for this; the lure of group fulfillment has taken many

19. See, e.g., R. DWORKIN, *TAKING RIGHTS SERIOUSLY* (1977); Borgo, *Causal Paradigms in Tort Law*, 8 J. LEGAL STUD. 419 (1979); Fletcher, *Fairness and Utility in Tort Theory*, 85 HARV. L. REV. 537 (1972).

20. See Michelman, *Political Markets*, *supra* note 18, at 149-52.

societies down the road to serfdom. Nevertheless, one must admit the possibility that there is something to it; it unquestionably has appealed to many persons in many places at many times. In fact, most local officials who implement public land-use controls would explain, if asked, that "community self-determination" was precisely what they were up to.

Michelman admits that community self-determination is a fuzzy notion, but warns that it may be dangerous to ignore what one has a hard time grasping. This is a warning that the best lawyer-economists have always heeded. Professor Guido Calabresi admitted in his famous article (coauthored with Melamed) that the lens of economics provided only "One View of the Cathedral."²¹ Leff and Michelman themselves might concede that economics is, in fact, the best lens now available. But there are, they say, other lenses and other vantage points.

As this conference is being held in Cambridge, Massachusetts, where Hegelian analysis seems to be making a bit of a comeback,²² it is fitting to close with an Hegelian metaphor. All the law professors who have made presentations at this conference are members of a generation that entered the teaching profession during the period 1965-1971. This was a period when the work of Coase and Calabresi was opening up new opportunities to legal academicians cocky enough to try their hand at economics. Members of our generation seized that opportunity. Some may have done so to excess. Against this thesis of law and economics there has recently sprung up an Hegelian antithesis: law and philosophy. Many of the young talents in law teaching now have as their gods, not Coase and Calabresi, but Ackerman, Dworkin, Michelman, and Rawls. The conference discussion has made it clear that around Harvard these days one can score more points criticizing law and economics than practicing it. In fact, in spots, the conference discussion has revealed that the critics can be as guilty of excessive zeal as the most militant lawyer-economists. Hegel would forecast a future synthesis, no doubt from a later generation of scholars whose work will utterly baffle us.

21. Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

22. See R. UNGER, *KNOWLEDGE AND POLITICS* (1975); Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976).

