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BOOK REVIEW

PROPERTY, COMPENSATION AND RISK

Property Rights and Compensation: Compulsory Acquisition and Other Losses. By Jack L. Knetsch. Published in the *Studies in Law and Economics* series. Toronto: Butterworths. 1983.

*Reviewed by John P. Palmer**

Traditionally, nearly all economic analysis of law has used as a starting point a concept which has come to be known as "the Coase Theorem."[1] The importance of the theorem's conclusions and assumptions becomes very clear as one works through the arguments in Jack Knetsch's penetrating study, *Property Rights and Compensation: Compulsory Acquisition and Other Losses*. The other key concept in economic analysis of law is the determination of which party or parties in society can bear certain risks at the lowest cost. While Knetsch does a very good job at applying the Coase theorem to problems of eminent domain, his analysis of risk and efficient risk-bearing is less satisfactory. This discussion of Knetsch's work begins with a review of the Coase theorem and its extensions, and then follows through with a discussion of the costs of risks. A concluding section treats the purported dilemma of trading off equity for efficiency.

Although Coase does not formally state his theorem in his classic article, restatements abound in other literature.[2] Before providing one of these restatements, let me first indicate that the importance of the Coase theorem lies not so much in its conclusion as in the analysis of what happens if its assumptions are not satisfied.

According to the Coase theorem: (1) if transactions costs (broadly defined) are negligible, (2) if markets are reasonably competitive, (3) if wealth effects are negligible, and (4) if property rights are well-defined, then resources will be allocated efficiently regardless of who owns the property rights.

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[1] Coase, *The Problem of Social Cost* (1960), 3 J. Law & Econ.1

[2] See *e.g.* Posner, *Economic Analysis of Law* (2nd ed., 1977); Polinsky, *An Introduction to Law and Economics* (1983); and many of the journals which now deal exclusively with law and economics, such as *The Journal of Law and Economics*, *The Journal of Legal Studies*, or *Research in Law and Economics*.

To those unversed in the economic analysis of law, this theorem may seem either obfuscated in economic jargon or trivial. Both perceptions are correct. Loosely interpreted, it says that if people can be made better off by making a deal with each other they will probably do so. This result is not at all surprising, and in fact forms the basis of most economic theory.[3] The interesting and policy-relevant aspect of the theorem comes to light when we ask, 'under what conditions might otherwise mutually beneficial deals *not* be made?'[4]

The simplest answer to this question is 'whenever the assumptions of the Coase theorem are violated.' In particular, if the costs of making the deal outweigh the expected gains (that is if transactions costs are high), if entitlements are poorly defined, or if markets are seriously non-competitive, then some potentially beneficial deals will not be made.[5] Knetsch's discussion of the Coase theorem and the importance of its assumptions is superb, especially in Chapter 9 of his treatise.[6]

Extensions and applications of the results of and exceptions to the Coase theorem are now abundant.[7] Two of the earliest (and hence classic) developments were by Demsetz[8] and Calabresi and Melamed[9]. Both articles extend the analysis of Coase by examining the more realistic situations in which transactions costs might seriously impede market transactions. Their analyses particularly emphasize the role of transactions costs in the development of different types of entitlements. Specifically, Calabresi and Melamed show that on efficiency grounds property rules are preferable if transactions costs are very high. Again, Knetsch makes effective use of examples and cases to illustrate these developments. A problem with Knetsch's treatment of this material is that his discussion of different types of costs is quite uneven. He elabo-

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[3] The careful reader will recognize that the Coase theorem is really not much different from the notions which motivated Adam Smith in his "invisible hand" pronouncements about the efficiency of laissez faire.

[4] The analysis of the conditions under which free-markets do not perform efficiently is probably best laid out in Bator, *The Anatomy of Market Failure* (1958), 72 Q. J. Econ. 351.

[5] The assumptions concerning wealth effects are of less interest for the ensuing discussion. They deal instead with which of many different possible efficient allocations would be the resultant one.

[6] One major exception to this praise of Knetsch's restatement is that, contrary to Coase, Knetsch has no qualms about attributing causation when social costs exist. Coase, in his discussion of *Bryant* v. *Lefever* [1878-1879] 4 C.P.D. 172, makes clear that it takes more than one economic agent to have the existence of a social cost. Attributing causation to one or the other is rarely more than a red herring since the important question is, 'who has the entitlement to do what?'

[7] *Supra*, note 2.

[8] Demsetz, *When Does the Rule of Liability Matter?* (1972), 1 J. Legal Stud.13

[9] Calabresi and Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral* (1972), 1 Harv. L. Rev. 1089.

rates with abundant clarity on the problems of strategic bargaining as a cost which impedes transactions. Unfortunately he pays considerably less attention to the measurement, administrative, and social costs of different incentive effects of alternative entitlement schemes. This underemphasis is created by, or possibly results from a bias in the author, which leads him both to underestimate the net benefits of most current compensation schemes and to overestimate the net benefits of the alternative schemes which he proposes.

A central theme of Knetsch's study is that by relying on market values, compensation schemes systematically undervalue the amount of compensation which should be paid to people who suffer losses. The counter-theme of this review is that the current schemes are generally better than any feasible alternative.

In Chapters Two through Five, Knetsch develops his theme. The major aspect of this theme is that people usually value their possessions at more than the fair market value. If a shirt sells for $25.00, only for a person undecided about buying that shirt is it worth only $25.00; others who buy shirts would presumably be willing to pay more than $25.00, although how much more is difficult if not impossible to determine. The difference between what a shirt is worth to me, that is, the most I would be willing to pay for it, and what it is worth on the market is what economists call consumer's surplus. Economists specifically, and policy makers generally, recognize that consumer's surplus is something of value to society and often devote considerable time and effort to estimating the expected changes in consumer's surplus resulting from policy changes when doing cost-benefit analyses.

Under most circumstances, the amount of consumer's surplus I receive from any given shirt is quite small; I would not be willing to pay much more for a specific shirt because there are so many other shirts available to choose from at the market price. If you 'cause' the loss of one of my shirts through perhaps negligence, contract breach, eminent domain, or theft, then you can probably compensate my loss fully by paying me the market price of the shirt. Either you or I, if you give me the money and pay for my shopping time and expenses, can replace that loss by paying the market price for a nearly identical shirt. I will then be just as well off as I was before the loss.[10] My lost consumer's surplus in this situation would be negligible because there are so many other shirts available on the market.

An important exception to this proposition might occur if the shirt

[10] It is important to emphasize that all transactions costs must also be compensated for if this argument is to be correct.

is unique, so that market replacement is difficult, costly, or impossible. In these situation, using market values to estimate my loss would be imperfect at best and probably too low. Examples might include:

1. The shirt was the one worn by a Prime Minister at his wedding and hence cannot be replaced on the market. Just trying to determine the market value of the single item would be quite costly.

2. The shirt was a gift to me from a special friend or relative. Even though there are thousands like it on the market, the sentimental value of the particular shirt given to me cannot be replaced simply by giving me a similar shirt.

3. The shirt is no longer being produced so I cannot replace it, but it yielded a great deal of consumer's surplus to me.

In each of these similar cases, the combination of the unique item and my consumer's surplus means that compensating me for my loss at market value (even if that were possible without cost) would probably not fully compensate me. This lost consumer's surplus, or idiosyncratic value,[11] is a real cost to society. As Knetsch points out, ignoring this cost in policy-making will lead to distorted resource allocation.

Knetsch often ignores or slides over too glibly, the important question of "distorted resource allocation relative to what standard." Often he refers to distortions relative to an idealized norm of perfect competition with full and costless information. The comparison of different policies against this pollyanna idealization is a fallacy which Demsetz has called the "nirvana fallacy."[12] In policy analysis, it is extremely important to compare feasible alternatives; it is not enough simply to point out that a particular policy creates a distortion relative to some impossible goal and to argue that it should therefore be changed. The cure may be worse than the disease.

In defence of Knetsch, he does not completely fall into the trap of dreaming impossible dreams. Instead, he more subtly and with little or no empirical support assumes away many of the costs of schemes which appeal to him and perhaps exaggerates the costs of schemes which do not. Not surprisingly, the result is that the schemes which Knetsch favours end up looking very good in comparison with the *status quo*, when in fact they involve other costs or distortions which he has not discussed very thoroughly. His assertions may be correct, but my own

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[11] This is the term used by Goetz and Scott to describe the same concept in *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach* (1977), 77 Colum. L. Rev. 544.

[12] "In practice, those who adopt the nirvana approach seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient." Demsetz, *Information and Efficiency: Another Viewpoint* (1969), 12 J. Law & Econ. 1.

ad hockery coupled with his uncharacteristic lack of empirical evidence leave me unconvinced that his recommendations are better than most current compensation schemes.

EVERYTHING IS OPTIMAL

A corollary extension to the analysis of the Coase theorem is that current policies are optimal. For this corollary to be useful all costs must be taken into consideration, including the costs of lobbying and forming new voter coalitions to change current policies, adjustment and transition costs, and transaction and negotiation costs. Tautologically, if the current policies were not optimal they would have been changed; the fact that they have not been changed strongly suggests that the costs of changing (when fully considered) are greater than the expected benefits. More precisely, a dynamic version of this argument holds that because there are costs of changing from one policy to another too rapidly, there is an optimal speed of adjustment. By analogous reasoning, we must be on the optimal adjustment path, for if the one we are on were not optimal, considering *all* costs, we would not be on it.[13]

Whether one finds this corollary and its dynamic extension appealing or not, it provides a valuable starting point for analyzing proposed policy changes, including those recommended by Knetsch. For example, in breach of contract cases, Goetz and Scott note that rarely, if ever, are damages awarded for lost idiosyncratic value, consumer's surplus. While acknowledging that such awards may be problematic, they suggest that allowing penalty clauses may help to alleviate this loss. Despite their recommendation and the fact that consumer's surplus is indeed lost at times due to contract breach, the proposal that penalty clauses be used to help the contracting parties insure themselves against this loss (or pay others to help bear the risk) has not typically been accepted. One possible reason for this particular evolution of public policy is that the sanctification of penalty clauses would create a positive and socially detrimental incentive for people to attempt to frustrate the carrying out of contractual obligations. Another possibility might involve societal proscriptions against certain types of gambling, which might be encouraged if penalty clauses were permitted. It is at least plausible that these costs (plus the costs of adjustment were a change to be made) more than offset the possible benefits of implementing penalty clauses to compensate for lost consumer's surplus.

[13] This more dynamic version of the corollary is at least hinted at in a mimeo by James Buchanan, *The Irrelevance of Transactions Costs*, Public Choice Center, George Mason University, 1983.

The risk that I might suffer a loss of consumer's surplus due to someone else's breach of contract is a risk which I must bear. I cannot use penalty clauses to induce my contracting partner to accept the risk; nor can I purchase insurance against such risk in the marketplace, as it would be extremely costly for an insurer to identify and assess the risk. Also there are fairly obvious problems associated with any attempts to measure the amount of my loss, should the breach materialize. Furthermore, if I can buy some insurance against the risk of loss of some elusive consumer's surplus, I may have an incentive to purchase large amounts of the insurance and then devote considerable resources to frustrating the performance of the contract. This problem is commonly referred to as that of moral hazard.

To continue the example of contract breach, we always face a risk of lost consumer's surplus due to the breach. This risk is undesirable, and society would be better off if such risks could be reduced or removed without cost. The problem is that it is costly to reduce these risks, and virtually impossible (that is, of nearly infinite cost) to remove them. Consequently, someone must bear them. Generally, if someone can bear risks more efficiently or at a lower cost than others, that person gets paid to do so through the insurance markets. That such insurance markets have not evolved for lost consumer's surplus suggests that the person receiving the consumer's surplus is in all likelihood the least-cost bearer of this risk.

Consider, now, a different example. Suppose a person has purchased a house for \$100,000 even though she would have been willing to pay up to \$125,000 for the house.[14] By paying only the market price for the house, she received \$25,000 in consumer's surplus. If the house were to be destroyed by fire, she would lose an asset worth \$125,000 to her and yet worth only \$100,000 on the market. We are all aware of this risk of potential lost consumer's surplus; nevertheless, there are no mechanisms available for her to pay someone else to bear the risk. She would be unable to purchase insurance for her risk of loss of consumer's surplus. Possible suppliers of insurance would be reluctant to insure an unmeasurable loss; and they would balk at the idea of creating a large incentive for her to practice arson on her own house. Even if she had a legitimate desire for such insurance, others who might have fewer scruples would be induced to purchase large insurance contracts for alleged losses of consumer's surplus and then burn their houses intentionally. Social losses in the form of writing such insurance con-

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[14] There is, of course, no way for anyone to know this.

tracts, setting the fires surreptitiously, attempting to detect the arson, collecting evidence, punishing the arsonists, and generally deterring such undesirable activities may well be greater than the dollar value of the lost consumer's surplus. In fact it probably is greater or, according to the 'everything is optimal' corollary of the Coase theorem, people would have been willing to pay insurance companies enough to entice them to cover all of these additional costs and to offer such insurance policies. Consequently, it is likely that house-owners are the least-cost bearers of the risk of lost consumer's surplus.

Do these same problems apply for problems of compulsory acquisition? In a general sense they do, but the specifics are sufficiently different to merit explanation. Suppose that this same person from the previous example also faces a risk that her house will be taken from her *via* a compulsory acquisition. As her house is worth $25,000 more to her than it is on the market, she faces, then, a risk of losing this consumer's surplus. Unlike the situation with a fire, she is unlikely to be able to have much of an impact on the probabilities that such a loss might occur; it would be much more difficult for her to surreptitiously cause a compulsory acquisition of her house than to cause a fire. Hence moral hazard would be unlikely to keep the private market from providing her with insurance against this loss. Instead, the private market does not provide such insurance because of the problem known as adverse selection. This problem reduces the potential profitability of certain types of insurance since primarily the bad risks are those who would wish to purchase it. In the case of lost consumer's surplus as a result of eminent domain, only those who are very likely to suffer from such a loss, namely high risk house owners, would purchase such insurance, especially if the premiums were the same for everyone. Similar premiums would be likely as risk-rating such insurance would be very costly for private insurers. They would have to remain well informed of all possible future exercises of eminent domain authority in order to do an adequate job of risk rating. Consequently, insurers would be forced to charge very high premiums to cover their payouts, so high in fact that there would be too little of the insurance demanded to justify offering it.

In a sense, then, Knetsch is correct in arguing that private markets break down and are unable to offer insurance against the risk of lost consumer's surplus. However it is important to keep in mind that they break down relative to an idealized norm. It is not at all clear that there is any feasible alternative to having house owners bear these risks themselves. Suppose compensation through some government scheme were offered to those people who lost consumer's surplus as a result of a compulsory acquisition. How would the appropriate amount to pay be determined? Not only would the administrative costs of measurement be very large, but there would also be a strong likelihood that the measures would create serious errors.

Even more seriously, any measurement scheme devised could create strong incentive effects which would alter the allocation of society's resources. Using rejected offers as evidence of a lower bound of consumer's surplus has some merit at first blush, but the incentives for prevarication which become readily apparent could create massive detection problems and costs for society. To continue our example, if evidence of the house owner's lost consumer's surplus were garnered from the fact that she had recently rejected an offer of $125,000 for her property, than others would have an incentive to bribe associates to offer large amounts for their property too, with the understanding that the offers would be rejected. Due to the potentially massive costs of such a scheme, it should not be surprising that house owners are now required to bear these risks themselves. When all costs are taken into consideration, it is the house owners who are the least-cost bearers of the risk of lost consumer's surplus.

Potential house owners, recognizing that they must bear such risks themselves, will reduce the amount they are willing to pay for a house. The amount of the reduction in their willingness to pay then, is a measure of the compensation they require to bear the risk themselves. In a sense, this reduction can be viewed as *ex ante* compensation for their risk bearing. Those potential purchasers who can bear such risks at the lowest cost will demand the smallest reductions in purchase price and will therefore be the most efficient owners of the property. To award them compensation after the compulsory acquisition would therefore be awarding them double compensation.[15]

EFFICIENCY AND EQUITY

To this point, the efficiency aspects of compensation schemes have been discussed to the exclusion of equity concerns. The two are not as easily separated as I may have unintentionally implied by this false dichotomy. It can easily be argued that in the end the two concerns are inextricably entwined.

Equity concerns typically have two aspects, both of which are also related to economic efficiency: (1) the first is a concern that people's

[15] Of course, the market price would eventually adjust upward if everyone were certain to receive compensation, and hence the amount of *ex ante* compensation would be reduced.

reasonable expectations about the future not be thwarted; with this first aspect, a policy is viewed as being unfair if it hurts people who had good reason to expect something different; (2) the second is a concern with redistributing society's wealth in a more nearly equal fashion.

The first aspect is congruent with long-run economic efficiency. If people's reasonable expectations are not satisfied, long term investment decisions will become more risky, more costly, and hence less likely. Society will be worse off.[16] It is in this sense that Posner argues that justice is equivalent to efficiency.[17]

The second aspect of equity relates to economic efficiency in a different way. Programmes designed to redistribute society's wealth must be based on some sort of criteria that determines who is to receive the fruits of the scheme. These criteria, whatever they may be, create incentives for people to redirect their efforts and to reallocate society's resources. Consequently, even though a policy may be proposed on the basis of some desire to equalize wealth distribution, it will also have efficiency effects which could, in some instances, be quite large.

Furthermore, arguments in favour of particular policies on distributional grounds have an interesting way of being misleading at best. In the case of compensation for lost consumer's surplus due to eminent domain, it is not that the wealthy would not benefit more than the poor. If there is a positive relationship between a person's wealth and the amount paid for a house, as seems plausible, then awarding compensation for lost consumer's surplus would indeed redistribute wealth, but to the rich, rather than the poor. Perhaps this result provides an additional explanation as to why we do not award such compensation. More generally, it is with some skepticism that one views such arguments since they often represent carefully disguised pleadings for special interest groups.

It must be clear by now that there are theoretical problems with the policy implications which Knetsch tries to draw from his work. Nevertheless, his study is very exciting and provocative. It is extremely unfortunate that the book itself is so expensive, because it would make an excellent basis for much discussion by students of both economics and law. The organization of the material and the presentation of the legal and economic problems is superb. Every page stimulates one to ponder issues which are at the frontiers of the disciplines. One hopes

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[16] This notion of justice is consistent with economic efficiency explanations of the evolution of the rule of *stare decisis.*

[17] I have no desire to enter the fray. Interested readers may wish to consult Posner, *The Economics of Justice* (1982) and the references contained therein.

that the fair-use exemptions or defences in copyright law will be exercised often for this book.