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# PART II:

## OTHER PERSPECTIVES ON LEGAL REFORM



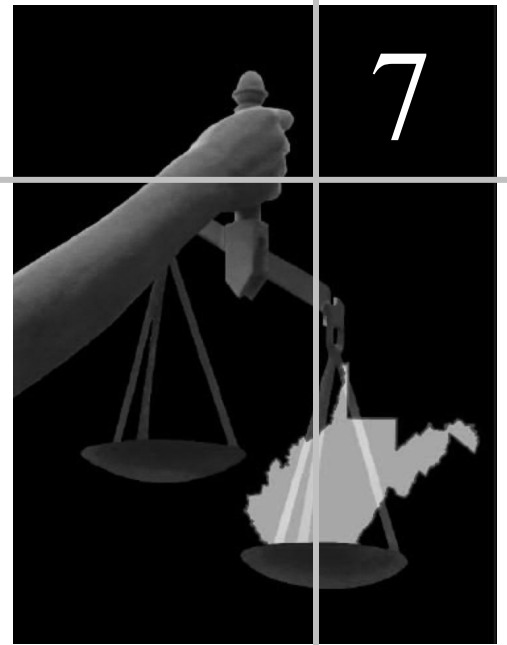


# CHAPTER 7

## THE LAW AND ECONOMICS OF PROPERTY AND CONTRACT

*by Edward J. López*

**The Rule of Law**





# 7

## THE LAW AND ECONOMICS OF PROPERTY AND CONTRACT

*Edward J. López*

A running theme in this book is that there are clear opportunities to enhance the judicial and legal systems in West Virginia to make them more conducive to economic growth and prosperity. This chapter points to some of these opportunities in the state's legal rules of property and contract. The upshot is that West Virginia can, and should, do a better job upholding the rule of law in these areas. Doing so will give consumers and businesses greater predictability and stronger incentives to make the everyday decisions that lead to economic growth and rising standards of living for all West Virginians.

The scholarly foundation for this chapter is the economics sub-discipline known as "law and economics." Nobel prize-winning economist, Ronald Coase, pioneered this field with the idea that legal rulings and regulations act like implicit prices on people's behavior. Friedrich Hayek, who won the Nobel Prize a generation earlier, also pioneered the economic analysis of the law. Hayek focused on the legal system as a set of rules that must be predictable and equally applicable to everyone in society, so that people have the opportunities to make future-oriented economic plans. The message of this chapter draws directly on the best theory and evidence available from the field of law and economics.

West Virginia ranks poorly in indices of the state's business climate and quality of the legal system, and its living standards suffer compared to other states as a result. By using the tools found in the field of law and economics, and drawing on the connection between economic growth and the rule of law, this chapter will explain how these troubling trends are related, and how West Virginia policymakers can remedy the problem by changing legal rules to improve the incentives, or implicit prices, generated by West Virginia's legal system.

### **THE RULE OF LAW**

The rule of law is a broad concept that describes circumstances under which a society is governed not by *people*, but instead by established *rules* of interaction. Without stable rules

that apply equally and predictably to all people, it is too easy for people in government to exercise their powers in arbitrary and capricious ways. The American Revolutionaries, for example, threw off the government of George III “[f]or abolishing the free system of English laws” and “establishing therein an arbitrary government.”<sup>1</sup> In its place, the American Framers set up a government based on the rule of law.

The “law,” in this context, is that body of rules and procedures that apply impartially and predictably to all people in society including (and perhaps *especially*) to government officials. When the decisions of government officials are held subject to predetermined rules, citizens in the society have a greater degree of certainty in their rights and freedoms. As Thomas Paine wrote in 1776, “[f]or as in absolute governments the King is law, so in free countries, the law ought to be King, and there ought to be no other.”<sup>2</sup>

In countries where the “law is king,” people are generally free from arbitrary and capricious acts by government officials. This makes people more able to predictably save, invest and make other sorts of long-term economic decisions that promote sustained economic growth and rising prosperity. In short, under the rule of law, government is a *protector* of rights, and that leads to a more industrious and prosperous society.

In economics, the rule of law supports capitalism first and foremost by protecting private property and enforcing contracts. When these economic institutions prevail, people’s rights are more secure and predictable so it is easier for people to make economic plans that build for the future. In addition to saving and investment, other key decisions supported by property and contract include research and development, improvements to property, going to college and graduate school, forming partnerships and long-term supplier contracts, and borrowing and lending in capital markets. These innumerable every-day decisions add up to good outcomes: efficient use of resources, rising living standards, growing tax bases, and generally increasing prosperity.

However, without the rule of law economic stagnation will prevail because people lack certainty that they will retain the fruits of their labor. There is constant fear of expropriation by government officials or other private individuals through lawsuits and theft. Richard Posner, a federal judge and leading scholar of the law and economics field, writes in his classic treatise on law and economics, “the absence of legally enforceable rights would bias investment toward economic activities that could be completed in a short time; and this would reduce efficiency” (Posner 1992, p.90). The rule of law makes economic life more predictable and helps to avoid these unhappy effects.

In short, the field of law and economics helps explain how property, contract and sound legal rules support economic success. This chapter will discuss the mechanisms by which the rule of law supports the market institutions of property and contract, which in turn is why the rule of law is necessary to economic success. In fact, the available evidence points to one conclusion: without the rule of law, societies fare much worse on a number of economic indicators.

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<sup>1</sup> The Declaration of Independence.

<sup>2</sup> Thomas Paine, *The Writings of Thomas Paine*, Collected and Edited by Moncure Daniel Conway (New York: G.P. Putnam’s Sons, 1894). Vol. 1. Accessed from <http://oll.libertyfund.org/title/343> on 2008-10-28.

## MEASURING THE RULE OF LAW

What are the basic legal principles that embody the rule of law, and are these principles amenable to empirical measurement? The American Bar Association breaks down the rule of law into four attributes.

1. The government and its officials and agents are accountable under the law.
  2. The laws are clear, publicized, stable and fair, and protect fundamental rights, including the security of persons and property.
  3. The process by which the laws are enacted, administered and enforced is accessible, fair and efficient.
  4. The laws are upheld, and access to justice is provided, by competent, independent, and ethical law enforcement officials, attorneys or representatives, and judges who are of sufficient number, have adequate resources, and reflect the makeup of the communities they serve.
- World Justice Project<sup>3</sup>

Several strands of research in empirical law and economics have developed methods to measure the legal principles that embody the rule of law. Most of this work focuses on the predictability of future-oriented economic decisions—for example, how secure business investment is from political manipulation. Researchers gather statistical and survey data on a broad range of factors that affect the political risks surrounding a number of economic activities. With these data in hand, researchers are able to calculate indexes to compare how well countries uphold the rule of law.

Figure 7.1 shows the top 15 and bottom 15 countries on the 2008 *Global Competitiveness Report (GCR)*, one of the leading international rule of law indices. Some countries—like the United States, Finland, South Korea, and Japan—have very low risk because they have relatively strong rules of law. But a large number of countries—such as Bolivia, Nepal, and Uganda—have earned reputations as confiscatory states. Not surprisingly, these economies rank very low in the rule of law index.

Countries that dismantle the rule of law find it difficult to promote business investment, so their economies become plagued by stagnation and their people begin to suffer declining living standards. The authors of the *Global Competitiveness Report* explain why.

Owners of land, corporate shares, and even intellectual property are unwilling to invest in the improvement and upkeep of their property if their rights as owners are insecure. Of equal importance, if property cannot be bought and sold with the confidence that the authorities will endorse the transaction, the market itself will fail to generate dynamic growth.

*Global Competitiveness Report* 2008-2009, p.4.

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<sup>3</sup>Verbatim from the “Rule of Law Index,” World Justice Project, American Bar Association, <http://www.worldjusticeproject.org/rule-of-law-index/>, accessed November 1, 2008.

Figure 7.1: Global Competitiveness Index for Select Countries, 2008

Top 15 Countries			Bottom 15 Countries		
Name	Rank	Score	Name	Rank	Score
United States	1	5.74	Nicaragua	120	3.41
Switzerland	2	5.61	Ethiopia	121	3.41
Denmark	3	5.58	Kyrgyz Republic	122	3.40
Sweden	4	5.53	Lesotho	123	3.40
Singapore	5	5.53	Paraguay	124	3.40
Finland	6	5.50	Madagascar	125	3.38
Germany	7	5.46	Nepal	126	3.37
Netherlands	8	5.41	Burkina Faso	127	3.36
Japan	9	5.38	Uganda	128	3.35
Canada	10	5.37	Timor-Leste	129	3.15
Hong Kong SAR	11	5.33	Mozambique	130	3.15
United Kingdom	12	5.30	Mauritania	131	3.14
Korea, Rep.	13	5.28	Burundi	132	2.98
Austria	14	5.23	Zimbabwe	133	2.88
Norway	15	5.22	Chad	134	2.85

Source: World Economic Forum, *Global Competitiveness Report*, 2008-2009, [www.weforum.org](http://www.weforum.org).

There is a large body of empirical research by independent scholars to corroborate the claim that the rule of law and economic growth are directly correlated. A seminal paper in the 1988 *Journal of Political Economy*, for example, shows that economic growth between 1960 and 1980 was three times faster in countries that securely enforced rights to private property and contract (Scully 1988). A large number of subsequent studies have studied this initial finding and extended it to a broader set of countries and more recent data.<sup>4</sup> Naturally many of these studies differ on important points, yet the overarching message is clear. As discussed by Richard Posner, “there is empirical evidence showing that the rule of law does contribute to a nation’s wealth and its rate of economic growth.” (Posner 1998, p. 3). In short, legal institutions that protect fundamental rights to property and contract under the rule of law are a *necessary groundwork* to be able to achieve economic growth and rising prosperity.

## CUES FROM LAW AND ECONOMICS

The same forces that connect economic growth to the rule of law internationally are also at work in the U.S. states. Those states with the best legal systems tend to economically outperform those with worse legal systems (see Chapter 4). Improvements to West Virginia’s legal institutions, therefore, are a route to increased economic prosperity for the state.

<sup>4</sup> For a more complete list of studies that support the claim that greater rule of law leads to greater economic prosperity, see the *Economic Freedom of the World* report, available at <http://www.freetheworld.com/papers.html>, accessed November 1, 2008.

The most fundamental point of law and economics is that legal rules and regulations act like implicit prices on people's behavior. We know from basic economics, as well as from our own experience, that consumer demand goes down when prices increase for things like gasoline and new washer/dryer sets. Law and economics says that people follow similar thought processes when evaluating the legal implications of their decisions.

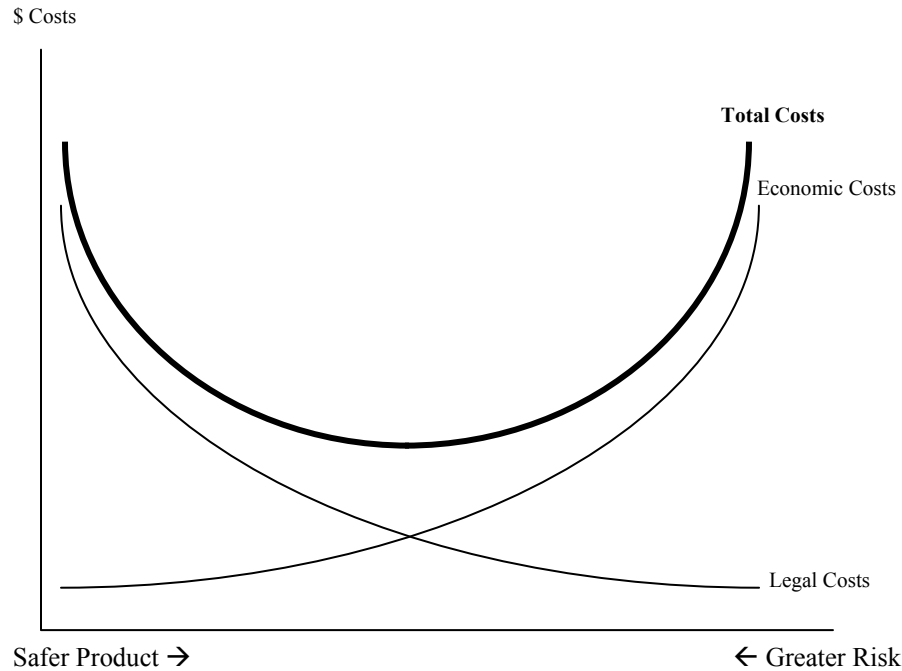
A classic example is how law and economics construes the total cost of doing business. A business firm must incur economic costs in its production and related operations—the payments to land, labor, capital, and entrepreneurship. A business firm also incurs legal costs, which get counted among the firm's "transaction costs," as they are known in law and economics (transaction costs measure the value of resources that get used in the process of forming agreements about how to use resources). Court decisions and other legal rules can influence the firm's transaction costs, and in doing so the law can alter business decisions. The question is, will the legal system encourage beneficial or harmful business decisions? The answer depends on the choice of legal rule and how it is enforced because these together determine which incentives the legal system will embody.

Economic costs of doing business tend to increase as a firm does more to decrease its legal costs. Suppose the "XYZ Drug Company" sells a medicine that helps adults who have some ailment but is harmful to children. The company knows that a fraction of its buyers will accidentally let children consume the product. Now there are options for reducing the product's risk to children, but some of these options can be very costly. A very simple step might be to install a child-proof bottle cap, but suppose the latest studies show that some fraction of children will be exposed anyway. The company could also sponsor a mass media campaign to educate buyers, but this will be very costly and still a few people won't get the message. Suppose, however, that the firm could buy a Super Bowl commercial to make certain that everyone gets the message and the firm's risk essentially disappears.

Figure 7.2 captures the interplay among a firm's economic, legal and total costs of doing business. As just described, with safer products come greater economic costs but lower legal costs. The vertical sum of these two costs is depicted in bold by the Total Costs line. The model shows why it is highly costly to make products that are either extremely dangerous or extremely safe. All other things equal, the drug company will choose some moderate risk level. If it can continue to produce and sell the medicine at the chosen risk level without losing money, then society is better off because people benefit from the treatment value of the medicine and the company earns a profit.

The Legal Cost curve in Figure 7.2 shows how legal rules can act like implicit prices on behavior. Suppose a child ingests some of the medicine despite the firm's efforts to achieve moderate risk reduction. Now suppose that a jury awards damages that greatly exceed the norm. In the model of Figure 7.2, the Legal Costs curve would shift upward, which would increase the firm's Total Costs even though its Economic Costs don't move. In this new scenario, it now makes sense for the firm to make a safer product. If it still makes the product at all. With greater total costs the firm may find that it can no longer operate without incurring losses in this market.

Figure 7.2  
Economic, Legal, and Total Costs of Doing Business



The example illustrates how the legal and regulatory rules chosen by states are significant factors in promoting economic activity that is socially beneficial. It is also important to point out that this is only a model. It does not suggest that business entrepreneurs sit down with economic graphs to decide how much risk to undertake. Likewise, there is no exact tool that policymakers can use to get the legal rules just right. That is partly because legal rules do not fully take shape in single strokes. Rather, in the form of government constructed by the American framers, a state's legal rules are written by the legislature, enforced by the state's executive branch, and interpreted by the judiciary. That is why it is the role of every government office to uphold the rule of law.

## INSTILLING GOOD INCENTIVES

An efficient legal system would harbor good incentives, making it in people's interests to make decisions that wind up promoting the public interest. In many ways the common law promotes efficient outcomes. In property law, for example, sellers are urged to scrutinize forms of payment and thereby deter fraud. In contracts, efficient enforcement doctrines accommodate uncontrollable changes of circumstances in ways that minimize the waste of valuable resources. Yet too many well intentioned policies interfere with the individual decisions that make these areas of the law work efficiently to begin with. In the following sections, we will discuss how West Virginia has opportunities in property and contract law to increase the rule of law and thereby create a climate of growth for the economy.

But first, how does property law urge sellers to decrease fraud? Suppose you agree to sell your car to a man over the phone. When he arrives the next day, he claims to have only a personal check for payment. You are tired, and you need the money. What's more, you haven't gotten many calls on the car. Should you take the check?

Your better judgment would probably say no, and the common law precedent on such a case sees things the same. The high court of Mississippi ruled on the case, which was brought by the seller to recover the fraudulently purchased car. The car had exchanged hands several times before ending up on a used car lot, from which the respondents in the case purchased the car. The court reasoned that "while the ... rule may seem harsh, it is in line with the purposes of the [law], to promote commerce and business..."<sup>5</sup>

The direct incentive effect of the Mississippi decision is to motivate people to be cautious about acceptable forms of payment. But the ruling embodies a deeper beneficial incentive as well. The decision reinforces the rule of law because judges do not have discretion to award similarly defrauded sellers on a case by case basis. This increases the security of buyers' property rights and therefore promotes exchange and the flow of resources to higher valued uses. The rule, in this instance, simply applies equally and impartially to all persons in society. Judges are not empowered under this rule to choose winners and losers after the fact. As alluded to by the court, the stability of this rule gives buyers a greater sense of security when acquiring title to purchased property.

A similar incentive effect is found in the doctrine of contributory negligence (and its modern counterpart, comparative negligence). This doctrine motivates people to avoid accidents that damage property, while punishing would be opportunists through doctrines such as last chance avoidance. Fewer accidents means there will be less waste of resources. By upholding the rule of law and promoting the flow of resources to their highest valued uses, the Mississippi ruling does the same thing.

## OPPORTUNITIES IN CONTRACT LAW

In the enforcement of contracts, there are direct opportunities for West Virginia to enhance the rule of law. Secure contract enforcement is vital to the complex types of exchange that occur in advanced economies.<sup>6</sup> Without contracts, exchanges would be limited to spot swaps, or between people who inherently trust each other. There would be very little division of labor, and economic activity would stagnate. But when strangers can agree to mutually beneficial terms that both sides believe will be enforced, then people can specialize according to their comparative advantages, which is elemental to productivity, economic growth, and rising living standards. Under the rule of law, contracts are enforced efficiently and that makes it in people's interests to behave in ways that serve the public interest. Unfortunately, West Virginia's rules and regulations fail in too many ways to uphold the rule of law in contract. This section presents ways in which West Virginia can improve the rule of law in contract and thus enhance the state's business climate.

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<sup>5</sup> *Paschal v. Hamilton*, 363 So. 2d 1360; 1978 Miss. Cole and Grossman (2005, p.93) provide further discussion.

<sup>6</sup> Posner's classic text in law and economics reads: "Thus the fundamental function of contract law (and recognized as such at least since Hobbes' day) is to deter people from behaving opportunistically toward their contracting parties, in order to encourage the optimal timing of economic activity and (the same point) obviate costly self-protective measures." *The Economic Analysis of Law*, Posner (1992, p.91).

When courts hear contract actions, the question is primarily whether to enforce or discharge the contract, and if enforced what remedies to assign. To make efficient rules, the courts must ask: “Will imposing liability create incentives for value-maximizing conduct in the future?” (Posner 1992, p.95). Again, legal rules help shape people’s incentives for future behavior. It is in the interests of the contracting parties, as well as in the interests of society, to reduce transaction costs. Contracting parties cannot prepare for all possible contingencies, and choosing not to specify even foreseeable contingencies can be a way to economize on transaction costs. Thus, it is inevitable that unforeseen, or unprepared for, contingencies arise for a third party to enforce. When doing so it is efficient for the courts to assign liability to the least cost avoider of the contingency, as this is how the parties would have done so had they assigned the risk when forming the contract.

Common law precedent harbors many examples in which it is efficient for courts to enforce performance, even after contingencies disadvantage one of the parties. Suppose, for example, that Dan in Dubai promises to ship Harry in Hamburg 30 tons of African spices for \$500 per ton. Dan intends to ship via the Suez Canal, as all other shipping routes would be much more expensive. Unfortunately, geopolitical tensions escalate to the point of closing the Suez Canal. Dan breaches on the claim that performance has become impossible. Harry sues for specific performance. How should the court rule?

In the 1962 precedent for such as case, Britain’s highest court (the House of Lords) ruled in favor of Harry.<sup>7</sup> Since Dan and Harry did not specify that the Suez Canal would be the one and only shipping route, the canal’s closure meant that, in a legal sense, other shipping routes would be, and in fact were, possible. Hence, legally Dan is obligated to find one. Furthermore, there was no evidence that an alternative route would have ruined Dan financially. So the contingency made Dan lose some money relative to his expectations at the time of forming the contract, but the contingency didn’t make Dan’s performance impossible.

In other cases, performance is genuinely impossible but the efficient ruling is for the courts to enforce the contract through compensatory damage awards. Suppose I promise to send you 1,000 bottles of wine from my California winery in two weeks. One week later, my winery burns to the ground and I cannot acquire replacement wine in time to fulfill the contract. In this case, while it may be genuinely impossible for me to perform, that does not mean the contract should be discharged. Even if the fire could not be prevented, I could have insured against the regrettable event. Insurance simply replaces the risk of a major loss (my winery burning) with a much smaller but certain cost (the insurance premium). The court’s ruling, in order to be efficient, must take into account whichever cost is lower. If the premium is a lower cost than the expected loss, then the risk is *insurable*, and the court’s efficient ruling would be to assign liability on the party that is the lower cost insurer.

To see the same point in another way, imagine that you and I return to the point in time when we formed our agreement, only this time we decide to specify how to handle the risk of fire at my winery. If you routinely purchase wine shipments from hundreds of wineries, it may be cheaper for you to insure against the small probability that one of the wineries will catch fire. It is more likely that I will be the lower cost insurer, since I am on site and can easier calculate (and even reduce) the relevant risks. With me as the lower cost bearer of the risk, it would make sense for the contract to assign the risk to me, and the

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<sup>7</sup> *Tsakiroglou & Co. Ltd. v. Noble Thorl G.m.b.h*, House of Lords [1962], A.C. 93. Cole and Grossman (2005, p.175 ff.) offer detailed discussion.

contract would therefore include a form of insurance. Insurability is the economic rationale for assigning risks in contracts. And this is why most commercial contracts assign risks of various sorts to one of the parties, specifically the party that is the lower cost insurer.

Some contracts are clearly against the public interest and must be discharged in order for the courts to give good incentives for future behavior. Suppose, for example, that you own a restaurant and contract with the “Jim and Mary Wine Company” to supply you with California wines. Secretly, Jim agrees to send California wine labels to Mary, who agrees then to switch labels with cheap wines she acquires from New York. After shipment, you notice uneven bulges in the bottle labels and discover that someone has merely glued the fake labels over the originals. The law protects your interests, of course, and it may even punish the Jim and Mary Wine Company. But what if Jim were to sue Mary? After all, she broke her promise and Jim was harmed as a result. In the 1956 precedent for such a claim, the Supreme Court of New York threw out the conspiratorial contract, saying that it was “repugnant to public policy” and “plainly prejudicial to the public good.”<sup>8</sup> Refusing contracts is the law’s way of *not* giving people the incentives to act against the public interest.<sup>9</sup> In fact, the same court earlier held that “the only method by which the law can prevent such agreements from being made is to refuse to enforce them.”<sup>10</sup>

The unifying theme of the above examples is that the courts should enforce contracts to instill good incentives, so that future contracts work to promote the public interest. Courts ought to enforce contracts against insurable risks and assign liability on the least cost avoider of the breach. Resources are wasted when inefficient producers make goods and services at high cost, and resources are wasted when people bear risks when there are other people who are lower cost insurers. On the other hand, the courts should discharge contracts whose performance would waste resources when uninsurable contingencies arise. Thus, law and economics offers a set of analytical tools to enforce contracts efficiently, which upholds the rule of law and thereby promotes economic growth.

By contrast, in recent years West Virginia’s courts have ruled in novel ways relative to economically sound legal principles and common law precedent. In 2006, for example, the state Supreme Court of Appeals held that businesses without a physical presence in the state are subject to the state’s franchise and corporate income taxes.<sup>11</sup> The Court eschewed the traditional physical presence doctrine for meeting the “substantial nexus” language in the commerce clause of the U. S. Constitution. The Court instead fashioned its own test, the “significant economic presence” doctrine, which only two other states’ courts had used (see Chapter 8). In doing so, the ruling arguably departed from common law precedent.<sup>12</sup>

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<sup>8</sup> *Mittenberg and Sampton, Inc. v. Mallor*, 1 A.D.2d 458; 151 N.Y.S.2d 748 (1956).

<sup>9</sup> Besides fraud, other doctrines of contract refusal include incompetence, unconscionable terms, duress, and uncontrollable circumstances such as *force majeure*. In each of these situations, resources would be wasted if the contract were enforced even in light of the performance or formation problems. Courts refuse such contracts because their enforcement would only give people bad incentives and undermine the public interest.

<sup>10</sup> *Coverly v. Terminal Warehouse Co.* 85 A.D. 488; 83 N.Y.S. 369 (1903).

<sup>11</sup> *Tax Commissioner of State v. MBNA America Bank, N.A.*, 220 W.Va. 163, 640 S.E.2d 226 (2006).

<sup>12</sup> The dissenting opinion of Justice Brent Benjamin reads: “There is no precedential support whatsoever for the conclusions reached by the majority decision. None. None at the state level. None at the federal level. Ignoring that our consideration here should be the effect of the tax in question on interstate commerce, rather than the type of tax it is, none of the rhetoric raised by the majority opinion explains why a state’s imposition of a tax on an out-of-state corporation with no presence, tangible or intangible, on income realized from an out-of-state account does not adversely affect the nation’s interstate commerce, an analysis identified by the United States Supreme Court as the cornerstone of constitutional jurisprudence. *Id.*; *Allied-Signal, Inc. v. Director, Div. of*

In 2007, West Virginia's courts continued to rule in exceptional ways, and West Virginia became home to three of the top seven verdicts across the nation that year. Large damage awards do not alone or necessarily perturb the rule of law, but unexpectedly high verdicts, which depart from the norm in significant ways, increase uncertainty of the state's business climate. Unexpectedly high damage awards make the legal costs of doing business less predictable. In Figure 7.1, for instance, firms cannot predictably estimate the position of the legal costs curve. Firms may instead estimate a high enough probability that their legal costs will be extremely high. When businesses cannot discern the rules of the game, they may just as soon decide not to do business in the state.

In addition to their high dollar amounts, the 2007 verdicts were noteworthy for their use of *punitive* damages in contract actions. This is yet another departure from the norms of legal precedent and the principles that uphold the rule of law. In the absence of evidence to the contrary, the law should assume that parties enter contracts in good faith and in the expectation of mutual gain. As Judge Posner writes in his classic treatise on law and economics: "Good faith performance...is an implied term of every contract" (Posner 1992, p.91). Thus, the common law norm is that contract remedies are intended to compensate, not punish, and therefore punitive damages are generally not awarded in contract actions. By departing from this norm, the Court again undermines the rule of law, making the business climate less predictable, and discouraging the very economic activity that creates growth and a more prosperous people.

## OPPORTUNITIES IN PROPERTY LAW

West Virginia law imparts very strong powers of eminent domain to local governments, in particular for purposes of economic development.<sup>13</sup> Yet law and economics provides the important lesson that security in property rights is elemental to economic growth. With the specter of condemnation hanging over property owners' heads, they are less likely to invest in improving properties. Homes and businesses are less likely to be sold to new owners, thus hindering the flow of resources to higher valued uses. The reason is clear: by undermining the rule of law, strong eminent domain powers and its erratic use make it hard to predict whether property investments will be recouped, or instead taken away as part of a public economic development plan.

The authority for West Virginia's broad takings powers originates in the state's legislative, executive, and judicial branches. The statutory code of West Virginia empowers

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*Taxation*, 504 U.S. 768, 112 S.Ct. 2251, 119 L.Ed.2d 533 (1992). The only state court decision on point with the specific credit card issues raised herein determined that the State of Tennessee exceeded its taxing jurisdiction in attempting to collect taxes from an out-of-state corporation on income generated by out-of-state credit accounts. *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927, 121 S.Ct. 305, 148 L.Ed.2d 245 (2005)." Available at <http://www.state.wv.us/WVSCA/docs/fall06/33049d.htm>. Accessed January 26, 2009.

<sup>13</sup> Certain local authorities in West Virginia can forcibly transfer ownership from one private party to another in order to support economic development. The law in all 50 states and the U.S. Constitution says that the takings power is reserved only for public uses and requires condemning authorities to pay just compensation to property owners. Like every other state, West Virginia acknowledges certain traditional functions as satisfying public use, such as common carriage rights of way, public buildings, recreation and conservation. But West Virginia is relatively aggressive in letting non-traditional functions count as public use. For further discussion of West Virginia's takings law, see the chapter by Lopez, Kerekes, and Johnson (2007) in *Unleashing Capitalism*. For analysis of takings law in the 50 states, see Lopez, Jewell, and Campbell (2009).

urban renewal authorities to acquire properties through eminent domain, but only in blighted areas.<sup>14</sup> But the rules of the game are rigged because the urban renewal authorities themselves determine which areas are blighted<sup>15</sup>, and the statute is very broad in defining the criteria that constitute blight.<sup>16</sup>

West Virginia's courts have upheld such condemnations by these local authorities. The legal precedent is a 1998 case between the Charleston Urban Renewal Authority (CURA) and the owner of a property being seized. The property itself was not blighted, but it was located within the contours of a zone that CURA had determined was a blighted area. In *CURA v. Courtland* (1998), West Virginia's Supreme Court ruled in favor of the government and this decision stands today.

To their credit, condemning authorities acknowledge the disruptive effects of using eminent domain to pursue public economic development plans. CURA's executive director, Pat Brown, said "we don't use it [eminent domain] very often, but we do use it. There is an extensive procedure, and we certainly don't want to abuse it."<sup>17</sup>

In reality, CURA's history is one of frequent and large-scale use of the takings power for economic development. From the 1960s through the middle of 2006, CURA condemned 523 properties for 47 development projects, 28 of which were private development projects.<sup>18</sup> Although CURA's condemnation rate has slowed in the past two decades, West Virginia is still a relatively aggressive user compared to other states. Since 1998, West Virginia ranks 19<sup>th</sup> in per capita properties condemned for private use.<sup>19</sup> CURA's property acquisitions have become so routine, the authority now performs many of the quotidian functions of a real estate company. "We do buy land that is blighted, if you will, and we also have property available for redevelopment. We usually put signs on our property. We get direct calls, referrals from the [Charleston Area] Alliance as well as the city, and we all work together."<sup>20</sup>

The power of eminent domain has a very long history in democratic government. Hugo Grotius, the 17<sup>th</sup> Century legal philosopher who coined the phrase, declared that the property of subjects is under the "supreme lordship" of the state, which can use and even alienate private property, but only for "public utility" and only if the state were to "make good" the loss to those who lose their property.<sup>21</sup> It is no surprise that Grotius cites the public use and just compensation requirements, since they go all the way to the Magna Carta

<sup>14</sup> Chapter 16 Article 18 Section 8 Paragraph (a) of the West Virginia Code reads: "An authority shall have the right to acquire by the exercise of the power of eminent domain...any real property which it may deem necessary for a redevelopment project or for its purposes under this article after the adoption by it of a resolution declaring that the acquisition of the real property described therein is necessary for such purposes."

<sup>15</sup> Chapter 16 Article 18 Section 8 Paragraph (b) of the West Virginia Code reads: "When an authority has found and determined by resolution that certain real property described therein is necessary for a redevelopment project or for its purposes under this article, the resolution shall be conclusive evidence that the acquisition of such real property is necessary for the purposes described therein."

<sup>16</sup> See Chapter 16 Article 18 Section 3 Paragraph (c) and (d) of the West Virginia Code. For more discussion, see Lopez, Kerekes, and Johnson (2007).

<sup>17</sup> Ann Ali, "Charleston's Past, Future Included in Redevelopment," WOWKTV.com, January 3, 2008, available online <http://wowktv.com/story.cfm?func=viewstory&storyid=33134&> accessed January 26, 2009.

<sup>18</sup> Anderson, Justin D. "Forced Property Sales Led to Many City Projects: Charleston Authority has bought 523 properties since 1960s," *Charleston Daily Mail*, May 15, 2006, p.1D.

<sup>19</sup> See López, Jewell and Campbell (2009) for a detailed comparative analysis of eminent domain use in the American states.

<sup>20</sup> Ali, *supra*.

<sup>21</sup> Hugo Grotius, *De Jure Belli et Pacis*, 1625.

(chapters 28 and 29, respectively). Throughout its history, eminent domain has been rightly considered to be a power of last resort, one that is inherently opposite to rule by consent of the governed. Thus it was with some justification that the U.S. Supreme Court referred to eminent domain as the “despotic power.”

It undermines the rule of law when authorities routinely use powers that are intended to be of last resort. Just like the law can set implicit prices on citizens, restrictions on takings power set implicit prices on the behavior of condemnation authorities. In the language of law and economics, West Virginia sets too low a price on the use of eminent domain for economic development. With broad takings powers, local authorities face bad incentives themselves. With bad incentives, their actions are not likely to serve the public interest. However well intentioned they may be, policymakers are put in bad positions when the law allows eminent domain to be used as an expedient to ensure that planners get their way.

Other states have taken meaningful steps to restore the rule of law against the threat of broad takings powers. According to new peer-reviewed studies on this topic, almost half the states have enacted new legislation that meaningfully restricts local authorities from over using eminent domain.<sup>22</sup> In addition, state courts are overturning earlier decisions in nearby states with similar economic challenges, such as Michigan, Ohio, and Oklahoma. West Virginia should take the lead in such beneficial movements. To seriously restore the rule of law in this area of property, West Virginia should enact legislation to restrict the definitions of public use and blight. The Supreme Court of Appeals should overturn *CURA v. Courtland*, and the powers of local authorities to condemn properties for private use should be curtailed. These changes to the law in West Virginia would increase the implicit price to local authorities of takings for non-public uses. Doing so will restore the rule of law in this important area, giving better incentives to both property owners and local developers, and putting their individual decisions in greater harmony with the public interest and a growing state economy.

## CONCLUSION

The rule of law makes economic life more predictable and helps to promote prosperity and rising living standards. Economic growth ultimately boils down to ordinary people making sound future-oriented decisions on everyday matters. For this process to work, people need good incentive structures and a reasonably predictable economic climate. Thus, it is the rightful place of the law to set the rules of the game and make economic life more predictable by protecting the security or rights to property and contract. By doing so, the legal system sets the right implicit prices for people to channel their own self-interested decisions into benefits for society. If we set good rules, people will have the right incentives to promote economic growth.

However, the law should not reward opportunistic behavior or set too low an implicit price on violating people’s property and contract rights. When the objective of a state’s legal system wrongly becomes to redistribute wealth, or change the winners and losers after the fact, this will distort people’s incentives and create an environment where people cannot

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<sup>22</sup> See recent work by Somin (2008), Morris (2008), and López, Jewell and Campbell (2009).

easily predict whether they will enjoy the benefits of their own good decisions. This severs the ties between the rule of law and economic growth. By ensuring sound and stable legal institutions, West Virginians will have the right incentives and a predictable environment for making the kinds of everyday decisions that lead to economic growth and a more prosperous West Virginia into the future.

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