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Zoning and Market Externalities

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ABSTRACT

The centennial of the 1916 New York City Ordinance and creation of zoning in the United States provides an exceptional opportunity to reconsider the regulatory and legal basis upon which the key governmental power of zoning is founded. The motive to control the various market externalities embedded in land use regulation, from effects on commercial activity to housing prices and job-related housing needs, has practically guided local governments from the very first days of zoning. Yet, at the same time, such considerations of market externalities remain in the shadows of explicit zoning law and policy, as the discussion is re-routed to the allegedly more stable foundations of zoning, such as control of environmental, fiscal, or social externalities.

This Article is the first to specifically explore the legitimacy of local governments regulating private economic activities that have an aggregate effect on the real estate market—defined here as "market externalities." May a local government limit the scope of new commercial uses, such as shopping malls, if it believes that there is already an excess supply of them; or constrain the entry of big-box retailers to preserve the economic viability of existing retailers in a downtown business district? Can a land use ordinance limit, or entirely prohibit, the renting out of housing units in a certain neighborhood, to keep out investors who might drive up real estate prices? Is government entitled to require a developer of market-rate properties to pay a mitigation fee to finance affordable housing units—under a theory that the project would generate new demand for local services provided by modest-income workers who are in need of housing solutions?

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This Article develops an innovative theory of zoning and market externalities. It argues that zoning power should extend to regulate market externalities—provided that such decisions are based on a general land use policy that can be clearly identified and are not tailored to intentionally block, or legitimize, specific projects.

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INTRODUCTION

The *New York Times* recently portrayed the growing economic distress of many enclosed shopping malls across the United States.[1] The potential reasons for this hardship are numerous, and not all malls share the same fate. While high-end "A-rated" malls are performing well, middle- and working-class malls are seeing increasing vacancy rates. The fundamental problem of the latter malls is arguably one of over-abundance, the result of a "long boom in building retail space of all kinds."[2] Moreover, once such a massive space becomes vacant or entirely "dead," its resurrection might prove a daunting task.[3]

This turn of events may reinvigorate a long-standing debate about the proper role of government in the real estate market. The current downturn

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1. Nelson D. Schwartz, *The Economics (and Nostalgia) of Dead Malls*, N.Y. TIMES, Jan. 3, 2015, at A1.

2. *Id.*

3. *See* Sarah Schindler, *The Future of Abandoned Big Box Stores: Legal Solutions to the Legacies of Poor Planning Decisions*, 83 U. COLO. L. REV. 471, 474 (2012) (describing lingering problems of blight, symbolic decline, and economic harm to the surrounding community resulting from largely vacant or entirely abandoned big-box retail stores and suggesting various strategies to revitalize such derelict spaces).

of multiple shopping malls could be seen as a sign of healthy competition among retailers and an inevitable result of changing consumer preferences. Alternatively, however, this decline might be an indication of some kind of market- or government-failure. If the latter proposition is embraced, government might legitimately avoid this failure by intervening early and explicitly considering, within its land use regulation powers, the potential effect of excess demand or other pecuniary impacts that a planned project might entail.

As this Article shows, the economic effect of real estate developments is a matter of crucial importance for private and public stakeholders, and such considerations play a key role in land use decisions. The issue of pecuniary externalities and other types of economic activities that have an aggregate effect on the real estate market—defined here as "market externalities"—may even be seen as going back to the days of establishing the institution of zoning in the United States.[4]

However, the jurisprudence on the legitimacy of the government explicitly addressing market externalities and on the standard of review that should apply has been sporadic.[5] In many cases, both policymakers and courts avoid these questions by rerouting the analysis to the allegedly more stable foundations of the zoning power, such as regulation of environmental externalities caused by conflicting land uses, or fiscal externalities that address developments' impact on public infrastructure.[6]

Therefore, while economists have long addressed the welfare and distributive effects of pecuniary externalities and have applied such insights to the spatial-urban context, the legal profession has done neither.[7] This Article sets out to close this gap by developing a legal framework for zoning and market externalities.

This Article asserts that the power of zoning and other types of land use regulation should extend explicitly to regulate market externalities. Regulatory decisions addressing pecuniary externalities should be considered legitimate when such regulation establishes a general land use policy and is not tailored to intentionally block or legitimize a specific project. Every zoning decision must obviously account also for the specific features of the project and the cost/benefit analysis it entails, and government should be entitled to deviate from its general policy under extraordinary

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4. *See infra* Section I.E.

5. *See infra* Part II.

6. *See infra* Sections I.B and I.C.

7. The legal literature on the matter focuses mostly on the boundaries of limiting competition but hardly addresses pecuniary externalities more systematically. *See, e.g.*, ROBERT C. ELLICKSON ET AL., LAND USE CONTROLS: CASES AND MATERIALS 112-21 (4th ed. 2013).

circumstances. At the same time, judicial review should examine the government's ability to explicitly anchor its individual decisions within a broader land use policy.

Although the dilemma of specific versus general decision making is present for the more established justifications for zoning power, this tradeoff is of particular importance in the context of regulating market externalities.[8] Accordingly, courts should defer to governments by lowering their standard of review only for actions made within a broader decision making framework—not actions made outside of it.

Moreover, a local government's zoning decision that regulates potential market externalities may generate other types of market externalities, positive or negative, across municipal borders. Judicial review of such zoning decisions should also hold the local government accountable for the potential threat of "regulatory opportunism," in which a certain municipality simply seeks to shoulder a specific negative market externality on the residents of adjacent localities.[9] The legal criteria for holding a municipality responsible for an *inter*-local market externality, generated by its zoning decision, should be based chiefly on the consistency of this effect with the broad-based policy adopted by the municipality to regulate its own *intra*-local externalities.

The Article is structured as follows. Part I starts by concisely portraying the power of zoning, and land use regulation in general, as it has emerged over the past century. It discusses the gradual, often implicit expansion of zoning's legitimate goals as identified by courts and the corresponding standards of judicial review applied to such measures. This Part analyzes the different treatment of technological and environmental externalities, fiscal externalities, and "social externalities" versus the treatment of market externalities. While the former types of effects are viewed as operating 'outside the market' and, thus, liable to generate welfare inefficiencies, economists have tended to view market externalities as operating 'within the market' by solely affecting prices, thus producing no inefficiencies.[10] From a legal perspective, however, pecuniary or market externalities, whether positive or negative, receive almost no explicit attention and remain in the shadows of zoning law.[11]

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8. *See* Eric Biber & J.B. Ruhl, *The Permit Power Revisited: The Theory and Practice of Regulatory Permits in the Administrative State*, 64 DUKE L. J. 133, 155-64 (2014) (delineating types of regulatory permits, from specific to general, and describing how these various options play out in the context of land use regulation).

9. *See* Amnon Lehavi, *Intergovernmental Liability Rules*, 92 V.A. L. REV. 929, 940-48 (2006) (discussing the concept of inter-local zoning externalities and the potential motives for it).

10. *See* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 43-45 (5th ed. 2007).

11. *See supra* note 7 and accompanying text.

Part II explores, in detail, market externalities. It discusses three different settings. First, this Part asks whether government can limit the scope of new commercial uses, such as shopping malls or big box retailers, if the city believes that there is already excess supply of commerce or if the city otherwise wishes to preserve the viability of its Central Business District ("CBD").[12] Second, it examines various limits imposed on renting out housing units in a certain jurisdiction, or parts thereof, in order to keep out investors who might drive up real estate prices. Third, it asks whether a local government is entitled to require a developer of market-rate properties to pay a mitigation fee to finance affordable housing units—under the theory that the project would generate demand for services, which would be provided by low- and modest-income workers in need of housing.

Part III outlines the standards of judicial review that should apply to such cases. It argues that land use decisions that regulate potential market externalities should be granted a high degree of deference, as falling within government's police power, if the regulation is anchored in a general policy that deals with the relevant features of the real estate market. The municipality would thus have to establish a "substantial relation"[13] between its broad policy on market activities and measures taken to control adverse market externalities. At the same time, such a local policy should be held accountable for potential market externalities that this strategy may generate for neighboring localities. This is required in order to prevent opportunism among local governments in regulating market externalities.

I. EXTERNALITIES AND THEORIES OF ZONING

A. The Zoning Power

Zoning was introduced in the United States—and quickly became established—during the first three decades of the twentieth century. Historical accounts of zoning regularly identify three key milestones in its early regulatory and legal development.[14]

Historians consider the 1916 New York City Ordinance ("NYC Ordinance") to be the first comprehensive scheme to divide an entire municipality into zones, in which permitted land uses, building volumes, height restrictions, and other details were regulated.[15] The second stage was

12. For the concept of a central business district as the commercial and financial hub of a certain city, see BRENDAN O'FLAHERTY, CITY ECONOMICS 126-27 (2005).

13. This standard of judicial review was set by the Supreme Court in the seminal case of Village of Euclid v. Ambler Realty Co., 272 U.S. 365, 388 (1926), discussed in *infra* notes 19-21 and accompanying text.

14. *See, e.g.*, O'FLAHERTY, *supra* note 12, at 170-74.

15. It should be noted that prior to this ordinance, a number of American cities adopted limited-purpose controls on construction, driven mostly by safety concerns, thus resembling building and fire codes. *See* ELLICKSON ET AL., *supra* note 7, at 57-58.

the nearly uniform adoption of the 1926 Standard State Zoning Enabling Act ("SZEA")[16] and the 1928 Standard City Planning Enabling Act ("SCPEA"),[17] through which states granted localities the power to regulate land use.[18] The third prong was the 1926 U.S. Supreme Court decision in *Village of Euclid v. Ambler Realty Co.*,[19] in which the Court validated zoning as falling within government's police power.[20] The Court held that the exercise of the zoning power is constitutionally valid, unless such provisions "are clearly arbitrary and unreasonable, having no substantial relation to the public health, safety, morals, or general welfare."[21]

Over the following decades, federal and state courts generally tended to frame the policy purposes and consequent legal contours of the zoning power as falling within the scope of health, safety, morals, and general welfare, with the latter, broad term allowing courts to give local governments significant leeway in exercising their zoning power.[22] While courts have examined whether a particular zoning scheme meets the "substantial relation" test and have otherwise developed a thick body of law on the potential application of the Takings Clause to the regulation of land use,[23] they have generally refrained from an elaborate analysis of the underlying goals of zoning.[24]

When federal and state courts have agreed to dig into the proper purposes of zoning, they have framed the analysis within zoning's more stable foundations, which include "technological" or environmental externalities.[25] This framing has also allowed courts to analyze certain types of legitimate—or illegitimate—forms of social planning by tying such "social externalities" to questions, for example, of incompatible uses or density control.[26] Courts also address the control of "fiscal externalities."[27] In contrast, judges have

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16. Advisory Comm. on Zoning, U.S. DEP'T OF COM., *A Standard State Zoning Enabling Act* (1926 rev'd ed.).

17. Advisory Comm. on City Planning and Zoning, U.S. DEP'T OF COM., *A Standard City Planning Enabling Act* (1928).

18. Over the years, several states amended their enabling statutes, and some aspects of zoning are also regulated by state-level and federal legislation. However, the overall focus of zoning on local government power remains intact. *See* Lehavi, *supra* note 9, at 935-37.

19. 272 U.S. 365 (1926).

20. *Id.* at 389-90.

21. *Id.* at 389-90, 395.

22. ELLICKSON ET AL., *supra* note 7, at 114-15.

23. For a survey of the case law on the types of land use regulation that may amount to an uncompensated taking in-effect of private property contrary to the Fifth Amendment, see *id*. at 134-87.

24. WILLIAM A. FISCHEL, ZONING RULES: THE ECONOMICS OF LAND USE REGULATION §§ 3.12-3.25 (2015).

25. *See infra* Section I.B.

26. *See infra* Section I.B.

27. *See infra* Section I.C.

rarely explicitly addressed the nature of underlying goals relating to "pecuniary externalities" or "market externalities."[28]

The NYC Ordinance[29] demonstrates how the promotion of zoning's four goals might actually affect the motivation for zoning and the ways in which some pronounced goals might take over the overt discourse.

The chief proponents of the measure were members of the real estate industry and business owners in the city who were "anxious to put an end to the damages wrought by uncontrolled development."[30] They were joined in their efforts by planning advocates, professional reformers, and public officials, who had different agendas.[31] Thus, for example, progressives and reformers viewed zoning as a means to limit "untrammeled capitalism" and to make the city more beautiful and livable.[32] The underlying views on the desirable nature of the market were far from uniform.

In breaking down the specific concerns that drove the promulgation of the NYC Ordinance, one can identify all the motives for zoning, namely: limiting technological or environmental externalities, fiscal externalities, market externalities, and promoting social planning. First, owners of downtown office buildings increasingly lost their access to sunlight and air to new skyscrapers, thus decreasing their rental value.[33] This loss of sunlight had a dramatic impact, because, up until the 1940s, sunlight was the principal source of illumination for interiors.[34] The scope of such externalities was considerable: the forty-story Equitable Building, completed in 1915, cast a shadow over four high-value blocks.[35] To control this externality, the NYC Ordinance imposed height limits and setback requirements.[36] As Section I.B shows, responses to these and other technological or environmental externalities became the mainstay of zoning concerning both land uses and building restrictions.

A second type of concern that drove the New York City regulation demonstrates how technological or environmental issues can become meshed with "social externalities." Owners and operators of high-end retail stores along Fifth Avenue were concerned about the entry of manufacturing

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28. *See infra* Section I.D.

29. *See Zoning Background*, N.Y.C. PLAN., http://www1.nyc.gov/site/planning/zoning/background.page [https://perma.cc/UGS6-F5SN].

30. Raphaël Fischler, *The Metropolitan Dimension of Early Zoning: Revisiting the 1916 New York City Ordinance*, 64(2) J. AM. PLAN. ASS'N 170, 170 (1998).

31. *Id.* at 171.

32. O'FLAHERTY, *supra* note 12, at 171-72.

33. Fischler, *supra* note 30, at 172-73.

34. *See* CAROL WILLIS, FORM FOLLOWS FINANCE: SKYSCRAPERS AND SKYLINES IN NEW YORK AND CHICAGO 24-26 (1995).

35. O'FLAHERTY, *supra* note 12, at 172.

36. *Id.* at 173.

lofts, which employed many poor immigrant women.[37] Their fear was that the mass presence of working-class women on the streets would deter the stores' wealthy clientele and undermine the area's appeal. Framed, however, as a problem of incompatible uses, the city was divided into three types of use districts: one reserved solely for housing, another open to commerce, and a third allowing industry.[38] Indirect social planning was, thus, promoted through zoning.

A third problem involved fiscal externalities, namely the growing pressure that the rapid private development of real estate placed on the city's public infrastructure. Both in the financial district and on Fifth Avenue, development caused acute street congestion.[39] Human congestion also posed health threats in both tenement areas and office buildings. Moreover, the congestion issue coincided with the city's effort to unite the five boroughs by an integrated public transit system.[40] Placing limits on building volumes was therefore intended to serve the broader goal of dispersing the population into outer areas, which would, in turn, facilitate the inter-borough layout of the public transit system.[41]

Further, the constant movement of different populations and activities made it difficult for school authorities to allocate children to particular schools. The mix of land uses also increased the costs of policing, fire-fighting, street maintenance, and postal delivery.[42] The division of the city into use-districts and limits on building volumes were, thus, essential to provide more permanent structure to the city's neighborhoods and allow for a well-functioning infrastructure. As Section I.C shows, fiscal zoning has since become an explicit regulatory principle.

Finally, market externalities were at play as a motivating force for the NYC Ordinance, although their role has been formally overshadowed by the other considerations mentioned above. In 1916, the New York office market went through a period of high vacancy rates, exacerbated by the 1.2 million square feet of the Equitable Building.[43] Owners of existing buildings, thus, wanted to limit new construction that might cause a drop in rents or drive up vacancy rates.[44] Concerns over the stability of real estate values were not constrained, however, to corporate and retail areas in the city. The NYC Ordinance sought also to protect residential properties and, in particular, the

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37. Fischler, *supra* note 30, at 172-73.
38. *Id*. at 170, 172; O'FLAHERTY, *supra* note 12, at 172-73.
39. Fischler, *supra* note 30, at 173.
40. *Id*. at 178-80.
41. *Id*.
42. *Id*. at 180-81.
43. O'FLAHERTY, *supra* note 12, at 172.
44. Fischler, *supra* note 30, at 172-73.

single-family home, considered to be the apex of the hierarchy of land uses.[45] The motives for doing so included a mix of technological or environmental concerns stemming from incompatible uses; social motives derived from the view of zoning as a "moral system that both reflects and assures social order," and economic concerns over the price effect of over-development.[46]

This mixture of motives typifies later waves of regulatory measures, including the proliferation of various growth-control schemes in suburban and metropolitan areas during the 1960s and 1970s, sometimes derogatively referred to as "exclusionary zoning."[47] From minimum-lot-size requirements to outright moratoria, those measures were motivated by current owners' wishes to limit housing supply.[48] In this sense, they feature a clear motive influenced by the control of market externalities.

These economic considerations were intermingled with other motivations, which played a more explicit role in the public discourse and legal controversies that ensued. With the rapid development of interstate highways, both businesses and lower-income households became physically more mobile, allowing them to move from cities into the suburbs.[49] Suburban localities, controlled politically by current homeowners, employed various land use controls to restrict development, particularly low-income housing opportunities.[50]

Localities sought to justify such constraints to guard against technological or environmental externalities, such as increased traffic congestion and air pollution.[51] Fiscal zoning also featured prominently. Residents of high-income suburbs feared that admitting families who purchase homes with a value below the community average, but who otherwise make equal or higher demands on the public infrastructure, such as schools, would lower the property tax base per family, thus resulting in an increase in tax rates.[52] Finally, social planning motives seemed to have drawn most of the attention. Viewed as measures aimed at discriminating against low-income households and racial minorities, zoning and planning programs were debated before

45. *Id*. at 178.

46. *Id*.

47. *See, e.g.*, Robert Inman & Daniel Rubinfeld, *The Judicial Pursuit of Local Fiscal Equity*, 92 HARV. L. REV. 1662, 1685-89 (1979).

48. *See* Robert C. Ellickson, *Suburban Growth Controls: An Economic and Legal Analysis*, 86 YALE L.J. 385, 430 (1977).

49. FISCHEL, *supra* note 24, at § 5.25.

50. *Id.*

51. ELLICKSON ET AL., *supra* note 7, at 850-51.

52. Inman & Rubinfeld, *supra* note 47, at 1685-86.

courts, with New Jersey's *Mount Laurel* litigation being the epitome of the scrutiny such motives faced.[53]

Differentiating between the various motives for zoning may, thus, prove a difficult task in examining individual instances of government action.[54] This chore is nevertheless essential, especially to the extent that one type of motive seeks to hide behind another more defensible ground. This is especially so with market externalities, which have largely remained a legal blind spot, although they play a significant practical role in zoning. The following sections set out to analyze each of the above-mentioned types of externalities, addressing their treatment in the academic literature and application to the legal setting.

B. Technological or Environmental Externalities

The British economist Arthur Pigou formalized the concept of technological or environmental externalities in the early twentieth century.[55] During the second half of the twentieth century, scholars increasingly examined the policy and legal implications of such externalities, with the two terms—"technological" and "environmental"—being used interchangeably.[56] Since then, it has become the subject of extensive scholarship.[57] Economists define a technological or environmental externality as the "indirect effect of a consumption activity or a production activity on the consumption set of a consumer, the utility function of a consumer, or the production function of a producer."[58] The term "indirect" relates to an effect that "does not work through the price system."[59]

Such externalities can be positive, such as when a firm makes available a new technology or information that allows other firms to manufacture

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53. For an overview of the *Mount Laurel* litigation, *see* ELLICKSON ET AL., *supra* note 7, at 758-78 (showing how the New Jersey courts gradually required local governments to affirmatively promote low- and modest-income housing by also providing a "builder's remedy" that grants developers a building permit as a right under certain conditions).

54. *See* Eric A. Haunshek & John M. Quigley, *Commercial Land Use Regulation and Local Government Finance*, 80(2) AM. ECON. REV. PAP. & PROC. 176, 177 (1990) (arguing, that as an empirical matter, "it is extremely hard to sort out the pecuniary from the [other] externality motives for zoning").

55. *See* ARTHUR C. PIGOU, THE ECONOMICS OF WELFARE, Ch. IX (4th ed. 1932).

56. Probably the two most notable examples are Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960), and Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

57. For a partial list of such current works, *see* Lisa Grow Sun & Brigham Daniels, *Mirrored Externalities*, 90 NOTRE DAME L. REV. 136, 136 n.1 (2014).

58. J.J. Laffont, *Externalities*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS (Steven N. Durlauf and Lawrence E. Blume eds., 2d ed. 2008).

59. *Id.*

improved products or to cut costs.[60] Negative externalities, which have attracted more attention in the policy and law context, prominently include adverse environmental effects. Air pollution is probably the best-articulated example.[61] Other technological or environmental externalities, which have a particular bearing on land use, have also been investigated in both theory and practice: noise, groundwater pollution, and the blocking of sunlight or the flow of air.[62]

A key point in understanding the role of technological or environmental externalities in land use regulation concerns the intricate ties between the zoning power and otherwise actionable harms, such as private or public nuisance.[63] On the one hand, zoning emerged as a top-down regulatory mechanism that controls in advance certain aspects of conflicting land uses, which might otherwise lead to nuisance litigation. Legislatures and courts have explicitly articulated the close ties between zoning and nuisance control from the early days of zoning. As the Supreme Court famously noted in *Euclid*, "a nuisance may be merely a right thing in the wrong place—like a pig in the parlor instead of the barnyard."[64] Zoning is thus justified as a mechanism that spatially orders land uses to minimize potential cases of nuisance.

Accordingly, zoning is intended to save on transaction costs that parties may incur in trying to privately resolve land use conflicts,[65] or on the costs of nuisance litigation.[66] As a doctrinal matter, the fact that an activity is "properly conducted at a place authorized for it under zoning" would regularly shield it from a private nuisance claim, although the case might be somewhat different for some types of public nuisance.[67] One further link between zoning and nuisance control concerns the "nuisance exception"

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60. For a discussion of positive externalities, and their respective economic and legal differences from negative ones, see, e.g., Giuseppe Dari-Mattiacci, *Negative Liability*, 38 J. LEGAL STUD. 21, 22-30 (2009).

61. Pigou discussed the adverse effects of smoke from factory chimneys on the surrounding community. PIGOU, *supra* note 55, at Ch. IX., § 10. This example has also been extensively analyzed in the foundational works of Coase, *supra* note 56, and Calabresi & Melamed, *supra* note 56.

62. Consider, for example, Coase's discussion of the confectioner, the noise and vibrations from his machine that disturb a neighboring doctor in his work, and how such a conflict may be reframed as a having a reciprocal nature. Ronald H. Coase, *The Federal Communications Commission*, 2 J. L. & ECON. 1, 26-27 (1959).

63. *See* EUGENE MCQUILLIN, 8 THE LAW OF MUNICIPAL CORPORATIONS § 25.3 (3d ed. 2000 & Supp. 2015).

64. Vill. of Euclid v. Ambler Realty Co., 272 U.S. 365, 388 (1926).

65. *See* Neil Komesar, *Housing, Zoning, and the Public Interest*, *in* PUBLIC INTEREST LAW: AN ECONOMIC AND INSTITUTIONAL ANALYSIS 218, 219-21 (Burton A. Weisbrod et al. eds., 1978).

66. *See* ELLICKSON ET AL., *supra* note 7, at 539-68.

67. MCQUILLIN, *supra* note 63, at § 25.13

doctrine, which stipulates that some types of land use regulations might not constitute a taking even if they proscribe, without compensation, preexisting activities that amount to "harmful or noxious uses."[68]

Nevertheless, the zoning power may go well beyond nuisance control.[69] Zoning regulates various types of technological or environmental externalities that do not amount to nuisances or other civil wrongs. For example, a zoning decision may impose a density limit to control several issues, including the level of traffic congestion within a development and its vicinity. Nuisance law does not regularly hold a car user liable for the potential externalities she may cause to other residents or drivers because of increased congestion.[70] It is not a type of behavior in which the law identifies a "wrongdoer" engaging in a harmful conduct toward others.[71] In fact, this is a type of behavior in which the law is aligned with Coase's view of nonconforming uses or externalities as having a "reciprocal nature," meaning that we cannot categorically identify a "wrongdoer" and a "victim" in such scenarios.[72] The solution for the lack of clear guidance by private law mechanisms is provided by regulation. One possible venue is a congestion fee—functioning as a "Pigouvian tax"—in which car users internalize the marginal externalities they generate by the payment of a time-based fee.[73] This is feasible for toll roads, bridges, and tunnels, which serve as transportation arteries. However, it is not regularly the case with residential neighborhoods, in which residents are tied to a specific place, meaning that fees would not self-resolve congestion problems. Zoning establishes the level of building density that is seen as appropriate for such developments,

68. This doctrine, while controversial and not fully articulated by courts, originates in the pre-zoning-era case of *Mugler v. Kansas*. The Court refused to apply the Takings Clause to a regulation that prohibited the manufacture and sale of liquor in Kansas, a prohibition that applied also to existing breweries. It reasoned that the regulation stopped an activity that was "injurious to the health, morals, or safety of the community." 123 U.S. 623, 668 (1887). In *Penn Central Transportation Co. v. City of New York*, Justice Rehnquist, in his dissent, referred to this exception but described it as applying only to "noxious uses." 438 U.S. 104, 144-46 (1978). In *Lucas v. South Carolina Coastal Council*, 505 U.S. 1003 (1992), Justice Scalia, writing for the majority, generally referred to the doctrine but held that it does not apply to the case at hand. 505 U.S. 1003, 1020-26 (1992).

69. *See generally* Robert C. Ellickson, *Alternatives to Zoning: Covenants, Nuisance Rules, and Fines as Land Use Controls*, 40 U. CHI. L. REV. 681, 719-60 (1973).

70. *See, e.g.*, Ralph Slovenko, *Desocialization by Automobile*, 54 WAYNE L. REV. 1767, 1788-89 (2008).

71. For the notion that nuisance law deals with identifying "substandard" behaviors, see Ellickson, *supra* note 69, at 728-31.

72. *See* Coase, *supra* note 56, at 2 (suggesting that "[w]e are dealing with a problem of a reciprocal nature. To avoid the harm to B would inflict harm on A. The real question that has to be decided is: should A be allowed to harm B or should B be allowed to harm A?").

73. O'FLAHERTY, *supra* note 12, at 58-61.

considering also on-site and off-site roads, parking, etc.[74] Zoning thus deals with technological or environmental externalities that go beyond nuisance control. The same holds true for other land use regulations, such as aesthetic controls.[75] Any such regulation would have to meet the "substantial relation" test set up in *Euclid* and subsequent cases,[76] but the underlying goals well exceed nuisance control.

The role of zoning in controlling technological or environmental externalities thus bears an important lesson for the other grounds for zoning, discussed in the following sections. The legitimacy of zoning is not dependent on demonstrating that a certain developer or a person who uses the land engages, or is about to engage, in wrongful conduct (in the private law realm). At the same time, to justify constraints imposed by a zoning scheme, the local government must provide a rationale for the ways in which land uses and building volumes are regulated. Moreover, the farther away from conduct that would otherwise be considered wrongful, the more the municipality would have to ground such constraints in a broad-based rationale. This insight has key implications for regulating market externalities.

C. Fiscal Externalities

According to the 2012 Census of Governments, state and local governments continue to rely heavily on revenues from their own sources to finance their expenditures.[77] For local governments, taxes represent the largest source of general revenue.[78] Property taxes are most prominent, accounting for 73.5 percent of all local tax revenues.[79] Between 2007 and 2012, local property tax receipts increased by more than fifteen percent.[80]

The prominence of local revenue—and property tax in particular—for local government finance has always had important implications for land use policy.[81] In making zoning decisions, local governments may often want to

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74. *See, e.g.*, Roberts v. Plan. and Zoning Comm'n, No. CV010379911S, 2003 WL 21235343, at *3-5 (Conn. Super. Ct. May 15, 2003) (highlighting the centrality of the traffic congestion factor in deciding about certain types of land use projects).

75. *See* Georgette C. Poindexter, *Light, Air, or Manhattanization?: Communal Aesthetics in Zoning Central City Real Estate Development*, 78 B.U. L. REV. 445, 483-88 (1998) (discussing the legitimacy of aesthetic zoning in the absence of recognition for aesthetic nuisance).

76. *See supra* text accompanying notes 19-21.

77. *See* Jeffrey L. Barnett et al., *2012 Census of Governments: Finance—State and Local Governments Summary Report,* 3 (Dec. 17, 2014), http://www2.census.gov/govs/local/summary_report.pdf [https://perma.cc/GF66-JL9P].

78. Taxes represent more than forty percent of localities' general revenues. *See id*.

79. *Id.*

80. *Id.*

81. *See* Lehavi, *supra* note 9, at 948-52 (discussing the "fiscalization of zoning").

ensure that "households or firms generate a fiscal surplus, not a deficit."[82] Thus, in considering whether to approve a new zoning scheme, a local government may be motivated to compare its expected marginal expenditures to its provision of public services with the expected marginal public revenues.[83]

In the residential context, suburban localities have often resorted to zoning mechanisms, such as minimum lot size or other density limits, to thwart indirect fiscal deficits. Such localities are often especially anxious about households that purchase small-size properties with a value below the community average—and thus pay lower property taxes—but otherwise have high demand for public infrastructure and schools.[84] The practical result of large-lot or other low-density zoning is one in which lower-income households with school-aged children would be largely left out of the community. In this sense, the fiscal motive plays an essential role in such types of exclusionary zoning.[85] The fiscal tradeoff would be different for high-value properties. The same may hold true for retail businesses that yield not only property tax revenues but also sales tax receipts.[86]

The SZEA empowers local governments to engage in fiscal zoning in the residential context by allowing them to control various aspects of private development, including the size of the lot, a building's height, or its contribution to overall density.[87] Moreover, local governments do not have to ground zoning rules, such as minimum lot size, explicitly in fiscal considerations. The reasons for minimum lot size can also be for positive environmental externalities—because people value open spaces between houses[88]—so that such zoning rules may otherwise promote *Euclid*'s idea of "general welfare."

In some cases, however, the question of legitimacy of fiscal zoning becomes explicit. The most prominent example is "exactions," requirements that "developers provide, or pay for, some public facility or other amenity as a condition for receiving permission for a land use."[89] Notwithstanding the

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82. ARTHUR O'SULLIVAN, URBAN ECONOMICS 228 (7th ed. 2009).

83. *See generally* ROBERT W. BURCHELL ET AL., DEVELOPMENT IMPACT: ASSESSMENT HANDBOOK 11-12 (1994).

84. *See supra* note 52 and accompanying text.

85. O'SULLIVAN, *supra* note 82, at 228-29.

86. Accordingly, in many cases, local governments seek to attract retail uses that yield high sales tax gains. *See* Jonathan Schwartz, Note, *Prisoners of Proposition 13: Sales Taxes, Property Taxes, and the Fiscalization of Municipal Land Use Decisions*, 71 S. CAL. L. REV. 183, 209-13 (1997) (analyzing the Oxnard-Ventura "sales tax war" in Ventura County, California as driving local land use decisions).

87. Fischel, *supra* note 24, at § 4.6.

88. O'SULLIVAN, *supra* note 82, at 229-30.

89. Vicki Been, *"Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine*, 91 COLUM. L. REV. 473, 479 (1991).

various complications entailed in this body of case law,[90] as most recently expressed in the Supreme Court decision *Koontz v. St. Johns River Water Management District*,[91] the focus of the legal debate on exactions can be conceptualized as involving the legitimate scope of government control over fiscal externalities.

Prior to the *Koontz* decision, the benchmark for the judicial review of exactions was established in *Nollan v. California Coastal Commission*[92] and *Dolan v. City of Tigard*.[93] In *Nollan*, the Court invalidated a California requirement conditioning a building permit for a beachfront property on the owner granting a public easement along the mean high tide line. The Court held that such an exaction lacked an "essential nexus" to the project's anticipated effects.[94] In *Dolan*, the court held that a substantial nexus did exist between a request to expand a hardware store and pave a parking lot and the city's requirement to hand over a piece of the property for a public flood plain and a bicycle path. However, the Court found that the scope of the exaction lacked "rough proportionality" to the expansion's impact.[95] A failure to meet the tests of "essential nexus" and "rough proportionality," respectively, triggers the Takings Clause.[96] The Court based its rulings on the "unconstitutional conditions" doctrine, by which government may not condition the granting of a discretionary benefit on the applicant's waiver of a constitutional right—in this case, payment of just compensation for the property interest in land taken by the city.[97]

In *Koontz*, a five to four majority applied the *Nollan*/*Dolan* framework to a case in which the petitioner was denied a permit request to develop 3.7 acres of privately owned wetland.[98] The denial followed Koontz's refusal to make a payment to finance the improvement of the drainage on another tract, owned by the government.[99] The majority applied the *Nollan*/*Dolan* standards and the Takings Clause to this required payment, reasoning that "the [demand for money] burdened petitioner's ownership of a specific parcel of land."[100] This exaction was, thus, materially different from tax

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90. *See* Lee Anne Fennell & Eduardo M. Peñalver, *Exactions Creep*, 2013 SUP. CT. REV. 289 (2014).

91. 133 S. Ct. 2586 (2013).

92. 483 U.S. 825 (1987).

93. 512 U.S. 374 (1994).

94. *Nollan*, 483 U.S. at 837-42.

95. *Dolan*, 512 U.S. at 391-95.

96. U.S. CONST. amend. V, § 3.

97. *See* Fennell & Peñalver, *supra* note 90, at 294-95.

98. Koontz v. St. Johns Water Mgmt. Dist., 133 S. Ct. 2586, 2592-93 (2013).

99. *Id.*

100. *Id.* at 2599.

liability.[101] Following *Koontz*, any exaction imposed on a private owner, whether in the form of a property interest in land or a monetary obligation, must meet the essential nexus/rough proportionality standard.

What does the jurisprudence on exactions demonstrate about the legitimacy of land use regulation, aimed at controlling fiscal externalities resulting from private developments? The *Nollan*/*Dolan* standard validates such a fiscal motive in principle, provided that the measure taken corresponds in both nature and scope to the specific fiscal externality generated by the proposed development. Even under such a heightened standard, therefore, the control of fiscal externalities would be considered legitimate.

A question that remains open in the aftermath of *Koontz* is whether the *Nollan*/*Dolan* framework applies only to a requirement made on an "ad hoc basis upon an individual permit applicant" or also to a "legislatively prescribed condition that applied to a broad class of permit applicants."[102] If the *Nollan*/*Dolan* framework is limited to only "ad hoc" or "adjudicative" situations—as the California Supreme Court recently held[103]—this means that "legislative" land use measures, such as a zoning ordinance, would enjoy the deferential "substantial relation" standard and would not implicate the Takings Clause. In such a case, the legislative measure would have to create a general framework for holding proposed developments accountable to the fiscal externalities they are expected to generate. The challenge for such a legislative measure would not be gaining the legitimacy to rely explicitly on fiscal considerations. It would lie, rather, in the ability of a broad-based ordinance to anticipate properly the marginal fiscal externalities of a range of specific projects in devising internalization mechanisms.[104] As Parts II and III show, this is exactly the challenge that applies to market externalities.

D. Social Externalities

The previous sections have already touched on the various ways in which zoning rules, otherwise grounded in considerations of environmental or fiscal externalities, may lead to exclusionary social practices—with low-income households being the usual victims.[105] However, the scope of social motives for zoning exceeds socioeconomic stratification or even covert issues of race and ethnicity. A municipality, especially one politically

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101. *Id.* at 2600-02.

102. *See* California Bldg. Industry Assn. v. City of San Jose, 351 P.3d 974, 990 n.11 (Cal. 2015).

103. *Id.* at 991-92.

104. Fennell & Peñalver, *supra* note 90, at 340-46.

105. *See supra* text accompanying notes 37-38, 47-53, 85-86.

dominated by current homeowners,[106] may engage in various methods to preserve social order through zoning. It would be particularly legitimate to do so when those affected by such measures do not belong to a constitutionally protected suspect class and when the social motive can be complemented by—or even hidden behind—the control of environmental or fiscal externalities.

A notable example is *Village of Belle Terre v. Boraas*,[107] in which the Supreme Court upheld the village's restriction of residential land uses to one-family dwellings based on the ordinance's definition of "family" as "[o]ne or more persons related by blood, adoption, or marriage, living and cooking together as a single housekeeping unit . . . ."[108] As a result, a village homeowner was barred from leasing his home to six college students.[109]

The Court rejected equal protection and other constitutional claims against the zoning measure and relied on a mix of environmental and social externality rationales.[110] It reasoned that "a quiet place where yards are wide, people few, and motor vehicles restricted are legitimate guidelines in a land use project addressed to family needs."[111] The Court also held that "the police power is not confined to elimination of filth, stench, and unhealthy places. It is ample to lay out zones where family values, youth values, and the blessings of quiet seclusion and clean air make the area a sanctuary for people."[112]

According to the Court, therefore, the negative externalities generated by a house occupied by college students comprise both environmental and social externalities, and the village could legitimately control them.[113] Next to urban problems of congestion and noise,[114] the Court viewed the presence of housekeeping units outside the scope of a "family"—as the zoning measure defined the term—as adversely affecting the village's "values."[115] While controversial, this decision seems to give a mandate to at least some sort of social planning via zoning.

However, social planning via zoning need not be necessarily about exclusion. In fact, the growing phenomenon of "inclusionary zoning" measures, by which localities require or encourage developers to include

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106. *See* FISCHEL, *supra* note 24, at § 5.24.
107. 416 U.S. 1 (1974).
108. *Id.* at 2.
109. *Id.* at 1.
110. *Id.* at 9.
111. *Id.*
112. *Id.*
113. 416 U.S. 9 (1974).
114. *Id.*
115. *Id.*

below-market-priced units in residential projects,[116] is embedded in a concept of positive social externalities. The U.S. Department of Housing and Urban Development ("HUD") has long adopted a policy, according to which the "integration of affordable units into market-rate projects creates opportunities for households with diverse socioeconomic backgrounds to live in the same developments" and providing access to the "same types of community services and amenities."[117]

Beyond the static concept of social justice, by which low- and modest-income households are able to afford housing in high demand areas, the rationale of inclusionary zoning also features a dynamic component that deals with positive social externalities.[118]

An underlying assumption that drives inclusionary zoning is positive synergy between different socioeconomic groups, serving mostly the interests of low- and modest-income households, and children in particular, while not harming upper-income households. Mixed-income neighborhoods, thus, arguably come closer to a socially optimal interpersonal spatial design.[119] While such inclusionary zoning mechanisms have had a fair number of critics[120] and existing data does not always point to success,[121] the positive social externalities remain a driving motivation of housing policy.

A 2015 decision by the California Supreme Court, *California Building Industry Association v. City of San Jose*,[122] highlights both the current features of inclusionary zoning and the way such schemes are viewed as entailing positive social externalities. In 2010, the City of San Jose enacted an inclusionary zoning ordinance, requiring developers of twenty or more

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116. *See* Rachel Meltzer & Jennifer Schuetz, *What Drives the Diffusion of Inclusionary Zoning?*, 29 J. POL'Y ANALYSIS & MGM'T 578 (2010); Jennifer Schuetz et al., *Silver Bullet or Trojan Horse? The Effects of Inclusionary Zoning on Local Housing Markets in the United States*, 48 URB. STUD. 298 (2011).

117. U.S. DEP'T OF HOUSING AND URB. DEV., EVIDENCE MATTERS: INCLUSIONARY ZONING AND MIXED-INCOME DEVELOPMENTS (Spring 2013), http://www.huduser.org/portal/periodicals/em/spring13/highlight3.html [https://perma.cc/D5WM-CCGQ].

118. *See* Amnon Lehavi, *Can the Housing Market be Split to Facilitate Long-Term Affordability*? 3-7 (Working Paper, 2013), http://ssrn.com/abstract=2386212 [https://perma.cc/PJ59-CPEN].

119. *See* LEE ANNE FENNELL, THE UNBOUNDED HOME: PROPERTY VALUES BEYOND PROPERTY LINES 123-48 (2009) (discussing the various dynamic effects of grouping-effects and neighborhood composition).

120. *See* Robert C. Ellickson, *The False Promise of the Mixed-Income Housing Project*, 57 UCLA L. REV. 983 (2010).

121. U.S. DEP'T OF HOUS. & URB. DEV., MOVING TO OPPORTUNITY FOR FAIR HOUSING DEMONSTRATION PROGRAM: FINAL IMPACTS EVALUATION (2011), http://www.huduser.org/publications/pdf/MTOFHD_fullreport_v2.pdf [https://perma.cc/QF9A-L9C4].

122. 351 P.3d 974 (Cal. 2015).

housing units to sell fifteen percent of the for-sale units at a price affordable to low- and moderate-income households.[123] The ordinance offered developers several alternatives to the provision of on-site affordable units—such as provision of a higher number of off-site affordable units or payment of a substitute fee—but strongly pushed developers toward the on-site alternative.[124] Upholding the ordinance, the Court identified the ordinance's legitimate purposes not only of increasing the number of affordable housing units, but more particularly, of "assuring that new affordable housing units that are constructed are distributed throughout the city as part of mixed-income developments in order to obtain the benefits that flow from economically diverse communities."[125]

The Court further viewed the requirement to sell fifteen percent of the for-sale units at an affordable price as a condition that "simply places a restriction on the way the developer may use its property," similar to other land use regulations or a rent control ordinance, which do not amount to exactions.[126] The Court reviewed the ordinance under a "reasonable relationship" standard, so that the City did not have to demonstrate the *Nollan*/*Dolan* nexus between the development and the additional need for affordable housing.[127] Following the *California Building Industry Association* decision, a government's use of on-site inclusionary zoning to promote positive social externalities in mixed-income neighborhoods is not subjected to heightened scrutiny of its fiscal motives.

As a final note, in 2015, New York City Mayor Bill de Blasio unveiled his plans to enact a citywide ordinance that will require all developers seeking to rezone land for housing to build a specific number of on-site affordable units.[128] The inclusionary zoning provisions are "hard, new requirements that for the very first time set a floor for the affordable housing communities are owed in new developments."[129] The focus on on-site units seeks to promote the social externalities of mixed-income housing. The program was approved by the city council in March 2016.[130] Accordingly, the promotion of inclusionary social externalities in New York City is no

123. San Jose Mun. Code, §§ 5.08.10-5.08.730.

124. 351 P.3d, at 983-84.

125. *Id.* at 979.

126. *Id.* at 991.

127. *Id.* at 987-91.

128. Sally Goldenberg, *De Blasio Plan Would Link Affordable Housing, Rezoning*, POLITICO (July 31, 2015 05:30 AM), http://www.politico.com/states/new-york/city-hall/story/2015/07/de-blasio-plan-would-link-affordable-housing-rezoning-024125 [https://perma.cc/CEN4-P23T].

129. *Id.* (quoting Mayor de Blasio).

130. NEW YORK CITY, MANDATORY INCLUSIONARY ZONING (Mar. 22, 2016), http://www1.nyc.gov/assets/planning/download/pdf/plans-studies/mih/approved-text-032216.pdf [https://perma.cc/83VR-KYDC].

longer done by *ad hoc* requirements but, instead, through a citywide policy anchored in zoning laws. The promotion of positive social externalities is now explicitly enshrined in the zoning power.

E. Pecuniary and Market Externalities

Alongside the analysis of technological or environmental externalities, economists have also considered the role of pecuniary externalities, which work through the price system.[131] In a market economy, certain activities by persons or firms change relative prices or affect the value of assets. These changes create benefits for, or impose costs on, third parties.[132] Economists regularly argue that pecuniary externalities do not affect welfare economics.[133] They suggest that "the ability of new firms to enter an industry and inflict pecuniary losses on existing firms is the process that generates efficiency in competitive markets."[134] Allowing firms to inflict losses on competitors may be viewed as necessary for economic efficiency. Because market actors have property rights over the resources they own but not over their future value, they are not entitled to compensation for pecuniary losses inflicted on them by other market actors.[135]

Over the past decades, however, some economists have acknowledged that, in the realistic world of imperfect markets, pecuniary externalities may have welfare effects. Paul Krugman has notably shown that in a world of imperfect competition and increasing returns to scale, pecuniary externalities do matter.[136] Market-size effects are a particular source of pecuniary externalities with genuine welfare impacts, and these, in turn, have substantial implications for siting choices of firms and the ordering of land uses.[137]

Krugman examines manufacturers whose industries, unlike agricultural producers, are typified by increasing returns to scale and a relatively compact use of land.[138] Manufacturers generally prefer to locate factories near their

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131. *See* Laffont, *supra* note 58.

132. Randall G. Holcombe & Russell S. Sobel, *Public Policy toward Pecuniary Externalities*, 29 PUB. FIN. REV. 304, 304 (2001).

133. Laffont, *supra* note 58. Welfare economics generally deals with ways to ensure a distribution of resources that would maximize overall utility across the relevant group or society. Kenneth J. Arrow, *An Extension of the Basic Theorems of the Classical Welfare Economics*, Cowles Commission Paper, New Series, No. 54 (1951), 507-32.

134. Holcombe & Sobel, *supra* note 132, at 305.

135. *Id*. at 304-05.

136. Paul Krugman, *Increasing Returns and Economic Geography*, 99 J. POL. ECON. 483, 485 (1991).

137. *See* Ron Martin & Peter Sunley, *Paul Krugman's Geographical Economics and its Implications for Regional Development Theory: A Critical Assessment*, 72 ECON. GEO. 259, 266-68 (1996).

138. Krugman, *supra* note 136, at 485.

demand markets, because this reduces transportation costs.[139] The source of the demand, however, does not come only from the agricultural sector or from end-consumers. It is also derived from within the manufacturing sector itself.[140]

The result is one of agglomeration or geographical concentration, and it is embedded in positive, reciprocal pecuniary externalities. On the supply side, "manufacturer production will tend to concentrate where there is a large market, but the market will be large where manufactures production is concentrated."[141] On the demand side, firms will tend to "live and produce near a concentration of manufacturing production because it will then be less expensive to buy the goods their central place provides."[142]

Accordingly, the demand for certain land uses, and the regulatory considerations that need to be taken into account in ordering land uses, might implicate market externalities that have genuine welfare effects. Consider, for example, a plan to rezone agricultural land, located at the fringe of an industrial zone. The developer intends to set up an industrial plant that will manufacture steel products. In deciding whether to approve such a development, the municipality should consider not only technological or environmental externalities, such as increased pollution, or fiscal externalities, such as increased pressure on public roads, but also potential market externalities. If the presence of the steel plant will benefit other industries already located in the adjacent industrial zone—serving both the demand and supply side of the industrial products market—this positive market externality should be considered.

This does not mean, of course, that the concentration of similar land uses will always generate positive market externalities with an overall welfare effect. This is especially true concerning retail businesses, in which the issue of an internal supply and demand of products among businesses themselves is less relevant. Market externalities will apply mostly to the effect that businesses have on other businesses in positively or negatively attracting customers. Several studies have examined the effects of large retail businesses on revenues of other retailers and local employment rates, coming at times to different conclusions: some works seek to document the adverse effects that Wal-Mart stores have on other retail firms and total retail

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139. *Id*. at 485-86.

140. *Id*.

141. *Id*.

142. *Id*. *See also* Gideon Parchomovsky & Peter Siegelman, *Cities, Property, and Positive Externalities*, 54 WM. & MARY L. REV. 211, 240 (2012) (noting the mutual nature of positive externalities in the case of agglomeration effects).

employment,[143] while other studies show positive pecuniary externalities that large retailers generate for nearby retail establishments.[144]

In a recent study of the effects of big-box retailers on nearby establishments, Daniel Shoag and Stan Veuger offer a theory that seeks to bridge previous studies.[145] They argue that while the overall pecuniary effects of large retailers are positive, directly competing retailers are economically harmed by the presence of a big-box store.[146] The businesses that are positively impacted by their presence are ones that depend heavily on foot traffic, such as small retailers or restaurants. This also means that such positive externalities are negatively correlated with distance from the big retailer, meaning that such positive effects will be particularly significant within approximately a one-mile radius.[147] Moreover, this positive dependence has welfare effects, because many of these affected businesses cannot relocate in the event that the big-box store closes down.[148]

From a broader perspective, localities making zoning decisions should consider three types of market externalities: (1) welfare effects, (2) distributive effects, and (3) "second-hand" off-site environmental or fiscal externalities.

First, developers' siting choices and resulting zoning decisions may yield market externalities with a genuine welfare effect. Importantly, adjacent land users, who may be positively or negatively affected by a decision to rezone land or to otherwise approve a certain development, should not be seen as having an enforceable individual legal interest concerning market externalities. Adversely affected competitors should not be entitled to block a development because of potential market externalities, the same way that positively affected land users are not in a position to force the municipality to approve the project. Yet zoning goes beyond identifying specific legal interests that may be otherwise enforceable or actionable. Just as considerations of technological or environmental externalities extend beyond the prevention of nuisances that would be otherwise actionable in

143. *See, e.g.*, David Neumark et al., *The Effects of Wal-Mart on Local Labor Markets*, 63 J. URB. ECON. 405 (2008) (presenting data by which a Wal-Mart store opening reduces county-level retail employment by about 150 workers, implying that each Wal-Mart worker replaces approximately 1.4 retail workers).

144. *See, e.g.*, Efraim Benmelech et al., *The Agglomeration of Bankruptcy*, NBER Working Paper no. 20254 (2014) (observing that retail stores' bankruptcies produce negative externalities for other businesses).

145. Daniel Shoag & Stan Veuger, *Shops and the City: Evidence on Local Externalities and Local Government Policy from Big-Box Bankruptcies* (Working Paper, 2015), http://scholar.harvard.edu/files/shoag/files/shops_in_the_city.pdf [https://perma.cc/HN6V-SCCJ].

146. *Id.* at 6-13.

147. *Id.* at 13.

148. *Id.*

private law litigation, so do market externalities merit consideration by local governments if such externalities entail potential welfare effects.

Second, the distribution of positive market externalities, notwithstanding aggregate welfare effects, may also be a legitimate consideration in zoning decisions. Economists have tended to view such distributive grounds suspiciously, suggesting that the political process may allow powerful industries to protect their pecuniary interests at the expense of promoting overall welfare, such as by blocking competing land uses.[149]

As Sections II.A and III.A show, there is indeed room for concern when decisions driven by market externalities seek merely to serve as an anticompetitive, or an otherwise protectionist measure, at the expense of competitors and other stakeholders.[150] Yet distributive considerations that stem from market externalities should not always be considered normatively inadequate, especially when they are grounded in broad-based policy decisions. Section II.C discusses, for example, the pecuniary effects that market-rate developments may entail for low- and modest-income households.[151] To the extent that inclusionary zoning schemes are grounded in such market externalities and are part of a broad-based policy that addresses access to housing, the consideration of market externalities and their distributive effects may be legitimately weighed in such decisions.

Third, market externalities may also indirectly generate second-hand off-site technological, environmental, or fiscal externalities. Section II.A discusses the effects that a big-box store, such as IKEA or Wal-Mart, may have on small retail businesses located in the municipality's CBD.[152] A land use decision approving big-box development may create adverse market externalities for nearby businesses. In some cases, the closing down of a critical mass of retailers and related businesses, such as restaurants, may cause the CBD to decline. As documented in numerous studies, such an urban decline may have long-lasting effects that also feature adverse technological or environmental or fiscal externalities—ones that take years and much effort to reverse.[153]

This does not mean that the interests of businesses and other stakeholders in the CBD should always prevail over those of developers, who may have a legitimate business interest in operating somewhere else. Moreover, such developers are not individually responsible for the adverse results of such

149. Holcombe & Sobel, *supra* note 132, at 319-22.

150. *See infra* Sections II.A, III.A.

151. *See infra* Section II.C.

152. For the concept of a CBD see *supra* note 12 and accompanying text.

153. *See, e.g.*, Dagney Faulk, *The Process and Practice of Downtown Revitalization*, 23 REV. POL'Y RES. 625 (2006) (surveying the literature on how CBDs decline over time and whether they can be revitalized).

urban decay, such as physical blight or a decreased sense of security among remaining residents and businesses. No individual legal fault should be attributed to such developers for second hand off-site effects. Yet, here, too, the zoning power could extend beyond harms that are otherwise actionable in private law to regulate adverse market externalities.

II. THE REGULATION OF MARKET EXTERNALITIES

This Part moves to explore in more detail three settings in which zoning and land use decisions may entail market externalities. It looks at the current judicial approach to the validity of such considerations, pointing to hitherto unobserved similarities between cases. This analysis leads to the construction of a unified theory.

A. Entry of Commercial Uses

Any type of land use regulation that places practical limits on development may generate market externalities. In the housing context, several authors have argued that restrictive regulation is the key variable that explains increasing housing costs.[154] Such market effects in the residential context serve the interests of existing homeowners in high demand areas, incentivizing them to influence the political and regulatory process.[155]

Because of the large number and dispersed nature of existing homeowners and, even more so, of adversely affected end users (i.e., prospective buyers and renters), controversies about land use decisions that restrict development formally feature the developer, neighbors, and the local government as the disputants.[156] Local governments tend to rely in such cases on explicit considerations embedded in the control of technological or fiscal externalities, and judicial review determines the deference to such considerations.[157]

Matters change, however, when the regulation implicates the entry of commercial uses. The developer will usually have a financial stake in the long-term profitability of the commercial use, for example, the retail revenues that a big-box store would generate over time.[158] At the other end,

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154. *See* Edward L. Glaeser et al., *Why Have Housing Prices Gone Up?*, 95 AM. ECON. REV. 329 (2005) (suggesting that the problem is not one of declining availability of land, but rather one of tight regulation); John M. Quigley & Steven Raphael, *Regulation and the High Cost of Housing in California*, 95 AM. ECON. REV. 323 (2005) (arguing that regulation increases housing costs in California). This is not to say, however, that such effects of government intervention cannot be outweighed by overall positive results of measures such as compact development. *See, e.g.*, Jae Hong Kim, *Linking Land Use Planning and Regulation to Economic Development: A Literature Review*, 26(1) J. PLAN. LIT. 35, 43 (2011).

155. FISCHEL, *supra* note 24, at § 5.24.

156. ELLICKSON ET AL., *supra* note 7, at 83-84.

157. *Id.* at 34-45.

158. *Id.* at 112-17.

while some residents or interest groups may object to the project due to environmental or fiscal externalities, current retailers or related businesses would seek to play an explicit role given the potential market externalities that the development entails. Even if courts deny standing to retailers made anxious by competition, such stakeholders may seek to employ at least one of two tactics: funding litigation for residents or groups with standing[159] or lobbying the government to protect their interests. In the latter case, if the government supports such interests, it would typically tie its reservations to general concerns over the economic viability of the relevant area or industry.[160]

How should land use regulation draw the normative dividing line between anticompetitive behavior, tailored to promote the particular interests of an existing commercial user, and legitimate broad-based considerations of market externalities? Market externalities should be evaluated along the three dimensions presented above: (1) welfare effects; (2) distributive concerns; (3) control of second-hand, off-site environmental/fiscal externalities.[161] Additionally, the need to rely on a broad-based issue in such matters entails both economic and legal considerations.

From an economic perspective, market externalities are inherently the manifestation of a change to a certain preexisting market-equilibrium.[162] This change implicates numerous parties on both the supply and demand sides. An understanding of the geographical scope and the kind of industries affected by the entry of a commercial development cannot rely solely on simple proxies, such as a fixed distance or estimated revenues per square foot. The calculation goes well beyond a zero-sum game between existing and future retailers. Evaluating the effects of market externalities requires local governments to have a broader understanding of the commercial activity that takes place within its area's borders (and also outside of them, as Section III.B shows) and how positive or negative market externalities affect not only direct competitors but also related businesses. As suggested above,[163] the entry of a competing commercial use, such as a big-box retailer, may have a very different effect on existing retailers than is the case with a nearby complementary business, such as a restaurant.[164]

Moreover, from the point of view of aggregate welfare, a regulatory analysis of market externalities—and the effect of a prospective development on the economic viability of preexisting commercial

159. *Id.* at 117.
160. *Id.*
161. *See supra* Section I.E.
162. Laffont, *supra* note 58.
163. *See supra* notes 147-150 and accompanying text.
164. Shoag & Veuger, *supra* note 145.

activities—requires the municipality to take a general stand on matters that are at the basis of agglomeration economics. For example, does the city place a special value on downtown business districts that feature a multitude of small- and medium-scale retailers, or does it prefer retail economy concentrated at its perimeter?

The same dilemmas also touch on the two other dimensions of market externalities. A decision by a local government to prefer small- and medium-scale businesses to large-scale retailers because of distributive considerations must consider the implications of a regulatory decision on other small businesses that are not direct competitors of the prospective large retailer and which may be generally better off situating themselves near such big businesses.[165] If the city wishes to differentiate between various types of businesses in its distributive agenda—e.g., it seeks to preserve small fashion stores but it is less concerned about protecting mom and pop restaurants—it should not only offer a normatively valid reason for this differential treatment of small businesses but also design its commercial zones to achieve such a result. The same requirement for a broad policy should apply to the control of second-hand environmental externalities or fiscal effects. If the city is determined to decrease the prospects that its CBD will become rundown, it should have an explicit policy on what types of businesses are inherently essential for the economic viability of the CBD as a whole or are particularly prone to market externalities.

From a legal perspective, a broad-based policy regulating the entry of commercial uses, due to considerations of market externalities, is justified because existing private-law mechanisms (such as nuisance law) may fail to resolve certain types of externalities. As suggested earlier, the further away one moves from land uses that may otherwise constitute a wrong in private law, the greater the burden on the local government to ground its restrictions in a broad-based policy.[166] Of all externalities, market externalities are most often reciprocal—Coase's term—in identifying the normativity of the conduct.[167] Therefore, to the extent that a land use regulation limits the entry of a commercial use because of market externalities, the regulation must show how such a decision promotes *Euclidean* general welfare, in the most genuine sense, and why such a decision is not merely a pretext for preserving the status quo in the service of a politically powerful economic actor. Even within the "substantial relation" deferential standard,[168] a legal limit based on market externalities must rely on a credible broad-based policy.

165. *Id.*
166. *See supra* Section I.B.
167. *See supra* note 72 and accompanying text.
168. Vill. of Euclid, Ohio v. Ambler Realty Co., 272 U.S. 365, 395 (1926).

These insights may be instrumental in delineating the normative dividing line between legally inadequate protectionism and a legitimate control of market externalities, even if existing businesses may benefit from limits on entry of commercial uses in both cases.

Consider, on the one hand, the legal controversy over zoning limits placed on the entry of "formula businesses," typified by a "standardized array of services or merchandise, trademark, logo, service mark, symbol, decor, architecture, layout, uniform, or similar standardized feature."[169] This term seeks to capture major national retailers, such as Wal-Mart, McDonalds, or Starbucks.

Numerous municipalities in the United States have placed limits on such retailers, subjecting them to special permit procedures or economic impact reviews.[170] The reasons provided for such limits are usually grounded in preserving an appropriate balance of small-, medium-, and large-scale businesses, or in controlling other effects that such retailers may have on the community.[171] However, courts have scrutinized such regulations, especially when similar limits were not placed on other large businesses that do not have standardized features, meaning that the true motive for such limits is a targeted policy against specific retailers, not a general policy on the preservation of small businesses or the viability of the CBD.[172] This targeted policy in the guise of market externality analysis is especially prominent in the context of Wal-Mart, where labor unions seek to use municipal zoning regulations to prevent the entry of Wal-Mart stores.[173]

On the other hand, courts have been more deferential to zoning regulations that are grounded in a broad-based policy. In *Hernandez v. City of Hanford*, the California Supreme Court upheld a 2003 amendment to the city's zoning ordinance.[174] Aimed at protecting the "economic viability of Hanford's downtown commercial district," typified by a large number of "regionally well-regarded retail furniture stores," the original ordinance prohibited the

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169. *See* Island Silver & Spice, Inc. v. Islamorada, 542 F.3d 844, 845 (11th Cir. 2008) (quoting the language of Ordinance 02-02 §§ 6.4.3-4(a-b), adopted in 2002 by the City of Islamorada, Florida).

170. ELLICKSON ET AL., *supra* note 7, at 120-21.

171. *Id.* at 121.

172. *Island Silver & Spice*, 542 F.3d at 847-49 (reasoning that the goal of preserving Islamorada's "small town" features does not stand if other large non-standardized retailers are allowed, and holding that the special limits on formula retail violate the Dormant Commerce Clause's protection of interstate commerce).

173. ELLICKSON ET AL., *supra* note 7, at 121. *See also* Richard A. Epstein, *On Wal-Mart: Doing Good by Doing Nothing*, 39 CONN. L. REV. 1287 (2007) (arguing that Wal-Mart, or other big-box retailers, should not be singled out for special treatment and that they are not immune to competitive pressures).

174. 159 P.3d 33 (Cal. 2007).

sale of furniture in another commercial district, the "PC district."[175] The amendment created a special exception for large department stores—those with at least 50,000 square feet of floor space—located in the PC district, allowing them to sell furniture within a specifically described area of no more than 2500 square feet in the department store.[176] In so doing, the amendment sought to add to the original goal of preserving the economic viability of the downtown commercial district a new goal of attracting the "type of large department stores that the city views as essential to the economic viability of the PC district."[177]

The court viewed both goals as legitimate purposes and validated the zoning measures taken to attain them. Surveying the history of the zoning ordinance and its amendments, the court noted that, when the PC district was established in the late 1980s, a city committee identified types of commercial uses already established in the downtown district and which the city did not want removed to the PC district. These uses included car dealerships, banks, professional offices, and furniture stores.[178]

The court concluded that the zoning power extended to the regulation of economic competition to advance a legitimate public goal.[179] It held that a zoning ordinance is not necessarily invalid because it has the effect of limiting competition. Zoning actions in which the "regulation of economic competition reasonably could be viewed as a direct and intended effect" would be valid as long as the primary purpose is a "valid *public* purpose such as furthering a municipality's general plan . . . for localized commercial development" rather than simply serving a business's private anticompetitive interests.[180]

Thus, for example, a city's decision to limit the entry of discount superstores and to organize its commercial development in existing neighborhood shopping centers would be legitimate, even if it has a "direct and intended effect of regulating competition."[181] Such zoning would be valid as long as it serves legitimate purposes, such as maintaining the "vitality and economic viability of the city's neighborhood commercial centers," thus avoiding an "urban/suburban decay" that might result from the shifting of commercial activity.[182]

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175. *Id.* at 35.
176. *Id.* at 39.
177. *Id.* at 35, 39-40.
178. *Id.* at 36.
179. *Id.* at 44-45.
180. *Id.* at 42.
181. *Id.* at 44.
182. *Id.* at 43-45.

In this case, in working to preserve the downtown district, the City of Hanford identified in advance the types of commercial uses that served as the economic anchors of district.[183] Similarly, the local government identified department stores as the commercial anchor of the PC district and ordered the types and scope of commercial land uses within the district.[184] Therefore, the zoning ordinance did reflect a broad-based policy, not one merely tailored to protect private revenue streams of specific stores. For example, the Hanford zoning ordinance did nothing to limit the entry of new furniture stores in the downtown district or new department stores in the PC district.[185] It did not limit the number of competitors, instead regulating their spatial distribution. *Hernandez* exemplifies how an explicit consideration of market externalities may be normatively legitimate when it relies on a broad-based policy.

B. Renting Out Investment Property

The economic literature deals extensively with the market effects of investment in real estate made for speculative purposes.[186] Researchers have tried to determine if real estate speculation is primarily a cause for or a symptom of a property cycle, with one prominent study concluding that the effects of speculation appear to be dominated by the price elasticity of the housing supply.[187] This means that markets with more responsive regulatory environments or with less physical constraints on increasing housing supply will experience lower price volatility, as well as less speculative behavior.[188] An analysis of the U.S. real estate housing market and its price fluctuations between 1960 and 2011 suggests that the pre-2000 era was dominated by periodic "intrinsic bubbles," with buyers overreacting to changes in the costs of renting.[189] In contrast, the post-2000 period is dominated by "rational speculative bubbles" in which buyers cease to be influenced by underlying fundamental market factors and, instead, become "fixated on nonlinearly extrapolating the historical growth in housing prices" and attempt to guess future trends by looking at past price trajectories.[190]

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183. *Id.*

184. *Id.* at 45-46.

185. *Id.*

186. A speculative investment refers to the purchase of an asset that is driven primarily by its anticipated resale value rather than by intent for ongoing use. Ngai Pindell, *Home Sweet Home? The Efficacy of Rental Restrictions to Promote Neighborhood Stability*, 29 ST. LOUIS U. PUB. L. REV. 41, 66 (2009).

187. Stephen Malpezzi & Susan M. Wachter, *The Role of Speculation in Real Estate Cycles*, 13 J. REAL EST. LIT. 141 (2005).

188. *Id.* at 157-60.

189. Ogonna Nneji et al., *Intrinsic and Rational Speculative Bubbles in the U.S. Housing Market: 1960-2011*, 35 J. REAL EST. RES. 121, 135-47 (2013).

190. *Id.* at 147.

At the local level, such property investment—if it reaches a critical mass—creates market externalities at both ends of the price fluctuations. When the market is dominated by investors and prices go up precipitously, existing homeowners stand to gain, but potential households seeking to enter the municipality for long-term residency may be left out. Adversely, when the bubble crashes—as in the subprime crisis—current homeowners are also adversely affected by the sharp decrease.[191] This is especially so when high-leverage property investments end up in foreclosure. In addition to environmental externalities resulting from vacancies and neglect of distressed assets, which may then translate into lower prices for adjacent properties,[192] some authors attribute foreclosure externalities to a supply effect by which nearby foreclosure increases competition among sellers, thus leading to lower transaction prices for adjacent non-distressed properties.[193] Although foreclosures are not unique to investment properties, speculative buyers tend to be particularly footloose when the asset's net value goes below their cash contribution.[194]

Assuming that a certain municipality concludes that a high rate of investment-based housing unit acquisition might create adverse market externalities, what measures can it take to mitigate this phenomenon through its land use regulation powers? A flat prohibition on investment-driven purchases or other measures directly targeting a certain group of purchasers, such as differential real estate transfer tax rates, would exceed the authority of municipalities.[195] Such measures may prove constitutionally problematic even when taken by state or federal governments.[196] Municipalities must thus find ways that focus on the land use rather than chiefly on the identity of the user and that are reasonably related to the goal of increasing market stability.

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191. Pindell, *supra* note 186, at 44.

192. *See* Kristopher Gerardi et al., *Foreclosure Externalities: New Evidence*, 87 J. URB. ECON. 42 (2015) (arguing that the measured price spillovers are physical externalities caused by a lack of property maintenance and not pecuniary externalities that reflect local supply or demand shocks).

193. *See* Elliot Anenberg & Edward Kung, *Estimates of the Size and Source of Price Declines Due to Nearby Foreclosures*, 104 AM. ECON. REV. 2527 (2014) (acknowledging also the effect of nearby disamenities).

194. Jeff Crump et al., *Cities Destroyed (Again) for Cash: Forum on the U.S. Foreclosure Crisis*, 29 URB. GEOGRAPHY 745, 767-68 (2008) (showing this phenomenon in the minority neighborhood of North Minneapolis).

195. *Cf.* Repair Master, Inc. v. Borough of Paulsboro, 799 A.2D 599, 608 (N.J. Super. Ct. App. Div. 2002) (holding that the state legislature did not grant localities the power to deny or regulate a property owner's right to rent non-owner occupied housing in order to alter the "community's dynamics and demographics").

196. The variety of potential legal challenges to such prohibitions may include claims about takings and violation of procedural or substantive due process. *See* Pindell, *supra* note 186, at 77-80.

One technique that may be used for this purpose is to regulate the scope and manner of renting out housing units in the municipality, such as by putting a cap on the overall number of rental properties or establishing rules of use that would limit short-term rentals.[197] As for the latter, the use of consecutive short-term rentals has gained currency among investors over the past few years, especially with the introduction of web platforms such as Airbnb.[198] One clear and probably uncontroversial way to control short-term rentals would be to clarify the distinction between housing and hotel uses in the zoning ordinance.[199] Yet, cities might need to resort to other measures to control against the broader market externalities that result from investment property.

As the following paragraphs show, lessons learned from the limited case law on such rental restrictions indicate that a broadly applied ordinance, intended to alleviate market externalities, is more likely to withstand judicial scrutiny than an individually applied measure. Similar to the discussion in Sections I.E and II.A in the context of regulating the entry of commercial uses,[200] the need for a broad-based policy relies on both economics and law.

Consider two state cases. In *Gangemi v. Zoning Board of Appeals of Fairfield*, the Connecticut Supreme Court invalidated the conditioning of a variance to the zoning ordinance's setback requirements on prohibiting the applicants from renting out their beach property.[201] The zoning board grounded its condition in the "uniqueness" of the beach property.[202] The board argued that this ban would promote "the public health of the neighborhood" as well as its "general welfare" and would "conserve the value of the buildings located in the neighborhood."[203]

Holding that restrictions on the free alienation of property are not upheld "unless they serve a legal and useful purpose," the court noted that the proposed limitation did "not adhere to the rest of the property owners in the beach district."[204] Such a disparity "gives those other property owners a grossly unfair advantage over the plaintiffs in the marketplace."[205] Put in

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197. *See* Pindell, *supra* note 186, at 50-57.

198. For this burgeoning phenomenon, *see, e.g.*, Georgios Zervas et al., *The Rise of the Sharing Economy: Estimating the Impact of Airbnb on the Hotel Industry*, *SSRN* (2016), https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2366898 [https://perma.cc/XK5F-73Q5].

199. *See, e.g.*, Juliane Pepitone, *Judge Rules Airbnb Illegal in New York City*, CNN MONEY (May 21, 2013, 12:49 PM), http://money.cnn.com/2013/05/21/technology/innovation/airbnb-illegal-new-york/ [https://perma.cc/946E-DKHU].

200. *See supra* Sections I.E., II.A.

201. 763 A.2d 1011, 1016-18 (Conn. 2011).

202. *Id.* at 1014 n.8.

203. *Id.*

204. *Id.* at 1016-17.

205. *Id.* at 1017.

other terms, imposing a restriction on a single property would not "conserve the value of the buildings located in the neighborhood,"[206] because renting it out would not create any change to the market equilibrium. From a legal perspective, the court found unjustified the singling out of such faultless behavior—to the extent that what is at stake is only a market externality.[207]

In contrast, in the recent *Dean v. City of Winona* case, the Minnesota Court of Appeals held that a municipal ordinance, limiting to thirty percent the number of lots on a block eligible to obtain certification as a rental property, was a valid exercise of the city's police power and did not violate the appellants' constitutional rights.[208] The explicit problem resulting from the previous overabundance of rental properties was a shortage in parking—a technological and fiscal externality—and the cure provided by the amendment was to apply the thirty percent quota to blocks within designated city districts.[209] The court concluded that the "public has a sufficient interest in rental housing to justify a municipality's use of police power as a means of regulating such housing."[210] It held that the application of the cap through the districts' blocks and the fact that rental certifications are awarded on a "first-come first-served basis" preclude constitutional arguments concerning equal protection or due process violations.[211] Since "the owners of certified rental properties do not determine which other lots may be certified"[212] and the "30% cap was adopted after long-deliberate information gathering process," the court rejected the arguments about protectionism in the guise of policy.[213]

While the City of Winona's ordinance was concerned mostly with the control of technological or environmental and fiscal externalities resulting from congestion, a similar zoning ordinance might instead seek to control the potential market externalities resulting from the over-abundance of investment property. This does not mean, of course, that all municipalities would necessarily consider investment property as generating adverse market effects. Many municipalities in the United States pride themselves on being magnets to wealthy investors. For example, foreign magnates purchase multi-million dollar units in Manhattan's high-end condominiums,

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206. *Id.* at 1013 n.8.
207. *Id.* at 1015-16.
208. 843 N.W.2d 249 (Minn. Ct. App. 2014).
209. *Id.* at 254.
210. *Id.* at 258.
211. *Id.* at 260.
212. *Id.* at 263.
213. *Id.* at 261.

which they rarely set foot in, with New York City facilitating such acquisitions.[214]

Yet many other decision makers may come to a different conclusion about the desirability of property investment within their respective jurisdictions.[215] The massive presence of investors, especially those who look for a quick profit on resale and who, in the meantime, engage in consecutive short-term leases, might generate market externalities that could have both aggregate welfare and distributive effects. This may also result in second-hand environmental externalities if a market crash will lead to mass foreclosures. To the extent that a municipality's policy relies on a broad-based view of its real estate market, and subsequent zoning measures are not applied on an *ad hoc* basis or otherwise used to single out homeowners, such measures should be considered legitimate.

C. Inclusionary Zoning and Market Nexus

Section I.D discussed inclusionary zoning and how the California Supreme Court's 2015 decision in *California Building Industry Association v. City of San Jose*[216] validated the requirement for on-site, below-market-rate units to promote the positive social externalities of mixed-income neighborhoods.[217] In addition to facilitating positive social externalities, inclusionary zoning can also control market externalities generated by new developments.

To understand what types of market externalities may exist in the case of new residential projects, and how inclusionary zoning requirements may work to internalize such externalities, consider the following legislative findings from San Jose's inclusionary zoning ordinance, cited by the California Supreme Court in its decision:

> New residents of market-rate housing place demands on services provided by both public and private sectors, creating a demand for new employees. Some of these public and private sector employees needed to meet the needs of the new residents earn incomes only adequate to pay for affordable housing. Because affordable housing is in short supply in the city, such employees may be forced to live in less than adequate housing within the city, pay a disproportionate share of their incomes to live in adequate housing in the city, or commute ever increasing distances to their jobs from

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214. *See,* e.g., Louise Story & Stephanie Saul, *Stream of Foreign Wealth Flows to Elite New York Real Estate*, N.Y. TIMES (Feb. 7, 2015), https://www.nytimes.com/2015/02/08/nyregion/stream-of-foreign-wealth-flows-to-time-warner-condos.html [https://perma.cc/BR7V-UF5L]. For a detailed theoretical analysis of this phenomenon, see Amnon Lehavi, *Property and Secrecy*, 50 REAL PROP., TR, & EST. L.J. 381, 382-84 (2016).

215. *See* Pindell, *supra* note 186, at 65-68.

216. 351 P.3d 974 (Cal. 2015).

217. *See supra* notes 122-30 and accompanying text.

> housing located outside the city. These circumstances harm the city's ability to attain employment and housing goals articulated in the city's general plan and place strains on the city's ability to accept and service new market-rate housing development.[218]

Put in simple terms: the development of market-rate units brings in new households to the city. The households use their income to consume goods and services. This additional consumption translates into new jobs. Many of these jobs, such as in the retail, restaurant, and health-care industries, are low-compensation jobs. This results in new low-income households unable to afford market-rate housing units in the city[219] and creates an aggregate "affordability gap" embedded in market conditions.[220] Because developers generate market externalities, which operate through the price system, they should internalize them by providing below-market units or paying in lieu fees.[221] This establishes a market nexus that should be regulated by inclusionary zoning.

The California Supreme Court did not explicitly address this type of market externality logic. It reasoned, instead, that the City of San Jose could promote a legitimate goal of "increasing the number of affordable housing units in the city in recognition of the insufficient number of existing affordable housing units" and that the zoning measures should only establish a general "reasonable relationship" to such a goal.[222] However, this section expands the market externality logic, showing how it could be tied to the state's broad land use policy.

Since 1980, California has required each local jurisdiction to plan for its share of the state's housing need for households of all income levels. Under this "Housing Element Law,"[223] localities are required to adopt the housing elements as part of their general plans, which should account for both existing and projected housing needs, and to submit such housing elements for state certification.[224] The Regional Housing Need Allocation ("RHNA") is the state-mandated process that identifies, for each eight-year period, the total number of housing units that each municipality must accommodate in

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218. *Cal. Bldg. Indus. Ass'n*, 351 P.3d at 982 (quoting San Jose, Cal., Mun. Code § 5.08.010 F).

219. *See* Keyser Marston Associates, *Residential Nexus Analysis: San Jose, California* 1, 6 (Oct. 2014), http://www.sanjoseca.gov/DocumentCenter/View/32877 [https://perma.cc/NQK3-PS72].

220. *Id.* at 38.

221. *Id.* at 4-6, 37-38.

222. *Cal. Bldg Indus. Ass'n*, 351 P.3d at 979, 987.

223. CAL GOV'T CODE § 65580 (Deering 2017).

224. *See* CAL. DEP'T OF HOUS. & CMTY. DEV., *Regional Housing Need Allocation and Housing Elements*, http://www.hcd.ca.gov/community-development/housing-element/index.shtml [https://perma.cc/U59C-VYZJ].

its housing element.[225] In the first stage, the state Department of Housing and Community Development determines the total housing needs, by affordability level, for each region in the state. Then, each regional "council of governments" is tasked with distributing these needs to local governments.[226]

Such regional and local RHNA allocations are divided into four income categories that encompass all levels of housing affordability: "very low" (up to fifty percent of the Area Median Income ("AMI")); "low" (fifty-one to eighty percent of AMI); "moderate" (81-120% of AMI); and "above moderate" (above 120% of AMI).[227] "Once the municipality receives its RHNA allocation, it must update the housing element of its general plan to show how it plans to meet the housing needs in its community."[228]

Importantly, the RHNA is a zoning requirement, meaning that cities must ensure their zoning schemes can accommodate the mandated housing elements, not that they actually produce those housing units.[229] This distinction is essential both legally and practically. While in some cases reluctant localities have been sued for failing to meet their RHNA zoning requirements, in most cases, zoning ordinances allow for a sufficient amount of housing, but the actual development is not completed.[230] This development gap occurs predominantly in all affordability levels below "above moderate" market-rate development. This is due to constant defunding by the federal government for the "very low" housing programs,[231] recent changes at the state level—such as the 2012 abolition of redevelopment agencies and Tax Increment Financing ("TIF") programs that

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225. *Id.*

226. *Id.*

227. *Id.*

228. *See* ASS'N OF BAY AREA GOV'TS (ABAG), *Regional Housing Need Plan: San Francisco Bay Area: 2014-2022*, 1, http://www.abag.ca.gov/planning/housingneeds/pdfs/2014-22_RHNA_Plan.pdf [https://perma.cc/URR8-YZ5Q]. The current RHNA covers the period between 2014 and 2022, and it has required all localities to update their general plans by early 2015. *Id.*

229. Interview with Glen Campora, Paul McDougal, Anda Draghici, and Melinda Coy, California Dept. of Hous. and Cmty. Dev., in Sacramento, Cal. (July 24, 2014).

230. Interview with Joshua Abrams, Baird + Driskell Cmty. Plan., in Berkeley, Cal. (June 13, 2014).

231. Interview with Hing Wong and Gillian Adams, Ass'n of Bay Area Gov't, in Oakland, Cal. (May 29, 2014).

had dedicated considerable funds to affordable housing[232]—and local political and financial obstacles to development.[233]

Inclusionary zoning schemes are therefore intended to bridge the gap between formal zoning for residential uses and the creation of mechanisms that will enable the actual development of affordable units across all income categories (based on the proposition that households should not spend over thirty percent of their income on housing costs).[234] More than 170 localities in California already adopted such schemes, offering different mixtures of inclusionary zoning alternatives including on-site units, off-site units, in lieu fees, dedication of land, or rehabilitation of existing affordable housing.[235]

The choice of the inclusionary zoning mechanisms may implicate both the legal standard that would apply to such zoning measures and the technique used to quantify the scope of market externalities created by the market-rate developments. It should be noted that the California Supreme Court's embrace of the deferential standard in *San Jose* was based on the conclusion that limiting the sale price of fifteen percent of the on-site units constitutes nothing more than a regulation of land use, within the scope of the city's police power.[236]

The legal standard may be, however, somewhat different for inclusionary zoning schemes that focus on market-rate rental projects or on the increasing tendency of California cities to embrace a mechanism of straight fees, instead of in lieu fees—thus allowing the city to support unit production independent of the given project for which the fee is assessed.[237] If a city establishes a legislative formula for a fee, whether explicitly defined as a mitigation fee covered under the Mitigation Fee Act[238] or otherwise substantially intended

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232. Interview with Charles Bryant, Dir., Plan. and Bldg. Env't, City of Emeryville, Cal. (June 9, 2014); interview with Norma Thompson, Dept. of Hous. and Cmty. Dev., and Alicia Parker, Dept. of Planning, City of Oakland (June 19, 2014). For the role of redevelopment agencies and TIFs in the financing of affordable housing, and the reasons for the dissolution of these agencies in 2012, see Mac Taylor, *The 2012-13 Budget: Unwinding Redevelopment*, LEGIS. ANALYST'S OFF. (Feb 17, 2012), http://www.lao.ca.gov/analysis/2012/general_govt/unwinding-redevelopment-021712.pdf [https://perma.cc/2B92-AQKW].

233. Interview with Eric Angstadt, Dir. of Planning, City of Berkeley (June 13, 2014).

234. This general benchmark for affordability guides both federal and state governments. *See Affordable Housing*, HUD, https://portal.hud.gov/hudportal/HUD?src=/program_offices/comm_planning/affordablehousing/ [https://perma.cc/W9VA-TECP].

235. California Bldg. Indus. Assn. v. City of San Jose, 351 P.3d 974, 977, 983-84 (Cal. 2015).

236. *Id.* at 987-88.

237. For a review of the entangled legal landscape prior to the San Jose ruling, see generally Andrew L. Faber, *Inclusionary Housing Requirements: Still Possible?*, LEAGUE OF CAL. CITIES (2014), http://www.cacities.org/Resources-Documents/Member-Engagement/Professional-Departments/City-Attorneys/Library/2014/2014-Annual/9-2015-Annual-Andrew-Faber-Inclusionary-Housing-Re.aspx [https://perma.cc/VWS5-5VHM].

238. CAL GOV'T CODE § 66001.

to offset the social costs of a project, it has to show a "reasonable relationship between the fee's use and the *type* of development project on which the fee is imposed."[239] A fee established legislatively in a zoning ordinance would not be subject to the *Nollan/Dolan* strict standard for *ad hoc* exactions, because it is not tied to the particular effects of a specific project but, rather, to the usual effects that such types of projects generate. On the other hand, the "reasonable relationship" is more demanding than the general standard that applies to the exercise of the police power, which looks more generally at the public goal.[240]

To meet the "reasonable relationship" standard that applies to the legislative setting of a fee channeled to affordable housing, cities in California are increasingly engaging in a "nexus" study, seeking to show the generic market effect of market-rate developments on low-compensation employees who enter the job market and must now search for housing.[241] These nexus studies clearly focus on market externalities. These studies do not deal with technological or environmental externalities or with fiscal ones. They do not focus on the project-specific effects of the development but on its general ones by establishing the projects' statistical share in the overall market effect.[242]

For example, a nexus study, prepared for the City of San Jose in 2014, showed support for a new legislative scheme for fees imposed on developers of market-rate rental projects (thus not covered under the 2010 ordinance upheld by the California court).[243] The study's methodology relied on the Impact Analysis for Planning ("IMPLAN") model, which quantified the effects of changes in a local economy, including impacts of changes in income on employment.[244] In essence, the study worked in modules of one hundred market-rate housing units built by the developer. It calculated the overall free income of such market-rate households and its impact on job creation in the local economy. It then identified the types of new jobs created, including low- and modest-income jobs, and the "affordability gap" that exists for new worker households that require subsidies or other forms of public assistance to afford housing in or around the community. The

239. *Id.* at § 66001a(3) (emphasis added).

240. Faber, *supra* note 237, at 8-9.

241. ADAM F. CRAY, THE USE OF RESIDENTIAL NEXUS ANALYSIS IN SUPPORT OF CALIFORNIA'S INCLUSIONARY HOUSING ORDINANCES: A CRITICAL EVALUATION - A REPORT TO THE CALIFORNIA HOMEBUILDING FOUNDATION (Nov. 2011), http://www.cbia.org/uploads/5/1/2/6/51268865/residential_nexus_analysis_in_support_of_california_complete.pdf [https://perma.cc/PF38-9J4F].

242. *Id.* at 9-15.

243. Keyser Marston Associates, *supra* note 219.

244. IMPLAN is a commercially available economic model and database. *See* IMPLAN, http://www.implan.com/ [https://perma.cc/3BPH-LKPK].

overall amount of public expenditures required to close the "affordability gap" is then broken-down to 1/100 shares to calculate the fee imposed on each market-rate unit.[245]

This type of market nexus analysis is embraced throughout California, although localities regularly establish the fee at a lower threshold than the maximum.[246] San Mateo County conducted, in 2015, a comprehensive nexus analysis for twenty-one localities.[247] With the tailwind provided by the recent *San Jose* case, more localities may follow suit.

The key lesson provided by this methodology is how the economic nexus study is translated into a regulatory and legal framework. Developers and, through them, market-rate households are required to account for the market externalities they generate. This mechanism is inherently based on a broad analysis. It does not—and cannot—attribute an "earmarked" market externality to a single unit. It is based on a system of statistical extrapolation and then distribution. This is understandable from an economic perspective because market changes are a result of aggregate changes in supply and demand. A single household does not create a discernible market change in housing. The aggregation of new residential developments does create such a change.

From a legal perspective, the use of a broad-based formula to calculate the individual fee representing a market-rate unit's pro rata contribution to the market externality is sound policy. It does not single out a developer or a

245. Keyser Marston Associates, *supra* note 219. The analysis followed a number of stages. First, the study identified rental prototypes that represent typical private, market-rate rental projects in San Jose and the current rental rates for average units in such projects. Second, average household income was determined from the rent levels, based on the assumption that market-rate renters spend thirty percent of their income on rent. To simplify the calculation, the analysis was then conducted on one hundred unit project modules. Third, the IMPLAN-based model linked these incremental annual household expenditures for the households in the one hundred market-rate units into job creation in the local economy. The model identified those jobs that serve new residents directly, such as supermarkets, those that serve businesses that serve residents, such as wholesalers, and jobs generated when these new employees spend their own wages in the local economy. The study then accumulated the number of new worker households expected in the city, recognizing that there is, on average, more than one worker per household. Fourth, these new worker households were then distributed via the model to the four income categories (very low; low; moderate; above moderate). The model then identified the average subsidy needed to provide affordable housing for each income category (such subsidy being referred to as the "affordability gap" in each income category). The model then summed up the overall affordability gap costs for each income category. Finally, when the affordability gap conclusions for each income category were linked to the overall amount of affordable housing required as a result of the market-rate development and were then divided by one hundred units, the result was the total nexus cost per new market-rate residential unit. Such a fee can be further divided and expressed in dollars per market-rate square foot. Either way, this nexus analysis establishes the maximum fee. *Id.*

246. Interview with Eric Angstadt, *supra* note 233.

247. Interview with Joshua Abrams, *supra* note 230.

unit owner for their individual generation of a market externality. It identifies, rather, the typical market externality that such projects generate and entrenches it in a legislative formula that does not favor specific developers or land users over others. In so doing, this broad-based scheme should be seen as meeting the legal standard of reasonable relationship between the "fee's use and the *type* of development project on which the fee is imposed."[248] It seeks to capture a broad economic phenomenon and regulate it through zoning power.

III. JUDICIAL REVIEW OF MARKET-BASED ZONING

This Part consolidates the lessons learned from the cases presented in Part II and offers a general framework for legitimizing the broad-based regulation of market externalities. It then addresses an important contingency: *inter-local* market externalities. This Part argues that local governments should be held accountable for the market externalities that their zoning decisions generate on other localities, whenever such effects contradict the broad-based policy that the city embraces to control its own *intra-local* market externalities.

A. Consistency with Overall Land Use Policy

Previous Parts laid the foundation for identifying market externalities resulting from land use and explained how zoning and other regulatory decisions could account for dimensions of aggregate welfare, distribution, and second-hand off-site technological or fiscal externalities embedded in market externalities.[249] While there may be room for debate about the analysis of potential market externalities and the respective conclusions in contexts such as the entry of commercial uses, renting out of investment property, or inclusionary zoning, the control of market externalities should be explicitly recognized as a legitimate basis for zoning power.

At the same time, the need to tie the level of judicial review to the breadth and scope of the local-land use policy plays a prominent role in the context of market externalities. The distinction between legislative or broad-based policy and *ad hoc* or adjudicative decision making goes beyond considerations of rule of law, democratic accountability, and the need for occasional flexibility that regularly implicate land use law and policy.[250] The need to have a citywide, or at least an industry-wide, analysis prior to regulation touches on the very foundations of identifying the existence of a

248. *See supra* notes 238-39 and accompanying text.

249. *See* discussion *supra* Sections I.E, II.A, II.B, II.C.

250. Fennell & Peñalver, *supra* note 90, at 34-46. *See also* Eric Biber & J.B. Ruhl, *The Permit Power Revisited: The Theory and Practice of Regulatory Permits in the Administrative State*, 64 DUKE L.J. 133, 178-212 (2014) (surveying the tradeoff between general versus specific permit-design in various contexts).

market externality and of normatively justifying the control over such potential effects through zoning rules.

From an economic perspective, a market externality is a process in which a certain market-equilibrium undergoes a change through the price system.[251] As such, it conventionally implicates numerous parties on both the supply and demand sides. This is the case when one examines the effects of a new commercial project on other businesses and consumers, the price effects of investment properties on the rental or sales market, or the influence of new residential market-rate projects on the local job market and consequently on the entry of low- and modest-income workers in need of housing.[252]

This means that in most cases, a single development will not generate any type of market externality, but it might contribute to such a change in conjunction with other contemporaneous projects, resulting in a critical mass that creates a new equilibrium.[253] When this is the case, identifying a market externality or designing an adequate regulatory response (whether through a limit on land use, quota setting, or a fee system) needs to be completed within a broader picture of the changing landscape of the city.

Indeed, there may be cases in which a single development could generate a market externality. This would be so especially in the case of a big-box retailer, such as a Wal-Mart.[254] Here too, however, a market analysis would require a broad analysis of the entire array of affected businesses and, more generally, of the policy choice between downtown business districts and spread-out retailers.[255] An economic analysis based on agglomeration effects, or even on distributive concerns, would make little sense without a general policy on retail. These settings are therefore materially different from purely anticompetitive motives, such as when a single grocery store objects to a variance to set up a new grocery store on the other side of the street—with no discernible broader effects.[256]

From a legal perspective, the generation of a market externality should be considered blameless conduct, with no clear division between wrongdoer and victim. This is unlike some cases of environmental externalities, in which the normative basis of regulation lies in identifying a party who creates a conflict (even if such an action is not proscribed as a nuisance or

251. *See supra* text accompanying notes 131-37.

252. See discussion of the various types of market externalities *supra* Part II.

253. Parchomovsky & Siegelman, *supra* note 142, at 237.

254. Shoag & Veuger, *supra* note 145, at 4.

255. *See* discussion *supra* Section II.A, about the entry of new commercial uses into cities.

256. *Cf.* Holcombe & Sobel, *supra* note 132, at 305 (suggesting that a Burger King wishing to open up next door to a McDonalds should not compensate the owners of McDonalds for the pecuniary externalities it may inflict).

another private law wrong)[257] or a fiscal externality, in which new public expenses must be incurred.[258] As a matter of policy, individuals and firms should be encouraged to act in the market, promote competition and innovation, and otherwise stimulate the economy.[259] There are cases in which considerations of agglomeration effects, distribution, or the possibility of second-hand externalities may justify the regulation of land uses intended for such an activity.[260] However, these limits are not based on an initial normative judgment about the wrongful nature of the activity.

In contrast, no individual party can be viewed as legally entitled to block such an economic activity because this would infringe a legally recognized right or immunity from a change to the status quo.[261] A retailer has no vested right not to have competition around it or to be compensated for such competition. A homeowner has no individual entitlement to prevent others from investing in real estate in her neighborhood. A low-income employee has no direct cause of action, or even a principled normative claim, against a market-rate household that generates demand for her services. In all of these cases, the justification for regulation lies in a general evaluation of the effects of a change to the market-equilibrium. As such, its legal validation must be based on a broad policy. These observations do not preclude the possibility that in some cases, the regulation of a market externality must go beyond fixed formulas to provide a proper solution. The physical location of a big-box store, the type of products it is selling, and the composition of preexisting businesses may change across different scenarios, and would accordingly affect the identification of the market externality and the measures of control.[262] This type of required flexibility should not be equated, however, with *ad hoc* decision making, which attempts both to identify the problem and to cure it solely on a case-specific basis.[263]

Conversely, in the case of technological or environmental or fiscal externalities, there could be cases in which an *ad hoc* analysis would be problematic, but, at the least, it would be based on some initial normative baseline that identifies the cause of the externality and its anticipated consequences.[264] The *Nollan*/*Dolan* framework, which requires localities that make *ad hoc* land use decisions to illustrate an "essential nexus" and "rough proportionality" between the development and its adverse

257. *See supra* Section I.B.
258. *See supra* Section I.C.
259. Holcombe & Sobel, *supra* note 132, at 304-06.
260. *See supra* Part II.
261. Holcombe & Sobel, *supra* note 132, at 305.
262. Shoag & Veuger, *supra* note 145.
263. Fennell & Peñalver, *supra* note 90, at 312-14.
264. *See supra* Section I.B.

consequences,[265] inherently assumes that such an analysis of the cause and the cure can be made on an individual basis. In the case of a market externality, this assumption does not work. When a market externality is concerned, the "substantial relation" or "reasonable relationship" tests, while generally more lenient, may prove the only feasible way for courts to address the legal validity of zoning mechanisms intended to address market externalities.[266] Such a legal standard provides relief to the local government by releasing it from having to identify a market externality that can be attributed to a specific project. At the same time, this standard also places a burden of persuasion on the local government. The city must demonstrate that the zoning rationale conforms to its broad policy and would be applied elsewhere in the city.

Finally, one should consider the role of zoning decisions, and the legal standard that should apply to their review, when such decisions seek to focus on the generation of positive market externalities, rather than merely on preventing or mitigating negative market externalities resulting from new development.

The discussion of positive market externalities requires even more differentiation between private law entitlements and the legitimacy of land use regulation than is the case with adverse market externalities. The law of restitution usually does not entitle a benefactor to require payment or another kind of compensation from beneficiaries-in-fact, including when a developer carries out a project that provides unsolicited positive externalities.[267] A neighbor cannot be held liable for a self-serving activity by another landowner that incidentally improves the neighbor's land, even when the monetary value of the benefit is easily measured.[268] This principle also applies when the benefit stems directly from a specific land use regulation, such as when a developer is required, as a condition for approving her subdivision map, to construct an additional road, which ensures that a neighboring landlocked property would gain access to the nearest thoroughfare.[269]

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265. *See supra* notes 92-105 and accompanying text.

266. *See supra* notes 20-24 and accompanying text.

267. *See generally* Green Tree Est. v. Furstenberg, 124 N.W.2d 90 (Wis. 1963) (holding that a developer was not entitled to recover from a neighbor for voluntary construction of street improvement, curbs, and gutters).

268. *See*, *e.g.*, Ulmer v. Farnsworth, 15 A. 65 (Me. 1888) (rejecting the plaintiffs' claim for recovery after their pumping of water from their own quarry unavoidably drained water from the defendant's quarry). *See also* Restatement (Third) of Restitution and Unjust Enrichment § 2(e) (Discussion Draft 2000).

269. *See generally* Dinosaur Dev. v. White, 265 Cal. Rptr. 525, 526 (Ct. App. 1989) (rejecting the restitution-based claim of a developer against his neighbor under such circumstances).

The reasons for private law's reluctance to require beneficiaries to contribute to the internalization of positive externalities lie in considerations of autonomy and preference for pre-activity agreements, especially if the activity is sufficiently profitable for its doer, so that the "free riding" by the beneficiary will not undermine the activity altogether.[270] Authors have also pointed to other dimensions of asymmetry between benefits and harms, including the nature of scope of the potential effects in the absence of private law rules.[271]

Yet, regardless of the arguments against restitution in the private law context, zoning and other types of land use regulation are entitled to take into account the positive externalities that a proposed project may entail and should aim at maximizing such social benefits in order to promote the local "general welfare."[272]

Consider the following hypothetical. A city wants to introduce more retail activity within its jurisdiction. For this purpose, the city considers rezoning for commercial use one of two agricultural or currently undeveloped areas located in different parts of the city. After a careful study, it concludes that, all other things being equal, rezoning Area A would generate more positive market externalities for adjacent businesses and households, as compared with Area B, because of geographic and other considerations. Assume further that the city concludes that rezoning both areas simultaneously would result in excess commercial development, which could end in a massive closing down of businesses. A decision to approve the rezoning of Area A, based on the analysis of such positive market externalities, should be considered legally valid. This would be so even if such a decision stands to benefit the current landowners of Area A over those of Area B, provided that retail developers could purchase land in Area A.

The more difficult issue is how to balance positive market externalities with the developer's self-interests, if these two components are not perfectly aligned. The municipality may have to offer developer incentives to ensure optimal land use. Consider again the city's hypothetical case. Assume now that the same developer owns both Area A and Area B in their entirety. The

270. *See* HANOCH DAGAN, THE LAW AND ETHICS OF RESTITUTION 130-45 (2004) (stressing the importance of restitution in solving free riding scenarios when the respective parties' interests are genuinely locked in).

271. *See, e.g.*, Ariel Porat, *Private Production of Public Goods: Liability for Unrequested Benefits*, 108 MICH. L. REV. 189, 199 (2009) (arguing that in the case of harm, without regulation or internalization, "there would be no restriction whatsoever on injurers' harmful activities," whereas no such risk exists in the case of benefits because, at worst, the level of positive externalities would fall to zero).

272. Referring to the underlying rationale of promoting the "general welfare" through the zoning power, articulated in Village of Euclid v. Ambler Realty Co., 272 U.S. 365, 388 (1926).

developer would actually prefer to develop Area B, because it is geographically closer than Area A to the seaport through which the developer imports its retail products, meaning that the developer would save on transportation costs if Area B is developed. Assume further that the sum of the developer's savings on transportation costs in Area B is smaller than the difference in positive market externalities in favor of Area A. However, because the developer cannot internalize the positive market externalities it is generating (assume that such externalities are not reciprocal), it will prefer to rezone Area B over Area A. What the city could do in such a case is to offer the developer a density bonus for developing Area A.

This decision should be anchored in a broad policy, by which the city incentivizes developers that generate positive market externalities. If the societal costs, including environmental costs resulting from increased density, do not outweigh the overall benefits from rezoning Area A over Area B, such a zoning decision should be considered both economically sensible and legally valid. Localities should accordingly extend explicit considerations of market externalities to facilitate positive externalities, instead of just controlling against negative ones.

B. Intergovernmental Market Externalities

The analysis so far assumes that both positive and negative market externalities fall within the boundaries of a single local government, which can then act to control or facilitate them through its power to regulate land use. In reality, however, all types of land use related externalities may, and often do, spill over across municipal boundaries.[273]

This could be the case with technological or environmental externalities, such as when a zoning decision enables the construction of a factory in City A that results in pollution that reaches City B.[274] Fiscal externalities may also cross municipal borders. For example, a busy commercial hub located in the outskirts of City A could increase congestion in nearby transportation arteries located in City B, requiring the latter to undertake public expenditures.[275] Social externalities may also cross municipal borders, such as when exclusionary zoning practices of wealthy suburbs pass the burden of accommodating low- and modest-income families to the nearby central city.[276]

Market externalities are no exception. Rezoning land for a big-box retailer located in City A might positively or negatively affect the market

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273. Shoag & Veuger, *supra* note 145.

274. For the prevalence of this phenomenon, see Lehavi, *supra* note 9, at 931-32, 940-48.

275. *See* Lehavi, *supra* note 9, at 931-32, 940-48.

276. GERALD E. FRUG, CITY MAKING: BUILDING COMMUNITIES WITHOUT BUILDING WALLS 76-85 (1999).

performance not only of existing businesses in the CBD of City A but also that of adjacent businesses located in City B.[277] Similarly, the abundance of investment properties in one city may affect market prices in another municipality, when the two localities are part of the same metropolitan area, meaning that prospective homebuyers and renters view them as a single real-estate market.[278] Finally, the entry of new market-rate residential projects and their residents' resulting demand for low-compensated service workers may affect housing needs and potential affordability gaps in all the municipalities located within commuting distance to these workplaces.[279]

The analysis of the challenge of inter-local market externalities is based on the following principles. First, it identifies why political and fiscal considerations operate differently for zoning decisions entailing intra-local externalities than those that generate inter-local effects. Second, it explains the normative foundations of limiting cities in generating foreseeable inter-local externalities when such decisions contradict their established policy for controlling against intra-local externalities. Third, it offers preliminary thoughts on potential mechanisms for facilitating positive intergovernmental market externalities.

When the negative and positive market externalities of a proposed development are concentrated in a single jurisdiction, political and fiscal reasons may drive the municipality to account for such externalities.[280] A spread-out big-box development project entailing significant adverse externalities for existing businesses in the CBD might result in political discontent by local business owners, their employees, and those who otherwise value a thriving CBD. While the balance of political influence changes across projects, there is some sense of political accountability in such settings.[281] From a fiscal perspective, market externalities might result in lower property taxes—or even in an effective loss thereof in the case of foreclosure or long-lasting vacancies—or in a drop in sales tax revenues

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277. Shoag & Veuger, *supra* note 145.

278. Edward L. Glaeser & Joshua D. Gottlieb, *The Economics of Place-Making Policies*, BROOKINGS PAPERS ON ECON. POL'Y, 155, 158-68, (Spring 2008), https://www.brookings.edu/wp-content/uploads/2008/03/2008a_bpea_glaeser.pdf [https://perma.cc/J5NZ-K68N].

279. One example is the San Joaquin Valley in central California, a mixed rural and urban area, which provides housing for low-income workers employed in affluent Bay Area cities. Interview with Glen Campora, Paul McDougal, Anda Draghici, and Melinda Coy, *supra* note 229.

280. Lehavi, *supra* note 9, at 941.

281. *See*, *e.g.*, Carol M. Rose, *Takings, Federalism, Norms*, 105 YALE L.J. 1121, 1131-35 (1996) (arguing that "exit" and "voice" options of constituents constrain local government's inefficient decision making).

when CBD businesses experience a decrease in proceeds.[282] This makes local governments internalize some of the adverse market externalities and generally motivates them to consider, upfront, the overall effects of a proposed project.

In contrast, when adverse market externalities fall outside the boundaries of the local government, there are no obvious incentives to consider their political and fiscal implications. Affected parties do not vote in the local elections, and the fiscal losses resulting from decreased property tax or sales tax revenues fall on other municipalities.[283] Notwithstanding the general model of long-term relationships among neighboring local governments, the problem of apathy to cross-border externalities is a documented phenomenon and is often exacerbated by an open contest for tax-yielding businesses.[284] In the latter case, apathy may turn into an intention to shift market activity across borders.[285]

To illustrate this problem, consider a 2004 amendment to the California Government Code, which forbids local governments to provide "any form of financial assistance to a vehicle dealer or big box retailer . . . that is relocating from the territorial jurisdiction of one local agency to the territorial jurisdiction of another local agency but within the same market area."[286] This legislation, while controversial,[287] clearly intends to limit intergovernmental market externalities by prohibiting neighboring agencies from luring developments.

This phenomenon is not limited to retail land uses: cities in California's Bay Area compete for big office complexes and use zoning to turn underutilized land uses into corporate offices.[288] Apple's new headquarters in Cupertino is a prominent example.[289] Recent empirical evidence shows that local governments are well aware of the nature and scope of market externalities and may consequently design their land uses to maximize positive externalities within their jurisdiction and to shift bad ones

282. *See, e.g.*, Helen F. Ladd, *Land Use Regulation as a Fiscal Tool, in* LOCAL GOVERNMENT TAX AND LAND USE POLICIES IN THE UNITED STATES: UNDERSTANDING THE LINKS 55 (Helen F. Ladd ed., 1998).

283. Lehavi, *supra* note 9, at 941-45.

284. *Id*. at 940-56.

285. Lehavi, *supra* note 9, at 940-56.

286. Cal. Gov. Code. § 53084 (West 2006).

287. *See* MAX NEIMAN ET AL., LOCAL ECONOMIC DEVELOPMENT IN SOUTHERN CALIFORNIA'S SUBURBS: 1990-1997 (2000) (offering a criticism of this statutory intervention and an argument that inter-local competition did not have an independent effect on local development policies prior to this legislation).

288. Interview with Joshua Abrams, *supra* note 230.

289. *See Apple Campus 2 Construction Update*, CITY OF CUPERTINO, http://www.cupertino.org/index.aspx?page=1223 [https://perma.cc/67HX-JEQ6].

elsewhere.[290] For example, as Shoag and Veuger show, the precise physical shape of municipal borders matters for capturing the positive market externalities of big-box stores.[291] "Compact" cities, such as a city shaped like a perfect circle, can capture nearly all the benefits of a big-box store placed in the middle. In contrast, non-compact cities, such as an "L" shaped-one, do not enjoy the same result, with much of the positive effects instead crossing their borders.[292] Accordingly, compact cities focus more on retail development, including through subsidies, than non-compact ones.[293] Cities consciously respond, therefore, to the inter-local dimensions of market externalities.

Should local governments ever be liable to adjacent municipalities for adverse market externalities? If so, what could be the basis for legal recourse against local governments for market externalities that can be attributed to zoning or other regulatory decisions? As shown above,[294] private law is not the appropriate means for addressing intra-local market externalities, and is similarly poorly suited to address inter-local market externalities. A developer's decision to set up a new business and, correspondingly, a city's decision to approve the required zoning cannot be viewed as constituting a legal wrong because the increased competition will inflict losses on current businesses.[295] An existing business should not be viewed as having an enforceable right or a principled normative claim for preserving the economic status-quo under such circumstances.[296] Awarding such a private entitlement could inadvertently lead to private litigation between two competitors, who will miss out on the broader view of the multi-party market-equilibrium effects.[297] The justification for controlling against potential market externalities lies in the local government's ability to shape a broad-based policy regarding the various aspects of market effects, and it should be held responsible for properly administering this policy.[298]

The appropriate entities to contest zoning measures that generate extra-local market externalities are adjacent local governments rather than private individuals or businesses located within them.[299] A neighboring local

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290. Lehavi, *supra* note 9, at 948-52.

291. Shoag & Veuger, *supra* note 145, at 16-23.

292. *Id*.

293. *Id*.

294. *See supra* note 166 and accompanying text.

295. *Cf.* the discussion about why businesses do not generally have legal obligations toward competitors for any pecuniary externalities inflicted by their market activity *supra* notes 267-71 and accompanying text.

296. *See supra* notes 267-71 and accompanying text.

297. *See supra* notes 267-71 and accompanying text.

298. *See supra* notes 267-71 and accompanying text.

299. Lehavi, *supra* note 9, at 962-77.

government is the body that can attest to, or at least claim to identify, the overall market externalities (positive and negative) within its boundaries.[300] Adjacent municipalities are better situated to assess the overall change in market-equilibrium and to act upon it.

One possibility is to introduce an "intergovernmental liability rule" regime[301] through which local governments could be held liable to adjacent municipalities for fiscal losses that the latter incurred in decreased property taxes and other revenues because of a land use decision with adverse extraterritorial effects. Focusing on these public entities and public revenues as the basis for compensation would keep intact the normative separation between private law entitlements and the collective implications of government regulation, with such payments serving as a proxy for societal welfare.[302]

Another suggestion, in the context of inter-local market externalities, is a more modest one. Judicial review of zoning decisions should hold the local government accountable for the potential threat of "regulatory opportunism,"[303] by which a certain municipality seeks to shoulder a specific negative market externality onto the residents of adjacent localities.[304]

The criteria for holding a municipality responsible for inter-local market externalities, generated by its zoning decision, should be based primarily on the consistency of such effects with the policy adopted by the municipality to regulate its intra-local externalities. For example, if City A explicitly adopts a policy that considers the effects of big-box retailers on the economic viability of small retailers in the CBD and, accordingly, allows big-box developments only beyond a certain radius—e.g., two miles from its own CBD—it should be scrutinized for rezoning a tract located only one mile from the CBD of City B. Even if no such explicit statement by City A exists on the record, City B should be able to otherwise demonstrate the existence of such a policy. City B can do so by pointing to previous zoning decisions or to the differential effects of the current one, passing the onus to City A to show that it would have made the same zoning decision had the entire array of market externalities remained within its boundaries. City A would thus have to show that its broad-based policy, under which it exercises its power to regulate market externalities, is furthered by the challenged decision and that the decision bears a reasonable relation to the broader policy.

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300. *Id.*

301. *Id.*

302. *Id.*

303. *Cf.* Thomas P. Lyon & John W. Mayo, *Regulatory Opportunism and Investment Behavior: Evidence from the U.S. Electric Utility Industry*, 36 RAND J. ECON. 628 (2005).

304. Lehavi, *supra* note 9, at 962-77.

This standard of review also sheds light on the potential legal implications of positive intergovernmental market externalities. A local government is not legally required to confer positive market externalities on adjacent municipalities.[305] As long as the current political system of local governments (rather than regional ones) remains intact,[306] with the power of zoning vested in them under the SZEA or other state law, a city is not required to share the benefits of positive market externalities with other cities if its neighbors cannot prove the existence of cross-border negative effects.[307]

Accordingly, the conferral of positive market externalities should be primarily the result of pre-zoning negotiations between the respective local governments, with adjacent localities potentially offering incentives or other goods to the municipality in which the project is located, so that the project would be designed to provide cross-border benefits. These could be similar to the incentives a local government offers developers to maximize intra-local positive externalities.[308]

CONCLUSION

The centennial of the 1916 New York City Ordinance and creation of zoning in the United States provides an exceptional opportunity to reconsider the regulatory and legal basis upon which this key governmental power is founded. The motive to control the various market externalities embedded in land use regulation, from effects on commercial activity, to housing prices and job-related housing needs, has practically guided local governments from the very first days of zoning. Yet, at the same time, such considerations of market externalities remain in the shadows of explicit zoning law and policy, as the discussion is re-routed to the allegedly more stable foundations of zoning, such as control of technological or environmental, fiscal, or social externalities. This reality must change.

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305. *Id*. at 984-87.

306. The debate over the appropriate form of sub-state governance remains, of course, outside the scope of this Article. For a discussion of the localism/regionalism debate, *see* Lehavi, *supra* note 9, at 949-52.

307. *See id*.

308. *See supra* Section III.A. A much more careful approach should be taken with respect to a potential claim in restitution made by a municipality that actually confers positive market externalities on adjacent local governments. Consider a scenario in which a zoning decision approving the construction of a high-end subdivision positively effects the real estate market for nearby properties across the municipal borders, resulting, in turn, in higher property tax receipts for the neighboring municipality. Creating an accounting mechanism could make sense only as part of a broader intergovernmental liability rule regime that is primarily targeted at disciplining adverse cross-border fiscal externalities. If done purely on the intergovernmental level, rather than through private law mechanisms, a normative case could be made for a mirror-imaged accounting system for positive and negative market externalities. I will leave the discussion of such a potential mechanism to a different time.

Beyond identifying the regulatory and legal principles for the use of the zoning power to control against market externalities, the analysis in this Article sheds new light on the interplay between legislative or broad-based policy and *ad hoc* or adjudicative decision making in land use regulation. Market externalities exemplify how legislative or broad-based decision making is essential to both identify externalities and devise regulatory solutions to them. From an economic perspective, a market externality is a process in which a certain market-equilibrium undergoes a change through the price system, implicating numerous parties on both the supply and demand sides. There is no economic justification to narrowly identifying a market externality, or in designing a response, without a broader picture of the changing economic landscape of the city.

From a legal perspective, out of all the types of land use related externalities, the generation of market externalities tends to be reciprocal and blameless in nature. This means that the legal validation of measures to control such externalities must be based on a credible, broad policy that does not solely rely on *ad hoc* normative judgment. When a market externality is concerned, a substantial relation or reasonable relationship may prove the only feasible way for courts to address the legal validity of broad-based, legislative zoning mechanisms intended to address the spectrum of market externalities.

The innovative framework developed in this Article provides a way to close the long-existing gap between economics and law in the study of zoning and externalities. These normative principles offer a promising start for the upcoming century of land use regulation, as American society deals with the increasing challenges of its cities.