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Bargaining with the State: Offsets and Mitigation in Developing Land

Robert D Cooter, *University of California, Berkeley*

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by

Robert Cooter

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rcooter@law.berkeley.edu

This short paper will appear in a commemorative book for Hans-Bernd Schäfer's 65th birthday, edited by Thomas Eger.

Abstract:

According to the economic theory of bargaining, each party to a voluntary agreement must receive at least the amount that he can get on his own (“threat value”), plus a share of the surplus from the bargain. Courts frequently monitor bargains between citizens and the state. To protect citizens, the courts should focus on the fairness and efficiency of the threat points of the citizens. Unfortunately, courts often focus on the terms of the agreement, not the threat points. The wrong focus leads courts to impose rules that block bargains that would benefit both parties. I analyze an example where the U.S. Supreme Court precluded the possibility of a beneficial bargain between a private property owner and a land-use planning authority. The private property owner wanted a permit to develop land. The state required the private owner to offset the harm by giving something to the public in exchange for the development permit. By focusing on the outcome and not the threat points, the Supreme Court misconceived the problem. Specifically, the Supreme Court misconceived the requirement of a “causal nexus” between the harm that private development will cause to the public and the bargain with the state to offset this harm.

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Introduction

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I. *Nollan v. California Coastal Commission*

Viewed from an ecological perspective, adjacent parcels of land are so interdependent that anything one owner does affects the others. When the “transformative economy” (Sax 1992 fall) meets ecology,¹ almost any restriction can be justified as controlling an externality. In such cases, property owners often bargain with

* Robert Cooter is Herman Selvin Professor of Law, University of California at Berkeley. This article is based on Chapter 12 of my book, The Strategic Constitution (Princeton University Press, 2000).

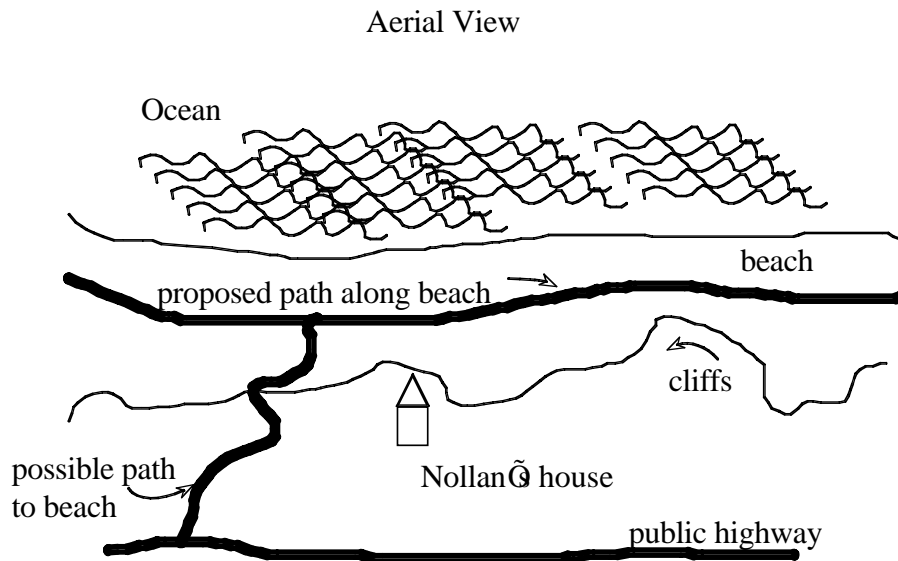
¹ Sax, J. L. (1993). "Property Rights and the Economy of Nature: Understanding *Lucas v. South Carolina Coastal Commission*." *Stanford Law Review* 45: 1433.

the state over permits. Sometimes the state grants a permit conditional on the owner mitigating the harm to the public. Sometimes the state grants a permit in exchange for the owner donating something valuable to offset the harm to the public. Mitigation and offset are quite different in their economic consequences for bargaining with the state. I will explain how an imperfect understanding of the difference resulted in an inferior court decision in a landmark case decided in the U.S. Supreme Court, *Nollan v. California Coastal Commission*.²

North of Los Angeles, the magnificent coastline of California remains largely unspoiled by development and the California Coastal Commission is responsible for keeping it that way. This case arose when a property owner sought a permit from the Commission to enlarge a small coastal dwelling into a house. The property was located between the beach and a public highway, as depicted in Figure 1. The house would have diminished and degraded the view of the coast from the highway.

²107 S.Ct. 3141 (1987). For a discussion of it, see Michelman, F. (1988). "Takings." *Columbia Law Review* 88: 1600-1629.

Figure 1: *Nollan*



The Commission wanted to protect the view from the road, but that was not its only purpose. In addition, the Commission wanted to obtain a walking path along the beach so the public could stroll there at high tide. The Commission did not refuse permission to build the house, which the Supreme Court suggests that the Commission could have done legally. Instead, the Commission required the owner to donate a public path along the beach in exchange for permission to build the house. The owner sued and the case was eventually appealed all the way to the U.S. Supreme Court.

The state can regulate property to protect the public against harm, but the supply of public goods must be financed from general taxes, not by expropriating selected property owners. Was the Coastal Commission protecting the public or forcing a private person to pay for a public easement? The US Supreme court reached the latter conclusion in a complex opinion written by Justice Scalia. Although the principles governing the protection of a scenic view are not so well developed in U.S. law, the opinion remarked that the Commission could require the property owner to draw up new plans for the house in order to reduce its intrusiveness. Another form of mitigation,

which is problematic but probably constitutional, would require the property owner to donate a path from the road *to* the beach, so the public could walk around the object obstructing its view.

Instead of requiring the owner to redesign the house or donate a path from the road to the beach, however, the Commission required him to donate a path *along* the beach, which would not mitigate the harm suffered by users of the road. The court looked for a "nexus" between the harm caused by the owner (obstructing the public view from the road) and the remedy demanded by the Commission (donating a public path along the beach), but could not find it. The court reasoned that without such a nexus, the regulation was an illegal taking.

A legal principle can be abstracted from this conclusion. In order for a regulation to count as a legitimate exercise of the police power of the state, not as a taking, the regulation must mitigate the harm that justifies it. Whereas mitigation reduces harm, offsets compensate for the harm by providing a valuable substitute. *Nollan* can be interpreted as standing for the principle that government cannot present property owners who want to use their property in a particular way with the choice of offsetting the harm caused by the use or not using it.

II. Mitigate or Offset?

I will explain the economic difference between mitigation and offset abstractly and by example. Perfect mitigation completely eliminates the harm in question, thus leaving victims indifferent between no harm or harm-and-mitigation. In reality, mitigation is usually imperfect. When mitigation of the public harm from a private act is imperfect, the public would prefer to forbid the act rather than allowing it conditional upon mitigation. So when the state faces only two alternatives, it will often choose no-permit rather than or permit-plus-imperfect-mitigation.

Blocking any development in these cases, however, can be wasteful. If the act's private value exceeds the public harm, then the owner could pay for an offset that makes the public and the owner better off than if the act were forbidden. In so far as *Nollan* is interpreted to prohibit offsets, the law will create inefficiencies.

The impulse to prevent offsets has a sound motive that goes wrong from inadequate analysis. The constitution gives government many more powers of regulation than it chooses to exercise against property owners. If building permits could be conditioned on offsets, government might choose to cash in on much more of its potential power. To cash in, government would regulate, or threaten to regulate, solely in order to obtain valuable offsets. Allowing regulation to become a source of government revenue creates an incentive for over-regulation and the opportunity for government to victimize politically disfavored property owners. For example, a mayor elected by tenants might avoid raising taxes by demanding offsets whenever landlords apply for building permits.

Allowing governments too much scope for bargaining with private owners invites another abuse as well. To speak of mitigating more than 100% makes no sense, so the upper limit on mitigation is the full extent of the harm. In contrast, the upper limit on an offset is the value of the building permit to the owner, which often exceeds the cost of the harm. Thus allowing government to require offsets as a condition for permitting private actions empowers it to extract most of their surplus value.

This analysis of *Nollan* illustrates an important principle in game theory: a restriction on the freedom of one party to compromise can strengthen its bargaining position. When constitutional restrictions on bargaining prevent one party from comprising, the other party may have to make the concession. Thus the restriction can benefit the restricted party.

The US doctrine of “unconstitutional conditions” sometimes has this effect. According to one commentator, this doctrine asserts that a state with absolute discretion to grant or deny a privilege cannot grant the privilege subject to conditions that pressure the waiver of constitutional rights.³ To illustrate, state governments in America can decide whether or not to provide benefits to unemployed workers, but if the states adopt an unemployment program, it cannot exclude striking workers from receiving the benefits. This constitutional requirement strengthens the bargaining position of unions against their employers. Similarly, an American state can decide whether or not to permit

³ See Epstein, R. (1988). "Foreward: Unconstitutional Conditions, State Power, and the Limits of Consent. (The Supreme Court, 1987 Term)." *Harvard Law Review* 102: 4-104.

foreign banks to operate in the state, but the state cannot require a foreign bank to waive its legal rights as a condition for doing business in the state. This constitutional requirement strengthens the bargaining position of foreign banks against the states.

Perhaps *Nollan* forbids offsets in order to strengthen the bargaining position of citizens against the state. This is one way to reduce the state's power to extract surplus value from property owners. A better solution, however, is to prohibit offsets unless the property owner also has the opportunity to mitigate. According to this rule, the state can only offer the property owner the opportunity to offset as a substitute for mitigation. Giving the property owner this additional opportunity cannot make him worse off than simply requiring mitigation, and the additional option may make both parties better off. Given that the owner has the right to develop and mitigate, there may be scope for a mutually beneficial bargain. If the private owner and the public both prefer offset to mitigation, the law should not prevent them from striking this bargain. So *Nollan* should be interpreted as standing for the principle that *government cannot require an offset as a condition for granting a building permit unless government also gives the applicant the alternative of mitigating*.

III. Hypothetical Example: Stylizing *Nollan*

The significance of this principle can be demonstrated by reading some hypothetical numbers into the facts of *Nollan*. The owner will either act (build house) or not act (don't build house). The consequences of this decision for the owner and the public are given in Figure 2. Thus the permit to build the house is worth 1,000 to the property owner, whereas the cost to the public from loss of view is 300 as estimated by the Commission.

Figure 2: Value of Alternative Acts in *Nollan*

	act (build house)	don't act (don't build house)
property owner	+1,000	0
public commission	-300	0

In addition, the Commission may require the owner who acts to mitigate (redesign the house) or offset (build a path along the beach). According to Figure 3, redesigning the house would cost the property owner 300, resulting in a net benefit from the building project of 700 for the property owner ($1000-300=700$). Redesigning the house would convey benefits of 250 upon the public, resulting in a net loss of 50 to the public ($-300+250=-50$). Alternatively, donating a path along the beach will cost the owner 250, for net private benefits of 750 for the property owner ($1,000-250=750$), and convey benefits of 400 upon the public, resulting in a net gain of 100 for the public ($-300+400=100$).

Figure 3: Cost of Mitigation and Offset in *Nollan*

	Private Property Owner	
	redesign house (mitigate)	path along beach (offset)
property owner	-300	-250
public commission	+250	+400

The net values of the alternatives are summarized in Figure 4. Consider the most efficient course of action. By definition the efficient solution maximizes the sum of the net benefits to the property owner and the public. Thus the efficient cell in Figure 4 requires the house to be built and the public to obtain the easement along the beach (act & offset). The result is net benefits of 750 to the owner ($1,000-250=750$) and 100 to the public ($-300+400=100$). Given these numbers, acting and offsetting, which yields 850 in total net benefits ($750+100=850$), is most efficient. Both parties also prefer it, so it is “Pareto superior” to the alternatives.

Figure 4: Net Values in *Nollan*

	don't act	act&mitigate	act&offset
property owner	0	700	750
public commission	0	-50	100
<u>Total</u>	0	650	850

Unfortunately, this result will not be achieved if law forbids offsets. Given this legal constraint, the Commission must either refuse to issue a building permit or issue a permit conditioned upon mitigation. If the Commission refuses to issue a building permit, the public will suffer no harm. In contrast, if the Commission issues a building permit and requires mitigation, the public will lose 50. So a public-minded commission will refuse to issue a building permit, even though both the owner and the public would prefer the issuing of a permit conditional upon an offset.

Prohibiting an offset, however, strengthens the bargaining position of owners. To speak of mitigating more than 100% makes no sense, so the upper limit on mitigation is the full extent of the harm. In contrast, the upper limit on an offset is the value of the building permit to the owner, which often exceeds the cost of the harm. To illustrate by the preceding example, the largest amount of money that the Commission could extract from the owner in exchange for the building permit would be the value of the latter to him, which is 1,000, whereas the cost of the (unmitigated) harm to the public is 300. If money offsets are allowed, the Commission could extract up to 1,000 for the building permit, even though the building only causes harm of 300 to the public. Thus allowing government to require offsets as a condition for permitting private actions empowers it to extract most of their surplus value.

On one interpretation, *Nollan* solves this problem by forbidding offsets. A better solution is to prohibit offsets except when the property owner is also given the opportunity to mitigate. By this rule, the owner has the option to act and mitigate, yielding a payoff of 700 to the owner and -50 to the public. By cooperating with each other, the owner can act and offset, which yields 750 to the owner and 100 to the public. Both parties benefit from cooperation, which shows that the rule of “offsets-permitted, mitigation-by-right” is Pareto superior to the rule “offsets-forbidden.”

IV. Conclusion

The courts must monitor bargains between citizens and the state partly to protect the rights of citizens. Instead of focusing on outcomes, courts should focus on threat points. The property owners should have the power to preserve the value of their property without agreeing to a bargain with the state. Starting from this threat position,

the property owner and the state may bargain to an agreement that benefits the private party and the public, in which case the courts should enforce the agreement. Specifically, courts should enforce agreements by property owners to donate resources in exchange for development permits, provided the private owners have the right to develop property with full mitigation of the resulting harm to the public.