

ECONOMIC ANALYSIS OF THE EMINENT DOMAIN LAW IN HUNGARY

By

Csaba János Gáli

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
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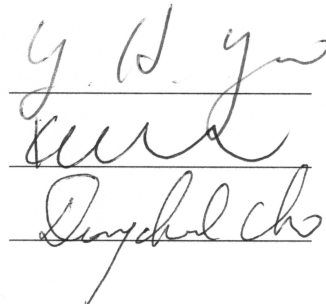
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ABSTRACT

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Taking private property by the government is a long tradition in market economies. Economic theories have been developed to support the case law and the legislation with efficient rules on the conditions and the compensations. Private property rights have been protected in Hungary since 1989, while the latest regulation on eminent domain has been in effect for less than four years. This paper examines the efficiency of the current regulation structure to see if the side effects of such a powerful tool distort the market economy. The analysis of the current regulation is based on the microeconomic incentives theory. It concludes that the regulation on different takings is not well structured and the property rights should be protected equally. The condition system of exercising the eminent domain power is lacking the most important economic justification, the holdout problem. Amending the rules is important to avoid harmful takings and inefficient substitutions. The compensation regulations are reasonable, but unable to mitigate the risk of takings driven by wealth transfers.

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INTRODUCTION

Private property is probably the most important foundation of a market economy. It is the precondition of trade and all of its consequences, such as the benefits of comparative advantages. The protection of private property is necessary for voluntary market transactions that maximize the value of the resources by allocating them efficiently to those who value them the most. This protection however, directly implies the existence of involuntary transactions. Without mandatory taxes, it is impossible to finance a judicial system to protect property rights. Microeconomic theory suggests that involuntary transactions have negative, distorting effects on the market causing the deadweight loss. Economists and policymakers want to reduce such effects, especially by spreading the risk among taxpayers or using a broad base for taxes or other restrictions.

Taxation is not the only justification for governments to deprive property rights. Government interference can also mitigate the negative consequences of some market failures. “The eminent domain is the strongest instrument of the government to interfere with property rights”, declares the Constitutional Court of Hungary in its most important decision on the law of eminent domain [35/2005. (IX. 29.) ABH¹]. This power authorizes the government to bypass the market mechanism with an involuntary transaction of property rights, typically to take the ownership of a piece of land.

There are many reasons for not selling a property, and so there are many justifications for takings as well; economic reasoning is just one of them. But without an economic justification, the negative consequences of bypassing the market can overwhelm the expected gains, thus takings can actually decrease the social wealth. The different conditions of the takings, the procedural costs, as well as the existence and the amount of compensation all matter to determine

¹ The abbreviation stands for the decision of the Constitutional Court.

whether the government's eminent domain power is beneficial or harmful for a society. The net result depends on the details of a country's regulation. A good regulatory system can make eminent domain a valuable mean for increasing social efficiency; while a poorly designed one can cause owners to reduce their investments, others to initiate takings for pure wealth transfers and the government to take instead of buying.

The Hungarian regulation is worth analyzing for two main reasons. First, the recently adopted Expropriation Act has not been discussed on efficiency basis. Second, there is no economic justification behind the Act, the practice of the Constitutional Court or the regular courts' case law. Without the practitioners' deep understanding of the economic reasons behind the power of takings, the effect of the text of the law gains utmost importance. This thesis does not seek to place an ultimate judgment on the question of whether the Hungarian regulatory system is generally good or bad. Instead, it will try to find the points where the regulation is improvable, where the incentives created have a negative effect on social efficiency and thus support the improvement.

Having identified the possible drawbacks to the Hungarian eminent domain power, this thesis aims to have an impact on the formation of this legal institution. The underlying cause of these problems is that the incentives are different from those under the market conditions. The people concerned act upon the non-natural incentives, trying to maximize their utility under the given conditions. It is possible to improve the efficiency of the incentive structure, by changing one or more aspects of the regulation, therefore this study will come up with recommendations.

METHODOLOGY

TERMINOLOGICAL DIFFICULTIES

The takings clause of the U.S. Constitution and the framework of the common law give an ambiguous meaning for the eminent domain concept. In each case, the ruling court decides whether the clause is applicable or not. Based on the different decisions, the economic theories could not give a generally undisputed, descriptive definition of eminent domain. They qualify the different restrictions applied by the government as police power, uncompensated regulatory taking or eminent domain. The studies take the legal interpretation given and propose changes in the legal practice. That's how the theory has become captive of the legislators and the judiciary: in practice, eminent domain must be defined as any seizure of property right when the government pays compensation.

This thesis cannot use the American terminology. The Hungarian legislation and rulings use a different conceptual and language framework with definitions often as vague as legal definitions can be. Thus, this thesis to remain self consistent has to give a meaning for each category it is going to use.

Taking is used in two senses: it is referring generally to the restrictions applied by the government on the property rights, and it is used as a synonym to substitute any specific form of those restrictions.

Eminent domain is also used generally, but only to identify the discussed framework, the topic of this thesis. The same expression is referring to the restrictions considered as eminent domain by any of the two examined legal system. This is a specific legal authorization for restricting private properties. Very simplified, takings (restrictions) can be over eminent domain

(where the government has no authorization to restrict the property rights), or under eminent domain (where the government can restrict the property rights without using the eminent domain power).

Expropriation is used only referring to the Hungarian legislation on the special legal process of taking real estate property. The Constitutional Court uses the same expression to refer to restrictions so serious that the Hungarian constitution's eminent domain clause should be applied to them. Therefore, for explaining and analyzing the Hungarian system, eminent domain will be used instead of expropriation.

Police power concept is referring to petty physical takings or regulatory actions where transaction costs prohibit efficient allocation by the market (except because of the holdout problem), but the government's interference does not reach the level of transferring the ownership as a whole. In presenting the practices, the same expression is used for regulatory actions that are not recognized as regulatory takings.

Regulatory action expression is referring to all restrictions on the property rights by regulations. These actions are regulatory in the sense that they are applied generally and not only to one or more previously identified pieces of land. *Regulatory takings* are regulatory actions where the eminent domain clause is or should be applied.

Holdout problem is the key element of the economic theory of eminent domain. It occurs when landowners can frustrate large projects by insisting on getting a too large share of the trade surplus, because their land necessary for the project.

METHODS OF THE ANALYSIS

This thesis conducts an analytical research on the Hungarian regulation on eminent domain. Due to the very limited publicity of the cases, the analysis must be rather theoretical, but the conclusions will be of practical use. The research is purely based on qualitative method, fundamentally on literature search, and the analysis of the Constitutional Court's cases and the legislative texts, and on comparing the theoretical findings and actual regulations.

Since 2008, court decisions on eminent domain must be made public on the homepage of the Hungarian Supreme Court. By April, 2010 a total of thirty-two cases have been disclosed. Cases, in which the landowner did not seek for judicial review are not made public at all. The limited numerical data does not allow a quantitative analysis. In none of the public cases did the court examine the legal conditions of the taking themselves. The remedy the plaintiffs sought was a raise in the compensation. The qualitative analysis of these court decisions is of little use. Unfortunately, the fact that the cases are anonymized makes it impossible to interview the landowners and collect direct data on their motives.

The review of the law and economics literature on eminent domain is the basis of this thesis's analytical parts. The theories were developed in an environment different from the Hungarian and the Hungarian literature has barely stepped over the boundaries of a strictly legal analysis. This paper does not make a comparative legal analysis, or an exhaustive description of the Hungarian eminent domain law. Without well developed descriptive theories, this thesis will not answer the question whether the Hungarian rules on takings fit any eminent domain definition or not either. Instead, with a broad scope, this paper is trying to use the findings of the foreign literature as a tool to analyze all the important economic aspects of the Hungarian

regulation on eminent domain, from the interpretation of the eminent domain clause of the Constitution to the Expropriation Act.

The description, the analysis and the evaluation is built on the concept of law and economics, the principles of microeconomic theory. Therefore this thesis does not identify the pros and cons of the regulatory framework, other than the economic efficiency and inefficiency of the different rules.

The most important constraint of this analysis is its focus on the current regulation. Instead of analyzing the effects of the regulatory framework based on the practice of the courts and the government agencies, conclusions must be drawn from the rules only. A second constraint is that the analysis focuses on the economically relevant parts of the legislation: the conditions of the takings and the compensation paid.

THEORIES AND PRACTICES

THE CONCEPT OF EMINENT DOMAIN

WHAT THE THEORY SUGGESTS? (BASED ON THE U.S. CONSTITUTION)

If any common element is to be found amongst the theories on eminent domain, it is clearly the government's interference in the actual endowment of property rights. The reason, the subject, the method, the amount of compensation, everything else is different according to the particular theory, no matter whether they want to define or describe the concept. However, all of the concepts are dependent on the law in effect. Most of the theories in the economic literature are based on the takings clause of the United States Constitution: "...nor shall private property be taken for public use, without just compensation" (Fifth Amendment).

To identify the scope of the eminent domain concept, let's examine what constitutes taking under the taking clause. The broadest interpretation by Epstein (1985) covers all nonmarket transactions enforced by the government: from taxation, through police power and regulatory takings, to the complete transfer of property rights on a certain land. In practice, the U.S. case law interprets the taking clause clearly in a much narrower sense: "direct government appropriation or physical invasion of private property" and – to a certain extent – regulatory actions [Lingle v. Chevron U.S.A. Inc., 554 U.S. 528 (2005)]. Physical acquisition covers the complete transfer of the ownership over the real estate, full or partial.

In the case of the regulatory actions, the fact that the courts usually decide on the question of compensation makes the interpretation a little complicated. In Lingle v. Chevron U.S.A. Inc., the Supreme Court found two cases that are takings per se: "(1) where government requires an owner to suffer a permanent physical invasion of her property, see Loretto v. Teleprompter Manhattan CATV Corp., 458 U. S. 419, or (2) where regulations completely

deprive an owner of ‘*all* economically beneficial us[e]’ of her property, *Lucas v. South Carolina Coastal Council*, 505 U. S. 1003, 1019”. Regulatory actions not reaching the above mentioned level are often considered police power without compensation for public use, especially when the restriction does not go “too far” in taking private property [*Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922)]. According to the *Penn Central Transp. Co. v. New York City*, 438 U.S. 104 (1978), the court would consider the economic impact of the regulation on the claimant, the extent to which the regulation has interfered with distinct investment-backed expectations and the character of the governmental action.

It is important to examine the role of regulatory takings in the regulation structure. The regulatory taking concept differs from police power in a sense, that the police power is efficient without any compensation, even if the state takes only the budget spending into consideration as the costs of the taking [the fiscal illusion concept (Miceli & Segerson, 2007, p. 31)]. This is simply because the economic concept of police power is restricted for situations when the government acts efficiently in restricting negative externalities (Segerson, 2000, p. 337). It is clear that the distinction is tautological and artificial: it uses the efficiency criteria to avoid taking efficiency into consideration. At the same time, the distinction has a practical value: clearly efficient restrictions are easier and cheaper to enforce. Another case of clearly efficient regulatory restrictions is when the subjects of the restrictions are difficult to identify or are in a large number. In this case the transaction costs of either purchasing or compensating is higher than the public benefit from the taking minus the loss of the owner [While the value of a property taken is always significant, in the case of regulatory takings we see more variation. Nobody would look for immediate compensation if the government authorized the Transportation Safety Bureau to enter one’s property in case of air crash. (Act CLXXXIV. of 2005.)] The regulatory

taking concept differs from eminent domain power as well. Bypassing the market mechanisms by the eminent domain power is justified by the holdout problem. The regulatory taking concept is to fit between the above mentioned two categories: any regulatory action restricting property rights that is not justified by transaction costs or the holdout problem.

THE HUNGARIAN CONCEPT

Unlike the Bill of Rights to the U.S. Constitution (drafted in 1787), the Hungarian Constitution's takings clause was drafted (in 1989) when the theory of eminent domain was already well developed. Thus the Hungarian Constitution uses a legal term to refer to the power of eminent domain: "Expropriation shall only be permitted in exceptional cases, when such action is in the public interest, and only in such cases and in the manner stipulated by law, with provision of full, unconditional and immediate compensation"(Paragraph 2, Article 13).

The differences between the common law and the continental legal system have some clear effect on the constitutional clauses. The American clause gives much more freedom for the courts for interpretation, while the Hungarian clause is less flexible. Some differences are clearly attributable to the history: the precondition of legislative decision and the immediateness of compensation are developed in the U.S. case law, but became enacted in the Hungarian constitution. The exceptionalness of the expropriation and the unconditional nature of the compensation are similar to the American concept of public use: they limit the power of eminent domain.

On the efficiency criteria, the following differences are worth analyzing. First, the Hungarian legal system – by using a specific legal term – excludes the takings by restrictive regulations from the eminent domain scope. This is more or less the codification of the findings of the *Lingle v. Chevron U.S.A. Inc.* case on regulatory takings. The Hungarian

Constitution applies a similar legal regime to regulatory actions, but with no constitutional obligation for compensation. Second, the justification of eminent domain is the public *interest*, instead of public *use*, and several other conditions limit the power of eminent domain. Third, the Hungarian constitution disposes *full* compensation, instead of *just* compensation.

According to the U.S. case law, eminent domain “may only be exercised through legislation or through legislative delegation, usually to another governmental body” (Service, Congressional Research, 2002)]. In comparison, the Hungarian Constitutional Court’s interpretation restricts the national legislation’s power to regulatory takings, and – to provide a legal remedy at the regular courts – physical takings must be administered by the executive power under the detailed conditions defined by the legislation.

ANALYSIS

The line between the different forms of taking can be overly casuistic for both legislations; the following table tries to show the approach of the two legislations to the different possible restrictions of property rights.

Type of taking	United States regulation	Hungarian regulation
Taxation	No regime	No regime
Nuisance regulation		Proportionality regime
Police power		
Regulatory taking	Eminent domain regime	Different partial taking regimes
Partial ownership taking		Eminent domain regime
Complete ownership taking		

The pursuit of maximizing social efficiency is clearly identifiable: different procedural and compensational rules help minimizing social costs (including the owner’s loss and the procedural costs). The social surplus of taxation or nuisance regulation is well accepted, and

monetary compensation would not increase it. In both legal systems, the government can use police power with no compensation under a certain threshold. Over this threshold, the U.S. Supreme Court and the Hungarian Constitutional Court compares the benefits and harms for the owner. The American test requires the regulation not to go “too far” [Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 (1922)], while the Hungarian test requires “proportionality” [64/1993. (XII. 22.) ABH]. The erga omnes decision of the Hungarian Constitutional Court (that is generally applicable to the individual cases without further legal procedure) seems to be more efficient, because the litigation cost can be cheaper with only one procedure. While the U.S. system provides individual reparation in each case, the Hungarian system provides reparation according to the case, e.g. individual reparation if the harm is individual and general reparation if the harm is general. This difference is related to the disparities between the common law and continental legal system.

In the followings, this thesis presents some important points, where the conceptual setting based on the Constitutional Court’s practice does not follow the theoretical findings. It will conclude that these discrepancies cause inefficiency in the power of eminent domain by changing the cost and benefit structure. The government uses the eminent domain power when it should not (because it is economically inefficient), and does not use the eminent domain power when it should (because it is economically efficient), moreover the government will use cheaper but less efficient forms of takings.

First, there is no economic rationale behind having two completely different regimes for physical takings and takings by regulation. Rose-Ackerman argues, that “from an economic perspective the distinction between physical invasions and value-reducing regulations is not a meaningful one” (Segerson, 2000, p. 338). However, the Constitutional Court developed a

practice that clearly separates these two regimes. While physical takings deserve full compensation (eminent domain regime); takings by regulations may or may not be compensated, it is sufficient if they are proportional with the public goal. The two systems have different incentive structures: the government in a state of fiscal illusion will tend to substitute and use the power of takings even when the physical acquisition would be more efficient. In the fiscal illusion, the government will not take anything into consideration but the amount of compensation, and regulations that are not necessarily compensated have a smaller cost. But the total cost of a regulation can exceed the compensation cost. (Rose-Ackerman's statement is valid if the two types of takings are based on the same conditions. However, distinguishing physical takings of lands with holdout problem and regulations with no holdout problem is meaningful. Unfortunately, in the Hungarian practice, this is not the case.)

Second, there is no solid justification of having separate regimes for complete ownership transfers (such as taking a whole piece of land) and partial takings (such as establishing equitable servitudes). Legal costs might make it reasonable to have a simpler, more flexible regime for takings of smaller values. But partial takings and low value takings are different. The slight restriction of expensive real estate can easily be of greater value than the complete taking of a cheap apartment. To make it more complex, partial takings have different legal regimes based only on the type of the public goal (such as the protection of cultural or natural heritage) or investment (such as mining or different infrastructures). Some of those regimes are considered uncompensated regulatory actions; some are more similar to the eminent domain regime. This obviously distorts the relative prices of different real estates and investment types, and cheaper takings have an inefficient substitution effect.

Third, the question of which regime is to be applied is decided only on gradualness (Jakab, 2009). The lack of clear distinction in conditions aggravates the above-mentioned inefficiency problem. To avoid falling into the area of uncertainty and risking of applying the more costly eminent domain regime, the government will substitute the near-borderline takings by regulations with more but less serious restrictions.

Finally, the proportionality test that the Constitutional Court uses to decide whether a regulatory taking or a law on taking is constitutional should be improved. On one hand, it shows some advantages of an efficiency test: the Constitutional Court can annul inefficient regulations on the basis of disproportionality. For example, in the decision 79/2006. (XII. 20.) ABH, the Constitutional Court held disproportionate the requirement to have the consent of all the neighboring apartments below, above and on the same level as the owners for keeping a dog. Moreover, the test is flexible; compensation is not the only accepted way to ensure the proportionality in a regulation for providing public goods. In this sense, the proportionality test – similarly to the fair market value compensation, in the case of eminent domain (Miceli & Segerson, 2007) – is a practical compromise between a strict economic efficiency test and the broad interpretation of police power in the U.S. On the other hand, the practice does not show any sign of the examination of transaction costs. It is easily possible, that a regulation is inefficient, because market transactions have smaller costs. One can argue that the Constitutional Court cannot review the government's decisions based on efficiency test (because of its expertise, its mission or constitutional role). This thesis only wants to claim that by ignoring an important factor to disproportionality, the Constitutional Court misses a necessary and inseparable part of the efficiency test.

PUBLIC USE OR PUBLIC INTEREST

THEORY REVIEW

The common element of every interpretation of the public use requirement is that the taking has to result in some benefit or advantage to the public. The U.S. Supreme Court doesn't constrain the condition any more than that, as seen in the recent cases. "The concept of the public welfare is broad and inclusive. The values it represents are spiritual as well as physical, aesthetic as well as monetary" [Berman v. Parker 348 U.S. 26 (1954)]. The public advantage can be indirect and distant, in *Kelo City of New London* 545 U.S. 469 (2005), the Supreme Court even allowed "to take property for the purpose of economic development". This is the result of an evolution in the practice from a public use to a public purpose requirement (Toll, 2007).

Theorists, on the contrary, derive a narrower meaning of the public use concept from the justification of the power of eminent domain: the holdout problem. Landowners can hold out for prices in excess of their true (subjective) valuation of the land, if the land is necessary for a project (Segerson, 2000, p. 330). The holdout problem's primary efficiency cost appears in the decrease or cancellation of the investment due to the higher prices. This is a deadweight loss: the harm to the investor is not offset by any benefit to the landowner, the society as a whole suffers. The holdout problem's importance related to the concept of eminent domain cannot be overemphasized. Even if the holdout problem was not the cause of the government's eminent domain power [as Benson (2008) claims], it is clearly the economic reason behind it. If there is a reason at all. Richard Posner does not find any other possible cases when eminent domain is justified in the real world: "the only case in which it is conceivably warranted on economic grounds: where the need to assemble contiguous parcels creates a holdout problem" (Posner, 1977, p. 44).

The holdout problem appears whenever a seller has monopoly power; theoretically it doesn't matter whether the buyer is public or private. Therefore some theorists suggest that private interests should be given the power of eminent domain as well (Segerson, 2000, p. 330), when it increases efficient allocation. Justice Antonin Scalia argues in the *Kelo v. City of New London* case that the proposed ruling destroy "the distinction between private use and public use", definitely it would to rule that a more efficient allocation is always for the public interest, therefore for public use. Others oppose the taking for private interests based on two practical reasons: first, the risk of corruption and rent seeking, second, other methods exists which private parties can use to prevent holdout problem, such as purchasing with dummy buyers. Nonetheless, this debate cannot be decided on only economic principles. There will always be situations when the holdout problem cannot be avoided; the regulation has to address these cases based on an evaluation of the possible benefits and harms.

THE HUNGARIAN APPROACH

Originally, there was a noteworthy difference between the "public use" concept of the U.S. Constitution and the "public interest" in the Hungarian. The first one is related to the direct beneficiary of the taking, while the second one is related to the justification of the taking. Nevertheless, both conditions are designed to restrict the power of eminent domain to the socially efficient occasions. Before the two milestone decisions of the new practice [35/2005. (IX. 29.) ABH and the 47/2006. (X. 5.) ABH], the Constitutional Court examined public interest only if its missing was evident (Jakab, 2009). In the current interpretation, a taking that directly serves private interest, but indirectly solves social problems, is considered serving the interests of the public as well. Nevertheless, a general reference to the public interest does not justify the power of eminent domain. Although the constitutional concept of public interest is broad, the

Constitutional Court expects the legislative power to concretize the cases, when the government can use the eminent domain power to serve public interest. Generally speaking, the two concepts are moving towards a same meaning: the ruling in the *Kelo v. City of New London* case and the current practice of the Constitutional Court as well requires an existent, but indirect public benefit only.

In 2005, the Constitutional Court examined the legislative framework of the eminent domain, and determined that there was an unconstitutional omission to legislate. The new Act on Expropriation Act (Act CXXIII. of 2007, entered into force in 1st January, 2008, applicable only to the complete physical takings of real estate properties) gives an exhaustive list of around forty investment situations, when the condition of public interest can be justified, such as the building of a nuclear reactor, a bridge or a tunnel, or stocking for a sustainable silviculture.

The Hungarian takings clause requires exceptionality to use the power of eminent domain. This condition means that no taking can occur if the public goal can be realized in any other, less restrictive way. The Expropriation Act has three alternatives to the taking: restrictive regulation without the transaction of property rights, purchase of the property, and the use of another area of real estate. The last condition of eminent domain is a comparison between the advantages and disadvantages of the taking, the public benefits have to considerably exceed the “damages caused by the expropriation”².

In the following analyses this thesis presents the various conditions to takings. These conditions are responsible to restrict the power of eminent domain to the economically efficient cases. The positive conditions are to be met before any taking to be constitutional. They should

² Expropriation Act, 3. § (1) d)

not be so restrictive to forbid economically efficient takings. The negative conditions (that must not be met for a taking to be constitutional) are responsible of forbidding takings that would not be economically efficient.

ANALYSIS 1 – POSITIVE CONDITIONS

Two causes make it impossible to evaluate the efficiency of taking conditions with purely economical methods. First, the socio-cultural environment is of high importance. In some cases, restricting the power of eminent domain to public investments can help preventing harmful bypasses of the market due to corruption. In other cases, it may have a market distorting effect favoring public companies against the privates. Second, different compensation rules are more or less efficient under different conditions. In an ideal world of perfect information, with a government that maximizes social efficiency, takings can be justified whenever the advantages (increased efficiency by making transactions happen through bypassing the holdout problem) outweigh the disadvantages (the efficiency loss due to the risk of a high subjective value of the original owner and wrong incentives for investment). Theories can give perfect solutions to avoid the disadvantages³, but – naturally – in practice there are just too many other factors to take into consideration. However, in the real world, the public use or public interest concept helps to restrict the eminent domain power to those cases when it really increases social efficiency.

It would be obvious to provide the power of eminent domain only for cases with holdout problem, as this is the most important factor behind high transaction costs. Without holdout

³ It is even possible to design an incentive structure that is efficient without the holdout problem as well: if we know the probability of taking, the level of efficient investment, and the owner has the right to buy back the property for the social surplus of the taking, there is no risk of having too high a subjective value.

problem, it is very unlikely to have prohibitive transaction costs (too high to make market transactions); therefore using the power of eminent domain is probably less efficient than letting the market forces prevail. This leads to a much higher probability of unlawful influence as well. Neither the Hungarian regulation, nor the practice of the Constitutional Court gives any explicit reference to the holdout problem or prohibitive transaction costs. While the Hungarian public interest concept has some relationship with the holdout problem, approximations like this are inefficient.

In the followings, this thesis analyzes different sides of the Hungarian regulation to find out if there is enough safeguard to restrict the power of eminent domain to the efficient cases and if it is possible to substitute the problem of holdout with other conditions. It will conclude that the public interest concept fails to act as an appropriate safeguard, restricting eminent domain to specific investment types is not efficient, and without the holdout condition, eminent domain for private use is dangerous.

The closest approximation to the holdout problem is in the interpretation of the public interest concept. According to the 42/2006. (X. 5.) ABH, the governmental agencies (or the courts, in case of litigation) have to confirm that the property to take has some special characteristics giving reason for the taking. It is not enough to demonstrate that the investment itself is for the public interest. Theoretically, such special characteristic could be an assembly of the land that leads to the holdout problem, but the decision does not specify. After meeting all the other conditions explicitly required by the Expropriation Act, a reference to the holdout problem seems to be a meaningful economic interpretation of such additional special characteristic. Unfortunately, the Constitutional Court's decision gives nothing explicit to confirm this interpretation. Moreover, the decision was brought in a case on regulatory taking,

and it is not undoubted that the above mentioned requirement applies to full physical takings (Jakab, 2009). All in all, the public interest concept itself is far from being a substitute of an explicit test for the holdout problem.

Based on the public interest requirement, the Expropriation Act gives an exhaustive list of different investment types when the power of eminent domain can be used. This may be another way in the Hungarian legislation to restrict the eminent domain power to the efficient cases. The elements of the list are either typical investment situations when the assembly of land is frequent (infrastructure and mining), or other extreme cases of possibly prohibitive transaction costs (when the government needs a land with strategic location for national defense, a holdout problem can occur without land assembly). However, and naturally, not every investment out of these types necessarily generates a holdout problem, and some planned investments with holdout problems will not fit in these types. Besides the inherent negative effects of not having a holdout condition, the restriction of eminent domain to certain investment types has some other negative consequences as well. First of all, it makes the investments on the list relatively cheaper than other investments; influencing the prices has a negative impact on efficiency. Second, some cases of existing holdout problems, while not on the list, still don't have an efficient solution.

The Hungarian legislation does not copy the original concept of the U.S. Constitution in restricting the power of eminent domain to the public use. The public interest concept serves a different purpose. The Expropriation Act is in alignment with the purely economic theories in the sense that the takings can be initiated both by public and private parties. However, this regulation is reasonable only under an efficient regulation, with the condition of the holdout problem. Without it, the chance to acquire property at market price induces private parties to initiate takings purely for wealth transfer reasons. (For example, assume that Dexter has real estate, with

a fair market value of \$30,000, but he values it at \$50,000. Sinister can pursue mining activity on Dexter's land, increasing its value to \$40,000. In this case, Sinister will try to acquire the land he cannot buy for the market price by applying for eminent domain. Without knowing Dexter's subjective value, it is easy to think that the eminent domain will increase efficiency.) It would be possible to limit the eminent domain power for the provision of public goods, as it would significantly decrease the risk of wealth transfer driven takings. But under the current regulations, the theoretically efficient solution to offer the eminent domain power for private parties, to provide private goods (mining, for example) is practically inefficient.

ANALYSIS 2 – NEGATIVE CONDITIONS

The constitutional condition of exceptionality serves the same purpose as all the other conditions discussed before. The exceptionality is the basis of the proportionality test, and – in the interpretation of the Constitutional Court – the most stringent requirement of takings (Jakab, 2009). As the interpretative 479/B/1993. ABH phrases: the deprivation of the property right should occur only if all the other conditions are met and “it is absolute necessary for realizing the public goal, and the public goal cannot be realized any other way but by violating the property rights”. This conceptualization does not refer to any economic terms, but from economic perspectives, it would be reasonable to see it as a reference to the holdout problem. (Even though it directly contradicts the cost principle of economics with the wordings “absolute” and “cannot be accomplished any other way”.) This conjecture is supported by the 35/2005. (IX. 29.) ABH and 7/2006. (II. 22.) ABH; these decisions claim that the state has to acquire the necessary property by transactions based on the civil law and the legislation “have to restrict the power of eminent domain to the cases when the public goal can only be accomplished finally by the deprivation of the ownership”. This is as far as the Constitutional Court gets: an ambiguous

reference that really has a meaning in economic literature, but does not give any clear guidance for the legislation.

The exceptionality requirement is reflected in the Expropriation Act in four conditions of any taking. These conditions will be discussed in the followings to analyze the positive and negative effects of every condition on the efficiency.

1. The first precondition based on the exceptionality requirement is that the public goal must not be attained by any other restriction of the property rights on the given real estate (lesser than the physical taking). The conclusion is that this rule leads to an inefficient effect of the division of lands.

This precondition seems to be a good way to minimize the impact of bypassing market mechanisms. However, in many cases partial takings are uncompensated (for example: restrictions for environmental protection not causing a considerable change in the production structure of the given property are not compensated⁴), thus the owners are not indifferent between the two options. As long as the difference between the owner's subjective value and the compensation for a complete physical taking is smaller than the loss due to an uncompensated partial taking, the owner (and the society) would be better off without this requirement. Under different compensation regimes, the exceptionality requirement is rather damaging than protecting the owners' interests.

While nonphysical takings are inefficiently favored by the law, partial physical takings are not. There is no obligation by the law to divide the real estate and to take only the necessary piece. This regulation could help in minimizing the owner's losses, because the difference

⁴ Act LIII. of 1996. on the protection of nature, 72. § (4)

between the subjective value and the compensation is smaller if the taken piece of land is smaller. However, the division of land can have other negative consequences (such as the economy of scale), therefore the law should provide a right for the owner to ask for full taking. Interestingly, the Expropriation Act already provides this right in some strict conditions (the previous use of the land or selling it for a fair price becomes impossible).

Without the obligation for minimal partial physical training, the regulation has an inefficient substitution effect. When the expected compensation is smaller than the subjective value, the owner is encouraged to keep smaller pieces of land. In an equilibrium condition (in a given regulatory framework) real estate sizes are optimal for their economic purposes. Implementing the Hungarian regulation, large lands will have relatively higher expected probability of being taken and owners will have higher possible loss of their subjective value. To increase the (expected) value of their lands, owners will have incentives to divide the lands to smaller portions.

2. The second precondition to a taking is that it must be impossible to acquire the ownership of the given real estate by purchase. The conclusion is that the rule is efficient when the purchase is frustrated for reasons beyond a purchase offer, but it leads to inefficiently low offers when there are no extraordinary transaction costs (besides the holdout problem).

In microeconomics, the impossibility concept [the condition in the Expropriation Act is even more stringent than the wordings of the 7/2006. (II. 22.) ABH, which refers to the incapability of the state to acquire the ownership] does not make much sense, but the law gives clarification. There are three possible reasons for this impossibility. First: the rejection of the owner, second: the owner is unknown or impossible to reach, third: the real estate is unique.

In the first case, it is impossible to acquire the ownership if the owner rejected or ignored the purchase offer. This is a natural reason for taking; however there is no rule for the amount of the offer. It is easy to realize that a cost minimizing buyer will offer and buy at a price that is equal with the expected compensation minus the procedural costs for the owner, plus the costs of the procrastination of the ownership transfer. This price may be higher or lower than compensation cost, but when it is lower, problems come. On this price, the owner agrees in the trade, but – as discussed later – undercompensation has a negative effect on efficiency (shortly: too much taking, too small investments). To avoid this situation, the law should require the buyer to offer at least fair market price.

In the second case of the second precondition, the owner of the real estate is uncertain or unknown. In the third case, the location of the owner is unknown or other reasons make the communication of the offer very difficult or considerably delayed. These two cases are related to extraordinarily high transaction costs and may be efficient cases of eminent domain without holdout problem. This implies that there should be a separate regime for these situations. The current regulation seems to be efficient for them.

3. The third precondition requires that the public goal couldn't be realized on any other real estate, or realizing it would mean greater harm of the property rights. The conclusion is that the first part of this precondition is efficient, but the second part may extend the power of eminent domain inefficiently to cases without holdout problem.

The first half of this precondition is a very important safeguard. When there is more than one piece of land appropriate for the investment, the holdout problem does not occur: the free market will make sure that any owner accepts the price higher than his own subjective value, and

this is the only efficient solution. However, if the owners can cooperate (especially, if the available lands are owned by the same owner), holdout problem can still occur, and the Hungarian legislation has no remedy for this situation.

The second half of this precondition is an alternative to the first half. Without any legal guidance on how to calculate the harm of the property rights, at least two interpretations are possible. Either this rule is supposed to minimize the expected loss of the owner (subjective value minus compensation) or the total (objective or subjective) value taken out of the market mechanism. Theoretically, the first option would be more efficient, but the subjective values are unknown. The second interpretation sounds reasonable, but it has a negative side-effect: owners can (and will) avoid takings with overinvestment. For example, if an owner has a high subjective surplus, she will be willing to invest wastefully in order to increase the objective value of the real estate, and decrease the possibility of losing the surplus because of a taking. This risk of wasteful investment can be mitigated by increasing the amount of compensation. Unfortunately – as discussed later – increasing the compensation prevents the owner from internalizing the risk of taking, causes a risk of wasteful investment as well. In an efficient system of eminent domain regulation, these effects have to be compared.

The most serious problem with these alternatives is that the mere existence of another piece of land economically suitable for the planned investment probably annuls the holdout problem. Contrary to this, the current set of regulation authorizes the government to use the power of eminent domain when there are two possible pieces of land: because taking one is always smaller harm of the property rights than taking the other. It may be reasonable to provide the power of eminent domain for similar situations. However, appropriate safeguards must be implemented to make sure that the holdout problem occurred.

4. The fourth precondition refers to the social surplus of the power of eminent domain: the public value of the investment has to be considerably larger than the harm of the taking. The conclusion is that this precondition is economically unjustified, because the measurement of the social surplus is unrelated to the rules of market transactions.

Once again, this is a requirement that could be interpreted as a substitute of the unmentioned holdout problem. According to theory, only when the transaction costs are prohibitive is it possible that there is a social surplus, but there is no market transaction satisfying both sides. Unfortunately, the law explicitly denies this interpretation: the significance of the public goal has to be compared to the features of the real estate. This comparison has nothing to do with the holdout problem or with the subjective values of the owner. Therefore the effects are similar to some previous rules: for economically justified takings it is an unnecessary burden, for other takings it has a limited effect in filtering the really inefficient ones.

To summarize it, the exceptionality concept of the Hungarian Constitution could have a very strong positive effect on the efficiency of eminent domain. The Constitutional Court's idea is to restrict the power of eminent domain to cases when the government cannot acquire the property through market transactions. However, this can be attributed to two distinct conditions: high transaction costs, or high subjective value of the owner. The Constitutional Court is unclear in the decisions and the Expropriation Act arguably fails to recognize the economic rationale behind eminent domain. The condition system has various effects, most of them negative on efficiency. However, the high number of conditions can have a strong effect overall in administratively restricting the cases of eminent domain to those absolutely necessary.

ANALYSIS 3 – THE PRACTICE

In the previous, several legal conditions of takings were listed to figure out, whether the holdout problem, an important economic condition of takings is appropriately taken into consideration before the decisions. This short chapter is based on the practice and not the general regulations. The first paragraph is based on the public decisions of the Hungarian courts⁵. The second paragraph is based on the decision of the Hungarian parliament in specific investments. The very little information available on the practice suggests that the practice is in conformity with the regulation: there is danger of inefficiency.

1. Unfortunately, no decision of the regular courts mentions any reference to the holdout problem. However, this is not very surprising, knowing that no plaintiff has questioned the legal conditions of the taking themselves in the court procedure. The matter of the case was always the amount of compensation. This suggests that the owners are either satisfied with the taking or do not believe in efficient remedy. This concludes that the government pays higher compensations or uses the eminent domain power more than the efficient.

2. The parliament of Hungary has adopted some acts on specific investments⁶. In these bills, the legislator weighed the public interest to the possible risks and losses of a taking. These acts declare that the power of eminent domain must be used if purchasing a certain set of lands (necessary for the investment) was unsuccessful. Moreover, they declare that the condition of public interest should not be individually examined during the taking processes. In these linear investments (the tracks or dikes cannot be built anywhere else), the holdout problem naturally

⁵ <http://www.birosag.hu/engine.aspx?page=anonim>

⁶ Such as the LXVII. Act of 2004. on the program of the protection against flood in the Tisza valley and the CXXVIII. Act of 2003 on the development of the motorways of the Republic of Hungary.

occurs, and authorizing the takings is reasonable, assuming that the net effect of the investment is positive to the economy. Unfortunately, there is no trace of any analysis to compare the possible harms of takings to the expected benefits when these decisions were made. Without such analyses, the government is subject of political or business influence, instead of economic efficiency.

COMPENSATION

THEORY REVIEW 1 – WHY COMPENSATE?

The compensation paid for the property taken is a key element of the eminent domain concept. In practice, it separates takings that fall under the eminent domain regime from takings that do not. The single idea behind paying compensation is that the U.S. Constitution's taking clause requires 'just compensation'. It is easy to find political, ethical and legal reasons to provide such compensation.

In the followings, the economic justifications of paying compensation are summarized.

1. One economic reason is the previously referred fiscal illusion concept. In this realistic model, the government considers only the budgetary cost of a taking, as opposed to its true opportunity cost (Miceli & Segerson, 2007, p. 31). The smaller cost leads to excessive takings [especially for real estates (Segerson, 2000, p. 349)] and inefficient substitution. (However Ian Ayres argues that in a representative political system, the lack of compensation have an effect of reducing takings as well, because the landowners might rouse political resistance against them (Ayres, 2009).)

Without compensation, the benefits of a taking are usually dispersed in the society, but the harms occur at the owner only. Because of the decreasing marginal utility, the society as a whole is better off if the costs are dispersed as well. Moreover, considering the taking as a special tax, the deadweight loss is smaller when imposed on the budget than when imposed on a single commodity due to the substitution effect and the elasticity of demand. It is also worth mentioning that if the regulation authorizes private parties to initiate takings, the lack of

compensation strongly encourages them to use “the takings mechanism rather than engaging in a voluntary transaction at their own cost” (Guerin, 2002).

2. If the government restricts the power of eminent domain to the economically efficient cases (no fiscal illusion), less than full compensation causes overinvestment (more improvement in the value of the land than it is socially efficient). The owner may overinvest to increase the value of the land in order to avoid the taking (Miceli & Segerson, 2007, p. 28). Moreover, due to the loss aversion of the individuals, one could argue that the compensation should be larger the full value.

3. Contrary to the aforementioned, there is a serious argument for paying no (or not full) compensation. Full compensation makes the owner indifferent between keeping the ownership and being compensated. The improvement of a real estate when the taking is imminent can be privately profitable, while socially wasteful (Cooter & Ulen, 2008, p. 185): for example repainting a house to enjoy the new color for only a few weeks. In other words, while choosing an efficient level of investment, the owner does not internalize the risks of taking⁷.

4. Finally, full compensation is never really “full”, because the subjective value of the owner is unknown; therefore no compensation rule uses the subjective value as a basis.

THEORY REVIEW 2 – HOW TO COMPENSATE?

Theories on an efficient compensation rule have been developed in a large number. These theories can create an incentive structure that does not result in wasteful improvement or underinvestment. However, the best applicable theory strongly depends on the conditions of the

⁷ Theoretically, no compensation makes the owner internalize the total risk of taking, however usually the owner has little information on these risks to determine the efficient level of investment.

taking and the model used to describe the government's behavior. In the real world, without perfect information, selecting a perfectly efficient model is impossible, and selecting a mostly efficient one is very difficult.

Some compensation models are simply inapplicable: for example, if there is a high risk of slightly under- or overestimating the efficient level of investment (or the risk of a taking), the model may amplify the negative consequences and it does not give the expected outcome. Another problem is that without knowing the subjective value of the property to the owner, the only thing known about the relationship between the known market value and the unknown subjective value is that the latter is higher. Based on these constraints, this thesis accepts Guerin's assertion on the limited usefulness of an economic analysis: "In the absence of accurate assessments of social benefit and cost, and of government decisions based solely on such assessments, the balance of judgment from these rules (...) is unavoidably subjective. (...) Economics does not give us a hard and fast operational framework for takings compensation" (2008).

Because of the above mentioned reasons this thesis is not going to choose between the developed models, nor will it recommend any specific model to the Hungarian legislation. There are models that are more efficient than the market value compensation in terms of solving the problem of fiscal illusion and moral hazard as well, but these models are based on unrealistic assumptions⁸. Hermalin's model⁹ is more realistic in the sense that it doesn't require information

⁸ In Miceli's model, the compensation equals with the market value at the efficient level of investment (knowing the probability of taking). Miceli and Segerson give an improved version of the no compensation rule that limits the government to the efficient takings: the government pays market value compensation when the investment is at efficient level, but no compensation if the landowner overinvested. While these rules lead to efficient level of

beyond the value of the land at the public use. Unfortunately, this model is practically unfeasible as it recommends negative compensation: the landowner pays the value of the land in public use to keep the ownership (Miceli & Segerson, 2007, p. 32). Theoretically this model means that the government takes all the land that has a public value and resells its majority to the owner, it represents an extreme end of the distribution of the social surplus.

It is possible to develop another efficient model based on Hermalin's. This model is very simple, and also does not require any information other than the market value of the land to be taken. Under this compensation rule, the government expends the market value of the real estate to anybody, except the owner: it can either randomly 'compensate' another taxpayer, distribute the value among the taxpayers or decrease the collected taxes by the given amount. The compensation is full for the government so it internalizes the costs of the taking, and zero for the owner to avoid the moral hazard problem.

The odds are against finding a model that compensates exactly on the subjective value. Moreover, theoretically efficient compensation rules are far from either subjective or market value compensation. Based on economic and non-economic reasons, fair market value compensation is still the most reasonable compensation rule. Fischel and Shapiro in their constitutional choice model show that the partial compensation rule is optimal (and only in that sense, efficient) in a majoritarian government model (Miceli & Segerson, 2007, p. 37), while

investment and taking as well, they unrealistically assume that the probability of taking is known by the owner. (Miceli & Segerson, 2007, pp. 31-33)

⁹ Hermalin gives two models, but in the first one the compensation is either higher than the subjective value (inefficiently increasing the cost of the public investment) or lower (inefficiently transferring the property rights).

Miceli shows that is effectively irrelevant (!)¹⁰ (Miceli, 2008). Miceli and Segerson conclude that in the real world, market value compensation is a practical compromise (Miceli & Segerson, 2007, p. 48).

THE HUNGARIAN APPROACH

The Hungarian Constitution – unlike the American – requires full compensation. The compensation must be unconditional and immediate as well. The meaning of the latter two provisions is obvious. As to the second, the government cannot impose any condition to the compensation, such as the limited budget or any attribution of the owner or the real estate (Jakab, 2009). As to the third, the compensation amount has to change ownership at the same time as the property taken [58/1991. (XI. 8.) ABH].

The legal interpretation of the full compensation requirement is straightforward: it equals the damages the owner has to suffer because of the taking. In the 904/B/2000. ABH, the Constitutional Court recognized the gains from the taking (the owner's share of the social gains from the given investment) as a counterpart of the damage, an element of the compensation. In this case, the Constitutional Court referred to the value of a piece of real estate before and after a partial taking, and argued that the compensation should be equal with the difference, conceived as the owner's damage. Without any guidance given by the Constitutional Court on how to calculate the value of a piece of real estate, the legislation came up with a concept similar to the fair market value concept. According to the Expropriation Act 9. § (3), the market value of the local comparable lands should serve as the basis in determining the value of the taken land. If

¹⁰ He assumes that "taxes are uniformly assessed on the market value of individual properties and that landowners authorize the number of parcels to be taken from behind a veil of ignorance regarding which particular parcels will be taken". The intuition for his result is that "landowners recognize the equivalence of taxes and takings in budgetary terms".

any reason prohibits the real market value to be determined, the value of the land has to be approximated based on a list of factors given by the law. Such factors are the situation of the real estate, the present or the possible public utilities, the geographical and economical capabilities of the real estate, the culture in case of an infield, the classification criteria of the land and the profitability of the real estate. Two other provisions related to the value of compensation are worth analyzing. The first one expands the compensation to some specific costs of the taking. The second one (implicitly) declines compensation for any profit loss, except those occurring because of moving the business to a new location.

ANALYSIS

This analysis concludes that it is practically impossible to find an optimal set of compensation rules, but it is clearly possible to improve the Hungarian regulation.

In the previous analyses, economic efficiency was the only aspect taken into consideration. In that sense, the compensation provision of the Hungarian regulation is not efficient, because its market value based compensation may lead to inefficient takings when the owner's subjective value is higher than the value of the property in the public use. Moreover, the regulation creates a moral hazard for the owners to invest more than the efficient level. It is important to note, that in theory, Hermalin's referred model would solve both problems.

However, the concept of uncompensated taking of real estate property forces us to leave the framework of simple compensation models, as models compensating above the subjective value inefficiently increase the price of the investment, while models compensating below the subjective value loses the benefits of risk and cost distribution.

Choosing the most efficient model in the Hungarian socio-cultural and economical environment would take a deep research (that should have been done before adopting the new regulation). Without such research and within the Constitution's "full compensation" clause, it is safe to say that the market value compensation is a good compromise: it is not far from efficiency and has a very low wealth distribution effect. Another practical reason behind the market value compensation is its relative ease to determine. However, a unique real estate market value determination is impossible, and instead a fair market value must be estimated. The Hungarian regulation addresses this problem well: the estimation of the market value and the fair market value is based on objective standards and not on the owner's preferences.

The most serious risk of the Hungarian compensation rule is the risk of takings driven by wealth transfer. As it was previously shown, providing the power of eminent domain for cases without holdout problem and for the provision of private goods may be inefficient, and it is especially true if the compensation is below the subjective value. It is recommended to change at least one of these criteria. If the compensation rule is to be changed, to ensure a division of the surplus as well, Epstein recommends a compensation rule for private investments that pays substantially more than the fair market value (and refers to the New Hampshire Mill Act that "fixed the compensation payable to the owner of a flooded land at 50 percent above the market value of the land") (1985, p. 174). That would be reasonable to adapt this rule in Hungary to mitigate the dangers of inefficient takings.

CONCLUSIONS AND RECOMMENDATIONS

With the power of eminent domain, the government can bypass market mechanisms to increase social wealth. This power is justified only under certain conditions; therefore the role and efficiency of the regulations is very important. This paper analyzed the effect of the Hungarian law on eminent domain and concluded that there is much to improve.

Without a single rationale behind the structure of the taking system, the applicable condition or compensation rule is inconsistent. The government and the owners have incentives to divert resources from their most efficient use, because they have different expected values under the different regimes. The Constitutional Court should revise its practice on regulatory actions and pronounce that examining the transaction costs is a part of the constitutional conformity analysis, and that regulatory takings must be compensated on the same level as the power of eminent domain.

Additionally, the legislation on physical takings needs to be reconsidered. The regulation can be greatly simplified by focusing only the real justification of eminent domain: excessive transaction costs. First, the amended regulation has to explicitly refer to the holdout problem as a condition of taking. Second, a well founded market value based offer must precede the initiation of the eminent domain procedure to minimize the legal costs. At the same time, the advantages of the current regulations should be kept: providing takings for private parties and giving a list of takings when the holdout problem is independent from land assembly.

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