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Bargaining with the State

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Heuristically, I think it would favor a regime based on unemployment benefits because at the margin firms extract the entire marginal return to capital. In contrast, under an institutional arrangement that guarantees workers a fraction of the surplus, an investor's return is smaller than optimal. As a result, I would expect that firms underinvest. Secondly, the model would need to include a dynamic consideration, in particular, because many labor regulations hinder efficient adjustments of the labor force. Both extensions go beyond this simple note and are left for future research.

References

Nash, F. (1953): Two Person Cooperative Games, Econometrica, 21, pp. 128-140

BARGAINING WITH THE STATE: OFFSETS AND MITIGATION IN DEVELOPING LAND

Robert Cooter*

A. Introduction

B. Nollan v. California Coastal Commission
C. Mitigate or Offset?
D. Hypothetical Example: Stylizing Nollan

A. Introduction

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.

B. 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) meets ecology,¹ almost any restriction can be justified as controlling an externality. In such cases, property owners often bargain with 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

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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.*

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.

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

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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. Hence, 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 compromising, 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 foreign banks to operate in the state, but the states 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.


D. 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.

<table>
<thead>
<tr>
<th></th>
<th>act (build house)</th>
<th>don't act (don't build house)</th>
</tr>
</thead>
<tbody>
<tr>
<td>property owner</td>
<td>+1,000</td>
<td>0</td>
</tr>
<tr>
<td>public commission</td>
<td>-300</td>
<td>0</td>
</tr>
</tbody>
</table>

Figure 2: Value of Alternative Acts in Nollan

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 (1,000 - 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).

<table>
<thead>
<tr>
<th>Private Property Owner</th>
<th>redesign house (mitigate)</th>
<th>path along beach (offset)</th>
</tr>
</thead>
<tbody>
<tr>
<td>property owner</td>
<td>-300</td>
<td>-250</td>
</tr>
<tr>
<td>public commission</td>
<td>+250</td>
<td>+400</td>
</tr>
</tbody>
</table>

Figure 3: Cost of Mitigation and Offset in Nollan

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.
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.”

### E. 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.

### References

