

# Takings\*

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## Abstract

This paper investigates government takings' effect on entrepreneurship and the market process. We find that takings redirect the market process along new paths, generating "hidden" costs in the form of foregone entrepreneurial opportunities. Because standard cost-benefit calculations of takings usage can't capture these costs, takings impact analyses systematically understate the cost of takings.

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# 1 Introduction

Eminent domain is the state's power to confiscate private property for its own use without the owner's consent. The Fifth Amendment's "takings clause" grants the US federal government authority to use eminent domain provided the taking is for "public use" and the property's owner is "justly compensated." The Fourteenth Amendment extends this right to state and local governments

The logic behind granting government the power of eminent domain is that it will occasionally need large tracts of land for public projects such as highways, schools, parks, hospitals, and so on. Acquiring adjacent pieces of property may confront a holdout problem whereby a project is delayed by a small number of owners who refuse to sell their property to the government. Granting government the right to confiscate the property of holdouts overcomes this problem.<sup>1</sup>

The associated conditions of "public use" and "just compensation" aim to prevent political abuse by placing constraints on the government's eminent domain power. For instance, the condition that the confiscated property must be for public use is intended to limit government's ability to interfere with the market and the private actors' valuations. The public use requirement is supposed to prevent the state from using its coercive power to bypass the market and transfer property from one private owner to another. Likewise, the condition of just compensation, which requires government to pay the market rate for confiscated property, aims to prevent government from arbitrarily taking private property to finance state operations. If the government is required to pay the market price for the confiscated property, there can be no profit from takings.

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<sup>1</sup> For a critique of the "holdout problem," see Benson (2005).

The conditions of public use and just compensation are broad in nature and often pose significant difficulties in practice. For instance, what projects fall under the category of public use? Similarly, how is just compensation to be determined when market value will, almost inevitably, differ from how the owner values the property? Given the vagueness of these conditions, there's much room for interpretation by both governments and courts. Although the recent case of *Kelo v. City of New London*<sup>2</sup> has made the government's eminent domain power front-page news, the interpretation of the conditions associated with government takings has a long and controversial history (see Paul 1985).

For example, in the case of *Berman v. Parker*<sup>3</sup> the United States Supreme Court upheld the District of Columbia's right to seize and demolish properties that were partially blighted and replace them with a privately owned department store. In doing so the Court broadened the interpretation of public use to include redevelopment. In *Poletown Neighborhood Council v. City of Detroit*<sup>4</sup> the Michigan Supreme Court upheld the City of Detroit's right to use eminent domain to displace several thousand private residents for the construction of a General Motors factory. The justification for this was that the expected creation of jobs and associated economic benefit were for the public use. For decades state-level Supreme Courts have referenced the *Poletown* decision (including the Connecticut Supreme Court in *Kelo*) in deciding similar cases.

The issues associated with government takings become still murkier when one includes cases of regulatory takings. Regulatory takings refer to situations where government regulations severely reduce the value of a property such that it effectively involves government takings. Examples of these types of indirect takings include zoning laws and land-use regulations. In a 1987 decision the US Supreme Court held that regulation is the equivalent of a government

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<sup>2</sup> 125 S. Ct. 2655 (2005).

<sup>3</sup> 348 U.S. 26 (1954).

<sup>4</sup> 410 Mich. 616 (1981).

taking when regulation deprives the property owner of economically viable use of the property.<sup>5</sup> The central issue is determining when a regulation has sufficiently infringed upon property rights such that it amounts to government takings. Typically, to receive compensation the owner must demonstrate he has been deprived all value of the property or that he was required to dedicate part of his property to government use without a justifiable reason. In reality, most government regulations may reduce the value the property to its owners without reducing the value to zero. In these cases the owner bears the regulations' cost.

This paper investigates a subsidiary cost of government takings. We examine government takings' effect on entrepreneurship and the market process. We find that takings redirect the market process along new paths, generating "hidden" costs in the form of foregone entrepreneurial opportunities. Because standard cost-benefit calculations of takings usage can't capture these costs, takings impact analyses systematically understate the cost of takings.<sup>6</sup> We consider takings in the broadest sense to include both direct (i.e., eminent domain) and indirect (i.e., regulatory takings) government takings.

Our analysis' starting point is the basic premise that institutional context and the resulting "rules of the game" matter for economic outcomes. Property rights are a crucial aspect of the broader rules of the game.<sup>7</sup> By defining what belongs to whom under which circumstance, property rights provide individuals with dependable information and incentives. Well-defined

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<sup>5</sup> *First Lutheran Church v. Los Angeles County*, 482 U.S. 304 (1987). The courts' recognition that a statute or ordinance may impose restrictions on the use of property that are so burdensome that they amount to takings by the government can be traced back to *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922) (see, Fischel 1998).

<sup>6</sup> Benson (2004) considers the costs of forgone opportunities associated with government regulation in general.

<sup>7</sup> We recognize that rules facilitating economic interactions are only beneficial up to a point. Too few rules will lead to chaos and dysfunction, but too many rules can be stifling. For instance, Michael Heller (1998) has identified the "tragedy of the anticommons," whereby individuals collectively waste a resource by underutilizing it because too many individuals have the right of exclusion. Heller and Eisenberg (1998) apply this logic to biomedical research and conclude that competition over patent rights may prevent beneficial products from reaching market. While we recognize that rules have diminishing returns, it's not our purpose here to determine the "optimal" quantity of rules. Our focus is on exploring the impact of eminent domain on the entrepreneurial process.

property rights encourage individuals to use resources efficiently and give them incentives to innovate by discovering new resources, introducing new cost-cutting technologies, and developing human capital. Our analysis examines takings' effect on economic outcomes in this context.

## **2 The Market Process and the Perils of Intervention**

### **2.1 The Market Process**

The market is a dynamic process driven by entrepreneurs seeking profit (see Kirzner 1973, 1979a). Entrepreneurs serve the dual role of pushing the economy toward the production possibility frontier and shifting this frontier out (an increase in real output due to an increase in real productivity). In an institutional context characterized by well-defined property rights, and minimal government regulation, entrepreneurs' activities continually reallocate resources to their most highly valued uses. Further, productive entrepreneurial actions create new opportunities to produce more goods and services by introducing new or cost-cutting production techniques and technologies. Entrepreneurs are the central mechanism through which market inefficiencies are corrected. Market inefficiencies are never completely eradicated. But entrepreneurs are the most effective means of correcting existing errors (see Leeson, Coyne, and Boettke 2006).

Entrepreneurs lack perfect information and face constant uncertainty. Because of this uncertainty, competition acts "as a discovery procedure." As Hayek (2002, 9) puts it, competition is a "procedure for discovering facts which, if the procedure did not exist, would remain unknown or at least would not be used." The competitive market process affords market

participants the opportunity to act on existing knowledge and generate previously unknown knowledge in the pursuit of profit.<sup>8</sup>

The market process takes place within an institutional context. Institutions are the formal and informal rules governing human behavior and mechanisms of these rules' enforcement. Institutions can be informal, such as customs, or formal, such as codified laws. However, as binding constraints on human action, they govern human affairs for good or bad and, as they change, so do lines along which an economy develops.

Property rights provide entrepreneurs incentives to pursue a perceived profit opportunities, facilitating economic improvement. Property rights also play a central role in communicating information about the best of use resources to market participants. Ludwig von Mises (1920) emphasized that private property in the means of production are necessary for the emergence of market prices.<sup>9</sup> Market prices reflect relative scarcities and are the very result of entrepreneurial activity. At any point in time they reflect entrepreneurial discoveries that have been made until that point. Existing prices thus also reflect entrepreneurial errors and highlight profit opportunities. As the market process unfolds and entrepreneurial activities reallocate resources, prices adjust to reflect those changes.

## **2.2 The Perils of Government Intervention**

Government interventions aim to influence the outcome of the market process. For instance, price controls seek to influence the nature of the prices that the market process would generate

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<sup>8</sup> We use the terms interchangeably here. Though, on the important distinction between knowledge and information, see Boettke (2002).

<sup>9</sup> For an overview of the socialist calculation debate and the parallels with the issue of government intervention, see Kirzner (1979b, 121-129).

absent that intervention. Similarly, zoning laws, which are regulations that restrict the uses of land and buildings, are intended to constrain the outcomes generated in real estate markets.

Government interventions change the institutional context within which the market process operates and hence the rules of the game. These interventions distort the market process relative to what would have unfolded without them. As Israel Kirzner (1979b, 134-5) points out, “government controls constrain and constrict; they rearrange and repattern the structure of incentives; they redistribute incomes and wealth and sharply modify both the process of production and composition of consumption.”

Although interventions “redirect” the market process, they don’t eradicate that process or associated profit opportunities. Interventions alter the opportunities and incentives that entrepreneurs face. Entrepreneurs responding to new, intervention-created incentives shift their activities to take advantage of intervention-created profit opportunities. While the direction and magnitude of intervention-created distortions varies in each case, we can offer some general insights about intervention’s effect on the market process. Kirzner (1979b, 136-145) considers four ways intervention affects the market process. Notably, each is negative.

First, the use of intervention to correct market outcomes assumes the manipulated process will be superior to the unregulated future outcome of the market process. But this neglects that market process is just that, a process. Future states of the world (i.e., market outcomes) are unknown, which is why the market process is inherently one of continuous discovery. Intervention assumes a desired, or perhaps even a superior, outcome won’t emerge as the market process continues to unfold. This is especially significant since, as noted above, market inefficiencies provide incentives for future entrepreneurial action that corrects them.

Second, successful intervention assumes public officials have knowledge that in many, if not most cases, they couldn't possibly possess. *Ex ante*, how can regulators know the "right" levels of intervention needed to create the desired outcomes? *Ex post*, outside the feedback loop of profit and loss, how can regulators judge if earlier decisions were correct?<sup>10</sup> Intervention-created inefficiencies are likely to emerge and persist when government intervenes in the market because "nothing within the regulatory process seems able to simulate even remotely well the discovery process that is so integral to the unregulated market" (Kirzner 1979b, 141).

Third, intervention stifles entrepreneurial discovery. As Kirzner (1979b, 141) notes, "the most serious effect of government regulation on the market discovery process well might be the likelihood that regulation, in a variety of ways, may discourage, hamper, and even completely stifle the discovery process of the unregulated market." The nature and magnitude of this stifling depends on the specific intervention. For instance, some regulations may raise the cost of engaging in certain activities. Others may restrict competition and freedom of entry and exit.

Although its effects can't be observed, critically, intervention equally affects *undiscovered* entrepreneurial opportunities. It not only hampers the market for existing goods and services. Intervention hampers the very process by which previously nonexistent goods and services are discovered and thus come into being. Interventions often distort or constrain profit opportunities for productive activities that provide the incentive for the discovery of entirely new opportunities for profit from such activities. Because it's unobservable, this consequence of intervention is often ignored. It's possible to observe shortages or surpluses associated with price controls. But

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<sup>10</sup> This is a fundamentally different point than the "dynamics of intervention" criticism of government intervention which holds that one intervention will lead to a series of subsequent interventions (see Mises 1929 and Ikeda 1997). While this criticism is relevant, our point here is one regarding fundamental discovery. Regulators have no means of discovering the means of correcting inefficiencies in the market process.



it's not possible to similarly observe an opportunity for discovery that would have taken place absent government intervention but goes unrealized because of it.

Intervention's final important effect on the market process is that "whether intended by regulatory authorities or not and whether suspected by them or not, the imposition of regulatory restraints and requirements tends to create entirely new, and not necessarily desirable opportunities for entrepreneurial discovery" (Kirzner 1979b, 144). Interventions alter the pattern of profit opportunities the full effects of which can't be known in advance by regulators designing and implementing interventions. By altering the pattern of profit opportunities, intervention may not only stifle productive entrepreneurial activities. It may create opportunities for unproductive activities. Such activities include crime, rent seeking, and violent conflict (Baumol 1990; Boettke and Coyne 2003; Coyne and Leeson 2004). Entrepreneurs earn profits through these activities, but these activities don't push the economy toward the production possibility frontier of move it out as productive, profit-generating entrepreneurial activities do.

### **3 The Perils of Takings**

William Minnich and his nephew Bill Minnich own Minic Custom Woodwork, a small family business that's over 75 years old. In 1981 they bought a run-down building in East Harlem to relocate their business. Besides buying the building, the Minnichs invested more than \$250,000 in renovating it. All was going well with the business until William read in the *New York Times* that the Empire State Development Corporation (ESDC)—a public authority of the State of New York that finances and operates state projects—planned to redevelop the East Harlem area. On closer inspection of the map associated with this project, Minnich realized the area for redevelopment included his building. The government planned to use eminent domain to seize

the property and sell it to the Blumenfeld Development Corporation to build a Home Depot, Costco, and other retail stores. The justification for this taking was that the transfer of property would be a net benefit to the community in terms of jobs and tax revenue (Berliner 2003, 145-146; Carney 2006, 91-96).

Much of the maneuvering between the ESDC and the Blumenfeld Development Corporation took place behind closed doors, preventing the Minnichs from mounting a defense of their property until it was too late. This opacity became clear when the New York Supreme Court dismissed Minnich's lawsuit to prevent the project because they missed the 30-day period to appeal based on a previous notice of "determination and findings" that authorized the confiscation of their property at some future time. The problem, William Minnich claimed, was that he never knew the project had been officially approved and therefore was unaware that the 30-day period had begun. A federal court confirmed this decision and, after exhausting all efforts at appeals, the Minnichs were forced to sell their building (Berliner 2003, 145-146; Carney 2006, 91-96).

The Minnich's story illustrates the perils of intervention discussed above and can be generalized to highlight takings' economic effects. Takings are fundamentally an exercise in central planning in which government officials intervene to change the market process' outcome. As the Minnich case demonstrates, the condition of "public use" has been broadly interpreted to include economic benefits (i.e., job creation, tax revenue, etc.) to the community. This interpretation has historical precedent in *Berman v. Parker* (1954), *Poletown Neighborhood Council v. City of Detroit* (1981), and more recently in *Kelo v. City of New London* (2005). These economic benefits are typically calculated by carrying out an "impact analysis" that considers the associated costs and benefits of an intervention. Such an analysis attempts to place

a monetary value on all of the costs of confiscating property and compares this to the expected benefits of redevelopment.

This approach confronts several problems. In assigning monetary values to expected costs and benefits, those carrying out the study must consider situations that have not yet occurred. In producing these calculations, assumptions about the future must be made regarding profitability, associated tax revenue, and job creation. Assumptions are also often made about the “multiplier effect” of each dollar spent on the redeveloped property. Recall that, as Kirzner noted, successful intervention assumes government planners have better information than market participants and that interventions will produce superior outcomes compared to the unregulated market process. It’s unclear why either how either of these assumptions would be satisfied in the case of takings. Further, because the use of takings doesn’t entail a penalty on private developers for failing to deliver on the projected benefits of the property reassignment, there’s an incentive to overstate the projections supporting the case for takings.

Consider a study published by the Cato Institute on the economic benefits of bringing a Major League Baseball team to Washington, D.C. (Coates and Humphreys 2004). A key aspect of negotiations between the city and baseball team was the promise of a new stadium using direct takings to acquire the land if necessary.<sup>11</sup> On the impact studies conducted in these types of situations, the Cato report’s authors note that “The results of those studies invariably reflect the desires of the people who commission them, and advocates of stadiums and franchises typically produce impact studies that find large economic benefits from building a stadium or enticing a team to relocate to the city” (2004, 3). In an analysis of 37 cities with sports teams over a 35-year period, Coates and Humphreys (2004, 5) found no positive effect on overall growth rates of real

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<sup>11</sup> In fact it was ultimately necessary for the city of Washington, D.C. to employ eminent domain to secure the property for the new stadium (see Lemke 2005).

per capita income and a significant, negative impact on the level of real per capita income. The authors attribute these findings to the tax breaks sports teams often receive to entice them to locate in a particular city.

Takings distort the structure of production that arises naturally from the market process. As Murray Rothbard points out (1977, 77), when government uses eminent domain “the result is an overextension of resources (a malinvestment) in the privileged firm or industry and an underinvestment in other firms and industries.” Takings shift the relative payoffs of with alternative entrepreneurial opportunities. Government’s property seizure raises the cost of investing in certain types of business ventures and lowers the cost of investing in others. The structure of production that arises on the unhampered market is a function of consumer valuations. Intervention distorts this process by creating incentives to divert resources into industries that may not represent consumer preferences.

Takings also generate uncertainty. This has adverse economic effects that bureaucrats can’t measure. For instance, in areas where government finds it comparatively easy to exercise takings, there’s an additional disincentive to purchase land or make improvements to existing land. Sandy Ikeda (2004) has analyzed how interventions not only distort the price system itself, but also erode the norms and trust levels that facilitate interpersonal interaction through the price system. Focusing on interventions in the form of “urban renewal,” Ikeda (2004, 258) emphasizes that such interventions “can threaten the stability of local communities because of the drastic changes it brings to an area in a time period too short for the informal networks to form that are needed for healthy economic development.” Similar logic applies to takings, which can destroy existing social networks and norms and generate uncertainty. As Jane Jacobs (1961, 5) notes, takings for economic development destroy “thousands upon thousands of small

businesses....whole communities are torn apart and sown to the winds, with a reaping of cynicism, resentment and despair that must be seen to be believed.”

Intervention-generated uncertainty lowers the payoff of productive entrepreneurial activities (Benson 2004). Productive activities that would have been exploited absent the possibility of intervention are no longer undertaken. For example, in the case of environmental regulations, uncompensated regulatory takings tend to increase uncertainty while discouraging private, voluntary conservation, and encourage the destruction of certain environmental resources. Further, the absence of compensation lowers government’s cost of environmental regulations.

It’s well known that secure property rights are critical for economic development (see, for instance, Acemoglu and Johnson 2005; Acemoglu, Johnson. and Robinson 2001, 2002; Hoskins and Eiras 2002; Rodrik, Subramanian, and Trebbi 2004). For instance, Hernando de Soto (1989) discusses how insecure property rights created uncertainty that drove a majority of productive economic underground in Peru. The fundamental problem for poor countries, de Soto (2000) notes, is transforming “dead capital” into “live capital.” But tis transformation can only take place where secure property rights diminish uncertainty.

Of course, the US doesn’t suffer from the extent of intervention-created uncertainty that Peru and other underdeveloped countries face. Still, takings in the US is a less extreme variant of the more extreme land-use policies that exist in many third-world countries where governments expropriate property as they see fit. The connection between the instability created by the land and property rights policies in these third-world countries and confiscatory policies, such as takings, in the US is clear. While the takings-created uncertainty in the US is less severe than that intervention-created uncertainty in countries where property rights are almost nonexistent, it

remains present and any movement in the direction of weakening of property rights increase this uncertainty.

In his analysis of land use regulation, Bruce Benson (1981, 435) suggests that “land use regulations are the result of public sector responses to demands of politically powerful special interest groups, rather than attempts to correct for market failures.” Land-use interventions aren’t benevolent. They reflect the outcome of the political decision-making process. This process is influenced by special interest groups, which attempt to manipulate political outcomes in their favor. For instance, Jane Jacobs (1961, 270-290, 311-314) argues that the use of eminent domain for the economic development and urban renewal often serves private interests at the expense of the communities it is intended to help. Donald Kochan (1998, 51) contends that the “public use doctrine is no longer an impediment to interest-group capture of the condemnation power in order to acquire private land by employing the power of the state to that end.” Thus, according to Kochan, legislatures can sell their power of takings to special interest groups because of the low probability that the judiciary will overturn it on the grounds that it violates public use. When the rules of the game allow for the use of the political decision-making process to secure transfers of private property, the payoff associated with unproductive activities, such as rent seeking, increases. This effect of takings is thus consistent with the effect of other interventions on rent seeking, described by Kirzner.

Consider the Minnich case discussed above. Recall that the Empire State Development Corporation (ESDC) used the state’s eminent domain power to take the Minnich’s property to transfer it to the Blumenfeld Development Corporation under the guise of “economic redevelopment.” However, a closer look at the ESDC and Blumenfeld indicates that there were

close political connections that likely played a role in government's decision to take the Minnich's property.

A 1996 report from the office of Democratic State Senator Franz Leichter suggest that "Since Pataki took office, more than 25 firms that made campaign contributions to Pataki, U.S. senator Al D'Amato and other State Republican political committee members have received grants and loans from the Empire State Development Corporation" (quoted in Carney 2006, 97). Indeed, since 1989 Blumenfeld had made political contributions to New York Mayor Ed Koch, Charles Schumer, Rudy Giuliani, and Al D'Amato, among many others (Carney 2006, 98). The resources Blumenfeld invested in developing relationships with New York's political leaders seem to have paid off. Besides obtaining the land in East Harlem via direct takings, he also received subsidies for the redevelopment project itself in the form of tax-breaks and low-interest state loans.

## **4 Concluding Remarks**

Our analysis leads to several conclusions. First, the idea that takings can correct market outcomes assumes the intervention-created outcome will be better than the market outcome. However, because government actors suffer from a fundamental knowledge problem about future entrepreneurial opportunities and the true costs and benefits of the redistribution, there's no reason to think this assumption holds. Indeed, once we also consider that takings are heavily influenced by the political-decision making process, we have good reason to believe that the intervention-created outcome will likely be worse than that which would result without the intervention.

Second, and closely related, the key costs of takings are “hidden.” They involve foregone entrepreneurial opportunities—discoveries never made and new forms of wealth never produced—because of intervention that directed the market process down some alternative, politically determined path. It’s impossible to know the magnitude of these costs in any particular case because takings “seal off” an unknown future by devoting resources along lines different from those that market participants would have directed them along. Those who would argue that preventing takings also “seals off” an unknown future, albeit a different one, are correct. Since resources are scarce, any allocation—market-, government-, or even thief-directed—involves a cost in terms of alternative, foregone allocations. But while there are strong theoretical and empirical reasons for thinking the market process will allocate resources in ways that create wealth, there are extremely weak theoretical or empirical reasons for thinking central planning, which is what takings is based on, will do so.

Finally, the “hidden” costs of takings our paper identifies are excluded from standard cost-benefit impact analysis because they represent unknown possibilities that were never realized. This exclusion casts serious doubt on usefulness of traditional impact studies for assessing the merits of takings. Further, it suggests that existing studies systematically underestimate the true cost of takings.



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